2000 Income Tax School

RULINGS AND CASES

EXPLANATION OF CONTENTS

Please Note. This chapter is a collection of some revenue rulings, revenue procedures, Treasury Regulations, announcements, tax cases, and letter rulings that have been issued during the past year, through approximately August 31, 2000. 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 [I.R.C. §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 does not exceed $10,000, the taxpayer may elect the Small Claims Division of the Tax Court. The Small Claims Division has a simplified petition and procedure so that the taxpayer can present his or her own case. Decisions by the Small Claims Division are not published and are final without appeal. The IRS can remove the case to the regular docket if the case involves an important policy question.
- The taxpayer can choose to file a refund suit in the Claims Court or the Federal District Court once the taxpayer has paid the deficiency. In both courts, decisions of the Tax Court are not binding. The Claims Court sits as a single judge. A jury trial is available only in the Federal District Court.

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

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

ACCOUNTING

Notice 2000-26
[I.R.C. §453]

> ☞ **IRS issues guidance on the ban on use of installment method reporting by accrual-method taxpayers.**

Purpose. The purpose of this notice is to provide guidance on the application of I.R.C. §453(a)(2) to certain installment sale transactions.

Background. An installment sale is defined in I.R.C. §453(b) as a disposition of property in which at least one payment is received after the close of the taxable year of disposition. I.R.C. §453(a)(1) provides that income from an installment sale must generally be taken into account under the installment method. **A recent law change added an exception to this general rule in I.R.C. §453(a)(2), which provides that the installment method does not apply to income from an installment sale if the income would be reported under the accrual method if not for I.R.C. §453.** This change is effective for dispositions occurring on or after December 17, 1999. I.R.C. §453(a)(2) does not affect cash method taxpayers.

Explanation

Corporations. For each situation, **assume that the shareholder uses the cash method, the corporation uses the accrual method, and the stock of the corporation is non-publicly traded**.

1. A **shareholder can report the gain from a sale of the shareholder's stock in the corporation in exchange for cash and an installment obligation on the installment method**.

   - If the buyer makes a I.R.C. §338 election, it will not affect the shareholder's ability to use the installment method. However, the corporation cannot report the gain from the deemed sale of assets on the installment method.
   - If the shareholder is a corporation and the buyer and the corporate shareholder join in making a I.R.C. §338(h)(10) election for the target corporation (a C corporation), which is either the corporate shareholder's affiliate or a member of its consolidated group, the corporate shareholder recognizes no gain or loss on the sale of the target corporation's stock. The target corporation cannot report the gain from the deemed sale of assets on the installment method.
   - If the buyer and the shareholder join in making a I.R.C. §338(h)(10) election for the corporation (an S corporation), the shareholder recognizes no gain or loss on the sale of the S corporation's stock. The S corporation cannot report the gain from the deemed sale of assets on the installment method. The shareholder may realize gain or loss on the deemed transfer of the S corporation's assets (including the installment obligation) to the shareholder after taking into account the effect of the deemed sale of the assets. The shareholder can report any gain from this deemed transfer on the installment method.

2. **The corporation cannot report the gain from the sale of its assets in exchange for cash and an installment obligation on the installment method**.

   - If the corporation, a C corporation, distributes the note to a shareholder in a liquidation meeting the requirements of I.R.C. §453(h), **the C corporation must recognize any gain or loss upon the distribution of the note**. The **shareholder can report the gain from the exchange of the stock for the note on the installment method**.

- If the corporation, **an S corporation, distributes the note to a shareholder in a liquidation meeting the requirements of I.R.C. §453(h)**, the **S corporation does not recognize gain or loss upon the distribution of the note** except for any taxes imposed by subchapter S. The **shareholder can report the gain from the exchange of the stock for the note on the installment method**.

Partnerships

1. A **cash-method partner can report the gain from a sale of the partner's interest in the partnership in exchange for cash and an installment obligation on the installment method**.
2. An accrual-method partnership cannot report the gain from the sale of its assets in exchange for cash and an installment obligation on the installment method.

Treatment of sales not on the installment method. If the sale of an asset for cash and an installment obligation is not eligible for installment reporting for any reason, generally the entire gain must be recognized in the year of sale.

If the installment obligation provides for one or more contingent payments, the taxpayer cannot recover basis first, then use the "open transaction" method to report the gain from the installment sale. Only in rare and extraordinary cases in which the fair market value of the obligation cannot reasonably be ascertained can basis be recovered first.

[Notice 2000-26, 2000-17 IRB 954 (April 10, 2000)]

Rev. Proc. 2000-22
[I.R.C. §446]

> ☞ **Small businesses with average gross receipts of $1,000,000 or less may use the cash method.**

Purpose. The IRS issued Rev. Proc. 2000-22, 2000-20, IRB 1008, to provide procedures for taxpayers with average annual gross receipts of $1,000,000 or less to elect the cash method of accounting. Procedures for obtaining automatic consent to change accounting methods are also provided.

Background. **I.R.C. §446 allows a taxpayer to select the method of accounting it will use to compute its taxable income, provided it clearly reflects income.** Treas. Reg. §1.446-1(c)(2)(I) requires that a taxpayer use an accrual method of accounting with regard to purchases and sales of merchandise whenever accounting for inventories is required.

I.R.C. §471 requires the use of inventories if necessary to clearly determine income of the taxpayer. Treas. Reg. §1.471-1 requires accounting for inventories when the production, purchase, or sale of merchandise is an income-producing factor in the taxpayer's business.

Treas. Reg. §1.162-3 requires taxpayers carrying non-incidental materials and supplies on hand to deduct only the cost of the materials and supplies actually consumed and used in operations during the tax year.

I.R.C. §263A generally requires that direct costs and an allocable portion of indirect costs be included in the cost of inventory.

Small Taxpayer Exception. **Taxpayers with average annual gross receipts of $1,000,000 or less that don't regularly use a non-cash method of accounting for books, records, and reports (including financial statements) are not required to account for inventories under I.R.C. §471 or to use an accrual method under I.R.C. §446. Preparing financial statements using an accrual method on an isolated basis, such as a one-time basis to obtain a bank loan, will not violate this conformity requirement.**

Taxpayers that do not want to account for inventories must treat merchandise inventory in the same manner as materials or supplies that are not incidental under Treas. Reg. §1.162-3. That is, **the**

taxpayer may deduct from gross income the cost of materials and supplies only in the amount that they are actually consumed and used in operations during the taxable year. Section 263A does not apply to such merchandise inventory.

Average Annual Gross Receipts Defined. A taxpayer has average annual gross receipts of $1,000,000 or less if, for each prior tax year ending on or after December 17, 1998, **the taxpayer's average annual gross receipts for the 3-tax-year period ending with the applicable prior tax year** do not exceed $1,000,000. Gross receipts for purposes of this procedure are consistent with the definition in Treas. Reg. §1.448-1T(f)(2)(iv). Thus, **gross receipts include all receipts derived from all of the taxpayer's trades or businesses that must be recognized under the method of accounting actually used by the taxpayer for that tax year for federal income tax purposes.** Gross receipts include total sales (net of returns and allowances), and all amounts received from services, interest, dividends, and rents. However, **gross receipts do not include sales tax or other similar state and local taxes** if the tax is legally imposed on the purchaser of the good or service and the taxpayer merely collects and remits the tax to the taxing authority.

Gross receipts must be aggregated for taxpayers treated as a single employer under I.R.C. §§52(a) or (b) or I.R.C. §§414(m) or (o).

Taxpayers in existence for less than 3 years determine average annual gross receipts for the number of years actually in existence (including short years). Gross income for short tax years must be annualized.

Change in Accounting Method. A taxpayer that qualifies for the small taxpayer exception and wants to change to the cash method must follow the automatic change in accounting method provisions of Rev. Proc. 99-49, 1999-52 IRB 725 (or its successor) with certain modifications. Taxpayers under examination before an appeals office or before a federal court with respect to any income tax issue must provide a copy of Form 3115, Application for Change in Accounting Method, to the examining agent, appeals officer, or counsel for the government at the same time that it files Form 3115 with the national office.

A taxpayer making a change for its first tax year ending on or after December 17, 1999 and filing its original federal income tax return before July 15, 2000 gets automatic approval for the change by completing Form 3115 in duplicate and attaching the original copy to an amended return filed no later than November 13, 2000. Taxpayers should write "Filed under Rev. Proc. 2000-22" at the top of the form.

Taxpayers that qualify for the small taxpayer exception and don't want to account for inventories must change the taxpayer's inventory method to treat merchandise inventory in the same manner as a material or supply that is not incidental. Taxpayers may file a single Form 3115 for both changes to the cash method and change of inventory method.

Taxpayers that cease to qualify for the small taxpayer exception are required to account for inventories and must change to an inventory method that complies with I.R.C. §§263A and 471 and an accrual method for sales and purchases of merchandise. Form 3115 must be filed.

Effective Date. This revenue procedure is effective for tax years ending on or after December 17, 1999.

[Rev. Proc. 2000-22, 2000-20 IRB 1008 (May 13, 2000)]

Osteopathic Medical Oncology and Hematology, P.C. v. Commissioner
[I.R.C. §§446 and 471]

> ☞ **Cash method was allowed. Drugs weren't "merchandise" since drug administration was an indispensable and inseparable part of health care provider's medical services.**

Facts. Osteopathic Medical Oncology and Hematology, P.C. (OMOH), a cash-method taxpayer, is a professional medical corporation specializing in oncology and hematology. At each of three offices, OMOH stores chemotherapy drugs and has the staffing, equipment, and supplies necessary to administer chemotherapy treatments. Under state law, the chemotherapy drugs must be prescribed by a doctor and may be sold only by a licensed pharmacist. OMOH is not a licensed pharmacist and may not lawfully sell the drugs. OMOH may use the drugs during the performance of its chemotherapy services. OMOH regularly purchases chemotherapy drugs from suppliers to insure that it has enough on hand to administer prescribed treatments and generally maintains about a 2-week supply of chemotherapy drugs. OMOH's patients are examined by one of their physicians, who prescribes the necessary chemotherapy treatment. The chemotherapy treatments cannot be self-administered. A nurse generally administers the treatment and a physician is always on site to respond to emergencies. OMOH generates a charge sheet for each patient, which itemizes the type and cost of the drugs administered and all professional services rendered. Medicare and private insurance provides coverage for most OMOH patients. The charge sheets are specific as to the particulars of chemotherapy treatments, in compliance with the guidelines of Medicare and the private insurance industry. Patients are billed for the copayments or for other charges not covered by insurance.

OMOH has always used the cash method for purposes of both financial and tax accounting, and has never maintained an inventory. OMOH expensed as supplies the cost of all chemotherapy drugs purchased during the tax year. The IRS determined that OMOH had to inventory its chemotherapy drugs as merchandise under Treas. Reg. §1.471-1, and thus did not qualify for the cash method of accounting.

Issue. Whether drugs on hand to be administered to patients by a health care provider are "merchandise" under Treas. Reg. §1.471-1, which would require use of the accrual method of accounting for sales and purchases under I.R.C. §446

Analysis. Under Treas. Reg. §1.162-3, if a taxpayer carries incidental materials or supplies on hand for which no record of consumption is kept, the cost of such supplies and materials purchased during the year may be deducted from gross income, provided taxable income is clearly reflected by this method.

Treas. Reg. §1.471-1 provides that "inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor." In *Wilkinson-Beane, Inc.*, T.C. Memo 1969-79, aff'd 70-1 USTC ¶9173 the Court held that "merchandise" for purposes of Treas. Reg. §1.471-1 is an item acquired and held for sale. *In Abbot Labs v. Portland Retail Druggists Association, Inc.*, 425 U.S. 1(1976), it was held that the purchase of pharmaceutical products that are dispensed to and consumed by a patient is a purchase of supplies for the hospital's "own use." In *Hospital Corporation of America v. Commissioner*, 107 T.C. 116, 143145 (1996), the Tax Court held that the income attributable to the pharmaceuticals and various medical supplies frequently used by the personnel of the taxpayer/hospital while performing medical services was not income from the sale of goods and that those items were "inseparably connected" to the taxpayer's services.

Holding. Chemotherapy drugs administered by a health care provider to its patients were not "merchandise" under Treas. Reg. §1.471-1 since the health care provider administered the drugs as an "integral, indispensable and inseparable" part of the performance of its medical services. The taxpayer may report all its income and expenses under the cash method.

[*Osteopathic Medical Oncology and Hematology, P.C.*, 113 T.C. No. 26]

IRS Acquiesced. The IRS has acquiesced in the result reached by the Tax Court in *Osteopathic Medical Oncology and Hematology, P.C.* The IRS agrees that, under circumstances comparable to those in this case, prescription drugs or similar items administered by health care providers are not merchandise within the meaning of Treas. Reg. §1.1471-1. However, the IRS said that under Treas. Reg. §1.162-3, a similarly situated health care provider may be required to treat the cost of drugs as deferred expenses that are deductible only in the year used or consumed.

Von Euw & L.J. Nunes Trucking, Inc. v. Commissioner.
[I.R.C. §§446 and 471]

☞ **Inventories and accrual method are required, even though there are usually no goods on hand at the end of the year.**

Facts. Von Euw & L.J. Nunes Trucking, Inc. (Trucking) **acquires and transports sand and gravel for its customers**–various contractors and developers–who use the sand and gravel to construct foundations for streets, houses, and buildings. **Most of the customers depend on Trucking to both acquire and transport the sand and gravel from storage sites to the customers' construction sites.** Some of the customers hire Trucking only for its transportation services.

On Trucking's federal corporate income tax return, the business activity was described as "sales" and its product as "construction materials." Trucking maintained its books and records on the accrual method of accounting and reported its income for federal tax purposes on the cash method. **In computing the cost of goods sold, Trucking reported purchases, cost of labor, and no beginning or ending inventories. The IRS determined that Trucking's use of the cash method of accounting did not clearly reflect income.**

Issue. Whether the IRS abused its discretion by requiring the taxpayer to change its method of accounting from the cash method to the accrual method, which requires the use of inventories for tax purposes

Analysis. Treas. Reg. §1.446-1(c)(2)(1) provides that a taxpayer required to use inventories must also use the accrual method of accounting with regard to purchases and sales. Under I.R.C. §471 and Treas. Reg. §1.471-1, a taxpayer must account for inventories if the production, purchase, or sale of merchandise is an income-producing factor in the taxpayer's business and the taxpayer has acquired title to the merchandise. In *Wilkinson-Bean, Inc. v. Commissioner*, T.C. Memo 1969-79, aff'd 70-1 USTC ¶9173, the Court held that merchandise, as used in Treas. Reg. §1.471-1, is an item acquired and held for sale. The Court also found that merchandise, the cost of which (in different taxable years) constituted 14.7% and 15.4% of the taxpayer's gross receipts, was an income-producing factor in the taxpayer's business. In *Knight-Ridder Newspapers, Inc. v. United States*, 84-2 USTC 9827, the Court found that merchandise, the cost of which constituted 17.6% of the taxpayer's total revenues, were to be considered an income-producing factor. **The cost of Trucking's sand and gravel constituted at least 31% of their gross receipts.**

Holding. The IRS did not abuse its discretion under I.R.C. §446 in requiring a corporation that acquired and delivered sand and gravel from storage sites to its customers' construction sites to change from the cash to the accrual method of accounting. **The taxpayer acquired title to the sand and gravel, which constituted merchandise that was an income-producing factor in its business; thus, it had to account for inventories and report its taxable income using the accrual method.** The taxpayer primarily sold the sand and gravel, and incidentally provided the service of transporting those items. Based on the state Commercial Code, the taxpayer's characterization as a seller, and its failure to dispute the transfer of title, it acquired title to the sand and gravel that it purchased from its suppliers.

[*Von Euw & L.J. Nunes Trucking Inc. v. Commissioner*, T.C. Memo 2000-114]

RACMP Enterprises, Inc. v. Commissioner
[I.R.C. §§446 and 471]

☞ **IRS abused its discretion in requiring contractor to use the accrual method.**

Facts. RACMP Enterprises, Inc. is a **licensed contractor that constructs, places, and finishes concrete foundations, driveways, and walkways.** When RACMP bids a job, it calculates the bid price by figuring the cost of labor and materials required plus a margin for profit based on the cost of the labor, the amount of materials, and the complexity of the job. The contract stipulates that RACMP agrees to furnish sufficient labor, materials, tools, equipment, and services and to properly perform the work in a sound workmanlike and substantial manner. RACMP constructed the concrete forms out of lumber in accordance with the developer's blueprints. RACMP then used fill sand and drain rock within the forms and placed wire mesh, rebar, and other hardware in the forms. Once the formwork was inspected and accepted by the developer, RACMP ordered delivery of the ready-mix concrete. **RACMP does not manufacture, deliver, or store this concrete. The supplier poured the concrete directly into the form.** RACMP then installed anchor bolts and performed other finishing work. **RACMP was not left with any concrete on hand at the end of the day.** A single invoice was submitted to the developer for the completed work, along with each supplier's invoice and lien release form. **The developer issued a check payable to RACMP and each supplier for the cost of materials, as stated on the suppliers' invoices and lien releases. RACMP endorsed each joint check and forwarded it to the appropriate supplier without depositing or otherwise cashing them.** The developer paid for the construction work in a two-part process. **The developer also issued a check payable only to RACMP for the balance of its invoice.**

RACMP used the cash method of accounting, reporting income for payments received from developers, and deducted the cost of materials when paid. The **IRS determined that the material** RACMP used in its construction activity was **merchandise that was income-producing and required RACMP to use the accrual method of accounting** to clearly reflect its income.

Issues

1. Whether the materials provided by petitioner in accordance with its contract to construct and place concrete foundations, driveways, and walkways are merchandise within the meaning of Treas. Reg. §1.471-1
2. Whether respondent abused his discretion in determining that taxpayer's use of the cash method of accounting did not clearly reflect its income

Analysis. Under Treas. Reg. §1.162-3, if a taxpayer carries incidental materials or supplies on hand for which no record of consumption is kept, the cost of such supplies and materials purchased during the year may be deducted from gross income, provided taxable income is clearly reflected by this method.

Treas. Reg. §1.471-1 provides that "in order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor." In *Wilkinson-Beane, Inc.*, T.C. Memo 1969-79, aff'd 70-1 USTC 9173 the Court held that "merchandise" for purposes of Treas. Reg. §1.471-1 is an item acquired and held for sale.

In *Galedridge Construction., Inc. v. Commissioner*, T.C. Memo 1997-240, the Court found that consumption of a material in the performance of a service or in a manufacturing process is indicative that the material is a supply, not merchandise held for sale. In *Osteopathic Medical Oncology and Hematology, P.C. v. Commissioner*, 113 T.C. 385, the Court held that where the inherent nature of the taxpayer's business is that of a service provider and the taxpayer uses materials that are an indispensable and inseparable part of the rendering of its services, the materials are not "merchandise" under Treas. Reg. §1.471-1.

Foundations, driveways, and walkways are improvements to real property. Courts have held previously that improvements to real property are not merchandise. [See *Homes by Ayres v. Commissioner*, 795 F.2d 832 (9th Cir. 1986), *W.C. & A.N. Miller Dev. Co. v. Commissioner*, 81 T.C. 630.]

Holding

Issue 1. The Tax Court concluded that **RACMP was inherently a service provider and that the material provided by RACMP was indispensable to and inseparable from the provision of that service, that the materials lost their separate identity to become part of the real property in the construction activity**, and **that, in substance, no sale of merchandise occurred between RACMP and its clients**. The Court found that **RACMP did not hold merchandise for sale**, and that there was no sale of merchandise between RACMP and its clients.

Issue 2. The Court held that the **IRS abused its discretion** in determining that RACMP's method of accounting did not produce a clear reflection of income. The Court noted that the cash method of accounting has been widely used throughout the contracting industry and accepted by the IRS and the Tax Court. The Court also noted that the IRS did not assert that RACMP attempted to unreasonably prepay expenses or purchase supplies in advance, and the evidence shows the contrary.

[*RACMP Enterprises, Inc. v. Commissioner*, 114 T.C. No. 16 (Mar. 30, 2000)]

Practitioner Note See also *Jim Turin & Sons, Inc. v. Commissioner*, 2000-2 USTC ¶50,610 (CA-9, July 21, 2000) and *Vandra Bros. Construction Co., Inc. v. Commissioner*, T.C. Memo 2000-233 [CCH Dec. 53,975(M)] for similar cases with the same outcome.

Rev. Proc. 99-49
[I.R.C. §§56, 162, 165, 166, 167, 168, 171, 174, 197, 263, 263A, 404, 446, 451, 454, 455, 461, 471, 472, 475, 481, 585, 1272, 1273, 1278, 1281, 1363, 601.201, and 601.204]

☞ **IRS updates procedures for automatic accounting method changes.**

Purpose. This revenue procedure provides the **procedures by which a taxpayer may obtain automatic consent to change its methods of accounting.** This revenue procedure clarifies, modifies, amplifies, and supersedes Rev. Proc. 98-60, 1998-51 IRB 16. It also consolidates automatic consent procedures for changes in several methods of accounting that were published subsequent to the publication of Rev. Proc. 98-60, and provides new automatic consent procedures for changes in several other methods of accounting. **A taxpayer complying with the provisions of the new revenue procedure has IRS consent to change its method of accounting** under I.R.C. §446(e).

Significant Changes

1. The term "district director" is now defined to include the district director or other appropriate examining office or official. This change was made to accommodate anticipated future changes in the organizational structure of the Internal Revenue Service.
2. The automatic consent procedure does not apply if the taxpayer would be required to accelerate the I.R.C. §481(a) adjustment in the year of change. However, this limitation does not apply to changes to permissible methods of accounting for depreciation.
3. **The additional statement required by Rev. Proc. 98-60 has been discontinued**. Therefore, taxpayers requesting automatic consent to change an accounting method no longer need to attach a written statement agreeing to all of the terms and conditions in the revenue procedure and stating the reason for claiming the adjustment period over which the taxpayer agrees to take the applicable I.R.C. §481(a) adjustment into account.
4. **A taxpayer under examination may change its method of accounting under this revenue procedure if the district director consents to the filing of the application**. The district director will consent to the filing of the application unless the district director determines that the method of accounting to be changed would ordinarily be included as an item of adjustment in the examination year(s). **The office conducting the examination gives consent to the filing of the application, rather than to the change itself**. This is consistent with the current authority of such office, upon examination, to deny the change if the taxpayer fails to comply with all the applicable provisions of this revenue procedure.

5. Certain changes in the method of accounting for depreciation or amortization for purposes of computing alternative minimum taxable income and adjusted current earnings under I.R.C. §56 are now covered by the procedure.
6. **Small resellers and taxpayers eligible to use the simplified resale method that are required to use an inventory method of accounting may use the new procedure for consent to change to an overall accrual method, provided they use a proper inventory method**.
7. The automatic consent procedure may not be used by a taxpayer with two or more trades or businesses to change to an overall accrual method unless the taxpayer uses or adopts the same overall accrual method for each trade or business.
8. The automatic consent procedure is now available for changes in the method of accounting for state unemployment taxes and railroad retirement taxes.
9. The automatic consent procedure is now available for the following changes in methods of accounting:

   a. revocation of an I.R.C. §171(c) election to amortize bond premium on taxable bonds
   b. accounting for deferred compensation
   c. accounting for accrual of interest on nonperforming loans
   d. accounting for I.R.C. §467 rental agreements
   e. elections to use the mark-to-market method of accounting under I.R.C. §§475(e) or 475(f)
   f. revocation of an I.R.C. §1278(b) election

Effective Date. Rev. Proc. 99-49 is generally effective for tax years ending on or after December 27, 1999.

[Rev. Proc. 99-49, IRB 1999-52, 725 (December 27, 1999)]

USFreightways Corporation v. Commissioner
[I.R.C. §§162, 263, and 446]

☞ **Accrual taxpayer could not expense one-year license fees and premiums benefiting future tax periods.**

Facts. USFreightways Corporation (USF) is engaged in the business of transporting freight for hire by trucks throughout the United States. **USF was required to purchase various licenses, permits, and fees with effective periods of up to one year. The expiration date of some of the licenses fell within the next taxable year. USF also purchased insurance coverage that extended into future tax years.**

USF **used the accrual method of accounting** for purposes of federal income taxes, book accounting, and financial reporting, and uses a 52/53-week fiscal year. For book and financial reporting purposes, USF expensed the licenses and insurance ratably over the periods covered. However, for federal **tax purposes, USF deducted the full amount expended for licenses and insurance in the year of payment**. The IRS disallowed the deduction for expenditures for licenses and insurance that benefited a future tax year and determined that these expenditures must be capitalized.

Issue. Whether an accrual method taxpayer may deduct costs expended for licenses, permits, fees, and insurance in the year paid rather than amortizing such costs over the taxable years to which they benefit

Analysis. I.R.C. §446(a) provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

I.R.C. §461(a) provides that the amount of any deduction shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

USF argued that since the benefit of the licenses and insurance extended less than one year into the following tax period, the costs did not relate to property having a useful life substantially beyond the tax year, and should not have to be capitalized under I.R.C. §263. **The Court rejected USF's interpretation of the Treas. Reg. §1.263(a)-2(a) reference to a benefit lasting "substantially beyond" the tax year as meaning that capitalization is required only when the benefit lasts more than one year beyond the tax year**. The Court noted that several cases cited by USF as support for the one-year rule are contrary to USF's position. Two of these cases suggest that an expenditure should be capitalized if the expenditure benefits a future period (see *Jack's Cookie Co. v. United States,* 79-1 USTC ¶9350 and *American Dispenser Co. v. Commissioner,* 68-1 USTC ¶9431).

The Court noted **that even if a one-year rule were widely recognized, it would not apply to an accrual-basis taxpayer**. In *Johnson v. Commissioner,* 108 T.C. 448 (1997), aff'd in part and rev'd in part on other grounds, 184 F3d 786 (CA-8 1999), a taxpayer using the accrual method purchased insurance policies covering periods of one to seven years. The court made no attempt to ascertain which of the policies, such as those covering only one year, would expire within the following tax year. Instead, the court ruled that "to the extent that part of any premium was allocable to coverage for subsequent years, it must be capitalized and amortized by deductions in those years."

Holding. The Court held that the taxpayer was not entitled to currently deduct license and insurance expenses allocable to the following taxable year.

[*USFreightways Corporation, F/k/a TNT Freightways Corporation and Subsidiaries v. Commissioner*, 113 T.C. No. 23 (November 2, 1999)]

Rev. Rul. 2000-7
[I.R.C. §§263 and 263A]

☞ **Cost of removing old depreciable asset is not required to be capitalized as part of cost of replacement asset.**

Issue. If the retirement and removal of a depreciable asset occurs in connection with the installation or production of a replacement asset, are the costs incurred in removing the retired asset required to be capitalized under I.R.C. §§263(a) or 263A as part of the cost of the replacement asset?

Facts. A telephone company replaces telephone poles in several service areas. In 2000, it incurs costs to remove and discard a telephone pole it placed in service in 1979 on property it owns, and installs a new pole where the old one was located. The telephone company also incurs costs to remove and discard a pole it placed in service in 1982 on land it does not own, and the replacement pole is installed in a different location from the old one.

Analysis. The costs of removing an asset have been historically allocable to the removed asset and generally deductible when the asset is retired and the costs are incurred. However, I.R.C. §280B requires that the costs of demolishing buildings be added to the basis of the land, and Treas. Reg. §1.165-3(a) requires capitalization of demolition costs when the taxpayer acquires an asset with the intent to demolish it. **The removal costs of both poles are properly allocable to the retired poles, and do not relate to assets having a useful life in the taxpayer's business extending substantially beyond the taxable year in which the removal costs are incurred** [see Treas. Reg. §§1.65-3(b) and 1.167(a)-1(c)].

The fact that the poles are retired as part of a replacement project does not mean that the removal costs are required to be capitalized under I.R.C. §263A.

Holding. If the retirement and removal of a depreciable asset occurs in connection with the installation or production of a replacement asset, the costs incurred in removing the retired

asset are not required to be capitalized under I.R.C. §§263(a) or 263A as part of the cost of the replacement asset.

Application. If a taxpayer changes its accounting method to conform to this ruling, it is treated as a change in accounting method under I.R.C. §§446 and 481. The provisions **for automatic change in accounting method of Rev. Proc. 99-49,** 1999-52 IRB 725 must be followed, except that the scope limitations in section 4.02 of the procedure don't apply.

[Rev. Rul. 2000-7, 2000-9 IRB 712 (February 8, 2000)]

ACTIVITIES NOT FOR PROFIT

Davis v. Commissioner
[I.R.C. §183 and 6662]

☞ **Horse-showing activity held for profit–taxpayers had an adequate business plan.**

Facts. In 1990, the taxpayers began to operate their horse activity when they acquired two Arabian geldings. **They drafted a business plan for 1991–1997 for their horse activity.** The business plan for the years in issue was to buy inexpensive horses and try to increase their value by training and showing them. **The plan analyzed costs to raise and train a horse. It included plans for breeding and showing the horses and building facilities for them.** The taxpayers concluded that in order to be profitable they had to raise extraordinary horses. They studied the bloodlines and history of Arabian horses back 100 years. They believed that it would take 10–13 years before the activity would be profitable, partly because it can take up to 5 years for an Arabian horse to reach maturity The taxpayers registered as breeders with the Arabian Registry and members of several professional associations. The taxpayers made improvements to their residence for use in the horse activity. The husband did most of the work himself. The improvements cost $23,000, with FMV in 1998 of $47,000. In 1995, Mr. Davis spent over 1,600 hours and Mrs. Davis spent over 700 hours on the horse activity. **The taxpayers did not keep a separate bank account for the horse activity, but did keep records of income and expenses. An appraisal of their horses in 1998 showed unrealized appreciation of $107,800.** Neither the taxpayers, their children, nor their grandchildren rode the horses for pleasure. The taxpayers find the horse activity rewarding. **They enjoy showing, competing, and visiting with other horse people. However, they do not enjoy the amount of time driving to shows or training away from home.**

Issue. Whether the taxpayers operated their Arabian showhorse-breeding activity for profit in 1994, 1995, and 1996

Analysis. In deciding whether the taxpayers operated the horse activity for profit, the court applied the **nine factors provided in Treas. Reg. §1.1.83-2(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 conducted their horse activity in a businesslike manner. The taxpayers had a business plan and generally followed that plan. The plan appropriately considered the costs of operating the activity. Although the plan did not include a detailed written budget, their overall plan was evidenced by their actions. In *Phillips v. Commissioner,* T.C. Memo 1997-128, the Court found that taxpayers engaged in Arabian horse-breeding activity for profit; their actions constituted a business plan despite the fact that they had no financial plan or written budget. **The taxpayers consulted and relied on a well-know expert, built a barn, stable, and arena, registered with the Arabian Registry as breeders, and filmed their horses' performances at horse shows to critique performance**.

The taxpayers devoted much time and effort to conducting the activity. **The appreciation in their horses and farm improvements was substantial in relation to their losses** and they reasonably expected appreciation to exceed their losses. The taxpayers had successfully managed other businesses.

Holding. After reviewing the nine factors, the court found that the taxpayers engaged in their horse activity for profit in the years at issue, particularly because of the **time and effort taxpayers spent** on the activity, their reasonable expectation of profit from appreciation of the assets used in the activity, **their business plan,** and **the startup nature of their activity.** The court noted that the holding should not be taken to mean that taxpayers would prevail in any later year without further changes in their operating methods or results.

[*Harvey J. Davis and Patricia A. Davis v. Commissioner,* T.C. Memo 2000-101 (March 27, 2000)]

Practitioner Note. Several other current cases involving horse activities were found to be **not-for-profit** and one of the factors frequently mentioned by the court was the **lack of a business plan.** [See *Fred B. and Georgia Elane Berry v. Commissioner,* T.C. Memo 2000-109 (March 29, 2000), *Robert Bryan Hudnall and Victoria A. Hudnall v. Commissioner,* T.C. Memo 1999-326 (September 29, 1999), *Courtney and Brenda Lundquist v. Commissioner,)*, 77 TCM 1556, aff'd without published opinion 211 F3d 600, *Sandra J. Brannon v. Commissioner,* T.C. Memo 2000-76 (March 6, 2000), *James C. Dodge and Vivian C. Dodge v. Commissioner*, 75 TCM 1914, aff'd 99-2 USTC ¶50,809, *Louis J. Novack v. Commissioner*, T.C. Memo 2000-234 (August 2, 2000), and *Richard E. Cramer v. Commissioner*, T.C. Memo 2000-229 (July 31, 2000).]

Practitioner Note. In view of the emphasis placed by the Tax Court presently on business plans and potential hobby activities, practitioners should strongly encourage taxpayers entering an activity that may be subject to scrutiny to develop and document a business plan prior to entering the activity. Reference material on developing business plans is available from tax and accounting publishers.

Nissley v. Commissioner
[I.R.C. §183]

☞ **Amway distributorship activity was a not-for-profit activity.**

Facts. The taxpayers, both licensed CPAs, operated an Amway distributorship beginning in 1991. The taxpayers spent the **majority of their time trying to recruit and retain downline distributors, and very little time actually selling Amway products.** Their Amway income was from bonuses earned from the sale or personal consumption of Amway products from downline distributors. **The taxpayers never earned a profit from their Amway activity.** They claimed losses every year from 1991 through 1998. Taxpayers claimed deductions for the cost of attending Amway conventions and seminars on a regular basis in cities such as New York, Denver, Atlanta, Orlando, and Minneapolis. The taxpayers had no previous experience with an Amway-type activity prior to being recruited into Amway. **The taxpayers did not maintain a written business plan or a written budget for their Amway activity.** A major reason why many individuals remain committed to Amway is the congenial sense of family and the gratifying motivational feeling that they derive from participating in the activity. The taxpayers have no intention of getting out of Amway.

Issue. Whether taxpayers engaged in their Amway activity with a profit motive within the meaning of I.R.C. §183

Analysis. In deciding whether the taxpayers operated their Amway activity for profit, the court did not apply all nine of the factors provided in Treas. Reg. §1.1.83-2(b), but some of the more important ones informed their decision (see *Harvey J. Davis and Patricia A. Davis v. Commissioner,* above, for a list of the nine factors).

The history of consistent and substantial losses indicate the lack of a profit motive [see *Golanty v. Commissioner*, 72 T.C. 411 (1979) aff'd without published opinion 647 F.2d 170 (9th Cir. 1981)]. For eight years the taxpayers incurred losses, which averaged $25,000 per year. There was no significant discernible trend in the taxpayers' losses. **Even though losses have decreased in recent years, gross income has decreased at a faster rate**.

The taxpayers did not conduct their activity in a businesslike manner since they did not employ elementary business practices, and did not maintain a written business plan, written budget, or monthly report of expenses.

Since the taxpayers earn substantial salaries from their full-time employment, they receive **substantial tax benefits from the Amway activity losses**. Additionally, there **are significant elements of personal pleasure** attached to the activities of an Amway distributorship [see *Brennan v. Commissioner,* T.C. Memo 1997-60].

Holding. The court held that the taxpayers failed to prove that they engaged in their Amway activity for profit within the meaning of I.R.C. §183.

[*Kenneth J. Nissley and Terri C. Connor-Nissley v. Commissioner,* T.C. Memo 2000-178 (May 30, 2000)]

> **Note.** A similar result was found in *Michael A. and Colleen Ogden v. Commissioner,* T.C. Memo 1999 397 (December 7, 1999). Again, the taxpayers' Amway distributorship activity was found not to have a profit motive.

Tobin v. Commissioner
[I.R.C. §183]

> ☞ **Farm and gardens were not separate activities and were operated with a profit motive.**

Facts. The taxpayer owned 3,300 acres of farmland on which she raised cattle and horses and grew corn, wheat, hay, and tobacco. **After looking for other sources of revenue to replace tobacco as her main cash crop, taxpayer developed part of her farm into a public display garden.**

Taxpayer added an addition to her residence, including a conservatory and an office. Taxpayer managed the farm and display gardens. **Employees generally worked both on the farm and in the gardens. Some equipment and facilities were used for both the farm and the gardens**. The taxpayer had only one bank account, which she used for the farm, display gardens, and for her personal expenses.

Issues

1. Whether the taxpayer's display gardens undertaking and farming undertaking are one activity
2. Whether depreciation of the addition to taxpayer's residence, which includes the conservatory used by the display gardens, is subject to the restrictions of I.R.C. §280A
3. Whether taxpayer is liable for the accuracy-related penalty for negligence under I.R.C. §6662(c)

Analysis

Issue 1. The court applied **factors previously used in deciding whether a taxpayer's characterization of two or more undertakings as one activity is unreasonable** for purposes of I.R.C. §183, including the following:

a. whether the undertakings share a close organizational and economic relationship
b. whether the undertakings are **conducted at the same place**
c. whether the undertakings were **part of a taxpayer's efforts to find sources of revenue from his or her land**
d. whether the undertakings were formed as separate business
e. whether one undertaking benefited from the other
f. whether the taxpayer used one undertaking to advertise the other
g. the degree to which the undertakings shared management
h. the degree to which **one caretaker oversaw the assets of both undertakings**
i. whether the taxpayers used the same accountant for the undertakings
j. the degree to which the undertakings shared books and records

[See *Keanini v. Commissioner,* 94 T.C. 41(1990); *Estate of Brockenbrough v. Commissioner,* T.C. Memo 1998-454; *Hotle v. Commissioner,* T.C. Memo 1994-592; *DeMendoza v. Commissioner,* T.C. Memo 1994-314; and *Scheidt v. Commissioner,* T.C. Memo 1992-9.]

Issue 2. I.R.C. §280A(c)(1)(A) allows a taxpayer to deduct home office expenses if the taxpayer uses the home office exclusively and regularly as the principal place of any trade or business. I.R.C. §280A(c)(5) limits a taxpayer's deductions for the business use of a residence to the amount that the gross income from the business use of the residence exceeds the amount of expenses which are allowable whether or not the residence was used for business (e.g., taxes and interest) plus deductions for expenses of the business not allocable to the business use of the residence.

Issue 3. I.R.C. §6662(b)(1) imposes a 20% penalty of the underpayment attributable to negligence. Good faith reliance on the advice of a competent, independent tax professional may offer relief from the imposition of the negligence penalty [see *United States v. Boyle*, 469 U.S. 241 (1985); *Leonhart v. Commissioner*, 414 F.2d 749 (4th Cir. 1969) aff'g T.C. Memo 1968-98; and *Otis v. Commissioner*, 73 T.C. 671 (1980)].

Holding

Issue 1. The court held that **taxpayer operated the farm and display gardens as one activity**, stating the following reasons: **the taxpayer created and developed the gardens in an attempt to replace tobacco as the farm's main cash crop**; both the gardens and the farm required the planting, tending, and harvesting of plants or crops; **taxpayer managed both undertakings as one activity**; **the farm and gardens shared the same employees, equipment, and same accountant**; taxpayer used the same checking account and books for both undertakings. The IRS conceded that if the court concluded that the taxpayer operated the two undertakings as one activity, the activity was operated for profit.

Issue 2. The court held that since the addition was part of the taxpayer's residence, the limitations of I.R.C. §280A apply to the addition.

Issue 3. The court held that taxpayer was not liable for the accuracy-related penalty since the taxpayer relied on the advice of a competent, independent tax professional.

[*Mary Ann Tobin v. Commissioner,* 78 TCM 517 (September 30, 1999)]

AGRICULTURE

Notice from IRS

> ☞ **Payments made directly to the IRS to cover tax due on USDA discrimination settlement payments may not have been applied correctly.**

A group of farmers sued the Department of Agriculture claiming discrimination in granting of farm loans. Approximately 776 claims have been settled. **The farmers received a payment in 1999 (most received $50,000, but some received higher amounts).**

As part of the settlement, a payment to help cover tax due on the award was paid directly to the IRS on behalf of each farmer. **For most of the farmers the amount of this payment was $12,000**. The IRS is in the process of crediting these payments to the taxpayers' account.

Notes. These cases are being worked in the Philadelphia Service Center. In some cases, the credits may not have been applied properly and some farmers may have received bills. Once the problem was identified, action was initiated to prevent further bills from being issued. **An individual involved in this settlement who receives an incorrect bill should call the 1-800-829-1040 phone number and identify him or herself as part of the "USDA Settlement"** The caller will need to give his or her complete name, address, daytime phone number, and state the best time to be reached by IRS. The caller should expect to receive a call back within three business days. All taxpayers should be contacted by phone.

Information should be sent to the following address:
Internal Revenue Service
Philadelphia Customer Service
P.O. Box 245
Drop Point 6114 Philadelphia, PA 19020
No phone number is available.

Notice 2000-45
[I.R.C. §263A]

> ☞ **IRS provides a list of plants that have a nationwide weighted-average preproductive period of more than two years.**

Purpose. This notice provides guidance to farm taxpayers in determining whether a plant has a preproductive period in excess of 2 years for purposes of I.R.C. §263A(d).

Background. 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. I.R.C. §263A(d)(1)(A)(ii) provides that I.R.C. §263A does not apply to a plant having a preproductive period of 2 years or less and that is produced by a taxpayer in a farming business. I.R.C. §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 legislative history of I.R.C. §263A explains that Congress expected the Treasury Department to periodically publish a list of the preproductive periods of various plants based on the nationwide weighted averages for such plants [see H.R. Rep. No. 426, 99th Cong., 1st Sess. 628 (1985), 1986-3 (vol. 2) C.B. 628]. A proposed list was included in the preamble of Prop. Reg. 1.263A-4. The IRS and Treasury Department received and considered comments relating to the proposed list.

Based on information provided by the U.S. Department of Agriculture, the IRS and Treasury Department have determined that **plants producing the following crops or yields have a nationwide weighted-average preproductive period in excess of 2 years**:

Almonds	Dates	Mangoes	Plums
Apples	Figs	Nectarines	Pomegranates
Apricots	Grapefruit	Olives	Prunes
Avocados	Grapes	Oranges	Raspberries
Blackberries	Guavas	Papayas	Tangelos
Blueberries	Kiwifruit	Peaches	Tangerines
Cherries	Kumquats	Pears	Tangos
Chestnuts	Lemons	Pecans	Walnuts
Coffee beans	Limes	Persimmons	
Currants	Macadamia nuts	Pistachio nuts	

This is **not an all-inclusive list** of plants that have a nationwide weighted-average preproductive period in excess of 2 years. In the case of other plants grown in commercial quantities in the United States, the nationwide weighted-average preproductive period must be determined based on available statistical data. **The IRS intends to update this list periodically as needed.**

Ltr. Rul. 199937050 (June 22, 1999)
[I.R.C. §1033]

☞ **Farmer's accidental poisoning of plants qualifies as an involuntary conversion.**

Facts. Taxpayer **grows plants and trees** that are harvested and sold in taxpayer's business. The taxpayer **used a chemical that destroyed them and caused soil contamination.** The taxpayer sued the chemical manufacturer for a defective product and obtained a cash settlement from the manufacturer.

Issue. Whether the destruction of the taxpayer's plants and trees and the receipt of damages from the manufacturer **qualifies as an involuntary conversion** under I.R.C. §1033(a)(2)(A)

Analysis. Rev. Rul. 54-395, 1954-2 C.B. 143 holds that loss of cattle by accidental poisoning amounted to destruction of property within the meaning of I.R.C. §1033(a). Another example of destruction includes losses of honeybees from application of pesticides on nearby property (see Rev. Rul. 75-318, 1975-2 C.B. 25.)

Holding. The IRS concluded that the damages qualify for involuntary conversion and that if the taxpayer makes the election and timely replaces the converted property with property similar or related in service or use to such property, it will recognize gain only to the extent the amount realized on such conversion exceeds the cost of the replacement property.

Prop. Reg. §1.1301-1
[I.R.C. 1301]

> ☞ **IRS has issued proposed regulations to explain income-averaging rules for farmers.**

IRS has issued proposed regulations under I.R.C. §1031, which allows an individual farmer to compute his current year tax liability by averaging all or a portion of his income from farming over the prior three-year period. As proposed, the regulations apply to any tax period ending on or after the date they are published as final regulations; however, taxpayers may rely on the rules in the proposed regulations for earlier periods.

> **Practitioner Note.** There is a major discussion of these regulations in Chapter 5, Agricultural Issues. See page 113.

ALIMONY/PROPERTY SETTLEMENT

Young v. Commissioner
[I.R.C. §§61, 212, and 1041]

> ☞ **Part of transfer to settle suit to enforce divorce agreement was taxable as discharge of indebtedness income.**

Facts. John B. Young and Louise F. Young were divorced in 1988 **and entered into a property settlement agreement in 1989** in which **Louise accepted John's promissory note for $1,500,000,** secured by a deed of trust on property that he received under the agreement. The note provided that John would make **five annual payments,** which included interest and, in case of default, would pay reasonable legal and other expenses related to collection proceedings. In 1990 **John defaulted on the note** and Louise filed a collection suit. In 1991 the court entered a judgment in her favor, awarding her principal and interest owed under the note and reasonable legal expenses. After the judgment, John paid Louise $160,000, which she reported as interest on her 1991 return.

In 1992, the parties negotiated a **settlement agreement under which John transferred a 59-acre tract of land** that he received as part of the 1989 property settlement **and Louise cancelled the judgment and surrendered the promissory note**. **The transfer of the land to Louise discharged all of John's debts to her, which totaled $2,153,845**, including $1,500,000 of note principal, $344,938 of accrued interest, $300,606 of legal expenses, and $8,300 of collection expenses.

The 1992 **agreement also granted John an option to repurchase the land for $2,265,000. John assigned the option and the party exercised the option**. Louise's attorneys received $300,000 of the sales proceeds as full payment for their legal services.

The **IRS determined that I.R.C. §1041 applies to John's transfer of the land to Louise and that the transfer discharged a $308,906 debt to Louise for legal and collection expenses** ($300,606 legal plus $8,300 collection), which is includible in Louise's gross income. The IRS determined that Louise could only deduct 30.36% of the collections and legal expenses she paid. This was calculated based on the ratio of taxable income to Louise from the transfer of $653,844 ($344,938 interest, $300,606 legal, and $8,300 collection) to total debts discharged by the transfer of $2,153,845 (i.e., $653,844 divided by $2,153,845 is equivalent to 30.36%).

Issues

1. Whether the transfer of property to resolve John and Louise's dispute that arose from their property settlement is subject to I.R.C. §1041
2. Whether the value of property transferred to Louise to discharge certain debts must be included in her gross income
3. Whether Louise is entitled, pursuant to I.R.C. §212(l), to a deduction for legal and collection expenses attributable to the collection of taxable income

Analysis

Issue 1. I.R.C. §1041 provides that no gain or loss is recognized on transfers between former spouses incident to divorce. When I.R.C. §1041 applies, the transferor's basis in the property becomes the transferee's basis under I.R.C. §1041(b)(2). **Under I.R.C. §1041(c), a transfer of property is "incident to divorce" if it either occurs within one year of the divorce or is "related to the cessation of the marriage." Treas. Reg. §1.1041-1T(b) provides that transactions occurring within 6 years of the divorce are related to the cessation of the marriage if the transfer is "pursuant to a divorce or separation instrument."** All parties agreed that the 1989 agreement was pursuant to the divorce. The court reasoned that the 1992 agreement resolved a dispute arising under the 1989 property settlement and completed the division of marital property.

Issue 2. Taxpayers generally realize taxable income when their expenses are paid by another [see *Commissioner v. Glenshaw Glass Co.,* 348 U.S. 426 (1955) and *O'Malley v. Commissioner*, 91 T.C. 352 (1988)].

