# 10 What's New: Rulings and Cases

## Explanation of Contents

**Please Note:** This chapter is a collection of some revenue rulings, revenue procedures, Treasury Regulations, announcements, tax cases, and letter rulings that have transpired during the past year, through approximately August 15, 1997. Since they appear in a condensed version, you should not rely on any given citation until you have read the complete text cited. This is not meant to be a comprehensive coverage of all tax law changes or explanations. We have tried to include those items we believe are most pertinent for the average tax practitioner. The source of each citation is given for each separate item.

**Following is a discussion of the significance (weight) given to the different sources:**

### Determination of Whether Substantial Authority Is Present

**Evaluation of Authorities.** There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment.

- All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists.
- The weight of authorities is determined in light of the pertinent facts and circumstances.
- There may be substantial authority for more than one position with respect to the same item.
- Because the substantial authority standard is an objective standard, the **taxpayer's belief** that there is substantial authority for the tax treatment of an item **is not relevant** in determining whether there is substantial authority for that treatment.

**Nature of Analysis.** The weight accorded an authority depends on its relevance and persuasiveness, and the type of document providing the authority. **For example,** a case or revenue ruling having some facts in common with the tax treatment at issue is not particularly relevant if the authority is **materially distinguishable** on its facts, or is otherwise inapplicable to the tax treatment at issue. **An authority that merely states a conclusion**

**authority that merely states a conclusion** ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts. **The weight of an authority from which information has been deleted,** such as a private letter ruling, is **diminished**to the extent that the deleted information may have affected the authority's conclusions. The type of document also must be considered. **For example,** a revenue ruling is accorded greater weight than a **private letter ruling** addressing the same issue. An **older private letter ruling,** technical advice memorandum, general counsel memorandum, or action on decision generally must be accorded less weight than a more recent one. Any document described in the preceding sentence that is more than 10 years old generally is accorded **very little weight. There may be substantial authority** for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.

**The following are authority for purposes of determining whether there is substantial authority for the tax treatment of an item:**

- Applicable provisions of the Internal Revenue Code and other statutory provisions
- **Proposed, temporary,** and **final regulations** construing such statutes
- Revenue rulings and revenue procedures
- Tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties
- Federal court cases interpreting such statutes
- Congressional intent as reflected in committee reports
- Joint explanatory statements of managers included in congressional conference committee reports, and floor statements made prior to enactment by one of a bill's managers
- General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book)
- **Private letter rulings and technical advice memoranda issued after October 31, 1976**
- Actions on decisions and general counsel memoranda issued after March 12, 1981
- Internal Revenue Service information or press releases, and notices, announcements, and other administrative pronouncements published by the Service in the Internal Revenue Bulletin.

**Internal Revenue Code.** The provisions of the Internal Revenue Code are binding in all courts except when the provisions violate the United States Constitution [Code Section 61(a)].

**Treasury Regulations (Income Tax Regulations).** The regulations are the Treasury Department's official interpretation and explanation of the Internal Revenue Code (IRC). Regulations have the force and effect of law unless they are in conflict with the statute they explain.

**Revenue Rulings.** The Internal Revenue Service has said the following about the weight given to revenue rulings (Rev. Rul.):

> Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as

precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

**Letter Rulings and Technical Advice Memoranda.** These are IRS rulings directed at a particular taxpayer. (See the discussion at the top of this page.)

## Procedure in Tax Disputes

- The taxpayer in a dispute with the Internal Revenue Service has two choices after he or she receives the "90 day letter": (1) file a petition in the Tax Court without paying the tax or (2) pay the tax and file a claim of refund. If the IRS rejects the claim of refund, the taxpayer can file a suit in the Federal District Court or the Claims Court.
- The Tax Court was originally the Board of Tax Appeals. In 1942 the name was changed to the Tax Court, and the court was deemed an Article I court in 1969. The Tax Court is composed of 19 judges acting as "circuit riders." This is the only forum in which a taxpayer can contest a tax liability without first paying the tax. However, jury trials are not available in this forum. More than 90% of all disputes concerning taxes are litigated in the Tax Court.
- The jurisdiction of the Tax Court is to hear an appeal of an IRS deficiency notice upon the filing of a petition by the taxpayer. This court also has limited jurisdiction under IRC §7428 to hear an appeal from an organization that is threatened with the loss of its tax-exempt status. Under IRC §7478, the Tax Court can also issue a declaratory judgment for a state or local government that has failed to get a tax exemption for a bond issue.
- The Tax Court sits as a single judge. The Chief Judge of the Tax Court decides which opinions are to be published. The Chief Judge can also order a review by the full court of any decision within 30 days. Published decisions are reported in the *Reports of the Tax Court of the United States*. Unpublished opinions are reported as Memorandum Decisions by tax service publishers. The IRS is not bound by any decision of the Tax Court except as to the taxpayer involved in the case.
- Published opinions of the Tax Court and Supreme Court decisions are binding in a dispute before the Tax Court. The decision of the Circuit Court of Appeals in which the current taxpayer litigant has a right of appeal is also binding on the Tax Court. The decision of the Tax Court can be appealed to the Circuit Court of the taxpayer's residence. (See the table at the end of this discussion.) A final appeal can be made to the Supreme Court, but since its jurisdiction is discretionary, the Court hears relatively few tax cases.
- If the amount in dispute is less than $10,000, the taxpayer may elect the Small Claims Division of the Tax Court. The Small Claims Division has a simplified petition and procedure so that the taxpayer can present his or her own case. Decisions by the Small Claims Division are not published and are final without appeal. The IRS can remove the case to the regular docket if the case involves an important

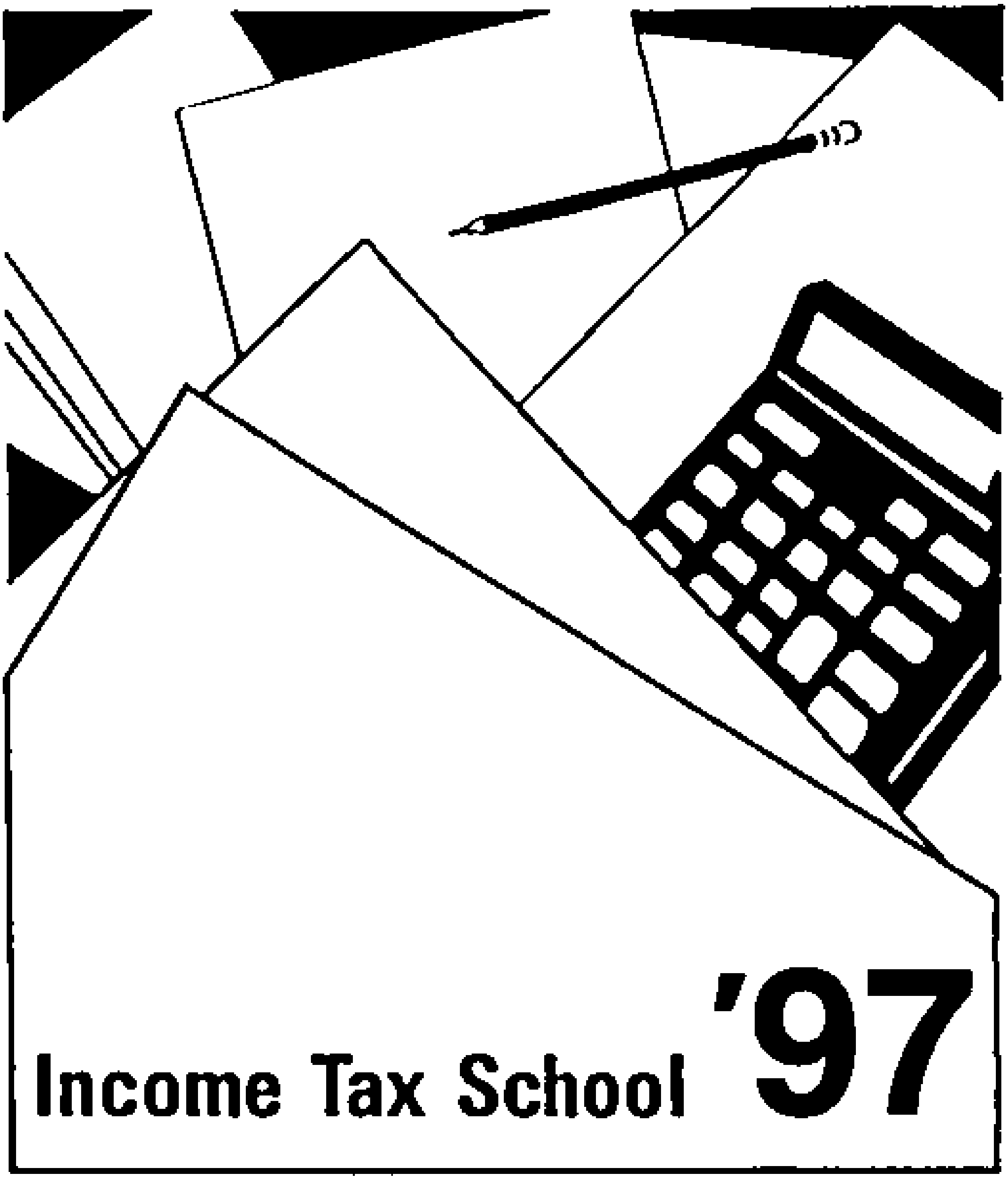
policy question.

- The taxpayer can choose to file a refund suit in the Claims Court or the Federal District Court once the taxpayer has paid the deficiency. In both courts, decisions of the Tax Court are not binding. The Claims Court sits as a single judge. A jury trial is available only in the Federal District Court.

## The 13 judicial circuits of the United States are constituted as follows:

| Circuits | Composition |
|---|---|
| District of Columbia | District of Columbia |
| First | Maine, Massachuestts, New Hampshire, Puerto Rico, Rhode Island |
| Second | Connectict, New York, Vermont |
| Third | Delaware, New Jersey, Pennsylvania, Virgin Islands |
| Fourth | Maryland, North Carolina, South Carolina, Virginia, West Virginia |
| Fifth | District of the Canal Zone, Louisiana, Mississippi, Texas |
| Sixth | Kentucky, Michigan, Ohio, Tennessee |
| Seventh | Illinois, Indiana, Wisconsin |
| Eighth | Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, South Dakota |
| Ninth | Alaska, Arizona, California, Idaho, Montana, Nevada, Oregon, Washington, Guam, Hawaii |
| Tenth | Colorado, Kansas, New Mexico, Oklahoma, Utah, Wyoming |
| Eleventh | Alabama, Florida, Georgia |
| Federal | All Federal judicial districts |

# 1997 Workbook



# What's New: Rulings and Cases

## Accounting

Filing Form 3115
Announcement 97-59

**Requirements respecting the adoption of change of accounting method; extensions of time to make elections; correction.**

### §1.1.446-1T [Corrected]

**Paragraph 1.** On page 26741, column 1, §1.446-1T, paragraph (e)(3)(i)(B) is corrected to read as follows:

(B) **For any Form 3115 filed on or after May 15, 1997,** to secure the Commissioner's consent to a taxpayer's change in method of accounting, the taxpayer must file the Form 3115 with the Commissioner during the taxable year in which the taxpayer desires to make the change in method of accounting.

### Change in Accounting—Automatic Consent Procedures

**Rev. Proc.** 97-37, 1997—33 I.R.B. 24

**Easier rules for changing accounting methods provided for in Rev. Proc. 97-37—automatic consent procedures (no fee) described.**

**Automatic Consent.** Pursuant to Treas. Reg. §1.446-1(e)(2)(i), the consent of the Commissioner is granted to any taxpayer within the scope of the procedure to change a method of accounting, provided the taxpayer complies with all the applicable provisions of the revenue procedure.

**Timely Duplicate Filing Requirement.** **In general.** A taxpayer changing a method of accounting pursuant to this revenue procedure must complete and file an application in duplicate. **The original must be attached to the taxpayer's timely filed (including extensions) original federal income tax return for the year of change.** [A copy of the application must be filed with the national office (see §6.02(6) of this revenue procedure for the address) no earlier than the first day of the year of change and no later than when the original is filed with the federal income tax return for the year of change.

**No User Fee.** A user fee is not required for an application filed under this revenue procedure, and the receipt of an application filed under this revenue procedure will not be acknowledged.

**Note:** The automatic changes (without fee) are listed starting on page 28 of 1997-33 I.R.B. in the section labeled "Appendix."

Below is a brief description of the items for which automatic changes are allowed. See the **Rev. Proc.** for details, requirements, and limitations.

## Section 1. Trade or Business Expenses (§162)

- **.01 Advances made by a lawyer on behalf of clients—Description of change and scope.** This change applies to a lawyer handling cases on a contingent fee basis that advances money to pay for costs of litigation or for other expenses on behalf of clients and that wants to change the method of accounting for such advances from treating them as deductible business expenses to treating them as loans.

## Section 2. Depreciation or Amortization

- **.01 Claiming less than the depreciation or amortization allowable.**

  **(1) Description of change.** (a) This change applies to a taxpayer that wants to change from an impermissible method of accounting for depreciation or amortization (depreciation) under which the taxpayer claimed less than the depreciation allowable, to a permissible method of accounting for depreciation under which the taxpayer will claim the depreciation allowable. The taxpayer has the option of either making the change in method of accounting under this revenue procedure or requesting permission to make the change under Rev. Proc. 97-27, 1997-21 I.R.B. 10. This change was formerly provided in Rev. Proc. 96-31, 1996-1 C.B. 714.

- **Section 3. Capital Expenditures (§263)**

  **.01 Package design costs. (1) Description of change and scope.** This change applies to a taxpayer that wants to change to one of the three alternative methods of accounting for package design costs described in §5 of Rev. Proc. 97-35, page 11. The three alternative methods of accounting for package design costs described are (1) the capitalization method, (2) the design-by-design capitalization and 60-month amortization method, and (3) the pool-of-cost capitalization and 48-month amortization method. This change was formerly provided in Rev. Proc. 90-63, 1990-2 C.B. 664.

- **Section 4. Uniform Capitalization (§263A)**

  **.01** Certain uniform capitalization (UNICAP) methods used by small resellers, formerly small resellers, and reseller producers.

- **Section 5. Methods of Accounting (§446)**

  **.01 Cash or hybrid method to accrual method.**

- **Section 6. Obligations Issued at Discount (§454)**

  **.01 Series E or EE U.S. savings bonds. (1) Description of change and scope.** This change applies to a cash method taxpayer that wants to change its method of accounting for interest income on series E or EE U.S. savings bonds. However, this change only applies to a taxpayer that has previously made an election under §454 to report as interest income the increase in redemption price on a bond occurring in a taxable year, and that now wants to report this income in the taxable year in which the bond is redeemed, disposed of, or finally matures, whichever is earliest. This change was formerly provided in Rev. Proc. 89-46. 1989-2 C.B. 597.

- **Section 7. Prepaid Subscription Income (§455)**

  **.01 Prepaid subscription income. (1) Description of change and scope.** This change applies to an accrual method taxpayer that wants to change its method of accounting for prepaid subscription income to the method described in §455 and the regulations thereunder, including an eligible taxpayer that wants to make the "within 12 months" election under §1.455-2. This change was formerly provided, in part, in Rev. Proc. 84-76, 1984-2 C.B. 751.

- **Section 8. Taxable Year of Deduction (§461)**

  **.01 Timing of incurring liabilities for employee compensation. (1) Description of change and scope. (a) Applicability.** This change applies to an accrual method taxpayer that wants to change its method of accounting in regard to the treatment of bonuses or self-insured medical benefits.

- **Section 9. Inventories (§471)**

  **.01 Cash discounts—Description of change and scope.** This change applies to a taxpayer that wants to change its method of accounting for cash discounts (discounts granted for timely payment) when they approximate a fair interest rate, from a method of consistently including the price of the goods before discount in the cost of the goods and including in gross income any discounts taken (the "gross invoice method"), to a method of reducing the cost of the goods by the cash discounts and deducting as an expense any discounts not taken (the "net invoice method"), or vice versa. See Rev. Rul. 73-65, 1973-1 C.B. 216.

- **Section 10. Last-in, First-out (LIFO) Inventories (§472)**
- **Section 11. Bank Reserves for Bad Debts (§585)**
- **Section 12. Original Issue Discount (§1273)**
- **Section 13. Short-Term Obligations (§1281)**

**Practitioner Note.**

For examples and procedural requirements for automatic changes, see pages 38–47 and 123–32 of this book.

Rev. Rul. 96-51

**Revenue ruling allows FICA and FUTA tax deduction in year of accrual if recurring item exception is met**

**Taxes, accrual of deduction.** Under the all events test of section 461 of the Code, an accrual method employer may deduct in Year 1 its otherwise deductible FICA and FUTA taxes imposed with respect to year-end wages properly accrued in Year 1, but paid in Year 2, if the requirements of the recurring item exception are met.

Section 1.461-4(g)(6) provides generally that, if a taxpayer is liable to pay a tax, economic performance occurs as the tax is paid to the governmental authority that imposed it.

Section 1.461-5 provides a recurring item exception to the general rule of economic performance. Under the recurring item exception, a liability is treated as incurred for a taxable year if: (1) at the end of the taxable year, all events have occurred that establish the fact of the liability and the amount can be determined with reasonable accuracy; (2) economic performance occurs on or before the earlier of (a) the date that the taxpayer timely files a return (including extensions), or (b) the 15th day of the ninth calendar month after the close of the taxable year; (3) the liability is recurring in nature; and (4) either the amount of the liability is not material or accrual of the liability in the earlier year results in a better matching of the liability against the income to which it relates.

Section 1.461-5(b)(5)(ii) provides that, in the case of a liability for taxes, the matching requirement of the recurring item exception is deemed satisfied.

Note: The IRS has acquiesced to the decision of *Eastman Kodak Co. v. United States,* 534 F.2d 252 (Ct. Cl. 1976), and *Burlington Northern R.R. v. Commissioner,* 82 T.C. 143 (1984).

## Activities Not for Profit

Activities Not for Profit
I.R.C. §183

**A golfer trying to qualify for the "Seniors tour" was not in a trade or business with intent to make a profit.**

**Facts.** The taxpayer has had a life-long goal of becoming a professional golfer. He has played golf since he was 13 years old and has had a "5" handicap since age 20. He had been employed as an optical engineer for over 30 years when he was laid off in May 1991. That is when he decided to exclusively devote his time to pursuing his goal of becoming a professional golfer.

In order to qualify to participate in the PGA Seniors tour, a golfer is required to qualify **either** through a "qualifying school" or individual tournaments. In July 1991 he attempted to qualify in a "qualifying school" but failed. Later in 1991 he tried to qualify through individual tournaments. He is required to pay an entrance fee in every tournament. But to date (March 1997), he has failed to qualify in any of the tournaments he entered. The best he has done in these tournaments is to qualify as an alternate.

In an attempt to improve his skills, he took **four golf lessons** from better players he met at the tournaments. He also saw a **psychiatrist** because, according to the taxpayer, "my golfing ability is not what's wrong; it's my thought process that's a problem."

On his 1991 Schedule C, the taxpayer reported **gross income of zero and $16,384 of expenses.** After 1991, the taxpayer did not file a Schedule C for his golfing activity. When asked why not, he offered this explanation: **"I had no wage income, so how could I write off my expenses against no income?"**

He kept no formal books or records. He did keep a sheet titled "Tax Info" that listed his golfing expenses for 1991, but the amount of the expenses shown did not correspond to the expenses claimed on the 1991 Schedule C.

**Issue.** Whether the taxpayer was engaged in his golfing activity for profit within the meaning of

I.R.C. §183.

**Discussion.** I.R.C. §183(c) **defines** an activity **not engaged in for profit** as "any activity other than one with respect to which deductions are allowable for the taxable year under I.R.C. §162 or 212." The determination of whether the requisite profit objective exists is to be resolved on the basis of all the surrounding facts and circumstances of the case. **Greater weight** is to be given to the **objective facts** than to the taxpayer's **mere statement of intent.**

**Treas. Reg.** §1.183-2(b) sets forth a nonexclusive list of **nine objective factors** to be considered when determining a taxpayer's intent. These factors are:

1. The manner in which the taxpayer carries on the activity;
2. The expertise of the taxpayer or his advisers;
3. The time and effort expended by the taxpayer in carrying out the activity;
4. The success of the taxpayer in carrying on other similar or dissimilar activities;
5. The expectation that the assets used in the activity may appreciate in value;
6. The taxpayer's history of income or losses with respect to the activity;
7. The amount of occasional profits, if any;
8. The financial status of the taxpayer; and
9. The elements of personal pleasure or recreation involved in the activity.

These factors are **not merely a counting device,** where the number of factors for or against the taxpayer is determinative, but rather, all the facts and circumstances must be taken into account, and **more weight may be given to some factors than to others.**

**Holding.** After considering all of the facts and circumstances, the Court concluded that the taxpayer **failed** to carry the burden of establishing that his golfing activity was carried on with the **actual and honest objective of making a profit.**

[***Courville v. Commissioner,*** 97-1 USTC 87,677 (March 13, 1997) [CCH ¶50,315], U.S. Ct. of Appeals, 9th Circuit.]

**Editorial Comment:** The IRS also asserted the negligence penalty under I.R.C. §6662(a) against Mr. Courville in the Appeals Court case shown above. The negligence or disregard of rules and regulations penalty is equal to 20% of the portion of the underpayment of tax that is caused by negligence or disregard of rules or regulations. This penalty was **upheld** by the Appeals Court as Mr. Courville failed to present any evidence to show **reasonable cause** why he should not be held liable for the penalty.

## Hobby or Engaged in for Profit—Unforeseen Circumstances
I.R.C. §183

**Taxpayers were engaged in a horse raising business for profit even in light of substantial early losses.**

**Facts.** A couple who engaged in an Arabian horse breeding activity were engaged in the activity for profit even though, during the three years at issue, they showed tax losses of $194,235.

## Decision

Based on our review of the record, we conclude that petitioners intended that an overall profit would result from the operation of their horse activity and from the appreciation in the value of the horses once it was realized. Petitioners had a world champion Arabian, Bella Joya, which earned them a substantial amount of money. Petitioners bred Bella Joya to Wiking, another champion horse, to produce a foal that they could race. The foal, however, had to be put to sleep. Bella Joya has produced another foal, which petitioners intend to race. Additionally, the petitioners' horses were appraised in 1995 at a value of between $96,000 and $106,000.

**During the years in issue, however, taxpayers were hampered by their bankruptcy payments and by Ms. Phillips' numerous medical problems. Once they are no longer hindered by such considerations, taxpayers will be able to invest more time and money on their horse activity.**

Accordingly, based on the record, we conclude that taxpayers intended that an overall profit would result from the operation of their horse activity and from the appreciation in the value of the horses once it was realized.

**Treas. Reg. §1.183-2(b)(6)** provides that "A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit." The regulations continue: "If losses are sustained because of unforeseen or fortuitous circumstances which are beyond the control of the taxpayer,...such losses would not be an indication that the activity is not engaged in for profit [Treas. Reg. 1.183-2(b)(6)].

[***Eugene J. and Barbara A. Phillips v. Commissioner,*** T.C. Memo 1997-128, 73 T.C.M. 2296 (1997) [CCH Dec. 51,936 (M)].

## Alimony

Deduction: Alimony
I.R.C. §215(a)

**A taxpayer's payments to his ex-spouse were voluntary, not pursuant to a divorce or separation agreement. They did not constitute deductible alimony payments.**

**Facts.** The taxpayer's wife filed for divorce on Aug. 26, 1988. On Dec. 12, 1988, a court hearing was held. Based on the facts established at the court hearing, **the judge issued a *pendente lite* support order** (ordering support payments during a pending divorce suit) **on Jan. 23, 1989.** The divorce became final in April 1990. The taxpayer substantiated that he made $2,903 in support payments to his wife (now ex-wife) during 1988, which he deducted as alimony. He also deducted as alimony $2,000 that she withdrew from their joint savings account in 1988.

**Issue.** Whether the taxpayer is entitled to any alimony deduction for 1988.

**Discussion.** I.R.C. §215(a) permits a deduction for the payment of alimony during a taxable year. §215(a) defines alimony as **alimony which is includible in the gross income of the recipient under I.R.C. §71.** I.R.C. §71(b)(1) defines alimony or separate maintenance as any **cash payments** meeting the four criteria provided in I.R.C. §71(b)(1) A, B, C, and D:

(A) Such payment is received by (or on behalf of) a spouse under a divorce or separation instrument,

(B) The divorce or separation instrument does not designate such payment as a payment which is not includible in gross income under this section and not allowable as a deduction under §215,

(C) In the case of an individual legally separated from his spouse under a decree of divorce or of separate maintenance, the payee spouse and the payor spouse are not members of the same household at the time such payment is made, and

(D) There is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse.

Therefore, if any portion of the alleged alimony payments fails **to meet all four criteria,** that portion is **not** alimony and thus is **not** deductible.

One of the four criteria mentioned above [I.R.C. §71(b)(1)(A)] is that **"such payment is received by a spouse under a divorce or separation instrument."**

**Holding.** The ***pendente lite*** **court order was issued Jan. 23, 1989.** All of the claimed alimony payments were made **before** that date. **Therefore, they are considered voluntary as they were not mandated by a qualifying divorce instrument at the time they were made.** Accordingly, the payments are **not** deductible.

[***Humes Houston Hart v. Commissioner,*** T.C. Memo 1997-11, 73 T.C.M. 1684 (Jan. 7, 1997) [CCH Dec. 51,812(M)].]

## Bankruptcy

Prepetition Taxes—Bankruptcy
I.R.C. §§6871 and 7122

**Bankruptcy—The 240-day period between the date of IRS assessment of the liabilities and the date of debtor's bankruptcy petition met by taxpayer, even if a formal rejection of an offer in compromise was not issued by the IRS.**

**Facts.** The taxpayer incurred federal income tax liability for tax years 1986 and 1987 as a result of certain corporate transactions. These liabilities, in the amount of $334,516, were assessed on **July 13, 1992.** On November 19, 1992, the taxpayer filed Form 656, Offer in Compromise, for $38,000. The offer was accepted for processing on December 12, 1992, formally rejected by the IRS on February 25, 1994, and appealed by the taxpayer on April 8, 1994. On February 13, 1995, the Appeals Conferee wrote to the taxpayer, indicating that the offer, as filed, would be denied and providing specific instructions as to how to file another offer in compromise. In August 1995, the taxpayer filed a Chapter 7 bankruptcy, and on March 28, 1996, the IRS filed a resistance to the taxpayer's motion for discharge.

Form 656, Offer in Compromise, provides for the waiver and suspension of any statutory periods of limitations for assessment and collection (1) while the offer is pending and (2) one year after the satisfaction of the terms of the offer.

The IRS contended that the 240-day prepetition period was still suspended, as no rejection of the offer in compromise occurred. The Internal Revenue Manual provides that Form 1271 be used for this purpose, and Form 1271 was not part of the administrative IRS file.

The Court, however, construed the appeals letter of February 13, 1995, to constitute a "rejection" of the offer, and held that the appeals process was concluded. As such, the 240-day prepetition period, covering the days from July 13, 1992, to December 12, 1992, and from February 13, 1995, to August 6, 1995, was met, and the tax liabilities were dischargeable.

[***Charles L. Hobbs, Plaintiff v. United States of America,*** U.S. Bankruptcy Court, No. Dist. Iowa, West Div., 97-1 USTC 87,092 (1996) [CCH ¶50,127].]

Once in Lifetime Exclusion on Sale of Principal Residence
I.R.C. §121

**Bankruptcy trustee could not claim I.R.C. §121 exclusion.**

**Facts.** The debtor, Ruby P. Barden, filed a voluntary bankruptcy petition on June 7, 1993, pursuant to Chapter 7 of the Bankruptcy Code. At that time, Ms. Barden owned a residential property located in Bellport, New York. The house was subject to two mortgages totaling $63,000. Ms. Barden also had $34,000 in unsecured debt at the time of the filing. Upon the filing of the bankruptcy petition, the debtor's interest in the real property became the property of the bankruptcy estate. (11 U.S.C. §541.)

The Bellport residence was sold by the Chapter 7 Trustee on February 28, 1994, for the sum of $101,500. The two mortgages were satisfied from the proceeds of the sale, and a capital gain of $46,695 was realized, which includes the debtor's $10,000 homestead exemption pursuant to §522 of the Bankruptcy Code.

The Trustee brought a motion in the Bankruptcy Court to determine the tax liability of the estate. In that motion the Trustee argued that the estate **should be entitled to exclude the gain on the sale of the Bellport residence from income under §121 of the Internal Revenue Code, which provides a one-time capital gain exclusion to individuals over the age of 55 who realize up to $125,000 on the sale of a primary residence.**

**Decision.** "The Trustee has not identified a provision in the Tax Code that unambiguously authorizes a bankruptcy estate to exclude the capital gain realized on the sale of the debtor's residence from the estate's income. See ***Payne*** (92-1 USTC ¶50,033), 778 F.Supp. at 808.

Rather, his arguments rely on analogy and implication. **In the Court's view, the Bankruptcy Court ruled correctly that the Trustee was not entitled to make an election pursuant to 26 U.S.C. ¶121 for the benefit of the bankruptcy estate.**"

[***In Re Ruby P. Barden, Debtor,*** U.S. Ct. of Appeals, 2nd Cir.; 97-1, USTC ¶87,435 (1997) [CCH ¶50,244].]

Tax Attributes—Transfer to Bankruptcy Estate—Short-Year Election

**The taxpayer, who took Chapter 7 bankruptcy but didn't elect the short year, lost his NOL carryover to that year to the bankruptcy estate.**

**Facts and Decision.** The taxpayer had an NOL carryover to the year he declared bankruptcy (Chapter 7). However, he did not make the election under I.R.C. §1398(d) to adopt a personal short taxable year. Because he didn't, the NOL along with his other tax attributes became tax attributes of the bankruptcy estate and were not usable by the debtor taxpayer for the year of filing for bankruptcy.

[***Douglas E. and Barbara W. Kahle v. Commissioner,*** T.C. Memo 1997-91, 73 T.C.M. 2080 (1997) [CCH Dec. 51,896(M)].]

## Capital or Ordinary Expense

Depreciation: Farmers Soil Conservation Expenditures
I.R.C. §§48, 167, and 175

**The cost of 250,000 trees and bushes planted as a windbreak and as a means of reducing moisture evaporation and soil erosion were not depreciable and had to be capitalized as part of the land cost.**

Affirming a 1995 District Court decision (95-1, USTC ¶50,150), the U.S. Court of Appeals for the 9th Circuit held that the taxpayer could not depreciate nor receive tax credits for the trees and bushes that served as windbreaks.

In the same decision, the Court of Appeals reversed the District Court on the assessment of the negligence penalty relating to the above issue.

[***Gary Everson and Mary Everson, Plaintiffs-Appellants v. United States of America, Defendant-Appellee,*** U.S. Court of Appeals, 9th Circuit, 97-USTC 87,490 (1997) [CCH ¶50,258].]

(Back reference: 1995 *Farm Income Tax Book,* page 245.)

Removal of Asbestos-Containing Materials—Ordinary or Capital Expense
I.R.C. §§263, 1001, 1060

**Asbestos removal cost was part of overall remodeling project and could not be treated as an ordinary and necessary trade or business expense.**

**Issue.** The issue for decision is whether taxpayer is entitled to deduct the costs of removing asbestos-containing materials from its Douglas Street bank building.

**Facts.** After considering the circumstances, taxpayer decided to remove the asbestos-containing materials from the Douglas Street building (other than the parking garage) in coordination with the overall remodeling project. Indeed, the remodeling could not have been undertaken without disturbing the asbestos-containing fireproofing. Thus, because taxpayer chose to remodel, it became a matter of necessity to remove the asbestos-containing materials. Taxpayer essentially decided that "managing the asbestos in place" was not a viable option, given the extent of remodeling that would disturb the asbestos. The cost of removal was $1.9 million. Taxpayer claimed $902,206 of this as an ordinary and necessary business expense. The IRS disagreed.

**Decision**

The asbestos removal and remodeling were part of one intertwined project, entailing a full-blown general plan of rehabilitation, linked by logistical and economic concerns. "A remodeling project, taken as a whole, is but the result of various steps and stages." ***Bank of Houston v. Commissioner*** [Dec. 24,204(M)], T.C. Memo 1960-110. In fact, removal of the asbestos fireproofing in the Douglas Street building was "part of the preparations for the remodeling project." Before remodeling could begin, nearly every ceiling light fixture in the building was ripped down, and crews removed all the asbestos-containing materials that had been sprayed on the columns, I-beams, and decking between floors, as well as the floor tiles in the customer lobbies. Only then could the remodeling contractor perform its work. As described above, the entire project required close coordination of the asbestos removal and remodeling work.

Clearly, the purpose of removing the asbestos containing materials was first and foremost to effectuate the remodeling and renovation of the building.

**Secondarily,** taxpayer intended to eliminate health risks posed by the presence of asbestos and to minimize the potential liability for damages arising from injuries to employees and customers.

In sum, based on our analysis of all the facts and circumstances, we hold that the costs of removing the asbestos-containing materials must be capitalized because they were part of a general plan of rehabilitation and renovation that improved the Douglas Street building.

[***Norwest Corporation and Subsidiaries v. Commissioner,*** 108 T.C. #15 (1997) [CCH Dec. 52,008].]

**Taxpayer was an investor in a piece of real estate. Losses were capital.**

### Loss on Sale of Real Estate—Capital or Ordinary
### I.R.C. §§1231 and 6662

**Facts.** The taxpayer Zurcher and another person jointly purchased a lot. The other person built a residence on the lot. The property did not sell as expected, and the other person quitclaimed his interest to taxpayer. (The taxpayer provided 100% of the funds for the lot residence.) Ultimately, the taxpayer sold the property, but at a loss. He reported this $71,504 loss on Schedule C. It was the first time he filed on Schedule C for this property. The IRS claimed it was a capital loss (Schedule D).

**Decision.** **We conclude that taxpayer held the property as a capital asset.** We find that he was merely an investor in the property, rather than a developer of it. He provided an infusion of capital for Mr. Grant's development of the property, and the taxpayer did not actively participate in the property's development. Although he sold the property himself, this was a **one-time event** in which he took a relatively passive role by retaining a real estate agent to sell it for him. Moreover, he sold the property himself only because Mr. Grant, after completing construction of a residence on the property, relinquished his interest to the taxpayer in satisfaction of the money Mr. Grant owed to him.

**This is** a capital asset, and there was no oral partnership. The taxpayer was merely a financer or investor.

[***James E. Zurcher, Jr. v. Commissioner,*** T.C. Memo 1997-203, 73 T.C.M. 2697 (1997) [CCH

Dec. 52,022 (M)].]

## Corporations, Partnerships, and LLCs

Salaries—Incentive Compensation Plans—Dividends
I.R.C. §162

**Salary—Incentive compensation plans covering shareholder employees were not compensatory in nature, but were distributions of profits based on stock ownership.**

The two shareholder-employees took total salaries of $686,996 over a three-year period. In that same time period, they took "incentive" payments of $3,897,290. The total payments represented 81%, 94%, and 92%, respectively, of the corporation's net income. During these three years, the corporation never declared or paid a dividend. The "compensatory" plan applied only to shareholders and no other employees. Moreover, the plan did not use the value of services rendered as the basis for calculating the amount of compensation. Dividends, on the other hand, are merely distributions of excess earnings to shareholders in proportion to their stock holdings.

