UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA
WESTERN DIVISION
CIVIL MINUTES - GENERAL

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Case No. CV 06-2136 GPS (PJWx) Date: August 20, 2007

Title: *United States v. Martin A. Kapp*

PRESENT: THE **HONORABLE GEORGE P. SCHIAVELLI**, JUDGE

Not present	Not present
Courtroom Clerk	Court Reporter

ATTORNEYS PRESENT FOR PLAINTIFFS:	ATTORNEYS PRESENT FOR DEFENDANTS:
Not present	Not present

PROCEEDINGS: Order Granting Plaintiff's Motion for Summary Judgment
Order Denying Defendant's Motion for Summary Judgment
(In Chambers)

On July 2, 2007, the Court heard argument on the parties' cross-motions for summary judgment on whether the Defendant, Martin Kapp, should be permanently enjoined from preparing returns that claim deductions for mariners who receive free meals from their employers (the "mariner's tax deduction" or "MTD").

The Court hereby **GRANTS** Plaintiff's Motion for Summary Judgment and **DENIES** Defendant's Motion for Summary Judgment because the mariner's tax deduction is illegal under *Westling v. Commissioner*, 80 T.C.M. (CCH) 373, 2000 Tax Ct. Memo LEXIS 340 (2000); and *Johnson v. Commissioner*, 115 T.C. 210, 2000 WL 1310661 (2000), and the Court established the elements of an injunction under 26 U.S.C. § 7407.[1]

I. BACKGROUND

A. Facts

From as early as January 10, 1997 to as recently as February 21, 2006, Defendant Martin Kapp prepared returns claiming a tax deduction that the Government labels the "mariner's tax deduction" ("MTD"). The MTD is an unreimbursed employee business expense deduction for meals and incidental

[1] Additionally, Defendant's evidentiary objections and motions to strike are **OVERRULED** and **DENIED**, respectively.

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expenditures ("M&IE") that is taken by mariners and seamen while traveling for work, though the mariners' employers provided them with free meals.

Through the present lawsuit, the Government seeks to permanently enjoin Defendant from preparing returns that claim deductions for mariners who receive free meals from their employers. The Government alleges this is proper because, as a CPA, Defendant knew or should have known that an employee business expense is only deductible if "paid or incurred" by the employee.

B. Legal Standard

The Government seeks to enjoin Defendant under two separate statutes.

First, section 7408 of the tax code authorizes a district court to "enjoin any person from further engaging in . . . conduct . . . subject to penalty under section . . .6701." 26 U.S.C. § 7408. In turn, section 6701 penalizes anyone who knowingly prepares another's tax return to understate tax liability. *Id.* at § 6701. Penalties under section 6701 can be assessed against:

> Any person-
> (1) who aids or assists in, procures, or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim, or other document,
> (2) who knows (or has reason to believe) that such portion will be used in connection with any material matter arising under the internal revenue laws, and
> (3) who knows that such portion (if so used) would result in an understatement of the liability for tax of another person . . .
> 26 U.S.C. § 6701.

Second, section 7407(b)(1) authorizes the court to enjoin a tax preparer from engaging in conduct subject to penalty under section 6694. 26 U.S.C. § 7407(b)(1). Section 6694 penalizes the understatement of tax liability by a tax return preparer.[2] *Id.* at § 6694.

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[2] Another provision of Section 7407(b) provides a third option to enjoin Defendant. Section 7407(b) states that if a tax return preparer has continually or repeatedly engaged in conduct described in § 7407(b)(1) and a narrower injunction prohibiting such conduct would be insufficient, then a court may enjoin such a person from ever acting as a tax return preparer. *See, e.g., United States v. Nordbrock*, 38 F.3d 440, 447 (9th Cir. 1994); *United States v. Baxter*, 372 F.Supp.2d 1326, 1329 (M.D. Ala. 2005). The Government is not seeking this type of broad injunction.

The Government must prove each element for enjoining a tax preparer by a preponderance of the evidence. *United States v. Estate Preservation Servs.*, 202 F.3d 1093, 1102 (9th Cir. 2000).

II. DISCUSSION

As applied to the present case, the common elements of each of these grounds for issuing an injunction are: (1) the legality of the MTD and (2) whether Defendant knew or should have known that the MTD is illegal. As shown below, the undisputed facts demonstrate that both of the elements are satisfied and therefore the Defendant should be enjoined. Accordingly, the Court **GRANTS** the Government's Motion for Summary Judgment.

A. The "Mariner's Tax Deduction" Is Illegal

Contrary to Defendant's allegations, the MTD is not allowable under the Tax Code. Thus, as shown below, the Court finds that Defendant advised his clients to claim illegal deductions.

