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Federal Income Taxation

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In 2017, the United States Court of Appeals for the Eleventh Circuit and courts within its jurisdiction decided a number of important federal taxation cases. Among these are a case that raises novel constitutional arguments under the Equal Protection Clause, a case that lodges a constitutional challenge to the United States Tax Court, and a case that addresses a matter of first impression in the circuit about the deductibility of amounts paid in the context of a divorce proceeding. These three cases are discussed herein.[1]

I. *MORRISSEY V. UNITED STATES*

Occasionally, tax disputes implicate the United States Constitution. *Morrissey v. United States*[2] represents one of those occasions, illustrating the unlikely intersection of the Equal Protection Clause of the Fifth Amendment[3] with section 213 of the United States Tax Code (the Code),[4] which allows for a deduction of certain medical expenses.[5]

In 2012, taxpayer Joseph F. Morrissey filed an amended return for the 2011 tax year, claiming a deduction under § 213 for medical expenses

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1. For an analysis of federal taxation cases decided during the prior survey period, see Robert Beard & Gregory S. Lucas, *Federal Income Taxation, Eleventh Circuit Survey*, 68 MERCER L. REV. 1041 (2017).

2. 871 F.3d 1260 (11th Cir. 2017).

3. U.S. CONST. amend. V.

4. I.R.C. § 213 (2018). All "section" references herein are to the Internal Revenue Code of 1986.

5. *Morrissey*, 871 F.3d at 1262.

relating to a surrogate pregnancy.[6] These medical expenses arose from Morrissey's own blood work and sperm collection, in the amount of approximately $1,500, as well as approximately $55,000 Morrissey incurred in procuring an egg donor and gestational surrogate. These latter expenses included the costs of identifying prospective donors and surrogates, paying for their travel and other expenses, and compensating them, in addition to paying for their direct medical expenses arising from the egg donation and surrogacy. The Internal Revenue Service (IRS) denied Morrissey the refund he claimed, explaining that § 213 does not permit deductions for the medical expenses of a person other than the taxpayer or the taxpayer's dependents or spouse.[7] IRS Appeals upheld this determination, and Morrissey filed a refund suit in the United States District Court for the Middle District of Florida.[8]

Morrissey made two arguments at the district court, both of which were rejected at summary judgment.[9] The first argument was that the plain language of § 213 permits the claimed deduction. The second argument was that the Equal Protection Clause of the Fifth Amendment requires the IRS to permit the deduction. Morrissey raised these same arguments again on appeal to the Eleventh Circuit.[10]

As for the statutory argument, § 213(a) allows a deduction for expenses not compensated by insurance or otherwise for the medical care of the taxpayer, the taxpayer's dependents, or spouse to the extent that the expenses exceed 10%—7.5% for the year at issue in this case—of the taxpayer's adjusted gross income.[11] Section 213(d)[12] defines "medical care," specifying that it means amounts paid "[f]or the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body."[13] Morrissey argued that the in vitro fertilization (IVF) treatment did amount to deductible medical care because the treatment, although performed on another person, was "made for the purpose of affecting his body's *reproductive* function."[14] This is because Morrissey, a homosexual man, is physiologically incapable of reproducing with his male partner, and thus,

6. *Id.* at 1263.
7. *Id.* at 1263–64.
8. *Id.* at 1264.
9. *Id.*
10. *Id.*
11. I.R.C. § 213(a) (2018).
12. I.R.C. § 213(d) (2018).
13. I.R.C. § 213(d)(1)(A) (2018).
14. *Morrissey*, 871 F.3d at 1265.

his only means of fathering his own children is through the IVF procedures.[15]

The IRS has ruled on various aspects of what constitutes deductible "medical care." The logic behind some of the distinctions is not always entirely clear. One revenue ruling explains that both hair transplants and hair removal are forms of medical care because they affect structures of the body (the scalp and hair follicles), but tattooing and ear-piercing are not medical care because they (according to the ruling) do not affect a structure of the body.[16] Although the cosmetic changes achieved by tattooing and ear-piercing are not medical care, the IRS elsewhere ruled that a facelift performed for purely cosmetic reasons is medical care.[17] Expenses need not relate directly to the taxpayer's body (or the body of a dependent or spouse) to be deductible medical care expenses. Transportation and lodging expenses can be medical care expenses, as can be insurance premiums.[18] Two longstanding revenue rulings hold that § 213 permits deductions of expenses relating to "[t]he acquisition, training, and maintenance of a dog for the purpose of assisting a dependent who is deaf."[19] On the reproductive front, the IRS has ruled that vasectomies, abortions, and sterilizations are forms of medical care.[20]