**Held.** $3,136,761 of the claimed $3,897,290 constitutes nondeductible dividends paid by the corporation.

[***O.S.C. and Associates, Inc. d.b.a. Olympic Screen Crafts v. Commissioner,*** T.C. Memo 1997-300, 73 T.C.M. 3231 (1997) [CCH Dec. 52,127(M)].]

Shareholder-Employee of Corporation—Payment of Corporate Expenses
I.R.C. §165

**Unreimbursed expenses of a corporate shareholder are not deductible, as they are expenses of the corporation.**

**Facts.** While attempting to contact potential investors for the financing of additional corporate assets, the shareholder spent $121,180 for travel, meals, legal, and other expenses. The corporation reimbursed the majority of the expenses, but $50,980 was not reimbursed.

**Holding.** The Court held that the expenses were not deductible by the shareholder, as they were the corporation's expense.

The taxpayer sought to deduct as his loss, expenses of the corporate taxpayer. "It has long been the general rule that a taxpayer may not deduct expenses incurred on behalf of another taxpayer's business [citing ***Deputy v. DuPont*** [40-1 USTC ¶9161], 60 S.Ct. 363, 366 (1940)]. Similarly, a shareholder ordinarily may not deduct expenses he has incurred on behalf of a corporation" [***Dietrick v. C.I.R.*** [89-2 USTC ¶9469], 881 F.2d 336, 338 (6th Cir. 1989) *cert. denied* 110 S.Ct. 565 (1989)]. "(T)he trade or business of a corporation is not that of its shareholders" [***Betson v. C.I.R.*** [86-2 USTC ¶9826], 802 F.2d 365 (1986)].

[***Mitchell Lambert et al., Plaintiffs v. Commissioner of Internal Revenue Service, Defendant,*** U.S. District Court, No. Dist., Ohio, West Div., 97-1 USTC 87,131 (1996) [CCH ¶50,225].]

Also see the Small Business chapter, page 104.

**Facts.** The shareholders testified in court that they had made loans either directly to the corporation or by paying the corporation's bills through their personal funds. For many of these loans there was **neither** documentation to show that the shareholders had loaned the money to the corporation **nor documentation** to show that the corporation had received the money. When the corporation filed bankruptcy, the shareholders **did not file a claim** against the corporation. They claimed the amounts paid were loans.

**Discussion and Holding.** The major component of the shareholders' evidence was their testimony. The Court felt that this was not sufficient, in light of their failure to list such sizable loans at the time of the initial returns and the impact of the loans on the corporation's balance sheet. From the standpoint of the technical side of the issue, the court considered the "debt" versus "equity" issue. In light of the ***Mixon*** case (72-2 USTC ¶9537), the following factors were considered in determining whether the advances, if and when made, were loans (debt) or contributions to capital (equity).

***"Mixon"*** factors

1. Name given to the certificates evidencing the debt
2. The presence or absence of a fixed maturity date
3. The source of payments
4. The right to enforce payment of interest and principal
5. Participation in management flowing as a result
6. The status of the contribution in relation to regular corporate creditors
7. The intent of the parties
8. "Thin" or adequate capitalization
9. Identity of interest between creditor and stockholder
10. The source of interest payments
11. The ability of the corporation to obtain loans from outside lending institutions
12. The extent to which the advance was used to acquire capital assets
13. The failure of the debtor to repay on the due date or to seek a postponement

**Based on the preponderance of the factors listed above, the Court found that the shareholders had failed to prove that the "loans" were debts and not capital contributions.**

[***Kenneth E. Rhea and Kathleen Rhea, Debtors,*** U. S. Bankruptcy Court, So. Dist. Ala., 97-1 USTC 88,179 (1997) [CCH ¶50,451].]

Reasonable Compensation

**Company salary was reasonable to sole**

**Facts.** Taxpayer's employee, Mr. Ginger (he and his wife owned all the stock), was paid a salary in 1990 of $1,069,000. (Gross profit that year was over $2.2 million.) The IRS claimed it was unreasonably high and reduced the wage deduction. The corporation had never paid dividends.

Some of the 1990 compensation was a catch-up for prior years of service.

**Decision.** Compensation was reasonable:

> Financial stability was a crucial element in taxpayer's growth strategy. Ginger knew that the company would need strong financial statements and considerable equity in order to work with the large developers. To this end, Ginger received less compensation in years prior to the years in issue. Taxpayer, as a result, retained a significant portion of its earnings and increased its equity base. After reaching its financial goals and securing a working relationship with the large developers, the company compensated Ginger for the extraordinary services he provided from 1984 to 1989.
>
> The relationship in this case, where Ginger and wife were the taxpayer's sole shareholders, warrants scrutiny. The mere existence of such a relationship, coupled with an absence of dividend payments, however, **does not necessarily lead to the conclusion that the amount of compensation is unreasonably high.** They are relevant factors but are not viewed in isolation. Furthermore, we shall not presume a disguised dividend from the bare fact that a profitable corporation does not pay dividends. ***Owensby & Kritikos, Inc. v. Commissioner*** [87-2 USTC ¶9390], 819 F.2d 1315, 1326-1327 (5th Cir. 1987), affg. [Dec. 42,133(M)] T.C. Memo. 1985-267.
>
> **Note:** The taxpayer had a good expert whom the court believed.

[***John L. Ginger Masonry, Inc. v. Commissioner,*** T.C. Memo 1997-251, 73 T.C.M. 2921 (1997) [CCH Dec. 52,071(M)].]

### Discharge of Indebtedness Income—Stock Basis Increase
I.R.C. §§61, 108, 1366, 1367

**Discharge of indebtedness income is an item of income that increases a shareholder's stock basis.**

**Issue.** The issue was whether taxpayers were entitled to claimed S corporation losses of approximately $1 million, which in turn depended upon whether taxpayers could increase their respective adjusted bases in the S corporation stock by their pro rata allocation of discharge of indebtedness income.

**Facts.** Taxpayers were shareholders in P.D.W. & A., Inc. (PDW&A), a Colorado corporation. In 1991, PDW&A had an election in effect to be taxed as a subchapter S corporation. Effective January 1, 1992, PDW&A revoked its S corporation election.

PDW&A was a partner in Parker Properties Joint Venture (Parker). Parker realized $4,154,891 in discharge of indebtedness income in 1991. PDW&A's distributive share of Parker's discharge of indebtedness income in 1991 **was $2,021,296.** At the time that Parker realized the discharge of indebtedness income, PDW&A was insolvent to the extent of $2,181,748.

**IRS Position.** If the Court were to hold that excluded COD [cancellation (discharge) of indebtedness] is an item of income under Code §1366, then the Court would have to find that it flows through to the taxpayers and they increase their basis. The IRS's position is that it's not an item of income and never flows through.

**Decision.** We hold that discharge of indebtedness is an "item of income" for purposes of determining a shareholder's basis in S corporation stock by its inclusion in the definition of gross income under §61(a)(12).

[***Phillip D. and Eleanor G. Winn v. Commissioner*,** T.C. Memo 1997-286, 73 T.C.M. 3167 (1997) [CCH Dec. 52,112(M)].]

## Termination of a Partnership under §708(b)(1)(B)
TD 8717

**This document contains final regulations relating to the termination of a partnership upon the sale or exchange of 50% or more of the total interest in partnership capital and profits within a 12-month period. The final regulations affect all partnerships that terminate under §708(b)(1)(B).**

**Agency.** Internal Revenue Service (IRS), Treasury.

**Action.** Final regulations.

**Dates.** These regulations are effective May 9, 1997.

For applicability dates, see Effective Dates.

**Explanation of Provisions.** Section 708(b)(1)(B) provides that, for purposes of §708(a), a partnership shall be considered terminated if within a 12-month period there is a sale or exchange of 50% or more of the total interest in partnership capital and profits. **The existing regulations under §1.708-1(b)(1)(iv) provide that, if a partnership is terminated by a sale or exchange of an interest, the following is deemed to occur: The partnership distributes its properties to the purchaser and the other remaining partners in proportion to their respective interests in the partnership properties; and, immediately thereafter, the purchaser and the other remaining partners contribute the properties to a new partnership, either for the continuation of the business or for its dissolution and winding up.**

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**The final regulations adopt the proposed regulations and change the mechanics of a termination under §708(b)(1)(B)** so that the following is deemed to occur on a termination: The partnership contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, immediately thereafter, the partnership liquidates by distributing interests in the new partnership to the purchaser and the other remaining partners, followed by the continuation of the business by the new partnership or its dissolution and winding up.

**The final regulations amend the regulations under §704(b)** to provide that the deemed contribution of assets to a new partnership and the distribution of the new partnership interests to the partners of the terminated partnership **are disregarded for purposes of maintaining capital accounts.**

As a result, the termination of a partnership does not change the capital accounts of the partners or the books of the partnership and the deemed contribution of assets to a new partnership **does not create additional §704(c) property.**

The final regulations also provide that the new partnership is not bound by the §704(c) method used by the terminated partnership.

A §708(b)(1)(B) termination no longer triggers recapture of the investment tax credit under the "mere change in form" exception in §1.47-3(f) of the regulations.

The §731(c) final regulations, December 26, 1996 (61 FR 67936), provide that the deemed distribution of partnership interests under §1.708-1(b)(1)(iv) does not trigger the application of §731(c).

**The final regulations provide that the regulations may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply the regulations to the termination in a consistent manner.**

The final regulations also provide an example illustrating the mechanics of a termination under §708(b)(1)(B).

In addition, the final regulations provide that the new partnership **retains the TIN** of the terminated partnership.

However, if the new partnership has already applied for a new TIN, the partnership should continue to use the new TIN.

**Effective Date.** These regulations apply to terminations of partnerships under §708(b)(1)(B) occurring on or after May 9, 1997; however, these regulations may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply these regulations to the termination in a consistent manner.

Definitions under Subchapter S of the Internal Revenue Code TD 8696

**Treasury issues final regulations related to S corporation and shareholder terminations.**

**Agency.** Internal Revenue Service (IRS), Treasury.

**Action.** Final and temporary regulations.

**Summary.** This document contains final regulations for S corporations and their shareholders relating to the definitions and the special rule provided in §1377 of the Internal Revenue Code. The final regulations reflect changes to the law made by the Subchapter S Revision Act of 1982 and the Small Business Job Protection Act of 1996. These final regulations are necessary to provide guidance for taxpayers to comply with the law.

**Effective Date.** These regulations are **effective January 1, 1997.**

## Explanation of Provisions

**Days on Which Stock Has Not Been Issued.** Section 1366(a)(1) requires a shareholder of an S corporation to take into account the shareholder's pro rata share of the corporation's items of income, loss, deduction, and credit. Section 1377(a) provides that, except in the case of an election under §1377(a)(2), each shareholder's pro rata share of any item for any taxable year shall be the sum of the amounts determined with respect to the shareholder by assigning an equal portion of such item to each day of the taxable year, and then by dividing that portion pro rata among the shares outstanding on such day. The proposed regulations provide that solely for purposes of determining a shareholder's pro rata share of an item, an S corporation's taxable year does not include any day on which the corporation has no shareholders.

**The final regulations revise the rule concerning no shareholder days and provide that, solely for purposes of determining a shareholder's pro rata share of an item for a taxable year under §1377(a), the beneficial owners of the corporation are treated as the shareholders of the corporation for any day on which the corporation has not issued any stock.**

## When a Post-Termination Transition Period Arises

The proposed regulations provide that a post-termination transition period (PTTP) arises following the termination under §1362(d) of a corporation's S election. By example, the proposed regulations state that a PTTP arises when a C corporation acquires the assets of an S corporation in a transaction to which §381(a)(2) applies.

The final regulations clarify that, pursuant to the rule in §1377(b)(1), a PTTP arises the day **after the last day that an S corporation was in existence if a C corporation acquires the assets of an S corporation in a transaction to which §381(a)(2) applies.**

## Changes to §1377 Made by the Small Business Job Protection Act of 1996

**Agreement to Terminate Year.** Section 1306 of the Small Business Job Protection Act of 1996 amended §1377(a)(2) to provide that only the affected shareholders and the corporation must consent to an election to treat the corporation's taxable year as two taxable years in the event of a complete termination of a shareholder's interest in the corporation.

In addition, the terminating election under §1377(a)(2) applies only to the affected shareholders [H.R. Conf. Rep. No. 104-737, 104th Cong. 2d Sess. 222 (1986)].

The term *affected shareholders* is defined as the shareholder whose interest is terminated and all shareholders to whom the shareholder has transferred shares during the taxable year. If the shareholder has transferred shares to the corporation, *affected shareholders* include all persons who are shareholders during the taxable year.

**Expansion of Post-Termination Transition Period.** Section 1307(a) of the Small Business Job Protection Act of 1996 expands the definition of PTTP under §1377(b)(1) to include the 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer that follows the termination of the S corporation's election and that adjusts a subchapter S item of income, loss, or deduction of the S corporation during the S period. In addition, the definition of *determination* is expanded to include any determination under §1313(a). The effect of this change is to expand the definition of *determination* to include a final disposition by the Secretary of a claim for refund and certain agreements between the Secretary and any person relating to the tax liability of the person. **The final regulations reflect these changes made to §1377(b) by §1307 of the Small Business Job Protection Act of 1996.**

## Coordination with Other Provisions and Other Clarifying Changes

**The final regulations revise the shareholder consent rules by removing the written consent requirement for each shareholder. The final regulations merely require an S corporation to include a statement by the corporation that each affected shareholder and the corporation consent to the election.**

**The final regulations clarify that a shareholder's entire interest in an S corporation is not terminated if the shareholder retains ownership of any stock, including an interest treated as stock under §1.1361-1(1), that would result in the shareholder continuing to be considered a shareholder of the corporation for purposes of §1362(a)(2).**

In addition, the final regulations clarify that a shareholder whose entire interest in an S corporation is terminated in an event for which a terminating election was made is not required to consent to an election under §1377(a)(2) for a subsequent termination of another shareholder within the taxable year unless the shareholder is an affected shareholder with respect to the subsequent termination.

**Effective Date.** These regulations apply to taxable years of an S corporation beginning after December 31, 1996.

**In this notice, the IRS describes the temporary QSSS election procedure.**

## Subchapter S Corporation Subsidiaries
Notice 97-4

**Purpose.** Section 1308 of the Small Business Job Protection Act of 1996 modified §1361 of the Internal Revenue Code to permit an S corporation (1) to own 80% or more of the stock of a C corporation, and (2) to elect to own a qualified subchapter S subsidiary (QSSS).

To help taxpayers comply with the law, the Department of the Treasury and the Internal Revenue Service intend to issue regulations interpreting §1308 of the Act.

**Background.** **Prior law** prohibited a subchapter S corporation from owning 80% or more of the stock of another corporation. Furthermore, an S corporation could not have a corporation as a shareholder. Congress modified these constraints by enacting §1308 of the Act, effective for taxable years beginning after December 31, 1996.

By removing §1361(b)(2)(A), **the Act permits an S corporation to own 80% or more of a C corporation. At the same time, new §1504(b)(8) prevents an S corporation from joining in the filing of a consolidated return with its affiliated C corporations, but does not prevent the C corporation subsidiary from filing a consolidated return with its affiliated C corporations.** *See* H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 224 (1996).

**Under prior law,** the S election of a corporation with C earnings and profits terminated if that S corporation received passive income, including dividends, in excess of 25% of gross receipts for three consecutive years. **Section 1363(d)(3)(F) modifies that general rule by excluding dividends from passive investment income to the extent that the dividends are attributable to the active conduct of a trade or business of a C corporation in which the S corporation has an 80% or greater ownership interest.**

However, neither the Act nor the legislative history provides rules for determining the attribution of dividends to an active trade or business.

**New §1361(b)(3)(B) defines the term "qualified subchapter S subsidiary" as a domestic corporation that is not an ineligible corporation, if (1) an S corporation holds 100% of the stock of the corporation and (2) that S corporation elects to treat the subsidiary as a QSSS.**

Section 1361(b)(3)(A) provides that a corporation that is a QSSS is **not treated** as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit of the QSSS **are treated as assets, liabilities, and items of income, deduction, and credit of the parent S corporation.**

The statutory provisions **do not provide guidance on how the corporation makes the election, the effective date of the election, or how the commingling of assets, liabilities, and other items occurs after the election is made.**

The legislative history, however, indicates that when the parent corporation makes the election, **the subsidiary will be deemed to have been liquidated under §§332 and 337 immediately before the election is effective.** *See* S. Rep. No. 281, 104th Cong., 2d Sess. 53 (1996) (Senate Report); H.R. Rep. No. 586, 104th Cong., 2d Sess. 89 (1996) (House Report).

Where the S corporation acquires the stock of the subsidiary in a qualified stock purchase, the corporation may make an election under §338 with respect to the subsidiary.

Section 1361(b)(3)(C) provides that any QSSS that ceases to meet the requirements of §1361(b)(3)(B) will be treated **as a new corporation acquiring all of its assets** (and assuming all of its liabilities) *immediately before the cessation from its S corporation parent in a deemed exchange for the subsidiary's stock.*

Upon the termination, §1361(b)(3)(D) provides that the former QSSS (and any successor corporation) is not eligible to make either a QSSS election or an election to be treated as an S corporation before its fifth taxable year that begins after the first taxable year for which the termination is effective, unless the Secretary consents to the election.

**Temporary QSSS Election Procedure.** The legislative history supporting §1308 of the Act indicates that when a parent corporation makes an election to treat a subsidiary as a QSSS, the subsidiary will be deemed to have liquidated under §§332 and 337 immediately before the election is effective. *See* Senate Report at 53; House Report at 89.

When a corporation liquidates under §332, that corporation must file a **Corporate Dissolution or Liquidation Form 966 within 30 days of the adoption of a liquidating plan or resolution.** In addition, that corporation must file a return for the short period ending on the date that it goes out of existence.

Until regulations are issued, however, taxpayers should follow the procedures listed **in this notice** to satisfy the election requirements.

To make the QSSS election, the parent corporation **should file a Form 966 with the Service Center. When completing the form, the parent corporation should follow the instructions applicable to that form with the following modifications:**

1. At the top of the Form 966, print "FILED PURSUANT TO NOTICE 97-4."
2. In the box labeled "Employer identification number" (EIN), enter the subsidiary's EIN (if applicable). If the subsidiary was not in existence prior to the time of election and does not have an EIN, there will be no need to obtain a taxpayer identification number for the subsidiary. In this case, insert "QSSS" in the box. (If the parent corporation chooses to obtain an EIN for the newly-formed QSSS, the parent should check "Other" when asked the "Type of entity" on the SS-4, and specify that the entity is a QSSS.)
3. In Box 4 on Form 966, enter the desired effective date for the election. The election may be effective on the date Form 966 is filed or up to 75 days prior to the filing of Form 966, provided that date is not before the effective date of §1308 of the Act and that the subsidiary otherwise qualified as a QSSS for the entire period for which the retroactive election is in effect. For these purposes, the requirement that Form 966 be filed within 30 days of the date in box 4 is ignored.
4. In box 7c on Form 966, enter the name of the parent. The parent's EIN should be included in box 7d.
5. In box 10 on Form 966, enter "§1361(b)(3)(B)."
6. Form 966 must be signed by a corporate officer authorized to sign the parent's tax return.

Banks and bank holding companies should consult Notice 97-5, 1997-2 I.R.B., before filing an election under the procedures listed above.

See pages 308–13 of this book for a thorough discussion and a copy of the new form.

LTR 9649028, September 6, 1996
Code §1362

**Company's rental income not passive investment income. Facts of involvement are critical.**

This Company requested a ruling that the rental income received by Company is not passive investment income under §1362(d)(3)(D)(i) of the Internal Revenue Code. Company represents the facts as follows.

Company was incorporated as a C corporation. Company seeks to elect S corporation status. Company anticipates having C corporation retained earnings and profits after making its S election.

Company owns real property, commonly known as Building. The premises are improved with a structure containing x commercial units on y floors. Company has entered into rental agreements with its tenants for each commercial unit. The rental income received by Company is its sole source of income.

Company has hired Manager as a maintenance company to make certain structural repairs and alterations to the commercial units. One of the shareholders of Company is the sole shareholder of Manager. At the cost and expense of Company, Manager has gutted certain units; replaced or repaired plumbing systems and appliances, electrical systems and fixtures, windows, doors, lights, walls, and ceilings; performed routine upkeep and odd job services to permit the subject premises to be and remain suited for each tenant's purposes.

In addition, Company performs a variety of functions for the rental operations including: security of the premises; installation and maintenance of tenants' door signs; access to storage space for tenants; providing financial aid through rent concessions; refuse removal; snow removal; landscaping; cleaning of the building; providing water, heat, and air conditioning; maintenance of elevator and boiler; repair of roof and parking lot; interviewing and screening of prospective tenants; negotiation of lease agreements; billing and collection; inspection of premises; filing all federal, state, and local tax reports; and payment of bills and payroll.

Section 1.1362-2(c)(5)(ii)(B)(2) provides that the term "rents" does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in an active trade or business of renting property **only if, based on all the facts and circumstances, the company provides significant services or incurs substantial costs in the rental business.**

Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases.

Whether significant services are performed or substantial costs are incurred in the rental business is determined based **upon all the facts and circumstances** including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

Based solely on the facts as presented in this ruling request, and viewed in light of the applicable law and regulations, we conclude that Company's rental income is **not passive investment income** within the meaning of §1362(d)(3)(D)(i).

## Credits

**IRS issues notice explaining the procedure for claiming qualified adoption expenses.**

### Adoption Assistance
Notice 97-9

This notice provides general guidance concerning the tax credit under §23 for qualified adoption expenses paid or incurred by an individual, and the exclusion from gross income under §137 for amounts paid or expenses incurred by an employer for qualified adoption expenses under an adoption assistance program. Both the credit and the exclusion are effective for taxable years beginning after December 31, 1996. They both generally terminate after December 31, 2001 (except for the credit with respect to a child with special needs).

This notice is divided into six sections. Section I explains the adoption credit. Section II explains the exclusion from gross income under an adoption assistance program. Section III describes the coordination of the credit and the exclusion. Sections IV and V cover filing and reporting requirements and the effective dates of the credit and the exclusion, respectively. Section VI invites comments on future guidance regarding the credit and the exclusion.

**Low-income housing tax credit for a period after 1995.**

### I.R.C. §42—Low-Income Housing Credit
Rev. Rul. 97-4

This revenue ruling clarifies that §502(e)(3) of the Tax Reform Act of 1986 does not prevent a taxpayer from claiming a low-income housing tax credit under §42 of the Code for a building's credit period beginning after 1995.

### Work Opportunity Tax Credit and Welfare-to-Work Tax Credit
Notice 97-54

**Certification Process.** There are two ways an employer can satisfy the requirement to obtain a certification that a worker is a member of a targeted group. First, the employer can obtain a certification from the SESA, on or before the day the individual begins work, stating that the individual belongs to a targeted group [I.R.C. §51(d)(11)(A)(i)].

Alternatively, the employer can complete a "pre-screening notice" with respect to the prospective employee on or before the day the individual is offered employment. Then, within 21 days after the individual begins work, the employer submits that notice to the SESA as part of a request for certification [I.R.C. §51(d)(11)(A)(ii)]. For this purpose, employers have been using Form 8850, Work Opportunity Tax Credit Pre-Screening Notice and Certification Request (issued September 1996).

**Revised Form 8850.** On September 20, 1997, **the IRS issued a revised and renamed Form 8850, Pre-Screening Notice and Certification Request for the Work Opportunity and Welfare-to-Work Credits.** The changes to the WOTC and the enactment of the Welfare-to-Work tax credit are reflected on a single form to simplify the certification process for prospective employees, employers, and SESAs.

## Deduction: Bad Debts

Business Bad Debt
I.R.C. §166

**The taxpayer's advances to his corporation were considered as additional capital contributions instead of loans, thereby negating any business bad debt deduction.**

**Facts.** In late 1986, the taxpayer along with other individuals incorporated a business for the purpose of operating a travel agency "National." The taxpayer acquired a 33% interest in National, and his total capital contribution was $300 (the total capital of National was $900). In May 1987, the taxpayer mortgaged his home and advanced National $74,700. At the same time, two other shareholders advanced monies to the corporation, and the funds were used, in part, to acquire an existing travel agency business.

**No repayments were ever made to the taxpayer by National for advances made, even though loan papers were prepared providing for monthly payments of principal and interest.** National subsequently defaulted on all shareholder advances and went out of business during 1989. Upon the advice of his attorney, the taxpayer claimed a **business bad debt** deduction on his 1989 income tax return for the advances that National never repaid.

**Issue.** Whether the taxpayer is entitled to a business bad debt deduction under I.R.C. §166 due to National's failure to repay his advances.

**Discussion.** I.R.C. §166(a)(1) provides that a deduction shall be allowed for debt that becomes worthless during the year. However, §166 distinguishes business bad debts from their nonbusiness counterparts.

The main issue to determine was whether the advances constituted a bona fide loan (debt) or an additional capital contribution (equity). In doing so, much weight was given to the 13-factor test as detailed in ***Estate of Mixon*** (72-2 USTC ¶9537). Elements such as thin capitalization and the use of the funds by National were reviewed in detail. The ratio of debt to equity in National was roughly 166 to 1. The shareholder advances were used to acquire an operating travel agency. That fact indicates that the advances were in the nature of a capital investment (equity) instead of funds used to satisfy the daily operating needs of National (debt).

In addition, the **intent** of the parties is a determining factor in the debt vs. equity determination. In this case, the fact that National never made any repayments, and the taxpayer did not demand repayment from the corporation, indicates that the $74,700 advance was more likely equity than debt.

**Holding.** The taxpayer is **not** entitled a business bad debt deduction for the $74,700 advance made to National. Rather, it constitutes a **contribution to capital.**

[***Thomas M. Fries v. Commissioner,*** T.C. Memo 1997-93, 73 T.C.M. 2085 (Feb. 24, 1997) [CCH Dec. 51,898(M)].]

## Depreciation

Depreciation
I.R.C. §168

**Certain assets are not component parts of a building and are eligible for shorter depreciation periods.**

**Facts.** Hospital Corporation of America (HCA) classified as tangible personal property certain assets constructed in 1985, 1986, and 1987. HCA used a five-year recovery period to depreciate these items, which included:

1. Primary and secondary electrical distribution systems allocable to the hospital's equipment
2. Branch electrical wiring and connections
3. Carpeting
4. Vinyl wall coverings
5. Vinyl floor coverings (vinyl tiles)
6. Kitchen hoods and exhaust systems

The IRS determined that these assets were **structural components** of the related buildings and **were not personal property, and that they must be depreciated over the same recovery period as the buildings.**

**Issue.** Whether a five-year recovery period can be used to depreciate the disputed assets.

**Discussion.** As with ACRS, the MACRS statutory language includes a prohibition on the use of **component** depreciation [I.R.C. §168(i)(6)]. The main issue to consider is whether the disputed assets are **personal property** as defined by I.R.C. §1245(a)(3). If they are, a five-year recovery period is permissible. The IRS position is that I.R.C. §168(f)(1), which prohibits **component** depreciation, effectively operates to change the definition of personal property to **eliminate it from §1245 property.** Rather, such property that **is attached to a building (structural components)** automatically becomes **§1250 property.** If the IRS position prevails, the disputed assets will be depreciated **over the same MACRS recovery period as the related buildings.**

**Holding.** We (the Tax Court) disagree with the IRS position. Neither the statute [I.R.C. §168(f)(1)] nor its legislative history reveals an intent by Congress to redefine §1250(c) to include property that was considered under long-standing precedent to constitute §1245 property.

The Tax Court in **Whiteco Industries Inc.** (1975) 65 T.C. 664 examined certain essential factors to see if property is inherently permanent:

1. Is the property capable of being moved, and has it in fact been moved?

2. Is the property designed or constructed to remain permanently in place?
3. Are there circumstances that tend to show the expected or intended length of affixation (i.e., are there circumstances that show that the property may or will have to be moved)?
4. How substantial a job is removal of the property, and how time-consuming is it? Is it "readily removable"?
5. How much damage will the property sustain upon its removal?
6. What is the manner of affixation of the property to the land?

We conclude that the tests developed to ascertain whether property constitutes **tangible personal property for purposes of the Investment Tax Credit** (old I.R.C. §38, which was repealed by the TRA of 1986) **are equally applicable in determining whether the property constitutes tangible personal property for purposes of MACRS.**

The general explanation of the Economic Recovery Tax Act of 1981 (ERTA) prepared by the staff of the Joint Committee on Taxation specifically states: **"The distinction between a structural component of a building, which is §1250 property, and an item of personal property that is §1245 property remains the same as under prior law."**

[***Hospital Corporation of America,*** 109 T.C. No. 2 (July 24, 1997) (CCH Dec. 52,163).]

**Editorial Comment.** This case is significant. Even though the case dealt with commercial property of a large corporation, it applies to all types of property owners, including taxpayers who own residential rental property. Therefore, the types of disputed property shown above that were previously depreciated under MACRS using either a 27.5- or 39-year recovery period are now eligible for the shorter 5-year or 7-year MACRS recovery period classification. Remember that, generally, §1245 property that has not been assigned a specific class life has a 7-year recovery period [I.R.C. §168(d)(3)(c)]. In addition, some of the disputed assets could qualify for §179 first-year expensing.

## Employee versus Independent Contractor

Employee versus Independent Contractor
I.R.C. §§62 and 401

**Ordained minister of the Assemblies of God Church ruled an independent contractor—not an employee—by the 8th Circuit Court of Appeals; *Weber* distinguished.**

**Facts.** James Alford was an ordained minister of an Assemblies of God Church in Hampton, AK during 1986, 1987, and 1988. The Assemblies of God Church is a national religious organization with its headquarters in Springfield, MO. On the joint 1986, 1987, and 1988 income tax returns, James Alford reported his ministry income and expenses on Schedule C. In doing so, he was able to deduct 100% of his ministry expenses rather than having them decreased by the 2% of AGI rule that applies to employees who must report their employment expenses on Form 2106 (Employee Business Expenses). Mr. Alford paid self-employment tax on his Schedule C reported net profits for 1986, 1987, and 1988.

The IRS examined the returns and determined that James Alford was a common-law employee rather than an independent contractor. Mr. and Mrs. Alford paid the tax deficiencies and interest for 1986, 1987, and 1988 and filed suit in District Court for refunds. The District Court ruled that Mr. Alford was an employee and denied the refund claims. The taxpayers appealed the District Court decision. The 8th Circuit U.S. Court of Appeals (states of AK, IA, MN, MO, MD, ME, and SD) heard the appeal in 1997.

James Alford signed a contract with the Hampton, AK local congregation. He was pastor of the church for a total of 10 years. He received a salary, a housing allowance, and an annual $1,000 social security (self-employment) tax allowance for the three tax years in question. In addition to his salary, he received an annual $750 Christmas bonus. The local congregation paid third parties on his behalf for his group health insurance coverage and retirement plan participation. He was provided a church credit card for gasoline, on which he charged up to $520 a year. The church provided a desk, chair, and copy machine for his use.

For the most part, he set his own schedule except, of course, for regularly scheduled church services. He was free to perform weddings, funerals, and revivals for a fee and was not required to pay over any of the fees to the church. He was not expected to pay for a substitute pastor if one was necessary.

The District Court concluded (and the IRS did not dispute) that, under the facts described, Mr. Alford **cannot be considered to have been an employee** of the Hampton, AK congregation. However, the District Court went **one step further** and considered the right of control over ordained ministers **by the regional and national offices** of the Assemblies of God Church. **After** considering that additional issue, the District Court concluded that Mr. Alford **was an employee** of the Hampton, AK congregation.

**Issue.** Whether the taxpayer is an employee or independent contractor. Should the taxpayer's ministry expenses be deducted on Schedule C or Form 2106, Employee Business Expenses?

**Discussion.** The District Court concluded that Mr. Alford was an **employee** because of the "significant control by the local congregation, through its supervision by the regional and national offices of the Assemblies of God Church." **We (the 8th Circuit Appeals Court) think the District Court erred.**

We (the 8th Circuit Appeals Court) are not convinced that the District Court properly combined the control exercised over Alford by the three separate entities in order to arrive at its decision that Alford was an **employee.** We are concerned that this rationale leaves us unable to identify Alford's actual employer.

The IRS urges us to rely on the opinion in the ***Weber*** court case [103 T.C. 378 (1994) (CCH Dec. 50,087)] and affirmed by the 4th Circuit Court of Appeals [95-2 USTC ¶50,409 (1995)] (shown on pages 255–56 of the 1995 *Farm Income Tax Book*). In ***Weber,*** both the Tax Court and the Appeals Court determined that a United Methodist minister was an **employee,** but did "not decide which **part** of the United Methodist Church **is the employer" because that was not an issue in the case. The court noted, however, "that there may be differences with respect to ministers in other churches or denominations, and the particular facts and circumstances must be considered in each case."**

That note was probably a reference to another Tax Court opinion filed the same day, ***Shelley*** [68 T.C.M. 584 (1994) [CCH Dec. 50,090(M)]]. In ***Shelley,*** a minister of the International Pentecostal Holiness Church (IPHC) was held to be an **independent contractor for the purposes of deducting business expenses. Differences in church structure between the Methodist Church and the IPHC accounted**

**for the contrary results.**

**Holding.** Clearly, the national and regional offices of the Assemblies of God Church had **little if any control over—or right to control—the "manner and means"** Alford used in accomplishing his duties as pastor at the local congregation in Hampton, AK during 1986, 1987, and 1988. We conclude that the national regional offices' right to control Alford, **in combination with the 20 common-law agency factors (Rev. Rul.** 87-41) **present in Alford's relationship with the Hampton Church, do not suffice to render Alford an employee within the meaning of the relevant provision of the tax code.**

[***Alford,*** 97-2 USTC 89,045 (June 20, 1997) [CCH ¶50,502], U.S. Ct. of Appeals, 8th circuit.]

**Editorial Comments:** As a practitioner, the important question is **what should you do when preparing 1997 tax returns of ministers? Do you treat them as independent contractors and report all ministry income and expenses on Schedule C, or should you treat them as common-law employees and deduct professional expenses on Form 2106?**

Please read and study carefully the Tax Issues of Ministers problem on pages 133–144 of this book. The information and instructions contained in that problem give the official IRS recommendations. Do not expect the IRS to acquiesce (agree) with the ***Alford*** decision. Clearly, United Methodist ministers should be treated as **employees,** not only in the 4th Circuit (states of MD, NC, SC, VA, and WV) but nationwide. At this time (September 1997), the rest is unclear.

### Allstate Agent—Self-Employed or Employee [I.R.C. §§83, 402, 1402, 3401, 6251]

**Allstate Insurance agent was treated as an employee by company but was actually an independent contractor. Various tax consequences result from the disparity.**

## Issues

1. Whether taxpayers performed services for Allstate Insurance Co. (Allstate) as employees or as independent contractors during the years at issue; and, if we find that taxpayers were independent contractors, then
2. Whether contributions made by Allstate to its pension plan and the Sears (Allstate's parent company) Savings and Profit Sharing Fund (hereinafter respectively referred to as the pension plan and the profit sharing fund, and collectively as the plans) on behalf of **Mrs. Lozon** are taxable to her when vested; and
3. Whether taxpayers should be credited with payroll taxes withheld from their income by Allstate and with payroll taxes paid by Allstate (employer's matching portion) in calculating taxpayers' self-employment tax liability.

