You are a rising star in a top law firm in Scranton, PA. For as long as you have been in the firm, you have been wanting to work on the A-team, which is in charge of our largest clients. You heard the firm’s largest client had a tax issue involving a family member and it could be your chance to shine. The senior partner sends you the email you have been waiting for.

From: Partner  
To: Associate  
Re: URGENT – Michael Scarn  
Date: September 4, 2019

Associate,

Jo Bennett, one of our largest clients has referred her nephew, Michael Scarn, for us to assist him with a tax matter. Mr. Scarn came into the office the other day and provided the following information.

In 2011, Mr. Scarn inherited some land when his grandfather passed away. When his grandfather died the land was worth $300,000. At around this time, Mr. Scarn discussed opportunities for the land with Rainn Wilson, an old friend. Relying on Mr. Wilson’s advice that the residential rental business was great, in 2012, Mr. Scarn partitioned the plot into three separate parcels and started construction on three (3) identical single family homes. His basis in the land was allocated in three equal parts to each subdivided parcel. Ignoring Aunt Jo’s advice to stay out of a business he did not know, Mr. Scarn spent his entire inheritance on building the houses. The building costs for each property were $560,000.

Many real estate agents offered their services to advertise the properties for rent. Mr. Scarn decided to do it himself. The homes were put up for rent on January 1, 2013 as unfurnished long term rental property. The homes were advertised in the newspaper and through signs on the properties. Property 1 was promptly rented on January 20, 2013, but properties 2 and 3 were not rented until October 1 and November 10, 2013, respectively, despite a booming residential real estate market. The three properties were rented for a term of 12 months. Mr. Scarn neglected to run credit checks on the tenants, and very soon, two of the tenants were in arrears. Mr. Scarn had a great heart and could not find it in himself to evict two young families so he let them stay with the promise they would pay all the back rent. By now, Mr. Scarn doesn’t know which months were paid in full and which ones still have an open balance because he failed to keep track of small miscellaneous partial payments paid by the two tenants in arrears. He is not too worried because he decided that he would curtail other annual giving by the total amount of the unpaid rent—on the basis that keeping a roof over two families’ heads was more important.
Despite all the issues he managed to turn a nominal profit most years. This was mostly because his expenses were low and, since he took pleasure in working with his hands, he took care of all the minor repairs. He took pride in running the most meticulously maintained rentals in the city. He was lucky his wife was a leading cardiac surgeon in the area whose $325,000 annual salary sufficed to support the family’s core necessities regardless of the meager return on his substantial assets. The family, however, had not taken a vacation in two years and even racked up some household debt for some unforeseen expenses.

In 2017, the Mr. Scarn took out a $100,000 mortgage on property 1 and used the proceeds to buy a brand new state-of-the-art electric car. In 2018, the Mr. Scarn took out a $100,000 mortgage on property 2 and built a new pool in his home and bought two jet-skis. On January 1, 2019, after very favorable zoning changes, the Mr. Scarn closed on the sale of property 3 to a commercial real estate developer for $2,000,000. Under the contract, the developer paid $1,000,000 at closing, $250,000 on July 1, 2019, $250,000 on January 1, 2020, $250,000 on July 1, 2020 and the final $250,000 on January 1, 2021. The developer agreed to pay 6% annual interest on the unpaid amounts along with each payment.

1) First, Mr. Scarn would like to know what gain he will need to recognize on the payments for sale of property 3 in 2019, 2020 and 2021 (Mr. Scarn would like the maximum deferral allowed). He was entitled to depreciation deductions of $10,000 per year but his accountant neglected to take the deductions.

2) Second, Mr. Scarn would like to know if he is entitled to take a deduction under section 199A with regards to his real estate activities in tax year 2018 and 2019? If so, Mr. Scarn would like to know whether there any limitations on the amount of the section 199A deduction?