Issue 3. In *Kelly v. Commissioner*, 23 T.C. 682 (1955) aff'd 228 F.2d 512 (7th Cir. 1956), the court allowed a deduction for legal expenses allocable to the recovery of taxable income.

Holding

Issue 1. The court held that the **1992 agreement was "incident to" the divorce and the transfer of the land to Louise "related to the cessation of the marriage"** under I.R.C. §1041 and its regulations.

Issue 2. The court held that **the transfer to Louise to discharge debts must be included in her gross income**.

Issue 3. The court held that Louise is entitled to a deduction for legal and collection expenses attributable to the collection of taxable income.

[*John B. Young and Martha H. Young v. Commissioner. Louise F. Young and James R. Ausman v. Commissioner*, 113 TC No. 11 (August 20, 1999)]

Read v. Commissioner
[I.R.C. §1041]

> ☞ **Taxpayer was not taxed on divorce-related stock redemption.**

Facts. Carol M. Read and William A. **Read owned all of the voting and most of the nonvoting stock of Mulberry Motor Parts, Inc. (MMP).** The Reads divorced in 1985 and **the divorce decree ordered that Carol sell to William (or at his election to MMP or the ESOP Plan of MMP) all of the outstanding stock she held in MMP,** consisting of 1,200 shares of voting stock and 12,000 shares of non-voting stock, in exchange for $200,000 plus a promissory note bearing 9% interest in the amount of $638,724. **William chose to have Carol sell the stock to MMP and to have MMP pay the cash down payment and issue the promissory note for the balance of the purchase price.**

The only income Carol reported from her transfer of stock to MMP was for the interest payments she received under the note. William did not report any income from Carol's transfer of stock to MMP. The company deducted the interest payments to Carol.

The **IRS determined that the principal payments made to Carol constituted long-term capital gain from the transfer of stock. The principal and interest payments made by MMP to Carol were determined by the IRS to be constructive dividends to William**. The IRS also determined that the interest payments made by MMP to Carol were not deductible.

William and MMP indicated in their motion that if the Court were to hold that I.R.C. §1041 applied to Carol's transfer, the IRS's determinations in regard to William and MMP should be sustained.

Issue. Whether I.R.C. §1041 applies to the transfer by Ms. Read to MMP of her stock in that company

Analysis. Treas. Reg. §1.1041-1T(c), Q&A-9 provides **three situations in which a transfer of property to a third party on behalf of a spouse (or former spouse) qualifies under I.R.C. §1041. The first situation occurs when the transfer to the third party is required by a divorce or separation instrument.** The second situation occurs when the transfer to the third party is pursuant to the written request of the other spouse (or former spouse). The third situation is where the transferor receives from the other spouse (or former spouse) a written consent or ratification of the transfer to the third party.

These regulations further provide that the deemed transfer from the non-transferring spouse (William) to the third party (MMP) is not a transaction that qualifies for nonrecognition of gain under I.R.C. §1041. In *Blatt v. Commissioner*, 102 T.C. 82, the court found the ordinary meaning of "on behalf of" to be "in the interest of" or "as a representative of." The court applied this meaning to determine whether the regulations applied to the stock transfer.

The court found that Carol was acting as William's representative in transferring her MMP stock to MMP and that Carol was acting in the interest of William in making the transfer, in that she was following and implementing his direction as reflected in his election under the divorce decree that she transfer her MMP stock to MMP. Without William's election, Carol was obligated to transfer the stock to William. Therefore, Carol's transfer was on behalf of William within the meaning of the regulations. The **court concluded that Carol's transfer of stock to MMP was a transfer of property by her to a third party on behalf of William within the first situation described in Q&A-9 of the regulations.**

Holding. The court held that I.R.C. §1041 applied to the transfer of MMP stock by Carol; therefore, **no gain shall be recognized by Carol** as a result of the transfer.

[*Carol M. Read v. Commissioner, Mulberry Motor Parts, Inc. v. Commissioner, William A. Read v. Commissioner*, 114 T.C. 14 (February 4, 2000)]

Leventhal v. Commissioner
[I.R.C. §71]

☞ **Taxpayer may deduct as alimony housing payments made "on behalf of" his wife.**

Facts. Hermine and Harvey Leventhal separated in 1987. Their attorneys exchanged letters, which proposed maintenance payments beginning in 1988. The April 1 letter discussed various payments that Harvey agreed to make, but the letter was not signed by Hermine. **The June 1 letter,** written and signed by Hermine's attorney and countersigned by Harvey's attorney, outlined specific and detailed terms under which **Harvey agreed to pay all normal and usual expenses of maintenance and operation of the home and apartment (the parties agreed to alternate residences).** No formal settlement agreement was executed until 1992. There was **no court decree of divorce or separate maintenance in effect in 1990 and 1991,** the years at issue. **Harvey claimed an alimony**

deduction for 1990 and 1991 and Hermine did not claim any alimony in gross income for those years.

The IRS issued inconsistent notices of deficiencies to Harvey and Hermine, determining that Harvey was not entitled to deduct the payments as alimony and Hermine was not entitled to exclude from gross income the disputed payments.

Issue. Whether certain payments made by Harvey constitute alimony or separate maintenance payments, includible in the gross income of Hermine under I.R.C. §71(a) and deductible by Harvey under I.R.C. §215(a)

Analysis. I.R.C. §71(b)(1)(A) defines alimony or separate maintenance payments as any payment in cash if such payment is received by (or on behalf of) a spouse **under a divorce or separation instrument. Under I.R.C. §71(b)(2), the term divorce or separation instrument means a decree of divorce or separate maintenance or a written instrument incident to such a decree, a written separation agreement,** or a decree requiring a spouse to make payments for the support or maintenance of the other spouse. **The term written separation agreement is not defined in the I.R.C., regulations, or in the legislative history.**

In *Grant v. Commissioner,* 84 T.C. 809, the court concluded that letters that do not show a meeting of the minds between the parties cannot collectively constitute a written separation agreement. However, in *Azenaro v. Commissioner*, T.C. Memo 1989-224, the court found that where one spouse assents in writing to a letter proposal of support by the other spouse, a valid written separation agreement exists. A written separation agreement may exist even though it does not enumerate a specific amount of required support, so long as there is some ascertainable standard with which to calculate support amounts [see *Jacklin v. Commissioner*, 79 T.C. 340 (1982)]. Treas. Reg. §1.71-1T(b), Q&A-6 provides that cash payments of rent, mortgage, tax, or tuition liabilities of the payee spouse made under the terms of a divorce or separation instrument will qualify as alimony or separate maintenance payments.

Holding. The court held that the April 1 letter did not constitute part of a written separation agreement within the meaning of I.R.C. §71(b)(2)(B); however, the **June 1 letter was held to constitute a written separation agreement.** Therefore, **Harvey was able to deduct all payments made for maintenance and operation of the home and half of the payments made for maintenance and operation of the apartment.** The court reasoned that since Hermine owned the home, all maintenance payments for the home and half of the maintenance payments of the apartment benefited her. **Hermine was required to include these payments in her gross income.** All other payments made by Harvey to or on behalf of Hermine were not deductible by Harvey and not includible in income by Hermine.

[*Hermine Leventhal v. Commissioner, Harvey R. Leventhal v. Commissioner*, T.C. Memo 2000-92 (March 20, 2000)]

Thomas B. Benham v. Commissioner
[I.R.C. §§71, 215, 212, 6662]

☞ **Payments made under written separation agreement qualify as alimony even though parties lived in same household.**

Facts. Thomas B. Benham and Leslie Benham were married from 1972 until their divorce in 1996. Thomas is an attorney. He had for years provided Leslie with $2,000 per month from his individual checking account to pay household bills. **Thomas filed for divorce in 1994, at which time the Benhams signed a temporary agreement in which they agreed to share the family residence and Thomas agreed to pay Leslie alimony in the amount of $2,000 per month and child support in the amount of $700 per month.** Thomas remained in the family residence through 1994 and most of 1995. During this time there were attempts to reconcile. From July 1994 through January 1995 Thomas made the agreed payments. **Thomas took alimony deductions** on his 1994 and 1995 tax returns in the amount of $12,000 and $2,000 respectively. He also deducted income tax paid in 1993 on his return for 1994 and attorney's fees and legal costs associated with his divorce action on both year's returns. Thomas conceded that he was not entitled to deduct the attorney's fees for the divorce and the state income taxes.

The IRS determined that Thomas was not entitled to an alimony deduction. The IRS also assessed an accuracy-related penalty due to negligence.

Issues

Issue 1. Whether taxpayer is entitled to deduct payments to his wife as alimony under I.R.C. 215(a)

Issue 2. Whether part of taxpayer's underpayment of tax is due to negligence

Analysis

Issue 1. **I.R.C. §71(b)(1)(C) precludes deduction for alimony "in the case of individuals legally separated under a decree of divorce or of separate maintenance" if the payee spouse and the payor spouse are members of the same household**. I.R.C. §71(b)(1)(A) defines alimony or separate maintenance payments as any payment in cash if such payment is received by (or on behalf of) a spouse under a divorce or separation instrument. Under I.R.C. §71(b)(2), the term divorce or separation instrument means a decree of divorce or separate maintenance or a written instrument incident to such a decree, a written separation agreement, or a decree requiring a spouse to make payments for the support or maintenance of the other spouse. **The separate household requirement of I.R.C. §71(b)(1)(C) applies by its terms only to an individual legally separated under a decree of divorce or of separate maintenance. If the spouses are not legally separated under a decree of divorce or separate maintenance, a payment under a written separation agreement or a decree described in I.R.C. §71(b)(2)(C) may qualify as alimony even if the payor and payee are members of the same household**.

The term written separation agreement is not defined in the I.R.C. regulations, or in the legislative history. In *Bogard v. Commissioner*, 59 T.C. 97 (1972), the court stated that **a written separation agreement is a clear, written statement of the terms of support for separated parties and that it is sufficient that the statement was entered in contemplation of a separation status and includes a statement of the terms of support**.

Issue 2. I.R.C. §6662 imposes a penalty of 20% of the portion of the underpayment attributable to negligence or disregard of rules or regulations. Under I.R.C. §6662(c), negligence is defined as any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code, and the term "disregard" includes any careless, reckless, or intentional disregard. If the taxpayer can demonstrate reasonable cause for the underpayment and that he acted in good faith, he can avoid the underpayment penalty. Under Treas. Reg. §1.16664-4(b)(1), reasonable cause and good faith include 'an honest misunderstanding of fact or law that is reasonable in light of the experience, knowledge and education of the taxpayer."

Holding

Issue 1. The court found that **payments to taxpayer's spouse meet the requirements of alimony payments under I.R.C. §71(b)(1)**. Since the payments are alimony, they are deductible under I.R.C. 215(a).

Issue 2. The court found that the taxpayer's explanations did not demonstrate an honest misunderstanding of fact or law reasonable in light of his experience, knowledge, and education. The accuracy-related penalty will apply to the disallowed deductions of attorney fees and legal costs.

[*Thomas B. Benham v. Commissioner*, T.C. Memo 2000-165 (May 22, 2000)]

BAD DEBT DEDUCTIONS

O'Neal's Feeder Supply, Inc. v. United States
[I.R.C. §166]

> ☞ **Bad debt deduction was disallowed since debtors continued to make payments.**

Facts. Taxpayer sold grain and animal feed to farmers. **At the end of each year, taxpayer assessed each farmer's financial condition and deducted as bad debts any debts believed to be uncollectible. If the farmer continued in business and made payments the following year, taxpayer applied the payments against the previous year's bad debt deduction.**

Taxpayer claimed over $700,000 in deductions on its 1988 tax return. **The IRS disallowed the majority of these deductions.** Taxpayer paid the deficiency and filed suit to contest the IRS's determination regarding 18 of the accounts, totaling $613,437 in disallowed bad debt deductions. **The jury found that the taxpayer was entitled to claim bad debt deductions on 16 of the 18 accounts at issue.** The government filed a motion for judgment as a matter of law, claiming that the evidence did not support the jury verdict.

Issue. Whether there was substantial evidence to support the conclusion of the jury that the debt had become totally worthless as of the end of 1988 for the 16 accounts found to be totally worthless by the jury

Analysis. I.R.C. §166(a)(1) allows a deduction for any business bad debt that becomes wholly worthless during the tax year. Taxpayer has the burden of proving that the debts had some value at the beginning of 1988 and that the debts were totally worthless by the end of the year [see *Cox v. Commissioner,* 68 F.3d 128 (5th Cir. 1995)]. "Debts are wholly worthless when there are reasonable grounds for abandoning any hope of repayment in the future, and it could thus be concluded that they have lost their 'last vestige of value' " [see *Estate of Mann v. United States*, 731 F.2d 267 (5th Cir. 1984].

The judge noted that **the taxpayer should have based its debt determinations on whether the debt was recoverable rather that its opinions about the farmers' financial situations. The fact that the taxpayer continued to extend credit to the farmers and the farmers continued to make payments indicated that the debts were not truly worthless.**

Holding. The judge concluded there was substantial evidence to support the conclusion of the jury **that the debt had become totally worthless for only two of the sixteen accounts.** Therefore, as a matter of law, the taxpayer's deduction is denied on 14 of the 16 accounts.

[O'Neal's Feeder Supply, Inc., 2000-1 USTC ¶50,193 (D.C.-La)]

Martens v. Commissioner
[I.R.C. §§162, 166, 6662]

> ☞ **Taxpayers could not deduct expenses and bad debts relating to their interest in company that was not their trade or business.**

Facts. Dan E. and Susan J. Martens are the taxpayers in this case. **Dan worked during adolescence, college, and law school at the maternity store owned by his mother.** In 1966, **she gave him a joint tenancy** with right of survivorship **in the stock of the store, located approximately 200 miles from taxpayers' residence.** Dan's mother operated the store until it ceased operations in 1993. **Dan made management decisions and Susan regularly handled inventory levels, but neither received any compensation.** The taxpayers made a series of loans to the store, and on their

1993 return **deducted these loans as business bad debts.** In 1994, the taxpayers claimed business expense deductions for amounts paid to the store's creditors.

Issues

1. Whether taxpayers are entitled to a business bad debt deduction under I.R.C. §166 for loans made to store owned by husband's mother
2. Whether taxpayers are entitled to a business expense deduction under I.R.C. §162 for payments made to the creditors of a store owned by husband's mother
3. Whether taxpayers are liable for accuracy-related penalties relating to disallowed deductions

Analysis

Issue 1. I.R.C. §166 allows a deduction for a bad debt that becomes worthless during the year and distinguishes between business and nonbusiness bad debts. Under I.R.C. §166(d)(2)**, a business bad debt must be related to the taxpayer's trade or business**. In *Whipple v. Commissioner*, 373 U.S. 193 (1963), the court stated that **someone in a trade or business gets income directly from his services rather than indirectly through the corporate enterprise**. In *Garner v. Commissioner*, 987 F.2d 267 (5th Cir. 1993), the court found that the shareholder's motive was to protect his investment and not his salary, which was zero.

Issue 2. I.R.C. §162(a) provides that a taxpayer engaged in a trade or business may deduct all ordinary and necessary expenses. Treas. Reg. §1.162-1(a) provides that to be deductible, business expenses must be "directly connected with or pertaining to the taxpayer's trade or business."

Issue 3. I.R.C. §6662 imposes an accuracy-related penalty equal to 20% of any underpayment attributable to a substantial understatement of income tax. Under Treas. Reg. §1.16664-4(b)(1), reasonable cause and good faith include "an honest misunderstanding of fact or law that is reasonable in light of the experience, knowledge and education of the taxpayer."

Holding

Issue 1. The court concluded that **since the taxpayers were not employees of the store, they were not in the trade or business of retailing maternity wear and not entitled to the business bad debt deduction**.

Issue 2. The court found that since the store was not the taxpayers' trade or business, they were not entitled to deduct the expenses.

Issue 3. Since taxpayers have not established that there was a reasonable cause and that they acted in good faith in claiming the deductions, they are liable for the accuracy-related penalties.

[*Dan E. and Susan J. Martens v. Commissioner*, 79 TCM 1483 (February 10,2000)]

Fleischaker v. Commissioner
[I.R.C. §§162, 166, and 6662]

☞ **Shareholder could not deduct loan guaranty payments and related legal fees as business expenses since he was not in a trade or business.**

Facts. **Dr. William Fleischaker and his associates formed Adult Living Centers, Inc.** with the intent to operate modern multifunctional elder and child care facilities. In order to obtain construction permission, **the taxpayer in his capacity as a shareholder guaranteed the construction loans.** However, **the taxpayer never received any compensation from the corporation as an officer,**

director, employee, or independent contractor. In 1988, the lenders foreclosed on the corporation and sued the taxpayer to collect on his guarantees. The taxpayer was required to pay $116,000 to satisfy the loan guarantees and incurred $258,000 in related legal fees. **Taxpayers claimed deductions for these expenses on their oil and gas business schedule C as trade or business expenses.**

The **IRS determined that the taxpayers could deduct the guaranty payments as non-business bad debts and the legal expenses as miscellaneous expenses, not as trade or business expenses**.

Issues

1. Whether taxpayers may deduct loan guaranty payments and related legal fees under I.R.C. §§166 and 162
2. Whether taxpayers are liable for the accuracy-related penalties under I.R.C. §6662 for 1991 and 1992

Analysis

Issue 1. Under I.R.C. §166(d)(2), a business bad debt must be related to the taxpayer's trade or business. I.R.C. §162(a) provides that a taxpayer engaged in a trade or business may deduct all ordinary and necessary expenses. Both I.R.C. §166 and I.R.C. §162 require that the taxpayer be engaged in a trade or business for such expenses to be deductible. In *Whipple v. Commissioner*, 373 U.S. 193 (1963), the Supreme Court held that the taxpayer's advances to one of a number of corporations he owned did not result in business bad debts, because the advances were not sufficiently related to the taxpayer's trade or business. In *Whipple,* the Supreme Court noted that devoting time and energy to the affairs of the corporation does not indicate a trade or business when the only return is that of an investor. Selling and promoting a business can be a trade or business; in *Deely v. Commissioner*, 73 T.C. 1081 (1980), the court found that the separate trade or business of promoting business "must be conducted for a fee or commission or with the immediate purpose of selling the corporations at a profit in the ordinary course of that business."

Issue 2. I.R.C. §6662 imposes an accuracy-related penalty equal to 20% of any underpayment attributable to a substantial understatement of income tax. The penalty can be avoided under I.R.C. §662(d)(2)(B) for an item (1) that was supported by "substantial authority" or (2) for which the relevant facts were "adequately disclosed in the return or in a statement attached to the return."

Holding

Issue 1. The court found that the **taxpayers were not in the trade or business of developing, promoting, and selling businesses and therefore, could not deduct as a business debt the guaranty payments and could not deduct the legal fees as ordinary and necessary business expenses**.

Issue 2. The court found that the taxpayers' position on the return was not supported by any well-reasoned construction of the tax laws and that, **by claiming the expenses on the Schedule C of the oil and gas business, the taxpayers had "disguised rather than disclosed the true substance of the payments**." Therefore, the taxpayers **were held liable for the accuracy-related penalties**.

[*William J. Fleischaker and Donni L. Fleischaker v. Commissioner*, T.C. Memo 1999-427 (December 30, 1999)]

BUSINESS EXPENSES

Pelton & Gunther, Professional Corporation v. Commissioner
[I.R.C. §§162, 172, 481, and 6662]

> ☞ **A law firm's payment of litigation costs on behalf of clients represented nondeductible loans since expenses were expected to be reimbursed.**

Facts

Issue 1. The taxpayer was a cash-basis law firm operating as a professional corporation that specialized in the defense of personal injury automobile accident lawsuits. Over 90% of taxpayer's services were performed for the policyholders of the California State Automobile Association (CSAA). At the request of CSAA, **taxpayer provided legal services for CSAA's policyholders in connection with controversies over automobile accidents. CSAA generally paid the taxpayer $400 when it requested representation for one of its policyholders. Taxpayer paid the litigation costs, which more often than not amounted to more than $400 per case**.

Taxpayer would bill CSAA for legal services at an hourly rate and for litigation costs incurred after the controversies were resolved and the cases closed. The cases were often open for more than one year. **Taxpayer deducted the litigation costs incurred in the year of payment and reported the $400 retainer and reimbursement of litigation costs as income in the year received**.

The **IRS determined that the litigation expenses were loans** and therefore disallowed the deduction for litigation costs for 1993 and reversed the taxpayer's 1993 income inclusion for reimbursement of litigation costs deducted in prior years.

Issue 2. The **IRS made an I.R.C. §481 adjustment, which effectively included in 1993 income the amount previously reversed out**. The IRS claimed that without this adjustment, the taxpayer would not be taxed on the 1993 reimbursement of the previously deducted items.

Issue 3. Taxpayer incurred net operating losses (NOLs) for its 1990 and 1991 tax years. Taxpayer did not carryback the NOLs to prior years and did not make an election to forego the carryback. Taxpayer carried the NOLs forward and applied them to 1992 and 1993. Taxpayer wrote a letter to the IRS on August 14, 1990 inquiring whether they were required to carryback the losses or could carry them forward to future years, but never received a response.

The IRS determined that the loss available for use against the 1993 income should be reduced by the amount of the loss, which would have been absorbed if carried back to pre-1990 fiscal years.

Issue 4. The IRS determined that taxpayer was negligent and liable for a penalty under I.R.C. §6662(a) and (b)(1).

Issues

1. **Whether litigation costs paid by taxpayer on behalf of clients and then reimbursed to taxpayer are deductible as ordinary and necessary business expenses or whether such payments are in the nature of nondeductible loans**
2. Whether the adjustment for litigation costs triggers an I.R.C. §481 adjustment
3. Whether taxpayer's 1990 and 1991 NOLs may be carried forward to the 1993 tax year, without first being applied to years prior to 1990 and 1991
4. Whether taxpayer is liable for an accuracy-related penalty under I.R.C. §6662(a)

Analysis

Issue 1. Longstanding case precedents treat payments or advances of the client's litigation costs like loans. In a similarly situated case, *Canelo v. Commissioner*, 53 T.C. 216 (1969), aff'd. 447 F.2d 484 (9th Cir. 1971), the court emphasized that **if expenditures are expected to be reimbursed, they are in the nature of loans**. The repayment of the taxpayer's payments was not contingent on the outcome of the litigation, but was made under an agreement that required them to be reimbursed. **Taxpayer's situation was distinguishable from the case they relied on, *Boccardo***, 56 F.3d 1016 (1995, CA9), rev'g T.C. Memo 1993-224, **in which the Ninth Circuit held that a law firm could deduct litigation expenses paid under a gross-fee contingency arrangement. Taxpayer's fee was billed at a stated hourly rate, not on any form of contingency basis, and the litigation costs were reimbursed on a dollar-for-dollar basis**.

Issue 2. I.R.C. §481(a) provides that where taxable income from any year is computed under a method of accounting that is different from the method used for the preceding year, the computation of the taxable income for the year of the change should account for those adjustments that are necessary because of the change in order to prevent duplications and/or omissions. An I.R.C. §481 change includes a change in the overall plan or method of accounting for income or deduction and also includes a change in the treatment of any material item used in the overall plan. Treas. Reg. §1.446-1(e)(2)(ii)(b) provides that a change in method of accounting does not include adjustment of any item of income or deduction, which does not involve the proper time for the inclusion of the item of income or the taking of a deduction. **The court determined that the IRS did not change the method of accounting by which taxpayer reported a particular item but instead determined that the item was not deductible**.

Issue 3. I.R.C. §172(a) allows taxpayers to carry NOLs from one taxable year to another. For the year at issue, under I.R.C. §172(b)(1)(A) taxpayers who sustain NOLs must first carry such losses back 3 years and then, if unabsorbed, the losses may be carried forward for as long as 15 years. (For NOLs in tax years beginning before August 1997, generally NOLs may be carried back 2 years and forward 20 years.) A taxpayer may elect under I.R.C. §172(b)(3) to relinquish the carryback period and simply carry forward the loss. This election is made by filing an election relinquishing the carryback period by the return date for the year in which the NOL was first incurred. Under Treas. Reg. §301.9100-asT(d), the election to forgo carryback period shall be made by a statement attached to the return (or amended return) for the taxable year. The statement shall indicate the section under which the election is being made and identify the election, the period for which it applies, and the taxpayer's basis for entitlement for making the election. The court concluded that the taxpayer did not comply with the requirements for making the election to forgo the carryback.

Issue 4. §6662(a) and (b)(1) impose an accuracy-related penalty equal to 20% of an underpayment that is attributable to negligence or disregard of rules or regulations. In *Leuhsler v. Commissioner*, 963 F.2d 907 (6th Cir. 1992), aff'g T.C. Memo 1991-179, negligence was defined as a "lack of due care or a failure to do what a reasonable person would do under the circumstances." In making its decision, the court took into account the legal background and years of legal experience possessed by the taxpayer's owners [see *Glenn v. Commissioner*, T.C. Memo 1995-355, aff'd without published opinion 103 F.3d 129(6th Cir. 1996)].

Holding

Issue 1. The court found that the **taxpayer's payments or advances of the client's litigation costs should be treated like loans and not deducted in the year paid**.

Issue 2. The court found that I.R.C. §**481 is not applicable**.

Issue 3. The court found that taxpayer's 1990 and 1991 NOLs must be first carried back since no election was made to forego the carryback.

Issue 4. The court found that **taxpayer was negligent** for deducting the advanced litigation costs as ordinary and necessary business expenses and for disregarding the regulations concerning the treatment of NOLs. Therefore, taxpayer was **liable for an accuracy-related penalty**.

[*Pelton & Gunther, Professional Corporation v. Commissioner*, T.C. Memo 1999-339 (October 8, 1999)]

Steger v. Commissioner
[I.R.C.§§162 and 263]

> ☞ **Retiring attorney may currently deduct malpractice insurance premium that covered an indefinite period of time.**

Facts. Taxpayer (husband) is a self-employed attorney. He **retired from the practice of law in 1993. During that year he purchased a malpractice insurance policy which covered him for an indefinite period of time but only against acts for professional services rendered before his retirement.** Taxpayer claimed a deduction for the entire cost of the policy on his 1993 Schedule C. The IRS determined that the policy was a capital asset and that taxpayers were entitled to deduct only 10% of the cost of the policy in 1993.

Issue. Whether taxpayers are allowed a deduction for the full cost of the policy in 1993 as an ordinary and necessary business expense under I.R.C. §162

Analysis. I.R.C. §162(a) allows a deduction for all ordinary and necessary business expenses paid or incurred during the taxable year in carrying on a trade or business. Under *Commissioner v. Tellier*, 393 U.S. 687 (1966), an expenditure is not "ordinary," and therefore not currently deductible, if it is in the nature of a capital expenditure. In *INDOPCO, Inc.*, 503 U.S. 79 (1992), it was concluded that the primary effect of characterizing a payment as either a business expense or a capital expenditure concerns the timing of the taxpayer's cost recovery. *INDOPCO* further explains that the cost of a capital asset is deductible only over the useful life of the asset because the Code tries to match expenses with revenues within the taxable period to which they are properly attributable, which results in a more accurate calculation of net income for tax purposes. In *INDOPCO*, **the court held that "where no specific asset or useful life can be ascertained," a capital expenditure is deducted upon the dissolution of the enterprise.** In this case, **the policy has no ascertainable useful life.**

Holding. The court found that since the taxpayer ceased to conduct business in the year in issue, **taxpayers are entitled to deduct the entire cost of the policy in 1993, irrespective of whether or not the policy is a capital asset.**

[*Merlin A. and Dee D. Steger v. Commissioner*, 113 T.C. No. 18 (October 1, 1999)]

Northrop v. Commissioner
[I.R.C. §§162, 212]

> ☞ **Taxpayer was investor, not in trade or business of stock trader.**

Facts. Taxpayer, a self-employed countertop resurfacer, invested in stocks. In 1995, he claimed he had a credit line of $150,000 used to purchase stocks. Taxpayer made eight short-term stock sales in 1995 and seven in 1996. He did not invest on behalf of other people. In 1995 and 1996, taxpayer deducted office expenses, interest, and depreciation on his countertop resurfacing business Schedule C which he asserted were related to his business as stock trader. He reported the sales of stock on Schedule D.

Issues

1. Whether taxpayer was in the trade or business of being a stock trader or whether he was an investor

2. Whether taxpayer is entitled to deduct office expenses, depreciation expense, and interest expense in his investment activity

Analysis

Issue 1. The court considered the three factors that were used in *Hart v. Commissioner*, T.C. Memo 1997-11, to determine whether taxpayer is a trader or investor. These factors are: 1) the taxpayer's investment intent, 2) the nature of the income to be derived from the activity, and 3) the frequency, extent, and regularity of the taxpayer's securities. In *Hart*, it was found that to be a trader, the trading activity must be substantial, which means "frequent, regular, and continuous enough to constitute a trade or business." The court stated that it was apparent that the taxpayer's trading activity of only eight sales in 1995 and seven in 1996 was not substantial.

Holding

Issue 1. The court found that taxpayer was an investor, not a trader.

Issue 2. The court found that since the taxpayer was not a trader, taxpayer was not entitled to deduct investment related expenses as trade or business expenses under I.R.C. §162. Furthermore, the court found that taxpayer failed to substantiate his investment expenses. Therefore, the taxpayer was not entitled to deduct the investment expenses under I.R.C. §212.

[*Sandra B. Ball and Keith M. Northrop v. Commissioner*, T.C. Memo 2000-245 (August 8, 2000)]

Muegge v. Commissioner
[I.R.C. §61]

☞ **Amounts received from estate were treated as reimbursement of expenses for care of decedent.**

Facts. While taxpayer was employed as a surgical technician, she met and became close friends with Ms. Stern, a cancer patient. Ms. Stern expressed her concern for her brother to the taxpayer. While Ms. Stern was dying, taxpayer promised to check on Ms. Stern's brother, Mr. Stern. Shortly after Ms. Stern's death, taxpayer began to visit Mr. Stern from time to time to check on his well-being. After Mr. Stern was severely injured in an accident, he lived with taxpayers for three or four months. A few days after returning to his apartment, taxpayer visited Mr. Stern and found him lying on a bloody mattress. Taxpayer took Mr. Stern to a medical facility where he was diagnosed with colon cancer. After surgery for a colon resection, taxpayers agreed that Mr. Stern could live with them until he recovered. Mr. Stern lived with the taxpayers until he died five years later. While he lived with them, taxpayers provided food, medicine, medical supplies, hygienic supplies, clothing, hair cuts, hobby supplies, and office supplies for Mr. Stern. Taxpayers tried to find relatives with whom Mr. Stern could live; however, he had no living relatives. On three occasions, taxpayers took Mr. Stern to nursing homes, but Mr. Stern refused to live anywhere other than taxpayers' home. Mr. Stern promised to compensate taxpayer for her care and reimburse the taxpayers for expenses paid on his behalf. Mr. Stern died, leaving $1,000 to charity and the remainder to the taxpayer. His estate was worth about $1,000,000. Taxpayer filed a claim against Mr. Stern's estate for $182,500, based on estimates of her expenses and the value of her services. The probate court approved the claim and ordered the estate to pay her $182,500, half of which was "reimbursement for living expenses and the other half for personal care."

The estate deducted the $182,500 payment on the estate tax return. The IRS disallowed the deduction; however, the District Court held that taxpayer's claim against the estate was deductible.

The taxpayers reported $91,250, one-half of the amount received as income from wages, salaries, tips, etc. They did not report the other half as income or deduct the expenses of caring for Mr. Stern. Taxpayers contended that $91,250 was a reimbursement of the expenses that they paid while caring for Mr. Stern. The IRS determined that the $182,500 taxpayers received was compensation for their services to Mr. Stern, and that they could not deduct their expenses since they paid the expenses in a prior year and the expenses were personal expenses not deductible under I.R.C. §162.

Issues. Whether certain payments from the Stern estate were nontaxable reimbursements of taxpayers' expenses and whether taxpayers proved that their expenses totaled $91,250

Analysis. In *Burnett v. Commissioner*, 66-1 USTC ¶9241 (5th Cir. 1966), the court found that expenditures made with the expectation of reimbursement are in the nature of loans or advances, even without formal indebtedness. In *Herrick v. Commissioner*, 63 TC 562 (1975), the court found that advances made with expectation of reimbursement even though there was not explicit promise or agreement to that effect were loans. A reimbursement is in the nature of a repayment of borrowed funds, which is not taxable [see *Gulf Life Ins. Co. v. United States*, 96-2 USTC ¶50,330 (Fed. Cir. 1997)].

The IRS claimed that taxpayers had not substantiated their expenses. The Tax Court disagreed, citing *Cohan v. Commissioner*, 2 USTC ¶489 (2nd Cir. 1930). The court found credible the petitioners' testimony that Mr. Stern paid for nothing except his doctor bills during the years he lived with them.

Holding. The court found that taxpayers received $91,250 in nontaxable reimbursements.

[*Ralph J. and Mary H. Muegge v. Commissioner*, T.C. Memo 2000-232 (August 2, 2000)]

CAPITAL GAINS

Ltr. Rul. 199945008
[I.R.C. §1221]

☞ **Lump-sum payments received for the right to future lottery winnings were taxable as ordinary income.**

Facts. Taxpayer won a state lottery entitling her to receive payments each year for several years. The lottery is funded by the state's investment in U.S. Treasury zero coupon bonds. As the bonds mature, the proceeds are used to make payments to lottery winners. The state lottery is the owner and beneficiary of these securities. They are not set aside for the exclusive benefit of the lottery winners and are not beyond the reach of other creditors of the state. The lottery winner receives no written, formalized contract acknowledging the promise to pay the prize over the set number of years it will be paid. Lottery winners receive a letter from the state certifying that they are winners and indicating how the prize will be paid.

Pursuant to two approved state court petitions, in year 2, taxpayer sold to buyer rights to some of the annual lottery payments for a fixed sum and later sold to same buyer rights to more of the annual payments for a second fixed sum.

Issue. Whether the proceeds that result from the sale of the right to receive lottery winnings are capital gain or ordinary income

Analysis. I.R.C. §1221 provides that to receive capital gain treatment from a sale or exchange, the asset disposed of must be a capital asset as defined under I.R.C. §1221. Treas. Reg. §1.1121-1 states that the term capital assets includes all classes of property not specifically excluded. However, the Supreme Court, in *Commissioner v. Gillette Motor Co.,* 364 U.S. 130 (1960), has found that not everything called property in the ordinary sense and not excluded under the statute qualifies as a capital asset; rather, the term **"capital asset is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year."** In deciding the *Gillette* case, the Court relied on two earlier Supreme Court cases that established that a transfer of a property interest that is really an assignment of future ordinary income is not capital gain property, *Hort v. Commissioner*, 313 U.S. 28 (1941) and *Commissioner v. P.G. Lake, Inc.* 356 U.S. 260 (1958). In *Hort*, the taxpayer received a lump-sum payment for the cancellation of a long-term lease, and in *P.G. Lake*, the taxpayer received oil rights in cancellation of debt. The Court held in both cases that the payments were a substitute for what would have been characterized as ordinary income. In *P.G. Lake*, the Court noted that the amount received did not represent payment for an increase in the value of income-producing property.

Holding. The IRS concluded that the **proceeds that result from the sale of the right to receive lottery winnings are ordinary income, noting that the taxpayer received a lump-sum payment in exchange for the transfer of a future ordinary income stream** like the taxpayers in *Hort* and *P. G. Lake*. The IRS stated that the lottery payment right is predictable, measurable, and can be ascertained with considerable accuracy.

Olstein v. Commissioner
[I.R.C. §§1221 and 1231]

> ☞ **Taxpayer allowed capital gain treatment for sale of lots where legal problems barred sales to public**.

Facts. Olstein, a real estate developer for 30 years, developed a tract of land into subdivided lots and built homes on some of them, homes which were then sold to homebuyers. Because of law suits damaging to his reputation, **taxpayer ceased development and sold the remaining 56 lots to real estate developers** (**the Kramer** Group) in three transactions. Before completion of the third transaction, Kramer defaulted on the note and mortgage relating to the second transaction. After a protracted dispute, the parties settled. Pursuant to the settlement agreement, **Kramer conveyed 28 of the lots to a new partnership controlled by Olstein, and Kramer performed all the activities necessary to develop, market, and sell the lots.** The partnership held title to the lots, provided financing to Kramer, and got 96% of the net proceeds from the sale of the lots. Kramer kept the 4% balance. **Olstein treated the sale of the lots as capital gain. The IRS determined that the lots were inventory** and should have been treated as ordinary income property.

Issue. Whether proceeds relating to the sale of 28 developed lots are ordinary income or capital gain

Analysis. I.R.C. §1221(1) provides that the term "capital asset" does not include property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. **The court noted that although taxpayer originally acquired the tract to sell in the ordinary course of its real estate development business, the taxpayer, through his partnership, did not hold the 28 lots for that purpose.** The lawsuits caused the taxpayer to abandon its plans to sell developed lots to individual homebuyers. In *Eline Realty Co. v. Commissioner*, 35 T.C. 1 (1960), the court held that, because a taxpayer's intent is subject to change, the **determining factor relating to a taxpayer's intent is the purpose for which the property is held at the time of sale.** The IRS contended that the Kramer activities should be imputed to the taxpayer's partnership and, as a result, the taxpayer held the lots for sale to customers in the ordinary course of business. The court concluded that the relationship between the Kramers and the taxpayer's partnership was irrelevant because the taxpayer was seeking only to dispose of a capital asset when it sold the lots; the court cited *Estate of Mundy v. Commissioner*, 36 T.C. 703 (1961), in which the court held that the activities of a taxpayer, including the activities of an agent imputed to the taxpayer, taken together with all other facts, must place the taxpayer in a business so that the property in question can be said to be held by the taxpayer for sale to customers in his business.

Holding. The Tax Court concluded that the lots were not held by taxpayer's partnership primarily for sale to customers in the ordinary course of its business; therefore, **the proceeds relating to the sale of the 28 developed lots were capital gain.**

[*Harry Olstein, Olstein Family Partnership, H-EAB-O, Whitehouse Partners, Harry Olstein, Tax Matters Partner v. Commissioner*, T.C. Memo 1999-290 (August 30, 1999)]

Hancock v. Commissioner
[I.R.C. §§165, 1014, 1221, and 7521]

> ☞ **Taxpayer's real estate sales activities yielded ordinary treatment since her sales were frequent, regular, and substantial.**

Facts. **Taxpayer began working with her husband in the real estate business in 1957.** They subdivided land and built homes for homebuyers. **After her husband died in 1985, taxpayer was left with 48 developed real estate lots. She sold all of these at an economic gain.** However, because the lots were owned jointly, **she received a fair market value basis when her husband died.** I.R.C. §1014(b)(6) provides that when a spouse dies owning community property and at least half of the entire community interest is includible in the deceased spouse's gross estate, the entire property, both the deceased and surviving spouse's interests, is treated for basis purposes as property acquired from a decedent. **All the lots declined in value after her husband's death; therefore, when she sold the lots, she realized a taxable loss on each lot because of her high basis. The IRS determined that the taxpayer held the lots as an investor and therefore must treat the losses as capital losses.** This decision resulted in a tremendous burden to the taxpayer since such losses can offset all capital gains but only $3,000 of ordinary income, while ordinary losses are not similarly limited.

Issue. Whether taxpayer held lots for sale to customers in the ordinary course of her trade or business

Analysis. I.R.C. §1221(1) provides that **the term "capital asset" does not include property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business.** Citing a number of cases, the court noted that the following six factors indicate whether property is held primarily for sale to customers in the ordinary course of a trade or business: 1) the frequency and substantiality of sales, 2) the nature of the taxpayer's business, 3) the purpose for which the taxpayer acquired and held the property before sale, 4) the time and effort the taxpayer habitually devoted to the sales, 5) the extent to which the taxpayer improved the property, and 6) the length of time the property was held. The court applied the factors relevant to this case.

The court said that **the frequency and substantiality of sales is the most important factor. The taxpayer satisfied this factor since she sold 47 lots over a 10-year period**; selling eight lots during the two years at issue was substantial since she only had 12 of the 48 lots left at the start of these years [see *Thornton v. Commissioner*, 63-2 USTC ¶9676 (5th Cir. 1963)]. The IRS argued that taxpayer's pattern of selling more lots in years when the local real estate market improved was evidence that she held the land for investment. The court pointed out **that taxpayer began selling lots when the local market was in decline and sold 12 of them before the market rebounded, which the court noted indicates dealer rather than investor status**. The IRS argued that the taxpayer did not devote much time or effort to selling her lots and did not advertise, and also that the lack of real estate development activities indicated investor status. The court noted that **the fact that the taxpayer sold the lots without using an outside agent, without having her own real estate sales office, and without incurring advertising expenses or broker's fees suggests that petitioner devoted enough time and effort to selling the lots**, citing *United States v. Winthrop*, 69-2 USTC ¶9686. The court further noted that the taxpayer and her husband developed the lots prior to her acquiring them, and that she paid real estate taxes, maintained liability insurance, and maintained the grounds. The IRS argued that the fact that the taxpayer had kept the lots for 6 years indicated she held them for investment. The court cited *Herndon v. Commissioner*, T.C. Memo 1968-135, in which lots that were held for 20 years by the taxpayer were held for sale in the ordinary course of business.

Holding. The Tax Court concluded that the **taxpayer held the eight lots sold** during the years in issue **for sale to customers in the ordinary course of her trade or business.**

[*Margaret Hancock v. Commissioner*, T.C. Memo 1999-336 (October 7, 1999)]

CORPORATIONS, PARTNERSHIPS, AND LLCs

The next seven cases involve the issue of whether excluded discharge of indebtedness income of an S corporation can be used to increase the shareholder's basis in his stock. The appellate level courts have issued conflicting opinions on this issue. Since essentially the same facts, issue, and analysis apply to the seven court cases, the common facts, issue, and analysis are presented first. Then, the separate holding for each case is presented after the case name.

[I.R.C. §§61, 108, 1017, 1366, and 1367]

Facts. The taxpayers were shareholders in S corporations. **The S corporations were insolvent, realized a discharge of indebtedness, and excluded from gross income the discharge of indebtedness. The taxpayers increased their basis in the stock of the S corporation by the amount that the discharge exceeded losses for the taxable year in which the discharge occurred.**

Issue. Whether discharge of indebtedness income realized and excluded from gross income under I.R.C. §108(a) **passes through to shareholders** of a subchapter S corporation as an item of income in accordance with I.R.C. §1366(a)(1)(A) **and in turn increases the basis of the corporate stock** under I.R.C. §1367

Analysis. I.R.C. §61(a)(12) provides that income from discharge of indebtedness (DOI) be included in gross income.

I.R.C. §108(a)(1) provides that a taxpayer is permitted to exclude DOI to the extent that a taxpayer is insolvent when the DOI occurs. I.R.C. §108(d)(3) defines insolvency as the excess of liabilities over the fair market value of assets immediately before the discharge. I.R.C. §108(b)(1) requires the taxpayer to reduce certain tax attributes by the amount of the debt discharged. I.R.C. §108(b)(2) provides the order of the attribute reduction: 1) net operating losses, 2) general business credit, 3) minimum tax credit, 4) capital loss carryovers, 5) basis reduction under I.R.C. §1017(b)(2), and 6) passive activity loss and credit carryovers and foreign tax credit carryovers. I.R.C. §108(b)(4)(A) provides that the reduction of attributes is made after determination of tax for the year. I.R.C. §**108(d)(7)(A) provides that, in the case of an S corporation, discharge of indebtedness income exclusion and the tax attribute reduction principles should be applied at the corporate level**.

I.R.C. §1366(a)(1)(A) provides that the determination of an S corporation shareholder's tax liability takes into account the shareholder's pro rata share of the S corporation's items of income (including tax-exempt income), loss, deduction, or credit. I.R.C. §1367(a)(1)(A) provides that an S corporation's shareholder's basis in the stock of the corporation is increased for any period by items of income described in I.R.C. §1366(a)(1)(A).

Final regulations were issued December 1999 (retroactively effective to tax years beginning after August 17, 1998) relating to S corporation pass-through of items and adjustments to the basis of stock of the shareholders. Treas. Reg. §1.1366-1(a)(2)(viii) provides that income excludible from gross income under I.R.C. §101 (certain death benefits) or I.R.C. §103 (interest on state and local bonds) is tax-exempt income, while income under I.R.C. §108 (income from discharge of indebtedness) and I.R.C. §109 (improvements by lessee on lessor's property) is not tax-exempt income. **These regulations were not in effect for the tax years at issue in any of the following cases**.

Gitlitz v. Commissioner

> ☞ **Taxpayer *could not use* the S corporation's excluded discharge of indebtedness income to increase the basis in his stock**.

Holding. The Court of Appeals for the Tenth Circuit affirmed the Tax Court's decision that an S corporation shareholder may not increase basis in stock due to excluded discharge of indebtedness (DOI) income. **The Tenth Circuit reasoned that if the taxpayers could increase their basis for the excluded DOI income, the shareholders would receive a windfall. The shareholders would avoid taxation on the corporation's DOI and also receive an upward basis adjustment, permitting them to use the corporation's net operating losses (NOLs) to reduce their own noncorporate related gross income without having to reduce the NOLs by the discharged debt** and (where basis is remaining) report a larger capital loss from the sale of their stock, even though those corporate losses had effectively given rise to the insolvency that produced the DOI-exempt income. The Tenth Circuit referred to *United States v. Skelly Oil Co*., 69-1 USTC ¶9343, in which the Supreme Court ruled that **the Internal Revenue Code "should not be interpreted to allow the practical equivalent of double deduction absent a clear declaration of intent by Congress."** The court interpreted this to include windfalls.

The Tenth Circuit concluded that I.R.C. §108(d)(7)(B) provides that S shareholder losses which were suspended under the basis limitations must be treated as NOLs for purposes of DOI tax attribute reduction. **The Tenth Circuit concluded that the taxpayers are required to offset the DOI-exempt income against their current period NOLs and suspended losses from prior years in the current year**. However, the Tax Court concluded that the tax attribute reductions should occur in the year following the year of discharge.

[*David A. Gitlitz, Louise A. Gitlitz v. Commissioner, Philip D. Winn, Eleanor G. Winn v. Commissioner*, 99-2 USTC ¶50,645 (CA-10) aff'g 75 TCM 1840]

> **Note. On May 1, 2000, the Supreme Court granted certiorari to *Gitlitz*.**

Nelson v. Commissioner

> ☞ **Taxpayer *could not use* the S corporation's excluded discharge of indebtedness income to increase the basis in his stock.**

Holding. The Court of Appeals for the Tenth Circuit affirmed the Tax Court's decision that an S corporation shareholder may not increase basis in stock due to excluded cancellation of debt income. The **Tax Court held that all DOI determinations are made at the corporate level under I.R.C. §108(d)(7), which precludes the pass-through of any basis adjustment.** The Tax Court noted that I.R.C. §108 was not intended to make DOI a permanent exemption from taxation, but only a deferral through the reduction of tax attributes. Therefore, they did not consider DOI as exempt income that would increase basis. Although the Court of Appeals affirmed the Tax Court's decision, it used a different reasoning. The judges noted that they used the same reasons outlined in their published opinion filed on the same day in *Gitlitz v. Commissioner* (see the previous case for their reasoning).