## Findings and Decision

1. The parties have stipulated that this case has the same essential facts as ***Butts.*** We find that there are no essential facts in the instant case distinguishable from those present in ***Butts*** and no legal arguments presented by the IRS in the instant case that were not addressed and rejected in ***Butts*** and ***Mosteirin.*** **Thus, on the basis of our reasoning in *Butts v. Commissioner,* as adopted**

**and applied in *Smithwick v. Commissioner*** and ***Mosteirin v. Commissioner,* we conclude that during the years in issue the taxpayers were professionally associated with Allstate as independent contractors. In short, we decline the IRS's offer to revisit an area that has been so thoroughly explored.**

2. I.R.C. §401(a) does not apply since the taxpayer was not an employee. The contributions to Allstate's pension plan on her behalf and when vested **were not taxable** [**Treas. Reg.** §1.402(a)-1(a)(1)(i)].
3. Taxpayers may not claim credit for Allstate's portion of the FICA taxes. Section 3111 imposes a tax on employers; taxpayers have **no right** to claim Allstate's potential tax refund.
4. Taxpayers may not reduce their self-employment income by the compensation paid them by Allstate under §1402(b). Section 1402(b) only allows such a reduction for **"wages."**
5. Other than §6521, there is no authority for offsetting SECA taxes with erroneously paid FICA taxes. **With certain exceptions not relevant to this case, §6521 provides for the mitigation of the effect of the expiration of the period of limitations in certain cases in which self-employment income is incorrectly classified as wages and FICA taxes are paid (the case at bar), or wages are incorrectly classified as self-employment income and self-employment taxes are paid.** [If the correction of the error would require the refund or credit of one tax and the assessment of the other, and if the period of limitations has expired as to only one of the taxes in question, then the one tax may be credited against the other despite the expiration of the period of limitations.]

[***Lozon v. Commissioner,*** T.C. Memo 1997-250, 73 T.C.M. 2914 (1997) [CCH Dec. 52,070(M)].]

Employment Taxes—Employee versus Independent Contractor
I.R.C. §3401

**Cosmetologists working under chair-lease agreements were independent contractors under the common-law rules.**

**Facts.** A corporation operated a cosmetology business with two salons. It treated some cosmetologists as employees but signed chair-lease arrangements with others, who were treated as independent contractors. Several workers began as employees and switched to chair leases, receiving both a Form W-2 and a Form 1099 for different portions of the same year. The corporation scheduled all appointments, set basic prices, and collected all receipts. All the cosmetologists were licensed and performed essentially the same duties. The **employees** worked assigned hours, were paid an hourly wage, were required to attend training sessions, were supplied with all materials, and were assigned clients.

The **lessees** were charged a percentage of their gross weekly receipts as rent. They furnished their own personal equipment and supplies, although many purchased supplies from the corporation as a matter of convenience. They had their own keys and could set their own schedules (with notice to the corporation) and hire assistants. They were **not** required to attend training sessions or participate in coupon promotions and **could refuse walk-in customers.** They received no pension or insurance coverage, and were responsible for obtaining worker compensation and liability insurance.

**First Issue.** Whether the corporation qualifies for potential employment tax relief under §530 of the Revenue Act of 1978.

Discussion. The safe harbor of §530 requires consistent treatment of workers as nonemployees. The employee and chair-lease cosmetologists performed basically the same duties (hair cutting, coloring, waving, and styling). Some workers changed status during a year.

Holding. The standard is **not** met and §530 does **not** apply.

**Second Issue.** Whether the **lessees** are common-law employees subject to withholding.

Discussion. Several factors are applied to determine whether a worker is a common-law employee. The court looked at the right to control the manner or means of providing services, skill required, source of instrumentalities and tools, location of work, duration of relationship, ability to assign additional projects, worker's discretion over working hours, method of payment, hiring and paying assistants, integration of business, employee benefits, and intent of the parties. No one factor is decisive on its own.

Holding. The court stated that it was "another close case," but the factor of control carried the most weight. **The lessees are independent contractors, not employees.**

[***Ren-Lyn Corp. v. USA,*** 97-1 USTC 87,901 (April 4, 1997) (CCH ¶50,385) (Northern District of Ohio).]

**Editor's Note:** This ordering of issues is now followed by the Internal Revenue Service during employment tax examinations. Since §530 criteria generally are less complex than the common-law tests for employee status, §530 is looked at first. If the business would qualify for §530 relief, time is not wasted on employee status determinations. Workers wanting a determination of their own status can file Form SS-8 for an individual ruling.

Announcement 97-52

**Extension of test of employment tax early referral procedures for appeals.**

**Summary.** **This document extends the test of the employment tax early referral procedures set forth in Announcement 96-13, 1996-12 I.R.B. 33, for an additional one-year period beginning on May 27, 1997.**

## Extension of Test of Employment Tax Early Referral Procedures for Appeals

**Summary.** **The purpose of early referral for employment tax issues is to resolve them more expeditiously through simultaneous action by the District and Appeals.**

Announcement 96-13 describes the method by which a taxpayer requests early referral of one or more unagreed employment tax issues from the District to Appeals.

A taxpayer may request early referral of any developed, unagreed employment tax issue, including the application of §530 of the Revenue Act of 1978, that is under the jurisdiction of the District Director arising from an audit.

This document extends the test of the procedure set forth in Announcement 96-13 **for an additional one-year period beginning on May 27, 1997.**

Section 530(e)(3) of the Revenue Act of 1978, as amended by the Small Business Job Protection Act of 1996, generally effective after December 31, 1996, clarifies that the first step in any case involving whether the business has the employment tax obligations of an employer with respect to workers is determining whether the business meets the requirements of §530. If so, the business will not have an employment tax liability with respect to the workers at issue. **As a result, IRS examiners will now consider the taxpayer's eligibility for relief under §530 of the Revenue Act of 1978 before initiating any examination of the relationship between a business and a worker.**

The application of §530 of the Revenue Act of 1978 is considered an appropriate issue for early referral under §2.02 of Announcement 96-13. Taxpayers that disagree with the District's determination regarding the application of §530 of the Revenue Act of 1978 **have the option of immediately requesting early referral of the issue from the District to Appeals.**

Appeals will try to resolve the §530 issue following the procedures set forth in Announcement 96-13 and Revenue Procedure 96-9, 1996-1 C.B. 575. See §6 of Announcement 96-13. If the §530 issue remains unresolved, or if it is determined that the taxpayer is not eligible for relief under §530, the case will be returned to the District for consideration of the worker classification issue(s).

## Estate and Gift Tax

### Gift Tax Annual Exclusion—Irrevocable Trust—*Crummey* Powers—Present-Interest Gifts I.R.C. §§2001 and 2503

***Crummey* powers in an irrevocable trust made gifts of a contingent remainder interest present-interest gifts eligible for the $10,000 annual exclusion.**

**Facts.** The taxpayer is the estate. In 1990 the decedent formed an irrevocable family trust and transferred a $155,000 building to the trust. The trust was for the equal benefit of decedent's two children.

Under the trust provisions, 16 contingent remainder beneficiaries were designated. Beatrice's three children and eight grandchildren were designated as contingent remainder beneficiaries in Beatrice's one-half share of the trust, and Peter's spouse and four sons were designated as contingent remainder beneficiaries in Peter's one-half share of the trust.

Beatrice and Peter, as well as the 16 contingent beneficiaries, were each given the right—following each transfer of property to the trust—to **demand from the trust an immediate distribution to them of property in an amount not to exceed the $10,000 annual gift tax exclusion under §2503(b) that was considered to be available to each beneficiary.** Each beneficiary's right to demand a distribution **lapsed 30 days after a transfer of property to the trust.** The guardian of any minor beneficiary was authorized to exercise the minor beneficiary's right to demand a distribution of property from the trust.

On April 2, 1990, within six days of decedent's transfer of the commercial building to the trust, the beneficiaries of the trust were timely notified of their rights to demand distributions of trust property of up to $10,000 each. **None of the beneficiaries exercised his or her right to demand a distribution**

**from the trust, and none of the beneficiaries required notification of future transfers of property to the trust.**

On the taxpayer's federal estate tax return, the estate treated the interests of the 16 contingent beneficiaries as qualifying for 16 annual gift tax exclusions under §2503(b) with regard to decedent's 1990 transfer of the commercial building to the trust.

**On audit of the taxpayer's federal estate tax return, the IRS denied the above 16 annual gift tax exclusions claimed by the taxpayer on the grounds that the contingent beneficiaries did not hold present interests in the trust.**

**Decision.** Where trust beneficiaries, including minor and contingent beneficiaries, are given **unrestricted rights to demand immediate distributions** of trust property, the beneficiaries generally are treated, under §2503 (b), as possessing present interests in property [***Estate of Cristofani v. Commissioner*** [Dec. 47,491], 97 T.C. 74, 84-85 (1991); see also ***Crummey v. Commissioner*** [68-2 USTC ¶12,541], 397 F.2d 82, 88 (9th Cir. 1968), affg. in part and revg. in part [Dec. 28,012(M)] T.C. Memo 1966-144; ***Perkins v. Commissioner*** [Dec. 22,082], 27 T.C. 601, 605-606 (1956)].

The contingent beneficiaries' unrestricted rights to demand immediate distributions of trust property are to be treated as present interests in property. The decedent's transfer of the commercial building to the trust qualifies for 16 annual gift tax exclusions under §2503(b) with regard to the present interests of the 16 contingent beneficiaries therein.

[***Estate of Lieselotte Kohlsaat, Deceased, Peter Kohlsaat, Co-Executor v. Commissioner,*** T.C. Memo 1997-212, 73 T.C.M. 2732 (1997) [CCH Dec. 52,031(M)].]

### Valuation of Gift—Fractional Interest—Timber Property
I.R.C. §2512

**The Court uses the income capitalization approach to value a fractional interest gift of timberland.**

**Issue.** The value of a 25% interest in certain timberland that was the subject of gifts made by Bonnie I. Barge in 1987.

**Facts.** The decedent (donor) and C.A. Barge had three children (the children): Richard, Betty, and Charlene. In 1959, C.A. Barge died. He devised his one-half interest in the timberland one-half to the decedent and one-half to the children, in equal shares (so that each child received an 8.33% undivided interest in the timberland). After the death of C.A. Barge, the decedent owned a 75% undivided interest in the timberland.

In 1976, the decedent gave a 25% undivided interest in the timberland to the children in equal shares. After the 1976 gift, the decedent owned an undivided 50% interest in the timberland, and each of the children owned an undivided interest of 16.67%.

Because of purchases and sales, in 1987 the timberland totaled approximately 44,972 acres. On or about February 6, 1987, the decedent gave an undivided 25% interest (the undivided interest) in the timberland to separate trusts established for the benefit of her 10 grandchildren (the 1987 gifts).

**The decedent reported the 1987 gifts on a U.S. Gift (and Generation-Skipping Transfer) Tax**

**Return, Form 709, for 1987. She reported the value of the 1987 gifts to be $2,450,002. In the IRS notice of deficiency for 1987, the IRS** explained that it had determined the value of the undivided interest to be $12,847,252.

## Decision

## Method of Valuation

Based on expert testimony, the taxpayer requests that we value the undivided interest in one of two ways: (1) apply a discount (50%) to 25% of the value of the timberland ($40 million) to take into account various problems relating to the ownership of an undivided fractional interest, or (2) use an income capitalization approach. Because of the possibility that, by way of an action for partition, the undivided interest could, in a reasonable amount of time, be liquidated or turned into a fee interest in some portion of the timberland, we believe that a capitalization approach is a reasonable way to arrive at a value for the undivided interest. **At the end of the partition period, a hypothetical owner of the undivided interest would receive either cash payment or a fee interest in certain acreage (a payment in kind).**

During the pendency of the action, she would (as will be shown) receive certain cash payments. We believe that we can value all of those payments and determine an appropriate discount rate.

With such data, we can determine a present value for the undivided interest. But cf. ***Harwood v. Commissioner*** [Dec. 40,985], 82 T.C. 239, 265 (1984) (declining to accept an income capitalization approach to value limited partnership interests in a family partnership engaged in the forest products business), affd. without published opinion 786 F.2d 1174 (9th Cir. 1986).

## Holding

Accordingly, using a 10% rate of return, a partition period of four years, future income of $293,000 per year during the partition period, partition costs of $662,500 (the purchaser's 50% share of $1,325,000) allocated equally over the partition period, and a value of $10,250,000 after partition, **we find the fair market value of the 1987 gift to be $7,404,649.**

[***Estate of Bonnie I. Barge, deceased, C. Richard Barge, Executor, v. Commissioner,*** T.C. Memo 1997-188, 73 T.C.M. 2615 (1997) [CCH Dec. 52,001(M)].]

Recapture of Saved Estate Tax
I.R.C. §2032A

**Cash leases to unrelated parties triggers recapture tax.**

***Hohenstein v. Commissioner,*** T.C. Memo 1997-56, 73 T.C.M. 1886 (1997) [CCH Dec. 51,859(M)]. Recapture of saved estate tax is required under I.R.C. §2032A because of postdeath cash rents to unrelated parties. Generally, under the law postdeath cash rents to related parties **triggered recapture, but see the retroactive** change in the TRA of 1997 chapter when there are cash rental arrangements to related parties (no recapture). ***Hohenstein,*** however, is correct under prior and present law because the leases were to unrelated parties.

**Facts.** The executors of decedent Hubert's substantial estate filed a federal estate tax return about a year after his death. Subsequently, petitioner Commissioner of Internal Revenue issued a notice of deficiency, claiming underreporting of federal estate tax liability caused by the estate's asserted entitlement to marital and charitable deductions. While the estate's redetermination petition was pending in the Tax Court, interested parties settled much of the litigation surrounding the estate that had begun after Hubert's death. The agreement divided the estate's residue principal, assumed to be worth $26 million on the date of death, about equally between marital trusts and a charitable trust. It also provided that the estate would pay its administration expenses either from the principal or the income of the assets that would comprise the residue and the corpus of the trusts, preserving the executors' discretion to apportion such expenses. The estate paid about $500,000 of its nearly $2 million of administration expenses from principal and the rest from income. It then recalculated its tax liability, reducing the marital and charitable deductions by the amount of principal, but not the amount of income, used to pay the expenses. The Commissioner concluded that using income for expenses required a dollar-for-dollar reduction of the deductions. The Tax Court disagreed, finding that no reduction was required by reason of the executors' power, or the exercise of their power, to pay administration expenses from income. The Court of Appeals affirmed.

**Held.** The judgment is affirmed.

[***Commissioner v. Estate of Hubert,*** U.S. Supreme Ct. 520 U.S. ____, #95-1402, (3-18-1997).]

I.R.C. §2032A—Valuation of Certain Farm, etc. Real Property
Rev. Rul. 97-13

**The 1997 interest rates to be used in computing the special use value of farm real property for which an election is made under §2032A of the Code are listed for estates of decedents, where the death of decedent is in 1997.**

This revenue ruling contains a list of the average annual effective interest rates on new loans under the Farm Credit Bank system. This revenue ruling also contains a list of the states within each Farm Credit Bank District.

Rev. Rul. 81-170, 1981-1 C.B. 454, contains an illustrative computation of an average annual effective interest rate. The rates applicable for valuation in 1996 are in Rev. Rul. 96-23, 1996-1 C.B. 198. For rate information for years prior to 1996, see Rev. Rul. 95-38. 1995-1 C.B. 184, and other revenue rulings that are referenced therein.

## Table of Interest Rates (Year of Valuation 1997)

| Farm Credit Bank District in Which Property Is Located | Interest Rate |
|---|---|
| Columbia | 8.88 |
| Omaha | 8.09 |
| | |

| | |
|---|---|
| Sacramento | 8.48 |
| St. Paul | 8.39 |
| Spokane | 8.27 |
| Springfield | 8.57 |
| Texas | 8.42 |
| Wichita | 8.21 |

## Table of Farm Credit Bank Districts

| District | States |
|---|---|
| Columbia | Delaware, District of Columbia, Florida, Georgia, Maryland, North Carolina, Pennsylvania, South Carolina, Virginia, West Virginia |
| Omaha | Iowa, Nebraska, South Dakota, Wyoming |
| Sacramento | Arizona, California, Hawaii, Nevada, Utah |
| St. Paul | Arkansas, Illinois, Indiana, Kentucky, Michigan, Minnesota, Missouri, North Dakota, Ohio, Tennessee, Wisconsin |
| Spokane | Alaska, Idaho, Montana, Oregon, Washington |
| Springfield | Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Rhode Island, Vermont |
| Texas | Alabama, Louisiana, Mississippi, Texas |
| Wichita | Colorado, Kansas, New Mexico, Oklahoma |

Rev. Rul. 96-56—Completed Gifts
[I.R.C. §2511]

**If certain conditions are satisfied, the delivery of a check to a noncharitable donee will be deemed to be complete for federal gift and estate tax purposes when the check is deposited, cashed against available funds of the donee, or presented for payment in the calendar year for which favorable gift tax treatment is sought. Rev. Rul. 67-396 modified.**

- In view of the Fourth Circuit's decision in *Metzger v. Commissioner*, 38 F.3d 118 (4th Cir. 1994) the Internal Revenue Service **has reconsidered** the rationale for the holding in Situation 1 of Rev. Rul. 67-396, 1967-2 C.B. 351.
- In *Situation 1*, the donor transferred a gift check on December 25 to a noncharitable donee, but the donee held the check until January 2 of the following year when it was cashed by the drawee bank. Rev. Rul. 67-396 concludes that the gift was not complete for federal gift tax purposes until the check was paid by the drawee bank on January 2, because prior to the check's payment, certification, acceptance by the drawee, or negotiation, the donor had not relinquished dominion and control over the funds. Prior to the occurrence of one of these events, the donor could have stopped payment and revoked the gift.
- *Metzger* holds that if a check is delivered to a noncharitable donee, for federal gift tax purposes, completion of the gift relates back to the date the check was deposited by the donee, provided the

check is paid by the drawee bank while the donor is alive and: (1) **the donor intended to make a gift;** (2) **delivery of the check was unconditional; and** (3) **the donee presented the check for payment in the year for which completed gift treatment is sought and within a reasonable time of issuance.**

- The Service will follow the *Metzger* decision.

## Holding

Rev. Rul. 67-396 is modified to provide that the delivery of a check to a noncharitable donee will be deemed to be a completed gift for federal gift and estate tax purposes **on the earlier of** (i) the date on which the donor has so parted with dominion and control under local law as to leave in the donor no power to change its disposition, or (ii) the date on which the donee deposits the check (or cashes the check against available funds of the donee) or presents the check for payment, **if it is established that:** (1) the check was paid by the drawee bank when first presented to the drawee bank for payment; (2) the donor was alive when the check was paid by the drawee bank; (3) the donor intended to make a gift; (4) delivery of the check by the donor was unconditional; and (5) the check was deposited, cashed, or presented in the calendar year for which completed gift treatment is sought and within a reasonable time of issuance.

- The result in *Situation 1* of Rev. Rul. 67-396 remains the same for two reasons: the check was not delivered unconditionally (the donor requested that the donee not deposit or cash the check for a few days) and the check was not presented for payment in the same calendar year for which completed gift treatment was sought.

## Effect on Other Documents

Rev. Rul. 67-396 is modified.

# FICA Tax

**Day laborers were employees of the individual or entity that paid them.**

Who Is the Employer—FICA and FUTA—Day Laborers
I.R.C. §3401

**Facts.** From 1980 to 1982, tenant farmers grew tobacco on Daniel Winstead's (taxpayer) land under sharecropping agreements with Winstead. Winstead operated this enterprise individually in 1980 and 1981. In 1982, he operated with his sons as the Winstead Family Partnership.

Under the sharecropping agreements, Winstead provided the sharecroppers with homes, land to farm, and equipment. He also agreed to split the costs of ordinary expenses such as fertilizer and chemicals. In return, the sharecroppers were responsible for working the land and were accountable for hired help. After the tobacco was sold, Winstead and the sharecroppers split the proceeds.

**The sharecroppers used migrant farm workers as day laborers to assist with the farming. All but two of the sharecroppers, however, were unable to pay for hired help until after the tobacco was sold each year. Winstead therefore paid the day laborers directly from his checking account, and**

**sold each year. Winstead therefore paid the day laborers directly from his checking account, and deducted this amount from the sharecroppers' share of the profits.**

The IRS assessed FICA and FUTA taxes against Winstead and the Winstead Family Partnership for the wages paid to the day laborers from 1980 to 1982. Winstead brought this action for a refund of the partial payment of FICA and FUTA taxes, asserting that neither he nor the partnership was the employer of the day laborers during the relevant period. The United States filled a counterclaim, **seeking the balance** of the unpaid taxes.

**Issue.** The only question raised by this appeal is the identity of the employer of the day laborers—Winstead and the partnership, or the sharecroppers?

## Decision

> No one other than the person who has control of the payment of the wages is in a position to make the proper accounting and payment to the United States. It matters little who hired the wage earner or what his duties were or how responsible he may have been to his common law employer. Neither is it important who fixed the rate of compensation. When it finally comes to the point of deducting from the wages earned that part which belongs to the United States and matching it with the employer's share of FICA taxes, the only person who can do that is the person who is in "control of the payment of such wages."
>
> ***Southwest Restaurant Systems*** [79-2 USTC ¶9578], 607 F.2d at 1240; **see also** ***Education Fund of Electrical Industry v. United States*** [70-1 USTC ¶9395], 426 F.2d 1053, 1057 (2d Cir. 1970)).

**It is undisputed that Winstead paid the day laborers directly from his checking account. Under §3401(d)(1), Winstead and the Winstead Family Partnership must therefore be considered employers for FICA and FUTA purposes.**

[***L. Dan Winstead v. USA,*** U.S. Ct. of Appeals, 4th Cir., 97-1 USTC 87,697 (1997) [CCH ¶50,322].]

IRS Assessment—Employers FICA Tax—Unreported Tips
I.R.C. §§3401 and 6053

**The IRS does not lack authority to assess an employer's share of FICA tax without first investigating employees to determine the tip underreporting.**

**Facts.** Morrison Restaurants operates 290 full-service restaurants under various trade names, including Ruby Tuesday. At these restaurants, tipping is customary, and the employees receive a portion of the tips either directly or indirectly through tip sharing. Morrison Restaurants routinely informs its restaurant employees that they are required to report all tips. Based on the employees' tip reports, Morrison Restaurants withholds the employees' shares of FICA taxes and then pays the employees' and employer's shares to the IRS as required by the Internal Revenue Code, 26 U.S.C. §§3102, 3111, 3401, 6051, and 6053.

**Discussion.** In 1993, the IRS notified Morrison Restaurants that one of its Ruby Tuesday restaurants, Unit 2607, would be investigated to assess compliance in tip reporting. Following a review of the records and returns of Unit 2607, the IRS assessed Morrison Restaurants an additional $10,124 in employer FICA taxes for unreported tips in 1990 and 1991. The amount of the assessment was based on a modified ***McQuatters*** formula for estimating unreported tips. *See* ***McQuatters v. Commissioner*** [CCH Dec. 32,197(M)], 32 T.C.M. (CCH) 1122 (1973) (setting forth a method of estimating the amount of tips for the purpose of collecting individual income tax on unreported tips). The IRS neither credited the individual employees' wage history accounts nor determined the amount of unreported tip income for each employee.

Morrison Restaurants paid a portion of the assessed amount and then filed suit in the district court for a refund of $3,110.71 and for abatement of the additional balance. The government filed a counterclaim for the unpaid balance of FICA taxes in the amount of $7,013.29. Each party moved for summary judgment.

**The district court granted the motion of Morrison Restaurants.** The court held that the IRS lacked the authority to assess employer FICA taxes on unreported tips in the aggregate without determining the individual employees' underreporting and without crediting the employees for the employer's share of the assessed FICA taxes. The government appealed the summary judgment.

**Conclusion and Holding.** In this appeal of the summary judgment granted in favor of Morrison Restaurants, the government argued that the IRS has statutory authority to **assess Morrison Restaurants for the employer's share of FICA taxes on unreported tips in the aggregate even if the individual employee shares are not determined and credited to the employees' wage history accounts.**

We conclude that the IRS's statutory interpretation is consistent with the structure and language of the Internal Revenue Code, the explicit purpose of the Social Security Act, and the policy of promoting accurate tip reporting.

Because the interpretation of the IRS is reasonable, we defer to the agency's statutory interpretation. Accordingly, we **Vacate** and **Remand** for proceedings consistent with this opinion.

[***Morrison Restaurants, Inc., Plaintiff-Appellee v. United States of America, Defendant-Appellant,*** U.S. Ct. of Appeals, 11th Cir., 97-2 USTC 89,394 (1997) (CCH ¶50,598). [Overturning and remanding to the District Ct., 96-1 USTC ¶50,202).]

Credit for Employer Social Security Taxes Paid on Employee Tips
I.R.C. §45B
TD 8699

**Temporary regulations removed in regard to credit for portion of employer social security taxes paid with respect to employee cash tips.**

**Summary.** This document removes the temporary regulations pertaining to the credit for employer FICA taxes paid with respect to certain tips received by employees of food or beverage establishments. The temporary regulations were published in the Federal Register on December 23, 1993. Statutory changes made by the Small Business Job Protection Act of 1996 have made these temporary regulations obsolete.

**Effective Date.** The removal of the temporary regulations if effective January 1, 1994.

The domestic employee coverage threshold amount is determined to be **$1,000 for 1997.**

LTR 9711001, January 23, 1995
Code §§3101 and 3121

**University's payment to purchase tenured faculty's tenure rights is subject to FICA tax.**

**Issue.** Whether payments made by the University to purchase tenured faculty member's rights to continuous academic year employment constitute wages for purposes of the Federal Insurance Contributions Act (FICA).

**Statement of Facts.** The University has adopted an early retirement policy whereby certain tenured faculty members ("Tenured Faculty Members") are eligible to enter into Early Retirement Agreements (the "Agreements") with the University. Pursuant to the Agreements, Tenured Faculty Members release, waive, and relinquish all tenure and other employment rights with the University **in exchange for a payment of up to 100% of the Tenured Faculty Member's final year salary.** The University adopted the early retirement policy both as a cost saving tool and as a vehicle for infusing new thoughts, ideas, and skills into the academic community.

**Law and Rationale.** In Rev. Rul. 58-301, 1958-1 C.B. 23, a taxpayer was employed under a written contract providing for five years of employment. During the second year of employment, the taxpayer and his employer agreed to cancel the remaining period of the contract. In consideration of the taxpayer's relinquishment of his contract rights, the employer paid him a specified amount during the taxable year. **The Service held that the lump-sum payment received by the taxpayer as consideration for the cancellation of his employment contract constituted gross income to the taxpayer in the taxable year of receipt and that such amount was not subject to the Federal employment and income tax withholding provisions of §3121 of the Code.**

In Rev. Rul. 75-44, 1975-1 C.B. 15, an employee acquired certain employment rights, including the right to security in his employment, as a consequence of past service under a general contract of employment. The employee subsequently entered into an agreement with his employer to perform a different type of work and to refrain from asserting the employment rights he had previously acquired. In consideration thereof, the employer agreed to pay the employee a lump sum. The Service held that the lump-sum payment received by the employee in recognition of his agreement to relinquish his employment rights constituted wages for purposes of income tax withholding.

**Holding.** Pursuant to Rev. Rul. 75-44, payment received by an employee in recognition of his agreement to relinquish employment rights acquired as a consequence of past services constitutes wages for purposes of employment taxes. Conversely, in Rev. Rul. 58-301, payment received by an employee as consideration for the cancellation of an employment contract was not subject to FICA. Rev. Rul. 58-301 is distinguishable from the instant matter because it involved the cancellation of an employment contract which, at the outset, bound the parties for a specific period of time. As indicated above, tenure is based on a faculty member's past performance of services to the University, not on negotiated contract rights. **Consequently, pursuant to Rev. Rul. 75-44, payments made to Tenured Faculty Members in accordance with the University's early retirement program are wages for purposes of FICA.**

LTR 9718001, December 10, 1996
Code §§3121 and 3401

**Referral fees paid to retired attorneys of firm subject to FICA if referrals are made prior to retirement.**

This memorandum is in response to your request for technical advice concerning whether amounts paid by Law Firm to former employees as referral fees for cases referred to Law Firm prior to the attorneys' retirements are wages for purposes of §§3121(a) and 3401(a).

**Issues.** Do referral fees paid to former employees of Law Firm for cases which such employees had referred to Law Firm prior to their retirement and which were settled favorably after their retirement constitute wages for federal employment tax purposes?

**Facts.** In Rev. Rul. 54-312, 1954-2 C.B. 327, the Service concluded that both deferred and renewal commissions received by an employee life insurance salesman for the sale of contracts of insurance are deemed to be remuneration for services performed at the time the sales were consummated and, thus, are wages.

Commissions paid by a company to one of its office employees for submitting the name of a prospective customer to whom merchandise was later sold by one of the company's regular salesmen, was held to constitute wages for all federal employment tax purposes in Rev. Rul. 69-452, 1969-2 C.B. 181.

**Conclusion.** Referral fees paid to former employees of Law Firm for cases which such employees had referred to Law Firm prior to their retirement and which were settled favorably after their retirement **constitute wages for FICA tax and income tax withholding purposes.**

## Form 1040 Items—Schedule A Items

I.R.C. §213—Medical, Dental, etc., Expenses
Rev. Rul. 97-9

**Payments for a controlled substance are illegal under federal law and not deductible.**

Amounts paid to obtain a controlled substance (such as marijuana) in violation of federal law, **are not deductible** expenses for medical care under §213 of the Code.

**Facts.** Based on the recommendation of a physician, *A* purchased marijuana and used it to treat *A*'s disease in a state whose laws permit such purchase and use.

## Gross Income

Gift Tax—Determination of What Constitutes a

**A family is allowed to split the proceeds of a $6.5 million lottery win. Existence of partnership**

**Facts.** Emerson Winkler was a retired farmer who lived in rural Armington, IL with his wife Elizabeth. They had five married children. Mr. Winkler was in poor health in 1989. His medical condition necessitated frequent trips to clinics in Urbana, IL and Rochester, MN. One or more of the Winkler children would drive Mr. Winkler to his appointments at the clinics.

On one occasion when Mr. and Mrs. Winkler and one or more of their children stopped for fuel while returning home from a clinic, someone suggested that they purchase State of Illinois lottery ("Lotto") tickets. It quickly became a family routine that on trips to or from a clinic, whichever family members were in the car would purchase three Lotto tickets when they stopped for fuel. Any family member would contribute toward the purchase of the tickets, and the driver would usually go into the store to buy the tickets. After obtaining the tickets, the driver would hand them to Mr. Winkler. Upon returning home, Mrs. Winkler would invariably place the tickets in a glass bowl in a china closet.

Family members referred to the Lotto tickets as "family tickets" and regarded them as being owned by the **entire family.** No records were maintained of exactly how much each family member contributed toward the purchase of Lotto tickets. The Winklers had no specific agreement as to how any potential winnings would be divided among them. However, the Winklers often discussed what they would do with any winnings. In this way, the purchase of Lotto tickets became a diversion for the family during Mr. Winkler's illness.

On Saturday morning, March 4, 1989, Mrs. Winkler and one daughter drove to a florist to buy flowers. The daughter reminded Mrs. Winkler that the three weekly Lotto tickets had not yet been purchased. So Mrs. Winkler stopped at a gas station and bought the tickets with her own money. The Lotto drawing was conducted by the state on Saturday night. On Sunday morning, March 5, 1989, Mrs. Winkler learned that one of the tickets was the sole winner of the weekly grand prize of about **$6.5 million dollars,** which was to paid in 20 annual installments.

Later the same day, the Winkler family contacted their accountant. Following his advice, they met with an attorney who prepared a partnership agreement. The partnership consisted of Mr. and Mrs. Winkler and their five children. The partnership agreement was executed on **March 8, 1989,** but was **dated March 4, 1989** (the day the winning ticket was purchased and the drawing was held). The name of the partnership was the E & E Family Partnership. The partnership agreement contained the following clauses:

1. "The partnership has been formed to memorialize the family's understanding concerning the purchase of lottery tickets. Tickets purchased were for the benefit of the family rather than the individual who purchased the ticket."
2. "Winnings. In the event a ticket purchased shall win, the payee shall be the partnership and the partnership's income and capital shall be distributed as follows:"

| | |
|---|---|
| Emerson Winkler (Father) | 25% |
| Elizabeth Winkler (Mother) | 25% |
| | |

| | |
|---|---|
| Each of the five children | 10% ($5 \times 10\% = 50\%$) |

Mr. and Mrs. Winkler **each** filed Gift Tax Returns on Form 709 on Feb. 12, 1990. Mr. Winkler's return reported **total gifts of $50,000.50.** This consisted of a **gift of 10 cents to each of her five children** that was labeled "Illinois Lottery Ticket #____ dated Mar. 4, 1989" plus a gift of $10,000 **in cash** to **each** of her children. The Form 709 reported that the date of the $50,000 of **cash gifts** was Dec. 16, 1989.

The IRS ignored the creation of the family partnership. The IRS position was that Mrs. Winkler purchased the winning Lotto ticket on her own behalf with her own funds and **then made a gift of a 10% interest in the ticket to each of her five children.** The IRS also objected to the unrealistic allegation on the gift tax return that Mrs. Winkler gave her share of the winning ticket to her five children **prior** to the time it was determined to be the winner (i.e., 10 cents to each child). The IRS assessed about $60,000 of additional gift tax.

**Issues.** Whether there was a valid family partnership in existence at the time Mrs. Winkler purchased the winning ticket. If so, whether Mrs. Winkler purchased the winning ticket on behalf of the partnership or on her own behalf.

**Discussion.** The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate [I.R.C. §7701(a)(2)]. Recognition of a partnership for federal tax purposes also requires that the parties **conduct some business activity.** A joint undertaking **merely to share expenses** is **not** a partnership. **Mere co-ownership of property** that is maintained, kept in repair, and rented or leased does **not** constitute a partnership. For example, if individual owners, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a partnership thereby.

**Holding.** We (the Tax Court) find that the Winklers engaged in the activity of pooling their money to purchase family Lotto tickets. They conducted this activity on a regular and consistent basis **for more than a year before March 4, 1989** (when the winning ticket was purchased). Thus, the Winklers in good faith and acting with a business purpose intended to join together in the conduct of an enterprise.

At the trial, the IRS emphasized the fact **that prior to the time Mrs. Winkler purchased the winning ticket, the Winklers did not have a specific agreement as to how they would divide proceeds. We do not find the absence of such agreement to be fatal to the existence of a partnership prior to the time she bought the winning ticket.**

Considering all of the facts and circumstances, we, the Court, find that each of the Winkler family members did in fact "own" a **capital interest** in the partnership prior to the time Mrs. Winkler bought the winning ticket. Each member of the family **contributed capital** in the form of dollar bills to purchase Lotto tickets on more than one occasion. Each member of the family, except for Mr. Winkler, also **contributed services** on more than one occasion by going into the store to purchase the tickets.

The second factual question is whether Mrs. Winkler purchased the winning Lotto tickets on behalf of the preexisting family partnership. The facts in this case show that she did not normally play games of chance, and she never purchased Lotto tickets other than the family tickets purchased in the presence of other family members. She purchased the winning ticket as one of three "family tickets" on March 4, 1989, while she was with her daughter. We find that Mrs. Winkler purchased the winning ticket on behalf of the family partnership and not as her sole property.

[***Winkler***, T.C. Memo 1997-4, 73 T.C.M. 1657 (Jan. 2, 1997) [CCH Dec. 51,805 (M)].]

Lump-Sum Severance Payments
I.R.C. §104(a)(2)

**Lump-sum severance payment was taxable and not paid for tort-type injuries.**

**Facts.** Taxpayer (Mrs. Keel) received a lump-sum severance payment from IBM in 1992 of $40,411. The amount was based on length of service and salary. Taxpayer excluded the payment from income, claiming she suffered "personal injury" from signing the settlement agreement with IBM. The IRS disagreed.

