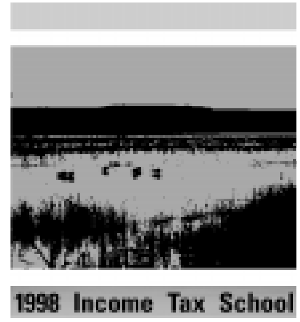


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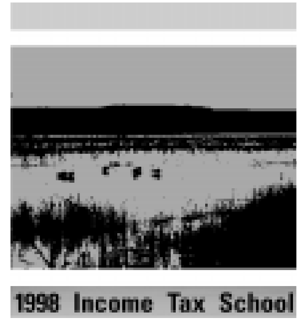



# WHAT'S NEW: RULINGS AND CASES

**Practitioner Caution.** Many late 1997 and 1998 **Rulings, Rev. Procs., Regs.** etc., relate to the 1997 Taxpayer Relief Act and can be found in that Chapter—15.

## 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, 1998. 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** 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 (I.R.C.). 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

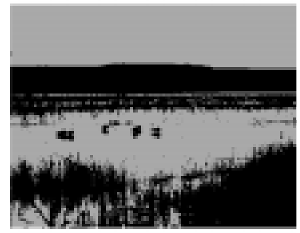
- The taxpayer in a dispute with the Internal Revenue Service has two choices after he or she receives the "90 day letter": (1) file a petition in the Tax Court without paying the tax or (2) pay the tax and file a claim of refund. If the IRS rejects the claim of refund, the taxpayer can file a suit in 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 I.R.C. §7428 to hear an appeal from an organization that is threatened with the loss of its tax-exempt status. Under I.R.C. §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, Massachusetts, New Hampshire, Puerto Rico, Rhode Island |
| Second | Connecticut, 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 |



1998 Income Tax School

# WHAT'S NEW: RULINGS AND CASES

## ACCOUNTING

Constructive Income
I.R.C. §61

> ☞ **A bankrupt corporation was in constructive receipt of certain governments payments made directly to its creditors.**

**Facts.** John Foust, the taxpayer, was a practicing Iowa CPA. In addition to his accounting practice, he also was engaged in crop farming via his wholly owned cash basis S corporation through 1988. In 1989, the S corporation filed a chapter 12 bankruptcy petition, which was **dismissed** by the Bankruptcy Court due to lack of cooperation with the trustee.

In 1989, the year after the termination of farming activity, the S corporation **was entitled** to $43,496 **Federal Crop Insurance proceeds** and $37,723 of 1988 corn and soybean **disaster payments** from the USDA. These payments, which totaled $81,219, **were made to creditors** of the S corporation rather than to the corporation itself. The S corporation **did not report the $81,219 as income** on the 1989 Form 1120S. The 1989 Form 1120S reported only "no activity" and showed no income or expenses.

### Issues

1. Whether the S corporation had unreported income in 1989 by reason of its **constructive receipt** of Federal disaster and crop insurance payments paid to its creditors; and
2. Whether the 20 percent accuracy-related penalty under I.R.C. §6662(b)(1) for **negligence** is applicable.

**Discussion.** In 1989, the USDA disaster payment and the Federal crop insurance payment were applied in their entirety to **discharge** the S corporation's debts due and owing. Therefore, the S corporation had income in 1989 to the extent of the debts discharged, and this income flowed through to the taxpayer as the sole shareholder. The debts of the S corporation **were not discharged in bankruptcy** as the bankruptcy petitions were dismissed.

### Holding

Issue 1. Taxpayer has **not** established that the Federal disaster and crop insurance payments are excludible from the gross income of the S corporation. The insurance coverage applied in the event of **nonproduction rather than destruction.** The crop insurance was paid because crops could not be produced, **not** as compensation for a casualty loss. It is well settled that proceeds from a **business interruption policy,** which compensates for lost profits or earnings, are taxable as **ordinary income.**

Regarding the USDA disaster payment, the cash basis S corporation had **no basis** in the 1988 damaged crops for which the 1989 disaster payment was made. Lacking any such basis, it would **not be entitled to a casualty loss** for which the disaster payment would have acted as reimbursement.

Issue 2. As a practicing certified public accountant with a law degree, taxpayer should have known that he was required to maintain and produce documentary evidence to support the positions on his return. His failure to do so is clearly negligent.

[*John F. Foust v. Commissioner*, T.C. Memo 1997-446, 74 T.C.M. 799 (1997) [CCH Dec. 52,281(M)].]

### Change in Method of Accounting

Rev. Proc. 98-29

☞ **This revenue procedure provides guidance for a taxpayer that wants to change to a method of accounting for estimating inventory "shrinkage" in computing ending inventory.**

"Shrinkage" refers collectively to such items as undetected theft, breakage, and bookkeeping errors. In addition, §4 of this revenue procedure provides interim guidance that describes the "retail safe harbor method" for a taxpayer that wants to change to the retail safe harbor method for estimating inventory shrinkage. The procedures for a taxpayer within the scope of this revenue procedure to **automatically change** to a method of accounting for estimating inventory shrinkage are provided in **Rev. Proc. 97-37,** 1997-33 I.R.B. 18, as modified by this revenue procedure.

### IRS Reassures Nursery Growers about Farming Exception

Announcement 97-120

☞ **Nursery growers qualify for I.R.C. §263A farming exception.**

This announcement confirms that recently issued proposed regulations specifically permit nursery growers to qualify for the "farming exception" to the uniform capitalization rules under §263A of the Internal Revenue Code.

Under §263A(d), the farming exception to the uniform capitalization rules is available for certain plants "produced" (e.g., grown) in a farming business. **Thus, the regulations permit nursery growers using the farming exception to deduct the costs of seeds and young plants purchased for further development and cultivation prior to sale, as well as the costs of growing the plants.**

Under the regulations, nursery growers using the farming exception are permitted to deduct these costs even if the plants are partly grown by another person or are grown by the nursery in temporary containers.

Because the statutory exception applies only to the costs of plants "produced" in a farming business, **the exception cannot be used for costs incurred by a taxpayer in activities in which the taxpayer does not grow plants.**

# ACTIVITIES NOT FOR PROFIT

Not For Profit Business
I.R.C. §183

☞ **Taxpayer did not have an honest objective to make a profit. Losses were denied.**

**Facts.** Taxpayer was employed by the Internal Revenue Service as a revenue agent. He had a B.S. degree in accounting and was a CPA. He and his wife were Amway distributors during the years 1992 through 1995. They claimed net Schedule C losses of $11,074 for 1992, $14,881 for 1993, $13,008 for 1994, and $11,681 for 1995. The IRS concluded that the taxpayers had no profit motive and disallowed the losses under I.R.C. §183. In addition, the IRS assessed the 20 percent negligence penalty under I.R.C. §6662 (b)(1).

### Issues

1. Whether taxpayers did not engage in their Amway activity for profit within the meaning of I.R.C. §183; and
2. Whether the 20 percent accuracy-related penalty under I.R.C. §6662(b)(1) for negligence is applicable.

**Discussion.** Amway distributors purchase company products for personal use, as well as for resale to their customers and to "downline" distributors. Distributors are strongly encouraged to recruit others to become "downline" distributors. The Amway system is based on a pyramid system whereby a distributor's direct and indirect sales are rewarded with bonuses.

On their Federal income tax returns for the years at issue, the taxpayers did not disclose that they were engaged in an Amway activity. Line A of the Schedules C, "Principal business or profession, including product or service," was left blank.

The evidence showed that the taxpayers did **not** operate in a businesslike manner. They did not have a business plan or budget, nor did they conduct a break-even analysis. In court testimony, the husband candidly admitted that one of the major benefits of being an Amway distributor was the ability to purchase various **personal** products at a 15 to 50 percent discount. The taxpayers' **personal** purchases for their family of four were **more** than the combined purchases for **resale** to their customers and "downline" distributors. For example, in 1992 the cost of **personal** purchases was $4,500 while **resale** purchases were only $3,262. In 1993, the cost of **personal** purchases was $10,729 while **resale** purchases were only $4,991.

In the opinion of the court, the taxpayers **intentionally** omitted the cost of motivational tapes in the calculation of the costs of goods sold. This enabled the taxpayers to avoid disclosing negative Schedule C gross income amounts. In addition, the claimed business auto expenses were in excess of the gross receipts reported on the Schedules C.

### Holding

Issue 1. We find that the taxpayers did **not** have an honest objective to make a profit in their Amway activity. They operated this activity **primarily** because it allowed them to purchase discounted **personal use** merchandise. Another purpose of the activity was to enable them to convert **personal** expenses such as auto and telephone to Schedule C deductions. I.R.C. §262 disallows any deduction for **personal, living, or family expenses.** Therefore, the taxpayers are entitled to **no** Schedule C deductions under I.R.C. §183 (b)(2).

Issue 2. The taxpayer (husband) possesses an accounting degree, is a CPA, and has been an IRS revenue agent for the past 10 years. Given his experience and his extensive background in tax-related matters, it is apparent that the taxpayers have **failed to exercise due care and that Internal Revenue laws were disregarded when personal expenses were claimed as business deductions.** Therefore, we find that taxpayers are liable for the 20 percent negligence penalty imposed by I.R.C. §6662 (b)(1).

[*Kenneth C. and Becky J. Theisen v. Commissioner*, T.C. Memo 1997-539, 74 T.C.M. 1327 (1997) [CCH Dec. 52,384(M)].]

# ADOPTIONS

Notice of Proposed Rulemaking and Notice of Public Hearing IRS Adoption Taxpayer Identification Numbers
Reg-103330-97

☞ **SUMMARY: In T.D. 8739, page 8, the IRS is issuing temporary regulations under section 6109 relating to taxpayer identifying numbers. The temporary regulations provide rules for obtaining and using IRS adoption taxpayer identification numbers. The temporary regulations assist individuals who are in the process of adopting children and wish to claim certain tax benefits with respect to these children. The text of those temporary regulations also serves as the text of these proposed regulations.**

[1997-49 I.R.B. Page 9]
Adoption Assistance
Notice 97-70

☞ **Deductibility of adoption cost clarified.**

This notice modifies Notice 97-9, 1997-2 I.R.B. 35, which provides, in part, general guidance concerning the income tax credit under §23 of the Internal Revenue Code for qualified adoption expenses paid or incurred by an individual. Notice 97-9 is modified to incorporate the amendment made to §23(a)(2) (relating to the year(s) in which the credit for certain qualified adoption expenses is allowed) by the Taxpayer Relief Act of 1997, effective for taxable years beginning **after December 31, 1996.**

Section I.E.1 and the first paragraph of section I.E.2 of Notice 97-9 are modified to read as follows:

## E. Year of Credit

**1. Domestic adoptions.** The credit for qualified adoption expenses paid or incurred to adopt an eligible child who is a citizen or a resident of the United States at the time the adoption commenced (including such amounts paid or incurred in an **unsuccessful effort** to adopt such a child) is allowed in the **next** taxable year unless the expenses are paid or incurred during or after the taxable year the adoption becomes final. The credit for qualified adoption expenses paid or incurred during or after the taxable year in which an adoption becomes final is allowed in the taxable year in which the expenses are paid or incurred.

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**2. Foreign adoptions.** A special rule applies in the case of the adoption of an eligible child who is not a citizen or resident of the United States at the time the adoption commenced. **The credit** is **only available for adoptions that become final.** Qualified adoption expenses paid or incurred in any taxable year before the taxable year in which the adoption becomes final are treated as paid or incurred in the taxable year in which the adoption becomes final.

Therefore, the credit for qualified adoption expenses paid or incurred in the taxable year in which the adoption is final, or in any earlier taxable year, is allowed in the taxable year the adoption becomes final. The credit for qualified adoption expenses paid or incurred after the taxable year in which the adoption becomes final is allowed in the taxable year in which the expenses are paid or incurred.

## AGRICULTURE

Self-Employment Tax
Conservation Reserve Program Payments
I.R.C. §1402

☞ **The payments were not subject to SE tax but were classified as rent even though the farmer was still operating other farmground.**

See page 313 of the Ag Issues Chapter.

*Wuebker v. Commissioner*, 110 T.C. #31 (June 23, 1998); [CCH Dec 52,748]

Constructive Receipt—Production
Flexibility Payments—Farmers

**Practitioner Note:** Under the 1996 Farm Act and recent 1998 legislation, farmers have several options. **First,** under the 1996 Act a farmer can receive, for example, one half of the PFC payment in one year and one half in the next year or 100% in the next year. 1998 legislation would allow farmers to collect (or not) 100% of the 1999 payment in 1998. Under **Rev. Rul.** 68-44 these options can be construed as "constructive receipt" even though the farmer doesn't exercise the early payment options. **HR** 4644 and 4579 would state that these options do not constitute constructive receipt, but neither of these House Bills have been passed (as of Oct. 6, 1998).

Several local USDA offices have indicated they only report **actual payments** on the 1099 G form–the form the practitioner relies on to report government program payments.

Watch for developments! However, it seems that for now, the practitioner can rely on the 1099 G information. [Editor]

## AMT

Alternative Minimum Tax
I.R.C. §55

☞ **Taxpayers were liable for AMT.**

**Facts.** Mr. and Mrs. Klaassen are members of the Reformed Presbyterian Church. Members of the church are taught that the production of many offspring is a blessing. Accordingly, they are opposed to birth control. On their joint 1994 tax return, they properly claimed a total of 12 exemptions; i.e., two for themselves and 10 for their children. They itemized deductions on the 1994 Schedule A. Included on Schedule A were deductions for **unreimbursed medical expenses** of $4,767 and state and local taxes in the amount of $3,264.

They neither completed nor attached Form 6251 [Alternative Minimum Tax (AMT)] to their 1994 tax return. **Their "regular tax" shown on line 38 on their 1994 Form 1040 was $5,111. IRS computed taxpayers' "tentative minimum tax"** on Form 6251 to be **$6,196. Since the "tentative minimum tax" exceeded the "regular tax" by $1,085, IRS assessed the taxpayers $1,085 of AMT for 1994.**

**Issues.** Whether the taxpayers are liable for the alternative minimum tax prescribed by I.R.C. §55.

**Discussion.** The alternative minimum tax is imposed **in addition** to the "regular tax." In the instant case, three **adjustments** are provided under I.R.C. §56 to convert "regular taxable income" to "alternative minimum taxable income." They are:

1. State and local taxes deducted on Schedule A are not allowed;
2. In computing the medical expense deduction, an AGI limitation of 10 percent is substituted in lieu of the "regular tax" limitation of 7.5 percent;
3. No personal exemptions are allowed.

We hold that the taxpayers **are liable for the alternative minimum tax** on their 1994 tax return. [*David R. and Margaret J. Klaassen v. Commissioner*, T.C. Memo 1998-241, 76 T.C.M. 20 (1998) [CCH Dec. 52, 775(M)].]

## ANNUITY CONTRACTS—OID

Annuities—Civil Service Retirement Systems
I.R.C. §§61, 72, and 402

☞ **Appeals Court affirms Tax Court in *Roundy* case.**

**Practitioner Note:** The *Roundy* Tax Court case was affirmed by the 9th Cir. U.S. Ct. of Appeals.

**Facts:** Elno Roundy was an employee of the Bureau of Land Management for 26 ½ years. He participated in the Civil Service Retirement System (CSRS), and his mandatory contribution came to $32,886.62. The employer made contributions in the same amount. [§8334(a)(1)] Mr. Roundy's contributions had been included in his taxable income in the years paid. *Hogan v. United States* [75-1 USTC ¶9313], 513 F.2d 170, 175 (6th Cir. 1975). Taxes on the government's contributions and on the interest earned on the employee's investment were deferred, pursuant to I.R.C. §§72 & 402(a), until the annuity was distributed and included as income in the years received.

Mr. Roundy retired in 1989 at the age of 48 when his job was discontinued and his supervisors suggested that he take early retirement. At that time, a civil service employee in his situation could elect to take an "alternative form of annuity," which provided a lump-sum payment equal to the amount of his contributions to the fund ($32,886.62), and a reduced annuity of $5,311.83 per year. [§8343a] He chose that option, and received the lump-sum payment in 1989. The Roundys did not declare the $32,886.62 as income, nor did they pay the early-withdrawal (10%) penalty provided under §72(t).

The IRS treated the lump-sum payment as 1989 income and assessed tax, plus penalties and interest. **The Tax Court upheld the IRS assessments.**

[*Roundy v. Commissioner; U.S. Ct. of Appeals,* 9th Cir. 97-2 USTC 89, 541 [CCH ¶ 50, 625]

Debt Instruments with Original Issue Discount Annuity Contracts
T.D. 8754 26 CFR Part 1

☞ **This document contains final regulations relating to the federal income tax treatment of certain annuity contracts. The regulations determine which of these contracts are taxed as debt instruments for purposes of the original issue discount provisions of the Internal Revenue Code. The regulations provide needed guidance to owners and issuers of these contracts.**

### ACTION

Final regulations.

### DATES

**Effective date.** The regulations are effective February 9, 1998.

**Applicability dates.** For dates of applicability, see §1.1275–1(j)(8).

## BANKRUPTCY

Test of Bankruptcy Appeals Process
Announcement 97-111

☞ **This Announcement describes a test process for quickly resolving certain IRS-related disputes connected with a taxpayer's bankruptcy case.**

## BUSINESS EXPENSES

Travel Expenses While Away from Home
I.R.C. §162 (a)(1)

☞ **Employment of Taxpayer was indefinite. Deduction of away from home expenses was denied.**

**Facts.** Elizabeth Turner, the taxpayer, received a Ph.D. in history in 1990 from Rice University in Houston, TX. She and her husband Albert had lived in Houston since 1982. After applying to many schools, Elizabeth accepted the position of Assistant Professor of History at Queens College in Charlotte, NC, for the 1990–91 academic year. **She had a "tenure track" position at Queens College.**

She and her teenage daughter moved from Houston to Charlotte in August 1990. During 1991, Elizabeth applied for employment at the University of Houston-Downtown. On May 10, 1991, she received a letter from the president of Queens College that offered continued appointment as Assistant Professor of History for the 1990–91 academic year. On May 13, she received a similar letter from the University of Houston-Downtown. She accepted the latter and she and her daughter moved back to Houston in June 1991.

On their joint 1991 tax return, the taxpayers deducted about $9,500 for Elizabeth's employee business expenses while she resided in Charlotte, NC. The expenses included apartment rental, utilities, and $3,120 for food. **The taxpayers' position was that a tenure-track position should be considered temporary because Elizabeth could be terminated by Queens College after her initial nine-month appointment.**

IRS disallowed the claimed employee business expenses. IRS claimed that she was not away from her tax home when she incurred the expenses.

**Issue.** Whether Elizabeth is entitled to deductions for "away from home" expenses pursuant to I.R.C. §162 (a)(2).

**Discussion.** I.R.C. §162 (a)(2) permits a deduction for traveling expenses including meals and lodging, incurred **while away from home** in the pursuit of a trade or business. This court has held that a taxpayer's home for purposes of I.R.C. §162 (a)(2) is the vicinity of the taxpayer's principal place of employment and not where his or her personal residence may be located.

**An exception exists when a taxpayer accepts employment away from home which is temporary, as opposed to indefinite, in duration.** If the employment is **temporary,** the tax home is considered to be the place of the taxpayer's residence; whereas, if the employment is **indefinite,** the tax home is the location of employment. Employment is considered to be **temporary** if termination within a short period could be expected. This expectation is measured by what was contemplated at the time employment was accepted.

**Holding.** **We find that taxpayer's employment at Queens College in 1991 was indefinite.** There was no evidence presented that indicated that Queens College expressed any intention to limit the duration of taxpayer's employment. We are convinced that taxpayer had a reasonable expectation that her employment at Queens College would continue for a substantial or indefinite period of time. **In fact, she was offered continued employment at Queens College. However, she declined the offer.**

We conclude that since her employment was **indefinite, she was not away from her tax home.** Her tax home from January through June 1991 was Charlotte, NC and not Houston, TX. **Therefore, the determination of IRS is sustained.**

[*Elizabeth H. and Albert B. Turner,* T.C. Memo 1997-522, 74 T.C.M. 1246 (1997) [CCH Dec. 52,363(M)].]

### Unreimbursed Employee Business Expenses

I.R.C. §162(a)

☞ **A taxpayer who could have requested reimbursement of employee business expenses but didn't, could not deduct the expenses.**

**Facts.** Thomas Spielbauer, the taxpayer, was employed by the Santa Clara County Public Defender's Office in 1992 as a senior deputy public defender. He had worked in that office since 1981. His employer had a reasonable reimbursement policy for employee expenses. County employees could be reimbursed 29¢ per mile for required business mileage. The county also reimbursed its employees for required travel expenses, certain educational expenses, and 50 percent of personal computer equipment costs.

The taxpayer **did not submit requests for reimbursement** of his employee business expenses to the county during 1992, the year of exam. He filed his 1992 tax return on February 14, 1995. He testified that he thought his 1992 tax return would show no balance due. On his 1992 Form 2106, **he deducted a total of $19,781 of unreimbursed employee expenses.** Included in that total were the following:

**a.** candy and flowers for office secretaries
**b.** cable television bills for his apartment
**c.** office stationery
**d.** magazine and newspaper subscriptions
**e.** parking garage expenses and parking violation citations
**f.** various club dues
**g.** operating expenses for the business use of three autos
**h.** the cost of four telephone lines in his apartment, including one for a fax machine
**i.** $1,944 for the cost of meals and entertainment incurred while dining and discussing case strategy with his office co-workers
**j.** purchases of luggage, an answering machine, a magazine rack, video tapes, a battery, a Sony tape player, and a Police Department T-shirt
**k.** the costs related to interns he had hired to help him with his legal briefs

IRS disallowed all of the claimed employee business expenses except $167 of unreimbursed educational expenses. The IRS also **assessed a failure to file penalty** of $4,972 and a 20 percent accuracy-related **negligence penalty** of $1,274.

**Issue.** Whether taxpayer may deduct any of his 1992 unreimbursed employee business expenses.

**Discussion.** **When an employee has a right to reimbursement for expenditures related to his status as an employee, but fails to claim such reimbursement, the expenses are not deductible. Those expenses are not "necessary," i.e., it is not necessary for an employee to remain unreimbursed for expenses to the extent he could have been reimbursed.** The employee has the burden of establishing that the employer would **not** reimburse the expense had the employee requested reimbursement.

**Holding.** We hold that many of the expenses deducted by taxpayer **do not constitute ordinary and necessary employee business expenses.** The taxpayer, as deputy public defender, incurred these expenses **voluntarily. The Public Defender's Office did not require him to do so as a condition of his employment.** Most of the remaining employee business expenses are those that taxpayer failed to request reimbursement for from his employer. These expenses are **not "necessary" and are not deductible** under I.R.C. §162(a).

[*Thomas J. Spielbauer v. Commissioner*, T.C. Memo 1998-80, 75 T.C.M. 1865 (1998) [CCH Dec. 52,591 (M)].]

Ordinary and Necessary Business Expenses
I.R.C. §162

☞ **A car owned by a corporation was not an ordinary and necessary business item. A constructive dividend resulted.**

**Facts.** Mohan and Vimal Roy, husband and wife, were physicians. Mohan was a heart surgeon and Vimal was an anesthesiologist. Mohan performed surgery at 10 different hospitals in Orange County, CA during the four years in question, 1991-94. Mr. and Mrs. Roy conducted their medical practices through their closely held corporation, Roy, Inc. The corporation owned a 1990 **Silver Spur Rolls Royce** auto during the four examination years. The corporation **deducted 100 percent of the operating expenses on the auto plus the maximum MACRS deduction** in each of the four years.

The taxpayers claimed that the Rolls Royce was acquired by the corporation **as a promotional tool to obtain referral business from other physicians and hospitals.** However, during the four-year period, the auto was driven a total of approximately 5000 miles, or an average of 1250 miles per year. Mohan Roy testified that it was decided **that it would be "inappropriate to showcase the Rolls Royce" for fear of offending potential referring physicians with declining incomes during an economic slump.**

The IRS disallowed all of the corporate auto expenses. The IRS contended that **since mileage records were not maintained,** the corporation failed to substantiate the business use of the Rolls Royce. In addition, the IRS claimed that the expenses were **not ordinary and necessary.** Furthermore, the IRS used the **constructive dividend theory** to increase the income on the individual tax returns of the Roys for the value of the personal use of the auto by Mohan Roy.

**Issues**

1. Whether the corporation is entitled to deductions under I.R.C. §162 for the expenses incurred for the Rolls Royce.
2. Whether Mr. and Mrs. Roy must include in income on their individual tax returns the value of Mohan Roy's use of the Rolls Royce.

### Discussion

Issue 1. **An expense is ordinary if it is common or frequently occurs. An expense is necessary if it is appropriate and helpful to the taxpayer's trade or business.** The taxpayer must show that there is a **proximate relationship** between the claimed expense and the operation of the taxpayer's trade or business.

Issue 2. Distributions of property from a corporation to a shareholder with respect to its stock constitute dividends to the extent of the corporation's earnings and profits. [I.R.C. §§301(c) and 316(a)] Dividends may be formally declared or they may be constructive. Nondeductible expenditures made by a corporation for the **personal benefit of a shareholder constitute a constructive dividend** to that shareholder.

### Holding

Issue 1. The corporation has failed to establish that the Rolls Royce resulted in even one physician referral. To the contrary, Mohan Roy testified that he thought the auto would **discourage patient referrals.** This undermines any claim that the auto was an ordinary and necessary expense to the corporation.

Further, **the business use of the auto has not been substantiated** as required by I.R.C. §274(d) via mileage logs or other business records which corroborate the taxpayers' own testimony. [**Treas. Reg.** §1.274-5T(c)] In conclusion, **none of the Rolls Royce expenses are deductible by Roy, Inc.**

Issue 2. **We hold that the individual taxpayers received constructive dividends from Roy, Inc. for Mohan Roy's personal use of the Rolls Royce auto.** Since the evidence regarding the **fair rental value of the auto was omitted,** we will use the actual operating expenses, excluding depreciation, to determine the amount of the constructive dividends.

[*Roy, Inc. and Mohan and Vimal Roy v. Commissioner*, T.C. Memo 1997-562, 74 T.C.M. 1428 (1997) [CCH Dec. 52,409(M)].]

### Office In Home—Business Deduction

I.R.C. §280 (A)(a)

> ☞ **Taxpayer was entitled to an office in the home deduction.**

**Facts.** The taxpayer, Valerie Genck, was a self-employed jazz band member and manager. She performed as the band's lead singer on an average of 12 hours per week in 1992. In addition, she served as the manager of the band. She spent an average of 30 hours per week performing management duties. The management duties were performed in her rented apartment. The apartment was divided, in roughly equal areas, into living quarters and an office. The two areas were connected by a single door. The living quarters consisted of two bedrooms, a living room, a kitchen, and a bathroom. The office portion consisted of a large recording and practice studio and a smaller adjacent room. The adjacent room contained a desk, telephone, couch, and kitchenette. She deducted a total of $2,489 of **home office** rent and utilities on her 1992 tax return. The IRS disallowed the entire amount.

**Issue.** Whether taxpayer is entitled to a home office deduction.

**Discussion.** I.R.C. §280A(a) provides that for individual taxpayers, no deduction shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the tax year as a residence. I.R.C. §280A(c) provides for **exceptions** to the general disallowance rule. Specifically, I.R.C. §280A(c)(1)(A) states that the disallowance provision does **not** apply where the home office is used **exclusively on a regular basis as the principal place of business** for any trade or business of the taxpayer.

**Holding.** The extent of the taxpayer's time spent on management duties (an average of 30 hours per week) convinces us that **her home office constitutes her primary place of business** as the band manager. Accordingly, we hold that she is entitled to the rent and utilities deductions she claimed as home office expenses. [*Valerie J. Genck v. Commissioner,* T.C. Memo 1998-105, 75 T.C.M. 1984 (1998) [CCH Dec. 52,621(M)].]

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**Notes concerning the Genck T.C. Memo case above.**

1. Because her apartment was held to her principal place of business, she was entitled to deduct transportation (auto) expenses for business-related round trips from her apartment to the various band performance sites. These transportation expenses **were not nondeductible commuting expenses.** Rather they are **deductible business expenses** under I.R.C. 162 (a).
2. The stringent office-in-home rules mandated by the *Soliman* Supreme Court decision have been relaxed for tax years beginning after Dec. 31, 1998. See the 1997 Taxpayer Relief Act chapter for details on the new rules, which will impact 1999 tax returns.

Salary Deductibility—Excessive
I.R.C. §16

☞ **The taxpayer received unreasonably high compensation from his corporation. The IRS determination is also rejected.**

**Facts.** H&A International Jewelry (H&A), a C corporation, was owned by Haim and Amy Haviv, husband and wife. The Havivs each owned 50% of the stock in H&A. The corporation conducted wholesale and retail sales of jewelry and precious stones. Mr. Haviv received the following amounts of compensation from H&A:

| Year | Salary | Year-end Bonus | Total Compensation Received |
|---|---|---|---|
| 1987 | $12,000 | $35,000 | $47,000 |
| 1988 | 26,000 | 125,000 | 151,000 |
| 1989 | 28,000 | 95,000 | 123,000 |
| 1990 | 30,000 | 105,000 | 135,000 |
| **1991** | **40,000** | **562,000** | **602,000** |
| **1992** | **68,000** | **535,000** | **603,000** |

In 1991 H&A took an order from a customer for an extremely rare 0.7-carat **red diamond. Mr. Haviv located and purchased the diamond for $56,000 and sold it to the customer for $600,000.** In 1991 Mr. Haviv's $602,000 compensation from H&A was four times larger than his average compensation for the prior three years. In 1992 his total $603,000 compensation exceeded that of 1991. **During the five-year period 1988-92, H&A paid Mr. Haviv the following percentages of its gross income:**

| Year | H&A's Gross Income | Mr. Haviv's Compensation | Percentage |
|---|---|---|---|
| 1988 | $3,914,409 | $151,000 | 3.9% |
| 1989 | 4,684,286 | 123,000 | 2.6% |
| 1990 | 4,740,731 | 135,000 | 2.8% |
| **1991** | **6,495,378** | **602,000** | **9.3%** |
| **1992** | **7,009,772** | **603,000** | **8.6%** |

**In 1992, Mr. Haviv's $603,000 compensation was greater than H&A's net income (before deduction of Mr. Haviv's compensation).** This resulted in a 1992 net operating loss of $132,278, which the corporation carried back to offset 1989, 1990, and 1991 income.

The IRS used Robert Morris Associates (RMA) Annual Statement Studies to determine Mr. Haviv's **reasonable compensation** for 1991 and 1992. **The IRS determined that Mr. Haviv's reasonable compensation was $207,852 in 1991 and $224,313 in 1992.** The IRS treated the excessive compensation of $394,148 in 1991 and $378,687 as **nondeductible disguised dividends. Since its incorporation in 1983, H&A had never paid a dividend to its two shareholders, Mr. and Mrs. Haviv.**

Mr. Haviv determined the compensation amounts for all employees of H&A. The corporation had no written policies for making such determinations. Year-end bonuses were approved by the board of directors, which consisted solely of Mr. and Mrs. Haviv, at the annual meeting preceding each year. Mr. and Mrs. Haviv were the only employees of H&A who ever received the year-end bonuses.

**Issue.** Whether the amount of executive compensation paid to Mr. Haim Haviv for 1991 and 1992 is unreasonable, and if so, what reasonable compensation is.

**Discussion.** I.R.C. §162(a)(1) allows a deduction for ordinary and necessary business expenses, including "a reasonable allowance for salaries or other compensation for personal services actually rendered." **Compensation that is a guise for the distribution of dividends to employee-stockholders is not deductible.** [**Treas. Reg.** §1.162-7(b)(1)]. The reasonableness of compensation is a question of fact to be determined in each case. In *Estate of Wallace* [95 T.C. 525 (1990) [CCH Dec. 46,977] and affirmed by the 11th Cir. Ct. of Appeals in 1992 (92-2 USTC 85 ¶50,387)], the courts used the following nine factors to determine reasonableness:

1. The employee's qualifications
2. The nature, extent, and scope of the employee's work
3. The size and complexities of the business
4. A comparison of salaries paid with the gross income and the net income
5. The prevailing general economic conditions
6. Comparison of salaries with distributions to stockholders
7. The prevailing rates of compensation for comparable positions in comparable concerns
8. The salary policy of the corporation as to all employees; an
9. In the case of small corporations with a limited number of officers, the amount of compensation paid to the particular employee in previous years



In analyzing these factors, **the Court must carefully scrutinize the facts of a case in which the corporation is controlled by the employees to whom the compensation is paid. In such a situation, the court must be convinced that the purported compensation was paid for services rendered as opposed to a nondeductible distribution of earnings.**

**Holding.** H&A's compensation deduction was unreasonable. The minutes for the 1991 and 1992 meetings of the board of directors of H&A make **no reference** to its **alleged contention** that a portion of Mr. Haviv's 1991 and 1992 compensation **was to compensate him for an underpayment of services in prior years.** Also, the absolute reliance of the IRS on the RMA survey was erroneous. On the basis of all evidence submitted, **$429,000 for 1991 and $305,000 for 1992 constituted reasonable compensation to Mr. Haviv.**

[*H&A International Jewelry, Ltd. v. Commissioner*, T.C. Memo 1997-467, 74 T.C.M. 915 (1997) [CCH Dec. 52,303(M)]]

Business Deduction—Trip
I.R.C. §162

> ☞ **Trip not primarily related to business, deduction denied.**

**Facts.** Derk Pehrson was a self-employed licensed Utah real estate broker. His wife Julia was employed as an executive by a Salt Lake City credit union. She was required to attend a 5-day business seminar in Orlando, FL in August 1993. Mr. Pehrson had known for several months prior to August 1993 that he needed to conduct real estate related business with a client in Harrisburg, Pennsylvania.

The Pehrsons rented a vehicle and drove from Salt Lake City to Orlando. Their two young children accompanied them on the trip. On the way to Orlando, they stopped to visit Graceland in Memphis, Tennessee. While Mrs. Pehrson attended her seminar in Orlando, Mr. Pehrson and his two children visited Walt Disney World, Universal Studios, Kennedy Space Center, and other tourist attractions.

Upon departing Orlando, the family drove to Harrisburg, Pennsylvania, where Mr. Pehrson spent 2 ½ days on his business activities. **The total length of the trip was 15 to 17 days.** The cost of the rental vehicle was $905 which Mr. Pehrson deducted as a business expense on his 1993 Schedule C. IRS disallowed the $905 deduction as the trip was, according to IRS, "not primarily related to Mr. Pehrson's real estate broker business."

**Issue.** Whether the $905 automobile rental expense constituted a trade or business expense under I.R.C. §162(a).

**Discussion.** If expenses for travel to and from a destination are incurred for **both business and other purposes, such expenses are deductible only if the travel is primarily related to the taxpayer's trade or business. If a trip is primarily personal in nature, expenses are not deductible even if the taxpayer engaged in some business activities at the destination. [Treas. Reg.** §1.162-2(b)(1)] Whether travel is related primarily to the taxpayer's trade or business or is primarily personal is a question of fact. [**Treas. Reg.** 1.162-2(b)(2)]

**The amount of time during the period of the trip that is spent on personal activity compared to the amount of time spent on trade or business related activities is an important factor in determining whether the trip is primarily personal.**

Taxpayers contend that any sight-seeing and other personal activity engaged in during the trip were purely incidental. IRS contends that the trip was **not primarily related** to Mr. Pehrson's real estate broker business. Therefore, the $905 auto rental cost is not deductible.

**Holding.** Mr. Pehrson admitted in court that the portion of the trip to Orlando was **not** related to his business, but rather, was related to his wife's employment. Mrs. Pehrson's employer reimbursed her fully for the cost of sending her to the Orlando seminar. **The amount of time spent on Mr. Pehrson's business activities was nominal in relation to the entire trip.** Furthermore, the date of the trip, as well as the travel route were determined primarily by Mrs. Pehrson's seminar in Orlando. Mr. Pehrson deliberately delayed the conduct of his business in Harrisburg, Pennsylvania, and chose to combine it with his wife's seminar trip as a matter of family convenience and economics. **Therefore, we find that the trip was not primarily related to Mr. Pehrson's business. Accordingly, we hold that the $905 automobile rental expense is not deductible. [***Derk O. and Julia K. Pehrson v. Commissioner*, T.C. Memo 1997-344, 74 T.C.M. 266 (1997) [CCH Dec. 52, 173(M)].]

Demolition Loss
I.R.C. §280B

> ☞ **Taxpayers were denied a loss deduction on the demolition of a building. The cost and loss is added to the tax basis of the land.**

**Discussion and Facts.** The United States Tax Court has made it clear that the limitation on deductions imposed by §280B is **not** applicable to losses that occur **before** a structure is demolished. In *DeCou v. Commissioner* [CCH Dec. 49, 998], 103 T.C. 80 (1994), the court considered §280B as it applied to a deduction taken by taxpayers for a building they purchased in 1984 and demolished in 1985. In April 1985, the taxpayers learned that latent structural defects in the building would require substantial repairs. Additionally, in April 1985, the health permit for the structure was suspended. The taxpayers determined that the necessary repairs were not economically feasible. Accordingly, in June 1985, the taxpayers bought out the remaining leases from their tenants and boarded up the building.