1. Legal Standard

IRC § 162 does not generally allow a taxpayer to deduct travel expenses absent compliance with the substantiation requirements of IRC § 274(d). However, taxpayers may deduct a set amount in lieu of substantiation for actual expenses while traveling away from home. Treas. Reg. § 1.274-5T(j). The parties do not dispute that Rev. Proc. 89-67 provides that "the amount of ordinary and necessary business expenses of an employee for lodging, meal, and/or incidental expenses incurred while traveling away from home will be deemed substantiated . . . when . . . [the employer] provides a per diem allowance" to the employee equal to the applicable M&IE rate. (U.S. Reply at 3). In other words, a per-diem amount (i.e., the M&IE rate) may be taken where no record of actual expenses are kept. (*Id.*) The size of the allowable traveling deduction is based on the M&IE rate of the particular locality to which the employee is traveling. Rev. Proc. 2004-60 § 3.02.

Such deductions are limited, however, because traveling expense deductions cannot be claimed where no expense is incurred. *Johnson v. CIR*, 115 T.C. 210, 211-212 (2000). The taxpayer in *Johnson*, a captain of a merchant ship, maintained a home on shore but was required to live aboard ship for extended periods during the tax years in question (1994 and 1996). 115 T.C. at 211-212. The taxpayer's employer provided his meals on board ship, but did not provide him with other personal necessities nor an allowance for incidental expenses. *Id.* at 215. While aboard, the taxpayer could purchase clothing items such as foul-weather gear, personal hygiene items, and bottled water at a small ship's store. *Id.* On the taxpayer's amended federal income tax return, prepared by Defendant, the taxpayer claimed miscellaneous itemized deductions for his incidental expenses, using the full M&IE rate provided in 41 C.F.R. § 301-7.3 (1994 and 1996). *Id.*

The *Johnson* court held that these deductions were improper because employees cannot claim the full M&IE rate when the employee incurs only incidental expenses. *Id.* at 226. Federal tax regulations "provide a specific mechanism under which the applicable M&IE rates are reduced whenever the employer provides the traveler with meals at no charge," and requires that "the M&IE rate must be reduced '[w]hen all or part of the meals are furnished at no cost or at a nominal cost to the employee.'" *Id.* at 226, 227-28 (*citing* 41 C.F.R. § 301-7.12(a)(2) (1994 & 1996)).

The Tax Court came to an identical conclusion in *Westling*, another case where the Defendant prepared a return for a seaman claiming the full M&IE rate. *Westling*, 2000 Tax Ct. Memo 448 at *13.

2. Analysis

As shown below, the holdings in *Johnson* and *Westling* demonstrate that the MTDs are illegal. Simply put, when an employer of mariners provides meals to its employees, the employees cannot claim a traveling expense deduction for meal costs that they did not incur. Although substantiation of M&IE expenses is not always required (pursuant to Treas. Reg. § 1.274-5T(j)), *some* expense must be incurred by the employee to be entitled to M&IE deductions.

Defendant challenges this conclusion on two grounds by arguing: (1) the Tax Court decisions do not preclude the MTDs and (2) other authority supports Defendant's view that the MTDs are proper. As demonstrated below, neither of these arguments are persuasive.

First, Defendant argues that the Tax Court decisions do not preclude the MTDs. Defendant claims that he "won" in the *Johnson* and *Westling* cases and that those cases support his position that taxpayers can claim traveling expense deductions without providing receipts or other substantiation. This argument fails to address the reasoning in these cases. Although Defendant is correct that *Johnson* allows mariners to claim *some* deduction for incidental expenditures without substantiation, no court has ever allowed one to claim the *full* M&IE rate when meals are provided for free. *See Johnson* at 226; *Westling*, 2000 Tax Ct. Memo 448 at *13; *Jewett v. CIR*, 2004 Tax. Ct. Memo LEXIS 23 at *6 (2004).

Further, Defendant claims that the *Johnson* decision is not relevant because "Mr. Johnson did not seek meal deductions, and therefore meal deductions were not before the court." (Kapp MSJ at 8.) This limited view of *Johnson* ignores the Tax Court's reasoning. The issue before the court in *Johnson* was twofold: (1) could the taxpayer deduct incidental expenditures without substantiation pursuant to Treas. Reg. § 1.274-5T(j) and (2) how should the deduction be measured? The first issue was decided in *favor* of the taxpayer by allowing a $2 per day deduction for incidental expenditures without substantiation. *Johnson*, 115 T.C. at 224-25, 227. The second issue

was decided *against* the taxpayer (and therefore against Defendant) by limiting the deduction to the portion of the M&IE rate allocable to incidental expenditures pursuant to 41 C.F.R. § 301-7.12(a)(2)(i) (1994 and 1996). *Id.* at 227. Thus, contrary to Defendant's view, the holding in *Johnson* supports the Government's motion.

Second, Defendant cites to myriad authorities in an attempt to justify the MTDs. As shown below, none of these authorities either refute *Johnson*, or are relevant to whether the MTDs are proper.

Defendant cites IRS Notice 90-95, which permits taxpayers to claim expenses of up to $75 without a receipt. However, IRS Notice 90-95 is derived from 26 U.S.C. § 162(a), which requires taxpayers to establish that an expense is actually incurred before claiming a deduction. Because an employee who receives meals for free from his employer incurs no meals expense, this IRS Notice does not allow a taxpayer to claim the full M&IE rate as Defendant did through the MTDs.