A few authorities have addressed IVF and surrogacy in the § 213 context. In *Magdalin v. Commissioner*,[21] the Tax Court denied a single, fertile man a deduction under § 213 for IVF expenses for an egg donor and surrogate.[22] The United States Court of Appeals for the First Circuit affirmed, explaining that such expenses were "[n]ot for the purpose of affecting any structure or function of [the] taxpayer's own body," but rather "affected the bodies of the gestational carriers."[23] In *Longino v.*

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15. Morrissey was unmarried at the time he incurred the expenses. He has since married. *Id.* at 1272 n.1.

16. Rev. Rul. 82-111, 1982-1 C.B. 48.

17. Rev. Rul. 76-332, 1976-2 C.B. 81. Congress subsequently added section 213(d)(9), which limits deductions to those cosmetic procedures that are "necessary to ameliorate a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma, or disfiguring disease." I.R.C. § 213(d)(9)(A) (2018).

18. I.R.C. § 213(d)(1)(B) (transportation); § 213(d)(2) (lodging); § 213(d)(1)(D) (insurance) (2018).

19. Rev. Rul. 55-261, 1955-1 C.B. 307; Rev. Rul. 68-295, 1968-1 C.B. 92.

20. Rev. Rul. 73-201, 1973-1 C.B. 140 (vasectomies and abortions); Rev. Rul. 73-603, 1973-2 C.B. 76 (female sterilization) (2018).

21. 2009 U.S. App. LEXIS 28966, at *1 (1st Cir. Dec. 17, 2009).

22. T.C. Memo. 2008-293.

23. Magdalin v. Commissioner, 2009 U.S. App. LEXIS 28966, at *1 (1st Cir. Dec. 17, 2009).

Commissioner,[24] the Tax Court denied a deduction to a male taxpayer for his fiancée's IVF treatments for the same reason.[25] The Eleventh Circuit affirmed in an unpublished opinion, finding that the taxpayer "had presented no evidence that any of the alleged care involved him, his spouse, or a dependent."[26] The IRS has, however, on at least one occasion permitted a taxpayer to deduct expenses relating to a third-party egg donor where the embryo was then implanted in the taxpayer's body.[27]

The Eleventh Circuit rejected Morrissey's argument that § 213 permitted his claimed deduction. The court focused on the statutory language, in particular the terms "affecting" and "function" in § 213(d)(1)(A).[28] Turning to the dictionary, the circuit court decided that, in order for the IVF treatment to "affect" a function of Morrissey's body, it would have to "materially influenc[e] or alter[]" that function.[29] As for "function," the court stated that that term "denotes a person's or thing's unique task or role."[30] Further, a "function of the body" should be read to mean the function of a single, particular body, rather than a function "achieved by the cooperation of multiple bodies."[31] Morrissey's error, the court explained, was to mistake "the entire reproductive *process* for his own body's specific *function* within that process."[32] The court thereupon pronounced that "[t]he male body's necessary function within the reproductive process is simply stated: it must produce and provide healthy sperm capable of fertilizing a female's egg."[33] As long as a male body can contribute viable sperm, there is no functional impairment. There being no argument that Morrissey had any functional impairment of that nature, the Eleventh Circuit held that § 213 did not allow the claimed deduction.[34]

Having disposed of Morrissey's statutory argument, the court turned to his constitutional claim. Morrissey argued that the IRS disallowance of his claimed deduction should be subject to strict scrutiny because it

24. 593 F. App'x 965 (11th Cir. 2014).

25. T.C. Memo. 2013-80.

26. *Longino*, 593 F. App'x at 968.

27. PLR 200318017 (May 2, 2003). This ruling analogizes the procedure to the costs incurred by the taxpayer for the medical expenses of a kidney donor, which was held to be deductible in Rev. Rul. 68-452, 1968-2 C.B. 111.

28. *Morrissey*, 871 F.3d at 1265.

29. *Id.*

30. *Id.*

31. *Id.*

32. *Id.*

33. *Id.* at 1266.

34. *Id.* at 1267.

infringes on a fundamental right—the right to reproduce.[35] Alternatively, some level of heightened scrutiny should apply because the disallowance discriminated against him on the basis of sexual orientation.[36] That is, in Morrissey's contention, the IRS's application of § 213 treats homosexual and heterosexual taxpayers unequally.

