RULINGS AND CASES

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EXPLANATION OF CONTENTS

Please Note. This chapter is a collection of selected cases, Revenue Rulings, Revenue Procedures, Treasury Regulations, Announcements, and Letter Rulings that have been issued during the past year, through approximately August 31, 2001. Since they appear in a condensed version, they should not be relied on as a substitute for the full documents. At the end of each item is a full citation for it. This is not meant to be a comprehensive coverage of all tax law changes or explanations. It is intended to report the cases and rulings that are likely to be of interest to the average tax practitioner.

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

SUBSTANTIAL AUTHORITY

If there is substantial authority for a position taken on a tax return, neither the taxpayer nor the tax preparer will be subject to the penalty for underreporting income even if the IRS successfully challenges the position taken on the return. By contrast, if there is not substantial authority for a position taken on a tax return, the underreporting penalties may be imposed unless the position has been adequately disclosed **and** there is a reasonable basis for the position.

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. Private rulings, technical advice memorandums, general counsel memorandums, Revenue Procedures and/or actions on decisions issued prior to the Internal Revenue Code of 1986, generally must be accorded less weight than more recent ones. 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 considered 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
- 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.

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:

> 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.

Field Service Advice (FSA). These are IRS rulings issued to the IRS field operations by the Office of Chief Counsel. They may be directed to a particular taxpayer or to a particular issue.

JUDICIAL SYSTEM FOR TAX DISPUTES

The taxpayer in a dispute with the Internal Revenue Service has two choices after he or she receives the statutory notice or notice of final determination ("90 day letter"):

1. File a petition in the Tax Court without paying the tax
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 U.S. Tax Court is a federal court of record established by Congress under Article I of the Constitution in 1942. It replaced the Board of Tax Appeals. Congress created the Tax Court to provide a judicial forum in which affected persons could dispute tax deficiencies determined by the Commissioner of Internal Revenue prior to the payment of the disputed amounts. The Tax Court is located at 400 Second Street, N.W., Washington, D.C. 20217. Although the court is physically located in Washington, the judges travel nationwide to conduct trial in various designated cities.

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 was greatly expanded by RRA 98. The jurisdiction of the Tax Court includes the authority to hear tax disputes concerning notices of deficiency, notices of transferee liability, certain types of declaratory judgment, readjustment and adjustment of partnership items, review of the failure to abate interest, administrative costs, worker classification, relief from joint and several liability on a joint return, and review of certain collection actions. Furthermore, 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 IRS issues a statutory notice of deficiency in tax disputes in which the Service has determined a deficiency. In cases in which a deficiency is not at issue, the IRS will issue a notice of final determination. A notice of final determination will be issued in the following types of tax disputes:

- Employee vs. Independent Contractor Treatment
- Innocent Spouse Claim Determinations
- Collection Due Process Cases

Both the statutory notice and the notice of final determination will reflect the date by which a petition must be filed with the Tax Court. The 90-day date cannot be extended by the Internal Revenue Service. If a Tax Court petition cannot be filed by the 90-day date, the taxpayer may write the Tax Court and request the correct forms to file a Tax Court petition. (The forms may also be obtained at the Tax Court Web site, webmaster@ustaxcourt.gov). If the letter is postmarked by the 90-day date, the Tax Court will treat the letter as an imperfect petition and allow the taxpayer an additional period of time to perfect the petition and pay the filing fee. If a taxpayer cannot pay the $60 filing fee at the time the petition is filed, he or she should request a waiver of the filing fee. The Tax Court may or may not grant a waiver of the filing fee, but will generally grant an extension for the taxpayer to pay the filing fee.

Taxpayers may represent themselves in Tax Court. Taxpayers may be represented by practitioners admitted to the bar of the Tax Court. In certain tax disputes involving $50,000 or less, taxpayers may elect to have their case conducted under the Court's simplified small tax case procedure. Trials in small tax cases generally are less formal and result in a speedier disposition. However, decisions entered pursuant to small tax case procedures are not appealable. The Small Claims Division has a simplified petition and procedure so that the taxpayer can present his or her own case. However, the IRS can remove the case to the regular docket if the case involves an important policy question

Cases are scheduled for trial as soon as practical (on a first-in, first-out basis) after the case becomes at issue. When a case is scheduled, the parties are notified by the court of the date, time, and place of trial.

The vast majority of Tax Court cases are settled by mutual agreement of the parties without the necessity of a trial. However, if a trial is conducted, in due course a report is ordinarily issued by the presiding judge setting forth findings of fact and an opinion. The case is then closed in accordance with the judge's opinion by entry of a decision stating the amount of the deficiency or overpayment, if any.

The Chief Judge of the Tax Court decides which opinions will 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. Both the published and unpublished opinions may be found on the United States Tax Court Web site, webmaster@ustaxcourt.gov.

Any decision of the Tax Court can be appealed to the Circuit Court of the taxpayer's residence. A final appeal can be made to the Supreme Court, but since its jurisdiction is discretionary, the court hears relatively few tax cases.

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
D. C.	District of Columbia
1st	Maine, Massachusetts, New Hampshire, Puerto Rico, Rhode Island
2d	Connecticut, New York, Vermont
3d	Delaware, New Jersey, Pennsylvania, Virgin Islands
4th	Maryland, North Carolina, South Carolina, Virginia, West Virginia
5th	District of the Canal Zone, Louisiana, Mississippi, Texas
6th	Kentucky, Michigan, Ohio, Tennessee
7th	Illinois, Indiana, Wisconsin
8th	Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, South Dakota
9th	Alaska, Arizona, California, Idaho, Montana, Nevada, Oregon, Washington, Guam, Hawaii
10th	Colorado, Kansas, New Mexico, Oklahoma, Utah, Wyoming
11th	Alabama, Florida, Georgia
Fed.	All Federal judicial districts

ACCOUNTING

Rev. Proc. 2001-10
[I.R.C. §446]

☞ **Taxpayers with average gross receipts of $1 million or less may be excepted from the requirement to use the accrual method and to account for inventories.**

Purpose. The purpose of this revenue procedure is to allow the IRS to exercise its discretion to except a qualifying taxpayer with average annual gross receipts of

$1,000,000 or less from the requirements to use an accrual method of accounting and to account for inventories. This revenue procedure also provides the procedures by which a qualifying taxpayer may obtain automatic consent to change to the cash method of accounting and to a method of accounting for inventory as materials and supplies that are not incidental under Treas. Reg. §1.162-3. Rev. Proc. 2000-22, 2000-20 IRB 1008, is modified and superseded. Rev. Proc. 99-49, 1999-52 IRB 725, is modified and amplified.

Background and Changes. 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 when accounting for inventories is required.

I.R.C. §471 requires the use of inventories if necessary to determine income of the taxpayer clearly. 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 direct costs and an allocable portion of indirect costs to be included in the cost of inventory.

Rev. Proc. 2000-22 is modified in the following respects:

1. Section 3 is modified to make clear that this revenue procedure does not apply to taxpayers described in I.R.C. §448(a)(3) (tax shelters).
2. Section 4.02 is added to clarify the proper time to take into account the cost of iventoriable items (i.e., merchandise purchased for resale and raw materials purchased for use in producing finished goods) that are treated as materials and supplies that are not incidental under Treas. Reg. §1.162-3.
3. The conformity requirement of I.R.C. §5.07 has been removed. Taxpayers are reminded that they must comply with the requirements under I.R.C. §446(a) and the regulations thereunder to maintain adequate books and records, which may include a reconciliation of any differences between such books and records and their return. See Treas. Reg. §1.446-1(a)(4).
4. Section 6.02(1) is modified to provide that qualifying taxpayers using an accrual method of accounting that are not required under I.R.C. §471 to account for inventories may use the automatic consent provisions of this revenue procedure to change to the cash method.
5. Section 6.02(2) is modified to provide that qualifying taxpayers (including taxpayers not currently accounting for inventories) may use the automatic consent provisions of this revenue procedure to change to the method of accounting for inventoriable items as materials and supplies that are not incidental under Treas. Reg. §1.162-3.
6. Section 6.03 is added to provide guidance on the computation of the adjustment required under I.R.C. §481(a) in connection with the automatic changes in method of accounting under this revenue procedure.
7. Section 8 is modified in accordance with the removal of the conformity requirement of I.R.C. §5.07.

Small Business Exception. Pursuant to the discretion under I.R.C. §§446(b) and 471, and to simplify bookkeeping requirements for small business, the IRS, as a matter of administrative convenience, will except qualifying taxpayers from the requirements to use an accrual method under I.R.C. §446 and to account for inventories under I.R.C. §471. For purposes of this revenue procedure, notwithstanding I.R.C. §1001 and the regulations thereunder, qualifying taxpayers that use the cash method include amounts in income attributable to open accounts receivable (i.e., receivables due in 120 days or less) as amounts are actually or constructively received. However, I.R.C. §1001 may be applicable to other transactions. **Qualifying taxpayers that do not want to account for inventories must treat inventoriable items (i.e., merchandise purchased for resale and raw materials purchased for use in producing finished goods) in the same manner as materials and supplies that are not incidental under Treas. Reg. §1.162-3.** I.R.C. §263A does not apply to inventoriable items that are treated as materials and supplies that are not incidental.

Under Treas. Reg. §1.162-3, **materials and supplies that are not incidental are deductible only in the year in which they are actually consumed and used in the taxpayer's business.** For purposes of this revenue procedure, inventoriable items that are treated as materials and supplies that are not incidental are consumed and used in the year in which the taxpayer sells the merchandise or finished goods. Thus, under the cash method, the cost of such inventoriable items are deductible only in that year, or in the year in which the taxpayer actually pays for the inventoriable items, whichever is later. Producers may use any reasonable method of estimating the amount of raw materials in their year-end work-in-process and finished goods inventory to determine the amount of raw materials that were used to produce finished goods that are sold during the tax year, provided that method is used consistently.

The IRS and Treasury expect to provide further guidance on when items may be treated as incidental materials and supplies (the cost of which may be deducted currently under Treas. Reg. §1.162-3) and when items are inventoriable items (the cost of which, under this revenue procedure, may be deducted no earlier than the year in which the items are consumed and used).

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

[Rev. Proc. 2001-10, 2001-1 C.B. 287]

Rev. Proc. 2000-50
[I.R.C. §167]

☞ **The IRS has issued guidance for change in method of accounting for costs paid or incurred to develop, purchase, lease, or license computer software.**

Purpose. The purpose of this revenue procedure is to provide guidelines on the treatment of the costs of computer software. The procedure supersedes Rev. Proc. 69-21 and modifies Rev. Proc. 97-50 and Rev. Proc. 99-49.

Background. In T.D. 8865, 2000-7 I.R.B. 589, the IRS advised taxpayers that they may not rely on the procedures in Rev. Proc. 69-21, 1969-2 C.B. 303, to the extent the procedures are inconsistent with I.R.C. §§167(f) or 197, or the final regulations thereunder.

I.R.C. §446(e) and Treas. Reg. §1.446-1(e) provide that a taxpayer must generally obtain the consent of the IRS before changing a method of accounting. Treas. Reg. §1.446-1(e)(3)(ii) authorizes the IRS to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting.

Explanation. The tax treatment of costs incurred in developing software will not be disturbed provided that they are attributed to the development of the software and are treated as current expenditures and deducted in full, or are treated as capital expenditures that are recoverable through deductions for ratable amortization. Moreover, the IRS will not disturb the tax treatment of costs of acquired computer software if they are included in the cost of computer hardware that is capitalized and depreciated or, if they are separately stated, are treated as a capital expense recovered by amortization deductions. A deduction for leased or licensed computer software will also not be disturbed. A change in the treatment of costs incurred to develop, purchase, lease, or license computer software to a method described in the procedure constitutes a change in accounting method.

Definition. For the purpose of this revenue procedure, "computer software" is any program or routine (that is, any sequence of machine-readable code) that is designed to cause a computer to perform a desired function or set of functions, and the documentation required to describe and maintain that program or routine. It includes all forms and media in which the software is contained, whether written, magnetic, or otherwise. Computer programs of all classes, for example, operating systems, executive systems, monitors, compilers and translators, assembly routines, and utility programs, as well as application programs, are included. Computer software also includes any incidental and ancillary rights that are necessary to effect the acquisition of the title to, the ownership of, or the right to use the computer software, and that are used only in connection with that specific computer software. Computer software does not include any data or information base described in Treas. Reg. §1.197-2(b)(4) (for example, data files, customer lists, or client files) unless the data base or item is in the public domain and is incidental to a computer program. Nor does it include any cost of procedures that are external to the computer's operation.

Costs of Developing Computer Software. The costs of developing computer software (whether or not the particular software is patented or copyrighted) in many respects so closely resemble the kind of research and experimental expenditures that fall within the purview of I.R.C. §174 as to warrant similar accounting treatment. Accordingly, the I.R.S. will not disturb a taxpayer's treatment of costs paid or incurred in developing software for any particular project, either for the taxpayer's own use or to be held by the taxpayer for sale or lease to others, where: (1) All of the costs properly attributable to the development of software by the taxpayer are consistently treated as current expenses and deducted in full in accordance with rules similar to those applicable under I.R.C. §174(a); or (2) All of the costs properly attributable to the development of software by the taxpayer are consistently treated as capital expenditures that are recoverable through deductions for ratable amortization, in accordance with rules similar to those provided by I.R.C. §174(b) and the regulations thereunder, over a period of 60 months from the date of completion of the development or, in accordance with rules provided in I.R.C. §167(f)(1) and the regulations thereunder, over 36 months from the date the software is placed in service.

Costs of Acquired Computer Software. With respect to costs of acquired computer software, the Service will not disturb the taxpayer's treatment of (1) costs that are included, without being separately stated, in the cost of the hardware (computer) if the costs are consistently treated as a part of the cost of the hardware that is capitalized and depreciated; or (2) costs that are separately stated if the costs are consistently treated as capital expenditures for an intangible asset whose cost is to be recovered by amortization deductions ratably over a period of 36 months beginning with the month the software is placed in service, in accordance with the rules under I.R.C. §167(f)(1) [Treas. Reg. §1.167(a)-14(b)(1)].

Leased or Licensed Computer Software. Where a taxpayer leases or licenses computer software for use in the taxpayer's trade or business, the Service will not disturb a deduction properly allowable under the provisions of Treas. Reg. §1.162-11 as rental. However, an amount described in Treas. Reg. §1.162-11 is not currently deductible if, without regard to Treas. Reg. §1.162-11, the amount is properly chargeable to capital account. See Treas. Reg. §1.197-2(a)(3).

Application. A change in a taxpayer's treatment of costs incurred to develop, purchase, lease, or license computer software to a method described in this revenue procedure is a change in method of accounting to which I.R.C. §§446 and 481 apply. However, **a change in useful life under the method described in this revenue procedure is not a change in method of accounting** [I.R.C. §1.446-1(e)(2)(ii)(*b*)].

A taxpayer that wants to change the taxpayer's method of accounting under this revenue procedure must follow the automatic change in method of accounting provisions in Rev. Proc. 99-49, 1999-52 I.R.B. 725 (or its successor), with some modifications.

Effective Date. This revenue procedure is effective for a Form 3115 filed on or after December 1, 2000, for taxable years ending on or after December 1, 2000. The Service will return any Form 3115 that is filed on or after December 1, 2000, for taxable years ending on or after December 1, 2000, if the Form 3115 is filed with the national office pursuant to the Code, regulations, or administrative guidance other than this revenue procedure and the change in method of accounting is within the scope of this revenue procedure.

[Rev. Proc. 2000-50, 2000-2 C.B. 601]

Ingram Industries, Inc. v. Commissioner
[I.R.C. §§162 and 263(a)]

> ☞ **Taxpayers were entitled to deduct the cost of maintaining their towboat engines under I.R.C. §162.**

Facts. Ingram Industries, Inc. is the common parent of an affiliated diversified group of corporations that includes an inland barge transportation service that tows commodities and materials on the Ohio and Mississippi rivers. Ingram owns and leases a fleet of towboats to transport the goods. The IRS determined income tax deficiencies for years 1992, 1993, and 1994.

Issue. Whether the maintenance expense to the towboat engines is a deductible expense under I.R.C. §162 or must be capitalized under I.R.C. §263(a).

Analysis. Expenses incurred for regular maintenance to keep property in an ordinarily efficient operating condition are currently deductible. Treas. Reg. §1.162-4 provides that the cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense. Similarly, Treas. Reg. §1.263(a)-1(b) provides that amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures. Conversely, I.R.C. §263 provides that no deduction may be taken for amounts expended for permanent improvements or betterments made to increase the value of property.

In using a three-part test to determine whether the expenditures should be capitalized, the court considered whether the expenditure has

(1) Adapted the property for a new or different use;
(2) Appreciably prolonged the life of the property; or
(3) Materially added to the value of the property.

It was easily determined that the procedures performed did not adapt the engine for a new or different use. However, it was more difficult to determine whether the expenditures appreciably prolonged the life of the property. The taxpayers claimed the expenditures were merely routine preventive maintenance, while the IRS argued the expenditures amounted to an overhaul of the engines. It was pointed out that approximately 79% of the parts were reused and only 21% replaced. The court thought that an engine overhaul would require that substantially more parts be replaced to totally recondition the engine.

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The court held that the work performed was merely routine maintenance that did not extend the expected 40-year life of the towboat or engine. It was determined that even though the work extended the life in the sense that failure to do the work could have hurt the engine, the work was not expected to make the engine last longer than its estimated 40-year life span.

Finding the $100,000 expenditure incidental by industry standards and in relation to the overall value of the boats, **the court found that the maintenance work did not increase each towboat's value.** The IRS argued that, according to the holding in *INDOPCO Inc. v. Commissioner*, 503 U.S. 79 (1992), the taxpayers must clearly show the expenditure is an incidental repair that does not appreciably prolong the property's useful life, but keeps it in an ordinarily efficient operating condition. In rebuffing the IRS, the court stated that there was nothing in the *INDOPCO* opinion that required a different analysis than that used by the court in this case.

Holding. The Tax Court held that the maintenance expense to the towboat engines was a deductible expense under I.R.C. §162.

[*Ingram Industries, Inc. v. Commissioner*, 80 T.C.M. (CCH) 532 (2000)]

See also Rev. Rul. 2001-4 I.R.B. 2001-3, Dec. 21, 2000, in which the service ruled that an airline may deduct the cost of heavy maintenance of its aircraft as an ordinary and necessary business expense. However, the airline must capitalize the cost of improvements that materially add to the aircraft's value or prolong its useful life.

Smith v. Commissioner

[I.R.C. §446]

> ☞ **Taxpayers were allowed to use the cash method since the Tax Court found the flooring materials they installed were not merchandise.**

Facts. The taxpayers, operating as an S corporation, installed flooring materials such as carpeting, vinyl and ceramic tile, and hardwood. After being awarded a contract, flooring materials were purchased and delivered to its 6,000 square-foot warehouse. Before forwarding to the job site, the materials were inspected as to quality and quantity. Customers were usually billed a service charge between 10 to 20% of the cost of the materials to cover the costs of receiving, storing, inspecting, and delivering the flooring materials to the job sites. Excess materials were kept for about a year in case repairs were needed. **The S corporation did not sell any flooring materials to the general public.** The taxpayers consistently used the cash method of accounting and assigned a value of $15,000 to their ending inventory to accounting for installation materials such as glue and nails. The S corporation did not include any flooring materials in inventory since they were purchased and designated for specific jobs.

The IRS determined a deficiency in the taxpayers' income taxes based on the determination that the S corporation was required to account for inventories and use the accrual method of accounting.

Issues

Issue 1. Whether the S corporation's contracts to purchase and install flooring materials constitute sales of "merchandise."

Issue 2. Whether the IRS abused its discretion in determining that the S corporation's use of the cash method of accounting does not clearly reflect its income.

Analysis. I.R.C. §446(b) provides that, if a taxpayer's method of accounting does not clearly reflect income, the taxpayer's computation of income "shall be made under such method as, in the opinion of the IRS, does clearly reflect income." I.R.C. §471(a) provides the general rule that a taxpayer is required to take inventories on such basis as the IRS may prescribe in order to clearly determine the taxpayer's income. Treas. Reg. §1.471-1 provides that a taxpayer must use inventories "in every case in which the production, purchase, or sale of merchandise is an income-producing factor." Treas. Reg. §1.446-1(c)(2)(i) provides that a taxpayer using inventories generally must use the accrual method of accounting. The IRS determined that the flooring was merchandise, that such merchandise was an income-producing factor, and that the taxpayers must use the accrual method of accounting to clearly reflect its income.

The taxpayers argued that they were service providers and that they purchased flooring materials solely as an accommodation to those contracting for their services. Therefore, they claimed that use of the cash method of accounting was proper.

The court noted that whether the taxpayers must use the accrual method of accounting instead of the cash method depends on whether the S corporation is in the business of selling merchandise (within the meaning of Treas. Reg. §1.471-1) to customers in addition to providing flooring installation services, or whether the flooring material provided by the corporation is a supply that is incidental to Smith Floors installation services.

In *RACMP Enters, Inc. v. Commissioner,* 114 T.C. 211 (2000), the Tax Court relied on *Osteopathic Med. Oncology & Hematology, P.C., v. Commissioner*, 113 T.C. 376 (1999), to conclude that **construction materials generally will not be considered merchandise** within the meaning of the regulation if the inherent nature of the taxpayer's business is that of a service provider and the materials are an indispensable and inseparable part of the rendering of the services.

Holding

(1) The Tax Court held that the **flooring materials that the S corporation purchases and installs in fulfilling its contracts did not constitute merchandise** within the meaning of Treas. Reg. §1.471-1.

(2) The Tax Court held that IRS's determination that the S corporation was required to use the accrual method of accounting was an abuse of discretion.