**In October 1985, the taxpayers demolished the building and claimed an abandonment or retirement loss deduction.** The Internal Revenue Service disallowed the deduction and the taxpayers appealed. The court found that the building suddenly and unexpectedly lost its usefulness in April 1985 when the defects were found and the health permit was suspended and that the building was withdrawn from use when the taxpayers bought out the remaining lease term and boarded up the building. *See DeCou* [CCH Dec. 49,998], 103 T.C. at 87. Therefore, the court reasoned, the loss occurred before the building was demolished and the deduction **was not** precluded by §280B. *See* id.

The taxpayers in the instant case, relying on *DeCou,* contend that their loss was incurred before the building was demolished because they withdrew the building from use prior to its demolition. *DeCou* is, however, distinguishable from the instant case.

In *DeCou,* the taxpayers took affirmative steps to withdraw the building from use in the year for which they sought the deductions. Further, the events which caused the building to lose its value, the discovery of latent defects and suspension of the health permit occurred during the tax year for which the taxpayers claimed a deduction.

In this, on the other hand, the taxpayers' decision to withdraw the building from use based on events which occurred in prior year, i.e., vandalism in 1988, the discovery of asbestos in 1988, and the withdrawal of interest by potential buyers in 1989.

**Decision:** The court notes that §280B would be rendered meaningless if the court were to adopt the position advocated by taxpayers, i.e., that a taxpayer's unilateral decision to withdraw an asset from service in and of itself entitles the taxpayer to a deduction in the year that the taxpayer makes the decision. Every taxpayer who decides to demolish a building makes the decision to withdraw the structure from use before arranging for the destruction of the building.

Thus, if the taxpayer's decision was itself sufficient to avoid §280B, as they urge, §280B would never apply because every structure would be withdrawn from use before its demolition.

**The deduction is denied.**
[*Gates v. U.S.,* U.S. Dist. Ct.; Mid. Dist. Pa.; 98-1 USTC 83,924; [CCH ¶ 50,353].]



Deductibility of Interest on Tax Deficiencies for the Individual Taxpayer

Preface to the next two court cases

☞ **Recent developments in deduction of interest paid on business-related tax deficiencies**

The next two court cases involve the issue of **interest paid to the IRS on income tax deficiencies for noncorporate taxpayers.** The Tax Court and the U.S. Court of Appeals (Eighth and Ninth Circuits) have differed on the interpretation of I.R.C. §163(h)(2)(A) and **Treas. Reg.** §1.163-9T(b)(2)(i)(A). See pages 243 and 244 in the 1997 *Farm Income Tax Book* and pages 626 to 629 in the 1996 *Farm Income Tax Book* for discussions of the *Miller* and *Redlark* court cases.

The first court case shown below is the U.S. Court of Appeals (Ninth Circuit) decision in the *Redlark* **case,** which originated in the Tax Court. The Ninth Circuit Court of Appeals **reversed** the prior Tax Court decision in *Redlark* which was favorable to taxpayers. The Ninth Circuit's decision in *Redlark* was issued in April 1998. The second court case shown below is the *Kikalos* Tax Court Memo case which was reported in March 1998. The *Kikalos* Tax Court decision is favorable to taxpayers and reinforced the Tax Court's opinion that **Treas. Reg.** §1.163-9T(b)(2)(i)(A) is invalid. Also see *Allen, Sr.,* below. The disputed regulation states:

> **Interest relating to taxes-(i) In general.** Personal interest (which is nondeductible) **includes** interest paid on underpayments of individual federal, state or local income taxes and on indebtedness used to pay such taxes, regardless of the source of the income generating the tax liability.

**Practitioner Caution.** Based on the Appellate Courts' two decisions in the *Miller* (Eighth Circuit) and *Redlark* (Ninth Circuit) cases, IRS examiners and Appeals officers will deny all tax deficiency-related interest deductions of noncorporate taxpayers. If a client insists on deducting such interest, it is strongly suggested that you use the disclosure Form 8275-R (to disclose a position contrary to a Treasury Regulation) and that you cite the *Kikalos* Tax Court Memo case as your authority in Part II of the form, Detailed Explanation. A Tax Court petition and determination will probably be necessary for taxpayers who live other than in the Eighth or Ninth Circuits to prevail. However, it is anticipated that the Tax Court may soon abandon its position that **Treas. Reg.** §1.163-9T(b)(2)(i)(A) is invalid, especially if a third Appeals Court agrees with the decisions already reached by the Eighth and Ninth Circuit Courts of Appeal in *Miller* and *Redlark* respectively.

**Note.** The **Eighth Circuit** includes Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota. The **Ninth Circuit** includes Alaska, Arizona, California, Hawaii, Idaho, Montana, Oregon, and Washington. For taxpayers in those states, the decisions reached by the Appellate Courts in Miller and Redlark upholding the Treasury Regulation is law.

**Brief analysis and discussion of the *Redlark* Ninth Circuit Court of Appeals case reported on April 10, 1998.**

**Discussion.** The Ninth Circuit focused on who has the authority to interpret ambiguous Internal Revenue Code sections passed by Congress. If a particular Code section is unclear, does Congress delegate authority to the IRS to clarify via a Treasury regulation?

**Holding.** The Ninth Circuit held that I.R.C. §163(h)(2)(A) was ambiguous. It states:

**Disallowance of deduction for personal interest.**

**In general.** In the case of a taxpayer other than a corporation, no deduction shall be allowed for personal interest paid or accrued during the taxable year.

**Personal interest.** The term "personal interest" means any interest allowable as a deduction other than–

interest paid or accrued on indebtedness **properly allocable to a trade or business** (other than the trade or business of performing services as an employee).

I.R.C. §163(h)(2)(A) is **ambiguous** because it does not define the term **"interest paid or accrued on indebtedness properly allocable to a trade or business."** As a result, there is implicit Congressional intent to delegate authority to the IRS to clarify I.R.C. §163(h)(2)(A). This was accomplished by **Treas. Reg**. §1.163-9T(b)(1)(i) (shown above in the Preface). **So long as the IRS interpretation of an ambiguous statute is reasonable, as it is here, we must uphold it.** [*Redlark v. United States,* U.S. Court of Appeals, 9th Cir., (1998)]

Full analysis and discussion of the *Kikalos* T.C. Memo case reported on March 3, 1998.

**Facts.** Nick and Helen Kikalos, the taxpayers, operated Nick's Liquors as a sole proprietorship. In an IRS exam of their 1986 and 1987 joint tax returns, tax deficiencies of approximately $275,000 for each year were assessed due to unreported Schedule C gross receipts. **In 1992, the taxpayers paid $393,024 of interest to the IRS on these two assessments. The interest was deducted on their 1992 Schedule C as business-related interest.**

The IRS disallowed the interest deduction, alleging that it was personal interest under **Treas. Reg.** §1.163-9T(b)(2)(i)(A).

**Note.** The holding which follows is quoted verbatim from the Tax Court's Opinion section.

**Holding.** We disagree . . . (with the IRS). I.R.C. §163(h)(2)(A) exempts from the category of personal interest (which is nondeductible for individuals) "interest paid or accrued on indebtedness properly allocable to a trade or business (other than the trade or business of performing as an employee)."

In *Redlark v. Commissioner*, on appeal to the Ninth Circuit, the taxpayers deducted the amount of interest on the portion of a deficiency in Federal income tax arising out of the Commissioner's adjustments that resulted from accounting errors in the taxpayers' unincorporated business. The Commissioner, relying on the provisions of Temporary Treasury Regulation §1.163-9T(b)(2)(i)(A), denied the deduction, arguing that the payment at issue was the payment of personal interest. We disagreed, holding that the regulation was invalid. We further held that the interest at issue was deductible as interest on an "indebtedness properly allocable to a trade or business" within the meaning of I.R.C. §163(h)(2)(A).

The principle of *Redlark* applies here. There is no dispute that petitioners, cash basis taxpayers, paid the interest at issue on income tax deficiencies resulting from their operation of Nick's Liquors, their unincorporated trade or business. **Under I.R.C. §163(h)(2)(A), the interest they paid is deductible because it was paid upon an indebtedness properly allocable to their trade or business.**

[*Nick and Helen Kikalos*, T.C. Memo 1998-92, 75 T.C.M. 1924 (1998) [CCH Dec. 52,604(M)]]

**Practitioner Note.** Taxpayers lost on this issue in *Stecher v. U.S.*, U.S. District Court in Colorado, 98 USTC 85,232 [CCH ¶50,543] and a recent Seventh Circuit Court of Appeals case stated the court was going to treat all IRS regulations as **valid.**

Taxpayer won in *Allen, Sr. v. U.S.A.*, 98-1 USTC 83,315, U.S. District Court in North Carolina [CCH ¶50,196].

Summary of 1998 Standard Mileage Rates

Rev. Proc. 97-58

| | |
|---|---|
| Business | 32.5 cents per mile |
| Charitable | 14 cents per mile |
| Medical and Moving | 10 cents per mile |

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If, after using the business standard mileage rate, the taxpayer uses actual costs, the taxpayer must use straight-line depreciation for the automobile's remaining estimated useful life (subject to the applicable depreciation deduction limitations under §280F).

Business Expense for Lodging,
Meal, and Incidental Expenses—1998
Rev. Proc. 97-59

☞ **This revenue procedure provides rules under which the amount of ordinary and necessary business expenses of an employee for lodging, meal, and incidental expenses or for meal and incidental expenses incurred while traveling away from home will be deemed substantiated under §1.274-5T when a payor (the employer, its agent, or a third party) provides a per diem allowance under a reimbursement or other expense allowance arrangement to pay for such expenses.**

**This revenue procedure also provides an optional method for employees and self-employed individuals to use in computing the deductible costs of business, meal, and incidental expenses paid or incurred while traveling away from home.**

**Use of a method described in this revenue procedure is not mandatory and a taxpayer may use actual allowable expenses if the taxpayer maintains adequate records or other sufficient evidence for proper substantiation. This revenue procedure does not provide rules under which the amount of an employee's lodging expenses will be deemed substantiated when a payor provides an allowance to pay for those expenses but not meal and incidental expenses.**

**Background and Changes.** Section 274(n) generally limits the amount allowable as a deduction under §162 for any expense for food, beverages, or entertainment **to 50 percent of the amount of the expense that otherwise would be allowable as a deduction.**

In the case of any expenses for food or beverages consumed while away from home (within the meaning §162(a)(2)) by an individual during, or incident to, the period of duty subject to the hours of services limitation of the Department of Transportation, §274(n)(3), as added by the Taxpayer Relief Act of 1997, gradually increases the deductible percentage to 80 percent for taxable years beginning in 2008. **For taxable years beginning in 1998, the deductible percentage for these expenses is 55 percent.**

Specific high-low rates. The per diem rate set forth in this section is $180 for travel to any "high-cost locality," or $113 for travel to any other locality within CONUS. Whichever per diem rate applies, it is applied as if it were the Federal per diem rate for the locality of travel.

For purposes of applying the high-low substantiation method, the Federal M&IE rate shall be treated as $40 for a high-cost locality and $32 (self-employed individuals for example) for any other locality within CONUS.

High-cost localities. The following localities have a Federal per diem rate of $147 or more for all or part of the 1998 calendar year, and are high-cost localities for all of the calendar year specified in parentheses under the key city name:

| Key City | County and other defined location |
|---|---|
| Arizona | |
| Grand Canyon | All points in the Grand Canyon National Park and Kaibab National Forest within Coconino County |
| California | |
| Los Angeles | Los Angeles, Kern, Orange, and Ventura Counties; Edwards Air Force Base, Naval Weapons Center and Ordinance Test Station, China Lake |
| Napa | Napa |
| (April 1–October 31) | |
| Palo Alto/San Jose | Santa Clara |
| Point Arena/Gualala | Mendocino |
| San Francisco | San Francisco |
| Colorado | |
| Aspen | Pitkin |
| Keystone/Silverthorne | Summit |
| Telluride | San Miquel |
| Vail | Eagle |
| (November 1–March 31) | |
| Delaware | |
| Lewes | Sussex |
| (June 1–September 14) | |
| District of Columbia | |
| Washington D.C. | Washington D.C.; the cities of Alexandria, Falls Church, and Fairax, and the counties of Arlington, Loudoun, and Fairfax in Virginia; and the counties of Montgomery and Prince George's in Maryland |
| Florida | |
| Key West | Monroe |
| (December 15–April 30) | |
| Naples | Collier |
| (December 15–April 30) | |
| Illinois | |
| Chicago | Du Page, Cook, and Lake |
| Indiana | |
| Nashville | Brown |
| (June 1–October 31) | |

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| Key City | County and other defined location |
| --- | --- |
| Maine | |
| Bar Harbor | Hancock |
| (July 1–September 14) | |
| Maryland | |
| (For the counties of Montgomery and Prince George's, see District of Columbia) | |
| Baltimore | Baltimore and Harford |
| Ocean City | Worcester |
| (May 1–September 30) | |
| Saint Michaels | Talbot |
| (April 1–November 30) | |
| Massachusetts | |
| Boston | Suffolk |
| Cambridge/Lowell | Middlesex |
| Martha's Vineyard | Dukes |
| (June 1–October 30) | |
| Nantucket | Nantucket |
| (June 1–October 30) | |
| Nevada | |
| Incline Village | All points in the Northern Lake Tahoe area within Washoe County |
| (June 1–September 30) | |
| New Hampshire | |
| Hanover | Grafton and Sullivan |
| (June 1–October 31) | |
| New Jersey | |
| Ocean City/Cape May | Cape May |
| (May 15–September 30) | |
| Parsippany/Dover | Morris; Picatinny Arsenal |
| New Mexico | |
| Santa Fe | Santa Fe |
| (May 1–October 31) | |
| New York | |
| New York City | The boroughs of Bronx, Brooklyn, Manhattan, Queens, and Staten Island; Nassau and Suffolk Counties |
| Tarrytown/White Plains | Westchester |

| Key City | County and other defined location |
|---|---|
| North Carolina | |
| Kill Devil/Duck/Outer Banks | Dare |
| (May 1–September 30) | |
| Pennsylvania | |
| Philadelphia | Philadelphia; city of Bala Cynwyd in Montgomery County |
| Rhode Island | |
| Newport/Block Island | Newport and Washington |
| (May 1–October 14) | |
| South Carolina | |
| Hilton Head | Beaufort |
| (March 1–September 30) | |
| Myrtle Beach | Horry; Myrtle Beach Air Force Base |
| (May 1–September 30) | |
| Utah | |
| Park City | Summit |
| (December 1–March 31) | |
| Virginia | |
| (for the cities of Alexandria, Fairfax, and Falls Church, and the counties of Arlington, Fairfax, and Loudoun, see District of Columbia) | |
| Washington | |
| Friday Harbor | San Juan |
| (June 1–October 31) | |
| Seattle | King |
| Wyoming | |
| Jackson | Teton |
| (June 1–October 14) | |

### Section 4. Per Diem Substantiation Method

.01 Per diem allowance. If a payor pays a per diem allowance in lieu of reimbursing actual expenses for lodging, meal, and incidental expenses incurred or to be incurred by an employee for travel away from home, **the amount of the expenses that is deemed substantiated for each calendar day is equal to the lesser of the per diem allowance for such day or the amount computed at the Federal per diem rate for the locality of travel for such day (or partial day).**

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.02 Meals only per diem allowance. If a payor pays a per diem allowance **only for meals and incidental expenses** in lieu of reimbursing actual expenses for meals and incidental expenses incurred or to be incurred by an employee for travel away from home, the amount of the expenses that is deemed substantiated for each calendar day is equal to **the lesser of** the per diem allowance for such day or the amount computed at the Federal M&IE rate for the locality of travel for such day.

.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 as described in section 4.02 of this revenue procedure 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 in accordance with section 4.03 of this revenue procedure.

**(2) Rates.** A taxpayer described in section 4.04(1) of this revenue procedure 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 OCONUS. A payor that uses either (or both) of these special rates with respect to an employee must use the special rate(s) for all amounts subject to §4.02 of this revenue procedure paid to that employee for travel away from home within CONUS and/or OCONUS, as the case may be, during the calendar year. Similarly, an employee or self-employed individual that uses either (or both) of these special rates must use the special rate(s) for all amounts computed pursuant to section 4.03 of this revenue procedure for travel away from home within CONUS and/or OCONUS, as the case may be, during the calendar year.

**(3) Periodic rule.**

**(4) Transportation industry defined.** For purposes of this section 4.04 of this revenue procedure, an employee or self-employed individual is "in the transportation industry" only if the employee's or individual's work (a) is of the type that directly involves moving people or goods by airplane, barge, bus, ship, train, or truck, and (b) regularly requires travel away from home which, during any single trip away from home, usually involves travel to localities with differing M&IE rates. For purposes of the preceding sentence, a payor must determine that an employee or a group of employees is "in the transportation industry" by using a method that is consistently applied and in accordance with reasonable business practice.

### Section 6. Limitations and Special Rules

.04 Proration of the federal per diem or M&IE rate. Pursuant to the Federal Travel Regulations, in determining the Federal per diem rate or the Federal M&IE rate for the locality of travel, the full applicable Federal M&IE rate is available for a full day of travel from 12:01 a. m. to 12:00 midnight. For purposes of determining the amount deemed substantiated under section 4 or 5 of this revenue procedure with respect to partial days of travel away from home, either of the following methods may be used to prorate the Federal M&IE rate to determine the Federal per diem rate or the Federal M&IE rate for the partial days of travel:

(1) Such rate may be prorated using the method prescribed by the Federal Travel Regulations. Currently the Federal Travel Regulations allow three-fourths of the applicable Federal M&IE rate for each partial day during which the employee or self-employed individual is traveling away from home in connection with the performance of services as an employee or self-employed individual; or

(2) Such rate may be prorated using any method that is consistently applied and in accordance with reasonable business practice. For example, if an employee travels away from home from 9 a.m. one day to 5 p.m. the next day, a method of proration that results in an amount equal to 2 times the Federal M&IE rate will be treated as being in accordance with reasonable business practice (even though only 1-1/2 times the Federal M&IE rate would be allowed under the Federal Travel Regulations).

Storage Tanks Section 162—Trade or Business Expense
Rev. Rul. 98-25

☞ **Under the circumstances described in this revenue ruling, the costs incurred to replace underground storage tanks containing waste by-products (including the cost of removing, cleaning, and disposing of the old tanks, and acquiring, installing, and filling the new tanks) are deductible as ordinary and necessary business expenses under section 162 of the Code.**

**Law and Analysis.** The useful life of an asset for §263 purposes is its useful life to the taxpayer; not its inherent useful life. *See Silverton v. Commissioner*, T.C.M. 1977–198; *Massey Motors, Inc. v. United States*, 364 U.S. 92 (1960). Unlike most storage tanks, which are used to hold a substance temporarily and are emptied and refilled repeatedly throughout their useful lives, X's new USTs are filled **with waste once, sealed indefinitely,** and **thereafter have no salvage value. Upon being filled with waste and sealed, the new USTs have no remaining useful life to X. X's new USTs are used merely to facilitate the disposal of waste and therefore are similar to a material or supply that is consumed and used in operation during the taxable year.**

Accordingly, because X acquired, filled, and sealed the new USTs all in 1998, the costs of acquiring and installing the new USTs **are not capital expenditures,** but **are ordinary and necessary business expenses deductible under §162.**

The new USTs, which are used once and then sealed indefinitely, are **distinguishable** from the groundwater treatment facilities in **Rev. Rul.** 94–38, 1994–1 C.B. 35, which are used by the taxpayer substantially beyond the taxable year.

Further, X’s costs of removing, cleaning, and disposing of the old USTs, and filling and on-going monitoring of the new USTs are deductible as business expenses under §162.

The results would be the same if X had instead ceased to operate the manufacturing facility in 1998 or in a previous taxable year. The results would also be the same if X had instead used storage tanks that were designed to store waste above ground.

**Holding.** Under the circumstances described above, the costs incurred to replace USTs containing waste by-products (including the cost of removing, cleaning, and disposing of the old USTs, and acquiring, installing, and filling the new USTs) are deductible by the taxpayer as ordinary and necessary business expenses under §162. [**Rev. Rul.** 94-38 is distinguished.]

Automobile Depreciation Limitations (Nonelectric)
Rev. Proc. 98-30

**Table 1: Depreciation Limitations for Automobile (Other than Electric Automobiles) First Placed in Service in Calendar Year 1998**

| Tax Year | Amount |
|---|---|
| 1st Tax Year | $3,160 |
| 2nd Tax Year | $5,000 |
| 3rd Tax Year | $2,950 |
| Each Succeeding Year | $1,775 |

**Table 2**
**Depreciation Limitations for Electric Automobiles First Placed in Service in Calendar Year 1998**

| Tax Year | Amount |
|---|---|
| 1st Tax Year | $9,380 |
| 2nd Tax Year | $15,000 |
| 3rd Tax Year | $8,950 |
| Each Succeeding Year | $5,425 |

Inclusions in Income of Lessees of Automobiles
Rev. Proc. 98-30

☞ **The inclusion in income amounts for automobiles first leased in calendar year 1998 are calculated under the procedures described in §1.280F-7(a). Lessees of automobiles other than electric automobiles should use Table 3 in applying these procedures, while lessees of electric automobiles should use Table 4.**

**Table 3**
**Dollar Amounts for Automobiles (Other than Electric Automobiles) with a Lease Term Beginning in Calendar Year 1998**

| Fair Market Value of Automobile | | Tax Year During Lease | | | | |
|---|---|---|---|---|---|---|
| Over | Not Over | 1st | 2nd | 3rd | 4th | 5th and Later |
| $15,800 | 16,100 | $ 1 | $ 5 | $ 8 | $ 12 | $ 14 |
| 16,100 | 16,400 | 4 | 10 | 16 | 22 | 25 |
| 16,400 | 16,700 | 6 | 15 | 25 | 31 | 36 |
| 16,700 | 17,000 | 9 | 20 | 33 | 41 | 47 |

| Fair Market Value of Automobile | | Tax Year During Lease | | | | |
|---|---|---|---|---|---|---|
| Over | Not Over | 1st | 2nd | 3rd | 4th | 5th and Later |
| 17,000 | 17,500 | 12 | 28 | 43 | 53 | 62 |
| 17,500 | 18,000 | 16 | 37 | 56 | 70 | 80 |
| 18,000 | 18,500 | 20 | 46 | 70 | 85 | 99 |
| 18,500 | 19,000 | 24 | 55 | 83 | 101 | 117 |
| 19,000 | 19,500 | 28 | 64 | 96 | 117 | 136 |
| 19,500 | 20,000 | 32 | 73 | 110 | 133 | 154 |
| 20,000 | 20,500 | 36 | 82 | 123 | 149 | 173 |
| 20,500 | 21,000 | 40 | 91 | 136 | 165 | 191 |
| 21,000 | 21,500 | 45 | 99 | 150 | 181 | 209 |
| 21,500 | 22,000 | 49 | 108 | 163 | 197 | 228 |
| 22,000 | 23,000 | 55 | 122 | 183 | 221 | 255 |
| 23,000 | 24,000 | 63 | 140 | 210 | 252 | 292 |
| 24,000 | 25,000 | 71 | 158 | 236 | 285 | 329 |
| 25,000 | 26,000 | 79 | 176 | 263 | 316 | 366 |
| 26,000 | 27,000 | 88 | 193 | 290 | 348 | 403 |
| 27,000 | 28,000 | 96 | 211 | 317 | 380 | 439 |
| 28,000 | 29,000 | 104 | 229 | 343 | 412 | 477 |
| 29,000 | 30,000 | 112 | 247 | 370 | 444 | 513 |
| 30,000 | 31,000 | 120 | 265 | 396 | 476 | 550 |
| 31,000 | 32,000 | 128 | 283 | 423 | 508 | 587 |
| 32,000 | 33,000 | 137 | 301 | 449 | 540 | 624 |
| 33,000 | 34,000 | 145 | 319 | 476 | 571 | 661 |
| 34,000 | 35,000 | 153 | 337 | 502 | 604 | 697 |
| 35,000 | 36,000 | 161 | 355 | 529 | 635 | 735 |
| 36,000 | 37,000 | 169 | 373 | 556 | 667 | 771 |
| 37,000 | 38,000 | 178 | 391 | 582 | 699 | 808 |
| 38,000 | 39,000 | 186 | 409 | 608 | 731 | 845 |
| 39,000 | 40,000 | 194 | 427 | 635 | 763 | 882 |
| 40,000 | 41,000 | 202 | 445 | 662 | 794 | 919 |
| 41,000 | 42,000 | 210 | 463 | 688 | 827 | 955 |
| 42,000 | 43,000 | 218 | 481 | 715 | 859 | 992 |
| 43,000 | 44,000 | 227 | 498 | 742 | 891 | 1,028 |
| 44,000 | 45,000 | 235 | 516 | 769 | 922 | 1,066 |
| 45,000 | 46,000 | 243 | 534 | 795 | 955 | 1,102 |

| Fair Market Value of Automobile | | Tax Year During Lease | | | | |
|---|---|---|---|---|---|---|
| Over | Not Over | 1st | 2nd | 3rd | 4th | 5th and Later |
| 46,000 | 47,000 | 251 | 552 | 822 | 986 | 1,140 |
| 47,000 | 48,000 | 259 | 570 | 849 | 1,018 | 1,176 |
| 48,000 | 49,000 | 268 | 588 | 875 | 1,050 | 1,213 |
| 49,000 | 50,000 | 276 | 606 | 901 | 1,082 | 1,250 |
| 50,000 | 51,000 | 284 | 624 | 928 | 1,114 | 1,286 |

**Note:** For autos with a F. M. V. over $50,000, see the **Rev. Proc.**

**Table 4**
**Dollar Amounts for Electric Automobiles**
**with a Lease Term Beginning in Calendar Year 1998**

**Note:** Not included here. See the **Rev. Proc.**

Notice of Proposed Rulemaking
Election to Amortize Start-Up Expenditures
Reg-209373-81

☞ **The proposed regulations provide that an election to amortize start-up expenditures is made by attaching a statement to the taxpayer's income tax return. The income tax return and statement must be filed not later than the date prescribed by law for filing the income tax return (including any extensions of time) for the taxable year when the active trade or business begins.**

**Explanation of provisions.** The proposed regulations are intended to simplify the filing of §195 elections in two ways. **First,** the proposed regulations clarify that a taxpayer who is uncertain as to the year in which the active trade or business begins need not file an election for each possible taxable year. **Rather**, a §195 election for a particular trade or business will be effective if the trade or business becomes active in the year for which the election is filed or in any subsequent year. **Second,** the proposed regulations also allow taxpayers who have made timely elections under §195 to file a revised statement with a subsequent return to include any start-up expenditures not included in the original statement.

Definition of Structure—Demolition of Building
T.D. 8745

☞ **This document contains final regulations relating to deductions available upon demolition of a building. These final regulations reflect changes to the law made by the Tax Reform Act of 1984 and affect owners and lessees of real property who demolish buildings.**

**Action.** Final regulations.

**Dates.** The regulations are effective December 30, 1997.

Qualified Environmental Remediation Expenses
Rev. Proc. 98-47

> ☞ **This revenue procedure provides procedures for taxpayers to make the election under §198 of the Code ("§198 election") to deduct any qualified environmental remediation expenditure ("QER expenditure").**

**Section 2. Background.** Section 198(a), as added by the Taxpayer Relief Act of 1997, provides that a taxpayer may elect to treat any QER expenditure as an expense that is not chargeable to the capital account, but is deductible for the taxable year in which it is paid or incurred.

.02 §198(b)(1) generally defines a "qualified environmental remediation expenditure" as any expenditure that is otherwise chargeable to the capital account, and that is paid or incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. However, under §198(b)(2) a QER expenditure does not include any expenditure for property subject to an allowance for depreciation, except that the portion of the allowance for depreciation of such property that is otherwise allocated to a qualified contaminated site is treated as a QER expenditure.

.03 §198(c)(1)(A) defines a "qualified contaminated site" as any area:

- **i.** that is held by the taxpayer for use in a trade or business or for the production of income, or that is property described in §1221(1) in the hands of the taxpayer;
- **ii.** that is within a targeted area (as defined in §198(c)(2)); and
- **iii.** at or on which there has been a release (or threat of release) or disposal of any hazardous substance.

> Section 198(c)(1)(B) provides that an area is treated as a qualified contaminated site with respect to expenditures paid or incurred during any taxable year only if the taxpayer receives a statement from an appropriate agency of the state (as defined by §198(c)(1)(C)) in which the area is located, verifying that the area meets the requirements of §198(c)(1)(A)(ii) and (iii) (described above).



.04 §198(d)(1) generally defines "hazardous substance" as any substance that is a hazardous substance as defined in §101(14) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA), and any substance that is designated as a hazardous substance under §102 of CERCLA.

.05 §198 is effective for expenditures paid or incurred after August 5, 1997, and on or before December 31, 2000. See §198(h).

> Note: See the **Rev. Proc.** for further information.

LTR 9818006, January 6, 1998
Code §162

> ☞ **Current deduction allowed for costs of certain trees**

### Trade or business (Deductible versus not deductible)

> **Issue.** Whether Taxpayers may deduct the purchase price of trees pursuant to §1.162-12 of the Income Tax Regulations.

**Conclusion.** The costs of purchasing the trees in this case are deductible by Taxpayers in the taxable year of purchase.

**Facts.** Taxpayers are engaged in the nursery business of selling trees with a three-inch to eight-inch diameter trunk. Taxpayers began their nursery operation in Year One. Trees purchased by Taxpayers are bare root trees, as opposed to container grown trees or trees removed from the ground with a dirt ball attached to the root system. The cost of the trees ranged from $7 to $23. The trees purchased are generally one to two years old at the time of purchase.

Bare root trees are trees that are removed from the ground with no soil attached to the roots. They are refrigerated in a dormant state until their sale to a commercial grower or nursery and then shipped via refrigerated truck. The trees are then "trenched" in mulching medium and kept moist until such time as the trees can be planted into the ground for further growth and cultivation. **Taxpayers represent that this method of removal from the ground causes the trees to lose a portion of their root system and, as a result, the trees require special care prior to and just after planting.** The survival rate of such bare root trees after transplanting is considerably lower than that of trees that are transplanted with their roots undisturbed. For this reason, **Taxpayers represent that bare root trees are not ready for resale to the general public in retail nursery operations after purchase.** The advantage to Taxpayers of purchasing these types of bare root trees is that bulk quantities of the trees can be shipped more easily and in a less costly manner than transplanted trees, which results in a lower purchase cost to Taxpayers.

Many of the trees purchased by Taxpayers are known as "whips" in the nursery industry. A "whip" is essentially a stick with attached roots and no branches. All of the trees purchased by Taxpayers are grown by Taxpayers for a minimum of five years before their ultimate sale. At the time of ultimate sale, the trees are sold with the dirt ball attached in contrast to the bare root trees that are originally purchased. New bare root trees are purchased annually to replenish trees that were sold or that did not survive.

Many of the trees purchased by Taxpayers do not resume growing for more than a year and many trees do not survive. Taxpayers represent that their business is not to maintain an inventory of trees for immediate sale, but rather to grow the trees to a larger size and then sell them for an increased price more than five years after initial purchase.

For Year Two, Taxpayers reported gross receipts of $**c** and deducted the cost of trees purchased in the amount of $**d**. Taxpayers do not use the crop method of accounting and, pursuant to §263A(d)(3), have properly elected to have the cost capitalization rules of §263A not apply to any trees grown in their nursery business.

> Because Taxpayers in this case have elected under §263A(d)(3) not to be subject to the capitalization rules of that section, **and because** the trees at issue require significant development and cultivation on Taxpayers' part to ensure survival and future marketability, we believe the trees are within the purview of the treatment accorded "seeds and young plants" under §1.162-12. Accordingly, the cost of the trees **is deductible by Taxpayers** in the taxable year of purchase pursuant to §§162 and 1.162-12.

# CAPITAL GAINS

Capital Asset
I.R.C. §§1221 and 165

☞ **The Court determined that the taxpayer's asset was not a capital asset.**

**Facts.** Richard Pettit, the taxpayer, was an "on call" reserve pilot of American Airlines. He had a substantial amount of free time, so he obtained a Connecticut home improvement contractor's license and started a construction business in 1987. He specialized in remodelings, additions, and decks. He believed that there was higher income potential in constructing new homes than in remodeling existing ones.

**In March 1989, he bought an unimproved lot for the purpose of building his initial single-family home for resale. He built a two-story house, which was completed in late 1989. He then enlisted a real estate agent to promote its sale**.

In February 1990 he and his wife separated. The marital problems negatively affected his construction business. For a period of time immediately following the acrimonious separation, his wife took possession of his pickup truck containing all of his tools. Shortly thereafter, she placed a lien on the newly constructed "spec house," which discouraged potential buyers. To add to Mr. Pettit's problems, the local real estate market took a significant prolonged downturn. Under these unforeseen circumstances, Mr. Pettit was unable to secure a buyer for the property.

He was unable to make the construction loan payments and deeded the "spec house" and lot to the lender (a bank) in lieu of foreclosure in October 1990. **He claimed a $25,621 loss on his 1990 construction business Schedule C. The IRS examined his 1990 tax return and recharacterized the $25,621 business loss as a long-term capital loss.** In so doing, the IRS limited Mr. Pettit's 1990 loss deduction to $1,500, with a $24,121 long-term capital loss carryover to 1991.

**Issue.** Whether the claimed $25,621 loss is properly characterized as an ordinary loss or a capital loss.

**Discussion.** **Capital assets do not include property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business** [I.R.C. §1211(b)]. This exclusion from capital gain treatment applies to a taxpayer other than a corporation.



The question of whether property **is held primarily for sale to customers in the ordinary course of the taxpayer's trade or business** is dependent on the facts or circumstances of each case.

**Holding.** **We find that the taxpayer did not hold the disputed property as a capital asset.** The construction and subsequent disposition of the property **arose within the context of the taxpayer's existing construction business.** The IRS attempts to isolate the construction and attempted sale of the "spec house" from his previous remodeling construction activity. We disagree with that rationale. **The taxpayer did not purchase the vacant lot with the intent of holding it as an investment. Rather, his intent was to increase its value by personally constructing a house on it and selling it for a profit. His business was building and selling home improvements, which in this case involved an entire home.** The fact that the disposition included a plot of land does not convert the entire finished product into a capital asset. [*Richard A. Pettit v. Commissioner,* T.C. Memo 1997-438, 74 T.C.M. 731 (1997) [CCH Dec. 52,272(M)].]

Loss deductions—Trader or Investor
I.R.C. §1221

☞ **Taxpayer was an investor not a dealer or trader and his losses were capital losses.**

**Holding.** Because the taxpayer was neither a trader nor a dealer, under the Tax Code he was required to treat his stock holdings as capital assets. Consequently, he was not entitled to net operating loss deductions for the year 1988. The losses were capital losses and deductions were subject to the limitations imposed by the Code. Similarly, taxpayer was required to treat his investment-related expenses as personal, itemized deductions.

[*Hart v Commissioner;* U.S. Ct. of Appeals; 3rd Cir.; (affirming Tax Ct.) 98-1 USTC 83,219 [CCH ¶50,163].]

Capital Gains and Charitable Remainder Trusts
Notice 98-20

☞ **This notice provides guidance on the ordering and taxation of distributions under §664(b)(2) of the Internal Revenue Code from a charitable remainder trust (CRT). The Treasury Department and the Internal Revenue Service plan to issue regulations incorporating the guidance contained in this notice.**

Temporary Regulations to Be Issued Under Section 1(h) of the Internal Revenue Code (Applying Section 1(h) to Capital Gain Dividends of RICs and REITs).
Notice 97-64

☞ **This notice describes temporary regulations that will be issued under §1(h) of the Internal Revenue Code, effective for taxable years ending on or after May 7, 1997, and provides guidance that regulated investment companies ("RICs"), real estate investment trusts ("REITs"), and their shareholders must use in applying §1(h) until further guidance is issued.**

Capital Gains Rates
Notice 97-59

☞ **Capital loss netting explained. These rules will apply for 1997.**

See Chapter 15

## CAPITAL OR ORDINARY EXPENSE

Capital Expenditure Asbestos Removal
I.R.C. §263

☞ **The cost of asbestos removal was part of a general plan of rehabilitation and had to be capitalized.**

**Facts.** The taxpayer incurred substantial costs in removing asbestos from one of its buildings as part of a remodeling plan.

In addition to removing the asbestos-containing materials on account of the remodeling, taxpayer also considered the health and welfare of its employees and customers. Even though the level of airborne asbestos fiber concentrations in the Douglas Street building did not exceed OSHA or EPA standards for exposure, the presence of asbestos-containing materials in the return air plenum nonetheless increased the possibility for release of asbestos fibers into the air.