The court conceded that Supreme Court precedents indicate that there is, under some circumstances, a fundamental right to procreation, such that the Constitution is implicated, but found no specific fundamental right to procreation via IVF procedures.[37] These procedures, along with surrogacy, are "decidedly modern phenomena" that, as the court noted, raise serious ethical issues and risk bringing different rights into conflict.[38] The court mentioned that numerous states have wrestled with the issue of what rights surrogates have in such arrangements. Because there was no longstanding recognition of a right to IVF-assisted procreation, and legislatures were still working through the conflicting claims of participants in those procedures, the court declined to step in and find a fundamental right to procreation through IVF.[39] Thus, the court rejected Morrissey's argument that strict scrutiny should apply to the IRS's denial of his claimed deduction.[40]

The court avoided directly addressing the question of whether some level of heightened scrutiny applies to discrimination on the basis of sexual orientation because it determined that Morrissey had not been treated differently than heterosexual taxpayers.[41] First, the court noted that the language of § 213 makes no distinction between homosexual and heterosexual taxpayers.[42] Thus, there were no grounds for a facial challenge to the statute. Second, the court stated that there was no evidence that the IRS applied § 213 to Morrissey's claim for a deduction any differently than the IRS has applied that section to heterosexual taxpayers who have claimed similar IVF-related expenses.[43] As mentioned, the two courts that have addressed this issue in relation to heterosexual taxpayers (in *Magdalin* and *Longino*) have both held that § 213 did not permit such deductions. Moreover, the IRS issued guidance

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35. *Id.* at 1268.

36. *Id.*

37. *Id.* at 1268–69 (citing Skinner v. Oklahoma, 316 U.S. 535, 541 (1942) (invalidating state law requiring sterilization of certain criminal offenders)).

38. *Id.* at 1269.

39. *Id.* at 1270.

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.*

in 2002 stating that "medical expenses paid for a surrogate mother and her unborn child would not qualify for deduction under § 213(a)."[44] Thus, Morrissey had not produced evidence to show that he had been treated differently on account of his sexual orientation.[45]

Morrissey stands as an example of how litigants are testing out the extent of the courts' willingness to extend the rights guaranteed in recent Supreme Court rulings relating to sexual orientation, most notably *Obergefell v. Hodges*,[46] which held that the Fourteenth Amendment[47] guaranteed a right to marriage to homosexual couples as well as to heterosexual couples.[48] Given the statutory language of § 213, and the existing authorities' disallowance of IVF and surrogacy deductions to heterosexual taxpayers, the result in *Morrissey* was perhaps predictable.

II. *BATTAT V. COMMISSIONER*

If *Morrissey* illustrates the intersection of the tax law and the Constitution's guarantees of fundamental rights, *Battat v. Commissioner*[49] gave the Tax Court, in a case appealable to the Eleventh Circuit, the opportunity to address the intersection of the tax law and the separation of powers doctrine embodied in the Constitution.[50] *Battat* is further interesting because it put the Tax Court in the unusual and paradoxical position of ruling on the constitutionality of its own authority to adjudicate disputes.

To understand how the dispute in *Battat* arose, it is necessary to understand the basic historical evolution of the Tax Court from executive agency to Article I court. The Tax Court has its origins in the Revenue Act of 1924, which created the Board of Tax Appeals (BTA) as an executive branch agency.[51] As an executive agency, the BTA consisted of members appointed by, and removable by, the President.[52] Initially, the President's removal power was limited to instances of "inefficiency, neglect of duty, or malfeasance in office, but for no other reason."[53] The President's removal power was further limited soon thereafter with the

44. IRS INFO 2002-0291, 2002 WL 31991849 (Dec. 31, 2002).
45. *Morrissey*, 871 F.3d at 1270.
46. 135 S. Ct. 2584 (2015).
47. U.S. CONST. amend. XIV.
48. *Obergefell*, 135 S. Ct. at 2588.
49. 148 T.C. 2 (2017), *appeal filed*, No. 17-11646 (11th Cir. Apr. 11, 2017).
50. *Id.*
51. Revenue Act of 1924, ch. 234 § 900(a).
52. *Id.* § 900(b).
53. *Id.*