## Decision

Prior court holdings imply that there must be an existing claim. Moreover, while it need not have been previously asserted, the absence of any knowledge of the claim on the part of the employer-payer obviously has a negative impact in determining the **requisite intent** of the payment.

Taxpayers have the burden of proving the specific amounts of the payments allocable to claims of tort or tort-type damages for personal injuries. **Failure to meet this burden results in the entire amount's being presumed not be excludible.**

Where damages are received pursuant to a settlement agreement, the nature of the claim that was the actual basis for settlement controls whether such damages are excludible under §104(a)(2). ***United States v. Burke*** [92-1 USTC ¶50,254], 504 U.S. 229, 237 (1992)

**We hold that the lump-sum payment is not excludible from gross income under §104(a)(2).**

[***Witon E. and Dorothy Keel v. Commissioner,*** T.C. Memo 1997-278, 73 T.C.M. 3092 (1997) [CCH Dec. 52,104(M)].]

Gross Income, Income from Sale, Cancellation of Indebtedness
I.R.C. §61

**Court determined that a series of conditioned transfers and payments was in fact a sale that did not create discharge of indebtedness income.**

**Facts.** Taxpayers transferred proceeds of a sale of property and also its cash reserves to a creditor for a discharge of indebtedness, but all the transactions were conditioned on the other by agreement.

## Decision

Taxpayer would have us treat the cash sale and the discharge of the loans as two independent events. The record before us, however, is replete with evidence that both loans were discharged as a result of a single transaction involving the sale of encumbered property. NCNB conditioned the discharge of the loans upon the sale of the property, and Dan Associates conditioned the purchase upon that discharge. At the end of the day, NCNB had the proceeds from the sale, Dan Associates had the property, and Briarpark was relieved of the entire balance of the loans. **In the foregoing context, the arrangement among NCNB, Dan Associates, and Briarpark embodied a single transaction to sell the property securing the loans.**

> Having found that Briarpark [taxpayer] discharged the loans as a result of the sale in 1989, we turn to consider the effect of that determination upon the characterization of Briarpark's income. **The amount realized on the sale, exchange, or disposition of property encumbered by nonrecourse debt includes the entire balance of the obligation.** ***Commissioner v. Tufts: Crane v. Commissioner*** [47-1 USTC ¶9217], 331 U.S. 1 (1947); ***Lockwood v. Commissioner*** [Dec. 46,412], 94 T.C. 252 (1990). In this case, §61(a)(12) has no application to a sale or exchange of property subject to nonrecourse liabilities. ***Estate of Delman v. Commissioner*** [Dec. 36,380], 73 T.C. 15 (1979).

**Holding.** There was no cancellation of indebtedness; the transaction was a sale.

[***Briar Park, Ltd., James C. Motley, Tax Matters Partner, v. Commissioner,*** T.C. Memo 1997-298, 73 T.C.M. 3218 (1997) [CCH Dec. 52,125(M)].]

### Age Discrimination in Employment Act Recoveries
### I.R.C. §104

**Recoveries based on the Age Discrimination in Employment Act are taxable.**

There are two independent requirements a taxpayer must meet before a recovery is excludible under §104(a)(2): "First, the taxpayer must demonstrate that the underlying cause of action giving rise to the recovery is 'based upon tort or tort type rights'; and second, the taxpayer must show that the damages were received 'on account of personal injuries or sickness.' " [95-1 USTC ¶50,309], 115 S. Ct. at 2167. The Court held a settlement under the Age Discrimination in Employment Act does not satisfy either requirement and no part of the settlement was excludible under §104(a)(2). See ***Gray v. Commissioner*** [97-1 USTC ¶50,136], 104 F.3d 1226, 1227 (10th Cir. 1997).

This issue was resolved in ***Commissioner v. Schleier*** [95-1 USTC ¶50,309], 115 S. Ct. 2159 (1995).

[Not a citable U.S. Ct. of Appeals Case, but follows ***Schleier.***]

### Gross Income
### I.R.C. §86

**Taxable social security benefits must be computed without reduction for worker compensation offsets.**

**Facts.** The taxpayer's social security disability benefits were reduced by weekly worker compensation benefits paid by his employer from a self-insured fund. In computing taxable benefits, the taxpayer used the **net** social security benefit **after** the offset.

**Discussion.** I.R.C. §104(a)(1) provides that gross income does not include amounts received under worker compensation acts as compensation for personal injuries or sickness. I.R.C. §86(d)(3) provides that when social security benefits are reduced because of a worker compensation benefit, the term "social security benefit" includes the portion of the worker compensation benefit equal to the reduction. The House Committee report on Public Law 98-21 explained that if an individual were entitled to $10,000 in social security benefits but received only $6,000 because of receipt of $4,000 in worker compensation benefits, the individual is considered to have received a $10,000 social security benefit.

**Holding.** The language of I.R.C. §86 is unambiguous and contains no exceptions. The **gross** social security benefit **before offset** must be considered.

[***Willis v. Commissioner,*** T.C. Memo 1997-290, 73 T.C.M. 3183 (June 26, 1997) [CCH Dec. 52,117(M)].]

Damages Received on Account of Personal Injuries or Sickness
I.R.C. §104(a)(2)
Rev. Rul. 96-65

**Back pay received in satisfaction of a claim for denial of promotion due to disparate treatment because of employment discrimination under Title VII of the 1964 Civil Rights Act is not excludible from gross income.**

Under current §104(a)(2), back pay and damages for emotional distress received to satisfy a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII of the 1964 Civil Rights Act are not excludible from gross income. Under former §104(a)(2), as in effect before August 21, 1996, back pay received to satisfy such a claim is not excludible from gross income. However, damages received for emotional distress under that statute are excludible.

**Issue.** Are amounts received in satisfaction of a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII of the Civil Rights Act of 1964 excludible from gross income under §104(a)(2) of the Internal Revenue Code?

**Holdings.** (1) **Current §104(a)(2).** Back pay received in satisfaction of a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII **is not excludible from gross income under §104(a)(2) because it is completely independent of, and thus is not damages received on account of, personal physical injuries or physical sickness under that section. Similarly, amounts received for emotional distress in satisfaction of such a claim are not excludible from gross income under §104(a)(2), except to the extent they are damages paid for medical care (as described in §213(d)(1)(A) or (B)) attributable to emotional distress.**

(2) **Former §104(a)(2).** Back pay received in satisfaction of a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII is not excludible from gross income under former §104(a)(2).

(3) **Wages and compensation.** Back pay includible in gross income under holding (1) or (2) is "wages" for purposes of §3121 [Federal Insurance Contributions Act (FICA)], §3306 [Federal Unemployment Tax Act (FUTA)], and §3401 (federal income tax withholding), and is "compensation" for purposes of §3231 [Railroad Retirement Tax Act (RRTA)].

**Prospective Application.** Pursuant to the authority contained in §7805(b), this revenue ruling will not apply adversely to damages received under any provision of law providing tort or tort type remedies for employment discrimination for race, color, religion, gender, national origin, or other similar classifications, if the damages are received (1) on or before June 14, 1995, the date that ***Schleier*** was decided by the Supreme Court, or (2) pursuant to a written binding agreement, court decree, or mediation award in effect on (or issued on or before) June 14, 1995.

## Income In Respect of a Decedent

Income in Respect of a Decedent—Cropshare Rental Income—No Material Participation by Owner
I.R.C. §§691 and 1014(a)

**Where there was no material participation by a landlord in a cropshare arrangement, crops and livestock were items of income in respect of a decedent under §691.**

**Facts.** Decedent was a non–materially participating farmer in a cropshare lease with his son. The estate argued that the cropshare due the decedent and paid to the estate was not income in respect of a decedent under §691 and should receive a step-up in basis under §1014 to its fair market value on date of death.

**Special Note.** The court said no in this case, correctly. However, it failed to distinguish between a materially participating cropshare landlord and a non–materially participating landlord. See Rev. Rul. 58-436 on page 663 in 19**95** *Farm Income Tax Book*. **Caution:** IRS agents may **incorrectly use** this case as **authority** to deny step-up in basis for a materially participating landlord under I.R.C. §1402.

[***Estate of Vernon Gavin v. USA;*** U.S. Ct. of Appeals, 8th Cir., 97-1 USTC 88,036 (1997) [CCH ¶50,417].]

## Interest and Applicable Federal Rates

**Interest on debt used by employee to buy stock in a C corporation was subject to investment interest limitation rules.**

**Facts.** Taxpayer and his brother and cousins were all employed full-time as funeral directors in a mortuary operated by a C corporation. They purchased all the stock of that corporation from its owners (their fathers) so they could conduct the mortuary business full-time and earn a living. All the assets of the corporation were used actively in the mortuary business. The corporation had never paid interest, dividends, annuities, or royalties to any of its shareholders during its existence of 26 years. Taxpayer testified that he had no substantial investment motive when he purchased the stock.

**Issue.** Is the interest paid on indebtedness incurred by the taxpayer to purchase his share of the stock deductible as business interest, or subject to the investment interest limitations of I.R.C. §163(d)?

**Holding.** The TRA of 1986 broadened the definition of investment interest. According to I.R.C. §511(a), property held for investment includes any property that produces income of a type described in I.R.C. §469(e)(1). The Court noted that the definition applied uniformly to every taxpayer and that a taxpayer's mindset was irrelevant. The Court pointed out that if the corporation had been an S corporation or a partnership, it appeared that the taxpayer, as an active manager, would be entitled to deduct the interest without limitation on the debt incurred to purchase the stock as a direct owner of the business.

**The interest paid by the taxpayer was subject to the investment interest limitations of I.R.C. §163(d).**

[*Russon v. Commissioner*, 107 TC_____, No. 15 [CCH Dec. 51,639] (filed 11-6-96)]

**Interest—Applicable Federal Rates announced.**

**Rev. Rul. 96-49 Table 1 Applicable Federal Rates (AFR) for October 1996**

| | *Period for Compounding* | | | |
|---|---|---|---|---|
| | **Annual** | **Semiannual** | **Quarterly** | **Monthly** |
| **Short-Term** | | | | |
| AFR | 6.07 | 5.98 | 5.94 | 5.91 |
| 110% AFR | 6.69 | 6.58 | 6.53 | 6.49 |
| 120% AFR | 7.31 | 7.18 | 7.12 | 7.07 |
| 130% AFR | 7.92 | 7.77 | 7.70 | 7.65 |
| **Mid-Term** | | | | |
| AFR | 6.72 | 6.61 | 6.56 | 6.52 |
| 110% AFR | 7.40 | 7.27 | 7.21 | 7.16 |
| 120% AFR | 8.09 | 7.93 | 7.85 | 7.80 |
| 130% AFR | 8.77 | 8.59 | 8.50 | 8.44 |
| 150% AFR | 10.17 | 9.92 | 9.80 | 9.72 |
| 175% AFR | 11.90 | 11.57 | 11.41 | 11.30 |
| **Long-Term** | | | | |
| AFR | 7.13 | 7.01 | 6.95 | 6.91 |
| 110% AFR | 7.86 | 7.71 | 7.64 | 7.59 |
| 120% AFR | 8.59 | 8.41 | 8.32 | 8.27 |
| 130% AFR | 9.32 | 9.11 | 9.01 | 8.94 |

**Rev. Rul. 96-52 Table 1 Applicable Federal Rates (AFR) for November 1996**

| | *Period for Compounding* | | | |
|---|---|---|---|---|
| | **Annual** | **Semiannual** | **Quarterly** | **Monthly** |
| **Short-Term** | | | | |
| AFR | 5.96 | 5.87 | 5.83 | 5.80 |
| 110% AFR | 6.56 | 6.46 | 6.41 | 6.37 |
| 120% AFR | 7.16 | 7.04 | 6.98 | 6.94 |
| 130% AFR | 7.78 | 7.63 | 7.56 | 7.51 |
| **Mid-Term** | | | | |
| AFR | 6.60 | 6.49 | 6.44 | 6.40 |
| 110% AFR | 7.27 | 7.14 | 7.08 | 7.04 |
| 120% AFR | 7.94 | 7.79 | 7.72 | 7.67 |
| 130% AFR | 8.62 | 8.44 | 8.35 | 8.30 |
| 150% AFR | 9.98 | 9.74 | 9.62 | 9.55 |
| 175% AFR | 11.68 | 11.36 | 11.20 | 11.10 |
| **Long-Term** | | | | |
| | | | | |

| | | | | |
|---|---|---|---|---|
| AFR | 7.02 | 6.90 | 6.84 | 6.80 |
| 110% AFR | 7.73 | 7.59 | 7.52 | 7.47 |
| 120% AFR | 8.45 | 8.28 | 8.20 | 8.14 |
| 130% AFR | 9.17 | 8.97 | 8.87 | 8.81 |

**Rev. Rul. 96-57 Table 1 Applicable Federal Rates (AFR) for December 1996**

| | ***Period for Compounding*** | | | |
|---|---|---|---|---|
| | **Annual** | **Semiannual** | **Quarterly** | **Monthly** |
| **Mid-Term** | | | | |
| AFR | 6.31 | 6.21 | 6.16 | 6.13 |
| 110% AFR | 6.95 | 6.83 | 6.77 | 6.73 |
| 120% AFR | 7.59 | 7.45 | 7.38 | 7.34 |
| 130% AFR | 8.23 | 8.07 | 7.99 | 7.94 |
| 150% AFR | 9.54 | 9.32 | 9.21 | 9.14 |
| 175% AFR | 11.17 | 10.87 | 10.73 | 10.63 |
| **Long-Term** | | | | |
| AFR | 6.77 | 6.66 | 6.61 | 6.57 |
| 110% AFR | 7.46 | 7.33 | 7.26 | 7.22 |
| 120% AFR | 8.15 | 7.99 | 7.91 | 7.86 |
| 130% AFR | 8.85 | 8.66 | 8.57 | 8.51 |

**Rev. Rul. 97-1 Table 1 Applicable Federal Rates (AFR) for January 1997**

| | ***Period for Compounding*** | | | |
|---|---|---|---|---|
| | **Annual** | **Semiannual** | **Quarterly** | **Monthly** |
| **Short-Term** | | | | |
| AFR | 5.63% | 5.55% | 5.51% | 5.49% |
| 110% AFR | 6.20% | 6.11% | 6.06% | 6.03% |
| 120% AFR | 6.77% | 6.66% | 6.61% | 6.57% |
| 130% AFR | 7.35% | 7.22% | 7.16% | 7.11% |
| **Mid-Term** | | | | |
| AFR | 6.10% | 6.01% | 5.97% | 5.94% |
| 110% AFR | 6.72% | 6.61% | 6.56% | 6.52% |
| 120% AFR | 7.34% | 7.21% | 7.15% | 7.10% |
| 130% AFR | 7.96% | 7.81% | 7.74% | 7.69% |
| 150% AFR | 9.22% | 9.02% | 8.92% | 8.86% |
| 175% AFR | 10.80% | 10.52% | 10.39% | 10.30% |
| **Long-Term** | | | | |
| AFR | 6.54% | 6.44% | 6.39% | 6.36% |
| 110% AFR | 7.21% | 7.08% | 7.02% | 6.98% |
| 120% AFR | 7.88% | 7.73% | 7.66% | 7.61% |
| 130% AFR | 8.55% | 8.37% | 8.28% | 8.23% |

## Applicable Federal Rates (AFR) for February 1997

| | Period for Compounding | | | |
|---|---|---|---|---|
| | Annual | Semiannual | Quarterly | Monthly |
| **Short-Term** | | | | |
| AFR | 5.81% | 5.73% | 5.69% | 5.66% |
| 110% AFR | 6.40% | 6.30% | 6.25% | 6.22% |
| 120% AFR | 7.00% | 6.88% | 6.82% | 6.78% |
| 130% AFR | 7.59% | 7.45% | 7.38% | 7.34% |
| **Mid-Term** | | | | |
| AFR | 6.38% | 6.28% | 6.23% | 6.20% |
| 110% AFR | 7.03% | 6.91% | 6.85% | 6.81% |
| 120% AFR | 7.68% | 7.54% | 7.47% | 7.42% |
| 130% AFR | 8.33% | 8.16% | 8.08% | 8.02% |
| 150% AFR | 9.64% | 9.42% | 9.31% | 9.24% |
| 175% AFR | 11.29% | 10.99% | 10.84% | 10.75% |
| **Long-Term** | | | | |
| AFR | 6.78% | 6.67% | 6.62% | 6.58% |
| 110% AFR | 7.47% | 7.34% | 7.27% | 7.23% |
| 120% AFR | 8.16% | 8.00% | 7.92% | 7.87% |
| 130% AFR | 8.86% | 8.67% | 8.58% | 8.52% |

## Rev. Rul. 97-10 Table 1 Applicable Federal Rates (AFR) for March 1997

| | Period for Compounding | | | |
|---|---|---|---|---|
| | Annual | Semiannual | Quarterly | Monthly |
| **Mid-Term** | | | | |
| AFR | 6.42% | 6.32% | 6.27% | 6.24% |
| 110% AFR | 7.07% | 6.95% | 6.89% | 6.85% |
| 120% AFR | 7.72% | 7.58% | 7.51% | 7.46% |
| 130% AFR | 8.39% | 8.22% | 8.14% | 8.08% |
| 150% AFR | 9.70% | 9.48% | 9.37% | 9.30% |
| 175% AFR | 11.37% | 11.06% | 10.91% | 10.81% |
| **Long-Term** | | | | |
| AFR | 6.86% | 6.75% | 6.69% | 6.66% |
| 110% AFR | 7.57% | 7.43% | 7.36% | 7.32% |
| 120% AFR | 8.26% | 8.10% | 8.02% | 7.97% |
| 130% AFR | 8.97% | 8.78% | 8.69% | 8.62% |

## Rev. Rul. 97-17 Table 1 Applicable Federal Rates (AFR) for April 1997

# 1997 Workbook

| | Period for Compounding | | | |
|---|---|---|---|---|
| | Annual | Semiannual | Quarterly | Monthly |
| **Short-Term** | | | | |
| AFR | 5.91% | 5.83% | 5.79% | 5.76% |
| 110% AFR | 6.51% | 6.41% | 6.36% | 6.33% |
| 120% AFR | 7.12% | 7.00% | 6.94% | 6.90% |
| 130% AFR | 7.72% | 7.58% | 7.51% | 7.46% |
| **Mid-Term** | | | | |
| AFR | 6.49% | 6.39% | 6.34% | 6.31% |
| 110% AFR | 7.15% | 7.03% | 6.97% | 6.93% |
| 120% AFR | 7.82% | 7.67% | 7.60% | 7.55% |
| 130% AFR | 8.48% | 8.31% | 8.23% | 8.17% |
| 150% AFR | 9.82% | 9.59% | 9.48% | 9.40% |
| 175% AFR | 11.49% | 11.18% | 11.03% | 10.93% |
| **Long-Term** | | | | |
| AFR | 6.88% | 6.77% | 6.71% | 6.68% |
| 110% AFR | 7.59% | 7.45% | 7.38% | 7.34% |
| 120% AFR | 8.28% | 8.12% | 8.04% | 7.99% |
| 130% AFR | 8.99% | 8.80% | 8.71% | 8.64% |

**Rev. Rul. 97-19 Table 1 Applicable Federal Rates (AFR) for May 1997**

| | Period for Compounding | | | |
|---|---|---|---|---|
| | Annual | Semiannual | Quarterly | Monthly |
| **Short-Term** | | | | |
| AFR | 6.23% | 6.14% | 6.09% | 6.06% |
| 110% AFR | 6.86% | 6.75% | 6.69% | 6.66% |
| 120% AFR | 7.51% | 7.37% | 7.30% | 7.26% |
| 130% AFR | 8.14% | 7.98% | 7.90% | 7.85% |
| **Mid-Term** | | | | |
| AFR | 6.85% | 6.74% | 6.68% | 6.65% |
| 110% AFR | 7.55% | 7.41% | 7.34% | 7.30% |
| 120% AFR | 8.25% | 8.09% | 8.01% | 7.96% |
| 130% AFR | 8.95% | 8.76% | 8.67% | 8.60% |
| 150% AFR | 10.37% | 10.11% | 9.99% | 9.90% |
| 175% AFR | 12.15% | 11.80% | 11.63% | 11.52% |
| **Long-Term** | | | | |
| AFR | 7.18% | 7.06% | 7.00% | 6.96% |
| 110% AFR | 7.92% | 7.77% | 7.70% | 7.65% |
| 120% AFR | 8.65% | 8.47% | 8.38% | 8.32% |
| 130% AFR | 9.39% | 9.18% | 9.08% | 9.01% |

**Rev. Rul. 97-24 Table 1 Applicable Federal Rates (AFR) for June 1997**

| | Period for Compounding | | | |
|---|---|---|---|---|
| | Annual | Semiannual | Quarterly | Monthly |
| **Short-Term** | | | | |
| AFR | 6.23% | 6.14% | 6.09% | 6.06% |
| 110% AFR | 6.86% | 6.75% | 6.69% | 6.66% |
| 120% AFR | 7.51% | 7.37% | 7.30% | 7.26% |
| 130% AFR | 8.14% | 7.98% | 7.90% | 7.85% |
| **Mid-Term** | | | | |
| AFR | 6.80% | 6.69% | 6.63% | 6.60% |
| 110% AFR | 7.50% | 7.36% | 7.29% | 7.25% |
| 120% AFR | 8.19% | 8.03% | 7.95% | 7.90% |
| 130% AFR | 8.89% | 8.70% | 8.61% | 8.55% |
| 150% AFR | 10.29% | 10.04% | 9.92% | 9.84% |
| 175% AFR | 12.05% | 11.71% | 11.54% | 11.43% |
| **Long-Term** | | | | |
| AFR | 7.11% | 6.99% | 6.93% | 6.89% |
| 110% AFR | 7.84% | 7.69% | 7.62% | 7.57% |
| 120% AFR | 8.57% | 8.39% | 8.30% | 8.25% |
| 130% AFR | 9.30% | 9.09% | 8.99% | 8.92% |

**Rev. Rul. 97-27 Table 1 Applicable Federal Rates (AFR) for July 1997**

| | Period for Compounding | | | |
|---|---|---|---|---|
| | Annual | Semiannual | Quarterly | Monthly |
| **Short-Term** | | | | |
| AFR | 6.07% | 5.98% | 5.94% | 5.91% |
| 110% AFR | 6.69% | 6.58% | 6.53% | 6.49% |
| 120% AFR | 7.31% | 7.18% | 7.12% | 7.07% |
| 130% AFR | 7.92% | 7.77% | 7.70% | 7.65% |
| **Mid-Term** | | | | |
| AFR | 6.65% | 6.54% | 6.49% | 6.45% |
| 110% AFR | 7.32% | 7.19% | 7.13% | 7.08% |
| 120% AFR | 8.00% | 7.85% | 7.77% | 7.72% |
| 130% AFR | 8.68% | 8.50% | 8.41% | 8.35% |
| 150% AFR | 10.05% | 9.81% | 9.69% | 9.62% |
| 175% AFR | 11.78% | 11.45% | 11.29% | 11.19% |
| **Long-Term** | | | | |
| AFR | 6.99% | 6.87% | 6.81% | 6.77% |
| 110% AFR | 7.70% | 7.56% | 7.49% | 7.44% |
| 120% AFR | 8.41% | 8.24% | 8.16% | 8.10% |
| 130% AFR | 9.13% | 8.93% | 8.83% | 8.77% |

**Rev. Rul. 97-30 Table 1 Applicable Federal Rates (AFR) for August 1997**

| | Period for Compounding | | | |
|---|---|---|---|---|
| | Annual | Semiannual | Quarterly | Monthly |
| **Short-Term** | | | | |
| AFR | 5.87% | 5.79% | 5.75% | 5.72% |
| 110% AFR | 6.47% | 6.37% | 6.32% | 6.29% |
| 120% AFR | 7.07% | 6.95% | 6.89% | 6.85% |
| 130% AFR | 7.67% | 7.53% | 7.46% | 7.41% |
| **Mid-Term** | | | | |
| AFR | 6.39% | 6.29% | 6.24% | 6.21% |
| 110% AFR | 7.04% | 6.92% | 6.86% | 6.82% |
| 120% AFR | 7.69% | 7.55% | 7.48% | 7.43% |
| 130% AFR | 8.35% | 8.18% | 8.10% | 8.04% |
| 150% AFR | 9.66% | 9.44% | 9.33% | 9.26% |
| 175% AFR | 11.31% | 11.01% | 10.86% | 10.77% |
| **Long-Term** | | | | |
| AFR | 6.73% | 6.62% | 6.57% | 6.53% |
| 110% AFR | 7.41% | 7.28% | 7.21% | 7.17% |
| 120% AFR | 8.10% | 7.94% | 7.86% | 7.81% |
| 130% AFR | 8.80% | 8.61% | 8.52% | 8.46% |

**Rev. Rul. 97-36 Table 1 Applicable Federal Rates (AFR) for September 1997**

| | Period for Compounding | | | |
|---|---|---|---|---|
| | Annual | Semiannual | Quarterly | Monthly |
| **Short-Term** | | | | |
| AFR | 5.81% | 5.73% | 5.69% | 5.66% |
| 110% AFR | 6.40% | 6.30% | 6.25% | 6.22% |
| 120% AFR | 7.00% | 6.88% | 6.82% | 6.78% |
| 130% AFR | 7.59% | 7.45% | 7.38% | 7.34% |
| **Mid-Term** | | | | |
| AFR | 6.23% | 6.14% | 6.09% | 6.06% |
| 110% AFR | 6.86% | 6.75% | 6.69% | 6.66% |
| 120% AFR | 7.51% | 7.37% | 7.30% | 7.26% |
| 130% AFR | 8.14% | 7.98% | 7.90% | 7.85% |
| 150% AFR | 9.42% | 9.21% | 9.11% | 9.04% |
| 175% AFR | 11.04% | 10.75% | 10.61% | 10.52% |
| **Long-Term** | | | | |
| AFR | 6.55% | 6.45% | 6.40% | 6.36% |
| 110% AFR | 7.23% | 7.10% | 7.04% | 7.00% |
| 120% AFR | 7.89% | 7.74% | 7.67% | 7.62% |
| 130% AFR | 8.57% | 8.39% | 8.30% | 8.25% |

## Involuntary Conversion

**Motel was not similar or related in service to an apartment building because of taxpayer's relationship to the properties.**

LTR 9723032, March 10, 1997
Code §1033

Taxpayer has requested a ruling concerning the federal income tax consequences of the involuntary conversion of a three-unit apartment building and Taxpayer's purchase of a 14-unit motel as a replacement.

**Facts.** Taxpayer owned for the production of rental income a three-unit, three-story apartment building located at Address A. Each unit had three bedrooms, a kitchen, pantry, bathroom, dining room, living room, front porch, and rear porch. The units were unfurnished, but did contain a stove and a refrigerator. As the landlord, Taxpayer performed certain duties, such as listing and showing vacant apartments, arranging for repairs, and maintaining the grounds. Taxpayer also had difficulty collecting rent from certain tenants and handled eviction proceedings when necessary.

On June 3, 1995, the apartment building **was destroyed by fire.** At the time of the fire, Taxpayer had an adjusted basis in the apartment building of $a. Taxpayer received insurance proceeds of $b, realizing a gain of $c.

On June 16, 1995, Taxpayer purchased for $d a motel located at Address B. The motel is a single-story, 14-unit building, and includes an owner's apartment and a trailer. The trailer is rented out on a monthly basis. The motel rooms each contain a bedroom and bathroom and are rented out weekly in the winter months and nightly in the summer months. The rooms are fully furnished and include cable television and air conditioning.

In the operation of the motel, Taxpayer or his employee will take reservations, collect payments, clean the rooms, wash the bedding and towels, perform or arrange for repairs, and maintain the grounds.

**Issue.** Whether the motel is similar or related in service or use to the apartment building so that Taxpayer's realized gain from insurance proceeds attributable to the apartment building may be deferred under §1033(a) of the Internal Revenue Code to the extent the amount realized was reinvested in the motel.

**Discussion.** **The purpose of §1033 is to relieve taxpayers of unanticipated tax liability arising from involuntary conversion of their property,** by freeing them from that tax liability to the extent they reestablish their prior commitment of capital within the period provided by the statute.

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In Rev. Rul. 64-237, 1964-2 C.B. 319, the Service modified its position because of the court's opinion in ***Liant Record.*** Rev. Rul. 64-237 provides that, in determining whether a taxpayer's relationship to the original and replacement properties is similar, the Service will first consider whether the taxpayer is an owner-user or owner-investor of the properties. In cases like Taxpayer's, in which an owner-investor acquires replacement property, the Service primarily considers the similarity in the relationship of the services or uses that the original and replacement properties have to the taxpayer. In applying this test, a determination is made as to whether the properties are of a similar service to the taxpayer, the nature of the business risks connected with the properties, and what such properties demand of the taxpayer in the way of management, services, and relations to his tenants.

The Service has issued several revenue rulings that demonstrate the application of Rev. Rul. 64-237 to owner-investors. In Rev. Rul. 70-399, 1970-2 C.B. 165, a taxpayer owned a resort hotel, which was leased to and operated by another party under a net lease agreement. The resort hotel was destroyed by fire and the taxpayer used the insurance proceeds to purchase another resort hotel, which he operated himself. The ruling holds that the taxpayer could not defer the gain on the insurance proceeds under §1033(a).

In Rev. Rul. 76-391, 1976-2 C.B. 243, the taxpayer owned unimproved farmland, which it leased to tenant farmers. The farmland required no maintenance by the taxpayer. The land was involuntarily converted and the proceeds were used to construct a commercial building on other land already owned by the taxpayer. The building was suitable for leasing as five separate units, the interiors of which were not finished. The taxpayer would be responsible for the parking lot surrounding the building and would have to make physical changes to the building to accommodate new tenants. The taxpayer would also be responsible for maintenance when vacancies occurred. The ruling applies the test for owner-investors and concludes that, although both properties were for the production of rental income, a commercial or industrial building to be held for lease does not qualify as similar or related in service or use to leased farmland.

In Rev. Rul. 79-261, 1979-2 C.B. 295, the taxpayer owned an office building that it leased to tenants for the production of rental income. The office building was destroyed by a tornado and the taxpayer used the insurance proceeds to construct a new office building. The new building was partially used by the taxpayer in conducting its banking business and the remainder was leased to tenants for the production of rental income. Applying the test for owner-investors, the ruling holds, in part, that the owner-occupied portion of the new building is not similar or related in service or use to the converted property because the taxpayer, by utilizing the premises for its own use, has so changed its relationship to the property as to be outside the provisions of §1033(a).

**Conclusion.** Accordingly, based on the facts and representations submitted, we conclude that the motel is not similar or related in service or use to the apartment building. Thus, Taxpayer's realized gain from insurance proceeds attributable to the apartment building may not be deferred under §1033(a).

**Note: The exchange rules under §1031 are much more liberal than under I.R.C. §1033.**

## Rev. Rul. 96-32

**Involuntary conversion of a residence; deduction for qualified residence interest.**

If a principal residence is destroyed, and the land portion is later sold, the sale is treated as part of the involuntary conversion of the residence, if the requirements of §1033(a) are met. Taxpayers may continue to deduct otherwise deductible mortgage interest on a destroyed residence during a reasonable period between the destruction of the residence and its sale or reconstruction and reoccupation.

## Medical Savings Accounts

Medical Savings Accounts
I.R.C. §220
Rev. Rul. 97-20

**Guidance is given concerning the definition of a "high-deductible health plan" under §220(c)(2)(A) of the Code.**

**Issue.** In the case of family coverage, what constitutes a "high-deductible health plan" for purposes of §220(c)(2)(A) of the Code?

### Facts

Situation 1. Plan A is a health plan that provides for the payment of medical expenses. Taxpayer X and her family are covered by plan A. Plan A provides for payment of covered medical expenses for all members of the family after the family's total covered medical expenses exceed $3,000 for the year. Plan A does not provide for payment of covered medical expenses until the family's total covered medical expenses exceed $3,000 for the year, regardless of which family member or members incur those covered expenses. Plan A limits out-of-pocket expenses to $5,000 for any year.

Situation 2. Plan B is a health plan that provides for the payment of medical expenses. Taxpayer Y and his family are covered by plan B. Plan B provides for payment of covered medical expenses for all members of the family after the family has satisfied a family deductible of $3,000 for the year. Plan B also provides for payment of covered medical expenses of any member of the family after that family member has satisfied an individual deductible by incurring covered medical expenses for the year of at least $1,500. Plan B limits out-of-pocket expenses to $5,000 for any year.

Neither of the special rules regarding the definition of a high-deductible health plan applies to Plan A or Plan B [see §220(c)(2)(B)].

**Law.** The Health Insurance Portability and Accountability Act of 1996, P.L. 104-191, added §220 to the Code to permit eligible individuals to establish medical savings account (MSAs) under a pilot project beginning on January 1, 1997.

The §220(c)(1) definition of an "eligible individual" includes, as one prerequisite for eligibility, the requirement that an individual be covered under a high-deductible health plan. Section 220(c)(2)(A) provides that "[t]he term 'high-deductible health plan' means a health plan—

(i) in the case of self-only coverage, which has an annual deductible which is not less than $1,500 and not more than $2,250,

(ii) in the case of family coverage, which has an annual deductible which is not less than $3,000 and not more than $4,500, and

(iii) the annual out-of-pocket expenses required to be paid under the plan (other than for premiums) for covered benefits does not exceed—

(I) $3,000 for self-only coverage, and

(II)

(II) $5,500 for family coverage."

Section 220(c)(5) defines family coverage as coverage that is not self-only coverage.

## Analysis and Holding

Situation 1. Plan A provides coverage for taxpayer X and other members of her family and is, therefore, family coverage within the meaning of §220(c)(5). Because plan A provides family coverage, plan A is a high-deductible health plan only if, as required by §220(c)(2)(A)(ii), it has an annual deductible that is not less than $3,000 and not more than $4,500. Plan A provides for the payment of covered medical expenses for taxpayer X or her family members only after the family has incurred covered medical expenses during the year of $3,000. Accordingly, the deductible under plan A is $3,000. Because plan A has a deductible that is not less than $3,000 and not more than $4,500, plan A meets the requirement with respect to the minimum and maximum deductible for a high-deductible health plan under §220(c)(2)(A)(ii). **Because the annual out-of-pocket expenses required to be paid under plan A can never exceed $5,000, which is less then $5,500, plan A is a high-deductible health plan for purposes of §220.**

Situation 2. Plan B provides coverage for taxpayer Y and other members of his family and is, therefore, family coverage within the meaning of §220(c)(5). Plan B provides for the payment of covered medical expenses of any member of taxpayer Y's family if the member has incurred covered medical expenses during the year in excess of $1,500, even if the family has not incurred covered medical expenses in excess of $3,000. For example, if taxpayer Y incurred covered medical expenses of $2,000 in a year, plan B would pay $500. Accordingly, depending on which family members incur the covered medical expenses, benefits are potentially available under plan B even if the family's covered medical expenses do not exceed $3,000. Because plan B provides family coverage with an annual deductible of less than $3,000, **plan B is not a high-deductible health plan an defined in §220(c)(2).**

**Application of §7805(b).** Section 7805(b) of the Code provides that the Secretary may prescribe the extent, if any, to which any ruling relating to the internal revenue laws shall be applied without retroactive effect.