**Issue.** Does the cost of the asbestos removal have to be capitalized?

**Discussion.** Expenses incurred as part of a plan of rehabilitation or improvement must be capitalized even though the same expenses if incurred separately would be deductible as ordinary and necessary *United States v. Wehrli* [68-2 USTC ¶9575], 400 F.2d 686, 689 (10th Cir. 1968); *Stoeltzing v. Commissioner* [59-1 USTC ¶9444], 266 F.2d 374 (3d Cir. 1959), affg. [Dec. 23,033(M)] T.C. Memo. 1958-111; *Jones v. Commissioner* [57-1 USTC ¶9517], 242 F.2d 616 (5th Cir. 1957), affg. [Dec. 21,098] 24 T.C. 563 (1955); *Cowell v. Commissioner* [Dec. 5794], 18 B.T.A. 997 (1930)]. Unanticipated expenses that would be deductible as business expenses if incurred in isolation must be capitalized when incurred pursuant to a plan of rehabilitation [*California Casket Co. v. Commissioner* [Dec. 19,243], 19 T.C. 32 (1952)]. Whether a plan of capital improvement exists is a factual question "based upon a realistic appraisal of all the surrounding facts and circumstances, including, but not limited to, the purpose, nature, extent, and value of the work done" [*United States v. Wehrli*, *supra* at 689-690].

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

**Holding.** 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 v. Commissioner,* 108 T.C. #15 (April 28, 1997) [CCH Dec. 52,008].]

## CORPORATIONS, PARTNERSHIPS, AND LLCS

10

### S Stock Basis Increase For Discharge of Indebtedness Income

☞ **The court found that an S corporation discharge of indebtedness income did result in an increase in the shareholder stock.**

**Note.** The following T.C. Memo court case (*Winn v. Commissioner*) **is a reconsideration of a previous T.C. Memo decision.** See pages 484-85 in the 1997 *Farm Tax School Book* for the **previous decision.** [T.C. Memo 1997-286, 73 T.C.M. 3167 (1997) [CCH Dec. 52,112(M)].] The previous 1997 decision favored the taxpayers. The **reconsidered decision** which follows **reverses** the previous decision and **favors the IRS.**

**The issue is whether excludable discharge-of-indebtedness (DOI) income realized by an insolvent S corporation results in an increase in the S shareholder's stock basis.** The reversal by the Tax Court is due to a full Tax Court decision which was released in February 1998 and involved the same issue. [*Mel T. Nelson v. Commissioner,* 110 TC No. 12 [CCH Dec. 52,578].]

Following is the **reconsidered** T.C. Memo decision of *Winn v. Commissioner.*

**Facts.** Philip and Eleanor Winn, the taxpayers, were shareholders in P.D.W. & A, Inc., an S corporation. Effective January 1, 1992, the S corporation revoked its S status election. The S corporation was a partner in Parker Properties (Parker), a joint venture. In 1991, Parker realized approximately $4 million in discharge of indebtedness (DOI) income. **The S corporation's distributive share of Parker's**

**DOI income in 1991 was $2,021,296. At the time that Parker realized the DOI income, the S corporation was insolvent to the extent of $2,181,748.**

**Philip Winn increased his basis in his S corporation stock by $1,010,648, the amount of his pro rata share of the DOI income.** The Winns did not claim an S corporation loss on their joint 1991 tax return as they believed that the passive activity loss limitations prevented them for doing so. **Instead, the Winns claimed a carryover S corporation loss on their joint 1992 tax return. IRS disallowed the loss because Philip Winn lacked sufficient basis in his S corporation stock.**

**Issue.** Whether Philip Winn may increase his S corporation stock basis by $1,010,648 which would entitle the taxpayers to deduct an equal amount of S corporation loss on their joint 1992 tax return.

**Discussion.** DOI income may be excluded from income **to the extent of the taxpayer's insolvency at the time of the discharge of indebtedness.** [I.R.C. §§108(a)(1)(B) and 108(a)(3)]

**Special Rules for S Corporation** [I.R.C. §108(d)(7)(A)]. For S corporations, the exclusion of DOI results in the reduction of tax attributes **at the corporate level.**

**Holding.** We, the Tax Court, agree with the IRS's position that the clear meaning of the I.R.C. §108(d)(7)(A) language **requires that the exclusion of DOI income must be made at the corporate level. I.R.C. §108(D)(7)(A) explicitly prohibits the DOI income from flowing through to an S corporation shareholder. Consequently, an S corporation shareholder may not increase S corporation stock basis under I.R.C. §1367(a)(1)(A) by the amount of excluded DOI income.** To allow the shareholder to increase stock basis due to the excluded DOI income would produce a windfall to him.

[*Philip D. and Elanor G. Winn v. Commissioner*, T.C. Memo 1998-71, 75 T.C.M. 1840 (1988) [CCH Dec. 52,582(M)].]

Rental Income and Deductions

I.R.C. §280A

☞ **Taxpayer denied rental income exclusion and deductions for rent of his home to his employer.**

**Facts.** The taxpayer, Leslie Roy, was a minority shareholder and full-time employee of Roy Farms, Inc., an S corporation, in 1992 and 1993. He and his wife Betsy owned a 5-acre parcel of land that was contiguous to corporation-owned farmland. Leslie and Betsy's personal residence was located on the 5 acres.

In addition to his wages, Leslie received $1,000 a month from Roy Farms, Inc. In return for this $1,000 monthly payment, Leslie agreed to let the corporation store apple bins, apples, and farm equipment on his 5–acre home site. Also, other corporate employees were permitted to use their telephone, bathroom facilities, and certain other areas of their home as needed for convenience.

On their joint **1992 tax return**, the taxpayers (Leslie and Betsy) reported the $12,000 payment from Roy Farms, Inc. as rental income on Schedule E. They deducted $12,000 in business expenses and depreciation on the 1992 Schedule E, resulting in a zero rental profit or loss.

On their joint **1993 tax return,** the taxpayers reported the $12,000 payment from the corporation as rental income on Schedule E. But they **excluded** the $12,000 as **de minimis income** under I.R.C. §280A(g)(2), which pertains to dwelling units **actually rented for less than 15 days during the tax year.**

In the exam of the taxpayer's 1992 tax return, the IRS disallowed the $12,000 Schedule E rental expenses. The IRS's authority was I.R.C. §280A(c)(6), **which denies rental deductions to an employee who rents a residence (or any portion thereof) to his/her employer.**

In the exam of the taxpayer's 1993 tax return, the IRS disallowed the $12,000 **de minimis exclusion from income** under I.R.C. §280A(g)(2). IRS's position was that since the corporation rented the taxpayer's home for **more than 15 days** during 1993, the exclusion did not apply.

### Issues

1. Whether taxpayers are entitled to rental expense deductions for their personal residence on their 1992 Schedule E; and
2. Whether taxpayers are entitled to exclude the $12,000 rental payment received from Roy Farms, Inc. on their 1993 tax return.

### Discussion

Issue 1. I.R.C. §280A(c)(6) provides that no deduction shall be allowed for **"any item which is attributable to the rental of the dwelling unit (or any portion thereof) by the taxpayer to his employer during any period in which the taxpayer uses the dwelling unit (or portion) in performing services as an employee of the employer."**

Issue 2. I.R.C. §280A(g) provides that **"if a dwelling unit is used during the taxable year by the taxpayer as a residence and such dwelling unit is actually rented for less than 15 days during the year,** then

1. **no deduction** otherwise allowable because of the rental use of such dwelling unit **shall be allowed,** and
2. the **income** derived from such use for the taxable year **shall not be included in the gross income** of such taxpayer under I.R.C. §61.

The taxpayers argued that the $12,000 received from Roy Farms, Inc. in **both** 1992 and 1993 should be excluded under I.R.C. §280A(g)(2) because their home was **not "actually rented"** to the corporation. It was not actually rented, according to the taxpayers, because the rent of $1,000 per month was **not the fair rental value of the dwelling unit.**

### Holding

Issue 1. The meaning of the statutory language is clear. Leslie Roy was employed by Roy Farms, Inc. during 1992 and 1993. He received $1,000 per month from the corporation in exchange for corporate business use of his residence and adjoining property. The taxpayers have offered no evidence which leads us to conclude that I.R.C. §280A(c)(6) should be ignored. **Therefore, the $12,000 of rental deductions on the property for 1992 are not allowable.**

Issue 2. I.R.C. §280A(g) contains **no requirement that the dwelling unit be rented at fair rental value for it to be "actually rented."** Therefore, we do not find the lack of fair rental value an issue that favors the taxpayers' position. However, in examining the language of I.R.C. §280A(g), we find that there is **another requirement which precludes the taxpayers from benefiting from the exclusion.**

I.R.C. §280A(g) requires that the taxpayer's "dwelling unit" be actually rented for **less than 15 days** out of the taxable year. A dwelling unit as defined by I.R.C. 280A(f)(1)(A) includes a "house. . . . and all other structures **or other property appurtenant** to such dwelling unit." The taxpayers received $1,000 a month from the corporation for corporate business use of portions of their personal residence and the 5 acre home site. The $1,000 monthly payments represent income from the rental of their dwelling unit **for the entire year (as opposed to less than 15 days), which deprives them of the exclusion.**

[*Leslie A. and Betsy M. Roy v. Commissioner*, T.C. Memo 1998-125, 75 T.C.M. 2081 (1998) [CCH Dec. 52,643(M)].]

10

Corporations
§1244 Loss Deduction

☞ **Stockholder was denied a §1244 loss deduction.**

**Facts.** Christopher Boyko, the taxpayer, was an attorney. He became interested in a computer software project in the development stage. The software developer was Raymond Kelley. In 1988, Mr. Boyko advanced over $70,000 to Mr. Kelly Mr. Kelley executed 25 notes in favor of the taxpayer. The notes called for 10 percent interest, but no principal or interest was paid on the notes.

In January 1989, Mr. Kelley formed a corporation, TIC, Inc. (TIC), to continue his software development efforts. The taxpayer was given 50 of the 764 outstanding shares of TIC in exchange for legal services he performed for the new corporation. In February 1991, TIC was replaced by a second corporation, Multilogic Corp. (Multilogic). Taxpayer's TIC shares were replaced by an equal percentage of Multilogic shares. In addition, Multilogic executed a demand note in favor of taxpayer in the amount of $74,749 for his investment in Multilogic stock.

Multilogic never made any principal or interest payments to Mr. Boyko. In November 1992, he obtained a judgment against Multilogic for enforcement of the demand note. **On his 1991 tax return, Mr. Boyko claimed a section 1244 stock loss in the amount of $74,749 for his investment in Multilogic stock.**

IRS disallowed the section 1244 ordinary loss. **IRS took the position that the stock loss was a capital loss and, therefore, subject to the capital loss limitation rules of I.R.C. §1211.**

**Issue.** Whether taxpayer is entitled to an ordinary or a capital loss deduction for funds expended in the business venture.

**Discussion.** I.R.C. §1244 provides that any loss resulting from the sale of §1244 stock shall be treated as an ordinary loss [I.R.C. §1244(a)]. To qualify as §1244 stock, the stock must be common stock issued by a domestic "small business corporation," as defined by I.R.C. §1244(c)(3). **Furthermore, the consideration paid by the shareholder must be money or other property** [I.R.C. §1244(c)(1)].

I.R.C. §1244(d)(1)(B) provides that **the increase in basis resulting from a contribution to capital "shall be treated as allocable to stock which is not section 1244 stock."** This statutory rule applies to any increase in basis, however effected.

**Holding. Taxpayer agrees that he did not contribute money or other property to TIC in exchange for his 50 shares in that original corporation.** Therefore, taxpayer is not entitled to section 1244 treatment for his original basis in the TIC stock. Taxpayer did advance Mr. Kelly over $70,000 prior to the formation of TIC, the predecessor of Multilogic.

Taxpayer contends his **advances to Mr. Kelly** prior to the incorporation of TIC should be considered capital contributions which would increase his basis in his TIC/Multilogic shares. Taxpayer's $74,749 section 1244 loss apparently included the advances. **IRS did not dispute the amount of the section 1244 stock loss, only that it should be treated as a capital loss as opposed to an ordinary section 1244 loss.** Therefore, IRS apparently agrees with taxpayer that his stock basis was properly increased by the advances he made to Mr. Kelly.

We agree with IRS that the $74,749 stock loss is a capital loss rather than a section 1244 ordinary loss. **Taxpayer did not contribute money or other property to acquire his 50 shares in TIC. Rather he contributed services in exchange for the 50 shares. In addition, the contribution to capital in the form of advances made by taxpayer to Mr. Kelly prior to the incorporation of TIC does not qualify for Section 1244 ordinary loss treatment.** I.R.C. §1244(d)(1)(B) governs the latter issue. [*Christopher A. and Roberta A. Boyko v. Commissioners,* T.C. Memo 1998-67, 75 T.C.M. 1830 (1998) [CCH Dec. 52,577(M)].]

**Note:** Another issue in this case was Mr. Boyko's personal payment of corporate lease expenses on behalf of TIC. Since Mr. Boyko was a shareholder in TIC, **the expenses he paid were corporate expenses and not deductible by Mr. Boyko** on his tax return as his trade or business expenses. A shareholder of a corporation is **not engaged in the trade or business in which the corporation is engaged.** Investing in a corporation by owning its stock does not constitute the carrying on of a trade or business by the shareholder.

It is well established that a shareholder is not entitled to a deduction for his payment of the expenses of his corporation. **Such amounts constitute either a loan or a contribution to the capital of the corporation and are deductible, if at all, by the corporation.** For more information on this issue, see pages 104 and 482 in the 1997 *Farm Income Tax Book*.

Partnership Magnetic Media
Filing Requirements
Notice 97-77

☞ **This notice provides guidance to partnerships having more than 100 partners regarding the requirement to file partnership tax returns on magnetic media under §6011(e) of the Internal Revenue Code, as amended by the Taxpayer Relief Act of 1997.**

Notice of Proposed Rulemaking
S Corporation Subsidiaries
Reg. 251698-96

☞ **SUMMARY: This document contains proposed regulations relating to the treatment of corporate subsidiaries of S corporations. The proposed regulations interpret the rules added to the Internal Revenue Code by section 1308 of the Small Business Job Protection Act of 1996. The proposed regulations affect S corporations and their subsidiaries.**

### Explanation of Provisions

**Overview.** Prior law prohibited an S corporation from owning 80 percent or more of the stock of another corporation. The Act repealed section 1362(b)(2)(A), thereby allowing an S corporation to own 80 percent or more of the stock of a C corporation. The Act also added section 1504(b)(8) to the Code to prevent an S corporation from joining in the filing of a consolidated return with its affiliated C corporations. A C corporation subsidiary of an S corporation, however, may file a consolidated return with its affiliated corporations.

**New section 1361(b)(3)(B) defines the term qualified subchapter S subsidiary as any domestic corporation that is not an ineligible corporation if,** (1) an S corporation holds 100 percent of the stock of the corporation, and (2) that S corporation elects to treat the subsidiary as a QSSS. **Except as otherwise provided in regulations, a corporation for which a QSSS election is made 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 legislative history accompanying section 1361(b)(3) indicates that, when the parent corporation makes the election, the subsidiary is deemed to have liquidated under sections 332 and 337 immediately before the election is effective.** [See S. Rep. No. 281, 104th Cong., 2d Sess. 53 (1996); H.R. Rep. No. 586, 104th Cong., 2d Sess. 89 (1996).] **However, the legislative history accompanying the technical correction made by the 1997 Act indicates that regulations may provide exceptions to that general rule.** [See S. Rep. No. 33, 105th Cong., 1st Sess. 320 (1997).]

Under current and prior law, the S election of a corporation with subchapter C corporation earnings and profits terminated if that S corporation received passive investment income, including dividends, in excess of 25 percent of gross receipts for three consecutive years. Section 1362(d)(3)(E) 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 percent or greater ownership interest.** Neither the Act nor the legislative history provides rules for determining the attribution of dividends to an active trade or business.

**QSSS Formation.** Under the proposed regulations, an S corporation makes a QSSS election with respect to an eligible subsidiary by filing a form to be developed by the IRS prior to the time these regulations become final. **This proposes to change the temporary election procedure provided in Notice 97-4, which provides that a parent S corporation files a completed Form 966, Corporation Dissolution and Liquidation (with some modifications),** to make a QSSS election.

Until these proposed regulations are finalized, taxpayers should **continue** to use the temporary election procedure in Notice 97-4 to make QSSS elections.

The proposed regulations also provide that the effective date of a QSSS election may be up to 2 months and 15 days prior to the day the QSSS election is made.

Adjustments Following Sales of Partnership Interests
Reg-209682-94

☞ **Partnerships—Partial Withdrawal of, and Amendment to, Notice of Proposed Rulemaking.**

**SUMMARY.** This document withdraws a portion of the notice of proposed rulemaking published in the **Federal Register,** February 16, 1984 (49 F.R. 5940); contains proposed regulations relating to the optional adjustments to the basis of partnership property following certain transfers of partnership interests under §743, the calculation of gain or loss under §751(a) following the sale or exchange of a partnership interest, the allocation of basis adjustments among partnership assets under §755, and the allocation of a partner's basis in its partnership interest to properties distributed to the partner by the partnership under §732(c); and, finally, amends proposed regulations relating to the computation of a partner's proportionate share of the adjusted basis of depreciable property (or depreciable real property) under §1017. The changes are necessary to provide clearer guidance on the proper application of these sections and will affect partnerships and partners where there are transfers of partnership interests, distributions of property, or elections under sections 108(b)(5) or (c). **In addition, the proposed regulations under §732(c) reflect changes to the law made by the Taxpayer Relief Act of 1997.**

**Tax Practitioner Note:** These changes are important, complex, and lengthy. They are not reproduced here.

Conversion of QSST to ESBT
Rev. Proc. 98–23

☞ **This revenue procedure provides guidance on (1) the conversion of a qualified subchapter S trust (QSST) to an electing small business trust (ESBT), and (2) the conversion of an ESBT to a QSST.**

Qualified Small Business Stock
Action: Final Regulations

☞ **This document contains final regulations relating to the 50-percent exclusion for gain from certain small business stock. The final regulations reflect changes to the law made by the Omnibus Budget Reconciliation Act of 1993 and provide guidance to the issuers and owners of the stock of certain small businesses.**

**Dates.** This regulation is effective December 31, 1997. [For dates of applicability of these regulations, see §1.1202-2(e).]

Publicly Traded Partnerships
Notice **98–3**

☞ **This notice provides the method for grandfathered publicly traded partnerships to elect to remain exempt from §7704 of the Internal Revenue Code pursuant to §7704(g). This notice also provides the procedures for revoking the election. In addition, this notice informs grandfathered publicly traded partnerships that do not elect the application of §7704(g) that the rules contained in proposed regulation §l.743-2 regarding special §743(b) basis accounts may be followed for purposes of a conversion from a partnership to a corporation. The references in this notice to §7704(g) reflect the amendments made by the Taxpayer Relief Act of 1997.**

Notice of Proposed Rulemaking and Notice of Public Hearing; Treatment of Changes in Elective Entity Classification
Reg-105162-97

☞ **This document contains proposed regulations addressing elective changes in entity classification. The proposed regulations describe how elective changes in classification will be treated for federal tax purposes. The proposed regulations would affect business entities and their members.**



## Supplementary Information

**Background.** This document proposes to amend the current Income Tax Regulations (26 CFR Parts 1 and 301) relating to the classification of entities for federal tax purposes. On December 18, 1996, the IRS and Treasury published final regulations under §7701 (final regulations), replacing the former classification rules with an elective regime. See T.D. 8797 (1997-2 I.R.B. 11).

Under the final regulations a business entity that is not specifically classified as a corporation in the final regulations (an eligible entity) can elect its classification for federal tax purposes under certain circumstances. An eligible entity with at least two members can elect to be classified as a partnership or as an association taxable as a corporation. An eligible entity with a single member can elect to be classified as an association or as an entity that is disregarded as an entity separate from its owner. An eligible entity may also elect to change its classification, except that an election may not be made more than once in any 60-month period. An eligible entity that does not make an election is classified under certain default provisions.

## Explanation of Provisions

Characterization of Elective Changes in Classification. The proposed regulations describe how elective changes in an entity's classification will be treated for federal tax purposes. **Under the final regulations, there are four possible changes in classification by election:** (i) a partnership elects to be an association; (ii) an association elects to be a partnership; (iii) an association elects to be a disregarded entity; and (iv) a disregarded entity elects to be an association. There are two other possible ways in which an entity's classification could change (a partnership converts to a disregarded entity or a disregarded entity converts to a partnership) but these changes occur only as result of a change in the number of members, not as the result of an elective change. The proposed regulations **do not address** the form of these two possible types of changes.

**The proposed regulations provide a specific characterization for each of the four possible elective changes.** In each case, the characterization provided in the proposed regulations attempts to minimize the tax consequences of the change in classification and achieve administrative simplicity. The proposed regulations provide that if an association elects to be classified as a partnership, the association is deemed to liquidate by distributing its assets and liabilities to its shareholders. Then, the shareholders are deemed to contribute all of the distributed assets and liabilities to the partnership. This characterization of an elective change from an association to a partnership is consistent with **Rev. Rul.** 63-107 (1963-1 C.B. 71).

If a partnership elects to be classified as an association, the partnership is deemed to contribute all of its assets and liabilities to the association in exchange for stock in the association. Then, the partnership is deemed to liquidate by distributing stock in the association to its partners. The proposed regulations do not affect the holdings in **Rev. Rul.** 84-111 (1984-2 C.B. 88), in which the IRS ruled that it would respect the particular form undertaken by the taxpayers when a partnership converts to a corporation.

If an association elects to be disregarded as an entity separate from its owner, the association is deemed to liquidate by distributing its assets and liabilities to its sole owner. Conversely, if an eligible entity that is disregarded as an entity separate from its owner elects to be classified as an association, the owner of the eligible entity is deemed to contribute all of the assets and liabilities of that entity to the association in exchange for stock of the association.

The proposed regulations also provide that the tax treatment of an elective change in classification is determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction doctrine. This provision in the proposed regulations is intended to ensure that the tax consequences of an elective change will be identical to the consequences that would have occurred if the taxpayer had actually taken the steps described in the proposed regulations.

Change in Number of Members of Entity. The proposed regulations address the effect of a change in the number of members on the classification of an entity. Under the proposed regulations, if there is a change in the number of members of an association, the classification of the entity is not affected. If an eligible entity classified as a partnership subsequently has only one member (and is still treated as an entity under local law), the entity will be disregarded as an entity separate from its owner. If a single-member entity that is disregarded as an entity separate from its owner subsequently has more than one member, the entity is classified as a partnership as of the date the entity has more than one member. The classifications provided in the proposed regulations can be changed by election, assuming that the entity is not subject to the 60-month limitation on elections.

Timing of Elective Changes in Classification. The proposed regulations provide that an election to change the classification of an entity is treated as occurring at the start of the day for which the election is effective. Any transactions that are deemed to occur as a result of the change in classification are treated as occurring immediately before the close of the day before the effective date of the election. For example, if an election is made to convert from an association to a partnership effective on January 1, the entity is treated as a partnership on January 1, and the deemed transactions specified in the proposed regulations are treated as occurring immediately before the close of December 31. As a result, the last day of the association's taxable year will be December 31 and the first day of the partnership's taxable year will be January 1.

Treatment of Foreign Eligible Entities. Any eligible entity, including a foreign eligible entity whose classification is not relevant for federal tax purposes, may elect to change its classification.

Special Basis Adjustments Under Section 743. Section 743 provides that the basis of partnership property is not adjusted as the result of a transfer of an interest in the partnership by sale or exchange unless the partnership has made an election under §754. If a §754 election is made, the transferee partner is treated as having a special basis adjustment with respect to partnership property. This adjustment constitutes an adjustment to the basis of partnership property with respect to the transferee partner only. Some uncertainty has remained as to the treatment of this special basis adjustment upon the contribution of the partnership property to a corporation in a §351 exchange, and because the proposed regulations provide for a deemed contribution by the partnership to a corporation in an elective conversion to an association, the proposed regulations address this uncertainty.

The proposed regulations provide that a corporate transferee's basis in property transferred by a partnership in a transfer described in §351 includes any special basis adjustment under §743. The special basis adjustment is also taken into account in determining the partner's basis in the stock received in the exchange. For example, assume a partnership owns Property X, which has a common basis of $100 for the partnership and in which Partner A has a $5 special basis adjustment under §743(b). Subsequently, the partnership validly elects to be classified as an association. The partnership is deemed to contribute all of its assets and liabilities to the association in exchange for stock in the association, and immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners. If the transfer of the assets to the association would be a transfer described in §351, then under the proposed regulations, the association's basis in Property X includes Partner A's $5 special basis adjustment. Thus, the association has a $105 basis in Property X (Partner A's $5 special basis adjustment plus the partnership's $100 common basis). Partner A's basis in the association's stock will reflect the $5 special basis adjustment previously on Property X.

The proposed regulations also provide, however, that the amount of gain, if any, recognized by the partnership on the transfer is determined without reference to any special basis adjustment. The partner with the special basis adjustment can then use the special basis adjustment to reduce its share of any gain recognized by the partnership. This approach of determining gain at the partnership level and allowing the partner to use the special basis adjustment as an offset is similar to the treatment of a sale of property with a special basis adjustment.

**Proposed Effective Date.** Except as otherwise specified, these regulations are proposed to apply as of the date the final regulations are published in the Federal Register.



S Corporations
Rev. Proc. 97-48

☞ **Late S corporation election relief explained.**

**Section 3. Scope.** This revenue procedure provides special procedures to obtain relief for certain late S corporation elections. The revenue procedure applies only to the following two situations:

1. A corporation **intends** to be an S corporation, the corporation and its shareholders reported their income consistent with S corporation status for the taxable year the S corporation election should have been made and for every subsequent year, and the corporation did not receive notification from the Service regarding any problem with the S corporation status within 6 months of the date on which the Form 1120S for the year was timely filed; and
2. For periods prior to January 1, 1997, a corporation **intends** to be an S corporation; however, due to a late S corporation election the corporation was not permitted to be an S corporation for the first taxable year specified in the election (because late S corporation election relief was not available during this period), the corporation and the shareholders treated the corporation as an S corporation for all succeeding years, and all relevant taxable years for both the corporation and all of its shareholders are open.

This revenue procedure does not provide relief for late shareholder elections including a qualified subchapter S trust (QSST) election or electing small business trust (ESBT) election.

The procedures in this revenue procedure **are in lieu of** the letter ruling procedure that is used to obtain relief for a late S corporation election under §1362(b)(5). **Accordingly, user fees do not apply to corrective action under this revenue procedure.**

A corporation that is not eligible for relief under this revenue procedure may request relief by applying for a private letter ruling. The Service will not ordinarily issue a private letter ruling under §1362(b)(5) if the period of limitations on assessment under §6501(a) has lapsed for any taxable year in which an election should have been made or any taxable year that would have been affected by the election had it been timely made. The procedural requirements for requesting a private letter ruling are described in **Rev. Proc.** 97-1, 1997-1, I.R.B. 11 (or its successor). See, also, **Rev. Proc.** 97-40, 1997-33 I.R.B. 50, for the special procedure to request relief for late S corporation elections that are filed within 6 months of the original due date of the election.

**Section 4. Automatic Relief for Late S Corporation Elections Under This Revenue Procedure.**

**.01.** *Situation 1: Automatic Relief Where Return Filed as an S Corporation.*

**(1)** E*ligibility for Automatic Relief.* Automatic relief is available in situation 1 if all of the following conditions are met:

**(a)**The corporation fails to qualify as an S corporation solely because the Form 2553 (Election by a Small Business Corporation) was filed timely;

**(b)**The corporation and all of its shareholders reported their income consistent with S corporation status for the year the S corporation election should have been made, and for every subsequent taxable year (if any);

**(c)**At least 6 months have elapsed since the date on which the corporation filed its tax return for the first year the corporation intended to be an S corporation; and

**(d)**Neither the corporation nor any of its shareholders was notified by the Internal Revenue Service of any problem regarding the S corporation status within 6 months of the date on which the Form 1120S for the first year was timely filed.

**(2)***Procedural Requirements for Automatic Relief.* The corporation must file with the applicable service center (or district director if under examination) a completed Form 2553, signed by an officer of the corporation authorized to sign and all persons who were shareholders at any time during the period that the corporation intended to be an S corporation. The Form 2553 must state at the top of the document "FILED PURSUANT TO REV. PROC. 97-48." Attached to the Form 2553 must be a dated declaration signed by an officer of the corporation authorized to sign and all persons who were shareholders at any time during the period that the corporation intended to be an S corporation, attesting (but, in the case of a shareholder, only with respect to that shareholder) that:

**(a)**the corporation and the shareholder reported their income (on all affected returns) consistent with S corporation status for the year the S corporation election should have been made, and for every subsequent taxable year; and

**(b)**"Under penalties of perjury, to the best of my knowledge and belief, the facts presented in support of this election are true, correct, and complete."

**.02** *Situation 2: Automatic Relief Where First Intended S Corporation Year Filed as a C Corporation.*

**(1)** *Eligibility for Automatic Relief.* Automatic relief is available in situation 2 if all of the following conditions are met:

**(a)** The corporation fails to qualify as an S corporation solely because the Form 2553 (Election by a Small Business Corporation) was not filed timely for a taxable year that began prior to January 1, 1997;

**(b)** The corporation received notification from the Service that the Form 2553 was not filed timely, that the corporation must file as a C corporation for the first taxable year the corporation intended to be an S corporation, and that the election would be treated as an S corporation for the following taxable year;

**(c)** The corporation and all of its shareholders reported their income (if any) properly treating the corporation as a C corporation for the first taxable year the corporation intended to be an S corporation;

**(d)** The corporation and all of its shareholders reported their income consistent with S corporation status for all subsequent years;

**(e)** The period of limitations on assessment under §6501(a) has not lapsed for any of the taxable years of the corporation beginning on or after the date the corporation intended to be taxable as an S corporation; and

**(f)** The period of limitations on assessment under §6501(a) has not lapsed for any taxable year of any of the corporation's shareholders in which any taxable year described in paragraph (e) above ends.

**(2)** *Procedural Requirements for Automatic Relief.* The corporation must file with the applicable service center (or district director if under examination) a completed Form 2553, signed by an officer of the corporation authorized to sign and all persons who were shareholders at any time during the period that the corporation intended to be an S corporation. The Form 2553 must state at the top of the document "FILED PURSUANT TO REV. PROC. 97-48." Attached to the Form 2553 must be a dated declaration signed by an officer of the corporation authorized to sign and all persons who were shareholders at any time during the period that the corporation intended to be an S corporation, attesting (but, in the case of a shareholder, only with respect to that shareholder) that:

**(a)** the corporation and the shareholder reported their income (on all affected returns) consistent with the requirements for automatic relief under §4.02 of this revenue procedure;

**(b)** the corporation and the shareholder agree to amend their tax returns for the first year and any other affected returns to reflect S corporation status; and

**(c)** "Under penalties of perjury, to the best of my knowledge and belief, the facts presented in support of this election are true, correct, and complete."

**.03** *Relief for Late S Corporation Elections.* A corporation that satisfies the requirements of either §4.01 or 4.02 of this revenue procedure will be deemed to have reasonable cause for the failure to file a timely S corporation election and will automatically be granted relief to file the election for S corporation status to commence on the date that it intended to have the S corporation election become effective. The Service will notify the corporation of the acceptance of its untimely filed S corporation election under this revenue procedure, or the denial of a request that fails to satisfy the requirements of this revenue procedure.

**.04** *Deemed Shareholders.* Any reference in this revenue procedure to a shareholder of an S corporation shall be treated as including a reference to those persons whose consent is required under §1.1362-6(b) of the Income Tax Regulations.

**Section 5. Examples**

**.01** *S corporation return filed and no notification from the Service.* *A*, *B*, and *C* formed *X* corporation on January 1, 1996. *X* intended to file an S corporation election; however, *X* did not file a timely Form 2553 (Election by a Small Business Corporation). On March 13, 1997, *X* files a Form 1120S (S corporation income tax return) for the 1996 taxable year, and *A*, *B*, and *C* file their individual tax returns as if *X* were an S corporation. In November 1997, *X* realizes that an S corporation election was not timely filed. Neither *X* nor its shareholders received any notification from the Service of any problem regarding the S corporation status of *X*. In this case, the shareholders and *X* meet the requirements of §4.01 of this revenue procedure. Consequently, *X* will be granted automatic late S corporation election relief if *A*, *B*, *C*, and *X* file a request for relief in accordance with the procedures described in this revenue procedure.

**.02** *C corporation return for first year. A* formed *X* corporation on January 1, 1990. *X* intended to file an S corporation election effective as of January 1, 1995; however, *X* did not file a Form 2553 (Election by a Small Business Corporation) until May 5, 1995. On June 15, 1995, *X* received a letter from the Service notifying *X* that its S corporation election was denied for the 1995 taxable year because the S corporation election was not timely filed, and that the election would be treated as effective for the 1996 taxable year. *X* filed a Form 1120 (C corporation income tax return) for the 1995 taxable year and *A* filed the individual tax return as if *X* were a C corporation. The period of limitations on assessment under §6501(a) has not lapsed for either the 1995 or the 1996 taxable years for either *X* or for *A*. In this case, *A* and *X* meet the requirements of §4.02 of this revenue procedure. Consequently, *X* will be granted automatic late S corporation election relief if *X* and *A* file a request for relief in accordance with the procedures described in this revenue procedure.

**Section 7. Effective Date.** This revenue procedure is effective for all applications for relief satisfying the requirements of §4 of this revenue procedure, including those applications now being considered by the Service.

LTR 9826016, March 25, 1998

Code §1374

☞ **Corporation did not have to recognize built-in gain.**

**Tax imposed on certain built-in gains (for corporations electing S status after 12/31/86).**

Taxpayer is a domestic corporation engaged in the business of growing timber, cutting the timber, and selling the logs produced therefrom to third parties. The average growth cycle for the various species of trees grown and harvested by Taxpayer is between 50 and 60 years.

Taxpayer elected S corporation status effective January 1, 1993, and will make an election under §631(a) of the Internal Revenue Code for the 1998 tax year. **Taxpayer requests rulings that its income from cutting timber or selling logs during the recognition period is not subject to tax under §1374.**

Section 1374 imposes a corporate-level tax on an S corporation's net recognized built-in gain during the ten-year recognition period following (a) a C corporation's conversion to S corporation status (§1374(a)), or (b) an S corporation's acquisition of C corporation assets in a carryover basis transaction (§1374(d)(8)).

- Section 1374(d)(2) provides that an S corporation's net recognized built-in gain for any tax year is generally its taxable income for the year computed as if it were a C corporation, but taking into account only items treated as recognized built-in gain or recognized built-in loss.

- Section 1.1374-4(a) provides that §1374(d)(3) applies to any gain or loss recognized during the recognition period in a transaction that is treated as a sale or exchange for federal income tax purposes.
- Section 1374(d)(3) provides that recognized built-in gain includes any gain recognized on the disposition of an asset during the recognition period, except to the extent the S corporation shows that (a) it did not hold the asset on the conversion date, or (b) the gain recognized was greater than the excess of the asset's fair market value over its adjusted basis on the conversion date.
- Section 1374(d)(6) provides that if the adjusted basis of any asset is determined (in whole or in part) by reference to the adjusted basis of any other asset held by the S corporation on the conversion date, the asset is treated as held by the S corporation on the conversion date, and any determination under §1374(d)(3) with respect to that asset is made by reference to the fair market value and adjusted basis of the other asset on the conversion date.

In **Example 1** of §1.1374-4(a)(3), X is a C corporation that converts to an S corporation effective January 1, 1996. On the conversion date, X owns a working interest in an oil and gas property on which production of oil has not yet begun, and the fair market value of the working interest exceeds X's adjusted basis in the working interest by $200,000. During the recognition period, X produces and sells oil from the working interest, and includes $75,000 in income on the sale. X's $75,000 of income is not recognized built-in gain because on the conversion date X did not hold the oil it sold for $75,000, it held only a working interest in an oil and gas property

- In Example 2 of §1.1374-4(a)(3), Y is a C corporation that elects to become an S corporation effective January 1, 1996. On the conversion date, Y owns a royalty interest in an oil and gas property, and the fair market value of the royalty interest exceeds Y's adjusted basis in the royalty interest by $100,000. During the recognition period, Y sells the royalty interest and recognizes a gain of $75,000 on the sale. Y's $75,000 gain is recognized built-in gain because Y held the royalty interest on the conversion date.
- Section 631(a) provides an election under which the cutting of timber by a taxpayer who owns or has a contract right to cut the timber is treated as a sale or exchange of the timber in the tax year the timber is cut, provided the timber or the contract right to cut the timber is held for more than one year, and irrespective of whether the timber or the products produced therefrom are sold in the tax year the timber is cut. If a §631(a) election is made, gain or loss is recognized in an amount equal to the difference between the fair market value of the timber and the adjusted basis for depletion of the timber in the hands of the taxpayer.
- Section 1.611-3(b)(1) provides that the depletion of timber generally takes place at the time timber is cut. To the extent that depletion is allowable in a particular year but the products of the cut timber are not sold during the year, the depletion allowable is included as an item of cost in the closing inventory of the timber products for the year.