[*Mel T. Nelson v. Commissioner*, 99-2 USTC ¶50,646 (CA-10) aff'g 110 TC 114]

Storch v. United States

> ☞ **Taxpayer *could use* the S corporation's excluded discharge of indebtedness income to increase the basis in his stock.**

Holding. **An Oregon District Court (appealable to the Ninth Circuit) held that an insolvent S corporation's discharge of indebtedness income (DOI) increased the stock basis of its shareholders, which allowed them to deduct suspended losses from prior years. The Court held that once the DOI income is excluded, it is treated as tax-exempt income under I.R.C. §1366(a)(1) and is therefore passed through to the shareholders.** The District Court said that when I.R.C. §108(d)(7)(A) is read in conjunction with I.R.C. §108(b)(4)(A), the DOI income passed from the S corporation to the shareholders in the year of the discharge and the tax attributes were decreased in the next year. The Court reasoned that the determination of the tax imposed for the discharge year could not take place until that tax year ended. The taxpayers' stock basis was increased under I.R.C. §1367(a)(1) because of the passthroughs in the discharge year. The increased basis allowed the taxpayers to claim suspended losses in the discharge year, carry back losses to a previous year, and carry forward the remaining losses.

[*James D. Hogue, Frank J. Storch, and Linda G. Storch v. United States*, 2000-1 USTC ¶50,149]

Witzel v. Commissioner

> ☞ **Taxpayer *could not use* the S corporation's excluded discharge of indebtedness income to increase the basis in his stock.**

Holding. The Court of Appeals of the Seventh Circuit affirmed the Tax Court's memorandum opinion that held that the S corporation shareholder could not increase the basis of his stock by the discharge of indebtedness (DOI) income. The Seventh Circuit agreed that the DOI provisions must apply at the corporate level and that the shareholder's suspended losses are deemed corporate net operating losses for purposes of the tax attribute reduction under I.R.C. §108(d)(7)(B). **The Seventh Circuit, as did the Tax Court, required the shareholder to offset the exempt DOI income against his suspended losses. However, in conflict with the Tax Court's memorandum opinion, the Seventh Circuit noted that once the tax attributes have been eliminated, the DOI untaxed income "will be tax-exempt in the fullest sense; it will not generate tax liability even indirectly." This would allow the shareholder to increase stock basis for the remaining DOI not offset by suspended losses,** which could provide a benefit on a future sale of the shareholder's stock.

[*William C. Witzel and Gene E. Witzel v. Commissioner*, 2000-1 USTC ¶50,165 (CA-7) aff'g 77 TCM 457]

United States v. Farley

> ☞ **Taxpayer *could use* the S corporation's excluded discharge of indebtedness income to increase the basis in his stock.**

Holding. The Court of Appeals of the Third Circuit, reversing a District Court's decision, held that the discharge of indebtedness (DOI) income excluded by an S corporation passed through to the shareholders, which allowed them to increase their stock bases and deduct suspended losses. **The Third Circuit concluded that the tax attribute reduction occurs after the income has passed through the S corporation to its shareholders.** The Third Circuit pointed out that the plain language of I.R.C. §108(b)(4)(A) clearly indicates that "tax attributes are reduced on the first day of the tax year following the year of the discharge of indebtedness." The Court further noted that I.R.C. §108(d)(7)(B) does not require that the S corporation offset the excluded DOI income against their net operating losses in the taxable year of the discharge.

[*United States v. Harold D. Farley, Gail D. Farley,* 2000-1 USTC ¶50,179 (CA-3) rev'g 99-1 USTC ¶50,370]

Pugh v. Commissioner

☞ **Taxpayer *could use* the S corporation's excluded discharge of indebtedness income to increase the basis in his stock.**

Holding. The Court of Appeals of the Eleventh Circuit, reversing a Tax Court decision, held that the plain language of the Code entitled the taxpayer to increase the basis in his S corporation stock by his pro rata share in the corporation's excluded discharge of indebtedness income for the taxable year of the discharge. The Eleventh Circuit recognized that the taxpayer would twice enjoy the tax-exempt status of the excluded DOI income, but concluded **that the court could not ignore the plain language of the statute,** "which clearly requires that all items of income included in I.R.C. §1366 must be used to increase the shareholder's basis under I.R.C. §1367."

[*James H. Pugh, Jr. and Alexis Pugh v. Commissioner*, 2000-1 USTC ¶50,514 (CA-11) rev'g 77 TCM 1367]

Gaudiano v. Commissioner

☞ **Taxpayer *could not use* the S corporation's excluded discharge of indebtedness income to increase the basis in his stock.**

Holding. The Court of Appeals of the Sixth Circuit affirmed the Tax Court's decision that S corporation shareholders were not entitled to deduct their suspended and ordinary losses for the tax year because those loses were offset at the corporate level by the excluded discharge of indebtedness (DOI) income realized by the insolvent S corporation. **Although the Sixth Circuit upheld the Tax Court's disallowance of the shareholders' deductions, it rejected the Tax Court's determination that DOI income does not pass through to shareholders and does not increase the basis of their shares. The Sixth Circuit concluded that any DOI remaining after it was offset against current and suspended losses would pass through to the shareholders and would increase their bases in the stock. The shareholders could then use the increased basis to deduct any losses that may accumulate in the future.**

[*Salvador A. Gaudiano, et al. v. Commissioner*, 2000-2 USTC ¶50,559 (CA-6) aff'g 76 TCM 858]

Practitioner Caution. Based on the success of the IRS and its unwillingness to give up on the issue, along with the conflicting opinions between the different circuits in the Court of Appeals, practitioners should give special attention to the rulings in their client's jurisdiction. A summary of the seven cases is presented below.

Case	Decided For	Court	Appeals Court	Jurisdiction
Gitlitz	IRS	CA	10th	Colorado, Kansas, New Mexico, Oklahoma, Utah, Wyoming
Nelson	IRS	CA	10th	(see previous case)
Hogue	Taxpayer	District	Appealable to 9th	Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, Washington
Witzel	IRS	CA	7th	Illinois, Indiana, Wisconsin
Farley	Taxpayer	CA	3rd	Delaware, New Jersey, Pennsylvania, Virgin Islands
Pugh	Taxpayer	CA	11th	Alabama, Florida, Georgia
Gaudiano	IRS	CA	6th	Kentucky, Michigan, Ohio, Tennessee

Sleiman v. Commissioner
[I.R.C. §§1366 and 1011}

> ☞ **An S corporation shareholder was denied a basis increase for personal guarantee of corporation loan.**

Facts. Principal taxpayers in this case **include three brothers, Eli, Peter, and Anthony Sleiman, who were real estate developers. Taxpayers operated their real estate development projects through three S corporations,** REE, TNE, and ME. Eli and Peter each entered into a lease agreement with Blockbuster Video, Inc. to purchase land, build a video store, and lease the property to Blockbuster. Eli and Peter then formed REE and TNE and assigned their rights under the lease to the corporations. REE and TNE **obtained financing from SouthTrust Bank of Alabama by pledging as collateral the properties they purchased.** Eli and Peter **personally guaranteed** the REE and TNE loans. Although Eli and Peter did not pledge any personal assets, they promised to refrain from transferring or pledging any of them for less than full and adequate consideration without SouthTrust's consent. SouthTrust never called on Eli or Peter's guarantee during the years at issue. During 1992, **Eli and Peter received distributions from REE and TNE. They claimed that the distributions were a tax-free return of bases because their bases included the bank loans they had guaranteed.** The IRS and the Tax Court held that Eli and Peter could not increase their bases by the loan guarantees.

Anthony was the sole shareholder of ME, **an S corporation that purchased a shopping center in 1992. The purchase and sale agreement allocated $60,000 to the land and the remaining purchase price to the depreciable building. The IRS and Tax Court determined that $377,700 should be allocated to the land**, a decision which reduced the depreciable basis of the building.

Issues

1. Whether Eli and Peter are entitled to increase their stock bases in their wholly owned S corporations by the principal amounts of bank loans to the S corporations, which they personally guaranteed
2. Whether the IRS properly reallocated Anthony's basis in a piece of real property

Analysis

Issue 1. I.R.C. §1368(b) provides that **when an S corporation** with no accumulated earnings and profits **makes a distribution to a shareholder, the shareholder must recognize capital gain only on the portion of the distribution that exceeds the shareholder's adjusted basis in the shares of the S corporation's stock**. Under I.R.C. §1367, the shareholders' adjusted basis in the stock is increased by amounts the shareholder contributes to the S corporation's capital.

In *Selfe v. United States*, 86-1 USTC ¶9115 (11th Cir. 1985), the taxpayer established a line of credit with a bank for her business in her own name, secured by stock that she and her family owned. Later she incorporated her business as an S corporation and, at the request of the bank, converted the personal loans to corporate loans. She executed a personal guarantee, but the bank retained its security interest in the pledged stock. The IRS and the District Court found that she could not increase her basis for the personal guarantee. However, the **Court of Appeals of the Eleventh Circuit held that a shareholder in an S corporation who personally guarantees a debt of the corporation may increase her basis in the corporation by the amount of the debt "where the facts demonstrate that, in substance, the shareholder has borrowed funds and subsequently advanced them to her corporation."**

In the present case, **the court noted that the record showed that the bank viewed REE and TNE as secure business concerns, with adequate collateral, that were likely to repay their loans**.

Issue 2. Taxpayer argued that the purchase and sale agreement is the best evidence of the fair market value of a piece of property since it is the price arrived at by the parties to a bargained-for, arm's length transaction. The IRS conceded that this is normally conclusive proof of the *total* value of the property; however, it argued that the **internal allocation of a total purchase price between the components of the property bargained for may not constitute proof of the components' relative values, because one part to the transaction may have no incentive to bargain for a particular allocation of the price**. The Eleventh Circuit agreed with the IRS's position, citing *Dixie Finance Co. v. Unites States*, 73-1 USTC ¶9204 (5th Cir. 1973) and *Blackstone Realty Co. v. Commissioner*, 68-2 USTC ¶9462 (5th Cir. 1968)

Holding

Issue 1. The Court of Appeals of the Eleventh Circuit held that Eli and Peter **were not entitled to increase their stock bases in their S corporations by the principal amounts of bank loans to the S corporations which they personally guaranteed**.

Issue 2. The Court of Appeals of the Eleventh Circuit held that the IRS properly reallocated Anthony's basis in a piece of real property.

[*Eli T. Sleiman, Jr. and Janie L. Sleiman v. Commissioner*, 99-2 USTC ¶50,828 (CA-11) aff'g 74 TCM 1270]

Van Wyk v. Commissioner

[I.R.C. §§465 and 6662]

> ☞ **An S corporation shareholder that borrowed funds from another shareholder and loaned them to the S corporation was not at risk with respect to the loan.**

Facts. The **taxpayer and his brother-in-law each owned 50% of the stock** of an S corporation engaged in the business of farming. **Taxpayer borrowed $700,000 from brother-in-law and his wife, executing an unsecured promissory note bearing interest at 10.5% annually.** Taxpayer **transferred the money to the S corporation** in retirement of a $253,583 debt that taxpayer owed the corporation, and the balance was **treated as a loan owed by the corporation to taxpayer.**

The IRS determined that the taxpayer was not at risk with respect to the loan to the S corporation and disallowed his deduction of losses from the S corporation for the years at issue. The IRS determined that the taxpayer was liable for a substantial understatement penalty pursuant to I.R.C. §6662.

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Issues

1. **Whether taxpayer is at risk with respect to a loan he made to an S corporation in which he owns 50% of the stock, where the source of the funds constituting the loan is the other 50% shareholder and that shareholder's wife**
2. Whether taxpayers are liable for substantial understatement penalties under I.R.C. §6662

Analysis

Issue 1. I.R.C. §465(b)(1) provides that a taxpayer shall be considered at risk for an activity with respect to (1) the amount of money and adjusted basis of property contributed to the activity, and (2) amounts borrowed with respect to the activity if the taxpayer is personally liable for repayment or has pledged property, other than property used in such activity, as security for the borrowed amount. I.R.C. **§465(b)(3)(A) provides that amounts borrowed shall not be considered at risk if such amounts are borrowed from any person who has an interest in such activity or from a related person to a person (other than the taxpayer) having such an interest. I.R.C. §465(b)(3)(B) provides two exceptions to I.R.C. §465(b)(3)(A): (i) subparagraph (A) shall not apply to an interest as a creditor in the activity, and (ii) subparagraph (A) shall not apply to an interest as a shareholder for amounts borrowed by a corporation from a shareholder**.

The court rejected the taxpayer's reliance on I.R.C. §465(b)(1)(A), and explained that I.R.C. §465(b)(1)(A) applies to personal funds contributed to the activity, and that since the taxpayer acquired the funds through borrowing, under the terms of I.R.C. §465(b)(1)(B), I.R.C. §465(b)(1)(A) did not apply. The taxpayer claimed he was at risk under the I.R.C. §465(b)(3)(B)(ii) exception. **The court noted that the exception in I.R.C. §465(b)(3)(B)(ii) applies only to borrowed amounts where the borrower that is claiming to be at risk is a corporation**.

Issue 2. I.R.C. §662(a) imposes a 20% penalty on the portion of an underpayment of tax that is attributable to any substantial understatement of income tax. I.R.C. §6662(d)(1)(A) defines a substantial understatement of tax as the amount which exceeds the greater of 10% of the tax required to be shown on the return for the taxable year or $5,000. I.R.C. §6662(d)(2)(b) provides that an understatement is reduced to the extent it is based upon substantial authority or adequately disclosed in the tax return or in a statement attached to the return and there was a reasonable basis for the treatment of the item. Under I.R.C. §6664(c)(1) the I.R.C. §6662 penalty does not apply if the taxpayer can show that there was reasonable cause and that the taxpayer acted in good faith. **The court noted that the complexity of I.R.C. §465 and the lack of express guidance in the regulations led the taxpayer to an honest mistake of law for which it would be inappropriate to penalize him**.

Holding

Issue 1. The **Tax Court concluded that since the source of the funds constituting the loan is not excepted by I.R.C. §465(b)(3)(b)(ii), the taxpayer is not considered to be at risk with respect to the loan** under I.R.C. §465(b)(3)(A).

Issue 2. The Tax Court concluded that taxpayers are not liable for substantial understatement penalties under I.R.C. §6662.

[*Larry W. and Cynthia J. Van Wyk v. Commissioner*, 113 T.C. No. 29 (December 21, 1999)]

Daniel J. Culnen v. Commissioner
[I.R.C. §§1001, 1231, and 1366]

☞ **S corporation shareholder was able to increase his basis for loans made to the S corporation by another S corporation owned by the shareholder.**

Facts. Taxpayer owned shares in a restaurant business, Wedgewood, organized as an S corporation. His ownership percentage ranged from 39.48% to 73% during the tax years at issue. **Wedgewood was unsuccessful,** ceased doing business, and **conveyed its property for the benefit of its creditors.** The property consisted of restaurant fixtures, equipment and furnishings subject to liens, a liquor license, cash on hand, accounts receivable, and liquor inventory.

During the years at issue, **taxpayer was the sole shareholder of a C corporation**, **C&H**, that operated as an insurance producer. On numerous occasions during the years at issue**, C&H made payments to Wedgewood on behalf of the taxpayer, paid Wedgewood's expenses, and made other payments related to Wedgewood.** The payments made by C&H were **treated on their books as shareholder loans** and on **Wedgewood's books as indebtedness to the taxpayer**. Taxpayer deducted losses passing through Wedgewood and C&H. Taxpayer also deducted a loss from Wedgewood for the disposition by Wedgewood of furniture, fixtures, restaurant equipment, and liquor license. The taxpayer argued that the payments made by C&H to Wedgewood were made on the taxpayer's behalf.

The **IRS determined that the taxpayer could not claim the losses since the payments made by C&H to Wedgewood could not be used to increase the taxpayer's basis in Wedgewood under I.R.C. §1374(c)(2)(B)**.

Issues

1. Whether taxpayer had sufficient basis with respect to an S corporation for the taxable years at issue to permit him to deduct his pro rata share of the corporation's ordinary losses for those years
2. Whether the corporation suffered a §1231 loss from the disposition of the property in 1990 and whether taxpayer had sufficient basis to permit him to deduct his pro rata share of that loss

Analysis

Issue 1. I.R.C. §1366(a)(1)(A) provides that the determination of a S corporation shareholder's tax liability takes into account the shareholder's pro rata share of the S corporation's items of income, loss, deduction, or credit. I.R.C. §1367(a)(1)(A) provides that an S corporation's shareholder's basis in the stock of the corporation is increased for any period by items of income described in I.R.C. §1366(a)(1)(A). A limitation is placed on the losses and deductions an S corporation shareholder may take into account for any taxable year under I.R.C. §1366(d). The shareholder may not take into account an aggregate amount of such losses exceeding the sum of (1) his adjusted basis in the stock of the S corporation and (2) his adjusted basis in any indebtedness of the S corporation to the shareholder.

The **IRS claimed that the fact that all payments to Wedgewood came directly from C&H precludes taxpayer from claiming those amounts as his basis in Wedgewood and thus precludes the deduction for Wedgewood losses**. The court stated that the IRS is wrong if it was suggesting that direct payments from C&H to Wedgewood establish C&H's status as an investor in Wedgewood. **The court relied on taxpayer's witnesses–the taxpayer and two accountants–who testified that the C&H payments to Wedgewood were made on the taxpayer's behalf**.

Issue 2. I.R.C. §1001(a) provides that the loss from the disposition of property shall be the excess of the adjusted basis in the property over the amount realized. I.R.C. §1001(b) defines "amount realized" from the sale or other disposition of property as the sum of any money received plus the fair market value of the property (other than money) received. Treas. Reg. §1.1001-2(a)(1) provides the general rule that the amount realized from the sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the disposition. Treas. Reg. §1.1001-2(a)(4) provides that, for purposes of that section, the sale or other disposition of property that secures a nonrecourse liability discharges that liability. Treas. Reg. §1.1001-2(b) provides that, generally, the fair market value of the security at the time of sale is not relevant for determining the amount of liabilities from which the taxpayer is discharged, or treated as discharged.

The court concluded that if the indebtedness was nonrecourse debt, then the amount realized on the disposition of the assets included the amount of the liens. The taxpayers failed to show that the indebtedness secured by the liens was other than nonrecourse. Therefore, the court determined the amount realized on the disposition of the assets by adding the amount of the liens plus the amounts received from the sale of the license and the liquor inventory. After subtracting the adjusted basis of the assets from the amount realized, the court concluded that Wedgewood's loss on the disposition of the assets amounted to $515,243.

Holding

Issue 1. The Tax Court concluded that the **taxpayer had adequate adjusted basis in his Wedgewood investment to deduct his pro rata share of Wedgewood's losses** for the years at issue.

Issue 2. The Tax Court concluded that **the corporation suffered a §1231 loss and that the taxpayer had adequate basis to deduct the loss**.

[*Daniel J. Culnen v. Commissioner*, 79 TCM 1933 (April 13, 2000)]

CREDITS

Johnston v. Hazlett
[I.R.C. §32, 6402, 6871]

☞ **A debtor's earned income credit is property of her bankruptcy estate even though petition was filed before the end of the tax year.**

Facts. The **taxpayer** filed a chapter 7 petition in October 1997 listing an earned income credit (EIC) for the 1997 tax year. She **argued that the EIC is not property of the estate since she had no legal or equitable interest at the commencement of her bankruptcy case. She claimed that the EIC did not accrue until the end of the tax year.** The bankruptcy court held that the EIC was estate property.

Issue. Whether an earned income tax credit is property of the debtor's bankruptcy estate when the bankruptcy petition is filed prior to the end of the tax year in which the EIC is earned

Analysis. That an EIC is property of a bankruptcy estate, the court noted, is overwhelmingly supported in the case law. In *Baer v. Montgomery (in re Montgomery)*, 98-1 USTC ¶50,389), the court found that **EICs constitute property of the estate under the Bankruptcy Code's inclusive definition of property, even when the bankruptcy petition is filed prior to the end of the tax year, and that there was no basis for treating EICs differently from a usual refund of tax overpayments.**

Conclusion. The court affirmed the bankruptcy court's decision, holding that the EIC was property of taxpayer's bankruptcy estate even though she filed for bankruptcy before the end of the year in which the EIC was earned.

[*Robin L. Johnston v. Thomas Hazlett (in re Johnston)*, 98-2 USTC ¶50,625]

A similar ruling was found in *Mary Kathleen Trudeau v. Randy Royal (in re Trudeau),* (B.A.P. 10th Cir. Sept. 1, 1999). Here, the appellate panel affirmed the bankruptcy court's decision that a debtor's EIC is property of her bankruptcy estate, even though the tax year ended post-petition.

Ltr. Rul. 200014035
[I.R.C. §32]

☞ **Earnings of a civilly committed sex offender are earned income for purposes of the earned income credit.**

Facts. A number of states have statutes that civilly commit sex offenders. "Sexually dangerous persons" who may be confined to treatment facilities include individuals who have been 1) found incompetent to stand trial, 2) found not guilty by reason of mental state, or 3) found guilty and civilly committed after released from prison. Most facilities are under control of the department of health rather than the department of corrections. Even though employment is not required, many residents choose to work.

Issues

1. **Whether amounts earned by an individual who has been civilly committed to a treatment facility for sex offenders are earned income under I.R.C. §32(c)(2)**
2. Whether amounts earned by an individual who is serving a prison sentence at a treatment facility for sex offenders are earned income under I.R.C. §32(c)(2)
3. Whether amounts earned by an individual who has been civilly committed to a treatment facility for sex offenders, but is physically located in a prison rather than a separate treatment facility, are earned income under I.R.C. §32(c)(2)

Analysis. I.R.C. §32(a) allows an earned income credit (EIC) based on a taxpayer's earned income, which includes wages, salaries, tips, and other employee compensation. I.R.C. §32(c)(2)(B)(iv) excludes amounts received for services provided while an inmate at a penal institution from the definition of earned income. I.R.C. §32 does not define penal institution or address the issue of services performed by an individual confined to a treatment facility. However, the same year that I.R.C. §32(c)(2)(B)(iv) was added to the Code, changes were made to the Social Security Act which denied benefits to persons confined to institutions when found guilty by reason of insanity, guilty but insane, or not being competent to stand trial.

In *Graves v. Heckler*, 607 F. Supp. 1186 (D.C. 1985), the court found that an individual who was merely civilly committed, but not convicted of a criminal offense, was entitled to disability benefits, noting that a mental hospital is not a jail, prison, or other penal institution or correctional facility. In *Kansas v. Hendricks*, 521 U.S. 346 (1997), the court found that the Kansas Sexually Violent Predator Act was nonpunitive in nature.

Holding

Issue 1. **The IRS concluded that amounts earned by an individual civilly committed to a treatment facility are earned income for purposes of EIC**.

Issue 2. **The IRS concluded that amounts earned by an individual who is serving a prison sentence at a treatment facility for sex offenders are not earned income for purposes of EIC**.

Issue 3. **Amounts earned by an individual who has been civilly committed to a treatment facility for sex offenders, but is physically located in a prison rather than a separate treatment facility, are earned income for purposes of EIC.**

IRS Problem Alerts Report
[I.R.C. §32]

☞ **1999 Tax Returns: Sale of property used in a trade or business creates potential Earned Income Credit problem.**

The IRS has issued a Problem Alerts Report announcing that due to a processing error, the agency improperly denied Earned Income Tax Credit to some taxpayers with investment income exceeding $2,350. The IRS sent erroneous error notices in response to certain 1999 returns with a combination of Form 4797 Sales of Business Property and EITC. According to the IRS, "a relatively small number" of taxpayers who filed returns claiming EITC and who sold property used in a trade or business including culled cows, farming equipment, and other business assets in 1999 were affected. The IRS is manually computing taxpayers' investment income to correct the problem. Taxpayers who used Form 4797 and subsequently received an error notice should contact the person or office listed on the notice. A taxpayer may also call the IRS at (800) 829-1040 and explain his or her position.

Ltr. Rul. 200028035
[I.R.C. §32]

☞ **Jury fees are not earned income for purposes of the EIC.**

Facts. A specific factual scenario is not addressed. The service noted that state statutes differ in how they describe jury fees, including terms such as "compensation," "travel allowance," and "attendance fee." State descriptions are not determinative of federal tax consequences.

Issue. Whether amounts received by a taxpayer for services performed as a juror are earned income for purposes of the Earned Income Credit (EIC)

Analysis. I.R.C. §32(a) allows an EIC for eligible individuals and is based, in part, on the individual's earned income. I.R.C. §32(c)(2)(A)(i) defines earned income as wages, salaries, tips, and other employee compensation, plus the amount of the taxpayer's net earnings from self-employment for the taxable year [within the meaning of I.R.C. §1402(a)], but after deductions allowed by I.R.C. §164(f). I.R.C. §1402(a) defines net earnings from self-employment as the gross income derived by an individual from any trade or business carried on by the individual, less deductions attributable to the trade or business, and certain adjustments specified by law.

Treas. Reg. §31.3121(d)-1(c)(2) provides that generally an employer-employee relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished.

I.R.C. §1402(c) provides that generally the term "trade or business" shall not include, for purposes of net earnings from self-employment, the performance of the functions of public office. The IRS stated that the definition of public office is broad enough to include the role of juror.

The IRS concluded that jurors are not, by nature of the services provided, employees; therefore, the services performed as a juror are not wages, salaries, tips, or other employee compensation. Rev. Rul. 61-113, 1961-1 C.B. 400, ruled that services provided by members of a hearing board of an air pollution control district constituted the performance of functions of a public office and did not constitute a "trade or business" for purposes of I.R.C. §1402(c)(1). The IRS found that the services of jurors are analogous to public office, as described in Rev. Rul. 61-113, and thus are not net earnings from self-employment.

Holding. Jury fees are not earned income for purposes of the EIC.

CCA 200022051
[§§32 and 1402]

☞ **Advice is provided on taxpayer's understatement of expenses to qualify for EIC.**

Facts. Specific facts were not provided. Questions have been received regarding how the EIC is determined in cases involving taxpayers that reported an amount of net earnings from self-employment that maximized the taxpayers' EIC.

Issues

1. How are a taxpayer's EIC and self-employment tax liability computed in cases where the taxpayer reports net earnings from self-employment on Schedule C without claiming the business expenses applicable to the Schedule C business?
2. How are a taxpayer's EIC and self-employment tax liability computed in cases where the taxpayer reports net earnings from self-employment on Schedule C but cannot show that the business exists?

Analysis. I.R.C. §32(c)(2)(A)(i) defines earned income as wages, salaries, tips, and other employee compensation, plus the amount of the taxpayer's net earnings from self-employment for the taxable year [within the meaning of I.R.C. §1402(a)]. 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 the individual, less deductions attributable to the trade or business, and certain adjustments specified by law. I.R.C. §162 allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Rev. Rul. 56-407, 2 C.B. 564, held that under I.R.C. §1402(a), taxpayers, with the exception of certain farm taxpayers, must claim all allowable deductions in computing net earnings from self-employment for self-employment tax purposes. Treas. Reg. §1.6001-(a) provides that taxpayers required to file a return must keep sufficient records to establish the amount of gross income, deductions, credits, or other matters required to be shown on the return. Under this authority, the IRS may require a taxpayer to substantiate any amount shown on a return, including both the income and expense elements of self-employment income shown on a Schedule C. Therefore, when a taxpayer who claims the EIC reports self-employment income with little or no expenses, the IRS must subtract these expenses when determining the taxpayer's net earnings from self-employment. If the IRS is unable to determine the amount of unreported expenses, it may disregard the claimed net earnings from self-employment for purposes of EIC and self-employment tax.

Holding

Issue 1. In cases where the taxpayer reports net earnings from self-employment without claiming the applicable business expenses, the net earnings from self-employment must be adjusted by those expenses. The taxpayer's EIC and self-employment tax liability are both computed on the adjusted net earnings from self-employment.

Issue 2. In cases where the taxpayer reports net earnings from self-employment but cannot show that the business exists, the taxpayer cannot claim the EIC based on those net earnings from self-employment. In addition, the taxpayer is not liable for self-employment tax on those net earnings.

Practitioner Note. The Chief Counsel pointed out that under I.R.C. §32(k)(1)(B)(i) and (ii), the EIC will be disallowed for a period of 10 years in cases where the taxpayer's claim for the EIC was due to fraud, and will be disallowed for a period of 2 years in cases where the taxpayer's claim was due to reckless or intentional disregard of rules and regulations. Under I.R.C. §32(k)(2), when a taxpayer is denied the EIC for a taxable year, no EIC will be allowed for a subsequent taxable year unless the taxpayer provides such information as the Secretary may require (see Treas. Reg. §1.32-3T).

Ltr. Rul. 200028034
[I.R.C. §32]

☞ **Taxpayer lacking a social security number may file amended return to claim EIC.**

Facts

Situation 1. Taxpayers X and Y file a Form 1040 for Year 1 with a filing status of married filing jointly and claim the EIC. The EIC is denied because Y does not have a social security number (SSN). After the Year 1 return is filed, Y receives a SSN that meets the requirements of I.R.C. §32(m).

Situation 2. X, a single parent who has a qualifying child under I.R.C. §32(c)(3), files a Form 1040 for Year 1 and claims the EIC on the basis of the qualifying child. The EIC is denied because the child does not have a SSN. After the Year 1 return is filed, the child receives an SSN that meets the requirements of I.R.C. §32(m).

Issue. Whether a taxpayer who otherwise met the requirements of I.R.C. §32(m) and claimed the EIC for the taxable year, but whose claim for the EIC was denied for that year for failure to have a SSN that met the requirements of I.R.C. §32(m), may claim the EIC for the taxable year on an amended federal income tax return if, after the close of the taxable year, the taxpayer is issued a SSN that meets the requirements of I.R.C. §32(m).

Analysis. I.R.C. §32(c)(1)(F) provides that no EIC will be allowed under I.R.C. §32 to an eligible individual who does not include on his or income tax return for the taxable year the individual's taxpayer identification number (TIN) and, if the individual is married, the spouse's TIN. I.R.C. §32(c)(3)(D) requires that the name, age, and TIN of a qualifying child be included on the taxpayer's return for the taxable year. Under I.R.C. §32(m), a TIN means a social security number.

There is no requirement under the plain language of I.R.C. §§32(c)(1)(F) and 32(c)(3)(D) that the taxpayer, taxpayer's spouse, and qualifying child have a SSN before the end of the taxable year or that the SSN be on the original, timely filed return.

Holding. A taxpayer who was denied the EIC for failure to have a SSN may claim the EIC on an amended return if the taxpayer, or qualifying child, is issued a SSN that meets the requirements of I.R.C. §32(m) after the close of the year and the amended return is filed within the statute of limitations on claims for credit or refund under I.R.C. §6511.

DEPRECIATION, DEPLETION, AND AMORTIZATION

Notice 2000-4
[I.R.C. §168]

☞ **The IRS provides guidance on depreciating property acquired in like-kind exchange or involuntary conversion.**

This notice provides guidance about the depreciation of MACRS property under I.R.C. §168 that is acquired in a like-kind exchange under I.R.C. §1031 or an involuntary conversion under I.R.C. §1033. The IRS announced that it intends to issue regulations with regard to this issue. This notice should be followed until the regulations are issued.

The basis of property acquired in a §1031 or §1033 transaction is generally the same as the property given up less any cash received plus any cash given. However, until this notice, there has been no guidance on how to depreciate the basis of the acquired property under I.R.C. §168. **For MACRS property placed in service after January 2, 2000, and acquired in a like-kind exchange or an involuntary conversion, to the extent of basis in the property given up, the acquired property is depreciated using the same period and method as the exchanged or involuntarily converted property. To the extent the basis in the acquired property exceeds the basis in the property given up, the acquired property is treated as newly purchased MACRS property.** Therefore, when the basis in the acquired asset is greater than the basis in the asset given up, **the taxpayer is treated as if he or she owns two properties for depreciation purposes.**

For property placed in service before January 3, 2000, taxpayers may either continue using their present depreciation method or switch to the method provided in this notice. Taxpayers who want to switch the depreciation method for property acquired in a like-kind exchange or an involuntary conversion must be presently treating the property as newly purchased MACRS property, make the change for the first or second tax year ending after January 3, 2000, and change their accounting methods, using the automatic change in accounting method rules outlined in Rev. Proc. 99-49, 1999-52 IRB 725 (discussed in the Accounting section of this chapter).

[Notice 2000-4, 2000-3 IRB 313 (January 4, 2000)]

In response to the IRS's request for comments on the forthcoming regulations, commentators questioned several aspects of the proposed guidance, especially regarding an exchanged automobile. [See *Tax Notes* (May 1, 2000), p. 628.]

Rev. Proc. 2000-18
[I.R.C. §§61, 162, and 280F]

☞ **Depreciation limitations on automobiles.**

Table 1: Depreciation Limitations for Automobiles First Placed in Service in Calendar Year 2000 (Other than Electric Automobiles)

Tax Year	Amount
1	$ 3,060
2	4,900
3	2,950
Each succeeding year	1,775

Table 2: Depreciation Limitations for Electric Automobiles First Placed in Service in Calendar Year 2000

Tax Year	Amount
1	$ 9,280
2	14,800
3	8,850
Each succeeding year	5,325

Rev. Proc. 2000-18
[I.R.C. §§61, 162, and 280F]

☞ **The amounts to be included in income by lessees of passenger automobiles first leased during 2000, including separate inclusion amounts for electric automobiles.**

Table 3: Dollar Amounts for Automobiles (Other than Electric Automobiles) With a Lease Term Beginning in Calendar Year 2000

Fair Market Value of Automobile		Tax Year During Lease				
Over	But Not Over	1	2	3	4	5 and Later
$15,500	$15,800	3	6	9	10	12
15,800	16,100	5	12	17	20	23
16,100	16,400	8	17	25	30	34
16,400	16,700	10	23	33	40	45
16,700	17,000	13	28	42	49	57
17,000	17,500	16	36	52	62	72
17,500	18,000	20	45	66	78	91
18,000	18,500	25	54	79	95	109
18,500	19,000	29	63	93	111	128
19,000	19,500	33	72	107	127	147
19,500	20,000	37	81	121	143	166
20,000	20,500	41	91	133	160	185
20,500	21,000	45	100	147	176	204
21,000	21,500	50	109	160	193	222
21,500	22,000	54	118	174	209	241
22,000	23,000	60	132	194	234	269

Table 3: Dollar Amounts for Automobiles (Other than Electric Automobiles) With a Lease Term Beginning in Calendar Year 2000

Fair Market Value of Automobile		Tax Year During Lease				
Over	**But Not Over**	**1**	**2**	**3**	**4**	**5 and Later**
23,000	24,000	68	150	222	266	306
24,000	25,000	77	168	249	298	345
25,000	26,000	85	187	276	331	381
26,000	27,000	93	205	303	364	419
27,000	28,000	102	223	330	396	457
28,000	29,000	110	241	358	429	494
29,000	30,000	119	259	385	461	532
30,000	31,000	127	278	412	493	570
31,000	32,000	135	296	439	527	607
32,000	33,000	144	314	467	558	645
33,000	34,000	152	333	493	591	683
34,000	35,000	160	351	521	623	720
35,000	36,000	169	369	548	656	757
36,000	37,000	177	388	574	689	795
37,000	38,000	185	406	602	721	833
38,000	39,000	194	424	629	754	870
39,000	40,000	202	443	656	786	908
40,000	41,000	210	461	683	819	946
41,000	42,000	219	479	710	852	983
42,000	43,000	227	497	738	884	1,021
43,000	44,000	235	516	765	916	1,058
44,000	45,000	244	534	792	949	1,095
45,000	46,000	252	552	819	982	1,133
46,000	47,000	260	571	846	1,014	1,171
47,000	48,000	269	589	873	1,047	1,208
48,000	49,000	277	607	901	1,079	1,246
49,000	50,000	285	626	927	1,112	1,284

Practitioner Note. For electric automobiles (and for other than electric automobiles) with an FMV of $50,000 or more, see Rev. Proc. 2000-18, 2000-9 IRB 722.

[Rev. Proc. 2000-18, 2000-9 IRB 722 (February 27, 2000)]

Hayden v. Commissioner
[I.R.C. §179]

☞ **Partnership's income limitation under I.R.C. §179 expensing election was found valid.**

Facts. Dennis Hayden was a CPA who did a substantial amount of tax-related work. He and his wife were sole partners in **a partnership that reported losses in 1994 but elected I.R.C. §179 on the depreciation form attached to the partnership return. Taxpayers took a deduction for I.R.C. §179 on their individual return.** The taxpayers also claimed a payroll tax expense deduction for payment of their personal federal income taxes paid. The taxpayers claim this was due to a bookkeeping error.

The IRS disallowed the deduction of the I.R.C. §179 expense and the payroll tax deduction and assessed an accuracy-related penalty for the error in deduction of the payroll taxes. The Tax Court upheld the IRS's determination.

Issues

1. Whether partners are entitled to claim a flow-through deduction for the partnership's purchase of I.R.C. §179 property when the partnership realized no taxable income
2. Whether taxpayers are liable for the negligence component of the accuracy-related penalty

Analysis

Issue 1. I.R.C. §179(b)(3)(A) provides that the deduction under I.R.C. §179 "shall not exceed the aggregate amount of taxable income of the taxpayer for such taxable year which is derived from the active conduct by the taxpayer of any trade or business during such taxable year." **Treas. Reg. §1.179-2(c)(2) provides that the partnership may not allocate to its partners I.R.C. §179 expense deduction more than the partnership's taxable income for the year, and the partner may not deduct as I.R.C. §179 expense more than the partner's taxable income for that year.**

The taxpayers argued that the regulation is invalid and that I.R.C. §179(b)(3)(A) applies only to taxable income "of the taxpayer" derived from the trade or business "by the taxpayer." They claim that under I.R.C. §701, partnerships are not taxpayers, so the statute cannot apply to partnerships.

The Seventh Circuit noted that although a partnership is not a taxable entity, I.R.C. §703(a) refers to the "taxable income of a partnership."

Issue 2. I.R.C. §6662 imposes a 20 percent penalty on the portion of an underpayment attributable to accuracy-related deficiencies, including negligence or the disregard of rules or regulations. Treas. Reg. §1.16662-3(b)(1) provides that negligence includes any failure to make a reasonable attempt to comply with the provisions or to exercise ordinary and reasonable care in the preparation of the return, and includes any failure to keep adequate books and records or to substantiate items properly.

The Court noted that the erroneous payroll tax deduction was 17 percent of the taxable income of the CPA practice and 53 percent of the payroll tax deduction. Since the taxpayer was an accountant who prepared or supervised the preparation of the return, he should have questioned the size of the deduction.

Holding

Issue 1. **The Seventh Circuit affirmed the Tax Court's decision that the taxpayers were not entitled to claim a flow-through deduction for the purchase of I.R.C. §179 property since the partnership realized no taxable income.**

Issue 2. The Seventh Circuit affirmed the Tax Court's decision that the tax return errors resulted from negligence and the taxpayers were liable for the accuracy-related penalty.

[*Dennis L. Hayden and Sharon E. Hayden v. Commissioner*, 2000-1 USTC ¶50,219 (CA-7) aff'g 112 T.C. 115.]

FSA 199949031
[I.R.C. §167]

> ☞ **Manufacturer's showroom display furniture was inventory, and not depreciable property.**

Facts. The taxpayer corporation is a **high-end furniture manufacturer that uses showrooms** and outlet stores to market its furniture. **The showrooms contain many display suites for the various types of furniture it manufactures.** Generally, only designers, retailers, architects, dealers, and wholesalers are allowed to place orders through the showrooms. The general public may enter the showrooms to view the furniture samples; however, the furniture is not for sale to the general public unless returned to the factory or sold at an outlet store. **The taxpayer contends that the display furniture is sold off the showroom floor only if it is damaged, unproductive, or discontinued. However, the IRS examiner claims that frequently furniture in excellent condition is sold off the floor.** Taxpayer contends that the furniture remains on the floor from one month to 10 years, averaging three years' duration. However, the examiner claims that taxpayer's records indicate the display period is much shorter.

Display items are sold at gradually reduced prices. Items not sold are shipped to the factory and offered for sale to employees and the general public. Taxpayer recognizes a profit from the sale of display items, but there is a disagreement as to the amount of the profit.

Taxpayer depreciated the display furniture under MACRS, using a 5-year recovery period. Taxpayer stops depreciating the display items when they are put back into inventory or sold.

Issue. Whether furniture displayed by taxpayer should be treated for tax purposes as inventory or depreciable property used in its trade or business

Analysis. Under I.R.C. §167, a depreciation deduction is allowed for the exhaustion, wear and tear, or obsolescence of property used in the trade or business or held for the production of income. However, the depreciation allowance does not apply to inventories or stock in trade [Treas. Reg. §1.167(a)-2].

In Rev. Rul. 75-538, 1975-2 C.B. 35, a car dealer was denied a depreciation deduction for demonstrator autos because it was presumed to hold all its vehicles for sale to customers in the ordinary course of its business. In a similar ruling, Rev. Rul. 89-25, 1989-1 C.B. 79, a home builder was unable to depreciate houses used as models or sales offices. The houses were property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's business, even though the houses were used temporarily as models and/or sales offices, and even though the taxpayer may have been reluctant or unwilling to sell the houses while they were being used as such.

The IRS noted that the taxpayer had not clearly established that the display furniture was devoted to use in the taxpayer's business and that the taxpayer looked to use of the furniture in the business operation to recover its cost. **The IRS indicated that if the items were on display for the length of the actual useful life of the items, this would indicate that the taxpayer looked to recover its cost through use of the furniture in its business.** Another indicator would be selling the items below cost.

Holding. The IRS held that the taxpayer is considered to hold the display furniture primarily for sale to customers in the ordinary course of business and cannot depreciate the display furniture.

T.D. 8865
[I.R.C. §§162, 167, and 197]

☞ **Final regulations are issued on amortization of intangibles.**

This document contains final regulations under I.R.C. §197 relating to the amortization of certain intangibles, including purchased goodwill. The final regulations reflect changes by the Omnibus Budget Reconciliation Act of 1993 and affect taxpayers acquiring intangibles after August 10, 1993, or making retroactive election to apply the Act to intangibles acquired after July 25, 1999.

Explanation of Revisions and Summary of Comments

I.R.C. §162(k) Application. The proposed regulations provided that amounts paid for a covenant not to compete entered into in connection with a redemption was nondeductible under I.R.C. §162(k) and thus not subject to I.R.C. §197. Commentators suggested guidance on this application should be addressed in the regulations under I.R.C. §162(k). No reference is made to I.R.C. §162(k) in the final regulations.

Purchase of a Trade or Business. Intangibles are not I.R.C. §197 intangibles **if they are not acquired as part of a purchase of a trade or business.** Under the proposed regulations, a group of assets constitutes a trade or business if the assets' use would constitute such under I.R.C. §1060. The proposed regulations also treat a group of assets as a trade or business if they include any customer-based intangibles or, with certain exceptions, any franchise, trademark, or trade name (the "per se rules"). Commentators made suggestions to modify the per se rules. As a result, the final regulations limit the application of those rules to the situations specifically described in the legislative history of I.R.C. §197(that is, the acquisition of a franchise, trademark, or trade name), and clarify that a license of a trademark or trade name is disregarded in applying the per se rules.

Computer Software. The final regulations contain rules that supersede Rev. Proc. 69-21, 1969-2 C.B. 303. **Purchased computer software is amortized over 15 years if I.R.C. §197 applies, and over 36 months if the software is not a I.R.C. §197 intangible.** The final regulations also clarify that I.R.C. §197 may apply to costs incurred for leased software. **Computer software that is bundled with computer hardware and not separately stated continues to be depreciated as part of the hardware.** Also, software costs are currently deductible and not subject to I.R.C. §197 if they are not chargeable to a capital account under a licensing transaction and are otherwise currently deductible. **The IRS will issue a revenue procedure superseding Rev. Proc. 69-21, and in the meantime, taxpayers should not rely on it to the extent it is inconsistent with I.R.C. §167(f), I.R.C. §197, or the final regulations under I.R.C. §197.**

Mortgage Servicing Rights. The proposed regulations treat mortgage-servicing rights relating to a pool of mortgages as a single asset under I.R.C. §167(f). Commentators asserted that each mortgage should be treated separately. Nevertheless, the final regulations retain the rule that no loss is recognized if some but not all mortgages in a pool prepay or are sold or exchanged. The final regulations, however, provide that if a taxpayer established multiple accounts within a pool at the time of acquisition, gain or loss is recognized on the sale or exchange of all mortgage-servicing rights within any such account.

When §197 Amortization Begins. The proposed regulations provide that amortization begins **the later of the first day of the month in which the property is acquired, or the first month in which the active conduct of a trade or business begins.** Commentators suggested that I.R.C. §197 allows amortization beginning with the month the intangible is acquired. However, the final regulations retain the rule that amortization begins no earlier than the first day of the month in which the active trade or business or the activity described in I.R.C. §212 begins.

Transactions Involving Partnerships. The IRS changed the regulations as they relate to partnership transactions to reflect recommendations received from commentators. Example 16 in the proposed regulations provided that a partner could amortize a §743 adjustment for a I.R.C. §197 intangible only if the partnership formation and the sale of the partnership are unrelated. The final regulations remove the unrelated-transaction requirement.

The final regulations changed the proposed regulations to permit a partnership to make curative or remedial allocations to its noncontributing partners of amortization relating to an asset that was amortizable in the hands of the contributor. However, for assets that were nonamortizable in the hands of the contributor, the rules allow deductible amortization allocations to noncontributing partners only under the remedial method. In addition, remedial allocations of deductible amortization expenses may not be made to a party related to a partner who contributes an intangible subject to the antichurning rules. As suggested, the final regulations provide guidance for determining the basis adjustment under I.R.C. §§723(d) and 743 that is subject to the antichurning rules.

Contracts for the Use of a I.R.C. §197 Intangible. In response to comments, the final regulations provide that royalty payments for the use of I.R.C. §197 intangibles unconnected with the purchase of a trade or business are not required to be capitalized. The final regulations also provide that the acquisition of an interest in a franchise, trademark, or trade name is disregarded in determining whether acquired property is a trade or business if the grant of the interest is not a transfer of all substantial rights in the trademark or trade name.

Antichurning Rules. The antichurning rules of I.R.C. §197 prevent taxpayers from converting assets held during the transition period into amortizable I.R.C. §197 assets through transfers to related parties. The final regulations provide guidance on issues regarding the antichurning rules and the circumstances in which persons are treated as related under those rules. An exemption from the antichurning rules is provided if the person from whom the taxpayer acquires an intangible elects to recognize gain and agrees to pay a specified amount of tax. The final regulations provide guidance on how an exemption from the antichurning rules can be made.

Notice 2000-50
§613A

> ☞ **The IRS has updated the oil and gas production applicable percentages for marginal properties for 2000.**

Notice 2000-50 contains a table of **the applicable percentages for oil and gas production for marginal properties,** covering tax years beginning in 1991 through 2000.

I.R.C. §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 1999 calendar year is $15.56.

Calendar Year	Applicable Percentage
1991	15%
1992	18%
1993	19%
1994	20%
1995	21%
1996	20%
1997	16%
1998	17%
1999	24%
2000	19%

[Notice 2000-50, 2000-38 IRB 291]

ENVIRONMENTAL EXPENDITURES

Ltr. Rul. 199952075
[I.R.C. §162]

> ☞ **A public utility company was allowed a current deduction for environmental cleanup costs occurring *only* during ownership of the property.**

Facts. Taxpayer is a public utility company that **purchased a manufactured gas plant** that had been in operation for several years. Taxpayer **continued to operate the plant for two years** and then switched over to supplying natural gas. Taxpayer **then built a new operations facility on the**

site. While taxpayer was building the new facility, **it performed environmental cleanup operations on the site.** Taxpayer deducted its environmental cleanup costs, which included amounts paid or incurred for site investigations and reports, preparation and implementation of remediation actions plans, site remediation, and amounts paid or incurred for associated legal fees. The IRS's examination agent requested technical advice.