Defendant next points to 41 C.F.R. § 301-11.17, which states that "common carrier" meals do not affect M&IE deductions. Defendant contends that because mariners are on ships, which are included in the definition of "common carrier" under 41 C.F.R. § 301-10.100, the free meals provided by their employers do not affect the M&IE. (Kapp Depo. at Exs. 15-19.) This position is incorrect. Simply because a "common carrier" may include ships does not mean that all ships are common carriers. The "common carrier" allowance in 41 C.F.R. § 301-11.17 is designed for situations where persons on work-related travel receive complimentary meals from a transporter (as opposed to an employer), such as a meal for a passenger on an airplane. In that situation, the free meal received on the airplane would not affect the amount of M&IE expense that the taxpayer could claim. Thus, this section does not justify the MTDs.

Finally, Defendant points to *Murphy v. CIR*, which states that expenses for travel up to the per diem amount may be claimed "without regard to whether such expenses were substantiated or actually incurred." *Murphy*, 1993 Tax Ct. Memo LEXIS 295 at 18. Again, however, *Murphy* is irrelevant to the MTDs. Murphy's employer paid him $20 per day for food and incidental expenses. *Id.* at 14. The employee in *Murphy* therefore *still incurred a meals expense*, and used the $20 a day to pay for some of that expense. *Id.* This is an entirely different situation than the present case, where mariners receive meals for *free*, and therefore incurred no meal expense whatsoever. Where a mariner receives meals for free, *Johnson* and *Westling* are the relevant law, not *Murphy*.

Thus, the MTDs Defendant advised his clients to claim are illegal expense deductions.

B. The Government is Entitled to an Injunction Against Defendant

1. Section 7407

The Government seeks to enjoin Defendant under the provision of IRC § 7407. Under IRC § 7407, courts may enjoin return preparers who have either (1) violated IRC § 6694, which prohibits the preparation or submission of a return containing an unrealistic position, or (2) engaged in any other fraudulent or deceptive conduct substantially interfering with the proper administration of the tax laws. I.R.C. § 7407(b)(1)(A), (D). The Government must prove each element for enjoining a tax preparer by a preponderance of the evidence. *United States v. Estate Preservation Servs.*, 202 F.3d 1093, 1102 (9th Cir. 2000).

As shown above, the MTDs were illegal and Defendant therefore violated IRC § 6694. However, the Treasury regulations provide a safe harbor where the preparer's position had a realistic possibility of being sustained on the merits: "A position is considered to have a realistic possibility of being sustained on its merits if a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits (realistic possibility standard)." 26 C.F.R. § 1.6694-2(b)(1).

The regulations also state that "a 'frivolous' position with respect to an item is one that is patently improper." 26 C.F.R. § 1.6694-2(c)(2). However, there is no penalty for a frivolous position if the return preparer acted in good faith. IRC § 6694(a). Where a position is either frivolous or does not have a realistic possibility of being sustained on its merits, the burden is on the return preparer to show good-faith. 26 C.F.R. § 1.6694-2(e)(1)-(3).

In light of the analysis in the previous section, there was no realistic possibility that the MTD deductions would be sustained. Defendant's position could even be considered frivolous given the clear illegality of the MTDs under *Johnson*. The burden therefore shifts to Defendant to show that he acted in good faith in promoting the MTDs.

As discussed in the previous section, none of the authorities Defendant relies upon offers credible support for his position that mariners are entitled to M&IE deductions for expenses they never incurred. Moreover, a "reasonable accountant" would have realized that statements made in one particular case like *Murphy* cannot simply be taken "at face value," as Defendant suggests, but must be interpreted with respect to relevant authority on the subject. Defendant's selective interpretations and reliance on these authorities in the face of IRS statements to the contrary was not in good faith.

Because Defendant failed to meet his burden of showing that he used good faith in determining that the MTDs were proper deductions, he does not fall within the safe harbor for violations of IRC § 6694. Accordingly, the Government is entitled to an injunction under IRC § 7407(b)(1).[3]

2. Section 7408

Because the Government is entitled to an injunction under § 7407, it is not necessary to determine whether an injunction under § 7408 is appropriate.

C. Defendant's Motion for Summary Judgment

In his Motion, Defendant asks the Court to find that the Government is not entitled to an injunction as a matter of law. In light of the analysis above, Defendant's Motion is **DENIED**.

III. CONCLUSION

For the reasons above, the Government's Motion for Summary Judgment is **GRANTED** and Defendant's Motion for Summary Judgment is **DENIED**.

IT IS SO ORDERED.

[3] Given that Defendant violated IRC § 6694 many times, the Government is entitled to a broader injunction under IRC § 7407(b), enjoining Defendant from ever acting as a tax return preparer. However, the Government did not seek this type of injunction.