Based solely on the information submitted, we rule as follows:

1. Taxpayer's gain under §631(a) on cutting timber during the recognition period is not subject to tax under §1374.
2. Taxpayer's income from the sale of logs during the recognition period from timber taxpayer cuts on its timberlands during the recognition period is not subject to tax under §1374.

LTR 9739002, May 19, 1997
National Office Technical Advice Memorandum
Code §§752

☞ **Taxpayer could increase basis in partnership interest.**

## Treatment of certain liabilities

### Decrease in partner's liabilities

**Issue.** Whether Taxpayer properly increased his basis in his partnership interest under §705(a)(1)(A) for discharge of indebtedness income that was **excluded** from Taxpayer's gross income under the insolvency exclusion under §108(a)(1)(B)?

**Facts.** The Taxpayer owned a 50 percent interest in a partnership, Partnership, which was involved in the development of real property. Partnership had an outstanding debt owed to A in the principal amount of a. **The liability was secured by real property located at b.**

In c, Partnership defaulted on the liability. Consequently, the Resolution Trust Corporation ("RTC"), as receiver for A, foreclosed on the real property securing the liability. This foreclosure resulted **in a loss in the amount of d for each of Partnership's partners, including Taxpayer.** Taxpayer was able to claim the loss on his individual return due to adequate basis in his Partnership interest.

In e, Partnership, Taxpayer, and the RTC entered into a settlement agreement on the remaining liability. Under the settlement agreement, Partnership's liability was discharged, resulting in discharge of indebtedness income ("COD income") to Partnership. This COD income was allocated to each of the partners of Partnership, including Taxpayer. Taxpayer increased his basis in Partnership interest by this amount pursuant to §705(a)(1)(A). However, Taxpayer excluded the COD income from gross income on his individual return pursuant to the insolvency exclusion under §108(a)(1)(B).

**Conclusion.** The Taxpayer properly increased his basis in his partnership interest under §705(a)(1)(A) for COD income that was excluded from Taxpayer's gross income under the insolvency exclusion under §108(a)(1)(B).

LTR 9827034, June 13, 1998
I.R.C. §368
Tax Notes July 13, 1998

☞ **Division of Farming Business is Tax Free.**

The Service has ruled that a farming corporation may divide its assets between its quarreling farmer shareholders in a tax-free reorganization under §§355(a)(1) and 368(a)(1)(D).

The stock of Distributing, a wheat and livestock farm, is owned by two couples. One couple wants to expand the business and the other does not. Distributing will transfer half the farming assets to a controlled corporation and distribute it to one couple in exchange for their Distributing stock.

## CREDITS

Filing Requirements for Returns Claiming the Foreign Tax Credit
T.D. 8759 26 CFR Part 1

**Action.** Final Regulation.

**Explanation of Provisions**

§1.905-2(a)(2). Under former §1.905-2(a)(2), taxpayers generally were required to attach to their income tax returns either (1) the receipt for the foreign tax payment or (2) a foreign tax return for accrued foreign taxes. §1.905-2(a)(2) **removes the requirement that the documentation be attached to the income tax return**. The regulation now provides that such evidence of payment of foreign taxes must be presented to the district director **only upon request.**

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

☞ **The Taxpayer Relief Act of 1997 (the Act) was enacted on August 5, 1997. The Act extended and amended the Work Opportunity Tax Credit (WOTC) under §51 of the Internal Revenue Code and created the Welfare-to-Work tax credit under new §51A of the Code.**

**See Chapter 15**

## DEDUCTIONS AND BAD DEBTS

Business Bad Debt Deduction
I.R.C. §166

☞ **Taxpayers were denied a business bad debt deduction.**



**Facts.** Kent and Carol Jensen, the taxpayers, former K&C Industries, a closely held marketing corporation, in July 1984. The Jensens contributed $5,882 in cash in exchange for 10,000 shares of K&C common stock. The corporation was unable to obtain outside financing and was faced with immediate cash flow problems.

In order to ensure adequate operating capital, the Jensens and Kent Jensen's father contributed funds to K&C. During the three year period beginning in late 1984, Mr. and Mrs. Jensen contributed $38,538 to K&C and Mr. Jensen's father contributed $94,000. The father was issued 40,000 shares of K&C stock in August 1986. During 1984, 1985 and 1986, Kent and Carol Jensen received from K&C four documents designated as **promissory notes.** The total amount of the four alleged notes was $129,682. This total **included** the $94,000 contributed to K&C by the father.

**The corporation failed in late 1987.** On their joint 1987 tax return, the taxpayers **claimed a business bad debt deduction of $128,841,** which was approximately the amount of the four promissory notes they had received from the corporation. **The IRS disallowed the bad debt deduction.** The IRS's position was that the additional funds contributed to K&C by Mr. and Mrs. Jensen ($38,538) represented **contributions to capital** rather than loans to the corporation as the taxpayers contended.

## Issues

1. Whether taxpayers are entitled to an I.R.C. §166 **business bad debt deduction** in 1987 in the amount of $128,841.
2. Alternatively, whether taxpayers are entitled to an I.R.C. §1244 **ordinary loss deduction** in the same amount for 1987 with respect to the stock in K&C Industries.

## Discussion

Issue 1. The question of whether transfers of funds to **closely held corporations** constitute debt or equity must be decided on the basis of all the relevant facts and circumstances.

Various factors are often used to analyze whether funds transferred to closely held corporations are to be treated and debt or equity. They are:

1. The treatment of the funds on documents prepared by the parties;
2. the presence or absence of **fixed dates for repayment of the funds;**
3. the likely source of repayment of the funds;
4. efforts to enforce repayment of the funds;
5. participation by the transferor of the funds in management of the corporation;
6. whether the transferor of the funds was also a shareholder of the corporation;
7. the adequacy or inadequacy of the initial capitalization of the corporation;
8. the availability to the corporation of outside financing;
9. the use of the funds by the corporation; and
10. repayment history.

Transfers by **controlling shareholders** to closely held corporations are **subject to heightened scrutiny. Labels attached to such transactions through bookkeeping entries have limited significance unless supported by objective evidence.**

[*Fin Hay Realty Co. v. United States*, 68-2 USTC ¶9484, Third Cir. Appeals Ct. (1968).]

Issue 2. IRS's position on the §1244 small business stock issue was that the ordinary loss provisions would apply **only to the 10,000 shares owned by Mr. and Mrs. Jensen and not to the 40,000 shares owned by Kent Jensen's father.** The 40,000 shares issued to the father were due to his $94,000 contribution to K&C.

The position of the taxpayers was that the 40,000 shares were issued to the father due to a clerical error and that they (Kent and Carol Jensen) were the **real owners** of the stock.

## Holding

Issue 1. The evidence undermines the credibility of the four handwritten promissory notes on which the taxpayers rely. The timing and the amount of the four notes do not correlate with the timing and the amounts of the additional contributions of funds to K&C.

K&C's **initial capitalization** of only $5,882 is **grossly disproportionate to its debt obligations.** K&C appears to have been **undercapitalized** and unable to obtain outside financing. In addition, the **taxpayers received absolutely no repayments** from K&C of principal or interest thereon.

> Therefore, we find that the taxpayers **have not established that the $128,841 claimed business bad debt deduction relates to a bona fide loan.**

Issue 2. With regard to the taxpayers' alternative claim that the ordinary loss provisions of §1244 should apply to the 40,000 shares issued to the father, **we disagree.** They are entitled to a §1244 ordinary loss on the 10,000 shares of K&C stock issued to them. Generally, **we treat facts as they happened, not as they could or might have happened.**

[*Kent and Carol Jensen v. Commissioner*, T.C. Memo 1997-491, 74 T.C.M. 1076 (1997) [CCH Dec. 52,331 (M)].]

Business bad debt
I.R.C. §166

> ☞ **Taxpayer was not entitled to a business bad debt.**

**Facts.** Eric Jones, the taxpayer, was an attorney licensed to practice law in Georgia. He was also a 50-percent shareholder and secretary/treasurer of D.B. Metalworks, Inc. (Metalworks), a tree cutting and welding business. He purchased his 50-percent share of Metalworks for $1,000.

In July 1988, Metalworks borrowed about $23,000 from Farmers & Merchants Bank. Taxpayer signed a “Guaranty of Payment” form with the bank in which he personally agreed to make principal and interest payments on the note. Metalworks experienced severe cash flow problems and ceased business in late 1988. **In October 1989, taxpayer paid the bank $28,080 as required by the guaranty agreement.**

He deducted the $28,080 payment as a **business bad debt** on a separate 1989 Schedule C on which he listed “Finance Services” as the principal business or profession. The IRS determined that the $28,080 payment on the Metalworks note was not made in connection with taxpayer’s trade or business. **Consequently, the IRS disallowed the $28,080 business bad debt.** The IRS recharacterized the payment as a nonbusiness bad debt and treated it as a short-term capital loss.

**Issue.** Whether taxpayer is entitled to a business bad debt deduction for his payment as guarantor of the Metalworks note.

**Discussion.** A business bad debt deduction for a payment made in discharge of the taxpayer’s obligation as a guarantor is deductible only if two requirements are satisfied:

1. The taxpayer was engaged in a trade or business at the time the guaranty was made, and
2. The guaranty was proximately related to the conduct of that trade or business. [**Treas. Regs.** §§1.166-9(a) and 1.166-5(b)]

Whether a guaranty is proximately related to the taxpayer’s trade or business rests on the taxpayer’s **dominant motive,** at the time of the guaranty, for becoming a guarantor. The taxpayer’s dominant motive must be business related, as opposed to investment related, for the guaranty to be proximately related to the taxpayer’s trade or business. A motive is investment related when the taxpayer aims to increase or protect the value of his or her stock in the debtor corporation.



**Holding.** Mr. Jones testified that he made it a practice to participate in various businesses in order to generate fees for his law practice. He also testified that he had billed Metalworks for his legal services only once, and that was for the initial incorporation fees. Mr. Jones has failed to establish that his dominant motive in guaranteeing the Metalworks bank note was related to his attorney business as opposed to that of a mere investor. **Therefore, we hold that taxpayers are not entitled to their claimed business bad debt deduction of $28,080.**

[*Eric L. and Kay K. Jones v. Commissioner*, T.C. Memo 1997-368, 74 T.C.M. 311 (1997) [CCH Dec. 52,199(M)]]

# DEPRECIATION

§179 Depreciation Election
I.R.C. §179

☞ **Taxpayer was denied a §179 deduction because the election was not timely made.**

**Facts.** Robert was a self-employed real estate salesman in 1992. He reported the income and expenses from his business on Schedule C. He bought a new computer for business use in May 1992 for $2,145. This cost was deducted on the Office Expense line on the 1992 Schedule C. **Robert failed to attach to his 1992 return a Form 4562 (Depreciation).** When the return was examined, the IRS disallowed the $2,145 cost as an office expense and instead allowed Robert a depreciation deduction on the computer based on the MACRS tables. **The IRS refused to allow Robert to, claim a §179 current expense election retroactively** on the $2,145 cost of the computer.

## Issues

1. Whether the taxpayer is entitled to a $2,145 office expense deduction for the cost of the computer.
2. Whether the taxpayer is entitled to claim a §179 deduction retroactively on the cost of the computer.

**Discussion.** The cost of business property is **not** deductible currently if it is subject to the I.R.C. §168 depreciation rules. As an alternative to depreciation, I.R.C. §179(a) allows a taxpayer to elect to treat the cost of §179 property as a **current expense in the year the property is placed in service,** within certain dollar limitations.

**An election under §179 must be made on the taxpayer's original return for the taxable year or a timely filed amended return.** [I.R.C. §179(c)(1)(B) and **Treas. Reg.** §1.179-4(a)] The election must specify the **items** of §179 property to which the election applies and the **cost** of each of the **items.** [I.R.C. §179(c)(1)(A) and **Treas. Reg.** §1.179-4(a)(1) and (2)]

**Holding.** We find that the taxpayer **failed** to make the requisite §179 election. **He failed to specify that he was claiming a §179 deduction for the cost of the computer.** We therefore hold that the taxpayer is **not** entitled to a §179 deduction for 1992 for the cost of the computer. Rather, the taxpayer is entitled to a depreciation deduction on the cost as allowed by the MACRS calculations under I.R.C. §168.

[*Robert C. and Lucille Fors v. Commissioner,* T.C. Memo 1998-158, 75 T.C.M. 2221 (1998) [CCH Dec. 52,680(M)].]

LTR 9748002, June 27, 1997
Code §§168, 263A

☞ **Taxpayer who is only a grain harvester can use 200% DB depreciation method.**

**Issue.** Whether Taxpayer must limit its MACRS (Modified Accelerated Cost Recovery System) depreciation on equipment to the 150% declining balance method.

**Facts.** Taxpayer is a grain harvester. As such, Taxpayer contracts with other individuals to cut their grain and to haul the grain to areas designated by these individuals. These contracts are usually not formalized in writing and Taxpayer is usually paid an established amount per acre harvested. Once Taxpayer has finished cutting and hauling one individual's grain, Taxpayer will repeat its activities at another individual's field. To complete its work, Taxpayer has equipment and work crews.

**Taxpayer does not raise or grow the grain it cuts and hauls. Taxpayer does not own or lease the land on which the grain grows.** Taxpayer does not own any of the designated areas to which the grain is hauled.

Taxpayer is a sole proprietor who uses the overall cash receipts and disbursements method of accounting. Taxpayer has never capitalized any costs pursuant to §263A of the Internal Revenue Code and the Income Tax Regulations thereunder. Taxpayer has claimed MACRS depreciation on its equipment using the 200% declining balance method. The examining agent has disallowed Taxpayer's MACRS depreciation expense on equipment for amounts claimed in excess of the 150% declining balance method.

**Applicable Law.** §168(b)(2)(B) requires use of the 150% declining balance method in lieu of the 200% declining balance method when the depreciable property is used in a farming business [within the meaning of §263A(e)(4)].

Section 263A(e)(4)(A) defines **"farming business"** as the trade or business of farming. Section 263A(e)(4)(B)(ii) states that a farming business includes the raising or harvesting of trees bearing fruit, nuts, or other crops.

Section 1.263A-4T(c)(4)(i)(A) of the temporary Income Tax Regulations defines a farming business as a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. Examples include the raising or harvesting of crops.

Section 263A generally requires a taxpayer to capitalize direct costs and certain indirect costs properly allocable to certain property that is produced by the taxpayer or acquired by it for resale.

**Rationale.** The examining agent believes that Taxpayer has been using an incorrect depreciation method. Instead of the 200% declining balance method used by Taxpayer, the agent believes Taxpayer is required to use the 150% declining balance method. This belief is based on the argument that Taxpayer uses its equipment in a farming business [within the meaning of §263A(e)(4)] because Taxpayer harvests crops.

**Taxpayer is not using its equipment in a farming business** [within the meaning of §263A(e)(4)]. **Taxpayer is not engaged in the trade or business of farming.** Taxpayer is not raising or growing the grain it harvests and hauls. Instead, Taxpayer merely provides a service by cutting and hauling grain. Accordingly, because Taxpayer is not using its depreciable property in a farming business [within the meaning of §263A(e)(4)], §168(b)(2)(B) does not require the use of the 150% declining balance method in lieu of the 200% declining balance method.

**Conclusion.** Taxpayer may claim MACRS depreciation on its equipment using the 200% declining balance method.

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## DISCHARGE OF INDEBTEDNESS

Discharge of Indebtedness Income
Insolvency Test
I.R.C. §108

☞ **This is a good case because prior to this decision, there was little case guidance on what was and was not a liability that counted towards insolvency.**

**Discussion.** Although the discharge of indebtedness is initially taxable income, there are a number of exceptions. One exception is that the discharge is not taxable to the extent that the taxpayer is insolvent [I.R.C. §108(a)(1)(B)].

**Issue.** The issue in this case is what kinds of "liabilities" [I.R.C. §108(d)(3)] are counted toward the amount of the insolvency, especially items that are "contingent" liabilities.

**Decision.** "In conclusion, a taxpayer claiming the benefit of the insolvency exclusion must prove (1) with respect to any obligation claimed to be a liability, that, as of the calculation date, it is more probable than not that he will be called upon to pay that obligation in the amount claimed and (2) that the total liabilities so proved exceed the fair market value of his assets."

*Merkel v. Commissioner* and *Hepburn v. Commissioner*, 109 T.C. 22 (Dec. 30, 1997) [CCH Dec. 52,423]].

## EDUCATION CREDITS—DEDUCTIONS AND REPORTING

Returns Relating to Higher Education Tuition and Related Expenses
Notice 97-73

**See Chapter 15**

Availability of Publication 970, Tax Benefits for Higher Education
Announcement 98-24

New Publication 970 will be available in March, 1998. The publication explains the tax benefits for persons who are saving for or paying higher education costs for themselves and members of their families or who are repaying student loans.

Returns Relating to Interest on Education Loans
Notice 98–7

☞ **This notice describes the information reporting requirements for 1998 under §6050S of the Internal Revenue Code (as enacted by the Taxpayer Relief Act of 1997) that apply to certain persons who receive payments of interest that may be deductible as qualified education loan ("student loan") interest.**

**See Chapter 15**

Nonbank Trustees and Custodians for Education Individual Retirement Accounts
Notice 97-57

☞ **This notice informs entities already approved to serve as nonbank trustees and custodians of individual retirement accounts (IRAs) that they are also approved to serve as nonbank trustees and custodians of Education IRAs and provides guidance on the procedures for being approved to be a nonbank trustee or custodian of an Education IRA.**

Education Tax Incentives
Notice 97-60

**See Chapter 15**

☞ **The questions and answers contained in this notice provide guidance on the higher education tax incentives recently enacted by the Taxpayer Relief Act of 1997.**

Returns Relating to Higher Education Tuition and Related Expenses
Notice 98-46

**See Chapter 15**

## EARNED INCOME CREDIT

Earned Income Credit
I.R.C. §32

☞ **Court required all four tests of I.R.C. §32c to be met and allowed mother to claim child for EIC purposes.**

**Facts.** Jennifer (taxpayer), who had a 2 ½ year old son, lived with her mother in three different rented residences in 1994. Jennifer worked part-time and earned about $5,600 of wages in 1994. Jennifer claimed earned income credit of $1,479 and identified her son as her "qualifying child" under I.R.C. §32(c)(3).

Jennifer's mother (grandmother of Jennifer's "qualifying child") also claimed an earned income credit on her 1994 return. She identified her other daughter Heather as her "qualifying child" on her 1994 return. **Jennifer's mother did not identify Jennifer's son (her grandson) as her "qualifying child" on her 1994 return for earned income credit purposes.**

The IRS **disallowed** Jennifer's $1,479 earned income credit for 1994 under I.R.C. §32(c)(1)(C), which provides:

> "If two or more individuals would be treated as eligible individuals with respect to the **same** qualifying child for taxable years beginning in the **same** calendar year, **only** the individual with the **highest adjusted gross income** for such taxable years shall be treated as an **eligible individual** with respect to such qualifying child."

**Issue.** Whether the taxpayer (Jennifer) is entitled to $1,479 of earned income credit for 1994.

**Discussion.** I.R.C. 32(a) provides for an earned income credit in the case of an **"eligible individual."** I.R.C. 32(c)(1)(A) provides that an "eligible individual" means any individual who has a **"qualifying child"** for the taxable year. I.R.C. 32(c)(3) defines the four requirements that a "qualifying child" must meet as follows:

1. the **relationship** test (son, daughter, adopted child, grandchild, stepchild, or eligible foster child);
2. the **principal place of abode** test (the "qualifying child" must reside in the "eligible individual's" residence for more than one-half of the taxable year);
3. the **age** test (under 19 at the close of the year or under 24 if a full-time student or is permanently and totally disabled regardless of age); *and*
4. the **identification** test (the name, age, and TIN of each "qualifying child" must be shown on the return of the "eligible individual").

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The IRS contended that if a child met the **first three** tests shown above (relationship, abode, and age), the child is a "qualifying child." The IRS's position was that the fourth test (identification) was merely a requirement to ease administration of the law and to reduce IRS's administrative burden. In other words, the IRS contended that the **identification** test was imposed simply for reporting purposes.

Therefore, in the opinion of the IRS, the fact that Jennifer's mother **did not identify Jennifer's son as her "qualifying child"** on her 1994 return did not negate the conclusion that Jennifer's son (her grandson) was her "qualifying child."

Jennifer's representative argued that because Jennifer's mother **did not identify** her grandson as her "qualifying child," all four tests were **not met.** Therefore, the grandson was not a "qualifying child" of Jennifer's mother. Consequently, the provisions of I.R.C. 32(c)(1)(C) do not apply, as Jennifer and Jennifer's mother are not "eligible individuals" **with respect to the same "qualifying child."**

**Holding.** As long as the statutory language is clear and unambiguous, there is generally no need for courts to inquire beyond the plain language of the statute. A "qualifying child" under I.R.C. §32(c)(3)(A)(i)–(iv) is one who satisfies a relationship test, an abode test, an age test, **and** for whom the taxpayer satisfies an identification test. **The four requirements are conjunctive.**

In 1994, Jennifer's son met the four tests with respect to Jennifer. However, Jennifer's son met only the first three tests with respect to Jennifer's mother. **What is significant here is that the grandmother did not identify her grandson as her "qualifying child" on her 1994 return and thus failed to satisfy the identification test. Therefore, the grandson is not a "qualifying child" with respect to his grandmother.**

Because Jennifer and her mother are not "eligible individuals" with respect to the **same** "qualifying child," I.R.C. §32(c)(1)(C) does not preclude Jennifer from entitlement to $1,479 of earned income credit for 1994.

[*Jennifer A. Lestrange v. Commissioner*, T.C. Memo 1997-428, 74 T.C.M. 685 (1997) (CCH Dec. 52,261(M).]

Income Tax Return Preparer Penalties—1997 Federal Income Tax Returns—Due Diligence Requirements for Earned Income Credit (EIC)

Notice 97-65

☞ **This notice sets forth due diligence requirements that paid preparers of federal income tax returns or claims for refund (preparers) that involve the Earned Income Tax Credit (EIC) must meet to avoid imposition of the penalty under §6695(g) of the Internal Revenue Code for 1997 returns and claims for refund. The Treasury Department intends to issue temporary regulations under §6695(g) that will incorporate the requirements set forth in this notice and that will apply to 1997 returns and claims for refund. However, these regulations may impose different due diligence requirements for returns and claims for taxable years beginning after 1997.**

**See Chapter 15**

EIC Eligibility Requirements
T.D. 8773

☞ **This document contains temporary regulations that provide guidance to taxpayers who have been denied the earned income credit (EIC) as a result of the deficiency procedures and wish to claim the EIC in a subsequent year. The temporary regulations apply to taxpayers claiming the EIC for taxable years beginning after December 31, 1997, where the taxpayer's EIC claim was denied for a taxable year beginning after December 31, 1996.**

**See Chapter 15**

## EMPLOYEE VERSUS INDEPENDENT CONTRACTOR

Employee or Self-Employed
I.R.C. §3121

☞ **Taxpayer was an employee of his corporation.**

**Facts.** The taxpayer, a medical doctor, performed management and medical services for his wholly owned professional corporation. He was the sole shareholder and president of the corporation. He made all management decisions and signed all corporate checks. In 1989, he received $51,418 from the corporation for his services. The corporation failed to give the doctor **either** a 1989 Form W-2 or a 1099-MISC. The doctor reported the income he received from his corporation on his 1989 Schedule C as sole proprietorship income.

**Issue.** Whether the taxpayer was an employee or an independent contractor of his wholly owned professional corporation.

**Discussion.** The definition of "employee" is found in **I.R.C. §3121 (d).** It provides that "employee" means

1. Any **officer** of a corporation; or
2. Any individual who, under the usual **common law rules** that apply in determining the employer-employee relationship, has the status of an employee; or
3. Other employees listed (called statutory employees)

The IRS contended that the taxpayer was an employee **both** under I.R.C. §3121(d)(1) shown above, because he was an **officer** (president) of the corporation, **and** under the **common law test** of I.R.C. §3121(d)(2) above.

The taxpayer apparently conceded that he was an employee of the corporation with respect to the duties he performed as president. However, the taxpayer contended that he was an independent contractor with respect to the medical services he performed.

**Holding.** We hold that because the taxpayer was an **officer,** he is an **employee** under the **general rule** of I.R.C. §3121(d)(1) with respect to the **management duties** he performed as **president.** With respect to the **medical services** he performed, we look to the **common law test** as explained in I.R.C. §3121(d)(2). The taxpayer had a permanent relationship with the corporation. He was integral to its business and his medical services were essential. We conclude that the taxpayer was an **employee** under the **common law rules** as well.

**Note.** The taxpayer could **not** rely on §530 relief provided by the Revenue Act of 1978 to claim independent contractor status, as a 1989 Form 1099-MISC was **not** issued by the corporation.

[*Harish K. and Maggy M. Pariani v. Commissioner,* T.C. Memo 1997-427, 74 T.C.M. 682 (1997) [CCH Dec. 52, 260(M)].]

Employee or Self-Employed
I.R.C. §3401

☞ **Minister was an employee of the church.**

**Facts.** Henry Raddle, the taxpayer, was a United Methodist minister. In 1990, he was the senior pastor in Hurst, Texas for the first 5 months of the year. From June 1990 through December 1991, he was the District Superintendent of the Waco District of the Central Texas Conference of the United Methodist Church. On the joint 1990 and 1991 Forms 1040 of him and his wife Susan, he reported his ministry income on Schedule C as a self-employed individual. He deducted in full his professional expenses on the 1990 and 1991 Schedules C. Those amounted to $10,605 in 1990 and $19,314 in 1991. Both income tax returns for 1990 and 1991 were filed delinquently. The reason for the late filing, according to Mr. Raddle, was his father's death in 1983, which caused him to become seriously depressed.

### Issues

1. Whether the taxpayer is to be treated as an **employee** of the church or as a **self-employed** minister; and
2. Whether the delinquency penalty for failure to timely file an income tax return under I.R.C. §6651(a)(1) applies.

**Discussion.** The Tax Court observed that the first issue had already been decided by a previous Tax Court decision involving Michael D. Weber, a North Carolina United Methodist minister. (See pages 361–62 of the 1994 *Farm Tax School Book*, pages 255–56 of the 1995 *Farm Tax School Book*, and page 133 of the 1997 *Farm Tax School Book*.) In the *Weber* Tax Court decision, it was held that Michael Weber was an **employee** of the United Methodist Church rather than a self-employed minister. The Tax Court decision was **affirmed** by the 4th Circuit Appeals Court.

### Holding

Issue 1. The taxpayers have failed to distinguish the facts in their case from the facts in the *Weber* case. We conclude that for 1990 and 1991, Mr. Raddle should be treated as an **employee** of the United Methodist Church.

Issue 2. The taxpayers have not established that Mr. Raddle's alleged depression constitutes reasonable cause for their failure to timely file their tax returns.

[*Henry W. and Susan K. Raddle v. Commissioner,* T.C. Memo 1997-490, 74 T.C.M. 1072 (1997) [CCH Dec. 52,330(M)].]

Employee vs. Independent Contractor
IRC §530 and 3401

☞ **§530 applied to cab drivers under facts of their agreement.**

**Facts.** Howard's Yellow Cabs, Inc. (President Howard Sumlin), operates a cab service in Lenoir, North Carolina, and surrounding communities. This service is the only public transportation in the area. **The taxpayer and the drivers operate pursuant to a written agreement entitled "Acknowledgment of Independent Contractor Agreement,"** which states that the parties have a

"50/50 fares" arrangement; that the driver is an independent contractor, and not an employee, partner, agent, or joint venturer with Taxpayer; that taxpayer does not deduct withholding taxes, FICA, or any other taxes required to be deducted by an employer and that the driver is responsible for payment of such taxes; and that the driver is not entitled to any fringe benefits, retirement, pension, profit sharing, or any other benefits which might accrue to an employee.

**Holding.** **In sum, the Court finds that Taxpayer has established that it has met all of the requirements to be entitled to §530 relief from liability for past employment taxes.** Taxpayer did not treat any of its drivers as an employee for any time during the relevant period; Taxpayer filed all required tax returns consistent with its treatment of its drivers as non-employees; Taxpayer was not required to file Forms 1099 because Taxpayer did not make "payment" to its drivers; Taxpayer had a reasonable basis for not treating its drivers as employees, relying upon industry practice (see doc. #29, Ex. 6, Huntley Aff., survey results of fourteen cab companies), the Acknowledgment of Independent Contractor Agreement, and advice from its accountants, attorney, the North Carolina Employment Security Commission, and others.

**Discussion.** Section 530(a) provides that:

Termination of certain employment tax liability.–

1. In general. If
   - **A.** for purposes of employment taxes, the taxpayer did not treat an individual as an employee for any period, and
   - **B.** in the case of periods after December 31, 1978, all Federal tax returns (including information returns) required to be filed by the taxpayer with respect to such individual for such period are filed on a basis consistent with the taxpayer's treatment of such individual as not being an employee, then for purposes of applying such taxes for such period with respect to the taxpayer, the individual shall be deemed not to be an employee unless the taxpayer had no reasonable basis for not treating such individual as an employee.

2. Statutory standards providing one method of satisfying the requirements of paragraph (1). For purposes of paragraph (1), a taxpayer shall be treated as having a reasonable basis for not treating an individual as an employee for a period if the taxpayer's treatment of such individual was in reasonable reliance on any of the following:
   - **A.** judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer;
   - **B.** a past Internal Revenue Service audit of the taxpayer in which there was no assessment attributable to the treatment (for employment tax purposes) of the individuals holding positions substantially similar to the position held by this individual; or
   - **C.** long-standing recognized practice of a significant segment of the industry in which such individual was engaged.

[*Howard's Yellow Cabs, Inc. v. U.S.A.*, U.S. District, NC.; 97-2 USTC 89, 768 [CCH ¶ 50,694].

Employees vs. Independent Contractors
I.R.C. §3401

☞ **The Court distinguished the previous** *Ren Lyn* **court case and determined that the taxpayer's manicurists were employees.**

**Discussion and Facts.** The taxpayer leased the salon where the manicurists worked, it owned the work stations, it provided the supplies (with the exception of an electric file costing several hundred dollars), controlled the cash, issued pay checks, and had the right to fire the manicurists at any time. The manicurists could not subcontract, they worked for the taxpayer for (on average) a number of years, they

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had very little exposure to business loss, they could be discharged at any time, and they could quit at any time. All of these facts are indicative of an employee relationship. Furthermore, insurance, telephone, advertising, utilities and similar expenses were paid by the taxpayer.

Although there are some factors present in the salon/manicurist relationship that traditionally weigh toward independent contractor status such as the manicurists' level of professionalism, their setting their own hours, their furnishing one of their own tools and certain optional supplies, their having access to the premises (although many employees have such access), and, most significantly, their being paid on a commission basis, **the overwhelming weight of the factors relevant to the analysis indicates that no reasonable fact finder could find that these manicurists were independent contractors. Unlike the chair lessees in** *Ren-Lyn*, **the manicurists here did not lease booths from the employer, nor did they purchase supplies from the employer.**

There is also insufficient indication that the manicurists here had sole responsibility for resolving customer complaints, according to the deposition testimony of the receptionist, who did resolve them. **Thus, unlike the lessees in** *Ren-Lyn* see [97-1 USTC ¶50,385], 968 F.Supp. at 369, the manicurists here were, in substance, **employees.**

**Holding.** The manicurists were employees of the taxpayer.
[*L. A. Nails, Inc. v. U.S.*, U.S. District Ct. 98-1 USTC 84,213 [CCH Dec. ¶ 50,438].]

Employee or Independent Contractor
I.R.C. §530

**Practitioner Note:** For other cases applying §530 Relief, see *Options for Senior America Corp v. USA;* U.S. Dist. Ct. MD, 98-2 USTC 85,477 [CCH ¶ 50,620] (nonskilled home health aids) and *Taylor Blvd. Theater Inc vs U.S.;* U.S. Dist Ct. KY; 98-2 USTC 50,521 [CCH ¶ 50,521].

Introduction to Employee Plans Compliance Resolution System
Rev. Proc. 98-22

☞ **This revenue procedure provides a comprehensive system of correction programs for sponsors of retirement plans that are intended to satisfy the requirements of §401(a) or §403(a) of the Internal Revenue Code (the "Code"), but that have not met these requirements for a period of time.**

### Section 1. Purpose and Overview

**This system permits plan sponsors to correct these qualification failures and thereby continue to provide their employees with retirement benefits on a tax-favored basis.** The Internal Revenue Service previously established several programs allowing correction of qualification failures, including the Administrative Policy Regarding Self-Correction ("APRSC"), the Voluntary Compliance Resolution ("VCR") program, the Walk-in Closing Agreement Program ("Walk-in CAP"), and the Audit Closing Agreement Program ("Audit CAP").

This revenue procedure modifies these programs and consolidates them into a coordinated Employee Plans Compliance Resolution System ("EPCRS"). In response to requests by practitioners, this revenue procedure sets forth and assembles in one place the specific rules and procedures applicable to the programs, including illustrative examples.

I.R.C. §7436
Notice 98-43

☞ **New procedures for processing employment tax cases involving worker classification and §530 of the Revenue Act of 1978 under §7436 of the Code.**

**Purpose.** The Taxpayer Relief Act of 1997 (TRA '97), created new §7436 of the Internal Revenue Code (the "Code"), which provides Tax Court review rights concerning certain employment tax determinations. This notice provides information about how taxpayers may petition for Tax Court review of employment tax determinations under §7436. Attached to this notice as Exhibit 1 is a "Notice of Determination Concerning Worker Classification Under §7436" (a "Notice of Determination"). With respect to taxpayers whose workers are the subject of an employment tax determination, the attached Notice of Determination addressed to a taxpayer will constitute the "determination" that is a prerequisite to invoking the Tax Court's jurisdiction under §7436.

**Background.** Section 7436(a) of the Code provides the Tax Court with jurisdiction to review determinations by the Service that workers are employees for purposes of subtitle C of the Code, or that the organization for which services are performed is not entitled to relief from employment taxes under §530 of the Revenue Act of 1978. Section 7436(a) requires that the determination involve an actual controversy and that it be made as part of an examination. **§7436 became effective on August 5, 1997.**

Proceedings under §7436 may be conducted pursuant to the Tax Court's simplified procedures for small tax cases set forth in §7463 of the Code and Rule 295 of the Tax Court's Rules of Practice and Procedure. Currently, taxpayers may elect, with the concurrence of the Tax Court, to use these simplified procedures if the amount of employment taxes placed in dispute is $50,000 or less for each calendar quarter involved.

### Issues to Which §7436 Applies

Section 7436(a) provides the Tax Court with jurisdiction to review the Service's determinations that one or more individuals performing services for the taxpayer are employees of the taxpayer for purposes of subtitle C of the Code, or that the taxpayer is not entitled to relief under §530 with respect to such individuals.

- Thus, §7436(a) **does not** provide the Tax Court with jurisdiction to determine any amount of employment tax or penalties.
- **Nor does** §7436(a) provide the Tax Court with jurisdiction to review other employment tax issues.
- Moreover, the procedures set forth in §7436 do not apply to employment-related issues not arising under subtitle C, such as the classification of individuals with respect to pension plan coverage or the proper treatment of individual income tax deductions.
- Additionally, insofar as §7436(a) only confers jurisdiction upon the Tax Court to review determinations that are made by the Service as part of an examination, other Service determinations that are not made as part of an examination, including those that are made in the context of private letter rulings or Forms SS-8, Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding, are not subject to review by the Tax Court under §7436(a).
- The Service will issue a Notice of Determination only after the Service has determined **both** that one or more individuals performing services for the taxpayer are employees for purposes of subtitle C **and** that the taxpayer is not entitled to relief under §530. This will provide taxpayers with the opportunity to resolve both issues in one judicial determination.

**Taxpayers Eligible to Seek Judicial Review.** Section 7436(b) provides that a pleading seeking Tax Court review of the Service's determination may be filed only by "the person for whom the services are performed." Thus, workers **may not** seek review of the Service's determination under §7436. In addition, because there must be an actual controversy, review **may not** be sought by a third party that has not been determined by the Service to be the employer.

**Notice of Determination Concerning Worker Classification under §7436.** The Service will inform taxpayers of a determination described in §7436(a) by sending the taxpayer a Notice of Determination by certified or registered mail. A copy of the current Notice of Determination, which may be revised from time to time, is attached hereto as Exhibit 1.

