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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 been issued during the past year, through approximately August 31, 1999. 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:

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ACCOUNTING

Announcement 99-58
[I.R.C. §446]

Form 3115 for change in accounting method is revised.

The IRS has announced revisions to Form 3115, Application for Change in Accounting Method, and its instructions. The changes in this May 1999 revision are a clarification of the tax year to which question 18 (page 3) relates and an update of the cite to Rev. Proc. 99-1, 1999-1 IRB 6 in question 28 (page 3). The revised instructions provide an update to the list of automatic change procedures and the user fee provisions.

Copies of the revised Form 3115 and instructions are available by telephone at 1-800-TAX FORM and at the IRS’s Web site at www.irs.ustreas.gov.

[Announcement 99-58, 1999-24 IRB 51]

LTR 9848001, July 16, 1998
[I.R.C. §446]

The cash method of accounting clearly reflects the income from the taxpayer’s dentistry practice.

Facts. The taxpayer operates a dentistry practice as a sole proprietorship, using the cash method of accounting for both financial and tax reporting purposes. The dentist contracts with independent dental laboratories to provide crowns, bridges, and dentures that are custom-made for a specific patient. He generally makes an impression of a patient’s teeth and sends that impression to the dental laboratory to use in making these custom-ordered items.
Treas. Reg. §1.446-1(c)(2)(i) requires that the accrual method of accounting be used with regard to purchases and sales in any case in which it is necessary to use an inventory. Treas. Reg. §1.471-1 provides that “inventories are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor.”

**Issue.** Whether the cash method of accounting clearly reflects the income from the taxpayer’s dentistry practice under I.R.C. §446(b).

**Discussion.** In determining whether merchandise is an income-producing factor in the dentist’s business, the Service looked to the court rulings that have compared a taxpayer’s purchase of merchandise and the taxpayer’s gross receipts, computed on the cash basis. In *Wilkinson-Beane v. Commissioner*, 420 F.2d 352, 70-1 USTC ¶9173 (CA-1, 1970), caskets represented approximately 15% of the taxpayer’s cash-basis receipts and were considered to be an income-producing factor. The Service held that merchandise transactions were not an income-producing factor in LTR 9723006 (February 7, 1997), in which a medical clinic whose total purchases of merchandise, materials, and supplies amounted to less than 8% of the taxpayer’s gross receipts.

**Conclusion.** The Service did not indicate what the dentist’s percentage of merchandise purchases was to his gross receipts, but concluded that the **dentist’s merchandise purchases were not an income-producing factor**, and that he was not required to maintain inventories for this merchandise. If a taxpayer is not required to maintain inventories, then the cash method will generally clearly reflect the taxpayer’s income unless he is manipulating the method and such manipulation results in a material distortion of income. The Service found no evidence here that the dentist was involved in manipulation or intentional delays in collecting receivables. Therefore, the **cash method of accounting clearly reflects the income from the taxpayer’s dentistry practice.**

**LTR 199929001, April 6, 1999**

**Facts.** The taxpayer operates a fig orchard, which was planted in December of year 1 and January of year 2. Variety 3 fig trees and variety 4 fig trees were harvested in August of year 3.

**Issues**

1. For purposes of determining whether the costs of producing fig trees must be capitalized under I.R.C. §263A, is the nationwide weighted-average preproductive period of fig trees greater than two years?

2. For purposes of ending the actual preproductive period for cost capitalization under I.R.C. §263A, did the taxpayer produce a marketable quantity of figs in year 3?

**Analysis and Conclusion**

**Issue 1.** The general rule under I.R.C. §263A(a) requires that the direct costs and all indirect costs that directly benefit, or are incurred by reason of, the production of tangible personal property be capitalized. Code §263A(d)(1)(A)(ii) provides that I.R.C. §263A does not apply to a plant having a preproductive period of two years or less and that is produced by a taxpayer in a farming business. Code §263A(e)(3)(A)(i) defines preproductive period, in the case of a plant, as the period before the first marketable crop or yield from such plant. **The preproductive period of a commercially produced**
plant in the United States, as specified in I.R.C. §263A(e)(3)(B), shall be based on the nationwide weighted-average preproductive period for such plant.

The preproductive period of a fig tree begins when the plant is propagated and ends when the first marketable crop or yield is produced. The taxpayer improperly measured the preproductive period by using tax years in which the events that began and ended the preproductive period were deemed to occur on the first day of the year rather than using calendar days. When the calendar days are used to measure the preproductive period in the taxpayer’s examples, this period exceeds two years. In addition, the Department of Agriculture has provided the Service with information indicating that fig trees do not produce commercially significant quantities until the sixth year after planting. The Service concluded that, based on the information provided, the nationwide weighted-average preproductive period for all varieties of fig trees exceeds two years. Hence, the taxpayer’s production of fig trees is subject to the cost capitalization provisions of I.R.C. §263A.

Issue 2. To qualify as a marketable quantity under Treas. Reg. §1.263A-4T(c)(4)(ii)(B), a crop or yield must generate sufficient revenues both to cover the harvest’s direct costs as well as to contribute more than a de minimis amount toward recovering the direct and indirect costs of producing the plants and the crop or yield. The Service also stated that “the fact that production of a plant is not profitable on a financial or tax accounting basis during a particular year does not, in itself, preclude the production of a marketable crop from that plant during that year.” Weather, commodity prices, and plant diseases and pests are variables that can affect profitability.

In the present case, the taxpayer’s revenues from the variety 3 and variety 4 fig harvests were only 2.6% of the total Schedule F expenses for year 3, including depreciation. The variety 3 fig tree yield was 2.4% of the mature yield (no mature yield was provided for variety 4 fig trees). The Service concluded the variety 3 fig harvest was de minimis in terms of the mature productive capacity and the contribution toward recovery of costs. Therefore, the variety 3 fig trees were still in their preproductive period during year 3.

Owen v. United States
[I.R.C. §§461 and 1016]

A cash-basis taxpayer is not allowed to include in the property basis the unpaid cost of improvements financed by a promissory note to the vendor.

Facts. The taxpayers claimed they made capital improvements worth $225,000 to office condominiums before this property was sold in 1987. To substantiate these improvements, the taxpayers submitted copies of promissory notes issued to Section Seven Contractors, Inc., an entity that was owned and controlled by the taxpayer, Mr. Owen. Payments on the notes were not made until after 1987.

Issue. Whether cash-basis taxpayers can include the cost of improvements in the basis of property if they have not yet paid cash for these improvements.

Analysis. The taxpayers argued that by issuing promissory notes as payment for the improvements, they can increase their basis in the property under Crane v. Commissioner, 47-1 USTC ¶9217, 331 U.S. 1 (1947). The court distinguished Crane from the present case because it dealt with a taxpayer’s initial cost basis in his property and not subsequent adjustments to basis.

Code §1016 governs adjustments to basis and states, in part, that this basis adjustment shall be made “for expenditures, receipts, losses, or other items, properly chargeable to capital account.” The ordinary meaning of the terms “expenditures, receipts, and losses” does not include incurring liability. The court concluded that if Congress meant to include debt in this definition, it would have specifically included the term.
The fundamental principle underlying the cash method of accounting is that cash-basis taxpayers do not recognize income or expenses until cash is actually received or paid. This principle is what the court relied upon in the present case. The issuance of a promissory note as payment for benefits received should not be considered a cash payment that allows the taxpayer to take a current-year deduction.

Finding. The court determined that the taxpayers were not entitled to increase the basis in the condominiums by the improvements they made because the taxpayers had not made any cash payments for these improvements prior to the sale of the property. The taxpayers’ motion to reconsider was denied.


Observation. A cash-basis taxpayer could avoid the problem faced by Owen by borrowing from a third party and using the proceeds to pay the builder or contractor for the improvements.

Vanalco, Inc. v. Commissioner
[I.R.C. §§162 and 263]

Facts. Vanalco is an S corporation engaged in the business of smelting aluminum in Vancouver, Washington. The chemical process involved in the production of aluminum is electrolysis, which requires the use of reduction cells. In 1992 and 1993, Vanalco reported a repair expense of over $4.2 million each year for the cost of replacing the linings of some 200 cells each year.

The reduction cells are located in the cell rooms, where the molten metal is tapped and front-end loading machines operate. A brick layer of the cell room floor acted as insulation to prevent electrocution by contact with the iron rebar in the subfloor. The brick layer became hazardous due to equipment traffic and contact with spillage and waste. Vanalco replaced sections of the brick layer with Fondag cement, which is more pliable than regular cement and, like brick, acts as an insulator. The Fondag floor is easier and quicker to repair than brick and can be made more level than brick, which improves safety and allows the use of labor-saving mechanical cleaning equipment.

Vanalco's plant is an independent structure with a 122,567-square-foot roof made of fire-resistant material. During the period 1989–1994, Vanalco removed and replaced 42,514 square feet of roof decking and 78,197 square feet of roofing material. Vanalco used fire-resistant wood decking to replace the original corrugated metal decking, due to unavailability of the original material. Vanalco reported a repair expense of $115,346 for the removal and replacement of the roof material and decking in 1992.

Issue. Are the expenditures to replace cell linings, to install new flooring, and to replace a portion of the roof deductible repair expenses under I.R.C. §162, or must these costs be capitalized under I.R.C. §263?

Discussion. Treas. Reg. §1.162-4 provides: “The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense .... Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall... be capitalized.”

On the other hand, I.R.C. §263(a)(1) provides that no deduction is allowed for amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned...
by the taxpayer, or (2) to adapt property to a new or different use. However, Treas. Reg. §1.263(a)-1(b) specifically recognized that “amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures.”

Thus an expense that is “incidental” is currently deductible and is not a capital expenditure. If the repair is an improvement or replacement, or if it increases the property’s value or substantially prolongs its useful life, it is capital in nature and is not currently deductible. [See Wolfsen Land & Cattle Co. v. Commissioner, 72 T.C. 1, 14 (1979).]

A key test that normally is to be applied is that if the improvements were made to “put” the particular capital asset in efficient operating condition, then they are capital in nature. If, however, they were made merely to “keep” the asset in efficient operating condition, then they are repairs and are deductible.

The Cell Linings. The parties stipulated that (1) the cell linings have an average useful life of approximately three years, and (2) the cost of removing and replacing an exhausted lining is $23,334 plus some miscellaneous costs. Thus, the cell lining has a life that is independent of the cell unit as a whole, and the cost of the lining as a percentage of the total cost of the cell unit is substantial.

In replacing the lining, the cell essentially is rebuilt, thereby obtaining a new life expectancy of three years. In light of the facts of this case, the court found that replacing the cell linings cannot be classified as an incidental repair, and the cost must therefore be capitalized.

Cell Room Floors. In comparison to the brick floors, the Fondag cement floors are easier to repair, become electrically nonconductive much more quickly, and provide a more level surface, which enhances safety and allows the use of mechanical cleaning equipment. It is clear that replacing the bricks with Fondag cement provided a substantial functional improvement.

The evidence shows that the new floors were replacements and substantial improvements; therefore, the replacements were not merely repairs that kept the building in an ordinarily efficient, operating condition. In addition, the new, improved floors made the property more valuable to Vanalco in its business, because the Fondag cement enabled Vanalco to effect faster repairs and to use mechanical cleaning devices, in addition to increasing the safety of its employees.

Therefore, Vanalco must capitalize the costs of replacing the brick floors of its cell rooms with Fondag cement.

Plant Roof. Vanalco argued that the replacement of the portion of the roof in the year at issue was only to repair a leak and not part of a plan of rehabilitation. The IRS argued that the roof repair was more than patching a few leaks, and that when this repair is considered with the roof repairs performed in 1989 through 1994, it is evident that Vanalco had a plan to replace most of its roof over a period of years.

Expenses incurred as part of a general plan of rehabilitation, modernization, or improvement must be capitalized even though the same expenses if incurred separately would be deductible as ordinary and necessary. (See United States v. Wehrli, 400 F.2d at 689; Norwest Corp. & Subs. v. Commissioner, 108 T.C. at 280.)

At the time of the roof repair, the plant was in operating condition and had been for many years. Furthermore, although portions of the roof were repaired over a period of five years, no repairs were made during 1993. Therefore, the repairs during the year at issue were not part of a continuous process of roof rebuilding. Thus, the roof repair was not part of a general plan of rehabilitation.

There is no evidence that substitution of the wood decking for the corrugated metal provided a functional improvement to the roof or materially added to the value of the property. Accordingly, the court concluded that the cost of repairing the plant roof is deductible as an ordinary and necessary expense under I.R.C. §162.

Holding. Replacing the cell lining and replacing substantial portions of the brick flooring with cement constitute more than incidental repairs and therefore these costs must be capitalized according to I.R.C. §263. The cost of replacing roof decking and roofing material is deductible because the replacement is not part of a general plan of rehabilitation and did not functionally improve the roof, add to the property’s value, or appreciably prolong the property’s life.

[Vanalco, Inc. v. Commissioner, T.C. Memo 1999-265.]
**Facts.** The taxpayer is a corporation that operates a nursery and sells plants and related supplies to builders, landscapers, and retail customers. The taxpayer uses the accrual method of accounting and has annual sales of under $25,000,000. The taxpayer grows some plants from cuttings or from seeds, but purchases most of its plants in various stages of development. The taxpayer then cultivates these plants and sells them as healthy, marketable plants to the consumer.

**Issues**

1. Whether the seeds and young plants acquired by the taxpayer for further cultivation or development are currently deductible as governed by Treas. Reg. §1.162-12.
2. Whether I.R.C. §263A, which provides that both the direct and indirect costs allocable to property must be capitalized, applies to any of the taxpayer’s plants.

For federal income tax purposes, the taxpayer currently deducts the purchase price of the plants, direct labor costs, and any overhead costs associated with the plants. The taxpayer does not use the crop method of accounting and has properly elected under I.R.C. §263A(d)(3) not to apply the I.R.C. §263A capitalization provisions to plants produced in a farming business. The taxpayer does inventory those items other than its plants (fertilizer, pesticides, pots, and gardening implements) and applies I.R.C. §263A to these unsold items.

**Analysis.** Treas. Reg. §1.162-12(a) provides that a farmer who operates a farm for profit is entitled to deduct from gross income those necessary expenses incurred in the business of farming. A farmer may also deduct in the year of purchase the costs of seeds and young plants that are purchased for further development and cultivation prior to sale, provided the farmer does not compute income using the crop method and is consistent in deducting these costs each year.

Code §263A requires the taxpayer, in the case of any property to which this section applies, to capitalize the direct costs of the property and the property’s allocable share of indirect costs. This section applies to real or tangible personal property produced by the taxpayer and to real or personal property acquired by the taxpayer for resale. Thus, both the plants that are produced by the taxpayer and the other items acquired for resale are within the general rules of I.R.C. §263A.

Two relevant exceptions to the general rules of I.R.C. §263A are (1) the small reseller exception [I.R.C. §263A(b)(2)(B)], which applies to resellers whose average annual gross receipts do not exceed $10,000,000, and (2) the farming exception [I.R.C. §263A(d)], which applies to property produced in a farming business. Under the farming exception, the taxpayer is not required to capitalize costs under I.R.C. §263A with respect to property produced in the farming business if the taxpayer is not required to use an accrual method of accounting under I.R.C. §447 or §448(a)(3). The taxpayer must make this election for the taxpayer’s first tax year in the farming business, and may not change this election without the consent of the Commissioner.

The Service issued Announcement 97-120, 1997-50 IRB 61, to assure nursery growers that, if they are using the farming exception, they may continue to deduct the costs of seeds and young plants purchased for further development and cultivation even if the plants are partly grown by another person or are grown by the nursery in temporary containers.

**Conclusion.** Since the taxpayer qualifies to use the farming exception of I.R.C. §263A, the taxpayer may currently deduct under Treas. Reg. §1.162-12 the acquisition costs of the seeds and plants acquired for further cultivation and development. The taxpayer must capitalize under I.R.C. §263A the acquisition costs of the plants that are ready for immediate resale when purchased.
Vitale v. Commissioner
[I.R.C. §§162, 183, and 6662]

Facts. Ralph Vitale was employed full-time as a budget analyst with the U.S. Department of the Treasury. In 1992, in anticipation of his retirement, he began writing fiction. In 1993 Vitale had an idea for a book, a story about the experiences of two men who travel cross-country to patronize a legal brothel in Nevada. In order to develop the characters for the book and gather facts for the story, Vitale visited numerous legal brothels in Nevada, acting as a customer for the prostitutes. He kept a detailed journal of his visits.

Vitale submitted a manuscript for publication. He entered into an agreement with a publisher, paying $4,375 to publish 10,000 copies of his book. Vitale played an active role in all stages of the book’s publication and actively participated in the promotion of the book. He received $2,600 in royalties before the publisher filed for bankruptcy in 1996. After securing the return of his rights to the book, Vitale began marketing the book to other publishers. During the years in question, he spent 25 to 35 hours per week on his writing activity.

Vitale began treating his writing activity as a trade or business in 1993, filing a Schedule C in which he listed his principal business as “author.” His writing activity had not resulted in a profit for any year as of the date of trial. The Service disallowed all the expenses claimed under I.R.C. §§162 and 183 on Vitale’s Schedule C for 1993 and 1994, asserting that Vitale had not shown that he either started a trade or business or entered to an activity for profit, nor had he established that any amount was for an ordinary and necessary business expense.

Issues

1. Whether the taxpayer was in the trade or business of being an author during the years in issue
2. If so, whether expenses that the taxpayer incurred are deductible as ordinary and necessary under I.R.C. §162, and whether he adequately substantiated his travel expenses under I.R.C. §274(d)
3. Whether the taxpayer is liable for penalties for negligence or substantial understatement of tax under I.R.C. §6662(a)

Analysis and Holding

Issue 1. Code §162(a) allows a deduction for all ordinary and necessary business expenses paid or incurred during the taxable year in carrying on any trade or business. The Service argued that Vitale did not have a profit motive when he entered into his writing activity. The court looked to the nine factors provided in Treas. Reg. §1.183-2(b) to make this profit objective determination. (See Holmes v. Commissioner, elsewhere in this section, for a list of these factors.)

The court determined that, although Vitale could have been more organized in tracking his expenditures, his efforts to make a financial success of his writing activity displayed a profit objective. Vitale did not seek expert advice on how to start or maintain a business as a fiction writer, but the court noted that Vitale believed from his job assignments and performance ratings that he possessed a talent for writing. The court also stated that Vitale’s full-time employment at the Treasury did not
preclude the possibility that his writing activity constituted a separate trade or business [Gestrich v. Commissioner, 74 T.C. 525 (1980) [CCH Dec. ¶36,995]].

The court pointed out two important factors in this case with respect to Vitale’s losses from his writing activity. First, Treas. Reg. §1.183-2(b)(6) provides that **losses incurred during the startup phase of a business are not necessarily indicative of a lack of profit motive**. Second, the losses should be viewed in the context of the nature of Vitale’s fiction writing activity. The court did not find Vitale’s financial status to be detrimental to his profit motive. He did not treat his writing as a hobby and intended to profit from his work. In addressing the final factor, the court believed that Vitale derived personal pleasure from his writing and in helping the prostitutes seek a new way of life.

Vitale’s history of losses, the fact that he didn’t seek any expert advice, and the recreational element in his writing were all factors indicating a lack of profit motive. However, the court concluded that these factors were outweighed by the factors that did demonstrate that Vitale engaged in his writing activity with a profit objective.

Issue 2. The court allowed Vitale to deduct the payment to the publisher for publishing his book, but disallowed the interview expenses. **The court found that the expenditures incurred by Vitale to visit prostitutes were “so personal in nature as to preclude their deductibility.”** Most of Vitale’s claimed expenses were disallowed due to a lack of substantiation.

Issue 3. His seeking the advice of IRS representatives and of professional tax preparers on how to deduct expenses incurred as an author demonstrated that Vitale made a reasonable attempt to comply with the internal revenue laws. The court believed that he acted in good faith and declined to impose the accuracy penalty under I.R.C. §6662(a).

[Ralph Louis Vitale, Jr. v. Commissioner, T.C. Memo 1999-131 [CCH Dec. 53,346(M)]]

### Estate of Brockenbrough v. Commissioner

[I.R.C. §§183 and 6662]

**Facts.** In anticipation of their retirement, the Brockenbroughs purchased a 52-acre farm along with a house in Gay, Georgia. Mr. Brockenbrough was an airline pilot and his wife worked as a flight attendant.

Mrs. Brockenbrough liked antiques. In 1987 the Brockenbroughs opened an antique store in a building they purchased located in the town square. They relied primarily on friends to operate the antique store when Mrs. Brockenbrough was away. **By 1991, the Brockenbroughs knew that they could not make a profit from their antique store, but kept it open part-time until they could sell the remaining merchandise.** Finally, in 1992, they held an auction and sold their remaining inventory.

Mr. Brockenbrough decided to breed, raise, and train quarter horses at their farm in Gay. Before he bought any horses, he investigated the horse breeding and training business with others who had extensive experience in the field. He sought advice from a certified public accountant on how to keep books and records for the business. In 1991 Mr. Brockenbrough built a barn with stalls and a horse arena. That same year the Brockenbroughs purchased 15 horses and 16 cattle to use in training their horses, and hired a manager for the farm. They also advertised their horse business on the radio and in trade magazines.

Mr. Brockenbrough decided to hold rodeos to offset his initial losses from the farm. He consulted with members of the rodeo association, bankers, and accountants, and he attended numerous rodeos. Mr. Brockenbrough held a total of three rodeos during 1991 and 1992. He contracted with third parties to produce the first two, and he produced the last one himself with the help of his manager.

Mr. Brockenbrough determined that his manager was using Brockenbrough’s facilities for his personal gain, and dismissed him. **Based on the fact that they were unable to find a new manager**
and were also losing money on their horses and rodeos, the Brockenbroughs decided to discontinue these businesses.

Issues

1. Whether the taxpayers operated their antique store for profit
2. Whether the taxpayers operated their horse and rodeo undertakings as one activity
3. Whether the taxpayers operated their horse and rodeo activity for profit
4. Whether the taxpayers are liable for the accuracy-related penalty for negligence under I.R.C. §6662(a)

Analysis and Holding

Issue 1. In deciding whether the Brockenbroughs operated the antique store for profit, the court applied the nine factors provided in Treas. Reg. §1.183-2(b) (see Holmes v. Commissioner, elsewhere in this section, for a list of these factors). The only one of these factors that worked in favor of the Brockenbroughs was their expectation that the building would appreciate in value. The fact that they had no business plan, did not advertise, did not know what items were in inventory, and admitted that they knew in 1991 that their antique business could never be profitable led the court to conclude that this activity was not conducted in a businesslike manner. The Brockenbroughs had no experience and sought little advice about operating a retail store, and they had not previously engaged in similar business activities. They provided no evidence about how Mrs. Brockenbrough spent her time at the store.

The antique store was not profitable during any of the years it was open, and the Brockenbroughs did little to sell the building or the inventory during the two years after they knew that the business could not be profitable. The Brockenbroughs used these losses to shelter a large amount of their income. No evidence was provided that Mrs. Brockenbrough had a profit objective; she simply liked antiques. The court concluded that with the factors weighing heavily against them, the Brockenbroughs did not conduct their antique activity for a profit.

Issue 2. In determining whether two activities may be characterized as one activity, Treas. Reg. §1.183-1(d)(1) provides that the most important factors are the degree of organizational and economic interrelationship of the activities, the business purpose served by carrying on the activities separately or together, and the similarities of the activities. Both activities were conducted at the Brockenbroughs' farm, with the goal to make the farm profitable, and the farm assets were used for both activities. The rodeos were held, in part, to advertise and sell their horses. The court concluded that the Brockenbroughs operated their horse and rodeo activities as one activity under I.R.C. §183.

Issue 3. The court applied the nine profit motive factors provided in Treas. Reg. §1.183-2(b) to determine whether the Brockenbroughs conducted their horse and rodeo activity for profit. The Brockenbroughs conducted the horse and rodeo activity in a businesslike manner, consulted experts prior to undertaking these activities, kept adequate records, did not own the horses for personal pleasure, and adjusted their plan in their attempt to make a profit. Mr. Brockenbrough spent a lot of time and effort in the horse and rodeo activity. Factors weighing against the Brockenbroughs were the lack of profits from the horse and rodeo activity, and the fact that these losses were used to shelter a large amount of their income during the years in question. The Brockenbroughs did, however, abandon the horse and rodeo activity when they determined they could not make a profit. The court concluded that despite the lack of profitability, the Brockenbroughs had a good-faith intent to make a profit from their horse and rodeo activity.

Issue 4. The Brockenbroughs deducted a substantial amount of losses during the time after they realized that the antique store could not be profitable. The court concluded that the Brockenbroughs
were negligent in deducting these losses and held the Brockenbroughs liable for the accuracy penalty under I.R.C. §6662(a).


**Zdun v. Commissioner**

[I.R.C. §§183 and 6662]

*The taxpayer’s orchard activity cannot be combined with his dental practice to determine a profit motive.*

**Facts.** Terry Zdun is a dentist who practices holistic dentistry. His wife, Carol, is a dental assistant and assists Mr. Zdun in his dentistry practice. **Mr. Zdun recommends that his patients eat organic apples for their dental health.** In 1982 the Zduns planted a 5-acre apple orchard on their property surrounding their home. Due to a hard freeze, the apple trees did not produce any apples in 1992. In 1993 and 1994 Mr. Zdun estimated that the trees produced approximately 40,000 pounds of apples.

The Zduns did all the work to maintain the orchard, including picking the apples. Mr. Zdun picked only the “best” apples and threw the rest away. He took the apples to his office and sold the organic apples to his patients. If a patient could not afford to purchase the apples, Mr. Zdun simply gave them to the patient at no charge. The Zduns have never made a profit from their apple orchard activity, but considered this activity an integral part of his dental practice. The Zduns formed a partnership, and combined their dentistry activity gross receipts with their apple orchard activity income and expenses on one Form 1065, U.S. Partnership Return of Income.

The Service determined that the Zduns’ apple orchard activity was a separate and distinct undertaking from the dentistry activity, and that the Zduns engaged in the apple orchard activity with no bona fide profit objective.

**Issues**

1. Whether the taxpayers’ apple orchard activity and dentistry activity should be treated as one activity or two separate activities for purposes of I.R.C. §183
2. Whether the taxpayers’ apple orchard activity was engaged in with the intent to make a profit within the meaning of I.R.C. §183
3. Whether the taxpayers are liable for the accuracy-related penalty under I.R.C. §6662(a)

**Analysis and Holding**

**Issue 1.** In determining whether two activities may be treated as one activity, Treas. Reg. §1.183-1(d)(1) provides that the factors to consider are the degree of organizational and economic interrelationship of the activities, the business purpose served by carrying on the activities separately or together, and the similarities of the activities. The Zduns’ dentistry practice was year round, while their apple trees produced apples for only five months of the year. They had no cold storage facility to store the fruit during the rest of the year, so the apples were not available to the customers year round. Mr. Zdun also testified that only 10 to 15% of his customers actually took the apples. The Court concluded that the Zduns’ apple orchard activity and dentistry activity were two separate and distinct activities under I.R.C. §183.

**Issue 2.** In deciding whether the Zduns operated the apple orchard with “an actual and honest objective of making a profit,” the court applied the *nine factors provided in Treas. Reg. §1.183-2(b)* (see *Holmes v. Commissioner*, elsewhere in this section, for a list of these factors). The Zduns did not maintain
accurate books and production records for the apple orchard activity. They did not make any effort to sell the fruit to the public and, with his successful dentistry practice, could afford a “hobby” farm. The Court found that all nine factors weighed heavily against the Zduns and, accordingly, held that the Zduns did not have an actual and honest objective to make a profit with the apple orchard activity within the meaning of I.R.C. §183.

Issue 3. The court noted that the Zduns’ method of reporting the dental practice income grossed up with the farm income gave the apple orchard activity the appearance of a profit-making activity. The court concluded that the Zduns failed to provide adequate disclosure for purposes of I.R.C. §6662(d)(2)(B) and held that the Zduns were liable for the accuracy penalty.

[Terry F. and Carol J. Zdun v. Commissioner, T.C. Memo 1998-296, 76 TCM 278 [CCH Dec. 52,835(M)]]

**Wadlow v. Commissioner**
[I.R.C. §§183 and 6501]

**→** The election to postpone the determination of profit activity also impacts the extension by agreement provisions of statute of limitations on claiming a refund or credit.

**Facts.** The taxpayers began horse boarding and training activities in 1989. Under I.R.C. §183(d), if gross income exceeds the deductions for two of the seven years, the horse-related activity is presumed to be conducted for profit.

The taxpayers made valid elections on Form 5213, Election to Postpone Determination as to Whether the Presumption Applies That an Activity Is Engaged In for Profit, with their 1990–1993 tax returns. This postponement extended the taxpayers’ assessment period to April 15, 1998, two years after the due date for filing the return in the seven-year period. In August 1996 the IRS mailed deficiency notices to the taxpayer for tax years 1990 through 1994, disallowing deductions related to the horse activity claimed on Schedule C.

The tax years 1991 and 1992 remained in dispute in the Tax Court proceeding. The Tax Court stipulated in this proceeding that the taxpayers were entitled to claim additional Schedule C expenses during each of these two years, resulting in overpayments of $322 each year. The question here was whether the taxpayers can recover the overpayments in tax for these two years.

**Issue.** Whether an I.R.C. §183(e)(1) election to postpone determination of profit activity also impacts the extension by agreement provisions of the statute of limitations on claiming a refund or a credit under I.R.C. §6501(c)(4).

**Analysis.** The Tax Reform Act of 1976 [P.L. 94-455, §214(a)] added I.R.C. §183(e)(4). The report of the Senate Committee on Finance states that “the making of this election automatically extends the statute of limitations, but only with regard to deductions which might be disallowed under I.R.C. §183” [S. Rept. 94-938 (Part 1), at 67 (1976), 1976-3 C.B. 49, 106].

The overpayments of tax, in this case, were in connection with the taxpayers’ horse boarding and training activities. So the next question was whether the taxpayers satisfied the “written agreement” requirement for I.R.C. §6501(c)(4), thus extending the statute of limitations on refunds and credits under I.R.C. §6511(c). The Court agreed that by filing Form 5213, the taxpayers satisfied this written agreement requirement.

**Holding.** The Court held, in a 10-9 decision, that “the period of limitation for overpayments is extended because an I.R.C. §183(e)(4) election meets the requirements of an I.R.C. §6501(c)(4) agreement.”

[Robert E. Wadlow and Connie V. Wadlow v. Commissioner, 112 T.C. No. 18 (May 11, 1999) [CCH Dec. 53,375]]

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Holmes v. Commissioner  
[I.R.C. §183]


Facts. The taxpayers claimed deductions for losses incurred in operating a 165-acre farm, where they endeavored to grow Christmas trees for the commercial market, harvest timber, plant and cultivate row crops, and engage in the raising of trout and catfish. The Tax Court disallowed all the deductions claimed by the taxpayers as farm expenses incurred during the five years at issue. The Tax Court based their decision primarily on the conclusion that the taxpayers’ business records were “generally unbusinesslike, careless, and sloppy,” and that the taxpayers derived some personal benefits from their farming operations.

Issue. Whether the taxpayers were engaged in their farming activities with the actual and honest intent to earn profits, thereby entitling them to deduct their losses from these activities.

Analysis. In considering whether a profit motive exists, the court looked to the objective facts and also to the nine general factors set out in Treas. Reg. §1.183-2(b). These factors are:

1. The manner in which the taxpayer carried on the activity
2. The expertise of the taxpayer or his or her advisors
3. The time and effort expended by the taxpayer in carrying on the activity
4. The expectation that assets used in the activity may appreciate in value
5. The success of the taxpayer in carrying on similar or dissimilar activities
6. The taxpayer’s history of income or loss with respect to the activity
7. The amount of occasional profit, if any, that is earned
8. The financial status of the taxpayer
9. The elements of personal pleasure or recreation

The taxpayers carried on these farming activities in a businesslike manner by consulting with experts, engaging in manual labor and educational pursuits, and expending significant sums of money into the ventures. The taxpayers also demonstrated a genuine desire to operate a profitable business by implementing practices to correct the causes of their failures.

The taxpayers stated that they initially purchased the land with the expectation that their land would increase in value and elected to pursue farming activities on the land in the meantime. Their previous financially successful risk ventures and the losses sustained by the unforeseen circumstances such as drought did not negate their profit motive. The taxpayers denied that they derived any recreational benefit from their manual labor exerted in the spruce tree, timber reserve, row crop, or fishery efforts.

Holding. After reviewing the relevant facts in the case as they relate to the nine general profit motive factors, the Sixth Circuit concluded that the taxpayers possessed the requisite profit motivation in pursuing their farming endeavors and should be allowed to deduct the farm expenses from gross income. The Tax Court erred by focusing on the taxpayers’ “amateurish record keeping practices” and the minor personal benefits that they may have realized from their agricultural pursuits. The judgment of Tax Court was reversed.

[Robert E. Holmes and Carolyn S. Holmes v. Commissioner, 99-2 USTC ¶50,642 (CA-6, 1999)]
Gladden v. Commissioner
[I.R.C. §1221]

Water distribution rights are considered a capital asset, but the cost basis in the land cannot be allocated to the rights.

Facts. In 1976 William and Nicole Gladden and other investors formed a partnership, Saddle Mountain Ranch, and purchased ownership interest in farmland in Harquahala Valley, Arizona, for approximately $675,000. In 1983 the Interior Department allocated to the Harquahala Valley Irrigation District (HID) rights each year to receive, through the Central Arizona Water Conservation District, up to a specified quantity of Colorado River water. HID was granted the right to redistribute the river water to the Harquahala Valley landowners for the purpose of irrigating farmland on a per-acre basis. These landowners were required to pay HID for the Colorado River water they received under the allocation.

Issues
1. Whether water distribution rights are considered a capital asset under I.R.C. §1221, eligible for capital gain treatment
2. Whether any portion of the taxpayers’ basis in the land can be allocated to the water rights in determining this gain

In 1992 the Interior Department and HID entered into an agreement for relinquishment of HID’s water rights under the subcontract. The Interior Department agreed to discharge HID’s obligations to the federal government and to pay HID $28.7 million. In 1993 HID authorized distribution of the funds to the Harquahala Valley landowners who had approved relinquishment of the water rights. Saddle Mountain Ranch’s part of the distribution was $1.1 million.

Analysis and Holding. The allocation of water rights to the partnership was directly linked to and dependent upon the partnership’s ownership of the land. Landowners could sell their beneficial interests in the water rights, but only as part of a sale of their ownership interests in the land. The court held that the water rights represented one component of the partnership’s investment in the farmland, and that the partnership’s water rights should be treated as a capital asset. Capital asset treatment under I.R.C. §1221 results because the contract rights did not constitute any of the five types of property excluded from capital gain treatment under I.R.C. §1221(1) through (5) (namely, inventory, depreciable personal or real property used in a trade or business, certain intangible property, accounts receivable acquired in a trade or business, and certain governmental publications). Neither party pursued the possible treatment of the partnership’s water rights as I.R.C. §1231 real property (which would result in capital gain under I.R.C. §1231 anyway).

The funds received from the government were labeled “relinquishment funds” and were received in exchange for relinquishment of the water rights. HID distributed those funds to the partnership only in exchange for relinquishment of the partnership’s water rights. Therefore, this transaction constituted a sale or exchange of the water rights.

The court refused to let the partnership allocate any of its $675,000 cost basis in the land to offset the $1.1 million it received. When the partnership acquired the Harquahala Valley land in 1976, it did not have any vested rights to the Colorado River water. The partnership acquired and relinquished the water rights separately from the acquisition or sale of its ownership interest in the land.

**Facts.** Carl and Patricia Fabry operated a nursery in Florida, growing ornamental plants and citrus trees. In connection with the operation of the nursery, the Fabrys used a fungicide, Benlate, manufactured by E.I. duPont de Nemours and Co. (duPont). Their stock of plants suffered extensive damage during the years 1988 to 1991 as a result of their use of Benlate. The Fabrys filed a lawsuit against duPont in 1991, demanding monetary damages from the company. DuPont agreed to pay the Fabrys $3,800,000 in return for a “general release of all claims” signed by them. The Fabrys excluded $500,000 of these proceeds from gross income on their 1992 federal income tax return, claiming that this amount was allocable to business reputation damages.

**Issue.** Whether damages received on account of damage to business reputation are received on account of personal injuries within the meaning of I.R.C. §104(a)(2) and are, therefore, excludable from the taxpayers' gross income.

**Analysis.** Code §104(a)(2) provides that “the amount of any damages received on account of personal injuries or sickness” is excludable from gross income. The Fabrys argued that injury to business reputation is, as a matter of law, a personal injury. In *Threlkeld v. Commissioner*, 87 T.C. 1294 (1986) [CCH Dec. 43,530], the court stated that “the determination depended on the nature of the claim presented.” Neither in *Noel v. Commissioner*, 73 T.C.M. 2178 (1997) [CCH Dec. 51,920(M)], nor in *Knevelbaard v. Commissioner*, 74 T.C.M. 161 (1997) [CCH Dec. 52,158(M)], did the courts establish that business reputation damage is considered personal injury as a rule of law.

**Holding.** The court, in the present case, found that the release executed by duPont and the Fabrys “lacks specific language from which we can conclude that the $500,000 payment was received on account of personal injuries.” In examining the complaint, the mediation preceding the settlement, and the settlement negotiations, the Court found no evidence of a claim for personal injuries within the meaning of I.R.C. §104(a)(2). The taxpayers failed to prove that the $500,000 was received on account of “personal injuries” and were not allowed to exclude this amount from gross income under I.R.C. §104(a)(2).

[Carl J. Fabry and Patricia P. Fabry v. Commissioner, 111 T.C. No. 17 (December 16, 1998) [CCH Dec. 52,993]]

(See also *Fred Henry v. Commissioner*, T.C. Memo 1999-205, 77 T.C.M. 2209, for a similar ruling in which the taxpayer failed to prove that the settlement payment from duPont was received on account of “personal injuries.” The Court held that the taxpayer must include this amount in his gross income. In *Henry*, the taxpayer also received an assistance payment from duPont two years prior to the settlement, which the taxpayer claimed was a gift, and excluded this amount from his gross income. The Court rejected this contention because upon receipt of the payment, the taxpayer had agreed with duPont that this amount would be deducted from any ultimate settlement.)
**Klaassen v. Commissioner**  
[I.R.C. §55]

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**Note.** The following Appeals Court case affirms the decision reached by the Tax Court in 1998. See page 388 of the 1998 *Income Tax Workbook* for details.

**Brief analysis and discussion of the *Klaassen* 10th Circuit Court of Appeals case reported April 7, 1999.**

**Facts.** David and Margaret Klaassen did **not** attach Form 6251, Alternative Minimum Tax – AMT, to their 1994 tax return. They had no items of tax preferences as defined by I.R.C. §57. However, they **had 10 dependent children.** Included on their 1994 Schedule A were deductions for unreimbursed medical expenses of $4,767 and state and local taxes of $3,264.

The Klaassens reported a “regular tax” of $5,111 on their joint 1994 return but did not compute AMT. The IRS computed their “tentative minimum tax” on Form 6251 to be $6,196. Since the “tentative minimum tax” exceeded the “regular tax” by $1,085, the IRS assessed the taxpayers $1,085 of AMT for 1994.

**Issue.** Whether the Tax Court either (1) erred in applying the alternative minimum tax (AMT) provisions to taxpayers that had no tax preferences or (2) violated the taxpayers’ First and Fifth Amendment rights.

**Analysis.** The Klaassens are members of the Reformed Presbyterian Church. As part of their religious beliefs, they are opposed to any form of birth control. They contended that, by disallowing the personal exemption deduction for their 10 children, the AMT statute impermissibly burdens their free exercise of religion.

**Holding.** The Tax Court correctly held that the statute’s plain language unequivocally reaches the Klaassens. While the law may result in some unintended consequences, it must be applied as written. **Neither the statutory language nor the legislative history supports the argument that the AMT is limited to individuals with tax preferences.**

>[David R. Klaassen and Margaret J. Klaassen v. Commissioner, 99-1 USTC 50,418 (CA-10, 1999)].

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**Prosman v. Commissioner**  
[I.R.C. §55]

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**Facts.** George Prosman was employed as a consultant for Command Systems, Inc. (Command) in 1995. Most of his projects were out of town, and he incurred substantial travel expenses. He bid for...
various projects with Command using a formula that included both a standard hourly amount and a “per diem allowance” amount.

Prosman requested that Command separate the “per diem allowance” amount, which he used to pay for employee business expenses, from his base pay. Command refused his request and included both amounts as wages on his 1995 Form W-2.

The joint 1995 tax return of George and his wife reflected the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>AGI (mainly the W-2 wages from Command)</td>
<td>$83,143</td>
</tr>
<tr>
<td>State and local taxes deduction on Schedule A</td>
<td>8,825</td>
</tr>
<tr>
<td>Unreimbursed employee business expenses in excess of the 2% AGI floor on Schedule A</td>
<td>28,590</td>
</tr>
<tr>
<td>Taxable income</td>
<td>32,843</td>
</tr>
<tr>
<td>Total tax</td>
<td>4,924</td>
</tr>
</tbody>
</table>

Form 6251 (AMT—Individuals) was omitted from the taxpayers’ 1995 Form 1040.

**Issue.** Whether the taxpayers are subject to the alternative minimum tax (AMT) under I.R.C. §55.

**Analysis.** In calculating alternative minimum taxable income (AMTI, from line 21, Part II of the 1998 Form 6251), no deduction is allowed for state and local taxes and for miscellaneous itemized deductions paid. In addition, no deduction is allowed for personal exemptions. If AMTI exceeds the $45,000 exemption amount for married couples who file jointly, AMT liability may be created if the tentative minimum tax exceeds the regular tax.

**Holding.** The taxpayers contended that if Command had separated the “per diem allowance” amount from the standard hourly amount, they would not have been subject to the AMT. While the court sympathized with the taxpayers, under the plain meaning of the statute, the Prosms are liable for AMT in the amount of $2,688.

*George and Joan Prosman v. Commissioner, T.C. Memo 1999-87, 77 T.C.M. 1580 [CCH Dec. 53,300(M)]*

### BAD DEBT / LOSSES

**Starnes v. United States**

[I.R.C. §§1244 and 6662]

An ordinary loss deduction is disallowed for worthless stock that fails to qualify as §1244 stock.

**Facts.** In January 1992 Willis Starnes purchased shares of Regan Austin, Inc. stock from an individual for $30,000. In February 1992 he sold the stock to his ex-brother-in-law for $40. Starnes and his wife claimed the $29,960 capital loss on their 1992 tax return.