Issue. Whether taxpayer may currently deduct under I.R.C. §162 the costs of cleaning up environmental contamination on its property or whether such costs must be capitalized under I.R.C. §§263 and 263A

Analysis. Taxpayer argues that environmental costs are deductible under Treas. Reg. §1.162-4 as incidental repair costs that neither materially add to the value of its property nor appreciably prolong its useful life, but keep its property in an ordinarily efficient operating condition. Taxpayer cited Rev. Rul. 94-38, wherein a taxpayer was allowed a current deduction under I.R.C. §162 for costs incurred for environmental cleanup of property that the taxpayer had contaminated with hazardous wastes.

The examination agent claims that the environmental costs must be capitalized under I.R.C. §§263 and 263A since taxpayer's environmental cleanup costs were incurred in connection with the construction of a new building on the site, and were therefore incurred to adapt this property to a new or different use under Treas. Reg. §1.263(a)-1(b). The agent argued that under *Norwest Corp. v. Commissioner*, 108 T.C. 265, the taxpayer was required to capitalize its environmental cleanup costs as part of a general plan of rehabilitation of its manufactured gas plant property.

The IRS distinguished the taxpayer's situation from *Norwest* and other cases where the plan of rehabilitation applied, since the **taxpayer's environmental cleanup costs were not directly related to the construction of the building, but to the land, an asset separate and apart from the new building.** The IRS noted that, in general, **courts and the IRS have been reluctant to apply the plan of rehabilitation doctrine to require capitalization of otherwise deductible expenses when the expenses related to an asset different from the asset that is being rehabilitated or improved.**

The IRS concluded that to **the extent that the utility's cleanup costs were allocable to the remediation of contamination that was present when it acquired the site,** the cleanup of preexisting contamination did more than restore the site to the condition that existed at the time the utility purchased it. **Rather, those costs were an improvement or betterment to the site compared to its condition when acquired.**

Holding. The IRS concluded that the **taxpayer may currently deduct** under I.R.C. §162 the **costs of cleaning up environmental contamination to the extent that these costs are allocable to contamination that occurred during taxpayer's ownership of the site. To the extent that taxpayer's cleanup costs are allocable to contamination that occurred prior to taxpayer's acquisition of the site, taxpayer must capitalize these cleanup costs under I.R.C. §§263 and 263A.**

ESTATE AND GIFT TAX

T.D. 8854
Treas. Reg. §§20.2001-1, 25.2504-2, 301.6501(c)-1
[I.R.C. §§2001, 2504, 2511, and 6501]

☞ **Final regulations provide adequate disclosure requirements for running of period of limitations.**

This document contains final regulations relating to changes made to I.R.C. §§2001, 2504, and 6501 by the Taxpayer Relief Act of 1997 and Internal Revenue Restructuring and Reform Act of 1998 regarding the valuation of prior gifts in determining estate and gift tax liability and the period of assessing and collecting gift tax. These regulations are necessary **because I.R.C. §6501(c)(9) now requires that a gift must be adequately disclosed on a gift tax return in order for the period of limitations on assessment to begin running for that gift. Once the period of limitations has expired, the amount of the gift reported on the return may not be adjusted for determining future gift and estate tax liability.** These regulations provide guidance on what constitutes adequate disclosure for purposes of the statute.

Explanations of Revisions and Summary of Comments

Commentators expressed concern that the proposed regulations would impose two requirements for adequate disclosure. Taxpayers would have to provide adequate information on the nature of the gift, etc., and taxpayers would also have to provide the information listed in Treas. Reg. §301.6501-1(f)(2). The final regulations clarify that **adequate disclosure is satisfied if the information listed in the regulation is provided.**

The proposed regulations required that taxpayers transferring property in trust provide a brief description of the terms of the trust. In response to comments, taxpayers may submit a complete copy of the trust document in lieu of a description of trust terms.

Several commentators expressed concern over the requirement that taxpayers that transferred a less-than-100-percent interest in a non-actively traded entity must submit a statement regarding the fair value of 100 percent of the entity determined without regard to any discounts. The final regulations do not require a statement of the fair market value of 100 percent of the entity if the value of the interest in the entity is determined without using net asset value of the entire entity.

The proposed regulations required valuation information for each entity (and its assets) that is owned or controlled by the entity subject to the transfer. In response to commentators, the final regulations require that the information on the lower-tiered entities must be submitted if the information is relevant and material in determining the value of the interest in the entity. In addition, following commentators' suggestions, under final regulations an appraisal satisfying specific requirements may be submitted in lieu of a detailed description of the method used to determine the fair market value and in lieu of information regarding tiered entities.

Commentators complained that the proposed regulations' requirement of a statement of relevant facts that would make IRS aware of potential gift tax controversies was too subjective and open ended. This requirement has been eliminated from the final regulations.

In response to comments, a rule was added regarding split gifts under I.R.C. §2513. **Gifts attributed to the non-donor spouse are deemed adequately disclosed if the gifts are disclosed on the return filed by the donor spouse.**

Commentators objected to the rule in the proposed regulations that the IRS is not precluded from making adjustments involving legal issues, even if the gift was adequately disclosed. The final regulations preclude adjustments with respect to all issues related to a gift once the gift tax statute of limitations expires with respect to that gift.

Commentators expressed concern about the requirements for nongift transfers. One commentator suggested that the adequate disclosure standard is higher for a nongift than it is for a gift transfer because under the proposed regulations a donor making a transfer not constituting a gift must provide all the information required by the regulation as well as a statement of why the transaction is not a gift. In response, the final regulations limit the information required in a nongift situation. In addition, the final regulations provide that completed transfers to members of the transferor's family in the ordinary course of operating a business will be deemed adequately disclosed if the transfers are properly reported by all parties for income tax purposes.

The final regulations clarify the effective dates. The period for assessment with respect to any gift made after December 31, 1996, does not commence to run unless the gift is adequately disclosed. Also, for gifts made prior to 1997, the IRS may not revalue the gift for purposes of determining prior taxable gifts for gift tax purposes if a gift tax was assessed and paid and the period for assessment has expired. However, the IRS may adjust the gifts for purposes of determining adjusted taxable gifts for estate tax purposes.

Requirement for Adequate Disclosure Under Treas. Reg. §301.6501(c)-1(f)(2)

The final regulations require that transfers reported on a gift tax return as transfers of property by gift are **considered adequately disclosed if the return, or attached statement, provides the following information:**

1. A description of the property and any consideration received by the transferor
2. The identity of transferor and the relationship between the transferor and the transferee
3. If the property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust, or in lieu of the description, a copy of the trust instrument
4. a. A detailed description of the method used to determine the fair market value of the transferred property, including any financial data (e.g., balance sheets) that were used in determining the value of the interest and a description of any discounts or restrictions on the transferred property that were considered in determining its value (see Treas. Reg. §301.6501(c)-1(f)(2)(iv) for details regarding this requirement), or

   b. An appraisal of the transferred property meeting the requirements of Treas. Reg. §301.6501(c)-1(f)(3)
5. A statement describing any position taken that is contrary to any proposed, temporary, or final regulations or revenue rulings published at the time of the transfer [see Treas. Reg. §301.6501(c)-1(f)(2)]

Practitioner Note. The IRS has corrected the final regulations (Document 2000ARD 005-1 TD 8845 Correction) **The final regulations contain the following errors:**

1. **Treas. Reg. §301.6501(c)-1(f)(5): the language "transfer *will not* be subject to inclusion" is corrected to read "transfer *will* be subject to inclusion."0**
2. **Treas. Reg. §301.6501(c)-1(f)(5): the language "purposes. On the other hand, if the . . ." is corrected to read "purposes only to the extent that a completed gift would be so included. On the other hand, if the . . . ."**

Estate of Cavett v. Commissioner
[I.R.C. §2040]

☞ **Payments made to a long-time companion were taxable gifts and not compensation for services.**

Facts. Lloyd Cavett died in 1992, leaving the bulk of his estate to Rose Bell, his longtime companion. Bell had unrestricted access to the decedent's wealth, including a joint bank account and ownership of the residence as joint tenancy with rights of survivorship. **Decedent kept meticulous journals in which he recorded a series of payments to or on behalf of Bell labeled as birthday gifts, Valentine's Day gifts, or gifts for special occasions. Other payments to Bell were labeled "Sal.," "Rose Exp.," and "RAB Exp."** The taxpayers, co-executors of the estate, claimed the other payments were compensation to Bell for services rendered, basing this on statements in decedent's **1981 will. The will stated that income from a trust would go to Rose as compensation for care, attention, and services rendered to his invalid daughter.**

After decedent's death, the taxpayers filed a suit against Bell in state court for theft, fraud, and breach of fiduciary duty to decedent for some of the checks Bell had written on decedent's account. The state court found that the payments were gifts to Bell. Taxpayers timely filed the estate tax return claiming no deduction for claims against the estate by Bell. **The decedent filed only one gift tax return during his life, reporting a gift of real property to Bell.**

The IRS determined that certain payments to Bell in 1964–1991 represented unreported gifts to Bell from decedent. **Taxpayers filed a claim for refund in 1996, claiming that the bequest to Bell on the original estate tax return was properly classified as a debt of the estate under a contract to make a will.** Taxpayers filed a second claim for refund, claiming that on account of a prior gift, only one-half the value of the residence is properly includable in his estate and the estate incurred administrative expenses not previously deducted.

Issues

1. Whether certain inter vivos payments to decedent's longtime companion were gifts or payments for services rendered
2. Whether a bequest to the longtime companion is a deductible claim against the estate on account of an agreement to make a will
3. Whether only one-half the value of decedent's residence is includable in the gross estate
4. Whether certain bequests to Masonic and fraternal organizations are deductible for estate tax purposes

Analysis

Issue 1. The court noted that the issue in this case is similar to *Pascarelli v. Commissioner,* 55 T.C. 1082 (1971), where a couple lived much like the decedent and Bell and where the court had to determine whether payments were gifts or compensation. The court concluded, in *Pascarelli,* that the individual did not perform services for the purpose of obtaining compensation, but rather with the same spirit of cooperation that would motivate a wife to strive to help her husband, and the payments were gifts because they "proceeded from disinterested and detached generosity . . . motivated by sentiments of affection, respect, and admiration." The court noted in the current case, that the **decedent and Bell had a close, personal, and loving relationship, resembling a marriage,** and it was persuaded that **the services were freely and voluntarily given, out of love and affection, and received in the same spirit.**

Issue 2. The court noted that taxpayers **failed to prove that any obligation imposed on decedent by the agreement in the 1981 will was for an adequate and full consideration in money or money's worth, which is required to support a deduction under I.R.C. §2053(a)(3) and (c)(1)(A).**

Issue 3. I.R.C. §2040 provides that the value of the gross estate shall include the value of all property to the extent of the interest held as joint tenants with right of survivorship by the decedent and another person.

Issue 4. I.R.C. §2055(a)(3) allows a deduction for bequests to a fraternal society, order, or association operating under the lodge system, but only if such contributions are to be used exclusively for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals. Taxpayers failed to introduce any evidence to show the organizations' use of the contribution.

Holding

Issue 1. The Tax Court held that the inter vivos payments were gifts, not compensation for services rendered.

Issue 2. The Tax Court held that the bequest is not a deductible claim against the estate.

Issue 3. The Tax Court held that all of the value of the residence is includable in the gross estate, but no portion is includable as an "adjusted taxable gift."

Issue 4. The Tax Court held that no deduction is allowed for the bequests to the Masonic and fraternal organizations, since taxpayer has failed to prove the exclusive charitable purpose of those bequests.

[*Estate of Lloyd P. Cavett, Deceased, Lloyd Peterson and Kyle C. Brooks, Co-Executors v. Commissioner*, 79 TCM 1662 (March 15, 2000)]

Church v. United States

[I.R.C. §§2033, 2703, 2036, 2038, and 2501]

☞ **Family limited partnership formed shortly before death, which greatly reduced estate taxes, was formed for bona fide business purpose.**

Facts. On October 22, 1993, two days before decedent's death, Elsie Church and her two children signed a limited partnership agreement. The purpose of the partnership was twofold: (1) the partners wished to consolidate their undivided interests in a family ranch **to provide for centralized management of their interests and preserve the ranch as an on-going enterprise for future generation,** and (2) decedent was concerned about **protection of her substantial assets from judgment credits** in the event of a catastrophic tort claim against her.

Decedent and her two children were limited partners in the partnership. **A corporation was designated as the general partner** and was to be owned 50-50 by the two children to reflect their active roles in managing the ranch. **This corporation, however, had not yet been formed when the son signed the partnership agreement on its behalf on October 22, 1993.** The capital contributions to the partnership consisted of each limited partner's undivided interest in the ranch. In addition, the decedent contributed approximately $1,000,000 in securities held in street name and some cash. At the time, the limited partners owned 57 percent of the ranch while members of another family owned the remaining 43 percent. Of the 57 percent interest owned by the partnership, decedent owned 62 percent in her individual capacity, decedent's two children owned 18 percent each, and decedent owned the remaining 2 percent as a trustee. The market value of the interest in the ranch contributed by decedent was $380,038, and the combined market value of her children's interests was $232,927.

Two days after these transactions, decedent died suddenly and unexpectedly of cardiopulmonary collapse. At the time she died, decedent had breast cancer. However, the court accepted the testimony of decedent's physician that her death was unexpected and unrelated to her cancer.

The organization of the partnership affairs was not completed prior to decedent's death. The partnership certificate was not filed with the State of Texas until October 26, 1993, and the corporate general partner was not actually organized until March 1994. Decedent's investment account was not changed to a partnership account until March 1994.

Issues

Issue 1. Whether the formation of a limited partnership was a bona fide business transaction or simply a device to transfer property to members of her family for less than full and adequate consideration

Issue 2. Whether the transfer of securities and an undivided interest in a family ranch in exchange for an interest in a limited partnership two days prior to decedent's death constitute a taxable gift to the decedent's heirs

Analysis. The IRS contended that the formation of the partnership was a sham transaction entered into solely for the purpose of reducing the decedent's estate taxes. **The District Court found this not to be the case.** The court found that the character of the interests owning a majority of the ranch changed dramatically as a result of the partnership. Prior to the partnership formation, the parties owned an undivided interest with each carrying the right to use and enjoy the property, or force a partition or possible sale. **Formation of the partnership placed ownership of a majority of the ranch in an entity that was not controlled by any single person.**

The IRS argued that **decedent had not conveyed the securities to the partnership prior to her death.** The court pointed out that **under well-established principles of Texas law, ownership**

of property intended to be a partnership property is not determined by legal title, but rather by the intention of the parties, and that the decedent's intention was to relinquish her beneficial interest in the securities held by the broker, as expressed by her execution of the partnership agreement.

The IRS then argued that if the securities were effectively conveyed to the partnership, there was **a taxable gift on formation of the partnership represented by the difference between the value of the assets transferred by decedent to the partnership,** $1,467,748, **and the value of the partnership interest she received in return,** $617,591, the estimated market value at her death. The court said that the IRS confused the market value of the interest passing at death with the value of the partnership interest decedent received in return for her contribution, and the court said the two were not comparable. The court noted that the **IRS ignored the fact that this was a pro rata partnership that did not confer a financial benefit on, or increase the wealth of, any partner.** The court pointed out that there never could be a gratuitous transfer in the formation of a business entity in which each investor's interest is proportional to the capital contributed. Furthermore, the court said a gift requires a donee, and there was no donee in this case.

Holding

Issue 1. The District Court found that the partnership had a bona fide business purpose and was not a sham transaction as that term is used in estate taxation.

Issue 2. The District Court found that the transfer of securities and an undivided interest in the family ranch in exchange for an interest in a limited partnership two days prior to decedent's death did not constitute a taxable gift to the decedent's heirs.

[*Elsie J. Church, Deceased, Marshall B. Miller, Jr. and Mary Elsie Newton, Independent Co-Executors v. Unites States of America*, 2000-1 USTC ¶60,369 (D.C. Texas, January 18, 2000)]

Ltr. Rul. 199938005
[I.R.C. §2036]

☞ **The value of closely held stock transferred to a family limited partnership was includable in taxpayer's gross estate, because he retained voting rights.**

Facts. Decedent and his brother each owned a 50 percent interest in the voting and nonvoting shares of a corporation. In renegotiating a revolving credit agreement, the bank required the shareholders to devise a plan of management and ownership succession. Therefore, **each shareholder transferred 55 percent of his stock to a family limited partnership** in exchange for 10 general partnership units, 1,000 Class A limited partnership units, 100 Class B limited partnership units, and 100 Class C limited partnership units. On the same day, **decedent transferred** 50 Class B units to Child 1, 50 Class B units to Child 2, 50 Class C units to Child 3, 50 Class C units to Child 4, and his **remaining partnership units and stock to a revocable trust of which he was trustee.** Under the terms of the trust, the trust assets passed to his four children.

The partnership agreement authorized the general partners to vote the shares of the corporation. At his death, the trust held decedent's 10 general partnership units, his 1,000 Class A limited partnership units, and 22.5 percent of the outstanding stock in the corporation. These items were included in his estate.

Issue. Whether the value of the closely held stock transferred by decedent to the partnership is includable in decedent's gross estate under I.R.C. §2036(b), because in his capacity as general partner, decedent retained the right to vote the stock

Analysis. Under I.R.C. §2036(a), the **gross estate includes the value of property the decedent transferred** (except for a bona fide sale for adequate consideration) **during his life if he retained possession or enjoyment of, the right to income of, or the right to designate the persons who**

may enjoy the property or income from the property. I.R.C. §2036(b)(1) provides that the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation is considered retention of enjoyment of transferred property. A corporation is a controlled corporation for purposes of this provision if at any time after the transfer and during the 3-year period ending on the decedent's death, the decedent owned (with application of I.R.C. §318 constructive ownership rules) or had the right (either alone or in conjunction with any person) to vote stock possessing at least 20 percent of the total combined voting power of all classes of stock.

The IRS concluded that the transfer of decedent's shares of voting stock to the partnership was properly viewed as a transfer of the stock for less than adequate consideration, since his children received part of the consideration for his transfer of stock to the partnership.

As a general partner, the decedent retained the right to vote the voting shares. The IRS noted that the legislative history of I.R.C. §2036(b) indicates that it applies regardless of the capacity in which the decedent exercises the voting rights. The IRS concluded that I.R.C. §2036(b) thus applies where the stock is voted by the decedent indirectly through a fiduciary and, accordingly, would necessarily apply where the decedent holds the voting rights directly, as a fiduciary. **Therefore, the decedent's retention of the right to vote the corporation's stock in his capacity as a general partner constitutes the retention of the right to vote the transferred stock for purposes of I.R.C. §2036(b).** This resulted in inclusion of the date-of-death value of the voting shares held by the partnership in decedent's estate.

The estate argued that I.R.C. §2036(b) does not apply since the decedent could vote the corporation stock only in conjunction with the other general partner. The partnership agreement provided that if the general partners cannot agree on how the shares in the corporation are to be voted, then each general partner is to vote that number of shares proportionate to his general partnership unit. The IRS expressed its belief that I.R.C. §2036(b) applies even if the voting power is exercisable by a decedent only in conjunction with another.

The IRS also expressed its belief that I.R.C. §2036(b) would apply if the steps of the transaction had occurred several years apart. That is, if decedent had transferred his shares of corporation voting and nonvoting stock in exchange for the partnership units and two years later transferred the Class B and C units to his four children, then under I.R.C. §2036(b) the date-of-death value of the shares held in the partnership would be includable in decedent's gross estate.

Holding. The IRS held that the value of the closely held stock transferred by decedent to the partnership is includable in decedent's gross estate under I.R.C. §2036(b).

FICA TAX

Quietwater Entertainment, Inc. v. United States
[I.R.C. §§3401 and 6053]

> ☞ **The IRS does have the authority to assess employer FICA on aggregate unreported tips where employees share tips.**

Facts. The employees of taxpayer's restaurant shared their tips with the support staff. **Taxpayer received and recorded employee tip reports and withheld employee taxes and employer share of FICA taxes on the basis of reported tips.** The IRS issued a notice and demand for payment after **determining that taxpayer owed additional unpaid FICA taxes on unreported tips for 1990 and 1991.** The determination was made on an aggregate basis using the gross earnings of the restaurant as reported on its Form 8027, Annual Information Return of Tip Income and Allocated Tips. The IRS used a modified "McQuatters formula" to calculate the taxes owed. Taxpayer paid the amount of taxes assessed and filed a refund claim. After the refund claim was denied, taxpayer sued for a refund and won in District Court. The IRS appealed to the Eleventh Circuit.

Issue. Whether the IRS has the authority to assess an employer's share of FICA tax on the unreported tips of employees on an aggregate basis where employees share tips

Analysis. In *Morrison Restaurants Inc. v. United States*, 97-2 USTC ¶50,598, the Eleventh Circuit, reversing a District Court decision, **held that the IRS could assess employer FICA taxes on what it calculates under a formula to be aggregate unreported tips of a taxpayer's employees, without first determining that any individual employee underreported tips.** Taxpayer, in the present case, argued that since the Eleventh Circuit's decision in *Morrison* did not consider the issue of shared tips, *Morrison* was not controlling.

The taxpayer also argued that *Morrison* did not consider the effect of I.R.C. §6053(c)(3), which requires employers of large food or beverage establishments to report to the IRS the gross receipts, the aggregate amount of charge receipts, the aggregate amount of charged tips shown on the charge receipts, and the aggregate amount of tips reported by employees. If the aggregate amount of tips reported by employees is less than 8 percent of gross receipts, the amount of the deficiency is allocable to each employee.

After reviewing the briefs in *Morrison*, the Eleventh Circuit concluded that both of the issues (i.e., the context of shared tips and the effect of I.R.C. §6053) were argued to the *Morrison* panel, and thus were necessarily rejected.

Holding. The Court of Appeals of the Eleventh Circuit held that the IRS **has the authority to assess an employer's share of FICA tax on the unreported tips of employees on an aggregate basis where employees share tips,** reversing the District Court's decision, and remanded the case to the district court with instructions to enter judgment for the IRS.

[*Quietwater Entertainment, Inc. v. United States*, 2000-2 USTC ¶50,540 (CA-11)]

Shotgun Delivery, Inc. v. United States
[I.R.C. §62]

☞ **Drivers' reimbursements were wages subject to payroll taxes because they were not based on actual expenses.**

Facts. Taxpayer is a **corporation in the business of providing courier services for point-to-point deliveries. Its drivers generally use their own vehicles. During the relevant years, drivers were paid on a commission basis, receiving 40 percent of the tag rate for each job they completed.** After submitting hours worked, distance traveled, and tag rates charged, **the drivers were paid via two separate checks.** The first check was **a wage check for hours worked,** calculated at $4.25 per hour for regular time and $6.38 per hour for overtime. **The second check, referred to as reimbursement for expenses/lease fee, was the 40 percent commission minus the wage check.** Taxpayer treated the second check as a reimbursement of expenses; therefore, no withholdings were made for income tax or employment taxes, and the amount was not reported on the employees' W-2 Forms.

The IRS determined that the amounts treated as reimbursements were wages for purposes of employment taxes and assessed a deficiency.

Issue. Whether the amounts paid to taxpayer's employee-drivers for automobile expense allowances constitute wages subject to employment taxes or were made pursuant to an accountable plan under I.R.C. §62(a)(2)(A)

Analysis. Under Treas. Reg.§1.62-2(c)(4), amounts paid by an employer under an accountable plan are excluded from the employee's gross income, are not reported as wages or other compensation on the employee's W-2 Form, and are exempt from the withholding and payment of employment taxes. **To be considered an accountable plan** under the regulations, the expenses must be for business-related activities only [Treas. Reg. §1.62-2(d)]; **the expenses must be substantiated to the employer within a reasonable period of time** [Treas. Reg. §1.62-2(e)]; and **the arrangement must require**

that the employee return to his employer, within a reasonable time, any amounts paid in excess of the expenses substantiated [Treas. Reg. §1.62-2(c)(2)(i)]. Treas. Reg. §1.62-2(k) provides that if a payor's reimbursement or other expense allowance arrangement indicates a pattern of abuse of the rules of I.R.C. §62(c), all payments made under the arrangement will be treated as made under a nonaccountable plan.

The court determined that **taxpayer's reimbursement program does not meet the business connection requirement, since it reimbursed the drivers regardless of actual mileage driven or expenses incurred.** The court acknowledged that the drivers submitted reports detailing the hours worked and miles driven; however, **taxpayer did not comply with the requirement of returning amounts in excess of expenses substantiated.** The court concluded that since taxpayer's reimbursement arrangement had no logical correlation to actual expenses incurred, it was an abuse of I.R.C. §62(c) and is therefore a nonaccountable plan.

Holding. The District Court concluded that taxpayer's plan did not constitute a valid accountable plan and amounts paid to taxpayer's employee-drivers for automobile expense allowances constituted wages subject to employment taxes.

[*Shotgun Delivery, Inc. v. United States*, 2000-1 USTC ¶50,210 (D.C. Calif. January 20, 2000)]

Escobar de Paz v. Commissioner
[I.R.C. §67]

> ☞ **All income of owner-operators who hauled cargo for carriers in their trucks was held to be wages.**

Facts. Taxpayers **own their trucks and contract under lease agreements with shippers or carriers to haul cargo using their own trucks. The taxpayers reported part of the income from the carrier as wage income and the remainder as rental income on Schedule E** and reported the expenses related to their trucks on Schedule E as rental expenses.

Issue. Whether the lease agreements have independent significance so as to create a separate business activity for tax purposes

Analysis. The **taxpayers contend** that as owner-operators, **they were engaged in two separate activities:** (1) **leasing of their trucks to the carrier companies** for a rental, which is the equivalent of their expenses; and (2) **providing the service of driving the trucks for wages.** The IRS contends that taxpayers are engaged in a single activity, that of providing transportation of cargo for the carriers by use of their own vehicle.

The court noted that *Black's Law Dictionary* defines a lease as a "contract by which the rightful possessor of personal property conveys the right to use that property in exchange for consideration." The court concluded that in the instant cases, the **carriers did not contract solely to use the owner-operators' trucks for a stipulated period of time for consideration, but agreed to enter into a business relationship for the purpose of transferring cargo from one point to another using the owner-operators' vehicles.** The payments for services provided were based on weight of the cargo and distance transferred. The court pointed out that **the owner-operators are not paid for the use of their trucks if they do not drive, and they do not receive wages for driving if they do not provide their own vehicles.**

Holding. The Tax Court held that for income tax purposes the lease arrangements with the carriers had no independent economic significance, that all the income the owner-operators received from the carriers was wage income, and that the expenses pertaining to the operation of the trucks are deductible as itemized deductions on Schedule A subject to the limitations of I.R.C. §67(a).

[*Marcos Eliseo and Teodora C. Escobar de Paz, Jose A. and Dina Batres, Augustin Perec and Isabel Sanchez,* T.C. Memo 2000-176 (May 26, 2000)]

Ltr. Rul. 200006005
[I.R.C. §62]

> ☞ **Tool rental payments made by owner of automobile repair facility to employees are wages.**

Facts. Taxpayer plans to construct and **operate an automotive repair facility as a sole proprietorship.** Taxpayer plans to hire **two automotive technicians as employees, who must agree to provide their own tools as a condition of employment.** The **taxpayer plans to compensate the employees with wages of $8.55 per hour and $4.77 per hour for the use of the employee's tools, which will not be reported to the employee as wages on their Form W-2.**

Taxpayer represented that tool rentals are common in the automotive industry. Taxpayer asserted that it is financially beneficial for taxpayer to compensate its employees with tool rentals because it would cost taxpayer more to purchase or rent similar tools. Taxpayer determined the tool rental amount based upon various factors, including the hourly rate he would pay an employee without tools, replacement cost value of the employees' tools, and expenses he would incur to rent the same tools from a third party.

Issue. Whether amounts taxpayer proposes to pay its employees for the use of the employees' tools are subject to federal employment taxes or paid under an accountable plan as defined in I.R.C. §62

Analysis. Under Treas. Reg. §1.62-2(c)(4), amounts paid by an employer under an accountable plan are excluded from the employee's gross income, are not reported as wages or other compensation on the employee's W-2 Form, and are exempt from the withholding and payment of employment taxes. To be considered an accountable plan under the regulations, the expenses must be for business-related activities only [Treas. Reg. §1.62-2(d)]; the expenses must be substantiated to the employer within a reasonable period of time [Treas. Reg. §1.62-2(e)]; and the arrangement must require that the employee return to his or her employer, within a reasonable time, any amounts paid in excess of the expenses substantiated [Treas. Reg. §1.62-2(c)(2)(i)]. Under Treas. Reg. §1.62-2(k), if a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of I.R.C. §62(c), all payments made under the arrangement will be treated as made under a nonaccountable plan.

The IRS notes that **under the taxpayer's proposed arrangement, he will employ only employees who have their own tools and pay them an hourly amount for tool rental, which bears no relationship to the expenses the employee incurs related to the tools. It notes further that taxpayer will pay the employee the tool rental regardless of whether the employee incurred expenses related to those tools, and this payment plan does not satisfy the business connection requirement.**

Holding. The IRS held that the tool rental arrangement proposed by the taxpayer is not a reimbursement or other expense allowance described in I.R.C. §62(c), but rather, as described in Treas. Reg. §1.62-2(k), a reimbursement arrangement that indicates a pattern of abuse of I.R.C. §62(c).

ISP Paper
[I.R.C. §62]

> ☞ **Generally, amounts paid as tool reimbursements are subject to employment taxes.**

Facts. Automobile dealerships and repair and body shops hire service technicians to perform repair and maintenance service on vehicles. As a condition of employment, the service technicians are required to provide and maintain their own tools. Instead of paying an hourly wage for the performance of services, many employers divide the payment into "wages" and "tool reimbursements." Income and employment taxes are withheld and paid on the wages, but not on the tool reimbursement payment.

Employers use a variety of methods to determine the amount of the tool reimbursements. None of the methods used, however, base the reimbursement payment on actual expenses paid or incurred by the technicians for the tools.

Issue. Whether amounts paid to motor vehicle service technicians as reimbursements for the use of the technicians' tools are paid under an accountable plan

Analysis. Treas. Reg. §1.162-2(c)(4) provides that amounts an employer pays to an employee for employee business expenses under an "accountable plan" are excluded from the employee's gross income, are not required to be reported on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes.

Under Treas. Reg. §1.62-2(c)(2)(i), if a reimbursement or other expense allowance arrangement satisfies the three requirements set forth Treas. Reg. §1.62-2(d), (e), and (f), all amounts paid under the arrangement are treated as paid under an accountable plan. The three requirements are (1) there must be a business connection, (2) the expenses must be substantiated, and (3) amounts in excess of expenses must be returned to the employer.

An arrangement meets the business connection requirement under Treas. Reg. §1.62-2(d) if it provides advances, allowances (including per diem allowances, allowances for meals and incidental expenses, and mileage allowances), or reimbursements for business expenses that are allowable as deductions and that are paid or incurred by the employee in connection with the performance of services as an employee. Treas. Reg. §1.62-2(d)(3)(i) provides that the business connection requirement will not be satisfied if the payor arranges to pay an amount to an employee regardless of whether the employee incurs or is reasonably expected to incur business expenses. Treas. Reg. §1.62-2(e) provides that the substantiation requirement is met if the arrangement requires each business expense to be substantiated to the payor (the employer, its agent, or a third party) within a reasonable period of time. Treas. Reg. §1.62-2(f) provides that the requirement that amounts in excess of expenses must be returned to the payor is met if the arrangement requires the employee to return to the payor, within a reasonable period of time, any amount paid under the arrangement in excess of the expenses substantiated.

Treas. Reg. §1.62-2(k) provides that if a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules, all payments made under the arrangement will be treated as made under a nonaccountable plan.

In *Shotgun Delivery, Inc. v. United States*, 2000-1 USTC ¶50,210 (D.C. Calif. January 20, 2000), the taxpayer, a courier business, reimbursed its drivers regardless of the actual miles driven or expenses incurred. The District Court concluded that since the taxpayer's reimbursement arrangement had no logical correlation to actual expenses incurred, it was an abuse of I.R.C. §62(c) and was therefore a nonaccountable plan.

The IRS noted that employers typically rely on Rev. Rul. 68-624, 1968-2 C.B. 424, as authority for designating a portion of the employee's compensation as tool reimbursements. The IRS concluded that, even though Rev. Rul. 68-624 has not been obsoleted, it should not be relied upon to exclude tool reimbursement payments from wages since the ruling does not comport with current law under I.R.C. §62(c). The IRS indicated that to exclude employee reimbursements or other expense allowance payments from wages, an employer must establish an accountable plan that meets the three requirements of business connection, substantiation, and return of excess.

The IRS pointed out that it is also important to determine when the employer began compensating its employees in part with a tool reimbursement program, whether the arrangement is written, and whether the terms comply with the requirements of an accountable plan. The IRS noted that there is no "industry practice" exception to the accountable plan requirements.

Conclusion. Generally, amounts paid to motor vehicle service technicians as tool reimbursements will not meet the accountable plan requirements and are therefore included in the employee's gross income, reported to the employee on Form W-2, and are subject to the withholding and payment of federal employment taxes.

FSA 1999400002
[I.R.C. §§62 and 3121]

☞ **If amounts paid to employees as rig rentals are paid under an accountable plan, they are not wages for employment tax purposes.**

Facts. Generally, an employer engaged in the business of specialized industrial construction will hire employee rig welders. **Welders are highly skilled, and when hired to perform welding services they perform only that function at the job site. They provide all of their own equipment, which generally includes a truck, welder, welding tanks, and related items. On a non-union job, welders are required to provide all their own welding supplies. On a union job, supplies are generally provided by the employer.**

Typically, the welders are paid $10 per hour, which is treated as wages subject to employment taxes, and an additional amount, such as $20 per hour, to rent the employee's welding equipment, commonly referred to as rig rental. The welder is paid when he turns in his rig ticket, which reports the hours worked each day but does not indicate the expenses the welder incurred associated with his equipment. **The rig rent is based solely on hours worked and has no apparent relationship to expenses incurred.** The employer issues two checks, one for wages and one for rig rentals. The amount treated as wages will be reported to the employee on Form W-2, and **the rig rental, if reported, will be reported on Form 1099.**

Issue. Whether amounts paid to employees as rig rentals are wages for federal employment tax purposes

Analysis. Under Treas. Reg. §1.62-2(c)(4), amounts paid by an employer under an accountable plan are excluded from the employee's gross income, are not reported as wages or other compensation on the employee's W-2 Form, and are exempt from the withholding and payment of employment taxes. To be considered an accountable plan under the regulations, the expenses must be for business-related activities only [Treas. Reg. §1.62-2(d)]; the expenses must be substantiated to the employer within a reasonable period of time [Treas. Reg. §1.62-2(e)]; and **the arrangement must require that the employee return to his employer, within a reasonable time, any amounts paid in excess of the expenses substantiated** [Treas. Reg. §1.62-2(c)(2)(i)]. Under Treas. Reg. §1.62-2(k), if a payor's reimbursement or other expense allowance arrangement indicates a pattern of abuse of the rules of I.R.C. §62(c), all payments made under the arrangement will be treated as made under a nonaccountable plan.

An arrangement meets the business connection requirement of Treas. Reg. §1.62-2(d) if it provides advances, allowances (including per diem allowances, allowances for meals and incidental expense, and mileage allowances), or reimbursements for business expenses that are allowable as deductions under I.R.C. §§161 through 196, and that are paid or incurred by the employee in connection with the performance of services as an employee. Under Treas. Reg. §1.62-2(d)(3)(i), **the business connection requirement will not be satisfied if the payor arranges to pay an amount to an employee regardless of whether the employee incurs, or is reasonably expected to incur, business expenses** described in paragraph (d)(a) or (d)(2).

In Rev. Rul. 68-624, 1968-2 C.B. 424, the corporation hires a truck and driver, pays a fixed amount per load, and allocates one-third of the payment as wages and two-thirds as payment for use of the truck. The ruling states that if the contract of employment does not specify a reasonable division of the total amount paid between wages and equipment, a proper allocation may be arrived at by reference to the prevailing wage scale in a particular locality for similar services in operating the same class of equipment or the fair rental value of similar equipment. The IRS expressed its belief that Rev. Rul. 68-624 should not be relied upon to exclude rental payments for equipment from wages because it is incomplete under current law since it does not consider whether the rental payments are paid under an accountable plan. The IRS noted that an employment contract that merely allocates compensation between wages and rentals will not satisfy the requirements of I.R.C. §62(c). The IRS maintains that to exclude employee reimbursements or other expense allowance payments from wages an employer must establish an accountable plan.

In *Trans-Box Systems v. United States*, No. C-97-2768, 1998 U.S. Dist. LEXIS 3560 (N.D. Cal. August 28, 1998), a courier service paid its drivers, who used their own cars to make deliveries, $8.95 per hour. Trans-Box treated 45 percent of the payment as wages subject to employment taxes and treated the remaining 55 percent as either lease payments or vehicle expense payments. The IRS assessed employment taxes on the entire $8.95. The court found that Trans-Box failed to comply fully with the accountable plan requirements and granted the IRS summary judgment.

In *Welch v. Commissioner*, T.C. Memo 1998-310, the taxpayer, a carpenter and construction coordinator, was paid by his employer both wages for his labor and rental payments for the use of his tools and equipment. Mr. Welch and the employer would enter into a "deal memorandum," which set forth the terms of his employment, including the rate he would be paid and the rate at which he rented his equipment to the company. The employer issued a 1099 for the rental payments and a W-2 for the wage payments. He also reported $1,500 for rental of tools to a third party for which he was not the construction coordinator. The IRS contended that Mr. Welch's rental activity was a passive activity. However, the Tax Court concluded that it was not because he provided equipment to production companies for an average period of 30 days or less and he performed significant personal services in connection with making the property available for use by customers.

The IRS acknowledged that the Tax Court was not required to decide whether the rental arrangement was an accountable plan under I.R.C. §62(c) or whether Mr. Welch was an employee or an independent contractor; however, the facts illustrate an arrangement for the rental of equipment that was an arms-length transaction and in writing. The IRS pointed out that perhaps the most significant fact was that Mr. Welch actually rented his tools to a third party that did not also employ him as the construction coordinator, and therefore his rental activity was separate from the services he performed as an employee.

Holding. The IRS concluded that **whether rig rentals are wages depends on whether the rentals are paid pursuant to an accountable plan. If so, the payments are not wages for employment tax purposes.** Thus, the issue that must be resolved based on the facts and circumstances of each case is whether the rig rentals are paid pursuant to an accountable plan.

GAINS AND LOSSES

Rev. Rul. 99-56
[I.R.C. §165]

☞ **The IRS revokes rulings on casualty losses on timber that conflict with recent court decisions.**

Issue. Whether to revoke Rev. Rul. 66-9, 1966-1 C.B. 39, and Rev. Rul. 73-51, 1973-1 C.B. 75

Analysis. Treas. Reg. §1.165-7(b)(2) provides that a casualty loss must be determined by reference to a single, identifiable property (SIP) damaged or destroyed by casualty. **Rev. Rul. 66-9 held that, in the case of timber, the SIP damaged or destroyed by casualty is the quantity of timber–the units of wood in standing trees that are available and suitable for use by forest industries–rendered unfit by the casualty.** The ruling required total destruction of the timber to trigger a casualty loss. The ruling also held that the loss from the sale of timber not destroyed by the casualty was determined at the time of sale by subtracting the adjusted basis of the quantity of timber disposed of from the amount received for the timber.

Rev. Rul. 73-51 repeated the SIP definition of Rev. Rul. 66-9 and disallowed a casualty loss. The ruling held that root damage stunting tree growth did not result in any of the existing timber being rendered unfit for use.

Recent cases were decided contrary to Rev. Rul. 66-9 and Rev. Rul. 73-51. In *Westvaco Corp. v. United States*, 85-1 USTC ¶9101 (Ct. Cl. 1980), the Court of Claims held that **the SIP damaged or destroyed by storms and fires included all of the taxpayer's standing timber in the district (block) directly affected by each casualty and not just the units of timber contained in the trees suffering mortal injury.** The court stated that the appropriate SIP was any unit of property that has an identifiable adjusted basis that was reasonable, logical, and identifiable in relation to the area affected by the casualty. The court held that the allowable loss for casualty is not limited to merchantable units of timber totally destroyed.

In *Weyerhauser Co. v. United States*, 96-2 USTC ¶50,420 (CA-FC), the U.S. Court of Appeals for the Federal Circuit held that **the SIP damaged or destroyed by several forest fires and a volcanic eruption affecting the taxpayer's timber property was the block–i.e., the subdivision of the taxpayer's forest holdings selected as a means of tracking the adjusted basis in the timber for depletion purposes.** Consistent with *Westvaco*, a casualty loss was allowed for trees that were damaged but not rendered worthless.

Holding. In light of the court decisions in *Westvaco* and *Weyerhauser*, the IRS revoked Rev. Rul. 66-9 and Rev. Rul. 73-51.

[Rev. Rul. 99-56, 1999-51 IRB 676 (December 06, 1999)]

Lund v. United States
[I.R.C. §165]

☞ **Casualty deduction for the decreased appraisal value of home due to avalanches was denied because decrease was not permanent change.**

Facts. Taxpayers owned a vacation home in Utah that was **damaged by avalanches in 1986 and 1993.** Taxpayers claimed a $221,000 casualty loss deduction on their 1993 tax return for the decrease in value, even though their repair costs were only $9,000. The IRS disallowed the deduction.

Issue. Whether taxpayers are allowed a casualty deduction for the reduction in value of their property

Analysis. Taxpayers claimed that **because their home is in an avalanche zone, the use of the home is permanently restricted** during the winter months and **the drop in the appraisal value of their home is not due to mere temporary buyer resistance.**

I.R.C. §165(a) allows a deduction for losses sustained during the taxable year that are not compensated for by insurance or otherwise. Under I.R.C. §165(c)(3), a loss may be deducted if the loss arose from fire, storm, shipwreck, or other casualty, or from theft. Treas. Reg. §1.165-7(a)(2) provides that the casualty loss should be limited to the actual loss resulting from damage to the property, and the appraisal determining the fair market value immediately before and after the casualty should recognize the effects of any general market decline affecting undamaged as well as damaged property.

In *Kamanski v. Commissioner*, 477 F.2d 452 (9th Cir. 1973), in finding that the drop in market value of the taxpayers' residence was due to buyer resistance rather than damage caused by the landslide, the **Ninth Circuit** held that the loss was not attributable to the slide, but to the existence of soil conditions that the occurrence of the slide served to demonstrate. The court **found that loss of value based on buyer predictions that future casualties would cause further damage is not deductible as casualty loss under I.R.C. §165(c)(3).**

In *Finkbohner v. United States*, 86-1 USTC ¶9393 (11th Cir. 1986), the court found that if a taxpayer's property is damaged by a permanent impairment of value caused by the event, but not physically damaged, the taxpayer may claim a casualty deduction. However, the court held that a taxpayer may not claim a casualty deduction for "temporary buyer resistance," which is the loss of present value caused by a fear of future casualty damage. In *Finkbohner*, a flood destroyed 7 out of 12 houses in a neighborhood subdivision, and city officials ordered that the 7 lots be permanently maintained as vacant lots.

The remaining homes lost market value because of the resulting diminished attractiveness of the neighborhood and the loss of privacy.

Holding. The District Court held that the damage was not due to a permanent change and disallowed the casualty deduction.

[*Gordon L. and Lillie D. Lund v. United States*, 2000-1 USTC ¶50,234 (D.C. Utah January 21, 2000)]

Harding v. Commissioner
[I.R.C. §172]

> ☞ **Election to waive NOL carryback was held valid despite taxpayers' claim of invalidity.**

Facts. Taxpayers **reported a net operating loss (NOL) for 1993 and carried it back to 1991** tax return and received a refund for 1991 tax liability. **In 1994 taxpayers reported an NOL and attached a statement to their return electing to relinquish the carryback period.** After filing the 1994 return, the IRS audited the 1993 return and **disallowed the 1993 NOL,** resulting in an income tax deficiency of the 1991 tax liability, which had been refunded.

Issue. Whether the taxpayers' election to waive NOL carrybacks was valid and binding

Analysis. The taxpayers argue that the election made on their 1994 return not to carry their 1994 NOL back 3 years was ambiguous or invalid, pointing out that **they cited an incorrect subsection, I.R.C. §172(B)(3), instead of I.R.C. §172(b)(3).**

I.R.C. §172(b)(3) allows taxpayers to elect to waive or relinquish the carryback deduction and only carry forward their NOLs but cautions that once the election is made for any taxable year, the election shall be irrevocable. Under Treas. Reg. §301.9100-12T(d), this election is made by a statement attached to the return (or amended return) for the taxable year. The statement should indicate the section under which the election is being made and provide information to identify the election, the period for which it applies, and the taxpayer's basis for making the election.

In *Santi v. Commissioner*, T.C. Memo 1990-137, it was held that the following statement was sufficient to waive the carryback and permit the carryover of the taxpayer's NOL deduction: "Taxpayer elects to carry net operating loss over under I.R.C. §172(b)(2)(C)." **Even though the taxpayer cited the wrong portion of I.R.C. §172, the court interpreted the statement in the context of the entire return and held that the waiver was valid.**

Holding. The Tax Court held that the taxpayers' 1994 election was valid and binding and that it precludes carryback of the 1994 NOL deduction to 1991.

[*John M. Harding and Mary J. Harding v. Commissioner*, T.C. Memo 1999-378 (November 16, 1999)]

GAMBLING

Thomas v. United States
[I.R.C. §451]

> ☞ **Lottery prize was taxable when verified, not when the ticket was drawn.**

Facts. Roy Thomas had the winning ticket in the Ohio Super Lotto drawn on December 12, 1992. On December 14, 1992, Mr. Thomas received a receipt for a winning cash option ticket. On January 4, 1993, the lottery produced a pay ticket for Thomas's claim. Prior to issuing a warrant to the taxpayer, the claims department sent a pay list and summary voucher to the Office of Budget Management

(OBM) for approval. The OBM confirmed that sufficient monies were available to pay the claim and transferred the warrant to the office of Auditor to prepare a warrant for the taxpayer. Mr. Thomas presented this warrant for payment on January 28, 1993.

Thomas and his wife filed joint returns for 1992 and 1993 using the cash method. They initially reported the lottery winnings with a present value of approximately $8.9 million on their 1993 return, but **later filed for a refund claiming that the income should have been reported in 1992.** (In 1993, Congress instituted higher tax rates for taxpayers with income over $250,000.) The IRS denied their claim, and a district court granted summary judgment to the IRS.

