United States Tax Court

T.C. Memo. 2022-16

BARRY A. HACKER AND CELESTE HACKER,
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

Docket No. 3870-12. Filed March 7, 2022.

Steven P. Flowers and *Nathalie M. Cornett*, for petitioners.

William F. Castor and *Vassiliki Economides Farrior*, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

PARIS, *Judge*: By notice of deficiency dated November 14, 2011, respondent determined deficiencies in federal income tax of $125,070, $191,417, $146,712, $196,940, and $171,760 for petitioners' tax years 2004, 2005, 2006, 2007, and 2008, respectively, and civil fraud penalties under section 6663(a)[1] of $93,802.50, $126,201.75, $110,034, $121,176.75, and $128,820 for petitioners' tax years 2004, 2005, 2006, 2007, and 2008, respectively. In the alternative, respondent determined accuracy-related penalties pursuant to section 6662(a) for the years at issue. Respondent additionally determined that petitioners are liable for an addition to tax pursuant to section 6651(a)(1) for 2004 of $12,507.40.

[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code, Title 26 U.S.C. (section), in effect at all relevant times, all regulation references are to the Code of Federal Regulations, Title 26 (Treas. Reg.), in effect at all relevant times, and all Rule references are to the Tax Court Rules of Practice and Procedure.

Served 03/07/22

[*2] After concessions,[2] the issues for decision are whether:

1. petitioners received imputed wage income from Blossom Day Care Centers, Inc. (Blossom), of $198,740, $209,200, $220,210, $231,800, and $244,000 for 2004, 2005, 2006, 2007, and 2008, respectively, from distributions and personal expenses Blossom paid for services petitioners performed as employees;

2. petitioners received constructive dividends from Blossom of $594,170, $446,782, $375,246, $327,503, and $319,854 for 2004, 2005, 2006, 2007, and 2008, respectively, relating to distributions and personal expenses Blossom paid to or on behalf of petitioners as shareholders;

3. petitioners received unreported gross income based upon unexplained cash deposits into their personal bank accounts of $20,221, $57,322, $69,088, $98,567, and $24,895 for 2004, 2005, 2006, 2007, and 2008, respectively;

4. petitioners' net nonpassive income from Hacker Corporation (Hacker Corp.), reported on Schedule E, Supplemental Income and Loss, should be decreased by $96,647 for 2004 and increased by $66,956, $13,694, $99,902, and $156,653 for 2005, 2006, 2007, and 2008, respectively;

5. petitioners received distributions in excess of basis from Hacker Corp. of $65,914 for 2008;

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[2] Petitioners have conceded that they received (1) distributions in excess of basis from Hacker Corporation (Hacker Corp.) of $8,400 in 2004; (2) unreported nonemployee compensation from the Oklahoma Child Care Association of $4,950 and $1,600 in 2006 and 2008, respectively; (3) unreported interest income of $1,450.26 and $79.49 in 2007 and 2008, respectively; (4) an unreported taxable State income tax refund of $2,783 in 2008; and (5) unreported gambling winnings of $15,140 in 2008. Petitioners have also conceded that Hacker Corp. was not entitled to deduct reported advertising expenses of $300 in 2008, and that all income or loss from Hacker Corp. reported as passive should be reclassified as nonpassive for 2004, 2005, and 2006. Respondent has conceded adjustments to petitioners' net income from Accurate Electric reported on Schedule C, Profit or Loss From Business, of $11,638 and $20,750 for 2007 and 2008, respectively.

[*3] 6. petitioners received unreported rental income of $1,180 for 2004;

7. petitioners are entitled to deduct rental expenses reported on Schedule E of $31,164 in excess of those amounts respondent allowed for 2004;

8. petitioners failed to report capital gain income of $21,031 on the sale of the property located at 1006 Cleveland Avenue, Sand Springs, Oklahoma (Cleveland Ave.), for 2005;

9. petitioners' net Schedule E passive income from Hacker Investment, LLC (Hacker Investment), should be increased by $18,919, $29,149, $106, and $14,019 for 2005, 2006, 2007, and 2008, respectively;

10. petitioners failed to report capital gain income of $138,612 on the sale of rental real estate by Hacker Investment for 2007;

11. petitioners are liable for an addition to tax for failure to timely file, pursuant to section 6651(a)(1), for 2004; and

12. petitioners are liable for civil fraud penalties under section 6663(a) or, in the alternative, accuracy-related penalties under section 6662(a) for 2004 through 2008.[3]

FINDINGS OF FACT

I. *Related Cases and Entities*

This case is before the Court in connection with respondent's examination of returns of petitioners and Blossom, an Oklahoma corporation of which petitioners are the sole shareholders. Following that examination, respondent issued to Blossom notices of deficiency

[3] Respondent additionally reduced petitioners' 2004 net capital loss carryforward from $1,332 to $278, resulting in an increase in 2005 capital gain income of $1,054, and disallowed $3,091 of petitioners' claimed mortgage interest expense deduction for 2007. Although petitioners challenged the adjustments in the petition, they did not introduce any evidence at trial or raise any arguments on brief in support of their positions. Accordingly, the Court deems petitioners to have conceded those issues. Respondent's remaining adjustments are computational; the Court does not further address them.

[*4] and determination of worker classification, and to petitioners a notice of deficiency that is the subject of this opinion. Petitioners and Blossom petitioned this Court for redetermination of the deficiencies and employment classification, and those cases were consolidated for trial, briefing, and opinion.[4] The records for the consolidated cases include the consolidated Stipulation of Facts, the First through Sixth Supplemental Stipulations of Facts, evidence presented at trial, and the consolidated Stipulation of Settled Issues. The Court determined that petitioners were both employees of Blossom in *Blossom Day Care Centers, Inc. v. Commissioner* (*Blossom I*), T.C. Memo. 2021-86, and that Blossom was liable for deficiencies in *Blossom Day Care Centers, Inc. v. Commissioner* (*Blossom II*), T.C. Memo. 2021-87. As discussed in greater detail below, many of the Court's holdings in those cases affect the resolution of the issues herein. The Court takes judicial notice of all facts and issues presented at trial in the three consolidated cases in considering the issues relating to this case.

II. *Background of Petitioners*

Barry A. Hacker and Celeste Hacker (Hackers or petitioners), husband and wife, resided in Oklahoma at the time they filed the Petition.

Beginning in 1986 and at all relevant times, petitioners were the sole shareholders and corporate officers of Blossom, an Oklahoma corporation that operated childcare centers in the Tulsa metropolitan area. In addition to running the daycare centers, Mr. Hacker worked as an electrician, doing business under the name Accurate Electric and reporting income on Schedule C. The Hackers were also the sole owners of the passthrough entities Hacker Corp., an S corporation, and Hacker Investment, a limited liability company.

Petitioners have three children, sons Steven and Ashley, born in 1975 and 1979, respectively, and daughter Whitney, born in 1987 (collectively, Hacker children or their children).

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[4] By Order dated July 7, 2021, after trial and briefing were complete, the Court severed the present case from the consolidated group.

[*5] III. *Blossom Day Care Centers*

Blossom is discussed more fully in *Blossom II*, at *5–18. The Court restates those findings relevant to the resolution of petitioners' liability herein.

A. *Operation of Business*

Mrs. Hacker opened Blossom as an unincorporated business entity in 1982. Blossom was incorporated in 1986 and was a valid corporation in the State of Oklahoma during all years at issue. Petitioners were the sole shareholders of Blossom, with Mrs. Hacker owning 51% and Mr. Hacker owning 49% of Blossom's stock.

During the years at issue Blossom operated child daycare centers in the Tulsa metropolitan area at the following locations:

1. 801 Long St., Sand Springs, Oklahoma (Long St.);

2. 4744 South Mingo Rd., Tulsa, Oklahoma (Mingo Rd.);

3. 800 North 81st West Ave., Tulsa, Oklahoma (81st West Ave.);

4. 11505 East 76th St. North, Owasso, Oklahoma (76th St. North); and

5. 9135 East 61st St., Tulsa, Oklahoma (East 61st St.).

Beginning in May 2005 and through the years at issue, Blossom also operated a sixth location at 1020 South Elm Pl., Broken Arrow, Oklahoma (Elm Pl.). Before the property transfers described *infra*, petitioners owned the Long St. and Mingo Rd. properties, and Blossom owned the 81st West Ave., 76th St. North, East 61st St., and Elm Pl. properties.

B. *Role of the Hackers*

Petitioners were Blossom's only corporate officers from its incorporation through the years at issue. Mrs. Hacker served as Blossom's president, as well as its director of curriculum and education. Her duties included personally overseeing and supervising employees, making hiring and firing decisions, and managing Blossom's six daycare directors. All of Blossom's employees ultimately reported to her.