[*Smith v. Commissioner*, 80 T.C.M. (CCH) 701 (2000)]

Practitioner Note. In FSA 200125001, issued January 18, 2001, the IRS determined that a proposed notice of deficiency imposing a change in a drywall installer's method of accounting from the cash method to an accrual method should not be issued. The IRS based its decision on the Tax Court's conclusion in *Smith v. Commissioner*, 80 T.C.M. (CCH) 701 (2000), that **construction materials generally will not be considered merchandise if the inherent nature of the taxpayer's business is that of a service provider and the materials are an indispensable and inseparable part of the rendering of the services**.

Chief Counsel Notice CC-2001-010

[I.R.C. §§446, 448, and 447]

☞ **The IRS will not require construction contractors involved in paving, painting, roofing, drywall, and landscaping to use the accrual method of accounting.**

Purpose. The purpose of this chief counsel notice is to announce a change in the IRS's litigating position regarding the requirement that certain taxpayers must use inventory accounts and an accrual method of accounting.

Background. Several court decisions have recently upheld the use of the cash method of accounting by certain contractors. In these cases, the courts have rejected the IRS's argument that the taxpayers were in the business of providing merchandise and therefore required to use inventory accounts and an accrual method of accounting. In *Smith v. Commissioner*, 80 T.C.M. (CCH) 701 (2000), the Tax Court held that a taxpayer who installed flooring materials for customers was inherently a service provider eligible to use the cash method of accounting. The court rejected the IRS's argument that the taxpayer's purchase and warehousing of flooring materials prior to installation constituted the production, purchase, or sale of merchandise within the meaning of Treas. Reg. §1.471-1. Similarly, in *Jim Turin & Sons, Inc. v. Commissioner*, 219 F.3d 1103 (9th Cir. 2000), the Ninth Circuit held that a taxpayer that purchased asphalt and used the emulsified asphalt to provide paving services was not required to use inventory accounts and an accrual method of accounting. The court concluded that because the asphalt could not be stored, it was not susceptible of being inventoried and was not merchandise within the scope of Treas. Reg. §1.471-1. In *RACMP Enterprises, Inc. v. Commissioner*, 114 T.C. 211 (2000), in a court reviewed opinion, the Tax Court held that a construction contractor that constructed, placed, and finished concrete foundation, driveways, and walkways was permitted to use the cash method of accounting. See also *Galedrige Construction v. Commissioner*, 73 T.C.M. (CCH) 2838 (1997), involving a contractor using emulsified asphalt where the court permitted the taxpayer to use the cash method of accounting.

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Explanation. The Office of Chief Counsel is studying the issue addressed by the courts in the cases discussed above. Until further guidance is issued, the Office of Chief Counsel will not assert that taxpayers in businesses similar to those considered by the courts in these cases are required to use inventory accounts and an accrual method of accounting. In particular, this notice covers construction contractors involved in paving, painting, roofing, drywall, and landscaping.

This interim policy does not apply to taxpayers that are resellers, manufacturers, or otherwise required by I.R.C. §448 to use an accrual method of accounting—e.g., a C corporation with gross receipts of $5 million or more. In addition, this interim policy does not apply to situations subject to the provisions of Treas. Reg. §1.162-3 (involving materials and supplies).

In determining whether a taxpayer is permitted to use the cash method of accounting, taxpayers should be aware of Rev. Proc. 2001-10, 2001-2 I.R.B. 272, which permits taxpayers with average annual gross income of $1 million or less to use the cash method of accounting. In addition, the IRS has recently acquiesced in the result reached in *Osteopathic Med. Oncology & Hematology. P.C., v. Commissioner*, 113 T.C. 376 (1999), where the taxpayer furnished chemotherapy drugs in the course of providing medical services. As explained in AOD 2000-05 (April 8, 2000), under circumstances comparable to those presented in *Osteopathic*, **the IRS agrees that prescription drugs or similar items administered by health care providers are not merchandise** within the meaning of Treas. Reg. §1.471-1. However, **a health care provider may be required to treat the cost of prescription drugs or similar items as deferred expenses that are deductible only in the year used or consumed** under Treas. Reg. §1.162-3.

Date Issued. February 9, 2001.
[Chief Counsel Notice CC-2001-010]

T.D. 8940
[I.R.C. §§56, 197, 338, 368, 597, 921, 1031, 1060, 1361, and 1502]

> ☞ **Final regulations provide guidance on purchase price allocations in asset acquisitions.**

This document contains final regulations, Treas. Reg. §§1.338-6, 1.338-7, 1.338-10, and 1.1060-1, relating to deemed and actual asset acquisitions under I.R.C. §§338 and 1060. The final regulations affect sellers and buyers of corporate stock that are eligible to elect to treat the transaction as a deemed asset acquisition. The final regulations also affect sellers and buyers of assets that constitute a trade or business. The regulations are effective March 16, 2001, and generally adopt the proposed regulations published on August 10, 1999, and the temporary regulations published on January 7, 2000, with some modifications.

Explanation of Revisions and Summary of Comments

Insurance Transactions. The final regulations clarify the scope of the anti-abuse rule by changing the phrase "to more than an insignificant extent," to "primarily." This change is meant to clarify that **some continuing use in its original location of an asset transferred to or from the target is permitted.**

Closing Date Issues. Some commentators suggested that a purchaser acquiring stock of a subsidiary member of a consolidated group could, after acquiring the target stock, cause the target to sell all of its assets to another person later on the closing date and then make a unilateral I.R.C. §338(g) election. Even though the IRS and Treasury do not believe that Treas. Reg. §1.1502-76(b), as written, automatically precludes the operation of the next day rule in an I.R.C. §338 context, they have provided a new rule in the final regulations that requires the application of the next day rule in an I.R.C. §338 context where the target engages in a transaction outside the ordinary course of business on the acquisition date after the event resulting in the qualified stock purchase (QSP).

Purchase Definition. The final regulations include a single definition of "purchase" that applies to both targets and target affiliates, which generally conforms to the definition of "purchase of target affiliate" in the temporary regulations. Under this definition, **stock in a target or target affiliate may be considered purchased if, under general principles of tax law, the purchasing corporation is considered to own stock of the target or target affiliate** meeting the requirements of I.R.C. §1504(a)(2), notwithstanding that no amount may be paid for or allocated to the stock.

Transactions After QSPs. The final regulations provide that consideration other than voting stock issued in connection with a QSP is ignored in determining whether a subsequent transfer of assets by the target corporation to a member of its new affiliated group satisfies the solely for voting stock requirement of a "C" reorganization.

Treatment of Liabilities. Commentators asked for further clarification of the standards for taking certain taxes into account. Rather than providing more specific guidance, which would be inconsistent with the overall philosophy of deferring to general tax principles governing actual transactions, the final regulations further simplify the discussion of liabilities.

Valuation Rules. The final regulations delete the sentence about valuing goodwill and going concern value. Under the final regulations, **the IRS retains the ability to challenge a taxpayer's valuation of assets in Classes I through VI, but will do so on grounds consistent with the residual method of allocation.**

Top-Down Allocation. In the final regulations, the scope of Class II assets described in Treas. Reg. §1.338-6(b)(2)(ii) is modified to provide that Class II assets do not include stock of target affiliates, other than actively traded stock described in I.R.C. §1504(a)(4) (certain preferred stock). Instead, **stock of target affiliates is included in Class V.** This would exclude target affiliate stock from Class II where the target holds an 80% or greater interest in the target affiliate but a minority interest in target affiliate stock of the same class is actively traded.

Class III Assets. Under the final regulations, Class III assets generally consist of assets that the taxpayer marks to market at least annually and debt instruments (including receivables). However, **debt instruments issued by related parties, and certain contingent payment and convertible debt instruments, are not included in Class III.**

First Year Price Adjustments. The final regulations remove the rules providing special treatment for changes in ADSP or AGUB occurring before the close of new target's first taxable year. Instead, the general rule in Treas. Reg. §1.338-7 governs the allocation of all changes in ADSP or AGUB after the acquisition date.

S Corporations. The final regulations include a statement in Treas. Reg. §1.1361-1(l)(2)(v) that **the payment of varying amounts to S corporation shareholders in a transaction for which an I.R.C. §338(h)(10) election is made will not cause the S corporation to violate the single class of stock requirement** of I.R.C. §1361(b)(1)(D) and Treas. Reg. §1.1361-1(l), provided that the varying amounts are negotiated in arm's length negotiations with the purchaser.

[T.D. 8940, 2001-15 I.R.B. 1016 (April 9, 2001)]

Practitioner Note. The IRS has corrected the final regulations (Document 2001ARD 063-2 TD 8940, Correction). **The final regulations contain the following errors:**

1. On page 9929, in the table, the entry for Treas. Reg. §1.197-2(k), Example 23, the language "as these terms are defined in as in defined in" is corrected to read "as these term are defined in" in both the remove and add columns of the table.
2. On page 9935, column 3, Treas. Reg. §1.338-3, paragraph (b)(3)(iv), paragraph (ii) of *Example 1.*, line 9 from the bottom of the paragraph, the language "§338(h)(3)(A)(iii). See §1.338-2(b)(3)(ii)(C)." is corrected to read "§338(h)(3)(A)(iii). See §1.338-3(b)(3)(ii)(C)."
3. On page 9944, column 3, Treas. Reg. §1.338-6, paragraph (d), paragraph (ix) of Example 1 line 1, the language "The liabilities of T as of the beginning" is corrected to read "The liabilities of T1 as of the beginning."

Notice 2001-22
[I.R.C. §453]

☞ **Accrual method taxpayers can use the installment method.**

Purpose. The purpose of this notice is to provide guidance on the application of the Installment Tax Correction Act of 2000, Pub. L. No. 106-573, to an accrual method taxpayer that disposed of property in an installment sale on or after December 17, 1999, and filed by April 16, 2001, a federal income tax return reporting the gain on the disposition using an accrual method of accounting rather than the installment method.

Background. An installment sale is defined in I.R.C. §453(b) as a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs. I.R.C. §453(a) provides the general rule that income from an installment sale must be taken into account under the installment method. However, the Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. No. 106-170, added I.R.C. §453(a)(2), which provided that the installment method did not apply to income from an installment sale if the income would be reported under an accrual method of accounting without regard to §453. The provision was effective for sales or other dispositions occurring on or after December 17, 1999.

On December 28, 2000, the Installment Tax Correction Act repealed I.R.C. §453(a)(2) with respect to sales and other dispositions occurring on or after December 17, 1999. Under I.R.C. §453(d)(1), the installment method does not apply to any disposition for which the taxpayer elects out of the installment method. Treas. Reg. §15A.453-1(d)(3)(i) provides that a taxpayer that reports an amount realized equal to the selling price on the tax return filed for the taxable year in which the installment sale occurs is considered to have made an effective election out of the installment method. Under I.R.C. 453(d)(3), an election out of the installment method with respect to a disposition may be revoked only with the consent of the IRS. According to Treas. Reg. §15A.453(d)(4), a revocation is retroactive.

Application. An accrual method taxpayer that entered into an installment sale on or after December 17, 1999, and filed a federal income tax return by April 16, 2001, reporting the sale on an accrual method, **has the consent of the IRS to revoke its effective election out of the installment method,** provided the taxpayer files, within the applicable period of limitations, amended federal income tax return(s) for the taxable year in which the installment sale occurred,

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and for any other affected taxable year, reporting the gain on the installment method.

[Notice 2001-22, 2001-12 I.R.B. 911]

Keith v. Commissioner

[I.R.C. §§172, 446 and 451]

> ☞ **Taxpayer's installment contracts for real estate were completed sales when executed.**

Facts. The taxpayer owned a proprietorship that had been formed in order to generate tax savings. The business was formed primarily to sell insurance, to purchase real estate for resale or rent, and to broker. The business sold real property by means of contracts for deed. Once a contract was executed, the buyer was completely responsible for the property, responsible for payments, and free to alter the property in any way.

The transactions were reported on the taxpayer's Schedules C (Form 1040). The taxpayer reported use of accrual accounting method on her Schedules C. **During the term of a contract for deed, taxpayer would report the interest received on the promissory note entered into in conjunction with the contract as income. The portion of any payment allocable to principal would be treated as a deposit on the purchase and would be recorded as a liability on the books of the company.** If a property were repossessed prior to completion of the contract, this deposit would be applied first to repairs and maintenance, and any remaining amount would be reported as miscellaneous income. The properties would also be depreciated during the payment period. Upon full payment of the contract price, taxpayers would recognize income on the disposition of the property. Gain on the sale would be computed by reducing the total sale price by taxpayer's adjusted basis in the property.

The IRS concluded that the sales should have been reported in the years the contracts were executed. Further, the IRS concluded that the taxpayer's use of an incorrect method of accounting resulted in inflated losses in prior years and, therefore, the net operating loss carryovers to the years at issue should be reduced accordingly. Based on these conclusions, the IRS determined tax deficiencies.

Issues

Issue 1. Whether the gain attributable to sales of property by means of contracts for deed should be recognized at the time of execution of the contracts or when the deed is transferred.

Issue 2. Whether the net operating loss carryovers from years preceding the years in issue should be reduced to reflect income attributable to contracts for deed executed in those prior years.

Analysis

Issue 1. I.R.C. §61(a) indicates that gross income for purposes of calculating such taxable income means "all income from whatever source derived." I.R.C. §61(a)(3) expressly includes "gains derived from dealings in property." I.R.C. §1001(a) defines such gains as the amount realized "from the sale or other disposition of property," less the adjusted basis. Accordingly, gross income does not arise until property is considered sold or otherwise disposed of for tax purposes.

In determining whether passage either of title or of benefits and burdens has occurred, the court looked to state law. According to Georgia law, **the contracts for deed passed equitable ownership to the buyers and left the taxpayer with what was essentially a security interest.** The court acknowledged that it reached a contrary conclusion in its decision in *Baertschi v. Commissioner,* 49 T.C. 289 (1967), *rev'd.,* 412 F.2d 494 (6th Cir. 1969). However, the court will no longer follow this decision since it was reversed by the Sixth Circuit. The **court maintained that the single fact of a "no recourse" clause (limiting the remedy for nonperformance to moneys paid) could not delay the finality of the sale for tax purposes until final payment of the total purchase price had been made.**

Under I.R.C. §451(a), "the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period." Treas. Reg. §1.451-1(a) specify that under an accrual method of accounting, income is includable in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy, and under the cash receipts and disbursements method of accounting, such an amount is includable in gross income when actually or constructively received. Under I.R.C. §446(a) and (b), taxable income is generally "computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books," with the exception that "if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the IRS, does clearly reflect income."

Noting that the taxpayer had herself claimed that her business operated on the accrual method, the court determined that the all events test was satisfied at the time the contracts were executed, the sale had been completed, and the income was, therefore, reportable at that time. **The only way the taxpayer could fail to receive the full amount of the purchase price would be if the buyer defaulted.** And **a default,** said the court, **is irrelevant in an accrual analysis;** it would be a condition subsequent to the completion of the sale, and therefore did not impact the fact of the sale itself.

Issue 2. I.R.C. §172(a) authorizes a net operating loss deduction. A net operating loss is the excess of deductions over gross income, with enumerated modifications [I.R.C. §172(c) and (d)]. The net operating loss so determined may be carried back to the 3 preceding taxable years and carried forward to the 15 succeeding years, until absorbed by taxable income [for a tax year beginning before August 6, 1997, which applied to the years at issue, see I.R.C. §172(b)]. Under I.R.C. §6214(b), the court has jurisdiction to consider such facts related to years not in issue as may be necessary for redetermination of tax liability for the period before the court.

Holding

Issue 1. The Tax Court held that **gain attributable to sales of property by means of contracts for deed should be recognized at the time of execution of the contracts.**

Issue 2. Because income from the completed contracts had not been reported in the years for which losses had been claimed, the court held that the NOL carryovers should be reduced to the extent of the unreported income.

[*Keith v. Commissioner*, 115 T.C. 605 (2000)]

Raymond v. Commissioner

[I.R.C. §§453 and 1001]

> ☞ **Home builder, as dealer, was denied installment method of reporting income.**

Facts. Taxpayer operated a construction sole proprietorship. He purchased a tract of land and subdivided it into 58 lots in 1992. He obtained financing and completed 14 homes in 1994 and 44 homes in 1995. All the homes were sold in the year built. To facilitate the sales in 1995, **the taxpayer accepted promissory notes for part of the purchase prices** on 41 of the 44 homes sold and requested second deeds of trust to secure the notes. Since the taxpayer believed he did not have to report income until payment was received, he did not recognize gain from the construction business on the installment method and did not include the face value of the promissory notes in gross income on his 1995 tax return. The taxpayer reported interest income from the promissory notes on his 1995–1999 tax returns. The IRS concluded that the face value of the notes should have been included in the taxpayer's 1995 income and, accordingly, determined a deficiency in the taxpayer's taxes.

Issue. Whether taxpayer is entitled to use the installment method under I.R.C. §453 to report gain realized from the sale of single-family homes.

Analysis. The tax law provides that for certain sales of property the taxpayer can use the installment method to defer recognition of income [I.R.C. §§451(a), 453, and 1001(c)]. According to I.R.C. §453(b)(2)(A), however, dealer dispositions are not installment sales. Therefore, the gains associated with dealer dispositions cannot be reported under the installment method. Under I.R.C. §453(l)(1)(B), the term **"dealer disposition" includes "any disposition of real property which is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business."** Generally, the court looks to the following factors when making such evaluation: (1) The taxpayer's purpose for initially acquiring the property; (2) the purpose for which the property was subsequently held; (3) the extent to which the taxpayer made improvements to the property; (4) the frequency, number, and continuity of sales; (5) the extent and nature of the taxpayer's efforts to sell the property; (6) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; (7) the extent and nature of the transactions involved; and (8) the taxpayer's everyday business and the relation of realty income to total income [*Cottle v. Commissioner*, 89 T.C. 467 (1987) and *Tollis v. Commissioner*, 65 T.C.M. (CCH) 1951 (1993)]. The court noted that the **taxpayer purchased the land with the intention to subdivide it, construct homes on it, and sell them,** and, in a two-year period, he build and sold 58 homes on the tract.

Holding. The Tax Court held that **the taxpayer held the homes primarily for sale to customers in the ordinary course of business, and the sales were dealer dispositions,** not qualifying for installment sales treatment under I.R.C. §453.

[*Raymond v. Commissioner*, 81 T.C.M. (CCH) 1535 (2001)]

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LTR 200043010
[I.R.C. §§446 and 1286]

> ☞ **Using the same incorrect tax treatment of an income or expense in two consecutive years established a method of accounting.**

Facts. Taxpayer, a wholly owned subsidiary, uses an overall accrual method of accounting and is included in consolidated federal income tax returns filed by the parent. Taxpayer is engaged in the mortgage banking business. As a mortgage banker, taxpayer originates mortgages for sale in the secondary mortgage market and sells and services mortgages. Mortgages are originated in two ways: either directly by taxpayer or alternatively by a third-party mortgage originator and then acquired by taxpayer. The mortgages are pooled by taxpayer and sold into the secondary mortgage market. Taxpayer typically retains the right to service the mortgages sold.

Taxpayer filed a Form 3115, Application for Change in Accounting Method, with parent's Year 1 consolidated return and obtained consent to change its method of accounting in relation to mortgages sold where it retained mortgage servicing rights, effective for its Year 1, to a method in accordance with Rev. Rul. 91-46, 1991-2 C.B. 358, and I.R.C. §1286. [I.R.C. §1286 provides for the tax treatment of stripped bonds. Rev. Rul. 91-46 explains the application of I.R.C. §1286 to certain mortgage transactions.] Taxpayer also made an election, effective for its Year 1, to apply the safe harbor rules of Rev. Proc. 91-50, 1991-2 C.B. 778, to amounts received under mortgage servicing contracts by attaching a statement to that effect to the Year 1 return.

Taxpayer filed a second Form 3115 and received consent to a change in its method of accounting for computing the amount of basis to be allocated to retained mortgage servicing rights, effective in Year 3. Taxpayer had been allocating its total basis in mortgages originated by third parties and then acquired by taxpayer between the mortgages that it sold in the secondary market and the mortgage servicing rights which it retained in a manner inconsistent with the requirements of Rev. Rul. 91-46, Rev. Proc. 91-50, and I.R.C. §1286. This change was implemented on a cut-off basis and thus covered only mortgages sold on or after the first day of Year 3. The method of accounting for mortgages sold before Year 3 was not affected by the change and no I.R.C. §481(a) adjustment was involved.

Parent filed amended returns for its Year 1 and Year 2, to "correct" taxpayer's allocation of the basis of purchased mortgages between mortgages sold in Year 1 and Year 2 and mortgage servicing rights retained **because taxpayer failed to allocate basis in a manner that complied with the requirements** of Rev. Rul. 91-46, Rev. Proc. 91-50, and I.R.C. §1286.

Issue. Does the modification that taxpayer seeks to make to its Year 1 and Year 2 allocation of its basis in certain mortgages, in situations where I.R.C. §1286 applies, constitute the correction of an error or a change in taxpayer's method of accounting?

Analysis. I.R.C. §446(e) and Treas. Reg. §1.446-1(e)(2)(i) require that, except as otherwise expressly provided, a taxpayer must secure the consent of the IRS before changing a method of accounting for tax purposes. Consent must be secured whether or not such method is proper or is permitted.

Taxpayer had permission to apply the provisions of Rev. Rul. 91-46, Rev. Proc. 91-50, and I.R.C. §1286 to the sale of all mortgages where excess servicing rights were retained, beginning with Year 1. Taxpayer had received consent to use the method of accounting prescribed as a result of its filing pursuant to Rev. Proc. 91-51, 1991-2 C.B. 779. Taxpayer had also made a valid election to use the safe harbor provisions of Rev. Proc. 91-50 to determine the extent to which amounts that it was entitled to receive under mortgage servicing contracts represented reasonable compensation for services to be rendered. Any amounts that were to be received in excess of the safe harbor amount should have been accounted for as a stripped coupon, as provided by Rev. Proc. 91-50.