In December 1992, Starnes’ accountant told him that if Regan Austin, Inc. issued stock directly to him, then he could claim an I.R.C. §1244 stock loss. Backdated documents prepared in 1994 or later purport to indicate that Starnes was issued 301 shares of Regan Austin, Inc. stock in December 1992 for $100,500. These shares were sold days later, and Starnes claimed a $100,000 ordinary loss under I.R.C. §1244 on his joint 1992 income tax return.

Another backdated document dated December 1993 purported to show that Starnes purchased one share of Regan Austin, Inc. stock for $127,000, which the corporation issued as I.R.C. §1244 stock.
This share of stock became worthless when Regan Austin, Inc. went out of business at the end of 1993. Starnes, once again, claimed a $100,000 ordinary loss under I.R.C. §1244 on his joint 1993 tax return.

**Issue.** Whether the taxpayers were entitled to an ordinary loss deduction under I.R.C. §1244 for the taxpayers’ purported stock purchases.

**Analysis.** To qualify as I.R.C. §1244 stock, the stock must be common stock issued by a domestic small business corporation, 50% of whose income does not come from investment activity. The fact that Regan Austin, Inc. qualified under these requirements is not disputed here. The question here was whether the corporation issued common stock and whether the Starnes actually purchased stock in December 1992 and December 1993.

Regan Austin, Inc.’s articles of incorporation authorized the corporation to issue 10,000 shares of stock, all of which were issued prior to Starnes’ December 1992 transaction. Since the corporation was not authorized to issue any more shares of stock, Starnes could not have purchased any shares from the corporation in 1992 or 1993. Additionally, Starnes was unable to provide stock certificates to substantiate the purchases, and the backdated documents did not provide credible evidence.

**Holding.** Having determined that Starnes could not have purchased any I.R.C. §1244 stock, he and his wife are not entitled to the $100,000 ordinary losses for 1992 and 1993. The Court also held that the Starnes were liable for an accuracy-related penalty under I.R.C. §6662. “While good faith reliance on the advice of an accountant is a defense to the underpayment of income tax, merely hiring an accountant does not insulate a taxpayer from negligence penalties.”

**Pecora v. Commissioner**
[I.R.C. §§61, 1244, and 6662]

An unsubstantiated §1244 stock loss is disallowed.

**Facts.** In 1993 Antonio Pecora and other investors incorporated Bis Restaurant, Ltd. The Certificate of Incorporation authorized the issuance of 200 shares of no-par-value stock. On their 1993 income tax return, the Pecoras reported a $32,500 ordinary loss on Form 4797, Sale of Business Property, for I.R.C. §1244 stock associated with Bis. The Service disallowed this loss. The taxpayers also failed to report a portion of the interest income they received in 1993, but contended that although the bank accounts listed their own names and their social security numbers, they were held by the Pecoras for the benefit of their children.

**Issues**

1. Whether the taxpayers are entitled to a $32,500 ordinary loss deduction under I.R.C. §1244
2. Whether the taxpayers must report interest income held for the benefit of their children
3. Whether the taxpayers are liable for an accuracy-related penalty under I.R.C. §6662(a) for the underpayment of income tax

**Analysis and Holding**

**Issue 1.** Code §1244 allows an individual taxpayer to treat a loss on “section 1244 stock” as an ordinary loss instead of as a capital loss under the general rule as provided in I.R.C. §165(g)(1) and (2)(A). Treas. Reg. §1.1244(e)-1(a)(2) provides that in order to substantiate this ordinary loss deduction, a corporation should maintain records that show (1) the persons to whom the stock was issued, (2) the date
of issuance to these persons, and (3) a description of the amount and type of consideration received from each person. The Pecoras failed to provide any such documentation to establish that the Bis stock qualified as “section 1244 stock.” They were also unable to provide any records to establish their ownership and basis in the Bis stock. Finally, the Pecoras were unable to establish that this stock became worthless. Therefore, the court held that the taxpayers were not entitled to a $32,500 ordinary loss deduction.

Issue 2. The taxpayers’ bank accounts listed their own names and social security numbers, which established that the Pecoras are the beneficial and legal owners of these accounts. Code §61(a)(4) provides that any interest earned from these accounts must be reported as interest income by the taxpayers.

Issue 3. The court concluded that the Pecoras were liable for an accuracy-related penalty under I.R.C. §6662(a). The taxpayers failed to provide documentary evidence to support the $32,500 ordinary loss deduction. They also failed to report interest income as required. The Court held that the Pecoras “actions were not those of a reasonable and prudent under the circumstances.”

[Antonio and Francesca Pecora v. Commissioner, T.C. Memo 1998-393 [CCH Dec. 52,942(M)]]

Facts. August Klaue, a sophisticated businessman, believed that one of Roger Estes’ inventions, the Theratech device, had the potential to be a financial success. This device relieved the suffering caused by hemorrhoids without surgery.

In 1980 Klaue entered into a partnership agreement with Estes to finance a gold-dredging operation. The partnership borrowed funds from the bank in 1981, and in 1982 Klaue repaid the loan plus interest and the partnership ceased all business activities. Estes signed a promissory note for $177,000, representing one-half of the loan repayment amount, payable to Klaue in December 1983. At the same time, Estes transferred his stock in the Theratech device (worth $100,000) to a joint account with Klaue. These shares were sold in small amounts and the proceeds used to reduce the promissory note balance. These events placed Estes in financial trouble.

Klaue continued to advance Estes additional money, for which Estes signed promissory notes. Klaue believed that once the Theratech device became a financial success, Estes would be able to repay the amounts that Klaue lent him. Estes made no payments on these notes, and in 1993 Klaue demanded payment on the notes. Estes transferred his only asset, a powerboat, to Klaue. Based on the advice of his attorney, Klaue decided that any further efforts to collect the notes would be futile. The Klaues claimed a bad debt loss deduction on their 1993 income tax return. The Service disallowed the deduction, stating that these advances were not bona fide loans because they were contingent on the inventor’s success.

Issue. Whether the taxpayer is entitled to a nonbusiness bad debt deduction for cash advances to an inventor, when the debt became totally worthless in the year the inventor became insolvent.

Analysis. For purposes of I.R.C. §166, Klaue must prove that these advances were, in fact, bona fide debt and made with a reasonable expectation, belief, and intention that they would be paid. Additionally, Klaue must prove that the debt became wholly worthless in 1993, the year of the deduction.

The Court disagreed with the Service’s contention that the advances represented contingent loans, stating that risk should not be confused with contingencies. The Court found no express or implicit agreements between Klaue and Estes that the repayment of the advances was contingent upon the success of the Theratech device.
Once Estes encountered difficulties in marketing his Theratech device, the stock dropped from $1 to $0.10 per share. At this time, Klaue knew that Estes' financial success was dependent on the success of his medical device. The Court stated that an experienced businessman who was aware of Estes' financial situation could not have had a reasonable expectation that Estes would be able to repay this additional debt.

**Holding.** The Court concluded that only the advances made prior to the marketing difficulties were bona fide debt. The amount of the bad debt deduction, however, must be reduced by the value of the powerboat transferred to Klaue from Estes, and also by the sales proceeds of the medical device stock. The Court stated that Estes became insolvent at the time that he transferred his only remaining asset (the powerboat) to Klaue. Therefore, the Court agreed that the debt became wholly worthless in 1993.

> [August V. and Mary E. Klaue v. Commissioner, TC. Memo 1999-151 [CCH Dec. 53,368(M)]]

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**Gates v. Commissioner**

[I.R.C. §§165, 167, and 280B]

> No deduction is allowed for the loss of a building that was not abandoned prior to demolition.

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**Facts.** In 1984 Linden and Lois Gates purchased real property consisting of land and an old school building with the intention of renovating and leasing the building. In 1988 the Gates discovered asbestos in the floor tiles and heating system in the building, and, during the same year, vandals caused significant damage to the building. The following year, negotiations with the last entity interested in purchasing or leasing the building broke off. Then, in 1991, the Gates became convinced that the building had become worthless and had it demolished.

**Issue.** Whether the taxpayers were precluded by I.R.C. §280B from deducting any loss in 1991 as a result of the demolition of their building.

In 1995 the Gates filed an amended return for the tax year 1991 and claimed a deduction for the loss of the building. The IRS denied the deduction. The District Court held that the Gates could not take any deduction for loss on the building under I.R.C. §§165 or 167, since any loss during 1991 was "on account of" the demolition of the building and was disallowed by I.R.C. §280B. The judge reasoned that the allowable deductions for the vandalism and the discovery of the asbestos should have been taken in 1988.

**Analysis.** Code §165(a) provides that "there shall be allowed as a deduction any loss sustained during the taxable year not compensated for by insurance or otherwise." Code §167(a) provides that "there shall be allowed as a depreciation deduction a reasonable allowance for the wear and tear (including a reasonable allowance for obsolescence)...." Code §280B excludes from deductions allowable under these sections any losses incurred "on account" of the demolition of any structure.

The Gates relied on DeCou v. Commissioner [103 T.C. 80, 1994] and contended that their loss was incurred before the building was demolished because they withdrew the building from use prior to its demolition. The vandalism, the discovery of asbestos, and the withdrawal of interest by potential buyers were the events that the Gates claimed resulted in their decision to withdraw the building from use, resulting in their loss. These events had occurred in prior years, not the current year. Therefore, the building's usefulness was not suddenly and unexpectedly terminated, as in DeCou. Thus, the Court determined that the Gates failed to show that they abandoned the building before the demolition.

Any deductions for vandalism or the discovery of asbestos should have been taken in the year of the loss. The withdrawal of the potential buyer's interest was not a tax event that gives rise to a deductible loss.
**Holding.** The Third Circuit affirmed the decision of the District Court, agreeing that there was no deductible loss in 1991 that was not incurred on account of the building’s demolition.

*Linden Gates and Lois Gates v. Commissioner, 98-2 USTC ¶50,814 (CA-3, 1998)*

**Note.** See pp. 396–397 in the 1998 Income Tax Workbook for a discussion of the District Court decision in this case.

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**Rev. Rul. 99-13**

[I.R.C. §165]

The IRS has issued a list of areas that were adversely affected by disasters of sufficient severity and magnitude to warrant assistance from the federal government as presidentially declared disaster areas during 1998 under the Disaster Relief and Emergency Assistance Act. This list includes disaster areas in 33 states, the Marshall Islands, Micronesia, the Mariana Islands, Puerto Rico, and the U.S. Virgin Islands.

Under I.R.C. §165(i), if a taxpayer suffers a loss attributable to a disaster occurring in one of the listed areas, the taxpayer may elect to claim a deduction for that loss on the federal income tax return for the taxable year preceding the taxable year in which the disaster occurred.

Treas. Reg. §1.165-11(e) provides that the election to deduct a disaster loss for the preceding year must be made by filing a return, an amended return, or a claim for refund on or before the later of (1) the due date of the taxpayer’s income tax return for the taxable year in which the disaster actually occurred, or (2) the due date of the taxpayer’s income tax return for the taxable year immediately preceding the taxable year in which the disaster actually occurred.

For detailed listings of the affected states, counties, cities, or other areas, refer to Rev. Rul. 99-13, IRB 1999-10.


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**LTR 199903030, November 24, 1998**

[I.R.C. §162]

Restoration costs for flood-damaged business property are deductible as repairs.

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**Facts.** The taxpayer’s uninsured business property was damaged as a result of severe flooding in the Red River Valley of North Dakota and Minnesota. The taxpayer asked for guidance on the proper tax treatment for the cost of restoring this property to its pre-flood condition.

**Issue.** Whether the taxpayer should treat the expenses for restoring business property to its pre-flood condition as part of the casualty loss under I.R.C. §165, as deductible repairs under I.R.C. §162(a), or as capital expenditures under I.R.C. §263.

**Analysis.** The I.R.C. §165(a) deduction is generally available to taxpayers for losses sustained and not compensated for by insurance or otherwise to the extent of the subject property’s basis. Generally, the amount of the deduction is the difference between the fair market value of the property
before and after the casualty, to the extent such amount does not exceed the property's adjusted basis. Thus, the casualty loss does not include the repair or restoration expenses.

The Service explained that the costs of restoring flood-damaged property aren't deductible as a casualty loss, but may be deducted under I.R.C. §162 or treated as capital expenditures under I.R.C. §263, depending on the taxpayer's particular set of facts. Treas. Reg. §1.162-4 provides that taxpayers may currently deduct “the costs of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in ordinary efficient operating condition.” Treas. Reg. §§1.263(a) and (b) provide that the taxpayers must capitalize amounts incurred that add to the value of the property, substantially prolong the life of the property, or adapt the property to a new or different use.

Conclusion. The Service concluded that if the taxpayer simply restored its business property to its pre-flood condition, and these expenditures did not materially enhance the value, use, or life expectancy of the property, then the taxpayer may currently deduct these costs as repair expenses under I.R.C. §162.

**Cziraki v. Commissioner**
[I.R.C. §§165 and 6662]

The casualty loss deduction for the storm-damaged road is limited to the adjusted basis of the road.

**Facts.** Imre and Gizella Cziraki purchased 80 acres of real property (property A) in 1975 for $70,000. In 1983 they purchased 38 acres of real property (property B) adjacent to property A for $150,000. The Czirakis used these properties for their farming business, the Rainbow Hills Nursery. A road, partially constructed of asphalt, existed on a portion of property A at the time of the purchase. In 1983 Mr. Cziraki personally constructed dirt and gravel extensions to this road transversing both property A and property B to provide access to areas used by the nursery. An asphalt extension of the road was constructed in 1984 by outside contractors for a cost of $10,400.

Between late 1992 and early 1993, severe rainstorms damaged a portion of the asphalt road and much of the dirt and gravel road. The area was declared a federal disaster area, and the Czirakis filed for disaster relief. The Small Business Administration (SBA) estimated the cost to repair the road at $208,000. On their 1992 income tax return, the Czirakis claimed a casualty loss of $220,000, which was equivalent to the original cost of properties A and B. The Service disallowed the loss.

**Issues**

1. Whether the taxpayers are entitled to a casualty loss deduction of $220,000 for the storm damage to the roads on their farm property
2. Whether the taxpayers’ underpayment of tax is attributable to either negligence or intentional disregard of rules or regulations and should, therefore, result in an accuracy-related penalty

**Analysis and Holding**

**Issue 1.** The Service challenged the taxpayers’ computation of the casualty loss deduction under I.R.C. §165. Treas. Reg. 1.165-7(b)(1) provides that in the case of a casualty loss for property used in a trade or business or for the production of income, the amount of the loss shall be the lesser of: (1) the fair market value of the property immediately before the casualty reduced by the fair market value of the property immediately after the casualty, or (2) the adjusted basis of the property. Treas. Reg. 1.165-7(b)(2)(i) provides that this loss must be determined “by reference to the single, identifiable property damaged or destroyed.”

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The taxpayers argued that the road could not be separated from the surrounding real property; therefore, the basis limitation should be $220,000, which is the taxpayers’ combined purchase price of property A and property B. Contrary to their own argument that the road is part of the real property, the taxpayers were depreciating the 1984 road extension.

The court agreed with the Service that the road must be viewed separately as a single, identifiable piece of property. Since the Czirakis did not provide evidence to establish a separate basis in the dirt and gravel road, the Court concluded that the taxpayers’ casualty loss is limited to the adjusted cost basis in the 1984 road extension.

Issue 2. The Court believed that the Czirakis’ failure to comply with the regulations “was due to their reasonable belief that their cost could be allocated to the damage to the road.” The taxpayers relied upon their accountant to prepare their income tax return. Consequently, the Court ruled that the taxpayers were not liable for an accuracy-related penalty under I.R.C. §6662(a).

[Imre and Gizella Cziraki v. Commissioner, T.C. Memo 1998-439 [CCH Dec. 53,989(M)]]

Caan v. Commissioner
[I.R.C. §165]

A casualty loss deduction is denied to the taxpayer because there was no physical damage to the property.

Facts. Michael and Yvonne Caan filed a refund claim based on a disallowed casualty loss deduction of $400,000 taken under I.R.C. §165(c)(3). The Caans asserted that they were entitled to the deduction because their home fell in value by at least that amount after the double murders of Nicole Brown Simpson and Ronald Goldman and the subsequent media attention on the suspect, O.J. Simpson, whose house was located close to theirs.

Issue. Whether the taxpayers should be allowed a casualty loss deduction under I.R.C. §165(c)(3) as a result of the purported decrease in the value of their home resulting from the high-profile murder trial of one of their neighbors.

Analysis. In order for a taxpayer to be allowed to take a casualty loss deduction under I.R.C. §165(c)(3), the loss must have arisen “from fire, storm, shipwreck, or other casualty, or from theft.” The meaning of “other casualty” has been determined by looking to the shared characteristics of the listed casualties of fire, storm, shipwreck, and theft.

Code §165(c)(3) does not apply to losses to property value based solely on “buyer resistance.” The taxpayer must provide evidence that the murders and subsequent trial directly caused “physical damage” to the property to qualify for an I.R.C. §165 casualty loss deduction.

Holding. The Court held that the Caans were not entitled to a casualty loss deduction because they failed to show that the murders or the media attention caused “physical damage” to their property.

**Facts.** In 1983 Dale Carter, Jess Claiborne, and Dennis Porter formed Seminole Thriftway, Inc. Each shareholder contributed cash of $10,000 and loans of $50,000 in return for one-third of the 1,000 shares of authorized Thriftway stock. That same year, Thriftway obtained $1 million from a 15-year revenue bond issue. Carter, Claiborne, and Porter executed a guaranty agreement personally guaranteeing these bonds.

In 1985 Thriftway hired John Kildow as general manager of the Seminole store, and each shareholder transferred 70 shares of Thriftway stock to him, giving Kildow a total of 210 shares. In 1987 Dennis Porter transferred all of his shares to his wife, Cynthia. Three days later Porter, Carter, and Claiborne were elected to serve as directors for Thriftway. They authorized payments of guarantor fees to be paid annually to the three original shareholders on the total outstanding indebtedness – 8% in 1987 and 10% for each year beginning in 1988.

During 1992, 1993, and 1994, Thriftway paid neither dividends nor director’s fees, but it did pay the guarantor fees, deducting these amounts on its tax returns. The Service disallowed the deductions. Thriftway paid the resulting tax liability and filed for a refund.

**Issue.** Whether the guarantor fees paid by a closely held corporation to its shareholders qualify for a deduction under I.R.C. §162, or whether these fees were, in fact, disguised dividends.

**Analysis.** The Court cited a number of cases that provide a legal framework for defining when guarantor fee payments should be considered ordinary and necessary and when those payments should be considered as constructive dividend transactions. The cited cases include:

- *Tulia Feedlot, Inc. v. United States*, 75-2 USTC ¶9522, 513 F.2d 800 (CA-5, 1975)
- *Olton Feed Yard, Inc. v. United States*, 79-1 USTC ¶9299, 592 F.2d 272 (CA-5, 1979)

This framework includes several factors. First, the fees must be reasonable (*Tulia, 75-2 USTC ¶9522*). Second, businesses of the same type and size as the payor corporation must customarily pay guarantor fees to their shareholders [*Tulia, 75-2 USTC ¶9522; Fong, CCH Dec. 41,387(M)*]. Third, shareholders must demand compensation in exchange for signing on as guarantors [*Olton Feed Yard, 79-1 USTC ¶9299; Fong, CCH Dec. 41,387(M)*]. Fourth, the payment of guarantor fees suggests a constructive dividend if the corporation was profitable and could pay a dividend, but did not do so during the tax year (*Tulia, 75-2 USTC ¶9522; Olton Feed Yard, 79-1 USTC ¶9299*). Fifth, the courts consider the proportional relationship between the amount of the payments and the shareholders’ stock ownership (*Tulia, 3 Cl. Ct. 364*).

The Court agreed that the taxpayer’s type of business customarily pays guarantor fees and that the fees paid to the shareholders were reasonable. The shareholders signed the guaranty agreement without agreeing to compensation from the corporation. Because the decision to grant the fees did not come until four years later, the Court held that the guarantor fees were not a necessary part of the agreement.
The corporation claimed that, because of the change in ownership of stock, it made disproportionate contributions to its shareholders. With regard to Mr. Porter’s transfer to Mrs. Porter, the Court determined that Mr. Porter had continuity of ownership through his wife. Mr. Kildow did not come to the corporation until two years after the incorporation. He had no role in the original guarantor agreement and did not contribute any capital to the corporation. Thus, the guarantor payments were tied closely to the amount of stock owned immediately after incorporation by the three controlling shareholders.

The corporation earned profits during 1992, 1993, and 1994 but did not pay dividends to its shareholders during these years. The guarantor fees were paid out of the corporation’s current or accumulated earnings. The Court did not find the relationship between the dividend history and the payment of guarantor fees coincidental.

Conclusion. Although the Court agreed that the guarantor fees were both reasonable in amount and customary in the corporation’s type of business, the other factors in the case led the Court to conclude that the guarantor payments were a constructive dividend and were not deductible as an ordinary and necessary business expense.

[Seminole Thriftway, Inc. v. United States, 99-1 USTC ¶50,155 (Fed. Cl., 1998)]

Smith v. Commissioner
[I.R.C. §§162, 262, and 274]

Facts. During 1994 Kenneth Smith owned 50% of a corporation’s voting stock. He served as the corporation’s vice president and as a member of the board of directors. Smith was authorized to use the corporate charge cards to purchase equipment for the corporation and to charge his travel, meals, and other expenses incurred in connection with the corporation’s business. Smith also charged personal expenses on the corporate charge card.

Each month Smith forwarded the corporate charge card statement and his personal charge card statement to the corporation. The bookkeeper determined which charges were business and which charges were personal in nature. Then the corporation would pay the entire balance of both charge accounts, debiting the personal expenses to a receivable account. Smith’s periodic bonus payments with the corporation in early 1995. He disputed his liability with the corporation for some of the charges that were characterized as personal expenses, and was in litigation with the corporation during the trial in the present case.

The Smiths filed a joint income tax return for 1994 and claimed a Schedule C business loss deduction for $19,600 and a Schedule A deduction for unreimbursed employee business expenses in the amount of $23,500. The Service disallowed the claimed deductions.

Issue. Whether the taxpayers are entitled to certain business expense deductions, or whether these expenses are nondeductible personal expenses.

Analysis and Holding. The disputed credit card charges totaled $17,500. The taxpayer contended that he was entitled to deductions for these expenses because they constituted business expenses paid by him during 1994. To the extent that the disputed expenses are personal in nature, they are deductible pursuant to I.R.C. §262. To the extent that the disputed expenses are the corporation’s business expenses, they are not deductible by Smith because he failed to establish that his unreimbursed payment of the corporation’s business expenses qualifies as an ordinary and necessary expense of his own business under I.R.C. §162(a). The Court stated that the results from

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the litigation over the nature of the expenses will determine who is liable for the disputed charges. Thus, the Court held that the taxpayer was not entitled to deductions for the disputed charges.

The taxpayers also claimed deductions for interest and depreciation for their motor homes on their 1994 income tax return. Since the taxpayers were unable to substantiate with adequate records the extent that their motor homes were used for business purposes during 1994, the Court held that the taxpayers were not entitled to these deductions.

[Kenneth and Sheila Smith v. Commissioner, T.C. Memo 1998-368, 76 T.C.M. 674 [CCH Dec. 52,914(M)]]

Das v. Commissioner
[I.R.C. §§162, 280A, and 6662]

A shareholder-employee cannot shift expenses between the corporation and his Form 1040 Schedule C.

Facts. In 1993 Subhendo Das, an engineer, developed a computer-controlled sprinkler system and created a corporation to produce and market the system. He and his wife were officers and the only two shareholders of the corporation. On Schedule C of both his 1993 and 1994 income tax returns, Das claimed deductions for business expenses and for a home office. Das did not file a Schedule C with his 1995 joint income tax return. He filed returns for the corporation in 1993, 1994, and 1995. Das claimed expenses on the corporation’s return only when the corporation reported income. The Service disallowed the taxpayer’s Schedule C expenses for both years and contended that the claimed expenses belonged to the corporation and not to Das.

Issues

1. Whether the taxpayer is entitled to deduct business expenses on Schedule C, or whether these expenses belong to his corporation
2. If the Court holds that the taxpayer is entitled to deduct the business expenses, whether the taxpayer has substantiated the expenses
3. Whether the taxpayer is liable for the accuracy-related penalty under I.R.C. §6662(a)

Analysis and Holding

Issue 1. The taxpayer transferred all the equipment related to the sprinkler system to the corporation. Thus, the Court asserted that all the expenses related to the sprinkler system belonged to the corporation. The Court further pointed out that the fact that the expenses were deducted on the corporation’s tax return when the corporation had income shows that the expenses are those of the corporation. The taxpayer cannot shift expenses between the taxpayer and the corporation based on where the income is. The Court concluded that Das was furthering the business of the corporation [Leamy v. Commissioner, 83 T.C. 798 (1985) [Dec. 42,481]] and, therefore, the expenses belong properly to the corporation.

To determine whether the taxpayer is entitled to deduct home office expenses, the Court looked to the strict provisions of I.R.C. §280A(c). Code §280A(c)(1) provides that a taxpayer who is an employee must establish that a portion of this dwelling unit is (1) exclusively used, (2) on a regular basis, (3) for the purpose enumerated in I.R.C. §280A(c)(1)(A), and (4) maintained by the taxpayer for the convenience of his employer. Also, I.R.C. §280A(c)(5) provides that this home office deduction may not exceed the excess of gross income derived from such use over the deductions allocable to such use.

The taxpayer provided no evidence that he maintained a home office for the convenience of the corporation. Furthermore, there was no gross income from the taxpayer’s business as an
employee of the corporation. Thus, the Court concluded that the taxpayer is not entitled to deduct home office expenses on his personal income tax return.

Issue 2. The Court did not consider the issue of substantiation since it concluded that the expenses were those of the corporation and not of the taxpayer.

Issue 3. I.R.C. §6662(a) imposes a penalty for underpayment of income tax that is attributable to negligence or disregard of rules or regulations. The court found that the taxpayer was liable for the accuracy-related penalty for failing to report a capital gain and for improperly claiming expenses that were not allowable.

[Subhendo Das v. Commissioner, T.C. Memo 1998-353, 76 T.C.M. 594 [CCH Dec. 52,899(M)]]

**Lyle v. Commissioner**
[I.R.C. §§86, 162, 165, 6212, and 6662]

#* Job-hunting expenses are partly allowed, but temporary living expenses are denied.

**Issues**

1. Whether the taxpayers are entitled to deduct the alleged job-hunting expenses
2. Whether the taxpayers are entitled to deduct temporary living expenses
3. Whether the Service correctly determined that the taxpayers must recognize income from social security benefits in the 1995 tax year
4. Whether the taxpayers’ gambling losses are limited to their gambling income for the 1995 tax year
5. Whether the taxpayers are liable for the accuracy-related penalty under I.R.C. §6662(a) for negligence or disregard of rules or regulations.

**Issue 1: Job-Hunting Expenses**

**Facts.** In August 1994 the Lyles moved from El Paso, Texas, to Nashville, Tennessee, after Mrs. Lyle accepted a job in Nashville. In early 1995 Mr. Lyle had three interviews with prospective employers in the Nashville area, but none of the interviews resulted in employment. At the time of the interviews, the Lyles were living in an apartment in Nashville. In April 1995 Mr. Lyle went to Las Vegas, Nevada, to search for a job and to gamble. He drove from Nashville to Las Vegas and had three interviews while he was there, none of which resulted in employment. While in Las Vegas, Mr. Lyle contacted a high school principal he knew in El Paso, who hired him. After a three-month stay in Las Vegas, Mr. Lyle left for El Paso. He claimed $9,800 in job-hunting expenses on their 1995 income tax return, which the Service disallowed.

**Discussion and holding.** The Service had two alternative reasons for disallowing the job-hunting expenses. The Service’s first contention was that Mr. Lyle had no tax home in 1993, and therefore the traveling expenses cannot be deducted since they were not incurred “while away from home” [Sapson v. Commissioner, 49 T.C. 636 (1968) [CCH Dec. 28,877]]. Alternatively, the Service contended that, even if Mr. Lyle’s tax home was Nashville, only the expenses directly attributable to job hunting are deductible.

Although Mr. Lyle did not have a principal place of business during much of 1995, the Court determined that Nashville was his permanent place of residence from January through July 1995. First, he lived there for an eight-month period, from August 1994 through March 1995, and second, the Lyles paid rent (a substantial living expense) on an apartment from January through August 1995.
Since Mr. Lyle’s permanent place of residence was Nashville, he was not away from home during his Nashville job interviews. The Court limited his deductions to the mileage to these Nashville interviews. Treas. Reg. §1.162-2(b) provides that if an employee travels to an area to seek new employment and also engages in personal activities, traveling expenses are deductible only if the trip is related primarily to seeking new employment. The Court determined that since Mr. Lyle spent approximately one-fourth of his time job hunting while he was in Las Vegas, the trip was primarily personal in nature. Therefore, he was not entitled to deduct his travel expenses from Nashville to Las Vegas. The Court did allow Mr. Lyle to deduct one-fourth of his meals and lodging while in Las Vegas, as well as the mileage for the job interview that Mr. Lyle substantiated.

Issue 2: Temporary Living Expenses

Facts. Mr. Lyle’s teaching position in El Paso commenced in August 1995. As of September 1997, Mr. Lyle continued to reside in El Paso and Mrs. Lyle continued to reside in Nashville. Mr. Lyle claimed temporary living expenses that were incurred from August through December 1995, contending that he was entitled to the deduction since he lived in El Paso for less than 6 months during the year.

Discussion and holding. With regard to the temporary living expenses, the Court found the fact that Mr. Lyle lived in El Paso for less than six months during the year to be irrelevant. When a husband and wife are employed in two widely separated locations, they cannot deduct living expenses at either location [Foote v. Commissioner, 67 T.C. 1 (1976), (CCH Dec. 34,047)]. Since Mr. Lyle continued to reside in El Paso two years after the job commenced, the Court held that Mr. Lyle failed to establish that his El Paso job was temporary, and denied the temporary living expense deduction.

Issue 3: Social Security Benefits

Discussion and holding. The Lyles reported receiving social security benefits of $9,000 on their 1995 tax return, but failed to compute the taxable portion of the benefits to be included in their gross income. The Lyles argued that the taxation of social security benefits is an ex post facto law in violation of Article I of the Constitution. The Ex Post Facto Clause is not applicable in a civil context [Johannessen v. United States, 225 U.S. 227 (1912)]. The Court concluded that their position had no merit, and that I.R.C. §86 does not violate the Ex Post Facto Clause of the Constitution.

Issue 4: Gambling Losses

Discussion and holding. The Lyles claimed $1,200 in gambling wins and $35,000 in gambling expenses and losses on their 1995 income tax return. Code §165(d) provides that the losses from gambling shall be allowed only to the extent of the gains from gambling. Relying on Commissioner v. Groetzinger (87-1 USTC ¶9191, 480 U.S.), the taxpayers maintained that the net wagering losses represented a deductible trade or business expense. In Groetzinger, the taxpayer was a full-time gambler who was engaged in gambling as a trade or business. However, even if the gambling activity was a trade or business, the deduction of net wagering losses is precluded by I.R.C. §165(d), which provides that losses from wagering transactions are allowed only to the extent of gains from such transactions. Thus, the Court held that the Lyles were not entitled to deduct gambling losses in excess of their income from gambling.

Issue 5: Accuracy-Related Penalty under I.R.C. §6662(a)

Discussion and holding. The Court determined that Mr. Lyle, as self-proclaimed “trained tax specialist,” should have realized that the deductions for living and job-hunting expenses were not reasonable, and that the gambling losses were a “too good to be true” situation. The Court held that the Lyles were liable for the I.R.C. §6662(a) accuracy-related penalty. [John Allen and Glenna A. Lyle v. Commissioner, T.C. Memo 1999-184, 77 T.C.M. 2106 (CCH Dec. 53,405(M)])
**Peaden v. Commissioner**  
[I.R.C. §§168 and 7701]

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**Facts.** Harry Peaden is the sole shareholder of Country-Fed, an S corporation in the state of Georgia. Country-Fed is in the business of selling meat, chicken, and seafood products through direct sellers. During 1993 Country-Fed entered into three separate master leases for 565 refrigerated trucks. Each of the trucks had a useful life that extended beyond its respective lease term. Country-Fed provided these trucks to direct sellers, who used the trucks to distribute Country-Fed’s products.

**Country-Fed was not required to make a down payment in conjunction with any of the lease transactions.** Country-Fed executed the certification as required by I.R.C. §7701(h)(2)(c). In each lease transaction, the lessor’s rental income over the period of the lease exceeded the sum of the lessor’s depreciation and the cost of financing its purchase of the trucks.

The base rent (also referred to as the capitalized value) was the sum of all monthly rent payments due throughout the lease and was dependent on the lessor’s cost of buying the truck and refitting it to Country-Fed’s specifications. Over the lease term, a fixed portion of the monthly rent was applied to reduce the base rent, which, at the end of the lease term, effectively reduced the base rent to zero. The remaining portion of the monthly rent was a service and administrative charge that was not applied to reduce the base rent. **Title to the leased trucks remained with the lessor throughout the lease term.**

Each of the leases contained a terminal rental adjustment clause (TRAC), which obligated the lessor to sell the truck at the end of the lease term. If the proceeds of the sale by the lessor exceeded any remaining base rent plus the cost of arranging the sale, the lessor was required to remit the excess to Country-Fed. Conversely, if the proceeds of the sale by the lessor were less than the remaining base rent plus the cost of arranging the sale, Country-Fed was required to remit the difference to the lessor. Although not all of the master leases provided direct purchase options, **Country-Fed acquired title to most of the trucks by paying a nominal amount at the end of the respective lease transactions.**

The IRS disallowed the $2.9 million Schedule E rental deduction for the leased trucks and related equipment, concluding that the substance of the lease transactions was the purchase of a truck.

**Issues**


2. Whether such agreements should be treated as leases or purchases of trucks

**Analysis.** Code §7701(h)(1) provides that in the case of a qualified motor vehicle operating agreement which contains a TRAC:

1. Such agreement shall be treated as a lease if (but for such TRAC) such agreement would be treated as a lease under this title, and

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The Court disregards master lease “terminal rental adjustment clause” (TRAC) in determining whether lease transactions are entitled to lease treatment.
2. The lessee shall not be treated as the owner of the property subject to an agreement during any period such agreement is in effect.

The legislative history indicates that Congress did not elect to place any limitations that would have denied the protection provided by I.R.C. §7701(h) to lease transactions, such as those in this case, where “the total rental payments paid all but a nominal amount of the cost of the leased property.” [See Swift Dodge v. Commissioner, 76 T.C. 547 (1981) [CCH Dec. 37,805.] Thus, the Court stated that it would adhere to the plain language of I.R.C. §7701(h) and analyze the lease transactions without the TRAC.

**Holding.** The Tax Court concluded that, once the TRAC is disregarded, the lease transactions constituted leases.

[Harry E. Peaden, Jr. and Cindy D. Peaden v. Commissioner, 113 T.C. No. 6 (August 9, 1999) [CCH Dec. 53,494]]

**Observation.** The leasing deals effectively allowed the taxpayer to write off the trucks’ entire purchase price over a much shorter period of time than the 5-year MACRS depreciation recovery period that would have applied had the taxpayer bought the trucks instead of leasing them.

**Rev. Proc. 98-47**

[I.R.C. §198]

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**Purpose.** The Service issued Rev. Proc. 98-47, 1998-37 IRB 8, to provide procedures for taxpayers to elect to deduct any qualified environmental remediation expenditure (QER expenditure) under I.R.C. §198, which was added by the Taxpayer Relief Act of 1997 (P.L. 105-34).

**Background.** Code §198(a) allows a taxpayer to elect to treat any QER expenditure as an expense, currently deductible for the tax year in which it is paid or incurred. Code §198(b)(1) generally defines a QER 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 as a qualified contaminated site. A “qualified contaminated site” is defined in I.R.C. §198(c)(1)(A) as any area:

1. 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 I.R.C. §1221(1) in the hands of the taxpayer;
2. That is within a targeted area; and
3. At or on which there has been a release (or threat of release) or disposal of any hazardous substance.

Code §198(c)(1)(B) provides that before the area can be treated as a qualified contaminated site, the taxpayer must receive a statement from the appropriate state agency [as defined in I.R.C. §198(c)(1)(C)] where the area is located, verifying that the area meets requirements (2) and (3) above.

**Procedure.** The I.R.C. §198 election must be made on or before the due date (including extensions) for filing the tax return for the tax year in which the QER expenditures are paid or incurred. The taxpayer may make this election for any portion of QER expenditures for that year. The taxpayer must make an I.R.C. §198 election for each year in which the taxpayer intends to deduct these QER expenditures. Under the transition rules, taxpayers that claim a deduction for QER expendi-
BUSINESS EXPENSES: HOME OFFICE

Individuals making this election must include the total amount of I.R.C. §198 expenses on the “Other Expenses” line on Schedule C, E, or F (as appropriate) for their federal income tax returns. The taxpayer should identify these other expenses by writing “Section 198 Election” on the lines on which these amounts separately appear.

Persons other than individuals making this election must include the amount of I.R.C. §198 expenses on the “Other Deductions” line on their appropriate federal income tax return. On the attached schedule that separately identifies each expense included in “Other Deductions,” the taxpayer must write “Section 198 Election” on the lines on which these amounts separately appear.

The I.R.C. §198 election may be revoked only with the prior written consent of the Commissioner. The taxpayer must submit this request in the form of a private letter ruling for any taxable year for which the period of limitations for filing a claim for credit or refund of overpayment of tax has not expired.

Effective Date. This revenue procedure is effective for QER expenditures paid or incurred after August 5, 1997, and on or before December 31, 2000.


BUSINESS EXPENSES: HOME OFFICE

Gosling v. Commissioner
[I.R.C. §§162 and 280A]

Facts. John Gosling, a resident of Savannah, Georgia, reported home office expenses as deductions on his 1993 and 1994 tax returns. Gosling also claimed car and truck expense deductions for those years. Gosling used the fourth bedroom of his home as an office to conduct his music business. The room was used exclusively by Gosling as a home office. The majority of Gosling’s working hours were spent in his home office. Gosling used the home office to select repertoires for concerts, coordinate musicians, negotiate contracts, and prepare schedules. With the exception of rehearsals in Hilton Head (120 miles round trip), Gosling performed almost all of his duties at home.

Issue. Does Gosling’s home office meet the requirements of I.R.C. §280A(c) as the principal place of business?

Discussion. Deductions are allowed for the ordinary and necessary expenses paid or incurred in conducting a trade or business [I.R.C. §162(a)]. Code §280A(a) disallows deductions involving use of a dwelling unit that is used by taxpayer as a residence; however, I.R.C. §280A(c) creates an exception if the home office was (1) exclusively used, (2) on a regular basis, and (3) as the principal place of the petitioner’s business. Car and truck expense deductions for travel between the home office and other places of business are dependent upon meeting the home office requirement. Code §162(a) allows for deduction of travel expenses between a home office and another place of business.

In Commissioner v. Soliman (93-1 USTC ¶50,014), the two primary factors to be considered in deciding whether a home office is the taxpayer’s principal place of business are: (1) the relative importance of the activities performed at each business location and (2) the time spent at each place. Since Gosling was not only a conductor but also rendered services in a number of other capacities, the
Court determined that his most important functions were performed at the home office. He also spent the majority of his working hours at the home office.

**Holding.** The Court held Gosling’s home office was used exclusively and regularly in his business. The home office was considered his principal place of business. Therefore, the home office and car and truck expense deductions were allowed.

*John A. Gosling et ux. v. Commissioner, T.C. Memo 1999-148*

**Note.** The Taxpayer Relief Act of 1997 changed the definition of “principal place of business” for purposes of the home office deduction effective for the 1999 tax years and thereafter. Code §280A is amended to specifically provide that a home office qualifies as the “principal place of business” if:

1. The office is used by the taxpayer to conduct administrative or management activities of a trade or business, and
2. There is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities of the trade or business.

This change might alter the decisions in the next three cases, so that the home office deduction would be allowed.

*Popov v. Commissioner*  
[I.R.C. §§162, 262, 274, 280A, and 6662]

The home office deduction is denied for a violinist.

**Facts.** Katia Popov is a professional violinist. During 1993 she traveled to 38 locations to play with orchestras that recorded music for the motion picture industry. Peter Popov operated an international dating service whose goal was to introduce educated Eastern Europeans to Americans. The Service disallowed some of the taxpayers’ deductions on their 1993 income tax return.

**Issues**

1. Whether the taxpayers are entitled to the claimed employee expenses on Schedule A for home office, electricity, telephone, car and truck, meals and entertainment, and clothing
2. Whether the taxpayers are entitled to the claimed Schedule C deduction for travel
3. Whether the taxpayers are liable for the accuracy-related penalty under I.R.C. §6662(a) for negligence or disregard of rules or regulations

**Analysis and Holding**

**Issue 1**

Home office. Because the orchestras Mrs. Popov played with did not provide a place for her to practice, Mrs. Popov used a large portion of her living room exclusively for practicing and recording purposes. Based on the square footage of the apartment, the Popovs allocated a portion of the rent and electricity as a home office deduction. Code §280A(c)(1)(A) allows a deduction for the use of a taxpayer’s personal residence if a portion of the taxpayer’s personal residence is *exclusively used on a regular basis as the principal place of business for any trade or business of the taxpayer.*
Satisfied with the allocated costs and the exclusive use of the living room, the Court addressed the question of whether the home office constituted Mrs. Popov’s principal place of business. The Supreme Court, in *Commissioner v. Soliman*, 93-1 USTC ¶50,014, 506 U.S. 168 (1993), identified two key considerations in deciding whether an office located within a taxpayer’s dwelling unit is a taxpayer’s principal place of business: (1) the relative importance of the activities performed at each business location, and (2) the time spent at each place.

The Court stated that although the home office where she practiced was an important place for her business, Mrs. Popov’s actual performances were what earned her income. Accordingly, the Court concluded, the home office was not Mrs. Popov’s principal place of business, and she was not entitled to a home office deduction.

Telephone expense. The Popovs claimed that all the long-distance calls on their home telephone line were related to Mrs. Popov’s business. Because the taxpayers did not provide the business purpose of any of the long-distance phone calls, the Court held that these charges were personal and not deductible.