[*6] Mr. Hacker, also since 1986 and through the years at issue, served as Blossom's corporate vice president, as well as its secretary and treasurer. During the years at issue Mr. Hacker also served as Blossom's director and as its director of accounting and finance. He had authority over all of Blossom's bank accounts, and his daily responsibilities included depositing parents' payments for childcare into Blossom's bank accounts and personally writing all of the payroll checks to Blossom's 90 employees.

Together petitioners actively participated in Blossom's daily operation, frequently working 50 to 60 hours per week, performing all levels of tasks from maintenance and custodial duties to classroom instruction and supervision of teachers to purchasing and delivering food. They were also responsible for ensuring that the programs and employees at Blossom complied with the standards of the Oklahoma Department of Human Services.

During the years at issue petitioners did not receive a salary or wages from Blossom. Rather, Blossom made payments in the form of management fees to Hacker Corp.,[5] which in turn paid wages to petitioners and the Hacker children for services rendered to Blossom. The Hacker children were not employees of Blossom during the years at issue.

C. *Corporate Spending*

During the years at issue Blossom maintained an American Express (AMEX) credit card, account ending x4001, for which petitioners were authorized users. Whitney was added as an authorized user in 2005 and Ashley in 2006. Mr. Hacker also maintained an AMEX credit card, account ending x1009, on which he, Mrs. Hacker, and Ashley were authorized users. Beginning in 2007 Mr. Hacker also maintained a Citi Cards (Citi) credit card account on which he was the sole authorized user, and Mrs. Hacker maintained a Bank of America credit card on which she was the sole authorized user.

Petitioners and their children used the credit cards to make purchases necessary to operate the daycare centers, but they also regularly used them to pay personal expenses. During 2004 through 2007 the Hackers and their children charged thousands of dollars in personal expenses on Blossom's credit card account, as well as their own

[5] Hacker Corp. is described in greater detail *infra* Findings of Fact, section IV.

[*7] AMEX, Citi, and Bank of America credit cards, all of which Blossom invariably paid. In addition to routine personal purchases, such as restaurant meals, auto expenses, and personal medical expenses, the Hackers either used the corporate credit card or had Blossom pay their personal credit card charges for such expenses as college tuition, vacations, jewelry, and other luxury items. The Hacker children continued to make personal purchases with the credit cards even though they were not employees of Blossom and during periods when they were not employees of Hacker Corp.

In addition to paying for credit card purchases, Blossom provided petitioners and their children with vehicles. During the years at issue, Mr. Hacker drove a 2003 Hummer as his personal vehicle, while Mrs. Hacker primarily used a 2000 Lexus as her personal vehicle. Both vehicles were titled in petitioners' names, but Blossom paid the notes on the vehicles and claimed depreciation deductions for them on its tax returns. In March 2004 Blossom traded in a Ford Expedition that it owned for $24,919 toward the purchase of a 2004 BMW, which was titled in Steven's name. Steven was the borrower on the car loan and used the BMW for commuting and other personal purposes. Similarly, beginning in April 2004 Ashley began driving a 2004 Cadillac Escalade as his personal vehicle. The Escalade was titled in Ashely's name, and Ashley was the borrower on the car loan. Blossom paid the notes on both Steven's and Ashley's vehicles and claimed depreciation for those vehicles on its tax returns. Neither petitioners nor their children maintained any mileage logs or other records of the extent, if any, to which they used the vehicles for Blossom's business purposes.

D. *Bookkeeping and Return Preparation*

1. *Bookkeeping*

Blossom did not have an in-house bookkeeper before December 2007. Rather, Blossom engaged the services of Walters & Bailey, C.P.A., Inc. (Walters & Bailey), for bookkeeping and tax return preparation. Rob Crowder, a certified public accountant performing independent contract work for Walters & Bailey, prepared Blossom's general ledgers and financial statements, which would serve as the basis for its tax returns for 2004, 2005, and 2006.

Mr. Crowder prepared Blossom's general ledgers and financial statements using information petitioners provided. They gave him bank statements from Blossom's operating, payroll, and loan accounts but

[*8] failed to provide any records relating to substantial undeposited cash payments received from Blossom parents. The Hackers also provided credit card statements but did not provide Mr. Crowder with any guidance as to which expenditures were business expenses and which were personal. Although the petitioners and their children used the credit cards for both business purchases and personal expenditures, they did not categorize their business expenses or notate the statements to indicate which purchases were personal. Similarly, the checks reflected on Blossom's bank statements were not coded as to whether they related to a business expense or a personal expense.

Despite the lack of guidance from petitioners, Mr. Crowder determined that many of the expenses on the credit card statements were personal and used a general ledger account entitled "A/R–Officer" as a catchall for credit card charges that he determined were petitioners' personal expenses. The "A/R–Officer" general ledger account increased from $208,776.22 at the beginning of 2004 to $1,379,408.30 at the end of 2006 primarily on account of charges to the credit cards.

In December 2007 Blossom hired Bonnie King to perform in-house bookkeeping and accounting functions, including the preparation of its general ledger and financial statements for 2007 and 2008. Ms. King prepared the general ledger using Blossom's bank statements from its operating, payroll, and loan accounts, but, as with Mr. Crowder, petitioners did not provide any information regarding the undeposited cash or other payments. Ms. King prepared general ledgers that included the posting of payments of charges on the two AMEX credit card accounts, as well as the Bank of America credit card and the Citi credit card. Petitioners did not notate which expenditures were personal and which were business. Ms. King posted the majority of the credit card expenditures to Blossom's general ledger supplies account and the remainder to food and activities. Like Mr. Crowder, Ms. King posted in the "A/R–Officer" account those expenses that appeared to her to be personal.

2. *Blossom's Tax Returns*

Blossom's tax returns were prepared by Walters & Bailey, using the general ledgers and financial statements prepared by Mr. Crowder or Ms. King. The returns reported gross receipts of $2,473,118, $2,864,239, $2,766,247, and $2,718,796 for 2004, 2005, 2006, and 2007,

[*9] respectively.[6] Blossom claimed deductions for the expenses as posted in its general ledger. It included "Note Rec. Officer" among its current assets on the Schedule L, Balance Sheets per Books, attached to the returns, reporting the amounts believed to be personal expenditures. On its returns for 2004 through 2007, Blossom reported the beginning and ending balances of the "Note Rec. Officer" as follows:

Year	*Beginning balance*	*Ending balance*
2004	$236,189	$685,694
2005	685,694	348,390
2006	348,390	1,210,159
2007	1,210,159	1,332,066

Petitioners never made any repayment of the amounts designated as the "Note Rec. Officer", nor did Blossom pay them any wages or salary.

IV. *Hacker Corp.*

A. *Management Fees*

In 2002 petitioners incorporated Hacker Corp. as an Oklahoma corporation. During all years relevant to this case Hacker Corp. elected to be treated as an S corporation for federal income tax purposes. Petitioners were the sole shareholders of Hacker Corp., each owning 50% of the company's stock.

During 2004 through 2008 Blossom made payments in the form of management fees to Hacker Corp., which in turn paid wages to petitioners and their children for services they rendered to Blossom. Hacker Corp. paid wages to petitioners as follows:

Year	*Mr. Hacker*	*Mrs. Hacker*
2004	$44,615	$44,618
2005	36,923	36,925
2006	19,999	20,001
2007	26,153	27,694
2008	29,230	29,232

[6] Blossom's 2008 tax return was not submitted into evidence or otherwise included in the record.

[*10] Ashley was a paid employee of Hacker Corp. from 2005 through 2008. Steven was a paid employee of Hacker Corp. during 2004 and 2005. From January 2006 to August 2008 Steven operated a car stereo modification business and was not employed by Hacker Corp. Whitney was not a paid employee of Hacker Corp. during the years at issue. No written contract or fee agreement was prepared in connection with Blossom's arrangement with Hacker Corp.

B. *Property Transfers*

Before May 2005 Blossom or petitioners owned the real properties on which Blossom's daycare locations operated. In May 2005 title to each property was transferred by quitclaim deed to Hacker Corp., and the transfers were recorded in the Tulsa County land records. Following the transfers, Blossom continued to operate its daycare centers at the same locations, but Hacker Corp. assumed payment of the property taxes and in June 2005 began making payments on the mortgages securing the properties held by Security Bank. No formal lease agreement between Blossom and Hacker Corp. was signed, but Blossom began making rent payments either directly to Hacker Corp. or to Security Bank in payment of the mortgages on behalf of Hacker Corp. Beginning on its tax return for 2005, Hacker Corp. claimed deductions for depreciation with respect to the buildings, for payment of property taxes, and for interest paid in connection with the mortgages.

The management fees and rent payments from Blossom were Hacker Corp.'s only income for 2004 through 2008.