The Notice of Determination will advise taxpayers of the opportunity to seek Tax Court review and provides information on how to do so. Attached to the Notice of Determination will be a schedule showing each kind of tax with its proposed employment tax adjustment by calendar quarter. The schedule will be provided to enable the taxpayer to determine eligibility to elect use of the small tax case procedures under §7436(c). Currently, the small tax case procedures may be available under §7436(c) if the amount of employment taxes placed in dispute is $50,000 or less for each calendar quarter involved.

**Restrictions on Assessment.** Section 7436(d)(1) provides that the restrictions on assessment in §6213 of the Code apply in the same manner as if a notice of deficiency had been issued. Thus, pursuant to §6213(a), the Service **is precluded** from assessing the taxes attributable to the worker classification and §530 issues prior to expiration of the 90-day period during which the taxpayer may file a timely Tax Court petition. If the taxpayer does file a timely Tax Court petition, §6213(a) generally **precludes** the Service from assessing taxes attributable to the worker classification and §530 issues until the decision of the Tax Court has become final. If the taxpayer does not file a timely Tax Court petition before the 91st day after the Notice of Determination was mailed, the employment taxes attributable to the workers described in the Notice of Determination may thereafter be assessed.

**Agreed Settlements.** If the taxpayer wishes to settle the worker classification and §530 issues on an agreed basis before issuance of a Notice of Determination, the taxpayer must formally waive the restrictions on assessment contained in §§7436(d)(l) and 6213. This will generally be accomplished by execution of an agreed settlement that contains the following language:

> I understand that, by signing this agreement, I am waiving the restrictions on assessment provided in §§7436(d) and 6213(a) of the Internal Revenue Code of 1986.

The Service will not assess employment taxes attributable to worker classification or §530 issues unless either the Service has issued a Notice of Determination to the taxpayer and the 90-day period for filing a Tax Court petition has expired or, alternatively, the taxpayer has waived the restrictions on assessment. If the Service erroneously makes an assessment of taxes attributable to worker classification and §530 issues without first either issuing a Notice of Determination or obtaining a waiver of restrictions on assessment from the taxpayer, the taxpayer is entitled to an automatic abatement of the assessment. However, once any such procedural defects are corrected, the Service may reassess the employment taxes to the same extent as if the abated assessment had not occurred.

**Effective Date.** Section 1454 of TRA '97 is effective as of August 5, 1997. Thus, assessments that were made prior to the August 5, 1997, effective date of the Act **are not subject** to the new legislation or the procedures discussed above. All employment tax examinations involving worker classification and/or §530 issues that were pending as of August 5, 1997, are subject to the new legislation.

# ESTATE AND GIFT TAX & INCOME TAX

## Estate Tax Valuation—Minority Interest

☞ **The court allowed a substantial discount of a minority interest in an S corporation.**

**Facts.** When John Mitchell died on April 21, 1989 he owned 49 percent of a closely held S corporation, John Paul Mitchell Systems (JPMS). JPMS manufactured and marketed hair care products for the salon-only market. **The estate tax value of the shares was listed as $28.5 million.** IRS claimed that the date of death fair market value of the decedent's minority interest was **$81 million.** Numerous expert witnesses for both sides testified at the Tax Court trial.

In 1988, the Gillette Co. was interested in buying all of the stock of JPMS. Gillette had no interest in owning a minority interest in JPMS. **Gillette and JPMS executed a contract that gave Gillette the right of first refusal to buy all of the stock in JPMS until July 1988. Under the contract, the purchase price of 100 percent of the stock of JPMS was capped at $150 million.**

**Issue.** The date-of-death value of the 1226 shares of John Paul Mitchell Systems common stock.

**Discussion.** **The best method for valuing closely held stock is by reference to an actual arm's-length sale of stock within a reasonable time before or after the valuation date.** [*Estate of Andrews v. Commissioner*, 79 T.C. 938 (1982) [CCH Dec. 39,523].] Valuation is an approximation, and the figure we (the Tax Court) reach need not be one as to which there is specific testimony.

**Holding.** We are unable to accept the date-of-death valuations given by any of the expert witnesses. Instead, we rely on our own analysis, based on all the evidence in the record. **We begin by placing a $150 million value on JPMS at the moment immediately prior to Mr. Mitchell's death. This amount was stated in the contract with Gillette.**

**We next consider the impact of Mr. Mitchell's death on JPMS. Mr. Mitchell embodied JPMS** to distributors, hair stylists, and salon owners. He was the focal point of JPMS' advertising campaigns. He was vitally important to development and marketing of JPMS' products. Following Mr. Mitchell's death, the hair care industry widely perceived the JPMS had lost its creative and artistic leader. **It is clear that the loss of Mr. Mitchell created uncertainties as to the future of JPMS at the moment of his death.** In our opinion, the $150 million value of JPMS immediately prior to Mr. Mitchell's death **should be discounted by 10 percent to reflect the loss of Mr. Mitchell.** Thus, we lower the beginning valuation of $150 million to $135 million.

We further believe a **combined 35-percent discount for lack of marketability and minority interest** is appropriate. Finally, a $1.5 million discount should be applied to reflect the **possibility of a lawsuit** regarding the amount of the other principal shareholder's compensation. Taking these factors into consideration, **we find that the fair market value of decedent's 49 percent in JPMS was $41,532,600 as of the moment of his death.** [*Estate of Paul Mitchell v. Commissioner*, T.C. Memo 1997-461, 74 T.C.M. 872 (1997) [CCH Dec. 52,297 (M)].]

Estate and Gift Tax
Land trusts—Power of Direction
I.R.C. §§2035 and 2038

**Practitioner Note:** Although land trusts are authorized in only a few states (Illinois, for example), attorneys using them for estate planning (gift giving) should carefully study two recent Illinois decisions. Both cases suggest that in order to avoid 100% inclusion of the land trust property in the decedent's estate, the "power of direction" should be vested with 100% of the beneficial owners of the land trust. (See *Est. of Bowgren v Commissioner*, 105 Fed 3rd 1156, 7th Cir Ct of Appeals (1997), and *Swain v. U.S.A.*; Dist Ct of Ill. 97-2 USTC 91,216 [CCH ¶ 60,284].)

Valuation of Certain Farm, etc.,
Real Property
Section 2032A
Rev. Rul. 98-22

☞ **Special use value; farms; interest rates. The 1998 interest rates to be used in computing the special use value of farm real property for which an election is made under section 2032A of the Code are listed for estates of decedents.**

## TABLE OF INTEREST RATES

*(Year of Valuation 1998)*

| Farm Credit Bank District in Which Property is Located | Interest Rate |
|---|---|
| Columbia | 9.32 |
| Omaha | 8.17 |
| Sacramento | 8.38 |
| St. Paul | 8.28 |
| Spokane | 8.22 |
| Springfield | 8.74 |
| Texas | 8.19 |
| Wichita | 8.27 |

## 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. |

### Editorial Comment

**For example:** Decedent dies in 1998 owning 200 acres of land with a date of death value of $3,000 per acre and qualifies for I.R.C. §2032A.

Comparable property has a 5-year cash rent average of $150 per acre and a 5-year property tax average of $20 per acre. He lives in the St. Paul district. The §2032A value of this property is $150 – 20 ÷ 8.28%, or $1,570 per acre.

Transfer of Nonstatutory Stock Option–Gift.
Rev. Rul. 98-21
I.R.C. §2511

☞ **This ruling provides guidance on the time that a completed gift occurs when a nonstatutory stock option is transferred without consideration by the optionee to a family member.**

Compensatory Stock Options
Rev. Proc. 98-34

☞ **This revenue procedure sets forth a methodology to value for gift, estate, and generation-skipping transfer tax ("transfer tax") purposes certain compensatory stock options described in the revenue procedure. Taxpayers relying on this revenue procedure may use an option pricing model that takes into account on the valuation date specific factors that are similar to those established by the Financial Accounting Standards Board of Accounting for Stock-Based Compensation, Statement of Financial Accounting Standards No. 123, (Fin. Accounting Standards Bd. 1995), (FAS 123). The Internal Revenue Service will treat the value of a compensatory stock option as properly determined for transfer tax purposes, provided that the requirements of this revenue procedure are met.**

Disclaimer of Interests and Powers
26 CFR Parts 20 and 25
Treas. Reg 25.2581

☞ **This document contains final regulations relating to the treatment of disclaimers for estate and gift tax purposes. The regulations clarify certain provisions governing the disclaimer of property interests and powers and, in addition, conform the regulations to court decisions holding the current regulation invalid with respect to the disclaimer of joint property interests. The final regulations will affect persons who disclaim property interests, powers, or interests in jointly owned property.**



**Action.** Final Regulations.

**Dates.** Effective date. The final regulations are **effective** December 31, 1997.

Applicability dates. The amendments to §§25.2518-1(a) and 25.2518-2(c)(3) (substituting the statutory language in §2518(b)(2)(A) "transfer creating the interest," for "taxable transfer") and conforming changes to §§20.2041-3(d)(6)(i), 20.2046-1, 20.2056I(d)-2 (a) and (b), 25.2511-1(c)(1), 25.2514-3(c)(5), are applicable for transfers creating the interest or power to be disclaimed made **on or after** December 31, 1997. The amendments to §25.2518-2(c)(4) (relating to the disclaimer of joint property and bank accounts) are applicable for disclaimers made **on or after** December 31, 1997.

**Background.** The proposed regulations substituted the statutory language of §2518(b)(2)(A), "transfer creating the interest," for **"taxable transfer" as the reference point for determining when a 9-month time period for making the disclaimer commences.** This change clarifies that the starting point for the 9-month period is not dependent on the actual imposition of a transfer tax at the time that the interest to be disclaimed is created.

**Under the proposed regulations, the one-half survivorship interest in jointly held property that was unilaterally severable could be disclaimed within 9 months of the date of death of the first joint tenant to die. The proposed regulations did not extend the same treatment to joint interests that are not unilaterally severable (e.g., tenancies by the entirety).**

> **The final regulations allow the disclaimer of jointly held property that is not unilaterally severable on the same basis as joint property that is unilaterally severable. Thus, a surviving joint tenant may disclaim the one-half survivorship interest in property that the joint tenant held either in joint tenancy with right of survivorship or in tenancy by the entirety, within 9 months of the death of the first joint tenant to die.** The rule also significantly simplifies the disclaimer of jointly held property, eliminating certain special rules that were dependent on the application of §2515 to the creation of the tenancy.

The proposed regulations provided rules regarding the disclaimer of interests in joint bank accounts and brokerage accounts, generally recognizing that the creation of such accounts are **not** completed gifts under certain circumstances.

> **Accordingly, the final regulations have expanded the special rule with respect to the disclaimer of jointly held bank and brokerage accounts to include jointly held investment accounts such as accounts held at mutual funds.**

Disposition of qualifying income interest. If a surviving spouse acquires the remainder interest in a trust subject to a QTIP election under §2056(b)(7) of the Code in connection with the transfer by the surviving spouse of property or cash to the holder of the remainder interest, the surviving spouse makes a gift under §§2511, 2512, and 2519 of the Code.

Gift Tax—QTIP Trust

Rev. Rul. 98-8

> ☞ **What are the gift tax consequences to the surviving spouse of the acquisition by the surviving spouse of the remainder interest in a trust subject to a qualified terminable interest property (QTIP) election under §2056(b)(7) of the Internal Revenue Code?**

**Facts.** The decedent, *D*, died in 1993 survived by *S*, *D*'s spouse. Under the terms of *D*'s will, a trust (the QTIP Trust) was established under which S was to receive all of the trust income, payable at least annually, for *S*'s life. On *S*'s death, the remainder was to be distributed outright to *C*, *D*'s adult child. *S* was **not given** a general power of appointment over the trust property.

- *On the federal estate tax return filed for D's estate*, the executor made an election under §2056(b)(7) to treat the trust property as QTIP, and a marital deduction was allowed to *D*'s estate for the value of the property passing from *D* to the QTIP Trust.
- Subsequently, *S*, *C*, and the trustee of the QTIP Trust entered into the following transaction: (1) *S* acquired *C*'s remainder interest in the QTIP Trust; (2) *S* gave *C* a promissory note in the face amount of x dollars (the value of the remainder interest) for the remainder interest: (3) the trustee distributed all of the QTIP Trust assets (having a value of x + y dollars) to *S;* and (4) *S* thereupon paid x dollars from those assets to *C* in satisfaction of the promissory note.
- At the conclusion of the transaction, the QTIP Trust was terminated; *S* held QTIP Trust assets having a value of y dollars (which was equal to the value of *S*'s life interest in the trust); and *C* held assets having a value of x dollars (which was equal to the value of the remainder interest in the trust). *S* contended that the transaction was not subject to gift tax because *S* received full and adequate consideration (the x dollar remainder interest in the QTIP Trust) in exchange for the x dollar promissory note given by *S* to *C*.

**Holding**

If a surviving spouse acquires the remainder interest in a trust subject to a QTIP election under §2056(b)(7) in connection with the transfer by the surviving spouse of property or cash to be the holder of the remainder interest, the surviving spouse **makes a gift both under §2519 and under §2511 and 2512.** The amount of the gift is equal to the greater of (i) the value of the remainder interest (pursuant to §2519), or (ii) the value of the property or cash transferred to the holder of the remainder interest (pursuant to §§2511 and 2512).

Treating Revocable Trusts As Part Of An Estate
Rev. Proc. 98-13

☞ **The Taxpayer Relief Act of 1997 added §646 to the Internal Revenue Code, which provides an election to have certain revocable trusts be treated and taxed as part of an estate. This revenue procedure provides the procedures and requirements for making the §646 election.**

**See Chapter 15**

Estate Tax Paid In Installments
Rev. Proc. 98-15

☞ **This revenue procedure provides procedures for estates of decedents dying before January 1, 1998, to make an election under §503(d)(2) of the Taxpayer Relief Act of l997. This §503(d)(2) election allows an estate to reduce the rate of interest on estate taxes deferred under §6166 of the Internal Revenue Code and forgo the deduction for interest paid on the deferred estate taxes under §§2053 and l63(h).**

**See Chapter 15**

LTR 9751003, August 28, 1997
National Office Technical Advice Memorandum
Code §2503

☞ **Annual gift tax exclusion not allowed for limited partnership gifts**



**Taxable gifts (Annual exclusion allowed versus not allowed); Present versus future interests.**

**Issue.** Do the gifts of limited partnership interests made by the Donor qualify for the annual exclusion provided for in §2503(b) of the Internal Revenue Code?

**Facts.** Donor is a widow with no children. Prior to the transactions described below, she owned several acres of land with a leased industrial building (Building 1), valued at approximately $2.4 million, and a second building (Building 2), valued at approximately $110,000.

- On December 30, 1991, when she was 71 years old, Donor gifted a one-eleventh interest in Building 2 to each of 11 family members. On January 1, 1992, the 11 family members reallocated their interests in Building 2 so that each of the four “family units,” representing Donor’s four siblings (one was deceased), owned a one-quarter interest in Building 2.
- On September 24, 1992, Donor set up an S corporation (Corporation) to which she transferred $9,800 in cash. Donor was the sole shareholder of Corporation. On September 25, 1992, Donor created 7 trusts, one each for the benefit of her 7 grandnieces and grandnephews who were minors. The initial corpus of each trust was $10.
- On December 22, 1992, the Donor formed the Limited Partnership under State’s revised limited partnership act. On December 31, 1992, all of the following occurred:

- Donor transferred a 94.77-percent interest in Building 1 to the Limited Partnership and received a 90.6-percent limited partnership interest. Donor transferred the remaining 5.23-percent interest in Building 1 to the Corporation. The Corporation transferred its 5.23-percent interest in Building 1 to the Limited Partnership and received a 5-percent general partnership interest. The 11 members of Donor's family who owned Building 2 transferred their 100-percent interest in Building 2 to the Limited Partnership and received, as a group, a 4.4-percent limited partnership interest.
- On the same day, Donor gifted a 29-percent limited partnership interest, in varying percentages, to 35 family members and trusts for the benefit of family members who were minors. Each of the four family units was given a total 7.25-percent interest. On the same day, five donees from one family unit, which consisted of ten donees, assigned a part or all of their gifted partnership interests to three other donees of the family unit–one adult and two trusts for minors.
- On March 10, 1993, the following occurred: The partners consented to the intra-family assignments of December 31, 1992. Donor gifted a 42-percent limited partnership interest, in varying percentages, to the same 35 family members and trusts for the benefit of family members who were minors. Each of the four family units was given a total 10.50-percent interest. Donor valued each 1-percent limited partnership interest at $9,900. The same five donees from the one family unit assigned a part or all or their gifted partnership interests to the same three donees within the family unit.
- In November 1993, Donor and Corporation made capital contributions to the Limited Partnership in the amounts of $283,027 and $14,896, respectively. The purpose of these contributions was to enable the Limited Partnership to purchase a tract of land. As a result of the contribution, Donor's limited partnership interest increased to 27.6 percent. Corporation remained the 5-percent general partner.
- On January 1, 1994, the following occurred: The partners consented to the intra-family assignments of March 10, 1993. Donor gifted her remaining 27.6-percent limited partnership interest, in varying percentages, to the 35 family members and trusts for the benefit of minor family members. Each of the four family units was given a total 6.90-percent interest. Donor valued each 1-percent limited partnership interest at $12,300. The same five donees from the one family unit assigned a part or all of their gifted partnership interests to the same three donees within the family unit.
- Following these transfers, members of Donor's family owned a 95-percent limited partnership interest and donor's wholly owned Corporation owned a 5-percent general partnership interest.
- **The Limited Partnership agreement contains the following provisions with respect to the limited partnership interests:**

**1. Concerning Distributions of Income**

**Sec. 5.1:** the General Partner may distribute funds of the partnership to the partners at such times and in such amounts as the General Partner, **in its sole discretion,** determines to be appropriate. Without limiting the generality of the foregoing, the General Partner shall have complete discretion to retain funds within the partnership for future partnership expenditures or **for any other reason whatsoever.** [Emphasis supplied.]

**2. Concerning withdrawal/return of capital contributions**

**Sec. 3.2:** [No right to withdraw or receive capital unless otherwise specified in the agreement.]

**Sec. 7.4:** No Limited Partner shall be entitled to . . . the return of its Capital Contributions except to the extent, if any, that distributions made pursuant to the express terms of this Agreement may be considered as such by law or upon dissolution and liquidation of the Partnership, and then only to the extent expressly provided for in the Agreement and as permitted by law.

**Sec. 7.4:** No Limited Partner shall be entitled to . . . withdraw from the Partnership except upon the assignment by it of all of its Partnership Interest in accordance with §10.2. [Emphasis supplied.]

**3. Concerning Transfers of the Interests**

**Sec. 10.2:** Except as provided in this article to the contrary, no Limited Partner's interest in the Partnership shall be assigned, mortgaged, pledged, subjected to a security interest or otherwise encumbered, in whole or in part, and any attempt by any Limited Partner to assign or otherwise encumber its interest shall be void ab initio. Notwithstanding the preceding sentence, [Donor] may, at any time and from time to time . . . transfer and assign her interest in the partnership by written instrument

**4. Concerning Substitution of Limited Partners**

**Sec. 10.3:** No person may become a Substituted Limited Partner except an assignee who complies with this §10.3. No assignee of a Partnership Interest of a Limited Partner or any portion thereof shall have the right to become a Substituted Limited Partner unless all of the following conditions are satisfied:

**a.** the assignor executes a written instrument of assignment together with such other instruments as the General Partner may deem necessary to effect the admission of the assignee as a Substituted Partner;

**b.** such instrument has been delivered to, received and approved in writing by the General Partner; and

**c.** the Super Majority Vote of the Partners **(which must also include the vote of the General Partner)** to such substitution has been obtained, the granting or denial of which shall be within the sole discretion of each Partner.

> A Super Majority Vote of the partners means (i) so long as Donor or her estate is a limited partner, a vote of Donor, or her estate, together with the vote of the partners holding at least 50 percent of the partnership interests held by partners other than Donor or her estate, or (ii) if neither donor nor her estate is a limited partner, a vote of the partners holding at least 67 percent of the partnerships interests.

At issue are the Donor's gift tax returns for the 1993 and 1994 tax years. In each year, Donor claimed an annual exclusion for each of the gifts of limited partnership interests made to the family members and trusts for the benefit of minor family members.

Under state law applicable in this case, a limited partnership interest is assignable in whole or in part, unless otherwise provided in the partnership agreement. A limited partner may withdraw only at the time specified in the agreement. Ordinarily, a general partner is a fiduciary with respect to the limited partners. See *McLendon v. McLendon,* 862 S.W.2d 662 (1993).

**Analysis.** In this case, the partnership agreement provides for income to be distributed to the limited partners in the "complete discretion" of the general partner. The general partner may retain funds within the partnership for future partnership expenditure. Further, the general partner may retain funds **for any reason whatsoever.** This provision for the general partner's retention of income "for any reason whatsoever" is extraordinary and outside of the scope of a business purpose restriction. **The provision effectively obviates the fiduciary duty ordinarily imposed upon a general partner, and clothes the general partner with the authority to withhold income for reasons unrelated to the conduct of the partnership.**

> Consequently, it was uncertain, at the time of the gifts, whether any income would be distributed to the limited partners. For this reason, the income component of the limited partnership interests failed to require, at the time of the gifts, that there be a steady and ascertainable flow of income to a donee/limited partner. Because the income component of the limited partnership interests did not entitle the donees to the immediate use, possession or enjoyment of the income, the income component was not a present interest for purposes of §2503(b).

The limited partnership interests also were subject to restrictions, contained in the limited partnership agreement, that prohibited certain actions that might otherwise be taken by limited partners. For example, under the agreement, the donees could not transfer or assign the gifted interests; nor could they withdraw from the partnership or receive a return of capital contributions until the year 2022.

Section 7.4 of the agreement provides that a Limited Partner may assign its partnership interest only in accordance with §10.2. It is clear from §10.2 that only the Donor could assign limited partnership interests. This being the case, §10.3 must be read to apply only to assignees of the Donor. The fact that all partners consented to the intra-family assignments of December 31, 1992, and March 10, 1993, does not void this provision of the partnership agreement.

In the present case, although title vested in the donees, the limited partnership interests lacked the tangible and immediate economic benefit required under §2503(b) for a present interest in property. See, e.g., *Hamilton v. United States,* 553 F.2d 1216 (9th Cir. 1977) [77-1 USTC ¶13,196]; *Berzon v. Commissioner,* 534 F.2d 528 (2d Cir. 1976) [76-1 USTC ¶13,140].

**Conclusion.** The gifts of limited partnership interests are gifts of **future interests** and, therefore, **do not qualify** for the annual exclusion under §2503(b).

# FICA TAX

Social Security Contribution and Benefit Base for 1998

Under authority contained in the Social Security Act ("the Act"), the Commissioner, Social Security Administration, has determined and announced (62 F.R. 58762, dated October 30, 1997) that the contribution and benefit base for remuneration paid in 1998, and self-employment income earned in taxable years beginning in 1998 is **$68,400.**

FICA and FUTA Taxation of Amounts under Employee Benefit Plans

Reg–209484–87
Reg–209807–95

☞ **This document contains a revision to the proposed regulations under §3121(v)(2) of the Internal Revenue Code of 1986, relating to when amounts deferred under or paid from certain nonqualified deferred compensation plans are taken into account as "wages" for purposes of the taxes imposed by the Federal Insurance Contributions Act (FICA). This document extends the proposed general effective date of the regulations to January 1, 1998. The extension also applies to the proposed regulations under §3306(r)(2), relating to when amounts deferred under or paid from certain nonqualified deferred compensation plans are taken into account as "wages" for purposes of the taxes imposed by the Federal Unemployment Tax Act (FUTA), due to the cross-reference therein to the provisions of the proposed regulations under §3121(v)(2).**

**Action.** Notice of proposed rulemaking.

**Explanation of Provisions.** Section 31.3121(v)(2)–1(g)(1)(i) of the proposed regulations provides that the proposed general effective date of the regulations is January 1, 1997. Because the final regulations have not been issued, **this document contains an amendment to the proposed regulations to extend the proposed general effective date to January 1, 1998.** This extension of the proposed general effective date also applies to §31.3306(r)(2)–1 of the proposed regulations due to the cross-reference therein to the provisions in the proposed regulations under §3121(v)(2).

Employment Taxes
Rev. Proc. 98-16

☞ **This revenue procedure sets forth generally applicable standards for determining whether service in the employ of certain public or private nonprofit schools, colleges, universities, or affiliated organizations described in §509(a)(3) of the Internal Revenue Code performed by a student qualifies for the exception from Federal Insurance Contributions Act (FICA) tax provided under §3121(b)(l0) of the Code (Student FICA exception). These standards are intended to provide objective and administrable guidelines for determining employment tax liability. The Student FICA exception standards were developed in response to requests for guidance by many public and private nonprofit institutions of higher education.**

## FORM 1040 ITEMS, SCHEDULE A

10

Charitable Donations Qualified Appraisal Requirement
I.R.C. §170

☞ **Because the taxpayers did not obtain a "qualified" appraisal for donated stock that was not publicly traded, their deduction was limited to their basis in their gifted stock.**

**Facts.** The taxpayers filed timely joint federal income tax returns for the taxable years 1990 and 1991. Attached to the 1990 return were Schedule A (Itemized Deductions), noting gifts to charity other than cash or check in the amount of $35,745, and Form 8283 (Noncash Contributions). In section B of Form 8283 (Appraisal Summary of $5000 or More Items), the taxpayers reported the donation of two blocks of stock valued at $26,000 and $7,000, respectively, which they reported as acquired by purchase on August 14, 1982, for $522 and $131, respectively, and for which they claimed deductions of $26,000 and $7,000, respectively.

Attached to their 1991 Form1040 were Schedule A, noting gifts to charity other than cash or check in the amount of $89,479, and Form 8283. In section A of Form 8283 (items of $5000 or less and certain publicly traded securities), they reported a contribution to the foundation of stock acquired by purchase on August 1, 1982, with a basis of $2,832 and a value of $48,000. They also reported a contribution to the church of stock acquired by purchase on August 1, 1982, with a basis of $3,057 and a value of $40,000.

**No section B (Appraisal Summary of $5000 or More Items) was attached.**

They did not obtain a qualified appraisal, as defined in §1.170A-13(c)(3), **Income Tax Regs.,** of the Jackson Hewitt stock they donated in 1990 and 1991. The fair market values claimed by them with respect to their gifts of Jackson Hewitt stock in 1990 and 1991 were based on the average per-share price of Jackson Hewitt stock traded in bona fide, arm's-length transactions at approximately the same time as they made the gifts.

**Issues.** Can the charitable deduction be denied by the IRS because a "qualified" appraisal was not attached to Form 8283?

**Discussion.** The taxpayers furnished practically none of the information required by either the statute or the regulations. Given the statutory language and the thrust of the concerns about the need of the IRS to be provided with appropriate information in order to alert the IRS to potential overvaluations, taxpayers simply do not fall within the permissible boundaries of *Bond v. Commissioner*, where an appraisal summary, which was completed by a qualified appraiser, contained most of the required information and could therefore be treated as a written appraisal, was attached to the return. *D'Arcangelo v. Commissioner* [Dec. 50,248(M)], T.C. Memo 1994-572.

We find nothing in *Bond v. Commissioner* that relieves the taxpayers of the requirement of obtaining a qualified appraisal. Such a requirement is statutorily imposed by §155(a)(1)(A), and its impact is reflected in the legislative history of that provision. See H. Conf. Rept. 98-861, at 995-996 (1984), 1984-3 C.B. (Vol. 2) 1, 249-250, stating:

> "pursuant to present law (§170(a)(1)), which expressly allows a charitable deduction only if the contribution is verified in the manner specified by Treasury regulations, no deduction is allowed for a contribution of property for which an appraisal is required under the conference agreement **unless the appraisal requirements are satisfied."**
>
> "For donations of property as to which the donor appraisal requirements apply, the donor **must** obtain and retain a qualified written appraisal by a qualified appraiser for the property contributed and must attach a signed appraisal summary to the return on which the deduction is first claimed (with such other information as prescribed by regulations)."

**Decision.** We hold that the taxpayers are not entitled to deduct amounts in excess of those allowed by the IRS for the contributions of Jackson Hewitt stock. [*Hewitt v. Commissioner,* 109 T.C. #12 (Oct. 29, 1997) [CCH Dec. 53, 326].]

## Overall Limitation on Itemized Deductions

☞ **For tax years beginning in 1998, the "applicable amount" of adjusted gross income, above which the amount of otherwise allowable itemized deductions is reduced, is $124,500 (or $62,250 for a separate return filed by a married individual).**

## FRINGE BENEFITS

Qualified Transportation Fringe
I.R.C. §132 (f)(2)(B)

☞ **For tax years beginning in 1998, the monthly limitation regarding the aggregate fringe benefit exclusion amount for transportation in a commuter highway vehicle and any transit pass, is $65. The monthly limitation regarding the fringe benefit exclusion amount for qualified parking is $175.**

## GROSS INCOME

Gross Income—Sales Award
I.R.C. §61

☞ **The taxpayer was required to report as taxable income the value of a sales award trip.**

**Facts.** Gregory Maslow and his wife, Marina, the taxpayers, did **not** file their 1988 through 1992 income tax returns until contacted by an IRS revenue agent in 1993. As a result, the taxpayers filed four delinquent returns for 1988 through 1992. The delinquent 1992 tax return was filed in November 1993. Mr. Maslow was a self-employed general agent for several life and health insurance companies. He received Forms 1099-MISC for his commission income. He received a 1992 Form 1099-MISC from Kentucky Central Life Insurance Co. in the amount of $7,220, which reported the fair market value of a trip to England he won as a sales award. **This $7,220 was omitted on his 1992 Schedule C.** Mr. Maslow contended the value of the trip was not includible as income because it was a "company conference" business trip.

Mr. Maslow deducted $8,013 for the 50% of his home that he claimed was used as his office. The home was owned by his father-in-law.



### Issues

1. Must the taxpayers include as income the $7,220 representing the market value of a trip earned by Mr. Maslow as a sales award?
2. Are the taxpayers entitled to deduct a home office expense of $8,013 on the 1992 Schedule C?
3. Are the taxpayers liable for the **accuracy-related penalty for negligence** under I.R.C. §6662(b)(1) and the **penalty for failure to timely file** their 1992 tax return under I.R.C. §6651(a)(1)?

### Discussion

Issue 1. Gross income includes **all income from whatever source derived** [I.R.C. §61(a)]. Gross income includes income realized in **any form, whether money, property, or services** [**Treas. Reg.** §1.61-1(a)].

Issue 2. I.R.C. §280A denies a deduction with respect to a home office unless the home office is **exclusively used on a regular basis** either (1) as the principal place of business; (2) as a place of business that is used to meet or deal with patients, clients, or customers, or; (3) in the case of a separate structure that is not attached to the home, in connection with the taxpayer's trade or business.

### Holding

Issue 1. The sales award, a trip to England, represents compensation for services. Hence, Mr. Maslow must include the $7,220 fair market value of the trip (**and not his estimate of what the trip was worth**) as business income for 1992.

Issue 2. The taxpayer failed to prove that the portion of his home claimed as an office expense was exclusively used on a regular basis either as the principal place of business or as a place used to meet clients. Instead, the record shows that Mr. Maslow **did not meet his clients at his home but rather conducted his insurance activities by traveling to the homes of his clients.** The record further indicates that he (1) **occasionally, but not regularly,** met other insurance agents at his residence, and (2) that he had an outside office for three months during 1992. Because the taxpayer did not satisfy the disallowance provisions of I.R.C. §280A, we sustain the disallowance of the claimed home office expenses.

**Practitioner Note.** Beginning in 1999 (for tax years beginning after December 31, 1998), the strict disallowance rules for home office expenses as mandated by the *Soliman* Supreme Court decision have been considerably relaxed. See the 1997 TRA chapter for details.

Issue 3. Regarding the penalty for failure to timely file a 1992 income tax return, no evidence was presented to establish that the delinquent filing was due to reasonable cause. Indeed, the evidence reveals that the **taxpayers knew they were required to file returns but did not do so until contacted by an IRS revenue agent.**

Regarding the 20% accuracy-related penalty attributable to negligence, we conclude that the taxpayers **failed to exercise due care that a reasonable prudent person would have exercised by:**

1. **failing to maintain adequate books and records,**
2. **failing to report the $7,220 sales award as income, and**
3. **overstating Schedule C deductions.**

Accordingly, we sustain the determination of the IRS that taxpayers are liable for both penalties for 1992.

[*Gregory A. and Marina Maslow v. Commissioner*, T.C. Memo 1997-446, 74 T.C.M. 910 (1997) [CCH Dec. 52,302(M)].]

Certain Cost-Sharing Payments

Rev. Rul. 97-55

☞ **The Wetlands Reserve Program, the Environmental Quality Incentives Program, and the Wildlife Habitat Incentives Program are substantially similar to the type of programs described in section 126(a)(1) through (8) of the Code so that cost-share payments made under such programs and in connection with small watersheds are within the scope of section 126(a)(9) and, thereby, cost-share payments received under the programs are eligible for exclusion from gross income to the extent permitted by section 126.**

Income from United States Savings Bonds for Taxpayers Who Pay Qualified Higher Education Expenses
I.R.C. §135

☞ **For tax years beginning in 1998, the exclusion regarding income from United States savings bonds for taxpayers who pay qualified higher education expenses, begins to phase out for modified adjusted gross income above $78,350 for joint returns and $52,250 for other returns. This exclusion completely phases out for modified adjusted gross income of $108,350 or more for joint returns and $67,250 or more for other returns.**

## INCOME IN RESPECT TO A DECEDENT

LTR 9829025, July 27, 1998
Sec. 691—Income in Respect of a Decedent
Tax Notes, July 27, 1998

☞ **Proceeds of like-kind exchange aren't IRD.**

The Service has ruled that a husband's share of the proceeds from a like-kind exchange is not income in respect of a decedent and that the wife is entitled to a **basis adjustment** for the properties received in the exchange.

A husband and wife transferred two properties to a grantor trust. Subsequently, they exchanged one of the properties in a like-kind exchange under §1031. Before they could exchange the second property, the husband died. Following the husband's death, the wife exchanged the second property in another §1031 exchange.

The Service ruled that the husband's share of the proceeds from the exchanges is **not a right to receive an item of income in respect of a decedent because the properties qualified for nonrecognition treatment under §1031.** In addition, it concluded that the husband owned one-half of the properties received in the exchange and the wife is **entitled to a basis adjustment** for the properties received in the exchange.



## INNOCENT SPOUSE

Innocent Spouse Relief
I.RC. §6013(e)

☞ **Spouse did not qualify for innocent spouse relief.**

**Preface to the Infelise Tax Court Memo case which immediately follows.** The following court case involves previous law pertaining to innocent spouse relief. See pages 54–61 of this book for the substantial revisions and liberalizations to innocent spouse relief made by the IRS Restructuring and Reform Act of 1998. The new law code section for innocent spouse relief is I. R. C. §6015 as added by the **1998 tax legislation.**

**Facts.** Ann Infelise, the taxpayer, married Ernest Infelise, a member of the Chicago organized crime family in 1981. Ernest Infelilse operated an extensive illegal gambling business that included sports bookmaking and card games. Shortly after their marriage, Ann Infelise attended a “going away party” for William Jahoda, the partner of her husband. Mr. Jahoda had been convicted of tax fraud and was sentenced to 2 years in federal prison. At the party, and in Ann Infelise’s presence, Ernest Infelise and Mr. Jahoda discussed how the gambling activities would be reorganized during his incarceration. This discussion was taped by the F.B.I.

During the four-year period 1983 through 1986, Mr. Infelise continued to operate the gambling activity. Mr. Infelise’s net profit from the gambling activity for the four years was:

| Year | Gambling Activity Net Profit |
|---|---|
| 1983 | $368,000 |
| 1984 | $135,000 |
| 1985 | $110,000 |
| 1986 | $265,000 |

This income was not reported on the 1983 and assessed through 1986 joint tax returns of the taxpayers. IRS determined and assessed substantial income tax deficiencies for the four years. During the four-year period, Mrs. Infelise was aware that IRS was investigating her husband’s gambling activity. In 1983, IRS special agents searched their residence and seized cash, a radio scanner, and gambling records. In 1992, Mr. Infelise was convicted for, among other things, the false filing of Federal income tax returns for 1983 through 1986.

**Issue.** Whether Mrs. Infelise is entitled to innocent spouse relief under I.R.C. §6013(e) for the years at issue.

**Discussion.** Generally, spouses who file joint returns are jointly and severally liable for the tax due. [I.R.C. § 6013 (d)(3)] **However,** Mrs. Infelise may be relieved from the general rule of joint and several liability if she establishes, by a preponderance of the evidence, each of the following requirements:

1. A joint return was filed;
2. on the return there is a substantial understatement of tax attributable to Mr. Infelise’s grossly erroneous items;
3. in signing the return, **she did not know, and had no reason to know, that there was a substantial understatement;** and
4. it would be inequitable to hold her liable [I.R.C. 6013(e)(1)].