Car and truck expenses. Treas. Reg. §1.274-5T(b)(6) requires that, in order to substantiate a deduction attributable to listed property, a taxpayer must maintain adequate records or present corroborative evidence to show (1) the amount of each automobile expenditure, (2) the automobile’s business and total usage, (3) the date of the automobile’s use, and (4) the business purpose of the automobile trip. Mrs. Popov prepared a log that listed the date, destination, and round-trip mileage for each automobile trip she made. The Court found that this log contained sufficient information to satisfy the I.R.C. §274(d) requirements.

Meals and entertainment. Mrs. Popov dined frequently with other musicians in order to make contacts and obtain engagements. She submitted receipts from the restaurants, indicating the names of the people present at the meals. The Court held that Mrs. Popov did not substantiate the business purpose of these meals, and that casual conversation about business matters does not satisfy the business purpose requirement of I.R.C. §274(d). The Court disallowed the meal expense deduction.

Performance clothing. Mrs. Popov was required to wear certain types of clothing for her violin performances. Clothing that is suitable for general or personal wear does not qualify as a business expense under I.R.C. §162 [Green v. Commissioner, T.C. Memo 1989-599 [Dec. 46,133(M)]]]. The Court found that the majority of the clothing was suitable for general and personal wear, and was not a deductible ordinary and necessary business expense. However, the Court also held that the more formal items were not adaptable for general and personal wear, and allowed a deduction for these items.

**Issue 2.** Mr. Popov’s mother, who resides in Bulgaria, regularly placed advertisements in the local newspaper for Mr. Popov to promote his dating service business. During a period when his mother was visiting the United States, Mr. Popov flew to Bulgaria to place these advertisements in a number of other cities. He also wanted to establish an office in Bulgaria and had to go there in person since most transactions in Bulgaria are done in cash. The Court found that Mr. Popov’s trip to Bulgaria was primarily related to his dating service business, satisfying the I.R.C. §274(d) requirements, and thus constituted a deductible expense.

**Issue 3.** Code §6662(a) imposes a penalty on any portion of underpayment of tax that is attributable to negligence or disregard of rules or regulations. The Court concluded that the taxpayers had not proved that they acted in good faith with respect to the underpayment of tax attributable to the disallowed deductions, and held that the taxpayers were liable for the accuracy-related penalty. [Katia V. and Peter Popov v. Commissioner, T.C. Memo 1998-374, 76 T.C.M. 695 [CCH Dec. 52,920(M)]]
**Cole v. Commissioner**  
[I.R.C. §§162 and 280A]

**Facts.** Roy Cole owns a floor covering business. He spends approximately one hour each morning in his home office contacting customers, builders, and suppliers. When he returns home at night, he spends a few more hours preparing and returning calls from his home office. Cole converted one of his home’s bedrooms into the home office, and it is used exclusively in conducting his business. Cole does not have an office located anywhere else. The home phone is used for both business and personal use. Cole’s floor covering services are performed not at the home office but at the job sites. The IRS denied the home office expense deductions on Cole’s 1995 tax return. Cole petitioned the U. S. Tax Court to allow the home office deductions.

**Issue.** Does Cole’s home office meet the requirement of I.R.C. §280A(c)?

**Discussion.** Deductions are allowed for the ordinary and necessary expenses paid or incurred in conducting a trade or business [I.R.C. §162(a)]. Code §280A(a) disallows deductions involving use of a dwelling unit that is used by taxpayer as a residence; however, I.R.C. §280A(c) creates an exception if the home office was (1) exclusively used, (2) on a regular basis, and (3) as the principal place of petitioner’s business. In addition, in deciding if the home office is the taxpayer’s principal place of business, the relative importance of activities performed at each business location and the time spent at each place of business are controlling factors. The point where goods or services are delivered is given greater weight in determining where the most important functions are performed.

**Holding.** The Tax Court held that Cole’s home office was used exclusively and regularly in conducting his business but was not the principal place of Cole’s business. Since Cole’s services are not performed at the home office but at the job sites, the home office, although important, was not the principal place of business. Therefore, Cole’s deductions for home office expenses were disallowed.

[Roy J. Cole et ux. v. Commissioner, T.C. Memo 1999-207]

**Strohmaier v. Commissioner**  
[I.R.C. §§162, 262, and 280A]

**Facts.** Walter Strohmaier was an independent agent for an insurance brokerage firm and a part-time minister in Florida. Strohmaier was not provided an office by the insurance brokerage firm (which was located some 50 miles from his residence), and he was not required to report to or visit the brokerage firm office. Strohmaier was provided a customer list of insured persons, and, from this list, he serviced policyholders having problems or questions regarding their coverage, and he endeavored to sell them other coverage. Strohmaier performed background and preparatory work in his home office for both business and personal use.

**Issue.** Does Strohmaier’s home office meet the requirement of I.R.C. §280A(c)?

**Discussion.** Deductions are allowed for the ordinary and necessary expenses paid or incurred in conducting a trade or business [I.R.C. §162(a)]. Code §280A(a) disallows deductions involving use of a dwelling unit that is used by taxpayer as a residence; however, I.R.C. §280A(c) creates an exception if the home office was (1) exclusively used, (2) on a regular basis, and (3) as the principal place of petitioner’s business. In addition, in deciding if the home office is the taxpayer’s principal place of business, the relative importance of activities performed at each business location and the time spent at each place of business are controlling factors. The point where goods or services are delivered is given greater weight in determining where the most important functions are performed.

**Holding.** The Tax Court held that Strohmaier’s home office was used exclusively and regularly in conducting his business but was not the principal place of Strohmaier’s business. Since Strohmaier’s services are not performed at the home office but at the job sites, the home office, although important, was not the principal place of business. Therefore, Strohmaier’s deductions for home office expenses were disallowed.

[Strohmaier v. Commissioner, T.C. Memo 1999-207]
office, but he did not receive or interview clients there. Instead, he met with clients at their homes or other locations.

Strohmaier also performed services as a minister for approximately 6 months each year, essentially during the winter and spring. He was not affiliated with a particular church and served as chaplain to a mobile home community. He conducted services there twice weekly during the winter and spring. His sermons were prepared at his home office, but no services were performed there, and he did not receive or counsel religious patrons there.

Strohmaier combined his insurance and ministerial activities on Schedule C for 1993 and 1994. He deducted expenses for a home office, as well as for car and truck mileage in association with the two activities. He considered all mileage from the home to any place of business to be business transportation. Strohmaier also deducted meal expenses as travel costs, alleging that a medical condition required him to take rest periods during the day, which resulted in longer workdays and additional meal expenses.

Issues

1. Whether Strohmaier is entitled to a home office deduction under I.R.C. §280A(c) for the year 1994 in connection with his trade or business activities
2. Whether he is entitled, under I.R.C. §162(a), for the years 1993 and 1994, to deductions for car and truck expenses in excess of amounts allowed by the IRS
3. Whether he is entitled, under I.R.C. §162(a)(2), for the years 1993 and 1994, to deductions for travel expenses in excess of amounts allowed by the IRS

Discussion

The home office. Under I.R.C. §162(a), a taxpayer is permitted to deduct all ordinary and necessary expenses paid or incurred in carrying on a trade or business. Under I.R.C. §280A(c)(1)(A), however, deductions associated with a home office are generally disallowed unless the home office was used exclusively and regularly as the principal place of business of the taxpayer. The IRS does not dispute that Strohmaier used a portion of his apartment exclusively and regularly in his business activities, but denies that his residence constituted the principal place of business for his two activities.

Where a taxpayer's business is conducted in part in the taxpayer's residence and in part at another location, the following two primary factors are considered in determining whether the home office qualifies under I.R.C. §280A(c)(1)(A) as the taxpayer's principal place of business: (1) the relative importance of the functions or activities performed at each business location, and (2) the amount of time spent at each location. (See Commissioner v. Soliman, 93-1 USTC ¶50,014.)

Whether the functions or activities performed at the home office are necessary to the business is relevant but not controlling. The location at which the goods and services are delivered to customers generally will be regarded as an important indicator of the principal place of taxpayer's business.

Strohmaier contends that virtually all the work he did with respect to his insurance clients was done at home to determine what insurance coverage a customer had, and the additional coverage such customer might need. His visit to each customer was to close the deal. However, the visit by Strohmaier to each customer to close a transaction represented the most important function of his activity because, no matter how much preparatory work was done by Strohmaier at home, none of this work was of any value unless the customer agreed to buy the insurance. The preparatory work at his home, while necessary and relevant, was not controlling.

With respect to Strohmaier’s ministerial activity, his sermons and other services were not offered at his apartment; the delivery of those services occurred away from his apartment. While he prepared and researched his topics or sermons at home, the most significant function of his activity was the delivery of his services to the places where his patrons were located. The preparation for his services at his apartment, while certainly relevant and necessary, was secondary to the delivery of the services.
Car and truck expenses. It is well settled that, as a general rule, the expenses of traveling between one’s home and place of business or employment constitute commuting expenses that are nondeductible personal expenses. The Tax Court has previously held that “a taxpayer’s cost of transportation between his residence and local job sites may be deductible if his residence serves as his ‘principal place of business’ and the travel is in the nature of normal and deductible business travel” [Wisconsin Psychiatric Services v. Commissioner, 76 T.C. 839 (1981) [Dec. 37,923]]. Strohmaier’s residence, however, was not his principal place of business.

The Court noted, however, that in Walker v. Commissioner, 101 T.C. 537 (1993), the taxpayer was allowed to deduct transportation expenses incurred between his residence and local temporary job sites. In Walker, the taxpayer’s residence was considered his “regular” place of business rather than his “principal” place of business. However, the conclusion in Walker was based on a concession of the issue by the Commissioner based on Rev. Rul. 90-23, 1990-1 C.B. 28. This revenue ruling has subsequently been amended to reflect existing case law, as articulated above. (See Rev. Rul. 94-47, 1994-2 C.B. 18.) Since Strohmaier’s residence was not his “principal place of business,” the expenses relating to the disallowed mileage for each year constitute commuting expenses that are not deductible.

Travel expenses. Strohmaier agreed with the IRS that, as to the amounts at issue, he was not away from home overnight and did not obtain lodging in connection with those expenses. The disallowed amounts represented costs of meals he incurred in connection with his two business activities.

Strohmaier contended that he incurred the meal expenses because he suffered from a medical condition, apnea, which required that he take rest periods during the day. As a result, his workday was much longer than normal, and he therefore sustained the cost of these meals on his extended workdays.

Code §162(a)(2) permits the deduction of traveling expenses, including meals, while one is away from home overnight and did not obtain lodging in connection with those expenses. The disallowed amounts represented costs of meals he incurred in connection with his two business activities.

Code §162(a)(2) permits the deduction of traveling expenses, including meals, while one is away from home overnight and did not obtain lodging in connection with those expenses. The rest period required for the deductibility of travel expenses requires a rest of sufficient duration in time that necessitates the securing of lodging; a mere pause in the daily work routine does not satisfy the requirements of I.R.C. §162(A)(2). In Barry v. Commissioner, 71 U.S.T.C. ¶9126, the Court held that a taxpayer does not “qualify as one obliged to sleep or rest simply because the length of his trip tired him, and he stopped by the side of the road for a brief nap.”

Holding

1. The residence was not Strohmaier’s principal place of business and, accordingly, the home office expenses are not deductible under I.R.C. §280A.
2. The car and truck expenses incurred by Strohmaier between his residence and the places where he conducted religious services, and the car and truck expenses between his residence and the first and last place of insurance customer contact each day are nondeductible commuting expenses.
3. The expenses for meals, in the absence of overnight lodging, are not deductible as travel expenses away from home under I.R.C. §162(a)(2), where the meal expenses incurred are occasioned by Strohmaier’s rests to accommodate his medical condition.

[Walter R. Strohmaier v. Commissioner, 113 T.C. No. 5 (August 3, 1999)]
BUSINESS EXPENSES: REASONABLE COMPENSATION

Herold Marketing Associates, Inc. v. Commissioner
[I.R.C. §162]

The compensation for the sole shareholder, president, and sole director of a marketing company was reasonable.

Facts. Stephan Herold is the sole shareholder, sole director, and CEO of Herold Marketing Associates, Inc. (Herold). Herold is a manufacturer’s representative for consumer electronic components. Stephan is involved in all aspects of the company’s operations, including the hiring process, business planning, sales forecasting and reporting, and development of customer relationships. Despite setbacks encountered by Herold, Stephan was able to maintain and improve the profitability of Herold by implementing changes that turned the company around. More than once, Stephan placed his personal assets at risk in order to keep the company going. Herold has never paid any dividends throughout its existence.

Stephan has no written employment contract with Herold, but does have a written bonus plan. As the sole member of Herold’s board of directors, Stephan devised formulas under which his bonus was paid, keying the bonus to specific sales increase percentages. In establishing his compensation, Stephan focused on executives at firms in related fields, and arrived at a figure that he considered an appropriate level to aspire to himself. In 1992 and 1993, he considered his salary and bonus target to be $1.2 million. Stephan stuck to his bonus plans each year, and in years in which he failed to achieve his sales target, he did not receive the maximum bonus attainable in the plan. At the time of the trial, a potential buyer had offered $25 million to Stephan for his stock in Herold. Stephan had not accepted the offer at that time.

The Service determined that Herold’s deduction for compensation paid to Stephan was unreasonable, and disallowed $700,000 of the $1.2 million deduction.

Issue. Whether a marketing company is entitled to deduct the full $1.2 million payment under I.R.C. §162 as reasonable compensation to its CEO and sole shareholder.

Analysis. The court looked to the factors provided in Rutter v. Commissioner, 88-2 USTC ¶9500, 853 F.2d 1267 (CA-5, 1988), in considering whether the compensation was reasonable. These first nine of these factors include:

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 gross income and 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 amount of compensation paid to the employee in previous years
9. The salary policy of the taxpayer as to all employees
10. The employer’s financial condition
11. Whether the employer and employee dealt at arm’s length
12. Whether the employee guaranteed the employer’s debt
13. Whether the employer offered a pension plan or profit sharing plan to its employees
14. Whether the employee was reimbursed by the employer for business expenses that the employee paid personally

Stephan was highly qualified and the primary reason for Herold’s success. He oversaw all the executive and managerial functions. The Court determined that his salary was reasonable during 1992 and 1993, representing less than 3.4% of gross receipts and less than 30% of gross income. As indicated above, Stephan implemented changes when the company faced financial setbacks.

The Court refused to second-guess the business judgment of Stephan and viewed the decision not to pay dividends as a reasonable business decision. Stephan contended that he treated his company as a “growth stock,” reinvesting earnings in order to derive a return on his investment when he sold his shares in the company. His decision to increase retained earnings rather than to pay out dividends was supported by the recent $25 million offer to purchase Stephan’s stock in Herold.

Herold was very profitable under Stephan’s leadership. Although Stephan controlled every detail of the process by which his compensation was determined, he went to great lengths to develop an objective bonus formula each year. Stephan pledged his own assets to keep the company going and ensure its success. Herold did not have a pension or profit-sharing plan, so Stephan did not receive any benefits of retirement plan contributions. Also, the Court found no evidence that Herold incurred unreimbursed expenses on Stephan’s behalf.

**Holding.** The court found that the analysis of these factors weighed in favor of Herold, and held that all of the compensation paid to Stephan by Herold during the years in question was reasonable and, therefore, deductible.


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**Labelgraphics, Inc. v. Commissioner**

(I.R.C. §§162 and 6662)

# Compensation to the sole-shareholder/president of a label and printing manufacturer is reduced/was unreasonable.

**Facts.** Lon Martin was the president and sole shareholder in Labelgraphics, Inc. during the fiscal year in question. **Mr. Martin has been extremely successful in operating Labelgraphics and in expanding its sales.** He was instrumental in developing the “Micro Clean process” for producing labels that meet the “clean room” production facility standards of Labelgraphics electronics industry customers. Labelgraphics began selling these clean labels in 1990 and anticipated that the clean labels would produce significant sales and profits in future years. By 1995 these labels accounted for 30% of Labelgraphics’ sales.

The directors of Labelgraphics had no fixed formula for determining Mr. Martin’s annual bonuses, but generally considered Labelgraphics’ financial performance for the fiscal year. For fiscal year 1990 the directors agreed to pay Mr. Martin a total bonus of $722,913, which was almost three times as much as the largest previous bonus of $250,000, paid to him in 1988. As a result of this bonus, Labelgraphics suffered a loss for the year. In 1992 Mr. Martin sold all of his stock in Labelgraphics to his son, Mike. From its incorporation through the time that Mr. Martin sold his stock, Labelgraphics neither declared nor paid any formal dividends.

The Service disallowed a large portion of Labelgraphics’ deduction for compensation paid to Mr. Martin for 1990, stating that this amount did not constitute reasonable compensation.
Issues

1. What is the amount that a label and printing manufacturer is entitled to deduct under I.R.C. §162 as reasonable compensation to its president and sole shareholder?

2. Is the manufacturer liable for an accuracy-related penalty under I.R.C. §§6662(a) and (b)(2) with respect to its claimed compensation deduction?

Analysis and Holding

Issue 1. Treas. Reg. §1.162-7(a) provides a two-prong test for determining deductibility of compensation: (1) whether the amount of compensation is reasonable in relation to the services performed, and (2) whether the payment is in fact purely for services rendered. Generally, the courts have focused on the reasonable requirement in determining the deductibility of the compensation. In Elliotts, Inc. v. Commissioner, 83-2 USTC ¶9610, 716 F.2d 1241 (CA-9, 1983), the Ninth Circuit used a five-factor test to determine the reasonableness of compensation:

1. The employee’s role in the company
2. A comparison of the compensation paid to the employee with the compensation paid to similarly situated employees in similar companies
3. The character and condition of the company
4. Whether a conflict of interest exists that might permit the company to disguise dividend payments as deductible compensation
5. Whether the compensation was paid pursuant to a structured, formal, and consistently applied program

There was no question that Mr. Martin was the primary reason for the success of Labelgraphics; however, the 1990 bonus was unusually high compared with previous years. Labelgraphics claimed that this large bonus was to compensate Mr. Martin for his services in prior years, but offered no explanation in support of this claim. Labelgraphics contended that this bonus was the equivalent of the stock options that many high-technology companies give their top executives, but failed to offer any details concerning the specific high-technology companies upon which this claim was based.

As a result of the 1990 bonus, Labelgraphics had a negative 6.19% return on equity for the year. The Court believed that an independent investor would not be happy with such a return, especially since the unusually high bonus payment that produced the loss was equal to 45.37% of the investor’s equity in the company.

Although it considered the $156,000 salary paid to Mr. Martin to be reasonable, the Court decided that Mr. Martin should receive a bonus tied to Labelgraphics’ financial performance, as had been its practice in previous years. The analysis of the facts in this case led the Court to hold that the bonus amount paid to Mr. Martin for 1990 was unreasonable. The Court concluded that a $250,000 bonus to Mr. Martin would be reasonable, and that the resulting revised return on equity would satisfy an independent investor.

Issue 2. The Court determined that Labelgraphics provided adequate disclosure in its income tax return since it included a properly completed Schedule E concerning its officers’ compensation, and that Labelgraphics was not liable for a penalty under I.R.C. §§6662(a) and (b)(2).

[Labelgraphis, Inc. v. Commissioner, T.C. Memo 1998-343, 76 T.C.M. 518 [CCH Dec. ¶52,889(M)]]
BUSINESS EXPENSES: REASONABLE COMPENSATION

O.S.C. & Associates v. Commissioner
[I.R.C. §§162 and 6662]

Incentive plan payments made to employee-shareholders were not made with compensatory intent.

Facts. In 1970 Allen Blazick bought a silk-screening business for $180. As the business grew, he hired his brother-in-law, Steven Richter, to help him with manufacturing. In 1982, Olympic Screen Crafts (OSC) was incorporated. Blazick became OSC’s president and chief executive officer, and owned 90% of its stock. Richter became OSC’s vice president, and received the remaining 10% of OSC stock. In 1991 OSC employed over 200 people and grossed over $13 million a year.

Three years after OSC incorporated, it adopted an incentive compensation plan that was developed by Leo Rosi, Blazick’s college acquaintance and OSC’s CPA. The purpose of the plan was “to recognize and compensate Blazick and Richter for their . . . contributions to the business.” Under the terms of the plan, the amount of the incentive compensation pool was to be determined at the end of each fiscal year by calculating the difference between a hypothetical adjusted industry gross margin and OSC’s actual gross margin. The plan expressly provided that payments from the incentive compensation pool would be made “according to stock ownership.” In practice, this incentive plan resulted in the distribution of between 81 and 94% of the corporation’s net income to Blazick and Richter.

Rosi performed the implementation of the incentive plan. He miscalculated OSC’s gross profits, resulting in an arbitrary increase to the incentive compensation pool. Rosi specifically advised OSC to pay dividends, but Blazick was strongly opposed to the idea. A credit memorandum prepared by a bank officer in 1992 contained a statement regarding Blazick’s $1.8 million salary in 1991. “The reasoning behind the higher salary is taxable income. Mr. Blazick does not intend to be taxed twice for the profitability of his business.”

The Tax Court found that the plan allocations were not made with compensatory intent. It found that the plan “was both designed and manipulated to direct the flow of corporate earnings to Blazick and Richter and to disguise such payments as compensation.”

Issues

1. Whether OSC, pursuant to I.R.C. §162, is entitled to deduct certain compensation payments to the shareholders in amounts in excess of the amounts determined by the IRS.
2. Whether OSC, pursuant to I.R.C. §6662(a), is liable for the accuracy-related penalties for negligence.

Analysis and Holding

Issue 1. When payments are made to an individual who is both a corporate employee and a principal shareholder, a two-prong test is applied to determine whether the distribution is truly compensatory and, therefore, deductible under I.R.C. §162(a)(1). First, the amount of the compensation must be reasonable; second, the payment must be purely for services or have a purely compensatory purpose. In Elliotts, Inc. v. Commissioner, 83-2 USTC ¶9610 (CA-9, 1983), the Ninth Circuit noted that since the existence of a compensatory purpose can often be inferred if the amount of the compensation is determined to be reasonable, the courts generally concentrate on this first prong. The Court in Elliotts specifically held that “where there is evidence that an otherwise reasonable compensation payment contains a disguised dividend, the inquiry may expand into compensatory intent apart from reasonableness.”

In the present case, the Tax Court relied on several factors in finding disguised dividends:

1. The percentage of OSC’s net income paid to its two employee-shareholders was high during the years in question.
2. OSC never paid or declared a dividend.
3. Rosi manipulated the actual implementation plan to increase the allocations above what the plan itself authorized.
The design of the plan itself was inconsistent with compensatory intent:

a. It applied only to the corporation's shareholders and no other employees.

b. Payments were calculated with reference to their proportionate stock ownership.

c. The method of calculation was not based on the value of services rendered, but was structured to distribute every dollar of gross profit in excess of the hypothetical gross profit.

The Ninth Circuit found that the Tax Court’s findings were not erroneous. Therefore, it affirmed the Tax Court’s determination that OSC’s incentive plan payments were not made with compensatory intent.

Dissenting was Circuit Judge Charles Wiggins. He agreed with factual findings but believed that an apportionment between the allowed amount for deductible compensation and nondeductible disguised dividend payments was required in this case. OSC, however, did not raise the apportionment issue. OSC’s contention was that the entirety of the claimed amounts of incentive compensation should have been allowed.

Issue 2. The Tax Court concluded that OSC failed to exercise ordinary care in attempting to comply with Internal Revenue Code. OSC’s incentive plan was designed to direct the flow of corporate earnings to its shareholders. Further, OSC ignored the advice of its accountant to pay dividends. Since OSC has failed to produce sufficient evidence to overcome the presumption of negligence, the Ninth Circuit affirmed the Tax Court’s penalty assessment.


BUSINESS EXPENSES: TRAVEL AND TRANSPORTATION

Rev. Proc. 98-64
[I.R.C. §274]

The per diem rates for substantiation of business expenses for lodging, meals, and incidental expenses are provided for 1999.

Changes. Rev. Proc. 98-64 (1998-52 IRB 32) supersedes Rev. Proc. 97-59 (1997-52 IRB 31) with respect to per diem allowances paid on or after January 1, 1999. This revenue procedure also contains revisions to the list of high-cost localities and to the high-low rates for purposes of the high-low substantiation method.

Background. Code §274(n) generally limits the amount allowable as a deduction under I.R.C. §162 for any expense for food, beverages, or entertainment to 50% of the amount of the expense that otherwise would be allowable as a deduction.

In the case of expenses for food or beverages consumed while away from home [within the meaning of I.R.C. §162(a)(2)] by an individual during, or incident to, the period of duty subject to the hours-of-service limitations of the Department of Transportation, I.R.C. §274(a)(3) gradually increases the deductible percentage to 80% for taxable years beginning in 2008. For 1999, the deductible percentage for these expenses is 55%.

Per Diem Substantiation Method

Per diem allowance. If a payor pays a per diem allowance in lieu of reimbursing actual expenses for lodging, meals, and incidental expenses incurred by an employee for travel away from home, the amount of the expenses that is deemed substantiated for each 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).
Meals-only per diem allowance. If a payor pays a per diem allowance only for meals and incidental expenses (M&IE) in lieu of reimbursing actual expenses for these items incurred by an employee for travel away from home, the amount of the expenses that is deemed substantiated for each 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 (or partial day).

Special rules for transportation industry. A taxpayer (either an employer or a self-employed individual) in the transportation industry may treat $38 as the federal M&IE rate for any locality of travel within the continental United States (CONUS), and $42 as the federal M&IE rate for any locality of travel outside the continental United States (OCONUS).

High-Low Substantiation Method

Specific high-low rates. The per diem rate for lodging, meals, and incidental expenses set forth in this section is $185 for travel to any “high-cost locality” specified in this revenue procedure, or $115 for travel to any other locality within CONUS. For purposes of applying the high-low substantiation method and the I.R.C. §274(n) limitation on meal expenses, the federal M&IE rate shall be treated as $42 for a high-cost locality and $34 for any other locality within CONUS.

High-cost localities. The following localities have a federal per diem rate of $150 or more for all or part of the calendar year, and are high-cost localities for all of the calendar year or the portion of the calendar year specified under the key city name:

<table>
<thead>
<tr>
<th>State</th>
<th>Key City</th>
<th>County or Other Defined Location</th>
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<tbody>
<tr>
<td>Alabama</td>
<td>Gulf Shores (May 1–September 30)</td>
<td>Baldwin</td>
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<td>California</td>
<td>Gualala</td>
<td>City limits of Gualala</td>
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<td>Palo Alto</td>
<td>City limits of Palo Alto</td>
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<td>California</td>
<td>San Francisco</td>
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<td>California</td>
<td>Sunnyvale</td>
<td>City limits of Sunnyvale</td>
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<td>California</td>
<td>Yosemite National Park (April 1–October 31)</td>
<td>Mariposa</td>
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<td>Colorado</td>
<td>Aspen (June 1–March 31)</td>
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<td>Telluride (November 1–March 31)</td>
<td>San Miguel</td>
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<td>Colorado</td>
<td>Vail</td>
<td>Eagle</td>
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<td>Florida</td>
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<td>Jupiter (January 1–April 30)</td>
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<td>Maine</td>
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<td>Hancock</td>
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</table>
Limitations and Special Rules

Proration of the federal per diem or M&IE rate. 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 substantiated under this revenue procedure with respect to partial days of travel away from home, either of the following methods may be used to the prorate these rates:

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1. Such rate may be prorated using the method prescribed by the federal travel regulations, which currently allow three-fourths of the applicable Federal M&IE rate for each partial day an employee or self-employed individual is traveling away from home; 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 two-times the federal M&IE rate will be treated as being in accordance with reasonable business practice (even though only 1½ times the federal M&IE rate would be allowed under the federal travel regulations.


The Service has advised that independent contractors cannot use the federal rate to substantiate lodging expenses. Actual documentation, such as receipts or paid bills, is required to support an expenditure for lodging [Treas. Reg. §1.274-5T(c)(2)(iii)(A)]. While Rev. Proc. 98-64 (1998-52 IRB 32) allows employees and self-employed individuals to use the federal M&IE rate to substantiate meal expense deductions, the federal lodging rate may not be used to substantiate deductions for lodging.

Note. The federal per diem rates that include both lodging and meals and incidental expenses can be used only under an accountable plan for substantiation and reimbursement purposes. Taxpayers cannot use the lodging component of the per diem rate to substantiate unreimbursed lodging expenses or lodging expenses reimbursed under a nonaccountable plan.

The 1999 standard mileage rates are announced.

<table>
<thead>
<tr>
<th></th>
<th>January 1 through March 31, 1999</th>
<th>April 1 through December 31, 1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business</td>
<td>32.5 cents per mile</td>
<td>31 cents per mile</td>
</tr>
<tr>
<td>Charitable</td>
<td>14 cents per mile</td>
<td>14 cents per mile</td>
</tr>
<tr>
<td>Medical and moving</td>
<td>10 cents per mile</td>
<td>10 cents per mile</td>
</tr>
</tbody>
</table>

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This information was correct when originally published. It has not been updated for any subsequent law changes.
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 I.R.C. §280F).


T.D. 8784
[I.R.C. §274]

The regulations regarding the use of mileage allowances to substantiate automobile business expenses are released.

This document contains temporary and final regulations concerning the use of mileage allowances to substantiate automobile business expenses. The rules apply to payors who make payments and employees who receive payments under reimbursement or other expense allowance arrangements for the use of an automobile in a business. The regulations are effective October 1, 1998.

Explanation of Provisions. Treas. Reg. §1.274(d)-1 provides that the Commissioner may prescribe rules under which mileage allowances reimbursing ordinary and necessary expenses of local travel and transportation while away from home will satisfy the substantiation requirements of Treas. Reg. §1.274-5T(c). However, Treas. Reg. §1.274(d)-1(a)(3) provides that those mileage allowances are only available to the owner of a vehicle. New Treas. Reg. §1.274(d)-1T applies the substantiation rules to mileage allowances for business use of an automobile after December 31, 1997, without the limitation that the allowance is available only to the owner of a vehicle. Therefore, the standard mileage allowance can be used in conjunction with a leased vehicle.


Rev. Rul 99-7
[I.R.C. §162]

Deduction rules for daily transportation expenses to temporary work locations are clarified.

Issue. In what situations are daily transportation expenses incurred by a taxpayer in going between the taxpayer’s residence and work locations deductible under I.R.C. §162(a)?

Holding. Daily transportation expenses may be deducted if a worker is traveling between his or her residence and a temporary work location outside the metropolitan area where the worker normally lives and works. A worker with one or more regular work locations outside his or her residence may deduct daily transportation expenses if he or she is traveling between the residence and a temporary work location (inside or outside the metropolitan area) in the same trade or business. Additionally, a worker who uses his or her residence as the principal place of business may deduct daily travel expenses if he or she travels between the residence and other work locations (regular or temporary, inside or outside the metropolitan area) in the same trade or business.

The following rules apply in determining whether a work location is temporary. If employment at a work location is realistically expected to last (and does in fact last) for one year or less, the employment is temporary in the absence of facts and circumstances indicating otherwise. If employment at a work...
location is realistically expected to last for more than one year or there is no realistic expectation that
the employment will last for one year or less, the employment is not temporary, regardless of whether it
actually exceeds one year. If employment at a work location initially is realistically expected to last for
one year or less, but at some later date the employment is realistically expected to exceed one year,
that employment will be treated as temporary (in the absence of facts and circumstances indicating oth-
erwise) until the date that the taxpayer’s realistic expectation changes, and it will be treated as not tem-
porary after that date.

**CORPORATIONS, PARTNERSHIPS, AND LLCS**

Rev. Rul. 99-6
[I.R.C. §§708, 731, 732, 735, and 1012]

**Issue.** What are the federal income tax consequences if one person purchases all of the ownership
interests in a domestic limited liability company (LLC) that is classified as a partnership under Treas.
Reg. §301.7701-3, causing the LLC’s status as a partnership to terminate under I.R.C. §708(b)(1)(A)?

**Facts.** In each of the following situations, an LLC is formed and operated in a state that allows single-
owner LLCs. Each LLC is classified as a partnership under Treas. Reg. §301.7701-3. Neither LLC holds
any unrealized receivables, substantially appreciated inventory, or indebtedness. After the sale
described in each situation, no election is made under Treas. Reg. §301.7701-3(c) to treat the LLC as an
association for federal tax purposes.

**Situation 1.** A and B are equal partners in AB, an LLC. A sells A’s entire interest in AB to B for
$10,000. After the sale, the business is continued by the LLC, which is owned solely by B.

**Situation 2.** C and D are equal partners in CD, an LLC. C and D sell their entire interests to E, an
unrelated person, in exchange for $10,000 each. After the sale, the business is continued by the LLC,
which is owned solely by E.

**Analysis and Holding**

**Situation 1.** The AB partnership terminates under I.R.C. §708(b)(1)(A) when B purchases A’s entire
interest in AB. As provided in Treas. Reg. §1.741-1(b), A must treat the transaction as a sale of a part-
nership interest. A must report any gain or loss resulting from the sale of A’s partnership interest in
accordance with I.R.C. §741.

The AB partnership is deemed to have made a liquidating distribution of all of its assets to A and B,
and following this distribution, B is treated as having acquired the assets deemed to have been distrib-
uted to A in liquidation of A’s partnership interest [Edwin E. McCauslen v. Commissioner, 45 T.C. 588
(1966); Rev. Rul. 67-65, 1967-1 C.B. 168]. B’s basis in the assets attributable to A’s one-half interest in
the partnership is $10,000, the purchase price for A’s partnership interest (I.R.C. §1012). B’s holding
period for these assets begins on the day immediately following the date of the sale (Rev. Rul. 66-7,
1966-1 C.B. 188).
B must recognize gain or loss on the deemed distribution of those assets attributable to B’s former interest in AB to the extent required by I.R.C. §731(a). B’s basis in the assets received in this deemed distribution is equal to the adjusted basis of B’s interest in the partnership as provided under I.R.C. §732(b). B’s holding period for the assets attributable to B’s one-half interest in AB includes the partnership holding period for these assets as provided in I.R.C. §735(b).

Situation 2. The CD partnership terminates under I.R.C. §708(b)(1)(A) when E purchases the entire interests of C and D in CD. C and D must report any gain or loss resulting from the sale of their partnership interests in accordance with I.R.C. §741.

The CD partnership is deemed to make a liquidating distribution of its assets to C and D. Following this distribution, E is deemed to acquire, by purchase, all of the former assets of CD partnership. Under I.R.C. §1012, E’s basis in the assets is $20,000, the purchase price of CD partnership interests. E’s holding period for these assets begins on the day immediately following the date of sale.

[Rev. Rul. 99-6, 1999-5 IRB 1]

Issue. What are the federal income tax consequences when a single-member domestic limited liability company (LLC) that is disregarded as an entity separate from its owner under Treas. Reg. §301.7701-3 becomes an entity with more than one owner that is classified as a partnership for federal tax purposes?

Facts. In each of the following situations, an LLC is formed and operated in a state that allows single-owner LLCs. Each LLC has a single owner and is disregarded as an entity separate from its owner for federal tax purposes under Treas. Reg. §301.7701-3. All the assets held by each LLC are capital assets or I.R.C. §1231 property, and neither LLC holds any indebtedness. After the sale described in both of the situations, no election is made under Treas. Reg. §301.7701-3(c) to treat the LLC as an association for federal tax purposes.

Situation 1. B, who is not related to A, purchases 50% of A’s ownership in the LLC for $5,000. A does not contribute any portion of the $5,000 to the LLC. A and B continue to operate the business as co-owners of the LLC.

Situation 2. B, who is not related to A, contributes $10,000 to the LLC in exchange for 50% ownership in the LLC. The LLC uses all of the contributed cash in its business. A and B continue to operate the business as co-owners of the LLC.

Analysis and Holding

Situation 1. The LLC is converted to a partnership when the new member, B, purchases an interest in the disregarded entity from the owner, A. B’s purchase of 50% of A’s ownership interest in the LLC is treated as the purchase of a 50% interest in each of the LLC’s assets, which are treated as held directly by A. A and B are then treated as contributing their respective interests in those assets to a partnership in exchange for an ownership interest in the partnership.

Under I.R.C. §1001, A recognizes any gain or loss from the deemed sale to B of the 50% interest in each asset of the LLC. No gain or loss is recognized by A or B as a result of the conversion of the disregarded entity to a partnership under I.R.C. §721(a). Under I.R.C. §722(a), B’s basis in the partnership interest is equal to $5,000, the amount paid by B to A for the assets that B is deemed to contribute to the newly created partnership. A’s basis in the partnership interest is equal to A’s basis in A’s 50% share...
of the LLC assets. As provided in I.R.C. §723, the basis of the property treated as contributed to the partnership by A and B is the adjusted basis of that property in A's and B's hands immediately after the deemed sale.

Under I.R.C. §1223(1), A's holding period for the partnership interest received includes A's holding period in the capital assets and I.R.C. §1231 property held by the LLC when it converted to a partnership. B's holding period for the partnership interest begins on the day following the date of B's purchase of the LLC interest (Rev. Rul. 66-7, 1966-1 C.B. 188).

Situation 2. The LLC is converted to a partnership when B contributes cash to the LLC. B's contribution is treated as a contribution to a partnership in exchange for an ownership interest in the partnership. A is treated as contributing all of the assets of the LLC to the partnership in exchange for a partnership interest.

Under I.R.C. §721(a), neither A nor B recognizes gain or loss as a result of the conversion to a partnership. Under I.R.C. §722, B's basis in the partnership interest is equal to $10,000, the amount of cash contributed to the partnership. A's basis in the partnership interest is equal to A's basis in the assets of the LLC that A was treated as contributing to the newly created partnership.

As provided by I.R.C. §723, the basis of the property contributed by A to the partnership is the adjusted basis of that property in A's hands. The basis of the property contributed to the partnership by B is $10,000, the amount of cash B contributed to the partnership. Under I.R.C. §1223(1), A's holding period for the partnership interest received includes A's holding period in the assets deemed contributed upon the conversion. B's holding period for the partnership interest begins the day following the date of B's contribution of money to the LLC (Rev. Rul. 66-7). Under I.R.C. §1223(2), the partnership's holding period for the assets transferred to it includes A's holding period.

[Rev. Rul. 99-5, 1999-5 IRB]

Betpouey v. Commissioner
[I.R.C. §316]

Facts. Clement Betpouey acquired a contracting business, Betpouey, Inc. (BI) from his father in the mid-1980s, becoming the sole shareholder, president, and CEO of the corporation. Betpouey began making cash withdrawals from BI, establishing a “loan account” on BI’s books to keep track of these advances and the subsequent sporadic repayments. As to the loans, there were no notes or writings that evidenced the advances, no interest ever accrued on the loan account balances, no maturity date or repayment schedule existed on the loans, and no security was ever given.

There was no evidence that BI ever paid dividends, but it authorized bonuses on a regular basis at fiscal year end. For years 1988 to 1990, Betpouey contributed his annual bonuses as repayment to BI's loan account. He reported these bonuses on his individual tax returns and paid the taxes on them.

In 1989 Betpouey transferred property to BI as repayment of a portion of the advances. As a result of problems with the conveyance of this property, the credit for this portion of the advances was subsequently reversed. The Service determined that the excess withdrawals in 1989 (and a similar withdrawal for 1990) were constructive dividends to the taxpayer (under I.R.C. §316) that had not been reported. Betpouey paid the “loan account” balance, just prior to filing for bankruptcy in 1992.

Issue. Whether advances from a closely held corporation to its sole shareholder, president, and CEO were loans rather than constructive dividends.

Analysis. The following factors were applied to the facts of this case to determine whether the corporate advances were loans or dividends:

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1. The extent to which the shareholder controls the corporation
2. The earnings and dividend history of the corporation
3. The magnitude of the advances
4. Whether a ceiling existed to limit the amounts advanced
5. Whether or not security was given for the loan
6. Whether there was a set maturity date and repayment schedule
7. Written evidence of a loan, such as an interest-bearing note
8. Whether the corporation ever undertook to force repayment
9. Whether the shareholder was in a position to repay the loan
10. Whether there was any indication of attempts to repay by the shareholder

Betpouey obviously had total control of the company. BI had sufficient earnings to authorize sizable bonuses to the taxpayer but did not pay any dividends during this period. These advances were quite large, and there was apparently no limit to the advances. As indicated previously, there was no proof of any loan “formalities.” BI apparently never forced repayment of the loans, although the year-end bonuses provided Betpouey with considerable funds to repay these advances. The Court considered the key factor to be that Betpouey was in a position to repay the “loan account,” and did in fact repay these amounts.

**Holding.** Weighing these factors and the statements by Betpouey and his CPA that the advances were actually loans, the Court concluded that the advances are more properly classified as loans than constructive dividends and, therefore, that the IRS erred in determining that the excess withdrawals were constructive dividends. With the determination that the withdrawals were loans, the Court also held that the corporation was not responsible for unpaid employment taxes and penalties.

*Joly v. Commissioner*  
[I.R.C. §§61, 1367, and 6662]

**Facts.** In 1982 Michael Joly incorporated his sole proprietorship as J. Michael Joly, Inc. and elected S corporation status for federal tax purposes. Michael served as the corporation’s president throughout its existence and was the primary reason for the corporation’s success. Jody, his son, began working for the corporation in 1993 and served as vice president and operations manager. During the years in question, Michael owned 70% of the Joly stock. The other 30% was owned by his son, David, for one year, and by Jody during the other two years. Since the corporation failed to maintain books and records, the stockholders’ bases in their stock could not be determined. The corporation regularly issued checks from its bank account to pay the family members’ personal expenses. The Service determined that certain amounts paid to or on behalf of Michael and Jody constituted employee wages.

**Issues**

1. Whether amounts paid to officers of an S corporation constituted wages
2. The correct method of computing the amounts of the gains and losses that the shareholders must recognize with respect to their stock
3. Whether the taxpayers are liable for the accuracy-related penalty
Analysis and Holding

Issue 1. The Jolys argued that the amounts that the Service determined to be employee wages constituted loans from the corporation, but provided no loan documents or other records to support this argument.

The Court first considered the facts and circumstances to determine whether, in fact, an employer-employee relationship existed. The Court concluded that Michael and Jody were, in fact, employees of the corporation by virtue of having been officers of the corporation, and having provided more than minor services to the corporation [Employment Tax Reg. 31.3121(d)-1(b)]. The Court rejected the taxpayers’ claim that the failure to pay employee wages to Michael and Jody was reasonable, despite an agreement that each of them signed stating that “the sole compensation for their services would be their share of the corporation’s profits.”