addition of a public hearing requirement in 1926.[54] In 1942, the BTA was renamed the "Tax Court of the United States," but remained an executive branch agency.[55] Due to its status as an executive branch agency, there was initially no jurisdiction for Article III courts to review factual determinations made by the BTA, so long as those determinations were supported by any evidence in the record.[56] Amendments passed in 1948, however, introduced appellate review of BTA decisions "in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury."[57] With this, the Tax Court could be seen as a hybrid of an executive branch agency and a court. In 1969, Congress renamed the court the "United States Tax Court" and removed the statutory language indicating that the Tax Court was an "independent agency in the Executive Branch of the Government."[58] Instead, the Tax Court was to be a "court of record" established "under Article I of the Constitution of the United States."[59] As the Senate Committee on Finance explained in its report, "[s]ince the Tax Court has only judicial duties, the committee believes it is anomalous to continue to classify it with quasi-judicial executive agencies that have rulemaking and investigatory functions."[60] Thus, by 1969, the Tax Court seemed to have shed most of the trappings of an executive branch agency.

Two years after the 1969 amendments, a taxpayer challenged the constitutionality of the Tax Court, alleging that the "judicial powers" it exercised were proper only to Article III courts.[61] In affirming its constitutionality, the Tax Court explained:

> The basic jurisdiction of the Tax Court was not changed by the Tax Reform Act [of 1969]. That basic jurisdiction is now limited to redetermining deficiencies in Federal income, estate, and gift taxes, as was the jurisdiction of the Tax Court of the United States and the Board of Tax Appeals . . . . The Court presently has no jurisdiction to execute its decisions; it does not render a monetary judgment; it simply determines the amount of the deficiency or overpayment of tax. The Tax Court has only such jurisdiction as is conferred upon it by statute. It has no jurisdiction to exercise the broad common law concept of "judicial power" invested in courts of general jurisdiction by Article III

54. Revenue Act of 1926, ch. 27 § 951.
55. Revenue Act of 1942, ch. 619 § 504(a).
56. *See* Dobson v. Commissioner, 320 U.S. 489 (1943).
57. *Battat*, 148 T.C. at *4.
58. *Id.* at *4–5.
59. *Id.*
60. Kuretski v. Comm'r of IRS, 755 F.3d 929, 944 (D.C. Cir. 2013)
61. Burns, Stix Friedman & Co. v. Commissioner, 57 T.C. 392 (1971).

> of the Constitution. If the jurisdiction and function presently vested in the Tax Court could be exercised constitutionally by an "independent agency within the Executive Branch," . . . there is little reason to believe that Congress could not constitutionally delegate that jurisdiction to a "legislative court."[62]

Thus, because the Tax Court's jurisdiction was limited to so-called "public rights" disputes, and those were not within the jurisdiction granted to Article III courts under the Constitution, Congress was within its Article I authority in creating the Tax Court.[63] Two decades later, the Supreme Court confirmed that the Tax Court was an Article I court that "remains independent of the Executive and Legislative Branches."[64]

Given the weight of statutory and judicial authority supporting the Tax Court's status as an Article I court, rather than an Executive Branch agency, it was perhaps inevitable that the President's continued authority to remove Tax Court judges would produce controversy. Indeed, in *Kuretski v. Commissioner*,[65] the United States Court of Appeals for the District of Columbia Circuit was tasked with determining whether the President's removal authority violates separation of powers principles.[66] If the answer is that it does violate the separation of powers, then the very legitimacy of the Tax Court would be jeopardized. The D.C. Circuit held that the Tax Court was within the Executive Branch, and therefore there was no separation of powers issue to address.[67]

In avoiding the separation of powers issue in this way, however, the D.C. Circuit seemingly brought itself into direct conflict with Congress's expressed intent to have the Tax Court be an Article I court and the Supreme Court's statement that the Tax Court "remains independent of the Executive and Legislative Branches."[68] In fact, Congress responded soon after the D.C. Circuit rendered *Kuretski*. In 2015, Congress reinforced the Tax Court's independence from the executive branch, adding to § 7441[69] the direct statement that "[t]he Tax Court is not an agency of, and shall be independent of, the executive branch of the Government."[70]

62. *Id.* at 396 (internal citations removed).
63. *See id.* at 399–400.
64. Freytag v. Commissioner, 501 U.S. 868, 890–92 (1991).
65. 755 F.3d 929 (D.C. Cir. 2014).
66. *Id.*, *aff'g* T.C. Memo. 2012-262.
67. *Kuretski*, 755 F.3d at 938–42.
68. *Freytag*, 501 U.S. at 891.
69. I.R.C. § 7441 (2018).
70. Consolidated Appropriations Act, Pub. L. No. 114-113, div. Q, § 441 (2015).