**Holding.** Mrs. Infelise contends that she did not know that she and her husband had understated their income on their 1983–1986 joint returns. The evidence, however, strongly implies the opposite. Mrs. Infelise knew that her husband operated an extensive gambling business and that IRS agents had searched their home for, and in fact seized, gambling records.

Mrs. Infelise is a highly intelligent woman and **had reason to know that the joint returns she signed understated their income. Therefore, she is not entitled to relief from liability as an innocent spouse under I.R.C. §6013(e).** [*Ernest R. and Ann Infelise,* T. C. Memo 1998-191, 75 T.C.M. 2359 (1998) [CCH Dec. 52, 715(M)].]

# INSTALLMENT PAYMENTS OF TAX

Agreements for Payment of Tax Liability in Installments Notice of Proposed Rulemaking
Reg-100841-97

☞ **This document contains proposed regulations relating to terminations of agreements for the payment of tax liabilities in installments (installment agreements). The proposed regulations reflect changes made to §6159 of the Internal Revenue Code of 1986 (Code) by the Taxpayer Bill of Rights 2 (TBOR2). The proposed regulations provide a procedure for requesting an independent administrative review of an alteration, modification, or termination of an installment agreement.**

## Explanation of Provisions

Sections 201 and 202 of TBOR2 amended §6159 of the Code with respect to installment agreements. Section 201 provides that the Secretary may not alter, modify, or terminate an installment agreement unless notice of such action is given to the taxpayer at least 30 days before the action. The notice must explain why the Secretary intends to take the proposed action. Notice is not necessary if collection of the tax to which the installment agreement relates is in jeopardy.

Prior to the enactment of TBOR2, §6159 of the Code required notice only if the Internal Revenue Service intended to alter, modify, or terminate an installment agreement because of a change in the taxpayer's financial condition. Section 301.6159–1(c)(4) of the regulations that are being amended by this notice of proposed rulemaking, however, already requires 30 days notice whenever the IRS intends to alter, modify, or terminate any agreement, regardless of the reason for the action. **The only exception to this rule** is that no notice is required if collection of the tax to which the installment agreement relates is in jeopardy. In addition, existing paragraph (c)(4) requires the notice to explain the reason for the intended action. In light of existing paragraph (c)(4), the regulations do not have to be amended to reflect §201 of TBOR2.

Section 202 of TBOR2 provides that, upon request by a taxpayer, the Secretary shall provide an independent administrative review of the termination of an installment agreement. In addition, although the IRS rarely alters or modifies an installment agreement, the proposed regulations grant taxpayers the right to request an independent administrative review of alterations of modifications. **Procedures for requesting an independent administrative review are contained in the proposed regulations.**

When the Internal Revenue Service intends to terminate an installment agreement, it currently sends the taxpayer a written notice of its intent. The notice (1) informs the taxpayer why the Internal Revenue Service intends to terminate the agreement, (2) notifies the taxpayer that the Internal Revenue Service intends to levy the taxpayer's property, (3) explains that the taxpayer has a right to request an independent review of the Internal Revenue Service's decision, and (4) tells the taxpayer to call the telephone number listed on the notice within 30 days of the date of the notice if the taxpayer wishes to stay collection and request the Internal Revenue Service to **review its decision.**

If the taxpayer timely calls the telephone number listed on the notice, the employee attempts to resolve the case with the taxpayer. If the taxpayer and the employee are not able to resolve the case to the taxpayer's satisfaction, a **conference** is set up with a manager. If the manager and the taxpayer are unable to resolve the case, the manager forwards the case to **Appeals** for an independent administrative review. Absent jeopardy, collection action is stayed until the appeals officer has informed the taxpayer of a decision.

The proposed regulations provide that, if a taxpayer disagrees with a determination to alter, modify, or terminate an installment agreement, the taxpayer may initiate an independent administrative review of the determination by calling the telephone number listed on the notice within 30 days of the date of the notice. This will set the review process in motion.

## INTEREST AND APPLICABLE FEDERAL RATES

Imputed Interest
I.R.C. §7872

☞ **Taxpayer had to report imputed but unpaid interest on a demand loan but gets no offsetting deduction. The imputed interest is treated as a dividend when the borrowers are shareholders. However, the shareholders can deduct the imputed interest on their return.**

**Facts.** During the years in issue, the taxpayer corporation provided various services within the coatings industry, including consulting, engineering, inspection, and lab analysis. Kenneth B. Tator is the president of the corporation, and he and his wife (the Tators) are its sole shareholders.

In **1991 the Tators began two construction projects.** The **first project** involved the expansion of taxpayer's Pittsburgh headquarters, which the Tators owned and leased to the corporation. **The second project** involved the construction of a new office building in Houston, Texas, which the Tators would own and lease to the corporation.

The corporation was authorized by its board of directors to loan funds to the Tators for construction, the purchase of land, and other business purposes.

During the construction phase of the two projects, the corporation made over 100 advances of funds to the Tators. Each advance was executed by issuing a separate corporate check, and the Tators used the advances to pay contractors and meet other expenses. The advances were not subject to written repayment terms. On the corporate balance sheets, the taxpayer reported the advances as loans to shareholders. Monthly and year-to-date totals were recorded in two accounts entitled "Mortgage Receivable–Pittsburgh" and "Mortgage Receivable–Houston."

The Houston project was completed in October 1992, and the Pittsburgh project was completed in October 1993. **Upon the completion of each project, the Tators prepared an amortization schedule and began repaying the advances.** The amortization schedule for each project delineated monthly payments over 20 years at an interest rate of eight percent. The amortization schedule for the Houston project had a beginning principal balance of $400,218, and the amortization schedule for the Pittsburgh project had a beginning principal balance of $225,777.60.

On its 1992 and 1993 corporate income tax returns, the corporation **did not report interest income from the advances.** On September 27, 1995, the IRS issued a notice of deficiency. The IRS determined that the corporation, pursuant to §7872, had unreported interest income of **$30,718** for 1992 and **$5,225** for 1993.

**Issue.** Is the corporation required to report the unpaid interest on the loans?

**Discussion.** Section 7872 recharacterizes a below-market loan as an arm's-length transaction in which the lender made a loan to the borrower in exchange for a note requiring the payment of interest at a statutory rate. **As a result, the parties are treated as if the lender made a transfer of funds to the borrower, and the borrower used these funds to pay interest to the lender. The transfer to the borrower is treated as a gift, dividend, contribution of capital, payment of compensation, or other payment depending on the substance of the transaction. The interest payment is included in the lender's income and generally may be deducted by the borrower.**

Section 7872 applies to a transaction that is (1) a loan, (2) subject to a "below-market" interest rate, and (3) described in one of several enumerated categories. [I.R.C. §7872(c)(1), (e)(1), (f)(8)]. The parties agree that the third requirement has been met.

**A demand loan** is a below-market loan **if it is interest free or if interest is provided at a rate that is lower than the applicable Federal rate (AFR)** as determined under [I.R.C. §1274(d) §7872(e)(1)(A)].

If a demand loan is classified as a below-market loan, the lender has interest income (forgone interest) equal to the difference between (1) the interest that would have accrued on the loan using the AFR as the interest rate and (2) any actual interest payable on the loan [I.R.C. §7872(e)(2)]. The parties are treated as though, on the last day of each calendar year, the lender transferred an amount equal to the forgone interest to the borrower and the borrower repaid this amount as interest to the lender [I.R.C. §7872(a)].

**Decision.** During the construction phase of each project, the corporation made loans to the Tators. Prior to the completion of construction and the preparation of the amortization schedules, the Tators did not pay interest on these loans. **Therefore, we conclude that the loans are below-market demand loans.**

The corporation is subject to tax on the forgone interest but is **not entitled to a deduction** for the deemed distribution it made to the shareholder. Therefore, it has no deduction to offset the interest income from the loan. Similarly, the corporation **has interest income** but is not entitled to a deduction for the deemed distribution it made to the Tators corporation.

[*KTA-Tator, Inc. v. Commissioner*, 108 T.C. #18, (Mar. 11, 1997) [CCH Dec. 51,931].]

Interest Deduction
I.R.C.§163

☞ **Interest payment made from same Lender to whom the interest was owed was not deductible.**

**Summary:** The Tax Court upheld the Commissioner's disallowance of the Davisons' deduction of their allocable share of an interest payment made by a general partnership in which Charles H. Davison was a partner.

**Because the interest payment was made using funds borrowed from the same lender to whom the interest was owed, for the purpose of making that interest payment, the Tax Court concluded that the true effect of the transaction was to "postpone, rather than pay, the interest."**

Accordingly, the Tax Court held that the general partnership, and hence the Davisons, could not properly claim a deduction for "interest paid . . . within the taxable year on indebtedness."

**Holding:** The Court of Appeals affirmed the tax court's decision.

[*Davison v. Commissioner,* U.S. Ct. of Appeals, 2nd Cir; 98-1 USTC 83,673 [CCH ¶ 50,296].

10

Interest Rates
1998-25 I.R.B.

**☞ Table of IRS Interest Rates from Jan. 1, 1987–Present**

| | Overpayments Rate Table PG 1995-1 C.B. | Underpayments Rate Table PG 1995-1 C.B. |
|---|---|---|
| Jan. 1, 1987–Mar. 31, 1987 | 8% | 9% |
| Apr. 1, 1987–Jun. 30, 1987 | 8% | 9% |
| Jul 1, 1987–Sep. 30, 1987 | 8% | 9% |
| Oct. 1, 1987–Dec. 31, 1987 | 9% | 10% |
| Jan. 1, 1988–Mar. 31, 1988 | 10% | 11% |
| Apr. 1, 1988–Jun. 30, 1988 | 9% | 10% |
| Jul. 1, 1988–Sep. 30, 1988 | 9% | 10% |
| Oct. 1, 1988–Dec. 31, 1988 | 10% | 11% |
| Jan. 1, 1989–Mar. 31, 1989 | 10% | 11% |
| Apr. 1, 1989–Jun. 30, 1989 | 11% | 12% |
| Jul. 1, 1989–Sep. 30, 1989 | 11% | 12% |
| Oct. 1, 1989–Dec. 31, 1989 | 10% | 11% |
| Jan. 1, 1990–Mar. 31, 1990 | 10% | 11% |
| Apr. 1, 1990–Jun. 30, 1990 | 10% | 11% |
| Jul. 1, 1990–Sep. 30, 1990 | 10% | 11% |
| Oct. 1, 1990–Dec. 31, 1990 | 10% | 11% |
| Jan. 1, 1991–Mar. 31, 1991 | 10% | 11% |
| Apr. 1, 1991–Jun. 30, 1991 | 9% | 10% |
| Jul. 1, 1991–Sep. 30, 1991 | 9% | 10% |
| Oct. 1, 1991–Dec. 31, 1991 | 9% | 10% |
| Jan. 1, 1992–Mar. 31, 1992 | 8% | 9% |
| Apr. 1, 1992–Jun. 30, 1992 | 7% | 8% |
| Jul. 1, 1992–Sep. 30, 1992 | 7% | 8% |
| Oct. 1, 1992–Dec. 31, 1992 | 6% | 7% |
| Jan. 1, 1993–Mar. 31, 1993 | 6% | 7% |
| Apr. 1, 1993–Jun. 30, 1993 | 6% | 7% |
| Jul. 1, 1993–Sep. 30, 1993 | 6% | 7% |
| Oct. 1, 1993–Dec. 31, 1993 | 6% | 7% |
| Jan. 1, 1994–Mar. 31, 1994 | 6% | 7% |
| Apr. 1, 1994–Jun. 30, 1994 | 6% | 7% |
| Jul. 1, 1994–Sep. 30, 1994 | 7% | 8% |
| Oct. 1, 1994–Dec. 31, 1994 | 8% | 9% |
| Jan. 1, 1995–Mar. 31, 1995 | 8% | 9% |
| Apr. 1, 1995–Jun. 30, 1995 | 9% | 10% |
| Jul. 1, 1995–Sep. 30, 1995 | 8% | 9% |
| Oct. 1, 1995–Dec. 31, 1995 | 8% | 9% |
| Jan. 1, 1996–Mar. 31, 1996 | 8% | 9% |
| Apr. 1, 1996–Jun. 30, 1996 | 7% | 8% |
| Jul. 1, 1996–Sep. 30, 1996 | 8% | 9% |
| Oct. 1, 1996–Dec. 31, 1996 | 8% | 9% |

| | Overpayments Rate Table PG 1995-1 C.B. | Underpayments Rate Table PG 1995-1 C.B. |
|---|---|---|
| Jan. 1, 1997–Mar. 1, 1997 | 8% | 9% |
| Apr. 1, 1997–Jun. 30, 1997 | 8% | 9% |
| Jul. 1, 1997–Sep. 30, 1997 | 8% | 9% |
| Oct. 1, 1997–Dec. 31, 1997 | 8% | 9% |
| Jan. 1, 1998–Mar. 31, 1998 | 8% | 9% |
| Apr. 1, 1998–Jun. 30, 1998 | 7% | 8% |
| Jul. 1, 1998–Sep. 30, 1998 | 7% | 8% |

Rev. Rul. 97-41

## ☞ Applicable federal rates (AFR) for October 1997

*Period for Compounding*

| | Annual | Semiannual | Quarterly | Monthly |
|---|---|---|---|---|
| *Short-Term* | | | | |
| AFR | 5.84% | 5.76% | 5.72% | 5.69% |
| 110% AFR | 6.44% | 6.34% | 6.29% | 6.26% |
| 120% AFR | 7.03% | 6.91% | 6.85% | 6.81% |
| 130% AFR | 7.63% | 7.49% | 7.42% | 7.38% |
| *Mid-Term* | | | | |
| AFR | 6.34% | 6.24% | 6.19% | 6.16% |
| 110% AFR | 6.98% | 6.86% | 6.80% | 6.76% |
| 120% AFR | 7.63% | 7.49% | 7.42% | 7.38% |
| 130% AFR | 8.27% | 8.11% | 8.03% | 7.98% |
| 150% AFR | 9.58% | 9.36% | 9.25% | 9.18% |
| 175% AFR | 11.22% | 10.92% | 10.77% | 10.68% |
| *Long-Term* | | | | |
| AFR | 6.68% | 6.57% | 6.52% | 6.48% |
| 110% AFR | 7.36% | 7.23% | 7.17% | 7.12% |
| 120% AFR | 8.04% | 7.88% | 7.80% | 7.75% |
| 130% AFR | 8.72% | 8.54% | 8.45% | 8.39% |

Rev. Rul. 97-44

☞ **Applicable federal rates (AFR) for November 1997**

*Period for Compounding*

| | Annual | Semiannual | Quarterly | Monthly |
|---|---|---|---|---|
| *Short-Term* | | | | |
| AFR | 5.69% | 5.61% | 5.57% | 5.55% |
| 110% AFR | 6.27% | 6.17% | 6.12% | 6.09% |
| 120% AFR | 6.84% | 6.73% | 6.67% | 6.64% |
| 130% AFR | 7.42% | 7.29% | 7.22% | 7.18% |
| *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 | 6.42% | 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% |

Rev. Rul. 97-50

☞ **Applicable federal rates (AFR) for December 1997**

*Period for Compounding*

| | Annual | Semiannual | Quarterly | Monthly |
|---|---|---|---|---|
| *Short-Term* | | | | |
| AFR | 5.68% | 5.60% | 5.56% | 5.54% |
| 110%AFR | 6.25% | 6.16% | 6.11% | 6.08% |
| 120%AFR | 6.83% | 6.72% | 6.66% | 6.63% |
| 130%AFR | 7.41% | 7.28% | 7.21% | 7.17% |
| *Mid-Term* | | | | |
| AFR | 6.02% | 5.93% | 5.89% | 5.86% |
| 110%AFR | 6.63% | 6.52% | 6.47% | 6.43% |
| 120%AFR | 7.25% | 7.12% | 7.06% | 7.02% |
| 130%AFR | 7.86% | 7.71% | 7.64% | 7.59% |
| 150%AFR | 9.10% | 8.90% | 8.80% | 8.74% |
| 175%AFR | 10.65% | 10.38% | 10.25% | 10.16% |
| *Long-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% |

Rev. Rul. 98-4

## ☞ Applicable federal rates (AFR) for January 1998

*Period for Compounding*

| | Annual | Semiannual | Quarterly | Monthly |
|---|---|---|---|---|
| *Short-Term* | | | | |
| AFR | 5.70% | 5.62% | 5.58% | 5.56% |
| 110% AFR | 6.28% | 6.18% | 6.13% | 6.10% |
| 120% AFR | 6.85% | 6.74% | 6.68% | 6.65% |
| 130% AFR | 7.44% | 7.31% | 7.24% | 7.20% |
| *Mid-Term* | | | | |
| AFR | 5.93% | 5.84% | 5.80% | 5.77% |
| 110% AFR | 6.52% | 6.42% | 6.37% | 6.34% |
| 120% AFR | 7.13% | 7.01% | 6.95% | 6.91% |
| 130% AFR | 7.73% | 7.59% | 7.52% | 7.47% |
| 150% AFR | 8.95% | 8.76% | 8.67% | 8.60% |
| 175% AFR | 10.48% | 10.22% | 10.09% | 10.01% |
| *Long-Term* | | | | |
| AFR | 6.13% | 6.04% | 6.00% | 5.97% |
| 110% AFR | 6.75% | 6.64% | 6.59% | 6.55% |
| 120% AFR | 7.38% | 7.25% | 7.19% | 7.14% |
| 130% AFR | 8.00% | 7.85% | 7.77% | 7.72% |

Rev. Rul. 98-7

## ☞ Applicable federal rates (AFR) for February 1998

*Period for Compounding*

| | Annual | Semiannual | Quarterly | Monthly |
|---|---|---|---|---|
| *Short-Term* | | | | |
| AFR | 5.54% | 5.47% | 5.43% | 5.41% |
| 110% AFR | 6.11% | 6.02% | 5.98% | 5.95% |
| 120% AFR | 6.67% | 6.56% | 6.51% | 6.47% |
| 130% AFR | 7.24% | 7.11% | 7.05% | 7.01% |
| *Mid-Term* | | | | |
| AFR | 5.69% | 5.61% | 5.57% | 5.55% |
| 110% AFR | 6.27% | 6.17% | 6.12% | 6.09% |
| 120% AFR | 6.84% | 6.73% | 6.67% | 6.64% |
| 130% AFR | 7.42% | 7.29% | 7.22% | 7.18% |
| 150% AFR | 8.60% | 8.42% | 8.33% | 8.28% |
| 175% AFR | 10.06% | 9.82% | 9.70% | 9.62% |
| *Long-Term* | | | | |
| AFR | 5.93% | 5.84% | 5.80% | 5.77% |
| 110% AFR | 6.52% | 6.42% | 6.37% | 6.34% |
| 120% AFR | 7.13% | 7.01% | 6.95% | 6.91% |
| 130% AFR | 7.73% | 7.59% | 7.52% | 7.47% |

Rev. Rul. 98-11

## ☞ Applicable federal rates (AFR) for March 1998

*Period for Compounding*

| | Annual | Semiannual | Quarterly | Monthly |
|---|---|---|---|---|
| *Short-Term* | | | | |
| AFR | 5.39% | 5.32% | 5.29% | 5.26% |
| 110% AFR | 5.94% | 5.85% | 5.81% | 5.78% |
| 120% AFR | 6.48% | 6.38% | 6.33% | 6.30% |
| 130% AFR | 7.04% | 6.92% | 6.86% | 6.82% |
| *Mid-Term* | | | | |
| AFR | 5.59% | 5.51% | 5.47% | 5.45% |
| 110% AFR | 6.15% | 6.06% | 6.01% | 5.98% |
| 120% AFR | 6.72% | 6.61% | 6.56% | 6.52% |
| 130% AFR | 7.29% | 7.16% | 7.10% | 7.06% |
| 150% AFR | 8.44% | 8.27% | 8.19% | 8.13% |
| 175% AFR | 9.87% | 9.64% | 9.53% | 9.45% |
| *Long-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% |

Rev. Rul. 98-18

## ☞ Applicable federal rates (AFR) for April 1998

*Period for Compounding*

| | Annual | Semiannual | Quarterly | Monthly |
|---|---|---|---|---|
| *Short-Term* | | | | |
| AFR | 5.51% | 5.44% | 5.40% | 5.38% |
| 110%AFR | 6.07% | 5.98% | 5.94% | 5.91% |
| 120% AFR | 6.64% | 6.53% | 6.48% | 6.44% |
| 130% AFR | 7.19% | 7.07% | 7.01% | 6.97% |
| *Mid-Term* | | | | |
| AFR | 5.70% | 5.62% | 5.58% | 5.56% |
| 110% AFR | 6.28% | 6.18% | 6.13% | 6.10% |
| 120% AFR | 6.85% | 6.74% | 6.68% | 6.65% |
| 130% AFR | 7.44% | 7.31% | 7.24% | 7.20% |
| 150% AFR | 8.61% | 8.43% | 8.34% | 8.29% |
| 175% AFR | 10.08% | 9.84% | 9.72% | 9.64% |
| *Long-Term* | | | | |
| AFR | 5.98% | 5.89% | 5.85% | 5.82% |
| 110% AFR | 6.58% | 6.48% | 6.43% | 6.39% |
| 120% AFR | 7.19% | 7.07% | 7.01% | 6.97% |
| 130% AFR | 7.81% | 7.66% | 7.59% | 7.54% |

Rev. Rul. 98-23

## ☞ Applicable federal rates (AFR) for May 1998

*Period for Compounding*

| | Annual | Semiannual | Quarterly | Monthly |
|---|---|---|---|---|
| *Short-Term* | | | | |
| AFR | 5.50% | 5.43% | 5.39% | 5.37% |
| 110% AFR | 6.06% | 5.97% | 5.93% | 5.90% |
| 120% AFR | 6.63% | 6.52% | 6.47% | 6.43% |
| 130% AFR | 7.18% | 7.06% | 7.00% | 6.96% |
| *Mid-Term* | | | | |
| AFR | 5.69% | 5.61% | 5.57% | 5.55% |
| 110% AFR | 6.27% | 6.17% | 6.12% | 6.09% |
| 120% AFR | 6.84% | 6.73% | 6.67% | 6.64% |
| 130% AFR | 7.42% | 7.29% | 7.22% | 7.18% |
| 150% AFR | 8.60% | 8.42% | 8.33% | 8.28% |
| 175% AFR | 10.06% | 9.82% | 9.70% | 9.62% |
| *Long-Term* | | | | |
| AFR | 5.94% | 5.85% | 5.81% | 5.78% |
| 110% AFR | 6.54% | 6.44% | 6.39% | 6.36% |
| 120% AFR | 7.14% | 7.02% | 6.96% | 6.92% |
| 130% AFR | 7.75% | 7.61% | 7.54% | 7.49% |

Rev. Rul. 98-28

## ☞ Applicable federal rates (AFR) for June 1998

*Period for Compounding*

| | Annual | Semiannual | Quarterly | Monthly |
|---|---|---|---|---|
| *Short-Term* | | | | |
| AFR | 5.58% | 5.50% | 5.46% | 5.44% |
| 110% AFR | 6.14% | 6.05% | 6.00% | 5.98% |
| 120% AFR | 6.71% | 6.60% | 6.55% | 6.51% |
| 130% AFR | 7.28% | 7.15% | 7.09% | 7.05% |
| *Mid-Term* | | | | |
| AFR | 5.77% | 5.69% | 5.65% | 5.62% |
| 110% AFR | 6.36% | 6.26% | 6.21% | 6.18% |
| 120% AFR | 6.95% | 6.83% | 6.77% | 6.73% |
| 130% AFR | 7.54% | 7.40% | 7.33% | 7.29% |
| 150% AFR | 8.72% | 8.54% | 8.45% | 8.39% |
| 175% AFR | 10.21% | 9.96% | 9.84% | 9.76% |
| *Long-Term* | | | | |
| AFR | 6.02% | 5.93% | 5.89% | 5.86% |
| 110% AFR | 6.63% | 6.52% | 6.47% | 6.43% |
| 120% AFR | 7.25% | 7.12% | 7.06% | 7.02% |
| 130% AFR | 7.86% | 7.71% | 7.64% | 7.59% |

Rev. Rul. 98-33

## ☞ Applicable federal rates (AFR) for July 1998

*Period for Compounding*

| | Annual | Semiannual | Quarterly | Monthly |
|---|---|---|---|---|
| *Short-Term* | | | | |
| AFR | 5.56% | 5.48% | 5.44% | 5.42% |
| 110% AFR | 6.12% | 6.03% | 5.99% | 5.96% |
| 120% AFR | 6.69% | 6.58% | 6.53% | 6.49% |
| 130% AFR | 7.25% | 7.12% | 7.06% | 7.02% |
| *Mid-Term* | | | | |
| AFR | 5.68% | 5.60% | 5.56% | 5.54% |
| 110% AFR | 6.25% | 6.16% | 6.11% | 6.08% |
| 120% AFR | 6.83% | 6.72% | 6.66% | 6.63% |
| 130% AFR | 7.41% | 7.28% | 7.21% | 7.17% |
| 150% AFR | 8.58% | 8.40% | 8.31% | 8.26% |
| 175% AFR | 10.04% | 9.80% | 9.68% | 9.61% |
| *Long-Term* | | | | |
| AFR | 5.88% | 5.80% | 5.76% | 5.73% |
| 110% AFR | 6.48% | 6.38% | 6.33% | 6.30% |
| 120% AFR | 7.08% | 6.96% | 6.90% | 6.86% |
| 130% AFR | 7.68% | 7.54% | 7.47% | 7.42% |

## ☞ Applicable federal rates (AFR) for August 1998

*Period for Compounding*

| | Annual | Semiannual | Quarterly | Monthly |
|---|---|---|---|---|
| *Short-Term* | | | | |
| AFR | 5.48% | 5.41% | 5.37% | 5.35% |
| 110% AFR | 6.04% | 5.95% | 5.91% | 5.88% |
| 120% AFR | 6.60% | 6.49% | 6.44% | 6.40% |
| 130% AFR | 7.15% | 7.03% | 6.97% | 6.93% |
| *Mid-Term* | | | | |
| AFR | 5.57% | 5.49% | 5.45% | 5.43% |
| 110% AFR | 6.13% | 6.04% | 6.00% | 5.97% |
| 120% AFR | 6.70% | 6.59% | 6.54% | 6.50% |
| 130% AFR | 7.27% | 7.14% | 7.08% | 7.04% |
| 150% AFR | 8.41% | 8.24% | 8.16% | 8.10% |
| 175%AFR | 9.84% | 9.61% | 9.50% | 9.42% |
| *Long-Term* | | | | |
| AFR | 5.72% | 5.64% | 5.60% | 5.57% |
| 110% AFR | 6.30% | 6.20% | 6.15% | 6.12% |
| 120% AFR | 6.88% | 6.77% | 6.71% | 6.68% |
| 130% AFR | 7.46% | 7.33% | 7.26% | 7.22% |

Rev. Rul. 98-43

☞ **Applicable federal rates (AFR) for September 1998**

*Period for Compounding*

| | Annual | Semiannual | Quarterly | Monthly |
|---|---|---|---|---|
| *Short-Term* | | | | |
| AFR | 5.42% | 5.35% | 5.31% | 5.29% |
| 110% AFR | 5.98% | 5.89% | 5.85% | 5.82% |
| 120% AFR | 6.52% | 6.42% | 6.37% | 6.34% |
| 130% AFR | 7.08% | 6.96% | 6.90% | 6.86% |
| *Mid-Term* | | | | |
| AFR | 5.54% | 5.47% | 5.43% | 5.41% |
| 110% AFR | 6.11% | 6.02% | 5.98% | 5.95% |
| 120% AFR | 6.67% | 6.56% | 6.51% | 6.47% |
| 130% AFR | 7.24% | 7.11% | 7.05% | 7.01% |
| 150% AFR | 8.38% | 8.21% | 8.13% | 8.07% |
| 175% AFR | 9.80% | 9.57% | 9.46% | 9.38% |
| *Long-Term* | | | | |
| AFR | 5.74% | 5.66% | 5.62% | 5.59% |
| 110% AFR | 6.33% | 6.23% | 6.18% | 6.15% |
| 120% AFR | 6.91% | 6.79% | 6.73% | 6.70% |
| 130% AFR | 7.50% | 7.36% | 7.29% | 7.25% |

Abatement of Interest
Notice of Proposed Rulemaking
Reg-209276-87

☞ **This document contains proposed regulations relating to the abatement of interest attributable to unreasonable errors or delays by an officer or employee of the IRS in performing a ministerial or managerial act. The proposed regulations reflect changes to the law made by the Tax Reform Act of 1986 and the Taxpayer Bill of Rights 2 (TBOR2). The proposed regulations affect both taxpayers requesting abatement of certain interest and IRS personnel responsible for administering the abatement provisions.**

**Explanation of Provisions.** TBOR2 expanded the scope of abatement relief under §6404(e)(1). Consistent with congressional intent, the proposed regulations permit abatement of interest in more situations than under prior law. Nothing in the proposed regulations is intended to limit the extent to which the IRS could abate interest before the effective date of TBOR2.

The proposed regulations define managerial act and incorporate other changes made by TBOR2. TBOR2 did not alter the definition of ministerial act under prior law. Accordingly, the proposed regulations retain the definition of ministerial act in the temporary regulations.

Managerial act is defined as an administrative act that occurs during the processing of a taxpayer's case involving the temporary or permanent loss of records or the exercise of judgment or discretion relating to management of personnel. A decision concerning the proper application of federal tax law (or other federal or state law) **is not** a managerial act. Further, interest attributable to a general administrative decision, such as the IRS's decision on how to organize the processing of tax returns or its delay in implementing an improved computer system, **cannot** be abated under §6404(e)(1).

In addition, the proposed regulations provide **examples** to illustrate the definitions of ministerial act and managerial act. Examples 1, 2, 3, 7, and 8 of the proposed regulations are substantially similar to Examples 1 through 5 of the temporary regulations. However, in Example 3 of the proposed regulations (Example 4 of the temporary regulations), **a decision to approve extended training is a managerial act,** and in Example 8 of the proposed regulations (Example 5 of the temporary regulations) the type of work priority is specified.

The provisions of the regulations relating to a ministerial act apply to interest accruing with respect to deficiencies or payments of any tax described in §6212(a) for taxable years **beginning after December 31, 1978,** for which the applicable statute of limitations has not expired.

The provisions of the regulations relating to a managerial act are proposed to apply to interest accruing with respect to deficiencies or payments of any tax described in §6212(a) for taxable years beginning **after July 30, 1996.**

## MEDICAL SAVINGS ACCOUNTS, LONG-TERM CARE INSURANCE

Qualified Long-Term Care Insurance Contracts—Proposed Regulations
Reg-109333-97

☞ **This document contains proposed regulations relating to consumer protection with respect to qualified long-term care insurance contracts and relating to events that will be considered material changes with respect to long-term care insurance contracts issued prior to January 1, 1997. Changes to the applicable law were made by the Health Insurance Portability and Accountability Act of 1996. The regulations affect issuers of long-term care insurance contracts and individuals entitled to receive payments under these contracts. The regulations are necessary to provide these taxpayers with guidance needed to comply with these changes.**

# MINERALS, FUELS

Advance Ruling Procedure
Rev. Proc. 97-55

☞ **This revenue procedure sets forth the conditions under which the Internal Revenue Service will consider issuing an advance ruling that a right to mineral is a production payment as defined in §1.636-3(a) of the Income Tax Regulations.**

Marginal Production Rates
Notice 98-42

☞ **Applicable percentage for marginal production.**

Section 613A(c)(6)(C) of the Internal Revenue Code defines the term "applicable percentage" for purposes of determining percentage depletion for oil and gas produced from marginal properties. The applicable percentage is the percentage (not greater than *25* percent) equal to the sum of 15 percent, plus one percentage point for each whole dollar by which $20 exceeds the reference price (determined under §29(d)(2)(C)) for crude oil for the calendar year preceding the calendar year in which the taxable year begins. The reference price determined under §29(d)(2)(C) for the 1997 calendar year is $17.24.

Applicable percentages for marginal production for taxable years beginning in calendar years 1991 through 1998:

| Calendar Year | Applicable Percentage |
|---|---|
| 1991 | 15 percent |
| 1992 | 18 percent |
| 1993 | 19 percent |
| 1994 | 20 percent |
| 1995 | 21 percent |
| 1996 | 20 percent |
| 1997 | 16 percent |
| 1998 | 17 percent |



# MISCELLANEOUS

**TREASURY SECRETARY RUBIN** tells the Senate Finance Committee that a shift from the income tax to a consumption tax–whether flat or value-added–"would have little impact on the savings rate," contrary to claims by proponents. To boost savings, he backs such incentives as IRAs. [7-29-98, *The Wall Street Journal*, p. 1]

Rulings; obsolete
Rev. Rul. 98-37

☞ **A list is given of rulings under the jurisdiction of the Associate Chief Counsel (Domestic) that have been identified as no longer determinative.**

The Internal Revenue Service is continuing its program of reviewing rulings (including revenue rulings and revenue procedures) published in the Internal Revenue Bulletin to identify and publish lists of those rulings that, although not specifically revoked or superseded, **are no longer considered determinative because:** (1) the applicable statutory provisions or regulations have been changed or repealed; (2) the ruling position is specifically covered by a statute, regulation, or subsequent published position; or (3) the facts set forth no longer exist or are not sufficiently described to permit clear application of the current statute and regulations.

This revenue ruling publishes a list of rulings under the jurisdiction of the Associate Chief Counsel (Domestic) that have been identified under the Service's review program as no longer being determinative. The rulings are categorized by subject matter.

Accordingly, the rulings listed below are hereby declared obsolete.

## Entity Classification

| *Rev. Rul. No.* | *C.B. Citation* |
|---|---|
| 71-277 | 1971-1 C.B. 422 |
| 71-434 | 1971-2 C.B. 430 |
| 71-574 | 1971-2 C.B. 432 |
| 72-75 | 1972-1 C.B. 401 |
| 72-120 | 1972-1 C.B. 402 |
| 72-121 | 1972-1 C.B. 403 |
| 72-122 | 1972-1 C.B. 405 |
| 75-19 | 1975-1 C.B. 382 |
| 77-214 | 1977-1 C.B. 408 |
| 79-106 | 1979-1 C.B. 448 |
| 88-8 | 1988-1 C.B. 403 |
| 88-76 | 1988-2 C.B. 360 |
| 88-79 | 1988-2 C.B. 361 |
| 93-4 | 1993-1 C.B. 225 |
| 93-5 | 1993-1 C.B. 227 |
| 93-6 | 1993-1 C.B. 229 |
| 93-30 | 1993-1 C.B. 231 |
| 93-38 | 1993-1 C.B. 233 |
| 93-49 | 1993-2 C.B. 308 |
| 93-50 | 1993-2 C.B. 310 |

| Rev. Rul. No. | C.B. Citation |
|---|---|
| 93-53 | 1993-2 C.B. 312 |
| 93-81 | 1993-2 C.B. 314 |
| 93-91 | 1993-2 C.B. 316 |
| 93-92 | 1993-2 C.B. 318 |
| 93-93 | 1993-2 C.B. 321 |
| 94-5 | 1994-1 C.B. 312 |
| 94-6 | 1994-1 C.B. 314 |
| 94-30 | 1994-1 C.B. 316 |
| 94-51 | 1994-2 C.B. 407 |
| 94-79 | 1994-2 C.B. |
| 95-2 | 1995-I C.B. |
| 95-9 | 1995-1 C.B. |

### Other Guidance

| Rev. Rul. No. | C.B. Citation |
|---|---|
| 57-271 | 1957-1 C.B. |
| 74-77 | 1974-1 C.B. |
| 76-562 | 1976-2 C.B. |
| 83-113 | 1983-2 C.B. |
| 85-143 | 1985-2 C.B. |

| Rev. Proc. No. | C.B. Citation |
|---|---|
| 83-58 | 1983-2 C.B. |



## PASSIVE ACTIVITY

Passive Activities—Deduction of Losses
I.R.C. §469

☞ **The court found there was "material participation" for one rental property and not for another.**

**Facts.** George and Bozenna Pohoski, the taxpayers, owned two Hawaiian vacation condominiums, one on Maui and the other on Molokai. The Maui condo was rented for 22 weeks during 1993, with an average stay for a tenant of 6.5 days. The Molokai condo was rented for 5 weeks during 1993, with an average stay of 6.5 days. The taxpayers reported 1993 **net rental losses** of $17,641 for the Maui condo and $16,336 for the Molokai condo. Both rental losses were reported on separate 1993 Schedule Cs, on which the taxpayers **marked yes** to the **material participation question.**

The taxpayers contended that they spent 325.5 hours in various duties in 1993 regarding the rental of their Maui condo. They calculated 275.5 hours that they spent in 1993 regarding rental of the Molokai condo. The rental duties included taking phone calls from prospective tenants, making travel agents contacts preparing and revising web pages for the Internet, checking E-mail responses, and maintenance working done on the condos during the taxpayers' 14-day Hawaiian "working vacation."