The taxpayers did not argue that a lesser amount of employee wages would be more appropriate and did not provide any credible evidence upon which lesser amounts could be determined. Since the corporation failed to provide any corporate books or records, the Service’s determination of the amount of the wages was based on the corporation’s bank statements. Based on the factors in this case, the Court held that the Service’s determination of the amounts of Michael’s and Jody’s employee wages constituted reasonable compensation for the services that they provided to the corporation.

Issue 2. Taking into account the total amounts paid to or on behalf of Michael, Jody, and David during the taxable years in question and the portions of such amounts the Court held to be employee wages, the Court determined that the Service erred in its determination of the taxpayers’ stock bases. Treas. Reg. §1.1367-1(e) provides that a shareholder’s adjusted basis in the stock of an S corporation is (1) increased by the shareholder’s pro rata share of the corporation’s income, (2) decreased by the shareholder’s pro rata share of the corporation’s losses and deductions, and (3) decreased by the amount of the shareholder’s I.R.C. §1368 distribution. The Service erroneously computed the bases by performing step (3) before step (2).

Issue 3. The Court determined that the taxpayers did not exercise ordinary and reasonable care in the preparation of their tax return. The Jolys also failed to prove that the underpayments were due to reasonable cause or that they acted in good faith. Accordingly, the Court held that the Jolys were liable for the accuracy-related penalty under I.R.C. §6662(a).

[J. Michael Joly and Bonnie B. Joly, Jody Steven Joly, and David Andrew Joly v. Commissioner, T.C. Memo 1998-361 [CCH Dec. 52,907(M)]]

Cane Creek Sportsman’s Club v. Commissioner
[I.R.C. §7701]

Corporation’s existence cannot be disregarded when it carries on business activity.

Facts. Cane Creek Sportsman’s Club was incorporated under the laws of the State of Alabama in 1971, with six shareholders. At the time of its incorporation, Cane Creek acquired 450 acres of land along with a cabin that they used as a private hunting lodge. These six shareholders signed an agreement stating that only the six original “partners” of the hunting club and their immediate families would use the property. The agreement further stipulated that if any of the “six partners” wanted to withdraw from the “partnership,” he must sell his shares to the other “partners” only. By 1982, only two of the shareholders were remaining; each was holding 50% of Cane Creek stock.

Cane Creek issued stock, adopted bylaws, elected directors and officers, secured an employee identification number, and filed corporate tax returns. On the tax returns, Cane Creek depreciated the cabin and reported net income for the years 1980 through 1986, and 1990.
In early 1993, Cane Creek sold the property for $168,750. Later that year, Cane Creek was dissolved. This sale was reported on Cane Creek’s income tax return, showing no gain—both the sales price and the adjusted basis of the property were reported as $33,750. The Service determined a deficiency based on the assertion that Cane Creek realized a gain of $112,053 from the sale of the property. No issue was raised as to the Service’s determination that basis in the property was $56,697 and that the sale resulted in a taxable gain amount of $112,053. The taxpayer believed that this gain should be treated as taxable income to a partnership and not a corporation.

**Issue.** Whether an entity’s corporate existence can be disregarded and its realized gain on the 1993 sale of improved land be treated as income taxable to a partnership.

**Analysis.** The remaining two shareholders and officers of Cane Creek argued that they did not intend to incorporate Cane Creek. They contended that Cane Creek was not a business venture, and its corporate existence should therefore be disregarded.

The Court determined in *Moline Properties, Inc. v. Commissioner*, 43-1 USTC ¶9464, 319 U.S. 436 (1943), that a corporation will not be disregarded if either (1) the corporation was formed for business purposes, or (2) its creation is followed by the carrying on of business activity. The Court stated that Cane Creek’s adoption of bylaws, election of officers and directors, issuance of stock, purchase and sale of property, obtainment of an employer identification number, filing of corporate tax returns, depreciation of the hunting lodge, and reporting of net income all indicated that Cane Creek did engage in business. The absence of books and a bank account, and the failure to hold corporate meetings were not enough to rule otherwise.

**Holding.** The Court held that the shareholders did in fact use Cane Creek to such an extent that its separate identity must be recognized, and sustained the Service’s notice of deficiency that Cane Creek must report the taxable gain on the sale of the property.

* [Cane Creek Sportsman’s Club v. Commissioner, T.C. Memo 1998-341 [CCH Dec. 52,886(M)]

**Rev. Proc. 98-55**

[I.R.C. §§1361 and 1362]

* The IRS provides relief for late S Corporation elections.


**Scope.** Rev. Proc. 98-55 extends the special procedure for late S corporation elections described in Rev. Proc. 97-40 from 6 months to 12 months for the first year the corporation intended to be an S corporation. This revenue procedure also provides similar relief for certain qualified Subchapter S subsidiary (QSST) elections and extends the application of Rev. Proc. 94-23 to electing small business trust (ESBT) elections.

**Procedure.** To be eligible for relief when a late S election is the sole defect, a corporation must meet the following requirements:

1. The corporation fails to qualify as an S corporation on the first date that S corporation status was desired solely because Form 2553, Election by a Small Business Corporation, was not filed timely.
2. The due date for the tax return (excluding extensions) for the first year the corporation intended to be an S corporation has not passed.

3. The corporation has reasonable cause for its failure to timely make the S corporation election.

Rev. Proc. 98-55 provides that within 12 months of the original due date for the S corporation (but in no event later than the due date for the tax return, excluding extensions, for the first year the corporation intended to be an S corporation) the corporation must file a completed Form 2553. Form 2553 must be signed by an officer of the corporation and all persons who were shareholders at any time during the period beginning on the first day of the tax year for which the election is to be effective and ending on the day the election is made. The corporation must also state “FILED PURSUANT TO REV. PROC. 98-55” at the top of Form 2553, and attach a statement explaining the reason for failure to file a timely S corporation election.

This revenue procedure also outlines procedures for obtaining similar relief for certain other elections, including:

1. A late S election combined with a late electing small business trust (ESBT), qualified subchapter S trust (QSST), or qualified subchapter S subsidiary (QSSS) election,
2. Valid S elections that have failed to file timely QSSS elections, and
3. Automatic inadvertent invalid election or inadvertent termination relief for a QSST or an ESBT.

**Note.** See Rev. Proc. 98-55 for details regarding the procedures for obtaining relief for these other elections.


**Gitlitz v. Commissioner**

[I.R.C. §§108 and 1366]

**Shareholder basis in S corporation stock is not increased by discharge of indebtedness income.**

**Facts.** David Gitlitz and Phillip Winn each owned 50% interest in the S corporation PDW&A. PDW&A was a partner in a real estate partnership that realized $4.2 million in discharge of indebtedness (DOI) income in 1991. PDW&A’s pro rata share of this DOI income was $2.0 million. Since PDW&A, at that time, was insolvent to the extent of $2.2 million, this DOI income was excluded from tax liability.

Both Gitlitz and Winn had suspended losses at the beginning of 1991 because each lacked sufficient basis in their PDW&A stock. On their respective 1991 income tax returns, Gitlitz and Winn claimed increases in the bases of their PDW&A stock in the amount of their pro rata share of the DOI income. This basis adjustment allowed each of them to claim the full amount of PDW&A’s ordinary losses.

The Commissioner determined that the taxpayers could not use PDW&A’s excluded DOI income to increase their stock bases, and therefore, disallowed the ordinary loss deductions. The Tax Court relied on the decision in *Nelson v. Commissioner* [CCH Dec. 52,578] 110 T.C. 12 (1998), which held that although DOI income realized is excluded from gross income under I.R.C. §108(a), this exclusion does not pass through to the shareholders of an S corporation as an item of income.

**Issue.** Whether S corporation shareholders are entitled to increase their stock basis by the amount of the discharge of indebtedness (DOI) income realized by an insolvent S corporation.
Analysis. The appeals court rejected the taxpayers’ claim that the PDW&A’s DOI income was an “item of income” under I.R.C. §1366(a)(1)(A) which required them to increase their stock bases. The court reasoned that if they allowed this position, then “the shareholders would receive a windfall. The shareholders would not only avoid taxation on the S corporation’s discharged debt, but they would also receive an upward basis adjustment, thereby permitting them to report a larger capital loss from the sale of their stock.”

According to I.R.C. §108(d)(7)(A), the DOI income exclusions and related tax attribute reduction must be applied at the corporate level for S corporations. The timing of the pass-through to the shareholders is the issue in this case. The court stated that the attribute reductions must precede the pass-through so that the S corporation’s excluded DOI income is absorbed before it can pass through to the shareholders and result in basis adjustments and windfalls.

The taxpayers also argued that S corporations have no net operating losses (NOLs) because the NOL tax attribute is confined to shareholder suspended losses. The court pointed out that nothing in the Internal Revenue Code requires that corporate NOLs pass immediately to shareholders. An immediate pass-through would eliminate the “price” Congress imposed upon entities whose DOI income is excluded under I.R.C. §108.

Gitlitz and Winn also argued that I.R.C. §108(b)(4)(A) requires the attribute reduction to be made “after the determination of the tax imposed for the taxable year of the discharge.” The court interpreted this section as simply requiring the computation of certain tax applications before reducing tax attributes. Code §108(d)(7)(A) requires that tax attribute reductions be applied at the entity level for S corporations.

Holding. The Tenth Circuit affirmed the Tax Court’s ruling that the taxpayers are not allowed to increase the basis of their S corporation stock by the DOI income of an insolvent S corporation because this DOI income is not passed through to the shareholder.

[David A. Gitlitz and Louise Gitlitz v. Commissioner, 99-2 USTC ¶50,645 (CA-10, 1999)]

Note. For a discussion of the Tax Court’s decision in this case, see pp. 413–414 of the 1998 Income Tax Work Book.


Cusick v. Commissioner
[I.R.C. §§162 and 761]

Existence of a partnership requires that co-owners carry on business activity.

Facts. Tim Cusick (taxpayer) and Lance and Elizabeth Pugh (the Pughs) bought two real estate properties in 1987. Mr. Cusick and the Pughs each had a 50% interest in both properties. They informally agreed to share profits and losses from the properties equally. Both properties were rented to various tenants in 1992, the year in question. A formal written partnership agreement was not prepared. All rental income from the two properties was deposited to separate bank accounts, and all expenses were paid from the accounts.

Mr. Cusick did not file his 1992 tax return until March 1997, after he had been contacted by the IRS. In an examination of that return, the IRS refused to allow Mr. Cusick the deduction of 50% of the rental expenses on the two properties. In addition, the IRS assessed the failure to file (delinquency) penalty under I.R.C. §6651(a).
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Issues

1. Whether the taxpayer is entitled to deduct 50% of the substantiated expenses relating to the two properties.

   [Note. Issue 1 turns on whether the taxpayer’s rental real estate activities were conducted as a partnership.]

2. Whether the taxpayer is liable for the failure to file penalty.

Analysis and Holding

Issue 1. The taxpayer’s accountant advised him that a partnership return was unnecessary. Therefore, no partnership return was filed. The taxpayer and the Pughs reported the profits and losses relating to the two rental properties on their own respective tax returns.

The principal issue in question is whether a partnership existed between the taxpayer and the Pughs for federal income tax purposes. A partnership is defined in I.R.C. §761(a) as “a syndicate, group, pool, joint venture, or other unincorporated organization through which any business . . . is carried on.” The essential question is whether the parties intended to, and did in fact, join together for the conduct of an undertaking or enterprise. Recognition of a partnership for federal tax purposes also requires that the parties conduct some business activity.

The mere ownership of property does not create a partnership. However, co-owners may be partners if they carry on business activities. A joint undertaking merely to share expenses is not a partnership. The Court determined that the degree of business activity shown by Mr. Cusick and the Pughs in conducting their rental real estate activities results in characterizing their relationship as a partnership. Therefore, the Court concluded that Mr. Cusick is entitled to deduct 50% of the rental expenses.

Issue 2. Mr. Cusick did not request an extension of time to file his 1992 Federal income tax return. He did not file the return until March 28, 1997. He testified that he did not file his return timely because he could not get the needed information from the Pughs. However, Mr. Cusick did not ask the Pughs to provide the information until sometime in March 1997. Mr. Cusick did not do what a reasonable person would do. Therefore, the failure to file penalty is sustained.


T.D. 8798 and Reg. 120168-97
[I.R.C. §6695]

Explanation of Provisions. The IRS has issued temporary and proposed regulations providing due diligence requirements for paid preparers of federal income tax returns or claims for refund involving the earned income credit (EIC). These temporary regulations reflect the addition of I.R.C. §6695(g) by the Taxpayer Relief Act of 1997.

I.R.C. §6695(g) imposes a $100 penalty for each failure by an income tax return preparer to meet the due diligence requirements set forth in this regulation. The term income tax return preparer refers to anyone who prepares for compensation or who employs one or more persons to prepare for compensation, any return or claim for refund imposed by subtitle A. This definition, for the purposes of I.R.C. §6695(g), does not include preparers who merely give advice or prepare another return that affects the EIC return or refund claim.

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This information was correct when originally published. It has not been updated for any subsequent law changes.
The temporary regulations adopt the **four due diligence requirements** in Notice 97-65 [1997-51 I.R.B. 14 (December 22, 1997)] to avoid the I.R.C. §6695(g) penalty. These due diligence requirements are:

1. **Complete the Form 8867**, Paid Preparer’s Earned Income Credit Checklist, or otherwise record in the preparer’s files the information necessary to complete this checklist;
2. **Complete the computation** worksheet contained in the Form 1040 instructions, or otherwise record in the preparer’s files the information necessary to complete this worksheet;
3. **Have no knowledge and no reason to know** that any of the information used by the preparer in determining EIC eligibility and the amount of the EIC is incorrect.
4. **Retain for three years**, the information required by (1) and (2) above.

The temporary regulations also provide that the income tax return preparer may avoid the I.R.C. §6695(g) penalty with respect to a particular income tax return or claim for refund if the preparer can demonstrate to the satisfaction of the IRS that, considering all the facts and circumstances, the preparer’s normal office procedures are reasonably designed and routinely followed to ensure compliance with the due diligence requirements of the regulations, and that the particular failure was isolated and inadvertent.

**Effective Date.** This section applies to income tax returns and claims for refund for taxable years beginning after December 31, 1996. [T.D. 8798, 26 CFR Parts 1 and 602]

**Note.** See the What’s New Supplement (December 30, 1998), pp. 6–9, for a copy of Form 8867.

**IR 98-66; Rev. Rul. 98-56**

[I.R.C. §32]

The gain from sale of business assets is not included in disqualified investment income for EIC purposes.

Code §32 allows an individual whose income does not exceed certain limits to claim an earned income credit (EIC). Code §32(i) denies the EIC to an otherwise eligible individual if the individual’s “disqualified income” exceeds a specified level for the taxable year for which the credit is claimed.

The Service now says in its News Release IR 98-66 (November 10, 1998) that gain that is treated as **long-term capital gain under I.R.C. §1231(a)(1) does not constitute disqualified income** for purposes of the EIC. These gains should be included in the taxpayer’s total income figure. Individuals who couldn’t claim the credit in 1996 or 1997 because they included long-term gains from the sale of business assets in their EIC calculations for those years may apply for a refund on an amended return, Form 1040X.

See Issue No. 3 in the Agricultural Issues chapter for a detailed discussion of the consequences of this ruling.

Montoya v. Commissioner
[I.R.C. §1016]

The basis of the asset is reduced by the greater of allowable or allowed depreciation.

Facts. During the second half of the 1980s, Miguel Espinoza Montoya was frequently away from home while working in the construction industry. He thought it would be more economical to buy a used bus and convert it into a motor home, which he would live in when he worked away from home, than to pay for commercial food and lodging. Montoya placed the bus in service in 1985. He made substantial improvements to the bus, reporting $5,000 of costs in 1985, in addition to the purchase price of the bus of $14,359. Montoya claimed $18,500 in depreciation on his 1985–1989 returns.

In December 1990, the bus was destroyed by fire. In early 1991, Montoya received $58,475 from his insurance provider for the replacement value of the converted bus. He used the proceeds to buy land, rather than to purchase a replacement bus. Montoya reported no gain or loss from the disposition of the bus. The IRS determined that Montoya's adjusted basis in the bus was $824 and that he realized $18,500 of §1245 gain and $39,100 of capital gain on the disposition.

Montoya argued that he spent substantially more for improvements to the bus than he reported. According to Montoya, he spent $21,400 in 1985 but reported only $2,099 for improvement to the bus on his return.

The Court accepted Montoya's testimony that he spent much more on the bus than claimed and that depreciation was not claimed for the full amount expended in 1985 and 1986. Montoya conceded the §1245 gain.

Issue. Did Montoya realize capital gain in 1991 from the involuntary conversion of the bus?

Discussion. Montoya argued that he did not realize any capital gain from the conversion as his basis in the bus was equal to the amount of the insurance proceeds received. Montoya's argument essentially is that his adjusted basis in the depreciable property is not decreased by depreciation that he did not claim as a deduction on his Federal income tax returns.

Pursuant to §1011(a), the adjusted basis for determining the gain or loss from the sale or other disposition of property is the cost of the property determined under §1012 adjusted as provided in §1016. Code §1016(a)(2) provides, in effect, that the basis of the property shall be adjusted by the amount of depreciation previously allowed, but not less than the amount allowable, with respect to the property. Depreciation “allowed” is the amount actually deducted by the taxpayer and not challenged by the Commissioner. [See Virginian Hotel Corp. v. Helvering, 319 U.S. 523, 527 (1943)]. Consequently, the taxpayer's basis in a depreciable asset is reduced by the greater of the amount of depreciation that is allowed or allowable in a tax year.

The expenditures that Montoya made in 1985 to acquire and improve the bus would have been recovered completely in 1989. See I.R.C. §168(b)(1), 1954 (as amended). Although it may seem a harsh result as Montoya did not claim the full amount of depreciation allowable, these costs provide Montoya no basis in 1990. The expenditures that Montoya made in 1986 to improve the bus would have been recovered completely in 1990; however, as the bus was destroyed in that year, no deduction is allowed. See I.R.C. §168(d)(2)(B), 1954 (as amended). Accordingly, the Court finds that petitioners had an adjusted basis in the bus at the time of the involuntary conversion that is equal to the percentage of the costs incurred during 1986 allowable for recovery in 1990.

Holding. The basis of the bus is reduced by the greater of depreciation allowed or allowable. Thus, since the expenditures made in 1985–86 would have been completely recovered in 1989
DEPRECIATION, DEPLETION, AND AMORTIZATION

(five-year property), no basis for the bus remained in 1990. As a result, Montoya realized $39,100 of capital gain, in addition to the $18,500 of §1245 gain already conceded.

The Court also sustained a late-filing penalty and an accuracy-related penalty for negligence.

[M.E. Montoya v. Commissioner, T.C. Memo 1999-269]

Hayden v. Commissioner
[I.R.C. §§179 and 6662]

Taxable income limitation for the I.R.C. §179 deduction for the partnership is valid.

Facts. Dennis and Sharon Hayden were the sole partners in a partnership that began operations in 1994. During that year, the partnership purchased equipment for $26,750 and elected under I.R.C. §179 to expense $17,500 of this amount. The partnership reported a loss of $15,700 (before any I.R.C. §179 deduction) on its 1994 partnership tax return. The Haydens included the $17,500 I.R.C. §179 deduction on Schedule E of their income tax return, and the Service disallowed this deduction.

Dennis Hayden is a certified public accountant who operates a practice as a sole proprietorship. During the 1994 taxable year, the taxpayers paid $9,300 for their 1993 federal income tax liability. On their 1994 tax return, the Haydens included this 1993 income tax liability as part of the total payroll taxes deduction for the sole proprietorship on Schedule C. The Service assessed the taxpayers an accuracy-related penalty for the underpayment of their income taxes related to this deduction.

Issues

1. Whether the taxpayers are entitled to a $17,500 I.R.C. §179 deduction related to a partnership with no taxable income for the taxable year.
2. Whether the taxpayers are liable for an accuracy-related penalty under I.R.C. §6662(a) for an overstatement of payroll taxes on their Schedule C.

Analysis and Holding

Issue 1. Treas. Reg. §1.179-2(c)(2) provides that a partnership may not allocate to its partners and a partner may not deduct an I.R.C. §179 expense deduction that exceeds the partnership’s taxable income for that taxable year. The taxpayers argued that this regulation is invalid, contending that I.R.C. §179(b)(3)(A) applies only to the taxable income “of the taxpayer,” and under I.R.C. §701 a partnership is not a taxpayer. The court noted that a taxpayer, as defined in I.R.C. §7701(a)(14), is any person subject to any internal revenue tax. Further stated in I.R.C. §7701(a)(1) is that a person includes a partnership.

The taxpayers also argued that the term “taxable income” should be interpreted as gross receipts of the trade or business. The Court determined that this interpretation had no basis in the law. Accordingly, the Court agreed with the Service’s determination and denied the taxpayers the $17,500 I.R.C. §179 deduction.

Issue 2. The Haydens argued that the overstated payroll taxes deduction was the result of a reasonable mistake by an employee. The Court stated that Mr. Hayden either prepared or directly supervised the preparation of the 1994 income tax return. The erroneous income tax deduction represented a significant amount in relation to the taxable income of the sole proprietorship as well as to the payroll taxes for the business. Mr. Hayden is an accountant and should have questioned the size of the deduction. The Court concluded that Mr. Hayden had not established that he was not negligent, and, therefore, sustained the Service’s determination as to the accuracy-related penalty under I.R.C. §6662(a).

[Dennis L. Hayden and Sharon E. Hayden v. Commissioner, 112 T.C. No. 11, 112 T.C. 115 (1999) [CCH Dec. 53, 293]]

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This information was correct when originally published. It has not been updated for any subsequent law changes.
**Facts.** Gary and Linda Hart own a 187-acre farm on which they grow burley tobacco and raise beef cattle. The Harts acquired a new tobacco barn in 1994. The tobacco barn is an enclosed structure with wooden walls, a dirt floor, and three doors on each of two opposite sides large enough to allow farm machinery to pass through. This barn is not foundationally strong, and, because of the ventilation doors and cracks between wallboards, it cannot be used for grain storage. It is not insulated, has no heating or plumbing, and is equipped with minimal electrical wiring and lighting fixtures.

During the curing season, the Harts use the tobacco barn mainly as a curing facility for their tobacco harvest. For about five months after the curing season, the taxpayers use the stripping room located in the barn for stripping, grading, baling, and boxing the tobacco leaves.

On their 1994 income tax return, the Harts reported the $16,730 cost of the tobacco barn and deducted $6,750 of that amount under I.R.C. §179. The taxpayers claimed depreciation on the remaining balance of the cost using the 150% declining-balance method with a 10-year recovery period. The Service determined that the tobacco barn was not eligible for I.R.C. §179 treatment and that the proper recovery period was 20 years.

**Issues**

1. Whether the taxpayers’ tobacco barn is I.R.C. §179 property.
2. What is the applicable recovery period for the taxpayers’ tobacco barn?

**Analysis and Holding**

**Issue 1.** The Harts contended that the tobacco barn qualified as I.R.C. §1245 property as defined under both I.R.C. §§1245(a)(3)(B) and 1245(a)(3)(D) and, therefore, qualified as I.R.C. §179 property.

First, the taxpayers claimed that the barn is a structure, other than a building, used as an integral part of the manufacturing or production of tobacco, and meets the requirements of I.R.C. §1245(a)(3)(B). Treas. Reg. §1.48-1(e)(1) defines the term “building,” and has been interpreted to establish an “appearance” and “function” test in determining whether a structure is a building. The tobacco barn clearly resembles a building in appearance, and would be considered a building under the appearance test. One of the major focuses in applying the functional test is whether the structure provides working space for employees that is more than incidental to the primary function of the structure. Because the tobacco barn was used five months of the year as working space for employees to prepare the tobacco for sale, the Court concluded that the Harts’ tobacco barn did not pass the function test. Accordingly, the tobacco barn does not qualify as I.R.C. §1245(a)(3)(B) property.

Alternatively, the taxpayers contended that the tobacco barn was a “single-purpose horticultural structure” as defined in I.R.C. §1245(a)(3)(D). To be classified as a single-purpose horticultural structure, I.R.C. §165(i)(13)(B) requires that an asset meet three tests: (1) the specific design test, (2) the exclusive use test, and (3) the actual use test. The specific design test requires that the structure be specifically designed and constructed for permissible purposes [Treas. Reg. §1.48-10(c)(1)(i)]. The only permissible purposes are for the commercial production of plants in a greenhouse or the commercial production of mushrooms. The tobacco barn is not a greenhouse, nor is it used in the commercial production of mushrooms. Therefore, the tobacco barn does not meet the specific design test.
To pass the exclusive use test, the horticultural structure must not contain an area for processing plants or plant products, which is considered a nonpermissible use [Treas. Reg. §1.48-10(e)(1(iv)). Because the tobacco barn was used a large portion of the year for the preparation of tobacco for sale, the court concluded that the tobacco barn does not meet the exclusive use test. Since the tobacco barn did not meet either of the first two tests, the court did not need to consider whether it met the actual use test. Based on this analysis, the Court held that the tobacco barn was not a single-purpose horticultural structure and is, therefore, not I.R.C. §179 property.

Issue 2. As indicated above, the Court concluded that the tobacco barn is not a single-purpose horticultural structure and, therefore, does not have a 10-year recovery period. The Service also rejected the Harts’ claim that the tobacco barn was a land improvement with a 15-year recovery period. A class 00.3 asset as defined in Rev. Proc. 87-56, 1987-2 C.B. 677, specifically excludes buildings. Since the taxpayers have not claimed that the tobacco barn is 10-year or 15-year property by virtue of being in any other class of assets, the Court agreed with the Service that the appropriate class is 01.3, farm buildings, with a 20-year recovery period.


For purposes of I.R.C. §142(d) and 145(d), the ruling provides that the availability of continual or frequent medical, nursing, or psychiatric services in a facility for the residents of the facility will cause the facility to be other than residential rental property. Other non-housing services available in a facility for the residents of the facility generally will not cause the facility to be other than residential rental property.


FSA 1998-271

[16.9.5192]

Frequent medical services prevent facility from being residential rental property

For purposes of I.R.C. §142(d) and 145(d), the ruling provides that the availability of continual or frequent medical, nursing, or psychiatric services in a facility for the residents of the facility will cause the facility to be other than residential rental property. Other non-housing services available in a facility for the residents of the facility generally will not cause the facility to be other than residential rental property.


Store equipment and warehouse equipment used in the retail industry are eligible for a five-year life.

Facts. A food retailer filed claims requesting additional depreciation as a result of the retailer’s change in depreciating store equipment assets and warehouse equipment from MACRS seven-year life (asset class 00.11) to MACRS five-year life (asset class 57.0). These assets included store fixtures, shelving, food cases, coders, deli equipment, custom décor, and shopping carts.

Issue. What is the proper class life to be used in depreciating store equipment assets and warehouse equipment?

Discussion. According to Rev. Proc. 87-56, 1987-2 C.B. 674, asset class .011 is defined as office furniture, fixtures, and equipment, and includes furniture and fixtures that are not a structural component of a building, such as desks, files, safes, and communications equipment. The Service has interpreted this provision as assets used in an office setting, and, therefore, would not apply to the retailer’s store and warehouse equipment.
Conclusion. The Service concluded that store equipment assets and warehouse equipment used in the retail industry are properly classified under asset class 57.0 as assets used in the wholesale and retail trade rather than under asset class 00.11, which includes only those assets used in an office setting. However, assets that can be used either in an office setting or as an asset used in the wholesale or retail trade (for example, telephones or cabinets) should be depreciated as asset class 00.11 if used in an office or as asset class 57.0 if used as part of taxpayer’s wholesale or retail business. The fact that taxpayers are engaged in the wholesale or retail industries does not enable them to depreciate office furniture under asset class 57.00. Rather, because office furniture is a general purpose class, the class life of the general purpose class must be used. The Service advised that the retailer’s change was appropriate and necessary.

ILM 199921045, April 1, 1999
[I.R.C. §1245]

Facts. The Service’s chief counsel office was asked to clarify the position that examiners should take in light of the Tax Court’s decision in Hospital Corp. of America, Inc. (HCA) v. Commissioner, 109 T.C. 21 (1997) [CCH Dec. 52,163]. In HCA, the petitioners argued that several disputed items associated with facilities built in the 1980’s were properly depreciated as I.R.C. §1245 property using a five-year recovery period. The Service argued that the taxpayer was using “component depreciation,” which is no longer allowed under ACRS and MACRS.

The Tax Court rejected the Service’s argument in this case, stating that Congress did not intend to redefine §1250 property to include property that had been §1245 property prior to the enactment of ACRS for purposes of the investment tax credit.

Issue. What are the relevant factors in determining whether an item is a structural component of a building or tangible personal property?

Analysis and Conclusion. The Tax Court in HCA employed the following factors set forth in Whiteco Indus., Inc. v. Commissioner, 65 T.C. 664 [CCH Dec. 33,594 (1975)], to determine whether these disputed items of property were inherently permanent and thus not tangible personal property within the meaning of Treas. Reg. §1.48-1(c).

1. Is the property capable of being moved, and has it in fact been moved?
2. Is the property designed or constructed to remain permanently in place?
3. Are there circumstances that tend to show the expected or intended length of affixation?
4. How substantial a job is removal of the property and how time-consuming is it? Is it “readily removable”?
5. How much damage will the property sustain upon its removal?
6. What is the manner of affixation of the property to the land?

The Court summarized Treas. Reg. §1.48-1(c) saying, “An item constitutes a structural component of a building if the item relates to the operation and maintenance of the building . . .” The determination of whether an asset is a structural component or tangible personal property is based on the facts and circumstances, with no bright-line tests.

The Service also noted that any change in the depreciation method or the recovery period of an asset is clearly a change in method of accounting, and the taxpayer must obtain approval from the Commissioner prior to the change.
Editorial Comment. The HCA case is significant. Even though the case dealt with commercial property of a large corporation, it applies to all types of property owners, including taxpayers who own residential rental property. Therefore, the types of disputed property shown above that were previously depreciated under MACRS using either a 27.5- or 39-year recovery period are now eligible for the shorter five-year or seven-year MACRS recovery period classification. Remember that, generally, I.R.C. §1245 property that has not been assigned a specific class life has a seven-year recovery period [I.R.C. §168(d)(3)(c)]. In addition, some of the disputed assets could qualify for I.R.C. §179 first-year expensing.

Note. This issue was covered extensively in the 1997 Income Tax Workbook on pp. 494–495.

Notice 99-46

The IRS has updated the oil and gas production applicable percentages for marginal properties for 1999.

Notice 99-46 contains a table of the applicable percentages for oil and gas production for marginal properties, covering tax years beginning in 1991 through 1999.

Code §613A(c)(6)(C) defines “applicable percentage” as the percentage (not greater than 25%) equal to the sum of 15%, plus 1 percentage point for each whole dollar by which $20 exceeds the reference price for crude oil for the calendar year preceding the calendar year in which the taxable year begins. The term “reference price” is determined under I.R.C. §29(d)(2)(C) and is the estimate of the annual average wellhead price per barrel for all domestic crude oil. The reference price for the 1998 calendar year is $10.88.

<table>
<thead>
<tr>
<th>Calendar Year</th>
<th>Applicable Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>15%</td>
</tr>
<tr>
<td>1992</td>
<td>18%</td>
</tr>
<tr>
<td>1993</td>
<td>19%</td>
</tr>
<tr>
<td>1994</td>
<td>20%</td>
</tr>
<tr>
<td>1995</td>
<td>21%</td>
</tr>
<tr>
<td>1996</td>
<td>20%</td>
</tr>
<tr>
<td>1997</td>
<td>16%</td>
</tr>
<tr>
<td>1998</td>
<td>17%</td>
</tr>
<tr>
<td>1999</td>
<td>24%</td>
</tr>
</tbody>
</table>

[Notice 99-46, 1999-37 IRB 415]

The regulations provide that an election to amortize start-up expenditures is made by attaching a statement to the taxpayer’s return. This statement shall include the following information:

1. A description of the trade or business to which it relates with sufficient detail so that expenses relating to the trade or business can be identified properly for the taxable year in which the statement is filed and for all future taxable years to which it relates; and
2. The number of months (not less than 60) over which the expenditures are to be amortized, and a description of each start-up expenditure incurred (whether or not paid), and the month in which the active trade or business began.

A revised statement may be filed to include any start-up expenditures not included in the taxpayer’s original election statement, but this revised statement may not include any expenditures for which the taxpayer had previously taken a position on a return inconsistent with their treatment as start-up expenditures.

The 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 in which the active trade or business begins. This election is irrevocable, and the amortization period selected by the taxpayer may not be subsequently changed.

**Effective Date.** This final regulation applies to elections filed on or after December 17, 1998. [T.D. 8797, 26 CFR Parts 1 and 602]

**Issue.** When a taxpayer acquires the assets of an active trade or business, which expenditures will qualify as investigatory costs that are eligible for amortization as start-up expenditures under I.R.C. §195 and which expenditures must be capitalized.

**Facts**

**Situation 1.** In April 1998, a corporation hired an investment banker to evaluate the possibility of acquiring an unrelated trade or business. After investigating several industries, the investment banker narrowed its focus to one industry. The investment banker evaluated several businesses within the industry before commissioning an appraisal of the assets and an in-depth review of the books and records of the target corporation. On November 1, 1998, the corporation entered into an agreement to purchase all of this target’s assets. The corporation did not prepare or submit any documents indicating its intent to purchase this business prior to the acquisition agreement.
Situation 2. In May 1998, a corporation began searching for a trade or business to acquire. The corporation hired an investment banker to evaluate three potential businesses and a law firm to begin drafting regulatory approval documents for a target. Eventually, the corporation decided to purchase all the assets of the target corporation, and entered into an acquisition agreement with them on December 1, 1998.

Situation 3. In June 1998, a corporation hired an accounting firm and a law firm to assist in the potential acquisition of a target corporation. These firms performed “preliminary due diligence” services which included researching the target’s industry and analyzing the target’s financial projections for 1998 and 1999. In September 1998, at the corporation’s request, the law firm submitted a letter of intent to the target stating that a binding commitment with respect to the proposed transaction would result only when the two parties executed an acquisition agreement. Both the law and accounting firms continued to provide “due diligence” services, including a review of the target’s internal documents, an in-depth review of the target’s books and records, and the preparation of an acquisition agreement. On October 10, 1998, the corporation and the target signed an acquisition agreement to purchase all of the target’s assets.

In each of these three situations, the targets are unrelated active trades or businesses, and each corporation uses the accrual method of accounting and a calendar taxable year. Each corporation completed the acquisitions in 1998 and elected on their 1998 income tax returns to amortize start-up expenditures over a period of at least 60 months.

Analysis. Code §195(b) provides that start-up expenditures may be amortized over a period of not less than 60 months, beginning with the month in which the active trade or business begins. Code §195(c)(1) defines start-up expenditures as any amount (A) incurred in connection with investigating the creation or acquisition of an active trade or business, and (B) which, if incurred in connection with the operation of an existing active trade or business, would be allowable as a deduction for the taxable year in which incurred.

Expenditures incurred in order to determine whether to enter a new business and which new business to enter are considered investigatory costs that may be amortized under I.R.C. §195. All costs incurred in the attempt to acquire a specific business must be capitalized. The facts and circumstances of the transaction must be analyzed to make this determination.

Situation 1. The Service concluded that the costs incurred to conduct industry research and evaluate the publicly available financial information are investigatory costs amortizable under I.R.C. §195. These costs are typical of the costs related to a general investigation. However, the costs related to the asset appraisal and review of books and records are capital acquisition costs, since they facilitate consummation of the acquisition.

Situation 2. In this situation, the Service said that the costs incurred to evaluate potential businesses are investigatory costs eligible for I.R.C. §195 amortization to the extent they relate to the whether and which decisions. The costs incurred to draft the regulatory approval documents prior to the time the corporation decided to acquire the target are not start-up expenditures because this cost was incurred to facilitate an acquisition.

Situation 3. The Service concluded that the costs related to the “preliminary due diligence” services provided before the corporation’s decision in September 1998 to acquire the target were eligible for amortization under I.R.C. §195. The costs related to “due diligence” services which were provided after that time related to the attempt to acquire the business and must be capitalized under I.R.C. §263.

Holding. Expenditures incurred in the course of a general search of an active trade or business in order to determine whether to enter a new business and which business to enter are eligible for amortization under I.R.C. §195. Expenditures incurred in the attempt to acquire a specific business are capital acquisition costs under I.R.C. §263. The nature of the expenditures must be analyzed based on all the facts and circumstances.

Facts. The taxpayers acquired a principal residence and obtained a mortgage from the lender to finance the purchase. In connection with the mortgage, the taxpayers paid points to the lender. Taxpayers' itemized deductions, including the points paid to the lender, are less than the standard deduction for that year. They propose to use the standard deduction for the current year and amortize the points over the life of the loan, rather than deduct the points in the current year.

Issue. Whether taxpayers can elect to amortize points paid on a mortgage to purchase their principal residence over the life of the loan rather than deducting the total amount in the year of purchase.

Analysis and Conclusion. The legislative history of I.R.C. §461(g) indicates an intent to permit, but not require, taxpayers to currently deduct points on their home acquisition debt. Code §461(g)(2) simply provides that the general rule requiring the amortization of prepaid interest does not apply to points paid on mortgages for the purchase or improvement of a principal residence. This section does not mandate that the points be deducted currently, nor does it prohibit a taxpayer from adopting the general rule. Based on this interpretation, the Service concluded that the taxpayers may amortize these points over the life of the loan.

Observation. Taxpayers can elect to amortize points on a home acquisition loan if they are using the standard deduction in the year the loan is obtained. This will preserve the ability to deduct the points in future years, since no tax benefit is derived from a current deduction of the points.
Depreciation limitations for automobiles.

Table 1: Depreciation Limitations for Automobiles (Other than Electric Automobiles) First Placed in Service in Calendar Year 1999

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$3,060</td>
</tr>
<tr>
<td>2</td>
<td>5,000</td>
</tr>
<tr>
<td>3</td>
<td>2,950</td>
</tr>
<tr>
<td>Each succeeding year</td>
<td>1,775</td>
</tr>
</tbody>
</table>

Table 2: Depreciation Limitations for Electric Automobiles First Placed in Service in Calendar Year 1999

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<thead>
<tr>
<th>Tax Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$9,280</td>
</tr>
<tr>
<td>2</td>
<td>14,900</td>
</tr>
<tr>
<td>3</td>
<td>8,950</td>
</tr>
<tr>
<td>Each succeeding year</td>
<td>5,325</td>
</tr>
</tbody>
</table>

[Rev. Proc. 99-14, 1999-5 IRB 56]
### Table 3: Dollar Amounts for Automobiles (Other than Electric Automobiles) with a Lease Term Beginning in Calendar Year 1999

<table>
<thead>
<tr>
<th>Fair Market Value of Automobile</th>
<th>Tax Year During Lease</th>
</tr>
</thead>
<tbody>
<tr>
<td>Over 15,500</td>
<td>$2</td>
</tr>
<tr>
<td>15,800</td>
<td>4</td>
</tr>
<tr>
<td>16,000</td>
<td>6</td>
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<td>16,400</td>
<td>8</td>
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<td>13</td>
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<td>19</td>
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<tr>
<td>18,500</td>
<td>22</td>
</tr>
<tr>
<td>19,000</td>
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<td>48,000</td>
<td>215</td>
</tr>
<tr>
<td>49,000</td>
<td>221</td>
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</tbody>
</table>

**Note.** For automobiles other than electric automobiles with a FMV of $50,000 or more, and for electric automobiles, see Rev. Proc. 99-14, 1999-5 IRB 56.
Johnson v. Commissioner
[I.R.C. §61]

Facts. Jerry Johnson borrowed $130,000 from PNC Mortgage Corporation (PNC) in 1990 to finance the purchase of his personal residence. He defaulted on the loan and the house was sold in a foreclosure sale in 1994. The pertinent facts regarding the sale are shown below:

Sales price $93,251

Mr. Johnson owed PNC a total of $160,014 at the time of the foreclosure, consisting of the following:

- Outstanding loan principal: $129,292
- Accrued and unpaid interest: 23,489
- Unpaid escrow fees: 3,672
- Liquidation expenses of sale: 3,561
- Total owed by borrower: $160,014

The house had a fair market value of $105,000 at the time of the foreclosure. Mr. Johnson was not insolvent at that time. PNC issued him a 1994 Form 1099-C (Cancellation of Debt). Box 2 of the form reflected $66,763 ($160,014 – $93,251 sales price) discharge of indebtedness income. Mr. Johnson did not report any of this income on his 1994 tax return.

Issue. Whether the taxpayer must recognize discharge of indebtedness income pursuant to I.R.C. §61(a)(12).

Discussion. Generally, a taxpayer must include in gross income discharge of indebtedness [I.R.C. §61(a)(12) and Treas. Reg. §1.61-12(a)]. There are, however, exceptions to this general rule. Code §108(a) provides that a taxpayer may exclude from gross income the discharge of indebtedness if the discharge occurs in the following situations:

1. The taxpayer is bankrupt.
2. The taxpayer is insolvent.
3. The indebtedness discharged is qualified farm indebtedness.
4. In the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness.

Mr. Johnson does not meet any of the exceptions to the general rule. Nor is there any indication that PNC intended to make a gift to him.
DISCHARGE OF INDEBTEDNESS

The amount of the discharge that is taxable is the amount by which the outstanding loan balance exceeds the fair market value of the property. Under I.R.C. §108(e)(2), however, the accrued interest of $23,489 may be excluded from the discharged indebtedness, because payment of the unpaid interest would be deductible as home mortgage interest. Therefore the correct amount of the taxable portion of the discharge is computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total owed by borrower at time of foreclosure</td>
<td>$160,014</td>
</tr>
<tr>
<td>Less: Fair market value of property at the time of foreclosure</td>
<td>$105,000</td>
</tr>
<tr>
<td>Debt discharge</td>
<td>$ 55,014</td>
</tr>
<tr>
<td>Less: Accrued and unpaid mortgage interest</td>
<td>$ 23,489</td>
</tr>
<tr>
<td>Taxable portion of the debt discharge</td>
<td>$ 31,525</td>
</tr>
</tbody>
</table>

Holding. Accordingly, under I.R.C. §61(a)(12), the taxpayer must include the $31,525 discharge of indebtedness in gross income.


Editorial Note. This case shows that practitioners should not assume that the figures shown on Form 1099-C represent taxable income. A good discussion of this topic can be found in IRS Publication 544, Sales and Other Dispositions of Assets.