Enter the taxpayers in *Battat*, who raised again the issues argued in *Kuretski* about the constitutionality of the President's authority to remove Tax Court judges. As in *Kuretski*, the *Battat* taxpayers argued that § 7443(f),[71] which authorizes the President to remove Tax Court judges "after notice and opportunity for public hearing, for inefficiency, neglect of duty, or malfeasance in office, but for no other cause,"[72] marks an unconstitutional breach of the separation of powers, and that the Tax Court should declare § 7443(f) unconstitutional.[73] Further, given the unconstitutionality of the statute, the taxpayers sought "rulings that all Tax Court Judges must recuse themselves from deciding any further cases."[74] Given the recent amendment of § 7441, the answer provided by *Kuretski* to these questions was undoubtedly unavailable to the court in *Battat*.

As a preliminary matter, addressing these issues put the Tax Court in a paradoxical position: if it ruled in favor of the taxpayer, it would be ruling that its judges lacked the authority to rule at all in the case. The Tax Court noted, however, that "[c]ourts have occasionally been presented with issues in which all judges of the court have a conflict of interest or are alleged to be biased, and, because it is necessary for the work of the court to proceed, have not recused themselves."[75] This resolution, called the "Rule of Necessity," the Tax Court summarized with the "maxim of law that where all are disqualified, none are disqualified."[76] The Tax Court concluded that under the Rule of Necessity, it was able to exercise its jurisdiction to decide if § 7443(f) is unconstitutional and if the Tax Court judges must recuse themselves.[77]

Turning to the substance of the taxpayers' claim, the Tax Court framed the question as follows: "[d]oes providing to the President the authority to remove Tax Court Judges give the President any unconstitutional power to interfere with the Article III judicial power of the United States?"[78] The court held that the answer is that it does not, employing a public rights rationale similar to the doctrine that the Tax Court employed in *Burns, Stix Friedman & Co. v. Commissioner*.[79] This public rights doctrine takes as its starting point that Article III courts are only

71. I.R.C. § 7443(f) (2018).
72. *Battat*, 148 T.C. at *2.
73. *Id.* at *25.
74. *Id.* at *24.
75. *Id.* at *25.
76. *Id.*
77. *Id.* at *25–26.
78. *Id.* at *27.
79. 57 T.C. 392 (1971); *Battat*, 148 T.C. at *27–29.

granted exclusive jurisdiction over "suit[s] at the common law, or in equity, or admiralty."[80] However, under the historical doctrine of sovereign immunity, those courts lacked jurisdiction over the sovereign.[81] Because the sovereign could not be sued in those courts (except insofar as it consented to be sued), matters involving "public rights"—disputes with the government—could be adjudicated in non-Article III courts.[82] The Tax Court noted that a long line of Supreme Court precedents have established that "controversies 'between the government and others' involve public rights and thus may be removed from Article III courts and delegated to Article I courts or administrative agencies for their determination."[83] Further, "[t]he Tax Court decides only disputes between the sovereign and the subject which are neither suits at common law, nor in equity, nor admiralty."[84]

Thus, for the President's removal authority to violate the separation of powers, it would have to be shown that it "could interfere with 'the constitutionally assigned mission of' the judicial branch."[85] However, given that the jurisdiction of the Tax Court is limited to the adjudication of public rights, "if the President sought to exercise the power to remove a Tax Court Judge, the President would not thereby be affecting any matter within the portion of the 'judicial Power of the United States' that is necessarily exercised by Article III judges."[86]

The Tax Court further backstopped its ruling, noting that "[i]nterbranch removal is not necessarily constitutionally impermissible."[87] In support, the Tax Court cited *Mistretta v. United States*,[88] wherein the Supreme Court noted that it was incorrect to read its precedents as "suggest[ing] that one Branch may never exercise removal power, however limited, over members of another Branch. Indeed, we already have recognized that the President may remove a judge who serves on an Article I court."[89] The Supreme Court was referring to *McAllister v. United States*,[90] which permitted the President to remove a judge who was serving a four-year term as a district judge