Issue. Whether the taxpayers could use the economic benefit doctrine to support reporting lottery winnings in 1992 instead of 1993

Analysis. The taxpayers argued that even though they did not receive their lottery winnings until 1993, the winnings constituted income in 1992 under the economic benefit doctrine. The economic benefit doctrine was developed in response to the use of deferred compensation plans for employees. **The doctrine has three elements: (1) the existence of a fund in which money has been placed (2) that is irrevocable and beyond the reach of creditors and (3) in which the beneficiary has vested rights to the money, with receipt conditioned only on the passage of time.** The district court found that the taxpayer's lottery award did not satisfy any of the elements of this doctrine. The court found that their right in the lottery prize wasn't vested until the lottery commission had completed its verification process in 1993. **The Sixth Circuit had the most difficulty with the lack of identification of a fund to which the taxpayers claimed to have an irrevocable right that would have entitled them to apply the economic benefit doctrine.**

Holding. The Sixth Circuit, affirming the district court's decision, **held that the lottery prize was taxable in 1993 when the state verified the winning ticket, and not in 1992 when the winning ticket was drawn.** The economic benefit doctrine did not apply to the lottery income.

[*Roy V. and Eloise F. Thomas v. United States*, 2000-1 USTC ¶50,496 (CA-6, 2000)]

Torpie v. Commissioner
[I.R.C. §63]

> ☞ **A non-itemizer is not allowed to deduct gambling losses.**

Facts. During 1996, Roger Torpie won $858 in a lottery, which he reported on his 1996 tax return. Uncertain of the exact amount of his gambling losses during 1996, all parties agreed that it was more than $858. Mr. Torpie took $858 as a deduction in computing adjusted gross income and claimed the standard deduction on his 1996 return. The IRS disallowed the $858 deduction.

Issue. Whether or not the taxpayer is entitled to a gambling loss deduction

Analysis and Holding. **The Tax Court noted that had the taxpayer been involved in the trade or business of gambling, the gambling losses would have been deductible from gross income on Schedule C, but only to the extent of gambling income.** However, the taxpayer did not argue that he was in the trade or business of gambling. **Since he was not in the trade or business of gambling, his only option was to deduct the gambling losses on Schedule A as an itemized deduction.** Since the taxpayer had no other itemized deductions, it was more advantageous to use the standard deduction. The taxpayer argued that Congress did not intend this result because it discriminates against low-income taxpayers that rarely have sufficient deductions to itemize. The Tax Court noted that it is bound by the literal language of the statutes enacted by Congress, and thus the $858 gambling loss deduction was not allowable.

[*Roger John Torpie v. Commissioner*, 79 T.C.M. 2064 (May 22, 2000) [CCH Dec. 53,893(M)]]

Ltr. Rul. 199945008, July 29, 1999
[I.R.C. §1221]

> ☞ **The sale of rights to lottery winnings is ordinary income.**

Facts. The taxpayer won a prize payable in annual installments in a state lottery. The taxpayer later sold the rights to receive some of the payments.

Issue. Whether or not proceeds that result from the sale of the right to receive lottery winnings are capital gain or ordinary income

Analysis. The IRS found that the taxpayer's case was different from cases in which property was found to constitute a capital asset. **The payment the taxpayer received was merely the discounted present value of her future ordinary stream. The taxpayer did not transfer the right to earn the income; the income was already earned and merely had to be collected.** The IRS noted that what the taxpayer received was a substitute for ordinary income, which was the situation in *Hort v. Commissioner*, 313 U.S. 28 (1941); *Commissioner v. P.G. Lake Inc*., 356 U.S. 260 (1958); *Commissioner v. Gillete Motor Co*., 364 U.S. 130, 134 (1960); and *U.S. v. Midland-Ross*, 381 U.S. 54 (1965). Those cases dictate that the amount received upon the sale of an ordinary income stream is a substitute for ordinary income and must be taxed as ordinary income.

Conclusion. The proceeds that result from the sale of the right to receive lottery winnings are ordinary income.

GROSS INCOME

Warren v. Commissioner
[I.R.C. §107]

> ☞ **Parsonage exclusion for minister is the amount used to provide a home, not the fair market rental value.**

Facts. Richard Warren is a minister of the gospel. In 1992 he and his wife purchased a home for $360,000. **The fair market rental value of the home was $58,061 in 1993, $58,004 in 1994, and $59,479 in 1995. As compensation, the church paid Richard $77,663, $86,175, and $99,653 for the years 1993, 1994, and 1995, respectively.** For some of the years in question, the entire amount of compensation was designated as a housing allowance.

The Warrens spent a total of $77,663 in 1993, $76,309 in 1994, and $84,278 in 1995 for home expenditures (which included the mortgage, utilities, furnishings, landscaping, repairs, maintenance, taxes, and insurance). Based on these expenditures, they excluded all of the 1993 compensation and reported $9,866 in 1994 and $19,654 in 1995. **The IRS determined that the Warrens could exclude only the fair market rental value of the home**. Thus, gross income was increased by the difference between the compensation paid and the fair market rental value of the home for 1993, 1994, and 1995.

Issue. Is the exclusion under I.R.C. §107(2) limited to the fair market rental value?

Analysis. The Tax Court and the IRS differed over the interpretation of the statutory language of I.R.C. §107, which appears below:

Sec. 107. Rental Value of Parsonages
In the case of a minister of the gospel, gross income does not include–

1. the rental value of a home furnished to him as part of his compensation or
2. the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home.

The Tax Court disagreed with the IRS contention that the title of I.R.C. §107, "Rental Value of Parsonages," shows that Congress intended to impose a rental value limit under I.R.C. §107(2), noting that it is well established that the heading of a section does not limit the plain meaning of the text. **The IRS interpreted the exclusion under I.R.C. §107(2) to be the lesser of the amount used to provide a home or the fair market rental value of the home**. It argued that to permit a greater exclusion would be contrary to the "rental" language in the Code and contrary to the legislative history of concern for equality among ministers. **The court noted that although I.R.C. §107(1) limits the exclusion to the rental value of a home furnished as part of a minister's compensation, there is no mention of rental value in I.R.C. §107(2) or the regulations**.

Dissenting were Judges Nims, Cohen, and Ruwe, who stressed that the majority opinion ignored the modifier "rental" in I.R.C. §107(2). The dissenting judges believed that Congress intended an exclusion correlated to rental value, and that the majority's opinion placed ministers or churches utilizing I.R.C. §107(2) rather than I.R.C. §107(1) in a more favorable position.

Holding. The court found that the exclusion from income under I.R.C. §107(2) is the amount used to provide a home, which is not limited to the fair market rental value of the home.

[*Richard D. and Elizabeth K. Warren v. Commissioner*, 114 T.C. No. 23 (May 16, 2000) [CCH Dec. 53,880]]

> **Practitioner Note.** See pages 513 for an illustration of this housing exclusion.

Coady v. Commissioner
[I.R.C. §§61, 104, and 7482]

> ☞ **Legal fees paid directly to attorneys out of a judgment do not offset the amount of the award includable in gross income.**

Facts. In 1990 Nona Coady was discharged from her position as a senior loan officer at Alaska Housing Finance Corporation (AHFC). Ms. Coady and her husband retained a law firm to represent her in a wrongful termination suit against AHFC for a contingent fee of 33.33% or $185 per hour plus costs. A court held that AHFC was liable to Coady for $373,307 ($89,225 for back pay, $76,980 for future lost earnings, and $207,102 for lost fringe and pension benefits). AHFC issued a check to Coady for $259,611 in full payment of the judgment ($373,307 minus federal income tax and FICA). The Coadys paid $221,338 to the law firm for attorneys' fees and litigation costs.

On their 1994 return, the Coadys reported the $89,225 that was paid for back wages as income. They reported the balance of the award, $284,082 (76%), as self-employment income on Schedule C. They claimed $168,217 (76%) of the attorneys' fees and litigation costs as a deduction on Schedule C. The Coadys deducted the balance of the attorneys' fees and litigation costs on Schedule A.

The **IRS contended** that the entire award of $373,307 should have been included in gross income and the $221,338 in **attorneys' fees and litigation costs were deductible as a miscellaneous itemized deduction**.

The **Coadys conceded** that none of the award should have been reported on Schedule C, but should have been reported as income from wages. However, the **Coadys argued that the reportable income should be reduced by the attorneys' fees and litigation costs of $168,217.**

Issue. Whether attorneys' fees and litigation costs paid from a wrongful termination award can be netted against the damage award before inclusion in gross income

Analysis. Relying on *Cotnam v. Commissioner* [263 F.2d 119 (5th Cir. 1959)], **the taxpayers argued that they were entitled to exclude $168,217 from gross income, because they assigned that portion of their settlement to counsel.** In *Cotnam*, the Fifth Circuit concluded that the taxpayer did not have to include the attorney's fee in income because state law (Alabama) gave a superior lien or ownership interest to the attorney in a portion of the award. The Sixth Circuit followed *Cotnam* in *Estate of Clarks* [202 F.3d 854 (6th Cir. 2000)], concluding that the interest portion of an attorney's contingency fee should not be included in gross income, because the common law lien under applicable state law (Michigan) was similar to the Alabama lien in *Cotnam*. The Ninth Circuit noted that the Coady case was different from *Cotnam* and *Clarks*, because under the law of the state involved (Alaska), attorneys don't have a superior lien or ownership interest in the cause of action as they do in Alabama and Michigan.

Holding. **The Ninth Circuit affirmed the Tax Court's ruling that Nona Coady's award was in lieu of wages and compensation, and the entire amount is gross income.** The Coadys simply used a portion of the award to discharge their liability to their attorneys.

[*Franklin P. and Nona Coady v. Commissioner*, 2000-1 USTC ¶50,528 (CA-9, 2000)]

Kenseth v. Commissioner
[I.R.C. §104(a)(2)]

> ☞ **Legal fees paid directly from an age discrimination settlement are includable in gross income.**

Facts. On March 27, 1991, Eldon R. Kenseth was terminated by APV Crepaco, Inc. (APV). Mr. Kenseth was 45 years old and had been employed by APV for 21 years. Mr. Kenseth and 16 other former employees of APV retained the law firm of Fox & Fox to file suit against APV. All of the former APV employees signed identical contingent fee agreements with Fox & Fox. In 1993 Fox & Fox negotiated a total settlement of $2,650,000 on behalf of the claimants. Out of the total settlement, 40% or $1,060,000 went to Fox & Fox pursuant to the contingent fee agreements.

Eldon Kenseth's share of the settlement was $229,501. Of this amount, $32,477 (less applicable employment taxes) was paid directly to Mr. Kenseth as lost wages. The remaining portion of the settlement, $197,024, was characterized as personal injury damages excludable from income under I.R.C. §104(a)(2). APV issued a check to Fox & Fox for the personal injury portion. Fox & Fox calculated a fee of $91,800, deducted a retainer payment of $500, and issued a check to Mr. Kenseth for $105,724.

On their 1993 income tax return, Mr. and Mrs. Kenseth reported only the portion of the settlement ($32,477) that was allocated to wages. They did not report any of the personal injury damage award, nor did they deduct any attorneys' fees. The IRS increased their gross income by $197,024, but allowed $91,800 in legal fees as an itemized deduction. The Kenseths conceded that all of the settlement proceeds were includable in gross income except for the portion used to pay Fox & Fox under the contingent fee agreement.

Issue. Whether attorneys' fees that were paid out of an age discrimination settlement are includable in income under the assignment-of-income doctrine

Analysis. **The Kenseths argued that they had insufficient control over the settlement funds used to pay the attorneys and should not be taxed on amounts to which they had no legal right and which they could not and did not receive.**

The majority declined to follow the reasoning of *Cotnam* (59-1 USTC ¶9200) and *Estate of Clarks* (2000-1 USTC ¶50,158). In both *Cotnam* and *Clarks*, the taxpayers were entitled to exclude legal fees because the applicable state law gave a superior lien or ownership interest to the attorneys for a portion of the award. The majority in the current case adhered to *O'Brien* (63-2 USTC ¶9633), which held that even if the taxpayer has made an irrevocable assignment of a portion of his future recovery to his attorney to such an extent that he never thereafter became entitled to it for even a split second, it would still be gross income to him under the assignment-of-income principles. **The majority discussed the split of authority among the Federal Courts of Appeal on this issue, but noted its belief that the court should not modify established tax law principles or doctrines to counteract hardship in specific cases**.

Judge Herbert Chabot, dissenting, noted that the majority taxes the Kenseths with substantial funds that the couple never received and were never entitled to receive in the name of the assignment-of-income doctrine, even while acknowledging that there may be injustice in doing so. Judge Renato Beghe also dissented, finding that the facts don't call for the application of the assignment-of-income doctrine. Judge Beghe noted that most of the assignment-of-income cases decided by the Supreme Court have involved intrafamily donative transfers with the issue being the retained control over the subject matter. He noted that Kenseth's retained control, if any, was so small as to make it unreasonable to charge him with the full amount of the settlement.

Holding. In a divided decision, the Tax Court held that **the attorneys' fees were includable in income** under the assignment-of-income doctrine.

[*Eldon R. and Susan M. Kenseth v. Commissioner*, 114 T.C. No. 26 (May 24, 2000) [CCH Dec. 53,895]]

> See also *Benci-Woodward v. Commissioner*, 2000-2 USTC ¶50,595, for a similar result, where the Ninth Circuit, affirming the Tax Court, held that the **full amount of a punitive damages award was includable in gross income.** No exclusion was allowed for the portion of the award that was retained by the attorney under a contingent fee agreement. The court noted that under California law, an attorney's lien does not confer an ownership interest upon the attorney or grant the attorney any right or power over the client's suits, judgments, or decrees.
>
> See also *Srivastava and Pascual v. Commissioner*, 2000-2 USTC ¶50,597, for a different result, where the Fifth Circuit, reversing and remanding a Tax Court decision in part, held that a portion of a defamation settlement payable to attorneys pursuant to a contingent fee agreement was **excludable from the taxpayers' gross income.** The court noted that under Texas law, the attorneys had an ownership interest in the taxpayers' recovery to the extent of their contingent fee. Moreover, the contingency fee arrangement was a division of property, rather than an assignment of income. Thus, the income had to be charged to the attorneys who earned and received the funds.

Wollenburg v. Commissioner

[I.R.C. §§105, 106, and 7402]

> ☞ **Retroactive medical expense reimbursements are not excluded from employee's income.**

Facts. Walter Wollenburg is a farmer in Nebraska. On December 16, 1993, Walter adopted a medical expense reimbursement plan, which was intended to meet the requirements for qualification under I.R.C. §105. Benefits paid to employees under the plan would be excludable from their gross income under I.R.C. §105(b). **Although Mr. Wollenburg did not implement the plan until December 16, 1993, the terms of the plan provided that the plan would go into effect on January 1, 1993.**

On the same date that Walter adopted the medical expense reimbursement plan, Walter and his wife, Leola, signed a formal agreement outlining their employer-employee relationship. Walter agreed to compensate Leola and provide benefits in exchange for Leola's performance of farm services. **The Wollenburgs filed a joint return for 1993, excluding from gross income reimbursements for medical expenses incurred by Leola prior to December 13, 1993**. They also excluded health plan premiums paid by Walter for Leola from Leola's gross income. The IRS disallowed reimbursement of the medical expenses Leola incurred between January 1, 1993, and December 16, 1993. The Wollenburgs paid the disallowance amount and filed a Claim for Refund.

Issues

1. **Whether or not taxpayer could exclude from gross income reimbursements for medical expenses incurred between the effective coverage date of the medical reimbursement plan and the date the plan was adopted**
2. Whether or not taxpayer could exclude health plan premiums made on her behalf by her employer/husband under I.R.C. §106

Analysis. The court noted that retroactive accident and health plans would obliterate the nondiscrimination purpose of I.R.C. §105(b), because they would enable employers to make year-end choices about which medical expenses or employees to cover.

Holding

Issue 1. **The medical reimbursements made by Walter Wollenburg to Leola Wollenburg for medical expenses she incurred between January 1, 1993 (the effective coverage date of the plan), and December 16, 1993 (the date the plan was adopted), are includable in her gross income**.

Issue 2. The court lacked sufficient evidence to decide whether Leola could exclude under I.R.C. §106 the premium payments made on her behalf by her employer. The court gave the Wollenburgs 10 days to amend their complaint to address the issue.

[*Walter W. and Leola Wollenburg v. United States*, 2000-1 USTC ¶50,156 (D. Neb. December 1, 1999)]

Practitioner Note. The court cited *American Family Mutual Ins. Co. v. United States* [815 F. Supp. 1206, 1209] as the case most relevant to the medical expense reimbursement issue.

Visco v. Commissioner
[I.R.C. §§61, 104, 451, and 6651]

☞ **Back pay and accrued interest are includable in gross income even though the taxpayer refused to accept or cash checks.**

Facts. Diana Visco, a reading specialist, was **wrongfully terminated** by a school district. She was reinstated in September 1991 and worked for the district until June 1992. During 1992 Ms. Visco received and cashed checks for her services totaling $38,224. **During 1992 the school district made two attempts to pay Ms. Visco for back pay and interest. Ms. Visco refused the checks on both occasions.** On the second occasion, she notified the school district's attorney and told him that she was refusing the checks and returned them to the courier. **The district sent Ms. Visco a Form W-2 for 1992 that included her regular pay, back pay, and interest on the back pay.**

The taxpayer filed extensions for 1992 and questioned the accuracy of her Form W-2. She filed a Form 4582, a substitute for Form W-2, asserting that her employer's Form W-2 was not valid. She also requested a criminal investigation into the matter and stated that she wished to complete her 1992 federal tax return in a manner that would allow her to preserve her legal rights.

In October 1993 the state court ordered the school district to pay the court the amount owed to Ms. Visco, which the school district did in March 1994. **In 1995 the state court opened a bank account for Visco's benefit and notified her of its existence**. The taxpayer never filed a return for 1992.

Issues

1. Whether the taxpayer is required to include the compensation for services, back pay, and interest on back pay in her 1992 gross income

2. Whether the taxpayer is required to include a $182 state income tax refund and $15 of interest in her 1992 gross income
3. Whether the taxpayer is liable for penalties for failure to timely file her 1992 federal income tax return under I.R.C. §6651(a)(1)

Analysis and Holding

Issue 1. **Taxpayer agreed with the court that the amounts she received and cashed as compensation for services were includable in gross income under I.R.C. §61(a)(1). Regarding the back pay and interest on the back pay, the taxpayer argued that she never constructively received these amounts;** the money was a damage award in a tortlike action and not back pay; and the money was an unauthorized withdrawal from her pension plan. In response to her first argument, the court concluded that the **money was available to the taxpayer,** and the district was willing and able to pay her. In response to her second argument, the court noted that **in order for damages to be excludable under I.R.C. §104(a)(2), the taxpayer must demonstrate that the dispute involves a tortlike action or personal injury. The facts of the case did not support either of those critical elements**. In response to her third argument, the court noted that the taxpayer bears the burden of proof, and Ms. Visco could offer no proof to support her argument. **The back pay and interest on the back pay were includable in the taxpayer's 1992 gross income.**

Issue 2. The taxpayer stipulated that she received a $182 tax refund in 1992 that she had taken as a deduction in prior years. She also stipulated that she had received $15 of interest in 1992. **Both of these amounts are includable in the taxpayer's gross income.**

Issue 3. **The court concluded that Ms. Visco was not liable for the penalty for failing to file a timely return under I.R.C. §6651(a)(1).** She was genuinely confused about the nature of her back pay. She reported her confusion to the IRS in a timely fashion, asked for assistance, followed an agent's instructions, and did her best to comply with the law.

[*Diana T. Visco v. Commissioner*, T.C. Memo 2000-77, 79 T.C.M. 1613 [CCH Dec. 53,786(M)]]

Nielsen v. Commissioner
[I.R.C. §§61 and 1001]

> ☞ **Payments for condemned property are includable in income to the extent they exceed basis.**

Facts. Karen Nielsen owned a home in Sioux Falls, South Dakota, which had a cost basis to her of $25,000. In 1990 the **state of South Dakota began civil condemnation proceedings against Ms. Nielsen to acquire her property for purposes of a federally funded highway construction project.** In 1992 Nielsen received a $65,000 settlement for her residence. In 1996 Nielsen **received an additional $100,000 as a relocation assistance payment** under the Relocation Act. Nielsen did not report any of the payments, asserting that they were excludable under the Relocation Act. The IRS contended that the Relocation Act did not exempt the $65,000 received by the taxpayer.

Issue. Whether proceeds received by the taxpayer in condemnation of her residence are includable in gross income to the extent that they exceed her basis in the property.

Analysis. The taxpayer argued that the $65,000 was a portion of her relocation assistance. However, the court found that it was the policy of South Dakota to maintain a distinction between the fair market value paid for property and assistance under the Relocation Act. Indeed, the state had followed its policy by negotiating two separate agreements with Nielsen. **The documents included the wording "purchase of the entire lot and house is agreed in the amount of $65,000"** and "relocation assistance is separate and apart from this agreed compensation and is treated as a separate proceeding."

Holding. The $65,000 received by the taxpayer is not exempted from taxation by the Relocation Act. The taxpayer is required to recognize a $40,000 capital gain.

[*Karen Y. Nielsen v. Commissioner*, 114 T.C. No. 10 (March 8, 2000) [CCH Dec. 53,789]]

Randolph v. Commissioner
[I.R.C. §§61, 6651, and 6654]

> ☞ **The taxpayer realized income from corporation's cancellation of debt.**

Facts. Loretta Randolph and her husband **owned about 15% of the stock of a corporation** formed by her parents. On April 10, 1989, **Loretta received a check for $50,000 from the corporation.** The check memo line denoted that $10,000 was a gift and $40,000 was a loan. On that same date, **she signed a promissory note** in which she promised to pay the corporation $50,000. The note was payable on demand and did not provide for the payment of interest. **On its 1993 tax return, the corporation listed the note among its assets.** During 1993 and 1994, Loretta's parents caused a **reorganization of the corporation under which its assets were divided among it and three newly formed corporations. None of the corporations included the note as an asset as of year end 1994** on the Schedules L they filed with their corporate income tax returns.

The taxpayers filed a Form 1040 for the 1994 tax year. Before submitting the form, **Loretta struck the words "penalties" and "perjury" from the verification portion of the jurat that appeared immediately above her signature.** The Form 1040 reflected no tax payments made for that year through either withholding or estimated payments. The **IRS determined that the taxpayer's 1994 Form 1040 did not constitute a valid return because she did not sign it under penalty of perjury**. In the notice of deficiency, the **IRS included $50,000 in income on the ground that the corporation had relieved her indebtedness to it by that amount in connection with the reorganization.**

Issues

1. Whether taxpayer realized income of $50,000 from the discharge of indebtedness
2. Whether taxpayer was liable for the addition to tax for late filing
3. Whether taxpayer was liable for the addition to tax for failure to pay sufficient estimated tax

Analysis and Holding

Issue 1. The **taxpayer maintained that the forgiveness of debt was a gift from her parents**. The court noted that the payment came from the corporation and not directly from Loretta's parents. The **taxpayer offered no evidence in establishing the corporation's intent** in paying her $50,000, and **she did not call her parents as witnesses**. Based on the lack of evidence of intent to make a gift, the evidence pointing toward a loan, and the failure of the corporations to list the loan as a 1994 asset, **the court held that Loretta realized cancellation of indebtedness income of $50,000 in 1994**.

Issue 2. **The court agreed with the IRS that the 1994 Form 1040 did not constitute a valid return, so the taxpayer was liable for the addition to tax** under I.R.C. §6651(a)(1) for failure to file a timely and valid tax return.

Issue 3. Unless a taxpayer can show that a statutory exception applies, imposition of the addition to tax under I.R.C. §6654(a) is automatic where payments of tax do not equal the percentage required under the statute. **Since the taxpayer offered no evidence that any of the statutory exceptions applied, the court held that she was liable for the addition to tax under I.R.C. §6654(a).**

[*Loretta Jean Randolph v. Commissioner*, 80 T.C.M. 192 (August 9, 2000) [CCH Dec. 53,992(M)]]

INFORMATION REPORTING

SCA 199945043
[I.R.C. §6045]

> ☞ **Information reporting requirements are the same for Internet stock sales as for traditional stock sales.**

Issue. Does a broker who effects sales of stock over the Internet have the same reporting requirements as a traditional broker?

Discussion. Every person doing business as a broker must, when required by regulations, report gross proceeds and other information (I.R.C. §6045). A broker is a person that, in the ordinary course of a trade or business, stands ready to effect sales by others (Reg. §1.6045-1(a)(1)). Under Treas. Reg. §1.6045-1(c)(2), a broker must make an information return for each sale effected by the broker in the ordinary course of business. The information reported on Form 1099 includes the name, address, and taxpayer identification number of the customer; the property sold; the Committee on Uniform Security Identification Procedures (CUSIP) number of the security sold (if known); gross proceeds; sale date; and such other information as may be required by Form 1099 (Treas. Reg. §1.6045-1(d)(2)).

Conclusion. The SCA (Service Center Advice) said that **no provision of I.R.C. §6045 or its regulations excludes a broker from information reporting merely because the sale is effected over the Internet.** The SCA also noted that the Internet Tax Freedom Act, P.L. 105-277, 112 Stat. 2681 (1998), has no impact on a broker's reporting obligations.

Reg. 105316-98
[I.R.C. §6050S]

> ☞ **The IRS provides guidance for entities receiving qualified tuition payments and interest payments on educational loans.**

Explanation of Provisions

The proposed regulations provide guidance on information reporting to educational institutions and insurers that receive qualified tuition payments (Form 1098-T) and to lenders that receive interest payments on qualified educational loans (Form 1098-E). The proposed regulations significantly expand the reporting requirements for Form 1098-T. Previously, those reimbursing or refunding qualified tuition or related payments under insurance arrangements weren't required to file Form 1098-T. The reporting requirements for lenders that receive interest payments on qualified educational loans are essentially the same as they are for 2000.

Prop. Reg. §1.6050S-1: Information Reporting for Payments and Reimbursements or Refunds of Qualified Tuition and Related Expenses

Requirements. Under the proposed regulations, **eligible educational institutions** subject to I.R.C. §6050S(a) reporting rules and taxpayers who must report under I.R.C. §6050S(b) would have to **report the following information to the IRS on Form 1098-T** (Tuition Payments Statement):

1. Name, address, and TIN of the institution or insurer;
2. Name, address, and TIN of the individual for whom payments of qualified tuition and related expenses were received, or reimbursements or refunds were made;

3. Aggregate amount of payments of qualified tuition and related expenses from any source that the institution received with respect to the individual during the calendar year (except for any scholarship or grant that, by its terms, must be applied to expenses other than qualified tuition and related expenses, such as room and board);
4. Aggregate amount of reimbursements or refunds of qualified tuition and related expenses that the institution or insurer made for the individual during the calendar year;
5. Aggregate amount of any scholarships or grants that the institution processed during the calendar year for the payment of the individual's costs of attendance;
6. Whether the individual was enrolled for at least half of the normal full-time work load for the course of study he is pursuing for at least one academic period that begins during the calendar year;
7. Whether the individual was enrolled in a program leading to a graduate-level degree or other recognized graduate-level educational credentials; and
8. Any other information required by Form 1098-T and its instructions.

> **Practitioner Note.** For 2000, Form 1098-T must include only the information in items (1), (2), (6), and (7).

Exceptions. Institutions are **not required to report information on nonresident aliens or on students enrolled in classes for which they do not receive academic credit. Institutions are also not required to report information on individuals who will claim the student as a dependent.**

Time and Place for Filing Return. Form 1098-T would generally have to be filed with the IRS no later than February 28 (March 31, if filed electronically) of the year following the calendar year in which payments were received or reimbursements or refunds were made. The institution or insurer must furnish a statement to each individual for whom it is required to file a Form 1098-T no later than January 31 of the year following the calendar year in which payments were received or reimbursements or refunds were made. These statements will carry the same information detailed in Form 1098-T with several cautions regarding the individual's eligibility for education credits.

Prop. Reg. §1.6050S-2: Information Reporting for Payments of Interest on Qualified Education Loans

Requirements. Under the proposed regulations, any person engaged in a trade or business that receives from any payor interest of $600 or more for any calendar year on one or more qualified education loans would be required to file a Form 1098-E (Student Loan Interest Statement) with the IRS. Under the proposed regulations, lenders are required to report interest payments received on qualified education loans only for the first 60 months that interest payments are required under the loan. The form would have to carry the payee's and payor's name, address, and TIN, and the aggregate amount of interest received during the calendar year from the payor. Lenders must provide borrowers with the information reported on the Form 1098-E.

Time and Place for Filing. The time and place for filing are the same as for Form 1098-T.

Effective Date. The proposed regulations apply to information returns required after December 31, 2001.

INNOCENT SPOUSES

Rev. Proc. 2000-15
[I.R.C. §§66 and 6015]

> ☞ **The IRS issues guidance for innocent spouses seeking equitable relief for liabilities properly reported on a joint return.**

Purpose. **This revenue procedure provides guidance for taxpayers seeking equitable relief (the requesting spouse) from joint and several liability under I.R.C. §6015(f) or relief from separate liability under I.R.C. §66(c) that arises due to the operation of community property law.** This revenue procedure **applies to any tax liability arising after July 22, 1998, or any tax liability arising on or before July 22, 1998, that was unpaid on that date.** Rev. Proc. 2000-15 supersedes Notice 98-61.

Background. The Restructuring Act of 1998 enacted I.R.C. §6015. Under both I.R.C. §§6015(b) and 6015(c), relief is available only from proposed or assessed deficiencies. Neither I.R.C. §6015(b) nor I.R.C. §6015(c) authorizes relief from liabilities that were properly reported on the return. However, equitable relief under I.R.C. §6015(f) or I.R.C. §66(c) may be available for such liabilities. The legislative history to I.R.C. §6015(f) shows that Congress wants the IRS to grant equitable relief when a spouse did not know, and had no reason to know, that funds intended for payment of tax were instead taken by the other spouse for that other spouse's benefit. Congress also intends the IRS to grant equitable relief in other situations where it is inequitable to hold an individual liable for all or part of any unpaid tax or deficiency arising from a joint return.

Threshold Conditions. **An individual must satisfy all of the following conditions** before the IRS will consider a request for equitable relief under I.R.C. §6015(f). In addition, with the exception of conditions (1) and (2), all of the following conditions must be satisfied before the IRS will consider a claim for equitable relief under I.R.C. §66(c). The threshold conditions are:

1. The requesting spouse filed a joint return for the taxable year for which relief is sought.
2. Relief is not available to the requesting spouse under I.R.C. §6015(b) or I.R.C. §6015(c).
3. **The requesting spouse applies for relief no later than two years after the IRS's first collection activity after July 22, 1998, with respect to the requesting spouse.**
4. The liability must remain unpaid at the time relief is requested. However, the individual may get relief in the form of a refund for (a) amounts paid after July 21, 1998, and before April 16, 1999; and (b) installment payments, made after July 22, 1998, under an agreement with the IRS to which the individual is not in default, that are made after the claim for relief is requested.
5. No assets were transferred between the spouses filing the joint return as part of a fraudulent scheme by them.
6. **There were no disqualified assets transferred to the requesting spouse by the nonrequesting spouse. If disqualified assets were transferred, relief will be available only to the extent that the liability exceeds their value.**
7. The requesting spouse did not file the joint return with fraudulent intent.

Factors Weighing in Favor of Relief. The factors weighing in favor of relief include, but are not limited to, the following:

1. The requesting spouse is separated (either living apart or legally separated) or divorced from the nonrequesting spouse.
2. The requesting spouse would suffer economic hardship if relief were not granted.

3. The requesting spouse was abused by the nonrequesting spouse, but such abuse did not amount to duress.
4. In the case of a properly reported but unpaid liability, the requesting spouse did not know and had no reason to know that the liability would not be paid. In the case of a deficiency, the requesting spouse did not know and had no reason to know of the items giving rise to the deficiency.
5. The nonrequesting spouse has a legal obligation under a divorce decree or agreement to pay the liability, and the requesting spouse did not know or have reason to know at the time the agreement was entered into that the nonrequesting spouse wouldn't pay the liability.
6. The liability for which relief is sought is solely attributable to the nonrequesting spouse.

Factors Weighing against Relief. The factors weighing against relief include, but are not limited to, the following:

1. The unpaid liability or item giving rise to the deficiency is attributable to the requesting spouse.
2. **The requesting spouse knew or had reason to know of the item giving rise to the deficiency or that the reported liability would be unpaid at the time the return was signed. This is an extremely strong factor weighing against relief.**
3. The requesting spouse has **significantly benefited (beyond normal support)** from the unpaid liability or items giving rise to the deficiency.
4. The requesting spouse will not experience economic hardship if relief is not granted.
5. **The requesting spouse has not made a good faith effort to comply with federal income laws** in the tax years after the year for which relief is requested.
6. The requesting spouse has a **legal obligation under a divorce decree or agreement to pay the liability.**

Procedure. A requesting spouse seeking relief under I.R.C. §6015(f) or I.R.C. §66(c) must file Form 8857, or other, similar statement signed under penalties of perjury, within 2 years of the first collection activity against the requesting spouse. If a requesting spouse has already filed an application for relief under I.R.C. §6015(b) or I.R.C. §6015(c), no additional filing is necessary. The IRS will automatically consider whether equitable relief under I.R.C. §6015(f) is appropriate when relief is not available under I.R.C. §6015(b) or I.R.C. §6015(c).

Effective Date. Rev. Proc. 2000-15 is effective January 18, 2000.

Corson v. Commissioner
[I.R.C. §6015]

☞ **Individual can contest the IRS's grant of innocent spouse relief to his former wife.**

Facts. Thomas and Judith Corson **filed a joint return for 1981 and divorced in 1984.** In 1985 **the IRS determined a deficiency for 1981. The deficiency was mainly due to the disallowance of losses claimed from tax-sheltered limited partnerships.** In 1985 the taxpayers filed a petition contesting the notice of deficiency.

After a test case involving tax shelter partnerships found that investment losses were nondeductible, settlement negotiations were initiated. On June 11, 1996, **Judith filed a motion to amend the 1985 petition and to claim innocent spouse relief under I.R.C. §6013(e).** Neither the IRS nor Thomas objected. The court granted Judith's motion, and filed the amendment on June 18, 1996.

In November 1996 Judith and the IRS entered into a stipulation resolving all issues except innocent spouse relief. **In early 1998 an appeals officer recommended that innocent spouse relief be**

denied. On July 22, 1998, the Restructuring Act was enacted. This statute, among other things, revised and expanded the relief available to spouses filing joint returns. One of the changes was to allow an individual who filed a joint return and who is no longer married to the spouse with whom the return was filed, to elect separate liability for any deficiency from the joint return [I.R.C. §6015(c)]. **Judith then elected to have I.R.C. §6015(c) apply.**

In late 1998 the IRS denied Judith's request for innocent spouse relief but reversed itself in 1999 and **entered into a stipulation with Judith that she qualified for separate liability relief** under I.R.C. §6015(c) and was not liable for any deficiencies, interest, or additions to tax for 1981. **Thomas then refused to sign a stipulated decision.** The IRS filed a motion with the court to enter a decision. The court refused to do so.

Issue. **Whether or not the nonelecting spouse has the right to dispute the IRS's granting of innocent spouse relief to his spouse or former spouse**

Analysis. Under the earlier innocent spouse provisions, the courts had held that an individual didn't have a right to challenge by litigation an IRS decision to grant relief to his spouse or former spouse. The IRS and Judith contended that the Restructuring Act does not give the nonelecting spouse an independent right to litigate or contest a grant of relief under I.R.C. §6015 to the electing spouse. They also argued that the Tax Court has jurisdiction under I.R.C. §6015(e) only over **denials of relief,** which was not the current situation, where the **IRS had already granted relief.**

The Tax Court noted that I.R.C. §6015(g)(2) provides an opportunity for the nonelecting spouse to participate at the administrative level, while I.R.C. §6015(e)(4) speaks of a similar chance for participation should the matter move from an administrative to a judicial forum. The court believed that the statutory framework reveals a concern on the part of lawmakers to be **fair to the nonelecting spouse and allow the nonelecting spouse an opportunity to be heard first** in administrative proceedings and then in judicial proceedings. This is to ensure that innocent spouse relief is granted on the merits of all the relevant evidence. **The court noted that easing the standards for obtaining relief is not equivalent to giving relief where it is unwarranted.**

Holding. **The court gave Thomas the right to dispute the IRS's grant of relief to Judith.**

[*Thomas and Judith Corson v. Commissioner*, 114 T.C. No. 24 (May 18, 2000) [CCH Dec. 53,882]]

> See *Kathy A. King v. Commissioner*, 115 T.C. No. 8 (August 10, 2000), for a similar result, where the court held that it is necessary to provide the nonelecting spouse with both notice of, and an opportunity to be heard in, any case where the other spouse (or former spouse) is claiming relief from joint liability under I.R.C. §6015.

Milne v. United States
[I.R.C. §7426]

> ☞ **Innocent spouse recovers half of proceeds from a home sold to satisfy an IRS lien.**

Facts. The IRS made an assessment of $342,453 against Jane Milne and her husband, John, for unpaid taxes for the 1992 tax year. The unpaid taxes were **due to John Milne's fraudulent billing practices** involving insurance company reimbursements. As part of a plea bargain, the Milnes established an irrevocable trust to convert property into cash for restitution. The property included the Milnes' former residence, which was community property. The home was sold for $186,259, which was divided between the IRS and the U.S. attorney.

In August 1997 Ms. Milne applied for relief from the 1992 tax liability as an innocent spouse under I.R.C. §6015. **The IRS granted Ms. Milne innocent spouse relief in the fall of 1998, eliminating her personal liability for the 1992 unpaid income tax. Ms. Milne requested that her share of the proceeds from the sale of the community property be applied to her separate tax liabilities for 1994 and 1997. The IRS denied her claim.**

Issue. Whether the taxpayer, who had been granted innocent spouse status, was entitled to a refund for her interest in community property proceeds that had been applied to her spouse's separate debt

Analysis. The IRS agreed that the residence was community property prior to transfer to the trust. However, it said that the transfer to the trust changed the legal ownership and therefore destroyed the community property status. The court noted that the IRS presented no binding authority, precedent, or statute for this assertion. The court found that, with no evidence that the parties intended to change the character of the property, the property remained community property after transfer to the trust. The court cited *Overman v. United States* [70-1 USTC ¶9342], which stated, **"The government cannot claim from the proceeds of a sale more than the share of proceeds attributable to the taxpayer's half of the community interest in the asset. It cannot reach the proceeds attributable to the wife's interest."**

Holding. The court granted summary judgment to the taxpayer, allowing recovery of half of the sale proceeds of the home she had owned jointly with her husband.

[*Jane E. Milne v. United States of America*, 2000-1 USTC ¶50,291 (U.S. Dist. Ct., West. Dist. Wash., at Seattle, February 24, 2000)]

Butler v. Commissioner
[I.R.C. §6015]

> ☞ **Wife was denied innocent spouse relief because she had reason to know of an understatement on the return.**

Facts. Michael and Jean Butler have been married for 35 years. Jean works for her husband's surgical practice as a medical transcriber. **Jean handles the family's checking account and pays all the bills for the household expenses. Jean also oversees the operation of JCB, an S corporation of which she has always been the sole owner.**

B.G. Enterprises (BGE) was an S corporation owned by Michael Butler and another individual. BGE was in the nursery business and suffered a large loss due to damage caused by a fungicide. **BGE received a damage award for $812,411 that was paid out in 1991 and 1992.** After expenses, BGE received net proceeds of $158,759 from the fungicide manufacturer in 1992. The **exact amount of the distributions from BGE to Michael Butler is not known, because the Butlers' bank records for the period are incomplete.**

The IRS determined, and the taxpayers conceded, that **Michael Butler's share ($79,380)** of the net settlement proceeds received by BGE during 1992 **was not reported on the taxpayers' 1992 tax return.** The taxpayers also conceded the receipt of $18 in interest income from BGE, which was not reported on the 1992 tax return. However, the Butlers filed a petition seeking innocent spouse relief under I.R.C. §6013(e). After trial, Congress enacted I.R.C. §6015 and repealed I.R.C. §6013(e), making relief unavailable under §6013(e). The Butlers asked the court to decide their petition pursuant to I.R.C. §6015(b), to receive evidence for proportionate relief under I.R.C. §6015(b)(2), and to grant equitable relief pursuant to I.R.C. §6015(f).

Issues

Issue 1. **Whether the taxpayer is entitled to innocent spouse relief under I.R.C. §6015(b)** for the understatement of tax on her 1992 joint tax return

Issue 2. Whether the record should be reopened to receive additional evidence regarding the taxpayer's ability to qualify for proportionate innocent spouse relief under I.R.C. §6015(b)(2)

Issue 3. Whether the court has jurisdiction to review the IRS's denial of the taxpayer's request for innocent spouse relief and whether it was an abuse of the IRS's discretion to deny such relief

Analysis and Holding

Issue 1. In deciding **whether Jean "had reason to know" of the understatement** [one of the elements necessary for innocent spouse relief listed in I.R.C. §6015(b)(1)], Judge Thomas B. Wells stated **four relevant factors.** First, he noted that **Jean was college educated.** Second, **Jean was involved in both the family and business finances and recordkeeping.** The third factor, the presence of expenditures that appear lavish or unusual compared with the family's past income levels and spending patterns, neither supported nor weakened Jean's claim for innocent spouse relief. As to the fourth factor, whether the taxpayer's husband was evasive about his finances, the court determined that Michael was not evasive about his finances. **Rather, he "always told her about everything he was involved in."** Thus, the court held that **Jean was not entitled to innocent spouse relief** under I.R.C. §6015(b)(1).

Issue 2. I.R.C. §6015(b)(2) explicitly provides for proportionate relief of the tax liability (including interest, penalties, and other amounts) that is attributable to the portion of understatement of which the innocent spouse did not know and had no reason to know. Former I.R.C. §6013(e) did not have an explicit provision for proportionate relief. **The court did not grant Jean's motion to reopen the record,** because she did not describe in any way the new evidence she would offer, and she failed to explain how the evidence would support her claim for proportionate relief under the new I.R.C. §6015(b)(2). The court held that **Jean did not qualify for proportionate innocent spouse relief.**

Issue 3. Under provisions of I.R.C. §6015(f), the Secretary may grant equitable relief if (1) it finds that it is inequitable to hold the individual liable for any unpaid tax or deficiency and (2) relief is not available to the individual under I.R.C. §6015(b) or (c). The IRS contended that the Tax Court had no authority to review the Commissioner's denial of the taxpayer's request for equitable relief under I.R.C. §6015(f). Judge Wells found nothing in the statute or the legislative history denying the Tax Court's jurisdiction to review this requested relief. However, he found that Jean had reason to know of the understatement, and nothing in the record indicated that there would be any economic hardship to Jean if the relief were not granted. Thus, the court held that the IRS **denial of equitable relief under I.R.C. §6015(f) was not an abuse of discretion by the IRS.**

[*Michael B. and Jean Butler v. Commissioner*, 114 T.C. No. 19 (April 29, 2000) [CCH Dec. 53,869]]

INTEREST AND AFRs

Rev. Rul. 2000-42

☞ **Table of IRS Interest Rates from Jan. 1, 1987, to present.**

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

	Noncorporate Overpayments and Underpayments	
	Overpayments (Rate Table PG 1995-1 C.B.)	Underpayments (Rate Table PG 1995-1 C.B.)
Jul. 1, 1996–Sep. 30, 1996	8%	9%
Oct. 1, 1996–Dec. 31, 1996	8%	9%
Jan. 1, 1997–Mar. 31, 1997	8%	9%
Apr. 1, 1997–Jun. 30, 1997	8%	9%
Jul. 1, 1997–Sep. 30, 1997	8%	9%
Oct. 1, 1997–Dec. 31, 1997	8%	9%
Jan. 1, 1998–Mar. 31, 1998	8%	9%
Apr. 1, 1998–Jun. 30, 1998	7%	8%
Jul. 1, 1998–Sep. 30, 1998	7%	8%
Oct. 1, 1998–Dec. 31, 1998	7%	8%
Jan. 1, 1999–Mar. 31, 1999	7%	7%
Apr. 1, 1999–Jun. 30, 1999	8%	8%
Jul. 1, 1999–Sep. 30, 1999	8%	8%
Oct. 1, 1999–Dec. 31, 1999	8%	8%
Jan. 1, 2000–Mar. 31, 2000	8%	8%
Apr. 1, 2000–Jun. 30, 2000	9%	9%
Jul. 1, 2000–Sep. 30, 2000	9%	9%
Oct. 1, 2000–Dec. 31, 2000	9%	9%

[Rev. Rul 2000-42]

Rev. Rul. 99-41

☞ **Applicable federal rates (AFR) for October 1999.**

Period for compounding

	Annual	Semiannual	Quarterly	Monthly
Short-term AFR	5.54%	5.47%	5.43%	5.41%
Mid-term AFR	6.02%	5.93%	5.89%	5.86%
Long-term AFR	6.31%	6.21%	6.16%	6.13%

[Rev. Rul. 99-41, 1999-40 IRB]

Rev. Rul. 99-45

☞ **Applicable federal rates (AFR) for November 1999.**

Period for compounding

	Annual	Semiannual	Quarterly	Monthly
Short-term AFR	5.57%	5.49%	5.45%	5.43%
Mid-term AFR	6.08%	5.99%	5.95%	5.92%
Long-term AFR	6.39%	6.29%	6.24%	6.21%

[Rev. Rul. 99-45, 1999-45 IRB]

Rev. Rul. 99-48

☞ **Applicable federal rates (AFR) for December 1999.**

Period for compounding

	Annual	Semiannual	Quarterly	Monthly
Short-term AFR	5.74%	5.66%	5.62%	5.59%
Mid-term AFR	6.20%	6.11%	6.06%	6.03%
Long-term AFR	6.47%	6.37%	6.32%	6.29%

[Rev. Rul. 99-48, 1999-49 IRB]

Rev. Rul. 2000-1

☞ **Applicable federal rates (AFR) for January 2000.**

Period for compounding

	Annual	Semiannual	Quarterly	Monthly
Short-term AFR	5.88%	5.80%	5.76%	5.73%
Mid-term AFR	6.21%	6.12%	6.07%	6.04%
Long-term AFR	6.45%	6.35%	6.30%	6.27%

[Rev. Rul. 2000-1, 2000-2 IRB]

Rev. Rul. 2000-9

☞ **Applicable federal rates (AFR) for February 2000.**

Period for compounding

	Annual	Semiannual	Quarterly	Monthly
Short-term AFR	6.20%	6.11%	6.06%	6.03%
Mid-term AFR	6.56%	6.46%	6.41%	6.37%
Long-term AFR	6.77%	6.66%	6.61%	6.57%

[Rev. Rul. 2000-9, 2000-6 IRB]

Rev. Rul. 2000-11

☞ **Applicable federal rates (AFR) for March 2000.**

Period for compounding

	Annual	Semiannual	Quarterly	Monthly
Short-term AFR	6.45%	6.35%	6.30%	6.27%
Mid-term AFR	6.80%	6.69%	6.63%	6.60%
Long-term AFR	6.75%	6.64%	6.59%	6.55%

[Rev. Rul. 2000-11, 2000-10 IRB]

Rev. Rul. 2000-19

☞ **Applicable federal rates (AFR) for April 2000.**

Period for compounding

	Annual	Semiannual	Quarterly	Monthly
Short-term AFR	6.46%	6.36%	6.31%	6.28%
Mid-term AFR	6.71%	6.60%	6.55%	6.51%
Long-term AFR	6.49%	6.39%	6.34%	6.31%

[Rev. Rul. 2000-19, 2000-14 IRB]

Rev. Rul. 2000-23

☞ **Applicable federal rates (AFR) for May 2000.**

	Period for compounding			
	Annual	**Semiannual**	**Quarterly**	**Monthly**
Short-term AFR	6.42%	6.32%	6.27%	6.24%
Mid-term AFR	6.40%	6.30%	6.25%	6.22%
Long-term AFR	6.20%	6.11%	6.06%	6.03%

[Rev. Rul. 2000-23, 2000-19 IRB]

Rev. Rul. 2000-28

☞ **Applicable federal rates (AFR) for June 2000.**

	Period for compounding			
	Annual	**Semiannual**	**Quarterly**	**Monthly**
Short-term AFR	6.53%	6.43%	6.38%	6.35%
Mid-term AFR	6.62%	6.51%	6.46%	6.42%
Long-term AFR	6.39%	6.29%	6.24%	6.21%

[Rev. Rul. 2000-28, 2000-23 IRB]

Rev. Rul. 2000-32

☞ **Applicable federal rates (AFR) for July 2000.**

	Period for compounding			
	Annual	**Semiannual**	**Quarterly**	**Monthly**
Short-term AFR	6.60%	6.49%	6.44%	6.40%
Mid-term AFR	6.62%	6.51%	6.46%	6.42%
Long-term AFR	6.40%	6.30%	6.25%	6.22%

[Rev. Rul. 2000-32, 2000-27 IRB]

Rev. Rul. 2000-38

☞ **Applicable federal rates (AFR) for August 2000.**

Period for compounding

	Annual	Semiannual	Quarterly	Monthly
Short-term AFR	6.37%	6.27%	6.22%	6.19%
Mid-term AFR	6.33%	6.23%	6.18%	6.15%
Long-term AFR	6.22%	6.13%	6.08%	6.05%

[Rev. Rul. 2000-38, 2000-32 IRB]

Rev. Rul. 2000-41

☞ **Applicable federal rates (AFR) for September 2000.**

Period for compounding

	Annual	Semiannual	Quarterly	Monthly
Short-term AFR	6.33%	6.23%	6.18%	6.15%
Mid-term AFR	6.22%	6.13%	6.08%	6.05%
Long-term AFR	6.09%	6.00%	5.96%	5.93%

[Rev. Rul. 2000-41, 2000-36 IRB]

Rev. Rul. 2000-45

☞ **Applicable federal rates (AFR) for October 2000.**

Period for compounding

	Annual	Semiannual	Quarterly	Monthly
Short-term AFR	6.30%	6.20%	6.15%	6.12%
Mid-term AFR	6.09%	6.00%	5.96%	5.93%
Long-term AFR	5.96%	5.87%	5.83%	5.80%

[Rev. Rul. 2000-45]

Rev. Rul. 2000-26

> ☞ **The rates in this revenue ruling may be used by estates that value farmland under I.R.C. §2032A as of a date in 2000.**

Farm Credit Bank District in Which Property Is Located	Interest Rate
Columbia	9.82
Omaha/Spokane	8.10
Sacramento	8.06
St. Paul	8.26
Springfield	8.93
Texas	8.19
Wichita	8.18

[Rev. Rul. 2000-26, 2000-22 IRB 5]

IRS MSSP AUDIT TECHNIQUE GUIDES

☞ The IRS released the following Market Segment Specialization Program (MSSP) guides from September 1999 to August 2000.