The IRS argued that

1. the taxpayers **did not spend at least 100 hours** participating in the rental of **each** of the condos, and
2. other **individuals,** namely the maids and front-desk employees at the two Hawaiian resorts, **participated more** in the two rental activities **than did the taxpayers.**

Consequently, in the IRS's opinion, the two rental losses were **passive activity losses and were not deductible.**

**Issue.** Whether taxpayers **materially participated** in the rental of their two Hawaiian condominiums for purposes of the passive activity loss rules pursuant to I.R.C. §469(a).

**Discussion**

> According to I.R.C. §469(a), **a passive activity loss is generally not allowed as a deduction for the year sustained. Rental activity ordinarily is treated as a passive activity regardless of whether the taxpayer materially participates** [I.R.C. §469(c)(2)]. However, an **exception** to the general rule exists for **rentals in which the average rental period does not exceed 7 days** [**Treas. Reg.** 1.469-1T(e)(3)(ii)(A)].

The taxpayers contend that they **materially participated** in the rental of both the Maui and Molokai condos, **thus making I.R.C. §469(a) inapplicable. Material participation is defined as regular, continuous, and substantial involvement [I.R.C. §469(h)(1)].**

**Material Participation Safe Harbor provided by Treas. Reg.** §1.469-5T(a)(3). This regulation section provides for material participation if:

> The individual participates in the activity for **more than 100 hours during the taxable year, and such individual's participation is not less than the participation of any other individual (including individuals who are not owners of interests in the activity) for such year.**

**Holding.** We are satisfied that taxpayers participated in the rental of their Hawaiian condominiums on a regular, continuous, and substantial basis. However, we find the number of hours claimed by the taxpayers in rental activity duties excessive. We are mindful that both taxpayers were full-time employees, each working 40 hours per week in 1993. They were also managing their two California condominiums during 1993.

Using our best judgment, we find that taxpayers spent **between 200–250 hours** participating in the rental of their **Maui** condo **rather than the 325.5 hours** they claimed. We further find that taxpayers spent **less than 100 hours** participating in the rental of their **Molokai** condo **as opposed to the 275.5 hours** they claimed.

However, there still remains the question of the **amount of time spent by others** working on the rental of taxpayers' condominiums. We first consider the **Maui** condo. Based on court testimony, we believe that the front desk personnel spent approximately 5 to 10 minutes checking in a tenant for the taxpayer's **Maui** condo. We also find that the maid service spent an average of 2 to 3 hours cleaning the Maui condo after the departure of a tenant. It is evident that the time spent checking tenants in and out, the maid services, the managing of the rent collection and disbursements, and a few other tasks performed by the resort employees **did not exceed 200 hours during 1993, and certainly did not exceed the time spent by the taxpayers.**

In regards to the **Molokai** condo, we have already found that the **taxpayers participated less than 100 hours** during 1993. Thus, we hold that the taxpayers **did not materially participate in the rental of their Molokai condo during 1993.**

**In conclusion,** the $17,641 rental loss from the operation of the taxpayers' **Maui** condo during 1993 **is deductible.** The $16,336 rental loss from the operation of their **Molokai** condo is a **passive activity loss and is nondeductible** under I.R.C. §469(a).

[*George and Bozenna Pohoski v. Commissioner*, T.C. Memo 1998-17, 75 T.C.M. 1574 (1998) [CCH Dec. 52,520(M)].]

LTR 9742002, July 3, 1997
National Office Technical
Advice Memorandum
Code §469

☞ **Netting of passive activity gain explained.**

## Passive Activity Losses and Credits Limited

### Disposition of entire interest in passive activity

**Issue.** When a taxpayer disposes of a passive activity with current and suspended passive losses that exceed the gain on disposition, **and also has net passive income and net passive losses from other activities,** to what extent are the current and suspended passive losses from the disposed of activity offset with the net passive income from other activities before being treated as losses not from a passive activity under §469(g)(1)(A) of the Internal Revenue Code (the "Code")?

### Conclusion

When a taxpayer disposes of a passive activity with current and suspended passive losses that exceed the gain on disposition, the net passive income and net passive losses from all of the taxpayer's other passive activities should be netted **before any excess** passive income is applied against the current and suspended passive losses from the disposed of activities.

Any excess losses from the disposed of activity are treated as losses not from a passive activity under §469(g)(1)(A).

**Please note,** however, that it has been represented that the taxpayer in this case did not realize any gain on disposition of the passive activities. **To the extent that the taxpayer may have realized any gain on disposition, however, this disposition gain must first be applied against the current and suspended losses from the disposed of activities, before §469(g)(1)(A) is applied.**

# PERSONAL EXEMPTION AND FILING STATUS

Exemptions—Dependents
I.R.C. §151

☞ **Taxpayers were denied a dependency deduction for their daughter because they could not prove they provided over half of her support.**

**Facts.** Larry and Gloria Beard, the taxpayers, reported $9,367 of wages and $1,250 of gambling winnings on their joint 1992 tax return. After the IRS had initiated an examination of their return, they filed an amended 1992 return and reported an additional $3,377 of income earned from Mr. Beard's "sideline" drywall installation services. The taxpayers did **not** pay the self-employment tax on the $3,377 of drywalling services' net profit. **They claimed a dependency exemption for their 20-year-old daughter Jacqueline on their original 1992 tax return.**

The IRS **disallowed** Jacqueline's exemption and **assessed** the self-employment tax on the net profit from Mr. Beard's "sideline" drywalling services. The IRS contended that the taxpayers did not establish that they had provided **more than half of Jacqueline's support** during 1992.

Jacqueline was 20 years old at the close of 1992. She was a junior college student in 1992 and reported $5,183 of wages on her 1992 tax return. She resided in a college dorm for over eight months in 1992. Her parents, the taxpayers, provided Jacqueline with an occasional place of abode, some food, and perhaps some clothing. Jacqueline reimbursed her parents for her car insurance premiums and most of the cost of the clothes her parents bought for her.

### Issues

1. Whether the taxpayers are entitled to a dependency exemption for their daughter Jacqueline for 1992.
2. Whether the taxpayers are liable for self-employment taxes pursuant to I.R.C. §1401.

### Holding

Issue 1. **The taxpayers have not presented competent evidence to establish the total support provided to Jacqueline during 1992 and, of such total support, that more than half was provided by them.** Therefore, the IRS is sustained on this issue.

Issue 2.
The income earned by Mr. Beard from his "sideline" work installing drywall **is subject** to self-employment tax.

[*Larry J. and Gloria D. Beard v. Commissioner*, T.C. Memo 1998-110, 75 T.C.M. 2002 (1998) [CCH Dec. 52,627(M)].]

Filing Separate Returns
I.R.C. 6013

☞ **Taxpayers initially filed a joint return. Then they unsuccessfully tried to change their filing status after the due date of the original return.**

**Facts.** Taxpayers filed their married, filing jointly federal income tax return for 1994 on April 15, 1995. They subsequently filed amended, **separate returns** on May 9, 1995. Taxpayers' stated purpose for amending their 1994 tax return was to include dividend income and interest of $372.46 which was not reflected on the initial return. They also claimed a refund of $945.00 resulting from the change in their filing status **from joint to separate.**

The IRS disallowed Taxpayers' claim for refund because taxpayers had changed their filing status from joint to separate **after April 15, 1995, the due date of the return.**

**Holding.** Once taxpayers make the choice to file a joint return, they cannot undo this choice by filing separate returns **after the original time for filing has expired.** Pursuant to §7805, the Secretary of the Treasury promulgated **Treas. Reg.** §1.6013-1(a), stating in pertinent part: "for any taxable year with respect to which a joint return has been filed, separate returns shall **not be made** by the spouses after the time for filing the return for either has expired."

[*Neil v. U.S.A.*, U.S. Dist Ct., Okla; 97-2 USTC 89,809, [CCH par. 50,698]

Exemption
I.R.C. §151

☞ **Taxpayers were not allowed to claim a dependency deduction for their son.**

**Facts.** Paul Sengpiehl, the taxpayer, was a self-employed attorney. When he prepared the joint 1991 tax return for himself and his wife, June, he claimed a dependency exemption for his married son Jeffrey. **Jeffrey filed a joint return with his wife for 1991.** The IRS disallowed the exemption for Jeffrey.

Mr. Sengpiehl's law practice was conducted from his residence. On his 1991 Schedule C, he deducted home office expenses of $4,143 based on his calculation that the portion of the residence used for his office was 42 percent. The IRS recalculated an allowable home office deduction of $786 based on a 7 percent of square footage use for home office purposes.

Taxpayers contended that the dining room, living room, bathroom, first floor hallway, and a 272 square foot storage area of the basement were used exclusively for home office purposes in 1991. They also contended that half of the kitchen space was used for similar purposes.

**Issues**

1. Whether taxpayers are entitled to a dependency exemption for their married son Jeffrey; and
2. What portion of their residence qualifies for the home office deduction under IRC §280A.

**Discussion.** Issue 1. IRC §151(c)(2) provides that no deduction for a dependency exemption is allowed for any dependent **who filed a joint return with his or her spouse for the taxable year at issue.**



Issue 2. IRC §280A generally prohibits a deduction for business use of a taxpayer's residence. An exception to the general disallowance rule applies to a portion of the home that is exclusively used on a regular basis as the principal place of business for the taxpayer's trade or business.

**Holding.** Issue 1. The language of IRC §151(c)(2) is clear and unambiguous. Taxpayers' reliance on Form 1040EZ instructions which they allege allows parents to claim a dependency exemption for a married child is clearly incorrect. **We sustain the position of the IRS that the dependency exemption for their married son Jeffrey is not allowable.**

Issue 2. We find that the dining room, kitchen, bathroom and first floor hallway were not used exclusively for Mr. Sengpiehl's law practice business in 1991. Based on the evidence presented, we find that the living room and the 272 square foot basement storage area **do meet the exclusive use test.** Therefore, the $786 home office deduction allowed by the IRS is increased.

[*Paul M. and June S. Sengpiehl v. Commissioner,* T.C. Memo 1998-23, 75 T.C.M. 1604 (1998) [CCH Dec. 52,526(M)].]

Personal Exemption Phaseout
1997-52 I.R.B.

☞ **For tax years beginning in 1998, the personal exemption amount begins to phase out at, and is completely phased out after, the following adjusted gross income amounts:**

| Filing Status | Threshold Phaseout Amount | Completed Phaseout Amount After |
|---|---|---|
| Married Individuals Filing Joint Returns and Surviving Spouses | $186,800 | $309,300 |
| Heads of Households | $155,650 | $278,150 |
| Unmarried Individuals (Other than Surviving Spouses and Heads of Households | $124,500 | $247,000 |
| Married Individuals Filing Separate Returns | $93,400 | $154,650 |

## PROCEDURE, PENALTIES, TAX LIENS, LEVIES, AND EXAMINATIONS

Withholding Tax—100% Penalty
I.R.C. 6672

☞ **Taxpayer was not a responsible person subject to the penalty.**

**Facts.** Precision Corp. employed over fifty employees, approximately ten to fifteen in the administrative area and forty to fifty in manufacturing operations. The president and primary stockholder of Precision was, and still is, Ira Houseman.

Richard DeAlto, the taxpayer, was hired as the controller for Precision in December 1985 by Mr. Housman. As controller, he supervised an accounting staff whose duties included collecting and paying federal employment taxes and filing related tax forms. Taxpayer was promoted to vice president and general manager of Precision in April 1987. According to an interoffice memorandum from Mr. Housman, Taxpayer "will represent [Mr. Housman] at [Precision] when [Mr. Housman is] not present, with full authority to use his discretion and judgement [sic] over all matters."

Employers are obligated under the Internal Revenue Code (I.R.C.) to withhold Federal insurance contributions and income taxes from employee wages in trust for the United States. The company did not follow this rule. **Responsible persons who fail to fulfill obligations under these provisions are subject to assessment of a 100-percent penalty on any unpaid tax The IRS assessed the penalty against the taxpayer.**

**Issue.** Is taxpayer a "responsible person" subject to the tax penalty?

**Discussion.** In order to determine whether an individual is a responsible person, the court must look beyond formal titles and mechanical functions to search for the person or persons **with ultimate authority to expend funds.** See *Godfrey* [84-2 USTC ¶9974], 748 F.2d at 1575. More than one person within the corporation, however, can be "responsible." *See White* [67-1 ISTC ¶9250], 178 Ct. Cl. at 775, 372 F.2d at 518. In other words:

It is not necessary that an individual have the final word as to which creditors should be paid in order to be subject to liability under [§6672]. Rather it is sufficient that the person have significant control over the disbursement of funds.

Here, the taxpayer holds the titles of vice president and general manager. The fact that a person is a corporate officer alone, however, is **insufficient** to hold a person responsible for the failure to pay trust-fund taxes. *See Ghandour v. United States,* 36 Fed. Cl. 53, 60-61 (1996).

In this case the taxpayer did not control the voting stock. In fact, he was not a shareholder. He could not prevent the issuance of checks by withholding his signature. His control over payroll was no greater than whatever check-writing authority he had. In this case, therefore, check-signing authority will be crucial to consider.

**For practical purposes, therefore, the taxpayer's check-signing authority was exercised infrequently and fundamentally ministerial.**

**Holding.** Because we find he was not a responsible person, **the taxpayer is not subject to the 100% penalty** and is thus entitled to his refund. Assuming, arguendo, that the taxpayer were a responsible person, the facts indicate that very few, if any, payments were made willfully by him.

**[***Richard G. DeAlto v. IRS*, U.S. Ct. of Claims, 98-1 USTC 84, 187 [CCH par 50, 43.]

Disclosure on 1997 Tax Return
Avoiding Understatement of Income Tax
Rev. Proc. 97-56
I.R.C. §6662(d)

☞ **This revenue procedure identifies circumstances under which the disclosure on a taxpayer's 1997 return of a position with respect to an item is adequate for the purpose of reducing the understatement of income tax penalty under §6662(d).**

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 amounts disallowed under §163(d) unless Form 4952, Investment Interest Expense Deduction, is completed, or 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 or Business Expenses** (including the following six expenses as they relate to the rental of property):

   a. **Casualty and Theft Losses:** The procedure outlined 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 Debt 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 [1997 year].

   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 non-employee 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.

**Effective Date**

This revenue procedure applies to any return filed on 1997 tax forms for a taxable year beginning in 1997, and to any return filed on 1997 tax forms in 1998 for short taxable years beginning in 1998.

Penalty Relief for TIN Errors on 1996 and 1997 Forms 1099-R
Announcement 98-73

☞ **In early August, the Internal Revenue Service (IRS) will send certain filers of Form 1099-R (payers of distributions from pensions, annuities, retirement or profit-sharing plans, individual retirement accounts, insurance contracts, etc.) lists of payees whose taxpayer identification numbers (TINs) on 1996 Forms 1099-R filed with the IRS have been identified as missing or incorrect based on the IRS matching process.**

Most of these listings will be included with the Notice 972CG, but some will be sent separately. The law provides a penalty of $50 per return for filing an information return with a missing or incorrect TIN.

For 1996 and 1997, for the Forms 1099-R only, the IRS **will not assess** this TIN penalty, merely because the TIN has been identified as missing or incorrect based on the IRS matching process. In certain cases this penalty may be assessed after an examination of a payer's returns. Payers should use these listings to correct their records and perform necessary solicitations to obtain correct payee information to establish reasonable cause for any TIN penalties in future years.

The IRS will still send out proposed penalty notices for the 1996 Form 1099-R, as well as for other information returns, in early August to those who filed late or failed to file on magnetic media when required to do so.

## Questions & Answers on the Form 1099-R TIN Listing

**Q-1.** *Why is the IRS sending this listing?*

**A-1.** The IRS is sending this listing so that the payer can compare the data on it to the information in its records and then take steps to secure correct payee information so that future information returns may be filed accurately.

**Q-2.** *What is contained in this listing?*

**A-2.** This listing consists of the Forms 1099-R filed for Tax Year 1996 that have been identified as having missing or incorrect TINs based on the records of the IRS and the Social Security Administration (SSA).

**Q-3.** *When does the IRS consider a TIN to be missing or incorrect?*

**A-3.** A TIN is identified as missing if there is no entry in the TIN block of a Form 1099 or if the number is obviously incorrect. A number is obviously incorrect if, for example, it does not have nine characters or it includes alpha characters. A TIN is identified as incorrect if the name/TIN combination on a Form 1099 does not match the name/TIN combination found in IRS and SSA files.

**Q-4.** *What should be done with the information in the listing?*

**A-4.** The payer should compare the information in the listing with its records to identify accounts or records with the same name/TIN combination and account or other number (if provided). The IRS recommends that the payer contact these payees and ask them for the correct name/TIN combination that can be used on future information returns. Although a certified TIN is not required from these payees, the payer may use Form W-9, "Request for Taxpayer Identification Number and Certification," for this purpose. The payer should also check its records for errors (such as transposition of digits) so that the correct name/TIN combination can be used on any future information returns.

**Q-5.** *What should be done if the payer does not have a payee's TIN?*

**A-5.** The payer should comply with the TIN solicitation requirements in Regulations §301.6724-1(e). In addition, Federal income taxes should be withheld from any payments made to the payee that are designated distributions under Code section 3405. In the case of nonperiodic payments, a flat rate of 10% should be withheld on non-eligible rollover distributions. On eligible rollover distributions, the withholding rate of 20% should continue to be used. In the case of periodic payments, the payer should withhold using the wage withholding rates for a single taxpayer claiming zero (0) allowances.

**Q-6.** *What should be done if a payee refuses or neglects to provide a TIN?*

**A-6.** The payer should withhold under the provisions of Code §3405. See Q&A5.

**Q-7.** *What should be done if a payee provides the same name and TIN that was on the listing?*

**A-7.** The payer should continue to use the name and TIN provided and keep a copy on file of the documentation received from the payee.

**Q-8.** *What should be done if a TIN was actually on file but was left off the Form 1099 or reported incorrectly?*

**A-8.** The payer should make the change to its records and use the correct information on future filings.

**Q-9.** *Will the IRS impose a penalty under Code §6721 with respect to the information returns merely because a TIN is identified as missing or incorrect on this listing?*

**A-9.** No. In August 1998 (for Tax Year 1996), the IRS is providing this listing so that payers can obtain correct name/TIN information for use on any future Forms 1099-R filed. Incorrect name/TIN combinations and missing TINs on future Forms 1099-R filed may result in a penalty.

**Q-10.** *Is this listing a notification, under Code §3405(e)(12)(B), that the TIN furnished by the payee is incorrect?*

**A-10.** No. The informational listing provided in August 1998 will not be treated as a notice under Code §3405(e)(12)(B) that the TIN furnished by the payee is incorrect. In 1998 (for Tax Year 1996), the IRS is only providing this informational listing so that payers can contact these payees and obtain correct name/TIN information for use on future Forms 1099-R filed.

**Q-11.** *Where can I find additional information about the reasonable cause regulations and requirements for missing and incorrect name/TIN combinations?*

**A-11.** See Publication 1586, "Reasonable Cause Regulations and Requirements for Missing and Incorrect Name/TINs."

**Q-12.** *Since it is likely that Forms 1099-R for Tax Year 1997 have already been filed with the missing or incorrect information found on this listing, will penalty relief for 1997 also be granted?*

**A-12.** Yes. For Tax Year 1997, this relief will be granted for the TIN penalty for Forms 1099-R only.

**Q-13.** *Who should be called with any questions?*

**A-13.** The Information Reporting Program Centralized Call Site may be called at (304) 263-8700 (not a toll-free number) between 8:30 a.m. and 4:30 p.m. (EST). Payers may also access the Information Returns Program Bulletin Board using standard personal computing equipment at (304) 264-7070 (not a toll-free number).

## RETIREMENT PLANS, RETIREMENT INCOME, ROTH IRA

IRA-Tax-Free Rollover

I.R.C. §§402 and 408

☞ **The taxpayer rolled over amounts from qualified plans within the proper time frame but invested the distributions in another stock during the interval. The Tax Court found this was not a qualified rollover.**

**Facts.** As of December 1993, the taxpayer maintained Keogh accounts and IRAs with Green Point and Apple Bank for Savings (Apple). On December 14, 1993, his account balances in the Keogh accounts and IRAs at Green Point totaled $327,252 and those at Apple totaled $165,695. On December 14, 1993, he made the following withdrawals from his Keogh and IRA accounts (amounts rounded down to the nearest whole dollar):

| Bank | Amount | Type of Account |
|---|---|---|
| Green Point | $250,651 | Keogh |
| Green Point | 50,130 | Keogh |
| Green Point | 13,939 | IRA |
| Apple | 153,828 | Keogh |
| Apple | 6,377 | IRA |
| Apple | 5,489 | IRA |
| Total | $480,414 | |

Green Point and Apple withheld federal income tax from the distributions of $50,130 and $153,828, respectively, in the amounts of $12,532.58 and $30,765.62, respectively.

The taxpayer used the net Keogh and IRA distributions ($437,117) plus $12,883 of his own funds to pay the $450,000 purchase price of the GP Financial Corp. stock. On January 28, 1994, he received 25,193 shares of GP Financial Corp. stock, not the 30,000 shares as per the subscription agreement. The 25,193 shares (the stock) at $15 per share cost $377,895. On January 29, 1994, he received a stock purchase refund of $72,105 plus interest from Green Point.

On February 11, 1994, he opened an IRA with Smith Barney Shearson (the Smith Barney IRA). On February 11, 1994, **he deposited the stock into the Smith Barney IRA.**

He did not report any of the Keogh and IRA distributions on his 1993 Federal income tax return. He did claim a credit for the $43,298.20 in Federal income tax withheld by Green Point and Apple.

The IRS determined that all $480,414 of the 1993 distributions (the net amount distributed plus withholding) from the taxpayer's Green Point and Apple and Keogh accounts **were includable** in his 1993 income.

### Issue

1. Whether his use of distributions from Keogh and individual retirement accounts (IRAs) to purchase stock that was contributed to an IRA constitutes a tax-free rollover contribution.
2. Whether the taxpayer received a taxable distribution of money not contributed to an IRA.

**Discussion.** Whether the portions of the IRA and Keogh distributions used to purchase the stock are excludable from income turns on whether the respective rollover provisions of §§408(d)(3) and 402(c) require, since the distributions consisted of money, that the taxpayer transfer **money** to the Smith Barney IRA.

### Decision

Based on the language of the statutory provisions and the legislative histories of those provisions, the taxpayer's use of the distributions from his Keogh and IRAs to purchase stock which he then contributed to the Smith Barney IRA does not constitute a tax-free rollover contribution under §§402(c) or 408(d)(3), respectively. [*Lemi Show v. Commissioner*, 110 T.C. #11 (Feb. 18, 1998) [CCH Dec. 52,574].]

Lump Sum Payment—10-Year Averaging

I.R.C. §402

☞ **Lump sum payment did not qualify for 10-year averaging because it was not from a qualified plan.**

**Facts.** Harvey Nordin retired in April 1992 from the North Dakota Highway Department and received a lump sum distribution of $25,872.56 from the state employees' deferred compensation plan. It was reported on his W-2 as "wages, tips, other compensation" and the plan was designated as a "nonqualified plan." Nordin attempted to pay tax on the funds using a 10-year averaging method rather than as ordinary income in tax year 1992. The Internal Revenue Service (I.R.S.) disallowed the 10-year averaging method and Nordin paid the deficiency. Nordin filed an administrative refund claim which the I.R.S. denied. Nordin then commenced this action seeking a refund.

**Holding.** Eligibility for averaging is governed by U.S.C. §402(e). Under §402(e)(4)(A), lump sum distributions eligible for averaging must be: 1) paid within one taxable year of the employee's separation from service; 2) constitute the entire balance to the credit of the employee; 3) paid on account of his separation from service; and 4) **paid from a plan described in §401(a) or §403(a).**

Although the distribution to Nordin may satisfy the first three requirements of §402(e)(4)(A), **it does not satisfy the fourth requirement,** because his plan was not a plan described in either 401(a) or 403(a) (commonly referred to as a "qualified" plan); rather it was a §457 plan addressed in *Rheal v. Commissioner.*

[*Nordin v. IRS*, U.S. Dist. Ct. N.D.; 97-2 USTC 90,077; [CCH ¶ 50,769].]

Minimum Distribution Requirements
Notice 97-75

☞ **This notice provides guidance relating to the amendments to the minimum distribution requirements of §401(a)(9) of the Internal Revenue Code ("Code") made by §1404 of the Small Business Job Protection Act of 1996.**

### I. Purpose

- Answers questions regarding the actuarial increase that must be provided under a **defined benefit plan** for an employee who retires after age 70½, and the interaction of this actuarial increase with §411.
- Coordinates the §401(a)(4) nondiscrimination requirements with the §401(a)(9) requirement that certain preretirement distribution options be available to an employee at age **70½.**
- Permits plans to allow participants who commenced distributions under pre-SBJPA §401(a)(9) to stop receiving those distributions, and provides guidance on the applicable notice and spousal consent requirements.
- Clarifies the extent to which distributions made after 1996 to an employee who has attained age **70½** will be considered eligible rollover distributions under §402(c)(4)(B).
- Gives relief from the direct rollover requirements of §401(a)(31), the written explanation requirement under §402(f) and the mandatory 20-percent withholding requirement under §3405(c) for certain distributions made in 1997.
- Provides an optional rule under which an employee's required beginning date under pre-SBJPA §401(a)(9) may be retained.

### II. Questions and Answers

[See Notice 97-75]

Interim Guidance on Roth IRAs
Announcement 97-122

☞ **The Service is issuing two model Roth IRA Forms, 5305-R and 5305-RA, for use by trustees and custodians, respectively, beginning in 1998. In addition, the following interim guidance is provided for prototype sponsors and individual contributors to Roth IRAs established under §408A of the Internal Revenue Code in response to questions from the public.**

**See Chapter 15**



Eligible Deferred Compensation Plans Under Section 457
Notice 98-8

☞ **This notice provides guidance relating to the requirements applicable to eligible deferred compensation plans described in §457(b) of the Internal Revenue Code ("§457(b) plans"). Section 457 was amended by §§1447 and 1448 of the Small Business Job Protection Act of 1996, and more recently by §1071 of the Taxpayer Relief Act of 1997.**

Specifically, this notice provides guidance on:

- in-service distributions from a §457(b) plan if the total amount payable to the participant does not exceed $5,000;
- an additional election to defer commencement of distributions from a §457(b) plan;

- cost of living adjustments to the $7,500 limitation on maximum deferrals under a §457(b) plan; and
- the trust requirements: applicable to state and local government employers maintaining a §457(b) plan, including the requirements for custodial accounts and annuity contracts.

SIMPLE IRA Plan Guidance
Notice 98-4

☞ **This notice modifies and supersedes Notice 97-6, 1997-2 I.R.B.26, relating to SIMPLE IRA Plans described in §408(p).**

**See Chapter 13–Retirement**

Minimum Distribution Requirements
Notice 97-75

**Purpose** This notice provides guidance relating to the amendments to the minimum distribution requirements of §401(a)(9) of the Internal Revenue Code ("Code") made by §1404 of the Small Business Job Protection Act of 1996. Specifically, this notice:

- Answers questions regarding the actuarial increase that must be provided under a defined benefit plan for an employee who retires after age 70½, and the interaction of this actuarial increase with §411.
- Coordinates the §401(a)(4) nondiscrimination requirements with the §401(a)(9) requirement that certain preretirement distribution options be available to an employee at age 70½.
- Permits plans to allow participants who commenced distributions under pre-SBJPA §401(a)(9) to stop receiving those distributions, and provides guidance on the applicable notice and spousal consent requirements.
- Clarifies the extent to which the distributions made after 1996 to an employee who has attained age 70½ will be considered eligible rollover distributions under §402(c)(4)(B).
- Gives relief from the direct rollover requirements of §401(a)(31), the written explanation requirement under §402(f) and the mandatory 20-percent withholding.
- Provides an optional rule under other language.

Roth IRA Guidance
Notice 98-49

☞ **This notice provides guidance relating to Service-approved Roth IRA documents and IRA reporting requirements. In addition, this notice summarizes a number of recent changes in the law governing all IRAs, which affect Notice 87-13, 1987-1 C. B. 432, and Notice 87-16, 1987-1 C. B. 446.**

**See Chapter 15**

Roth IRAs—Proposed Regulations

**See Chapter 15**

IRA Rollover Permitted—Decedent's Estate
LTR 9826055, April 2, 1998
Code §408

☞ **IRA rollover permitted–Decedent's estate.**

## Individual retirement accounts

### Distributions.

- Decedent A died on Date X at Age R. At the time of his death, Decedent A left Will W. In Will W, Decedent A appointed Individual B, his spouse, as his personal representative.
- The major asset of Decedent A's probate estate is IRA C which on Date X was valued at Dollar Y. The beneficiary of IRA C is Decedent A's estate. Article Six, entitled RESIDUARY ESTATE OF WILL W, gives Decedent A's entire residuary estate to Individual B. IRA C is a part of Decedent A's residuary estate.
- Individual B has not taken any distribution from IRA C nor exercised any right to withdraw. Individual B will turn age 70½ during the 1998 calendar year. Individual B proposes to roll over the proceeds of IRA C into an individual retirement account established in Individual B's name within 60 days of receipt of IRA C proceeds.
- Based on the above facts and representations, you request the following rulings:

1. Provided that the 60-day time period is met as defined in §408(d)(3)(A) of the Code, Individual B, as the surviving spouse of Decedent A and the sole beneficiary of Decedent A's residuary estate, **may roll over the proceeds of Decedent A's IRA into Individual B's own IRA** under the spousal roll over rules contained in §408 without including the distribution into income by Individual B.
2. After the rollover of the proceeds in Decedent A's IRA to Individual B's IRA, Individual B will treat the proceeds **as part of Individual B's IRA** for the purpose of timing the required distributions described in §401(a)(9) of the Code.

Based on the foregoing, we conclude with respect to the **first ruling request** that provided that the 60-day time period is met as defined in §408(d)(3)(A) of the Code, Individual B, as the surviving spouse of Decedent A and as sole beneficiary of Decedent A's residuary estate, may roll over the proceeds of Decedent A's IRA into an IRA established by Individual B in her own name under the spousal roll over rules contained in §408 without including the distribution into income by Individual B.

**With respect to the second ruling request,** we conclude that after the rollover of the proceeds in Decedent A's IRA to an IRA established by Individual B in her own name, Individual B will treat the proceeds as her own for the purpose of timing the required minimum distributions described in §401(a)(9) of the Code.

These rulings are based on the assumption that Decedent A's IRA and the IRA that will receive the rollover amounts satisfy the requirements of §408(a) of the Code at all times during the transaction, and that the transfer from Decedent A's IRA to an IRA established by Individual B in her own name will meet all the applicable requirements of §408(d)(3).

LTR 9831032, May 7, 1998

Code §408

☞ **IRA Rollover Permitted–Decedent's Estate**

### Individual retirement accounts

- Individual B died on June 3, 1997. At the time of his death, Individual B owned IRA D, which had an account balance of approximately $1,650,000.
- Taxpayer A is Individual B's surviving spouse. When IRA D was established in 1985, Individual B designated Taxpayer A as the primary beneficiary. He did not name a secondary or contingent beneficiary of IRA D. However, on May 16, 1992, he executed a beneficiary designation form naming "my estate" as the primary beneficiary of IRA D. The estate includes IRA D. However, no funds from IRA D have been distributed to the estate or otherwise.
- Under Item V of Individual B's will, Individual C, son of Individual B and Taxpayer A, is executor of Individual B's estate. The executor is given complete power and discretion in the management and control of the estate. The trustee is authorized to make all tax returns which may be required and to pay out of the trust funds any taxes which are properly or necessarily payable. The trustee is further authorized to pay from the trust funds such other charges and expenses as are necessary and proper in the management of the trust, including reasonable compensation to counsel, accountants, and agents employed by him.
- Under Item IV of Individual B's will, Taxpayer A inherits the residue of Individual B's estate.
- Under Item VI of Individual B's will, taxes and related items are to be paid and discharged in full out of Individual B's residuary estate.
- Taxpayer A proposes to roll over the proceeds from IRA D to her own IRA. Taxpayer A has made no other rollover contributions to an IRA during the last 12 months.
- **Based on these facts and representations, you request a ruling that Taxpayer A may roll over the proceeds from IRA D to an IRA to be established by Taxpayer A in her own name without the rollover being taxable in the year of such rollover to either Taxpayer A or Individual B's estate.**

**Holding.** Based on the foregoing facts and representations, we conclude with respect to your ruling request that under the spousal rollover rules of §408 of the Code, the rollover by Taxpayer A, as sole beneficiary of Individual B's estate, of the proceeds of IRA D (net of any liabilities belonging to Individual B's estate with respect to IRA D) to an IRA established in Taxpayer A's own name **will not be** taxable in the year of such rollover to either the estate of Individual B or to Taxpayer A if rolled over within 60 days of the day after the date of distribution to the estate.

This letter ruling is based on the assumption that IRA D satisfied the requirements of §408(a) of the Code at all relevant times. In addition, this letter ruling is based on the assumption that the IRA set up by Taxpayer to receive her rollover will meet the requirements of §408(a).

Railroad Retirement

I.R.C. §3221

☞ **Railroad retirement; rate determination; quarterly. The Railroad Retirement Board has determined that the rate of tax imposed by section 3221 of the Code shall be 35 cents for the quarter beginning April 1, 1998, and 35 cents for the quarter beginning July 1, 1998.**

Deferred Compensation Plans
Rev. Proc. 98-40

☞ **This Revenue Procedure describes the conditions under which the sponsor of an eligible deferred compensation plan under §457(b) of the Internal Revenue Code may obtain a ruling from the Service that takes into account changes made by the Small Business Job Protection Act of 1996 ("SBJPA") and the Taxpayer Relief Act of 1997("TRA '97").**

## RETURN PREPARERS

**ARTHUR ANDERSEN WINS a closely watched Texas showdown.** The big Chicago-based accounting firm says Texas has dropped charges that it engaged in the unauthorized practice of law in the state. The battle revolved around tax-advisory services that have been offered traditionally by both accountants and lawyers. The fight drew close attention because of growing rivalries and turf battles between major accounting and law firms.

The Andersen investigation has been "terminated" and the complaint "dismissed," said a letter from Scott A. Dyche of the Dallas subcommittee of the Supreme Court of Texas's Unauthorized Practice of Law Committee. John Niemann, head of Andersen's tax practice in Texas, says the panel's decision "struck a blow for freedom of choice in tax advisers." Earlier this year Deloitte & Touche said it received an "inquiry" from a Texas panel on this subject. The firm says it doesn't engage in the unauthorized practice of law anywhere, and that it won't comment further "while this matter is part of an active inquiry." [7-29-98, *The Wall Street Journal*, p. 1.]

LTR 9821038, February 19, 1998
Code §6695

☞ **Tax Return Preparer–Manual Signing Requirement**

### Other Assessable Penalties with Respect to the Preparation of Income Tax Return for Other Persons

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This is in response to your request made on behalf of P for a letter ruling concerning the use of new technologies to eliminate paper records. This letter ruling will address only the specific issue of whether the Service will permit P to electronically image paper copies of income tax returns that bear the manual signatures of the income tax return preparers, and then destroy the paper copies of the income tax returns.

- **P** is a professional services firm with a tax compliance practice. **P** is pursuing the use of new technologies to achieve a paperless office. As part of this effort, **P** proposes to create electronic client files that would include clients' income tax returns. With regard to the income tax returns prepared by **P**'s return preparers, **P** made the proposal described below.
- An income tax return preparer (return preparer) would manually sign, as prescribed in the appropriate income tax form instructions, a paper copy of an income tax return (return) prepared for a client. **P** will then electronically image this paper copy of a prepared return manually signed by the return preparer and electronically store the return image in the client's electronic file. **P** represents that the imaging process, including storage and retrieval, would be done in a manner consistent with Internal Revenue Service (Service) guidance for electronic storage, in accordance with **Rev. Proc.** 97-22, 1997-13 I.R.B. 9, which provides guidance regarding the electronic storage of books and records. **P** would then destroy the paper copy of the return that the return preparer had manually signed.