V. *Rental Real Estate Activities*

A. *Hacker Investment, LLC*

Petitioners formed Hacker Investment as an Oklahoma limited liability company in August 2002. During 2005, 2006, 2007, and 2008 Mr. and Mrs. Hacker each held one-half of the outstanding membership interests in Hacker Investment. Hacker Investment filed Form 1065, U.S. Return of Partnership Income, for 2005, 2006, and 2008; although Hacker Investment prepared a Form 1065 for 2007, respondent has no record that the return was filed. [7]

[7] Petitioners' 2007 tax return is consistent with the amounts reported on the unfiled 2007 Form 1065.

[*11] B. *Rental Activities*

During the years at issue petitioners owned, either directly or through Hacker Investment, several rental properties. They maintained a spreadsheet to track the rents received from each property. They reported the income and expenses from their rental activities directly on Schedule E attached to their individual return for 2004. For subsequent years Hacker Investment reported the rental income and expenses on Forms 1065, and those amounts flowed through to petitioners' individual returns.[8]

In June 2002 petitioners purchased the property located at 419 North Lincoln Avenue, Sand Springs, Oklahoma (Orleans Apartments), for $355. They subsequently transferred that property to Hacker Investment. They continued to make various improvements to the property. In May 2007 Hacker Investment sold the Orleans Apartments for $475,000.

Petitioners purchased the property located at 500 North Washington Avenue, Sand Springs, Oklahoma (Washington Ave.), for $39,000 in June 2004 and subsequently deeded it to Hacker Investment. On August 21, 2007, Hacker Investment divided the property in half and sold one portion for $16,000.

In June 2004 petitioners also acquired the Cleveland Ave. property for $27,500. They made various improvements to the property before selling it for $95,500 in November 2005. After settlement fees, they received proceeds of $88,942. They did not report the sale on their 2005 tax return.

VI. *Return Preparation*

Petitioners received extensions of time to file their return for each of the years at issue and filed joint individual income tax returns for 2004, 2005, 2006, 2007, and 2008 on December 5, 2005, October 15, 2006, October 15, 2007, October 15, 2008, and October 15, 2009, respectively. On their returns, they reported total tax of $50,775, $6,976, $65,568, zero, and zero for 2004, 2005, 2006, 2007, and 2008,

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[8] Among the rents received listed in the spreadsheet were rents attributable to the property located at 839 Katy Street. Although Hacker Investment reported those rents on its returns, property records show that Blossom owned that property during the years at issue. The Court has held that those rents are income to Blossom for 2005, 2006, and 2007. *See Blossom II*, at *31–32.

[*12] respectively. Their reported income for each year included the wages received from Hacker Corp.; income or loss from Hacker Corp., reported on Schedule E; and income or loss from rental real estate (which they reported directly on Schedule E for 2004 and as flowthrough amounts from Hacker Investment in subsequent years). For 2006, 2007, and 2008, they also reported income from Accurate Electric on Schedule C. They did not report wages, salary, or dividends from Blossom for any year 2004 through 2008.

VII. *Examination*

Respondent examined petitioners' tax returns for 2004, 2005, 2006, 2007, and 2008 in an examination that also covered the tax returns of Hacker Corp. for 2004 through 2008, Hacker Investment for 2005 through 2008, and Blossom for 2004 through 2007, as well as Blossom's worker classifications of petitioners for 2005 through 2008. Beginning in March 2008 petitioners executed, both for themselves and on behalf of Blossom, a series of timely Forms 872, Consent to Extend the Time to Assess Tax, for 2004, 2005, 2006, and 2007.

During the examination of petitioners' returns, Revenue Agent Floyd (RA Floyd) conducted a bank deposits analysis of petitioners' bank accounts, as well as the accounts of their business entities. RA Floyd examined their bank account records, identified all of the deposits, and, after subtracting out reported income and items identified as nontaxable, concluded that petitioners had received unreported income. RA Floyd additionally determined that the 2004 Note Rec. Officer beginning balance was a personal loan forgiven by Blossom. Throughout the examination, petitioners attempted to conceal their receipt of personal benefits from Blossom. Mr. Hacker claimed that Steven's wedding was "a big celebration of Blossom" and that the various trips of petitioners and their children to the Bahamas, Europe, Hawaii, Las Vegas, and New Orleans, paid for by Blossom, were for business or so that they would not be distracted while performing administrative tasks. Following the examination, respondent issued the notice of deficiency to petitioners, as well as notices of deficiency and determination of worker classification to Blossom, determining that petitioners were employees of Blossom and should have received wage compensation during the years covered.

In the notice issued to petitioners, respondent determined deficiencies of $125,070, $191,417, $146,712, $196,940, and $171,760 for

[*13] 2004, 2005, 2006, 2007, and 2008, respectively, on the basis of the following adjustments:

	2004	*2005*	*2006*	*2007*	*2008*
a. Wages from Blossom – Taxpayer Wife (TPW)	$99,370	$104,600	$110,105	$115,900	$122,000
b. Wages from Blossom – Taxpayer Husband (TPH)	99,370	104,600	110,105	115,900	122,000
c. Rental expenses/depr.	31,164	—	—	—	—
d. Sch. E1 – rents received	1,180	—	—	—	—
e. Distributions from Hacker Corp. in excess of basis	8,400	—	—	—	65,914
f. Sch. E nonpassive income/loss Hacker Corp.	(96,647)	66,956	13,694	99,902	156,653
g. Sch. E passive income/loss Hacker Corp.	(86,803)	(10,762)	(107,102)	—	—
h. Unexplained deposits	20,221	57,322	69,088	98,567	24,895
i. Qualified dividends from Blossom	594,170[9]	446,782	375,246	327,503	319,854
j. SE AGI adjustments	(1,429)	(4,050)	(4,036)	(5,462)	(3,213)
k. Itemized deductions	17,804	27,558	11,982	18,284	3,682
l. Standard deduction	(9,700)	(10,000)	—	—	—
m. Exemptions	9,920	9,600	3,168	6,801	3,501
n. Sch. E passive income/loss Hacker Investment	—	18,919	29,149	106	14,019
o. Capital gain or loss	—	22,085	—	138,612	—
p. 1099 Income – Oklahoma Child Care Association	—	—	4,950	—	1,600
q. Sch. C from Accurate Electric loss	—	—	—	11,638	20,750
r. Interest income	—	—	—	1,450	79
s. State refunds, offsets	—	—	—	—	2,783
t. Gambling winnings	—	—	—	—	15,140
Total Adjustments	**$687,020**	**$833,610**	**$616,349**	**$929,201**	**$869,657**

[9] This amount includes the $236,189 Note Rec. Officer beginning balance determined to be a loan forgiven.

[*14] In addition respondent determined civil fraud penalties under section 6663 of $93,802.50, $126,201.75, $110,034, $121,176.75, and $128,820 for the years at issue. Respondent determined the $93,802.50 fraud penalty for 2004 on the basis of the following adjustments:

Adjustments to income to which fraud penalty applies	*Amount*
Wages from Blossom–TPW	$99,370
Wages from Blossom–TPH	99,370
Dividends	594,170
Unexplained deposits	20,221

Respondent determined the $126,201.75 fraud penalty for 2005 on the basis of the following adjustments:

Adjustments to income to which fraud penalty applies	*Amount*
Wages from Blossom–TPW	$104,600
Wages from Blossom–TPH	104,600
Dividends	446,782
Unexplained deposits	57,322

Respondent determined the $110,034 fraud penalty for 2006 on the basis of the following adjustments:

Adjustments to income to which fraud penalty applies	*Amount*
Wages from Blossom–TPW	$110,105
Wages from Blossom–TPH	110,105
Dividends	375,246
Unexplained deposits	69,088

Respondent determined the $121,176.75 fraud penalty for 2007 on the basis of the following adjustments:

Adjustments to income to which fraud penalty applies	*Amount*
Wages from Blossom – TPW	$115,900
Wages from Blossom – TPH	115,900
Dividends	327,503
Unexplained deposits	98,567

Respondent determined that the fraud penalty applies to all of the adjustments to petitioners' 2008 income.

[*15] A Civil Penalty Approval Form was signed on November 10, 2009, by the immediate supervisor of RA Floyd, who examined petitioners' returns, approving the imposition of the fraud penalties and the accuracy-related penalties for underpayments due to substantial understatements of income tax. Respondent also determined that petitioners were liable for an addition to tax pursuant to section 6651(a)(1) for 2004 of $12,507.40.

Respondent issued the notice of deficiency on November 14, 2011, and petitioners timely petitioned this Court for redetermination.