Pursuant to §7805(b), a health plan acquired before November 1, 1997 that provides family coverage that becomes effective before November 1, 1997 will not fail to be treated as a high-deductible health plan merely because the health plan provides for individual deductibles of at least $1,500 and not in excess of $2,250 (the permitted range of deductibles for a high-deductible health plan providing self-only coverage). The relief provided in the preceding sentence will apply until the first renewal date on or after December 31, 1997 (in the case of a health plan that provides for renewal), or for the term of the health plan (in the case of a health plan that has a specified term and that does not provide for renewal). For purposes of this paragraph, a health plan that continues in force for an indeterminate period as long as premiums are paid and does not otherwise provide for renewal, will be treated as a health plan that provides for renewal and each premium due date (determined without regard to any grace period) will be treated as a renewal date. In no event will the relief provided in this paragraph terminate before December 31, 1997, or extend beyond December 31, 1998.

## Medical Savings Accounts
Notice 96-53

**IRS issues detailed information on medical savings accounts**

The Health Insurance Portability and Accountability Act of 1996 added section 220 to the Internal Revenue Code to permit eligible individuals to establish medical savings accounts (MSAs) under a pilot project beginning on January 1, 1997.

This notice provides certain basic information about MSAs. It does not attempt to summarize all of the specific rules that apply.

The notice is divided into seven parts. Part I of the notice explains what MSAs are and who can have them. Part II describes how MSAs can be established. Parts III and IV cover contributions to MSAs and distributions from MSAs. Part V deals with the statutory limit on the number of taxpayers who can use MSAs. Part VI relates to information reporting by MSA trustees and custodians, and Part VII addresses other matters relating to MSAs.

## Miscellaneous

Innocent Spouse Relief
I.R.C. §6013

**It is not inequitable to hold a spouse liable for a deficiency on joint returns, when both spouses have equivalent financial knowledge.**

**Facts.** The taxpayers conceded deficiencies resulting from the disallowance of limited partnership losses and credits on their 1980–1984 joint federal income tax returns. The husband had been a police dispatcher and was a licensed real estate salesman. The wife had been a dental assistant and a licensed real estate seller. She stopped working in 1978. Thereafter, the husband earned the family's incomeand the wife handled the household finances. Their bank accounts were joint. Before investing in the partnership, both spouses met with a general partner. Both "looked" at a prospectus, but both testified they did not understand its contents. Both signed documents authorizing the investments, and both were named as partners on Schedules K-1. When they divorced in 1986, neither took substantial assets from the marriage, and both later declared bankruptcy.

**Issue.** Whether the wife qualifies for relief of tax liability as an **innocent spouse** under I.R.C. §6013(e).

**Discussion.** An **"innocent spouse"** can be relieved of liability for a deficiency if each of four elements are proved:

1. A joint return was filed;
2. The return contained a **substantial understatement** of tax due to grossly erroneous items of the other spouse;
3. The spouse seeking relief **did not know and had no reason to know** of the substantial understatement when signing the return; and
4. It would be **inequitable** to hold the spouse liable for the deficiency.

Failure to prove any one of the four elements will prevent innocent spouse relief.

**Holding.** Only the joint return test was met. **The wife is not entitled to innocent spouse relief.**

[***Pewitt v. Commissioner,*** T.C. Memo 1997-288, 73 T.C.M. 3176 (June 25, 1997) [CCH Dec. 52,115(M)].]

Basis Reduction Due to Discharge of

**Basis reduction rules due to discharge of**

**Agency.** Internal Revenue Service (IRS), Treasury.

**Action.** Notice of proposed rulemaking and notice of public hearing.

Long-Term Care Services and Insurance
Notice 97-31

**This notice provides interim guidance relating to qualified long-term care services and qualified long-term care insurance contracts under §§213, 7702B, and 4980C of the Internal Revenue Code. It is effective pending the publication of proposed regulations or other guidance.**

### Interim Guidance

**I. Chronically Ill Individual.** This section of the notice provides interim guidance including safe harbors relating to the determination of whether an individual is a "chronically ill individual" under §7702B(c)(2). Taxpayers (including uninsured individuals, insurance companies, employers, policyholders, and certificate holders) may rely on this interim guidance to determine whether an individual is a chronically ill individual under the ADL Trigger or the Cognitive Impairment Trigger for purposes of the definitions of "qualified long-term care services" in §7702B(c) and "medical care" in §213(d).

## Procedure, Penalties, Tax Liens, Levies, and Examination

Trust Fund Recovery Penalty, §1244 Losses,
Accuracy Penalty—Disclosure
I.R.C. §§162, 166, 6662

**Trust fund recovery penalties are not deductible. The dominant motive of a guaranty must be business related.**


**Summary**

1. The taxpayer could not deduct amounts paid to the government in settlement of trust fund recovery penalties.
2. Payments made as guarantor of corporate mortgage liabilities were not business bad debts.
3. Imposition of substantial understatement penalty by IRS was not appropriate.


### Facts and Decision

**Issue 1.** The taxpayer paid $31,000 to settle his liability for the trust fund recovery penalty. The original liability of his corporation for unpaid employment taxes was over $100,000. The taxpayer claimed the expense as a "business bad debt" on the basis that he had an indemnification agreement with his corporation for this payment, and the corporation failed to make good. The Tax Court found no evidence of such an agreement, and had there been one, it would have been irrelevant. Amounts paid for

I.R.C. §6672 assessments are nondeductible.

**Issue 2.** Taxpayer deducted $50,000 and $47,350 in 1991 and 1992 as an I.R.C. §1244 loss. He then abandoned this argument and claimed the amounts as business bad debts incurred as a guarantor of a defunct corporation's liabilities. The "dominant" motive of the guaranty must be business-related, as opposed to investment-related. The taxpayer testified that he expected the corporation's business and stock value to increase as a result of the mortgage loan. In addition, the taxpayer had taken large amounts of salary income following and including the year of the mortgage loan, leading the court to find that the taxpayer's guaranty was not tied to his receipt of income. The deductions were allowed as non-business bad debts.

**Issue 3.** The taxpayer filed Form 8275, Disclosure Statement, with attachments, setting forth the facts of the case as well as the position regarding I.R.C. §1244. The IRS assessed the I.R.C. §6662(a) penalty on the basis that the taxpayer relied on I.R.C. §1244 and then abandoned that position duringthe proceeding. The Court held for the taxpayer, indicating that the critical point is whether relevant data was adequately disclosed concerning the treatment of an item to alert the Commissioner to a potential controversy.

[***Herbert C. Elliot v. Commissioner,*** T.C. Memo 1997-294, 73 T.C.M. 3197 (1997) [CCH Dec. 52,121(M)].]

## Levy by IRS; Social Security Benefits
I.R.C. §§6334, 7402

**Although social security benefits are generally exempt from IRS levy, I.R.C. §6334 supersedes and allows garnishment.**

**Facts.** The taxpayer owed over $100,000 to the IRS, attributable to both unpaid income taxes and trust fund recovery tax. An IRS Revenue Officer sent a notice of levy to the Social Security Administration, garnishing the plaintiff's entire social security benefit for the month of September 1995 and one-half of each month's check thereafter.

According to 42 U.S.C. §407(a), federal old-age, survivors, and disability insurance benefits are not subject to execution levy, attachment, garnishment, or other legal process, or to the operation of any bankruptcy or insolvency law. However, 42 U.S.C. §407(b) provides that §407(a) may be modified by other provisions of law, so long as the modification is by "express reference to this section." I.R.C. §6334(c) provides an express reference to §407(a), as follows:

> I.R.C. §6334(c): No other property exempt
>
> Notwithstanding any other law of the United States (including section 207 of the Social Security Act), no property or rights to property shall be exempt from levy other than the property specifically made exempt by subsection (a).

**Note:** Section 207 of the Social Security Act has been codified and renumbered as 42 U.S.C. §407.

**Holding.** **The Court held that the IRS has the authority to garnish the monthly social security**

**benefit.**

[***George C. Leining, Plaintiff v. United States of America, Defendant,*** U.S. District Court, Dist. Conn.; 97-1 USTC 87,479 (1996) [CCH ¶50,254].]

Trust Fund Recovery Penalties—Responsible Parties
I.R.C. §§6672 and 7402

**In a summary judgment decision, the court determined that two persons involved in two companies were not responsible parties and not subject to trust fund recovery penalties.**

**Issue.** Whether a daughter and a grandson of the founder of two companies had adequate authority to be liable for a trust fund recovery penalty: Were they "responsible persons"?

## Discussion of the Law

**A. Section 6672—Responsible Person.** "[A] party may be liable [under §6672] for unpaid withholding taxes if: first, [he or she is] the **'responsible person'** for collection and payment of the employer's taxes,...and second, [he or she] **'willfully'** failed to comply with the statute." ***Fiataruolo v. United States*** [93-2 USTC ¶50,627], 8 F.3d 930, 938 (2d Cir., 1993).

**Under the first prong of the test,** courts generally take a broad view of who qualifies as a responsible person. Such determination of responsibility is based upon the individual's "status, duty and authority" to ensure compliance with the employer's tax withholding obligations (quoting ***Raba v. United States*** [93-1 USTC ¶50,039], 977 F.2d 941, 943 (5th Cir. 1992)).

The core question "is whether the individual has *significant control* over the enterprise's finances." ***Fiataruolo*** [93-2 USTC ¶50,627], 8 F.3d at 939 (quoting ***Hochstein v. United States*** [90-1 USTC ¶50,205], 900 F.2d 543, 546 (2d Cir.), *cert. denied,* 504 U.S. 985 (1992)). **"[S]ignificant control does not...translate into a requirement of absolute authority."** ***Fiataruolo*** [93-2 USTC ¶50,627], 8 F.3d at 939.

Section 6672(a) is "not meant to snare those who have merely technical authority or titular designation." ***Fiataruolo*** [93-2 USTC ¶50,627], 8 F.3d at 939.

**Many factors are examined to determine whether an individual has the requisite significant control over an enterprise to be found a responsible person within the meaning of §6672.** ***Fiataruolo*** [93-2 USTC ¶50,627], 8 F.3d at 939.

The factors that must be examined include whether the person:

> (1) is an officer or member of the board of directors, (2) owns shares or possesses an entrepreneurial stake in the Company, (3) is active in the management of day-to-day affairs of the company, (4) has the ability to hire and fire employees, (5) makes decisions regarding which, when, and in what order outstanding debts or taxes will be paid, (6) exercises control over daily bank accounts and disbursement records, and (7) has check-signing authority.

The question of control over the employer's finances must be answered in light of the totality of the circumstances; no one factor is determinative. The fact that others in the corporation may also have been responsible under §6672 **does not relieve** a person of responsibility. ***Roth v. United States*** [83-2 USTC ¶9526], 567 F.Supp. 496, 498-99 (E.D.N.Y.), *aff'd*, 742 F.2d 1434 (2d Cir. 1984).

### 1. Mrs. Knowles

The IRS contends that Mrs. Knowles satisfies the requirements for being a responsible person within the meaning of §6672. Specifically, the IRS puts forth the following examples to illustrate the "significant control" Mrs. Knowles exercised over the financial affairs of the companies: (i) Mrs. Knowles was a corporate officer of Trucking; (ii) although she was not an officer or director of Excavators, she was paid by Excavators, rather than by Trucking, and her job duties (i.e., managing the payroll) were the same for both Trucking and Excavators; (iii) Mrs. Knowles was a signatory on the checking accounts of Trucking, and she exercised her authority to sign checks; (iv) Mrs. Knowles had the authority to use or direct the use of the signature stamp for Excavator's checks, and exercised such authority; (v) Mrs. Knowles unilaterally determined when she would receive an early paycheck; (vi) she hired employees responsible for the bookkeeping operations of the companies; (vii) Mrs. Knowles signed a loan agreement on behalf of Trucking for the purchase of a piece of equipment; and (viii) Mrs. Knowles loaned substantial amounts of money to the companies over the years.

Mrs. Knowles, **in response to the** government's motion for summary judgment, submits numerous affidavits and depositions contending that she is not a responsible person within the meaning of §6672.

**First,** Mrs. Knowles contends that although she was an officer in Trucking she never had any "clear decisive role" in determining either the finances or business direction of the company.

**Second,** Mrs. Knowles asserts that she had no ownership interest in either company and no authority over either company's policies.

**Third,** Mrs. Knowles asserts that William Mitchell appears to have run both companies himself. Specifically, she asserts that William Mitchell supervised the estimators, was in charge of customer relations, received and acted on all of the daily mail and correspondence, handled the headquarters and plant expansion in 1982, took care of most equipment purchases, and was present at all times when payroll taxes were not made to the IRS.

**Fourth,** Mrs. Knowles claims that she performed only limited hiring. At most, she hired one or two assistants to help her with filing and payroll computations. Mrs. Knowles further asserts that the limited hiring she did do was done with William Mitchell's permission.

**Fifth,** Mrs. Knowles asserts that she did not exercise substantial discretion with respect to the payment of bills. She further asserts that William Mitchell received the mail and told her what to do. Moreover, Mrs. Knowles asserts that she was not responsible for payment of payroll taxes.

**Sixth,** Mrs. Knowles claims that she did not know what funds or balances were in the accounts of companies, unless requested to find out, and that she was never in charge of paying payroll taxes to the IRS.

**Seventh,** Mrs. Knowles asserts that it is generally acknowledged that she had no check signing authority for Excavators. Furthermore, she contends that her check signing authority for Trucking was limited. She worked at the direction of William Mitchell.

**Decision.** Drawing all inferences in favor of Mrs. Knowles and viewing the issue of whether Mrs. Knowles had significant control over the finances of Trucking and Excavators in light of the totality of the circumstances, **the court concludes that genuine issues of material fact exist with respect to whether Mrs. Knowles was a responsible person within the meaning of §6672.**

Therefore, the plaintiff's motion for summary judgment should be denied. Accordingly, the court does not address the further issue as to whether Mrs. Knowles acted willfully within the meaning of §6672.

## 2. Elton Knowles

The government also contends that Mr. Knowles satisfies the requirements for being a responsible person within the meaning of §6672. Specifically, the government argues that the following material facts illustrate the "significant control" Mr. Knowles exercised over the financial affairs of Trucking and Excavators: (i) Mr. Knowles was employed by Trucking from 1981 through September 1, 1989, but he had responsibilities for both companies; (ii) Mr. Knowles was Mrs. Knowles' son; (iii) Mr. Knowles was a signatory on the bank accounts of both companies and exercised his authority to sign checks; and (iv) Mr. Knowles was aware that the financial condition of the companies was bad in 1988 and 1989, and he discussed this matter with his mother, Mrs. Knowles, during the relevant periods.

**Mr. Knowles asserts** that he does not qualify as a responsible person within the meaning of §6672. Specifically, Mr. Knowles contends that "given how the companies were run...[signature authority] alone is not enough to find [Mr. Knowles] is a responsible person under §6672." **Moreover, Mr. Knowles asserts, among other things, that:** (i) he was not an officer, director, or shareholder of Trucking or Excavators; (ii) William Mitchell would instruct him as to which creditors were to be paid; (iii) Mr. Knowles did not have a financial stake in the company; (iv) Mr. Knowles did not decide which creditors would be paid and how much they would be paid; and (v) Mr. Knowles had no authority to hire or fire any employees of Trucking or Excavators.

**Decision.** Drawing all inferences in favor of Mr. Knowles and viewing the issue of whether Mr. Knowles had significant control over the finances of Trucking and Excavators in light of the totality of the circumstances, **the court concludes that genuine issues of material fact exist with respect to whether Mr. Knowles was a responsible person within the meaning of §6672.**

Therefore, the plaintiff's motion for summary judgment should be denied. Accordingly, the court does not address the further issue of whether Mr. Knowles acted willfully within the meaning of §6672.

[***U.S.A. v. William Mitchell, et al.*** U.S. Dist. Ct., Dist. Conn., 97-1 USTC 87,823 (1997) [CCH ¶50,361].]

**Indirect evidence can be used to establish proof**

**Facts.** Taxpayer testified that on 4-15-93 he timely mailed an application for an automatic extension of time to file his 1992 tax return along with a check for $5,000. The IRS claimed it did not receive the form until 4-26-93. The taxpayer was not able to offer any direct evidence of the postmark. Likewise, the IRS offered no evidence as to what the postmark date of the envelope was.

**Issue.** Can indirect evidence be used to establish that a return was timely mailed and therefore timely filed?

**Holding.** I.R.C. §7502 does not require direct proof of a postmark. The statute is silent other than in regard to registered and certified mail as to other ways a taxpayer can prove the date of the U.S. postmark. In this case, since the IRS had not retained the envelope and had no direct proof of the postmark, the taxpayer was allowed to prove the timely mailing through indirect evidence. The taxpayer was able to show that the state tax filing was timely, that he had a habit of timely filing, that the date on the check was consistent with a timely filing, that the memory of the taxpayer was good as to when and where the envelope was mailed, and that the form did in fact arrive. **This indirect evidence was sufficient to prove the return had been timely filed.**

[*Lewis v. U.S.A.*, U.S. District Court, Eastern District of California, 96-2 USTC 85,791 [CCH 50,571] (1996)]

### Environmental Cleanup Costs; Private Letter Rulings; Pre-Submission Conferences
Announcement 97-22

**Explanation of pre-submission conference in regard to environmental cleanup costs provided.**

Taxpayers may request at this time a pre-submission conference in anticipation of filing a request for a private letter ruling under the revenue procedure proposed in **Notice** 97-7, 1997-1 I.R.B. 8 (Jan. 6, 1997). The proposed revenue procedure, when finalized, will provide special procedures for requesting private letter rulings from the Internal Revenue Service on the tax treatment of environmental cleanup costs under §§162 and 263 of the Internal Revenue Code in transactions that span past and future taxable years.

A taxpayer may request a pre-submission conference to discuss the procedures for submitting a letter ruling request and/or the substantive issues relating to the taxpayer's environmental cleanup transaction. However, any discussion of substantive issues at a pre-submission conference is advisory only, is not binding on the Service, and cannot be relied upon as a basis for obtaining retroactive relief under the provisions of §7805(b).

A pre-submission conference will be held only if the taxpayer actually intends to file a request under the proposed revenue procedure after it is finalized, and only on a time-available basis. If the environmental cleanup issue is currently under examination or before appeals, the examining or appeals officer handling the case will be asked to participate in the conference. For the general rules for requesting a pre-submission conference, see Rev. Proc. 97-1, 1997-1 I.R.B. 11 (Jan. 6, 1997), §11.07.

### Records—I.R.C. §6001
Rev. Proc. 97-22

**Storage of records using an electronic storage system.**

**Section 1. Purpose.** This revenue procedure provides guidance to taxpayers that maintain books and records by using an electronic storage system that either images their hardcopy (paper) books and records, or transfers their computerized books and records, to an electronic storage media, such as an optical disk. Records maintained in an electronic storage system that complies with the requirements of this revenue procedure will constitute records within the meaning of §6001 of the Internal Revenue Code.

List of Designated Private Delivery Services—
I.R.C. §7502
Notice 97-26

**Four private delivery systems can be used and the taxpayer can meet the "timely mailing as timely filing/paying" rule.**

**Summary.** This notice provides the first list of private delivery services ("PDSs") that are designated private delivery services ("designated PDSs") during the interim period described in Rev. Proc. 97-19, 1997-10 I.R.B. 55. The interim period ends on the date on which the Service issues guidance superseding Rev. Proc. 97-19.

Designation is for purposes of the "timely mailing as timely filing/paying" rule of §7502 of the Internal Revenue Code. This notice also provides special rules for determining the date that will be treated as the postmark date for purposes of §7502.

**Background.** Section 7502 provides rules that apply when a document is required to be filed (or a payment is required to be made) within a prescribed period or on or before a prescribed date under the authority of any provision of the internal revenue laws. Section 7502 provides what is commonly called the "timely mailing as timely filing/paying" rule. **For example,** an individual income tax return is considered timely filed even though it is received by the Service after the April 15 due date if the return was delivered to the Service by United States mail in a postage prepaid, properly addressed envelope that had a post office postmark dated on or before the April 15 due date.

Prior to the amendment made by the Taxpayer Bill of Rights 2 (TBOR 2), the "timely mailing as timely filing/paying" rule applied only to documents and payments sent by United States mail. TBOR 2 amended §7502 by adding subsection (f), which authorizes the Secretary to designate certain PDSs for the "timely mailing as timely filing/paying" rule.

This notice provides the first list of the designated PDSs for the interim period.

**List of Designated PDSs and Types of Services.** The following PDSs and the following specific types of delivery services are designated for purposes of §7502(f):

1. Airborne Express (Airborne): Overnight Air Express Service, Next Afternoon Service, and Second Day Service
2. DHL Worldwide Express (DHL): DHL "Same Day" Service and DHL USA Overnight
3. Federal Express (FedEx): FedEx Priority Overnight, FedEx Standard Overnight, and FedEx 2Day
4. United Parcel Service (UPS): UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, and UPS 2nd Day Air A.M.

Airborne, DHL, FedEx, and UPS are not designated with respect to any type of delivery service not identified above. Consequently, the "timely mailing as timely filing/paying" rule of §7502 does not apply to any other type of delivery service offered by the designated PDSs.

Designation under this notice is effective until the Service issues a revised list of designated PDSs. On or before September 1 or March 1 of each year of the interim period, the Service will issue other notices that provide a revised list of designated PDSs. In unusual circumstances, the Service may issue additional notices at other times.

If taxpayers use a business that provides mailing services of a designated PDS, but the business itself is not a designated PDS, taxpayers should be aware that the "timely mailing as timely filing/paying" rule will not apply unless an item is actually given to, or picked up by, a designated PDS on or before the due date. Taxpayers should take appropriate precautions to ensure that the item will be given to, or picked up by, a designated PDS on or before the due date.

**Special Rules for Determining Postmark Date.** Section 7502(f)(2)(C) requires a PDS to either (1) record electronically to its database (kept in the regular course of its business) the date on which an item was given to the PDS for delivery or (2) mark on the cover of the item the date on which an item was given to the PDS for delivery. Under §7502(f)(1), the date recorded or the date marked under §7502(f)(2)(C) is treated as the postmark date for purpose of §7502.

This notice provides rules for determining the date that is treated as the postmark date for purposes of §7502. There is one set of rules for the designated PDSs that qualified for designation because their "postmark date" is recorded electronically to their databases. There is another set of rules for the designated PDS that qualified for designation because its "postmark date" is marked on the cover of an item.

Airborne, DHL and UPS. The date on which an item is given to Airborne, DHL, or UPS is recorded electronically to the databases of these designated PDSs. Accordingly, the date recorded in the electronic database of these designated PDSs is treated as the postmark date for purposes of §7502.

For items that are delivered after their due dates, there is a presumption that the postmark date is the day that precedes the delivery date by an amount of time that equals the amount of time it would normally take for an item to be delivered under the terms of the specific type of delivery service used (e.g., two days before the actual delivery date for a two-day delivery service). This presumption applies to items sent by taxpayers and, in appropriate cases, items sent by the government.

Taxpayers who wish to overcome this presumption will need to provide information that shows that the date recorded in the electronic database is on or before the due date. For example, a taxpayer could obtain such information in the form of a written confirmation produced and issued by the designated PDS before the expiration of the period for storing the date recorded in its electronic database. If taxpayers wish to maintain this type of proof for their records, they should make a timely request to receive this information from the designated PDS before the expiration of that designated PDS's data storage period.

Airborne, DHL, and UPS entered into agreements pursuant to Rev. Proc. 97-19 that require these designated PDSs to store (electronically or by microfiche) the dates recorded in their electronic databases for at least six months. Although Airborne, DHL, and UPS may choose to store the dates for more than six months, the agreements do not require them to do so. Prior to the expiration of the data storage period, senders or recipients can obtain information concerning the date recorded to the electronic database by contacting Airborne, DHL, or UPS. The toll-free telephone numbers for these designated PDSs are as follows: Airborne, 1-800-247-2676; DHL "Same Day" Service, 1-800-345-2727; DHL USA Overnight, 1-800-225-5345; and UPS, 1-800-742-5877.

FedEx. An electronically generated label is applied to the cover of all items delivered by FedEx, including those items that already have an airbill attached. The date on which an item is given to FedEx for delivery is marked on the label. There are two types of labels (which are distinguishable from each other). One type of label is generated and applied to an item by a FedEx employee. The other type of label is generated (using computer software and/or hardware provided by FedEx) and applied to an item by a customer.

The date that will be treated as the postmark date for purposes of §7502 is determined under the following rules:

1. If an item has a label generated and applied by a FedEx employee, the date marked on that label is treated as the postmark date for purposes of §7502, regardless of whether the item also has a label generated and applied by the customer.
2. If an item has a label generated and applied by a customer, the date marked on that label is treated as the postmark date for purposes of §7502 if the item is received within the normal delivery time. (Normal delivery time is one day for FedEx Priority Overnight and FedEx Standard Overnight, or two days for FedEx 2 Day.) If an item is not delivered within the normal delivery time, the person required to file the document or to make the payment must establish (a) that the item was actually either given to, or picked up by, a FedEx employee on or before the due date and (b) the cause of the delay in delivery of the document or payment. These rules are similar to the rules for United States mail that has a postmark made other than by the United States Postal Service. [See Treas. Reg. §301.7502-1(c)(1)(iii)(b).]
3. The information recorded electronically to the database of FedEx (in the regular course of its business) can be used to show that the item was actually either given to, or picked up by, a FedEx employee on or before the due date when (a) an item has a label generated and applied by a customer or (b) an item has a label generated and applied by a FedEx employee, but the date is illegible or otherwise unavailable.

**Effective Date.** Designation under this notice is effective for documents and payments that are given by taxpayers to a designated PDS **on or after April 11, 1997.** Designation is not effective for documents and payments that are given by taxpayers to a designated PDS before April 11, 1997, even if such documents and payments are delivered by the designated PDS on or after April 11, 1997.

Notice 97-43

**Electronic funds transfer—temporary waiver of failure-to-deposit penalty for certain taxpayers.**

**This notice provides guidance relating to the waiver of penalties announced in News Release IR-97-32, issued June 2, 1997.** In IR-97-32, the Internal Revenue Service announced that it will waive the failure-to-deposit penalty under §6656 of the Internal Revenue Code for certain taxpayers first required to make federal tax deposits by electronic funds transfer on or after July 1, 1997.

**Note:** The TRA of 1997 extended this date to July 1, 1998. See the TRA of 1997 chapter.

## Temporary Waiver of Penalty for Certain Taxpayers.

Although taxpayers with more than $50,000 of federal employment tax deposits in calendar year 1995 are required to make federal tax deposits electronically on and after July 1, 1997, the Service will not impose the 10% §6656 penalty solely for the failure to make those deposits by electronic funds transfer. However, a taxpayer will remain liable for the failure-to-deposit penalty under §6656 (absent reasonable cause) if the taxpayer fails to make a required deposit (using either electronic funds transfer or paper coupons) in a timely manner.

This waiver of the failure-to-deposit penalty applies only to deposit obligations incurred on or before December 31, 1997. The penalty waiver includes deposits made after December 31, 1997, so long as the deposit obligation was incurred on or before December 31, 1997.

This waiver of the failure-to-deposit penalty does not apply to taxpayers that were required to begin using electronic funds transfer in 1995 or 1996.

Disclosure—Relief from Penalties
I.R.C. §6662(d)
Rev. Proc. 96-58

**This revenue procedure updates Rev. Proc. 95-55, 1995-2 C.B. 457, and identifies circumstances under which the disclosure on a taxpayer's return of a position with respect to an item is adequate for the purpose of reducing the understatement of income tax under §6662(d) of the Internal Revenue Code and for the purpose of avoiding the preparer penalty under §6694(a).**

This revenue procedure applies to any return filed on 1996 tax forms for a taxable year beginning in 1996, and to any return filed on 1996 tax forms in 1997 for short taxable years beginning in 1997.

## Section 3. Background.

**.01** If §6662 applies to any portion of an underpayment of tax required to be shown on a return, an amount equal to 20% of the portion of the underpayment to which the section applies is added to the tax. (The penalty rate is 40% in the case of certain gross calculation misstatements.) Under §6662(b)(2), §6662 applies to the portion of an underpayment that is attributable to a substantial understatement of income tax.

## Section 4. Procedure

Additional disclosure of facts relevant to, or positions taken with respect to, issues involving any of the items set forth below is unnecessary for purposes of reducing any understatement of income tax under §6662(d) provided that the forms and attachments are completed in a clear manner and in accordance with their instructions.

The money amounts entered on the forms must be **verifiable,** and the information on the return must be disclosed in the manner described below. For purposes of this revenue procedure, a number is verifiable if, on audit, the taxpayer can demonstrate the origin of the number (even if that number is not ultimately accepted by the Internal Revenue Service) and the taxpayer can show good faith in entering that number on the applicable form.

(1) **Form 1040, Schedule A, Itemized Deductions:**

(a) Medical and Dental Expenses: Complete lines 1 through 4, supplying all required information.

(b) Taxes: Complete lines 5 through 9, supplying all required information. Line 8 must list each type of tax and the amount paid.

(c) Interest Expense: Complete lines 10 through 14, supplying all required information. This section does not apply to (i) amounts disallowed under §163(d) unless Form 4952, Investment Interest Expense Deduction, is completed, or (ii) amounts disallowed under §265.

(d) Contributions: Complete lines 15 through 18, supplying all required information. Merely entering the amount of the donation on Schedule A, however, will not constitute adequate disclosure if the taxpayer receives a substantial benefit from the donation shown. If a contribution of property other than cash is made and the amount claimed as a deduction exceeds $500, a properly completed Form 8283, Noncash Charitable Contributions, must be attached to the return. This section will not apply to any contribution of $250 or more unless the contemporaneous written acknowledgment requirement of §170(f)(8) is satisfied.

(e) **Casualty and Theft Losses: Complete Form 4684,** Casualties and Thefts, and attach to the return. Each item or article for which a casualty or theft loss is claimed must be listed on Form 4684.

(2) **Certain Trade of Business Expenses** (including, for purposes of this section, the following six expenses as they relate to the rental of property):

(a) Casualty and Theft Losses: The procedure outlined in §4.01(1)(e) above must be followed.

(b) Legal Expenses: The amount claimed must be stated. This section does not apply, however, to amounts properly characterized as capital expenditures, personal expenses, or nondeductible lobbying or political expenditures, including amounts that are required to be (or that are) amortized over a period of years.

(c) Specific Bad Debts Charge-off: The amount written off must be stated.

(d) Reasonableness of Officers' Compensation: Form 1120, Schedule E, Compensation of Officers, must be completed when required by its instructions. The time devoted to business must be expressed as a percentage as opposed to "part" or "as needed." This section does not apply to "golden parachute" payments, as defined under §280G. This section will not apply to the extent that remuneration paid or incurred exceeds the $1 million employee remuneration limitation, if applicable.

(e) Repair Expenses: The amount claimed must be stated. This section does not apply, however, to any repair expenses properly characterized as capital expenditures or personal expenses.

(f) Taxes (other than foreign taxes): The amount claimed must be stated

(3) **Form 1120, Schedule M-1, Reconciliation of Income (Loss) per Books with Income per Return, provided:**

(a) The amount of the deviation from the financial books and records is not the result of a computation that includes the netting of items; and

(b) The information provided reasonably may be expected to apprise the Internal Revenue Service of the nature of the potential controversy concerning the tax treatment of the item.

(4) **Foreign Tax Items:**

(a) International Boycott Transactions: Transactions disclosed on Form 5713, International Boycott Report.

(b) Intercompany Transactions: Transactions and amounts shown on Schedule M (Form 5471), Transactions Between Controlled Foreign Corporation and Shareholders or Other Related Persons, lines 19 and 20, and Form 5472, Part IV, Monetary Transactions Between Reporting Corporations and Foreign Related Party, lines 7 and 18.

(5) **Other:**

(a) **Moving Expenses:** Complete Form 3903, Moving Expenses, or Form 3903-F, Foreign Moving Expenses, and attach to the return.

(b) **Sale or Exchange of Your Main Home:** Complete Form 2119, Sale of Your Home, and attach to the return.

(c) **Employee Business Expenses:** Complete Form 2106, Employee Business Expenses, or Form 2106-EZ, Unreimbursed Employee Business Expenses, and attach to the return. This section does not apply to club dues, or to travel expenses for any nonemployee accompanying the taxpayer on a trip.

(d) **Fuels Credit:** Complete Form 4136, Credit for Federal Tax Paid on Fuels, and attach to the return.

(e) **Investment Credit:** Complete Form 3468, Investment Credit, and attach to the return.

### Rev. Proc. 97-21

**This revenue procedure provides the rules applicable to a new pilot program under which pre-submission conferences may be held in the national office for matters that a district director or a chief, appeals office, is preparing to submit for technical advice under Rev. Proc. 97-2, 1997-1 I.R.B. 64.**

- In an effort to promote expeditious processing of requests for technical advice, national office personnel generally will meet with the district or appeals office personnel and the taxpayer prior to the time a request for technical advice is submitted to the national office.
- The pre-submission conference procedures set forth in this revenue procedure are intended to facilitate agreement between the parties as to the appropriate scope of the request for technical advice, the factual information to be included in the request for technical advice, any collateral issues that either should or should not be included in the request for technical advice, and any other substantive or procedural considerations that will allow the national office to provide the parties with technical advice as expeditiously as possible.
- The pre-submission conference procedures are not intended to create alternative procedures for determining the merits of the substantive positions advocated by the district or appeals office or by the taxpayer, but instead are intended only to facilitate the overall technical advice process.

## IRS Publications

### Announcement 97-47

**Availability of Publication 968, Tax Benefits for Adoption.**

New Publication 968 will be available in May 1997. The publication explains the new tax credit for expenses connected with the adoption of a child. The credit can be as much as $5,000 ($6,000 fora child with special needs). The publication also covers the exclusion from income for employer-provided adoption benefits. The exclusion can be as much as $5,000 ($6,000 for a child with special needs). Taxpayers may be able to claim both the credit and the exclusion if the total amount of adoption expenses is more than the amount provided by the employer.

Adoption tax benefits are effective for tax years beginning in 1997. New Form 8839 is being developed for taxpayers to figure the credit and exclusion. **The form will be available in January 1998 for taxpayers to file with their 1997 tax return.**

You can get a copy of this publication by calling 1-800-829-3676. Or you can write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. Local adoption agencies also may have a copy. The publication is also available on the IRS Internet Web site at www.irs.ustreas.gov.

## Retirement Plans—Retirement Income—Fringe Benefits

### Gross Income—Lump-Sum Credit Received by Retired Federal Employee from Civil Service Retirement System (CSRS) Annuity I.R.C. §72(e)(5)(E) and §414(k)

**The taxpayer's CSRS plan did not have a defined contribution plan component. The entire lump-sum amount had to be included in the taxpayer's income.**

**Facts.** The taxpayer, a federal government employee, retired in 1991. Federal employees who retired after June 5, 1986, could elect to receive the **basic annuity or the alternative annuity.** The **alternative annuity** consists of a **lump-sum credit** and a reduced annuity. The **lump-sum credit** amount is equal to the unrefunded amount of the employee's previously taxed CSRS contributions.

The taxpayer elected to receive the **alternative annuity,** consisting of his **lump-sum credit** payment of $62,873 plus the reduced annuity. The 1991 Form 1099-R from CSRS included the **entire** lump-sum credit payment as **both a gross distribution and a taxable amount.** However, the taxpayer reported only $11,808 of the $62,873 on lines 17a (Total pensions) and 17b (Taxable amount) on his 1991 Form 1040.

The IRS assessed about $25,000 of additional tax on the omitted $51,065 of pension income. The IRS also assessed the 20% substantial understatement of tax penalty.