However, for Year 1 and Year 2, taxpayer applied the provisions of Rev. Rul. 91-46, Rev. Proc. 91-50, and I.R.C. §1286 only to the sale of mortgages originated by it directly. Taxpayer did not apply these provisions to the sale of mortgages originated by and acquired from third parties. Instead, taxpayer continued to apply its previous method of accounting when making basis allocations between mortgages sold and mortgage servicing rights retained upon the sale of mortgages originated by third parties. Taxpayer asserts that this method produced basis allocations, which did not comply with the requirements of Rev. Rul. 91-46, Rev. Proc. 91-50, and I.R.C. §1286.

Rev. Rul. 90-38, 1990-1 C.B. 57, held that a similarly situated taxpayer could not retroactively change from an erroneous to a permissible method of accounting by filing amended returns.

Holding. The IRS held that the change in the methodology used by the taxpayer in Year 1 and Year 2 involves a change in taxpayer's method of accounting under I.R.C. §446(e), which requires the consent of the

IRS. **The taxpayer may not change from its established method of accounting by filing amended returns, even though the method that it had previously utilized was not consistent with the requirements** of Rev. Rul. 91-46, Rev. Proc. 91-50, and I.R.C. §1286.

[LTR 200043010 (June 9, 2000)]

FSA 200048012
[I.R.C. §§446 and 481]

> ☞ **Taxpayer's reallocation from depreciable to nondepreciable asset constitutes a change of accounting method.**

Facts. A bank holding company's subsidiaries purchased the assets and liabilities of two savings and loan institutions. In accordance with I.R.C. §1060 as in effect at the time of the acquisitions, taxpayer allocated a portion of the premiums paid to the core deposit intangible, a depreciable Class III asset. The balance of the premiums paid was allocated to goodwill and going concern value, a nondepreciable Class IV asset. Taxpayer claimed core deposit depreciation deductions under I.R.C. §167 based upon the economic life established for the core deposits. Taxpayer did not depreciate the premium allocable to goodwill.

The IRS determined that the taxpayer had overstated the fair market value of the deposits, reallocated the excess to Class IV, and proposed an I.R.C. §481(a) adjustment to disallow the net excess depreciation claimed by taxpayer in the closed years.

Issue. Whether the reallocation of basis from a depreciable asset to a nondepreciable asset constitutes a change in method of accounting.

Analysis. Treas. Reg. §1.446-1(e)(2)(ii)(b) provides that a correction to require depreciation in lieu of a deduction for the cost of a class of depreciable assets which had been consistently treated as an expense in the year of purchase involves the question of the proper timing of an item and is to be treated as a change in method of accounting.

If a taxpayer's practice involves timing, a change from that practice is a change in method of accounting only if the taxpayer has adopted that practice. Although a method of accounting may exist without the necessity of a pattern of consistent treatment of an item, Treas. Reg. §1.446-1(e)(2)(ii)(a) provides that in most instances a method of accounting is not established for an item without such consistent treatment. For purposes of this regulation, **the erroneous treatment of a material item in the same way in two or more consecutively filed tax returns represents consistent treatment of that item** [Rev. Proc. 97-27, 1997-1 C.B. 680 and Rev. Rul. 90-38, 1990-1 C.B. 57].

The IRS concluded **that the change from treating the asset as a depreciable Class III asset to treating such property as a nondepreciable Class IV asset involves the timing of deductions.** Therefore, **even if the change was a change in characterization, a change in method of accounting occurred** in accordance with I.R.C. §446(e), *its regulations,* and Rev. Proc. 97-27.

Holding. **A reallocation of basis from a depreciable asset to a nondepreciable asset** results in a change in the timing of basis recovery and **constitutes a change in method of accounting.**

[FSA 200048012 (August 21, 2000)]

FSA 200102004
[I.R.C. §446]

> ☞ **Taxpayers were not forced to return to an incorrect method of accounting even though a retroactive change was made.**

Facts. The taxpayer sells time-shares and capitalized the selling expenses instead of deducting them. When the taxpayer later changed accountants, an amended return was filed to correct the error.

Issue. Whether the IRS should deny taxpayer's use of the correct method of accounting and return it to its prior erroneous method because taxpayer impermissibly changed its method of accounting.

Analysis. Treas. Reg. §1.446-1(e)(2)(i) provides that a taxpayer who changes the method of accounting used in keeping his books must obtain the consent of the IRS before computing his income upon such new method for tax purposes. Consent must be secured whether or not the method is proper or is permitted under the Code or regulations.

If the taxpayer's method of accounting clearly reflects income, the IRS may not require the taxpayer to change to a method that, in the IRS's view, more clearly reflects income [*W.P. Garth v. Commissioner*, 56 T.C. (1971), *acq.* 1975-1 C.B. 1]. The ruling noted that the IRS has broad powers to determine whether accounting method clearly reflects income but does not have authority to force a change from a method, which does clearly reflect income, to a method which in the IRS's opinion more clearly reflects income.

The courts have made it clear that **the denial of a request to change from an incorrect to a correct method would constitute an abuse of discretion** [*Wright Contracting Co. v. Commissioner*, 36 T.C.

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620 (1961), *acquiesced* 1966-2 C.B. 7, *aff'd*, 316 F.2d 249 (5th Cir. 1963) [63-1 USTC ¶9416], *cert. denied*, 375 U.S. 879 (1963) (court indicated that it would amount to an abuse of discretion for the IRS to refuse a request for change from an improper to a proper method)].

Holding. Since there was apparently no tax avoidance scheme, **the IRS recommended against returning taxpayer to its prior incorrect method of accounting.**

[FSA 200102004 (August 14, 2000)]

Brookshire Brothers Holding, Inc., v. Commissioner

[I.R.C. §§168 and 446]

☞ **Reclassification of depreciable property to 15-year life was not a change of accounting method.**

Facts. Accrual method taxpayer calculated its depreciation deductions for tax purposes using 31.5- and 39-year lives for 1993, 1994, and 1995. **Taxpayer later filed amended returns** for 1993–1995, **reclassifying their gas stations as 15-year property**, based upon an Industry Specialization Program Coordinated Issue Paper issued by the IRS. Taxpayer then filed original 1996 and 1997 using the 15-year life. The IRS claimed this was an unauthorized change in accounting method.

Issue. Whether reclassification of the gas station properties represented a change in accounting method made without the consent of the IRS as required under I.R.C. §446(e).

Analysis. Treas. Reg. §1.446-1(e)(2)(ii)(a) provides that a change in accounting method includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. However, Treas. Reg. §1.446-1(e)(2)(ii)(b) provides that a change in the method of accounting does not include an adjustment in the useful life of a depreciable asset. Nonetheless, in *Standard Oil Co. v. Commissioner,* 77 T.C. 349 (1981), it was held that a change in depreciation method was a change in accounting method requiring consent. The **IRS argued that a change from MACRS 31.5-year life to MACRS 15-year life was a change in depreciation method, from straight-line to accelerated, and a change in life.** After reviewing the legislative history, **the court concluded that the IRS's argument would severely restrict the usefulness of the exception**.

Holding. The Tax Court held that the **change to the 15-year depreciation method was not a change in method of accounting**, requiring consent of the IRS under I.R.C. §446(e).

[*Brookshire Brothers Holding, Inc.*, 81 T.C.M. (CCH) 1799 (2001)]

Practitioner Note. The argument that a change in recovery period is within the "useful life" exception has been rejected in ***Kurzet v. Commisioner*** [222 F.3d 830 (8-16-00) *aff'g* 73 T.C.M. 1867] and ***H.E. Butt Grocery Co. v. U.S.*** [108 F.Supp.2d 709 (W.D. Tex. 2000)]. Therefore, practitioners may wish to err on the side of caution and continue to file Form 3115, especially since the change in depreciation method is an automatic change requiring no user fee.

See also *FPL Group, Inc., et al. v Commissioner* [115 T.C. No. 38, December 13, 2000], in which the Tax Court held that a power company's recharacterization of items from capital expenditures to repair expense is a change of accounting method requiring IRS consent.

Alacare Home Health Services, Inc. v. Commissioner

[I.R.C. §§263 and 6662]

☞ **Home health agency was not allowed to expense assets costing less than $500 that had a useful life greater than one year.**

Facts. Taxpayer, a Medicare-certified home health care agency, accounted for certain assets in accordance with Medicare guidelines. Under these guidelines, if an asset has a historical cost of less than $500, or if the asset has a useful life of less than 2 years, its cost is allowable in the year it is acquired. Accordingly, **taxpayer expensed all assets with a cost of less than $500.** The IRS determined that the policy of expensing assets that cost less than $500 was not a proper method of accounting.

Issue. Whether taxpayer must capitalize the cost of items that cost less than $500 and have a useful life of more than one year.

Analysis. I.R.C. §263 provides that amounts paid to acquire machinery and equipment, furniture and fixtures, and similar property have a useful life substantially beyond the taxable year must be capitalized. I.R.C. §446 provides the general rule (a) 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, and (b) exception, if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the IRS, does clearly reflect income.

Relying on *Cincinnati, New Orleans & Tex. Pac. Ry. Co. v. United States*, 424 F.2d 563 (1970), taxpayer argued that its method of accounting clearly reflected its income within the meaning of I.R.C. §446. In *Cincinnati*, the company was required by the Interstate Commerce Commission (ICC) to expense purchases of certain property costing less than $500, and the Court of Claims held that Cincinnati could deduct a de minimis amount of expenses for low-cost capital assets that had a useful life greater than 1 year if the accounting method established by the ICC clearly reflected income. However, the Court of Claims, in *Cincinnati*, pointed out that the disputed items were a minute fraction of Cincinnati's net income, yearly operating expenses, and yearly depreciation deduction, concluding that the ICC's minimum expensing rule was in accordance with generally accepted accounting principles and that the taxpayer's financial statements clearly reflected income.

In distinguishing this case from *Cincinnati,* the Tax Court noted that (1) the ratios of disputed items to various measures of taxpayer's size were substantially larger than in *Cincinnati*; (2) the ICC required that *Cincinnati* use minimum expensing while Medicare allowed, but did not require, expensing of certain items; and (3) *Cincinnati*'s expensing was in accordance with generally accepted accounting principles.

Holding. The Tax Court held that taxpayer's method of accounting did not clearly reflect income, therefore, taxpayers could not expense the cost of its assets that cost less than $500 and have a useful life greater than 1 year.

[*Alacare Home Health Services, Inc., v. Commissioner*, 81 T.C.M. (CCH) 1794 (2001)]

ACTIVITIES NOT FOR PROFIT

Ogden v. Commisioner

[I.R.C. §183]

☞ **Taxpayers' Amway objective was not profit but to purchase household goods and claim deductions to offset their wage income.**

Facts. Taxpayers operated an Amway distributorship. The Tax Court found that they failed to comply with tax law provisions, did not exercise due care insofar as they continued with an unprofitable endeavor, and maintained unbusinesslike records in connection with disallowed business expense deductions. The **Tax Court determined that the taxpayers operated the Amway activity for deductions, for personal pleasure, and to offset wages.** The Tax Court determined additional tax liability and assessed an accuracy-related penalty for negligence.

Issue. Whether the Tax Court was erroneous in the inquiry of profit motive and determination of negligence for an accuracy-related penalty.

Analysis and Holding. The Fifth Circuit found that the record supported the finding that the Ogdens' objective was not profit but to purchase household goods and make financial deductions to offset their wage income. Therefore, the Tax Court did not err and its determination of tax liability was affirmed.

The Fifth Circuit found that the record supported the finding that the taxpayers failed to comply with provisions of the Internal Revenue laws, failed to exercise due care by continuing with an unprofitable endeavor, and maintained unbusinesslike records. The Tax Court's imposition of an accuracy-related penalty was affirmed.

[*Ogden v. Commissioner*, 244 F.3d 970 (5th Cir. 2001) *affirming* 78 T.C.M. (CCH) 913 (1999)]

Stasewich v. Commissioner

[I.R.C. §§183 and 6662]

☞ **A CPA's artist activity was not engaged in for profit.**

Facts. Taxpayer supported himself from income from his accounting practice and **claimed losses for 14 years from his activity as an artist.** He provided adequate substantiation for his expenses. During the years in issue, he kept a spreadsheet of income and expenses, a cash receipts journal, and receipts for expenses. In a previous Tax Court case for the years 1988–1991, the taxpayer was found not to have engaged in his artist activity for profit. The IRS determined that the taxpayer's artist activity was not engaged in for profit within the meaning of I.R.C. §183 for the years 1992–1995.

Issue

Issue 1. Whether the taxpayer engaged in the artist activity with a profit motive within the meaning of I.R.C. §183.

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Issue 2. Whether the taxpayer is liable for accuracy-related penalties pursuant to I.R.C. §6662(a).

Analysis. Treas. Reg. §1.183-2(b) provides relevant factors for determining whether an activity is engaged in for profit. The relevant factors include (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his or her advisers; (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 other similar or dissimilar activities; (6) the taxpayer's history of income and loss with respect to the activity; (7) the amount of occasional profits, if any, which are earned; (8) the financial status of the taxpayer; and (9) the elements of personal pleasure or recreation.

Even though the taxpayer maintained books and records to substantiate his deductions, **he failed to show that the books and records were kept for the purpose of cutting expenses, increasing profits, and evaluating the overall performance of the operation.** He did not maintain a budget for the activity or make any sort of financial projections.

The court noted that the large unabated expenditures, the **absence even at this late date of any concrete business plans to reverse the losses,** and the manner in which taxpayer conducted his artist activity lead to the conclusion that this was not an activity engaged in for profit.

Holding

Issue 1. The Tax Court held that the **taxpayer's artist activity was an activity not engaged in for profit** within the meaning of I.R.C. §183(a).

Issue 2. In view of taxpayer's training and experience, the Tax Court held that imposition of the accuracy-related penalty was justified for all years in issue.

[*Stasewich v. Commissioner*, 81 T.C.M. (CCH) 1122 (2001)]

Zarins v. Commissioner

[I.R.C. §§183, 6501 and 6503]

> ☞ **Taxpayers' tree-farming activity was not engaged in for profit.**

Facts. Married taxpayers, an engineer and a computer manager, bought an 85-acre farm, built a house on the farm, and cultivated 40 acres. In 1990, the husband began planting trees on the land. In 1994 and 1995, he worked approximately 15 to 20 hours per week on the farm. In 1994 and 1995, he built an irrigation pond with dam and a gravel access road and purchased equipment to use on the farm. Taxpayers sold few trees in 1994 and 1995. They had planted 3,500 trees by 1996 and 5,000 by March 2000. Taxpayers reported a small amount of income that was offset by a large amount of expenses, resulting in large losses on their Schedule F for 1993 through 1998. In 1997, the taxpayers signed a Form 872, consenting to extend the period to assess tax until 1999. The IRS determined that the taxpayers' tree-farming activity was not operated with a profit motive and issued a deficiency notice in June 1998.

Issues

Issue 1. Whether taxpayers operated their tree farm activity for profit in 1994 and 1995.

Issue 2. Whether the limitation on the time to assess tax for 1994 or 1995 expired before the IRS issued the notice of deficiency.

Analysis. In considering the factors in Treas. Reg. 1.183-2(b), the court determined that the activity was not operated in a businesslike manner. **The taxpayers did not maintain a business plan or accurate production records** with respect to the tree farm. They had no marketing plan, obtained no expert advice to correct the farm's losses, and did not spend a significant amount of time raising or selling trees. Also, they produced no evidence in support of their contention that future appreciation in the value of the farm, together with anticipated farm income, would permit them to recoup prior farm losses. Also, the court noted that the tree farm had a history of losses. Three of the factors were neutral, and no factor supported a profit motive.

In dismissing the taxpayer's argument that the time to assess taxes for 1994 and 1995 had expired, the court noted that the IRS issued a deficiency notice to the couple before the statute ran and that the notice suspended the period of limitations for assessment until 60 days after the decision in the case was final.

Holding

Issue 1. The Tax Court held that the **taxpayers did not operate their tree farm activity for profit** in 1994 and 1995.

Issue 2. The Tax Court held that the time to assess tax for 1994 and 1995 had not expired before the IRS issued the notice of deficiency.

[*Zarins v. Commissioner*, 81 T.C.M. (CCH) 1375 (2001)]

Strickland v. Commisioner
[I.R.C. §183]

> ☞ **Taxpayers operated their horse-breeding and boarding activity for profit.**

Facts. The taxpayers began breeding horses in 1993 and boarding them in 1995. Before the taxpayers were married, the wife purchased a farm because she wanted to raise and train horses, an activity she had enjoyed participating in since childhood. In 1993, the taxpayers began to breed, show, and sell quarter horses. They **engaged a CPA to set up their records and consulted with successful breeders about the types of horses to acquire.** The wife ran the daily operations, and by the end of 1996 the taxpayers owned 12 horses. Their **horses were successful in the horse show competitions, even winning grand championships.**

Issue. Whether taxpayers operated their horse-breeding and boarding activity for profit under I.R.C. §183 in 1995 and 1996.

Analysis. In deciding whether taxpayers operated their horse activity for profit, the court considered the nine factors of Treas. Reg. §1.1.83-2(b) [see *Zarins v. Commissioner,* elsewhere in this section, for a list of the nine factors]. The court concluded that the taxpayers conducted their operation in a businesslike manner, keeping complete and accurate records, boarding other people's horses to defray costs, and advertising at horse shows and in a local newspaper. Moreover, they had the expertise to conduct a profitable horse operation: they considered the best use of their land and the growing interest in horses in the area and were intimate with horse raising and its associated costs. The IRS argued that the taxpayers had no business plan. However, the court found that the taxpayers had a business plan and pursued it consistently, even though it was not written, citing *Phillips v. Commissioner*, 73 T.C. (CCH) 1766 (1997), in which it was found that a written financial plan was not required for a 32-horse farm where the business plan was evidenced by action.

Finally, the court found that the **taxpayers operated their horse activity in a "serious and organized manner," while trying to keep cost as low as possible by doing most of the work themselves.** The court noted that because the operation was relatively new at the time of audit, it was reasonable for the taxpayers to use personal funds to pay for the operation's expenses and incur substantial losses during the years at issue.

Holding. The Tax Court held that **the taxpayers operated their horse activity for profit** under I.R.C. §183 during 1995 and 1996.

[*Strickland v. Commissioner*, 80 T.C.M. (CCH) 451 (2000)]

FSA 200042001
[I.R.C. §§162 and 183]

> ☞ **Activities of a C corporation cannot be aggregated with those of an S corporation to determine profit motive of the S corporation.**

Facts. The taxpayer owns a personal service C corporation and also owns an S corporation that owns several airplanes. The **airplanes are not available for lease to the public, and the only income the S corporation earns is from the personal service C corporation.** Almost exclusively the taxpayer and his family use the airplanes. Taxpayer argues that the activities of the C corporation should be aggregated with the S corporation under the I.R.C. §183 hobby loss rules.

The contract between the C corporation and the taxpayer contains a clause that attempts to recharacterize certain deductions claimed at the C corporation level. In essence, the clause provides that, if a deduction is disallowed by the IRS, then the amount of that deduction will be recharacterized as compensation to the taxpayer.

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Issues

Issue 1. Whether the activity of an S corporation may be aggregated with that of a C corporation under the aggregation rules of Treas. Reg. §1.183-1(d)(1) for the purposes of determining the profit motive of the S corporation under I.R.C. §183.

Issue 2. Whether the C corporation may reclassify disallowed personal expenses of the taxpayer as deductible compensation.

Analysis and Holding

Issue 1. Treasury Regulation §1.183-1(a) explicitly excludes C corporations from analysis under I.R.C. §183. The IRS concluded that by attempting to aggregate a C corporation with an S corporation, taxpayer is attempting to pull a C corporation into the purview of I.R.C. §183 in violation of the regulations. The IRS noted that **undertakings conducted separately by two different taxpayers cannot be combined as a single activity** under the Treas. Reg. §1.183-1(d)(1) [see Rev. Rul. 78-22, 1978-1 C.B. 72]. Therefore, the IRS held that the activity of an S corporation may not be aggregated with that of a C corporation under the aggregation rules of Treas. Reg. §1.183-1(d)(1) for the purposes of determining the profit motive of the S corporation under I.R.C. §183.

Issue 2. The IRS noted that under the regulations and controlling precedent there is a two-prong test for the deduction of compensation, first, whether the payments were reasonable as salaries and, second, whether there was a compensatory purpose. However, lack of compensatory purpose has been relied upon to find that amounts paid to employees are not deductible even though they might have been reasonable in amount. [*O.S.C. & Associates, Inc. v. Commissioner*, 187 F.3d 1116 (9th Cir. 1999)]. The IRS determined that the amounts in question were paid without any prior intent to compensate the taxpayer and, therefore, they are not reasonable compensation deductible under I.R.C. §162(a)(1). The IRS held that **the C corporation may not reclassify disallowed personal expenses of the taxpayer as deductible compensation.**

[FSA 200042001 (October 30, 2000)]

AGRICULTURE

McNamara v. Commissioner
[I.R.C. §1402]

> ☞ **The Eighth Circuit reverses and remands on farmland rentals subject to self-employment tax in *McNamara*, *Hennen*, and *Bot*.**

Facts. Each of the three couples, McNamara, Bot, and Hennen, had owned farmland for many years. Each of the couples rented the farmland to the farm activity for at or below market rates, and each had employment contracts requiring material participation by the landlord. For the years at issue the couples reported real estate rental income and wages paid on their joint returns. The IRS determined deficiencies for self-employment tax on the rental payments. The Tax Court agreed with the IRS.