OPINION

I. *Burden of Proof*

In general the Commissioner's determinations set forth in a notice of deficiency are presumed correct, and the taxpayer bears the burden of showing the determinations are in error. Rule 142(a); *Welch v. Helvering*, 290 U.S. 111, 115 (1933). When, as here, a case involves unreported income, however, the U.S. Court of Appeals for the Tenth Circuit, to which this case would be appealable absent a stipulation to the contrary, *see* § 7482(b); *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971), has held that the Commissioner's determination of unreported income is entitled to a presumption of correctness only once some substantive evidence is introduced demonstrating that the taxpayer received unreported income, *United States v. McMullin*, 948 F.2d 1188, 1192 (10th Cir. 1991). Once the Commissioner introduces some substantive evidence linking the taxpayer to the income, the presumption of correctness applies, and the burden shifts to the taxpayer to produce substantial evidence overcoming it.[10] *Id.*

II. *Income from Blossom*

A. *Background*

During the years at issue, petitioners were the sole corporate officers of Blossom and performed substantial services for Blossom in that capacity. They were also its sole shareholders. They did not receive

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[10] Petitioners have not raised the issue of section 7491(a), which shifts the burden of proof to the Commissioner in certain situations. The Court concludes that section 7491(a) does not apply here because petitioners have not produced any evidence that they have satisfied the preconditions for its application.

[*16] a salary or wages from Blossom during the years at issue. Nevertheless, during that time, they received, either directly to themselves or indirectly to their children or other businesses, substantial economic benefit from Blossom in the form of money, property, and other remuneration. Respondent contends that such benefits constitute wages and dividends.

B. *Wages*

Respondent determined that petitioners received wage income from Blossom as follows:

Year	*Mr. Hacker*	*Mrs. Hacker*	*Total*
2004	$99,370	$99,370	$198,740
2005	104,600	104,600	209,200
2006	110,105	110,105	220,210
2007	115,900	115,900	231,800
2008	122,000	122,000	244,000

Respondent's wage determinations were considered in connection with the notice of determination of worker classification that was the subject of *Blossom I* and the notice of deficiency that was the subject of *Blossom II*. In those reports the Court sustained respondent's determinations that petitioners were employees of Blossom and that remuneration provided directly or indirectly to them for their work as such constituted wages. Petitioners provided substantial services to Blossom and received compensation in the form of money, property, and other direct and indirect benefits. Such compensation constitutes gross income to them. *See* Treas. Reg. § 1.61-2(a)(1) ("Wages . . . are income to the recipients unless excluded by law."). Petitioners offer no argument or evidence to show that the wages respondent determined are erroneous or unreasonable or should be excluded from gross income. Consistent with our holdings in *Blossom I* and *Blossom II*, the wage adjustments here are sustained.

C. *Constructive Dividends*

Respondent determined that petitioners, as shareholders, received constructive dividends from Blossom of $594,169.87, $446,782.26, $375,246.30, $327,503.57, and $319,854 for 2004, 2005, 2006, 2007, and 2008, respectively.

Section 61(a)(7) includes dividends in a taxpayer's gross income. When a corporation distributes property to a shareholder as a dividend,

[*17] whether formally or informally, the shareholder must include the distribution in gross income to the extent of the corporation's earnings and profits. *See* §§ 301(a), (c)(1), 316; *see also Welle v. Commissioner*, 140 T.C. 420, 422 (2013). A constructive dividend arises when a corporation confers an economic benefit upon a shareholder without expectation of repayment and the corporation on the date of the deemed distribution had current or accumulated earnings and profits. *See Welle*, 140 T.C. at 422. The shareholder need not receive the dividend directly and must include in gross income payments the corporation made on the shareholder's behalf. *See Epstein v. Commissioner*, 53 T.C. 459, 474–75 (1969); *Vlach v. Commissioner*, T.C. Memo. 2013-116, at *32–33. In determining whether a shareholder received a constructive dividend, the Court considers whether the payment benefited the shareholder personally rather than furthering the interest of the corporation. *Hagaman v. Commissioner*, 958 F.2d 684, 690–91 (6th Cir. 1992), *aff'g in part and remanding on other grounds* T.C. Memo. 1987-549; *Vlach*, T.C. Memo. 2013-116, at *33. Where a corporation constructively distributes property to a shareholder, the constructive dividend received by the shareholder is ordinarily measured by the fair market value of the benefit conferred. *Welle*, 140 T.C. at 423.

Respondent based his determination of dividends on distributions of cash and property and payments of personal expenses by Blossom as follows:

	2004	*2005*	*2006*	*2007*	*2008*
Checks	$36,779.02	$14,862.33	$14,077.99	$26,830.00	$74,803.13
Credit card charges for personal expenses	312,031.44	389,056.95	342,411.60	271,867.00	—
Payments on personal vehicle loans	93,715.34	105,439.25	84,984.88	73,462.74	57,423.50
Personal auto, insurance, and interest expenses	41,827.76	48,286.54	40,417.96	31,865.00	71,798.00
Undeposited payments from parents	47,448.31	54,839.21	86,228.74	88,767.78	99,798.00
Distribution of vehicles	24,919.00	—	14,000.00	—	—
2004 A/R – officer beginning balance recharacterized as dividend	236,189.00	—	—	—	—

[*18] Repairs	—	9,535.95	—	—	—
Net value of distributed real property	—	33,962.00	—	—	—
Real property tax payments	—	—	3,835.13	—	2,866.00
Loan payments on petitioners' personal residence	—	—	—	29,811.05	39,522.84
Transfers	—	—	—	9,000.00	—
Payments to Accurate Electric	—	—	9,500.00	27,700.00	41,631.00
Other payments of personal expenses	—	—	—	—	176,011.23
Reduction for wage adjustment	(198,740.00)	(209,200.00)	(220,210.00)	(231,800.00)	(244,000.00)
Total	**$594,169.87**	**$446,782.23**	**$375,246.30**	**$327,503.57**	**$319,853.70**

Petitioners do not present any arguments or evidence to dispute respondent's determination of dividends, except insofar as they disagree with the adjustments to Blossom's income and deductions. In *Blossom II*, at *32–46, the Court considered those arguments and found that certain expenditures paid by credit card and determined by respondent to be personal were in fact business expenses. The Court concluded that Blossom was entitled to additional business expense deductions totaling $95,452.59, $83,671.47, and $23,023.57 for 2004, 2005, and 2007, respectively. *Id.* Accordingly, the Court concludes those expenditures were business expenses and not personal expenses of petitioners, and those amounts do not constitute dividends to them. The credit card amounts shown above should be reduced by those same amounts for 2004, 2005, and 2007, respectively.

At all relevant times prior to the transfer to Hacker Corp., petitioners owned the Long St. and Mingo Rd. properties. Therefore, Blossom did not own two of the properties that petitioners caused to be transferred to Hacker Corp. in 2005. *Id.* at *26–31. Blossom did not distribute those properties, and the net value of those properties thus does not constitute dividends to petitioners. The 2005 dividend amount should be reduced by the net value of the Long St. and Mingo Rd. properties.

The remaining amounts constitute economic benefits to petitioners, either directly or indirectly, as shareholders of Blossom. The

[*19] Court holds that those amounts are dividends to petitioners subject to the above adjustments:

Year	*Dividend per respondent*	*Adjustment per opinion*	*Dividend after adjustment*
2004	$594,169.87	$95,452.59	$498,717.28
2005	446,782.23	*	*
2006	375,246.30	—	375,246.30
2007	327,503.57	23,023.57	304,480.00
2008	319,853.70	—	319,853.70

The Court holds that the 2005 dividend amount should be reduced by $83,671, which relates to reasonable business expenses of Blossom, and further reduced by the net value of the Long St. and Mingo Rd. properties, which were not distributions to petitioners. The 2005 dividend after adjustment shall reflect these reductions to respondent's dividend determination.

III. *Unexplained Deposits*

As previously discussed, gross income means all income from whatever source derived. § 61(a). Gross income is construed broadly to include all "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955). Every person subject to income tax is required to maintain books and records to establish the amount of gross income and deductions shown by that person on his or her income tax return. *See* § 6001; Treas. Reg. § 1.6001-1(a).

Bank deposits are prima facie evidence of income. *Tokarski v. Commissioner*, 87 T.C. 74, 77 (1986); *Bolles v. Commissioner*, T.C. Memo. 2019-42, at *14. The bank deposits method of proof presumes that all deposits into a taxpayer's bank account during a given period constitute taxable income unless the taxpayer can show that the deposits were nontaxable. *Clayton v. Commissioner*, 102 T.C. 632, 645 (1994). The Government must take into account any nontaxable source or deductible expense of which it has knowledge. *DiLeo v. Commissioner*, 96 T.C. 858, 868 (1991), *aff'd*, 959 F.2d 16 (2d Cir. 1992).

During the examination of petitioners' returns, RA Floyd conducted a bank deposits analysis of their accounts and concluded that they received unreported income of $20,221, $57,322, $69,088, $98,567, and $24,895 for 2004, 2005, 2006, 2007, and 2008, respectively.