Preslar v. Commissioner
[I.R.C. §108]

Couple must recognize discharge-of-indebtedness income since the debt was not disputed and the purchase price adjustment provision did not apply.

Facts. In 1983, Layne and Sue Preslar bought a ranch in New Mexico from High Nogal Ranch, Inc., a debtor-in-possession in a bankruptcy proceeding. Layne wanted to develop a portion of the property as a sportsman’s resort and subdivide the rest as one- to two-acre lots. He negotiated a $1 million purchase price. The amount was to be entirely financed by a bank. Under the agreement with the bank, the couple was allowed to repay the loan by assigning lot installment sales contracts to the bank. The bank credited the Preslars' debt with an amount equal to 95% of the contract price after each sale and assignment. A security interest in each lot was received by the bank.

The bank had received $200,540 in payments from lot purchasers by August 1985. At the end of the same month, the bank declared insolvent and the FDIC became its receiver. The FDIC directed the Preslars to make payments on the loan directly to the FDIC because it would not accept further assignment of lot sales contracts as repayment. The couple did not sell any more lots or make any more payments on the loan after this time.

The FDIC was sued by the Preslars for breach of contract, and the parties settled the matter in 1988. The FDIC agreed to accept $350,000 in full satisfaction of the Preslars’ indebtedness. The amount actually paid on the Preslars' loan was then a total of $550,540. On their 1989 income tax return, the couple did not include any discharge-of-indebtedness income. They instead elected under I.R.C. §108(e)(5) to reduce their basis in the ranch. The IRS assessed a deficiency, claiming that the Preslars should have reported $449,640 in DOI income. The Service’s determination was rejected by the Tax Court.

Issue. Should the Preslars have recognized discharge-of-indebtedness income when they negotiated with the FDIC to settle a liability they owed to a bank that had become insolvent?
Discussion. The concept of discharge-of-indebtedness income requires taxpayers who have incurred a financial obligation that is later discharged in whole or in part, to recognize as taxable income the extent of the reduction in the obligation. It is undisputed that when the Preslars settled their lawsuit with the FDIC in 1988, all obligations arising from the 1983 loan were extinguished and only $550,537 had been paid on the loan principal. The Tax Court ruled that the underlying debt was disputed and fell within the judicially created “contested liability” exception to discharge-of-indebtedness income.

The “contested liability” or “disputed debt” doctrine rests on the premise that if a taxpayer disputes the original amount of a debt in good faith, a subsequent settlement of that dispute is “treated as the amount of debt cognizable for tax purposes” Zarin v. Commissioner [90-2 USTC ¶50,530]. The Tax Court observed in this case that “the unusual payment arrangement between the Preslars and Moncor Bank relating to the bank loan cast significant doubt on the Preslars’ liability for the $1 million stated principal amount of the bank loan.” The Preslars contended that the $1 million stated principal amount of the loan was inflated and did not represent the fair market value of the ranch. However, they offered no evidence to support this claim. The Tax Court held that when the FDIC refused to honor the payment arrangement, “a legitimate dispute arose regarding the nature and amount of the Preslars’ liability on the bank loan.” The Tax Court reasoned that the amount of liability on the loan was not established until the settlement of the lawsuit between the Preslars and the bank.

The Preslars advanced no competent evidence to support their theory that the loan obligation was linked to the repayment scheme. They maintain that, although they did not state it in writing, their acquiescence in the $1 million purchase price hinged on their ability to satisfy the debt through assignment of installment contracts. Thus, when the FDIC refused to honor the assignments, a concomitant reduction in their liability was necessary. In other words, the “FDIC could not enforce the ranch loan without abiding by the [unsigned] Dealer Agreement. The loan and the Dealer Agreement were two sides of an integrated transaction.” Neither the May 1984 letter from Moncor Bank to Layne Preslar nor the unsigned 1985 Dealer Agreement, however, contains any statement evidencing an intent to link the underlying liability with the repayment scheme. Further, if the parties desired the loan obligation to be inextricably intertwined with the repayment arrangement, that condition should have been memorialized in the loan document.

The dispute with the FDIC focused only on the terms of repayment; it did not touch upon the amount or validity of the Preslars’ debt. As an alternative to accepting assignment of contracts, the Preslars requested that the FDIC “substantially discount the remaining amount due on their loan.” Such a position evidences the Preslars’ recognition that they had a fixed and certain liability at the time the FDIC took control of their loan from Moncor Bank. In fact, Layne Preslar conceded he understood he was personally liable for the full amount of the $1 million note in the event he could not sell a sufficient number of lots. In sum, the Preslars’ underlying indebtedness remained liquidated at all times.

The Tenth Circuit then determined that the Preslars could not treat the FDIC settlement as a purchase-price reduction under I.R.C. §108(e)(5). This rule permits taxpayer to reflect their debt reduction by adjusting the basis of their property rather than recognizing an immediate gain as cancellation of indebtedness. The purchase price adjustment provision only applies, however, to direct agreements between a purchaser and seller. Neither the bank nor the FDIC was the seller.

Holding. The Tenth Circuit reversed the Tax Court’s decision. The Preslars must recognize discharge-of-indebtedness income on the settlement of the liability.

[Layne E. Preslar, et ux. v. Commissioner, 99-1 USTC 50,258]
This document contains final regulations concerning three related but distinct tax issues:

1. Reduction of basis in property under the discharge-of-indebtedness rules of I.R.C. §§108 and 1017, including rules for a partner’s treatment of partnership discharged debts.
2. Recapture of basis reductions under I.R.C. §1017 upon sale of a personal residence.
3. The limitations on the exclusion of income from discharge of qualified real property indebtedness.

Explanation of Revisions and Summary of Comments

**Basis reduction.** The statute, in §1017(b)(2), provides only one limitation on basis reduction for insolvent and bankrupt taxpayers who do not make an election under §108(b)(5). Under that rule, the basis reduction may not exceed the excess of the aggregate of the bases of the property held by the taxpayer immediately after the discharge over the aggregate of the liabilities of the taxpayer immediately after the discharge.

Allocation of basis reduction of multiple properties within the same class. The proposed regulation incorporate the limitation described in I.R.C. §1017(b)(2) which provides that the basis reduction for bankrupt and insolvent taxpayers may not exceed the excess of the aggregate of the bases of the property held by the taxpayer immediately after the discharge over the aggregate of the liabilities of the taxpayer immediately after the discharge.

The overall limitation on basis reduction is determined by reference to the adjusted basis of property and the amount of money held by the taxpayer over the liabilities of the taxpayer “immediately after the discharge.” By contrast, under the basis reduction rules applicable for purposes of I.R.C. §108(b)(2)(E), the taxpayer must reduce the adjusted basis of property “held by the taxpayer at the beginning of the taxable year following the year in which the discharge occurs” [I.R.C. §1017(a)].

The proposed regulations also provided that a taxpayer must treat a distributive share of a partnership’s COD income as attributable to a discharged indebtedness secured by the taxpayer’s interest in that partnership. The rule in the proposed regulations for allocating basis reduction among multiple properties under §108(b)(2)(E) contained parenthetical language cross-referencing the partnership provision for the property classes that included secured real and personal property used in a trade or business or held for investment. This parenthetical language was intended to remind taxpayers that partnership indebtedness is treated as indebtedness secured by the taxpayer’s interest in the partnership.

One commentator stated that the cross-reference with respect to secured real property was confusing since a partnership interest presumably should be treated as personal property in reducing basis under §108(b)(2)(E). This is contrasted with the modified basis reduction rules under §§108(b)(5) and 108(c) which, assuming the appropriate requests are made and consents are granted, apply a look-through rule to reduce the inside basis of depreciable property or depreciable real property held by a partnership.

As under the proposed regulations, the final regulations continue to treat a distributive share of a partnership’s COD income as attributable to a discharged indebtedness secured by the taxpayer’s partnership interest.
Mandatory request and consent. The proposed regulations provided that a partner may treat a partnership interest as depreciable property under §108(b)(5) [or as depreciable real property under §108(c)] only if the partnership consents to make corresponding adjustments to the basis of the partnership’s depreciable property (or depreciable real property). The IRS and Treasury Department generally believe, in this context, that whether or not a partnership consents to make the corresponding adjustments to the basis of its property should be a matter of agreement between the partner and the partnership. Therefore, the proposed regulations generally provided that a partner is free to choose whether or not to request that a partnership reduce the basis of partnership property and that the partnership is free to grant or withhold its consent.

As in the proposed regulations, the final regulations do not require a partnership to reduce the basis of its depreciable property (or depreciable real property) in all situations where the partnership is the source of the COD income. However, where a partnership is the source of the COD income and partners elect to exclude such income, such partners are required to request that the partnership reduce its basis in such property. Accordingly, if partners meeting certain regulatory requirements elect to exclude such income, the partnership must consent to reduce the basis of its depreciable property (or depreciable real property).

Timing and reporting. The proposed regulations provided that a partner requesting a reduction in inside basis must make the request and receive consent before the due date (including extensions) for filing the partner’s Federal income tax return for the taxable year in which the partner has COD income. The proposed regulations also provided that a partnership that consents to a basis reduction must include a consent statement with its Form 1065, U.S. Partnership Return of Income, and provide a copy of that statement to the affected partner on or before the date the Form 1065 is filed. One commentator stated that the final regulations should provide that: (i) partners should not be required to request consent, and (ii) neither the partner nor the partnership should be required to attach statements to their returns, until the filing date of their respective returns for the taxable year following the year that the partner excludes COD income.

Therefore, the final regulations provide that the partner must request and receive the consent of the partnership before the partner excludes the COD income. The final regulations do, however, adopt the suggestion that the partnership is not required to attach a statement to its return until the filing date of its Federal income tax return for the taxable year following the year that ends with or within the taxable year that the partner excludes COD income.

The IRS and Treasury Department continue to believe that a partner electing under §108(b)(5) or §108(c) must receive the consent of the partnership before the partner excludes the COD income. Therefore, the final regulations provide that the partner must request and receive the consent of the partnership prior to the due date (including extensions) for filing the partner’s Federal income tax return for the taxable year in which the partner has COD income. The final regulations provide that, for purposes of §108(b)(5) or §108(c), the partner must request and receive the consent of the partnership before the partner excludes the COD income. The final regulations do, however, adopt the suggestion that the partnership is not required to attach a statement to its return until the filing date of its Federal income tax return for the taxable year following the year that ends with or within the taxable year that the partner excludes the COD income.

Basis reduction with Respect to a Residence. A commentator requested that when the basis of a taxpayer’s residence is reduced under I.R.C. §1017 and is disposed of in a transaction subject to I.R.C. §1031 (which provided for the deferral of gain on the sale of a personal residence), the potential recapture income arising under §1245 should be carried into the replacement property. This comment is not adopted in the final regulations. Code §1034 was repealed by the Taxpayer Relief Act of 1997. New §121 enacted by the Taxpayer Relief Act of 1997, exempts certain gain on the sale of a residence, but does not provide that the potential gain will be transferred to a replacement residence. Therefore, under the new law, there is no mechanism to preserve the potential recapture income with respect to a new residence, and the potential recapture income must be recognized on the sale of the residence under §1245.

Qualified Real Property Indebtedness. Prop. Reg. §1.108-5(a) described the limitation under §108(c)(2)(A) and provided that the amount excluded under §108(a)(1)(D) (concerning discharges of qualified real property business indebtedness) could not exceed the excess of the outstanding principal amount of that indebtedness immediately before the discharge over the net fair market value of the qualifying real property (as defined under §1.1017-1(c)(1)) immediately before the discharge. The final regulations provide that, for purposes of §108(c)(2)(A) and §1.108-6 only, outstanding principal amount means the principal amount of an indebtedness and all additional amounts owed that, immediately before the discharge, are equivalent to principal, in that interest on such amounts would accrue and compound in the future. Amounts that
are subject to §108(e)(2) are excepted from the definition of principal amount. In addition, principal amount must be adjusted to account for unamortized premium and discount consistent with §108(e)(3).

Meaning of “in connection with” in §108(c)(3). A commentator requested that the final regulations provide that the phrase “in connection with” in §108(c)(3) does not require that the proceeds of debt incurred or assumed before January 1, 1993 be traced to real property used in a trade or business, but only requires that the debt be secured by real property used in a trade or business as of January 1, 1993. The final regulations do not adopt this comment. Code §108(c)(3)(A) defines qualified real property business indebtedness as indebtedness which “was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property.” The IRS and Treasury Department do not believe that this sentence should be interpreted to mean only that the debt must be secured by real property used in a trade or business as of January 1, 1993.

**Frazier v. Commissioner**

*I.R.C. §§108 and 1001*

**Facts.** The Fraziers owned real property in Austin, Texas, that was secured by a recourse loan. The property was foreclosed by the lender on August 1, 1989, at a time when the Fraziers were insolvent. **At the foreclosure sale, the lender bid on the property for $571,179.** The Fraziers owed $585,943 on the property and had an adjusted basis of $495,544 in the property at this time. They presented an appraisal stating that the fair market value of the property was actually $375,000 at the time of the foreclosure sale.

The Internal Revenue Service determined that the Fraziers realized $571,179 on the foreclosure sale, which represents the amount bid in by the lender.

**Issue.** Did the Fraziers realize $571,179 on the foreclosure sale, or was the amount realized limited to the $375,000 fair market value of the property?

**Discussion.** The transfer of property in consideration of the discharge of indebtedness is equivalent to the sale of property, and gain or loss is realized. Under I.R.C. §1001(a), the gain realized is the excess of the amount realized over the taxpayer’s adjusted basis in the property. In the case of recourse debt, the amount realized equals the property’s fair market value. Absent clear and convincing proof to the contrary, the sale price of property at a foreclosure sale is presumed to be its fair market value. However, the Fraziers rebutted this presumption with the required clear and convincing proof (an unchallenged appraisal for $375,000). The Court noted that it could look behind a paper façade to find the actual substance and economic realities of a transaction. Indeed, where the transaction is so disparate from the actual substance and economic realities of the situation, the court is duty-bound to look behind the transaction in order to apply the Internal Revenue Code.

The Court went further to note that Treas. Reg. §1.1001-2(a)(1) effectively bifurcates the transaction into a taxable transfer of property and a taxable discharge from indebtedness. Thus, each should be treated as a separate transaction for tax purposes. As a result, the Fraziers realized a capital loss of $120,544 on the transfer of the property ($375,000 fair market value less $495,544 adjusted basis).
On the second step of the analysis, the Fraziers realized $210,943 of ordinary income from discharge of indebtedness ($585,943 debt less $375,000 deemed payment).

According to I.R.C. §108(a)(1)(B), a taxpayer does not have to include in gross income the income from the discharge of indebtedness if it occurs while the taxpayer is insolvent. The exclusion cannot be more than the amount by which the taxpayer is insolvent.

Holding. Because the petitioners’ insolvency exceeded the income realized from the discharge of indebtedness, the Court determined that this income is excluded from their gross income under I.R.C. §108(a)(1)(B).

[Richard D. Frazier and Yvonne Frazier v. Commissioner, 111 T.C. 243 (1998)]

**EDUCATION CREDITS AND BENEFITS**

Notice 98-54

☞ No information reporting is required with respect to “mixed use” loans.

Discussion. Code §221(e)(1), as amended by RRA 1998, provides that the term “qualified education loan” means any indebtedness incurred by the taxpayer solely to pay qualified higher education expenses. The amendment to §221(e)(1) is effective as if included in the Taxpayer Relief Act of 1997 and applies to interest payments due and paid after December 31, 1997. Thus, the payee must not report under §6050S information on mixed use loans (whether or not secured by real property) because they are not qualified education loans under §221(e)(1) as amended. However, information reporting under §6050S continues to be required for any loan (including a loan secured by real property) or revolving account, such as credit card account, that the payor certifies is used solely for the purpose of paying qualified higher education expenses. The payee may rely on this certification when filing Form 1098-E, Student Loan Interest Statement, for 1998 and need not verify the payor’s actual use of the funds. In all other respects, the requirements of §6050S with respect to qualified education loan interest reporting for 1998 remain the same as described in Notice 98-7.

The Service is currently revising Form W-9S, Request for Student’s or Borrower’s Social Security Number and Certification, to remove the certification for mixed use loans. In addition, payees should disregard the instructions regarding mixed use loans and revolving accounts, which are found in the Form 1098-E section of the 1998 Instructions for Forms 1099, 1098, 5498, and W-2G. Those instructions will be revised for 1999.

[Notice 98-54, 1998-46 IRB]

Notice 98-59

☞ Educational institution reporting requirements are modified.

This notice modifies Notice 97-73, 1997-2 C.B. 335, and Notice 98-46. 1998-36 I.R.B. 21, by providing that the Internal Revenue Service will not require an eligible educational institution to file information
returns under §6050S of the Internal Revenue Code for 1998 or 1999 with respect to students who are enrolled during the year only in courses for which the student receives no academic credit from the institution. In addition, this notice modifies Notice 97-73 and Notice 98-46 by providing that eligible educational institutions are not required to file information returns for 1998 for 1999 with respect to nonresident alien students, unless requested to do so by the student.

[Notice 98-59, 1998-49 IRB]

Reg. 106177-97
[I.R.C. §529]

New regulations explain the qualified state tuition programs requirements.

Explanation of Provisions

Qualification as Qualified State Tuition Program: Unrelated Business Income Tax and Filing Requirements. The proposed regulations provide guidance on the requirements for a program to qualify as a qualified state tuition program (QSTP) under I.R.C. §529. A QSTP is generally exempt from income tax, but is subject to tax on unrelated business income (UBI) under I.R.C. §511. An interest in a QSTP shall not be treated as debt under I.R.C. §514, and, consequently, investment income earnings on contributions by purchasers will not constitute debt-financed income subject to the unrelated business income tax (UBIT). Investment income to the extent the QSTP incurs indebtedness when acquiring or improving income-producing property will be subject to the UBIT. Earnings forfeited on educational contracts or savings, amounts collected as penalties on refunds or excess contributions, and certain administrative and other fees are not considered UBI to the QSTP. Although a QSTP is not required to file Form 990, Return of Organization Exempt from Income Tax, it is required to file Form 990-T, Exempt Organization Business Income Tax Return.

Established and Maintained. The proposed regulations define when a state, an agency, or an instrumentality of the state establishes and maintains a QSTP. The factors that are relevant in determining whether a state, an agency, or an instrumentality of the state is actively involved in the administration of the QSTP include the manner and extent to which it is permissible for the program to contract out for professional and financial services.

Safe Harbors for Penalties and Substantiation. The proposed regulations provide that a penalty is considered more than de minimus if it is consistent with a program intended to assist individuals in saving exclusively for higher education expenses. For purposes of the safe harbor, a penalty is more than de minimus if it is equal to or greater than 10% of the earnings. The proposed regulation also set forth safe harbor practices and procedures that may be implemented by a QSTP for identifying whether a distribution is subject to a penalty and for collecting any penalty that is due.

Other Requirements for QSTP Qualification. Contributions to the QSTP can be placed into either a prepaid educational contract or an educational savings account, or both, but cannot be placed in any other type of account. A program must be able to provide an individual annual account statement showing the transactions related to the account upon the request of the account owner or designated beneficiary.

Code §529(b)(7) requires a program to prevent excess contributions for a designated beneficiary. The proposed safe harbor permits a program to bar additional contributions when the total contributions for a designated beneficiary exceed the actuarial estimated amount necessary to pay tuition, fees, and room and board expenses for five years of undergraduate enrollment at the highest cost institution allowed by the program.
Income Tax Treatment of Distributions. The proposed regulations provide that distributions made by a QSTP must be included in the gross income of the distributee to the extent that distribution consists of earnings. A non-taxable rollover distribution is allowed as long as there is a change of beneficiary, and the distribution is deposited into the account of another member of the family of the designated beneficiary. A transfer from the designated beneficiary to himself is not a considered rollover distribution and is taxable under the general rule.

Estate and Gift Tax Consequences. Guidance is provided on the gift and generation-skipping tax consequences of QSTP contributions, a change in a QSTP designated beneficiary, and a rollover from the QSTP account of one beneficiary to the QSTP account of another beneficiary. The proposed regulations also provide guidance on whether the value of an interest in a QSTP is includible in the gross estate of a contributor or designated beneficiary, and to what extent this interest is included.

Effective Date. Taxpayers may rely on the proposed regulations for taxable years ending after August 20, 1996. Special transition rules are provided for programs in existence on August 20, 1996.

Reg. 106388-98
[I.R.C. §25A]

Explanation of Provisions

The Taxpayer Relief Act of 1997 (P.L. 105-34) added I.R.C. §25A to provide taxpayers with the Hope Scholarship Credit and the Lifetime Learning Credit. The Service published Notice 97-60, 1997-46 IRB 8, to provide general guidance on the higher education tax incentives enacted by TRA '97. These proposed regulations are intended to provide detailed guidance on the I.R.C. §25A education credits.

Calculation of Education Credit and General Eligibility Requirements. Under the proposed regulations, a taxpayer may claim a nonrefundable credit equal to the total Hope Scholarship Credit and Lifetime Learning Credit allowed for the taxpayer, the taxpayer’s spouse, and any claimed dependents. The rules for coordinating these two credits are provided in these proposed regulations. A taxpayer may claim either the Hope Scholarship credit or the Lifetime Learning Credit for the qualified tuition and related expenses of the same student in the same tax year.

The education credit is phased out for taxpayers with modified adjusted gross income (MAGI) between $40,000 and $50,000 ($80,000 and $100,000 for joint return taxpayers) for the tax year. The phase out amounts will be adjusted for inflation beginning after 2001. Form 8863, Education Credits (Hope and Lifetime Learning Credits), must be filed with the taxpayer’s income tax return for the tax year in which the credit is claimed.

The proposed regulations further provide that the taxpayer who claims the student as a dependent is the only one that may claim the education credit for the student’s qualified and related expenses. If the student is not claimed as a dependent, then the student may claim this education credit for qualified tuition and related expenses.

Definitions

1. Claimed dependent is a dependent defined in I.R.C. §152.

2. Eligible educational institution means a college, university, vocational school, or other post-secondary educational institution that is described in §481 of the Higher Education Act of 1965 and participates, or is eligible to participate, in a federal student financial aid program under title IV of the HEA.
3. **Academic period** means a quarter, semester, trimester, or other period of study.

4. **Qualified tuition and related expenses** is defined as the tuition and fees required for the enrollment of a student for courses at an eligible educational institution. The regulations provide that the test for determining whether the fee is treated as qualified tuition and related expenses is whether the fee is required to be paid to the eligible educational institution by students as a condition of the students' enrollment or attendance. Qualified tuition and related expenses do not include the costs of room and board, insurance, medical expenses, or transportation, regardless of whether the fees must be paid to the eligible educational institution for the students' enrollment or attendance.

**Hope Scholarship Credit.** The Hope Scholarship Credit is allowed for only two taxable years for each eligible student. The **maximum amount of this credit is $1,500**, 100% of the first $1,000 of the qualified tuition and related expenses paid for each eligible student during the tax year and 50% of the next $1,000 of these expenses. This credit amount will be adjusted for inflation for years beginning in 2002.

An **eligible student** for purposes of the Hope Scholarship Credit is defined in the proposed regulations as a student who meets all of the following requirements:

1. **Degree requirement** – The student is enrolled in an eligible educational institution for at least one academic period during the tax year in a program leading toward a post-secondary degree, certificate, or other recognized post-secondary education credential;

2. **Workload requirement** – The student is enrolled for at least half of the normal full-time work load for at least one academic period during the tax year for the course of study the student is pursuing;

3. **Year of study requirement** – As of the beginning of the tax year, the student has not completed the first two years of post-secondary education at an eligible educational institution; and

4. **Felony drug conviction restriction** – The student has not been convicted of a federal or state felony offense for the possession or distribution of a controlled substance as of the end of the tax year for which the credit claimed.

The Hope Scholarship Credit is effective for expenses paid after December 31, 1997, for education furnished in academic periods beginning after that date.

**Lifetime Learning Credit.** The Lifetime Learning Credit is a per-taxpayer credit rather than a per-student credit. The **maximum Lifetime Learning Credit amount is $1,000** or 20% of up to $5,000 of the qualified tuition and related expenses paid during the tax year for education furnished to the taxpayer, taxpayer’s spouse, and any claimed dependents. Beginning in 2003, the maximum credit amount is $2,000 or 20% of up to $10,000 of these expenses.

The degree requirement, workload requirement, year of study requirement, and felony drug conviction requirement are not conditions for the Lifetime Learning Credit. However, the proposed regulations do require that the expenses be part of a postsecondary degree program or part of a nondegree program that is taken by the student to acquire or improve job skills.

The Lifetime Learning Credit is effective for expenses paid after June 30, 1998, for education furnished in academic periods beginning after that date.

**Special Rules Relating to Characterization and Timing of Payments.** If a third party makes a payment directly to an eligible educational institution to pay for a student’s qualified tuition and related expenses, the student is treated as receiving the payment from the third party, and paying the qualified tuition and related expenses to the institution.

Qualified tuition and related expenses, for purposes of the education credit, must be reduced by the following amounts paid to, or on behalf of, a student during the taxable year:

1. A qualified scholarship that is excludable from gross income under I.R.C. §117;

2. A veterans’ or member of the armed forces’ educational assistance allowance under Chapter 30, 31, 32, 34, or 35 of Title 38, U.S.C., or Chapter 1606 of Title 10, U.S.C.;
3. Employer-provided educational assistance that is excludable from gross income under I.R.C. §127; and

4. Any other education assistance that is excludable from gross income (other than as a gift, bequest, devise, or inheritance).

An education credit may be claimed for the qualified tuition and related expenses paid with the proceeds of a loan only in the taxable year in which the expenses are paid, and not in the taxable year in which the loan is repaid. Loan proceeds disbursed directly to an educational institution are treated as paid on the date of the disbursement.

The regulations provide that an education credit is generally allowed only for payments of qualified tuition and related expenses that cover an academic period beginning in the same taxable year in which the payment is made. However, if qualified tuition and related expenses are paid during a taxable year to cover an academic period that begins during the first three months of the taxpayer’s next taxable year, an education credit is allowed only in the taxable year in which the expenses are paid.

The taxpayer must reduce the amount of qualified tuition and related expenses for any refund from an educational institution of qualified tuition and related expenses for which the taxpayer claimed an education credit in a prior taxable year, provided the refund is received before the taxpayer files a federal income tax return for the prior year. If the taxpayer has already filed his tax return for that year, then he must increase the tax for the subsequent year by the recapture amount. The recapture amount is the difference between the credit claimed and the redetermined credit.

Effective Date. Taxpayers may rely on these regulations for guidance pending the issuance of final regulations. If the future guidance is more restrictive than the guidance in the proposed regulations, the future guidance will not be applied retroactively.

Note. See the Education Provisions chapter for further explanation and examples of these provisions.

Notice 99-32
[I.R.C. §25A]

The Service has announced that the final regulations under I.R.C. §25A will allow taxpayers to elect to claim the Hope Scholarship Credit and the Lifetime Learning Credit on amended, as well as original, tax returns. These education credits are available for taxable years beginning after 1997.

Proposed regulations (Reg. 106388-98), issued in January 1999, provided that these education credits could be claimed on timely-filed original returns by attaching Form 8863, “Education Credits (Hope and Lifetime Learning Credits),” to their federal income tax return for the taxable year in which it was claimed. Because the Treasury Department and the IRS have determined that taxpayers should also be able to elect to claim this credit on an amended return, the final regulations under I.R.C. §25A will allow individuals to claim these education credits on timely-filed original or amended tax returns. If this credit is claimed on an amended return, it must be done before the expiration of the limitations period for filing a credit or refund claim for the tax year in which the credit is claimed. The election procedure provided in the final regulations will apply to taxable years beginning after 1997.


**ESTATE AND GIFT TAX**

_Estate of Mellinger v. Commissioner_

[I.R.C. §2044]

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**Facts.** Frederick Mellinger was the founder of Frederick’s of Hollywood, Inc. (FOH). At the time of his death, he and his wife, Harriet, held 4.92 million shares of FOH stock in a family trust. Under the terms of the family trust, Frederick left his community property interest of 2.46 million shares of FOH stock in a **qualified terminable interest property (QTIP) trust** for the benefit of Harriet during her lifetime. Frederick’s estate claimed a marital deduction for the value of the stock under I.R.C. §2056(b)(7). After Frederick’s death, Harriet removed her 2.46 million shares of FOH stock from the family trust, and contributed it to a newly established **revocable trust** (the Harriet trust). The shares in each trust represented **27.87% of the outstanding FOH stock.**

Harriet died testate in 1993. Her executors filed Form 706, U.S. Estate and Generation-Skipping Tax Return, **valuing the stock in each of the trusts separately.** In valuing the stock, the executors obtained two appraisals, each one treating the shares as separate 27.87% interests in FOH. One appraiser valued the stock at $4.85 per share, applying a 30% discount, and the **other appraiser valued the stock at $4.79 per share, applying a 31% discount.** The executors filed the estate tax return using $4.79 per share, resulting in a value of $11.8 million in each trust. The Service determined that the FOH shares held by the Harriet trust and the QTIP trust should be merged for valuation purposes, and valued as a **55.74% ownership block.** The Service applied a value of $8.46 per share of FOH stock, resulting in a total value of $20.8 million for each trust.

**Issues**

1. Whether I.R.C. §2044 requires aggregation, for valuation purposes, of the stock held in a trust established by the decedent’s predeceased spouse under I.R.C. §2056(b)(7) with stock held in decedent’s revocable trust.

2. If I.R.C. §2044 does not require aggregation, what is the fair market value of the stock at decedent’s death?

**Analysis and Holding**

**Issue 1.** Code §2044 provides for the taxation of QTIP property upon the death of the second spouse. The QTIP property does not actually pass to or from the surviving spouse. Therefore, **Harriet did not possess, control, or have any power of disposition over these FOH shares in the QTIP trust.** The Court indicated that nothing in the legislative history of I.R.C. §2044 indicates that the decedent should be treated as the **owner** of QTIP property for this purpose. The Court cited Estate of Bonner v. United States, 84 F.3d 196 (CA-5, 1996), in which the Fifth Circuit, relying on the **decedent’s lack of control of the disposition of the property,** stated that the statute did not require that the QTIP assets be merged with other assets for valuation.

The Court concluded that the blocks of FOH stock should not be aggregated for purposes of estate tax valuation.

**Issue 2.** Treas. Reg. §20.2031-2(e) provides that a blockage discount may be applied when the block of stock to be valued is so large that it cannot be liquidated in a reasonable time without depressing the market. The parties in this case agreed that the undiscounted fair market value of the FOH shares on
the valuation date was $6.9375 per share, but disagreed as to the appropriate marketability discount to be applied. The Service contended that a 15% discount should be applied to the stock, and the estate argued that a 31% discount was more appropriate.

The Court was more satisfied with the method used by the estate’s experts, but indicated that the claimed discount was overstated. The Court concluded that the marketability discount should be 25%. Accordingly, the fair market value of each of the two 27.87% interests in FOH should be $12.8 million, or $5.2031 per share.


**Estate of Jameson v. Commissioner**

[I.R.C. §2031]

The value of stock of a closely held corporation is based on the value of the underlying assets, capital gains discount, and lack of marketability.

**Facts.** John Jameson incorporated Johnco in 1968. At the time of his death in 1990, John owned 82,865 of the 83,000 outstanding shares of Johnco. He made a specific bequest of his remaining unified credit amount to his two children, Andrew and Dinah. The residuary estate passed to his surviving spouse, Helen. Andrew’s share of the unified credit bequest was to be satisfied out of the Johnco stock based on the value determined by an independent appraisal as of John’s date of death. John’s estate filed a timely Form 706, U.S. Estate and Generation-Skipping Tax Return, reporting a value of $72 million or $86.80 per share for the Johnco stock passing through the estate.

Helen Jameson died testate in 1991. At the time of her death, she owned the portion of the 82,865 shares of Johnco stock that had not been bequeathed by John to Andrew. Johnco’s principal asset was well managed and highly productive timberland. The executor of Helen’s estate obtained two appraisals of Johnco stock. The value of the decedent’s Johnco stock on the date of her death (decedent appraisal) was determined to be $43.90 per share, and the value of the Johnco stock held by John on his date of death (John appraisal) was determined to be $44.65 per share. The John appraisal was then used to value the number of shares that passed to Andrew at the time of John’s death. The $44.65 per share value was utilized notwithstanding the fact that John’s date-of-death value for such stock was reported on John’s Form 706 as $86.80 per share, or $7.2 million for 82,865 shares. The Form 706 filed by John’s estate has not been amended. After taking into account this bequest to Andrew, Helen’s estate determined that she owned 79,730 shares of Johnco stock valued at $3.5 million. The number of shares and the value of these shares included in Helen’s estate are the controversial issues in the present case.

**Issues**

1. How many shares of Johnco, Inc. stock did the decedent own at the time of her death?
2. What was the fair market value of the Johnco shares of stock the decedent owned at the time of her death?
3. Whether the method prescribed for the computation of the federal estate tax transforms any part of such tax into a direct tax which has not been apportioned in accordance with the Constitution.

**Analysis and Holding**

Issue 1. Helen’s estate stated that Helen did not obtain an independent appraisal of the Johnco stock passing through John’s estate as per the terms of the will. Therefore, the estate claimed, the $86.80 per share value reported on John’s estate tax return should not be used to determine the number of shares required to satisfy the unified credit bequest to Andrew. The Court disagreed, and held that the same per-share value used on John’s estate tax return must also be used for purposes of fund-
Issue 2. Treas. Reg. §20.2031-1(b) provides that, for federal estate tax purposes, the fair market value of property is generally determined as of the decedent’s date of death, and ordinarily, no consideration is given to any unforeseeable future event that may have affected the value of the property on some later date.

One of the estate’s experts used income and marketing approaches in valuing the decedent’s Johnco stock, trying to show that Johnco was not viable as a going concern. The other expert engaged by the estate used the assumption that a prospective buyer would consider the liquidation value of Johnco’s assets to be the primary factor. The Court rejected both of these approaches, and agreed with the Service’s expert that the stock should be valued based on the fair market value of the corporation assets. Rev. Rul. 59-60, 1959-1 C.B. 237, states that “the value of the stock of a closely held investment or real estate holding company . . . is closely related to the value of the assets underlying the stock.”

The Service opposed the application of a built-in capital gains discount in this valuation. The Court disagreed, stating that a hypothetical willing buyer of decedent’s Johnco stock would take into account Johnco’s built-in capital gains. On the valuation date, Johnco had an election under I.R.C. §631(a) to treat the cutting of timber as though it was a hypothetical sale or exchange of the timber. Johnco will recognize its built-in capital gains under I.R.C. §1231 as it cuts the timber. The Court calculated the net present value of the built-in capital gains tax liability, and allowed a reduction for this amount in determining the fair market value of the Johnco stock in Helen’s estate.

The estate offered no expert evidence to support a 10% discount for lack of marketability. The Service’s expert calculated a 6% lack of marketability discount, but also asserted that Johnco’s other real estate lacked marketability. Adjusting the Service’s calculation, the Court concluded that the estate was entitled to a 3% discount for lack of marketability. Further, the Court agreed with the Service that no nuisance discount was warranted.

On the basis of these conclusions, the Court found that the fair market value of the 81,641 shares of Johnco stock included in Helen’s estate was $5.8 million or $71 per share on the date of decedent’s death. This was more than the $50.94 per share value reported by the estate, but less than the $77 per share value asserted by the IRS.

Issue 3. The Court concluded that the imposition of estate tax in this case falls well within the taxing power sanctioned by the Supreme Court.

[Estate of Helen Bolton Jameson v. Commissioner, T.C. Memo 199-43, 77 T.C.M. 1383 [CCH Dec. 53,247(M)]]

Reg. 106177-98
[Treas. Reg. §§20.2001-1,25.2504-2,301.6501(c)-1]

Proposed regulations explain the adequate disclosure requirement and valuation of prior gifts.

Explanation of Provisions

Statute of Limitations for Assessment of Gift Tax under I.R.C. §6501(c)(9). Under the Taxpayer Relief Act of 1997 (P.L. 105-34) and Restructuring and Reform Act of 1998 (P.L. 105-206), the adequate disclosure requirement was extended to all gifts, affecting the statute of limitation protection for gifts. For gifts made in a calendar year ending after August 5, 1997, the period of assessment will not close for any gift that is not adequately disclosed on a gift tax return.

The proposed regulations provide a list of information that must be provided on a gift tax return, or on an attached statement, to be considered adequately disclosed to cause the
period of assessment to begin. The required information must completely and accurately describe the transaction and include:

1. A description of the transferred property and any consideration received by the transferor;
2. The identity of, and relationship between, the transferor and the transferee;
3. A detailed description of the method used to determine the fair market value of the property transferred;
4. If the property is transferred in trust, the trust’s tax identification number and a brief description of the trust terms;
5. Any restrictions on the transferred property that were considered in determining the fair market value of the property;
6. A statement of facts affecting the gift tax treatment of the transfer to apprise the IRS of any potential controversy concerning the gift tax treatment of the transfer; and
7. A statement describing any position taken that is contrary to any temporary or final Treasury regulations or revenue rulings.

Under the proposed regulations, the statute of limitations under I.R.C. §6501(c)(9) will commence upon the adequate disclosure of a transfer that is reported as a completed gift on the gift tax return even if the transfer is ultimately determined to be an incomplete gift. On the other hand, the statute of limitations does not commence upon the adequate disclosure of an incomplete gift until the donor reports the transfer as a completed gift. This adequate disclosure requirement is intended to provide the IRS the opportunity to identify, in a timely manner, returns that present issues that require further examination.

Valuation of Prior Gifts for Gift Tax Purposes. The proposed regulations for I.R.C. §2504(c) provide that if a gift was adequately disclosed and the time has expired for assessing gift tax for a preceding calendar period under I.R.C. §6501, then the value of that gift cannot be adjusted. Since I.R.C. §2504(c) applies only to adjustments involving issues of valuation, adjustments unrelated to the valuation, such as erroneous inclusion or exclusion for gift tax purposes, may be made to adequately disclosed prior taxable gifts.

Valuation of Prior Gifts for Estate Tax Purposes. The proposed regulations added I.R.C. §2001(f) to serve as the estate tax provision corresponding to I.R.C. §2504(c). Under I.R.C. §2001(f), if the time has expired for assessing gift tax for a preceding calendar period under I.R.C. §6501, then the value of the gift for estate tax purposes is the value of the gift finally determined for gift tax purposes. As discussed above, this provision only limits the IRS’s ability to make adjustments to the valuation of gifts.

Effective Date. The provisions of this proposed regulation apply to any gifts made in a calendar year occurring after August 5, 1997.

**Eisenberg v. Commissioner**

Irene Eisenberg owned all the stock of a closely held C corporation whose only asset was a commercial building that was leased to third parties. In 1991, 1992, and 1993, she gifted shares of the corporation to her son and two grandchildren. In valuing these gifts, Eisenberg reduced the value of closely held stock can include a discount for built-in capital gains.

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the stock by the full amount of the capital gains tax that she would have incurred had the corporation liquidated, sold, or distributed this building.

**Issue.** Whether the donor was entitled to discount the value of the stock for gift tax purposes, to reflect the built-in capital gains tax liabilities the corporation would incur if it were to liquidate or distribute its sole asset, a commercial building.

The IRS agreed with Eisenberg’s use of the net-asset-value method for determining the fair market value of the property along with the 25% minority discount she used, but disagreed with the taxpayer on the valuation reduction for the capital gains liabilities. The Tax Court ruled in favor of the Service and Eisenberg appealed.

**Analysis.** The Tax Court has consistently held in similar cases that a reduction of the value of closely held stock for potential capital gains tax liabilities at the corporate level is not appropriate where there is no evidence that a liquidation or sale of the corporation’s assets is likely to occur. The law in this area was based on the Supreme Court decision in *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935), that a corporation did not recognize gain on a dividend distribution of appreciated property. By employing the *General Utilities* doctrine, a corporation could liquidate and distribute appreciated or depreciated property to its shareholders without recognizing built-in gain or loss, and thus avoid double taxation.

The Tax Reform Act of 1986 (P.L. 99-514) repealed the *General Utilities* doctrine and added I.R.C. §§331(b) and 336(a) to provide for the corporate level recognition of gain on distributions or sales of appreciated property. Since the avoidance of capital gains tax at the corporate level was no longer an issue in this case, the court looked to what considerations a hypothetical buyer would take into account in computing the fair market value of the stock.

In *Estate of Davis v. Commissioner*, 110 T.C. No. 35 (June 30, 1998), the Tax Court allowed a discount for the built-in capital gains tax because “that is what a hypothetical willing seller and a hypothetical willing buyer would have done.”

**Holding.** The Second Circuit agreed that, with the repeal of the *General Utilities* doctrine, the avoidance of the corporate-level capital gains tax is not at issue here. The appeals court held that this adjustment for capital gains tax liabilities should be taken into account in valuing the closely held stock even though no liquidation or sale of the corporation or its asset was planned at the time of the gift of the stock. The court remanded to the Tax Court to determine the gift tax liability consistent with this opinion.

*Irene Eisenberg v. Commissioner*, 98-2 USTC 60,322 (CA-2, 1998)

**Facts.** The decedent died in 1980, leaving farm property to the taxpayer, a qualified heir within the meaning of I.R.C. §2032A(e)(1). The decedent’s estate elected to value the farm under I.R.C. §2032A.

In 1983 the taxpayer began renting the farm property on a cash lease basis. In 1991, the taxpayer reported the cash lease of the property on Form 706A, Additional Estate Tax Return. Based on this return, the Service assessed a recapture tax imposed under I.R.C. §2032A and the related interest charge. The taxpayer paid this recapture tax the same year and then filed for a refund. The Service disallowed the refund claim in 1993, and the taxpayer paid the underpayment interest in 1996.

In 1997, after the enactment of I.R.C. §2032A(e)(7)(E), which provided that the rental of property to a family member on a net cash basis would be considered a qualified use, the taxpayer filed a claim for refund of the recapture tax and the interest paid.
Issues

1. Whether the effective date of I.R.C. §2032A(c)(7)(E) constitutes a waiver of the period of limitations for filing a claim under I.R.C. §6511(a), otherwise applicable to the taxpayer’s claim.
2. Whether the taxpayer’s claim for refund was timely filed, for purposes of I.R.C. §6511(a), with respect to the claim for refund of the recapture tax.
3. Whether the taxpayer is entitled to receive interest on the refund of underpayment interest.