Issue. Whether rental payments received by taxpayers from the farm activity are includable in taxpayers' net earnings from self-employment under I.R.C. §1402(a)(1) and thus subject to self-employment taxes.

Analysis. The court noted that generally taxable self-employment income excludes sources that do not depend on an individual's labor, including rentals from real estate. Under I.R.C. §1402(a)(1), however, rents are included if, "derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities . . . on such land, and that there shall be material participation by the owner or tenant . . . in the production or the management of the production of such agricultural or horticultural commodities, and . . . there is material participation by the owner or tenant . . . with respect to any such agricultural or horticultural commodity."

The court disagreed with taxpayers' contention that §1402(a)(1) applies only to rental payments derived from sharecropping or share-farming, stating that no such restriction appears in the Code. The court also rejected taxpayers' contention that the instructions accompanying Form 4835 (Farm Rental Income and Expenses) contradict and therefore override §1402(a)(1).

Further, the court acknowledged that the Tax Court did not clearly err in concluding that the wives were required by the employment arrangements to materially participate. However, the court found compelling the taxpayers' argument that the lessor-lessee relationships should stand on their own apart from the employer-employee relationships. The court acknowledged that **rents consistent with market rates very strongly suggests that the rental arrangement stands on its own** as an independent transaction and not part of an "arrangement" for participation in agricultural production. The court found missing from both the IRS's and the Tax Court's analyses any mention of a nexus between the rents received by taxpayers and the "arrangement" that requires the landlords' material participation. The court remarked, "mere existence of an arrangement requiring and resulting in material participation in agricultural production does not automatically transform rents received by the landowner into self-employment income. It is only where the payment of those rents comprise part of such an arrangement that such rents can be said to derive from the arrangement."

Holding. The **Eighth Circuit reversed and remanded** the Tax Court's decisions to give the IRS an opportunity to show a connection between those rents and the production arrangement.

[*McNamara v. Commissioner*, 236 F.3d 410 (8th Cir. 2000), reversing and remanding 78 T.C.M. (CCH) 530 (1999); *Hennen v. Commisioner*, 78 T.C.M. (CCH) 445 (1999); and *Bot v. Commissioner*, 78 T.C.M. (CCH) 220 (1999)]

Thom v. Commissioner
[I.R.C. §453]

> ☞ **Farm equipment dealer cannot report sales using the installment method.**

Facts. The taxpayers owned **an S corporation that was engaged in the business of manufacturing, selling, and leasing farm equipment,** which included irrigation systems. The corporation sold and leased the irrigation systems through a dealer and made direct sales and leases of the irrigation systems to farmers. The corporation financed the direct sales to farmers through agreements that required at least one payment in a later year. **The corporation accounted for these sales under the installment method.** The IRS disallowed the use of the installment method for these sales, which resulted in tax deficiencies for the taxpayers since they were shareholders of the S corporation.

Issue. Whether a dealer in farm equipment is covered by the farm property exception in I.R.C. §453(l)(2)(A).

Analysis. According to I.R.C. §453(b)(2), dealers in property generally may not use the installment method to report sales of property. However, I.R.C. §453(l)(2)(A) provides an exception for dispositions of property used or produced in the trade or business of farming.

The taxpayers argued that the words in the I.R.C. §453(l)(2)(A) farming exception "used or produced in the trade or business of farming" mean that a merchant who sells personal property to a farmer is entitled to report the sale on the installment basis. The taxpayers claimed that this is true even though the dealer is not engaged in farming prior to the sale and the property is not "used" in farming before the sale.

Rejecting the taxpayers' argument, **the court said that the words, structure, and historical evolution of the statute make clear, the "farm property" exception is limited to farmers' (and not merchants') dispositions of property used or produced in the business of farming.** The court maintained that the ordinary sense of the words "used or produced" in I.R.C. §453(l)(2)(A), when coupled in that same sentence with the phrase "in the trade or business of farming," establishes that the property must be "in" farming at the time of sale.

Holding. The District Court held that as a merchant, and not a farmer, **the taxpayer is not covered by the "farm property" exception** under I.R.C. §453(l)(2)(A).

[*Thom v. Commissioner*, 134 F.Supp.2d 1093 (D.Neb. 2001)]

Seggerman Farms, Inc. v. Commissioner
[I.R.C. §357]

> ☞ **Taxpayers had to recognize gain upon incorporation when transferred liabilities exceeded asset basis even though liabilities were personally guaranteed.**

Facts. The taxpayers incorporated their family farming business, which had previously been operated as a joint venture. As part of the incorporation, various farm assets were transferred to the corporation. The corporation assumed the farm liabilities, and some of the property was transferred subject to liability. The adjusted **basis of the assets was less than the liabilities assumed plus the amount of liabilities to which property was subject. However, the taxpayers were personally liable for all the debt before and after the incorporation.**

Issue. Whether taxpayers must recognize a gain on the transfer of assets to the corporation under I.R.C. §357 to the extent that the amount of liabilities that were assumed plus the amount of liabilities to which the property was subject exceeds the total of the adjusted basis of the property that was transferred to the corporation.

Analysis. In general, I.R.C. §357(c)(1)(A) provides that in the case of an exchange to which I.R.C. §351 applies, if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

In *Rosen v. Commissioner,* 62 T.C. (CCH) 11 (1974), *aff'd without published opinion,* 515 F.2d 507 (3rd Cir. 1975), the court addressed the same issue in similar circumstances. The taxpayer, in *Rosen*, transferred all of the assets and liabilities of a sole proprietorship to a

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corporation in which he owned 100% of the outstanding stock. The liabilities exceeded the adjusted basis of the assets that were transferred, and the taxpayer remained personally liable for the liabilities that were transferred. The court ruled, in *Rosen*, that the even though the taxpayer remained personally liable for the payment of the liabilities, there is no requirement in I.R.C. §357(c)(1) that the transferor be relieved of liability and held that the taxpayer had to recognize a gain under I.R.C. §357(c).

The taxpayers rely on two Court of Appeals decisions in which the Courts of Appeals granted taxpayers relief from recognizing a gain under I.R.C. §357(c). In *Lessinger v. Commissioner*, 872 F.2d 519 (2nd Cir. 1989), *rev'g* 85 T.C. (CCH) 824 (1985), the difference between the adjusted basis of the assets and the liabilities that were transferred was recorded as a loan receivable from the taxpayer to the corporation. As a result of including the face value of the loan receivable in the assets, the Second Circuit ruled there was no I.R.C. §357 gain. In *Peracchi v. Commissioner*, 143 F.3d 487 (9th Cir. 1998), *rev'g,* 71 T.C.M. (CCH) 2830, in a similar situation, the difference in liabilities and asset basis was recorded as a personal note from the taxpayer to the corporation. The Ninth Circuit, in *Peracchi*, held that the taxpayer had a basis in the personal note equal to the face value of the note and that there was no gain to recognize under I.R.C. §357(c).

The IRS argued that the structure of the taxpayers' I.R.C. §351 transaction was not the same as the structure of the taxpayers' transactions in *Lessinger* and *Peracchi*. Agreeing with the IRS, the court concluded that **personal guaranties of corporate debt are not the same as incurring indebtedness to the corporation** because a guaranty is merely a promise to pay in the future if certain events should occur and taxpayers' guaranties do not constitute economic outlays.

Holding. The Tax Court held that under I.R.C. §357, taxpayers must recognize a gain on the transfer of assets to the corporation.

[*Seggerman Farms, Inc. v. Commissioner*, 81 T.C.M. (CCH) 1543 (2001)]

> **Practitioner Note.** In 1999, Congress enacted changes to I.R.C. §357(c) that were effective for transfers occurring after October 18, 1998. The amendment struck the words "plus the amount of liabilities to which the property is subject," from I.R.C. §357(c)(1). This provided relief for the taxpayer who transferred assets subject to liabilities and remained personally liable on the debt, but where the corporation did not assume the liability. Congress also added I.R.C. §357(d), which provides guidance in determining the amount of liabilities that are assumed and states in I.R.C. §357(d)(1)(A) that "a recourse liability (or portion thereof) shall be treated as having been assumed if . . . the transferee has agreed to, and is expected to, satisfy such liability (or portion), whether or not the transferor has been relieved of such liability." [Miscellaneous Trade and Technical Corrections Act of 1999, Pub. L. 106-36]

Ward Ag Products, Inc., v. Commissioner
[I.R.C. §§446, 448 and 471]

> ☞ **Farm supply business was required to use the accrual method of accounting.**

Facts. Taxpayer sold seeds, herbicides, fertilizers, and pesticides to local farmers, and the owner provided advice and some financial assistance to the taxpayer's customers. Taxpayer used the cash method of accounting for the years at issue. The IRS determined that the taxpayer was required to use the accrual method of accounting and, accordingly, assessed tax deficiencies for the 1990 and 1992. The Tax Court held that the taxpayer must use the accrual method of accounting since **the taxpayer's purchase and sale of merchandise was a material income-producing factor and the taxpayer did not qualify as a farmer for purposes of using the cash method of accounting.** The Tax Court further held that the IRS's determination was not an abuse of discretion.

Issue

Issue 1. Whether the IRS's determination was an abuse of discretion because, in determining that taxpayer's use of the cash method did not clearly reflect income, the IRS compared only 3 years of taxpayer's income under the cash and accrual methods of accounting.

Issue 2. Whether taxpayer qualifies as a farmer for purposes of using the cash method of accounting.

Issue 3. Whether taxpayer's purchase and sale of merchandise was a material income-producing factor.

Analysis and Holding

Issue 1. The IRS did not abuse its discretion when it required the to change from the cash to the accrual method of accounting. It did not act arbitrarily in basing its decision on an examination of the taxpayer's returns for only three tax years, even though the taxpayer alleged that, over a longer period of time, its income and tax liability would be approximately equal under both accounting methods.

Issue 2. The **taxpayer did not qualify as a farming business eligible to use the cash method of accounting.** The taxpayer did not cultivate, operate or manage a farm for profit. Its loans and extensions of credit to farmers did not expose it to a substantial risk of loss from the growing process since they were secured by collateral that was not limited to the current crop and the evidence did not establish that all of its security interests were subordinated to its customers' mortgages. The taxpayer produced no evidence to show that it had received any income from the occasional farming activities of its founder. Since the taxpayer did not retain title to the products that it sold to farmers, it did not have control and management over any farming operation.

Issue 3. The taxpayer was properly required to use the accrual method of accounting because nearly all of its income came from product sales. The taxpayer's purchase and sale of merchandise was a substantial income-producing factor and, thus, it was required to use inventories.

[*Ward Ag Products, Inc., v. Commissioner*, 216 F.3d 1090 (11th Cir. 2000), *unpublished opinion aff'g* 75 T.C.M. (CCH) 1886 (1998)]

Crop Care Applicators, Inc., v. Tax Court

[I.R.C. §§34 and 7805]

> ☞ **Pesticide applicator was denied fuel tax credit because it did not get formal waivers from customers prior to filing tax returns.**

Facts. The taxpayer is an agricultural chemical application company that applies pesticides to various farms and orchards. The written contracts taxpayer entered into with its customers have no explicit provision addressing fuel tax credits but provide that taxpayer will be responsible for "wages, salaries, bills and taxes for labor, materials and equipment used in performance" of its services. **Taxpayer filed Forms 4136, Credit for Federal Tax Paid on Fuels, with its corporate tax return for the years at issue, but did not secure formal waivers of the fuel tax credits from its customers** before filing its returns. The IRS determined that taxpayer was not entitled to credits for federal tax on fuels since taxpayer failed to secure the waivers. After receiving the notice of deficiency and before petitioning the Tax Court, taxpayer was able to obtain five waivers from customers, which relate to approximately 70% of taxpayer's gross revenue during each year at issue.

Issue. Whether taxpayer is entitled to the credit for federal tax on fuels.

Analysis. Under I.R.C. 6420(a), the "ultimate purchaser" of the gasoline is entitled to a credit determined by multiplying the number of gallons used by the rate of tax applied to the gasoline on the date he purchased the gasoline. I.R.C. §34(a)(1) allows a credit against federal income tax for the taxable year in an amount allowed under I.R.C. §6420(a). I.R.C. 6420(c)(3) provides, in general, that gasoline is considered used for farming purposes only if used by the owner, tenant, or operator of a farm for various farming purposes.

I.R.C. §6420(c)(4), however, provides that "an aerial or other applicator of fertilizers or other substances" who is the ultimate purchaser of the gasoline will be treated as having used the gasoline on a farm for farming purposes if the owner, tenant, or operator of the farm "waives (at such time and in such form and manner as the Secretary shall prescribe) his right to be treated as the user and ultimate purchaser of the gasoline." Taxpayers are specifically required under Treas. Reg. §48.6420-4(1)(2) to obtain waivers from its farmer customers "no later than the date on which the aerial applicator or other applicator claiming the credit or payment files its return for the taxable year in which the gasoline is used."

The court concluded that even though the instructions to Form 4136, the form used to claim the credits, did not indicate that the waivers were required, it did not absolve the taxpayer from strict adherence to the applicable regulatory guidelines, pointing out that instructions published by the IRS are not authoritative sources of tax laws.

The court held that the doctrine of substantial compliance could not be applied to otherwise entitle the taxpayer to the credits because the waiver requirement related to the substance or essence of the statute. The court noted **the waiver requirement for pesticide applicators was designed to ensure that farmers were aware of their entitlement to the**

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credit and to prevent two taxpayers from both claiming the same credit. Accordingly, the court concluded that extending the credit without strict adherence to the waiver requirements would defeat the statutory policies of Code I.R.C. §6420.

Holding. The Tax Court held that the taxpayer was not entitled to the credit for federal tax on fuels for the years at issue.

[*Crop Care Applicators, Inc.*, T.C. Summary Opinion (CCH) 2001-21]

ALTERNATIVE MINIMUM TAX

LTR 200103073
[I.R.C. §55]

> ☞ **Taxpayers who use the standard deduction for regular tax purposes may not itemize deductions for AMT purposes.**

Issue. Whether a taxpayer who uses the standard deduction in computing taxable income for regular tax purposes may use itemized deductions when computing alternative minimum taxable income (AMTI) for alternative minimum tax (AMT) purposes.

Analysis. I.R.C. §55(b)(2) states, "The term 'alternative minimum taxable income' means *the taxable income of the taxpayer* for the taxable year–(A) determined with the adjustments provided in I.R.C. §§56 and 58, and (B) increased by the amount of the items of tax preference described in I.R.C. §57." Thus, under I.R.C. §63, a taxpayer who has elected to use the standard deduction in lieu of itemized deductions begins the computation of AMTI by using a taxable income figure that takes into account the standard deduction, but not itemized deductions.

I.R.C. §56(b)(1)(E) then states that in computing AMTI the standard deduction shall not be allowed. Thus, taxable income is increased by the amount of the standard deduction. The IRS pointed out that no provision exists, however, for decreasing taxable income by the amount of itemized deductions that were never taken into account when computing taxable income. The IRS noted that without such authority, a taxpayer is precluded from using itemized deductions for both regular and AMT purposes by I.R.C. §63. Under Treas. Reg. §1.55-1(a), "Except as otherwise provided by statute, regulations or other published guidance . . . all Internal Revenue Code provisions that apply in determining the regular taxable income of a taxpayer also apply in determining the alternative minimum taxable income of the taxpayer."

I.R.C. §56(b)(1)(F) states that when computing AMTI "I.R.C. §68 (overall limitation on itemized deductions) shall not apply." The IRS clarified that **this provision does not permit a taxpayer to take itemized deductions that are not allowable for purposes of regular tax** and commented that the legislative history underlying I.R.C. §68 confirms this intent.

Holding. The IRS concluded that a taxpayer who uses the standard deduction in computing taxable income for regular tax purposes may not use itemized deductions when computing alternative minimum taxable income (AMTI) for alternative minimum tax (AMT) purposes.

[LTR 200103073 (December 15, 2000)]

AMORTIZATION, DEPLETION, AND DEPRECIATION

Patton v. Commissioner
[I.R.C. §179]

> ☞ **§179 expensing election cannot be changed after tax return is filed.**

Facts. The taxpayer, a self-employed welder, **reported a business loss for 1995 and was unable to benefit from his §179 election** to expense a $4,100 asset. On audit, the IRS determined that due to unreported income the business actually earned a profit. The IRS also recharacterized as depreciable assets three items that taxpayer had expensed as materials and supplies. The IRS denied the taxpayer's request to revoke, amend, or modify his I.R.C. §179 election to expense the three assets.

Issue. Whether IRS abused its discretion in refusing to grant consent to taxpayer to revoke (modify or change) his election to expense depreciable business assets under I.R.C. §179.

Analysis. An I.R.C. **§179 election must be made on the taxpayer's first income tax return** (whether or not the return is timely) or on an amended return filed within the time prescribed by law (including extensions) for filing the original return for such year [*Genck v. Commissioner*, 75 T.C.M. (CCH) 1984 (1998); I.R.C. §179(c)(1)(B); and Treas. Reg. §1.179-5(a)]. An election made under I.R.C. §179 and any specifications contained in such election may not be revoked (modified or changed) without the IRS's consent [I.R.C. §179(c)(2); *King v. Commissioner*, 60 T.C.M. (CCH) 1048 (1990)].

The taxpayer argued that his dilemma was caused by the IRS, since it was IRS' determination after the taxpayer could make a timely election, that necessitated taxpayer's request for consent to revoke. The court noted that the taxpayer sought to capitalize on his initial misclassification by reducing taxable income that was caused by the unreported business receipts that the IRS discovered. Accordingly, the court concluded it was taxpayer's mischaracterization that precipitated the need for change.

Holding. The Tax Court held that IRS did not abuse its discretion in refusing to consent to taxpayer's request to revoke (modify) the 1995 election under I.R.C. §179.

[*Patton v. Commissioner*, 116 T.C. 206 (2001)]

Solomon v. Commissioner
[I.R.C. §179]

> ☞ **It was not necessary to determine profit motive to disallow I.R.C. §179 expense since tractor was used to maintain personal use property.**

Facts. Taxpayer, a full-time practicing neurologist, purchased 49 acres of land in 1986. Taxpayer's presumed farming activity is conducted on 6 acres. Taxpayer cultivated the 6 acres for hay and, during 1995, rented the land for $150 to a farmer who harvested the hay. The remaining acreage consisted of 39 acres of forest, 2 acres of open land, and 2 acres associated with a house that was taxpayer's residence during 1995. In 1995, **taxpayer purchased a tractor and fuel tank for use in maintaining the perimeter of his property and elected to "expense" these items under I.R.C. §179.** The IRS determined that the taxpayer was not engaged in his farming activity for profit under I.R.C. §183 and disallowed the deduction.

Issue. Whether taxpayer may expense the cost of the tractor and fuel tank used to maintain his property under I.R.C. §179.

Analysis. The court concluded that **cutting the perimeter of the property was for aesthetic, personal reasons, and whether it was cut or not had nothing to do with the farming activity.** The court cited *Dobra v. Commissioner*, 111 T.C. 339 (1998), "It is a fundamental policy of federal income tax law that a taxpayer should not be entitled to a deduction for 'personal' expenses, such as the ordinary expenses of everyday living" [I.R.C. §262(a)].

Holding. The Tax Court held that the expenses of purchasing the tractor and fuel tank were personal expenses and were not deductible.

[*Solomon v. Commissioner*, T.C. Summary Opinion (CCH) 2001-53]

FSA 200110001
[I.R.C. §167]

> ☞ **Raised floor facilitating installation of computer systems is structural component of building, not personal property.**

Facts. A business that provides computer-related services to banks **built a building with a two-foot raised floor for the installation of wiring, plumbing, and ventilation for the computers.** There is no finished floor below the raised floor, and if the raised floor were removed the building would require a major renovation, including the repositioning of all interior doors and frames and the lowering of all electrical outlets, light switches, and thermostat controls. Taxpayer identified the raised floor as personal property under I.R.C. §1245 and claimed the raised floor was 5-year property for purposes of I.R.C. §168.

Issue. Whether a raised floor installed during the initial construction of an office building to facilitate the installation of computer systems is personal property under I.R.C. §168 or a structural component of a building.

Analysis and Holding. I.R.C. §1.48-1(c) provides that buildings and other inherently permanent structures (including items which are structural components of such buildings or structures) are not tangible personal property.

Rev. Rul. 74-391, 1974-2 C.B. 9, considered a raised floor built over an existing floor to permit wiring, air-conditioning ducts, and other services for computer equipment to be installed. The ruling concluded that the raised false floor built on the existing floor was a necessary part of the installation and operation of the computer equipment, an accessory of such equipment, and not a "structural component" of the building.

In determining whether a particular item was a structural component the court looked to whether the item was incorporated in the original plan, design, and construction of the building [*Metro National Corp. v. Commissioner*, 52 T.C.M. (CCH) 1440 (1987)].

Whiteco Indus., Inc. v. Commissioner, 65 T.C. 664 (1975), set forth the following factors to ascertain whether the items were inherently permanent and, accordingly, structural components:

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

(2) Is the property designed or constructed to remain permanently in place?

(3) Are there circumstances that tend to show the expected or intended length of affixation, that is, are there circumstances which show that the property may or will be moved?

(4) How substantial a job is removal of the property and how time-consuming is it; is it readily removable?

(5) How much damage will the property sustain upon its removal?

(6) What is the manner of affixation to the land?

This field service advice is in response to a request for reconsideration of FSA 200033002 dated April 17, 2000, in which the IRS held that the floor was personal property, according to Rev. Rul. 74-391. In reconsideration of the issue, **the IRS distinguished Rev. Rul. 74-391 on the basis that the removal of the raised floor would require extensive renovations or the building would not be functional.** The IRS applied the factors of *Whiteco* and concluded the raised floor should be treated as a structural component because of its permanence.