[*20] Petitioners acknowledge that the funds were deposited in their accounts but do not offer any satisfactory explanation as to the source of the funds or whether the funds were nontaxable or otherwise reported on their returns. At trial Mr. Hacker speculated that the funds may have been gambling winnings or rental payments but provided no additional evidence or explanation to corroborate this testimony. He was emphatic, however, that the unexplained deposits were "absolutely not" the undeposited payments from Blossom parents. Respondent's determination of gross income based on unexplained deposits is sustained.

IV. *Income from Hacker Corp.*

A. *Schedule E Nonpassive Income*

1. *Adjustments*

An S corporation is not subject to federal income tax at the entity level. § 1363(a). The corporation's income, losses, deductions, and credits are passed through to the shareholders at their pro rata shares. § 1366(a). Where a notice of deficiency includes adjustments for S corporation items with other items unrelated to the S corporation, the Court has jurisdiction to determine the correctness of all adjustments. *See Winter v. Commissioner*, 135 T.C. 238 (2010); *Berry v. Commissioner*, T.C. Memo. 2018-143, at *6. The substantiation requirements of section 162 also apply to business expense deductions for S corporations. *Tabe v. Commissioner*, T.C. Memo. 2019-149, at *21; *see also* § 1363(b).

On its returns, Hacker Corp. reported income of $173,606, $21,525, and $114,204 for 2004, 2005, and 2006, respectively, and losses of $47,560 and $114,609 for 2007 and 2008, respectively, which petitioners reported on Schedules E of their returns for the respective years.[11] Respondent determined adjustments to the tax returns of Hacker Corp. as follows:

[11] For each year, 2004 through 2006, petitioners reported 50% of the income from Hacker Corp. as passive income and 50% of the income as nonpassive. The parties have stipulated that all income or loss from Hacker Corp. should have been classified as nonpassive. In addition, because of a clerical error, petitioners erroneously reported 2006 income from Hacker Corp. of $214,204, rather than $114,204.

[*21]	*2004*	*2005*	*2006*	*2007*	*2008*
Gross receipts	($183,450)	($38,187)	($6,499)	$86,811	$142,917
Interest expense	—	59,066	—	—	345
Depreciation	—	35,315	13,091	13,091	13,091
Advertising expense[12]	—	—	—	—	300
Total adjustments	**($183,450)**	**$56,194**	**$6,592**	**$99,902**	**$156,653**

The Court addresses respondent's adjustments below.

2. *Gross Receipts*

Gross income means all income from whatever source derived, including income derived from business. *See* § 61(a)(2). Hacker Corp. received payments from Blossom for services the Hackers and their children rendered and, beginning in May 2005, for the use of the buildings. On its returns, Hacker Corp. reported gross receipts of $309,300, $342,650, $377,125, $228,100, and $204,514 for 2004, 2005, 2006, 2007, and 2008, respectively. During the examination of Hacker Corp.'s returns, RA Floyd performed a bank deposits analysis of Hacker Corp.'s bank accounts, as well as the books and records of Blossom, and determined that Hacker Corp. received payments from Blossom totaling $125,850, $304,463, $370,626, $314,911, and $347,431 for 2004, 2005, 2006, 2007, and 2008, respectively.

Petitioners disagree with respondent's adjustments of Hacker Corp.'s gross receipts but do not identify any errors in respondent's analysis. Indeed, on brief, they appear to accept that adjustments for 2004, 2005, and 2006 are appropriate when arguing for an increase in Blossom's deductions for management fees. *See Blossom II*, at *41–42. Consistent with the Court's findings in *Blossom II*, the Court finds that Hacker Corp. received gross receipts of $125,850, $304,463, and $358,026 for 2004, 2005, and 2006, respectively. The evidence supports respondent's adjustments to gross receipts for 2007 and 2008, and those adjustments are sustained.

[12] Petitioners concede that respondent properly disallowed the claimed $300 advertising expense deduction.

[*22] 3. *Interest Expense*

Respondent determined adjustments to Hacker Corp.'s claimed interest expense deductions for 2005 and 2008. For 2005 Hacker Corp. deducted interest expenses of $118,132 paid on the note on the daycare center properties it acquired from Blossom and petitioners in May of that year. Respondent disallowed $59,066, or one-half of the claimed amount, on the grounds that that amount was paid by the properties' respective prior owners and not by Hacker Corp.[13] Respondent additionally disallowed $345 of a claimed interest expense deduction for 2008 on account of lack of substantiation.

Hacker Corp. acquired the daycare center properties in May 2005 and did not begin making the note payments until June 2005. *See also Blossom II*, at *9. Accordingly, it is not entitled to deductions for interest paid before that time. With respect to the 2008 interest, petitioners have not offered any evidence or argument to support Hacker Corp.'s entitlement to the disallowed deduction. Respondent's adjustments are sustained.

4. *Depreciation*

On its 2005, 2006, 2007, and 2008 returns, Hacker Corp. claimed a depreciation deduction of $72,747 with respect to the daycare center properties for each year. Hacker Corp. calculated its depreciation by carrying over the same cost basis in the properties that Blossom had used to calculate the depreciation on its 2004 return. Respondent recalculated a depreciation amount using the fair market value of the buildings at the time of transfer and, in turn, increased Hacker Corp.'s cost basis in the property acquired from Blossom.

Section 301(d) provides that the basis of property received in a distribution made by a corporation to a shareholder shall be the fair market value of the property. Section 362(a)(1) provides that, in the case of a transaction to which section 351 (relating to transfer of property to a corporation controlled by the transferor) applies, the transferee corporation's basis in the transferred property shall be the same as it would be in the hands of the transferor. In May 2005 Blossom transferred to Hacker Corp. the properties at 81st West Ave., 76th St. North, East 61st St., and Elm Pl. in a transaction deemed to be a

[13] Respondent allowed (and the Court sustained) a corresponding increase in Blossom's interest expense deduction for 2005 to account for the other half of the interest paid that year. *See Blossom II*, at *42–43.

[*23] distribution to petitioners pursuant to section 301(a). *See also Blossom II*, at *26. Accordingly, respondent correctly determined that the depreciable bases in those properties should have been the fair market value at the time of distribution.

With respect to the Long St. and Mingo Rd. properties, however, Blossom did not own the properties or distribute them to petitioners. Petitioners owned the properties, and upon their transfer of those properties to Hacker Corp., Hacker Corp.'s basis in such properties is the same as it was in the hands of petitioners. *See* § 362(a)(1). The Court thus finds that Hacker Corp. properly calculated its depreciation from the basis carried over from the 2004 return. The amounts Hacker Corp. claimed with respect to those properties were correct.[14]

B. *Distributions in Excess of Basis*

Sections 1366 through 1368 govern the tax treatment of S corporation shareholders with respect to their investments in such entities. Section 1366(a)(1) provides that a shareholder shall take into account his or her pro rata share of the S corporation's items of income, loss, deduction, or credit for the S corporation's taxable year ending with or in the shareholder's taxable year.

With respect to basis, section 1012 sets forth the foundational principle that the basis of property for tax purposes shall be the cost of the property. Cost, in turn, is defined by regulation as the amount paid for the property in cash or other property. Treas. Reg. § 1.1012-1(a). Section 1367 then specifies adjustments to basis applicable to investments in S corporations. Basis in S corporation stock is increased by income passed through to the shareholder under section 1366(a)(1) and decreased by, inter alia, distributions not includable in the shareholder's income pursuant to section 1368; items of loss and deduction passed through to the shareholder under section 1366(a)(1); and certain nondeductible, noncapital expenses. § 1367(a); *see also Gleason v. Commissioner*, T.C. Memo. 2006-191, 2006 WL 2601835, at *5.

Section 1368 addresses treatment of distributions. The typical rule for entities without accumulated earnings and profits is that distributions are not included in a shareholder's gross income to the

[14] Respondent does not dispute Hacker Corp.'s reported depreciation method or recovery period. The Court will accept them as correct.

[*24] extent that they do not exceed the adjusted basis of his or her stock (but are applied to reduce basis), while any distribution amount in excess of basis is treated as gain from the sale or exchange of property. § 1368(b); *see also Gleason v. Commissioner*, 2006 WL 2601835, at *6.