80. *Battat*, 148 T.C. at *27.
81. *Id.* at *28–29.
82. *Id.* at *27.
83. *Id.* at *30.
84. *Id.*
85. *Id.* (quoting Mistretta v. United States, 488 U.S. 361, 411 n.35 (1989)).
86. *Id.* at *30–31.
87. *Id.* at *31.
88. 488 U.S. 361 (1989).
89. *Battat*, 148 T.C. at *31 (quoting *Mistretta*, 488 U.S. at 411 n.35).
90. 141 U.S. 174 (1891).

for the District of Alaska.[91] At that time, Alaska was still a territory and the district judges were appointed under the authority of Article I rather than Article III.[92]

In deciding that the President's removal authority over Tax Court judges did not violate the separation of powers, *Battat* provided what is likely to be a more enduring resolution to this issue than was provided in *Kuretski*. The *Battat* holding comports more closely with the clear intent Congress has expressed with regard to the status of the Tax Court, as well as Supreme Court precedents on the separation of powers. Nonetheless, the taxpayers in *Battat* have appealed their case to the Eleventh Circuit.

III. *MIHELIK V. UNITED STATES*

Finally, in what appears to be a case of first impression, the United States District Court for the Middle District of Florida determined that a payment made by a taxpayer under a separation agreement that related to litigation that began during the marriage was nondeductible.[93]

The taxpayer was formerly married to Michael Bluso, who was employed by a family-owned corporation of which he was the majority shareholder.[94] During the pendency of divorce proceedings, Bluso was sued by his sister, Pamela Barnes, who was a minority shareholder of the corporation. Barnes alleged that Bluso had used his control of the corporation to pay himself an excessive salary to the detriment of the corporation.[95]

While the litigation was still ongoing, the taxpayer and Bluso entered into a separation agreement (the Separation Agreement).[96] One of the provisions of the Separation Agreement noted the existence of potential liability under the lawsuit and stated that any such liability would be considered a marital liability and that the taxpayer and Bluso "will be jointly and severally liable for all damages, costs, attorney fees and other expenses incurred in this litigation by [Bluso,] which is a marital liability."[97] This provision was apparently contested during the divorce proceedings, but the taxpayer ultimately agreed to include it. Sometime after the divorce, the litigation was settled, with Bluso agreeing to pay

91. *Id.*

92. *Id.* at 185–86.

93. Mihelick v. United States, 2017 U.S. Dist. LEXIS 167897 (M.D. Fla. Oct. 10, 2017), *appeal filed*, No. 17-14975 (11th Cir. Nov. 8, 2017).

94. *Id.* at *1–2.

95. *Id.* at *1–4.

96. *Id.* at *2.

97. *Id.* at *3 (quoting Separation Agreement).

$600,000 to Barnes to resolve the excess compensation claim.[98] As required by the Separation Agreement, the taxpayer paid $300,000 to Bluso for her share of the settlement payment.[99]

The taxpayer filed a refund claim on the basis of the payment. The taxpayer argued that the payment was deductible under § 165(c)(2)[100] as a loss relating to an activity carried on for profit.[101] The taxpayer further argued that the favorable rules of § 1341[102] should apply to the deduction.[103] Under that section, certain restorations of income held under a "claim of right" get beneficial tax treatment.[104] More specifically, if a taxpayer includes income in one year because "it appeared that the taxpayer had an unrestricted right to the item," but if a deduction is subsequently allowed because it is established that the taxpayer did not have an unrestricted right to the income, then the taxpayer generally calculates the tax benefit of the deduction under § 1341.[105] The § 1341 rules are intended to deal with certain inequities that can arise from year-by-year tax accounting. If, based on the facts known at the end of a taxable year, a taxpayer appears to have earned income, that income is taxed. Even if later events demonstrate that income was not truly earned, year-by-year tax accounting precludes a retrospective adjustment to the original return. Instead, the taxpayer is stuck reporting income in the earlier year and a deduction in the later year. In many cases, this can produce unfair results for the taxpayer, who may be unable to benefit from the later deduction for various reasons.[106] In lieu of this treatment, § 1341 effectively provides a tax credit in lieu of the deduction in an amount equal to the tax that was originally paid on the affected income. In most cases, this treatment produces a more beneficial outcome for the taxpayer.