[FSA 200110001 (September 13, 2000)]

Frontier Chevrolet Co. v. Commissioner
[I.R.C. §197]

> ☞ **Taxpayer must amortize covenant not to compete over 15 years since it occurred as part of a business acquisition transaction.**

Facts. Taxpayer is an auto dealership that sells and services new and used cars. Taxpayer was owned and operated by Roundtree Automotive Group, Inc., a firm that purchases and operates auto dealerships and provides consulting services to the dealerships. Roundtree purchased taxpayer in 1987 and filled the executive position with a long-time employee who was allowed to purchase stock in taxpayer. In 1994, when the employee owned 25% of taxpayer's stock, taxpayer redeemed the remaining stock owned by Roundtree with borrowed funds. At the same time, taxpayer entered into a noncompetition agreement with Roundtree and Roundtree's president for five years. On tax returns for 1994–1996, taxpayer amortized the noncompetition payments over 15 years. In 1999, taxpayer filed a claim for refund for 1995 and 1996 taxes, claiming the noncompetition agreements should have been amortized over the life of the agreement.

Issue. Whether a covenant not to compete is amortizable over 15 years under I.R.C. §197 or over the life of the agreement.

Analysis. I.R.C. §197(d)(1)(E) provides that a covenant not to compete entered into in connection with a direct or indirect acquisition of an interest in a trade or business is a I.R.C. §197 intangible. Under I.R.C. §197(c)(1), an "amortizable §197 intangible" is any I.R.C. §197 intangible acquired by a taxpayer after August 10, 1993, and held in connection with the conduct of a trade or business. I.R.C. §197(a) provides that the deduction is determined by amortizing the adjusted basis of the intangible ratably over a 15-year period beginning with the month in which such intangible was acquired.

Taxpayer argued that it did not acquire any interest in a trade or business; therefore, the covenant not to compete was not a I.R.C. §197 intangible and the payments should be amortized over 60 months, the life of the covenant. In disagreement, the court noted that the legislative history of I.R.C. §197 contains no evidence that it meant for a stock purchase to be excluded from acquisition because it occurred in a redemption. The court remarked that taxpayer's execution of the stock sale agreement caused it to indirectly acquire an interest, in the form of stock, in a corporation engaged in a trade or business.

Holding. The Tax Court held that the noncompetition agreement was entered into in connection with an acquisition of an interest in a trade or business and, therefore, must be amortized over 15 years pursuant to I.R.C. §197.

[*Frontier Chevrolet Co. v.* Commissioner, 116 T.C. No. 23 (May 14, 2001)]

FSA 200122002
[I.R.C. §§168, 263, and 446]

> ☞ **IRS concluded that tires and tubes that have a life of more than one year must be capitalized whether purchased for new vehicles or as replacement.**

Facts. Taxpayer purchased new vehicles without tires and contracted with tire companies to purchase the tires in bulk. **Taxpayer deducted the cost of the tires and tubes as a current expense** when the cost of the vehicles was capitalized and deducted the cost of replacement tires when replaced. The taxpayer claimed the tires and tubes were "rapidly consumable separate assets," however, the IRS claimed that the taxpayer's tires and tubes lasted several years.

Issues

Issue 1. Whether the cost of tires and tubes purchased for new vehicles must be capitalized and recovered through depreciation, or currently deductible as a business expense. If depreciable, what is the recovery period?

Issue 2. Whether the cost of tires and tubes purchased for replacement must be capitalized and recovered through depreciation, or currently deductible as a business expense. If depreciable, what is the recovery period?

Issue 3. Whether a change from currently deducting the cost of tires and tubes to capitalizing and depreciation such cost is a change in method of accounting.

Analysis and Holding

Issues 1 and 2. The IRS held that **if the tires and tubes have a useful life of more than one year whether purchased for new vehicles or as replacement, the cost must be capitalized and recovered through depreciation** using the recovery period of 5 years for general depreciation purposes under I.R.C. §168(a) or 8 years for alternative depreciation system under I.R.C. §168(g). The IRS held that if the tires and tubes do not have a useful life of more than one year, they are deductible currently as a business expense.

Issue 3. The IRS held that the change from currently deducting the cost of tires and tubes to capitalizing and depreciating such cost is a change in method of accounting under I.R.C. §446.

[FSA 200122002 (January 30, 2001)]

BAD DEBTS

Kidder v. Commissioner
[I.R.C. §§166, 6651 and 6662]

> ☞ **Taxpayers were not allowed a bad debt deduction for loan to wife's son since it was not a valid debt.**

Facts. Taxpayers made advances to the wife's son from 1987 until 1992, at which time the son filed bankruptcy. After discussion with the bankruptcy attorney, taxpayers filed a claim for the advances made to their son. **The taxpayers' CPA informed them that the advances would be tax deductible as a capital loss.** The taxpayers had significant capital gains in the year at issue and claimed the advances as a capital loss. When gathering information for their tax preparation, they made a more thorough analysis of the advances and determined that the amount was almost double the amount reported to the bankruptcy court. In 1992, the capital loss for the advances was more than the capital gain, allowing a net capital loss of $3,000, and the remaining loss was carried to the next year, in which it was used to offset other capital gains. The IRS determined that the advances were not valid debts and disallowed the deduction.

The Tax Court found that the advances were not formalized, no collateral or security was provided, and taxpayers made no written demands for repayment. During some of the period the advances were made, the son was involved in a business. The Tax Court noted that in order for taxpayers to be successful, they would have to show, among other things, a reasonable expectation, belief, and intention that taxpayers would be repaid as creditors regardless of the success of the business and that the advances were not contributions to capital put at risk in the venture. The Tax Court found that **the record generally reflected that the advances made to the son were randomly made without any apparent formality or expectation of repayment.** The documents supporting the advances indicated the payments were for personal expenses of the son, such as medical expenses and credit card bills. The Tax Court held that the circumstances did not show a bona fide debtor-creditor relationship and the taxpayers were not entitled to a bad-debt deduction under I.R.C. §166.

Issue. Whether the Tax Court erred in determining that the taxpayers failed to establish that a valid debt existed between them and the wife's son.

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Analysis. The Ninth Circuit agreed with the Tax Court's analysis.

Holding. The Court of Appeals held that the Tax Court did not err in determining that **the taxpayer failed to establish that a valid debt existed between them and the wife's son.**

[*Kidder v. Commissioner*, 2001-1 USTC (CCH) ¶50,258 (9th Cir. 2001), unpublished opinion affirming 78 T.C.M. (CCH) 602 (1999)]

J&W Fence Supply Co., Inc., v. Commissioner

[I.R.C. §7422]

> ☞ **Taxpayers were denied a bad debt deduction because advances were capital contribution.**

Facts. Taxpayers operated an accrual basis S corporation that sells building materials. In 1989, the S corporation loaned $984,000 to a supplier; however, there was no evidence of a promissory note, security, or a fixed date for repayment. The S corporation is 100% owned by the taxpayer, who also owns 49% of the supplier. In 1992, the supplier went into receivership. The S corporation filed a claim for $1.25 million, which included interest on the loan. The IRS also filed a claim for taxes owed. S corporation took a bad debt deduction of $984,000, which is the amount it determined to be worthless. The IRS audited the taxpayers' return and disallowed the deduction. The taxpayers paid the tax, claimed a refund, and then filed suit. The district court found that the taxpayer's ownership interest in the second company, the fact that the company was undercapitalized, and the lack of any loan documentation or security indicated the absence of a bona fide debt. The IRS was not collaterally estopped from challenging the validity of the debt, even though a state court had previously decided that issue in a receivership action, since the IRS lacked notice of that decision. The taxpayers then asked the district court to reopen the case and direct the IRS to recognize a capital loss deduction in 1992. The district judge declined, observing that the request came too late.

Issue

Issue 1. Whether the District Court abused its discretion in denying the taxpayers motion to reopen the case.

Issue 2. Whether the District Court erred in determining that no state judge addressed the choice between debt and equity.

Analysis and Holding

Issue 1. In concluding **there was no abuse of discretion in denying the taxpayers motion to reopen the case**, the Seventh Circuit remarked, "appellate review of decisions under Rule 60(b) is deferential, as it must be if litigants are to be induced to present their arguments before rather than after judgment [*Metlyn Realty Corp. v. Esmark, Inc.*, 763 F.2d 826 (7th Cir. 1985)].

Issue 2. Noting that taxpayers had a number of theories that could have been pursued and were not, the Seventh Circuit held that the District Court did not err in determining that no state judge addressed the choice between debt and equity.

[*J&W Fence Supply Co., Inc.*, 230 F.3d 896 (7th Cir. 2000), *aff'g* 99-1 USTC ¶50,396]

BANKRUPTCY AND INSOLVENCY

Jelle v. Commissioner

[I.R.C. §§61, 86 and 6662]

> ☞ **Recapture agreement did not preclude discharge of indebtedness income from FmHA debt forgiveness.**

Facts. Taxpayers who were dairy farmers couldn't make payments on their Farmers Home Administration (FmHA) loan. **To prevent foreclosure they agreed to buy out the mortgage at net recovery value and entered into a recapture agreement with FmHA for 10 years.** The FmHA agreed to write off 66% of the loan balances provided the land that secured the mortgages was not sold for 10 years. Taxpayers received a 1099-C, Cancellation of Debt, showing the debt cancellation income, but did not report the income on their 1996 tax return.

Issue. Whether the recapture agreement executed by taxpayers continues their obligation to FmHA in a manner such that there was no discharge of indebtedness within the meaning of the Internal Revenue Code in 1996.

Analysis. Under I.R.C. §61(a)(12) specifically includes "income from discharge of indebtedness" in the definition of gross income. The underlying rationale for such inclusion is that to the extent a taxpayer is released from indebtedness, he or she realizes an accession to income due to the freeing of assets previously offset by the liability [*United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931)].

The **taxpayers argued that their transaction with FmHA merely generated an agreement to cancel their debt at a future time.** The IRS argued that the transaction involved a present cancellation with a contingent future obligation to repay. If there is only an agreement to cancel prospectively, the debt is not discharged until the specified conditions are satisfied [*Walker v. Commissioner,* 88 F.2d 170 (5th Cir. 1937), *aff'g White v. Commissioner,* 34 B.T.A. 424 (1936)]. However, if an arrangement effects a present cancellation of one liability but imposes a replacement obligation, the mere chance of some future repayment does not delay income recognition where the replacement liability is highly contingent or of a fundamentally different nature [*Carolina, Clinchfield & Ohio Ry. v. Commissioner,* 82 T.C. 888 (1984), affirmed. 823 F.2d 33 (2nd Cir. 1987)].

The court concluded that whether and when the taxpayers will ever be required to make any further payments to FmHA rested totally within their own control. Citing the rationale of *United States v. Kirby Lumber Co*., the court noted the recapture agreement leaves taxpayers in complete control of their assets and free to arrange their affairs so that none of their property's value need ever be delivered to FmHA. The court also concluded that 85% of the taxpayers' social security income was taxable, and since the taxpayers did not show that their failure to report the cancellation of debt income was due to reasonable cause, the court sustained the accuracy-related penalties under I.R.C. §6662.

Holding. The Tax Court held that taxpayers received discharge of indebtedness income in 1996 when FmHA wrote off the taxpayers' outstanding loan obligation.

[*Jelle v. Commissioner*, 116 T.C. 63 (2001)]

Carlson v. Commissioner

[I.R.C. §§108 and 6662]

> ☞ **Assets exempt under state law must be included in calculation of insolvency to determine discharge of indebtedness income.**

Facts. In 1982, taxpayers borrowed money from the bank to purchase a fishing vessel, granting the bank a preferred marine mortgage interest in the vessel. In 1992, taxpayers became delinquent on the loan, and the bank foreclosed in 1993. **The proceeds from the sale were used to reduce the principal balance of the loan, and the bank discharged the remaining balance.** As a result of the sale, taxpayers realized capital gain and discharge of indebtedness (DOI) income, neither of which was reported on the taxpayers' return. The taxpayers attached a copy of the 1099-A, Acquisition of Abandonment of Secured Property with a written note that stated "Taxpayer Was Insolvent—No Tax Consequence" to their 1993 tax return.

The IRS issued a deficiency notice that included the DOI income and the capital gain in the taxpayers' 1993 income, and imposed an accuracy-related penalty under I.R.C. §6662.

Issues

Issue 1. Whether taxpayers are entitled to exclude from gross income under I.R.C. §108(a)(1)(B) discharge of indebtedness (DOI) income.

Issue 2. Whether taxpayers are liable for the accuracy-related penalty under I.R.C. §6662(a).

Analysis. I.R.C. §61(a)(12) specifically includes "income from discharge of indebtedness" in the definition of gross income. I.R.C. §108(a)(1)(B) provides an exception to I.R.C. §61(a)(12) when the taxpayer is insolvent. I.R.C. §108(a)(3) provides that the DOI income excluded is not to exceed the amount by which the taxpayer is insolvent. I.R.C. §108(d)(3) defines "insolvent" as the excess of liabilities over the fair market value of assets determined immediately before the discharge. **The taxpayers argued that the term "assets" in I.R.C. §108(d)(3) does not include assets exempt from the claims of creditors under state law.** Included in the taxpayers' assets immediately before the foreclosure was a fishing permit with a fair market value of $393,400, which was exempt from the claims of creditors under state law. If the fishing permit were not included in the taxpayers' assets, the taxpayers would be insolvent under I.R.C. §108(d)(3) and the DOI income would be excluded.

In support of their argument, the taxpayers cited *Cole v. Commissioner*, 42 B.T.A. 220 (1940), in which the value of life insurance policies was excluded from "assets" because the policies were free from creditors' claims under state law. The court rejected the taxpayers' argument, remarking that when Congress enacted the insolvency exception it also enacted I.R.C. 108(e)(1) which provides that for purposes of the Code (including I.R.C. §61 (a)(12), "there shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness" except as provided in I.R.C. §108(a)(1)(B). Citing *Gitlitz v. Commisioner*, 531 U.S. 69 (2001), **the court noted that the Supreme Court recently stated, "I.R.C. §108(e) precludes us from relying on any understanding of the judicial insolvency exception that was not codified in I.R.C. §108.**"

The court concluded I.R.C. §108(e)(1) precludes the application of *Cole v. Commissioner* and any other

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judicially developed insolvency exception to the general rule of I.R.C. §61(a)(12) that gross income includes income from DOI.

The court noted that the IRS conceded that the accuracy-related penalty should not be imposed on the taxpayers related to the DOI income since it was adequately disclosed on the return. However, the court sustained the penalties on the capital gain since the taxpayers failed to disclose the capital gain and had no reasonable basis for omitting it.

Holding

Issue 1. The Tax Court held that taxpayers are not entitled to exclude from gross income under I.R.C. §108(a)(1)(B) discharge of indebtedness (DOI) income.

Issue 2. The Tax Court held that taxpayers are liable for the accuracy-related penalty under I.R.C. §6662(a) for the portion related to the capital gain.

[*Carlson v. Commissioner,* 116 T.C. 87 (2001)]

Notice 2001-8

[I.R.C. §§6050P, 6721, and 6722]

> ☞ **Penalties will be suspended for certain organizations that are recently required to file 1099's for debt discharge income.**

Purpose. This notice extends the suspension of penalties under I.R.C. §§6721 and 6722 provided by Notice 2000-22, 2000-16 I.R.B. 902, for certain organizations newly subject to I.R.C. §6050P [that is, those organizations of which a significant trade or business is the lending of money and that are not otherwise described in I.R.C. §6050P(c)(1) or (2)]. Under this notice, **penalties will not be imposed on such an organization for failure to file information returns under I.R.C. §6050P for any discharge of indebtedness that occurs prior to the first calendar year beginning at least two months after the date that appropriate guidance is issued.**

Background. Generally, I.R.C. §6050P(a) requires applicable entities to file returns with the IRS, and to provide statements to payees, setting forth certain information regarding discharges of indebtedness of $600 or more. I.R.C. §§6721 and 6722 impose penalties for failure to file correct information returns or to provide correct payee statements, respectively.

I.R.C. §533(a) of the Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. No. 106-170, 113 Stat. 1860 (1999) ("the Act"), amended I.R.C. §6050P by expanding the types of entities that are required to report discharges of indebtedness to include any organization of which a significant trade or business is the lending of money. The Act was made effective for discharges of indebtedness occurring after December 31, 1999. Notice 2000-22 suspended penalties for failures to file information returns or to furnish payee statements for discharges of indebtedness by these newly included organizations occurring prior to January 1, 2001.

Penalty Suspension. The IRS will not impose penalties on these newly included organizations for failure to comply with the requirements of §6050P for discharges of indebtedness occurring prior to the first calendar year beginning at least two months after the date that appropriate guidance is issued.

[Notice 2001-8, 2001-4 I.R.B. 374]

BUSINESS EXPENSES

Catalano v. Commissioner

[I.R.C. §§1366, 111, 1311, and 6662]

> ☞ **S corporation could not deduct boat lease payments made to its 100% shareholder, but shareholder must include rental income.**

Facts. Taxpayer, an attorney, leased boats to his wholly owned S corporation. Taxpayer used the boats on weekends, often inviting clients and their spouses. Although business discussions took place on board, taxpayer and his guests also used the TV and stereo and had refreshments. Taxpayer reported the lease payments as rental income on his personal return and deducted the lease payments on the S corporation return. The IRS disallowed the deductions on the S corporation return. The Tax Court held that the S corporation could not deduct the boat lease payments because I.R.C. §274 prohibits deductions otherwise allowable for expenses paid with respect to a facility used in connection with an activity generally considered to constitute entertainment, amusement, or recreation. **The Tax Court remarked that, objectively, taxpayer's boats constitute entertainment facilities and, therefore, the related expenses are not deductible.** The Tax Court rejected the taxpayer's argument that if the corporation is not allowed to deduct the boat lease payments, the court should accord him some relief because, as a result of the disallowance, he is being taxed twice on the same income. The Tax Court assessed an accuracy-related penalty because his treatment of the boat lease expenses for his legal practice indicated disregard for the law.

Issues

Issue 1. Whether the disallowance of the S corporation deduction for lease payments should result in an offsetting adjustment to reduce the shareholder's rental income reported on his individual return.

Issue 2. Whether the taxpayer is liable for the accuracy-related penalty under I.R.C. §6662.

Analysis. The Ninth Circuit noted that **there is a fundamental principle that an S corporation is a separate entity from its shareholders**. The Ninth Circuit rejected the taxpayer's attempt to invoke the tax benefit rule and the doctrine of equitable recoupment, stating that neither applied to this situation. The Ninth Circuit also rejected the taxpayer's arguments against the negligence penalty, that this was an issue of first impression and that taxpayer relied on the advice of his accountant. The Ninth Circuit noted that the nondeductability of boats as entertainment facilities was a settled issue during the years at issue and that the taxpayer provided no evidence suggesting the nature of any advice that was given.

Holding. In affirming the Tax Court's decision, the Ninth Circuit held **that the taxpayer was not allowed an offsetting adjustment to reduce the shareholder's rental income**. Also, the Ninth Circuit affirmed the Tax Court's imposition of the accuracy-related penalty.

[*Catalano v. Commissioner*, 240 F3d 842 (9th Cir. 2001) *aff'g* 76 T.C.M. (CCH) 1029 (1998)]

Baratelle v. Commissioner

[I.R.C. §§162, 179, 274 and 6662]

☞ **Taxpayer was denied deductions and imposed an accuracy-related penalty for failure to substantiate expenses.**

Facts. Taxpayer, a manufacturing consultant, deducted business expenses on his Schedule C (Form 1040) for 1994. The IRS audited the return and disallowed all of the taxpayer's deductions for failure to substantiate. At trial, the IRS conceded some of the deductions, leaving advertising, automobile, depreciation and I.R.C. §179, travel, meals and entertainment, and wages in dispute.

Issues

Issue 1. Whether taxpayer may deduct Schedule C (Form 1040), Profit or Loss From Business, expenses in excess of those conceded by the IRS.

Issue 2. Whether taxpayer is liable for the accuracy-related penalty

Analysis. A taxpayer is permitted to deduct the ordinary and necessary expenses that he pays or incurs during the taxable year in carrying on a trade or business under I.R.C.§162(a). However, I.R.C. §6001 and Treas. Reg. §1.6001-1(a) requires **that a taxpayer maintain records sufficient to establish the amount of his deductions**. When a taxpayer establishes that he paid or incurred a deductible expense but does not establish the amount of the deduction, the amount allowable may be estimated in some circumstances [*Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930)]. **There must be sufficient evidence in the record to permit the court to conclude that a deductible expense was paid or incurred in at least the amount allowed** [*Williams v. United States,* 245 F.2d 559 (5th Cir. 1957)]. For certain kinds of business expenses, such as travel, meal, and entertainment expenses, and those expenses attributable to "listed property," I.R.C. §274(d) overrides the *Cohan* rule [Treas. Reg. §1.274-5T(a)]. Listed property includes any passenger automobile and any other property used as a means of transportation, under I.R.C. §280F(d)(4)(A)(i) and (ii), unless excepted by I.R.C. §280F(d)(4)(C) or (d)(5)(B).

Under I.R.C. §274(d), a taxpayer must satisfy strict substantiation requirements before a deduction is allowable [I.R.C. §274(d); I.R.C. §6001; and Treas. Reg. §1.6001-1(a), (e)]. If I.R.C. §274(d) applies, the *Cohan* doctrine may not be used to estimate those expenses covered by that section.

The court reviewed each disputed expense category. **The court found that the taxpayer failed to substantiate his business use of a television and VCR.** The court held that the taxpayer could not deduct the costs of boarding his dog, traffic tickets and towing, and unsubstantiated airfares, hotel stays, meals, golf, and wage expenses.