3) Third, Mr. Scarn would like confirmation that he can deduct the interest on the mortgages he took out in 2017 and 2018, as a business expense.

If it is helpful, Mr. Scarn mentioned that he and his wife file their federal tax return jointly.

Setting aside Mr. Scarn’s real estate activities, Mr. Scarn also filed a petition with the Tax Court related to tax issues for the 2015 tax year. Mr. Scarn represented himself in an audit of tax year 2015, but because no agreement could be reached he filed his Tax Court petition. It was only when he received a notice setting his case for trial that he realized he was out of his league and frantically sought help. Here is what we know about his Tax Court case.

In early 2015, Mr. Scarn ran into Mr. Wilson at the Sovereign Citizen Conference. Mr. Wilson was there promoting an investment in a partnership involving fracking rigs. For a small investment and an “administrative fee”, Mr. Scarn could purchase 20 units of the partnership. The 20 units would purportedly allow Mr. Scarn to take a large deduction each year for the following seven years. Mr. Scarn thought it was too good to be true but Mr. Wilson assured him that everything was perfectly legal and even had him fill out Form 8886, to prove the deduction
was “on the up and up.” Mr. Scarn decided to purchase the 20 units because he was so pleased with Mr. Wilson’s advice related to the real estate activities. Eager to get his hands on the big tax refund resulting from the partnership investment, Mr. Scarn filed his 2015 Income tax return early, on February 15, 2016, claiming his first large deduction.

The IRS learned of the fracking partnership from another person who had invested in a different “snake oil” enterprise with Mr. Wilson. The IRS issued a “30-day Letter” to Mr. Scarn disallowing the large deduction for tax year 2015. Mr. Scarn’s secretary accidentally placed the letter in a pile of junk mail and Mr. Scarn never saw the letter. Thirty days later the IRS mailed a Notice of Deficiency to Mr. Scarn. The Notice of Deficiency was sent via certified mail to “St. Mulvania Drive” and was dated and postmarked April 16, 2019. Mr. Scarn’s current address, and address on all his tax returns, is “57 Mulvania Street.” Because the delivery person knows Mr. Scarn, he noticed there was a mistaken address, but to avoid a detour on his route, he decided to deliver it to Mr. Krasinski’s office. Mr. Krasinski is a local CPA who has performed business services for Mr. Scarn in the past but has never assisted him in personal matters. Mr. Krasinski personally delivered the Notice of Deficiency to Mr. Scarn’s office on May 14, 2019.

After receiving the Notice of Deficiency, Mr. Scarn immediately called Mr. Wilson to ask him for advice. Mr. Wilson; who is not an attorney, CPA, or enrolled agent; told Mr. Scarn the Notice of Deficiency was not valid because it was mailed to the wrong address. A couple of months later, Mr. Scarn was reading a thread concerning a similar issue on a sovereign citizen message board and decided to file a protest with the U.S. Tax Court. Mr. Scarn filed a protest with the Tax Court on August 1, 2019. His basis for the protest is that the Notice of Deficiency is not valid because: (1) it was mailed to the wrong address, and (2) it was issued more than three years after his 2015 Income tax return was filed.

Before we figure out how to proceed, we need you to answer a few threshold questions that may resolve this matter on procedural grounds:

1. Is the April 16, 2019 Notice of Deficiency invalid because it was mailed to the wrong address?

2. Did the period of limitations on assessment expire before the notice was issued, and, if so, would that invalidate the notice?

3. Assuming no period of limitations issue with the Notice of Deficiency, was the petition to the Tax Court timely?

4. If the petition was late, can Mr. Scarn still challenge his tax liability in another court?

While Mr. Scarn’s matter may raise other tax issues, please address only the seven issues that I have asked you to research. Other associates are also working on this matter. Additionally, because it is unclear how the Tax Court matter will be resolved, please do not
consider those issues in relation to Mr. Scarn’s real estate activities. Make sure to let us know if there is any additional information we might need.