Analysis

Issue 1. Code §2032A(c)(7)(E) applies with respect to leases entered into after December 31, 1976. In several situations where Congress has retroactively amended I.R.C. §2032A, Congress specifically extended the period for filing a claim to receive the benefit of the amendment. In the present situation, nothing in the legislative and administrative history, the statutory language of I.R.C. §2032A(c)(7)(E), or the effective date of the provision indicates a congressional intent to extend the period of limitations for filing a claim by reopening closed tax years.

Issue 2. Code §6511(a) provides that a claim for refund of an overpayment of tax shall be filed by the taxpayer within three years from the time the return was filed or two years from the time the tax was paid, whichever period expires later. Additionally, I.R.C. §6511(b)(2)(B) states that if the claim is not filed within the three-year period, the amount of the credit or refund is limited to the tax paid during the two years immediately preceding the filing of the claim. In this case, the taxpayer filed the claim for refund within two years from the time the Form 706A was filed. However, during the two years immediately preceding the filing of the refund claim, the taxpayer paid the underpayment interest which, for this purpose, is treated as payment of tax.

Issue 3. Code §6611(a) provides that interest shall be allowed and paid on any overpayment with respect to any internal revenue tax at the overpayment rate established under I.R.C. §6621. There is no provision in the 1997 Act that expressly prohibits the payment of interest on overpayments resulting from the application of I.R.C. §2032A(c)(7)(E).

Conclusion

Issue 1. The I.R.C. §2032A(c)(7)(E) effective date does not constitute a waiver of the period of limitations otherwise applicable to the taxpayer’s claim. The taxpayer’s claim for refund of recapture tax is not timely.

Issue 2. Since the taxpayer filed her claim for refund within two years from the time the underpayment interest was paid, the claim was considered timely with respect to this interest amount.

Issue 3. Since the underpayment interest paid by the taxpayer during the two years immediately preceding the filing of the refund claim constitutes an overpayment tax, the taxpayer is entitled to overpayment interest on the amount of overpayment.

Note. Same ruling in LTR 9843002, LTR 9843003, LTR 9843004, and LTR 9843005.
**Estate of Shackleford v. United States**

**Facts.** Thomas Shackleford purchased a one-dollar California lottery ticket in 1987 and won a jackpot of more than $10 million. These winnings were to be distributed in 20 annual payments of $508,000. After receiving three of these payments, Shackleford died testate in 1990.

On its first federal estate tax return, the estate estimated the gross estate to be $4.4 million, of which $4.0 million represented the value of the remaining lottery payments. The estate filed a number of amended tax returns; the last one claiming that the value of the remaining 17 lottery payments was zero. The IRS rejected this final claim and the estate filed this suit.

**Issue.** Whether a more realistic valuation method than Treas. Reg. §20.2031-7 valuation tables was available for valuing a decedent’s interest in future annual lottery payments.

**Analysis.** The government argued that decedent’s interest in the lottery payments is a term-of-years annuity that must be included in his gross estate under I.R.C. §2039(a), and should be valued using the Treas. Reg. §20.2031-7 valuation tables. The estate argued that the lottery payments fall within the I.R.C. §2039(b) exception, because only $1 was attributable to the decedent’s contribution.

The District Court disagreed with the estate’s interpretation of the I.R.C. §2039(b) exception and concluded that the lottery payments represented the accumulated wealth of the decedent. **These payments must be included in the gross estate under both I.R.C. §2039(b) and the catchall provision I.R.C. §2033.**

As to the value of the lottery payments, the estate argued that these payments should be valued as commercial annuities under Treas. Reg. §20.2031-8(a)(1) by looking at the sale of comparable contracts issued by the company. The Court disagreed, stating that lottery payments are not issued by a company that is regularly engaged in the sale of commercial annuities.

The estate’s next argument was that even if the payments do constitute a private annuity, the value of the payments using the Treas. Reg. §20.2031-7 tables is unrealistic because **these tables do not take into consideration the restrictions on marketability.** After taking marketability restrictions into account, the estate declared that a more accurate valuation of this interest is $2.4 million rather than the $4 million result with the tables.

**Holding.** The Court concluded that the estate demonstrated as a factual matter that $2.4 million is the realistic value of the decedent’s interest in the lottery payments. Therefore, the valuation tables in the regulations were not used.


**LTR 199909001, October 19, 1998**

**Facts.** After the decedent and her sister-in-law won the state lottery, they executed a limited partnership agreement to receive the lottery winnings, and the state made the first of 20 annual payments to the partnership. Prior to her death, the decedent executed a revocable living trust and transferred her partnership interest to the trust.
In valuing the decedent’s partnership interest, the estate first determined the value of the partnership’s underlying assets, cash and 19 lottery payments receivable. The estate discounted the payments to present value using a discount rate based on the AAA-rated general obligation bond yield. The estate then discounted the payments by 39.6% for federal income taxes and 25% for lack of marketability. The executor took additional discounts in valuing the partnership, 20% for lack of control and 25% for lack of marketability. Then a proportionate value of the partnership was allocated to decedent’s partnership interests.

**Issue.** For estate tax purposes, what is the appropriate method for valuing lottery winnings that are payable to a partnership over a specified period?

**Analysis and Conclusion.** The lottery winnings represent the right to receive a fixed dollar amount annually for a defined period of time and an annuity valuation method should be used to determine the value of the winnings. Since the right of the partnership to receive the lottery winnings is not restricted or limited in this case, the estate must use the I.R.C. §7520 standard annuity factor to determine the value of the lottery winnings for estate tax purposes. The present value of the right to receive the 19 remaining annuity payments is computed by using this standard annuity factor contained in the appropriate table under Treas. Reg. §20.2031-7(d) reflecting the I.R.C. §7520 interest rate on the valuation date.

The Service also stated that the executor may not take a reduction for income taxes payable or a discount for lack of marketability. See Estate of G.R. Robinson v. Commissioner, 69 T.C. 222 (1977), CCH Dec. 34,736, for a holding that the estate could not discount the value of an installment obligation by estimated income taxes payable. The Service did not address the discounts for lack of control and lack of marketability in valuing the partnership.

**Estate of Gibbs v. United States**
[I.R.C. §2032A]

**Facts.** James C. Gibbs, Sr., owned and operated a dairy farm at the time of his death in 1984. The estate elected to value the farmland based on its special use as farmland under I.R.C. §2032A. By making this election, the taxpayer, James C. Gibbs, Jr., agreed to be personally liable for any additional estate tax due if he disposed of any interest in the property within 10 years of his father’s death. In 1993, Gibbs granted the state of New Jersey a development easement in exchange for $1.4 million. This easement prohibited nonagricultural use of the land, and these restrictions run with the land in perpetuity. The IRS asserted that this conveyance was a disposition of an interest in the property, triggering the I.R.C. §2032A recapture tax. The taxpayer paid this tax and filed suit in the district court seeking a refund.

The district court held for the taxpayer based on the determination that the taxpayer did not part with a real property interest by granting this easement to the state. The easement granted contract rights, not property rights. The Court denied a subsequent request by the taxpayer to recover attorney’s fees.

**Issue.** Whether, by granting the State of New Jersey a development easement in his family farm in exchange for $1.4 million, a qualified heir disposed of an interest in the farm, and was subject to the I.R.C. §2032A recapture tax.

**Analysis.** Using the rationale in United States v. National Bank of Commerce, 472 U.S. 713 (1985), the Third Circuit agreed with the government that the state law is relevant here only to the extent that it defines the easement that the taxpayer deeded to the state. Once the determination is made that the easement is recognized under state law, then the question becomes whether the transfer...
of the easement constituted a “disposition of interest” in the taxpayer’s farmland under I.R.C. §2032A. The Court noted that there are no published judicial opinions addressing this “disposition of interest” aspect under I.R.C. §2032A.

The Court viewed the real property that passed to the taxpayer as two “bundles of rights.” The first bundle of rights related to the agricultural use of the land, and the second bundle of rights related to the development uses of the land. By electing under the special use provision, the taxpayer avoided paying taxes on the value of the development uses of the land, with the understanding that he would not realize the value of those rights within the 10-year recapture period.

**Holding.** Relying on established principles of property law and estate taxation, the appeals court concluded that the conveyance of the development easement was a disposition of an interest in the farmland. The taxpayer disposed of valuable development property rights that the IRS would have been taxed in his father's estate had the taxpayer not elected the special use valuation under I.R.C. §2032A. Because this disposition occurred within 10 years of the decedent's death, the recapture tax was due. The Third Circuit reversed the order of the District Court.

[Estate of James C. Gibbs, Sr., v. United States of America, 98-2 USTC ¶60,333 (CA-3, 1998)]

**Facts.** Welders hired by specialized industrial construction companies generally provide their own equipment, including trucks, welders, welding tanks, and related items. Job supplies are provided on union jobs, but not on non-union jobs. Welders are paid both a wage and a rig rental fee. The wages are subject to employment tax and are reported on Form W-2. The rental fees are reported on Form 1099.

**Issue.** Are the rig rental fees wages for employment tax purposes?

**Discussion.** If an arrangement meets the three requirements of an “accountable plan” under Treas. Reg. §1.162-2, the amounts paid under the arrangement are above-the-line deductions to the employee. The three requirements are business connection, substantiation, and returning amounts in excess of expenses. Amounts paid under a “nonaccountable plan” are gross income to the employee and must be reported on the employee’s Form W-2.

**Conclusion.** The determining factor is whether the rig rental payments are made under an accountable plan under I.R.C. §62. The rig rentals are not wages if they are paid under an “accountable plan.” However, if the payments are made under a “nonaccountable plan,” they are reported as wages and are subject to employment taxes.

**Note.** See the Michael D. Welch case in the Passive Activities and Rentals section of this chapter for a related issue.
Facts. According to the Office of Chief Counsel, the general rule that a member of an LLC is not personally liable for the employment taxes incurred by the LLC does not apply to a single-member LLC unless it elects association status under the “check-the-box” regulations.

Issue. Is the individual owner of a single-member LLC personally liable for the organization’s employment tax liability?

Discussion. A single-member LLC may elect to be taxed like a corporation under the “check-the-box” regulations. The entity is disregarded as an entity separate from its owner if no election is made.

Conclusion. If the single owner makes no election under the “check-the-box” regulations and reports all income on an individual return, the owner is the employer and is personally liable for employment taxes incurred by the LLC.

Marlar, Inc. v. United States
[I.R.C. §3121]

Facts. Marlar, Inc. operates an establishment that offers nude and seminude dancing to the general public. During 1990 and 1991, Marlar followed the industry practice of the Seattle area and treated its dancers as lessees. Marlar accepted a “rental fee” from its dancers and provided them with stages and other dance facilities. The dancers earned their money from one-on-one performances with customers and from credits received for accepting drinks purchased by Marlar customers.

Marlar did not pay employment taxes on the dancers or file employment tax returns. The IRS audited Marlar in 1994 and determined that the dancers should be classified as employees. Marlar was assessed $282,082.11 (plus interest and penalties) in employment taxes for the years 1990 and 1991. Marlar paid part of the amount and then sought a refund. The United States countered by filing a claim for the unpaid balance.

Marlar moved for summary judgment before the district court. After being granted summary judgment, Marlar applied for and was awarded litigation costs. The government appealed the grant of litigation costs and of summary judgment.

Issues

1. Are the dancers lessees of Marlar or employees for whom Marlar should pay employment taxes?
2. Was the government justified in its position in the proceeding?
FRINGE BENEFITS

Discussion

Issue 1. Section 530 of the Revenue Act of 1978 relieves a taxpayer of employment taxes if both (1) the taxpayer reasonably relied on something such as industry practice, and (2) the taxpayer filed all necessary forms consistent with the treatment of the workers as not being employees.

Issue 2. Code §7430(c)(4)(B)(i) states that fees shall not be awarded if the United States establishes that its position in the proceeding was “substantially justified.”

Holding. The district court held that Marlar satisfied the first requirement of §530 because it relied on the undisputed industry practice of treating dancers as lessees. The Court found that this reliance was reasonable because a reasonable person could find the practice to be correct.

According to the government, Marlar should have filed Form 1099, which reports payments made by a trade or business, for each of its dancers. However, the Court did not find that the money received by the dancers were payments. Therefore, Marlar satisfied both requirements of §530.

The court of appeals found that the district court underestimated the government’s argument. However, the Court did not determine if the government’s position was “substantially justified.”

The Ninth Circuit therefore affirmed the district court’s granting of summary judgment, but remanded the attorney’s fees question to the district court.

[Marlar, Inc. v. United States of America, 98-2 USTC 50,619]

See also 303 West 42nd St. Enterprises, Inc. v. IRS, et al., 99-2 USTC ¶50,611 (CA-2), for a similar issue.

FRINGE BENEFITS

ISP Coordinated Issue Paper, March 29, 1999
[I.R.C. §§105 and 162]

Employers may deduct the cost of health coverage for employee-spouses.

Facts. A self-employed individual hires his or her spouse. Accident and health coverage is then provided to the spouse through the employer’s self-insured medical reimbursement plan or through a purchased accident and health insurance policy. As a member of the employee’s family, the employer-spouse is covered by the plan. The employer-spouse deducts 100% of the cost of providing health insurance for his or her family and the employee-spouse excludes from gross income the cost of the health coverage and medical reimbursements.

Issues

1. Is the cost of accident and health insurance coverage provided to an employee-spouse deductible by the employer under I.R.C. §162?

2. Is the cost of health coverage and medical reimbursements provided by an employer-spouse excludable by an employee under I.R.C. §§105(b) and 106?
Discussion

Issue 1. In Rev. Rul. 71-588, 1971-2 C.B. 91, the taxpayer operated a business as a sole proprietorship with several bona fide full-time employees, including his wife. The taxpayer had a self-insured accident and health plan that covered all employees and their families. During 1970, two of the employees, including the wife, incurred expenses for medical care for themselves, their spouses and their children, and were reimbursed pursuant to the plan. Under these facts, the Service held that the amounts paid in reimbursement were deductible by the taxpayer as business expenses under I.R.C. §162 and excludable by the employees (including the wife) under I.R.C. §105(b).

Accordingly, the Service’s position is that the cost of accident and health coverage, including medical expense reimbursements, are deductible by the employer-spouse if the employee-spouse is determined to be a bona fide employee of the business under the common law rules or otherwise provides services to the business for which the accident and health coverage is reasonable compensation. However, if the “employee-spouse” does not meet this standard, the accident and health coverage is a personal expense under I.R.C. §262(a), which is not deductible under I.R.C. §162(a).

Issue 2. Code §105(b) allows an employee to exclude from gross income amounts paid to the employee for medical reimbursements. Code §106 excludes employer-provided health plan coverage from an employee’s gross income. The Service’s position is that the cost of accident and health coverage or medical expense reimbursement is excludable from gross income by the employee-spouse only if the employee-spouse is a bona fide employee under the common law rules. If the “employee-spouse” is not a bona fide employee, then the cost of accident and health coverage provided by the “employee-spouse” is not excluded from the gross income of the “employee-spouse” under I.R.C. §106(a) because the I.R.C. §106 exclusion only applies to the “gross income of an employee.” Similarly, medical expense reimbursements received by the “employee-spouse” are not excluded from gross income under I.R.C. §105(b). However, if the cost of accident and health coverage provided by the “employee-spouse” is included in the “employee-spouse’s” gross income, all amounts received by the “employee-spouse” and family for personal injury and sickness under the coverage are excludable under I.R.C. §104(a)(3).

An additional factor to consider in this situation is the eligibility provisions of a self-insured accident or health plan. The adoption agreement and plan document must provide that the employee-spouse is eligible to participate. For example, very often a specific service requirement applies to current employees as well as new employees. This waiting period may not have been applied to the employee-spouse, but may have been used to exclude other employees. Thus, if it is not documented that the employee-spouse has met the service requirement, the employee-spouse may not participate and medical expense reimbursements would not be excludable under I.R.C. §105(b) because they would not be received under an accident and health plan. In addition, if the service requirement has not been consistently applied to all employees, the self-insured plan could be discriminatory under I.R.C. §105(b).

Note that if an accident and health policy is purchased in the name of the employer-spouse, the limitations of I.R.C. §162(1) (the deduction for self-employed health insurance) apply. Therefore, the employer-spouse cannot claim the expense as a deduction on Schedule C or Schedule F. The employee-spouse does not have to report the amount paid for the policy as income.

Conclusion. Under I.R.C. §162, employer-souses may deduct the cost of health coverage provided to a spouse who is a bona fide employee. Under I.R.C. §§105(b) and 106, spouses who are bona fide employees may exclude from gross income the cost of health coverage and medical reimbursements furnished by the employer.

UIL 162.35-02

Note. See the Schedule C chapter for a problem and extensive analysis of this ISP Coordinated Issue Paper and the one following this discussion.
Facts. Employers sometimes retroactively adopt self-insured health plans to cover medical expenses incurred during the taxable year, but prior to the date of the plan’s adoption. This allows employees to exclude the medical expense reimbursements from income. The retroactive adoption of health plans occurs most often in cases where a self-employed business owner hires his or her spouse and wants to cover family medical expenses.

Issues

1. Are employer reimbursements under a self-insured health plan for medical expenses incurred prior to the plan’s adoption excludable from the employee’s gross income under I.R.C. §105(b)?

2. Are employer reimbursements under a self-insured health plan for medical expenses incurred prior to the plan’s adoption deductible by the employer under I.R.C. §162(a)?

Discussion

Issue 1. Code §105(b) excludes from an employee’s gross income amounts paid to the employee to reimburse expenses incurred by him, his spouse, or dependants for medical care. Code §105(e) states that amounts received under health plans are treated as amounts received through accident or health insurance under I.R.C. §§105(a) and (b). The I.R.C. §105(b) rule applies only when the reimbursements are received under a health plan. Citing American Family Mutual Insurance Co. v. United States, 815 F. Supp. 1206 (W.C. Wis. 1992) and Rev. Rul. 71-403, 1971-2 C.B. 91, the Service pointed out that “for there to be a plan, the employer must be committed to certain rules and regulations governing payment,” and “those rules must be made known to employees as a definite policy and must be determinable before the employee’s medical expenses are incurred.” Accordingly, the Service concluded that payments for reimbursement of medical expenses before the adoption of a plan are not paid or received under an accident or health plan for employees and are not excludable from gross income under I.R.C. §105(b).

Issue 2. Code §162(a)(1) allows a taxpayer to deduct all ordinary and necessary business expenses paid or incurred during the taxable year in relation to carrying on a trade or business. In determining if a payment is deductible under I.R.C. §162(a), it does not matter if the payment is made under a health plan. The expenses only need to be ordinary and necessary for carrying on a business. Consequently, payments that aren’t excludable by employees under I.R.C. §105(b) may still be deductible by employers under I.R.C. §162.

Conclusion. Reimbursements under a self-insured health plan for medical expenses incurred before the plan’s adoption are not excludable from employee’s gross income under I.R.C. §105(b), but are deductible by the employer under I.R.C. §162(a).
Facts. As a fringe benefit, BMW allowed certain employees to use BMW vehicles. In 1988 and 1989, BMW assigned a particular series of models to the employees based on their job titles. The more important the job title, the better the series of car the employee was able to use. However, the supply and demand of the cars would override any predetermined benefits. For example, if a vice president was to receive a series 7 car (manufacturer’s suggested retail price (MSRP) of $54,000 to $69,000), he might be demoted to a series 5 car (MSRP of $32,000 to $47,000) if supplies were low in series 7 vehicles. To calculate the amount of fringe benefits to include in an employee’s gross income, the Annual Lease Value Table in Treas. Reg. §1.61-21(d)(2)(iii) was used. BMW determined the fair market value of each vehicle and plugged it into the table to come up with the annual fringe benefit value [Treas. Reg.§1.61.21(d)(5)]. BMW provided more than 2000 vehicles to its employees in 1988 and 1989. The fair market value was determined by the employees’ purchase price, a price offered to employees under a vehicle purchase plan. BMW justified a lower fair market value because the cars were not to be parked in certain areas. Additionally, the vehicle color and options were not determined by the employees. The IRS determined that BMW inappropriately used the special lease valuation rule in determining the amount on which to pay employment tax. The IRS reached this conclusion because the fair market for use in the table is supposed to be “the amount that an individual would pay in an arm’s-length transaction to purchase the particular automobile.” The IRS disallowed BMW’s use of the special valuation rules because the company had improperly applied the special valuation rules. BMW was assessed with additional employment taxes of $698,000 and $651,000 for 1988 and 1989.

Issues

1. Whether Treas. Reg. §1.61-21(c)(5) is a penalty provision that prevents taxpayers from using special valuation rules after they have improperly applied the rule.
2. Whether BMW can reduce the fair market value of its fringe benefit vehicles due to restrictions on their use, colors, and options.

Discussion

1. Treas. Reg. §1.61-21(c)(5) states that “when a special valuation rule is not properly applied to a fringe benefit, or when a special valuation rule is used to value a fringe benefit by a taxpayer not entitled to use the rule, the fair market value of that fringe benefit may not be determined by reference to any value calculated under any special valuation rule.”
2. Therefore, a taxpayer who violates the special valuation rule or who is not entitled to use the rule is limited to the general valuation rules contained in the fringe benefit regulations. The Court noticed that without such a penalty provision, taxpayers could improperly apply the special valuation rules to their benefit until caught, and then go back and properly apply the same beneficial rules the second time, losing nothing. The Court interprets paragraph (c)(5) of Treas. Reg. §1.61-21 to prevent such a situation, and as an attempt to prevent an abuse of the rules.
3. Treas. Reg. §1.61-21(d)(5) states that the fair market value of the vehicles should be “the amount that an individual would have to pay in an arm’s length transaction to purchase the particular automobile in the jurisdiction in which the vehicle is purchased or leased. … Any special relationship that may exist between the employee and employer must be disregarded. Also, the employee’s subjective perception of the value of the automobile is not relevant to the determination of the automobile’s fair market value.”
Holding. The Court held Treas. Reg. §1.61-21(c)(5) to be a penalty provision that the IRS may invoke to prevent BMW from using any special valuation rule after BMW had improperly applied the rule. BMW was not allowed to reduce the fair market value of automobiles provided as a fringe benefit because of restrictions on use, color, or options. BMW may only use the general valuation rules to determine the value of the fringe benefit of providing automobiles.

[BMW of North America Inc. v. United States, 99-1 USTC ¶50,255]

This document contains final regulations revising the uniform premiums used to calculate the cost of group-term life insurance provided to employees. These final regulations reflect changes to the income tax regulations under I.R.C. §79. The regulations are effective July 1, 1999.

Explanation of Provisions. Code §79 states that group-term life insurance costs should be calculated using five-year age brackets prescribed by the regulations. Table I under Treas. Reg. §1.79-3(d)(2) sets forth these costs. The revisions to Table I lowered the uniform premiums in all age groups and added a new age bracket for ages under 25.

The revised uniform premiums are effective generally on July 1, 1999. However, employers have until the last pay period of 1999 to make any needed adjustments of amounts withheld for purposes of the FICA. Further, an employer may continue using only 10 age brackets for making its calculations until January 1, 2000. A special effective date applies to a policy of life insurance issued under a plan in existence on June 30, 1999, if the policy would not be treated as carried directly or indirectly by an employer under Treas. Reg. §1.79-0 using the I.R.C. §79 uniform premium table in effect on June 30, 1999. If this is the case, the employer may continue using such table for determining if the policy is carried directly or indirectly by an employer until January 1, 2003.

Code §79 generally permits an employee to exclude from gross income the cost of $50,000 of group-term life insurance carried directly or indirectly by an employer. The remaining cost of the group-term life insurance is included in the employee’s gross income to the extent it exceeds the amount, if any, paid by the employee for the coverage. Income imputed under I.R.C. §79 is not subject to federal income tax withholding. However, it is subject to FICA tax and, for active employees, an employer is required to withhold the FICA tax at least once a year. Also, the amount of income imputed under I.R.C. §79 is reported on an employee’s Form W-2.
Unifor?m Premiums for $1,000 of Group-Term Life Insurance Protection

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<th>Five-Year Age Bracket</th>
<th>Cost of $1,000 of Protection for One Month</th>
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<tr>
<td>25 to 29</td>
<td>0.06</td>
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<tr>
<td>30 to 34</td>
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<tr>
<td>35 to 39</td>
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<tr>
<td>40 to 44</td>
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<tr>
<td>70 and above</td>
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</tbody>
</table>

The above table is for the cost of group-term life insurance provided after June 30, 1999.

*Boyd Gaming Corp. v. Commissioner*

[I.R.C. §119]

Casinos may deduct 100% of meal expenses since the stay-on-premises policy for employees was for the convenience of the employer.

**Facts.** During 1987 and 1988, Boyd Gaming Corporation operated four hotel and casino properties in Las Vegas, Nevada. For security and logistical reasons, the company required its employees to stay on the casino premises throughout their entire shift. Because of this policy, employees received free meals at on-site cafeterias.

Boyd deducted 100% of the expenses associated with the meals provided to employees. The Commissioner assessed the company with deficiencies resulting from excessive deductions. Boyd petitioned the Tax Court for redetermination of the deficiencies. The Commissioner claimed that Boyd’s deductions were subject to the 80% cap on food and beverage expenses under I.R.C. §274(n). Boyd claimed that it was exempt from the 80% limitation because the meals were a de minimis fringe benefit provided to more than half of its employees for the employer’s convenience. The Tax Court determined that Boyd’s deductions were limited to 80% because the casinos did not furnish the meals to substantially all their employees for the convenience of the employer. Boyd appealed the decision, relying on the catch-all provision of I.R.C. §119(b)(4), amended in 1998, which allows an employer to deduct the cost of employer-provided meals if “more than half of the employees to whom such meals are furnished . . . are furnished such meals for the convenience of the employer.”

**Issue.** Does Boyd Gaming Corporation qualify for an exception to the 80% cap on food and beverage expense because the meals are provided to more than half of its employees for Boyd’s convenience? Does the stay-on-premises policy of Boyd Gaming constitute a substantial, noncompensatory business reason for furnishing meals?

**Discussion.** In general, I.R.C. §132 excludes de minimis fringe benefits from an employee’s gross income. Under this section, an employer’s operation of an eating facility provides a de minimis fringe benefit if it meets two criteria: (1) the facility is located on or near the employer’s premises, and (2) the revenue derived from the facility normally meets the operating costs of the facility.
facility. Boyd’s cafeterias were on-site, so it satisfied the first requirement. Because Boyd did not charge for the meals provided to employees, the company could not establish that the revenue/operating cost test was met. There is a statutory presumption under I.R.C. §119, however, that treats revenue as equal to operating costs for meals supplied to employees who are allowed to exclude the value of the meals from gross income. Therefore, the requirements of I.R.C. §119 must also be looked at in assessing the applicability of the 80% cap.

Code §119(b)(4) provides a catch-all provision that allows employers to deduct the cost of employer-provided meals if more than half of the employees to whom the meals are provided are furnished such meals for the convenience of the employer. The Commissioner determined that between 41% and 48% of Boyd’s employees received meals for the convenience of the employer. Because Boyd does not meet the more-than-half threshold, the “convenience of the employer” test must be satisfied by a determination that the stay-on-premises policy was a substantial, noncompensatory business reason for furnishing employee meals.

In Commissioner v. Kowalski (77-2 USTC ¶9748), the Court concluded that the “convenience of the employer” standard should be measured by “business necessity.” Boyd argued that “stay-on-premises” policy resulted in a “substantial noncompensatory business reason” to provide meals to employees. In Caratan v. Commissioner [442 F.2d 606 (9th Cir. 1971)] the court held that the Tax Court may not substitute its own judgment that is contrary to the taxpayer’s unimpeached and uncontradicted evidence. The Ninth Circuit in Caratan rejected the Tax Court’s narrow focus on whether the employees could do their jobs without remaining on the taxpayer’s business premises, concluding that the taxpayer’s policy was dispositive. The same reasoning applies to Boyd: once the stay-on-premises policy was embraced, the “captive” employees had no choice but to eat on the premises. Boyd is entitled to use the catch-all provision of I.R.C. §119(b)(4) since “more than half” of Boyd’s employees received meals for the “convenience of the employer” as a result of the “stay-on-premises” requirement.

Holding. Boyd may deduct 100% of the expenses associated with the meals provided to employees.

[Boyd Gaming Corp., et al. v. Commissioner, 99-1 USTC ¶50,530]

Observation. This case was originally discussed on page 630 of the 1996 Income Tax Workbook.

LTR 9850011, September 10, 1998
[I.R.C. §105]

Same-sex domestic partner does not qualify as spouse, but may qualify as dependent.

Issue. What are the federal tax consequences of extending health benefits to an employee’s same-sex domestic partner?

Facts. A fund, established through a collective bargaining agreement between a union and several employees, has a family health plan that reimburses various medical expenses for employees, their spouses, and dependents. The fund wishes to amend this plan to allow employees to receive benefit coverage for same-sex domestic partners. The employee and his or her partner must file a declaration of domestic partnership in order to be eligible for the benefit coverage.

Conclusion. A same-sex domestic partner does not qualify as the spouse of an employee, but may qualify as a dependent if the requirements of I.R.C. §152(a)(9) and I.R.C. §152(b)(5) are met. To be a dependent, the domestic partner must receive more than half of his or her support from the employee, live in and be part of the employee’s household, and not violate local law by engaging in the relationship. Neither the employee nor the domestic partner will include in gross
income amounts received from the health plan to the extent that employee contributions pay for the domestic partner’s coverage. Excludability of amounts paid or contributed by the fund will not be affected by coverage of domestic partners. However, if a same-sex partner does not qualify as a spouse or a dependent, the employee must include in gross income the excess of the fair market value of coverage provided to the partner over the amount paid by the employee for the coverage. Any amount included in an employee’s gross income because of the partner’s coverage constitutes wages under I.R.C. §3401(a) and is subject to income tax withholding under I.R.C. §3402.

Note. Publication 501, Exemptions, Standard Deductions and Filing Status, states that “a person does not meet the member of household test if at any time during your tax year the relationship between you and that person violates local law.” This requirement will preclude taxpayers in some states from claiming an exemption for a live-in companion.

GAINS AND LOSSES

T.D. 8836, Treas. Reg. §1.453-12
[I.R.C. §453]

Final regulations are released on taxation of capital gains from some installment sales of depreciable real property.

Explanation of Provisions

The Taxpayer Relief Act of 1997 (P.L. 105-34) reduced the maximum net capital gain tax rates for individuals. Changes and technical corrections to I.R.C. §1(h) were enacted as part of the Restructuring and Reform Act of 1998 (P.L. 105-206) and the Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1999 (P.L. 105-277).

The maximum marginal rate for unrecaptured I.R.C. §1250 gain is 25%. A maximum marginal rate of 20% applies to adjusted net capital gain, defined in I.R.C. §1(h)(4) as the portion of the net capital gain that is not taxed at the 28% or 25% rate. The 10% rate applies to this portion of adjusted net capital gain that would otherwise be taxed at a 15% rate if taxed as ordinary income. But I.R.C. §1(h) does not address how to treat an installment sale of depreciable real property when the gain to be reported consists of both 25% and 20/10% gain.

Front-Loaded Allocation of Unrecaptured §1250 Gain. Under Treas. Reg. §1.453-12(a), if a portion of the capital gain from an installment sale is 25% gain and a portion is 20/10% gain, the taxpayer must take the 25% gain into account before the 20/10% gain, as payments are received. This front-loaded allocation method is similar to previously adopted front-loaded methods with respect to installment sales.

Interaction with §1231. The regulations address the interaction of the capital gains rates, the installment method, and the rules in I.R.C. §1231. Notice 97-59 (1997-45 IRB 7) already provides that I.R.C. §1231 gain that is recharacterized as ordinary gain under I.R.C. §1231(c) is deemed to consist first of 28% gain, then 25% gain, and finally 20/10% gain. These regulations focus on examples involving I.R.C. §1231 since these situations are the most common.

Treatment of Installment Payments from Sales prior to May 7, 1997. Treas. Reg. §1.453-12(b) provides that installment payments that are received on or after May 7, 1997, from sales prior to that date are determined as if all payments received before May 7, 1997, had taken into account the 25% gain before the
its use as a principal residence for at least two of the past five years [Popa (98-1 USTC ¶50,2760), 218 B.R. at 426].

The Court determined that the use of real property as a residence constitutes a character of that asset. This is different from the trustee asserting that the debtors satisfied an age requirement, so therefore he too satisfies that age requirement. The character of the asset itself, a character to which the trustee succeeds under I.R.C. §1398(g)(6), allows the sale to qualify for the I.R.C. §121 exclusion.

Had the property been sold by debtors, there is no question that the I.R.C. §121 exclusion would automatically apply. With the 1997 revisions to I.R.C. §121, allowing the trustee to assert the I.R.C. §121 exclusion will not result in debtors being prohibited from taking advantage of the exclusion upon a subsequent sale of their qualifying property. With this ruling, the taxable income of the estate will be computed in the same manner as for an individual, in accordance with I.R.C. §1398(c). Further, the estate will be treated as the debtors with respect to property transferred to the bankruptcy estate, as mandated in I.R.C. §1398(f)(1).

The Court noted that a trustee’s inability to assert the I.R.C. §121 exclusion could result in a decision to abandon property where the tax eliminates any equity that would have otherwise benefited the unsecured creditors of the estate. This would leave debtors free to sell qualifying property after its abandonment, assert the exclusion, and get a “head start” above their statutory exemptions far in excess of the “fresh start” that the Bankruptcy Code envisions. Allowing the trustee to assert the I.R.C. §121 exclusion “upholds the public interest in a responsible bankruptcy system and does not frustrate any clearly defined federal policy” [Bradley, 222 B.R. at 317; Popa (98-1 USTC ¶50,276)].

Holding. The majority of court decisions prior to the amendment of I.R.C. §121 disallowed bankruptcy trustees from electing the exclusion. Before the Taxpayer Relief Act of 1997, bankruptcy trustees were usually not allowed to assert the I.R.C. §121 exclusion because they were not considered the taxpayers. The courts’ reasoning prior to the amendments was that the age limitation and one-time availability restricted the trustees from using the exclusion. However, the majority of court decisions after the amendments to I.R.C. §121 allow the bankruptcy trustee to utilize the exclusion. The courts’ reasoning points to the elimination of the age requirement and the elimination of the exclusion’s one-time availability. Amended I.R.C. §121 along with I.R.C. §1398 have led the majority of post-1997 court decisions to allow bankruptcy trustees to assert the exclusion.

The Court found that I.R.C. §1398 and I.R.C. §121 allow the bankruptcy trustee to exclude the gain from the sale from the bankruptcy estate’s gross income.

[Facts. George Coloney reported $7,984 ($25,309 less than his actual winnings) of gambling winnings and the I.R.S. allowed a $7,984 deduction for gambling losses on Schedule A of his 1994 income tax.
To prove his losses, Coloney produced 83 race tickets and a copy of a complaint filed by Trump Plaza Associates, a casino, for his failure to make good on $124,000 in checks. The TPA complaint included a form indicating Coloney was approved for a line of credit on March 13, 1992. Coloney was also denied deductions for supplies expense, taxes and licenses, travel, meals and entertainment, and other expenses claimed on Schedule C of his 1994 income tax return. No evidence supported Coloney’s supplies expense deduction. He produced an undated, handwritten Estimated Income Tax Voucher for 1994 and a New York income tax adjustment statement for his taxes and licenses deduction. Although the Estimated Income Tax Voucher states that a payment of $35,000 was made, Coloney was unable to produce a check or proof of actual payment. The amount is also in conflict with the amount shown on the New York income tax adjustment. Coloney could prove actual payment of only $2,610 of state tax withheld during the 1994 taxable year. Coloney evidenced his travel expenses of $16,500 and his meals and entertainment expenses of $14,400 by producing his 1994 American Express Card statements and receipts.

Issues

1. Whether Coloney has substantiated alleged gambling losses over the amount already allowed by respondent, entitling him to deduct such losses against his unreported gambling winnings of $25,309.

2. Whether Coloney is entitled to deduct certain expenses claimed on Schedule C of his 1994 federal income tax return.

Discussion

1. Code §165(d) provides: “Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions.” The burden lies with the petitioner to prove with competent evidence the fact and amount of gambling losses, if any. Prior court decisions have established that pari-mutuel tickets alone carry insufficient evidentiary weight, if no corroborating evidence is given to prove that the ticket was a losing ticket purchased by the petitioner. Coloney failed to keep adequate records of his winnings and losses and could not produce any evidence to corroborate his assertion that the pari-mutuel tickets represent losses sustained by him. The Court noted that Coloney could have acquired the tickets from friends or by “stooping” (picking up discarded stubs of disheartened bettors) (Scocciaro v. Commissioner, T.C. Memo 1979-455). The TPA complaint and accompanying credit record indicate only that Coloney was issued credit and failed to make good on his checks. There is no evidence that Coloney sustained losses in an amount equal to the line of credit.

2. Code §§162 and 274(d) require the petitioner to substantiate Schedule C expenses in order to deduct them. Code §164(a)(3) allows a deduction for state income taxes paid during the taxable year. Travel, meals, and entertainment expenses are governed by I.R.C. §162(a), which states that the petitioner must show that each item was (1) paid or incurred during the taxable year, (2) for carrying on any trade or business, (3) an expense, (4) a necessary expense, and (5) an ordinary expense. Code §274(d) requires substantiation showing: (a) the amount of such expense or other item, (b) the time and place of the travel, entertainment, amusement, recreation, or use of the facility or property, (c) the business purpose of the expense or other item, and (d) the business relationship to the taxpayer of persons entertained. Coloney’s American Express Card statements do not meet the substantiation requirements of I.R.C. §274(d) because, among other things, they do not show the business purpose of the expense, or, with regard to entertainment expenses, information on the persons entertained.
**Holding.** Coloney is not entitled to deduct gambling losses in excess of the $7,984 already allowed by the IRS. The travel expenses and meals and entertainment expenses, as well as other deductions for supplies, “other expenses,” and taxes and licenses, are disallowed.

*George Coloney v. Commissioner, T.C. Memo. 1999-194*

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**Kent v. Commissioner**
[I.R.C. §165]

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**Facts.** Michael and Michelle Kent indisputably gamble as a trade or business. The Kents petitioned the court to allow them to deduct their gambling losses and expenses just as any other taxpayers engaged in a trade or business. The Kents received an unfavorable ruling from the district court. The case was appealed to the U.S. Court of Appeals for the Ninth Circuit.

**Issues**

1. Can professional gamblers, who indisputably engage in gambling as a trade or business, deduct their losses and expenses, and take loss carrybacks like any other taxpayers engaged in a trade or business?

2. Does the limitation on gambling deductions in I.R.C. §165(d) apply to those who gamble professionally?

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**Discussion.** Code §162 allows a trade or business to deduct its losses and other expenses, and take loss carrybacks.

Code §165 states that gambling losses can’t offset non-gambling income. The Court noted that while the U.S. Supreme Court’s 1997 decision in Commissioner v. Groetzinger (87-1 USTC ¶9191) casts some doubt on the continued vitality of the reasoning of prior decisions ([Nitzberg, 78-2 USTC ¶9667, and Boyd, 85-2 USTC ¶9458]) holding that I.R.C. §165(d) limits gambling losses even of professional gamblers, the Supreme Court did not overrule those decisions. Therefore, professional gamblers may not deduct gambling losses under I.R.C. §162, and deductions for gambling losses are limited under I.R.C. §165(d) to the amount of gambling income.

**Holding.** The U.S. Court of Appeals upheld the district court’s previous decision that I.R.C. §165(d) limits the deduction of gambling losses regardless of whether it is part of a trade or business.

*Michael P. Kent, et ux. et al. v. United States, 99-2 USTC 50,608*
**Facts.** Pavel and Ana Dobra owned four residential properties that were used to provide residential care to adults. The Dobras resided in one of the properties. The petitioners provided personal care in their own residence but hired others to provide personal care at the other three properties. During 1992 and 1993, the Dobras were paid by the state for the care provided at all four properties. Asserting that the payments were excludable under I.R.C. §131 as “qualified foster care payments,” the Dobras did not report any of the state payments received. The IRS determined that the only payments excludable under I.R.C. §131 were those received for care given to the foster adults living in the Dobras’ own residence.

**Issue.** Were the payments received by the Dobras from the state for care provided in dwellings other than their residence excludable from their income under I.R.C. §131 as “qualified foster payments”?

**Discussion.** Code §131(a) provides that “gross income shall not include amounts received by a foster care provider as qualified foster care payments.” Under I.R.C. §131(b)(1)(B), a payment may be a qualified foster care payment only if it is either a “difficulty of care payment,” as defined in I.R.C. §131(c), or is “paid to the foster care provider for caring for a qualified foster individual in the foster care provider’s home.” The parties stipulated that none of the payments at issue were “difficulty of care payments.” Thus, the case depends upon the interpretation of the phrase “the foster care provider’s home” in I.R.C. §131(b)(1)(B). Code §131(b)(2) defines a “qualified foster individual” as “any individual who is living in a foster family home.” There is no evidence that the Dobras resided in any of the three properties that were not their family residence.

The petitioners’ position is that each of the four properties is “the foster care provider’s home” even though they do not live in three of those “homes.” The petitioners claim that their position is supported by the plain meaning of I.R.C. §131(b)(1)(B). The petitioners note that the properties are dwellings of the type commonly referred to as “houses” or “homes.” The petitioners also note that they own, and provide foster care in, those homes. Therefore, according to the petitioners, in ordinary, everyday speech, all the homes are their (i.e., the foster care providers’) homes, and all such homes therefore satisfy the statutory standard—whether or not they reside in them.

The IRS’s position, by contrast, is that only the Morris Street property—the only property in which the petitioners reside—can be “the foster care provider’s home.” Unlike the petitioners’ position, the IRS’s position is not based on any assertedly plain meaning of the statute. Instead, the IRS adopts an interpretation of the term “foster care provider’s home” that is based on a specialized definition of the term “foster family home” used in I.R.C. §131(b)(2). The IRS asserts that “in a foster care context” or “among state and local government agencies,” foster family home means “the family residence of a licensed foster care provider in which the licensee is the primary provider of foster care.”

However, the Court was not persuaded that the IRS’s specialized or technical definition is necessary, helpful, or appropriate in this case. Therefore, the Court saw no reason to deviate from the general rule that a statute should be interpreted in accordance with the “plain” or “ordinary, everyday” meaning of its terms. The Court then noted that, although the term “home” is used numerous times elsewhere in the Code, the Code contains no general-purpose definition of “home,” applicable to all sections.