The government made two arguments to deny the taxpayer's refund claim. First, the government claimed that the $300,000 payment was not deductible by the taxpayer.[107] Deductibility under another provision of

98. *Id.* at *4.
99. *Id.*
100. I.R.C. § 165(c)(2) (2018).
101. *Mihelik*, 2017 U.S. Dist. LEXIS 167897, at *9.
102. I.R.C. § 1341 (2018).
103. *Mihelik*, 2017 U.S. Dist. LEXIS 167897, at *6–7.
104. I.R.C. § 1341(a) (2018).
105. *Mihelik*, 2017 U.S. Dist. LEXIS 167897, at *7.
106. For example, expenses relating to the trade or business of being an employee are subject to various limitations, which could reduce or eliminate the benefit of the later deduction.
107. United States' Motion for Summary Judgment at 5, Mihelick v. United States, No. 2:16-cv-741 (M.D. Fla. June 30, 2017), ECF No. 47.

the Code is a precondition to favorable treatment under § 1341. As noted above, the taxpayer based her deduction on § 165(c)(2) of the Code, which relates to losses on transactions entered into for profit. The government argued that the payment was voluntarily agreed to by the taxpayer in connection with the divorce settlement.[108] Personal expenses, including "costs paid in connection with a divorce [or] separation," are not deductible.[109] A key fact supporting this argument was that only Bluso was a defendant in the Barnes litigation.[110] It appears that the taxpayer's only exposure to the litigation was its indirect effect on the assets in the marital estate. She was not, it seems, exposed to a direct judgment.

Second, the government argued that, even if the payment were deductible, § 1341 should not apply, since the payment was not sufficiently related to the earlier income inclusion.[111] The government relied on Tax Court and Eleventh Circuit precedent that required a "substantive nexus" between the original income and the subsequent deduction before § 1341 treatment would apply.[112] The government relied on the fact that the taxpayer's payment was made under the Separation Agreement, which arose out of the taxpayer's divorce proceedings and had nothing to do with Bluso's employment.[113] The government also pointed out that the taxpayer voluntarily entered into the Separation Agreement.[114]

The district court agreed with the government that the payment was not deductible under § 165 and, accordingly did not reach the question of § 1341's applicability.[115] The court reasoned that the Separation Agreement was a "private settlement" and that the taxpayer did not have any personal obligation from the Barnes litigation.[116] Moreover, the taxpayer herself was not engaged in a relevant trade or business or any other profit-oriented transaction that could sustain the loss.[117] One open question is whether the court would have arrived at a different conclusion if the taxpayer was a co-defendant in the lawsuit and made the payment in that capacity, rather than under the settlement agreement.

108. *Id.* at 6–7.

109. I.R.C. § 262 (2018); Treas. Reg. § 1.262-1(b)(7) (2018).

110. United States' Motion for Summary Judgment, *supra* note 107, at 6–7.

111. *Id.* at 8.

112. *See* Batchelor-Robjohns v. United States, 788 F.3d 1280 (11th Cir. 2015); Blanton v. Commissioner, 46 T.C. 527 (1966).

113. United States' Motion for Summary Judgment, *supra* note 107, at 9–10.

114. *Id.* at 10–11.

115. *Mihelik,* 2017 U.S. Dist. LEXIS 167897, at *10–11.

116. *Id.*

117. *Id.*

Although the court did not address the issue, it implicitly refused to allow the taxpayer to rely on Bluso's trade or business of being employed by the corporation during the period when they were married and filing a joint return. Presumably, Bluso deducted at least his 50% share of the payment to Barnes and may well have deducted the entire $600,000. Given that the taxes originally imposed on Bluso's salary were borne by the couple jointly and that the settlement payment to Barnes was borne equally under the Separation Agreement, the court's decision arguably creates an unjust hardship for the taxpayer, who was taxed on $300,000 of income that was ultimately not retained.

Even if the court had permitted the taxpayer to "step into the shoes" of Bluso for purposes of establishing a trade or business, the court did not reach the issue but the government made arguments on this front as well.[118] Recall that § 1341 requires that a deduction be allowed because it is "established" that the taxpayer did not have an unrestricted right to an item that was previously included in income. In this case, the taxpayer would have needed to establish that a deduction allowable to her as a result of the payment under the Separation Agreement was ultimately allowed because the Barnes litigation "established" that Bluso did not have an unrestricted right to wages paid to him by the corporation. While this chain of reasoning is certainly plausible, there is a significant degree of attenuation between the payment giving rise to the deduction and the original inclusion of income. The *Mihelick* decision has been appealed to the Eleventh Circuit.

118. *Id.* at *7 n.3.