- In order to provide a client with a return, **P** would access the client's electronic file and print a paper copy of the electronically stored return, including an electronic image of the return preparer's manual signature. **P**'s client would sign this return and file the return with the Service.
- **P** intends that the imaged return electronically stored in **P**'s client file would meet the requirement in **§1.66951(b)(4)(i)** of the **Income Tax Regulations** that if a return preparer does not manually sign the return presented to the taxpayer for the taxpayer's signature, the return preparer must keep a manually signed copy of the return.
- Section 7701(a)(36)(A) of the Internal Revenue Code provides that, in general, the term "income tax return preparer" means any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by subtitle A (Income Taxes) or any claim for refund of tax imposed by subtitle A. For purposes of the preceding sentence, the preparation of a substantial portion of a return or claim for refund shall be treated as if it were the preparation of such return or claim for refund.
- Section 6695(b) of the Code provides that any person who is an income tax return preparer with respect to any return or claim for refund, who is required by regulations prescribed by the Secretary to sign such return or claim, and who fails to comply with such regulations with respect to such return or claim shall pay a penalty of $50 for such failure, unless it is shown that such failure is due to reasonable cause and not due to willful neglect. The maximum penalty imposed under this subsection on any person with respect to documents filed during any calendar year shall not exceed $25,000.
- Section 1.66951(b)(4)(i) of the regulations provides, in part, that unless the Secretary has prescribed another method of signing pursuant to §301.6061-1(b) of this chapter on or after July 21, 1995, an individual who is an income tax return preparer with respect to a return of tax or claim for refund of tax shall manually sign the return or claim for refund (which may be a photocopy) in the appropriate space provided on the return or claim for refund after it is completed and before it is presented to the taxpayer (or nontaxable entity) for signature.
- Section 1.6695-1(b)(4)(i) of the regulations provides, in part, that the manual signature requirement of (b)(1) of §1.6695-1 may be satisfied by a photocopy of a copy of the return or claim for refund which copy is manually signed by the preparer after completion of its preparation. The employer of the preparer or the partnership in which the preparer is a partner, or the preparer (if not employed or engaged by a preparer and not a partner of a partnership which is a preparer), shall retain the manually signed copy of the return or claim for refund.
- **Rev. Rul.** 78-370, 1978-2 **C.B.** 355, permits a return preparer to sign a return it prepared, photocopy the signed return, and present the photocopied return to the taxpayer for the taxpayer to sign and file with the Service. By following this procedure, the photocopy of the prepared return that the taxpayer signs and files becomes the original return. The return signed by the preparer becomes a copy of the return signed and filed by the taxpayer. The return preparer must now keep the manually signed copy of the return for the three-year period following the close of the return period during which the return was presented for signature to the taxpayer.
- If a return preparer chooses not to provide a manual signature on the return presented to a taxpayer for the taxpayer's signature, the return preparer must keep a manually signed copy of the return presented to the taxpayer for signature. See §1.6695-1(b)(4)(i) of the regulations. A return preparer who images a manually signed copy of a return and then destroys the manually signed copy of the return no longer has a manually signed copy of the return as §1.6695-1(b)(4) requires. Such a return preparer has only an image of a manually signed copy of a return.

Accordingly, for federal income tax purposes, **P will not meet** the §6695(b) requirement to sign a return if **P** does not either manually sign the return presented to the taxpayer for the taxpayer's signature or **keep a manually signed copy** of the return presented to the taxpayer for signature.

# SALES AND EXCHANGES, PRINCIPAL RESIDENCE ISSUES

Tax-Deferred Exchanges
I.R.C. §1031

☞ **Taxpayers did not meet the timing requirements of I.R.C. §1031. The exchange was taxable.**

**Facts.** The taxpayers entered into a tax deferred exchange **but did not acquire the exchange property before the due date of their 1988 tax return,** which was earlier than 180 days after they transferred their rental property. In addition, they did not request or receive an extension of time to file their 1988 return. The Commissioner of Internal Revenue determined that the taxpayers' exchange did not qualify as a like-kind exchange because it did not satisfy the time limits prescribed by §1031(a) As a result, the Commissioner assessed a deficiency. In response, the taxpayers filed suit in tax court. **The tax court agreed with the Commissioner and entered a decision of deficiency in tax of $218,789 for 1989.**

**Discussion.** In general, the gain or loss on the sale or exchange of property is taxable [§1001]. One notable exception to this rule is §1031 which provides for the nonrecognition of gain or loss in the case of like-kind exchanges of property held for productive use in a trade or business or for investment. Thus, a taxpayer can avoid recognition of gain when he continues his investment in qualifying property.

In 1984, Congress amended §1031 to limit the circumstances in which a deferred exchange could qualify for nonrecognition. Congress was motivated in part by a concern that the law did not require that a like-kind exchange be completed within a specified period. [See H.R. Conf. Rep. No. 98-861, at 866 (1984).] The amended §1031(a)(3) provides:

**3.** Requirement that property be identified and that exchange be completed not more than 180 days after transfer of exchanged property. For purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if

**A.** such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

**B.** such property is received **after the earlier of–**

- **i.** the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or
- **ii.** the due date (determined with regard to extension) for the transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs.

This amendment imposed clear time requirements on any proposed like-kind exchange.

**Holding.** We conclude that the taxpayers did not satisfy the requirements for a like-kind exchange under 26 U.S.C. §1031. Thus, the judgment of the tax court is affirmed.

[*Christensen v. Commissioner, U.S. Ct of Appeals, 9th Circuit;* For a similar result, see *Knight v. Commissioner.* 98-1 USTC 83, 922 [CCH ¶ 50, 352].]

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Use of Home as Primary Residence
I.R.C. 3121

☞ **Facts and circumstances test used by court to determine if taxpayer used her residence for three of five years prior to sale.**

**Facts.** Hulda V. Gummer (over age 55), owned and resided in a home in Santa Rosa California (hereinafter "the Santa Rosa residence") for approximately 22 years prior to her relocating to a rented apartment in Reno, Nevada, on or about October 1, 1990. **The Santa Rosa residence had been listed for sale on or about March 1, 1990, approximately seven months prior to plaintiff's relocation to Reno.**

Gummer alleges that a subsequent decline in the local real estate market conditions frustrated efforts to sell the house despite her and her real estate agent's best efforts to find a buyer. She eventually sold the Santa Rosa residence on June 24, 1994, for $420,000. The depressed real estate market allegedly caused numerous reductions in the original $690,000 list price for the residence.

She alleges that she was over 55 years of age at the time of sale and otherwise eligible to exclude recognition of $125,000 of the gain from the sale of the Santa Rosa residence under I.R.C. section 121.

Gummer alleges that she physically occupied the Santa Rosa residence for approximately one year, six months and five days during the five-year period preceding the date the house was sold.

On the advice of her realtor that a well-maintained, lived-in house is easier to show than a vacant house, plaintiff had her adult grandchildren reside in the house for approximately one and one-half years while the house was on the market.

In addition, she kept a substantial amount of her furniture in the house to maintain a "lived in" appearance. Plaintiff alleges that while the house was listed, she continuously believed that a sale was "imminent."

IRS claimed she did not meet 3 of 5 residence requirements of I.R.C. §121.

**Issue.** Did she, under these facts, meet the test?

**Discussion.** In establishing whether a taxpayer has satisfied the requirement of [three] years of use, short temporary absences such as for vacation or other seasonal absence (although accompanied with rental of the residence) are counted as periods of use.

Whether or not property is used by the taxpayer as her residence, and whether or not property is used by the taxpayer as her principal residence (in the case of a taxpayer using more than one property as a residence), **depends upon all the facts and circumstances in each case,** including the good faith of the taxpayer.

Cases interpreting whether property is "used" as a "principal residence" under §1034 **do not always require strict physical occupancy,** but rather analyze whether the facts and circumstances surrounding any absence still entitle the party to a finding that the old property was used as a principal residence.

**Holding.** The court finds as a matter of law that whether the property is "used as a principal residence" for the requisite three out of five years pursuant to I.R.C. §121 does not depend solely on physical occupancy and instead will be determined under a "facts and circumstances" analysis. The court notes that the analysis will focus upon all facts and circumstances, including the taxpayer's good faith, surrounding whether the property was "used" as the taxpayer's "principal residence" for the purposes of §121. **Taxpayer here meets the test.**

[*Hulda V. Gummer v. U.S.*, U.S. Ct. of Claims, 98-1 USTC 84,099 [CCH ¶ 50,401].]

New I.R.C. §121 Exclusion—Bankruptcy Estate
I.R.C. §§121 and 1398

☞ **A debtor's residence was sold by the bankruptcy estate and qualified for the new §121 $250,000 exclusion.**

**Summary.** The guidelines for the taxation of a Chapter 7 bankruptcy estate are in §1398 I.R.C.

The authority for the estate's use of §121 I.R.C. exclusion is provided by these provisions. Subsection (g)(6) provides that the estate succeeds to the Debtor's holding period. If the debtor has owned the property for the time required in §121 I.R.C., the estate succeeds to that holding period. Next, §1398(g)(6) provides that the estate succeeds to the "character" of the asset "it had in the hands of the debtor." "Character" is not defined by §1398 I.R.C., but the characteristics of the Property relevant to the tax code include its use as a principal residence for at least two of the past five years. Those attributes constitute the "character if had in hands of the debtor."

**Holding. Because the bankruptcy estate succeeds to those attributes, it qualifies to use the §121 I.R.C. exclusion when it sells the home.**

**[In Re Popa,** U.S. Bank Ct; No. Dist. Ill; 98-1 USTC 83,585 [CCH ¶ 50,276].

Sale of Residence
I.R.C. §121

☞ **Gain from the sale of a residence owned by a real estate partnership did not qualify for the I.R.C. §121 exclusion.**

[*Gibbons v. Commissioner,* 98-2 USTC 85,248; U.S. Ct. of Appeals, 4th Cir. [CCH ¶ 50,547].]

Taxable Gain—Foreclosure
I.R.C. §§165 and 1001

☞ **Taxpayers had taxable gain to the extent their mortgage indebtedness paid off with foreclosure proceeds exceeded their basis in the properties.**

**Facts.** In 1991, taxpayers owned two rental income properties that they had owned for more than one year. These properties were located in Chicago, Illinois, at 5335 South Honore (Honore property) and 7332 Campbell (Campbell property).

In 1991, taxpayers' adjusted basis for the Honore property was **$32,963,** and they were personally liable for a mortgage on the property in the amount of **$43,356.** The property was foreclosed and sold in that year for **$54,435.** Of this amount, **$43,356** was used to pay off taxpayers' mortgage on the property. Taxpayers did not receive any other amounts from the sale.

In 1991, taxpayers' adjusted basis for the Campbell property was **$84,459,** and they were personally liable for a mortgage on the property in the amount of **$88,491.** The property was foreclosed and sold in that year for **$106,620.** Of this amount, **$88,491** was used to pay off taxpayers' mortgage on the property. Taxpayers did not receive any other amounts from the sale.

On their 1991 federal income tax return (return), they did not report any gain with respect to the foreclosure transactions, but instead claimed a deduction for ordinary losses on Form 4797 in the amount of $13,600, which they computed as the excess of the properties' foreclosure sales prices over the mortgage balances plus depreciation. **In effect, they claimed a loss for their equity in the properties less depreciation.**

In the notice of deficiency, the IRS disallowed the $13,600 in claimed losses and determined that taxpayers had long-term capital gains in the amount of **$43,633,** computed as the difference between the total sales prices from both sales ($161,055) and taxpayers' total adjusted basis in both properties ($117,422). Taxpayers did not receive the sales proceeds that exceeded the amounts due on the mortgages.

**As a result, the IRS has conceded $29,208 of the $43,633 adjustment for capital gains, and now contends that taxpayers only had gain of $14,425, which is the difference between their total adjusted basis in the two properties ($117,422) and the combined mortgage liabilities from which they were relieved ($131,847).**

**Discussion and Holding.** A taxpayer is treated as having gain when he benefits from having his debts paid off, as if the money were first paid to the taxpayer and then paid over by him to his creditors.

Therefore, a taxpayer who transfers mortgaged property, whether to the mortgagee or another third party, and is discharged from his liability on the mortgage debt in consideration for the transfer, realizes a benefit in the amount of the liability discharged.

**In this case, this reasoning dictates that taxpayers have taxable capital gain to the extent that their personal mortgage indebtedness, paid off with the foreclosure proceeds, exceeded their basis in the properties.**

[*Emmons v. Commissioner*, T.C. Memo 1998-173, 75 T.C.M. 2275 [CCH Dec. 52,696(M)].]

Section 1045: Rollover of Gain From Qualified Small Business Stock to Another Qualified Small Business Stock
Rev. Proc. 98-48

☞ **This revenue procedure provides procedures for taxpayers to make an election under §1045 of the Internal Revenue Code ("§1045 election") to defer recognition of certain gain on the sale of qualified small business stock ("QSB stock").**

**See Chapter 15**

## SELF-EMPLOYMENT TAX

Self-Employment Tax
I.R.C. §1402

☞ **Pass-through items on an S corporation K-1 are not considered in determining a shareholder's self-employment income.**

**Facts.** Taxpayer owned 100 percent of the stock in one S corporation and more than 50 percent of the stock in two other S corporations. He also operated a sole proprietorship business, which reported its income and expenses on Schedule C. In 1991, the Schedule C business showed a substantial net profit. Two of the S corporations had sizable 1991 losses, while the other S corporation reported a very small profit. Taxpayer received correctly prepared Schedules K-1 from the three 1120S corporations for 1991.

In computing his 1991 Schedule SE (Self-Employment Tax), taxpayer included the following as net earnings from self-employment:

1. The substantial Schedule C net profit, and
2. His **one pass-through profit and the two pass-through losses from** the three Schedules K-1s from the §1120S corporations.

As a result, **taxpayer reported negative net earnings from self-employment for 1991 and reported no self-employment tax liability.**

The IRS recalculated taxpayer's 1991 net earnings from self-employment by eliminating the two pass-through 1120S losses and the one pass-through 1120S profit. The result, according to the IRS, was a 1991 self-employment tax liability of $3,562.

**Issue.** What constitutes "net earnings from self-employment" as defined by I.R.C. §1402(b)?

**Discussion.** Briefly stated, income derived by an individual from carrying on a trade or business through a sole proprietorship or as a partner (other than a limited partner) in a partnership generally constitutes net earnings from self-employment (**Treas. Reg.** §1.1402 (c)-1).

Neither I.R.C. §1402, which provides the definition of net earnings from self-employment, nor its regulations contain **any reference to S corporation pass-through items.**

**Holding.** We hold that taxpayer must compute his 1991 net earnings from self-employment, and correspondingly his self-employment tax liability, **without taking into account pass-through items from the S corporations.**

> **Note.** A related new issue was raised by the IRS in the exam of the subsequent year (1992) Form 1040. The taxpayers attempted to use a disputed net operating loss carryover to 1992 in calculating 1992 net earnings from self-employment. The IRS objected and recalculated the 1992 self-employment tax without the net operating loss. The Tax Court agreed with the IRS on this issue also.

[*Paul B. and Jane C. Ding v. Commissioner,* T.C. Memo 1997-435, 74 T.C.M. (1997) [CCH Dec. 52, 269(M)].]

## SOCIAL SECURITY

Taxation of Social Security Benefits under U.S.–Canada Income Tax Treaty

Notice 98-23

> **This notice provides guidance, in a question and answer format, regarding recent changes to the taxation of cross-border social security benefits under the Convention Between the United States of America and Canada With Respect to Taxes on Income and on Capital.**



## TAX DEPOSITS

Order of Applying Federal Tax Deposits

Notice 98–14

> **This notice provides an interim procedure that taxpayers may use to request abatement of the failure-to-deposit penalty imposed by §6656 of the Internal Revenue Code when the manner in which the Internal Revenue Service applies deposits, as set forth in Rev. Proc. 90-58, 1990-2 C.B. 642, produces multiple failure-to-deposit penalties as a result of a single failure to deposit.**

> **Interim Relief Procedure.** Any taxpayer that receives multiple failure-to-deposit penalty notices as a result of a single failure to deposit, may call the toll-free number shown on the penalty notice. The Service will, if it deems appropriate, reduce the multiple penalty to the penalty amount due on the missed deposit with respect to return periods beginning after December 31, 1997.

# TAX REPORTING: TAX FORMS—FILING, INCLUDING ELECTRONIC

**NEW FORMS to calculate the child credit look highly taxing even to experts.** Part of the 1997 tax act created a tax credit of as much as $400 a child this year and $500 starting in 1999. Taxpayers who qualify may begin claiming the credit on their 1998 returns, to be filed early next year. While the credit may sound relatively simple, tax advisers say newly released proofs of IRS forms and worksheets demonstrate the provision's remarkable complexity.

Many people "will be totally overwhelmed" by the worksheet, says Phillip J. Wiesner of KPMG Peat Marwick in Washington. It provides an additional reminder of "the difficulty of implementing public policy through the tax code." Lawyers say the problem lies not with the IRS but with Congress. "The IRS is just making people do what the law requires them to do," a congressional staffer says.

*"I'm almost glad my children are getting to an age where I won't have to fool" with it, the staffer adds.* [7-29-98, *The Wall Street Journal*, p. 1]

## Proposed Changes to 1999 Forms W-2 and W-3

Announcement 98-55

Based on recommendations from the Information Reporting Program Advisory Committee (IRPAC), the Social Security Administration (SSA), and others, the Internal Revenue Service (IRS) plans to revise Form W-2, Wage and Tax Statement, and Form W-3, Transmittal of Wage and Tax Statements. Some revisions will reduce reporting burden and some will enable the SSA to more accurately capture the data reported on the forms. The revisions are proposed for the 1999 Forms W-2 and W-3 to be filed in 2000.

## Electronic Submission of Forms

Announcement 98-27

☞ **The IRS will permit electronic submission of forms W-9 and W-9S.**

**Form W-9.** The Internal Revenue Service will allow payers to establish a system to electronically receive Forms W-9, Request for Taxpayer Identification Number and Certification. In general, the electronic system must meet the requirements described in paragraphs (1) through (5) below. However, for **Forms W-9 that are not required to be signed**, the electronic system **need not meet the requirements described in paragraph (3).** The IRS will revise the "Instructions for the Requester of Form W-9" to reflect the provisions of this announcement.

For purposes of this announcement, "payer" refers to a person required to file an information return. "Payee" refers to the person required to submit Form W-9 to the payer.

**Form W-9S.** The Internal Revenue Service will also allow educational and lending institutions to establish a system for students and borrowers to electronically submit Form W-9S, **Request for Student's or Borrower's Social Security Number and Certification.** The IRS will revise the instructions for Form W-9S to reflect the provisions of this announcement. In general, the electronic system must meet the requirements described in paragraphs (1), (2), (4), and (5) below. Further, if an electronic Form W-9S is used to certify that the borrower will use the loan proceeds to pay for qualified higher education expenses, the lending institution's electronic system must also meet the requirements described in paragraph (3)(A) below.

**Requirements**

1. **In general.** The electronic system must ensure that the information received by the payer or educational or lending institution is the information sent by the payee, student, or borrower. The system must document all occasions of user access that result in the submission. In addition, the design and operation of the electronic system, including access procedures, must make it reasonably certain that the person accessing the system and submitting the Form W-9 or W-9S is the person identified in the form.
2. **Same information as paper Form W-9 or W-9S.** The electronic submission must provide the payer or educational or lending institution with exactly the same information as the paper Form W-9 or W-9S.
3. **Signature requirements and perjury statement.** The electronic submission **must be signed with an electronic signature** by the payee whose name is on the Form W-9 or by the borrower whose name is on the Form W-9S.

   a. **Electronic signature.** The electronic signature must identify the payee or borrower submitting the electronic form and must authenticate and verify the submission. For this purpose, the terms "authenticate" and "verify" have the same meanings as they do when applied to a written signature on a paper Form W-9 or W-9S. An electronic signature can be in any form that satisfies the foregoing requirements. The electronic signature must be the final entry in the submission.

   b. **Perjury statement.** The electronic signature on Form W-9 must be under penalties of perjury. The perjury statement must contain the language that appears on the paper Form W-9. The electronic system must inform the payee that he or she makes the declaration contained in the perjury statement and that the declaration is made by signing the Form W-9. The instructions and the language of the perjury statement must immediately follow the payee's certifying statements and immediately precede the electronic signature.
4. **Copies of electronic Forms W-9 or W-9S.** Upon request by the Internal Revenue Service, the payer or educational or lending institution **must supply a hard copy of the electronic Form W-9 or W-9S** and a statement that, to the best of the payer's or educational or lending institution's knowledge, the electronic Form W-9 or W-9S was submitted by the named payee, student, or borrower. The hard copy of the electronic Form W-9 or W-9S must provide exactly the same information as, but need not be a facsimile of, the paper Form W-9 or W-9S.



5. **Effective date.** The announcement applies to Forms W-9 and W9S submitted electronically by payees, students, or borrowers on or after April 13, 1998.

Change in Record Format for TY 1998
Returns to Be Filed in CY 1999
Announcement 98-20

☞ **The purpose of this announcement is to inform all payers/transmitters, who file information returns magnetically or electronically with Internal Revenue Service (IRS) Martinsburg Computing Center, of a change in the record format for** *tax year 1998* **returns to be filed in** *calendar year 1999***.**

Due to the century date change, legislative changes, and proposed future expansion, the record size will be increased from the current 420 positions to 750 positions. This will enable IRS to capture all data required to be filed. Several examples of changes are: the number of money fields have been expanded from 9 to 12, and blank fields have been added to enable IRS to capture more complete name and address information in the future. Although the record has changed, much of the information is data already requested in the present format.

Publication 1220–Specifications for Filing Forms 1098, 1099 series, 5498, 5498-MSA and W-2G Magnetically or Electronically, **is being revised** and is scheduled to be available on the Information Reporting Program Bulletin Board System (IRP-BBS) by **May 1998** in an effort to give payers/transmitters as **much time as possible** to incorporate the changes into their programs. The telephone number for the IRP-BBS is 304-264-7070. IRS is planning additional Information Reporting Seminars to assist filers with the new format.

Revision of Form 3115
Announcement 98-13

☞ **Form 3115, Application for Change in Accounting Method, and the Instructions for Form 3115 have been revised. This November 1997 revision is the current Form 3115 and replaces the February 1996 version of Form 3115. Copies of the revised form and instructions are available at most IRS offices.**

Information Returns—Real Estate Reporting Person
Rev. Proc. 98-20

☞ **This revenue procedure sets forth the acceptable form of the written assurances (certification) that a real estate reporting person must obtain from the seller of a principal residence to except such sale or exchange from the information reporting requirements for real estate transactions under §6045(e)(5) of the Internal Revenue Code.**

**Section 2. Background.** The Income Tax Regulations generally require a real estate reporting person to file an information return regarding a real estate transaction and to furnish a payee statement to the seller regarding that transaction. The information return and statement must include the name, address, and taxpayer identification number (TIN) of the seller, and the gross proceeds of the real estate transaction. This information is reported on Form 1099-S, Proceeds from Real Estate Transactions.

The Taxpayer Relief Act of 1997 (the Act), effective for sales or exchanges after May 6, 1997, amended §6045(e) by adding a new paragraph (5), which **excepts a sale or exchange of a residence from the §6045(e) information reporting requirements if the seller provides the real estate reporting person with a certification setting forth certain written assurances, including an assurance that the residence is the seller's principal residence (within the meaning of §121) and an assurance that the full amount of the gain on the sale or exchange of the principal residence is excludible from gross income under §121.**

**Section 4. Seller Certification.** .01 To be excepted from the information reporting requirements in §6045(e) on the sale or exchange of a residence (including stock in a cooperative housing corporation), the real estate reporting person must obtain from the seller a written certification, signed by the seller under penalties of perjury, **that assurances (1) through (4) set forth in §4.02** of **this revenue procedure** are true. For purposes of this certification, the term "seller" includes each owner of the residence that is sold or exchanged. **Thus, if a residence has more than one owner, a real estate reporting person must either obtain a certification from each owner (whether married or not) or file an information return and furnish a payee statement for any owner that does not make the certification.**

4.02. The assurances are:

**(1)** The seller owned and used the residence as the seller's principal residence for periods aggregating 2 years or more during the 5-year period ending on the date of the sale or exchange of the residence.

**(2)** The seller has not sold or exchanged another principal residence during the 2-year period ending on the date of the sale or exchange of the residence (not taking into account any sale or exchange before May 7, 1997).

**(3)** No portion of the residence has been used for business or rental purposes by the seller (or the seller's spouse if the seller is married) after May 6, 1997.

**(4)** At least one of the following three statements applies:

**a.** The sale or exchange is of the entire residence for $250,000 or less, OR

**b.** The seller is married, the sale or exchange is of the entire residence for $500,000 or less, and the gain on the sale or exchange of the entire residence is $250,000 or less, OR

**c.** The seller is married, the sale or exchange is of the entire residence for $500,000 or less, and (a) the seller intends to file a joint return for the year of the sale or exchange, (b) the sellers spouse also used the residence as his or her principal residence for periods aggregating 2 years or more during the 5-year period ending on the date of the sale or exchange of the residence, and (c) the seller's spouse also has not sold or exchanged another principal residence during the 2-year period ending on the date of the sale or exchange of the residence (not taking into account any sale or exchange before May 7, 1997).

**Section 5. Format for Making Seller Certification.** A sample certification form that may be used by a real estate reporting person to obtain the applicable assurances from the seller is provided in the Appendix of this revenue procedure. However, use of this sample certification form is not required. The requirements of the certification under §6045(e)(5) will be met if the content and wording of a written certification provide the same information as required by §4.02 of this revenue procedure.

**Section 6. Obtaining and Retaining Seller Certification.**

.01 General rule. Except as provided in §6.02 of this revenue procedure, the real estate reporting person may obtain a certification at any time on or before January 31 of the year following the year of the sale or exchange of the residence. The certification must be retained by the real estate reporting person for 4 years after the year of the sale or exchange of the residence to which the certification applies.



.02 Transition rule. For a sale or exchange of a residence occurring after May 6, 1997, and on or before December 31, 1997, the real estate reporting person may obtain a certification at any time on or before February 28, 1998.

**Section 7. Penalties.** A real estate reporting person who relies on a certification made in compliance with this revenue procedure **will not be liable** for the penalties under §6721 for failure to file an information return, or under §6722 for failure to furnish a payee statement to the seller, unless the real estate reporting person has actual knowledge that any assurance is incorrect.

Year 2000 Changes
Announcement 98-5

☞ **The purpose of this announcement is to identify forms and date fields that will be affected by the impending expansion of the date field to accommodate the Year 2000.**

The Information Reporting Program has date fields within the information return records filed magnetically/electronically to the Martinsburg Computing Center. Currently we allow a two-position field for the year (YY) which appears in both the Payer "A" Record and Payee "B" Record. All other dates within the Payee Records are currently six-digit fields in the format of MMDDYY.

For Tax Year 1998, the information returns date fields will be expanded and reformatted by changing the two-digit tax year field to four-digits in preparation for the Year 2000. To accommodate the change, the four-digit tax year field in the Payer "A" Record will be in positions 2 to 5. The sequence number field will be eliminated due to the date expansion. The tax year will be dropped in the Payee "B" record since the tax year of the return can be determined by the tax year provided in the Payer "A" Record. By expanding the tax year field to four positions, the Information Reporting Program will be consistent with the industry standard.

The record format for information returns filed magnetically/electronically will have the following changes:

1. Two-digit date fields (YY) will be expanded to four digits (YYYY)
2. Six-digit date fields (MMDDYY) will be changed to eight digits (YYYYMMDD)

In addition to the necessary Year 2000 changes, there are changes that will be made as a result of legislative requirements. The current 420 position record will be expanded to accommodate this new information. **It is our intention to make the Publication 1220, which will identify these changes, available as soon as possible.**

## TIP REPORTING

Electronic Tip Reports
Reg-104691-97

☞ **This document proposes to amend the regulations dealing with the requirement that tipped employees report their tips to their employer. The proposed regulations permit employers to establish electronic systems for use by their tipped employees in reporting tips to the employer. The proposed regulations also address substantiation requirements for employees using the electronic system.**

**Action: Notice of proposed rulemaking**

**Background.** In general, under §6053(a), every employee who receives tips must report the tips to the employer. The tips that must be reported are those that are wages for purposes of federal income tax withholding and the Federal Insurance Contributions Act (FICA) and compensation for purposes of the Railroad Retirement Tax Act (RRTA). The tips must be reported in a written statement or statements furnished to the employer on or before the 10th day following the month in which the tips are received.

Generally, all cash tips (which include tips that are charged) are wages (or compensation), with **one exception.** If the amount of cash tips received in a calendar month by an employee in the course of any one employment is less than $20, the cash tips received in that employment during that month **are not wages subject to income tax withholding, FICA taxes, or RRTA taxes.**

**For example,** A is a full-time tipped employee of X and a part-time tipped employee of Y. During the month, A received $1,000 in tips in A's employment with X and $10 in tips in A's employment with Y. The $1,000 in tips received in the course of employment with X are wages for income tax withholding and FICA (or RRTA) tax purposes. A must report the $1,000 in tips to X no later than the 10th day of the following month. The $10 in tips received in the course of employment with Y are not wages for those purposes. The $10 are, however, subject to federal income tax and must be reported as wages by the employee on Form 4137, Social Security and Medicare Tax on Unreported Tip Income, **which the employee must file** with Form 1040–U.S. Individual Income Tax Return.

**Section 31.6053-1(b)(1) prescribes rules for tip statements.** The statement furnished by the employee to the employer must be in writing and must be signed by the employee. The statement must disclose (1) the employee's name, address, and social security number; (2) the employer's name and address; (3) the period for which and the date on which the statement is furnished; and (4) the total amount of tips received by the employee during the period that are required to be reported to the employer.

Under §31.6053-1(b)(2), no particular form is prescribed for use in furnishing the tip statement. If the employer does not provide a form for use by the employee in reporting tips received by the employee, the employee may use Form 4070–Employee's Report of Tips to Employer. Twelve blank Forms 4070 and 12 blank Forms 4070A–Employee's Daily Record of Tips are reproduced in Publication 1244–Employee's Daily Record of Tips and Report to Employer. (Daily completion of Form 4070A constitutes sufficient evidence of tip income under the substantiation requirements of §31.6053-4.) Pub. 1244 is a convenient pocket-sized document that also includes the basic rules for reporting tips.

Copies of Pub. 1244 are available from the IRS by calling 1-800-829-3676.

- The **regulations specifically permit employers** to design their own forms for use by employees in reporting tips. A form used solely to report tips must include (1) the employee's name, address, and social security number; (2) the employer's name and address; (3) the period for which and the date on which the statement is furnished; and (4) the total amount of tips received by the employee during the period that are required to be reported to the employer.
- **In lieu of** a special tip reporting form that is used solely for the purpose of reporting tips, employers may provide for reporting of tips on regularly used forms, such as time cards. The regularly used forms need not include the employer information, but they must accurately identify the employee, identify the reporting period, and specify the amount of tips received. If a regularly used form is used to report tips, the employer must furnish the employee a statement showing the amount of tips reported by the employee for the period. This statement must be furnished no later than shortly after the first wage payment following the employee's tip report. A payroll check stub or other similar payroll document may be used for this purpose.
- **The period covered by a tip statement may not exceed one calendar month.** An employer may require tip statements more frequently, such as daily, weekly or every pay period, if not less frequently than monthly. In no event, however, may an employer permit tips received in one month to be reported after the 10th of the following month. (See §6053(a).)
- **For example,** X has a weekly payroll period, beginning on Sunday and ending on Saturday. X requires that all tip statements be submitted to X no later than the Monday following each payroll period. For the payroll period beginning on Sunday, March 30, and ending on Saturday, April 5, the statements must be furnished on or before Monday, April 7. If this occurs, the 10th-of-the-month requirement for March is met. If X's payroll period were biweekly and began on March 30 and ended on April 16 and if X required that all tip statements be submitted to X no

later than the Monday following each payroll period, the 10th-of-the-month requirement for March would not be met.

- **A tip statement furnished after this deadline does not meet the requirements of §6053(a).** The employer is not required to withhold income, FICA, or RRTA taxes on tips reported after the 10th of the following month and is not responsible for reporting those tips to the IRS. The responsibility for reporting and paying the employee portion of the FICA tax **shifts to the employee. The employee must complete and attach Form 4137—Social Security and Medicare Tax on Unreported Tip Income, to the employee's federal income tax return.** Moreover, an employee who fails to report tips as required by §6053(a) is subject to an addition to the FICA tax or the RRTA tax, whichever is applicable, **equal to 50 percent** of the employee portion of the FICA or RRTA tax on those tips.
- **Section 31.6053-4(a)(1) provides that an employee must maintain sufficient evidence to establish the amount of tip income received during a taxable year.** Sufficient evidence consists of either a daily record or, if the employee does not maintain a daily record, other evidence (such as documentary evidence) that is as credible and as reliable as a daily record. Nevertheless, if the facts or circumstances indicate that the employee received a larger amount of tip income, a daily record or other evidence may not be sufficient evidence.
- **Section 31.6053-4(a)(2) describes the requirements for a daily record.** In general, the daily record must show the amount of cash and charge tips received directly from customers or other employees and the amount of tips, if any, that the employee paid out to other employees through tip sharing, tip pooling, or other arrangements and the names of the employees. The daily record must show the date on which each entry is made. Each entry must be made on or near the date the tip income is received. An entry made when the employee has full present knowledge of those receipts and payments satisfies this requirement.
- **Section 31.6053-4(a)(3) describes documentary evidence.** Documentary evidence consists of copies of any documents that contain amounts added as a tip to a check by a customer or amounts paid by a customer for food or beverages with respect to which tips generally would be received. Examples of documentary evidence are copies of restaurant bills, credit card charges, or charges under any other arrangement containing amounts added by the customer as a tip.

## Explanation of Provisions

Electronic tip statements. No provision currently exists for employees to furnish tip statements to employers in a form other than on paper. **The proposed regulations would permit an employer to adopt a system under which some or all of the tipped employees of the employer would furnish their tip statements electronically.** Therefore, the employer could include in its electronic system any tipped employee or employees working in any location or locations.

- **The proposed regulations set forth requirements for employers who wish to establish electronic systems for employees to use to furnish tip statements to their employers.** The proposed regulations apply only to tip statements required by §6053(a) and not with respect to any other Code sections.
- **An employer that chooses to establish an electronic tip reporting system may select the type or types of electronic systems (such as telephone or computer) to be used by its employees.** The system must, however, ensure that the information received is the information transmitted by the employee and must document all occasions of access that result in the transmission of a tip statement. The design and operation of the electronic system, including access procedures, must make it reasonably certain that the person accessing the system and transmitting the tip statement is the employee identified in the transmission. In the event of an examination, the employer must supply a hard copy of the electronic statement to the IRS upon request.

- **The electronic tip statement must contain exactly the same information that is required to be reported on a paper tip statement and must contain the employee's electronic signature.** The electronic signature must identify the employee furnishing the electronic tip statement and authenticate and verify the transmission. An electronic signature can be in any form that satisfies the foregoing requirements. An electronic signature has the same effect as a signature written on a paper tip statement.
- **The proposed regulations provide that an employee maintains sufficient evidence to establish the amount of tip income received by the employee during a calendar month through a daily record** (as described in **§**31.6053-4(a)(2)) if the employee both reports tips on a daily basis through an electronic system that otherwise meets the substantiation requirements of the regulations and receives from the employer a hard copy of a daily record based on those entries for the period.

Employee substantiation requirements. Because the proposed regulations expand the permissible array of employer-designed reporting systems to include electronic methods, employers will be providing a statement to employees of the tips reported consistent with the existing requirements of §31.6053-1(b). The Treasury and the IRS recognize that many of these systems may capture tip reporting on a very current basis (e.g., point-of-sale or end-of-shift). Thus, the information in these systems offers a reasonable substitute for a daily record maintained by the employee if the employer's system provides the employee with a printout that would satisfy the current substantiation requirements of §31.6053-4.

- **Thus, these proposed regulations provide that, if the employer, at its option, provides employees with a copy of the daily record based on entries made by the employee in the system and otherwise satisfying the substantiation requirement of §31.6053-4, the entry in the electronic system on a daily (or more frequent) basis by the employee, together with the daily record based on these entries provided by the employer, will satisfy the substantiation requirements of §**31.6053-4.
- **For example,** assume an employee enters tips in the employer's electronic system at the end of each shift, but does not provide the employer with a signed paper record of these tips. After the end of each weekly payroll period, the employer provides the employee with a paper record that includes all the information specified in §31.6053-4(a)(2) and that shows the total amount of tips reported for each day during the period based on the employee's entries. If the employee maintains this employer generated paper record, the substantiation requirements of §31.6053-4 are satisfied.



Railroad Retirement Tax Act provisions. The tip-reporting provisions of §6053(a) apply to tips that are either wages for income tax withholding and Federal Insurance Contributions Act (FICA) purposes or compensation for Railroad Retirement Tax Act (RRTA) purposes. The proposed regulations would clarify that the regulations under §6053(a) apply to tips that **are compensation** as well as to tips that **are wages**.

### Proposed Effective Date

The revisions and additions in the proposed regulations apply to tips required to be reported to the employer **after these regulations are published as final regulations in the Federal Register.** However, taxpayers may rely on the guidance in these proposed regulations for **prior periods**.

# TRUSTS

Qualified Funeral Trust
Notice 98–6

**See Chapter 15.**

☞ **Section 1309 of the Taxpayer Relief Act of 1997 added §685 of the Internal Revenue Code to permit certain trusts to elect Qualified Funeral Trust (QFT) status. This notice provides guidance on QFT eligibility requirements, election procedures, and simplified reporting requirements.**