The taxpayer argued that his previously taxed contributions to the plan were made to a separate account in the CSRS, thus satisfying the separate account requirement of I.R.C. §414(k). Therefore, the taxpayer argued, his receipt of the lump-sum credit in 1991 was simply a tax-free return of his own contributions.

### Issues

1. Whether the entire lump-sum credit received in 1991 is taxable.
2. Whether the taxpayer is liable for the substantial understatement of tax penalty.

### Discussion

Issue 1. I.R.C. §72(e) governs the taxation of amounts received under an annuity contract but not received as an annuity. The CSRS plan is a defined benefit plan. Both parties agree that the taxpayer's previously taxed contributions to the CSRS should be recovered tax-free. Consequently, the issue does not involve the question of **whether** the taxpayer can recover his contributions tax-free, but rather **when** that recovery should occur. It is well-settled case law that a **lump-sum credit does not fall within the definition of a defined contribution plan** [*Malbon* (1994) (95-1 USTC ¶50,016), U.S. Ct. of Appeals, 9th Circuit].

Issue 2. I.R.C. §6662(a)(2) imposes a 20% accuracy-related penalty on any portion of any underpayment that is attributable to any **substantial understatement of income tax.**

## Holding

Issue 1. We (the Tax Court) hold that the CSRS plan does not have a defined contribution plan component because the separate account requirement of I.R.C. §414(k) was not met. Therefore, the entire lump-sum credit of $62,873 is required to be included in the taxpayer's 1991 AGI pursuant to I.R.C. §72(e)(2).

Issue 2. We find no basis to conclude that the taxpayer acted with **reasonable cause** and in good faith with respect to the understatement. The taxpayer has **failed** to prove that he **adequately disclosed** the relevant facts concerning the lump-sum credit. Therefore, the penalty has been properly applied.

[***Logsdon,*** T.C. Memo 1997-8, 73 T.C.M. 1674 (Jan. 2, 1997) [CCH Dec. 51, 809 (M)].]

### Early Distribution; 10% Additional Tax; Definition of "Disability" I.R.C. §72

**A commercial airline pilot could not prove that he had a medical condition sufficiently severe to preclude him from gainful employment.**

**Facts.** The taxpayer, an airline pilot, voluntarily took early retirement at age 57 due to what he called "certain health problems." These problems were respiratory in nature, diagnosed as chronic bronchitis exacerbated by allergies and high blood pressure. The high blood pressure was controlled with medication and the respiratory problems on an "as needed" basis. (The Court noted that part of the problem was the taxpayer's failure to follow medical advice, i.e., quit smoking 1½ packs a day and lose weight.) In spite of the above, the taxpayer routinely passed annual FAA medical examinations, including one in 1993, and flew during the entire period 1976–1993.

## Decision

> I.R.C. §72(m)(7): "...an individual shall be considered to be disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long, continued, and indefinite duration. An individual shall not be considered by be disabled unless he furnishes proof of the existence thereof in such form and manner as the secretary may require."

The taxpayer has the burden of proof to establish that he is sufficiently "disabled." In this case, the taxpayer grounded himself **and** provided no medical records or test results demonstrating the severity of his condition in 1993 of its likelihood to continue in that state indefinitely. For these reasons, the court held that the taxpayer should not be excepted from the 10% additional tax on early distributions from his retirement plan.

[***Black,*** U.S. Bankruptcy Court, West Texas District, 97-1 USTC 87,261 (1996) [CCH ¶50,297].]

### Retirement Plans: Portion of Lump-Sum Distribution That Is Taxable

**A lump-sum payment from a pension plan was made to the taxpayer and not to his ex-spouse. It**

**Facts.** The taxpayer's employment was terminated in March 1991. He divorced his wife in June 1991. The divorce decree required him to transfer his ownership interest in the jointly owned personal residence to his former wife. It also required him to make a lump-sum distribution of his qualified pension plan with his former employer, use the proceeds to pay off the mortgage on the residence, and pay his former wife $30,000 of the remaining balance.

The divorce decree stated that the taxpayer "shall be responsible for all taxes due on the lump-sum retirement withdrawal."

The lump-sum distribution amount received by the taxpayer was $176,755. He was under age 59½ when he received it in May 1991. Subsequently, the taxpayer paid off the mortgage debt of $126,000 and paid his former wife $30,000.

On his 1991 federal income tax return, the taxpayer properly reported the $176,755 lump-sum distribution amount as pension income. He also deducted **as alimony** the $126,000 mortgage debt payment and the $30,000 payment to his former wife. His total alimony deduction was $175,394. He did not pay the 10% premature distribution penalty on the lump-sum distribution for the following reason: he contended that the $126,000 mortgage debt payment and the $30,000 payment to his former wife were made pursuant to a *qualified domestic relations order (QDRO)*, which is a *valid exception* to the 10% penalty.

> **Note:** The taxpayer had previously agreed, before the case went to trial, that his allowable alimony deduction for 1991 was only $5,425, the cash payment of alimony to his ex-wife after the divorce decree became final in June 1991.

**Issue.** Whether the taxpayer is liable for the 10% premature distribution penalty on the $176,755 lump-sum qualified retirement plan distribution.

**Discussion.** The main issue for the Tax Court to decide was whether the divorce decree met the requirements of I.R.C. §414(p), which defines QDRO's. To qualify as a QDRO, a domestic relations order must meet the following tests:

1. It must create, recognize, or assign, to an **alternate payee,** rights under a qualified employee benefit plan **otherwise payable to the plan recipient.**
2. It must clearly specify certain facts, including the names and last known address of the participant and the alternate payee, the amount or percentage of the benefits to be paid, the number of payments, and each plan to which the order applies.
3. It may not alter the amount or the form of the benefits.

**Holding.** The facts do not satisfy the requirements of I.R.C. §414(p)(1). The taxpayer's employment was terminated in March 1991. The lump-sum distribution was made to the taxpayer in May 1991. The lump-sum distribution **was made to the taxpayer and not to his former wife. In addition, the**

**distribution was made in May 1991, in advance of the finalization of the divorce (the decree was dated June 1991).** Therefore, it **cannot be argued** that the distribution was made by the plan administrator **to an alternate payee in response to the divorce decree.** Accordingly, the taxpayer is liable for the 10% premature distribution penalty on the entire $176,755 lump-sum distribution, as no exceptions apply.

[***Burton v. Commissioner,*** T.C. Memo 1997-20; 73 T.C.M. 1729 (Jan. 13, 1997) [CCH Dec. 51,822(M)].]

Individual Retirement Account—Active Participant
I.R.C. §408

**A person who left her job during year and had no vested rights in the pension plan was still an "active participant" for that year.**

**Facts.** Taxpayer Susanne J. Nicolai was employed by Morton F. Plant Hospital in 1992. Mrs. Nicolai began working at the hospital in 1990 and terminated her employment during the summer of 1992. The hospital had a pension plan wherein an employee received forfeitable rights until vested, which required six years of employment. Since Mrs. Nicolai worked approximately two years for the hospital, her rights did not vest in the pension plan.

**Issue.** Is she an active participant in that plan and restricted as to deductible IRA contributions?

**Decision.** Yes!

While Congress included a definition of "active participant" in §219(g)(5), that definition itself uses the term "active participant." However, Congress's intent as to the meaning of "active participant" is clear from the report of the House Committee on Ways and Means:

> An individual is to be considered an active participant in a plan if he is accruing benefits under the plan **even if he only has forfeitable rights to those benefits** [H. Rept. 93-807 at 129 (1974), 1974-3 C.B. (Supp.) 236,364].

See also ***Eanes v. Commissioner*** [Dec. 42,266], 85 T.C. 168, 171 (1985). The regulations further provide that "an individual is an active participant ...**if for any portion of the plan year ...he is not excluded under the eligibility provisions of the plan**" [Treas. Reg. §1.219-2(b)(1)].

[***Hugo Madioni, and Susanne J. Nicolai v. Commissioner,*** T.C. Memo 1997-108, 73 T.C.M. 2157 (1997) [CCH Dec. 51,915(M)].

IRA Distribution Taxability and Penalty Exception
I.R.C. §72

**A taxpayer's IRA distribution to his former spouse for child support owed by the taxpayer is a taxable distribution and not an exception to the 10% penalty.**

**Facts.** Pursuant to a judgment for arrearages entered by the taxpayer's former spouse for back child support payments, the taxpayer's individual retirement account (balance $8483) was transferred in a garnishment proceeding to the former spouse in 1992. The taxpayer neither reported the IRA distribution as income nor paid the 10% premature distribution penalty on his 1992 tax return. The taxpayer was unaware of the garnishment until notified by the IRS upon examination of his 1992 tax return.

**Issues.** Whether such distribution of IRA proceeds to a former spouse is tantamount to a distribution from the IRA to the taxpayer, and if so, whether such distribution is subject to the 10% penalty as provided by I.R.C. §72(t)(1).

**Discussion.** Because the transfer of funds from the IRA to the taxpayer's former spouse at least partially discharged a legal obligation of the taxpayer, **the transfer to her is equivalent to receipt by him.** The taxpayer cannot escape taxation merely because he does not actually receive the money.

There are several exceptions to the 10% penalty imposed under §72(t)(1). The taxpayer presented neither argument nor evidence in support of the application of any exception.

**Holding.** An amount transferred out of an individual retirement account to a former spouse to satisfy a prior legal obligation is treated as a taxable distribution to the owner of the IRA, and such distribution is subject to the 10% penalty in the absence of any statutory exceptions.

[***Mark Vorwald v. Commissioner,*** T.C. Memo 1997-15, 73 T.C.M. 1697 (Jan. 8, 1997) [CCH Dec. 51, 816(M)].]

### Notice 97-10

**Sample language for a spouse's waiver to a QJSA or a QPSA.**

**Purpose.** **This notice provides sample language designed to make it easier for spouses of plan participants to understand their rights to survivor annuities under qualified plans.** The sample language can be included in a form used for a spouse to consent to a participant's waiver of a qualified joint and survivor annuity (QJSA) or qualified preretirement survivor annuity (QPSA), or to a participant's choice of nonspouse beneficiary in a defined contribution plan not subject to the QJSA and QPSA requirements.

The language is designed to assist plan administrators in preparing spousal consent forms that meet the statutory requirements. No one is required to use the sample language, and plan administrators that choose to use it are free to incorporate all or any part of it in their spousal consent forms.

### Notice 97-11

**Sample language for a qualified domestic relations order.**

**Purpose.** **This notice provides information intended to assist domestic relations attorneys, plan participants, spouses and former spouses of participants, and plan administrators in drafting and reviewing a qualified domestic relations order (QDRO).**

The notice provides sample language that may be included in a QDRO relating to a plan that is qualified under §401(a) (qualified pension, profit sharing, and stock bonus plans) or §403(a) (taxation of beneficiary under a qualified annuity plan) of the Internal Revenue Code of 1986 ("qualified plan" or "plan") and that is subject to §401(a)(13) (the assignment and alienation section).

The notice also discusses a number of issues that should be considered in drafting a QDRO.**A QDRO is a domestic relations order that provides for payment of benefits from a qualified plan to a spouse, former spouse, child, or other dependent of a plan participant and that meets certain requirements.**

**Section 1. Purpose.** This revenue procedure provides a model amendment that may be used to assist employers in adopting a plan that contains 401(k) SIMPLE provisions.

The model amendment gives plan sponsors a way to incorporate 401(k) SIMPLE provisions in plans containing cash or deferred arrangements (CODAs) and matching contributions.

I.R.C. §1421—SIMPLE IRAs; Questions and Answers
Notice 97-6

**The purpose of this notice is to provide guidance, in the form of questions and answers, with respect to the SIMPLE plan provisions.**

This notice provides guidance solely with respect to certain issues relating to SIMPLE plans under §1421 of the SBJPA.

This notice does not provide guidance with respect to §1422 of the SBJPA, which provides for a simplified 401(k) arrangement within a qualified plan that shares many characteristics with the SIMPLE plans described in this notice.

## A. SIMPLE Plans in General

**Question A-1.** *What is a SIMPLE plan?*

**Answer A-1.** A SIMPLE plan is a written arrangement established under §408(p) of the Code that provides a simplified tax-favored retirement plan for small employers. If an employer establishes a SIMPLE plan, each employee may choose whether to have the employer make payments as contributions under the SIMPLE plan or to receive these payments directly in cash. An employer that chooses to establish a SIMPLE plan must make either matching contributions or nonelective contributions. All contributions under a SIMPLE plan are made to SIMPLE IRAs.

**Question A-2.** *Can contributions made under a SIMPLE plan be made to any type of IRA?*

**Answer A-2.** Contributions under a SIMPLE plan may only be made to a SIMPLE IRA, not to any other type of IRA. A SIMPLE IRA is an individual retirement account described in §408(a), or an individual retirement annuity described in §408(b), to which the only contributions that can be made are contributions under a SIMPLE plan and rollovers or transfers from another SIMPLE IRA.

**Question A-3.** *Can a SIMPLE plan be maintained on a fiscal year basis?*

**Answer A-3.** A SIMPLE plan may only be maintained on a calendar year basis. Thus, for example, employer eligibility to establish a SIMPLE plan (see Q&As B-1 through B-5) and SIMPLE plan contributions (see Q&As D-1 through D-6) are determined on a calendar year basis.

## B. Employers that Can Establish SIMPLE Plans

**Question B-1.** *Can any employer establish a SIMPLE plan?*

**Answer B-1.** SIMPLE plans may be established only by employers that had no more than 100 employees who earned $5,000 or more in compensation during the preceding calendar year (the "100-employee limitation"). See Q&As C-4 and C-5 for the definition of compensation. For purposes of the 100-employee limitation, all employees employed at any time during the calendar year are taken into account, regardless of whether they are eligible to participate in the SIMPLE plan. Thus, employees who are excludable under the rules of §410(b)(3) or who have not met the plan's minimum eligibility requirements must be taken into account. Employees also include self-employed individuals described in §401(c)(1) who received earned income from the employer during the year.

**Question B-2.** *Is there a grace period that can be used by an employer that ceases to satisfy the 100-employee limitation?*

**Answer B-2.** An employer that previously maintained a SIMPLE plan is treated as satisfying the 100-employee limitation for the two calendar years immediately following the calendar year for which it last satisfied the 100-employee limitation. However, if the failure to satisfy the 100-employee limitation is due to an acquisition, disposition, or similar transaction involving the employer, then the two-year grace period will apply only in accordance with rules similar to the rules of §410(b)(6)(C)(i).

**Question B-3.** *Can an employer make contributions under a SIMPLE plan for a calendar year if it maintains another qualified plan?*

**Answer B-3.** An employer cannot make contributions under a SIMPLE plan for a calendar year if the employer, or a predecessor employer, maintains a qualified plan under which any of its employees receives an allocation of contributions (in the case of a defined contribution plan) or has an increase in a benefit accrued or treated as an accrued benefit under §411(d)(6) (in the case of a defined benefit plan) for any plan year beginning or ending in that calendar year. For this purpose, a "qualified plan" means a plan, contract, pension, or trust described in §219(g)(5) and includes a qualified plan [described in §401(a)], a qualified annuity plan [described in §403(a)], an annuity contract [described in §403(b)], a plan established for employees of a state, a political subdivision or by an agency or instrumentality of any state or political subdivision [other than an eligible deferred compensation plan described in §457(b)], a simplified employee pension ("SEP"), [described in §408(k)], and a trust [described in §501(c)(18)]. In applying these rules, transfers, rollovers, or forfeitures are disregarded, except to the extent forfeitures replace otherwise required contributions.

**Question B-4.** *Are tax-exempt employers and governmental entities permitted to maintain SIMPLE plans?*

**Answer B-4.** Yes. Excludable contributions may be made to the SIMPLE IRA of employees of tax-exempt employers and governmental entities on the same basis as contributions may be made to employees of other eligible employers.

**Question B-5.** *Do the employer aggregation and leased employee rules apply for purposes of the SIMPLE plan rules under §408(p)?*

**Answer B-5.** For purposes of applying the SIMPLE plan rules under §408(p), certain related employers (trades or businesses under common control) are treated as a single employer. These related employers include controlled groups of corporations under §414(b), partnerships or sole proprietorships under common control under §414 (c), and affiliated service groups under §414(m). In addition, leased employees described in §414(n) are treated as employed by the employer.

Example. Individual P owns business A, a computer rental agency, that has 80 employees who received more than $5,000 in compensation in 1996. Individual P also owns business B, which repairs computers and has 60 employees who received more then $5,000 in compensation in 1996. Individual P is the sole proprietor of both businesses. Section 414(c) provides that the employees of partnerships and sole proprietorships that are under common control are treated as employees of a single employer. Thus, for purposes of the SIMPLE plan rules, all 140 employees are treated as employed by individual P. Therefore, neither business A nor business B is eligible to establish a SIMPLE plan for 1997.

## C. Employee Eligibility to Participate in a SIMPLE Plan

**Question C-1.** *Which employees of an employer must be eligible to participate under the SIMPLE plan?*

**Answer C-1.** If an employer establishes a SIMPLE plan, all employees of the employer who received at least $5,000 in compensation from the employer during any two preceding calendar years (whether or not consecutive) and who are reasonably expected to receive at least $5,000 in compensation during the calendar year, must be eligible to participate in the SIMPLE plan for the calendar year.

An employer, at its option, may exclude from eligibility employees described in §410(b)(3). These employees are:

1. Employees who are included in a unit of employees covered by an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, if there is evidence that retirement benefits were the subject of good faith bargaining between such employee representatives and such employer or employers;
2. In the case of a trust established or maintained pursuant to an agreement that the Secretary of

§911(d)(2)] from the employer that constitutes income from sources within the United States [within the meaning of §861(a)(3)].

As noted in Q&A B-5, the employer aggregation and leased employee rules apply for purposes of §408(p). Thus, for example, if two related employers must be aggregated under the rules of §414(b), all employees of either employer who satisfy the eligibility criteria must be allowed to participate in the SIMPLE plan.

**Question C-2.** *May an employer impose less restrictive eligibility requirements?*

**Answer C-2.** An employer may impose less restrictive eligibility requirements by eliminating or reducing the prior year compensation requirements, the current year compensation requirements, or both, under its SIMPLE plan. For example, the employer could allow participation for employees who received $3,000 in compensation during any preceding calendar year. However, the employer cannot impose any other conditions on participating in a SIMPLE plan.

**Question C-3.** *May an employee participate in a SIMPLE plan if he or she also participates in a plan of a different employer for the same year?*

**Answer C-3.** An employee may participate in a SIMPLE plan even if he or she also participates in a plan of a different employer for the same year. However, the employee's salary reduction contributions are subject to the limitations of §402(g), which provides an aggregate limit on the exclusion for elective deferrals for any individual. Similarly, an employee who participates in a SIMPLE plan and an eligible deferred compensation plan described in §457(b) is subject to the limitations described in §457(c). An employer that establishes a SIMPLE plan is not responsible for monitoring compliance with either of these limitations.

**Question C-4.** *What definition of compensation applies for purposes of the SIMPLE plan rules in the case of an individual who is not a self-employed individual?*

**Answer C-4.** For purposes of the SIMPLE plan rules, in the case of an individual who is not a self-employed individual, compensation means the amount described in §6051(a)(3) [wages, tips, and other compensation from the employer subject to income tax withholding under §3401(a)], and amounts described in §6051(a)(8), including elective contributions made under a SIMPLE plan, and compensation deferred under a §457 plan. For purposes of applying the 100-employee limitation, and in determining whether an employee is eligible to participate in a SIMPLE plan (i.e., whether the employee had $5,000 in compensation for any two preceding years), an employee's compensation also includes the employee's elective deferrals under a §401(k) plan, a salary reduction SEP, and a §403(b) annuity contract.

**Question C-5.** *What definition of compensation applies for purposes of the SIMPLE plan rules in the case of a self-employed individual?*

**Answer C-5.** For purposes of the SIMPLE plan rules, in the case of a self-employed individual, compensation means net earnings from self-employment determined under §1402(a), prior to subtracting any contributions made under the SIMPLE plan on behalf of the individual.

## D. SIMPLE Plan Contributions

**Question D-1.** *What contributions must an employer make under a SIMPLE plan?*

**Answer D-1.** If an employer establishes a SIMPLE plan, it must make salary reduction contributions, as described in Q&A D-2, to the extent elected by employees. In addition, the employer must make employer matching contributions, as described in Q&As D-4 and D-5, or employer nonelective contributions, as described in Q&A D-6. These are the only contributions that may be made under a SIMPLE plan.

**Question D-2.** *What is a salary reduction contribution?*

**Answer D-2.** A salary reduction contribution is a contribution made pursuant to an employee's election to have an amount contributed to his or her SIMPLE IRA, rather than have the amount paid directly to the employee in cash. An employee must be permitted to elect to have salary reduction contributions made at the level specified by the employee, expressed as a percentage of compensation for the year. Additionally, an employer may permit an employee to express the level of salary reduction contributions as a specific dollar amount. An employer may not place any restrictions on the amount of an employee's salary reduction contributions (e.g., by limiting the contribution percentage), except to the extent needed to comply with the annual limit on the amount of salary reduction contributions described in Q&A D-3.

**Question D-3.** *What is the annual limit on the amount of salary reduction contributions under a SIMPLE plan?*

**Answer D-3.** For 1997, the maximum annual amount of salary reduction contributions that can be made on behalf of any employee under a SIMPLE plan is $6,000. This amount will be adjusted by the Service to reflect any changes in the cost of living.

**Question D-4.** *What employer matching contribution is generally required under a SIMPLE plan?*

**Answer D-4.** Under a SIMPLE plan, an employer is generally required to make a contribution on behalf of each eligible employee in an amount equal to the employee's salary reduction contributions, up to a limit of 3% of the employee's compensation for the entire calendar year.

**Question D-5.** *Can the 3% limit on matching contributions be reduced?*

**Answer D-5.** The 3% limit on matching contributions is permitted to be reduced for a calendar year at the election of the employer, but only if:

1. The limit is not reduced below 1%;
2. The limit is not reduced for more than two years out of the five-year period that ends with (and includes) the year for which the election is effective; and
3. Employees are notified of the reduced limit within a reasonable period of time before the 60-day election period during which employees can enter into salary reduction agreements. See Q&A E-1.

For purposes of applying the rule described in paragraph (2) of this Q&A, in determining whether the limit was reduced below 3% for a year, any year before the first year in which an employer (or a predecessor employer) maintains a SIMPLE plan will be treated as a year for which the limit was 3%. If an employer chooses to make nonelective contributions for a year (see Q&A D-6), that year also will be treated as a year for which the limit was 3%.

**Question D-6.** *May an employer make nonelective contributions instead of matching contributions?*

**Answer D-6.** As an alternative to making matching contributions under a SIMPLE plan (as described in Q&A D-4 and D-5), an employer may make nonelective contributions equal to 2% of each eligible employee's compensation for the entire calendar year. The employer's nonelective contributions must be made for each eligible employee regardless of whether the employee elects to make salary reduction contributions for the calendar year. The employer may, but is not required to, limit nonelective contributions to eligible employees who have at least $5,000 (or some lower amount selected by the employer) of compensation for the year.

For purposes of the 2% nonelective contribution, the compensation taken into account must be limited to the amount of compensation that may be taken into account under §401(a)(17) for the year. The §401(a)(17) limit for 1997 is $160,000. This amount will be adjusted by the Service for subsequent years to reflect changes in the cost of living.

An employer may substitute the 2% nonelective contribution for the matching contribution for a year, only if:

1. Eligible employees are notified that a 2% nonelective contributions will be made instead of a matching contribution; and
2. This notice is provided within a reasonable period of time before the 60-day election period during which employees can enter into salary reduction agreements. See Q&A E-1.

## E. Employee Elections

**Question E-1.** *When must an employee be given the right to enter into a salary reduction agreement?*

**Answer E-1.** During the 60-day period immediately preceding January 1 of a calendar year (i.e., November 2 to December 31 of the preceding calendar year), an eligible employee must be given the right to enter into a salary reduction agreement for the calendar year, or to modify a prior agreement (including reducing the amount subject to this agreement to $0). However, for the year in which the employee becomes eligible to make salary reduction contributions, the period during which the employee may enter into a salary reduction agreement or modify a prior agreement is a 60-day period that includes either the date the employee becomes eligible or the day before that date. For example, if an employer establishes a SIMPLE plan effective as of July 1, 1997, each eligible employee becomes eligible to make salary reduction contributions on that date and the 60-day period must begin no later than July 1 and cannot end before June 30, 1997.

During these 60-day periods, employees have the right to modify their salary reduction agreements without restrictions. In addition, for the year in which an employee becomes eligible to make salary reduction contributions, the employee must be able to commence these contributions as soon as the employee becomes eligible, regardless of whether the 60-day period has ended.

**Question E-2.** *Can a SIMPLE plan provide additional or longer election periods?*

**Answer E-2.** Nothing precludes a SIMPLE plan from providing additional or longer periods for permitting employees to enter into salary reduction agreements or to modify prior agreements. For example, a SIMPLE plan can provide a 90-day election period instead of the 60-day period described in Q&A E-1. Similarly, in addition to the 60-day period described in Q&A E-1, a SIMPLE plan can provide quarterly election periods during the 30 days before each calendar quarter.

**Question E-3.** *Does an employee have the right to terminate a salary reduction agreement outside a SIMPLE plan's normal election period?*

**Answer E-3.** An employee must be given the right to terminate a salary reduction agreement for a calendar year at any time during the year. A SIMPLE plan may provide that an employee who terminates a salary reduction agreement at any time other than the periods described in Q&A E-1 or E-2 is not eligible to resume participation until the beginning of the next calendar year.

**Question E-4.** *Must an employer allow an employee to select the financial institution to which the employer will make all SIMPLE plan contributions on behalf of the employee?*

**Answer E-4.** Generally, under §408(p), and employer must permit an employee to select the financial institution for the SIMPLE IRA to which the employer will make all contributions on behalf of the employee. If an employer uses Form 5305-SIMPLE as modified in Q&A K-3, the employer may modify page 3 of Form 5305-SIMPLE (October 1996) (Model Salary Reduction Agreement) to include a section for employees to indicate the financial institution they have selected and any additional information necessary to facilitate transmittal of the contribution to that institution. Alternatively, under the exception described in Q&A J-1, an employer may require that all contributions be made to a designated financial institution.

## F. Vesting Requirements

**Question F-1.** *Must contributions under a SIMPLE plan be nonforfeitable?*

**Answer F-1.** Yes. All contributions under a SIMPLE plan must be fully vested and nonforfeitable when made.

**Question F-2.** *May amounts held in a SIMPLE IRA be withdrawn at any time?*

**Answer F-2.** Yes. An employer may not require an employee to retain any portion of the contribu- tions in his or her SIMPLE IRA or otherwise impose any withdrawal restrictions.

## G. Employer Administrative and Notification Requirements

**Question G-1.** *What notification requirements apply to employers?*

**Answer G-1.** An employer must notify each employee, immediately before the employee's 60-day election period described in Q&A E-1, of the employee's opportunity to enter into a salary reduction agreement or to modify a prior agreement. If applicable, this notification must disclose an employee's ability to select the financial institution that will serve as the trustee of the employee's SIMPLE IRA as described in Q&A E-4. If an employer uses Form 5305-SIMPLE as modified in Q&A K-3, the employer may modify page 3 of Form 5305-SIMPLE (October 1996) (Model Notification to Eligible Employees) to disclose an employee's ability to select the financial institution that will serve as the trustee of the employee's SIMPLE IRA as described in Q&A E-4. The notification must also include the summary description described in Q&A H-1. In the case of a SIMPLE plan established using Form 5305-SIMPLE, the summary description requirement may be satisfied by providing a completed copy of pages one and two of Form 5305-SIMPLE that reflects the terms of the employer's plan (including the materials provided by the trustee for completion of Article VI).

**Question G-2.** *May the notifications regarding a reduced matching contribution (described in Q&A D-5) and a nonelective contribution in lieu of a matching contribution (described in Q&A D-6) be provided at the same time as the notification of an employee's opportunity to enter into a salary reduction agreement and the summary description?*

**Answer G-2.** Yes. An employer is deemed to provide the notification regarding a reduced matching contribution or a nonelective contribution in lieu of a matching contribution within a reasonable period of time before the 60-day election period if, immediately before the 60-day election period, this notification is included with the notification of an employee's opportunity to enter into a salary reduction agreement.

**Question G-3.** *What reporting penalties under the Code apply if an employer fails to provide one or more of the required notices?*

**Answer G-3.** If the employer fails to provide one or more of the required notices described in Q&A G-1, the employer will be liable, under the Code, for a penalty of $50 per day until the notices are provided. If the employer shows that the failure was due to reasonable cause, the penalty will not be imposed. To the extent that each employee is permitted to select the trustee for his or her SIMPLE IRA pursuant to Q&A E-4, and is so notified in accordance with Q&A G-1, and the information with respect to the trustee (the name and address of the trustee and its withdrawal procedures) is not available at the time the employer is required to provide the summary description, the employer is deemed to have shown reasonable cause for failure to provide this information to eligible employees, but only if the employer sees to it that this information is provided to the employee as soon as administratively feasible once the trustee has been selected.

**Question G-4.** *What if an eligible employee is unwilling or unable to establish a SIMPLE IRA?*

**Answer G-4.** If an eligible employee who is entitled to a contribution under a SIMPLE plan is unwilling or unable to establish a SIMPLE IRA with any financial institution prior to the date on which the contribution is required to be made to the SIMPLE IRA of the employee under Q&A G-5 or G-6, an employer may execute the necessary documents to establish a SIMPLE IRA on the employee's behalf with a financial institution selected by the employer.

**Question G-5.** *When must an employer make salary reduction contributions under a SIMPLE plan?*

**Answer G-5.** The employer must make salary reduction contributions to the financial institution maintaining the SIMPLE IRA no later than the close of the 30-day period following the last day of the month in which amounts would otherwise have been payable to the employee in cash. The Department of Labor has indicated that most SIMPLE plans are also subject to Title I of the Employee Retirement Income Security Act of 1974 (ERISA). The Department of Labor has informed the Treasury Department and the Service that, as a matter of enforcement policy, for these plans, salary reduction contributions must be made to the SIMPLE IRA as of the earliest date on which the contributions can reasonably be segregated from the employer's general assets, but in no event later than the 30-day deadline described above.

**Question G-6.** *When must an employer make matching and nonelective contributions under a SIMPLE plan?*

**Answer G-6.** Matching and nonelective employer contributions must be made to the financial institution maintaining the SIMPLE IRA no later than the due date for filing the employer's income tax return, including extensions, for the taxable year that includes the last day of the calendar year for which the contributions are made.

## H. Trustee Administrative Requirements

**Question H-1.** *What information must a SIMPLE IRA trustee provide to an employer?*

**Answer H-1.** Each year, a SIMPLE IRA trustee must provide the employer sponsoring the SIMPLE plan with a summary description containing the following information:

1. The name and address of the employer and the trustee.
2. The requirements for eligibility for participation.
3. The benefits provided with respect to the arrangements.
4. The time and method of making elections with respect to the arrangement.
5. The procedures for, and effects of, withdrawals (including rollovers) from the arrangement.

The trustee must provide the summary description to the employer early enough to allow the employer to meet its notification obligation described in Q&A G-1. However, a trustee is not required to provide the summary description prior to agreeing to be the trustee of a SIMPLE IRA for the SIMPLE plan.

A trustee that fails to provide the employer with a summary plan description incurs a $50 penalty, under the Code, for each day the failure continues, unless the trustee shows that the failure is due to reasonable cause. To the extent that the employer or trustee provides the information described in paragraphs (1) through (5) of the Q&A within the time period prescribed in Q&A G-1 to the employee for whom the SIMPLE IRA is established, the trustee of that SIMPLE IRA is deemed to have shown reasonable cause for failure to provide that information to the employer. For example, if the employer provides its name and address and the information described in paragraphs (2) through (4) of the Q&A, and the effects of withdrawal to all eligible employees in a SIMPLE plan in accordance with Q&A G-1, and the trustee provides its name and address and its procedures for withdrawal to each eligible employee for whom a SIMPLE IRA is established with the trustee under the SIMPLE plan, the trustee will be deemed to have shown reasonable cause for failing to provide the employer the information described in paragraphs (1) through (5) of this Q&A.

In the case of a SIMPLE plan established using Form 5305-SIMPLE, a trustee may satisfy this obligation by providing an employer with a current copy of Form 5305-SIMPLE, with instructions, the information required for completion of Article VI, and the name and address of the financial institution. The trustee should provide guidance to the employer concerning the need to complete the first two pages of Form 5305-SIMPLE in accordance with its plan's terms and to distribute completed copies to eligible employees.

The trustee of a transfer SIMPLE IRA is not required to provide the summary description described in the preceding paragraph. A SIMPLE IRA is a transfer SIMPLE IRA if it is not a SIMPLE IRA to which the employer has made contributions under the SIMPLE plan.

**Question H-2.** *What information must a SIMPLE IRA trustee provide to participants in the SIMPLE plan?*

**Answer H-2.** Within 30 days after the close of each calendar year, a SIMPLE IRA trustee must provide each individual on whose behalf an account is maintained with a statement of the individual's account balance as of the close of the calendar year and the account activity during that calendar year. A trustee who fails to provide individuals with this statement incurs a $50 penalty, under the Code, for each day the failure continues, unless the trustee shows that the failure is due to reasonable cause. However, no penalty will apply if a trustee provides this statement not later than January 31 following the calendar year to which the statement relates. The trustee must also provide any other information required to be furnished to IRA holders (e.g., disclosure statements for individual retirement plans as referred to in §1.408-6 of the regulations).

**Question H-3.** *What information must a SIMPLE IRA trustee provide to the Service?*

**Answer H-3.** Section 408(i) requires the trustee of an individual retirement account to make reports regarding these account to the Service. The Service intends to modify Form 5498, Individual Retirement Arrangement Information, to require that the amount of contributions to a SIMPLE IRA, rollover contributions, and the fair market value of the account be reported, and that contributions to a SIMPLE IRA be identified as such. A trustee who fails to file these reports incurs a $50 penalty under the Code for each failure, unless it is shown that the failure is due to reasonable cause.

**Question H-4.** *Are distributions from a SIMPLE IRA required to be reported on Form 1099-R?*

**Answer H-4.** Pursuant to §6047 of the Code and §35.3405-1 of the regulations, the payor of a designated distribution from an IRA must report the distribution on Form 1099-R. A distribution from a SIMPLE IRA is a designated distribution from an IRA and thus must be reported on Form 1099-R. The IRS intends to revise Form 1099-R, Distributions From Pension, Annuities, Retirement orProfit-sharing Plans, IRAs, Insurance Contracts, Etc., to reflect the requirements that apply to SIMPLE IRAs. The penalty, under the Code, for failure to report a designated distribution from an IRA (including a SIMPLE IRA) is determined under §§6721–6724.

**Question H-5.** *Is a SIMPLE IRA trustee responsible for reporting whether a distribution to a participant occurred during the two-year period described in Q&A I-2?*

**Answer H-5.** Yes. A SIMPLE IRA trustee is required to report on Form 1099-R whether a distribution to a participant occurred during the two-year period described in Q&A I-2. A trustee is permitted to prepare this report on the basis of its own records with respect to the SIMPLE IRA account. A trustee may, but is not required to, take into account other adequately substantiated information regarding the date on which an individual first participated in any SIMPLE plan maintained by the individual's date on which an individual first participated in any SIMPLE plan maintained by the individual's employer. See Q&A I-2 on the effect of distribution within this two-year period.