Petitioners' basis in Hacker Corp. at the end of 2004 was zero, because of distributions in excess of basis in 2004.[15] Following the adjustments to Hacker Corp.'s income for 2005 through 2008, respondent computed petitioners' basis for each year and determined that they received distributions from Hacker Corp. in excess of basis in 2008 of $65,914. Respondent determined this amount by using a 2008 beginning basis of $240,857, adding postexamination ordinary income of $156,653 and capital contributions of $9,168, then subtracting distributions of $340,764, to arrive at an adjustment for distributions in excess of basis of $65,914.[16]

The Court has determined that in 2005 the Hackers contributed daycare center properties to Hacker Corp. Respondent's calculation of basis fails to take into account their 2005 contributions of the daycare center properties, which increase petitioners' basis in Hacker Corp. by their bases in those properties. *See* § 358(a). The parties have stipulated that petitioners' basis in Hacker Corp. at the end of 2004 was zero. Petitioners' basis for 2005 should include the adjustments for the contribution of the properties. Even if the Court accepts respondent's starting 2008 basis of $240,857, adjusts for income and capital contributions as determined by respondent, then subtracts distributions of $340,764, respondent has misread the results. The remaining $65,914 represents petitioners' remaining basis and not distributions in excess of basis. Further, the Court has redetermined Hacker Corp.'s income to reflect substantial adjustments, as discussed *supra*. In the Rule 155 computation, the parties shall take these adjustments into account and recalculate the amount, if any, by which petitioners' 2008 distributions from Hacker Corp. exceeded their basis therein.

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[15] Respondent determined, and petitioners agree, that they received distributions from Hacker Corp. in excess of basis of $8,400 in 2004.

[16] The parties are in agreement that Hacker Corp. did not have accumulated earnings and profits at the time of the distributions at issue.

[*25] V. *Rental Real Estate Activities*

A. *The Hackers*

1. *2004 Rental Income and Expenses*

On Schedule E, attached to their 2004 return, petitioners reported rental income of $77,862 and expenses totaling $102,289. Respondent determined that they failed to report $1,180 in rental income, on the basis of a review of petitioners' records. Respondent additionally disallowed claimed deductions for insurance expenses of $783, interest payments totaling $28,487, and depreciation of $1,894, on account of lack of substantiation. Petitioners dispute the adjustments, but did not present any evidence at trial or offer any argument on brief in support of their position. Respondent's determinations are sustained.

2. *2005 Capital Gains Income*

Respondent determined that petitioners failed to report capital gains income of $21,031 on the sale of the Cleveland Ave. property in 2005.

Gross income includes gains from dealings in property. § 61(a)(3). A taxpayer must recognize gain on the sale of property in an amount equal to the difference between the amount realized and basis. §§ 1001, 1012; *see also O'Boyle v. Commissioner*, T.C. Memo. 2010-149, 2010 WL 2766818, at *3, *aff'd per curiam*, 464 F. App'x 4 (D.C. Cir. 2012). Petitioners bear the burden of establishing basis in their property. *See* Rule 142(a); *O'Boyle v. Commissioner*, 2010 WL 2766818, at *3.

Petitioners purchased the Cleveland Ave. property in June 2004 for $27,500 and sold it in November 2005 for $95,500. After settlement fees, petitioners received net proceeds of $88,942. On the basis of invoices and verified payments petitioners submitted, respondent allowed additional basis of $40,411 for improvements to the property. Respondent therefore determined a gain of $21,031.

On review of the evidence, including petitioners' bank statements and claimed improvements, the Court finds that petitioners are entitled to additional basis of $1,294 paid on November 15, 2004, for miscellaneous improvements provided on check No. 6094. Petitioners did not introduce any additional evidence or arguments to otherwise rebut respondent's determination. Accordingly, the Court finds that

[*26] petitioners' adjusted basis in the Cleveland Ave. property was $69,205, and that their gain on the sale was $19,737.

B. *Hacker Investment*

1. *Overview*

As a general rule partnerships are not subject to Federal income tax, and items of partnership income, loss, deduction, and credit are reflected on the partners' individual income tax returns. *See* § 701; *Keeter v. Commissioner*, T.C. Memo. 2018-191, at *9. On its returns Hacker Investment reported losses of $5,616, $30,295, and $14,019 for 2005, 2006, and 2008, respectively. Hacker Investment prepared a return for 2007, showing income of $4,536, but respondent has no record that the return was filed. Petitioners reported those amounts as passive income or loss on Schedules E of their returns for the respective years.

Respondent determined adjustments to the income and expenses of Hacker Investment as follows:[17]

	2005	*2006*	*2007*	*2008*
Rental income	$12,002	$9,752	$51,715	—
Depreciation	2,227	2,138	(4,673)	$4,346
Interest	4,690	(4,072)	(16,751)	3,341
Repairs	—	21,626	—	—
Depreciation—windows/doors	—	(295)	—	—
Other rental expenses	—	—	(25,649)	—
Total	**$18,919**	**$29,149**	**$4,642**	**$7,687**

[17] Respondent's adjustments to Hacker Investment's income and expenses, set forth on the Form 4605–A, Examination Changes–Partnerships, Fiduciaries, S Corporations, Etc., issued after respondent's examination of Hacker Investment, are based on a 2007 reported income of zero.

[*27] On the basis of these adjustments, respondent determined an increase in Schedule E income of $18,919, $29,149, $106,[18] and $14,019[19] for 2005, 2006, 2007, and 2008, respectively.[20]

2. *Rental Income*

Hacker Investment reported gross rents of $78,963, $79,536, and $55,014 for 2005, 2006, and 2007, respectively. Hacker Investment maintained records that showed it received gross rents of $90,965, $89,288, and $51,715 for 2005, 2006, and 2007, respectively,[21] and respondent determined that these amounts constituted the correct rents received by Hacker Investment. Petitioners have not offered any argument or evidence to dispute respondent's adjustment. Respondent's adjustment is sustained.

3. *Repairs Expense*

Section 162(a) allows as a deduction all ordinary and necessary business expenses paid or incurred in carrying on any activity that constitutes a trade or business. No current deduction is allowed for capital expenditures, however. *See* § 263(a). Capital expenditures include amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 83 (1992); *see also* § 263(a)(1). The capitalization rules of section 263(a) and the regulations thereunder do not treat an expense to repair property as

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[18] Petitioners' 2007 tax return reflected income from Hacker Investment of $4,536 as calculated on the prepared 2007 partnership return. The $106 adjustment in the notice of deficiency is the difference between respondent's adjustment in the Form 4605-A and the amount petitioners reported.

[19] Although respondent determined a $7,687 adjustment to the 2008 partnership return, respondent disallowed the entirety of petitioners' claimed loss of $14,019, as the loss was claimed as passive on petitioners' Schedule E. *See* § 469.

[20] The unified audit and litigation procedures of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, §§ 401–406, 96 Stat. 324, 648–71, do not apply to Hacker Investment. Hacker Investment qualifies as a small partnership under section 6231(a)(1)(B)(i) and did not elect, pursuant to section 6231(a)(1)(B)(ii), to have TEFRA apply. *See Cvancara v. Commissioner*, T.C. Memo. 2013-20, at *3 n.4; *Wadsworth v. Commissioner*, T.C. Memo. 2007-46, 2007 WL 610069, at *6 ("The small partnership exception permits this Court to review in a deficiency suit items that otherwise would be subject to partnership-level proceedings.").

[21] These amounts exclude amounts attributable to the property located at 839 Katy Street, which was owned by Blossom during the years at issue.

[*28] a capital expenditure. *See Gibson & Assocs., Inc. v. Commissioner*, 136 T.C. 195, 232 (2011). Such an expense is not a capital expenditure because it does not increase the value or prolong the useful life of the property (or adapt the property to a different or new use). *Id.* at 232–33. Whether an expense is for a repair is a factual determination that turns on a finding that the work did or did not prolong the useful life of the property, increase its value, or make it adaptable to a different use. *Id.* at 233. As a general, though not absolute, rule, an important factor in determining whether the appropriate tax treatment is an immediate deduction or capitalization is the taxpayer's realization of benefits beyond the year in which the expenditure is incurred. *INDOPCO, Inc. v. Commissioner*, 503 U.S. at 87; *Tsakopoulos v. Commissioner*, T.C. Memo. 2002-8, 2002 WL 23952, at *7–8.

On its 2006 return Hacker Investment claimed a deduction for rental repair expenses of $34,994. Respondent disallowed $21,626 of that amount, comprising $11,309.31 for a new roof on the Orleans Apartments and $10,316.96 to replace windows and doors, on the grounds that such costs should have been capitalized, rather than deducted. Petitioners introduced into evidence invoices from Metro Construction, Inc., showing work performed on various properties, but not showing that the replacement roof, doors, or windows were of such a nature as to constitute only minor repairs. The Court concludes that those expenses should have been capitalized.[22] In turn the basis of the Orleans Apartments should also be adjusted to reflect the capital improvements of the new roof, windows, and doors.

4. *Depreciation*

Hacker Investment claimed depreciation deductions of $16,980, $16,980, $8,892, and $12,841 for 2005, 2006, 2007, and 2008, respectively. These amounts included depreciation with respect to Hacker Investment's rental properties for each year, as well as the 839 Katy Street property and a warehouse.