The Court believes that in ordinary, everyday speech the phrase “the petitioners’ home” means the place (or places) where the petitioners reside. Put more plainly, in order for a “house”
to constitute the “petitioners’ home,” the petitioners must live in that house. As Justice Scalia has recently written: “**People call a house ‘their’ home** when legal title is in the bank, when they rent it, and even when they merely occupy it rent-free—**so long as they actually live there**.” [Minnesota v. Carter, 525 U.S.T.C.M. 67 U.S.L.W. 4017, 4021 (1998) (Scalia J., concurring)].

**Holding.** The payments made with respect to the properties other than the Dobras’ own residence are not excludable from the Dobras’ income under I.R.C. §131, since the care was not provided in the foster care provider’s home.

[Pavel Dobra, et ux. v. Commissioner, 111 T.C. No. 19]

**Ingham v. United States**

[I.R.C. §1041]

**Facts.** Marsha and Ken Hatch married in 1974 and divorced in 1991. During their marriage, the couple purchased a parcel of land containing two lakefront lots and two roadside lots for $160,000. The couple’s home was located on one of the lakefront lots. Under the property settlement, Marsha received the two lakefront lots and the house. Ken received the two roadside lots. **Marsha agreed to pay Ken $404,102 for the value of his community and separate property interests in the lakefront properties she received.** Shortly after the divorce, all four lots were sold to the same buyer for $4.25 million. **Marsha made her required payment to Ken immediately after the sale.** On her 1991 tax return, Marsha reported her share of the sale proceeds and paid the applicable tax. She later claimed a refund asserting that the proceeds were not taxable because they were received incident to divorce. The district court denied her claim and found in favor of the government. The taxpayer appealed.

**Issue.** Was the capital gain arising from the sale of the property eligible for nonrecognition treatment because the transaction involved a transfer of property to a former spouse incident to divorce under I.R.C. §1041(a)(2)?

**Discussion.** Temp. Reg. §1.1041-1T provides that “transfers of property to third parties on behalf of a former spouse” qualify for nonrecognition as a transfer incident to divorce. The taxpayer argued that this regulation applies in the case because the properties were sold to satisfy her obligation required by the divorce decree. Thus, she asserted that the transaction should not be treated as a direct sale from Marsha to the third-party buyer, but rather as a constructive transfer first to Ken and then a direct sale by Ken to the third party.

In Arnes v. United States, 93-1 USTC ¶50,016, it was pointed out that the temporary regulation makes plain that a **transfer must be “on behalf of” a former spouse. In this case, the transfer was not on behalf of the taxpayer’s ex-husband, Ken. It did not relieve Ken of any obligation, but allowed Marsha to satisfy the debt she owed to him.**

**Conclusion.** The taxpayer’s sale of property was not “incident to divorce.” Thus, the sales proceeds are taxable to the plaintiff, Marsha Hatch Ingham.

[Marsha Hatch Ingham v. United States of America, 99-1 USTC ¶50,249]
Medical savings account pilot project is still going.

The IRS has announced that October 1, 1998, is not the cutoff date for the medical savings account (MSA) pilot project. Code §220(i) and (j) mandate that October 1, 1998, be the cutoff date for the project if the number of MSA returns filed for 1998 exceeds 750,000. The IRS has projected applicable returns of 50,172 for 1998. Therefore, October 1, 1998, is not the cutoff date and 1998 is not the cutoff year for the project. Thus, the pilot project’s scheduled cutoff year of 2000 remains in effect.

[Announcement 98-88, 1988-42 IRB]

Tax relief guidance is provided for overseas U.S. military and support personnel.

This notice provides guidance in question-and-answer format on the tax relief available under Executive Order No. 13119 and Public Law 106-21 for U.S. military and support personnel involved in military operations in Yugoslavia, Albania, the Adriatic Sea, and the Ionian Sea north of the 39th parallel. These areas are designated as a combat zone for purposes of I.R.C. §112. Members of the armed forces who perform services in these areas are treated as if they performed services in a combat zone.

Issues covered in the notice include:

- The amount of military pay excluded from gross income
- Treatment of annual leave payments accrued during service in the combat zone
- Extensions for filing and paying income taxes
- Application of extension deadlines to nonmilitary personnel, spouses, and dependents
- Deadline extensions for IRA contributions, estimated tax payments, and installment payment of taxes
- The refund of excise taxes paid on phone calls to the United States from the hazardous duty area


Exclusion requires payment for combat services, not merely acceptance while in combat zone.

Facts. Ralph Waterman served as an enlisted member of the Navy for over 14 years. In April 1992 Waterman accepted an offer of early separation from service. He received a separation payment of almost $45,000 in exchange for his agreement to leave the Navy early and give up any future pension benefits. Waterman was advised by the Navy to exclude the payment from gross income because it was received when he was serving in the Persian Gulf, an area designated at the time as a combat zone. In 1995 Waterman was assessed a $10,038 tax deficiency by the IRS. He then filed a petition in U.S. Tax
Court contending that the payment was excludable from income under I.R.C. §112(a)(1), which excludes compensation for active service in a combat zone from income. The Tax Court determined that the separation payment should have been included in income because it was paid in exchange for Waterman’s agreement to leave the Navy, not for active service in a combat zone. Waterman appealed.

**Issue.** The core issue is whether a separation payment for an agreement to leave service early in lieu of retirement that accrues while the service member is on active duty in a combat zone constitutes compensation for active service such that it is excluded from gross income under I.R.C. §112(a).

**Discussion.** Code §112(a)(1) states that “gross income does not include compensation received for active service as a member below the grade of commissioned officer in the Armed Forces of the United States for any month during any part of which such member served in a combat zone.” Treas. Reg. §1.112-1(b)(4) provides that the compensation must fully accrue in a month during which the member served in the combat zone. A divided Fourth Circuit concluded that Waterman did not receive the separation payment for services rendered while actively serving in the Navy. He received the compensation for agreeing to leave the Navy and forgo any future right to pension benefits. Therefore, the payment did not accrue during a particular month of active service and did not qualify as compensation received for active service.

The dissenting opinion relied on Example 5 of Treas. Reg. §1.112-1(b)(5), which confirms that a member of the armed forces who voluntarily reenlists while serving in a combat zone may exclude the reenlistment bonus under I.R.C. §112, even though the member actually receives the bonus outside of the combat zone and in the following tax year. The service member’s act of accepting a standing offer from the military—compensation for reenlistment—constitutes “services rendered in active service” for purposes of I.R.C. §112. Similarly, Waterman accepted the proposal of the Navy regarding the term of his active service. In both cases, a service member has accepted the military’s offer of additional compensation in exchange for his agreement to take action that the military has requested, either leaving or reenlisting in the armed forces. Waterman, like the member in Example 5, accepted the offer while in active service in a combat zone. Thus, the dissenting opinion would exclude the payment from income.

**Holding.** The Tax Court's decision is affirmed. The separation payment does not qualify for exclusion as payment for combat services.

[Ralph F. Waterman v. Commissioner, 99-1 USTC ¶50,569]
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[Rev. Rul 99-36]
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[Rev. Rul. 99-8, 1999-6 IRB]

### Applicable Federal Rates (AFR) for March 1999

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[Rev. Rul. 99-11, 1999-10 IRB]
**Period for compounding**

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<th>Quarterly</th>
<th>Monthly</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term AFR</td>
<td>4.99%</td>
<td>4.98%</td>
<td>4.89%</td>
<td>4.87%</td>
</tr>
<tr>
<td>Mid-term AFR</td>
<td>5.28%</td>
<td>5.30%</td>
<td>5.27%</td>
<td>5.24%</td>
</tr>
<tr>
<td>Long-term AFR</td>
<td>5.67%</td>
<td>5.71%</td>
<td>5.67%</td>
<td>5.64%</td>
</tr>
</tbody>
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[Rev. Rul. 99-25 IRB]
### Applicable Federal Rates (AFR) for July 1999

**Period for Compounding**

<table>
<thead>
<tr>
<th>Period for Compounding</th>
<th>Annual</th>
<th>Semiannual</th>
<th>Quarterly</th>
<th>Monthly</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term AFR</td>
<td>5.32%</td>
<td>5.25%</td>
<td>5.22%</td>
<td>5.19%</td>
</tr>
<tr>
<td>Mid-term AFR</td>
<td>5.82%</td>
<td>5.74%</td>
<td>5.70%</td>
<td>5.67%</td>
</tr>
<tr>
<td>Long-term AFR</td>
<td>6.10%</td>
<td>6.01%</td>
<td>5.97%</td>
<td>5.94%</td>
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### Applicable Federal Rates (AFR) for August 1999

**Period for Compounding**

<table>
<thead>
<tr>
<th>Period for Compounding</th>
<th>Annual</th>
<th>Semiannual</th>
<th>Quarterly</th>
<th>Monthly</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term AFR</td>
<td>5.43%</td>
<td>5.36%</td>
<td>5.32%</td>
<td>5.30%</td>
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<tr>
<td>Mid-term AFR</td>
<td>5.96%</td>
<td>5.87%</td>
<td>5.83%</td>
<td>5.80%</td>
</tr>
<tr>
<td>Long-term AFR</td>
<td>6.23%</td>
<td>6.14%</td>
<td>6.09%</td>
<td>6.06%</td>
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</table>


### Applicable Federal Rates (AFR) for September 1999

**Period for Compounding**

<table>
<thead>
<tr>
<th>Period for Compounding</th>
<th>Annual</th>
<th>Semiannual</th>
<th>Quarterly</th>
<th>Monthly</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term AFR</td>
<td>5.42%</td>
<td>5.35%</td>
<td>5.31%</td>
<td>5.29%</td>
</tr>
<tr>
<td>Mid-term AFR</td>
<td>5.98%</td>
<td>5.89%</td>
<td>5.85%</td>
<td>5.82%</td>
</tr>
<tr>
<td>Long-term AFR</td>
<td>6.25%</td>
<td>6.16%</td>
<td>6.11%</td>
<td>6.08%</td>
</tr>
</tbody>
</table>

[Rev. Rul. 99-37]
Applicable federal rates (AFR) for October 1999.

Period for compounding

<table>
<thead>
<tr>
<th></th>
<th>Annual</th>
<th>Semiannual</th>
<th>Quarterly</th>
<th>Monthly</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term AFR</td>
<td>5.54%</td>
<td>5.47%</td>
<td>5.43%</td>
<td>5.41%</td>
</tr>
<tr>
<td>Mid-term AFR</td>
<td>6.02%</td>
<td>5.93%</td>
<td>5.89%</td>
<td>5.86%</td>
</tr>
<tr>
<td>Long-term AFR</td>
<td>6.31%</td>
<td>6.21%</td>
<td>6.16%</td>
<td>6.13%</td>
</tr>
</tbody>
</table>

[Rev. Rul. 99-41]

The rates in this revenue ruling may be used by estates that value farmland under I.R.C. §2032A as of a date in 1999.

<table>
<thead>
<tr>
<th>Farm Credit Bank District in Which Property Is Located</th>
<th>Interest Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Columbia</td>
<td>9.65</td>
</tr>
<tr>
<td>Omaha</td>
<td>8.07</td>
</tr>
<tr>
<td>Sacramento</td>
<td>8.25</td>
</tr>
<tr>
<td>St. Paul</td>
<td>8.21</td>
</tr>
<tr>
<td>Spokane</td>
<td>8.31</td>
</tr>
<tr>
<td>Springfield</td>
<td>8.78</td>
</tr>
<tr>
<td>Texas</td>
<td>8.11</td>
</tr>
<tr>
<td>Wichita</td>
<td>8.25</td>
</tr>
</tbody>
</table>


The next two court cases involve the issue of interest paid to the IRS on income tax deficiencies for noncorporate taxpayers. With the two decisions shown below, four circuits of the U.S. Court of Appeals now agree that interest on an individual income tax deficiency is never deductible. The IRS has won every appeal of prior district court and tax court decisions that allowed the deduction of such interest.
Practitioner Caution. Based on the success of the IRS on this issue at the appeals court level, IRS examiners and Appeals Office personnel will deny all tax deficiency-related interest deductions of noncorporate taxpayers.

For taxpayers residing in the Fourth, Sixth, Eighth, and Ninth Circuits, the decisions reached on this issue (disallowance of the interest deduction) are law.

<table>
<thead>
<tr>
<th>Appeals Court Circuit</th>
<th>Jurisdiction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fourth</td>
<td>Maryland, North Carolina, South Carolina, Virginia, West Virginia</td>
</tr>
<tr>
<td>Sixth</td>
<td>Kentucky, Michigan, Ohio, Tennessee</td>
</tr>
<tr>
<td>Eighth</td>
<td>Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, South Dakota</td>
</tr>
<tr>
<td>Ninth</td>
<td>Alaska, Arizona, California, Hawaii, Idaho, Montana, Oregon, Washington</td>
</tr>
</tbody>
</table>

See pages 397–399 of the 1998 Income Tax Workbook for extensive information on this issue.

Allen v. United States
[I.R.C. §163]

Interest on tax deficiency allocable to business is still nondeductible to individual.

Facts. Richard Allen was a self-employed real estate developer. In 1984 he contributed real estate he owned to his closely held general contracting business. At the time of the transfer, the corporation was failing and in need of additional working capital. The corporation sold the real estate shortly after Mr. Allen transferred it at a substantial profit.

An IRS examination of the 1984 corporate return was initiated. The IRS position was that Mr. Allen should have reported the sizable gain on his 1984 individual return rather than on the 1984 corporate return. The issue was finally settled by the Tax Court in 1993. The Tax Court determined that the IRS position was correct. As a result, Mr. Allen’s 1984 individual tax deficiency was over $500,000.

Mr. Allen had paid $500,000 of interest to the IRS in 1992 in anticipation of the Tax Court decision. In 1993 he filed an amended return and claimed the interest as a business interest expense. The IRS disallowed the 1992 claim, and Mr. Allen sued in district court. The IRS lost the district court case in 1998.

Holding. The Court found the IRS regulation to be an eminently reasonable and easily administrable construction of the ambiguous I.R.C. §163(h). Therefore, it reversed the decision of the district court and held that individual income tax deficiency interest is a nondeductible personal expenditure.

[Richard R. Allen, Sr., v. United States of America, 99-1 USTC ¶50,470 (CA-4, 1999)(CCH ¶50,470)]
**Facts.** Michael and Mary McDonnell’s 1987–89 income tax returns were examined by the IRS. As a result, the McDonnells paid over $100,000 of interest to the IRS in 1992. They attempted to deduct the interest payment as investment interest on their 1999 individual tax return. The IRS disallowed the interest as nondeductible personal interest.

**Holding.** The court held that the interest at issue is nondeductible personal interest. Temp. Reg. §1.163-9T(b)(2)(I)(A) is neither arbitrary, capricious, nor in conflict with any other statutory provision of the Code as a whole.

[Michael and Mary McDonnell v. United States, 99-1 USTC ¶88,489 (CA-6, 1999)(CCH ¶50,556)]

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**ITEMIZED DEDUCTIONS**

**Rev. Rul. 99-28**

[I.R.C. §213]

**Facts.** Taxpayer A participated in a smoking cessation program and supplemented the program with nonprescription nicotine gum and patches. Participation in the program was not suggested by a doctor. Taxpayer B purchased prescription drugs to alleviate the effects of nicotine withdrawal. Neither A nor B received reimbursements from medical insurance or their employer for the treatment costs.

**Issue.** Are uncompensated amounts paid for nicotine gum and patches that do not require a prescription, prescription drugs to alleviate nicotine withdrawal, and participation in smoking cessation programs deductible medical expenses under I.R.C. §213?

**Holding.** A report of the Surgeon General, *The Health Consequences of Smoking: Nicotine Addiction* (1988), states that scientists in the field of drug addiction agree that nicotine, a substance common to all forms of tobacco, is a powerfully addictive drug. Other reports of the Surgeon General have concluded, based on numerous studies, that a strong causal link exists between smoking and several diseases. Science has thus established that nicotine is addictive and that smoking is detrimental to the health of the smoker. Because the smoking cessation program and prescription drugs are designed to treat nicotine addiction, they are deductible medical expenses under I.R.C. §213. The nicotine gum and patches are not deductible medical expenses because they contain a drug (other than insulin) and do not require a prescription of a physician.

**Observation.** In a related news release (IR 1999-55), the IRS noted that smokers who incurred costs for smoking cessation programs in recent years may file amended returns claiming the smoking cessation costs as an itemized deduction for medical expenses. This could create a refund opportunity if aggregate medical expenses exceed 7.5% of adjusted gross income.

**Issue.** Are expenses for a child with a neurologically based learning disability to attend private school deductible as expenses for medical care under I.R.C. §213(a)?

**Facts.** A child diagnosed with attention deficit hyperactivity disorder (ADHD) attends a private school where he is enrolled in a special program that provides support and monitoring for students with ADHD. Only students with a written ADHD diagnosis are eligible for the program. The cost of the program is separate from the school’s basic tuition.

**Discussion.** The general program at the school is educational and not medical in nature. The school is not a “special school” within the meaning of Treas. Reg. §1.213-1(e)(1)(v)(a), which provides that ordinary education is not medical care. However, the cost of medical care includes the cost of attending a special school for a mental or physically handicapped individual, if his condition is such that the resources of the institution for alleviating such mental or physical handicap are a principal reason for his presence there. If this provision applies, the cost of attending such a special school includes the cost of meals and lodging, and the cost of ordinary education furnished that is incidental to the special services furnished by the school. Thus, the cost of medical care includes the cost of attending a special school designed to compensate for or overcome a physical handicap in order to qualify the individual for future normal education or for normal living.

Treas. Reg. §1.213-1(e)(1)(v)(b) provides that if an individual is in an institution providing medical care, but the availability of medical care is not a principal reason for the individual’s presence there, then only that part of the cost of the institution that is attributable to medical care (and not the cost of other services, such as meals and lodging) is a cost of medical care.

**Conclusion.** Basic tuition is not deductible as a medical expense. The cost of the special program is deductible as a medical expense under I.R.C. 213(a) because the program specifically addresses learning disabilities of a medical nature.

**Ferguson v. Commissioner**
[I.R.C. §170]

**Facts.** Roger and Sybil Ferguson and their children owned 18% of American Health Companies, Inc. (AHC). The couple and their son, Michael, were on the company’s board of directors. Late in 1987 Goldman, Sachs, and Co. was contacted and authorized by the board of directors to locate a buyer for...
AHC and handle the negotiations. In August 1988 AHC entered into a merger agreement with CDI Holding, Inc. and its wholly owned subsidiary D.C. Acquisition Corporation. A tender offer was announced on August 3, 1988. During the same month, the Fergusons created three charitable foundations and stated their intentions to donate AHC stock to the Church of Jesus Christ of Latter Day Saints. On September 8 the Fergusons’ stockbroker transferred some shares to a church account and some shares to the charitable foundations. The following day the Fergusons exchanged a significant amount of AHC stock for CDI stock and tendered the rest in accordance with the tender offer. The three charities also tendered the shares they received. The IRS determined that the gain on the AHC shares donated to the charities was taxable to the Fergusons. The Tax Court found in favor of the IRS. The Fergusons appealed to the Ninth Circuit.

**Issue.** Were the charitable contributions completed before the stock ripened from an interest in AHC to a fixed right to receive cash?

**Discussion.** By August 31, more than half of the outstanding AHC shares had been tendered. That was all that was required for the merger agreement to be approved. This is when the stock was determined to be ripened. The donation-in-kind record showed a “date of donation” as 9/9/88. The Fergusons’ stockbroker stated that was the date the charities instructed him to do something with the stock rather than the earlier date they actually received the stock.

Regarding the anticipatory assignment of income, Judge Choy noted that this court has not addressed the question of when a right to receive income has “ripened” for tax purposes. A court must consider the “substance of events,” Judge Choy wrote, “to determine whether the receipt of income was practically certain to occur. . . . While the finding of a mere anticipation or expectation of the receipt of income [is] insufficient to conclude that a fixed right to income existed, . . . the overall determination must not be based on a consideration of mere formalities and remote hypothetical possibilities.”

As to the Fergusons’ lament that there is no fine line, Judge Choy noted the danger of “walking the line between tax evasion and tax avoidance,” and he remarked, “Any tax lawyer worth his fees would not have recommended that a donor make a gift of appreciated stock this close to an ongoing tender offer and a pending merger, especially when they were negotiated and planned by the donor.”

**Holding.** Because the Fergusons did not donate their AHC stock until nine days after the shares had ripened into a fixed right to receive cash, the Ninth Circuit affirmed the Tax Court’s decision. The Fergusons are taxable on the gain derived from the AHC shares donated to the charities.

*Micahel Ferguson, et al. v. Commissioner, 99-1 USTC ¶50,412*

**Benci-Woodward v. Commissioner**

*I.R.C. §§56 and 67*

Legal expenses attributable to punitive damages are miscellaneous itemized deductions.

**Facts.** The Benci-Woodwards, Mangums, and Ragatzes (petitioners) all won large compensatory and punitive damages and interest from Dayton-Hudson. The petitioners received the award, less attorney’s fees and costs, in October 1992, but did not include the awards in their 1992 gross income. The attorney’s fee for the lawsuit amounted to 40% of the award received. The attorney’s share was reported on his 1992 income tax return. After the IRS filed a deficiency notice, the petitioners agreed to include the amount of the damage award in their gross income for 1992 pursuant to I.R.C. §61. The IRS allowed a miscellaneous itemized deduction of the attorney’s fees and costs for the petitioners’ regular income tax, but not for the Alternative Minimum Tax calculation. The petitioners argued that the legal expenses should not fall under miscellaneous itemized deductions, and therefore should not be
subject to the 2% floor under I.R.C. §67(a). The petitioners also argued that disallowance of the miscellaneous itemized deduction for AMT purposes created a case of double taxation because the attorney and petitioners were paying tax on the same income. Finally, the petitioners argued that the punitive damages should be included in gross income net of attorney’s fees and costs.

Issues

1. Whether legal expenses associated with receipt of punitive damages should be deducted as miscellaneous itemized deductions under I.R.C. §67(b)
2. Whether the deductions are allowable in computing AMT liability
3. Whether attorney’s fees and costs may be subtracted in arriving at the amount to be included in gross income

Discussion

1. Code §67(a) provides a 2% floor on miscellaneous itemized deductions for all tax years after 1986. Miscellaneous itemized deductions can be taken only to the extent that they exceed 2% of AGI. Legal expenses fall under miscellaneous itemized deductions because they are not specifically enumerated in I.R.C. §67(b).
2. AMT is paid only if, and to the extent that, it exceeds the taxpayers’ regular income tax [I.R.C. §55(a)]. Code §56(b)(1)(A)(i) disallows any miscellaneous itemized deduction included in I.R.C. §67(b).
3. The Court determined that in California the case law is clear that the full amount of punitive damages should be included in the gross income. Liens for attorney fees in California do not transfer to the attorney an ownership or proprietary interest in the client’s cause of action.

Holding. The Court held that the attorney’s fees and costs represent miscellaneous itemized deductions according to I.R.C. §67(b). The Court also held that the miscellaneous itemized deductions were disallowed for AMT purposes under I.R.C. §56(b)(1)(A)(i). Finally, the Court held that the punitive damages were to be fully included in the gross income of the petitioners without regard to the legal expenses.


LIKE-KIND EXCHANGES

C. Bean Lumber Transport, Inc. v. United States [I.R.C. §1031]

Truck purchases and trade-ins were separate transactions and did not qualify for exchange treatment.

Facts. From August 1992 to July 1994, C. Bean Lumber Transport purchased approximately 175 new trucks from Texarkana Truck Center (TTC). The entire purchase price was generally financed through third parties. During the period the trucks were purchased, approximately 107 trucks were “traded in” to TTC. TTC recorded the trade-ins as separate transactions since there was usually a difference between the time TTC sold the new trucks to Bean and the time TTC received the old trucks. TTC issued two checks for the used trucks. One was to the finance company for retirement of any remaining
debt owed by Bean, and the other was to Bean for its equity in the truck. On amended returns for 1993 and 1994, Bean claimed refunds on the basis that the purchase and sale of the trucks were really like-kind exchanges. The IRS denied the claim, and Bean filed suit in District Court.

**Issue.** Were the purchase of new trucks and the sale of used trucks to the same dealer like-kind exchanges under I.R.C. §1031?

**Discussion.** Three requirements must be met for a transfer to qualify as like-kind under I.R.C. §1031:

1. An exchange occurs.
2. The exchanged properties are of like-kind.
3. The property transferred and the property received must be held by the taxpayer for productive use in a trade or business, or for investment.

The United States contends that the purchase of new trucks and the sale of used trucks are not reciprocal and mutually dependent transactions. The United States also contends that the transactions violate application of the like-kind exchange rules because the new trucks were financed and cash was received for the used trucks. There was no restriction on Bean’s use of the cash received.

Rev. Rul. 61-119, on which Bean relied heavily, addressed the question of whether an I.R.C. §1031 like-kind exchange occurred: Where a taxpayer sells old equipment used in his trade or business to a dealer and purchases new equipment of like kind from the dealer under circumstances that indicate that the sale and the purchase are reciprocal and mutually dependent transactions, the sale and purchase is in exchange of property within the meaning of §1031 of the Internal Revenue Code of 1954, even though the sale and purchase are accomplished by separately executed contracts and are treated as unrelated transactions by the taxpayer and the dealer for record-keeping purposes.

**Holding.** The Court concluded that the transactions between Bean and TTC do not, as a matter of law, qualify as like-kind exchanges. There was no evidence that the cash received by Bean for the used trucks was applied in any way to the financed debt on the new vehicles. The unrestricted receipt of cash disqualifies the transactions as like-kind exchanges. The proceeds from the “traded in” vehicles were not reinvested, nor was this the typical case in which cash is given to equalize the value of the assets exchanged. The Court ruled that what Bean did was to convert the old trucks to cash. Therefore, like-kind exchange treatment is denied.

[C. Bean Lumber Transport, Inc. v. United States, 99-1 USTC ¶50,474]

**Facts.** Trust A and Trust B are testamentary trusts, each of which separately owns a farm in fee simple. An agricultural conservation easement in perpetuity was transferred by the trusts over both farms to an intermediary. The replacement property, a fee simple interest in a third farm, was deeded by the intermediary to the trusts in exchange for the easement. Beneficiaries of one of the trusts supplied the necessary funds to meet the excess of the farm’s purchase price over the easement’s price.

**Issue.** Does the exchange of an agricultural conservation easement for a fee simple interest in a farm qualify as a tax-free like-kind exchange under I.R.C. §1031(a)?
Discussion. Treas. Reg. §1.1031(a)-(1)(b) provides, in part, that as used in I.R.C. §1031(a) the words “like kind” have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for the fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or realization of the increment in value is held for investment and not primarily for sale.

Reg. §1.1031(a)-1(c) provides that no gain or loss is recognized if:

1. A taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for like purpose;
2. A taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate; or
3. A taxpayer exchanges investment property and cash for investment property of a like kind.

Rev. Rul. 55-749, 1955-2 C.B. 295, holds that where, under applicable state law, water rights are considered real property rights, the exchange of water rights in perpetuity for a fee interest in land constitutes a nontaxable exchange of property in like kind within the meaning of I.R.C. §1031(a).

Rev. Rul. 68-331, 1968-1 C.B. 352, holds that the exchange of a leasehold interest in a producing oil lease, extending until the exhaustion of the deposit, for a fee interest in improved ranch land is an exchange of property for property of like kind under I.R.C. §1031(a).

Rev. Rul. 72-549, 1972-2 C.B. 472, holds that an easement and right-of-way granted to an electric power company is of a “like kind” with real property with nominal improvements and real property improved with an apartment building under I.R.C. §1031(a).

Conclusion. The agricultural conservation easement is of like kind to the fee interests in the farm to be acquired by the trusts. The trusts will recognize no gain or loss on the exchange under I.R.C. §1031(a).

**Fransen v. United States**

[I.R.C. §469]

> Rental of real property to taxpayer’s business is not a passive activity; regulation is valid.

**Facts.** During the tax year 1995, Remy and Eugenie Fransen owned a one-half interest in a building located in New Orleans, Louisiana. The couple rented the building to Remy's personal-service C corporation. On their 1995 Form 1040, the Fransens reported $29,902 net rental income from the property. On their Form 8582, the taxpayers did not include any income derived from the building as passive income. At a later date, the Fransens filed an amended Form 1040 and attached a new Form 8582, which included the rental income from the building as passive income. The couple offset $32,606 in passive losses against the rental income. The Fransens then requested a refund of $12,036. Their claim was denied by the IRS under the self-rental rule of Treas. Reg. §1.469-2(f)(6). The taxpayers filed suit in district court.
Issue. Was Treas. Reg. §1.469-2(f)(6), “the self-rental rule,” properly applied in denying the Fransens’ refund claim?

Discussion. Under I.R.C. §469(c)(1), passive activities involve the conduct of a trade or business in which the taxpayer does not materially participate. Under I.R.C. §469(c)(2) and (4), however, passive activities include “any rental activity” regardless of whether the taxpayer materially participated in the activity. Congress therefore enacted the regulations to limit the income that can be offset with losses arising from passive activities. In this case, it would be inconsistent with the purpose of the regulations to treat the rental income as passive activity gross income. The Commissioner validly exercised the regulation.

Congress enacted I.R.C. §469 “to restore public confidence in the federal tax system by limiting the extent to which certain taxpayers could offset ordinary income with losses arising from activities in which they did not have a ‘substantial and bona fide involvement.’” Code §469 is intended, in part, to prevent taxpayers from sheltering active business income with losses from rental activities and passive business activities. In accordance with this general policy consideration, the House of Representatives and Senate stated that it would be appropriate for the Treasury to issue regulations regarding “related party leases or sub-leases, with respect to property used in a business activity, that have the effect of reducing active business income and creating passive income” [H.R. Conf. Rep. No. 99-841, 99th Cong., 2d Sess. 147 (1986); 53 Fed. Reg. at 5694]. Following Congress’s suggestion, the Commissioner issued Treas. Reg. §1.469-2(f)(6), explaining that in the absence of regulations, a taxpayer could derive passive activity gross income from an active business in which tangible property is used by renting the property to an entity conducting the activity (or by causing an entity holding the property to rent the property to the taxpayer). It would be inconsistent with the purposes of §469 to treat rental income as passive activity gross income in such cases.

Holding. Because the regulation is neither an arbitrary or capricious exercise of the Commissioner’s regulatory authority to enforce the passive activity provision, nor manifestly contrary to the underlying statute, the Service properly disallowed the Fransens’ characterization of rental income from the building in question as passive and correctly denied them a $12,036 refund.

[A. Remy Fransen Jr., et ux. v. United States, 98-2 USTC ¶50,776]

See Michael F. Conner, et ux. v. Commissioner, T.C. Memo. 1999-185, for a similar result, where a wife leased an office building to her husband’s dental practice operated as a PSC. The rental income was determined to be nonpassive and could not be used to offset passive losses related to another rental activity.

See also Stephen Schwalbach, et ux. v. Commissioner, 111 T.C. No. 9, in which the same regulation [Treas. Reg. §1.469-2(f)(6)] was determined to be valid in a case involving a dentist’s rental income from a building used by his personal-service corporation.

Barniskis v. Commissioner
[I.R.C. §469]

Condominium rental loss is denied because the owners did not materially participate.

Facts. Walter and Mary Barniskis purchased a condominium located on the shore of Lake Superior in October 1987. The couple became members of the condominium association, which owned all of the complex’s common properties. In 1991, the condominium association hired a management company to manage and operate the entire complex on a daily basis. On Schedules C of their 1991, 1992, and
1993 income tax returns, the couple reported net losses with respect to the rental of their condominium unit. The Barniskises claimed business loss deductions for these years in amounts equal to the amounts of net losses reported on the Schedules C (losses ranged from $8,425 to $10,158). Based on the claim that the losses were sustained in connection with an activity in which the petitioners did not materially participate, the IRS disallowed the claimed business loss deductions under I.R.C. §469.

Tofte Management Company (TMC) managed and operated the complex. TMC’s employees developed, drafted, and printed marketing and promotional materials for Bluefin Bay. TMC maintained a toll-free number for promotional and reservation purposes. TMC’s employees answered this telephone line, booked reservations for owners and guests, and mailed promotional and marketing materials to interested parties. TMC’s employees checked in guests, received deposits, and issued keys. They responded to maintenance calls and made any necessary repairs. TMC’s employees opened, closed, and cleaned the pool, hot tub, and pool house on a daily basis. They also maintained Bluefin Bay’s tennis courts and exercise room. In the winters, TMC’s employees plowed the parking lots and shoveled, salted, and sanded the walkways. TMC’s employees collected payments from guests and checked them out of the unit. They cleaned and inspected the unit after guests departed. TMC’s employees maintained daily books and records reflecting the collected rents and fees owed by petitioners. They issued monthly and annual reports to petitioners reflecting the rental activity, owner charges, and TMC’s share of gross rentals. The Barniskis’s duties under the management contract included providing TMC with a schedule of their intended personal use, maintaining adequate insurance on their unit, and complying with certain “interior quality standards.” TMC made detailed inspections of the petitioners’ unit at least annually and compiled lists of mandatory repairs and items that needed to be replaced in order to satisfy the interior quality standards. The petitioners were given the choice to personally make these repairs and improvements or to authorize TMC to make them.

The Barniskises traveled to Bluefin Bay five or six times during each of the taxable years. In most cases, they would stay at Bluefin Bay in their unit for a long weekend. They also spent one full week each summer in their unit. These trips to Bluefin Bay usually combined family vacations with owner activities such as attending board meetings and/or making some repairs to their unit. Mr. Barniskis also attended several BBCA meetings in St. Paul, Minnesota, during the taxable years in issue.

**Issue.** Is the condominium rental activity a passive business activity, resulting in disallowance of losses under I.R.C. §469?

**Discussion.** Code §469 generally disallows for the taxable year any passive activity loss that exceeds passive activity income. A passive activity is any activity, which involves the conduct of any trade, or business in which the taxpayer does not materially participate [see I.R.C. §469(c)(1)]. Code §469(h)(1) provides that a taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis that is regular, continuous, and substantial. Treas. Reg. §1.469-5T(a) outlines the seven situations in which a taxpayer will be treated as materially participating in an activity for the taxable year. The Barniskises argue that they satisfy the requirements of Treas. Reg. §1.469-5T(a)(3), which states that an individual has materially participated in an activity if he participates in the activity for more than 100 hours during the taxable year and does not participate in the activity less than any other individual.

While the Court acknowledged that the total hours of participation exceeded 100 hours for each of the years in question, the Court also noted that Treas. Reg. §1.469-5T(f)(2)(ii)(A) provides that work performed by an individual in the individual’s capacity as an investor in an activity shall not be treated as participation of the individual in the activity unless the individual is involved in the day-to-day management or operations of the activity. The Barniskises were not involved in the day-to-day management or operations of their unit because TMC managed and operated the entire Bluefin Bay complex on a daily basis.

Treas. Reg. §1.469-5T(f)(2)(ii)(B) provides that investor activities include:

1. Studying and reviewing financial statements or reports on operations of the activity,
2. Preparing or compiling summaries or analyses of the finances or operations of the activity for the individual’s own use, and
3. Monitoring the finances or operations of the activity in a nonmanagerial capacity.
Several of the activities described in Barniskis’s personal time records constitute investor activities. In particular, their activities of organizing their personal records, preparing their taxes, paying bills, and reviewing their monthly statements of the rentals of their unit all constitute investor activities. The petitioners failed to establish that they materially participated in the rental activity. **Even if the Barniskises expended 100 hours in their rental activity during the years in issue, they have not proved that their participation was greater than the management company’s participation.**

**Holding.** Based on the record, the Court determined that the Barniskises have failed to prove that they participated in the activity of renting their unit more than TMC’s employees during the years in issue. It is clear that the front desk staff checked in and out over 200 of the petitioners’ guests each year. In addition, the housekeeping staff inspected and cleaned the petitioners’ unit after each of their guests checked out. The frequency with which these services were required convinced the court that TMC’s employees devoted a substantial amount of time to the petitioners’ unit. The Court was unable to conclude from this record that the petitioners’ participation during the years in issue was greater than the participation of TMC’s employees.

Therefore, the petitioners did not materially participate in the activity of renting their unit during 1991, 1992, and 1993. Accordingly, their claimed losses from such activity constitute passive activity losses, which are not deductible in the taxable years in issue by reason of I.R.C. §469.

[Walter A. Barniskis, et ux. v. Commissioner, T.C. Memo. 1999-258]

See also Stephen D. Rapp, et ux. v. Commissioner, T.C. Memo. 1999-249, for a similar case and determination.

**Observation.** The taxpayers could not deduct their condominium activity losses as a rental activity loss since the average period of customer use is seven days or less. Thus, the condominium is not a rental activity.

**Jackson v. Commissioner**

I.R.C. §280A

Schedule E deductions are not allowed for rental of home to relatives at less than fair rental.

**Facts.** Vashon and Beverly Jackson purchased the residence of Beverly’s parents in 1987. The parents continued to live in the house after the sale, and actually paid the Jacksons $6,000 of rent in each of the years 1990, 1991, and 1992. The Jacksons reported the following rental income and expenses on Schedule E:

<table>
<thead>
<tr>
<th>Year</th>
<th>Rental Income</th>
<th>Rental Expense</th>
<th>Schedule E Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>$7,200</td>
<td>$25,453</td>
<td>$(18,253)</td>
</tr>
<tr>
<td>1991</td>
<td>7,200</td>
<td>23,586</td>
<td>(16,386)</td>
</tr>
<tr>
<td>1992</td>
<td>7,200</td>
<td>23,859</td>
<td>(16,659)</td>
</tr>
</tbody>
</table>

The amount of the yearly reported rental income of $7,200 is equal to the fair rental amount obtained from a local real estate agency.
Issues

1. The amount of the rental income received for each year
2. Whether the taxpayers are entitled to any deductions with respect to the rented product

Discussion and Holding

Issue 1. The taxpayers testified that they reported rental income of $7,200 per year rather than the actual rent amount of $6,000 per year to satisfy the “fair rental requirement” of I.R.C. §280A. The Court held that the taxpayers received actual rents in the amount of $6,000 during the three years in question. Therefore, that amount constitutes gross income.

Editorial Note. The $6,000 of rental income would properly be reported on either Part I of Schedule E or on the “Other Income” line on Form 1040.

Issue 2. Code §280A(a) generally provides that no deduction shall be allowed with respect to the use of a dwelling unit which is used as a residence. For purposes of I.R.C. §280A(a), a dwelling is used as a residence if it is used for personal purposes more than the greater of:

a. 14 days, or
b. 10% of the total days it is rented to others at a fair rental amount.

A dwelling unit is deemed to be used for personal purposes by the taxpayer on any day it is used for personal purposes by any member of the taxpayer’s family, unless the family member rents it at a fair rental for use as his or her principal residence. The facts reveal that Beverly Jackson’s parents actually paid $6,000 ($500 per month) of rent each year. The fair rental value was at least $7,200 ($600 per month) as determined by the local realtor. Therefore, the personal use of the property by Beverly's parents is treated as the taxpayers' personal use for every day of 1990, 1991, and 1992. Thus, under I.R.C. §280A(d)(1), the property was used by the taxpayers as a residence during the three-year period.

Since the property was not rented at a fair rental amount for any day of the three years in question, none of the claimed Schedule E deductions are allowable [I.R.C. §280A(c)(3) and (e)(1)]. The only expenses that are deductible are those expenses that are deductible without regard to whether the dwelling was rented [I.R.C. §280A(b) and (e)(2)]. Those expenses that are shown below are allowable as itemized deductions on Schedule A:

<table>
<thead>
<tr>
<th>Year</th>
<th>Home Mortgage Interest</th>
<th>Real Estate Taxes</th>
<th>Total Allowable Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>$4,522</td>
<td>$1,140</td>
<td>$5,662</td>
</tr>
<tr>
<td>1991</td>
<td>6,881</td>
<td>1,180</td>
<td>8,061</td>
</tr>
<tr>
<td>1992</td>
<td>4,659</td>
<td>1,195</td>
<td>5,854</td>
</tr>
</tbody>
</table>


Reference Note for the Jackson Case Above. See pages 92 and 93 in the 1997 Income Tax Workbook for three examples involving personal use days charged to the taxpayer when family members use the taxpayer’s dwelling unit. These rules under I.R.C. §280A are complex and are further complicated by exceptions.
Facts. As a construction coordinator for movie production companies, Michael Welch was required to furnish all the tools needed for projects. He received both a salary and a tool rental fee from the production companies. On Schedule C of his 1993 tax return, Welch reported a net loss of over $7,000 related to the tool rental activity. The IRS took the position that the loss was a passive loss attributable to a rental activity. The IRS alternatively asserted that the amounts could be classified as employee business expenses that should have been reported on Schedule A.

Issue. Was the tool rental a “rental activity” within the meaning of the passive activity rules of I.R.C. §469?

Discussion. Under I.R.C. §469(j)(8), a rental activity is defined as any activity where payments are principally for the use of tangible property. The term “passive activity” includes any rental activity. Michael Welch performed significant personal services in connection with the tool rental to production companies and provided the equipment to production companies for an average period of 30 days or less. Thus, the activity was not a rental activity within the meaning of I.R.C. §469(j)(8). The Court also determined that Welch materially participated in the tool rental activity, meeting the “regular, continuous, and substantial” test. The Court next determined that the tool rental activity was a separate activity of renting equipment properly reportable on Schedule C. However, only the expenses claimed for car and truck, equipment rental use, and location travel pertain to the rental activity. Other claimed expenses are not related to the rental activity and are deductible only as unreimbursed employee expenses on Schedule A.

Holding. The tool rental payments do not constitute payments from a rental activity under I.R.C. §469(j)(8) and are properly reportable on Schedule C as an active trade or business.

Issues

1. Was Rasco entitled to dependency exemption deductions for his girlfriend and her two children?
2. Does Rasco meet the requirements to file as head of household?
3. Is Rasco entitled to an earned income credit?

Discussion

1. Code §151(c)(1) allows an individual taxpayer an exemption for each qualifying dependent. Code §152(a) defines a dependent as one who receives over half of his or her support from the taxpayer for the taxable year in question. Code §152(a)(9) includes individuals who have as their principal place of residence the home of the taxpayer, and are included in the taxpayer's household for the taxable year in question.

2. Code §2(b)(1)(A)(ii) defines “head of household” status as an unmarried taxpayer who has a dependent whose principal place of residence is the taxpayer's home for more than half of the taxable year. Code §2(b)(1) requires the taxpayer to supply more than half the cost of maintaining the home for the taxable year.

3. An earned income credit is available when an individual is deemed eligible under I.R.C. §32(c)(1)(A)(i). An eligible individual is one who has a qualifying child for the taxable year. The requirements for a qualifying child are found in I.R.C. §32(c)(1)(A)(i) through (iii).