## I. Tax Treatment of SIMPLE Plans

**Question I-1.** *What are the tax consequences of SIMPLE plan contributions?*

**Answer I-1.** Contributions to a SIMPLE IRA are excludible from federal income tax and not subject to federal income tax withholding. Salary reduction contributions to a SIMPLE IRA are subject to tax under the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and the Railroad Retirement Act (RRTA), and must be reported on Form W-2, Wage and Tax Statement. Matching and nonelective contributions to a SIMPLE IRA are not subject to FICA, FUTA or RRTA taxes, and are not required to be reported on Form W-2.

**Question I-2.** *What are the tax consequences when amounts are distributed from a SIMPLE IRA?*

**Answer I-2.** Generally, the same tax results apply to distributions from a SIMPLE IRA as to distributions from a regular IRA [i.e., an IRA described in §408(a) or (b)]. However, a special rule applies to a payment or distribution received from a SIMPLE IRA during the two-year period beginning on the date on which the individual first participated in any SIMPLE plan maintained by the individual's employer (the "two-year period").

Under this special rule, if the additional income tax on early distributions under §72(t) applies to a distribution within this two-year period, §72(t)(6) provides that the rate of additional tax under this special rule is increased from 10% to 25%. If one of the exceptions to application of the tax under §72(t) applies (e.g., for amounts paid after age 59½, after death, or as part of a series of substantially equal payments), the exception also applies to distributions within the two-year period and the 25% additional tax does not apply.

**Question I-3.** *Are there any special rollover rules that apply to a distribution from a SIMPLE IRA?*

**Answer I-3.** Section 408(d)(3)(G) provides that the rollover provisions of §408(d)(3) apply to a distribution from a SIMPLE IRA during the two-year period described in Q&A I-2 only if the distribution is paid into another SIMPLE IRA. Thus, a distribution from a SIMPLE IRA during that two-year period qualifies as a rollover contribution (and thus is not includible in gross income) only if the distribution is paid into another SIMPLE IRA and satisfies the other requirements of §408(d)(3) for treatment as a rollover contribution.

**Question I-4.** *Can an amount be transferred from a SIMPLE IRA to another IRA in a tax-free trustee-to-trustee transfer?*

**Answer I-4.** During the two-year period described in Q&A I-2, an amount in a SIMPLE IRA can be transferred to another SIMPLE IRA in a tax-free trustee-to-trustee transfer. If, during this two-year period, an amount is paid from a SIMPLE IRA directly to the trustee of an IRA that is not a SIMPLE IRA, the payment is neither a tax-free trustee-to-trustee transfer nor a rollover contribution; the payment is a distribution from the SIMPLE IRA and a contribution to the other IRA that does not qualify as a rollover contribution. After the expiration of the two-year period, an amount in a SIMPLE IRA can be transferred in a tax-free trustee-to-trustee transfer to an IRA that is not a SIMPLE IRA.

**Question I-5.** *When does the two-year period described in Q&A I-2 begin?*

**Answer I-5.** The two-year period described in Q&A I-2 begins on the first day on which contributions made by the individual's employer are deposited in the individual's SIMPLE IRA.

**Question I-6.** *Do the qualification rules of §401(a) apply to contributions under a SIMPLE plan?*

**Answer I-6.** None of the qualification rules of §401(a) apply to SIMPLE plans. For example, the §§415 and 416 rules do not apply to contributions under a SIMPLE plan. Similarly, the §401(a)(17) limit does not apply to salary reduction contributions and matching contributions. However, as noted in Q&A D-6, the amount of compensation that may be taken into account for purposes of the 2% nonelective contribution is limited to the amount that may be taken into account under §401(a)(17) for the year.

**Question I-7.** *What rules apply to an employer's ability to deduct contributions under a SIMPLE plan?*

**Answer I-7.** Pursuant to §404(m), contributions under a SIMPLE plan are deductible in the taxable year of the employer with or within which the calendar year for which contributions were made ends [without regard to the limitations of §404(a)]. For example, if an employer has a June 30 taxable year end, contributions under the SIMPLE plan for the calendar year 1997 (including contributions made in 1997 before June 30, 1997) are deductible in the taxable year ending June 30, 1998. Contributions will be treated as made for a particular taxable year if they are made on account of that taxable year and are made by the due date (including extensions) prescribed by law for filing the return for the taxable year.

## J. Exception for Use of Designated Financial Institution

**Question J-1.** *Can an employer designate a particular financial institution to which all contributions under the SIMPLE plan will be made?*

**Answer J-1.** Yes. In accordance with §408(p)(7), instead of making SIMPLE plan contributions to the financial institution selected by each eligible employee (see Q&A E-4), an employer may require that all contributions on behalf of all eligible employees under the SIMPLE plan be made to SIMPLE IRAs at a particular financial institution if the following requirements are met:

1. The employer and the financial institution agree that the financial institution will be a designated financial institution under §408(p)(7) (DFI) for the SIMPLE plan;
2. The financial institution agrees that, if a participant so requests, the participant's balance will be transferred without cost or penalty to another SIMPLE IRA (or, after the two-year period described in Q&A I-2, to any IRA) at a financial institution selected by the participant; and
3. Each participant is given written notification describing the procedures under which, if a participant so requests, the participant's balance will be transferred without cost or penalty to another SIMPLE IRA (or, after the two-year period described in Q&A I-2, to any IRA) at a financial institution selected by the participant.

This Q&A is illustrated by the following examples:

Example 1. A representative of financial institution L approaches employer B concerning the establishment of a SIMPLE plan. Employer B agrees to establish a SIMPLE plan for its eligible employees. Employer B would prefer to avoid writing checks to more than one financial institution on behalf of employees, and is interested in making all contributions under the SIMPLE plan to a single financial institution. Employer B and financial institution L agree that financial institution L will be a DFI, and financial institution L agrees that, if a participant so requests, it will transfer the participant's balance, without cost or penalty, to another SIMPLE IRA (or, after the two-year period described in Q&A I-2, to any IRA) at a financial institution selected by the participant. A SIMPLE IRA is established for each participating employee of employer B at financial institution L. Each participant is provided with a written description of how and when the participant may direct that the participant's balance attributable to contributions made to financial institution L be transferred without cost or penalty to a SIMPLE IRA (or, after the two-year period described in Q&A I-2, to any IRA) at another financial institution selected by the participant. Financial institution L is a DFI, and employer B may require that all contributions on behalf of all eligible employees be made to SIMPLE IRAs at financial institution L.

Example 2. A representative of financial institution M approaches employer C concerning the establishment of a SIMPLE plan. Employer C invites financial institution M to make a presentation on its investment options for SIMPLE IRAs to employer C's employees. Each eligible employee receives notification that the employer must permit the employee to select which financial institution will serve as the trustee of the employee's SIMPLE IRA (see Q&A G-1). All eligible employees of employer C voluntarily select financial institution M to serve as the trustee of the SIMPLE IRAs to which employer C will make all contributions on behalf of the employees. Financial institution M is not a DFI merely because all eligible employees of employer C selected financial institution M to serve as the trustee of their SIMPLE IRAs and employer C consequently makes all contributions to financial institution M. Therefore, financial institution M is not required to transfer SIMPLE IRA balances without cost or penalty.

Example 3. Assume the same facts as Example 2, except that employee X and employee Y, who made salary reduction elections, failed to establish SIMPLE IRAs to receive SIMPLE plan contributions on their behalf before the first date on which employer C is required to make a contribution to their SIMPLE IRAs. Employer C establishes SIMPLE IRAs at financial institution M for these employees and contributes the amount required to their accounts. Financial institution M is not a DFI merely because employer C establishes SIMPLE IRAs on behalf of employee X and employee Y while all other employees voluntarily select financial institution M to serve as the trustee of the SIMPLE IRAs to which employer C will make contributions on their behalf.

**Question J-2.** *May the time and manner in which a participant may transfer his or her balance without cost or penalty be limited without violating the requirements of §408(p)(7)?*

**Answer J-2.** Yes. Section 408(p)(7) will not be violated merely because a participant is given only a reasonable period of time each year in which to transfer his or her balance without cost or penalty. A participant will be deemed to have been given a reasonable period of time in which to transfer his or her balance without cost or penalty if, for each calendar year, the participant has until the end of the 60-day period described in Q&A E-1 to request to transfer, without cost or penalty, his or her balance attributable to SIMPLE plan contributions for the calendar year following that 60-day period (or, for the year in which an employee becomes eligible to make salary reduction contributions, for the balance of that year) and subsequent calendar year.

If the time or manner in which a participant may transfer his or her balance without cost or penalty is limited, any such limitation must be disclosed as part of the written notification described in Q&A J-1. In the case of a SIMPLE plan established using Form 5305-SIMPLE, if the summary description requirement is being satisfied by providing a completed copy of pages one and two of Form 5305-SIMPLE, Article VI (Procedures for Withdrawal) must contain a clear explanation of any such limitation.

This Q&A is illustrated by the following examples:

Example 1. Employer A first establishes a SIMPLE plan effective January 1, 1998, and intends to make all contributions to financial institution M, which has agreed to serve as a DFI. For the 1998 calendar year, employer A provides the 60-day election period described in Q&A E-1 beginning November 2, 1997, and notifies each participant that he or she may request that his or her balance attributable to future contributions be transferred from financial institution M to a SIMPLE IRA at a financial institution that the participant selects. The notification states that the transfer will be made without cost or penalty if the participant contact financial institution M prior to January 1, 1998. For the 1998 calendar year, the requirements of §408(p)(7) will not be violated merely because participants are given only a 60-day period in which to request to transfer their balances without cost or penalty.

Example 2. Assume the same facts as Example 1. Participant X does not request a transfer of her balance by December 31, 1997, but requests a transfer of her current balance to another SIMPLE IRA on July 1, 1998. Participant X's current balance would not be required to be transferred without cost or penalty because participant X did not request such a transfer prior to January 1, 1998. However, during the 60-day period preceding the 1999 calendar year, participant X may request a transfer, without cost or penalty, of her balance attributable to contributions made for the 1999 calendar year and, if she so elects, for all future calendar years (but not her balance attributable to contributions for the 1998 calendar year).

Example 3. Assume the same facts as Example 1. Under the terms of the SIMPLE plan, participant Y becomes an eligible employee on June 1, 1998, and, for participant Y, the 60-day period described in Q&A E-1 begins on that date. For the 1998 calendar year, participant Y will be deemed to have been given a reasonable amount of time in which to request to transfer, without cost or penalty, his balance attributable to contributions for the balance of the 1998 calendar year if financial institution M allows such a request to be made prior to July 31, 1998.

**Question J-3.** *Is there a limit on the frequency with which a participant's balance must be transferred without cost or penalty?*

**Answer J-3.** In order to satisfy §408(p)(7), if a participant acts, within applicable reasonable time limits, if any, to request a transfer of his or her balance, the participant's balance must be transferred on a reasonably frequent basis. A participant's balance will be deemed to be transferred on a reasonably frequent basis if it is transferred on a monthly basis.

**Question J-4.** *How does a DFI transfer a participant's balance without cost or penalty?*

**Answer J-4.** In order to satisfy §408(p)(7), a participant's balance must be transferred in a trustee-to-trustee transfer directly to a SIMPLE IRA (or, after the two-year period described in Q&A I-2), to any IRA) at the financial institution specified by the participant.

A transfer is deemed to be made without cost or penalty if no liquidation, transaction, redemption, or termination fee, or any commission, load (whether front-end or back-end) or surrender charge, or similar fee or charge is imposed with respect to the balance being transferred. A transfer will not fail to be made without cost or penalty merely because contributions that a participant has elected to have transferred without cost or penalty are required to be invested in one specified investment option until transferred, even through a variety of investment options are available with respect to contributions that participants have not elected to transfer. This Q&A J-4 is illustrated by the following examples:

Example 1. Financial institution Q agrees to be a DFI for the SIMPLE plan maintained by employer D. Employer D provides the 60-day election period described in Q&A E-1 beginning on November 2 of each year, and each participant is notified that he or she may request, before the end of the 60-day period, a transfer of his or her future contributions from financial institution Q without cost or penalty to a SIMPLE IRA (or, after the two-year period described in Q&A I-2, to any IRA) at a financial institution selected by the participant. The notification states that a participant's contributions that are to be transferred without cost or penalty will be invested in a specified investment option and will be transferred to the financial institution selected by the participant on a monthly basis.

Financial institution Q offers various investment options to account holders of IRA SIMPLE accounts, including investment options with a sales charge. Any participant who does not elect to have his or her balance transferred to another financial institution may invest the contributions made on his or her behalf in any investment option available to account holders of SIMPLE IRA accounts at financial institution Q. However, contributions that a participant has elected to have transferred are automatically invested, prior to transfer, in a specified investment option that has no sales charge. The requirement that a participant's balance be transferred without cost or penalty will not be violated merely because contributions that have been designated to be transferred pursuant to a participant's election are automatically invested in one specified investment option and transferred on a monthly basis to the financial institution selected by the participant.

Example 2. Assume the same facts as in Example 1. Financial institution Q generally charges its IRA accounts a reasonable annual administration fee. Financial institution Q also charges this annual administration fee with respect to SIMPLE IRA accounts including SIMPLE IRA accounts from which balances must be transferred in accordance with participants' transfer elections. The requirement that participants' balances be transferred without cost or penalty will not be violated merely because a reasonable annual administration fee is charged to SIMPLE IRA accounts from which balances must be transferred in accordance with participants' transfer elections.

**Question J-5.** *Is the "without cost or penalty" requirement violated if a DFI charges an employer for a participant's transfe of his or her balance?*

**Answer J-5.** The "without cost or penalty" requirement of §408(p)(7) is not violated merely because a DFI charges an employer an amount that takes into account the financial institution's responsibility to transfer balances upon participants' requests or otherwise charges an employer for transfers requested by participants, provided that the charge is not passed through to the participants who request the transfer.

## K. SIMPLE Plan Establishment

**Question K-1.** *Must an employer establish a SIMPLE plan on January 1?*

**Answer K-1.** An existing employer may establish a SIMPLE plan effective on any date between January 1 and October 1 of a year beginning after December 31, 1996, provided that the employer (or any predecessor employer) did not previously maintain a SIMPLE plan. This requirement does not apply to a new employer that comes into existence after October 1 of the year the SIMPLE plan is established if the employer establishes the SIMPLE plan as soon as administratively feasible after the employer comes into existence. If an employer (or predecessor employer) previously maintained a SIMPLE plan, the employer may establish a SIMPLE plan effective only on January 1 of a year.

**Question K-2.** *When must a SIMPLE IRA be established for an employee?*

**Answer K-2.** A SIMPLE IRA is required to be established for an employee prior to the first date by which a contribution is required to be deposited into the employee's SIMPLE IRA (See Q&As G-5 and G-6).

**Question K-3.** *Will the Service issue model forms employers can use to establish SIMPLE plans?*

**Answer K-3.** Yes. On October 31, 1996, the Service issued Form 5305-SIMPLE, which is a form that may be used by an employer establishing a SIMPLE plan with a financial institution that is a DFI. The Service also intends to issue a model form that may be used by an employer establishing a SIMPLE plan that does not use a DFI. (The Service issued Form 5304-SIMPLE on December 30, 1996.) Until the

Service issues this model form, an employer establishing a SIMPLE plan that does not use a DFI and wishes to use a model form may use Form 5305-SIMPLE (October 1996).

Transition Relief for Failures to Make Plan Distributions to Certain Employees or Offer Options to Defer Distributions by April 1, 1997
I.R.C. §401(a)(9)
Announcement 97-70

**This announcement provides transition relief for qualified plans that fail to make distributions required under the terms of the plan to an employee who attained age 70½ in 1996 and who did not retire in 1996. This relief is conditioned upon the employer meeting specified requirements with respect to such an employee.**

Section 1404(a) of the Small Business Job Protection Act of 1996 (SBJPA) amended §401(a)(9) of the Code to provide that, in the case of an employee who is not a 5% owner, the required beginning date for minimum distributions from a qualified plan is April 1 of the calendar year following the later of the calendar year in which the employee attains age 70½ or the calendar year in which the employee retires. The amendment to §401(a)(9) applies to years beginning after December 31, 1996.

**Transition Relief.** **Under the announcement, if the requirements described below are satisfied, a plan will not be treated as failing to satisfy the requirements of §401(a) of the Code merely because the plan fails to make certain distributions required under the terms of the plan to an employee (other than a 5% owner) who attained age 70½ in 1996 and who did not retire from employment with the employer maintaining the plan by the end of 1996.**

The relief in this announcement applies to a plan with respect to distributions required under the terms of the plan to be made to such an employee between August 20, 1996 (the date of enactment of the SBJPA) **and December 31, 1997.**

This relief is available only if: (1) the employee is **offered an option to defer the distribution and elects to defer, or a make-up distribution is paid to such employee, and (2) the employee option or the make-up distribution meets the qualification requirements under §401(a) of the Code** (other than the requirement that a plan operate in accordance with its terms).

For example, the employee option or the make-up distribution must satisfy the requirements of §§401(a)(11) and 417 (relating to joint and survivor annuities).

**If the employer chooses to offer an election to defer, the election to defer must be made by the employee by December 31, 1997. If an employee chooses not to defer, the plan must pay a make-up distribution to the employee in a manner that satisfies the rules set out below.**

Whether a make-up distribution from the plan is paid to all employees (other than 5% owners) who attained age 70½ in 1996 and who did not retire from employment with the employer maintaining the plan by the end of 1996 or only to any such employee who is offered an election to defer but chooses not to defer, the make-up distribution must be made by December 31, 1997, and must include all of the employee's distributions required under the plan terms up to that date. The make-up distribution must restore to the employee the benefits that the employee would have had if the plan terms had been followed. For example, in the case of a defined benefit plan, the make-up distribution for an employee must be increased to take into account the delayed payment consistent with the plan's actuarial adjustments.

Further, future guidance will provide that an employer who offers the option to defer described above under a plan **must amend the plan retroactively, no later than the date specified in that guidance, to provide for the option.**

The retroactive plan amendment must conform the plan to its pre-amendment operation regarding the option to defer commencement of benefits.

However, a plan will not fail to satisfy this operational requirement merely because the amendment provides for an employee to have the option to either commence distribution by April 1, 1997 or to defer distribution beyond that date but, in operation, the plan provided for an election to defer or make up distributions in accordance with this announcement.

This announcement also applies to an employer that has adopted a master or prototype or a regional prototype plan. Such an employer should note that if a conforming amendment is not an available option under the sponsor's prototype plan document, the required amendment may result in the loss of prototype status.

**Educational assistance programs— I.R.C. §127**

Rev. Rul. 96–41

**Educational assistance after termination of employment.** Educational assistance plans that provide benefits to participants by reason of their employment with the employer will not fail to qualify as educational assistance programs described in section 127(b) of the Code merely because eligible participants include former employees, regardless of the reason for termination of employment.

**Surviving spouse allowed to roll over deceased husband's pension plan balance.**

LTR 9638040, June 27, 1996
Code §§401 and 402

Your husband was an employee of Employer M and a participant in plan X. On December 27, 1983, he signed a document entitled "Special Revocable Election Form". This was intended to be a written election made pursuant to section 242(b) of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). The election stated that the method of distribution of his account balance in Plan X would be a lump sum to be made on the close of the plan year in which he retired. The election did not name a beneficiary. However, the plan provides that in the absence of a beneficiary designation at death, the plan must distribute the account balance to the participant's surviving spouse.

He died on May 16, 1994, at the age of 77. At the time of his death, he had not modified or revoked the written election. In December 1995, you took a distribution of his entire account balance in Plan X and rolled it over to your own individual retirement arrangement ("IRA").

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Based on the foregoing facts and representations, you request a ruling that you may roll over a distribution of your deceased husband's entire account balance from Plan X to your IRA to the extent that the distribution does not include minimum distributions that should have been made to your deceased husband during his lifetime, as required by §401(a)(9) of the Internal Revenue Code ("Code").

Code §402(c)(9) provides in general that a surviving spouse may roll over into his/her IRA part or all of any eligible rollover distribution received from the employee's qualified plan after the employee's death. Therefore, pursuant to Code §§402(c)(1), 402(c)(4), and 402(c)(9), a distribution of your deceased husband's entire account balance from Plan X **is eligible for rollover to your IRA to the extent that such distribution does not include minimum distributions that should have been made to your deceased husband during his lifetime, for the year of his death, and for 1995,** the year of distribution from the Plan, as required by Code §401(a)(9).

## Return Preparers

### Scenarios of Disciplinary Actions from the Office of Director of Practice

**Actions of tax practitioners that may result in discipline discussed.**

The following scenarios are composites of matters that have come to the attention of the Office of Director of Practice. The scenarios are intended to inform tax practitioners of the types of activity that may result in disciplinary action under Treasury Department Circular No. 230, Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, and Appraisers Before the Internal Revenue Service. Because disciplinary matters are resolved on the basis of their particular facts and circumstances, these scenarios do not constitute precedent in any matter before the Director.

**False Statements.** The practitioner was engaged by a physician to prepare the physician's individual income tax return. When the physician delivered his records, he commented to the practitioner that he hoped he could take a substantial deduction for using his car in his practice. The practitioner did not ask for further substantiation and, on the tax return submitted to the IRS, deducted various automobile expenses: depreciation, insurance, maintenance, gas, and oil. When the tax return was audited, the physician explained to the IRS auditor that he considered his car to be used in his practice because he drove it between his home and office.

Thereafter, the Director called the practitioner's attention to possible violations of Circular 230: lack of due diligence in preparing tax returns in violation of §10.22(a); and giving false information to the Treasury Department in violation of §10.51(b). The practitioner asserted that he was entitled to place good faith reliance on his client's information. However, the practitioner could not cite any authoritative exception to the general rule that commuting expenses are not deductible. Consequently, the Director considered the practitioner to be in violation of §10.51(b).

**Contemptuous Conduct.** The practitioner called an IRS revenue officer to discuss his client's case. The revenue officer, after listening to the practitioner's comments, stated that the client could still expect enforcement action. Whereupon, the practitioner said, "How about my coming down there and jerking **you** around for a while?" He added he "would not mind kicking down the door." The revenue officer terminated the call and notified the IRS's Inspection Service. Later in the day, the practitioner called back to apologize.

The Director contacted the practitioner with regard to possible violations of Circular 230: attempting to influence an IRS employee's official action by use of a threat, a violation of §10.51(f); and contemptuous conduct consisting of abusive language, a violation of §10.51(i). In response, the practitioner offered little in the way of explanation, stating that he had simply lost his temper.

The Director determined that the practitioner's statements constituted contemptuous conduct in violation of §10.51(i). Since this was the only such instance involving the practitioner in many years of IRS practice, and in view of the quick apology, the Director determined that a reprimand, with a warning as to future conduct, was the appropriate sanction.

**Due Diligence.** The practitioner's employees completed clients' tax returns, which the practitioner reviewed and signed as the preparer. In completing a client's individual income tax return, one of the employees accepted the client's characterization of several trips as business trips. The employee made no further inquiry and did not request substantiation. In fact, no business purpose for the trips could be substantiated. The practitioner reviewed and signed the tax return.

The Director contacted the practitioner, stating that the practitioner may have violated the regulations in Circular 230: lack of due diligence in preparing tax returns in violation of §10.22(a); and giving false information to the Treasury Department in violation of §10.51(b). The practitioner responded that it would be unfair to hold him responsible for the actions of the employee, who had disregarded the office policy of obtaining substantiation for business trips.

In consideration of the practitioner's office policy, and in the absence of a history of inaccurate returns, the Director was satisfied that the practitioner had not knowingly submitted false information. Therefore, the Director resolved in the practitioner's favor any question with regard to a violation of §10.51(b). However, the practitioner, as the person who signed the tax return, could not disclaim responsibility for the tax return's accuracy. The Director considered the practitioner to be in violation of §10.22(a) for failing to exercise due diligence.

**Knowledge of Client's Mistake.** The client completed the practitioner's tax return preparation questionnaire, indicating that he was separated from his spouse. In reviewing the questionnaire, the practitioner asked the client whether he was "legally separated." The client replied that he was. The practitioner prepared the client's Form 1040, listing the client's filing status as single.

Later, the practitioner learned that although the client and the client's spouse had come to terms on a separation agreement, the agreement had not been incorporated into a decree of divorce or separate maintenance. The practitioner, knowing that the client had declined to file an amended tax return in a prior year, did not inform the client of the mistake.

The Director informed the practitioner that his conduct raised a question regarding violation of §10.21 of Circular 230, which requires a practitioner who knows that his client has not complied with the federal revenue laws or has made an error in, or omission from, a tax return or document to advise the client of such noncompliance, error, or omission. The practitioner's assumption that the client would not file an amended tax return did not relieve the practitioner of his duty to advise the client of errors. The practitioner's conduct violated §10.21, the Director found.

## Sales and Exchanges and Principal Residence Issues

Sales and Exchanges: Deferral of Gain on Residence
I.R.C. §1034

**All but 7.5 acres of a 51-acre tract on which the taxpayer built a replacement home were considered as part of the residence because there were no business uses on the 43.5 acres.**

**Facts.** The taxpayer purchased a principal residence and 5 acres of land in Livermore, CA in 1975 for $52,000. He sold the property in 1988 for an adjusted sales amount of $521,000. His total adjusted basis at the time of sale was $102,000. Thus his gain was $419,000. None of the Livermore property was used for business purposes.

**The taxpayer then bought 51 acres of undeveloped land in a secluded part** of Clayton, CA in December 1988 for $380,000. He built a residence on the upper portion of the 51 acres **within the 2-year period following the sale of the old residence.** He spent $146,922 to construct the new residence. He fenced off 7.5 of the 51 acres for his horse boarding and breeding business.

The IRS contended that the taxpayer could **include only 1 of the 51 acres** of the Livermore property as **replacement property** for purposes of deferring the $419,000 gain on the sale of the old residence under I.R.C. §1034(a). According to the IRS, the remaining 50 acres constituted **business use property** rather than residential property. The IRS relied on the decision reached in ***Beckwith*** [T.C. Memo 1964-254 [CCH Dec. 26, 980(M)]].

The taxpayer contended that only the 7.5 acres used for his horse-related business was business property and the remaining 43.5 acres were used as his residence.

**Issue.** What portion of the 51 acres represented residential replacement property for purposes of deferral of gain?

Neither the Internal Revenue Code nor the applicable regulations provide a specific method for determining what portion of a realized gain is attributable to the nonresidential use of the new residence. **Treas. Reg.** §1.1034-1(c)(3)(ii) merely states that "an allocation must be made."

**Holding.** The good faith of a taxpayer is taken into account in determining whether or not property is used by a taxpayer as his residence [Treas. Reg. §1.1034-1(c)(3)(i)]. In assessing the taxpayer's credibility, we (the Tax Court) note that we were influenced by the testimony of the revenue agent who was called as a witness for the government.

He testified that the taxpayer's girlfriend and bookkeeper spent numerous hours with him during the protracted examination. She helped him interpret her records. Moreover, the agent testified that both she and the taxpayer were very cooperative and that he (the agent) had "complete faith that what she was telling him was correct." Given that the taxpayer **is a credible witness** and based on the entire facts, we find that the taxpayer used only 7.5 of the 51 acres of the replacement property for business purposes. Residential purposes may include appreciating nature, living in open spaces, hiking, horseback riding, and enjoying unobstructed views of the countryside. In fact, this is quite common in the Western portion of our country, where land is more plentiful. Nothing in §1034 prohibits us from finding that such use constitutes "significant use" for residential purposes.

[***Schlicher v. Commissioner,*** T.C. Memo 1997-37, 73 T.C.M. 1801 (Jan. 21, 1997) [CCH Dec. 51, 839(M)].]

**A partially built house didn't qualify as a taxpayer's principal residence.**

Residence Not a Personal Residence
I.R.C. §§121 and 1034

**Facts.** The taxpayers purchased a parcel of land at 14321 S.W. 47th Court, Fort Lauderdale, Florida (the land), on July 20, 1983, for $50,000. They began building a house on the land in 1987. Lacking sufficient funds to continue construction beyond the completed foundation, the taxpayers sold the land on March 21, 1990, for $142,500. The taxpayers are over 55 years of age and did not live on the Fort Lauderdale land at any time.

**Decision.** The land contained only a foundation for a house and was never used as taxpayer's principal residence. The gain on the sale is taxable.

[***Jose M. and Ana Marie Vidaurre v. Commissioner,*** T.C. Memo 1997-164, 73 T.C.M. 2504 (1997) [CCH Dec. 51,977(M)].]

**Taxpayer must generally occupy and live in the home to qualify for the benefits of I.R.C. §1034.**

**Facts.** Taxpayer lived with his former wife for five years in their personal home. Taxpayer moved out of the house on 6-15-84 due to a failing marriage. Several months later, he moved into another house and lived there without interruption until 1989. The divorce was final in December 1985, and he gave his ex-wife and minor daughter exclusive use of the house until December 1987, when it was to be sold and the proceeds split equally. Taxpayer attempted to roll over, pursuant to I.R.C. §1034, his portion of the gain into a new residence. The IRS determined that §1034 treatment was not available.

**Issue.** Was the taxpayer's former home his principal residence for purposes of §1034?

**Holding.** No. I.R.C. §1034(a) generally requires that the taxpayer must physically occupy and live in the house. The taxpayer relinquished his right to reside in the home and retained only a financial interest. He never intended to return to the home.

[*Perry v. Commissioner,* U.S. Court of Appeals, 9th Circuit, 96-2 USTC 85,342 [CCH 50,405] (1996)]

## Self-Employment Tax

**Payments received by former insurance agent are not subject to self-employment tax. (1997 Act codifies result.)**

Self-Employment Income—Insurance Agents
I.R.C. §1402

**Generally.** Under case law, certain payments received by a former insurance salesman who had sold insurance as an independent contractor are not net earnings from self-employment and therefore are not subject to SECA. See, e.g., ***Jackson v. Commissioner,*** 108 T.C. No. 10 (1997); ***Gump v.***

***U.S.,*** 86 F.3d 1126 (CA FC 1996); ***Milligan v. Commissioner,*** 38 F.3d 1094 (9th Cir. 1994).

**Note:** The TRA of 1997 generally codifies case law but certain requirements have to be met. See page 453 of this book.

**Also Note:** The Act is effective with respect to payments after December 31, 1997. No inference is intended that the Act is not present law. Therefore, these cases, including ***Jackson,*** may be important authority for payments prior to that date.

[***William R. and Muriel Jackson v. Commissioner,*** 108 T.C.,____#10 (1997) [CCH Dec. 51,965].]

Self-Employment Income
I.R.C. §1402

**A farmer was liable for self-employment tax on income derived from the production of canning beets on his farm. The taxpayer materially participated in this crop.**

**Facts.** The taxpayer's principal occupation was that of a dairy farmer. In 1991 the taxpayer entered into a side venture with a food processor to grow canning beets on 16 acres of his farm land. The contract with the food processor called for the taxpayer to bear all expense, to provide all equipment, and to provide all labor to produce the beet crop. The taxpayer had received Forms 1099 from the food processor during all years (1991–93) under examination by the IRS, and he reported the payments as rental income on Schedule E, not subject to self-employment tax.

**Issue.** There is no question that income and expenses from the beet crop have been correctly reported. The sole issue is whether or not such income is subject to self-employment tax within the meaning of Code §1402. And this issue rests solely on the determination of the taxpayer's **material participation** in the beet production on his farm.

**Discussion.** The taxpayer's contract with the food processor required that he furnish machinery, labor, and other facilities necessary in the production of canning beets on land leased to the food processor. The taxpayer produced one beet crop per year, and made all management decisions regarding this crop without the benefit of any outside consultation.

However, the taxpayer contends that he spends less than 100 hours per year to produce the beet crop. This fact alone does not diminish the pivotal role played by the taxpayer to produce this beet crop.

The IRS attacked this arrangement on two fronts: on one hand, the payments received by the farmer under the contracts do **not** represent rentals from real estate, but rather **compensation for services;** and on the other hand, if such income were rentals from real estate, then the **material participation** required would require the taxpayer to treat the income as self-employment income.

**Holding.** Payments received by the taxpayer for the production of canning beets **do not qualify as rental income** that is excludible from self-employment tax, as the taxpayer was required to and did materially participate in the beet crop.

[***Kenneth and Elaine Schmidt,*** T.C. Memo 1994-41, 73 T.C.M. 1815 (Jan. 23, 1997) [CCH Dec. 51,843(M)].]

**Facts.** Taxpayers were actively engaged in the business of farming and cattle raising. In addition to the land used for those purposes, the taxpayers purchased 1022 acres of land that was placed in the Conservation Reserve Program for a 10-year period. Taxpayer did not include the payments on the CRP land as self-employment income but rather treated it as rental income. The IRS disagreed and assessed a deficiency.

**Holding.** "Since the CRP acreage was added to his existing farm land and since taxpayer was already in the business of farming and ranching, this was a payment to him in connection with his ongoing trade or business. Our conclusion is supported by Rev. Rul. 60-32. In that Ruling, it was emphasized that there should exist a connection or nexus between the payments received by the taxpayer and some trade or business from which they were derived. The taxpayer was an **active** farmer/rancher with respect to additional acreage [acreage other than the CRP acreage] and the payments received had a direct nexus to his trade or business."

[*Ray v. Commissioner*, T.C. Memo 1996-436, 72 T.C.M. 780 [CCH Dec. 51,572(M)] (1996)]

**Used car salesmen were independent contractors.**

**Facts and Holding.** The Court determined the taxpayer correctly treated his salesmen in his used car business as independent contractors. The requirements of §530 of the Revenue Act of 1978 were satisfied. Although the taxpayer was not able to show that every segment of the used car industry followed the practice of treating the salesmen as independent contractors, he was able to show that a significant segment of the industry followed that practice.

[See page 680 of the 1996 Book for new developments.]

[*Douglas Motors v. U.S.A.*, U.S. Court of Appeals, 9th Circuit, 96-2 USTC 85,173 [CCH 50,354] (1996)]

**Social Security benefit base for 1997 is $65,400.**

### Social Security Contribution and Benefit Base

The Commissioner, Social Security Administration, has determined and announced that the contribution and benefit base for renumeration paid in 1997, and self-employment income earned in taxable years beginning in 1997, is **$65,400.**

**Proposed regulations on the definition of "limited partner" for self-employment purposes. The TRA of 1997 delays the implementation date.**

### Withdrawal of Notice of Proposed Rulemaking Self-Employment Tax Treatment of Members of Certain Limited Liability Companies

Reg. 209729-94

**Agency.** Internal Revenue Service (IRS), Treasury.

**Action.** Withdrawal of notice of proposed rulemaking.

**Summary.** This document withdraws the notice of proposed rulemaking relating to the self-employment tax treatment of members of certain limited liability companies that was published in the Federal Register on Thursday, December 29, 1994. The proposed regulations sought to provide guidance concerning the applicability of certain self-employment tax rules to certain members of limited liability companies. The IRS and the Treasury have issued new proposed regulations that will provide guidance on this issue.

Notice of Proposed Rulemaking and Notice of
Public Hearing Definition of Limited Partner for
Self-Employment Tax Purposes
Reg. 209824-96

**Agency.** Internal Revenue Service (IRS), Treasury.

**Action.** Notice of proposed rulemaking and notice of public hearing.

See the discussion of these proposed regulations on pages 314–315 of this book. The TRA of 1997 prohibits IRS regulations on this subject until July 1, 1998.

## Tax-Exempt Organizations

I.R.C. §501—Exemption from Tax on Corporations, Certain Trusts, etc.
Rev. Rul. 97-21

**I.R.C. §501(c)(3) requirements for exemption and possible violation for physician recruitment incentives.**

This ruling provides examples illustrating whether nonprofit hospitals that provide incentives to physicians to join their medical staffs or to provide medical services in the community violate the requirements for exemption as organizations described in §501(c)(3) of the Code.