Holding

Issue 1. The Tax Court sustained the IRS's adjustment to the taxpayer's expenses.

Issue 2. The Tax Court held that the taxpayer was liable for the accuracy-related penalty since he failed to maintain adequate records to substantiate his deductions and could not offer any evidence to explain this failure.

[*Baratelle v. Commissioner*, 80 T.C.M. (CCH) 737 (2000)]

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Illinois Tool Works, Inc., v. Commissioner
[I.R.C. §§162 and 263]

> ☞ **Corporation must capitalize payment of assumed liability for potential patent infringement.**

Facts. A taxpayer purchased a company that was a defendant in a patent infringement lawsuit prior to the purchase. After evaluating the likelihood that the company would suffer substantial losses as a result of the lawsuit, the taxpayer and target corporation concluded that exposure was nominal. They decided that a reserve of $350,000, previously established by the target corporation, would be adequate to cover any future expenses related to the lawsuit. However, the jury awarded the plaintiff in the case $4.6 million for patent infringement and $6.2 million in prejudgment interest. The District Court doubled the damage award since the jury found willful infringement. After all appeals were exhausted, the final amount paid in judgment by the taxpayer was $17 million.

The taxpayer capitalized $1 million in his tax return and deducted the remaining $16 million. On audit, the IRS allowed a deduction for $2 million for post-acquisition interest expense, and a reduction of $7 million for disposal of acquisition assets. The IRS determined that $7 million should be capitalized as a cost of acquisition.

Issue. Whether the $7 million should be capitalized as a cost of acquisition or deducted as a business expense.

Analysis. Relying on *Nahey v. Commissioner*, 196 F.2d 866 (7th Cir. 1999) *aff'g* 111 T.C. 256 (1998), **the taxpayer claimed the damage award should be a deductible as an ordinary business expense since it was payment in satisfaction of an assumed liability, which would have been a deductible expense if it had been paid by the acquired corporation**.

The IRS argued that *David R. Webb Co. v. Commissioner*, 708 F.2d 1254 (7th Cir. 1983), *aff'g* 77 T.C. 1134 (1981) was controlling. In *Webb*, the 7th Circuit dismissed the taxpayer's argument that a contingent liability that was insusceptible of present valuation at the time of the acquisition could not be capitalized as a cost of acquisition, holding that **when the actual amount of the contingent liability is known, the amount can be added to the cost basis of the purchased property.**

Agreeing with the IRS, the Tax Court concluded that since the possibility of the lawsuit was considered by the parties in settling the purchase price, the suit was a contingent liability that the taxpayer assumed.

Holding. The Tax Court held that the $7 million should be capitalized as a cost of acquisition of the acquired company.

[*Illinois Tool Works, Inc., v. Commissioner*, 117 T.C. No. 4 (2001)]

LTR 200121070
[I.R.C. §280A(c)(6)]

> ☞ **Taxpayer that rents home to employer to perform services may only deduct mortgage interest, real estate taxes, and casualty losses.**

Facts. The employer is an S corporation of which the employee is the sole shareholder and sole employee. **The employee rented a portion of his home to the S corporation.** During the period of the rental **the individual used the rented portion in performing services as an employee**. The individual also used the dwelling unit as a principal residence.

Issue. How should an individual who rents a portion of his dwelling unit to his employer and who uses the dwelling unit in performing services as an employee of that employer treat the expenses attributable to the rental of the dwelling unit?

Analysis. I.R.C. §280A(c)(6), Treatment of rental to employer, provides that I.R.C. §280A(c)(1) and (c)(3), which provides **a deduction for home office expenses, does "not apply to any item which is attributable to the rental of the dwelling unit** (or **any portion thereof**) **by the individual to his employer** during any period in which the individual uses the dwelling unit (or portion) in performing services as an employee of the employer."

The individual falls directly within I.R.C. §280A(c)(6), because the individual is both renting to his employer and using the rented portion of his dwelling unit to perform services as an employee for the employer. Accordingly, I.R.C. §280A(c)(6) will bar taxpayer from deducting otherwise allowable I.R.C. §162 trade or business expenses, I.R.C. §165(c)(1) business casualty losses, and I.R.C. §167 depreciation.

Holding. The individual described above may deduct home mortgage interest, real property taxes, and personal casualty losses to the extent permitted by I.R.C. §§163, 164, and 165(c)(3) and (h). However, the individual may not deduct otherwise allowable trade or business expenses under I.R.C. §162, business casualty losses under §165(c)(1), or depreciation under I.R.C. §167, to the extent those expenses and losses are attributable to the use by the employee of the dwelling unit in performing services for the employer.

[LTR 200121070 (May 30, 2001)]

Mullin v. Commissioner

[I.R.C. §§162, 163, and 280A]

> ☞ **Psychologist cannot deduct home office expenses or student loan interest as trade or business expenses.**

Facts. Taxpayer is a psychologist who was employed by a clinic 7:00 A.M. to 3:00 P.M. Monday through Friday and operates a private practice in the afternoons in a separate rented office. **She deducted home office expenses for one-fourth of her small, 400-square-foot apartment**. Taxpayer claimed that she used the apartment to schedule private-practice appointments by telephone, store her business records, and read professional materials. However, she did not meet with any patients at the apartment. She also **deducted interest paid on the student loans she used to finance her doctorate degree**. She argued that the interest was paid in connection with educational expenses that were deductible as trade or business expenses under I.R.C. §163. These expenses were payments she made for personal therapy that she was required to take as a doctoral candidate. The IRS disallowed the home office expenses and student loan interest.

Issues

Issue 1. Whether taxpayer is entitled to trade or business expense deductions for home office expenses.

Issue 2. Whether taxpayer is entitled to trade or business expense deductions for interest paid on student loans.

Analysis

Issue 1. I.R.C. §280A(a) permit a home office deduction if a portion of the residence is "exclusively used on a regular basis" as either "the principal place of business for any trade or business of the taxpayer," or "as a place of business which is used by patients . . . in meeting or dealing with the taxpayer in the normal course of his trade or business." **The court failed to see how any portion of it could have been used "exclusively" for business purposes given the size and layout of the apartment, since area used for business purposes was also the main passageway**. The court also doubted whether taxpayer's apartment would qualify as the principal place of her private practice under *Commissioner v. Soliman*, 506 U.S. 168 (1993).

Issue 2. I.R.C. §163(a) allows a deduction for interest; however, I.R.C. §163(h) provides that personal interest is not deductible. I.R.C. §163(h)(2)(A) specifies "interest paid or accrued on indebtedness properly allocable to a trade or business (other than a trade or business of performing services as an employee)" is not personal interest. The deductibility as a business expense of interest on a loan obtained for educational expenses depends on whether the educational expenses are deductible. [*Holmes v. Commissioner*, 66 T.C.M. (CCH) 516 (1993)]. The court concluded that the taxpayer had not established that the expenses she incurred in earning her Ph.D. were deductible business expenses.

Holding

Issue 1. The Tax Court held that taxpayer was not entitled to deduct the home office expenses.

Issue 2. The Tax Court held that taxpayer was not entitled to deduct as a trade or business expense any portion of the interest paid on her outstanding student loans.

[*Mullin v. Commissioner*, 81 T.C.M. (CCH) 1655 (2001)]

Fields v. Commissioner

[I.R.C. §162]

> ☞ **Golf instructor could not deduct golf degree as educational expenses since business courses prepared him for new job.**

Facts. Taxpayer worked full time in construction and was self-employed as a golf instructor and worked at golf courses in the pro shops. In 1994, taxpayer enrolled in a golf academy and, in April 1995, was awarded a specialized associate degree in business. On his Schedule C (Form 1040) for 1995, taxpayer **listed "golf instructor" as his principal business or profession and deducted the tuition costs and related expenses as education expenses**. The IRS determined that the taxpayer failed to establish that the education expenses were "ordinary and necessary" business expenses and disallowed the deductions.

Issue. Whether the taxpayer is entitled to deduct education expenses incurred in earning an associates degree as trade or business expenses.

Analysis. In general, I.R.C. §162(a) allows a deduction for all ordinary and necessary expenses incurred in carrying on a trade or business. Expenditures made by an individual for education that maintains or improves the skills required by the individual in the individual's trade or business are deductible as ordinary and necessary business expenses under Treas. Reg. §1.162-5(a). No deduction is allowed, however, if the education expenses will qualify the individual in a new trade or business [Treas. Reg. §1.162-5(b)(3)].

The court noted that some of the courses that taxpayer took while attending the academy no doubt maintained or improved his skills as a golf instructor, but other courses were directed more to a general business education, citing *Kersey v. Commissioner*, 66 T.C.M. (CCH) 1863 (1993), which cited *Glenn v. Commissioner*, 62 T.C. 270 (1974), *aff'd without published opinion,* 50 F.3d 15 (9th Cir. 1995), "If the education qualifies the taxpayer to perform significantly different tasks and activities than could be performed prior to the education, the education qualifies the taxpayer for a new trade or business."

Holding. The Tax Court held that the education expenses were incurred in the course of study that would lead to qualifying taxpayer, who held no prior undergraduate degrees, in trades or businesses other than as a golf instructor and, therefore, the education expenses were not deductible.

[*Fields v. Commissioner*, T.C. Summary Opinion 2001-35 (2001)]

Test v. Commissioner
[I.R.C. §§67, 162, and 6662]

> ☞ **Physician's legal fees were Schedule A miscellaneous itemized deductions, not Schedule C business expenses.**

Facts. Taxpayer wife is a physician who worked for the University of California, San Francisco (UCSF) as director of their Center for Prehospital Research and Training (CPRT). While working at UCSF, taxpayer created a private-sector emergency response program known as Save-A-Life Systems (SLS). Later, when a state audit of UCSF's medical department, including CPRT, generated adverse publicity, taxpayer consulted attorneys because the publicity might hurt her professional reputation. Taxpayer retained another law firm later to perform legal services related to the state audit and her criminal prosecution for wrongdoing associated with CPRT. **Taxpayer deducted legal expenses in the amount of $87,300 on her Schedule C (Form 1040) in 1994**. The taxpayers have conceded that only $70,611 of the legal expenses was substantiated; of the substantiated expenses, $6,198.64 was expended for services in connection with SLS. The IRS determined that $70,600 of the fees was deductible as employee business expenses on Schedule A as miscellaneous itemized deductions. The IRS also imposed an accuracy-related penalty under I.R.C. §6662(a).

Issues

Issue 1. Whether legal fees in the substantiated amount of $64,412.36 and/or $6,198.64 of expenses in connection with SLS are deductible on taxpayer's Schedule C (Form 1040) as ordinary and necessary business expenses or whether they are deductible on taxpayers' Schedule A (Form 1040) as unreimbursed employee business expenses subject to the 2% of adjusted gross income floor and the alternative minimum tax.

Issue 2. Whether taxpayers are liable for an accuracy-related penalty under I.R.C. §6662(a).

Analysis

Issue 1. Ordinary and necessary legal expenses are generally deductible under I.R.C. §162(a) when the matter giving rise to the expenses arises from, or is proximately related to, a business activity [*Kornhauser v. United States*, 276 U.S. 145 (1928)]. If a taxpayer's trade or business is that of being an employee, however, then the legal expenses will be treated as an itemized deduction, subject to the limitation of I.R.C. §67. [*McKay v. Commissioner*, 102 T.C. 465 (1994) *rev'd on other grounds,* 84 F.3d 433 (5th Cir. 1996)] **The deductibility of legal fees depends on the origin and character of the claim for which the expenses were incurred and whether the claim bears a sufficient nexus to the taxpayer's business or income-producing activities** [*United States v. Gilmore,* 372 U.S. 39 (1963)]. The court concluded that in order for taxpayer's legal fees to be deductible on her Schedule C (Form 1040), the origin of those legal services must have been rooted in SLS, her Schedule C business. **The court found that the claim or event that prompted taxpayer to incur legal fees did not arise in connection with taxpayer's Schedule C trade or business.**

Issue 2. Taxpayers can avoid liability for the accuracy-related penalty if they engage a competent professional to prepare their returns, and they reasonably rely on the advice of that professional. See *Freytag v.*

Commissioner, 89 T.C. 849, 888 (1987), *aff'd,* 904 F.2d 1011, 1017 (5th Cir. 1990), *aff'd,* 501 U.S. 868 (1991). Taxpayers must show that they provided all relevant information to the professional. See *Pessin v. Commissioner*, 59 T.C. 473, 489 (1972).

The taxpayer engaged the same CPA to prepare her tax returns for the past 15 years. The CPA questioned her about the legal and professional fees because he wanted to understand what services the attorneys were performing.

Holding

Issue 1. The Tax Court held that the legal fees in the amount of $64,412.36 were deductible as unreimbursed employee business expenses on Schedule A and the $6,198.64 expended for services in connection with SLS were deductible on Schedule C (Form 1040).

Issue 2. The Tax Court found that taxpayers proved that their actions with respect to characterizing the legal fees as Schedule C deductions were reasonable; therefore, the court held that the taxpayers were not subject to the I.R.C. §6662(a) accuracy-related penalty on the substantiated legal expenses. However, they were subject to the penalty on the unsubstantiated legal expenses.

[*Test v. Commissioner*, 80 T.C.M. (CCH) 766 (2000)]

Vaksman v. Commissioner
[I.R.C. §§162, 274, 280A, and 280F]

> ☞ **Russian translator was not allowed to deduct expenses for automobile depreciation, cellular telephone use, education and home office use.**

Facts. Taxpayer completed contract Russian translation services early in the tax year and provided no other translation services during the remainder of the year. Taxpayer claimed expense deductions on his Schedule C (Form 1040) for automobile depreciation, cellular telephone use, education, and business use of his home through the end of the tax year. Taxpayer was enrolled in a doctoral program in history and the education expenses were for tuition for dissertation hours. The IRS claimed the taxpayer failed to substantiate the expenses and disallowed them.

Issues

Issue 1. Whether taxpayer was entitled to a deduction for depreciation on his automobile.

Issue 2. Whether taxpayer was entitled to a deduction for cellular telephone expenses.

Issue 3. Whether taxpayer was entitled to a deduction for educational expense.

Issue 4. Whether taxpayer was entitled to a deduction, in excess of the amount allowed by IRS in the notice of deficiency, for business use of home.

Analysis and Holding

Issue 1. The court noted that under I.R.C. §274(d)(4), no deduction is allowed with respect to listed property, which is defined to include a passenger automobile in I.R.C. §280F(d)(4)(A)(i). The taxpayer must substantiate a deduction for listed property by adequate records, or by sufficient evidence corroborating the taxpayer's own statement, showing, (1) the amount of such expense or other item; (2) the time and place of the use of the property; and (3) the business purpose of the expense or other item [I.R.C. 274(d); Treas. Reg. 1.274-5T(b)(6) and (c)]. The taxpayer had no such records. The Tax Court held that **taxpayer was not entitled to a deduction for depreciation on his automobile.**

Issue 2. The court noted that a cellular phone is classified as listed property under I.R.C. §280F(d)(4)(A)(v). No documentary evidence was provided by taxpayer. The Tax Court held that **taxpayer was not entitled to a deduction for cellular telephone expenses**.

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Issue 3. The court concluded that the taxpayer failed to demonstrate that there was a proximate and direct relationship between the education expenses incurred in pursuing the doctorate in history and his job skills as a Russian translator. The Tax Court held that taxpayer was not entitled to a deduction for educational expense.

Issue 4. The taxpayer claimed that he used 80% of his one-bedroom apartment for business. The **IRS allowed a deduction of 25% of the apartment rent**. The Tax Court held that taxpayer was not entitled to a deduction, in excess of the amount allowed by IRS in the notice of deficiency, for business use of home.

[*Vaksman v. Commissioner,* T.C. Memo 2001-165 (2001)]

Haeder v. Commissioner
[I.R.C. §§61, 74, 162, 166, 274, 408, 6651, and 6662]

> ☞ **Attorney failed to show that his wife provided services as an employee.**

Facts. Taxpayer, a sole-proprietor attorney, deducted **wages that he claimed were paid to his wife for services performed for his legal practice and**

amounts for a medical reimbursement plan on his Schedule C (Form 1040). The amounts deducted as wages were transferred into wife's IRA account and deducted as IRA contributions on taxpayers' jointly filed tax returns. The IRS disallowed the wage deductions, IRA contributions, medical plan expenses, legal and professional fees, travel, entertainment, bad debt deduction, and repairs to an Oriental rug. The IRS also determined that the taxpayers failed to report prize income and additional business income, but the taxpayers overstated their dividend income. The IRS imposed penalties for failure to file and understatement of taxes.

Issue

Issue 1. Whether taxpayer wife was an employee of taxpayer husband's attorney practice, which would allow deductions for wages, medical plan expenses, and IRA contributions.

Issue 2. Whether taxpayers were allowed deductions for legal and professional fees, travel and entertainment expenses, bad debt, and repairs to Oriental rug.

Issue 3. Whether taxpayers were subject to the failure to timely file penalty under I.R.C. §6651 and the accuracy-related penalties for negligence and substantial understatement of taxes under I.R.C. §6662.

Analysis and Holding

Issue 1. According to Treas. Reg. 1.162-7(a), salaries are deductible only if reasonable in amount and paid or incurred for services actually rendered. The court pointed out that, where a family relationship is involved, close scrutiny is applied to determine whether a bona fide employer-employee relationship exists and whether the payments received were made on account of the employer-employee relationship or the family relationship [*Denman v. Commissioner*, 48 T.C. 439 (1967)]. The court concluded that taxpayers failed to show that wife provided services as an employee since they provided no documentary evidence of the work performed, Forms W-2 were not issued in four of the five years at issue, and the payments were transferred directly to the IRA account. The court found that the taxpayers determined the purported salary on the basis of the maximum IRA deduction and claimed the employee relationship to enable them to deduct personal medical and dental expenses as business expenses and make deductible IRA contributions. Therefore, the Tax Court held that **taxpayer wife was not an employee of taxpayer husband's attorney practice**, which would not allow deductions for wages, medical plan expenses, and IRA contributions.

Issue 2. The court concluded that the taxpayers failed to substantiate the legal and professional fees for the law practice as required under I.R.C. §162 and failed to satisfy the substantiation requirements of I.R.C. §274(d) for travel, meal, and entertainment expenses. The court disallowed the bad debt deduction since the taxpayers failed to show that the debt arose from a true debtor-creditor relationship. The court found that the taxpayers failed to substantiate the rug repair cost or to show it was an ordinary and necessary business expense under I.R.C. §162. Therefore, the Tax Court held that **taxpayers were not allowed deductions for legal and professional fees, travel and entertainment expenses, bad debt, and repairs to Oriental rug**.

Issue 3. The Tax Court held that taxpayers were subject to the failure to timely file penalty under I.R.C. §6651 and the accuracy-related penalties for negligence and substantial understatement of taxes under I.R.C. §6662.

[*Haeder v. Commissioner*, 81 T.C.M. (CCH) 987 (2001)]

See also *James A. Poyda, et ux. v. Commissioner* (T.C. Summary Opinion 2001-91) for a similar result. In this case, medical insurance premiums were disallowed for a Schedule F farm activity because the compensation (including medical insurance) paid to the spouse was not commensurate with duties actually performed.

CAPITAL GAINS

Gladden v. Commissioner
[I.R.C. §§1016, 1221, and 1231]

> ☞ **Taxpayers** were entitled to apportion some of their cost basis in land to the sale of later acquired water rights appurtenant to the land.

Facts. In 1964, the Harquahala Valley Irrigation District (HID) was formed to acquire water rights and distribute irrigation water to the area. In 1968, Congress authorized a project to bring water from the Colorado River to, among other places, the Harquahala Valley. In 1976, a partnership, of which the taxpayers owned 50%, bought farmland in the Harquahala Valley. In 1983, HID was allocated rights to redistribute water and the taxpayers' partnership was eligible to receive a quantity of water each year. At that time, the landowners could sell the water rights, but only as part of a sale of their land. In 1993, under an arrangement between HID and the government, **the taxpayers received $543,566 in exchange for their water rights**.

The taxpayers reported the transaction as a capital gain, and offset the gain by a portion of the original purchase price for the land that they claimed was paid for the expectation of water rights. The IRS determined that the taxpayers' share of the sale of the water rights was ordinary income with no offset for any price paid for an expectancy of water rights. The Tax Court agreed with the taxpayers on the type of gain, ruling that the transaction was a sale that resulted in a capital gain. However, the Tax Court agreed with the IRS that the taxpayers could not apply any of their tax basis in the land to the sale of water rights because the partnership had purchased the land before acquiring those rights.

Issue. Can any of the cost basis in the land be allocated to water rights that were expected but not legally vested at the time of the land purchase?

Analysis. The 9th Circuit noted that the Tax Court's rule would produce odd economic circumstances, **causing land purchased at a premium based on the expectation of a future water right to have an artificially high basis, and the water rights to have an artificially nonexistent basis.** Further, the 9th Circuit found the Tax Court's rule in conflict with existing precedent set in *Piper v. Commissioner*, 5 T.C. 1104 (1945), in which the taxpayer was allowed to allocate basis to stock warrants even though they could not be exercised to immediate financial advantage at the time they were issued.

In Rev. Rul. 86-24, 1986-1 C.B. 80, the IRS ruled that a farmer was required to allocate the purchase price of cows that had been impregnated with transplanted embryos between the cows and the embryos. Under Rev. Rul. 86-24, the farmer's basis in the calves was the premium he paid for the cows based on his expectation that they would give birth.

Holding. The Court of Appeals of the 9th Circuit reversed the Tax Court's ruling, holding that the taxpayers could apply some portion of the cost basis of the partnership's land purchase to the sale of its water rights. However, the 9th Circuit remanded the case to the Tax Court for a determination of the premium paid by the partnership for the expectation of future water rights.