Relying on real property records and petitioners' cost bases, respondent calculated the depreciable basis, excluding land value, for each of the properties. In addition, respondent disallowed the claimed depreciation deduction for the property at 839 Katy Street, which

[22] On the basis of the invoices introduced at trial, respondent concedes that Hacker Investment is entitled to additional deductions for repair expenses of $9,535 for 2005 and $17,280.23 for 2006.

[*29] Blossomed owned, and the warehouse, which petitioners maintained for personal use. Respondent concluded that Hacker Investment was entitled to depreciation of $14,753, $14,842, $4,673, and $8,495 for 2005, 2006, 2007, and 2008, respectively.

Petitioners have not introduced any evidence or advanced any argument in support of their assertion that respondent's determinations of allowable depreciation are incorrect, and the Court sustains respondent's determinations.[23]

5. *Interest and Other Rental Expenses*

Petitioners do not raise any arguments or identify evidence in support of their position with respect to the disallowed deductions for interest or other rental expenses. Those adjustments are sustained.

6. *2007 Capital Gains Income*

On Form 4797, Sales of Business Property, attached to their 2007 return, petitioners reported gain of $27,200. The reported gain pertained to Hacker Investment's sale of the Orleans Apartments and was based on a sale price of $335,000 and an adjusted basis of $307,800. Respondent determined that petitioners underreported their gain by $138,612 by understating Hacker Investment's gain from the sale of the Orleans Apartments and omitting the sale of the Washington Ave. property. Respondent determined that Hacker Investment realized total gain of $165,812 on its sales, calculated as follows:

Property	*Amount realized*	*Cost*	*Capital improvements*	*Depreciation*	*Gain*
Orleans Apartments	$475,000	$355,000	$21,331	($51,143)	$149,812
Washington Ave.	16,000	—	—	—	16,000

Petitioners contend that respondent did not properly calculate the gain on either property. With respect to the Orleans Apartments, they

[23] The Court holds *infra* that respondent failed to include Hacker Investment's basis in the subdivided portion of the Washington Ave. property sold in 2007 and instructs the parties to calculate the correct basis and include in the computations pursuant to their Rule 155 submission in determining petitioners' capital gain income for that year. Although the basis calculation may result in a reduction in the allowable depreciation for 2007 and 2008, the Court will treat any reduction as a concession on the part of respondent.

[*30] identify no error in respondent's calculation, and the calculation is supported by the evidence. The Court sustains respondent's determination regarding the Orleans Apartments.

In the case of the Washington Ave. property, however, respondent has treated the gross amount received as income without taking into consideration the basis in the property or any adjustments thereto. Petitioners acquired the Washington Ave. property in June 2004 for $39,000 and subsequently deeded the property to Hacker Investment. Respondent determined that the correct depreciation on the Washington Ave. property in 2004 was $469, and that the correct depreciation in each of 2005, 2006, and 2007 was $865. In 2007 Hacker Investment divided the property in half and sold one portion for $16,000. Hacker Investment's correct basis in the sold portion of the Washington Ave. property, therefore, should have been one-half of the $39,000 purchase price, adjusted downward for allowable depreciation through the date of sale. The parties shall submit computations pursuant to the Court's determination of the issues in accordance with their Rule 155 computations.

VI. *Additions to Tax and Penalties*

A. *Section 6651(a)(1) Addition to Tax*

Section 6651(a)(1) imposes an addition to tax for failure to timely file a Federal income tax return unless it is shown that the failure is due to reasonable cause and not due to willful neglect. *See also Higbee v. Commissioner*, 116 T.C. 438, 447 (2001). The addition to tax is equal to 5% of the amount required to be shown as tax on the delinquent return for each month or fraction thereof during which the return remains delinquent, up to a maximum addition of 25% for returns more than four months delinquent. § 6651(a)(1). Under section 7491(c) the Commissioner bears the burden of producing evidence with respect to the liability of the taxpayer for any addition to tax. *See Higbee*, 116 T.C. at 446–47. The burden of proving reasonable cause and lack of willful neglect falls on the taxpayer. *See* § 6651(a); *Higbee*, 116 T.C. at 446–47.

For 2004 petitioners filed their income tax return on December 5, 2005, which was after the due date of October 15, 2005. *See* § 6081(a). Respondent has thus met his burden of production. Petitioners have not established that their failure to timely file was due to reasonable cause. Accordingly, the section 6651(a)(1) addition to tax is sustained for 2004.

[*31] B. *Penalties*

1. *Compliance with Section 6751(b)*

Respondent determined that petitioners are liable for section 6663(a) fraud penalties or, in the alternative, section 6662(a) accuracy-related penalties on the basis of underpayments due to negligence or substantial understatements of income tax for the years at issue. The Commissioner bears the burden of production with respect to an individual taxpayer's liability for any penalty, requiring the Commissioner to come forward with sufficient evidence indicating that the imposition of the penalty is appropriate. *See* § 7491(c); *Higbee*, 116 T.C. at 446–47. As part of that burden, the Commissioner must produce evidence that he complied with the procedural requirements of section 6751(b)(1). *See Graev v. Commissioner*, 149 T.C. 485, 492–93 (2017), *supplementing and overruling in part* 147 T.C. 460 (2016). Section 6751(b)(1) requires the initial determination of certain penalties to be "personally approved (in writing) by the immediate supervisor of the individual making such determination." *See Graev*, 149 T.C. at 492–93; *see also Clay v. Commissioner*, 152 T.C. 223, 248 (2019) (quoting section 6751(b)(1)), *aff'd*, 990 F.3d 1296 (11th Cir. 2021).

Where the taxpayer has challenged the Commissioner's penalty determination, the Commissioner must come forward with evidence of proper penalty approval as part of his initial burden of production under section 7491(c). *Frost v. Commissioner*, 154 T.C. 23, 34 (2020). Once the Commissioner makes that showing, the taxpayer must come forward with contrary evidence. *Id.* The supervisory approval must be secured no later than (1) the date on which the IRS issues the notice of deficiency or (2) the date, if earlier, on which the IRS formally communicates to the taxpayer the Examination Division's determination to assert a penalty. *Belair Woods, LLC v. Commissioner*, 154 T.C. 1, 15 (2020).

Respondent produced a copy of the Civil Penalty Approval Form signed on November 10, 2009, by the immediate supervisor of RA Floyd, who examined petitioners' returns, and approving the imposition of the fraud penalties and the accuracy-related penalties for underpayments due to substantial understatements of income tax. Respondent formally communicated his determination to assert the fraud penalties and the accuracy-related penalties against petitioners in the examination report, which respondent issued to petitioners on November 12, 2009. The notice of deficiency in this case was issued on November 14, 2011. Petitioners do not claim, and the record does not support a conclusion,

[*32] that respondent communicated his initial determination to petitioners before the date the examining agent's manager signed the Civil Penalty Approval Form. Accordingly, respondent has satisfied his burden with respect to section 6751(b).[24]

2. *Section 6663(a) Fraud Penalties*

Section 6663(a) imposes a penalty equal to 75% of the taxpayer's underpayment of Federal income tax that is due to fraud. Fraud is an intentional wrongdoing on the part of the taxpayer with the specific purpose of evading a tax believed to be owing. *Petzoldt v. Commissioner*, 92 T.C. 661, 698 (1989); *Minchem Int'l, Inc. v. Commissioner*, T.C. Memo. 2015-56, at *43, *aff'd sub nom. Sun v. Commissioner*, 880 F.3d 173 (5th Cir. 2018). If any portion of the underpayment is attributable to fraud, the entire underpayment will be treated as attributable to fraud unless the taxpayer establishes by a preponderance of the evidence that part of the underpayment is not due to fraud. § 6663(b); *see also Minchem Int'l, Inc.*, T.C. Memo. 2015-56, at *43–44.

Respondent has the burden of proving fraud by clear and convincing evidence. *See* § 7454(a); Rule 142(b). To carry that burden of proof, respondent must show, for each year, that (1) an underpayment of tax exists and (2) some portion is attributable to the Hackers' fraud. *See Hebrank v. Commissioner*, 81 T.C. 640, 642 (1983); *Benavides & Co., P.C. v. Commissioner*, T.C. Memo. 2019-115, at *31. Fraud is a question of fact to be resolved upon consideration of the entire record. *DiLeo*, 96 T.C. at 874. Fraud is never presumed and must be established by independent evidence. *Minchem Int'l, Inc.*, T.C. Memo. 2015-56, at *45.

Respondent has clearly and convincingly demonstrated for each year at issue that petitioners failed to report income from various sources. The first element of the fraud penalty has been established.

The Court now turns to the second element of the fraud penalty and must determine whether petitioners had the requisite fraudulent intent. Because direct evidence of fraudulent intent is seldom available, fraud may be proven by circumstantial evidence and reasonable inferences drawn from the facts. *Niedringhaus v. Commissioner*, 99 T.C. 202, 210 (1992); *Benavides & Co., P.C.*, T.C. Memo. 2019-115, at *34.