Alternative Minimum Tax for Individuals. The guide covers how to compute AMT, minimum tax credit carryforwards, and AMT under earlier law. The guide also discusses the interaction between AMT and the "kiddie tax," partnerships and S corporations, and the at-risk rules.

Car Wash Industry. The guide looks at different types of full- and self-service car washes, related businesses and services, and accounting methods. The guide also lists 12 case studies detailing audit problems and methods.

Child Care Providers. The guide covers such issues as income, expenses, advertising, depreciation, employee benefit programs, insurance, bad debts, travel, meals, and entertainment. Specific examination techniques outlined in the guide address the business use of the home, information document requests, the child care credit, and distinguishing between employees and independent contractors.

Construction Industry. The MSSP guide contains techniques for auditing general contractors, subcontractors, commercial project owners, residential construction developers, highway contractors, architects and engineers, materials suppliers, construction lenders, and surety companies. The guide differentiates among types of contracts, small and large contractors, what is being constructed, and construction joint ventures, and it deals with a variety of accounting methods and accounting method changes.

Drywallers. The guide supplements the MSSP audit guide for construction and outlines audit techniques that apply to drywallers in their usual capacity of subcontractors. The guide also highlights examination issues that pertain to drywallers, such as the failure to comply with employment tax requirements, and cash to accrual accounting method changes.

Garden Supplies Industry. The guide looks at garden centers, equipment dealers, greenhouses, nurseries, and mulch companies. It does not, however, focus on the service aspect of the industry, such as landscaping and lawn service.

Laundromats. The guide explains how to use a water consumption analysis to reconstruct income, assuming there is a reasonable indication of unreported income. It also covers customer use percentages, taxpayer arguments about dryer income, and what to do if the taxpayer won't cooperate.

Livestock. The guide focuses on the business of breeding, raising, buying, and selling livestock. It contains chapters on examination techniques and industry issues, including the dairy, cattle, horse, sheep, goat, and swine industries, as well as ratites and alternative livestock issues.

Masonry and Concrete Industries. The guide supplements the MSSP audit guide for construction and outlines audit techniques that apply to traditional brick layers; concrete block masons; concrete forming, placing, and finishing; and placing of masonry architectural details. However, the guide doesn't apply to the off-site manufacture of concrete components, noting that that work is typically more like manufacturing than construction.

The guide also highlights examination issues that are unique to the masonry and concrete industry, such as claiming deductions for fines and penalties, cost recovery, self-insurance, employment tax issues, transfer pricing, and pricing in general.

Sports Franchises. Although the guide focuses on major league sports franchises, the examination techniques and issues addressed also apply to minor league sports franchises.

ITEMIZED DEDUCTIONS

Ltr. Rul. 200004001, July 7, 1999
[I.R.C. §§170, 274, and 1366]

> ☞ **A university donor may deduct that portion of his donation for the right to buy tickets for skybox seating.**

Facts. The taxpayer is the sole shareholder of an S corporation. The S corporation made a donation to a university foundation. **In return for its donation, the S corporation said that it received a lease on a skybox for home football games for a number of years, parking for a certain number of cars at each game, and passes for guests to visit persons sitting in the skybox.** The university foundation provided a receipt on which it had calculated the value of the personal benefits received by the S corporation. On his tax return, **the taxpayer took a charitable deduction of 80% of the excess of the payment over the value of the personal benefits received.** The revenue agent proposed disallowance of the deduction under I.R.C. §274(1) on the grounds that it represented an amount paid for use of a skybox for more than one event. The corporation conceded that the amount of the deduction should be reduced by the part of the donation that paid for seats in the skybox. The per-seat ticket price was the same as the price for non–luxury seat tickets.

Issues

Issue 1. **Whether or not a donor may deduct a portion of a payment made to a state university's foundation for which the donor receives the right to purchase skybox seating in the university's stadium**

Issue 2. Is a portion of the payment to a state university foundation, for which the donor receives the right to purchase tickets for seating in a skybox at athletic events, that is otherwise deductible under I.R.C. §170(1) disallowed because of the limitations of I.R.C. §274(1)?

Issue 3. If an accrual-based S corporation authorizes a charitable contribution on the last day of its taxable year and pays the contribution by the 15th day of the third month following the close of its taxable year, may the S corporation elect to treat the contribution as paid during the taxable year under I.R.C. §170(a)(2), or is the charitable deduction properly taken when paid under I.R.C. §170(a)(1)?

Analysis and Conclusion

Issue 1. The IRS noted that, in return for its payment, the S corporation received the right to purchase tickets, the tickets themselves, the right to use the skybox, passes to visit the skybox, and parking. I.R.C. §170(1)(2) provides that, if a donor makes a payment for the benefit of an educational institution both for the right to purchase tickets and for the purchase of the tickets themselves, the portion of the payment subject to the 80% rule and the portion representing the ticket purchase are treated as separate amounts for purposes of I.R.C. §170(1). The IRS said that I.R.C. §170(1) is applicable despite the fact that the seating is located in a special viewing area within the athletic stadium. **Eighty percent of the portion of the S corporation's payment for the right to buy tickets is deductible under I.R.C. §170.** The **remainder of the payment, which was for the ticket purchase, the right to use the skybox, passes to visit the skybox, and parking privileges, is not deductible under I.R.C.**

§170. **The IRS did not address the university's valuation** of the skybox, the right to buy tickets, the passes to visit the skybox, or the parking privileges.

Issue 2. Under I.R.C. §274(f), I.R.C. §274(1) does not disallow a deduction determined under I.R.C. §170(1) that is specifically allowed a taxpayer without regard to the payment's connection to the taxpayer's trade or business.

Issue 3. The special rule for charitable contributions by accrual-based corporations in I.R.C. §170(a)(2) does not apply to S corporations, because charitable contributions by an S corporation are passed through to shareholders. **Therefore, a charitable contribution by an S corporation is taken by the shareholders in the year it is actually paid.**

Rev. Rul. 2000-24
[I.R.C. §213]

> ☞ **The costs of traveling to and attending a conference on a dependent's disease are deductible medical expenses.**

Facts. The taxpayer's child suffers from a chronic disease. **Upon the advice of the child's physician, the taxpayer traveled to another city to attend a conference sponsored by an association that supports research and education concerning the disease.** The taxpayer paid the following expenses in connection with the conference: transportation to the city, local transportation, registration fee, meals while attending the conference, and hotel lodging.

Issue. Whether amounts paid by a taxpayer for attending a medical conference relating to the chronic disease of the taxpayer's dependent are deductible as a medical expense under I.R.C. §213

Analysis and Holding. The deduction for medical care expenses will be confined strictly to expenses incurred primarily for the prevention or alleviation of a physical or mental defect or illness [Treas. Reg. §1.213-1(e)(1)(ii)]. Whether an expenditure is "primarily for" medical care is a question of fact. An expense that is merely beneficial to the general health of an individual is not an expense for medical care.

Amounts paid by a taxpayer for transportation and admission to a medical conference relating to the chronic disease of the taxpayer's dependent are deductible as medical expenses under I.R.C. §213 (subject to the limitations of that section), if the costs are primarily for and essential to the medical care of the dependent. The costs of meals while attending the conference are not deductible, because only meals provided at a hospital or similar institution where the taxpayer, the taxpayer's spouse, or a dependent is receiving medical care from a physician are deductible [Treas. Reg. §1.213-1(e)(1)]. **The cost of lodging while attending the conference is not deductible,** because lodging (up to $50 per night) is deductible only if it is primarily for and essential to medical care that is provided by a physician in a licensed hospital or related facility and there is no significant element of personal pleasure, recreation, or vacation in the travel away from home [I.R.C. §213(d)(2)].

[Rev. Rul. 2000-24, 2000-19 IRB]

Herman v. United States
[I.R.C. §170]

> ☞ **The fair market value of donated equipment is the appraised value and not what the taxpayers paid for it.**

Facts. Mr. and Mrs. Daniel Herman and their friend, Paul Brown, **purchased hospital equipment from a bankruptcy court for $40,000.** The Hermans and Mr. Brown each paid $20,000 in October

1988. In December 1990 **they donated the equipment to their new county hospital.** Upon the advice of their accountant, they asked the hospital administrator to recommend appraisers for the equipment. **Rick Rader of Skyland Hospital Supply appraised the value to be $1,002,348, and George Garrick of Mountain Medical Equipment appraised the value to be $1,037,348.**

Both the Hermans and Paul Brown claimed a charitable contribution deduction on their 1990 tax returns in the amount of $501,190. Because of the 30% limitation under I.R.C. §170(b), the excess contribution deduction was carried forward to tax years 1991, 1992, and 1993. On audit of both the Hermans and Paul Brown, **the IRS allowed only a charitable contribution deduction of $20,000** and imposed the gross valuation misstatement penalty under I.R.C. §6662–$23,219 for the Hermans and $13,472 for Mr. Brown.

Issues. What is the fair market value of the donated property, and should a penalty for gross valuation misstatement be assessed?

Analysis. The IRS first took the position that the taxpayers weren't eligible for any charitable deduction because they failed to satisfy the substantiation requirement under I.R.C. §170(a)(1). It based its argument on the fact that the taxpayers did not use a qualified appraiser within the meaning of Treas. Reg. §1.170A-13(c)(5). The court said that since the IRS had previously admitted that the taxpayers were entitled to charitable deductions, they could not now say that they were entitled to no deduction at all. Acquiescing, **the IRS argued that the fair market value should be the $40,000 paid to the bankruptcy court,** suggesting that this represented an arm's-length transaction between a willing seller and a willing buyer, which was the best evidence of what the property was worth. The court did not agree that the bankruptcy court was a willing seller, not compelled to sell.

Since the court would not use the bankruptcy court's sale price as fair market value, the next question was whether to rely upon the appraiser's amount as the fair market value. The court acknowledged that Mr. Rader's appraisal did not meet all the regulatory requirements of a qualified appraisal. However, Mr. Rader had 30 years experience in buying and selling new and used medical equipment, and he was accredited in medical sales by the Health Industries Distribution Association's Education Foundation. Also, Mr. Rader had no idea that his report would be used for tax purposes, and he was not paid for his services. He was asked by the hospital administrator to evaluate the equipment, and he thought he was simply determining the hospital's needs with the expectation that his company would be filling those needs. Because of these facts, the court found his appraisal to be qualified.

The court acknowledged the extreme discrepancy between what the taxpayers paid for the equipment and the value they claimed as deductions. However, the facts do not suggest that the taxpayers acted with any intent to defraud. The court noted that the facts suggest that the debtor hospital's trustee grossly undervalued the equipment to the detriment of the hospital's creditors.

Holding. The court relied on Mr. Rader's appraisal and found the fair market value of the hospital equipment to be $1,002,380. Thus, there was no basis for penalizing the taxpayers for a gross valuation misstatement.

[*Daniel Herman, Barbara Herman and Paul Brown v. United States*, 99-2 USTC ¶50,899 (DC TN, 9/28/99)]

Ltr. Rul. 200030023, June 27, 2000
[I.R.C. §63]

☞ **The standard deduction is unavailable if the taxpayer's spouse files as head of household and itemizes.**

Facts. Two taxpayers are legally married at the end of the tax year. They do not elect to file a joint tax return. One taxpayer qualifies to file as unmarried head of household. The other taxpayer files as married filing separately.

Issues

Issue 1. **If a married taxpayer that files as head of household itemizes his or her deductions, may the taxpayer's spouse claim the full standard deduction for married taxpayers filing separately?**

Issue 2. **If the spouse that files as married filing separately elects to itemize deductions, may the spouse who files as head of household claim the standard deduction for head of household status?**

Discussion. The right of a taxpayer to elect to itemize deductions or use the standard deduction is generally limited by I.R.C. §63(c)(6)(A). This limitation provides **that a married individual filing a separate return where either spouse itemizes deductions shall have a standard deduction of zero.** However, this limitation does not apply to a spouse that qualifies for and files as head of household because the s**pouse with head of household status is not considered a married individual** under I.R.C. §7703(b).

Conclusion

Issue 1. If a married individual files a separate return with head of household status and elects to itemize deductions, and if the other spouse continues to file as a married individual filing a separate return, then that **other spouse is not eligible for the standard deduction.**

Issue 2. If the spouse who files as married filing separately elects to itemize deductions, then the spouse who files a **separate return** with **head of household** status **may still use the full standard deduction available for head of household status.**

PASSIVE INCOME

Krukowski v. Commissioner
[I.R.C. §469]

> ☞ **Rental income from a taxpayer's property leased to the taxpayer's law firm is reclassified as nonpassive.**

Facts. Thomas Krukowski owned **two subchapter C corporations.** One corporation operated a health club, and the other operated a law firm where **Krukowski actively worked as an attorney. The taxpayer rented a building to the health club and a second building to the law firm.** On his 1994 return, Krukowski **offset a loss from the club rental against income from the rental of the office building.** The IRS recharacterized the income from the office building as nonpassive income under Treas. Reg. §1.469-2(f)(6), because the taxpayer materially participated in the law firm's business activity.

Issue. Whether the taxpayer may offset the income and loss that he realized on separate rental activities

Analysis. The taxpayer argued that **the recharacterization rule was invalid because it conflicts with explicit statutory text that a rental activity is generally passive** (I.R.C. §469(c)(2) and (4)). The court disagreed, stating that the recharacterization rule is invalid only if it is arbitrary, capricious, or manifestly contrary to the statute.

Next, the taxpayer argued that his situation meets the Treas. Reg. §1.469-11(c)(1)(ii) exception that applies to pre–February 19, 1988, written, binding contracts. Krukowski said that his 1991 lease was an extension of a 1987 lease. However, the court disagreed again, stating that under state law the 1991 lease is characterized as a renewal, which is a separate contract from the 1987 lease.

Next, the taxpayer correctly noted that the 1988 and 1989 temporary regulations provided an exception for an individual's regular, continuous, and substantial involvement in the operations of an activity not being treated as material participation when the activity is operated by a C corporation. Thus, he argued the recharacterization rule could not be applied to his 1994 income from the office building. The taxpayer claimed that since the 1992 proposed regulations were silent as to the exception, the exception continued to exist in 1992. The court said that the 1988 and 1989 temporary regulations were not applicable to the year of this case, and the silence of the 1992 proposed regulations did not mean affirmation of the exception.

Holding. The taxpayer may not offset income from the office building rental by the loss from the health club rental.

[*Thomas P. and Ermina A. Krukowski v. Commissioner*, 114 T.C. No. 25 (May 22, 2000) [CCH Dec. 53,888]]

Fransen v. United States
[I.R.C. §469]

> ☞ **A taxpayer's income from renting his property to his own business is not passive.**

Facts. The Fransens owned an undivided one-half interest in a building. They leased the building to the husband's law firm, a wholly owned C corporation. On their 1995 return, the Fransens **treated the rental income as passive activity income.** They also had substantial, unrelated passive activity losses, **so the passive income allowed them to deduct the passive losses** up to the amount of income. The IRS rejected the Fransens' characterization of their rental income as passive. The district court granted summary judgment to the government.

Issue. Whether Treas. Reg. §1.469-2(f)(6) was a valid interpretation of I.R.C. §469's provision for treating income from any kind of passive activity in which the taxpayer materially participates as arising from a nonpassive activity

Analysis. The Fransens claimed that the Treasury regulation relied upon by the IRS is invalid. The disputed **regulation,** called the **"self-rental rule," provides that rental income that otherwise would be passive activity income is treated as not from a passive activity if the property is rented for use in a trade or business activity in which the taxpayer materially participates for the tax year.** The IRS said that as an employee-owner of the lessee personal service corporation, Fransen was a material participant in its activities. The Fransens relied on I.R.C. §469(c), which defines passive activity as including rental activity. The Fifth Circuit rejected the Fransens' argument, pointing out that I.R.C. §469(1)(3) authorizes the promulgation of regulations that treat otherwise passive activity as nonpassive. Judge Higginbotham noted that the purpose behind I.R.C. §469 is to "foreclose tax shelters."

Alternatively, the Fransens argued that the regulation did not apply to them because Remy's law firm was a C corporation and Eugenie had no interest in the corporation. The court rejected the Fransens' argument, noting that the regulation does not limit itself to pass-through entities. The court also found that participation in the activity by one spouse is treated as participation by the other spouse under Temp. Reg. §1.469-5T(f)(3).

Holding. The Treasury regulation is a valid interpretation of I.R.C. §469 and was properly applied to the Fransens.

[*A. Remy, Jr. and Eugenie B. Fransen v. United States*, 99-2 USTC ¶50,882 (CA-5 October 1, 1999)]

Ltr. Rul. 200014010, December 20, 1999
[I.R.C. §469]

☞ **S corporation cannot combine rental and business activities to avoid passive activity losses.**

Facts. A subchapter S company in the business of selling petroleum products leased property from its shareholders. The various properties included convenience stores selling fuel. Under oral lease agreements, the company was entitled to use the properties in return for payment of all of the shareholders' out-of-pocket expenses associated with the properties. **The company subleased the properties to unrelated third parties.** The sublease agreements provided that the company would supply all of the gasoline sold at the convenience store locations, and the tenant would remit its costs and half of the gasoline sales profits to the company. **The IRS agent argued that the company is engaged in two separate activities: the business of selling petroleum products and a rental activity of leasing convenience store properties.** Because the rental costs exceed the rental revenues, they should be treated as a passive loss to the company's shareholders. **The company claimed that it was not involved in a rental activity but rather was in a joint venture with the convenience store tenants to sell petroleum products.**

Issues

Issue 1. Whether the company's activity of providing property is a rental activity under I.R.C. §469(j)(8)

Issue 2. If the activity is a rental activity under I.R.C. §469, whether the taxpayer may group the rental activity with its trade or business activity

Analysis and Conclusion

Issue 1. Some of the facts were consistent with the existence of a joint venture. However, the IRS noted that the facts must be viewed within the context of the complete relationship between the tenants and the company. The company did not share in the costs of constructing or operating the convenience stores, and there was no mechanism for the company to share in any profits of the convenience stores. There was not a complete sharing of costs and profits, which would help support the argument for a joint venture. **Thus, the IRS said that the company's activity of providing property to a tenant constituted a rental activity and not a joint venture.**

Issue 2. **The company argued that if it were engaged in a rental activity, it would be proper to group the rental activity with its trade or business activity of petroleum product sales.** In order for the company to group the two activities, the activities must **constitute an appropriate economic unit,** and the grouping must also satisfy I.R.C. §1.469-4(d)(1)(i)(A), (B), or (C). In determining whether activities constitute an appropriate economic unit, Treas. Reg. §1.469-4(c)(2) lists five nonexclusive factors to be considered. In the present case, since the two activities are under **common control** and the **rental activity furthers the wholesaling activity,** the IRS said that the two activities appear to constitute an appropriate economic unit. Treas. Reg. §1.469-4(d) provides that the **business activity and the rental activity can be treated as a single activity if the rental activity is considered insubstantial to the trade or business activity, or vice versa.** As applied to this situation, **the IRS said that the rental activity couldn't be treated as insubstantial for 1993 and 1994.** Although gross income is a starting point for determining insubstantiality, other things must be considered. In this case, the rental activity actually required a greater capital investment and had greater value. Therefore, the rental activity couldn't be considered insubstantial in relation to the trade or business activity. In addition, the trade or business activity couldn't be considered insubstantial in relation to the rental activity, because the business activity generated over 80% of the S corporation's gross income. **Thus, because neither activity could be treated as insubstantial to the other, the IRS said the two activities could not be treated as a single activity under I.R.C. §469.**

Kosonen v. Commissioner
[I.R.C. §469]

> ☞ **A real estate professional did not elect to treat his rental activities as one activity by aggregating his losses on Schedule E.**

Facts. **Matti Kosonen, a real estate professional, owned seven rental residential properties.** As of January 1, 1994, Kosonen had suspended losses totaling $215,860 from his seven properties. **On his 1994 and 1995 returns, he reported the income and losses using seven columns on three Schedule Es and then reported the totals from all seven properties in the eighth column. Kosonen did not attach a statement to his returns stating that he was electing to treat his real estate activities as one activity,** and he did not combine his 1994 Schedule E rental real estate losses with his previously suspended losses. He **did attach a statement to his 1996 return indicating that he was a qualified real estate professional** and that he elected to treat all of his rental real estate activities as one activity under I.R.C. §469(c)(7).

The IRS said that Kosonen failed to make the I.R.C. §469(c)(7) aggregation election for 1994 and 1995. As a result, each rental property had to be treated separately. Kosonen wasn't a material participant in any of the seven rental activities, so he couldn't use any of his losses to offset non–passive activity income.

Issue. **Whether the taxpayer made the election to treat his seven rental real estate activities as one activity for 1994 and 1995**

Analysis. The taxpayer contended that the fact that he aggregated his losses from his rental real estate activities on his 1994 and 1995 returns indicated that he elected under I.R.C. §469(c)(7) to treat them as one activity. The court **pointed out that a taxpayer has not made an election if it is not clear from the return that an election has been made.** In fact, the instructions for Schedule E require the taxpayer to aggregate rental real estate losses, so that act by itself does not make it clear that the taxpayer intends to make the election. The taxpayer also argued that he treated his net losses as active rather than passive, and by doing so he elected to treat the activities as one activity. The court held that this was not clear notice of the election, because he would also have reported his net losses were active if he had materially participated in each of the seven activities and had not elected under I.R.C. §469(c)(7). **The court also noted that the lack of guidance (other than proposed regulations) about how to elect under I.R.C. §469(c)(7) did not eliminate the statutory requirement to elect.**

Holding. **The Tax Court held that the taxpayer did not elect on his 1994 or 1995 return to treat his rental real estate activities as a single activity under I.R.C. §469(c)(7).**

[*Matti Kosonen v. Commissioner*, 79 T.C.M. 1765 (March 28, 2000) [CCH Dec. 53,821(M)]]

Strange v. Commissioner
[I.R.C. §61]

> ☞ **State income taxes are not deductible in determining net royalty income.**

Facts. Charles and Sherrie Strange **owned interests in oil and gas wells located in nine states.** Each of the nine states imposed an income tax on nonresidents who derived income from an income-producing activity within that state. The Stranges **reported all their royalty income on Schedule E.** In calculating their net royalty income, they **deducted** various expenses and **the state nonresident income taxes they paid.** They elected to take the standard deduction instead of itemizing.

Issue. Whether state nonresident income taxes paid on net royalty income are deductible for purposes of determining adjusted gross income

Analysis and Holding. The taxpayers argued that the Revenue Act of 1964 changed the existing law to provide "unequivocally" for the deduction of the state income taxes for the purpose of calculating adjusted gross income. The court held that taxes are not deductible under I.R.C. §62(a)(4) unless the taxes are directly attributable to a trade or business or to property from which rents or royalties are derived. Thus, **taxes imposed on property held for the production of royalties are deductible, but taxes on the net income from the property are not deductible in determining adjusted gross income.**

[*Charles E. and Sherrie R. Strange v. Commissioner*, 114 T.C. No. 15 (March 29, 2000) [CCH Dec. 53,822]]

PERSONAL EXEMPTIONS

Miller and Lovejoy v. Commissioner
[I.R.C. §152]

☞ **Permanent order of divorce did not meet the strict requirements for release of dependency exemptions by the custodial parent.**

Facts. Ms. Miller and Mr. Lovejoy separated in 1992 and divorced in 1993. Following a contested divorce, **the state court issued permanent orders granting Ms. Miller sole custody of the couple's two children.** The permanent orders **provided that Mr. Lovejoy would claim both of the children on his tax returns as exemptions.** Ms. Miller never signed the permanent orders, but the orders were signed by Ms. Miller's attorney signifying approval as to form.

Mr. Lovejoy claimed the dependency exemptions on his 1993 and 1994 tax returns but **did not attach Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents, signed by Ms. Miller, to either of the returns.** Instead, Mr. Lovejoy attached portions of the permanent orders to his returns as support for the claimed dependency exemptions. Ms. Miller did not claim the dependency exemptions for the children in either 1993 or 1994. However, she amended her petition to claim the dependency exemptions based on a Colorado law that a parent who fails to pay all court-ordered child support is not entitled to claim a child as a dependent if it would result in any tax benefit.

Issues

1. Whether a permanent order of divorce that awards the dependency exemptions to the noncustodial parent, but was not signed by the custodial parent, meets the waiver requirements of I.R.C. §152(e)(2)
2. If Issue 1 is resolved in favor of the noncustodial parent, whether the custodial parent regains the right to claim the dependency exemptions because the noncustodial parent failed to pay all the court-ordered child support

Analysis. The Tax Court compared the permanent orders with Form 8332 and noted several differences between the two documents. **Form 8332 requires a taxpayer to furnish the years for which the claims were released, the signature of the custodial parent, the date of that signature, and the social security number of the custodial parent. The permanent orders did not list the years for which the dependency exemptions were released, and they did not bear the signature of the custodial parent or her social security number.** The court noted that satisfying the signature requirement is critical to the successful release of the dependency exemption. The signature of Ms. Miller's attorney signified approval only as to form, not substance. Since Mr. Lovejoy did not do what was necessary to satisfy I.R.C. §152(e)(2), the court refused to address the second issue.

Holding. The noncustodial parent is not entitled to claim the dependency exemptions, because the permanent order of divorce did not satisfy the express requirements of I.R.C. §152(e)(2)(A).

[*Cheryl J. Miller, et al. v. Commissioner*, 114 T.C. No. 13 (March 24, 2000) [CCH Dec. 53,811]]

Ltr. Rul. 200007031, December 23, 1999
[I.R.C. §152]

☞ **A dependency exemption for all future years may be revoked if the two ex-spouses agree to the revocation..**

Issue. Whether a custodial parent who has released the dependency exemption for all future years may revoke the release

Analysis and Conclusion. The IRS has issued several memoranda stating its position that Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents, is not irrevocable. **Publication 504, *Divorced or Separated Individuals,* which previously contained language stating that Form 8332 could not be revoked, was revised to eliminate that sentence. However, the IRS has not developed or published procedures for revoking Form 8332.**

Form 8332 is attached only to the noncustodial parent's return. It is not filed by the custodial parent, and it contains no cancellation date. If the custodial parent releases the exemption for all future years, he or she executes the form only once and does not have to renew or reiterate the release. If the noncustodial parent does not agree to the revocation and continues to claim the child while the custodial parent also claims the child, an audit will result. The IRS has taken the position that the two **ex-spouses must agree to the revocation**. Thus, **due to the inherent difficulties in revoking Form 8332, custodial parents need to be careful not to release the claim for all future years if there is a possibility that circumstances may change** or that the noncustodial parent may not comply with the divorce decree conditions governing support and exemptions.

Burns v. McGill
[I.R.C. §§7402, 7421, and 7422]

☞ **The IRS properly denied dependency exemptions for a couple who would not provide social security numbers for their children.**

Facts. On their 1995 tax return, Mr. and Mrs. Burns claimed dependency exemptions for their three children. **The IRS denied the dependency exemptions because Mr. and Mrs. Burns failed to submit social security numbers for the children.** After sending numerous notices to Mr. and Mrs. Burns, the IRS issued a levy on Mr. Burns's wages. The Burnses filed suit against Janet McGill and John Stocker, employees of the IRS, stating that they had violated the Equal Protection Clause of the Fourteenth Amendment and the Civil Rights Act of 1964. Ms. McGill and Mr. Stocker asserted that the court lacked subject matter jurisdiction to hear this action because (1) IRS employees are immune from suits seeking damages under any civil rights statute for conduct within the scope of their employment, (2) the taxpayers had failed to comply with the requirements of bringing a federal tax refund action under I.R.C. §7422, (3) district courts may not grant declaratory relief regarding federal tax issues, and (4) district courts may not enjoin the IRS from collecting a tax deficiency pursuant to the Anti-Injunction Act.

Issue. Whether I.R.C. §6109 violated the taxpayers' constitutional rights by forcing them to provide their children's social security numbers on their tax return

Analysis. The Anti-Injunction Act and the tax exception to the Declaratory Judgment Act work together to ensure that preemptive taxpayer litigation will not frustrate the efforts of the IRS to assess and collect federal taxes. The Burnses argued that neither of these acts was applicable to their case. Instead, they argued that **by forcing them to participate in the social security system** ("mandatory socialism"), **the defendants violated their equal protection rights under the Fourteenth Amendment and arbitrarily discriminated against them in violation of the Civil Rights Act of 1964.** The court found that the taxpayers did not meet either of two narrow, judicially created exceptions to the Anti-Injunction and Declaratory Judgment acts. The court noted that the Burns' action concerned nothing more than the assessment and collection of a federal tax and the refund of a federal tax levy. Thus, because the taxpayer's action sought to restrain the assessment or collection of federal taxes, it was excluded from the court's jurisdiction.

The court noted that the Burnses must proceed in a tax refund suit if they wish to challenge the constitutionality of I.R.C. §6109(e). The taxpayers must pay the disputed taxes in full, satisfy their outstanding tax liability, file a claim for refund with the IRS, and bring suit against the United States rather than IRS employees.

Finally, **the court noted that "citizens without social security numbers" is not a recognizable class of persons under the Civil Rights Act, the Fourteenth Amendment does not apply to federal tax statutes, and the constitutionality of social security numbers has been upheld over various constitutional objections.**

Holding. The court granted the motion by two IRS employees to dismiss for lack of subject matter jurisdiction.

[*William M. and Stephanie R. Burns v. Janet E. McGill and John C. Stocker*, 99-2 USTC ¶50,954 (M.D. Tenn. October 13, 1999)]

Miller v. Commissioner
[I.R.C. §§151 and 6109]

☞ **Taxpayers must provide children's SSNs to claim dependency exemptions even though it violates their religious beliefs.**

Facts. John and Faythe Miller claimed their two children as dependents on their 1996 tax return. **Instead of providing social security numbers (SSNs) for their children, the Millers attached a notarized affidavit declaring their religious objection to the use of identifying numbers for their children.** They believe that SSNs are universal numerical markers equivalent to the "mark of the Beast" warned against in the Bible. However, the Millers **offered to obtain Individual Taxpayer Identification Numbers (ITINs) for their children, because they believed that ITINs are issued for a discrete purpose and are not universal identifiers.** The **IRS refused** to issue ITINs to the Millers' children because the Treasury **regulations allow ITINs to be issued only to those who are ineligible to receive SSNs. The IRS acknowledged** that the Millers had a **sincerely held religious belief against the use of SSNs** for their minor children, but **denied that it was required to accommodate that belief.**

Issue. Whether the requirement to provide social security numbers for dependent children as a condition for allowing the dependency deduction violates the taxpayers' right to freedom of religion

Analysis. Under the Religious Freedom Restoration Act of 1993 (RFRA), a claimant must show that the government has substantially burdened his or her free exercise of religion. However, under the RFRA, **the government may impose a substantial burden on the free exercise of religion if it demonstrates that that is the least restrictive means of achieving a compelling governmental interest.** The Tax Court found that the **government does have a compelling interest in effectively tracking claimed dependency exemptions.** The court also rejected the taxpayers' suggestion that the IRS could issue ITINs to their children, because issuing an ITIN to an individual who is eligible to receive a SSN creates the risk that the individual would thereafter obtain a SSN. The individual would then have two unique identifiers, decreasing the government's ability to detect fraud and abuse.

Holding. The court held that neither the Free Exercise Clause of the First Amendment to the Constitution nor the Religious Freedom Restoration Act of 1993 provides a basis for exempting taxpayers from the SSN requirement.

[*John W. and Faythe A. Miller v. Commissioner*, 114 T.C. No. 32 (June 23, 2000) [CCH Dec. 53,915]]

> See *Sherald Lynn Davis, et ux. v. Commissioner*, 80 T.C.M. 31 (July 10, 2000), for a similar result, where the taxpayers asserted that the RFRA and the Privacy Act of 1974 both provide an exception from the requirement to provide SSNs for claimed dependents. The court held that I.R.C. §7(a)(1) of the Privacy Act provides that disclosures required by federal statute are exempt from the Privacy Act.
>
> See *J. Erik Kocher, et ux. v. Commissioner*, 80 T.C.M. 147 (August 4, 2000), for a similar result.

Mueller v. Commissioner
[I.R.C. §§6651, 6654, and 7703]

> ☞ **A taxpayer in an "economic partnership" with a same-sex individual must use single filing status.**

Facts. Robert Mueller worked as a computer programmer for various companies and hospitals. **Mr. Mueller did not file tax returns for the years 1986 through 1995 and made no estimated tax payments during this time period.** He did have some tax withheld from his wages for four of the years in question. From 1989 through 1995, **Mr. Mueller had a relationship with a man he described as his roommate and partner.** The two men shared assets and income. Mr. Mueller was not married to his partner or anyone else for any of the taxable years 1986 through 1995. **The IRS used the single rates to calculate the deficiencies and additions to tax.**

Issues

Issue 1. **Whether a taxpayer who had an "economic partnership" with a same-sex individual may use another filing status besides "single"**

Issue 2. Whether the taxpayer is liable for penalties for failure to file under I.R.C. §6651(a)(1)

Issue 3. Whether the taxpayer is liable for penalties for failure to pay estimated tax under I.R.C. §6654

Analysis and Holding

Issue 1. Mr. Mueller argued that the tax code's unequal treatment between married taxpayers and unmarried taxpayers in an economic partnership violated the due process notions implicit in the Fifth Amendment. The court held that the tax code's distinction between married taxpayers and unmarried economic partners is constitutionally valid. **In order to determine that a statutory classification violates equal protection, the statute must be found to (1) interfere with the exercise of a fundamental right or (2) employ a suspect classification such as race.** The court held that neither of the two exceptions applied to Mr. Mueller. Thus, **Mr. Mueller must file using the single rates.**

Issue 2. **Mr. Mueller stated that his nonfiling was an act of "nonviolent civil disobedience" on a human rights issue. The court noted that the taxpayer's actions were deliberate, intentional, and in complete disregard of the statutes and IRS regulations. The penalties for failure to file were sustained.**

Issue 3. The addition to tax for failure to pay estimated tax payments is mandatory unless one of the exceptions is met. Mr. Mueller offered no evidence that any of the statutory exceptions applied to his situation.

[*Robert D. Mueller v. Commissioner*, T.C. Memo 2000-132, 79 T.C.M. 1887, [CCH Dec. 53,849(M)]]

Hughes v. Commissioner
[I.R.C. §§2, 32, and 152]

> ☞ **Father may claim dependency exemptions for his children, but he may not use head of household status or take earned income credit.**

Facts. Oscar Hughes and Delores Hamilton are the parents of three children. **Mr. Hughes and Ms. Hamilton lived together from 1980 until 1988 or 1989, but have never been married to each other.** In 1994 **Ms. Hamilton was awarded legal custody of the children,** and **Mr. Hughes was ordered to pay child support** and provide insurance for the children, which he did. On most weekends and throughout the summer, the children stayed with Mr. Hughes in his mobile home. When the children lived with him, **Mr. Hughes incurred expenses for their food, clothing, medical treatments, and recreational activities.**

For tax years 1995 and 1996, Mr. Hughes filed as head of household, claimed a dependency exemption deduction for each child, took the standard deduction, and computed the earned income credit using two of his children as "qualifying" children. During 1995 and 1996, the tax years in question, **Ms. Hamilton** lived in public housing, had no income, and did not file tax returns. **For each year she signed a Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents.** The IRS changed Mr. Hughes's filing status to single and disallowed the dependency exemption deductions and the earned income credit.

Issues

Issue 1. Whether the taxpayer is entitled to claim dependency exemptions for his three children

Issue 2. Whether the taxpayer qualifies as head of household

Issue 3. Whether the taxpayer is entitled to earned income credit

Analysis and Holding

Issue 1. The IRS argued that it had not been established that the children received over half of their support from their parents, because the record did not reveal the exact amount of public assistance that Delores Hamilton received on behalf of the children. However, the court was satisfied that the amount of child support that Mr. Hughes paid, plus the value of the housing he provided, plus the cost of medical insurance and incidentals, amounted to more than one-half of the children's total support during the years in question. **Mr. Hughes was entitled to the dependency exemption deductions for 1995 and 1996.**

Issue 2. **In order to qualify as head of household, a taxpayer must maintain a home that is the principal place of abode for the taxpayer's child for more than one-half the year.** Although Mr. Hughes enjoyed substantial visitation rights, the children resided with their mother for most of the year. **The taxpayer does not qualify as head of household.**

Issue 3. The **taxpayer is entitled to an earned income credit only if any of his children meet the definition of a qualifying child in I.R.C. §32(c)(3).** Among other requirements, the child must have the same principal place of abode as the taxpayer for more than half of the taxable year. For this reason, **the taxpayer does not qualify for the earned income credit.**

[*Oscar Hughes, Jr. v. Commissioner*, T.C. Memo 200-143, 79 T.C.M. 1945 [CCH Dec. 53,861(M)]]

PROCEDURE

IR 2000-23
[I.R.C. §§6012 and 6107]

> ☞ **The IRS will implement new Checkbox initiative to expedite return processing.**

The IRS has announced that it will implement a new initiative, called the Checkbox initiative, to expedite return processing beginning with the 2001 filing season. **It will allow paid preparers to work directly with the IRS to resolve tax return processing issues of clients who give them permission by checking a box on the return. Taxpayers who use the Checkbox initiative will not have to execute a power of attorney** in order to allow their preparers to resolve processing issues such as notices of mathematical errors relating to the specific return. However, **the initiative will not apply to examination matters, underreported income, appeals, collection notices, and other substantive issues.** Also, it will **not** be **available on TeleFile returns.** The Checkbox initiative is limited to paid preparers, but the IRS is looking into expanding the initiative to address the needs of businesses and taxpayers that depend on family and friends to prepare returns.

Parsons v. Commissioner
[I.R.C. §§6653 and 6661]

> ☞ **Pharmacist is liable for fraud and substantial understatement penalties.**

Facts. Philip Parsons and his wife, Karen, were both pharmacists. **Philip** was the president and sole shareholder of the Cedar Hill Drug Company. He **was also an employee of Cedar Hill and was issued Forms W-2 for the years in question. Karen worked at an unrelated pharmacy and kept the books for Cedar Hill.** An accounting firm performed bookkeeping services for Cedar Hill and prepared the corporate tax returns as well as the couple's individual returns. **Philip took cash for personal use and did not record all of it on the forms the accounting firm had provided for recording cash transactions.** The nonrecorded amounts added up to $57,106 in 1987 and $35,957 in 1988.

During an audit of Cedar Hill, **the IRS was unable to reconcile the deposits on the forms with the couple's bank deposits.** The audit was expanded to the couple's personal tax returns. The couple was convicted of two violations of I.R.C. §7206(1) for submitting false tax returns. The couple conceded the unreported income issue but contested the additions to tax due to fraud and substantial understatement of tax.

Issues

Issue 1. Whether the taxpayers were liable for additions to tax for fraud under I.R.C. §6653(b) for 1987 and 1988

Issue 2. Whether the taxpayers were liable for additions to tax for substantial understatement of tax for 1987 and 1988

Analysis and Holding

Issue 1. **To establish fraud,** the IRS must show that the taxpayers engaged in conduct with the **intent to evade taxes** that they knew or believed they owed. The Parsons made a number of arguments to show that they lacked the requisite intent, but the court **dismissed the couple's arguments as unconvincing.**

The courts have established several indicia or "badges" of fraud, including the following four, which the court said the taxpayers met: (1) understating income, (2) maintaining inadequate records, (3) giving implausible or inconsistent explanations, and (4) an intent to mislead. The court held that the couple's actions, removing the cash without recording it or telling their accountant for two years, and their convictions under I.R.C. §7206(a), were clear and convincing evidence of fraud on the couple's part.

Issue 2. **The court dismissed the couple's arguments that they had acted in good faith and had reasonable cause for their actions, and held that the couple was liable under I.R.C. §6661 for an addition to tax for the substantial understatement of income.**

[*Phillip E. and Karen Parsons v. Commissioner*, 80 T.C.M. 1 (July 5, 2000) [CCH Dec. 53,942(M)]]

T.D. 8893
[I.R.C. §6695]

> ☞ **The IRS gives preparers two ways to retain manually signed tax return copies.**

This document contains **final regulations giving income tax preparers two ways to satisfy the requirement that they retain manually signed copies of returns or claims for refund.** The regulations are effective July 18, 2000.

Background. An income tax return preparer who fails to sign any return or refund claim he prepares, where so required by the regulations, is subject to a $50 penalty unless it is shown that the failure is due to reasonable cause and not willful neglect. However, the regulations permit use of a photocopy of a return or refund claim that is manually signed after its preparation is completed. Under this procedure, a tax preparer completes the return, signs it before making a photocopy, makes a photocopy that includes a photocopy of the preparer's signature, and then uses it as the original return (or refund claim).

Explanation of Provisions. Effective for returns or claims for refund presented to a taxpayer for signature after December 31, 1998, and for returns or claims for refund retained on or before that date, if a preparer that presents for a taxpayer's signature a return or claim for refund that has a copy of the preparer's manual signature, he may either (1) retain a photocopy of the manually signed copy of the return or claim for refund or (2) use an electronic storage system that meets the requirements of Rev. Proc. 97-22, I.R.C. §4, 1997-1 C.B. 652, or procedures subsequently prescribed by the IRS, to store and produce a copy of the return or claim manually signed by the preparer.

[T.D. 8893, 2000-31 IRB 143 (July 31, 2000)]

Notice 2000-21
[I.R.C. §6053]

> ☞ **The IRS announces a new tip reporting program for those in the food and beverage industry with employees receiving both cash and charged tips.**

The IRS has introduced **a new tip reporting program that is available only for employers in the food and beverage industry that have employees who receive both cash and charged tips.**

Background. The Tip Rate Determination/Education Program (TRD/EP) currently offers employers the opportunity of entering into one of two types of agreements. The Tip Rate Determination Agreement (TRDA) requires the determination of tip rates; the Tip Reporting Alternative Commitment (TRAC) agreement emphasizes education and tip reporting procedures. In return for taking part in TRDA or TRAC, the IRS agrees not to initiate tip examinations of the employer while the agreement is in effect. The decision of whether to enter into either a TRDA or TRAC agreement is entirely voluntary on the part of the employer.

Discussion. Taxpayers in the food and beverage industry have expressed interest in designing their own TRAC programs. This notice sets forth the requirements that employers must meet and the procedures for obtaining approval of their individual programs (designated EmTRAC).

The IRS advises that it may terminate all EmTRAC programs at any time following a significant statutory change in the FICA taxation of tips. After May 31, 2005, the IRS may terminate prospectively the TRD/EP and all EmTRAC programs.

[Notice 2000-21, 2000-19 IRB]

IR 1999-105
[I.R.C. §7122]

> ☞ **The IRS offers a new payment option under the Offer-in-Compromise program.**

The IRS has announced **a new, simplified method** of settling taxpayer debts under the **Offer-in-Compromise** program.

Changes. The new, simplified offer will provide taxpayers a **fixed monthly payment option,** ending uncertainty about converting offer amounts into monthly payments. Under the old system, interest could be adjusted up to four times a year. With deferred payments spread out for up to 10 years, this created complicated calculations and uncertainty for everyone involved. The IRS will adopt the same fixed-payment policy for taxpayers choosing the other two Offer-in-Compromise payment options: cash or short-term payments.

New Form Package. The IRS has consolidated the instructions for the program into the **new Form 656 package.** This package **will replace Form 656-A, which means that taxpayers who previously had to fill out both Form 656 and Form 656-A will now have to fill out just one. All Offers in Compromise submitted after January 1, 2000, must be on the new Form 656.**

Waiver Provision Removed. Effective January 1, 2000, the time that the IRS has to collect the balance due is suspended by law rather than by the taxpayer signing the waiver on Form 656. The suspension occurs while the IRS processes and reviews the Offer in Compromise, plus 30 days, plus any time a rejected Offer in Compromise is being appealed.