Holding. The Court held that Rasco was entitled to dependency exemption deductions for his live-in girlfriend and her two children. The Court also found that Rasco met the requirements for filing as head of household. Furthermore, the two children are considered qualifying children, and Rasco is entitled to an earned income credit.

[Samuel K. Rasco v. Commissioner, T.C. Memo 1999-169]

Noah v. Commissioner
[I.R.C. §§151 and 152]

☞ Noncustodial parent cannot claim dependency exemptions without a signed Form 8332 from custodial parent.

Facts. Clifford Noah (taxpayer) and his first wife were divorced in 1981. They had two children, Laurie and Andrew. Clifford’s ex-wife was granted custody of the two children in the Tarrant County, Texas divorce decree. The decree was silent as to which of the parents was allowed to claim dependency exemptions for the children. Clifford’s ex-wife claimed both exemptions on her federal tax returns up to and including the 1992 tax year.

In January 1993, when she was 17, Laurie moved in with Clifford and his second wife, Leah, and lived with them for all of 1993 and 1994. Andrew continued to live with Clifford’s ex-wife. Clifford and his ex-wife orally agreed that, if Clifford would continue to pay child support of $468 per month, Clifford could claim the exemptions for both children for 1993 and 1994. Clifford did not go to court to arrange a formal hearing in order to change custody of Laurie. In the same month, Laurie signed an affidavit in which she chose Clifford as her custodial parent. However, Laurie’s affidavit was never submitted to the court for approval.

Contrary to her earlier oral agreement, Clifford’s ex-wife claimed exemption deductions for both children (Laurie and Andrew) on her 1993 and 1994 tax returns. Clifford and Leah Noah also claimed the exemptions for Laurie and Andrew on their joint 1993 and 1994 tax returns. In an examination of Clifford and Leah Noah’s 1993 and 1994 tax returns, the IRS disallowed the two exemptions. According to the IRS, Clifford was not the custodial parent and did not meet any of the three exceptions of I.R.C. §152(e).

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Issue. Whether the taxpayers (Clifford Noah and his second wife, Leah Noah) are entitled to claim dependency exemption deductions for Clifford’s two children (Laurie and Andrew) from his previous marriage.

Discussion. The custodial parent is generally entitled to claim the dependency exemption under I.R.C. §152(e)(1). “Custody” for I.R.C. §152 purposes is “determined by the terms of the most recent decree of divorce (or separate maintenance), or subsequent custody decree (or written separation agreement)” [Treas. Reg. §1.152-4(b)]. Laurie’s mother was granted custody of Laurie and Andrew in the 1981 divorce decree, and that decree was never amended by a court order that changed custody. Therefore, in the absence of a court order modifying custody, Clifford’s ex-wife remained the custodial parent of both Laurie and Andrew.

Clifford Noah, as a “noncustodial parent,” may still claim the dependency exemptions if one of the three exceptions to I.R.C. §152(e) is met. If the requirements of any of the three exceptions are met, the noncustodial parent is treated as providing over half of a child’s support for that year. The three exceptions are:

1. The custodial parent signs a written declaration that he or she will not claim the child as a dependent [I.R.C. §152(e)(2)(A)]. The noncustodial parent must attach the written declaration to his or her tax return for the tax year [I.R.C. §152(e)(2)(B)].

Note. Form 8332 (Release of Claim to Exemption for Child of Divorced or Separated Parents) is generally used to satisfy the “written declaration” requirement.

Clifford Noah (taxpayer) did not ask for, or receive, such a written declaration from his ex-wife, the custodial parent, and therefore did not attach it to his 1993 or 1994 tax return. He testified to an oral agreement with his ex-wife, but such an agreement does not satisfy the clear requirements of I.R.C. §152(e)(2).

2. The second exception concerns multiple-support agreements and does not apply to this case.

3. The third exception requires a “qualified pre-1985 instrument” [I.R.C. §152(2)(4)]. The taxpayer’s 1981 divorce decree does not provide that he, as noncustodial parent, is entitled to claim his children as exemptions. Therefore, the divorce decree does not qualify as a “qualified pre-1985 instrument” under I.R.C. §152(e)(4)(B).

Holding. Since Clifford Noah is not a custodial parent and has not satisfied any of the three exceptions, he and Leah are not entitled to the claimed dependency exemptions for Laurie and Andrew for the 1993 and 1994 tax years. [Clifford T. Noah v. Commissioner, T.C. Memo 1998-384, 76 T.C.M. 738 (1998) [CCH Dec. 52,931(M)]]

LTR 9838027, June 23, 1998 [I.R.C. §151]“Enrollment” in an educational institution for a student dependent starts with registration.

Facts. Daughter was enrolled at a university as a full-time student from August through December. She was a U.S. citizen, under the age of 24, and did not file a joint return. Parents provided more than half of Daughter’s support for the year. Daughter completed registration and paid tuition and fees on August 28, 1997, and attended a mandatory orientation from August 25 through August 28,
1999 Workbook

1997. Classes actually began on September 2, 1997. The IRS agent determined that Daughter was not “officially enrolled” at the university until classes began on September 2, 1997.

Issue. Is the five-month requirement for a student dependent as defined in I.R.C. §151(c)(4) satisfied if the student attends orientation and pays fees in August, but does not start classes until September?

Discussion. Code §151(c)(1) provides an exception for a dependent who is a student under the age of 24 at the close of the calendar year in which the taxable year of the taxpayer begins and who is a child of the taxpayer.

Code §151(c)(4) defines the term “student” as an individual who, during each of five calendar months during the calendar year in which the taxable year of the taxpayer begins, is a full-time student at an educational organization described in I.R.C. §170(b)(1)(A)(ii).

Treas. Reg. §1.151-3(b) provides that “a full-time student is one who is enrolled for some part of five calendar months for the number of hours of courses which is considered to be full-time attendance.” The issue then is the meaning of “enrolled” in the context of Treas. Reg. §1.151-3(b), which interprets I.R.C. §151(c)(4). The ordinary meaning of the word “enrolled” is “registered,” according to Black’s Law Dictionary. The interpretation of “enrolled” as “registered” is consistent with the apparent intent of the regulation. The “five-month rule” of the regulations seems to contemplate that, generally, an individual will qualify as a student if the individual is registered for a semester in a full-time course of study at an educational institution.

Holding. The ruling concluded that because Daughter registered for classes in August 1997 and remained registered through December 1997, Daughter was enrolled for “some part of five calendar months” and was therefore a “student” within the meaning of I.R.C. §151(c)(4) and Treas. Reg. §1.151-3(b). Parents are therefore entitled to a dependency exemption for Daughter.

PROCEDURES AND PENALTIES

Rev. Proc. 98-54

Instructions for entering into an agreement with the IRS to rescind a notice of deficiency.

Whether a notice of deficiency will be rescinded is discretionary on the part of the Secretary. A notice of deficiency may only be rescinded with the consent of the taxpayer.

If a notice of deficiency is rescinded, it is generally treated as if it never existed. Limitations regarding credits, refunds, and assessments relating to the rescinded notice are void and the rights and obligations of the parties that existed prior to the issuance of the notice of deficiency are reinstated. The rescinded notice does, however, suspend the running of the period of limitations under §6503 for the period during which the notice is outstanding. The Commissioner or the Commissioner’s delegate may issue a later notice of deficiency in an amount that exceeds, is the same as, or is less than the amount in the rescinded notice of deficiency. The taxpayer may exercise all administrative and statutory appeal rights from a reissued notice of deficiency, but cannot petition the Tax Court from a rescinded notice of deficiency.

A request to rescind a notice of deficiency should be made by the taxpayer as soon as possible after receipt of the notice because a notice will not be rescinded after the 90-day or 150-day restriction period under §6213(a) has expired.

Rev. Proc. 88-17, 1988-1 C.B. 692, is clarified, modified, and superseded.
This revenue procedure is effective with respect to notices of deficiency issued on or after January 1, 1986.


**Announcement 98-89**

The IRS announces new procedures for handling matters in bankruptcy.

The Internal Revenue Service has undertaken a new initiative to improve its procedures for handling bankruptcy cases. The new procedures are intended to minimize the likelihood that IRS collection actions will inadvertently violate the bankruptcy laws, to facilitate prompt correction of any violations that do occur, and to provide an administrative process for handling any claims for damages against the IRS that arise from such violations.

[Announcement 98-89, 1998-40 IRB]

**T.D. 8828**

[I.R.C. §6302]

The final regulations increase the deposit threshold to $200,000.

The final regulations also expand the types of nondepositary tax payments for which voluntary payment by EFT is allowed to include nondepositary payments of federal income, estate and gift, employment, and various specified excise taxes.

[T.D. 8828, 1999-31 IRB (July 26, 1999)]

Code §6302(h) requires that, beginning in fiscal year 1999, 94% of employment taxes and 94% of other depository taxes be collected by EFT. The IRS and the Treasury Department previously concluded that the deposit threshold had to be set at $50,000 to satisfy this statutory requirement. More recent experience suggests, however, that the statutory requirement can be satisfied even if the threshold is set at a substantially higher level. Moreover, an increase in the threshold would allow small businesses to make the transition to the EFT system at their own pace as they adopt electronic funds transfer in their other business operations. Accordingly, the final regulations increase the deposit threshold to $200,000 in aggregate federal tax deposits during a calendar year. (After the change, only about 9% of all businesses will be required to use EFTPS.)

The new $200,000 aggregate deposit threshold will be applied initially to 1998 deposits, and taxpayers that exceed the threshold in 1998 will be required to deposit by EFT beginning in 2000. Taxpayers that first exceed the threshold in 1999 or a subsequent year will similarly be required to deposit by EFT beginning in the second succeeding calendar year. A taxpayer that exceeds the threshold will not be permitted to resume making paper coupon deposits if its deposits fall below $200,000 in a subsequent year. Although a similar rule applies under the current regulations, taxpayers that are currently required to deposit by EFT will be given a fresh start and will not be required to use EFT unless they exceed the $200,000 threshold in 1998 or a subsequent calendar year.

The final regulations also expand the types of nondepositary tax payments for which voluntary payment by EFT is allowed to include nondepositary payments of federal income, estate and gift, employment, and various specified excise taxes.

[T.D. 8828, 1999-31 IRB (July 26, 1999)]
The Service has announced that penalty reductions may be available to some employers that were penalized for making untimely employment tax deposits during the first quarter of 1999. Under tax law changes that apply to federal tax deposits due after January 18, 1999, taxpayers may designate the period to which a specific deposit applies and have 90 days from the date of a penalty notice to contact the IRS and designate the periods against which the deposits apply. The IRS inadvertently omitted explanations of these relief provisions when it sent penalty notices to businesses for untimely employment tax deposits during the first quarter of 1999. Eligible taxpayers, who would have received the penalty notices in late May or early June, may get the penalty relief by calling the IRS at the number listed on the notice. In light of its omission of this relief information from the recent penalty notices, the IRS will give affected taxpayers 90 days from the date of the apology letter it sends them to call and make a deposit designation, rather than 90 days from the notice’s date. The other penalty relief provision is for employers who are required to change the frequency of their deposits. These taxpayers may get a penalty waiver for the first deposit due under the new schedule, provided they filed the applicable employment tax return on time and had a net worth under $2 million ($7 million, in the case of a corporation). All the taxpayer has to do is contact the IRS and request the waiver.

**The Bubble Room, Inc. v. United States**

[I.R.C. §3121]

**Facts.** The Bubble Room, Inc. operated two restaurant establishments and employed 159 tipped employees and other servers who did not receive direct tips from customers. The company did not have a mandatory tipping policy for large parties, and tipped employees did not have to share their tips with other servers. In 1989 the company began mandating that employees report all tips to the managers. The information was used to calculate FICA taxes and to prepare Form W-2s at year end. Form 8027 was filed in 1990 to report employees’ tip income from 1989.

The IRS selected Bubble Room for a compliance check on tip income reported in 1989, and informed the company in 1991 that tipped employees were not reporting their full amount of tip income. The Service estimated aggregate tip income using the *McQuatters* formula and the tip rate established by the tips shown on credit card receipts (see *McQuatters v. Commissioner*, T.C. Memo 1973-240). The IRS determined that Bubble Room’s average tipped employee earned $9.36 in tips every hour, and assessed the company with an employer-only FICA tax, which it paid under protest.

The Court of Federal Claims held that the Service may not assess employer-only FICA tax under I.R.C. §3111 when it has not determined the tip income of individual employees and awarded wage credits to those employees.

**Issue.** Does the IRS have statutory authority to assess FICA taxes against an employer based on an aggregate estimate of its employee’s unreported tip income, without determining each individual’s tip income?

**Analysis.** Code §3121(q) provides that “tips received by an employee in the course of his employment shall be considered remuneration for such employment (and deemed to have been paid by the employer for purposes of subsections (a) and (b) of I.R.C. §3111).”

Bubble Room contends that under this rule, the IRS is required to assess FICA tax on unreported tips on a per-employee basis before it can assess employer FICA tax based on
those tips. Bubble Room also argues that, where an employee fails to report tips, the IRS, not the employer, has the resources, statutory power, and obligation to audit the employee and determine the amount of tips received. Finally, the company contends that the phrase “tips received by an employee” in I.R.C. §3121(q) is grounded in the singular, and that the section therefore prohibits the IRS from making an assessment against the employer for FICA taxes without also making an assessment against the employee for FICA taxes.

The IRS argues that the general rule of construction found in 1 U.S.C. §1 provides that “in determining the meaning of an Act of Congress, unless the context indicates otherwise, words importing their singular include and apply to several personas, parts, or things.” Furthermore, the IRS asserts that, in adding the clause beginning “except that…” to I.R.C. §3121(q), “Congress specifically contemplated the assessment of an employer only FICA tax when employees do not accurately report their tip.”

The Court rejected Bubble Room’s interpretation of I.R.C. §3121(q), and agreed with the Court of Federal Claims that the phrase “tips received by an employee” in the first sentence of that section is not dispositive. The sentence provides that tips are considered wages received by the employee and paid by the employer, but does not expressly grant or deny the IRS the power to assess employer-only FICA taxes without first assessing the FICA tax liability of each tipped employee.

Under I.R.C. §6201, the IRS is “authorized and required to make the inquiries, determinations, and assessments” necessary for all taxes imposed by the Code, “which had not been duly paid… in the manner provided by law.” Code §6201 implicitly authorizes the Service to use an indirect formula in order to carry out the general power granted in that section.

Holding. The IRS has the statutory authority to assess FICA taxes against an employer without determining the tip income of individual employees and awarding wage credits to the employees.


Fran Corp. v. United States
[I.R.C. §§6651 and 6656]

Financial hardship may be a reasonable cause for nonpayment of employment taxes, but ordinary business care test must be met.

Facts. During a five-quarter period between April 1993 and June 1994, Fran Corp., an electrical contractor, failed to pay its employment taxes. During that period, the company experienced severe financial difficulties due to customers withholding progress payments. The taxes and interest and penalties were eventually paid by Fran Corp. The company then sought a refund of the penalties. The district court found that Fran’s failure to pay was not due to reasonable cause. The government’s motion for summary judgment was granted. Fran appealed to the Second Circuit, asserting that its financial hardship was reasonable cause for its failure to pay taxes and thus it was entitled to a refund of penalties.

Issue. Was Fran Corp’s financial difficulty reasonable cause for the failure to pay and deposit employment taxes?

Discussion. The IRS imposes mandatory penalties for failure to file returns, pay taxes, or deposit employment taxes in a government depository unless the taxpayer can demonstrate that such failure was due to “reasonable cause and not due to willful neglect” [I.R.C. §§6651(a)(1), (a)(2), 6656(a)]. The Supreme Court established that the taxpayer bears the “heavy burden of proving both (1) that the failure did not result from ‘willful neglect’ and (2) that the failure was ‘due to reasonable cause.’” In United States v. Boyle, 85-1 USTC ¶13,602, the Court interpreted the phrase “willful neglect” to mean “a conscious, intentional failure or reckless indifference.” The Treasury regulations interpret “reasonable cause” as follows: If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause. The
parties do not agree whether financial difficulties such as those faced by Fran Corp. can ever constitute “reasonable cause” to avoid the penalties at issue. The court of appeals, like the district court, rejected the government’s argument to apply the bright-line rule in *Brewery Inc. v. United States*, 33 F.3d 589, which held that financial difficulty is never an excuse for nonpayment. Based on the following facts, the Court of Appeals agreed with the District Court that Fran Corp. failed to exercise “ordinary business care and prudence” and did not show reasonable cause for nonpayment:

1. The company continued to pay $3,500 in monthly rent to the company’s president, despite an outstanding loan of approximately $150,000 made to him in 1991.
2. The company made payments for auto leasing and repair expenses.
3. The company made expenditures for entertainment.

Fran’s lack of priority demonstrated its failure to exercise ordinary business care and prudence.

**Holding.** Fran Corp. has not shown that it exercised ordinary business care and prudence in addressing its obligations to pay and deposit employment taxes. The district court’s ruling is affirmed. Fran Corp. is not entitled to a refund of penalties associated with the late payment of its employment taxes.

[Fran Corp. v. United States, 99-1 USTC 50,208]

**Announcement 99-62**

[I.R.C. §6104]

Tax-exempt organizations are reminded of public inspection and disclosure requirements.

The IRS has reminded tax-exempt organizations that they must either provide requesters with copies of approved exemption applications and their three most recent annual information returns or make the information available on a Web site. Previous rules did not require organizations to provide copies as long as they made the documents available for public inspection. Postage costs and reasonable copying fees may be charged. Penalties apply to failures to comply with the new requirements.

**Grossman v. Commissioner**

[I.R.C. §§6015 and 6653]

Tax attorney knowingly excluded spouse’s income and is not entitled to innocent spouse relief.

**Facts.** Robert Grossman, Jr., former IRS attorney, specialized in tax law for more than 20 years. Grossman’s now ex-wife Betsy owned several corporations. In 1980 Grossman took over control of the daily operations of these businesses. The Grossman family took several vacations during 1983–86 that were charged on a credit card issued to one of Betsy’s corporations. The corporation’s bookkeeper was instructed by Grossman to make the credit card payments with corporate funds. The bookkeeper was never informed that the expenses were personal. Checks for the credit card payments were generally signed by Grossman. The IRS determined that the Grossmans failed to report constructive dividend income for 1983–86. The Tax Court rejected Grossman’s argument that he was entitled to innocent spouse relief under I.R.C. §6013(e) and held that he fraudulently failed to report income only for 1985 and 1986. On appeal, the petitioner contended that he was entitled to relief under the new provisions of I.R.C. §6015.
**Issue.** Was the civil fraud penalty of I.R.C. § 6653 properly imposed for failure to report constructive dividends and was Grossman eligible for innocent spouse relief under the provisions of I.R.C. § 6015?

**Discussion.** A finding of fraud requires that the Commissioner “prove affirmatively by clear and convincing evidence actual and intentional wrongdoing on the part of the [taxpayer] with a specific intent to evade the tax” [Webb v. Commissioner (68-1 USTC ¶ 9341)]. Tax fraud implies “bad faith, intentional wrongdoing and a sinister motive” [Davis v. Commissioner (50-2 USTC ¶ 9427)]. A taxpayer cannot be held to have committed civil tax fraud when the understatement of tax results from “inadvertence, negligence, or honest errors.”

In the present case, both the documentary evidence and the testimony of several witnesses amply support the Tax Court’s findings of fact as to Grossman’s intent to defraud. The record contains evidence that Grossman was running the Sley corporations’ operations during the relevant years and that he knew that personal trips were being charged to a Markette Corporation credit card because he charged many of these expenses himself. The Sley corporations’ bookkeeper testified that Grossman directed her to pay the charges on the Markette credit card with Markette Corporation’s funds, and never informed her that any of these charges were for personal expenses. The evidence also demonstrates that Grossman signed most of the company checks to pay for these personal charges.

Moreover, the Tax Court carefully considered Grossman’s arguments that he lacked the requisite intent to defraud and this care is reflected in the fact that it refused to find that the Commissioner had met the requisite “heavy burden” for the 1983 and 1984 tax years.

On appeal, Grossman contends that the relatively small amount of his underpayments demonstrates a lack of intent to defraud. The Tax Court, however, considered this and determined that Grossman’s familiarity with the tax laws outweighed the fact that the constructive dividends constituted only a small percentage of Grossman’s income.

Grossman also claims that he justifiably relied on the accountant that prepared his income tax returns. A taxpayer’s reliance on his or her accountant to prepare accurate returns may indicate an absence of fraudulent intent [see Marinzulich v. Commissioner, 31 T.C. 487, 492 (1958)]. However, as the Tax Court noted, a taxpayer can rely on an accountant only when that “accountant has been supplied with all the information necessary to prepare the returns accurately” [Foster v. Commissioner, 68-1 USTC ¶ 9256]. Grossman did not supply his accountant with such information. Rather, the accountant was hired only to prepare tax returns and not to audit the corporate books or otherwise analyze Grossman’s travel expenses.

Under I.R.C. § 6015(b), the person claiming to be an innocent spouse must demonstrate that he or she “did not know, and had no reason to know” of any tax understatement. I.R.C. § 6015 provides that an individual must demonstrate inter alia that he had no “actual knowledge, at the time such individual signed the return, of any item giving rise to a deficiency.” The Tax Court held that Grossman was ineligible for relief under I.R.C. § 6013 because he “knew and intended that Betsy had constructive dividend income that was omitted from petitioner’s and Betsy’s 1986 joint tax return.” The Tax Court’s finding that Grossman intended to defraud necessarily also constitutes a finding that Grossman had actual knowledge of the underpayment.

**Holding.** The civil fraud penalty was properly imposed with respect to the underpayments arising from the failure to report constructive dividends. Grossman’s claim for innocent spouse relief under provisions of the IRS Restructuring and Reform Act of 1998 is denied because the ample evidence of his intent to defraud the IRS necessarily proved that he had actual knowledge of the understatements on his joint returns.

The IRS has issued interim guidance for taxpayers seeking equitable relief from joint and several liability for tax, interest, penalties, and other amounts as innocent spouses under new I.R.C. §§6015(f) and 66(c).

The following threshold conditions must be met for an individual to be considered for relief under I.R.C. §6015(f) from liability for tax:

1. The individual made a joint return for the taxable year for which relief is sought.
2. Relief is not available to the individual under I.R.C. §6015(b) or I.R.C. §6015(c).
3. The individual applies for relief no later than two years after the date of the Service’s first collection activity after July 22, 1998, with respect to the individual.
4. The liability remains unpaid at the time relief is requested.
5. No assets were transferred between individuals filing the joint return as part of a fraudulent scheme by such individuals.
6. There were no disqualified assets transferred to the individual by the nonrequesting spouse.
7. The individual did not file the joint return with fraudulent intent.

The following are the circumstances under which equitable relief from tax liability for a taxable year will ordinarily be granted to an individual requesting relief under I.R.C. §6015(f):

1. The liability reported on a joint return for such year was unpaid at the time such return was filed.
2. At the time relief is requested, the individual is no longer married to, or is legally separated from, the spouse with whom such individual filed the joint return to which the request for relief relates, or has at no time during the 12-month period ending on the date relief was requested, been a member of the same household as the spouse with whom such joint return was filed.
3. At the time the return was filed, the individual did not know, and had no reason to know, that the tax would not be paid.
4. The individual would suffer undue hardship if relief from the liability were not granted.

The following factors will be taken into account in determining whether to grant equitable relief under I.R.C. §6015(f) or I.R.C. §66(c):

1. Factors weighing in favor of relief:
   a. Marital status
   b. Hardship
   c. Abuse
   d. Spouse’s legal obligation
2. Factors weighing against relief:
   a. Attribution
   b. Knowledge, or reason to know
   c. Significant benefit
   d. Individual’s legal obligation
Chang v. Commissioner  
[I.R.C. §7502]

Facts. Edward and Margaret Chang received a notice of deficiency postmarked August 7, 1996. The couple had until November 5, 1996, to file a redetermination petition. The IRS asserted that the couple failed to file their petition before the deadline. The private postmark was within the deadline, but the petition arrived much later than the normal delivery time. The private postmark was dated November 5, 1996. However, the petition did not arrive until November 18, 1996. The petition did not have any mark of the U.S. Postal Service on it. Nothing about the appearance of the petition suggested that the normal course of delivery had been interrupted. The petition was signed and dated November 5, 1996, by the Changs’ attorney. It also included a check for the $60 filing fee dated November 5, 1996.

Issue. Whether the petitioners’ redetermination petition was filed within the 90-day period allowed by I.R.C. §6213(a).

Discussion. Code §6213(a) allows a taxpayer 90 days after the postmark of the notice of deficiency to file a redetermination petition. Saturdays, Sundays, and legal holidays are not counted. Code §7502(a)(1) allows the United States postmark to serve as the date of delivery. Privately postmarked mail is determined by the regulations provided by the Secretary. Code §7502(b) states that privately metered mail must be dated before the deadline, the same as the requirement for U.S. postmarked mail. It must also arrive in a timely manner just as U.S. postmarked mail would. The petitioner must bear the burden of proving that there was a delay in the transmission of the mail if the privately postmarked mail does not arrive in a timely manner.

Holding. The Tax Court held that the Changs failed to prove that their redetermination petition was timely mailed or that the delay in receipt was due to a delay in the transmission of the mail and the cause therefore.

[Edward C. Chang, et ux. v. Commissioner, CCH Dec. 52,837(M)]

Muhich v. Commissioner  
[I.R.C. §§661, 162, and 6662]

Facts. Frank Muhich owns a photography business, Midwest Portraits Corp., in Illinois. In March 1994, he met with a financial planner from Heritage Assurance Group to discuss the creation of a family trust. Heritage’s promotional materials outlined the necessary transactions associated with creating the trust. An individual first transfers assets to the newly created family trust and receives a certificate of beneficial interest, which gives the individual the right to receive distributions made by the trustee. The family trust pays and deducts the personal expenses of the trustee. Excess corpus is distributed to a charitable trust created under the scheme.

Midwest paid $12,000 to Heritage and received a packet of documents and forms that could be customized to operate the family trust. The Muhichs used the promotional materials as a model for their multitrust scheme. The Muhichs created five trusts in all and transferred the majority of their property to these trusts. They named themselves sole trustees and sole beneficiaries. Benefits derived from trust property were not any more restricted than before the creation of the trusts. The

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manner in which Midwest conducted business did not change. However, Frank’s compensation changed from a salary to consulting fees after the creation of the trusts.

Midwest deducted the $12,000 payment to Heritage and several amounts paid under the consulting contract on its 1994 and 1995 tax returns. On their own returns for those years, the Muhichs did not report any income from Midwest. The IRS determined a deficiency, noting that the Muhichs received constructive dividends and that Midwest was not entitled to the deductions related to the trusts.

**Issue.** Were the trusts shams that lacked economic substance?

**Discussion.** Four factors from *Markosian v. Commissioner*, 73 T.C. 1235, 1241, are used to decide whether a trust lacks economic substance for tax purposes:

1. Whether the taxpayer’s relationship as grantor to the property differed materially before and after the trust’s formation,
2. Whether the trust had an independent trustee,
3. Whether an economic interest passed to other beneficiaries of the trust, and
4. Whether the taxpayer felt bound by any restrictions imposed by the trust itself or by the laws of the trust.

In the Muhichs’ case, the property did not differ materially before and after the formation of the trusts, the trusts lacked an independent trustee, an economic interest in the trusts never passed to anyone besides the Muhichs, and the couple was not bound by any restriction imposed by the trust or the laws of the trust as to the use of trust property.

**Holding.** The trusts are shams that lack economic substance and should be ignored for tax purposes. Consulting fees paid by the business to the trust were includable in Muhich’s gross income and deductible by the business as compensation for services. The IRS’s determination that the consulting fees constituted nondeductible constructive dividends paid to Muhich was rejected by the Court. Payments made by Muhich to the promoters of the sham trusts did not qualify as ordinary and necessary business expenses. Because the payments were made solely to benefit the taxpayers personally, the funds were includable in their income as constructive dividends.

The accuracy-related penalties were also imposed, since the Court concluded that the taxpayers failed to act reasonably and in good faith based on Muhich’s business experience.


**T.D. 8803, Treas. Reg. §1.6695-1**

[§1.6695]

This document contains final and temporary regulations outlining the two alternative means of meeting the requirement that a preparer retain the manually signed copy of a return or claim. The regulations are effective December 31, 1998.

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Explanation of Provisions. If an income tax return preparer presents a return or claim for refund that has a copy of the preparer’s manual signature, the preparer may either retain a photocopy of the manually signed return or claim, or use an electronic storage system described in §4 of Rev. Proc. 97-22 to store and produce the manually signed return or claim.

T.D. 8835, Treas. Reg. §1.6109-2

[IR 1999-72]

Income tax return preparers may elect to use an alternative identification number by applying for a preparer tax identification number (PTIN) on Form W-7P.

Explanation of Provisions. The IRS has issued temporary and final regulations published in Treas. Reg. §1.6109-2 to allow income tax return preparers to elect an alternative to their social security number for purposes of identifying themselves on returns they prepare. These regulations are necessary to implement changes made to the applicable law by the Internal Revenue Service Restructuring and Reform Act of 1998. These regulations are effective August 12, 1999.

To apply for a preparer tax identification number (PTIN), preparers must file a Form W-7P, Application for Preparer Tax Identification Number. These forms may be obtained from the IRS’s Web site (www.irs.ustreas.gov) or by calling 1-800-829-3676.

The Service announced that it expects to begin issuing PTINs by mail beginning in early October 1999. Preparers who file their applications by November 1999 should receive PTINs by the start of the 2000 filing season. Preparers must use either their social security number or a PTIN. They may not write “PTIN applied for” in the Paid Preparer’s Use Only section of a return.

T.D. 8807, Treas. Reg. §301.7502-1

[I.R.C. §7502]

Regulations are issued to explain what constitutes timely mailing with regard to electronic postmarks.

This document contains final and temporary regulations concerning timely mailing treated as timely filing under I.R.C. §7502. The rules reflect changes to the law made by the Internal Revenue Service Restructuring and Reform Act of 1998. The regulations are effective January 15, 1999.

Explanation of Provisions. If the date of an electronic postmark is on or before the filing due date, the date of the electronic postmark will be deemed the filing date. The electronic postmark must be given by an authorized electronic return transmitter. For tax year 1998, the rules apply to returns filed through electronic return transmitters authorized to provide an electronic postmark under the Electronic Tax Administration’s Request for Agreement. For tax years after 1998, the rules apply to documents submitted to electronic return transmitters that are authorized to provide an electronic postmark under Treas. Reg. §301.7502-1T(d)(2).
The Service has announced that it is making its offer-in-compromise program more accessible to taxpayers. Changes to the program include:

- Allowing IRS employees to consider more than the standard cost-of-living formulas when assessing an individual’s ability to pay a tax bill,
- Requiring taxpayers to provide less financial information to qualify for smaller compromise offers,
- Implementing new rules for processing taxpayer offers, and
- Implementing new deferred-payment procedures to give taxpayers who may have been excluded under the old guidelines more opportunities to submit compromise offers.

Form 656, the offer-in-compromise form, has been revised to reflect the change. The revisions include:

- Providing that compromise offers will now require only 48 months of future income for payments made within 90 days
- Reducing the fair market value of assets by 20% up front
- Adding new protections that safeguard spouses who comply with the agreement, even if the other spouse defaults on payments.

**Note.** The offer-in-compromise program is covered in detail in the Troublesome Areas of Recent Legislation chapter.

**Jones v. United States**

**[I.R.C. §7431]**

**Facts.** The U.S. government was sued for disclosing confidential tax return information about Terry and Pat Jones. The disclosure allegedly caused emotional distress and damage to one of the couple’s businesses. The couple has businesses related to apartments, publishing, and oil. The businesses are controlled through a holding company. Jones Oil had established credit with many oil refineries. It also had a $1.5 million line of credit at a bank to cover expenses while it awaited customer payments. Jones Oil was never in default on its credit arrangements with the refineries or the bank. In January 1990, IRS agent Angelo Stennis told a confidential informant about a search warrant that was to be executed on Jones Oil. The informant was to contact Stennis about any threats or problems at Jones Oil. A news crew, alerted by an anonymous tip, covered the search. The IRS never charged Jones Oil with anything. However, the negative publicity caused Jones Oil to fail. The Joneses sued for damages, citing I.R.C. §7431. The district court improperly gave the Joneses the burden of proving bad faith on the government’s part. The claim was denied by the district court, but the Eighth Circuit reversed the ruling in part. The district court then held that the disclosure was not made in good faith,

"U.S. government is liable for $5.4 million in damages for unauthorized disclosure of return information."
and a trial for damages was held. The government argued that the news media would have found out about the search without the disclosure. It also argued the company could have failed for any number of reasons.

**Issue.** Whether the unauthorized disclosure caused damages to the Jones’s reputation and business.

**Discussion.** Code §7431 allows for the recovery of actual damages sustained by the plaintiff. Upon a finding of liability on the part of the defendant, the defendant shall be liable to the plaintiff in an amount equal to the sum of the greater of (1) $1,000 for each act of unauthorized inspection or disclosure of a return or return information or (2) the sum of the actual damages sustained by the plaintiff as a result of such unauthorized inspection or disclosure, plus in the case of a willful inspection or disclosure or an inspection or disclosure that is the result of gross negligence, punitive damages, plus the costs of the action.

**Holding.** The district court found that Jones Oil failed as a direct result of the disclosure and awarded the Joneses a total of $5.4 million in actual damages. The damages related to Jones Oil amounted to $4.5 million, while $590,000 in damages were related to the forced sale of Jones Oil’s real and personal property. The Court found nothing in §7431 to preclude an award for pain and suffering. Many of the Jones’s social and business relationships vanished, and, in short, their life as they knew it fell apart. The Court awarded the Joneses $325,000 in damages for emotional distress.

[**Terry L. Jones, et ux. v. United States,** 98-2 USTC ¶50,863]

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**Notice 98-50**  
[I.R.C. §408A]

*Guidance is provided for recharacterization and reconversions of Roth IRAs.*

This notice provides guidance on whether an individual who has converted a traditional IRA to a Roth IRA may transfer the converted amount back to a traditional IRA and subsequently reconvert the recharacterized amount back to a Roth IRA. An individual who transfers the converted amount back to a traditional IRA may reconvert that amount back to a Roth IRA one time only. Reconversion must occur no earlier than November 1, 1998, and no later than December 31, 1999.

**Note.** The Troublesome Areas of Recent Tax Legislation chapter addresses problems associated with Roth IRAs.
This document contains final regulations concerning Roth IRAs under I.R.C. §408A. The rules affect individuals establishing Roth IRAs, beneficiaries under Roth IRAs, and custodians, trustees, or issuers of Roth IRAs.

**Action.** T.D. 8816 adopts, with modifications, the proposed regulations published September 3, 1998 (Reg. 115393-98).

**Dates.** The regulations are effective February 3, 1999, and apply to tax years beginning on or after January 1, 1998.

**Explanation of Provisions.** Instead of opening a new account or issuing a new annuity contract for each conversion or recharacterization made with the same trustee, an account or annuity contract may simply be redesignated. Net losses on the amount to be recharacterized may be included when computing net income under Treas. Reg. §1.408A-4(c)(2)(iii) for a commingled IRA. Additionally, the regulations clarify that a nonqualified distribution from a Roth IRA is taxed only to the extent that the amount of the distribution, taking into account all previous distributions and subtracting the taxable amount, exceeds the owner’s contributions to all Roth IRAs.

**Note.** The Troublesome Areas of Recent Tax Legislation chapter addresses problems associated with Roth IRAs.

**Notice 98-53**

[I.R.C. §§61, 401, 402, 404, 409, 414, 415, and 457]

The IRS has announced the cost-of-living adjustments applicable to qualified retirement plan dollar limitations for 1999.

The Service has announced cost-of-living adjustments applicable to dollar limitations on benefits under qualified retirement plans and other provisions affecting such plans.
Facts. Husband (H) and Wife (W) rented farmland held by them as joint tenants to a corporation in which the husband is the only shareholder and officer. Under the rental agreement, Husband and Wife were not required to perform services in connection with farm production. However, both Husband and Wife entered into employment contracts with the corporation to provide farm production services to the corporation. Both worked full-time for the corporation during the years at issue and had no other employment.
Issue. Were the rental payments received by Husband and Wife from the corporation includable in net earnings from self-employment under I.R.C. §1402(a)(1)?

Discussion. Code §1402(a)(1) provides that there shall be excluded from net earnings from self-employment rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) together with the deductions attributable thereto. However, this section provides an exception to the rentals exclusion for any income derived by the owner or tenant of land if (a) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities on such land, and that there shall be material participation by the owner or tenant in the production or the management of the production of such agricultural or horticultural commodities, and (b) there is material participation by the owner or tenant with respect to any such agricultural or horticultural commodity (hereinafter, referred to as “includable farm rental income”).

The facts clearly demonstrate that there was actual material participation by both H and W in farming operations. Both H and W were employed full-time in the farming operation and had no outside employment. Therefore, the issue is whether there existed an “arrangement” obligating the petitioners to materially participate in the production or the management of the production of agricultural commodities within the meaning of I.R.C. §1402(a)(1).

The petitioners contend that the rentals were not self-employment income because the lease entered into with the corporation did not require the petitioners to perform any services in connection with farm production. Implicit in the petitioners’ argument is that the term “arrangement” for purposes of I.R.C. §1402(a)(1) means only the contractual lease agreement, and therefore it is not correct to look outside the four corners of the lease to determine whether an “arrangement” existed obligating the owner to materially participate in farm production. Therefore, the petitioners contend, because the services were performed pursuant to employment contracts, and not pursuant to the lease, the payments were not made under an “arrangement” for purposes of I.R.C. §1402(a)(1).

The IRS determined that the overall arrangement and understanding that existed between the corporation and the petitioners indicates that the petitioners were obligated to materially participate in agricultural production. The employment contracts, which required that H and W provide material services, and H’s position as sole officer of the corporation, which obligated him to manage the corporation, indicate the existence of an arrangement whereby the petitioners were obligated to materially participate in the production, or the management of the production of agricultural commodities.

According to the IRS, the fact that H and W were paid amounts under their respective employment contracts does not prevent the rental payments from being characterized as net earnings from self-employment. Under Mizell, the employment contracts must be considered in examining the general relationship or overall understanding between or among the parties. Likewise, H’s duties as sole officer must be considered in determining whether he was required to materially participate in the management of farm production, irrespective of whether he received any compensation for performing such duties.

Holding. The rental payments received by H and W from the corporation are includable in net earnings from self-employment under I.R.C. §1402(a)(1).

**Bot v. Commissioner**  
[I.R.C. §1402]

**Rental income for farmland rented to husband is self-employment income.**

Facts. Vincent and Judy Bot have farmed for 38 years in Minnesota. Vincent Bot operated the farm as a sole proprietorship and cash-rented 240 acres of farmland from Mrs. Bot under an oral rental agreement. Mrs. Bot owned this land in her own name, having acquired it by inheritance and
purchase. Mrs. Bot also provided general farming services to the sole proprietorship to the extent of approximately 1,800 hours per year. She performed these services under an employment agreement and received cash wages of approximately $15,000 per year. The IRS determined that the real estate rental payments Mrs. Bot received from Vincent are includable in Mrs. Bot’s net earnings from self-employment and are thus subject to self-employment tax.

**Issue.** Are the rental payments includable in Mrs. Bot’s self-employment income as “includable farm rental income” under Treas. Reg. §1.1402(a)-4(b)?

**Discussion.** The Court determined that since the rental income is derived under an arrangement between Mrs. Bot (the owner) and Vincent Bot that provides that Vincent will produce agricultural commodities on the land, and that there shall be material participation by Mrs. Bot in the production or the management of the production of such commodities, and there is such material participation by Mrs. Bot, then the rental income is considered earnings from self-employment.

The Court emphasized that the provisions of I.R.C. §§1401–1403 regarding whether compensation is includable in self-employment income are to be broadly construed. On the other hand, the rental exclusion in I.R.C. §1402(a)(1) is to be strictly construed to prevent the exclusion from interfering with the congressional purpose of effectuating maximum coverage under the social security umbrella. In determining whether Mrs. Bot received rental income from Vincent pursuant to an “arrangement” between the parties within the meaning of I.R.C. §1402(a)(1)(A), the Court looked not only to the obligations imposed upon Mrs. Bot by the oral lease, “but to those obligations that existed within the overall scheme of the farming operations which were to take place” on Mrs. Bot’s property (Mizell v. Commissioner, T.C. Memo 1995-571). These include Mrs. Bot’s obligations as a long-standing participant in the farming business as well as the “general understanding between” Vincent and Mrs. Bot with respect to the production of agricultural products. The fact that Mrs. Bot was paid a salary for her services was deemed immaterial.

**Holding.** The rental income is considered net earnings from self-employment under I.R.C. §1402(a)(1).

[ Vincent E. Bot, et ux. v. Commissioner, T.C. Memo 1999-256]

FSA 1999-528
[I.R.C. §1402]

Statutory employee expenses cannot offset self-employment income.

**Facts.** An insurance salesman sold policies full-time as a statutory employee for a company and in a separate business as an independent contractor. W-2 wages were received from the company, and Form 1099-MISC income was received from the contracting business. On Schedule C of his Form 1040, the petitioner reported the earnings from both the full-time statutory employee position and the contracting business. He also deducted expenses for statutory employment and self-employment. The petitioner did not, however, calculate or pay any self-employment tax.

**Issue.** May the petitioner reduce his earnings from self-employment by deductible expenses associated with his full-time insurance salesman position for purposes of determining his self-employment income under I.R.C. §1401(a) and (b)?

**Discussion.** Under I.R.C. §1402(a), “net earnings from self-employment” is defined as the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle that are attributable to such trade or business. Therefore, only the
deductions associated with the petitioner’s independent contracting business may be used to reduce his earnings from self-employment.

**Conclusion.** The petitioner may not reduce his earnings from self-employment by deductible expenses associated with his full-time position as an insurance salesman for purposes of determining his self-employment income under I.R.C. §1401(a) and (b). The IRS observed that if the petitioner reports both types of earnings and expenses on one Schedule C, he must make a separate calculation to determine his self-employment net profit reported on Schedule SE and taxable for self-employment purposes. Considering this, **it often is more practical for a taxpayer to prepare two separate Schedule C’s, one reporting his net earnings as a statutory employee and one reporting his self-employment net profit.**

**Note.** Special thanks to Nina S. Collum and Margaret A. Obringer for their assistance with the research and writing of this chapter.