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[24] Because petitioners' substantial understatement of income tax for each year is sufficient to sustain the accuracy-related penalty (to the extent that petitioners' conduct was not fraudulent), the Court does not address the accuracy-related penalties for negligence.

[*33] The taxpayer's entire course of conduct may be indicative of fraudulent intent. *Niedringhaus*, 99 T.C. at 210.

Circumstances that may indicate fraudulent intent, commonly referred to as "badges of fraud," include but are not limited to (1) understating income; (2) maintaining inadequate records; (3) giving implausible or inconsistent explanations; (4) concealing income or assets; (5) failing to cooperate with authorities; (6) engaging in illegal activities; (7) providing incomplete or misleading information to one's tax return preparer; (8) lack of credibility of the taxpayer's testimony; (9) filing false documents, including false income tax returns; (10) failing to file tax returns; and (11) dealing in cash. *Minchem Int'l, Inc.*, T.C. Memo. 2015-56 at *46. No single factor is dispositive; however, the existence of several factors "is persuasive circumstantial evidence of fraud." *Vanover v. Commissioner*, T.C. Memo. 2012-79, 2012 WL 952871, at *4.

Respondent argues that petitioners' fraudulent intent is demonstrated by a number of the badges of fraud, including their failure to maintain records with respect to personal expenses and cash receipts, the extravagant uses of Blossom's funds on personal expenses, and Mr. Hacker's vague, misleading, or uncorroborated statements to RA Floyd.

The Court agrees. Blossom consistently reported gross receipts over $2,000,000 while during the same period petitioners received no wages from Blossom. Even though Blossom paid a management fee to Hacker Corp., the Hackers were paid only relatively low wages. Mr. Hacker received wages of only $44,615, $36,923, $19,999, $26,153, and $29,230 while Mrs. Hacker received wages of $44,618, $36,925, $20,001, $27,694, and $29,232 for 2004, 2005, 2006, 2007, and 2008, respectively. Despite these low wages, petitioners and their children financed a lavish lifestyle through Blossom. Blossom provided petitioners and their children with the use of personal vehicles; paid for vacations for petitioners and their children to the Bahamas, Europe, Hawaii, Las Vegas, and New Orleans; purchased jewelry and other luxury items; and paid numerous routine personal expenses, including restaurant meals, auto expenses, personal medical expenses, mortgage payments, and college tuition. Petitioners did not report on their personal returns the receipt of these benefits, providing incomplete information to their bookkeepers and return preparers. During the examination of their returns, petitioners attempted to conceal them from respondent through the examination, such as by providing vague, misleading, or outright false statements to RA Floyd.

[*34] If any portion of an underpayment is attributable to fraud, the entire underpayment will be treated as attributable to fraud unless the taxpayer establishes by a preponderance of the evidence that part of the underpayment is not due to fraud. § 6663(b); *see also Minchem Int'l, Inc.*, T.C. Memo. 2015-56, at *43–44. In the notice of deficiency, respondent laid out the adjustments on which the fraud determination was based. The Court examines those amounts in greater detail below.

In the notice of deficiency, respondent determined the fraud penalty for 2004 on the basis of the following adjustments to income:

Adjustments to income to which fraud penalty applies	*Amount*
Wages from Blossom–TPW	$99,370
Wages from Blossom–TPH	99,370
Dividends	594,170
Unexplained deposits	20,221

The Court held *supra* that $95,452 of the 2004 dividend amount respondent determined related to reasonable business expenses of Blossom and was not a dividend to petitioners. With respect to the remaining adjustments to petitioners' wages from Blossom, dividends, and unexplained deposits, the Court sustains the application of the fraud penalty. However, the evidence shows and the Court finds that the adjustments to petitioners' income other than wages from Blossom, dividends, or unexplained deposits were not due to fraud and therefore not subject to the fraud penalty.

In the notice of deficiency, respondent determined the fraud penalty for 2005 on the basis of the following adjustments to income:

Adjustments to income to which fraud penalty applies	*Amount*
Wages from Blossom–TPW	$104,600
Wages from Blossom–TPH	104,600
Dividends	446,782
Unexplained deposits	57,322

The Court held *supra* that the 2005 dividend amount should be reduced by $83,671, which related to reasonable business expenses of Blossom, and further reduced by the net value of the Long St. and Mingo Rd. properties, which were not distributions to petitioners. With respect to the remaining adjustments to petitioners' wages from Blossom, dividends, and unexplained deposits, the Court sustains the application

[*35] of the fraud penalty. However, the evidence shows and the Court finds that the adjustments to petitioners' income other than wages from Blossom, dividends, or unexplained deposits were not due to fraud and therefore not subject to the fraud penalty.

In the notice of deficiency, respondent determined the fraud penalty for 2006 on the basis of the following adjustments to income:

Adjustments to income to which fraud penalty applies	*Amount*
Wages from Blossom–TPW	$110,105
Wages from Blossom–TPH	110,105
Dividends	375,246
Unexplained deposits	69,088

The Court sustained respondent's 2006 adjustments to petitioners' wages, dividends, and unexplained deposits. The fraud penalty, as applied to those adjustments, is sustained. However, the evidence shows and the Court finds that any adjustment to petitioners' income other than wages from Blossom, dividends, or unexplained deposits were not due to fraud and therefore not subject to the fraud penalty.

In the notice of deficiency respondent determined the fraud penalty for 2007 applies to the following adjustments to income:

Adjustments to income to which fraud penalty applies	*Amount*
Wages from Blossom–TPW	$115,900
Wages from Blossom–TPH	115,900
Dividends	327,503
Unexplained deposits	98,567

The Court held *supra* that $23,023.75 of the 2007 dividend amount respondent determined related to reasonable business expenses of Blossom and was not a dividend to petitioners. With respect to the remaining adjustments to petitioners' wages from Blossom, dividends, and unexplained deposits, the Court sustains the application of the fraud penalty. However, the Court finds that the adjustments to petitioners' income other than wages from Blossom, dividends, or unexplained deposits were not due to fraud and therefore not subject to the fraud penalty.

In the notice of deficiency respondent determined that the fraud penalty for 2008 applies to all of the adjustments to petitioners' income.

[*36] The Court held *supra* that respondent erred in calculating petitioners' distributions in excess of basis from Hacker Corp. In addition, respondent has conceded the $20,750 adjustment to petitioners' net income from Accurate Electric. The Court sustains the application of the fraud penalty to the adjustments to petitioners' wages from Blossom, dividends, unexplained deposits, and unreported gambling winnings. However, the evidence shows and the Court finds that the adjustments to petitioners' income other than wages from Blossom, dividends, unexplained deposits, or gambling winnings were not due to fraud and therefore not subject to the fraud penalty.

Petitioners have not raised any additional arguments or shown that any other amounts should be excluded from the fraud penalty. Accordingly, the Court holds that they are liable for fraud penalties for the years at issue to the extent discussed herein. To the extent that the Court's redetermination of petitioners' income affects those items to which respondent determined fraud penalties, however, a commensurate adjustment to the fraud penalties is required.

3. *Section 6662(a) Accuracy-Related Penalties*

Respondent determined, in the alternative, that petitioners are liable for accuracy-related penalties pursuant to section 6662(a) for the years at issue. Section 6662(a) and (b)(2) imposes an accuracy-related penalty equal to 20% of the portion of an underpayment of tax required to be shown on a tax return that is attributable to a "substantial understatement of income tax." An understatement of income tax is a "substantial understatement" if it exceeds the greater of 10% of the tax required to be shown on the return or $5,000. § 6662(d)(1)(A). Taxpayers may avoid a section 6662(a) penalty if they can show that they had reasonable cause and acted in good faith. § 6664(c). The accuracy-related penalty does not apply to any portion of an underpayment on which a fraud penalty is imposed under section 6663. § 6662(b) (flush language).

Petitioners reported income tax of $50,775, $6,976, $65,568, zero, and zero for 2004, 2005, 2006, 2007, and 2008, respectively. Even allowing for the adjustments the Court has made to respondent's determinations, petitioners' understatements of income tax were substantial for all years at issue. Petitioners do not argue that they had reasonable cause for their understatements. Petitioners are therefore liable for the accuracy-related penalty on those portions of the underpayment not subject to the fraud penalty for each year at issue.

[*37] VII. *Conclusion*

Petitioners are liable for deficiencies for 2004, 2005, 2006, 2007, and 2008 to the extent discussed herein. Respondent's determinations of fraud penalties for all years are sustained in part, and respondent's determinations of accuracy-related penalties for all years and an addition to tax for 2004 are sustained as set forth above.

The Court has considered all of the arguments made by the parties, and to the extent they are not addressed herein they are considered unnecessary, moot, irrelevant, or otherwise without merit.

To reflect the foregoing,

Decision will be entered under Rule 155.