East Wind Industries v. United States
[I.R.C. §§6651 and 6656]

> ☞ **Financial hardship can constitute reasonable cause for failure to pay tax or make deposits.**

Facts. East Wind Industries and Delaware East Wind **manufactured military clothing and goods** for the Defense Department. During the 1970s, **Defense employees responsible for acquisitions began soliciting bribes.** East Wind and Delaware East initially complied, but later **refused the demands.** At that point, they began having **trouble renewing contracts and obtaining payment.**

Until the 1980s, the taxpayers had a history of timely filing payroll tax returns and paying their withholding taxes. **Beginning in 1982, the taxpayers timely filed all of the appropriate tax returns but failed to pay the employment taxes.** A global settlement agreement was reached between the taxpayers and the Defense agencies as a result of the Bankruptcy Court's enforcement of the taxpayer's claims. **Out of the settlement, the taxpayers paid their delinquent employment taxes in full, including penalties and interest.**

The taxpayers brought suit in the district court **seeking a refund of the penalties.** They **alleged** that they were entitled to an abatement of the penalty because the delinquency was due to **reasonable cause,** i.e., **financial hardship resulting from government corruption,** and not willful neglect. The district court granted summary judgment in favor of the government. The taxpayers appealed.

Issue. Whether the district court erred in applying the bright-line test set forth in *Brewery, Inc.* that financial difficulties per se can never constitute reasonable cause for abatement of a penalty under I.R.C. §§6651 and 6656

Analysis. Relying on the Sixth Circuit's decision in *Brewery, Inc.* [33 F.3d 589 (6th Cir. 1994)], **the IRS took the position that financial distress alone does not establish reasonable cause.** The IRS also maintained that when trust fund taxes are at issue, a more stringent standard is applied (Treas. Reg. §301.6651-1(c)(2)). They argued that the taxpayers acted with willful neglect because they chose to pay employees and creditors instead of the IRS. Judge Carol Los Mansmann disagreed, pointing out that **"here the Government was not an unwilling partner in a floundering business but, indeed, an active participant."**

Judge Mansmann rejected the bright-line rule of *Brewery* in favor of the "facts and circumstances" test of *Fran Corp*. [164 F.3d 814 (2d Cir. 1999)]. To prove reasonable cause, a taxpayer must prove that its failure was not due to willful neglect (defined as a conscious, intentional failure or reckless indifference) and that it exercised ordinary business care and prudence and was nevertheless either unable to pay the tax or would suffer an undue hardship. **The court found that the companies' failure to pay was not due to willful neglect and that the companies had reasonable cause.** The principal officer of the companies incurred personal debts to provide funds for the companies and **the only customers for the companies' products were the agencies trying to obtain funds from bribes.** As to reasonable care and prudence, the court found that the companies did not pay many suppliers, rent, and other expenses and that they **used all income from government contracts to pay either taxes or employees' wages.**

Holding. Reversing the district court, the **Third Circuit concluded that reasonable cause existed for the taxpayers' failure to pay and deposit their employment taxes in a timely manner.**

[*East Wind Industries, Inc., Delaware East Wind, Inc. v. United States,* 99-2 USTC ¶50,968 (CA-3 November 16, 1999)]

Spiroff v. United States
[I.R.C. §§6511 and 6513]

> ☞ **A refund claim was filed three days too late.**

Facts. Craig Spiroff and Susan Teubert received an extension for filing their 1991 tax return until August 15, 1992. The taxpayers **waited until August 15, 1995, to mail their 1991 tax return,** claiming a refund of $9,853. **The tax return was received by the IRS on August 18, 1995.** Three months later, the IRS informed the taxpayers that they were **not entitled to a refund or credit** for the **1991 overpayment** of tax, because **the return was filed on August 18, 1995, three days too late to receive a refund.**

Issue. Whether the taxpayers' refund claim is barred by the three-year limitations period

Analysis and Holding. **The court held that a refund claim could be based on a delinquent return.** Applying I.R.C. §6511(b)(2)(A), the court said that **the taxpayers are entitled to a refund that cannot exceed the amount of tax paid during the three years immediately prior to the filing of the claim for a refund** (plus any extensions given). Consequently, the court held that the taxpayers could recover only the amount of tax paid after April 18, 1992. This is the date that is three years prior to the date the taxpayers filed their claim for a refund, which was August 18, 1995, plus the six-month extension that was granted. Accordingly, the taxes paid by the taxpayers during tax year 1991 are considered under I.R.C. §6513(b)(1) and (2) to have been paid on April 15, 1992. The taxpayers did not dispute that no tax payments attributable to tax year 1991 were made after April 15, 1992. **Because the amount of taxes paid toward tax year 1991 during the period prescribed under I.R.C. §6511(b)(2)(A) were zero, the court held that the taxpayers were not entitled to any refund for tax year 1991. If the IRS had received the return within three years of August 15, 1992, they would have received a refund.**

[*M. Craig Spiroff and Susan Teubert v. United States*, 2000-1 USTC ¶50,235 (E.D. Mich. January 27, 2000)]

Mitchell v. Commissioner
[I.R.C. §7430]

> ☞ **Taxpayer may recover attorneys' fees due to the IRS's position on accuracy-related penalties.**

Facts. In a **previous case** (see *Mitchell v. Commissioner* in the Travel Expenses section), **the court held that Thomas Mitchell was entitled to deduct travel and apartment rental expenses related to his employment.** His residence was his tax home, and since his employment was temporary (even though it spanned five years), he was "away from home." The court also held that Mitchell was not liable for accuracy-related penalties. Mitchell brought **this action to recover litigation costs under I.R.C. §7430.**

Issue. Whether the IRS's positions in previous proceeding were substantially justified

Analysis and Holding. **The court may award litigation costs to the taxpayer if the IRS's position is not justified, i.e., it does not have a reasonable basis in law and fact** [I.R.C. §7430(b) and (c)]. The Mitchell case was the first time the IRS applied a 1992 amendment to I.R.C. §162(a) to the case of an independent contractor such as Mitchell. The amendment says that a taxpayer "shall not be treated as being temporarily away from home during any period of employment if such period exceeds one year." **The court found that the IRS's position on the location of Mitchell's tax home was reasonable. Thus, the taxpayer could not recover attorneys' fees for this portion of the deficiency.**

However, the court held that **it was not reasonable for the IRS to assert an accuracy-related penalty under I.R.C. §6662(a) in a case of first impression involving the unclear application of an amendment to the Internal Revenue Code.** The court also noted that the taxpayers had acted reasonably and in good faith in taking their position, which made I.R.C. §6662(a) inapplicable in the Mitchell case. **Thus, the IRS's position was unreasonable in both fact and law. The court awarded attorneys' fees, equal to 15% of the requested costs.**

[*Thomas J. and Janice M. Mitchell*, 79 T.C.M. 1954 (April 21, 2000) [CCH Dec. 53,863(M)]]

Ltr. Rul. 200014001, April 10, 2000
[I.R.C. §§6201 and 6501]

> ☞ **A fraudulent Form W-2 is not a fraudulent tax return.**

Facts. **A prisoner used a Form W-2 that contained false employment, income, and withholding information to file a return and claim a refund.** Because the return was apparently complete as to required detail, the IRS processed the return and posted the reported income tax prepayment credits. It did, however, freeze the account so that a refund was not made. At the time this memorandum was issued, the basic assessment period of I.R.C. §6501(a) had expired.

Issues

Issue 1. Whether overstatement of a claim for refund or credit can be considered in a deficiency determination

Issue 2. **Whether a fraudulent Form W-2 can be considered a fraudulent return;** whether I.R.C. §6501(c)(1) applies to a return based on a false Form W-2; whether the civil fraud penalty must be assessed for the unlimited assessment period of I.R.C. §6501(c)(1) to apply

Issue 3. Whether the period of limitations for making an assessment under I.R.C. §6501(a) and the unlimited period in I.R.C. §6501(c)(1) apply to assessments of overstated prepayment credits made under I.R.C. §6201(a)(3)

Issue 4. Whether a reversal of income tax prepayment credit on the ground that the credit is overstated and does not exist, can be considered an assessment under I.R.C. §6201(a)(3)

Issue 5. What can be done with the frozen refund?

Issue 6. What must be shown "at a minimum" in order to assert fraud and keep the statute open?

Analysis and Conclusion

Issue 1. I.R.C. §6211(b)(1) and the legislative history to I.R.C. §6201(a)(3) preclude consideration of income tax prepayment credit or its overstatement in the determination of a deficiency. **The explicit definition of a deficiency does not consider the payment of estimated taxes or withholding of taxes in the calculation.**

Issue 2. A Form W-2 is an information return on which no tax is reported. It is separate and distinct from the Form 1040. Thus, **a fraudulent W-2 does not constitute a fraudulent income tax return, but the unlimited limitations period under** I.R.C. §**6501(c)(1) may apply if the IRS can show that the return is false or fraudulent with the intent to evade tax.** The IRS is not required to assert the civil fraud penalty in order for the unlimited period of I.R.C. §6501(c)(1) to apply.

Issue 3. Assessment of the amount of overstated income tax prepayment credits under I.R.C. §6201(a)(3) is governed by the applicable period of I.R.C. §6501, including I.R.C. §6501(c)(1) if the overstatement of the credit reported on the return is false or fraudulent with intent to evade the tax.

Issue 4. A reversal of an income tax prepayment credit does not comply with the requirements for assessment under I.R.C. §6201(a)(3).

Issue 5. The IRS should reverse the credit to the taxpayer's account, notify the taxpayer of this action, and issue a notice of claim disallowance. The taxpayer must file a refund suit within two years from the date the notice was filed. Once the two-year period has expired, the IRS may move the frozen funds to the excess collections file. After the overstated credit is reversed, the IRS should abate the assessment under I.R.C. §6404(a)(1).

Issue 6. If the IRS reverses the overstated credit and makes no assessment under I.R.C. §6201(a)(3), it is not necessary to determine what must be shown to assess fraudulent conduct for purposes of the statute of limitations under I.R.C. §6501(c)(1).

Olpin v. Commissioner
[I.R.C. §§6013 and 6061]

> ☞ **A joint return signed only by the tax preparer was not a valid return.**

Facts. **Nathan (taxpayer) and Susan Olpin were divorced on September 5, 1996.** On October 15, 1996, after two extensions had been filed, a 1995 Form 1040 was sent to the IRS. **The joint return was not signed by either of the Olpins, but was signed by their tax preparer.**

In a later year, during the course of a bankruptcy proceeding for Susan, the IRS filed a proof of claim asserting a tax liability for the 1995 tax year, based on unreported income for Nathan and on an unsigned joint tax return for 1995. In **February 1998, at the urging of the IRS, Susan signed and filed a 1995 tax return using the filing status of married filing separately. The IRS had recorded its receipt of the joint return in 1996, but later reversed its processing of the return to reflect that a valid return was not filed by Nathan.**

Issue. Whether the taxpayer filed a valid 1995 federal income tax return

Analysis. The taxpayer argued that (1) recent federal law has eliminated the manual signature requirement [I.R.C. §6061(b)] and (2) the facts of this case fall within an exception to the general rule requiring tax returns to be signed. The court responded that **I.R.C. §6061(b) applies only to electronic filings,** and this code section authorizes (but does not require) the IRS to waive the signature requirement until procedures are in place for the acceptance of signatures in an electronic form. The taxpayer's second argument was that the return was valid because he and his former spouse intended it to be their joint return. The court responded that even though **courts have long held that if an income tax return is intended by both spouses as a joint return, the absence of the signature of one spouse does not prevent the joint return. The absence of both signatures does not fall within this exception.**

Holding. The court held that **the taxpayer did not file a valid 1995 tax return** and must compute his tax on the basis of a married individual filing separately.

[*Nathan T. Olpin v. Commissioner*, 78 T.C.M. 1254 (Dec. 30, 1999) [CCH Dec. 53,680(M)]]

Smith v. Commissioner
[I.R.C. §§6212 and 6213]

☞ **Deficiency notice lacking dates is still valid since taxpayer received it and filed a petition in a timely manner.**

Facts. Eric and Dorothy Smith **filed their 1995 federal tax return in April 1996. The IRS sent a deficiency notice by certified mail,** which was received by the Smiths in the middle of March 1999. **The IRS had failed to include both a "letter date" and a date in the section entitled "Last Day to File a Petition with the United States Tax Court."** On April 29, 1999, the couple's attorney informed the IRS that the two dates were missing. On May 4, 1999, the couple received a new copy of the notice with the dates included. The Smiths mailed a timely petition to the Tax Court on June 3, 1999.

Issue. Whether failure by the IRS to include the petition date rendered the deficiency notice invalid

Analysis. The taxpayers contended that the failure to include the petition date rendered the notice invalid. Thus, the period of limitations was not tolled and, as a result, they were not liable for the deficiency or the penalty. I.R.C. §3463(a) provides that the Secretary shall include on each notice of deficiency under I.R.C. §6212 the date determined to be the last day on which the taxpayer may file a petition with the Tax Court. **The court noted that while Congress states that the IRS "shall include" the petition date on each notice, Congress failed to prescribe what consequences result from failure to include the date.**

Holding. The court held that **since the taxpayers received the notice prior to the expiration of the period of limitations and filed a petition in a timely matter, the notice was valid.**

[*Eric E. and Dorothy M. Smith v. Commissioner*, 114 T.C. No. 29 (June 8, 2000) [CCH Dec. 53,908]]

IR 2000-31
[I.R.C. §6402]

> ☞ **Form 1040PC format is not available for tax years after 2000.**

The IRS has announced that it will no longer accept paper returns in the Form 1040PC format after the current processing year. The availability of e-filing has reduced the need and attractiveness of the Form 1040PC format, and Form 1040PC usage has declined each year since 1997.

Williams v. Commissioner
[I.R.C. §§6011, 6065, 6662, and 6673]

> ☞ **A disclaimer negates the return's truthfulness and accuracy, causing it to be invalid.**

Facts. In 1994 Stephen W. Williams filed his Form 1040 for 1991. **Williams altered the form by marking through certain lines and typing the words "Non Taxable Compensation." He did not sign the return. The IRS treated the altered Form 1040 as a frivolous return** under I.R.C. §6702 and fined Williams $500. Williams stipulated that the altered Form 1040 was a frivolous return and not a return within the meaning of I.R.C. §6501(a).

In November 1996 **Williams mailed another Form 1040** for 1991 to the IRS. On the return, he reported adjusted gross income of $150,852, a total tax of $41,586, and an amount owed of $36,621. **Beside the amount owed, Williams placed an asterisk and at the bottom of the page stated, "The admitted liability is zero. See attached Disclaimer Statement."** The attached disclaimer read in part: "The above named taxpayer respectfully declines to volunteer concerning assessment and payment of any tax balance due on the return or any redetermination of said tax. Be it known that the **above said taxpayer, therefore, denies tax liability** and does not admit that the stated amount of tax on return is due and collectible."

Issues

Issue 1. Whether the taxpayer was liable for the deficiency in his 1991 taxes

Issue 2. Whether the taxpayer's Form 1040 containing a disclaimer statement was a valid return, and if so, whether the taxpayer is liable for a penalty under I.R.C. §6662

Issue 3. Whether the taxpayer is liable for an addition to tax for failure to file under I.R.C. §6651(a)(1)

Issue 4. Whether the taxpayer is liable for the penalty for a frivolous tax position under I.R.C. §6673

Analysis and Holding

Issue 1. The taxpayer did not challenge the IRS's calculation of tax. **The court noted that the taxpayer's claims were reminiscent of tax protestor rhetoric that has been universally rejected by the courts. The court held that the taxpayer was liable for the deficiency determined by the IRS.**

Issue 2. The IRS said that the taxpayer was liable for an accuracy-related penalty pursuant to I.R.C. §6662(a) for his underpayment of tax attributable to negligence or disregard of rules or regulations. **The penalty under** I.R.C. **§6662(a) applies only where a return has been filed, so the court had to determine whether the return was valid.** I.R.C. §6065 requires returns to contain or be verified by a written declaration that they are made under penalties of perjury. A taxpayer satisfies this requirement by signing the preprinted jurat on the Form 1040. **The court has generally found that alterations (either striking or adding text) to the jurat invalidate the Form 1040 as a return. However, Williams's return contained a disclaimer outside the jurat box, a situation the court had not addressed before.** The court applied the Supreme Court's test to determine whether a return is valid. One of the elements of the test is that a taxpayer must execute the document under penalties of perjury. **The court held that by his disclaimer, the taxpayer altered the meaning of the jurat. Thus, the return was not valid and the taxpayer was not liable for the penalty under I.R.C. §6662(a).**

Issue 3. **I.R.C. §6651(a)(1)** imposes an addition to tax for failure to file a return on the date prescribed (including extensions), unless the taxpayer can establish that such failure is due to reasonable cause and not willful neglect. Even if it were valid, the taxpayer's 1991 return was not filed until 1996, so **the court held the taxpayer liable for the maximum addition to tax: 25%.**

Issue 4. **Under I.R.C.** §6673, the court may impose a penalty not exceeding $25,000 if the taxpayer takes a frivolous position or institutes the proceeding primarily for delay. A frivolous position is one that is "contrary to established law and unsupported by a reasoned, colorable argument for change in the law." **The court imposed a penalty of $5,000 due to the taxpayer's groundless arguments and the waste of the court's time and resources.**

[*Stephen W. Williams v. Commissioner*, 114 T.C. No. 8 (March 1, 2000) [CCH Dec. 53,773]]

Jones v. United States
[I.R.C. §§6103 and 7431]

> ☞ **The IRS is liable for damages resulting from agent's disclosure to informant.**

Facts. In 1989 an informant told the IRS that Terry and Patricia Jones's oil company was violating federal excise tax laws. Shortly before executing a search warrant at the company's premises, an **IRS agent contacted the informant and revealed that a search would take place.** After receiving an anonymous tip, a **local television station sent a news team to cover the search.** Neither the Joneses nor the company were charged with any criminal tax violations, but their **business suffered from the adverse publicity.**

The Joneses sued the government for wrongfully disclosing tax information under I.R.C. §6103. The district court found that the IRS agent made a good faith interpretation of I.R.C. §6103(k)(6). [See (95-2 USTC ¶50,567), 898 F. Supp. 1360 (D. Neb. 1995).] The Eighth Circuit held that it was the government's burden to prove that its agent acted in good faith. [See (96-2 USTC ¶50,537), 97 F.3d 1121 (8th Cir. 1996).] On remand, **the district court concluded that the government failed to prove that the agent acted in good faith.** [See (97-1 USTC ¶50,489), 954 F. Supp. 191 (D. Neb. 1997).] **The district court determined consequential damages of $5,431,199** but did not award the Joneses punitive damages or attorneys' fees. [See (98-2 USTC ¶50,863) 9 F. Supp. 2d 1119, 1154 (D. Neb. 1998).] Both the Joneses and the IRS appealed.

Issues

Issue 1. Whether the district court erred in finding that the government failed to prove that its agent acted in good faith

Issue 2. Whether the district court erroneously included prejudgment interest in its damages award

Issue 3. Whether the district court erred in failing to award punitive damages or attorneys' fees

Analysis and Holding

Issue 1. I.R.C. §6103(k)(6) allows for the disclosure of information "only in such situations and under such conditions as [the Secretary of the Treasury or the Secretary's delegate] may prescribe by regulation." The Eighth Circuit noted that there is no regulation that allows for the disclosure of information in the circumstances of this case. **Thus, the court held that it was unlawful for the agent to disclose that a search would take place..**

Issue 2. The district court had based its damages award on the testimony of the taxpayers' expert, whose estimated amounts as of the date of loss were increased to amounts as of the date of the trial. **The Eighth Circuit noted that the district court had awarded amounts for the loss of investment capital between the time of the loss and the date of trial, which could not be characterized as anything other than interest. Under I.R.C. §1961(a), interest is allowable only from the date of judgment to the date of payment. The Eighth Circuit reduced the judgment by $2,560,081.**

Issue 3. Punitive damages may be awarded based on a wrongful disclosure of tax return information if the disclosure is willful or grossly negligent [I.R.C. §7431(c)(1)(b)]. Under I.R.C. §7430, attorneys' fees can be awarded only if the government's position was not substantially justified. **Writing for the majority, Judge Morris Sheppard Arnold held that the IRS agent did not act willfully or in a grossly negligent fashion and the government's position on the merits of this case was substantially justified. Thus, the district court was correct in not awarding punitive damages or attorneys' fees.**

[*Terry and Patricia Jones, et al. v. United States*, 2000-1 USTC ¶50,312, (8th Cir. March 24, 2000)]

Mom's Inc. v. Weber

[I.R.C. §7402]

> ☞ **An IRS agent may be personally liable for manipulating facts to obtain a search warrant.**

Facts. Mom's Inc. operated a restaurant called The Jewish Mother. **The restaurant hired Deborah Shofner as its bookkeeper, not knowing that she had three criminal convictions and was on parole.** During the purchase of a second restaurant, **Shofner** talked her supervisors into getting rid of the restaurant's CPA. She invalidated a management agreement by **forging the signature of one of the sellers, which caused the restaurant to operate without a liquor license. Shofner** also failed to pay any sales tax on the alcohol the restaurant served and she **began to embezzle money from the restaurant.**

When the owners discovered the embezzling, **they fired Shofner, called the police, and notified the state's attorney. Shofner then contacted the local Alcohol Beverage Control (ABC) officers and cooperated with them in their investigation of the restaurant.** The ABC officers notified the IRS, and the **IRS appointed Carol Willman to investigate**.

Willman failed to conduct her own investigation, and **simply used the information that Shofner and the ABC officers provided to draft search warrants for the restaurant and owners' homes.** ABC officers and IRS agents seized more than 150 boxes of information, but their investigation produced no evidence of wrongdoing. Shofner pleaded guilty to embezzling. The restaurant owners sued Willman, her supervisor (Cheryl Kast), and several ABC officers, claiming that they had violated their constitutional rights. Willman, Kast, and the ABC officers moved for summary judgment, arguing that they were immune from suit.

Issue. Whether the taxpayers' constitutional rights against unreasonable search and seizure were violated

Analysis and Holding. The court noted the "mob rule" mentality where insistence by a few individuals that some of the plaintiffs were criminals overcame calm analysis and good sense. There was no attempt by the investigators to contact those who did not believe Deborah Shofner.

The court found that **Willman and the ABC officers failed to corroborate or analyze the information that Shofner provided, and they falsely represented that they had corroborated the information.** The court found that Willman must have known she was violating the owners' constitutional rights when she created an affidavit containing false statements and omissions to support the search warrant. The court held that even though Willman's supervisor (Kast) acted in a grossly negligent manner by not insisting that the affidavit reflect that Shofner had been accused of embezzling funds, she did not know of Willman's failure to analyze or corroborate Shofner's information. Thus,

Kast was not personally liable for violating the restaurant owners' constitutional rights. The court held that **Willman and one of the ABC officers violated the restaurant owners' constitutional rights, and that reasonable people in their positions would have known that they were violating the owners' rights. A jury will decide the case.**

[*Mom's Inc., et al. v. Judith Weber, et al.*, 2000-1 USTC ¶50,204 (E.D. Va. January 13, 2000)]

REASONABLE COMPENSATION

Exacto Spring Corporation v. Commissioner
[I.R.C. §162]

> ☞ **Compensation paid to CEO by closely held corporation was reasonable because return to investors exceeded 13%.**

Facts. **In 1993 and 1994, Exacto Spring, a closely held corporation, paid William Heitz, its cofounder, chief executive, and principal owner, $1.3 and $1 million,** respectively, in salary. The IRS said that Heitz should have been paid no more than $381,000 in 1993 and $400,000 in 1994. The **Tax Court found that the maximum reasonable compensation for Heitz would have been $900,000 in 1993 and $700,000 in 1994.** Heitz appealed the Tax Court's decision.

Issue. **Whether compensation paid to CEO by a closely held corporation was reasonable**

Analysis. **In reaching its conclusion, the Tax Court applied a seven-factor test,** which included (1) the type and extent of the services rendered, (2) the scarcity of qualified employees, (3) the qualifications and prior earning capacity of the employee, (4) the contributions of the employee to the business venture, (5) the net earnings of the employer, (6) the prevailing compensation paid to employees with comparable jobs, and (7) the peculiar characteristics of the employer's business. **All the factors either favored the taxpayer or were neutral. Yet the Tax Court reached the conclusion that a portion of Heitz's salary was unreasonable.**

The Seventh Circuit rejected the seven-factor test for many reasons, namely, (1) there is no indication of the weighting of factors if all do not favor the same side; (2) many of the factors, such as scarcity of qualified employees, are vague; (3) the factors do not bear a clear relationship to each other or to the primary purpose of I.R.C. §162(a)(1), which is to prevent dividends from being disguised as salary; (4) judges are not equipped by training or experience to decide what business executives in a closely held corporation are worth; (5) the test invites the making of arbitrary decisions based on unprincipled rules of thumb; and (6) because the reaction of the Tax Court to a challenge of the deduction of executive compensation is unpredictable, corporations run unavoidable legal risks in setting levels of compensation that may be indispensable to the success of their business. **Instead, the Seventh Circuit applied the independent investor test.** The **IRS's expert said that investors in a company like Exacto would expect a 13% return on their investment. Since Exacto's investors earned a 20% return, the Seventh Circuit concluded that Heitz's salary was reasonable.**

Holding. The Seventh Circuit reversed the Tax Court, holding that the **compensation paid by a closely held corporation to its majority owner/CEO was reasonable.**

[*Exacto Spring Corporation v. Commissioner*, 99-2 USTC ¶50,964 (CA-7 November 16, 1999)]

Normandie Metal Fabricators, Inc. v. Commissioner
[I.R.C. §162]

> ☞ **Compensation paid to founder and founder's son was excessive.**

Facts. Isidore Klein invented and manufactured several successful baking products, often working 12–18 hours per day, 6 days a week. In 1949, Isidore developed and built Normandie Metal Fabricators, which manufactured small implements and metal food-handling equipment primarily for the bakery industry. Isidore's son, Steven, joined the business in 1963. In 1980, Isidore retired to Florida but remained involved in the business. From 1980 to 1992, Isidore set his own salary based on 8% of sales. **For 1993 and 1994, Isidore's salary was $352,000 and $368,000, respectively,** equivalent to 10% of sales. **Isidore usually paid Steven whatever he asked for. In 1993 and 1994, Steven was paid $500,000 and $450,000, respectively. In 1995,** Steven asked the company's accountant what salary would be reasonable for his new position as CEO. The accountant thought $800,000 would be reasonable and **Steven set his pay at $820,000.**

The IRS contended that a large portion of the Klein's salaries were actually dividends. The IRS said that Normandie's total compensation deduction should be limited to $405,000 for 1993, $392,000 for 1994, and $444,000 for 1995.

Issues

1. Whether salaries a corporation paid its 80-year old CEO/founder and his second-in-command son for 1993, 1994, and 1995 were reasonable compensation
2. Whether corporation was liable for substantial understatement of tax penalty under I.R.C. §6662

Analysis. The Kleins argued that the compensation was reasonable because (1) Isidore had superior skills, (2) part of Isidore's compensation represented catch-up pay for earlier years, (3) Normandie paid above-market salaries to its employees, and (4) Steven deserved a much higher salary in 1995 for doing both his and his father's jobs.

Following *Rapco* [85 F.3d 950 (2nd Cir. 1996)] and *Dexsil Corp*. [98-1 USTC ¶50,471], **the judge applied a five-factor test from the perspective of an independent investor. All five factors favored the IRS. The company had barely kept pace with inflation under Steven's management, earning a return on assets between 0.7 and 5.3%. His salary represented 90% of pretax profits in 1995.**

Holding. The court held that only $200,000 per year for Isidore and $300,000 per year for Steven was reasonable compensation for 1994. Only $440,000 was reasonable compensation for Steven for 1995. The corporation was liable for the negligence component of the accuracy-related penalty for 1993 and 1994, but not for 1995, because it had reasonably relied on the advice of its accountant.

[*Normandie Metal Fabricators, Inc. v. Commissioner*, 79 T.C.M. 1738 (March 27, 2000) [CCH Dec. 53,815(M)]]

Ashare, P.C. v. Commissioner
[I.R.C. §§162 and 7605]

> ☞ **Compensation of $1.75 million paid to highly qualified employee was reasonable, even though it was partly funded by a loan from the employee.**

Facts. Attorney Richard Ashare was the sole owner and professional employee of the Law Offices of Richard Ashare, P.C., a corporate law firm that specialized in employee pension benefits. **During his employment, Mr. Ashare focused almost exclusively on one case. In the Gentile case, Ashare**

represented 9,000 to 10,000 policemen and firemen in a suit against the city of Detroit for a correct computation of employee pension benefits. In 1989, after prolonged litigation, **the city agreed to pay $70 million to settle the Gentile case. The law office's portion was $12,567,623, which it received from 1989 through 1992.** Following the settlement, the law firm was required to perform additional work in administering the settlement fund, such as locating some of the plaintiffs and determining their share of the award. This **work was to continue for many years after the final disbursement of legal fees to the law firm.** On its 1993 Form 1120, the **law firm reported compensation of $1,750,000 to Mr. Ashare.** In order for the law firm to have the funds to pay Mr. Ashare, **most of its assets had to be liquidated and Mr. Ashare had to make a loan to the firm.**

Issues

1. Whether the IRS violated I.R.C. §7605(b) by examining taxpayer's books two times in 1993
2. Whether taxpayer's $1,750,000 was deductible under I.R.C. §162(a) as reasonable compensation

Analysis and Holding

Issue 1. I.R.C. §7605 generally limits the commissioner to one inspection of a taxpayer's books of account for each taxable year. The taxpayer argued that the IRS performed a second inspection when the revenue agent asked to see the board minutes and prepared two reports. **The court found that two reports did not necessarily equal two inspections.**

Issue 2. I.R.C. §162(a) allows a deduction for compensation if it is reasonable in amount and for services actually rendered to the payor in or before the year of payment. Ashare was a key employee, **vital and indispensable in the law firm's operation and success. His qualifications and expertise in a highly complex and specialized business justified his high compensation. The court found that $1,750,000 was reasonable compensation to Mr. Ashare.** The court then addressed whether the $1,750,000 was deductible in full, that is, whether the compensation was for services rendered in or before the year of payment. The IRS argued that the law firm paid such a large amount because 1993 was the last year from which it could carry back a net operating loss to 1990 to recover that year's taxes. The IRS also said that the firm did not follow the corporation's compensation formula for 1993. **The court noted that the corporation would not have received the $12.5 million fee without the services of Mr. Ashare and that the corporate board had resolved that Mr. Ashare was entitled to the specified amount of compensation.** The court declined to second-guess the board's wisdom.

[*Law Offices of Richard Ashare, P.C. v. Commissioner*, 78 T.C.M. 348 (August 24, 1999) [CCH Dec. 53,516(M)]]

RESIDENCE

Ltr. Rul. 200004022, October 28, 1999
[I.R.C. §121]

> ☞ **Taxpayers qualified for the exclusion of gain on sale of a residence even though a partnership held the title.**

Facts. **Two taxpayers deeded 98% of a home to a grantor trust formed by them.** The taxpayers and the **grantor trust then deeded the residence to a partnership.** The taxpayers each own a 1% interest in the partnership as general partners, and the trust owns the remaining 98% interest as a limited partner. Some time later, **the partnership distributed the title to the residence to its partners**

(**the taxpayers and the grantor trust**) in accordance with their partnership interests. The taxpayers now intend to sell the residence.

Issue. Whether the taxpayers owned the home during the period that the partnership held title to it for purposes of the home sale exclusion [I.R.C. §121(a)]

Analysis and Conclusion. The IRS concluded that, for purposes of the home sale exclusion, the taxpayers owned the home during the period that the partnership held title to it. Although a partnership held title to the home, **it hadn't been used in the conduct of the enterprise and served no business purpose of the taxpayers or the entity.** The taxpayers (either individually or as the grantors of the trust) owned 100% of the home during the period that the partnership held title to it, and didn't take business deductions for the home. The IRS cited **Rev. Rul. 66-159,** 1966-1 CB 162, which held that for purposes of a prior law's home sale rollover rules, **the sale of a home by a grantor trust was treated as if made by the grantor.** Also, Rev. Rul. 85-45, 1985-1 CB 183 held that where a beneficiary is treated as the owner of the entire trust under I.R.C. §§678 and 671, a sale by the trust was treated as a sale by the beneficiary for purposes of the prior law's one-time exclusion up to $125,000. The IRS did not express an opinion as to whether the taxpayers are to be treated as the owners of the trust under the grantor rules of I.R.C. §§671677 or whether the taxpayers have used the residence as their principal residence.

Ltr. Rul. 200018021, January 21, 2000
[I.R.C. §121]

> ☞ **An income beneficiary who lived in a home owned by a trust may not exclude the gain on the sale of the home by the trust.**

Facts. A mother established a trust to benefit her daughter. **The only asset of the trust was the mother's home. The daughter lived in the house for 18 years before moving to an assisted-living facility.** Under the trust, **the daughter was the income beneficiary, but did not have the power to transfer the house.** The trustees now plan to sell the house.

Issue. Whether the gain from the sale of the residence would be excluded under I.R.C. §121

Analysis and Conclusion. Under I.R.C. §678, a person other than the grantor may be treated as the owner of a trust. However, this section does not apply to the taxpayer in this situation, because **she never had the power to vest the trust corpus or income in any person.** The IRS concluded that the taxpayer is not considered the owner of any portion of the trust under I.R.C. §§671 and 678. Thus, the **taxpayer is not considered the owner of the residence** for purposes of satisfying the ownership requirements of I.R.C. §121, and **cannot exclude the gain from sale of the home from gross income.**

Ltr. Rul. 199950030, September 30, 1999
[I.R.C. §121]

> ☞ **Election for one-time home sale exclusion under the prior law is still available within two-year period after paying tax on the sale.**

Facts. Prior to the 1997 Taxpayer Relief Act, homesellers had filed Form 2119 declaring their intent to replace their residence, but had **never filed a follow-up Form 2119. The taxpayers were age 55 or older** when they sold their residences, but they did not buy replacement residences within the two-year replacement period. Instead of electing the exclusion, they chose to pay tax on the deficiency. More than three years after filing their returns for the home sale year, but **within two years of paying the tax on the deficiency, the taxpayers filed refund claims based on an election to use the home sale exclusion on their pre May 7, 1997 sales.**

Issue. Whether taxpayer may exclude the gain on the sale of a principal residence under former I.R.C. §121 if the election was made more than three years from the time the return for the year of sale was filed, but within two years from the date the tax on the gain was paid

Analysis and Conclusion. Under I.R.C. §1034, prior to its repeal by the Taxpayer Relief Act of 1997, homesellers could defer tax on gain from sale of a residence if they reinvested the sale proceeds in another residence within two years before or after the sale of the old one. Sellers who intended to replace but had not done so before filing their return for the sale year completed Form 2119 and declared their intent to replace. The period for assessing a deficiency attributable to the gain generally did not expire until three years after the filing of the second Form 2119. In addition, under prior I.R.C. §121, taxpayers that were age 55 or older at the time of sale could elect to exclude up to $125,000 of home-sale gain. The exclusion could only be elected once.

I.R.C. §121(c), in effect prior to the 1997 Act, provided that the election to exclude gain from the sale of exchange of a principal residence could be made at any time before the expiration of the period for making a claim for credit or refund of the tax on the gain. **Under** I.R.C. §**6511, a claim for credit or refund must generally be filed within three years from the date the return was filed or two years from the time the tax was paid, whichever is later. Thus, a taxpayer who claims the** I.R.C. §**121 election within two years after paying the tax on the gain from sale of a residence has made a timely election.**

Announcement 99-116, December 27, 1999
[I.R.C. §7805]

> ☞ **The IRS has acquiesced in a trustee's exclusion of the gain on a residence sale.**

The IRS has announced its acquiescence in several cases, including *Internal Revenue Service v. Waldschmidt (In re Bradley)*, (M.D. Tenn. 1999), aff'g 222 B.R. 313 (M.D. Tenn. 1998).

Facts. In *Bradley*, the trustee in Freda Bradley's chapter 7 case sold Bradley's residence, resulting in a gain. The trustee declared the gain on the estate's tax return, but excluded it from income under I.R.C. §121. The IRS questioned the use of I.R.C. §121, and the trustee filed a motion for determination of tax liability. A U.S. bankruptcy court held that the trustee properly used I.R.C. §121 to exclude from gross income the gain on the sale of the debtor's residence. A U.S. district court subsequently affirmed the bankruptcy court's judgment.

[Announcement 99-116, 1999-52, 763 IRB]

RETIREMENT PLANS

Bunney v. Commissioner
[I.R.C. §§72, 408, and 6662]

> ☞ **The distribution of one-half of a taxpayer's IRA to his former spouse is taxable to the taxpayer.**

Facts. Michael Bunney and his wife were residents of a community property state (California) at the time of their divorce in 1992. **The court ordered that all of Michael Bunney's retirement be divided equally between the parties.** During 1993, **Michael withdrew $125,000 from his IRAs** and deposited the funds in a money market account. That same year **he transferred $111,600 to his**

former wife to buy out her interest in the family residence. He reported only the remaining $13,400 of the distributions on his 1993 tax return.

On audit, **the IRS determined** that Bunney was the sole recipient of the distributions and that **the entire distribution was includible in his gross income.** The IRS also determined that Bunney was subject to penalties under I.R.C. §72(t) for early distributions and an accuracy-related penalty for negligence.

Issues

1. Whether taxpayer must include the entire $125,000 in distributions from his IRAs in gross income
2. Whether taxpayer is subject to the 10% penalty for early withdrawals under I.R.C. §72(t)
3. Whether taxpayer is liable for the negligence accuracy-related penalty under I.R.C. §6662(a)

Analysis and Holding

Issue 1. Even though I.R.C. §408(g) provides that I.R.C. §408 shall be applied without regard to any community property laws, the IRS and courts have sometimes considered community property rights in allocating the tax consequences of IRA distributions. In this particular case, the IRS took no position on the effect of I.R.C. §408(g). Instead, **it contended that the taxpayer was the sole taxable distributee because he was the sole recipient of the distributions.** Mr. Bunney argued that his former wife's interest arose *ab initio* and must be taken into account to determine the taxability of the distributions. The judge found that recognition of community property interests in an IRA for federal income tax purposes would conflict with the definition of an IRA–a trust created for the exclusive benefit of an individual. Recognition would also conflict with IRA provisions concerning rollovers and with the minimum distribution requirements. Mr. Bunney also argued that the distribution and transfer of the IRA proceeds was a nonrecognition event as a transfer incident to divorce. **The court held that the transfer did not meet the requirements for exclusion, because Bunney did not transfer his interest in the IRA to his former spouse. Rather, he cashed it out and gave the proceeds to his former wife. The court found that the distributions from the taxpayer's IRAs were wholly taxable to the taxpayer.**

Issue 2. I.R.C. §72(t)(1) imposes a 10% additional tax on early distributions from qualified retirement plans, which include IRAs. I.R.C. §72(t)(2)(A) lists the types of distributions to which the additional tax does not apply. The taxpayer did not produce any evidence that his situation fell within any of the exceptions. **The court sustained the 10% additional tax.**

Issue 3. I.R.C. §6662(a) imposes an accuracy-related penalty equal to 20% of the portion of an underpayment that is attributable to negligence. The taxpayer will avoid this penalty if he is able to show that he made a reasonable attempt to comply with the Internal Revenue Code and that he was not careless, reckless, or in intentional disregard of rules or regulations. Mr. Bunney contended that he was not liable for this penalty because Form 1040 is a "complicated return" and he used a tax software program to prepare his return. The court rejected his argument and **found Mr. Bunney liable for the negligence penalty with respect to the conceded items. However, the court did not assess either the penalty on one-half of the IRA distributions or the additional tax on those distributions, because the taxpayer had a reasonable basis for his position.**

[*Michael G. Bunney v. Commissioner*, 114 T.C. No. 17 (April 10, 2000) [CCH Dec. 53,839]]

Notice 2000-30
[I.R.C. §§72, 402, 408, and 408A]

> ☞ **The IRS explains a new method for reporting IRA recharacterizations and reconversions occurring after 2000.**

This notice specifies a new method to be used by IRA trustees, issuers, and custodians for reporting IRA recharacterizations and reconversions occurring after 2000. The method is designed to ensure consistent reporting among trustees.

Definitions. Recharacterizations are permitted only between different types of IRAs; for example, a traditional IRA may be recharacterized as a Roth IRA, and vice versa. A conversion is the transfer, by rollover or other means, of an amount in a non-Roth IRA to a Roth IRA. A reconversion is a conversion from a non-Roth IRA to a Roth IRA of an amount that had previously been recharacterized as a contribution to the non-Roth IRA after having been earlier converted to a Roth IRA.

Procedures. The new reporting method generally retains the requirement of Notice 98-49, 1998-38 IRB 5 that amounts recharacterized be identified separately from other types of distributions and contributions. The new method replaces the alternative methods permitted by Announcements 99-5, 1999-3 IRB 16 (January 19, 1999) and 99-106, 1999-45 IRB 561 (November 8, 1999). **Each recharacterization or reconversion that occurs after December 31, 2000 must be reported on Forms 5498 and 1099-R.**

[Notice 2000-30]

Ltr. Rul. 199951053, October 1, 1999
[I.R.C. §401]

> ☞ **IRA beneficiaries may take distributions over life expectancy of oldest beneficiary even though IRA owner took distributions based on her single life expectancy recalculated.**

Facts. In 1996, the taxpayer's husband died. **She elected to treat his IRA as her own and named her three sons as beneficiaries.** Until her death in 1998, the taxpayer had been receiving **distributions based on her single life expectancy recalculated annually.** Beginning in 1999, her **three sons wanted to receive distributions of the remaining amount based on the life expectancy of the oldest son.**

Issue. Whether the same method used to compute distributions before owner's death must be used to calculate distributions following time of death

Analysis. When an IRA owner dies after beginning required distributions, **I.R.C. §401(a)(9)(B)(I) requires that later distributions be made at least as rapidly as under the method being used at death.** If the life expectancy of an owner is being recalculated, the recalculated life expectancy is reduced to zero at the end of the calendar year following the year of the IRA owner's death (Prop. Reg. §1.401(a)(9)-1, Q&A E-8). Thus, in this case it would seem that the entire balance would have to be distributed by the end of the year following the taxpayer's death. However, the **IRS said that the taxpayer's election to accelerate distributions during her lifetime does not affect the determination that her timely designation of her sons as beneficiaries resulted in the required minimum distributions being computed using the taxpayer's and her oldest son's joint and survivor life expectancy.** Thus, the IRS ruled that the **"at least as rapidly rule" will not be violated if post-death distributions are calculated using the life expectancy of the taxpayer's oldest son,** since the taxpayer could have used his life expectancy to determine the amount of her required lifetime distributions.

Conclusion. Following the taxpayer's death, distributions from her IRA may be made over the life expectancy of her oldest beneficiary even though she had been taking required minimum distributions on her single life expectancy using the annual recalculation method.

Concurring Ruling. **Ltr. Rul. 200031056** reached the same conclusion when a father designated his two daughters as beneficiaries but did not establish separate accounts for them. Using the analysis outlined above, the IRS concluded that the daughters could receive distributions based on the joint life expectancy of the father and the oldest daughter for his year of death. For distributions after the year of death, the daughters could receive distributions based on the oldest daughter's life expectancy.

IR 1999-80
[I.R.C. §§61, 401, 402, 404, 408, 409, 414, 415, and 457]

☞ **The IRS has announced the cost of living adjustments applicable to qualified retirement plan dollar limitations for 2000.**

The IRS has announced cost of living adjustments applicable to dollar limitations on benefits under qualified retirement plans and to other provisions affecting such plans. Plan administrators with favorable determination letters do not need to request new determination letters solely because of yearly amendments to adjust maximum plan limitations.

		Amount	
Code Section	**Item**	**1999**	**2000**
§415(b)(1)(A)	Annual benefit for a defined benefit plan	$130,000	$135,000
§ 415(c)(1)(A)	Deductible contributions to defined contribution plan	30,000	30,000
§402(g)(1)	Exclusion for elective deferrals	10,000	10,500
§409(o)(1)(C)(ii)	Dollar amounts for tax credit ESOPs	145,000 or 735,000	150,000 or 755,000
§414(q)(1)(B)	Earnings limitation used to define highly compensated employees	80,000	85,000
§401(a)(17), §404(1), §408(k)(3)(C)	Annual compensation limit	160,000	170,000
§401(a)(17)	Annual compensation limit for eligible participants in some governmental plans	270,000	275,000
§408(k)(2)(C)	Maximum compensation for SEP coverage	400	450
§408(p)(2)(A)	Annual compensation limit for SIMPLE retirement plans	6,000	6,000
§457(b)(2), §457(c)(1)	Limit on deferrals for defined compensation plans of state and local governments and tax-exempt organizations	8,000	8,000
Reg. §1.61-21(f)(5)(I), Reg. §1.61-21(f)(5)(ii)	Earnings used to define "control employee" for fringe benefit valuation	Officer > 70,000, Anyone > 145,000	Officer > 75,000 Anyone > 150,000

Jones v. Commissioner
[I.R.C. §§72, 408, and 6651]

☞ **IRS distribution check endorsed over to wife did not constitute transfer of interest in IRA under divorce agreement.**

Facts. Taxpayer and his wife filed for divorce in 1992. In April of 1994, taxpayer and wife prepared a draft marital settlement agreement that required taxpayer to transfer his interest in his individual retirement account (IRA) to his wife. In May of 1994, when taxpayer was 47 years old, he cashed out his IRA and later endorsed the distribution check over to his wife. Shortly thereafter, taxpayer and wife executed the marital settlement agreement. Taxpayer filed his 1994 federal income tax return on July 15, 1996 and did not report the distribution from the IRA as income.

Issues

1. Whether taxpayer's gross income includes a distribution to him for his individual retirement annuity (IRA)
2. Whether taxpayer is subject to the 10% additional tax for early distributions under I.R.C. §72(t)
3. Whether taxpayer is liable for the addition to tax pursuant to I.R.C. §6651(a)(1) for failure to timely file his 1994 federal income tax return

Analysis

Issue 1. I.R.C. §408(d)(1) provides that any amount distributed from an IRA shall be included in gross income by the payee or distributee. However, **under I.R.C. §408(d)(6), the transfer of an individual's interest in an IRA to his spouse or former spouse under a divorce or separation instrument is not considered a taxable transfer made by the individual, and such interest at the time of the transfer is treated as an IRA account of the spouse, not the individual. The IRS asserted that the endorsement was not a transfer of the taxpayer's interest in his IRA because taxpayer's interest in the IRA was extinguished as of the time he withdrew the funds.** In *Bunney v. Commissioner*, 114 T.C. 259 (2000), and *Czepiel v. Commissioner*, T.C. Memo 1999-289, the court found that the transfer of IRA assets by a distributee to a nonparticipant spouse does not constitute the transfer of an interest in the IRA under I.R.C. §408(d)(6).

The Tax Court concluded that **the fact that petitioner endorsed the distribution check to his wife, rather than first depositing the funds in his own bank account, does not change the result.** The court pointed out that I.R.C. §408(d)(6) offers a means to avoid having the interest transfer treated as a distribution, but that it does not permit the IRA participant to allocate to a nonparticipant spouse the tax burden of an actual distribution.

Issue 2. I.R.C. §72(t) imposes a 10% additional tax on early distributions from qualified retirement plans. The distribution was an early distribution since taxpayer was not yet 59½ when he withdrew the IRA funds.

Issue 3. I.R.C. §6651(a)(1) imposes an addition to tax equal to 5% per month of the underpayment up to a maximum of 25% for untimely filed returns.

Holding

Issue 1. The Tax Court concluded that the transfer of IRA assets by a distributee to a nonparticipant spouse does not constitute the transfer of an interest in the IRA under I.R.C. §408(d)(6).

Issue 2. The Tax Court found that the taxpayer was liable for the 10% additional tax on early withdrawal.