[*Gladden v. Commissioner,* 2001-2 USTC ¶50,597 (9th Cir. 2001) *rev'g* and *rem'g* 112 T.C. 209 (1999)]

T.D. 8902

[I.R.C. §§1, 741, and 1223]

> ☞ **Final regulations provide maximum capital gains tax rate and holding period applied to sales of interests in pass-through entities.**

This document contains **final regulations relating to sales or exchanges of interests in partnerships, S corporations, and trusts**. The regulations interpret the look-through provisions of I.R.C. §1(h), added by I.R.C. §311 of the Taxpayer Relief Act of 1997 and amended by I.R.C. §§5001 and 6005(d) of the Internal Revenue Service Restructuring and Reform Act of 1998, and explain the rules relating to the division of the holding period of a partnership interest. The regulations affect partnerships, partners, S corporations, S corporation shareholders, trusts, and trust beneficiaries.

Explanation

Look-through Capital Gain. I.R.C. §1(h) provides maximum capital gains rates in three categories: 20% rate gain, 25% rate gain, and 28% rate gain. Twenty percent rate gain is net capital gain from the sale or exchange of capital assets held for more than one year, reduced by the sum of 25% rate gain and 28% rate gain. Twenty-five percent rate gain is limited to unrecaptured I.R.C. §1250 gain. Twenty-eight percent rate gain includes capital gains and losses from the sale or exchange of collectibles (as defined in I.R.C. §408(m) without regard to I.R.C. §408(m)(3)) held for more than one year and certain other types of gain.

Capital gain attributable to the sale or exchange of an interest in a pass-through entity held for more than one year generally is in the 20% rate gain category. However, the proposed regulations provide that, **when a taxpayer sells or exchanges an interest in a partnership, S corporation, or trust that holds collectibles, rules similar to the rules under I.R.C. §751(a) apply to determine the capital gain that is attributable to certain unrealized gain in the collectibles**. Furthermore, under the proposed regulations, rules similar to the rules under I.R.C. §751(a) also apply to determine the capital gain attributable to certain unrealized gain in I.R.C. §1250 property held by a partnership when a taxpayer sells or exchanges an interest in a partnership that holds such property.

Determination of Holding Period in a Partnership. The proposed regulations provide rules relating to the allocation of a divided holding period with respect to an interest in a partnership. These rules generally provide that **the holding period of a partnership interest will be divided if a partner acquires portions of an interest at different times or if an**

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interest is acquired in a single transaction that gives rise to different holding periods under I.R.C. §1223. Under the proposed regulations, the holding period of a portion of a partnership interest generally is determined based on a fraction that is equal to the fair market value of the portion of the partnership interest to which the holding period relates (determined immediately after the acquisition) over the fair market value of the entire partnership interest.

Under the proposed regulations, a selling partner generally cannot identify and use the actual holding period for a portion of the partner's interest. However, the proposed regulations provide that **a selling partner is permitted to identify the portion of a partnership interest sold with its holding period if the partnership is a publicly traded partnership** (as defined under I.R.C. §7704(b)), the partnership interest is divided into identifiable units with ascertainable holding periods, and the selling partner can identify the portion of the interest transferred.

Effective Date. These regulations are **effective September 21, 2000**.
[T.D. 8902, 2000-41 I.R.B. 323 (October 10, 2000)]

Prop. Reg. §§1.1221-2 and 1.1256(e)-1
[I.R.C. §§1221 and 1256]

> ☞ **The IRS has issued proposed regulations on the treatment of hedging transactions.**

The IRS has issued proposed regulations to conform existing final regulations to changes made to I.R.C. §1221 by the Ticket to Work and Work Incentives Improvement Act of 1999, P.L.106-170.

Background. Amended I.R.C. §1221 provides ordinary gain or loss treatment for hedging transactions that are clearly identified as such before the close of the day on which they were acquired, originated, or entered into.

Explanation. Under the proposed regulations, property that is part of a hedging transaction would not qualify as a capital asset. **When a short sale or option is part of a hedging transaction, any gain or loss would be ordinary**. If a transaction is not a hedging transaction under these regulations, gain or loss is not made ordinary on the grounds that property involved in the transaction is a surrogate for a noncapital asset, that the transaction serves as insurance against a business risk, that the transaction serves a hedging function, or that the transaction serves a similar function or purpose.

Hedging transaction defined. The term "hedging transaction" is generally defined by the proposals as **any transaction that a taxpayer enters into in the normal course of its business primarily to manage the risk of interest rate or price changes or currency fluctuations with respect to ordinary property, ordinary obligations, or borrowings of the taxpayer**, and to manager such other risks as the regulations prescribe. Generally, a hedging transaction does not include a transaction entered into to manage risks other than interest rate or price changes, or currency fluctuations.

Managing risk. A transaction that reduces risk would meet the risk management standard if it reduces the risk of a particular asset or liability and it is reasonably expected to reduce the overall risk when all of its operations are considered. Fixed to floating hedges, certain written options and transactions that counteract hedging transactions may manage risk.

However, a transaction that is not entered into to reduce risk does not manage risk; for example, a taxpayer that produces a commodity for sale, sells the commodity and enters into a long futures or forward contract in that commodity in the hope that the price increases. Since the long position does not reduce risk and is not included otherwise as a hedging transaction, it is not a hedging transaction, and the gain or loss is not made ordinary on the grounds that it is a surrogate for inventory.

The proposed regulations provide guidelines for consolidated group hedging. Generally, a consolidated group would take a single-entity approach in determining whether a transaction is a hedging transaction. However, **if certain requirements are met, a consolidated group may elect to have its members treated as separate entities when applying the hedging rules**.

Identification. Hedging transactions must be identified before the close of the day on which they are entered into. The hedged items or aggregate risk must be identified within 35 days after entering into the hedging transaction. Guidelines are provided in the regulations on how an identification is made.

Effective Date. Prop. Reg. §1.1221-2 apply to transactions entered into on or after January 18, 2001.

Prop. Reg. §1.1256(e)-1
[I.R.C. §1256]

> ☞ **The IRS has issued proposed regulations to amend regulations relating to hedging transactions.**

Purpose. The purpose of these proposed regulations is to amend Treas. Reg. 1.1256(e)-1.

Explanation. Under I.R.C. §1256(e)(2), a taxpayer that enters into a hedging transaction must identify the transaction as a hedging transaction before the close of the day on which the taxpayer enters into the transaction. The identification of a hedging transaction for purposes of I.R.C. §1256(e)(2) must satisfy the requirements of Treas Reg. §1.1221-2(e)(1). Solely for purposes of I.R.C. §1256(f)(1), however, an identification that does not satisfy all of the requirements of Treas. Reg. §1.1221-2(e)(1) is nevertheless treated as an identification under I.R.C. §1256(e)(2). Any identification for purposes of Treas. Reg. §1.1221-2(e)(1) is also an identification for purposes of this section. **If a taxpayer satisfies the requirements of Treas. Reg. §1.1221-2(f)(1)(ii), the transaction is treated as if it were not identified as a hedging transaction for purposes of I.R.C. §1256(e)(2).**

Effective Date. Prop. Reg. §1.1256(e)-1 applies to transactions entered into on or after January 18, 2001.

COOPERATIVE ISSUES

Announcement 2001-003
[I.R.C. §§1231 and 1382]

> ☞ **The IRS has acquiesced in whether gains and losses were patronage dividends.**

The IRS has announced its acquiescence in *Farmland Industries, Inc. v. Commissioner,* 78 T.C.M. (CCH) 846 (1999).

Facts. Farmland, a farm cooperative, sold its stock in an oil and gas production corporation. Farmland had organized the corporation as a source for its raw materials, to avert a financial crisis, and to enable it to avoid drastic reductions in other production and marketing activities. Farmland also disposed of its stock in two oil-related corporations at a loss and sold a gas processing plant, soybean processing facilities, and miscellaneous fully depreciated I.R.C. §1231 assets. Farmland treated the gains and losses as patronage income and losses.

Discussion. I.R.C. §1388(a) defines patronage income as income derived from "business done with or for patrons" of a cooperative. Treas. Reg. §1.1382-3(c)(2) defines nonpatronage income as "incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. For example, the income derived from the lease of premises, from investment in securities, or from the sale or exchange of capital assets, constitutes "nonpatronage income." The IRS argued in this and other cases that Treas. Reg. §1.1382-3(c)(2) means that rents, interest, and capital gains are per se nonpatronage income. In light of the cases, the IRS will view the examples of nonpatronage income in the regulations as instructive, but not controlling. It will look at the facts and circumstances to determine if each item of income or loss is patronage or nonpatronage sourced. **The patronage or nonpatronage character of every item of income or loss will be determined by the relationship of the activity producing the income or loss to the cooperative's business of serving its patrons.** Only where the activity generating the income or loss is directly related to the cooperative business, in the sense that it is an integral part of that business, will the income or loss be considered patronage sourced.

In the instant case, the Tax Court found that each corporation was formed, operated, and sold to facilitate the taxpayer's petroleum business. Because a sufficient nexus to the patronage business existed, the court found the stock not to be an investment and held its sale generated patronage income or loss. Likewise, the I.R.C. §1231 assets were found to be used in the taxpayer's cooperative business and sold in the course of that business, so that their sale produced patronage gain or loss.

The IRS agrees with the test used by the court and accepts the conclusions of the court. However, the IRS does not agree with the court's rationale to the extent of any inference that the underlying purpose for the sale may serve as the sole basis for characterizing the gain or loss from the sale as patronage sourced.

[Announcement 2001-3, 2001-13 I.R.B. 323]

Director of Revenue of Missouri v. CoBank ACB
[12 U.S.C. §§2001, 2002§]

> ☞ **Supreme Court reversed Missouri State Supreme Court holding that banks for co-ops are subject to state income tax.**

Facts. The Farm Credit Act of 1993 created various lending institutions within the Farm Credit System, including banks for cooperatives, and addressed their taxation. Each of these institutions is designated as a federally chartered instrumentality of the United States. CoBank ACB is the successor to all rights and obligations of a bank for cooperatives. CoBank ACB filed Missouri corporate income tax returns for 1991–1994 and paid the taxes shown on those returns. In 1996, **the banks filed amended returns, requesting an exemption from all state income taxes and refunds on the taxes paid erroneously, it alleged**. The banks asserted that the Supremacy Clause accords federal instrumentalities immunity from state taxation unless Congress has expressly waived this immunity, and that, because the Act's current version did not expressly do so, banks for cooperatives are exempt from Missouri's corporate income tax. The State denied the request, but the State Supreme Court reversed, stating that because the Act's current version is silent as to such banks' tax immunity, Congress cannot be said to have expressly consented to state income taxation and, thus, the banks were exempt.

Issue. Whether banks for cooperatives are exempt from state income taxation.

Analysis. According to the Supreme Court, Congress has provided that banks for cooperatives are subject to state taxation. The Supreme Court noted that the 1933 Act subjected such banks to state taxation except when the United States held stock in the banks, and that, as soon as governmental investment in the banks was repaid, which it was in 1968, exemption from such taxation no longer applied and the banks had to pay state income taxes.

The Supreme Court remarked that had Congress intended to confer upon banks for cooperatives the more comprehensive exemption it provided for other types of institutions, it would have done so expressly.

Holding. The Supreme Court held that banks for cooperatives are not exempt from state income taxation.

[*Director of Revenue of Missouri v. CoBank ACB,* 531 U.S. 316 (2001) (Sup. Ct. Feb. 20, 2001)]

CORPORATIONS, PARTNERSHIPS, AND LLCs

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

> ☞ **Supreme Court rules that taxpayer could use the S corporation's excluded discharge of indebtedness income to increase the basis in his stock.**

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**.

The IRS determined that the S corporation shareholder could not increase basis in stock due to excluded discharge of indebtedness income (DOI). The Tax Court agreed with the IRS, and the Tenth Circuit affirmed the Tax Court's decision.

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*., 394 U.S. 678 (1969), 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.

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).

The Supreme Court rejected the Tenth Circuit arguments, finding that the statute's plain language provides that excluded discharged indebtedness is an "item of income" that passes through to S corporation shareholders and increases their bases in the S corporation stock. The Supreme Court commented that I.R.C. §108(a) provides "only that the discharge ceases to be included in gross income when the S corporation is insolvent, not that it ceases to be an *item of income*." The Supreme Court further held that **the pass-through occurs before the reduction of the S corporation's tax attributes**. The Supreme Court noted that I.R.C. §108(b)(4)(A) explicitly provides for the sequencing by mandating that the attribute reductions "shall be made *after* the determination of the tax imposed by this chapter for the taxable year of the discharge." (Emphasis added by the Court.) The Supreme Court remarked that it is necessary for the shareholder to adjust his basis in the S corporation and pass through items of income and loss in order for the shareholder to determine the tax to be imposed.

Holding. The Supreme Court, reversing the Tenth Circuit, held that 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.

[*Gitlitz v. Commissioner*, 531 U.S. 206 (2001) *rev'g* 182 F.3d 1143 (10th Cir. 1999) *aff'g* 75 T.C.M. (CCH) 1840 (1998)]

> **Practitioner Note.** The Supreme Court vacated and remanded cases from the 6th and 7th Circuits in light of *Gitlitz*. ***Gaudiano v. Commissioner*** **(6th Cir.) and *Witzel v. Commissioner* (7th Cir.).** In *Gaudiano* and *Witzel*, petitions for writs of certiorari were granted. Previous judgments were vacated, and the cases were remanded to the United States Court of Appeals for the Sixth and Seventh Circuits for further consideration in light of *Gitlitz*. The Sixth and Seventh Circuits have vacated and remanded their decisions in *Gaudiano* and *Witzel* to the Tax Court **for a judgment in favor of the taxpayers**.
> [*Gaudiano v. Commissioner,* 531 U.S. 1108 (2001) and *Witzel v. Commissioner,* 531 U.S. 1108 (2001)]

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Conviser v. Commissioner
[I.R.C. §§61, 108, and 1367]

> ☞ **Taxpayers may increase S corporation stock basis by excluded discharge of indebtedness income.**

Facts. Taxpayers were shareholders of an S corporation from 1988 to 1995. The S corporation was a general partner in a limited partnership that realized discharge of indebtedness (DOI) income in 1992 and 1993. On an earlier decision, **the Tax Court held that the taxpayers could not increase their basis in the S corporation by the DOI**. The case is before the court for reconsideration in light of the Supreme Court decision in *Gitlitz* (see previous discussion).

Issue. Whether taxpayers may increase their S corporation basis by the amount of DOI income.

Analysis. In *Gitlitz v. Commissioner,* 531 U.S.206 (2001), the Supreme Court held that a shareholder of an insolvent S corporation may increase his or her basis by his or her pro-rata share of discharge of indebtedness income to the S corporation, contrary to the Tax Court's holding in *Nelson v. Commissioner,* 110 T.C. 114. The parties agreed that *Gitlitz* controls.

Holding. The Tax Court held that taxpayers' motion for reconsideration would be granted, and **taxpayers may increase their basis in S corporation by their share of the partnership DOI income**.

[*Conviser v. Commissioner*, 81 T.C.M. (CCH) 1258 (2001)]

Grojean v. Commissioner
[I.R.C. §1366]

> ☞ **Taxpayer could not increase his S corporation basis by his participation interest in corporate loan.**

Facts. Taxpayer formed an S corporation in order to buy a trucking company for approximately $14 million. To finance the purchase, taxpayer borrowed $10 million from the bank and signed a promissory note to acquire the company. **The bank made two loans to the S corporation, aggregating $10 million, plus a $1.2 million loan to taxpayer conditioned on his purchasing a $1.2 million participation in one of the bank's loans to the S corporation, a loan for $8.4 million**. The participation agreement subordinated taxpayer's interest in that loan to the bank's. It was agreed that taxpayer would receive no payments on his participation interest until the bank was repaid its share of the $8.4 million loan. In calculating his deductible S corporation losses, taxpayer included the $1.2 million participation interest in his basis.

The Tax Court held that the taxpayer could not increase his basis in the S corporation under I.R.C. §1366(d) by his participation interest in the S corporation note, concluding that taxpayer functioned as a guarantor of S corporation's indebtedness and taxpayer made no economic outlay. The court noted that the taxpayer would not be out-of-pocket unless the S corporation failed to make payments. Since there was no note or contract between taxpayer and the S corporation, the court rejected the taxpayer's claim that he was a lender to the S corporation.

Issue. Whether an S corporation shareholder may increase his basis in the S corporation under I.R.C. §1366(d) by the amount of his participation agreement in connection with a bank loan to his S corporation.

Analysis. The taxpayer argued that the participation interest in the loan was worth more to the bank than a guaranty, because the bank allowed taxpayer to substitute a $1.2 million participation interest for an $11 million guaranty. Another argument expounded by taxpayer was that the participation mode would be more advantageous to taxpayer if S corporation went into bankruptcy during the term of the loan. The court answered that the bankruptcy example actually strengthened the grounds for refusing to classify the loan as an indebtedness of the S corporation to the taxpayer.

Holding. The Seventh Circuit held that the taxpayer cannot increase his basis in the S corporation under I.R.C. §1366(d) by the amount of his participation agreement in connection with a bank loan to his S corporation.

[*Grojean v. Commissioner*, 248 F3d 572 (7th Cir. 2001) affirming 78 T.C.M. (CCH) 1999]

Jackson v. Commissioner
[I.R.C. §§1012 and 1366]

> ☞ **Taxpayers could not increase his S corporation basis by the amount of taxpayer's guaranty of corporate indebtedness.**

Facts. The taxpayer, **an S corporation shareholder, obtained bank loans for his S corporation, secured by a mortgage and guaranteed by the taxpayer and his father**. Taxpayers claimed losses from the corporation, and the IRS disallowed them.

Issue. Whether taxpayer can increase his basis in his S corporation stock by the amount of taxpayer's guaranty of indebtedness of that corporation.

Analysis. I.R.C. §1366(a) provides that a shareholder of an S corporation may deduct his pro-rata share of the S corporation's loss, subject to the limitations contained in I.R.C. §1366(d)(1), which provides that the amount of losses and deductions taken into account by a shareholder shall not exceed the sum of the adjusted basis of the shareholder's stock in the S corporation, and the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder. I.R.C. §1011 provides that the adjusted basis of property shall be the basis of such property determined under I.R.C. §1012, which provides that the basis of property shall be the cost of such property.

The taxpayer argued that his loan guaranties should be recharacterized as a capital contribution, relying on two cases. In *Plantation Patterns v. Commissioner*, 462 F.2d 712 (5th Cir. 1972), the Fifth Circuit determined that, because of the meager capital position of the nominal borrower corporation (a C corporation), lenders to that corporation were relying on the indirect shareholder's guaranty of the corporate debt to give borrowing power to the corporation. Since the nominal borrower corporation lacked borrowing power, the Fifth Circuit determined that the indirect shareholder was the real borrower, with the guaranty simply amounting to a covert way for him to put his money "at the risk of the business." In *Selfe*, 778 F.2d 769 (11th Cir. 1985) the Eleventh Circuit concluded that "under the principles of *Plantation Patterns*, a shareholder who has guaranteed a loan to a Subchapter S corporation may increase her basis (in her stock in the S corporation) where the facts demonstrate that, in substance, the shareholder has borrowed funds and subsequently advanced them to her corporation."

The IRS argued that the taxpayer had made no capital contribution to the corporation since he had made no "actual economic outlay," explaining that it is a well-established principle that a shareholder who guarantees the debt of a subchapter S corporation is not entitled to an increase in basis by the amount of the guaranteed loan [*Goatcher v. United States*, 944 F.2d 747 (10th Cir. 1991) and *Underwood v. Commissioner*, 63 T.C. 468 (1975)]. IRS noted that courts in almost every case that have dealt with this issue, have held that a shareholder who guarantees a debt of an S corporation must sustain some economic outlay and **absent an economic outlay a shareholder is not entitled to an increase in basis** [*Estate of Leavitt v. Commissioner*, 90 T.C. 206 (1988)].

In rejecting the taxpayer's argument, the court found that the taxpayer failed to prove that the corporation lacked capacity to repay the loans, that there was no prospect that it would repay the loans, or that the bank looked to the guarantors as the primary obligors. The court concluded that the loans were to the corporation.

Holding. Taxpayer cannot increase his basis in his S corporation stock by the amount of taxpayer's guaranty of indebtedness of that corporation.

[*Jackson v. Commissioner*, 81 T.C.M. (CCH) 1294 (2001)]

> **Practitioner Note.** See also *Estate of Bean v. Commissioner,* 80 T.C.M. (CCH) 713 (2000).

FSA 200111004
[I.R.C. §§304, 1368, and 1371]

> ☞ **IRS held I.R.C. §301(a)(1) does not limit a shareholder's basis recovery to only the basis of the shares actually redeemed.**

Facts. Two brothers each owned by attribution 50% of the stock in both the issuing and acquiring corporations. Each corporation had earnings and profits. At the beginning of the year of sale, Acquiring corporation, an S corporation, had an accumulated earnings and profits and an accumulated adjustment account (AAA) balance. At the end of 1997, **the brothers sold all their stock in Acquiring to Issuing and split the proceeds equally**. The amount exceeded Acquiring's accumulated earnings and profits but it did not exceed the AAA balance. After the redemption, the brothers, by attribution, each owned 50% of the stock of both Acquiring and Issuing.

Issues

Issue 1. Whether the language of the 1997 amendment to I.R.C. §304(a)(1) indicates a Congressional intent to limit the shareholder's basis recovery to only the basis of the shares actually redeemed (i.e., the basis of the hypothetical Acquiring stock).

Issue 2. What is the proper tax treatment of cash received by the brothers, and what is the proper determination of the bases of the brothers' stock of Acquiring in a transaction considered a redemption under I.R.C. §304(a)(1)?