I.R.C. §512
Rev. Proc. 97-12

**Unrelated trade or business income—exempt organizations.**

This revenue procedure amplifies, in part, and modifies, in part, Rev. Proc. 95-21, 1995-1 C.B. 686, which establishes when associate member dues payments received by organizations described in §501(c)(5) of the Internal Revenue Code will be treated as gross income from the conduct of an unrelated trade or business under §512.

**Section 3. Procedure.** **01. Rev. Proc. 95-21 will not apply to agricultural and horticultural organizations described in §501(c)(5) if annual dues payments from members do not exceed $100 for taxable years beginning after December 31, 1986.** The $100 dues amount is indexed according to a cost-of-living adjustment for taxable years beginning in a calendar year after 1995.

**02. Rev. Proc. 95-21 will continue to apply to agricultural and horticultural organizations described**

**in §501(c)(5) for purposes of determining whether member dues payments will be treated as gross income from an unrelated trade or business under §512 where required annual dues amounts paid by members exceed $100.** If required annual dues exceed $100 per member, the entire dues payment will be subject to the principles of Rev. Proc. 95-21.

**03. Rev. Proc. 95-21 will also continue to apply to labor organizations described in §501(c)(5) for purposes of determining whether associate member dues payments will be treated as gross income from an unrelated trade or business under §512.**

**04. Rev. Proc. 95-21 is amplified to the extent that the principles contained therein are also applicable to organizations described in §501(c)(6).**

Thus, Rev. Proc. 95-21 will also be applied to §501(c)(6) organizations for purposes of determining whether associate member dues payments will be treated as gross income from an unrelated trade or business under §512.

**Section 4. Effective Date.** This revenue procedure is effective for all open years.

**Instant Bingo Games revenue was unrelated business taxable income.**

**Facts and Holding.** The Court of Appeals decided that the taxpayer's Instant Bingo Games did not qualify for the Bingo Games Exception to the unrelated business taxable income provision of I.R.C. §511.

The taxpayer's Instant Bingo involved only a player's purchase of a prepackaged card from a series of similarly situated cards. Winning cards were those on which a preprinted appearance of numbers on the front of the card—which appearance was determined by the player's removing pull tabs from the card—matched the preprinted winning arrangements indicated on the reverse side of the card. The court determined that the game was devoid of any critical element of bingo.

[*Julius M. Israel Lodge of B'nai B'rith No. 2113 v. Commissioner,* U.S. Court of Appeals, 5th Circuit, 96-2 USTC 85,946 [CCH 50,5062] (1996)]

## Tax Reporting—Tax Forms

Moving Expense
Announcement 97-77

**Changes in employer reporting of moving expense reimbursements—elimination of Form 4782 and changes to Form W-2 reporting.**

**Purpose.** This announces that the Internal Revenue Service will eliminate Form 4782, Employee Moving Expense Information, **effective for tax year 1998.** Also included are changes to the reporting of moving expense reimbursements by employers to employees on Form W-2. These changes are effective for **1998 Forms W-2** that employees will receive in 1999.

**Form W-2 Reporting.** With the elimination of Form 4782, the IRS is further simplifying the reporting of qualified moving expenses on Form W-2. The IRS instructions for employers preparing

Forms W-2 for tax year 1998 will reflect that:

- Qualified moving expenses an employer pays **to a third party on behalf of the employee** (e.g., to a moving company) and services that an employer furnishes in kind to an employee will not be reported at all on Form W-2.
- Qualified moving expenses reimbursements an employer pays **directly to an employee** will be reported in box 13 of Form W-2 and will be identified using Code P. (Currently, **all** qualified moving expense reimbursements are identified with Code P, regardless of whether or not they were paid directly to the employee.)
- Other moving expense reimbursements (so-called nonqualified expenses), whether or not paid directly to a third party, will continue to be included in wages (Form W-2, box 1) and are subject to income tax withholding and social security and Medicare taxes.

**Employee Reporting on Form 3903.** As a result of the simplification of employer reporting, the deduction for qualified moving expenses by employees will also be simplified. Beginning with 1998 returns filed in 1999, employees will report on **Form 3903,** Moving Expenses, only the qualified moving expenses paid directly by them. On Form 3903, employees will reduce these expenses by the amounts reimbursed by their employers and reported in box 13 of Form W-2.

## Revision of Forms 5310, 5310A, and 6088
Announcement 97-81

**Form revisions announced in regard to pension plans.**

Form 5310, Application for Determination for Terminating Plan; Form 6088, Distributable Benefits from Employee Pension Benefit Plans; and Form 5310A, Notice of Plan Merger or Consolidation, Spinoff, or Transfer of Plan Assets or Liabilities—Notice of Qualified Separate Lines of Business, have been revised. The new revision date for all forms is June 1997 (Rev. 6/97).

Form 6088 and information-only copies of Forms 5310 and 5310A will be available through IRS electronic information services by July 25, 1997, at the following addresses:

- Modem: 703-321-8020 (modem settings are N,8,1)
- Internet: http://www.irs.ustreas.gov

However, except for Form 6088, these forms are printed in special ink suitable for use with optical reading equipment. Therefore, copies downloaded from the bulletin board are for information only and are not acceptable for submission to Covington or Brooklyn. The official versions will be available by the end of August by calling 1-800-TAX-FORM.

Except for the revision date, no significant changes have been made to Form 5310 and Form 6088. Therefore, the current revision (Rev. 1/96) may continue to be used until the form is next revised. Persons having approval to computer-generate this form may continue to use existing programs. Alternatively, the revision date may be changed from 1/96 to 6/97 without requesting reapproval, if no other changes are made to the OCR data sheet. The original SAN approval number must be transferred to the revised OCR data sheet.

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Significant changes have been made to Form 5310A. Therefore, the 6/97 revision must be used for submissions after January 1, 1998.

All Form 5310A submissions must now be filed with the IRS at P.O. Box 192, Covington, KY 41012-0192. Persons having approval to computer-generate this form must update their programs to incorporate the changes made to this application. The revised OCR data sheet must be resubmitted for reapproval to: EP OCR Coordinator, CP:E:EP:FC, Room 2232, 1111 Constitution Ave., Washington, DC 20224.

As stated in **Announcement 96-54,** 1996-23 IRB 12, persons using IRS software to computer-generate Form 5307 may continue to do so until further notice. Form 5307 produced by IRS software has a 5/93 revision date and the approval number "SAN. 50000".

**Publication 1544 updated and available.**

Availability of Publication 1544, Reporting Cash Payments of Over $10,000 (Revised Aug. 1997)

Announcement 97-80

Publication 1544, recently updated, is now available from the Internal Revenue Service. This publication is also available in Spanish as Publication 1544SP.

The publication is for persons who may receive large cash payments in the course of their business. Generally, any person in a trade or business who receives more than $10,000 in cash in a single transaction or in related transactions must file Form 8300, Report of Cash Payments Over $10,000 Received in a Trade or Business.

You can get a copy of Publication 1544 (or Publication 1544SP) by calling 1-800-829-3676. You can also write to the IRS Forms Distribution Center nearest you.

If you have access to a personal computer and modem, you can also get the publication electronically. You can get the publication at:

- World Wide Web—www.irs.ustreas.gov
- FTP—ftp.irs.ustreas.gov
- Direct dial (by modem)—IRIS at FEDWORLD, (703)321-8020

**Electronic Federal Tax Payment System information provided.**

Rev. Proc. 97-33

**Section 1. Purpose.** This revenue procedure provides taxpayers with information about the Electronic Federal Tax Payment System (EFTPS). EFTPS is an electronic remittance processing system for making federal tax deposits (FTDs) and federal tax payments (FTPs). EFTPS is the successor electronic funds transfer (EFT) system to TAXLINK, described in Rev. Proc. 94-48, 1994-2 C.B. 694.

**New codes for the 1997 Form W-2, box 13.**

Announcement 96-134

On the 1997 Form W-2, three new codes must be used to designate amounts reported in box 13. Descriptions of the amounts to be designated by the codes are given below. See the 1997 Instructions for Form W-2 for more information.

**Code R—Medical Savings Account (MSA).** Employer contributions to a medical savings account for an employee.

**Code S—Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) Retirement Account.** Salary reduction contributions to a SIMPLE.

**Code T—Adoption Assistance Benefits.** Employer payments under an adoption assistance plan for qualified adoption expenses.

## Methods of Signing

TD 8689

**The IRS has authority to prescribe methods of signing documents.**

**Agency.** Internal Revenue Service (IRS), Treasury.

**Action.** Final regulations.

**Summary.** This document contains final regulations relating to the methods of signing returns, statements, or other documents. The final regulations clarify that the IRS may prescribe a method other than pen and ink for signing any return, statement, or other document. This clarification will facilitate the IRS's implementation of paperless filings.

**Effective Date.** **These regulations are effective as of December 12, 1996.**

## Telephone Numbers on Substitute Statements to Recipients—Forms W-2G, 1098, and 1099

Announcement 97-60

**Where to place a contact's telephone number on Forms W-2G, 1098, and 1099.**

The 1997 Instructions for Forms 1099, 1098, 5498, and W-2G indicate that payors should include on statements to recipients the telephone number of a person to contact. On the official Internal Revenue Service forms, this number is included in the filer name and address area on statements to recipients. **However, on substitute forms, payors are permitted to include the telephone number in any conspicuous place on the statements.**

## Automatic Extension of Time for Filing Individual Income Tax Returns; Automatic Extension of Time to File Partnership Return of Income, Trust Income Tax Return, and U.S. Real Estate Mortgage Investment Conduit Income Tax Return

TD 8703

**Automatic extension of time to file certain returns explained in final regulations.**

**Agency.** Internal Revenue Service (IRS), Treasury.

**Action.** Final regulations.

**The final regulations provide the requirements for partnerships, trusts, and REMICs to obtain an**

**automatic three-month extension of time to file partnership, trust, and REMIC returns.**

- The final regulations remove the regulatory requirements that Forms 8736 be signed.
- Notwithstanding the current instructions to Form 8736, an unsigned Form 8736 will be processed.
- In addition, these final regulations provide that trusts and REMICs may obtain an automatic three-month extension of time to file a trust income tax return or a REMIC income tax return without remitting the unpaid amount of any tax properly estimated to be due with the application for extension of time to file.
- The final regulations provide that the IRS may prescribe additional methods of obtaining an extension of time to file in lieu of a paper application on Form 8736.

**Note: Effect of extension on beneficiary.** An automatic extension of time to file a trust income tax return under this section will not operate to extend the time for filing the income tax return of a beneficiary of the trust or the time for the payment of any tax due on the beneficiary's income tax return.

## New Reporting for Medical Savings Accounts, Long-Term Care Accounts, and SIMPLE Retirement Accounts
Announcement 97-10

**IRS announces availability of forms for medical savings accounts, long-term care accounts, and SIMPLE retirement accounts.**

The filing requirements for trustees and other payers are as follows:

| If the Form Is: | Then File with or Furnish to: | By This Date: |
|---|---|---|
| 1099-MSA (Copy A) | IRS | March 2, 1998 |
| 1099-MSA (Copy B) | Recipient | February 2, 1998 |
| Form 5498-MSA (Copy A) | IRS | June 1, 1998 |
| Form 5498-MSA (Copy B) | Participant | June 1, 1998 |
| Form 8851 | IRS | June 2, 1997 (For MSAs established from Jan. 1–Apr. 30, 1997) |
| Form 8851 | IRS | August 1, 1997 (For MSAs established from May 1–June 30, 1997) |
| Form 1099-LTC (Copy A) | IRS | March 2, 1998 |
| Form 1099-LTC (Copy B) | Policyholder | February 2, 1998 |
| Form 1099-LTC (Copy C) | Insured | February 2, 1998 |

No new forms are required for trustees to report distributions from and contributions to a SIMPLE. Trustees must report distributions from a SIMPLE on Form 1099-R and report contributions to a SIMPLE on Form 5498. The filing dates for Form 1099-R and Form 5498 will remain the same as in prior years. The 1997 versions of these forms have been revised for reporting SIMPLEs. Printed copies of Forms 1099-R and 5498 can be obtained by calling 1-800-829-3676.

All the forms discussed above can be downloaded from the IRS's Internet Web site at http://www.irs.ustreas.gov.

## Trade or Business Expenses

Office in Home Deduction
I.R.C. §280A

**The taxpayer (an attorney) could not deduct the portion of the residence used as an "art gallery." The portion of the home was not a separate dwelling unit.**

**Facts and Decision.** Affirming the Tax Court's decision (T.C. Memo 1996-141), the Appeals Court held that the "separate dwelling unit" did not exist. There were no permanent partitions or walls that physically or functionally separated the area used as an art gallery from the area used as a residence.

[***Joseph Francis Cunningham, Petitioner-Appellant v. Commissioner of Internal Revenue, Respondent-Appellee,*** U.S. Court of Appeals, 4th Circuit, 97-1 USTC 87,813 (1997) [CCH ¶50,358].]

**Interest on a tax deficiency was not a deductible business expense. *Redlark v. Commissioner* did not apply.**

**Facts.** The IRS determined that taxpayer was an independent contractor and owed self-employment tax and, as a result, $42,700 in interest. The interest was paid in 1991. Taxpayer claimed the interest as a business expense on his 1991 Schedule C.

**Holding.** The Court noted that *Redlark v. Commissioner* was not applicable here because the taxpayer was unable to show that his failure to pay self-employment tax arose as a normal and usual incident of his business as a furniture lumper. The Court noted that taxpayer had been put on notice of a possible problem with his status as an employee because he had never received a Form W-2 from any of the persons or entities he had worked for.

[*Michael v. Commissioner*, T.C. Memo 1996-466, 72 TCM 1031 [CCH Dec. 51,603(M)] (1996)]

Fringe Benefits Aircraft Valuation Formula
Rev. Rul. 97-14

**Rules for valuing noncommercial flights on employer-provided aircraft for first half of 1997 issued.**

For purposes of §1.61-21(g) of the regulations, relating to the rule for valuing noncommercial flights on employer-provided aircraft, the Standard Industry Fare Level (SIFL), cents-per-mile rates, and terminal charges in effect for the first half of 1997 are set forth.

| Period During Which the Flight Was Taken | Terminal Charge | SIFL Mileage Rates |
|---|---|---|
| 1/1/97–6/30/97 | $31.73 | Up to 500 miles = $.1735 per mile |
| | | 501–1,500 miles = $.1323 per mile |
| | | Over 1,500 miles = $.1272 per mile |

For purposes of §1.61-21 (g) of the regulations, relating to the rule for valuing noncommercial flights on employer-provided aircraft, the Standard Industry Fare Level, cents-per-mile rates, and terminal charges in effect for the **second half of 1997** are set forth.

| Period During Which the Flight Is Taken | Terminal Charge | SIFL Mileage Rates |
|---|---|---|
| 7/1/97–12/31/97 | $31.72 | Up to 500 miles = $.1735 per mile |
| | | 501–1,500 miles = $.1323 per mile |
| | | Over 1,500 miles = $.1272 per mile |

**Depreciation limitations for automobiles and lease inclusion amounts for 1997.**

## Rev. Proc. 97-20 Table 1

### Depreciation Limitations for Automobiles First Placed in Service in Calendar Year 1997

| Tax Year | Amount |
|---|---|
| First tax year | $3,160 |
| Second tax year | 5,000 |
| Third tax year | 3,050 |
| Each succeeding year | 1,775 |

**Inclusions in Income of Lessees of Automobiles.** The inclusion amounts for automobiles first leased in calendar year 1997 are calculated under the procedures described in §1.280F-7(a). Table 2 of this revenue procedure is the applicable table to be used in applying those procedures.

## Rev. Proc. 97-20 Table 2

### Dollar Amounts for Automobiles with a Lease Term Beginning in Calendar Year 1997

| Fair Market Value of Automobile | | Tax Year During Lease | | | | |
|---|---|---|---|---|---|---|
| Over | Not Over | First | Second | Third | Fourth | Fifth and Later |
| $15,800 | 16,100 | 1 | 5 | 5 | 8 | 10 |
| 16,100 | 16,400 | 4 | 10 | 13 | 18 | 21 |
| | | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| 16,400 | 16,700 | 6 | 15 | 22 | 27 | 32 |
| 16,700 | 17,000 | 9 | 20 | 30 | 36 | 44 |
| 17,000 | 17,500 | 12 | 28 | 40 | 49 | 58 |
| 17,500 | 18,000 | 16 | 37 | 53 | 65 | 77 |
| 18,000 | 18,500 | 20 | 46 | 66 | 82 | 95 |
| 18,500 | 19,000 | 24 | 55 | 80 | 97 | 114 |
| 19,000 | 19,500 | 28 | 64 | 93 | 113 | 132 |
| 19,500 | 20,000 | 32 | 73 | 106 | 129 | 151 |
| 20,000 | 20,500 | 36 | 82 | 120 | 145 | 169 |
| 20,500 | 21,000 | 40 | 91 | 133 | 161 | 187 |
| 21,000 | 21,500 | 45 | 99 | 147 | 177 | 205 |
| 21,500 | 22,000 | 49 | 108 | 160 | 193 | 224 |
| 22,000 | 23,000 | 55 | 122 | 180 | 216 | 252 |
| 23,000 | 24,000 | 63 | 140 | 206 | 249 | 288 |
| 24,000 | 25,000 | 71 | 158 | 233 | 280 | 326 |
| 25,000 | 26,000 | 79 | 176 | 259 | 313 | 362 |
| 26,000 | 27,000 | 88 | 193 | 287 | 344 | 399 |
| 27,000 | 28,000 | 96 | 211 | 313 | 377 | 435 |
| 28,000 | 29,000 | 104 | 229 | 340 | 408 | 473 |
| 29,000 | 30,000 | 112 | 247 | 366 | 441 | 509 |
| 30,000 | 31,000 | 120 | 265 | 393 | 472 | 546 |
| 31,000 | 32,000 | 128 | 283 | 420 | 504 | 583 |
| 32,000 | 33,000 | 137 | 301 | 446 | 536 | 620 |
| 33,000 | 34,000 | 145 | 319 | 472 | 568 | 657 |
| 34,000 | 35,000 | 153 | 337 | 499 | 600 | 693 |
| 35,000 | 36,000 | 161 | 355 | 526 | 631 | 731 |
| 36,000 | 37,000 | 169 | 373 | 552 | 664 | 767 |
| 37,000 | 38,000 | 178 | 391 | 578 | 696 | 804 |
| 38,000 | 39,000 | 186 | 409 | 605 | 727 | 841 |
| 39,000 | 40,000 | 194 | 427 | 632 | 759 | 878 |
| 40,000 | 41,000 | 202 | 445 | 658 | 791 | 915 |
| 41,000 | 42,000 | 210 | 463 | 685 | 823 | 951 |
| 42,000 | 43,000 | 218 | 481 | 712 | 854 | 989 |
| 43,000 | 44,000 | 227 | 498 | 739 | 886 | 1,026 |
| 44,000 | 45,000 | 235 | 516 | 765 | 919 | 1,062 |
| 45,000 | 46,000 | 243 | 534 | 792 | 951 | 1,098 |
| 46,000 | 47,000 | 251 | 552 | 819 | 982 | 1,136 |
| 47,000 | 48,000 | 259 | 570 | 845 | 1,015 | 1,172 |
| 48,000 | 49,000 | 268 | 588 | 871 | 1,047 | 1,209 |
| 49,000 | 50,000 | 276 | 606 | 898 | 1,078 | 1,246 |
| 50,000 | 51,000 | 284 | 624 | 925 | 1,110 | 1,282 |
| 51,000 | 52,000 | 292 | 642 | 951 | 1,142 | 1,320 |
| 52,000 | 53,000 | 300 | 660 | 978 | 1,174 | 1,356 |
| 53,000 | 54,000 | 308 | 678 | 1,004 | 1,206 | 1,394 |

| | | | | | | |
|---|---|---|---|---|---|---|
| 54,000 | 55,000 | 317 | 695 | 1,032 | 1,237 | 1,430 |
| 55,000 | 56,000 | 325 | 713 | 1,058 | 1,270 | 1,467 |
| 56,000 | 57,000 | 333 | 732 | 1,084 | 1,301 | 1,504 |
| 57,000 | 58,000 | 341 | 750 | 1,110 | 1,334 | 1,540 |
| 58,000 | 59,000 | 349 | 768 | 1,137 | 1,365 | 1,578 |
| 59,000 | 60,000 | 358 | 785 | 1,164 | 1,397 | 1,615 |
| 60,000 | 62,000 | 370 | 812 | 1,204 | 1,445 | 1,670 |
| 62,000 | 64,000 | 386 | 848 | 1,257 | 1,509 | 1,743 |
| 64,000 | 66,000 | 403 | 884 | 1,310 | 1,573 | 1,817 |
| 66,000 | 68,000 | 419 | 920 | 1,363 | 1,637 | 1,890 |
| 68,000 | 70,000 | 435 | 956 | 1,417 | 1,700 | 1,964 |
| 70,000 | 72,000 | 452 | 991 | 1,470 | 1,764 | 2,038 |
| 72,000 | 74,000 | 468 | 1,027 | 1,524 | 1,827 | 2,112 |
| 74,000 | 76,000 | 484 | 1,063 | 1,577 | 1,891 | 2,186 |
| 76,000 | 78,000 | 501 | 1,099 | 1,630 | 1,955 | 2,259 |
| 78,000 | 80,000 | 517 | 1,135 | 1,683 | 2,019 | 2,333 |
| 80,000 | 85,000 | 546 | 1,198 | 1,776 | 2,130 | 2,462 |
| 85,000 | 90,000 | 587 | 1,287 | 1,909 | 2,291 | 2,645 |
| 90,000 | 95,000 | 627 | 1,377 | 2,042 | 2,450 | 2,830 |
| 95,000 | 100,000 | 668 | 1,467 | 2,175 | 2,609 | 3,014 |
| 100,000 | 110,000 | 730 | 1,601 | 2,375 | 2,848 | 3,290 |
| 110,000 | 120,000 | 812 | 1,780 | 2,641 | 3,167 | 3,659 |
| 120,000 | 130,000 | 893 | 1,960 | 2,907 | 3,486 | 4,027 |
| 130,000 | 140,000 | 975 | 2,139 | 3,173 | 3,805 | 4,395 |
| 140,000 | 150,000 | 1,057 | 2,318 | 3,439 | 4,125 | 4,763 |
| 150,000 | 160,000 | 1,139 | 2,498 | 3,704 | 4,444 | 5,131 |
| 160,000 | 170,000 | 1,221 | 2,677 | 3,971 | 4,762 | 5,500 |
| 170,000 | 180,000 | 1,302 | 2,857 | 4,236 | 5,082 | 5,868 |
| 180,000 | 190,000 | 1,384 | 3,036 | 4,503 | 5,400 | 6,237 |
| 190,000 | 200,000 | 1,466 | 3,215 | 4,769 | 5,719 | 6,605 |
| 200,000 | 210,000 | 1,548 | 3,394 | 5,035 | 6,039 | 6,973 |
| 210,000 | 220,000 | 1,630 | 3,574 | 5,300 | 6,358 | 7,341 |
| 220,000 | 230,000 | 1,712 | 3,753 | 5,567 | 6,676 | 7,710 |
| 230,000 | 240,000 | 1,793 | 3,932 | 5,833 | 6,996 | 8,078 |
| 240,000 | 250,000 | 1,875 | 4,112 | 6,099 | 7,314 | 8,446 |

**Optional standard mileage rates for 1997 issued.**

Rev. Proc. 96-63

## Section 1. Purpose.

This revenue procedure provides optional standard mileage rates for employees, self-employed individuals, or other taxpayers to use in computing the deductible costs paid or incurred on or after January 1, 1997, of operating a passenger automobile for business, charitable, medical, or moving expense purposes.

## Section 2. Summary of Standard Mileage Rates.

| | |
|---|---|
| Business | 31.5 cents per mile |
| Rural mail carrier | 47.25 cents per mile |
| Charitable | 12 cents per mile |
| Medical and moving | 10 cents per mile |

**Per diem rates for 1997 available.**

Availability of Publication 1542, Per Diem Rates (Revised May 1997)
Announcement 97-71

Publication 1542, recently updated, is now available from the Internal Revenue Service.

The publication gives the maximum per diem rate employers can use without treating part of the allowance as wages for tax purposes. It also provides the listing of localities eligible for $166 per diem amount under the high-low substantiation method.

You can get a copy of this publication by calling 1-800-829-3676. You can also write to the IRS Forms Distribution Center nearest you.

If you have access to a personal computer and modem, you also can get the publication electronically. You can get the publication at:

- World Wide Web—http://www.irs.ustreas.gov
- FTP—ftp.irs.ustreas.gov
- IRIS at FEDWORLD—(703)321-8020

**The Supreme Court's decision in *INDOPCO, Inc. v. Commissioner,* 503 U.S. 79 (1992), does not affect the treatment of training costs as business expenses which are generally deductible under §162 of the Code.**

Trade or Business Expenses—Training Costs; Business Expenses
I.R.C §162
Rev. Rul. 96-62

**Issue.** Does the Supreme Court's decision in ***INDOPCO, Inc. v. Commissioner,*** 503 U.S. 79 (1992), affect the treatment of training costs as business expenses, which are generally deductible under §162 of the Internal Revenue Code?

**Explanation.** Training costs must be capitalized only in the unusual circumstance where the training is intended primarily to obtain future benefits significantly beyond those traditionally associated with training provided in the ordinary course of a taxpayer's trade or business. See, e.g., ***Cleveland Electric,*** 7 Cl. Ct. at 227-29 (capitalization of costs for training employees of an electric utility to operate a new nuclear power plant, which were akin to start-up costs of a new business).

**Holding.** The ***INDOPCO*** decision does not affect the treatment of training costs as business expenses, which are generally deductible under §162.

**This revenue procedure updates Rev. Proc. 96-28, 1996-1 C.B. 686, by providing rules under which the amount of ordinary and necessary**

Per Diem Amounts
Rev. Proc. 96-64

## Federal Per Diem Rate—Meals and Incidental Expenses Only

(Standard or "default" rate for localities not listed in the CONUS table)

| | |
|---|---|
| Within the continental United States | $30 per day |

**Note:** This standard rate for 1997 is $80 per day: $50 for lodging and $30 for meals and incidental expenses. The old standard rate prior to 1997 was $66 per day: $40 for lodging and $26 for meals and incidental expenses.

**4.03 Optional method for meals-only deduction.** In lieu of using actual expenses, **employees and self-employed individuals,** in computing the amount allowable as a deduction for ordinary and necessary meal and incidental expenses paid or incurred for travel away from home, may use an amount computed at the federal M&IE rate for the locality of travel for each calendar day the employee or self-employed individual is away from home. Such amount will be deemed substantiated, provided the employee or self-employed individual substantiates the elements of time, place, and business purpose of the travel expenses in accordance with those regulations.

**4.04 Special rules for transportation industry.**

1. **In general.** This section applies to (a) a payor that pays a per diem allowance only for meal and incidental expenses for travel away from home to an employee in the transportation industry, or (b) **an employee or self-employed individual in the transportation industry who computes the amount allowable as a deduction for meal and incidental expenses for travel away from home.**
2. **Rates.** A taxpayer described in §4.04(1) may treat $36 as the federal M&IE rate for any locality of travel in CONUS, and/or $40 as the federal M&IE rate for any locality of travel in OCONUS.

**7.07** A **self-employed individual** may deduct an amount computed pursuant to §4.03 in determining adjusted gross income under §62(a)(1). This deduction is subject to the **50% limitation** on meal and entertainment expenses provided in §274(n).

## High Cost--Low Cost Rates Announced for 1997

| | |
|---|---|
| High-cost areas | $166 ($40 to meals) |
| Low-cost areas | $109 ($32 to meals) |

Deduction of Rent Payment

***Cox,*** the Tax Court case dealing with a rent deduction for the portion of property considered as owned by the landlord spouse, has been affirmed [***D. Sherman Cox v. Commissioner,*** U.S. Ct. of Appeals, 8th Circuit, 97-2 USTC 89,333 (1997) (CCH ¶50,582).] See the discussion on pages 236–37 of this book.

LTR 9722005, February 5, 1997
Code §55

**Work credit reduces wage deduction for both regular and AMT purposes.**

**Issue.** For purposes of computing alternative minimum taxable income, does §280C(a) of the Internal Revenue Code reduce a taxpayer's wage deduction by the amount of targeted jobs credit claimed for such wages?

**Facts.** Taxpayer claimed a targeted jobs credit under §51(a). In computing taxable income Taxpayer reduced its deduction for wages by the amount of the targeted jobs credit generated for that year, but **did not do so** in computing alternative minimum taxable income (AMTI). Likewise, Taxpayer contends that it is not required to reduce its wage deduction in computing AMTI by the amount of any targeted jobs credit generated for its taxable years.

The separate but parallel nature of the AMT arises from the statutory provisions imposing AMT, and these provisions do not produce the result Taxpayer desires. Moreover, we find no persuasive evidence, either in the legislative history to the AMT or in the legislative history to §280C, that the language of §280C(a) should not be applied according to its literal meaning in computing AMTI.

**Conclusion.** For purposes of computing alternative minimum taxable income §280C(a) of the Code reduces a taxpayer's wage deduction by the amount of targeted jobs credit claimed for such wages.

## Trusts

Certain Abusive Trust Arrangements
Notice 97-24

**This notice is intended to alert taxpayers about certain trust arrangements that purport to reduce or eliminate federal taxes in ways that are not permitted by federal tax law. (The notice refers to such arrangements as "abusive trust arrangements.")**

This notice should not create concerns about the legitimate uses of trusts. For example, trusts are frequently used properly in estate planning, to facilitate the genuine charitable transfer of property, and to hold property for minors and incompetents.

## Examples of Abusive Trust Arrangements

Described below are five examples of abusive trust arrangements that have come to the attention of the Internal Revenue Service.

1. **The Business Trust.** The owner of a business transfers the business to a trust (sometimes described as an unincorporated business trust) in exchange for units or certificates of beneficial interest, sometimes described as units of beneficial interest or UBIs (trust units). The business trust makes payments to the trust unit holders or to other trusts created by the owner (characterized either as deductible business expenses or as deductible distributions) that purport to reduce the taxable income of the business trust to the point where little or no tax is due from the business trust. In addition, the owner claims the arrangement reduces or eliminates the owner's self-employment taxes on the theory that the owner is receiving reduced or no income from the operation of the business. In some cases, the trust units are supposed to be canceled at death or "sold" at a nominal price to the owner's children, leading to the contention by promoters that there is no estate tax liability.
2. **The Equipment or Service Trust.** The equipment trust is formed to hold equipment that is rented or leased to the business trust, often at inflated rates. The service trust is formed to provide services to the business trust, often for inflated fees. Under these abusive trust arrangements, the business trust may purport to reduce its income by making allegedly deductible payments to the equipment or service trust. Further, as to the equipment trust, the equipment owner may claim that the transfer of equipment to the equipment trust in exchange for the trust units is a taxable exchange. The trust takes the position that the trust has "purchased" the equipment with a known value (its fair market value) and that the value is the tax basis of the equipment for purposes of claiming depreciation deductions. The owner, on the other hand, takes the inconsistent position that the value of the trust units received cannot be determined, resulting in no taxable gain to the owner on the exchange. The equipment or service trust also may attempt to reduce or eliminate its income by distributions to other trusts.
3. **The Family Residence Trust.** The owner of the family residence transfers the residence, including its furnishings, to a trust. The parties claim inconsistent tax treatment for the trust and the owner (similar to the equipment trust). The trust claims the exchange results in a stepped-up basis for the property, while the owner reports no gain. The trust claims to be in the rental business and purports to rent the residence back to the owner; however, in most cases, little or no rent is actually paid. Rather, the owner contends that the owner and family members are caretakers or provide services to the trust and, therefore, live in the residence for the benefit of the trust. Under some arrangements, the family residence trust receives funds from other trusts (such as a business trust) which are treated as the income of the trust. In order to reduce the tax which might be due with respect to such income (and any income from rent actually paid by the owner), the trust may attempt to deduct depreciation and the expenses of maintaining and operating the

## Legal Principles Applicable to Trusts

Contrary to promises made in promotional materials, several well-established tax principles control the proper tax treatment of these abusive trust arrangements.

1. **Substance—not form—controls taxation.**The Supreme Court of the United States has consistently stated that the substance rather than the form of the transaction is controlling for tax purposes. See, For example, ***Gregory v. Helvering,*** 293 U.S. 465 (1935), XIV-1 C.B. 193; ***Helvering v. Clifford,*** 309 U.S. 331 (1940), 1940-1 C.B. 105.
   Under this doctrine, the abusive trust arrangements may be viewed as sham transactions, and the IRS may ignore the trust and its transactions for federal tax purposes. See ***Markosian v. Commissioner,*** 73 T.C. 1235 (1980) (holding that the trust was a sham because the parties did not comply with the terms of the trust and the supporting documents and the relationship of the grantors to the property transferred did not differ in any material aspect after the creation of the trust); ***Zmuda v. Commissioner,*** 731 F.2d 1417 (9th Cir. 1984).
   Accordingly, the income and assets of the business trust, the equipment in the equipment trust, the residence in the family residence trust, and the assets in the foreign trust would all be treated as belonging directly to the owner.
2. **Grantors may be treated as owners of trusts.** The grantor trust rules provide that if the owner of property transferred to a trust retains an economic interest in, or control over, the trust, the owner is treated for income tax purposes as the owner of the trust property, and all transactions by the trust are treated as transactions of the owner (§§671–677).
   In addition, a U.S. person who directly or indirectly transfers property to a foreign trust is treated as the owner of that property if there is a U.S. beneficiary of the trust (§679). This means that all expenses and income of the trust would belong to and must be reported by the owner, and tax deductions and losses arising from transactions between the owner and the trust would be ignored. Furthermore, there would be no taxable "exchange" of property with the trust, and the tax basis of property transferred to the trust would not be stepped up for depreciation purposes. See Rev. Rul. 85-13, 1985-1 C.B. 184.
3. **Taxation of Non-Grantor Trusts.** If the trust is not a sham and is not a grantor trust, the trust is taxable on its income, reduced by amounts distributed to beneficiaries. The trust must obtain a taxpayer identification number and file annual returns reporting its income. The trust must report distributions to beneficiaries on a Form K-1, and the beneficiary must include the distributed income on the beneficiary's tax return (§§641, 651, 652, 661, and 662).
4. **Transfers to trusts may be subject to estate and gift taxes.** Transfers to a trust may be recognized as completed gifts for federal gift tax purposes. Further, whether or not the gift tax applies, if the owner retains until the owner's death the use of, enjoyment of, or income from the property placed in a trust, the property will be subject to federal estate tax when the transferor dies [§2036(a)].
5. **Personal expenses are generally not deductible.**Personal expenses such as those for home maintenance, education, and personal travel are not deductible unless expressly authorized by the tax laws (see §262). The courts have consistently held that nondeductible personal expenses

charitable trusts if they do not satisfy the requirements of the tax law, including the requirement that their true purpose is to benefit charity.

Furthermore, supposed charitable payments made by a trust are not deductible charitable contributions where the payments are really for the benefit of the owner or the owner's family members. See, for example, ***Fausner v. Commissioner,*** 55 T.C. 620 (1971).

7. **Special rules apply to foreign trusts.** If an arrangement involves a foreign trust, taxpayers should be aware that a number of special provisions apply to foreign trusts with U.S. grantors or U.S. beneficiaries, including several provisions added in 1996.