Issue 3. The Tax Court found that the taxpayer was liable for the failure to file timely penalty since there was no evidence of reasonable cause for taxpayer's failure to file timely.

[*Stephen R. Jones v. Commissioner*, T.C. Memo 2000-219 (July 20, 2000)]

Alpern v. Commissioner
[I.R.C. §§72, 408, 6013, 6871, and 7442]

☞ **Taxpayer could not exclude IRA distributions from gross income.**

Facts. Taxpayer married in 1960 and has three sons from the marriage. Taxpayer's wife ceased living with him in October 1989, and the couple divorced on August 10, 1992, pursuant to a Judgment for Dissolution of Marriage of an Illinois circuit court. The taxpayer disputes the validity of the judgment and contends that he is still married. Taxpayer was granted a discharge of debtor under a chapter 11 bankruptcy. **In 1996, taxpayer received an IRA distribution of $12,905.89 and reported this amount on his return; however, he reported only $6,000 as the taxable amount of the distribution. Taxpayer did not file a Form 8606, Nondeductible IRAs.**

The IRS determined that all of the IRA distributions were includible in the taxpayer's gross income.

Issues

1. Whether the Tax Court lacks jurisdiction in this case because of an automatic stay pursuant to 11 U.S.C. §362(a)(8)(1994)
2. Whether taxpayer must include IRA distributions in gross income for the 1996 taxable year
3. Whether taxpayer's correct filing status for the 1996 is married filing separately or single

Analysis

Issue 1. The bankruptcy court that presided over the taxpayer's prior Chapter 11 petition ordered a discharge, which terminated the automatic stay, that had precluded commencement or continuation of Tax Court proceedings. The Tax Court lacks jurisdiction to review or set aside an order of discharge entered by the bankruptcy court.

Issue 2. Under I.R.C. §408(d)(2), a taxpayer is allowed a basis in IRA contributions to the extent the contributions are considered an "investment in the contract," defined by I.R.C. §72(e)(6) as being the consideration paid for the contract less amounts previously received under the contract that are excludible from gross income. **Form 8606 must be attached to the return for reporting the receipt of IRA distributions if the taxpayer made any nondeductible IRA contributions.** Taxpayer testified that he did not remember how he calculated the excluded portion of his IRA or whether any portion of the IRA distributions was from nondeductible IRA contributions. **Taxpayer did not produce any tax records to establish nondeductible IRA contributions.**

Issue 3. The Tax Court noted that it lacks jurisdiction to set aside the judgment for dissolution of marriage. Taxpayer introduced no evidence to support his claim that the divorce was not final.

Holding

Issue 1. The Tax Court held that it had jurisdiction to adjudicate the taxpayer's federal tax liability for the year at issue.

Issue 2. **The Tax Court held that all of the distributions must be included in the taxpayer's 1996 gross income.**

Issue 3. The Tax Court concluded that the taxpayer's filing status was single for 1996. Since the taxpayer was divorced on August 10, 1992, he was unmarried during the 1996 tax year.

[*Eugene W. Alpern v. Commissioner*, T.C. Memo 2000-246 (August 8, 2000)]

Phillip M. Wenger, CPA v. Commissioner
[I.R.C. §404, 412, 4971, and 7805]

☞ **Taxpayer who made required plan contribution by extended due date under IRS-approved plan failed to satisfy the minimum funding standard.**

Facts. Taxpayer, a sole practitioner CPA, adopted a self-employed money purchase retirement plan in 1984 and in August 1990 updated the plan using a prototype offered by Charles Schwab and Co., Inc. (Schwab). In June 1990, the IRS issued a favorable determination letter to Schwab for the prototype standardized money purchase pension plan. In December 1994, taxpayer adopted a further updated version using a prototype money purchase plan offered by Schwab.

The plan was in effect for taxpayer's 1994 tax year. **The plan is a qualified plan subject to the minimum funding standards of I.R.C. §412. The plan has a calendar year end of December 31. On July 6, 1995, taxpayer filed a Form 5558, Application for Extension of Time to File Certain Employee Plan Returns, requesting a 2½-month extension to file the annual return, Form 5500 C/R, for the plan.** The extension was granted, extending the due date to October 16, 1995. The return was filed no later than October 16, 1995. The required contribution, $18,275, was made on October 16, 1995 and reported as paid for the 1994 plan year. The taxpayer did not file a Form 5330, Return of Initial Excise Taxes Related to Pension and Profit-sharing Plans, for 1994.

The taxpayer was granted extensions for his 1994 individual tax return until October 16, 1995. **Taxpayer deducted the entire $18,275 on his 1994 Schedule C as a contribution to the pension plan.**

The IRS determined a funding deficiency for the 1994 year of $18,275 and concluded that the taxpayer was liable for an excise tax equal to 10% of the funding deficiency and an addition to tax for failure to timely file an excise tax return.

Issue. Whether taxpayer's money purchase pension plan satisfied the minimum funding standards of I.R.C. §412

Analysis. I.R.C. §412(a) generally requires that an employer who sponsors a qualified retirement plan such as a money purchase plan must satisfy the minimum funding standard for such plan for each plan year. In order to meet the minimum funding standard, the plan must not have an accumulated funding deficiency for the plan year.

I.R.C. §4971(a) imposes on the employer responsible for making the required contributions a 10% excise tax on any accumulated funding deficiency, as defined in I.R.C. §412(a), existing for any plan year. The parties agreed that for the plan year ending December 31, 1994, taxpayer was required to make contributions in the amount of $18,275 and that taxpayer's failure to make a timely contribution would result in accumulated funding deficiency in such amount.

I.R.C. §412(c)(10)(B) provides that any contributions for a plan year made by an employer after the last day of such plan year, but not later than two and one-half months after such day, shall be deemed to have been made on such last day. This two and one-half month period may be extended for not more than six months. Temp. Reg. §11.412(c)-12(b) automatically extends the 2½-month period by another 6 months for a total of 8½ months. **Thus, taxpayer's 8½-month period expired on September 15, 1995. The contributions were made on October 16, 1995.**

Taxpayer's plan provided that "the employer contribution for each plan year shall be delivered to the custodian not later than the due date for filing the employer's income tax return for its fiscal year in which the plan ends, including extensions thereof." Taxpayer contended that since the IRS issued a determination letter approving the language of the plan, the language of the plan should control whether a timely contribution was made. The Tax Court noted that the minimum funding standards appear in I.R.C. §412 and are not a qualification requirement of I.R.C. §401(a). The court pointed out that a plan may be deemed qualified and receive a favorable determination letter but still fail to satisfy the minimum funding standard of I.R.C. §412.

Taxpayer claimed that he relied on IRS Publication 560, *Retirement Plans for the Self-Employed,* for the proposition that, for the purpose of minimum funding standards, contributions can be retroactively applied to the previous year if the contributions are made by the due date of the employer's return plus extensions. The court pointed out that this language appears under the heading "Contributions" and deals with the deductibility of the contributions and that similar language does not appear under the heading of "Minimum Funding Requirements." Rather, it specifically states that **contributions to a plan will not be considered timely for the purpose of the minimum funding standard if made any later than 8½ months after the end of the plan year.** I.R.C. §404(a), dealing with deductibility, and I.R.C. §412, dealing with the minimum funding standard, provide for different periods within which a contribution must be made in order to be timely.

Holding. The Tax Court held that taxpayer's money purchase pension plan did not satisfy the minimum funding standards of I.R.C. §412.

[*Phillip M. Wenger, CPA, A Sole Proprietor v. Commissioner*, T.C. Memo 2000-156 (May 12, 2000)]

Ltr. Rul. 200027060
[I.R.C. §408]

☞ **Taxpayer receiving an IRA transfer incident to divorce is not required to continue to receive proportionate periodic payments to avoid the additional 10% tax.**

Facts. Taxpayers A and B married on August 4, 1991 and divorced on October 8, 1999. A is 48 years old and B is 52. **Their marital assets include an individual retirement account (IRA X) owned by B. In 1995, B began receiving periodic payments of approximately $3,495 a month. Pursuant to the divorce, a portion of IRA X is to be transferred by a trustee-to-trustee transfer from B's IRA X to a new IRA owned by A.** The transfer is equal to $65,000, or 13.349% of the total account balance of IRA X.

Issues

1. Whether the division of IRA X will be considered a nontaxable transfer under I.R.C. §408(d)
2. **Whether taxpayer A is required to continue to receive, in a proportionate amount [her transferred portion of IRA X to the total IRA (13%)], the substantially equal period payments** [under I.R.C. §72(t)(2)(A)(iv)] from her share (13%) of her former husband's IRA and, if not continuing these payments, whether she activates the I.R.C. §72(t) early withdrawal penalties because of I.R.C. §72(t)(4)(A), concerning a modification of a series of substantially equal period payments

Analysis

Issue 1. I.R.C. §408(d)(1) provides that any amount distributed from an IRA shall be included in gross income by the payee or distributee. However, under I.R.C. §408(d)(6), the **transfer of an individual's interest in an IRA to his spouse or former spouse under a divorce or separation instrument is not considered a taxable transfer** made by the individual, and **such interest thereafter is treated as an IRA account of the spouse, not the individual.**

Issue 2. I.R.C. §72(t)(1) provides that if a taxpayer receives any amount from a qualified retirement plan (including an IRA), the taxpayer's tax shall be increased by 10% of the portion of the amount, which is includible in gross income. However, I.R.C. §72(t)(2)(A)(iv) provides that a distribution from a qualified retirement plan that is a part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or joint lives (or joint life expectancies) of such employee and his designated beneficiary is not subject to the additional 10% tax. I.R.C. §72(5)(4)(A) provides that if the series of payments are subsequently modified (other than by reason of death or disability) (i) before the close of the five-year period beginning with the date of the first payment and after the employee attains age 59½, or (ii) before the employee attains age 59½, the taxpayer's tax will be increased by an amount equal to the tax which would have been imposed without such exception plus interest.

Since taxpayer A's IRA is treated as her own IRA, she is not required to begin receiving distributions from her IRA after transfer incident to the divorce decree to avoid the additional 10% tax under I.R.C. §72(t).

Holding

Issue 1. The IRS concluded that the division of IRA X and the subsequent transfer pursuant to divorce is considered a nontaxable transfer under I.R.C. §408(d)(6).

Issue 2. The IRS ruled that taxpayer A is not required to continue to receive, in a proportionate amount, substantially equal periodic payments from her share of taxpayer B's IRA X transferred to her IRA to preclude the additional 10% tax under I.R.C. §72(t) with respect to her IRA.

SELF-EMPLOYMENT

Wuebker v. Commissioner
[I.R.C. §§1402 and 7402]

> ☞ **Payments a farmer received from USDA for conservation program constituted self-employment income and not rental income.**

Facts. The Wuebkers owned 259 acres of land, which they had farmed for 20 years. In 1991, they executed a **Conservation Reserve Program (CRP) contract with the U.S. Department of Agriculture.** Pursuant to the contract, the **USDA agreed to pay a "rental rate per acre" for a period of 10 years.** In return, the Wuebkers agreed to, among other things, not produce any agricultural commodities and to establish ground cover on the land. In 1992 and 1993, the **Wuebkers reported the amounts received under the CRP as rents on Schedule E. They did not include the amounts in their computation of self-employment income.** The Tax Court agreed with the taxpayers, noting that the CRP contract identified the payments as rentals and the Wuebkers' service obligations were not substantial and were incidental to the primary purpose of the contract. The **Tax Court characterized the CRP payments as compensation for the use restrictions on the land, rather than payment for labor.**

Issue. Whether payments received by a farmer from the USDA under the Conservation Reserve Program constitute income subject to self-employment tax

Analysis. Mr. Wuebker argued that the CRP payments did not constitute self-employment income because they were not "derived" from his farming business. The **IRS contended that a "sufficient nexus" existed between the payments and his farming business.** The Sixth Circuit found the IRS to have the stronger argument.

The appeals court concluded that the CRP payments were not "rent" because they were not made in exchange for the use or occupancy of property. The Wuebkers continued to maintain control over the land and had free access to their land. The court said that **the essence of the CRP** was to prevent participants from farming the enrolled property and to **require them to con-**

tinuously perform various activities in connection with the land throughout the life of the contract. Thus, the Wuebkers' maintenance obligations were significant and the **payments were compensation for their labor**. The Sixth Circuit also concluded that the Tax Court had erroneously distinguished this case from *Ray v. Commissioner* (72 T.C.M. 780 (1996)) and Rev. Rul. 60-32, 1960-1 C.B. 23.

Holding. Reversing the Tax Court, the Sixth Circuit held that payments received under the USDA's Conservation Reserve Program constituted income from the trade or business of farming and were subject to self-employment tax.

[*Frederick and Ruth Wuebker v. Commissioner*, 2000-1 USTC ¶50,254 (CA-6 March 3, 2000)]

For a more extensive discussion of this case, see Issue 1: Self-Employment Tax in the "Agricultural Issues" chapter.

Charlton v. Commissioner

[I.R.C. §§195, 1402, and 6015]

☞ **The court allocates self-employment income to the spouse who earned the income.**

Facts. Sarah Hawthorne and Fredie Charlton were married in 1989, separated in 1995, and divorced in 1996. During 1994, **Sarah operated Medi-Task, a physician's transcription service.** A large corporation employed Fredie until the fall of 1994, when he moved to a lake and began renovating rental cabins. **On their 1994 joint tax return, Sarah and Fredie reported self-employment tax liability for the transcription business and deducted rental cabin expenses.**

The IRS determined deficiencies based on adjustments to self-employment tax and denied deductions relating to the cabins. Sarah and Fredie disputed the deficiencies and alleged that they each qualified for relief as an innocent spouse.

Issues

1. Whether all of the self-employment income from Medi-Task is allocated to Sarah Hawthorne for purposes of computing self-employment tax for 1994
2. Whether taxpayers may deduct expenses relating to their rental cabins in 1994
3. Whether Fredie Charlton is entitled to innocent spouse relief from taxpayers' 1994 joint return
4. Whether Fredie Charlton qualifies for limitation of liability under I.R.C. §6015(c) for the portion of the deficiency relating to Medi-Task
5. Whether court has jurisdiction to review whether relief is available to Sarah Hawthorne under I.R.C. §6015(f)

Analysis and Holding

Issue 1. Charlton contended that he and Hawthorne jointly operated Medi-Task and that Medi-Task was a partnership or should be treated as one. All of the gross income and deductions from a trade or business over which one spouse exercises substantially all of the management and control are attributable to that spouse [I.R.C. §1402(a)(5)(A)]. **The court held that Hawthorne managed Medi-Task and performed most of its day-to-day operations**. Charlton had a full-time job until September 1994 and also renovated cabins in 1994. He did not devote much time to Medi-Task. **The court held that all of the Medi-Task income in 1994 was attributable to Hawthorne for self-employment purposes.**

Issue 2. Charlton claimed deductions for **expenses related to their cabin rental activity** for 1994 under I.R.C. §162. The court noted that the **taxpayers incurred these expenses before the cabin became an active trade or business**. The cabins were renovated in 1994 but not offered for rent until 1998. **Thus, the court held that the claimed expenses were nondeductible startup expenses.**

Issue 3. I.R.C. §6015(b)(1)(C) requires that in signing the return the individual seeking relief did not know and had no reason to know of the understatement of tax attributable to erroneous items of the other individual. The court held that Charlton was generally familiar with Medi-Task. Hawthorne gave him the bank statements, Forms 1099 and W-2, and a computer-generated expense list. **Charlton had unfettered access to Medi-Task's financial records. The court held that Charlton had reason to know of Medi-Task's understatement of income. Thus, he did not qualify for relief as an innocent spouse under I.R.C. §6015(b)(1).**

Issue 4. Charlton argued that he qualified for limitation of liability under I.R.C. §6015(c) for the portion of the deficiency relating to Medi-Task. To be eligible for relief under I.R.C. §6015(c), the individual seeking relief must no longer be married to, or must be legally separated from, the individual with whom he or she filed the joint return and must have elected the applicability of I.R.C. §6015(c) not later than 2 years after the date on which the collection activity began. An election is not valid if the individual making the election had actual knowledge of any item giving rise to a deficiency not allocable to the electing individual. **The court maintained that Charlton should have known of the omitted income, but that this fact did not mean that he *actually* knew of the Medi-Task omitted income. Thus, the court held that Charlton qualified for relief under I.R.C. §6015(c).**

Issue 5. **Citing *Butler* (114 T.C. No. 19), the Tax Court held that it has jurisdiction to review whether relief is available under I.R.C. §6015(f).**

[*Fredie Lynn Charlton and Sarah K. Hawthorne v. Commissioner*, 114 T.C. No. 22 (May 16, 2000) [CCH Dec. 53,879]]

Ding v. Commissioner
[I.R.C. §§1366, 1402, and 7402]

> ☞ **S corporation pass-through items are not included in determining self-employment tax.**

Facts. **Paul and Jane Ding** owned between 50 and 100% of three S corporations. They **provided various services to the three S corporations through Ding Trading, a sole proprietorship**. For 1991, the Dings reported **negative net earnings from self-employment because of losses from two of the S corporations**. For 1992, the Dings carried over the excess 1991 losses and reported negative earnings from self-employment.

Issue. Whether pass-through items from S corporations can be included in determining self-employment tax liability under I.R.C. §1402(a)

Analysis. I.R.C. §1402(a) does not refer to pass-through items from S corporations. In addition, Treas. Reg. §1.1402(c)-1 states, **"In order for an individual to have net earnings from self-employment, he must carry on a trade or business, either as an individual or as a member of a partnership." The taxpayers argued that this constituted an accidental omission on the part of Congress** because I.R.C. §1402 was written prior to the creation of S corporations. **The appeals court disagreed, noting that Congress has not changed the law to include S corporations in more than 40 years, but that the IRS did issue a revenue ruling in 1959 which expressly states that S corporation pass-through items are not included as self-employment income** (Rev. Rul. 59-221, 1959-1 C.B. 225). The court cited *Durando* (70 F.3d 548, 550 (9th Cir. 1995)), where S corporation shareholders were not considered self-employed and thus could not deduct pass-through income contributed to a shareholder's Keogh plan. In addition, I.R.C. §1366 only permits use of S corporation pass-through items in calculating chapter 1 tax liability, not chapter 2 in which the self-employment tax provision is located.

Holding. Affirming the Tax Court, the Ninth Circuit held that S corporation pass-through items are not included in determining self-employment tax liability.

[*Paul B. and Jane C. Ding v. Commissioner*, 2000-1 USTC ¶50,137 (9th Cir. December 30, 1999)]

Walker v. United States
[I.R.C. §§446 and 1402]

> ☞ **Income is considered income for self-employment tax purposes when it is received and not when it is earned.**

Facts. Floyd Walker was a self-employed attorney from 1953 through 1974. He was employed by various law firms from 1975 through 1986. During those years, Walker paid the maximum amount of FICA taxes or Self-Employment Contributions Act (SECA) taxes as the particular year required. In 1972, under a contingency fee agreement, Mr. Walker represented Telex Corporation in antitrust litigation against IBM. In 1975, Telex and IBM settled their claims against each other, but Mr. Walker and Telex were unable to agree on the legal fees due Mr. Walker. **In 1981, Telex agreed to pay Mr. Walker $2,350,000 over a 20-year period**. Telex made payments until August 15, 1996, when Telex's successor declared bankruptcy.

Mr. and Mrs. Walker are cash-basis taxpayers. **Mr. Walker paid SECA taxes on payments he received from Telex in 1992, 1993, and 1994**. He did not pay SECA taxes on payments he received in 1995. In 1995, the Walkers **filed amended returns for 1992, 1993, and 1994, seeking refunds for the SECA taxes paid for those years**. The IRS denied the refund claims and audited the 1995 return. The Walkers paid the deficiency for 1995 and then requested a refund. The district court granted the Walkers summary judgment.

Issue. Whether the taxpayer was liable for self-employment taxes on income he received in 1992–1995 when the payments were for work he performed in previous years in which he had already paid the maximum amount of FICA taxes

Analysis and Holding. Under Treas. Reg. §1.1402(a)-1(c), **self-employment income for a cash-basis taxpayer is considered income for SECA purposes when the income is received, even if the income relates to services rendered in a prior year**. Taking a literal interpretation of the regulation, Walker argued that the regulation only applies to taxpayers that were not subject to SECA tax in the prior year. He noted that in 1975 he was not only subject to SECA tax, but paid the maximum. The Tenth Circuit rejected his interpretation, noting that the phrase in Treas. Reg. §1.1402(a)-1(c) is simply used to clarify that the taxpayer's choice of tax accounting requires that **self-employment income is received for SECA purposes when it is actually received by the taxpayer.** The court also pointed out that in 1975, Mr. Walker had only a claim to the payments, "the dimensions of which were completely unknown." Additionally, the fact that the Social Security Administration attributed the Telex payments to Mr. Walker's 1975 earnings had no bearing for tax purposes.

[*Floyd L. And Virginia G. Walker v. United States*, 2000-1 USTC ¶50,201 (10th Cir. February 4, 2000)]

Norwood v. Commissioner
[I.R.C. §1402]

> ☞ **A passive general partner is subject to self-employment tax on his share of partnership earnings.**

Facts. A number of years before 1995, **Matthew Norwood** started and worked full-time at Gallant Medical Supply, a partnership. Norwood **was a general partner of Gallant**. Norwood **stopped working at Gallant when the staff could operate the business without him**. **During 1995, Norwood spent approximately 41 hours on partnership matters**. He conducted periodic walk-throughs of Gallant and was consulted on major decisions of the firm. In 1995, Norwood received and reported $71,194 as his distributive share of Gallant's income. **He did not report or pay any self-employment tax on this amount**.

Issue. Whether taxpayer was liable for self-employment tax under I.R.C. §1401 on a distribution received from a partnership

Analysis and Holding. I.R.C. §1402(a) provides, subject to exceptions, that net earnings from self-employment includes a partner's distributive share of partnership trade or business income. One of the exceptions provides that a limited partner's share of partnership income is not subject to self-employment tax. **The taxpayer argued that his interest in Gallant was passive**. The IRS argued that it didn't matter whether the taxpayer's involvement was active or passive, because Norwood was a general partner. **The court agreed with the IRS, noting that the taxpayer's lack of participation in or control over the operations of Gallant did not turn his general partnership interest into a limited partnership interest.**

[*Matthew W. Norwood and Linda Kramer v. Commissioner*, 79 T.C.M. 1642 (March 13, 2000) [CCH Dec. 53,794(M)]]

Hennen v. Commissioner
[I.R.C. §1402]

> ☞ **Rental payments received from husband were subject to self-employment tax.**

Facts. **John and Teresa Hennen operated an 1100-acre farm**. John owned 320 acres, **Teresa owned 200 acres**, and they rented the rest. Mr. Hennen entered into an **oral agreement to lease the 200 acres from Mrs. Hennen**. Since the time that they began farming, **Mrs. Hennen provided general farming services, working approximately 1000 hours annually**. She ran errands for the business, handled the bookkeeping, and helped with livestock chores and field work. She did not participate in making decisions as to the type of crop to plant, nor did she participate in other management decisions. The Hennens reported the rental income on Schedule E for 1994, 1995, and 1996.

Issue. Whether rental payments received by a wife for farmland leased to her husband were includible in income subject to self-employment tax

Analysis. Generally, rentals from real estate are excluded from the computation of net earnings from self-employment. However, **if the rental income is derived under an arrangement between the owner of land and another person who produces agricultural commodities on the land, and there is material participation by the owner in the production of the agricultural commodities grown by the other person, then the rental income received by the owner is considered earnings from self-employment** [I.R.C. §1402(a)(1)].

The taxpayers contended that the oral agreement did not require Mrs. Hennen to materially participate in the farming operations. Judge John J. Pajak noted that Mrs. Hennen had performed general farming services for 38 years on a regular and intermittent basis. The court found that she did play a material role in the production of agricultural commodities under an arrangement with her husband.

Holding. The court held that the rental income was includible in Mrs. Hennen's net earnings from self-employment for each of the taxable years.

[*John P. and Teresa Hennen v. Commissioner*, 78 T.C.M. 445 (September 16, 1999) [CCH Dec. 53,545(M)]]

See the discussion of this issue in the 1999 *Farm Income Tax Book* "Agricultural Issues" chapter (Issue 1: Self-Employment Tax).

McNamara v. Commissioner
[I.R.C. §1402]

☞ **Rent payments received from husband's incorporated farm were subject to self-employment tax.**

Facts. Michael McNamara was the sole shareholder, officer, and director of McNamara Farms, Inc. During 1993, 1994, and 1995, **McNamara Farms leased 460 acres from joint tenants Michael and Nancy McNamara**. The McNamaras **reported the rental income on Schedule E**. The IRS divided the rents equally between the taxpayers with respect to self-employment income and self-employment tax.

Issue. Whether rental payments taxpayers received from husband's wholly owned corporation were subject to self-employment tax

Analysis. Generally, rentals from real estate are excluded from the computation of net earnings from self-employment. However, if the rental income is derived under an arrangement between the owner of land and another person who produces agricultural commodities on the land, and there is material participation by the owner in the production of the agricultural commodities grown by the other person, then the rental income received by the owner is considered earnings from self-employment [I.R.C. §1402(a)(1)].

The taxpayers contended that the written lease agreement did not require material participation by them in the farming operations. The court examined not only the obligations imposed by the lease, but also those obligations that existed "within the overall scheme of the farming operations." Michael McNamara was responsible for all the farming operations and management decisions, while Nancy performed bookkeeping, meal preparation, and other farming duties. **The court found that the arrangement between the taxpayers and McNamara Farms provided, or contemplated, that the taxpayers materially participate in the production of agricultural commodities on the farmland.**

Holding. The court held that the rental income was includible in the taxpayers' self-employment income.

[*Michael and Nancy McNamara v. Commissioner*, 78 T.C.M. 530 (October 4, 1999) [CCH Dec. 53,574(M)]]

See the discussion of this issue in the 1999 *Farm Income Tax Book* "Agricultural Issues" chapter (Issue 1: Self-Employment Tax).

SOCIAL SECURITY

> ☞ **The Social Security retirement earnings test is eliminated for persons who have reached full retirement age.**

CHANGE IN SOCIAL SECURITY RETIREMENT EARNINGS TEST

On April 5, 2000, President Clinton signed HR 5, the "Senior Citizens' Freedom to Work Act of 2000," which **eliminates the Social Security retirement earnings test** in and after the month in which a **person attains full retirement age (currently 65)**. Elimination of the retirement test will be effective for tax years ending after Dec. 31, 1999. In applying the earnings test for this calendar year, only earnings before the month of attainment of full retirement age are considered. The law also permits the retired worker, beginning with the month in which he or she reaches full retirement age and ending with the month prior to attainment of age 70, to earn a delayed retirement credit for any month for which the retired worker requests that benefits not be paid even though he or she is already on the benefit rolls.

With the signing of the law repealing the Social Security earnings test, people age 65–69 who work can receive all of their Social Security benefits no matter how much they earn. Until this change, people age 65–69 who earned over the limit ($17,000 in 2000) have had to give up $1 in social security benefits for every $3 they earned over that amount from working. The new law abolishes the earnings test for people age 65–69, but **the earnings test for people age 62–64 is still in effect**. Therefore, people in this category who earn above $10,080 in 2000 still have to give up $1 in benefits for every $2 earned over this limit. If a taxpayer is age 65–69 and has already had to give up some benefits this year due to over-the-limit earnings, he or she should get a lump-sum payment for the amount withheld since the first of the year.

Taxpayers will not receive any refund for prior years. If a taxpayer was age 65–69 and therefore eligible for Social Security, but did not apply for benefits due to earnings above the limit, he or she is eligible for benefits retroactive to the beginning of the year. For more information, taxpayers can either call Social Security at 800-772-1213 or visit their nearest Social Security office.

TRAVEL EXPENSES

Jorgensen v. Commissioner
[I.R.C. §§162 and 274]

> ☞ **Teacher is allowed to deduct travel and tuition costs for overseas courses.**

Facts. Ann Jorgensen was **an English teacher** and chair of the English department at a San Francisco **public high school with a predominantly Asian student population.** During 1995 and 1996, she enrolled in two courses offered by U.C.-Berkeley. The Legendary Greece course took place in **Greece** during the summer of 1995. For the second course, on the culture of Southeast Asia, Jorgensen **traveled to Thailand, Cambodia, and Indonesia** during the last week of 1996 and the first part of January 1997. The **taxpayer did not seek or obtain credit for these courses** and her employer did not require her to take these courses as a condition to retaining her employment.

The **taxpayer deducted the expenses of both trips** (tuition, meals, lodging, airfare, shuttles, etc.) on her 1995 and 1996 tax returns **as employee business expenses.** The IRS disallowed the deductions, claiming that the travel expenses were a form of education and nondeductible under I.R.C. §274(m)(2). Alternatively, if the court found that the expenses were for education other than that which resulted from the travel itself, the IRS argued that the expenses still were not deductible because they were not ordinary and necessary business expenses.

Issue. Whether taxpayer's travel and education expenses were deductible as ordinary and necessary business expenses under I.R.C. §162

Analysis. **I.R.C. §274(m)(2) provides that no deduction shall be allowed for expenses for travel on the ground that travel itself is a form of education**. This statute prevents a French teacher from deducting the costs of traveling to France to maintain familiarity with the French language and culture. The Tax Court agreed with the taxpayer that **the U.C. Extension classes were beyond the scope of I.R.C. §274(m)(2)** because of several factors. The U.C. **courses were conducted on an organized basis with regular lectures by university professors**, the courses had structured syllabi and significant reading assignments, and **university credit was available** for the courses.

Next, the court had to determine whether the expenses were deductible under I.R.C. §162. Expenses for education are **deductible if the education either (1) maintains or improves skills required in an individual's employment** or (2) meets the express requirements of the individual's employer or applicable law to retain employment. The second requirement was not applicable to the taxpayer's situation, but she provided specific examples of how her teaching skills were enhanced by both courses. The **Legendary Greece course helped her develop additional curriculum material for her English classes and the Southeast Asia course increased her understanding of her Asian students.** The taxpayer also had to prove that the expenses were ordinary, necessary, and reasonable. The court agreed that the expenses associated with the education developed her understanding of topics that were part of the curriculum she taught, helped her incorporate new materials into her curriculum, and increased her ability to reach out to her students. It also found the expenses to be reasonable.

Holding. The taxpayer's education and travel expenses, with the exception of hotel expenses incurred two days before a course began, were deductible as ordinary and necessary business expenses under I.R.C. §162.

[*Ann Jorgensen v. Commissioner*, 79 T.C.M. 1926 (April 13, 2000) [Dec. 53,855(M)]]

Robertson v. Commissioner
[I.R.C. §§61, 62, and 162]

☞ **"Away from home" expenses denied for state justice who kept his residence in his home district.**

Facts. James Lawton Robertson was a **law professor** at the **University of Mississippi** in 1983, when the **Governor of Mississippi appointed him to the Mississippi Supreme Court** to fill a retired justice's unexpired term. **Robertson had to travel to Jackson, Mississippi,** which is 157 miles from Oxford, Mississippi, where the university and Justice Robertson's home are located. Robertson continued to serve on the Supreme Court until the end of 1992. While serving on the Mississippi Supreme Court, Justice Robertson taught one course each semester at the law school. **He was reimbursed by the State of Mississippi for some of the travel, lodging, and meal expenses** incurred while attending Supreme Court sessions in Jackson and returning to his residence in Oxford. The Robertsons **did not report the reimbursements as income** on their tax returns for 1990, 1991, and 1992, but they **deducted the travel, lodging, and meal expenses that were not reimbursed by Mississippi.** The IRS disallowed the deductions and determined that the Robertsons had underreported their income by the amounts of the reimbursements. The Tax Court sustained the deficiencies.

Issue. Whether the Tax Court erred in determining that the taxpayer's reimbursed travel expenses were includible in income and in determining that the unreimbursed travel expenses were not deductible

Analysis and Holding. **I.R.C. §162(a)(2) allows a deduction for traveling expenses incurred while "away from home" in the pursuit of a trade or business.** The court noted that the term **"home" means the vicinity of the taxpayer's principal place of business** and not where his personal residence is located. If a taxpayer has two places of business or employment separated by considerable distances, the court applies an objective test in which it considers the length of time spent at each location, the degree of activity at each location, and the relative proportion of the taxpayer's income derived from each location. **The Fifth Circuit sustained the Tax Court's finding that Robertson's tax home was Jackson rather than Oxford. Thus, because the traveling expenses were not incurred while "away from home," the court concluded that they were not eligible for deduction as ordinary and necessary business expenses.** The court agreed with the Tax Court that *LeBlanc* [60-1 USTC ¶9472] was inapplicable in the present case, because Justice Robertson was not legally compelled to maintain his residence in Oxford after he became justice. He could have lived in Jackson and still run for office using Oxford as his home district.

In order for reimbursements under an accountable plan to be excluded from income, the reimbursed expenses must be expenses that would otherwise be deductible under I.R.C. §162. Since the court determined that the expenses were not deductible under I.R.C. §162, **the reimbursements must be included in income.**

[*James L. and Lillian Robertson v. Commissioner*, 99-2 USTC ¶50,875 (CA-5 September 30, 1999)]

Sutherland Lumber-Southwest, Inc. v. Commissioner
[I.R.C. §§162 and 274]

> ☞ **A corporation's deduction for supplying plane for employee vacations is not limited to employee's benefit income.**

Facts. Sutherland Lumber-Southwest, Inc. **provided its employees with the use of a company-owned aircraft for nonbusiness flights.** Sutherland instructed its employees to report the value of the flights as imputed income and deducted under I.R.C. §162 the expenses it incurred in providing the flights. **Sutherland's deductions associated with the vacation flights exceeded the amount the employees included in income.** The IRS determined that the deductions for the nonbusiness flights were limited to the amounts reported as imputed income by the employees under I.R.C. §274.

Issue. Whether taxpayer, under I.R.C. §274, may deduct in full expenses associated with operating an aircraft for employees' vacations or **whether the deduction is limited to the value of the vacation use reportable by the employees as compensation**

Analysis. Treas. Reg. §1.162-25T provides that if the value of a noncash fringe benefit is properly included in an employee's income, the employer cannot deduct that value as compensation, but can deduct only the costs incurred in providing the benefit to the employee. Some deductions previously allowable under I.R.C. §162 were disallowed by the enactment of I.R.C. §274, which was designed to eliminate or curb abuses with respect to business deductions for entertainment, travel, and gifts. The **taxpayer argued that** I.R.C. **§274(e)(2) provides an exception to the general limitation provisions.** Under this section, **the disallowance rules do not apply to expenses for goods, services, and facilities "to the extent that" the expenses are treated as compensation to the employee.** The IRS interpreted the phrase "to the extent that" to limit the deduction to the extent of compensation included in income. The court reviewed the legislative history of the provision and held that **Congress intended** I.R.C. §274(e)(2) **to be an exception and not a limitation to** I.R.C. **§274(a). Thus, Sutherland's deduction was not limited to the value reported by its employees as income.**

The IRS raised a final argument, pointing out that permitting a deduction in an amount greater than that which was required to be included in income would create a mismatch of income and deduction. The **judge noted that there was no indication that Congress attempted to fix any possible mismatch by enacting** I.R.C. §**274, and that the IRS did not raise the mismatch possibility when the costs were less than the required income inclusion.**

Holding. The **Tax Court held that the corporation's expense deduction for providing its employees with nonbusiness flights on the company's plane was not limited to the income reported by the employees.**

[*Sutherland Lumber-Southwest, Inc. v. Commissioner*, 114 T.C. No. 4 (March 28, 2000) [CCH Dec. 53,817]]

T.D. 8864
[I.R.C. §§62 and 274]

> ☞ **The regulations regarding substantiation for non-lodging travel, entertainment, and mileage allowances are released.**

This document contains final regulations on substantiation of business travel, entertainment, and auto expenses.

Explanation of Provisions. The **new regulations finalize the increase from $25 to $75 in the dollar limit triggering the documentation requirement for non-lodging travel and entertainment deductions.** Documentary evidence (such as a receipt) is not needed to support a non-lodging travel or entertainment expense of under $75 paid or incurred after September 30, 1995. Documentary evidence is still required for all away-from-home lodging expenditures.

The regulations also finalize the standard mileage allowance (32.5¢ per mile in 2000) to be used in figuring business deductions and reimbursements on leased, as well as owned, automobiles.

[T.D. 8864, 2000-7 IRB 614 (February 14, 2000)]

Rev. Proc. 2000-9
[I.R.C. §§62, 162, and 274]

> ☞ **The per diem rates for substantiation of business expenses for lodging, meals, and incidental expenses are provided for 2000.**

Changes. Rev. Proc. 2000-9 (2000-2 IRB) supercedes Rev. Proc. 98-64 (1998-52 IRB 32) with respect to **per diem allowances paid on or after January 1, 2000.** 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. I.R.C. §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 2000, the deductible percentage for these expenses is 60%.

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 employee 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 $201 for travel to any "high-cost locality"** specified in this revenue procedure, or **$124 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 $163 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 after the key city name:

State	Key City	County or Other Defined Location
California	San Francisco	San Francisco
	Sunnyvale, Palo Alto, San Jose,	Santa Clara
	Tahoe City	Placer
Colorado	Aspen (December 1–June 30)	Pitkin
	Silverthorne, Keystone	Summit
	Telluride (November 1–March 31)	San Miguel
	Vail (December 1–March 31)	Eagle
District of Columbia	Washington, D.C.	Washington, D.C.; the cities of Alexandria, Fairfax, and Falls Church, and the counties of Arlington, Fairfax, and Loudoun, in Virginia; and the counties of Montgomery and Prince George's in Maryland
Florida	Key West (December 15–April 30)	Monroe
Idaho	Sun Valley (June 1–September 30)	City limits of Sun Valley
Illinois	Chicago	Cook and Lake
Maryland	(For the counties of Montgomery and Prince George's, see District of Columbia)	
	Ocean City (June 1–September 15)	Worcester
Massachusetts	Boston	Suffolk
	Cambridge	Middlesex County (except Lowell)
	Martha's Vineyard (June 1–September 30)	Dukes

State	Key City	County or Other Defined Location
Michigan	Charlevoix (July 1–September 30) Mackinac Island	Charlevoix Mackinac
Montana	Big Sky	Gallatin (except West Yellowstone Park)
New Jersey	Cape May (June 1–September 30) Ocean City (June 15–September 15) Piscataway, Bellemead Princeton Union County	Cape May (except Ocean City) City limits of Ocean City Somerset and Middlesex City limits of Princeton Union County
New York	The Bronx, Brooklyn, Queens Manhattan Nassau County, Great Neck Suffolk County White Plains	The boroughs of The Bronx, Brooklyn, and Queens Manhattan Nassau County Suffolk County City limits of White Plains
Pennsylvania	Hershey (June 1–September 15) Philadelphia	City limits of Hershey Philadelphia
Utah	Park City (December 20–March 31)	Summit
Virginia	(For the cities of Alexandria, Fairfax, and Falls Church, and the counties of Arlington, Fairfax, and Loudoun, see District of Columbia)	

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 prorate these rates:

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 twice 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).

[Rev. Proc. 2000-9, 2000-2 IRB]

Rev. Proc. 99-38
[I.R.C. §§61, 62, 162, 170, 213, 217, 274, and 1016]

☞ **The 2000 standard mileage rates are announced.**

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

If, after using the business standard mileage rate for a car he owns, 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). The mileage allowance method can be used for a leased car only if the taxpayer uses it (or a FAVR allowance method) for the entire lease period (including renewals). If the lease period commenced before 1998, this rule only applies for the post-1997 portion of the lease period (including renewals).

[Rev. Proc. 99-38, 1999-43 IRB]

Mitchell v. Commissioner
[I.R.C. §162]

☞ **Taxpayer may deduct travel costs even though his away-from-home assignments were for one client and spanned five years.**

Facts. Thomas Mitchell was a self-employed printing consultant who worked out of an office in his **Chicago home.** From 1991 through 1995, Mitchell worked on a number of projects for American Collegiate Network (ACN), a magazine publisher based in Los Angeles, California. He did some of the work out of his home office, **but had to travel to California and work there for extended periods of time. Each of Mitchell's assignments for ACN lasted one year or less.** During 1994 and 1995, Mitchell rented an apartment in California to use when he was there on business because it cost less than renting hotel rooms. On his 1994 and 1995 tax returns, Mitchell deducted amounts for rent, travel, meals, and entertainment. **The IRS disallowed all of these deductions, claiming that Mitchell's tax home had shifted from Chicago to California.**

Issue. Whether taxpayer's travel expenses incurred while working on various assignments for one client over a five-year period were deductible

Analysis and Holding. The IRS argued that the taxpayer's stay in California occurred in at least five different years and, as such, violated I.R.C. §162(a), which provides that a "taxpayer is not temporarily away from home during any period of employment that exceeds one year." **The Tax Court held that Mitchell's stays in California did not violate the one-year rule, because he was not employed there continuously on one assignment for more than one year.** Rather, his work for ACN was "on again and off again," with ACN continually renewing his engagement with them because of unexpected events (such as the serious illness and ultimate death of a key executive). **Mitchell was not restricted to working solely for ACN and sought other engagements during the relevant time period. Thus, the court held that the taxpayer could deduct his business travel costs, including meals and apartment rent, even though his away-from-home assignments for a single client spanned a five-year period.**

[*Thomas J. and Janice M. Mitchell v. Commissioner*, 78 T.C.M. 355 (August 25, 1999) [CCH Dec. 53,517(M)]]

Ltr. Rul. 200020055, May 22, 2000
[I.R.C. §162]

☞ **The IRS addresses the deductibility of away-from-home travel expenses when temporary assignment exceeds one year.**

The Internal Revenue Service has addressed whether travel expenses are deductible in two different scenarios where temporary employment away from home exceeded the one-year time frame.

Scenario 1

Facts. The taxpayer is an **employee of a branch office** in California who **is assigned to company headquarters in Washington, D.C. for an eight-month period.** At the end of this assignment, the employee **accepts another six-month assignment at a client's office in Washington, D.C.** Between the two assignments, the employee goes home to California for more than a month.

Scenario 2

Facts. **Several employees from branch offices** around the country **have been assigned to company headquarters in Washington, D.C. for five months.** During this time period, the employees will be **competing for two permanent positions.** Once selected, the employees will regularly perform services for their original branch office as well as for the Washington office.

Issue. Whether taxpayer's travel expenses in Washington, D.C. are deductible

Conclusion. Travel expenses related to temporary employment in a single location away from home generally are deductible under I.R.C. §162(a)(2). However, in most situations a taxpayer is not treated as being temporarily away from home if employment exceeds one year. Rev. Rul. 93-86 provides that if employment away from home in a single location is initially expected to last for one year or less, but at some later date is realistically expected to exceed one year, the employment will be treated as temporary until the date that the taxpayer's expectations change. **The IRS said that under Scenario 1, the taxpayer is no longer temporarily away from home once the employee agrees to continue to work in Washington, D.C. At that point, the travel expenses are no longer deductible.** The IRS noted that the change in employers and the break between assignments are irrelevant. **Likewise in Scenario 2, once it is determined that employment in Washington is expected to last for more than one year, the employment is no longer temporary within the meaning of Rev. Rul. 93-86.** However, **in Scenario 2, once the employees are selected for the permanent positions**, they have more than one regular place of business. At that point, **the taxpayer must determine the principal place of business, and travel expenses to the other location would become deductible** under I.R.C. §162(a)(2) as "away from home" business travel expenses.

Ltr. Rul. 200030001, August 7, 2000
[I.R.C. §274]

☞ **Meals for independent contractors are subject to the 50% limitation.**

Facts. A brokerage firm held various regional and national conferences for their broker representatives. The firm treats the brokers as independent contractors. During the year, each broker was furnished with between $109 and $709 of complimentary food and beverages at the conferences. The firm deducted 100% of the cost of the food and beverages.

Issue. Whether the firm is subject to the 50% limitation for meals provided by I.R.C. §274(n)(1)

Discussion. Section 162(a) allows a deduction for ordinary and necessary business expenses. However, I.R.C. §274(n)(1) limits the deduction for any expense for food or beverages to 50% of the amount that otherwise would be allowable under I.R.C. §162(a) unless one of the exceptions apply.

The firm contends that the cost of the food is fully deductible because it qualifies as either

- a de minimis fringe benefit under I.R.C. §132(a)(4), or
- a social activity for employees within the meaning of I.R.C. §274(e)(4).

Conclusion. None of the exceptions to the 50% limitation rule apply. Even the lowest value ($109) of food and beverages provided to a broker exceeds an amount that would be considered de minimis. The exception for social activities applies only to expenses for employees, not for independent contractors. Therefore, the deduction for the cost of the meals and beverages is subject to 50% partial disallowance of I.R.C. §274(n)(1).

CCA 200026025, May 31, 2000
[I.R.C. §162]

☞ **Guidance on definition of "temporary workplace" for business transportation expenses.**

General Information. The IRS issued three Chief Counsel Advice memoranda (CCAs, or ILMs) in 2000 that provide the latest guidance on determining if a taxpayer has a "temporary workplace." If a taxpayer qualifies and meets the "temporary workplace" requirements, the following tax benefits are available:

1. The taxpayer can be reimbursed tax-free by his or her employer for expenses incurred in traveling to the temporary site. This assumes the accountable plan rules are met.
2. If no reimbursement is received, the taxpayer (employed or self-employed) can deduct the cost of transportation expenses incurred in traveling to the temporary site.

Practitioner Note. In the explanation that follows, the term "employment" is used in a generic sense to apply to both employees and self-employed taxpayers who travel to temporary work locations.

One-Year Rule as Outlined in Rev. Rul. 99-7. If employment at a location is realistically expected to last (and does in fact last) for one year or less, that location meets the revised definition of a "temporary workplace." By contrast, a location does not meet the requirements of a "temporary workplace' if

- employment at the location is realistically expected to last for more than one year, or
- there is no realistic expectation that it will last for one year or less.

"Break in Service" Rule as Explained in ILM 200026025. The following facts are similar to Examples 1 and 2 in this ILM.

Facts. On January 1, 2000, employee Sarah Bellum is told she will work at client ABC's office for eight months (Jan. 1 through Aug. 31). Then she will work at client XYZ's office for the first three weeks of September. After that, she will return to ABC to work for an additional four months (Sept. 22, 2000 through Jan. 21, 2001).

Question 1. How does Sarah's three-week break in service at ABC's office affect the "temporary workplace" rule?

Answer 1. The three weeks that Sarah spends at XYZ's office in September 2000 is inconsequential. As a result, her employment at ABC's office from Jan. 1, 2000 through Jan. 22, 2001 is not temporary. Therefore, any employer reimbursements for her transportation expenses to ABC's office are taxable wages.

Question 2. How long must a "break in service" be in order to not be considered inconsequential?

Answer 2. According to the IRS, a seven-month assignment at XYZ's office for Sarah would not be inconsequential. If Sarah spent seven months at XYZ's office (Sept. 22, 2000 through April 21, 2001) and then returned to ABC, her two stints at ABC would be considered as two temporary assignments. The result would be the same if Sarah had spent the seven months on vacation or in training rather than working at XYZ's office.

Practitioner Note. The ILM states that the "break in service" explanation described above is not a set guideline. The determination as to whether a consequential break in service has occurred is based on the facts and circumstances of each situation.

See also CCA 200018052 (March 10, 2000) and CCA 200025052 (April 26, 2000).

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2000 Workbook