Analysis. The amended language of I.R.C. §304(a)(1) recasts a brother-sister stock acquisition transaction as a deemed I.R.C. §351 transfer of Issuing stock to Acquiring in exchange for hypothetical Acquiring stock, followed by an immediate redemption of the stock it was treated as issuing in such transaction. The IRS was concerned that the amended language, which showed Congress' intent to specifically identify the shares redeemed, may have also indicated Congress' intention to limit the shareholder's basis recovery to only the basis of the shares actually redeemed, which would substitute a segregated basis rule in place of the spillover rule of I.R.C. §§1367 and 1368. The "spillover" rule, under Treas. Reg. §1.1367-1(a)(c)(3), allows a shareholder of an S corporation to apply losses and deductions in excess of the basis of a share of stock to which such items are attributable against the remaining bases of all other shares of stock in the S corporation owned by the same shareholder. After consideration the IRS concluded Congress did not intend such limitation.

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Holding

Issue 1. The language of the 1997 amendment to I.R.C. §304(a)(1) does not indicate a Congressional intent to limit the shareholder's basis recovery to only the basis of the shares actually redeemed (i.e., the basis of the hypothetical Acquiring stock). Thus, the amended language does not impact the spillover rule of I.R.C. §§1367 and 1368, and does not circumscribe the extent of the taxpayer's basis recovery to only the basis of the hypothetical shares of Acquiring.

Issue 2. Under the scheme of I.R.C. §1368(c), the brothers must apply the distribution in excess of their bases in the hypothetical S Corporation stock against the remaining bases of all other Acquiring Corporation shares of stock they hold. The brothers must treat any excess distribution, to the extent of Acquiring's AAA account, as gain from the sale or exchange of property. The portion of the distribution in excess of Acquiring's AAA account, if any, is treated as a dividend to the extent it does not exceed the accumulated E&P of both Acquiring and Issuing. The remainder of the distribution, if any, is taxed as a return of capital and/or gain from the sale or exchange.

[FSA 200111004 (November 14, 2000]

Midwest Stainless, Inc.

[I.R.C. §316]

> ☞ **Reduction of receivable from taxpayer on his solely owned corporation's books for taxpayer's legal fees was a constructive dividend to taxpayer.**

Facts. Individual incorporated his sole proprietorship stainless steel fabricating business. Individual received payments for the corporation's jobs in progress and paid the expenses. An accounting entry was made on the corporate books to show a receivable from individual to the corporation in the amount of the receipts. Individual was later indicted for failing to report income from the sole proprietorship on his jointly filed personal income tax returns for 1987–1990. Individual paid the legal fees and took no deduction on his jointly filed personal income tax return. He made an accounting entry on the corporate books to record the legal expenses and reduced the loan receivable from Individual. The corporation deducted the amount on its corporate income tax return. The IRS disallowed the deduction and treated the reduction in the individual's loan receivable as a constructive dividend.

Issue. Whether individual received a constructive dividend when his debt to the corporation was reduced by the amount of legal fees paid for his personal defense.

Analysis. Under *Halpern v. Commissioner,* 43 T.C.M. (CCH) 346 (1982), the test for a constructive dividend has two prongs: 1) the corporation must have conferred an economic benefit on the shareholder without expectation of repayment, and 2) the benefit conferred by the corporation must primarily advance the shareholder's personal interest as opposed to the business interest of the corporation. Taxpayer conceded that the corporation was not entitled to deduct the legal fees.

Holding. The Tax Court concluded that **the taxpayer received a constructive dividend that took the form of a debt reduction,** which was evidenced by the journal entry reducing the loan receivable from taxpayer in the books of the corporation.

[*Midwest Stainless, Inc. v. Commissioner*, 80 T.C.M. (CCH) 472 (2000)]

Buda v. Commissioner

[I.R.C. §§1361 and 333]

> ☞ **Taxpayer failed to properly elect deferral on gain from liquidation under I.R.C. §333.**

Facts. In 1969, taxpayer assigned his interest in property he leased from a couple to B&M, a corporation that was partially owned by taxpayer. In 1977, B&M subleased five acres of this property to MOC, a corporation owned by taxpayer and three other shareholders, under a 50-year lease. After acquiring 100% of MOC's stock, taxpayer converted the five acres to a retail outlet mall. The taxpayers claim that taxpayer entered into an oral sublease for five acres with MOC for an annual rental cost of $30,000. To obtain a loan to fund construction for the mall, taxpayer assigned his interest in two other properties and MOC assigned the leasehold interest in and right to all rental income from five acres.

In 1988, MOC was liquidated and all its assets, including the leasehold interest, were distributed to taxpayer. The **taxpayer claimed he intended to elect to postpone recognition of gain from the liquidation under I.R.C. §333**; however, he did not attach the proper form for the election. The IRS determined that the form was not timely filed and the taxpayer could not defer recognition of the liquidation gain. Also, the IRS found that the taxpayer understated the capital gain realized when he received the leasehold interest in the property. The Tax Court agreed with the IRS.

Issues

Issue 1. Whether the Tax Court erred in determining that there was no oral sublease between MOC and taxpayer.

Issue 2. Whether the Tax Court erred in determining that the taxpayer did not make an election to defer recognition of the gain realized upon the liquidation of MOC under I.R.C. §333.

Analysis. The Sixth Circuit noted that it is the Tax Court's role to find the facts, and it is the Court of Appeals role to review those factual findings for clear error [*Kearns v. Commissioner*, 979 F.2d at 1178]. The Sixth Circuit pointed out that the Tax Court heard taxpayer's evidence concerning the existence of a sublease between taxpayer and MOC and found that there was no such sublease. And, in determining the nature of the leasehold interest in the five acres, the Tax Court noted that it considered the testimony of taxpayer and his accountant to be "vague and contradictory."

The Sixth Circuit found that taxpayer's statements at trial that he filed the necessary form to elect deferral of the liquidation gain were suspicious in light of conflicting testimony from the IRS agent who conducted a four-year-long audit of taxpayer's returns and failed to see any evidence that the form was filed.

Holding

Issue 1. The Sixth Circuit found that the Tax Court did not err in determining that there was no oral sublease between MOC and taxpayer.

Issue 2. The Sixth Circuit held that the Tax Court did not err in determining that the taxpayer did not make an election to defer recognition of the gain realized upon the liquidation of MOC under I.R.C. §333.

[*Buda v. Commissioner*, unpublished 2000-2 USTC (CCH) ¶50,771 (6th Cir. 2000) *aff'g* 77 T.C.M. (CCH) 1878 (1999)]

Knight Furniture Co., Inc., v. Commissioner

[I.R.C. §§531 and 532]

> ☞ **Furniture retailer was not subject to the accumulated earnings tax since it met the business needs requirement.**

Facts. Taxpayer is a furniture company that operates two stores. The stock is owned by two families, with one family owning between 51 and 56% for the years at issue. There was some contention between the two families due to one of the minority shareholders having been demoted and removed from the board of directors during the years at issue. The stockholders are forbidden, by corporate by-laws, from selling their shares to unrelated third parties without the unanimous consent of all of the stockholders. The corporation has had a policy of paying cash to redeem stockholders' shares; however, due to a drop in sales in two previous years, the by-laws had been amended to provide for a 10% cash payment and a ten-year note with interest for the balance.

The corporation was sued as part of a class action lawsuit and estimated the cost of defense at $100,000. The corporation was interested in expanding the business to other locations. The minutes of the board of directors provided evidence that discussions and investigations of various sites were conducted; however, the taxpayer did not purchase or lease a new store during the years at issue. Taxpayer's board minutes also indicated plans for major repairs and renovations. Taxpayer has a history of making dividend payments, averaging 5 and 7% of taxable income and net book incomes, respectively.

The IRS determined a tax deficiency, including an amount with respect to the accumulated earnings tax under I.R.C. §531. The taxpayer, in accordance with I.R.C. §534(c), timely submitted a statement setting forth the grounds upon which it relied in determining that it did not accumulate earnings beyond the reasonable needs of the business. The grounds relied on by the taxpayer are identified below:

1. Liquidity. The company was not as highly liquid as other companies that have been found to have unreasonably accumulated earnings.
2. Investment in Assets Unrelated to Business. The company held low-earning, highly liquid investments unrelated to its business in order to pay for its future business needs and contingent liabilities.

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3. Redemption of Stock of Dissenting Stockholders. The company faced the contingent need to redeem the stock of the dissenting family stockholders.
4. Class Action Lawsuit. The company faced the contingent liability for damages as a defendant in a class action lawsuit.
5. Business Expansion Plans. The company had definite, substantial business plans to expand its business.
6. Repairs and Renovations. The company had both anticipated needs and made significant repairs and renovations to its assets.
7. Dividend History. The company had a history of paying regular dividends.

Issue. Whether taxpayer's accumulated earnings and profits exceeded the reasonable needs of the business.

Analysis. Treas. Reg. §1.537-1 provides that an accumulation of earnings and profits is in excess of the reasonable needs of the business if it exceeds the amount that a prudent businessman would consider appropriate for the present business purposes and for the reasonable anticipated future needs of the business. The court addressed each of the taxpayer's grounds, but only those of contention are addressed below.

3. The court noted that in *Wilcox Manufacturing Co. v. Commissioner*, 38 T.C.M. (CCH) 378 (1979), it was found that **the redemption of the stock of dissenting, minority stockholders is a reasonable need of the business** where the ability to redeem the stock of dissenting, minority stockholders appears necessary to preserve the existence of the corporation, or, at least necessary to promote the harmony in the conduct of a business. The court found that the taxpayer had met the burden of proof and allowed an amount equal to the complete redemption of all the stock held by the minority shareholders.
4. The court remarked that in *Steelmasters, Inc.*, 35 T.C.M. (CCH) 1460 (1976), it was reasoned that **uncertainties regarding outcome are inherent in any litigation and held that it was entirely reasonable for the taxpayer's officer to permit earnings to accumulate as a means of insulation.** The court allowed the estimate for legal defense fees in the year at issue.
5. The court found that **the taxpayer had not met the burden of proof as to the need for business expansion** since there was no specific, definite, and feasible business expansion plan that materialized from taxpayer's research of the sites. The court cited *Snow Manufacturing Co. v. Commissioner*, 86 T.C. 260 (1986), which found that definiteness of a plan coupled with action taken towards its consummation are essential to justify an accumulation as reasonable.

Holding. The Tax Court held that taxpayer's accumulated earnings and profits that were available during the years in question did not exceed the reasonable needs of its business and, therefore, taxpayer is not subject to the accumulated earnings tax imposed by I.R.C. §531.

[*Knight Furniture Co., Inc., v. Commissioner*, 81 T.C.M. (CCH) 1069 (2001)]

Prop. Reg. §301.7701-3(g)
[I.R.C. §7701]

> ☞ **When an association elects, under check-the-box rules, to be taxed as a partnership, it is deemed to distribute its assets to the shareholders who then contribute them to the partnership.**

The IRS has issued proposed amendments to the final check-the-box regulations under T.D. 8844. The proposed regulations address the requirements of I.R.C. §332 as applied to the deemed liquidation incident to an association's election to be classified as a partnership or to be disregarded as an entity separate from its owner.

Explanation. An elective conversion of an association to a partnership is deemed to have the following form: the association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership. An elective conversion of an association to an entity that is disregarded as an entity separate from its owner is deemed to have the following form: The association distributes all of its assets and liabilities to its single owner in liquidation of the association.

The regulations provide that I.R.C. §332 may be relevant to the deemed liquidation of an association if it has a corporate owner. Under I.R.C. §332, no gain or loss is recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation if the requirements of I.R.C. §332(b) are satisfied. Those requirements include the adoption of a plan of liquidation at a time when the corporation receiving the distribution owns stock of the liquidating corporation meeting the requirements of I.R.C. §1504(a)(2) (i.e., 80% of vote and value). The elective changes from association to a partnership and to a disregarded entity result in a constructive liquidation of the association for federal tax purposes.

To provide tax treatment of an association's deemed liquidation that is compatible with the requirements of I.R.C. §332, the proposed regulations state that, for purposes of satisfying the requirement of adoption of a plan of liquidation under I.R.C. §332(b), a plan of liquidation is deemed adopted immediately before the deemed liquidation incident to an elective change in entity classification, unless a formal plan of liquidation that contemplates the filing of the elective change in entity classification is adopted on an earlier date.

Effective Date. These regulations are proposed to apply to elections occurring on or after the date final regulations are published; however, it is also proposed that taxpayers may elect to apply the amendments retroactively.

[Prop. Reg. §301.7701-3(g)(1), 2001-12 I.R.B. 917 (March 19, 2001)]

Notice 2001-5

[I.R.C. §§443, 706, 708, and 6031]

> ☞ **Even though successor partnership retains EIN, terminated and successor partnerships must file separate partnership returns for the tax year.**

Purpose. The purpose of this notice is to provide guidance to partnerships regarding **the need to file a final short-year partnership tax return following a partnership termination** under I.R.C. §708(b)(1)(B).

Background. A partnership terminates for tax purposes under §708(b)(1)(B) as a result of the sale or exchange of 50% or more of the total interest in partnership capital and profits within a 12-month period. The regulations under §708(b) were modified in 1997 to provide that following the termination of a partnership, the terminated partnership is deemed to contribute all its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership.

Treas. Reg. §301.6109-1(d)(2)(iii) provides that the new partnership that is formed as a result of the termination of a partnership under §708(b)(1)(B) will retain the employer identification number of the terminated partnership.

Treas. Reg. §1.706-1(c)(1) provides that in the case of a termination, the partnership taxable year closes for all partners as of the date of termination. Thus, the taxable year of the partnership terminates with the termination of the partnership under I.R.C. §708(b)(1)(B). Under I.R.C. §6031(a) every partnership that is required to file a return must file a return of partnership income for each taxable year of the partnership.

Under I.R.C. §443(a)(2), a return is required to be made for a period of less than 12 months if the taxpayer is in existence for only part of what would otherwise be its taxable year.

Explanation.. A partnership that terminates under I.R.C. §708(b)(1)(B) is required to file a short-year final return for the taxable year ending with the date of its termination. The new partnership is required to file a return for its taxable year beginning after the date of termination of the terminated partnership.

[Notice 2001-5, 2001-3 I.R.B. 327 (January 21, 2001)]

CREDITS

In re Montgomery

[I.R.C. §§32, 3507, 6401, 6402, and 6871]

> ☞ **Earned income credit accrues during year, not at year-end, and is property of bankruptcy estate.**

Facts. Taxpayers are all debtors who filed bankruptcy petitions in 1996 and received earned income credits (EICs) in 1997 as part of their 1996 tax refunds. The trustees sought to include the EICs attributable to the portion of the tax year prior to the petition filing date. The bankruptcy court ruled that because an EIC does not accrue until the end of a debtor's tax year, no portion of it becomes property of the debtor's Chapter 7 bankruptcy estate if the debtor files for bankruptcy before the end of that tax year. The Bankruptcy Appellate Panel (BAP) reversed, holding for the trustees.

Issue. Whether EIC attributable to the tax year to the petition date should be included in the bankruptcy estate.

Analysis. Under I.R.C. §32, a qualifying individual is allowed a percentage of his or her income as a credit against the tax otherwise owed for a taxable year. The court explained that Congress made EICs available to qualifying low-income earners in order to reduce the disincentive to work caused by the imposition of Social Security taxes on earned income (welfare payments are not similarly taxed), to stimulate the economy by funneling funds to persons likely to spend the money immediately, and to provide relief for low-income families hurt by rising food and energy prices [*Sorenson v. Secretary of Treasury,* 475 U.S. 851 (1986)]. If the amount of an individual's EIC exceeds his tax liability, the excess is considered an overpayment of tax under I.R.C. §6401 and is refunded to the individual under I.R.C. §6402 "as if he had overpaid his tax in that amount" (*Sorenson).* Furthermore, under I.R.C. §3507, an individual eligible to receive EICs may obtain advance payment of a portion of the amount as part of his wages.

The court explained that a bankruptcy estate is defined in U.S.C. §541(a)(1) as "all the following property, wherever located . . . [including] all legal or equitable interests of the debtor in property as of the commencement of the case." The court pointed out that in *Barowsky v. Serelson*, 946 F.2d 1516 (10th Cir. 1991), the court held that **the pre-petition portion of a debtor's tax refund is property of the bankruptcy estate even though the relevant tax year did not end until after the petition in bankruptcy was filed.**

Holding. The Tenth Circuit held that a debtor's EIC for a tax year, as prorated to the date the bankruptcy petition was filed, is property of the estate regardless of whether the petition was filed prior to the end of the tax year.

[*In re Montgomery*, 224 F3d 1193 (10th Cir. 2000), *aff'g* 219 B.R. 913 (B.A.P. 10th Cir. 1998).]

Sutherland v. Commissioner

[I.R.C. §§1 and 32]

> ☞ **Tax Court finds retroactive application of 1998 earned income credit amendment constitutional.**

Facts. Taxpayer was unmarried and resided with her boyfriend, their child, and two children from her previous marriage. Each child was under the age of 19. Taxpayer filed her 1997 return as single and claimed dependency exemptions for the two children from her previous marriage and identified them as qualifying children for purposes of the earned income credit (EIC). Her boyfriend filed his 1997 return, claiming their child as a dependent and a qualifying child for EIC. His modified adjusted gross income was higher than taxpayer's. **The IRS disallowed taxpayer's EIC because all the children qualify both taxpayer and boyfriend for the EIC and taxpayer's income is not the highest, which would allow only boyfriend to qualify for the EIC.** The IRS suggested that boyfriend might amend his return to list the other two qualifying children for the EIC if he wished.

Issue

Issue 1. Whether taxpayer's boyfriend, and not taxpayer, is eligible for the EIC on taxpayer's children even though he did not identify the children as his qualifying children on his 1997 return.

Issue 2. Whether the retroactive application of the tie-breaker rule, under an amendment to I.R.C. §32, was a violation of taxpayer's Fifth Amendment due process rights.

Analysis

I.R.C. §32(c)(1)(C) provides a tie-breaker rule where there are two or more eligible individuals with respect to the same qualifying child for the same taxable year: If two or more individuals would be treated as eligible individuals with respect to the same qualifying child for taxable years beginning in the same calendar year, only the individual with the highest modified adjusted gross income for such taxable years shall be treated as an eligible individual with respect to such qualifying child. Applying the tie-breaker rule, boyfriend, and not taxpayer, is the individual eligible to claim the EIC.

Taxpayer maintained that the I.R.C. §32(c)(1)(C) tie-breaker rule is inapplicable since boyfriend failed to identify two children as his qualifying children on his 1997 return. Taxpayer relied on the definition of a qualifying child as it existed before the 1998 amendment. As enacted a qualifying child had to meet an "identification test" under I.R.C. §32(c)(3)(A)(iv). The identification test required a taxpayer to include on his or her income tax return the name, age, and taxpayer identification number of each qualifying child with respect to whom he or she claimed the earned income credit under I.R.C. §32(c)(3)(D).

The definition of a qualifying child, however, was amended in 1998 and no longer required the identification of a qualifying child on the qualified individual's income tax return. However, in addition to amending I.R.C. §32(c)(3)(A) in 1998, Congress enacted I.R.C. §32(c)(1)(G) which provides that a taxpayer who has one or more qualifying children, but does not identify any of them in accordance with, is not entitled to receive the earned income credit. "The bill clarifies that the identification requirement is a requirement for claiming the EIC, rather than an element of the definitions of 'eligible individual' and 'qualifying child'." S. Rept. 105-174, at 200 (1998). The 1998 amendment was effective retroactively as if it were included in the original provision.

The court pointed out that courts have held retroactive tax amendments unconstitutional only in those cases where the amendment imposes "a wholly new tax, which could not reasonably have been anticipated by the taxpayer at the time of the transaction" [*Wiggins v. Commisioner*, 904 F.2d 311 (5th Cir. 1990) and others].

Holding

Issue 1. The Tax Court held that the boyfriend, not taxpayer, was entitled to claim the EIC on the taxpayer's two children even though he did not identify the children as his qualifying children on his 1997 return.

Issue 2. The Tax Court held that retroactive application of the tie-breaker rule, under an amendment to I.R.C. §32, was not a violation of taxpayer's Fifth Amendment due process rights.

[*Sutherland v. Commissioner*, 81 T.C.M. (CCH) 1001 (2001)]

> **Practitioner Note.** Under new tiebreaker rules effective for tax years beginning after December 31, 2001, taxpayer would be allowed to claim the two children from her previous marriage as dependents. See page 488 of the New Tax Legislation chapter.

T.D. 8905
[I.R.C. §6695]

> ☞ **IRS has issued final regulations outlining the due diligence requirements for preparers of returns involving earned income credit.**

The IRS has issued final regulations, Treas. Reg. §1.6695-2, relating to due diligence requirements under I.R.C. §6695(g) for paid preparer of federal income tax returns or claims for refund involving the earned income credit (EIC), reflecting the changes made by the Taxpayer Relief Act of 1997.

Explanation. I.R.C. §6695(g) was added by §1085(a)(2) of the Taxpayer Relief Act of 1997, Public Law 105-34, effective for taxable years beginning after December 31, 1996. I.R.C. **§6695(g) imposes a $100 penalty for each failure by an income tax return preparer to meet the due diligence requirements set forth in regulations.**

On December 22, 1997, the IRS published Notice 97-65 (1997-2 C.B. 326), in which the IRS set forth the preparer due diligence requirements for 1997 returns and claims for refund involving the EIC. To avoid the imposition of the penalty under I.R.C. §6695(g) for 1997 returns and claims for refund, Notice 97-65 required preparers to meet four requirements: (1) complete the Earned Income Credit Eligibility Checklist attached to Notice 97-65, or otherwise record the information necessary to complete the checklist; (2) complete the Earned Income Credit Worksheet, as contained in the 1997 Form 1040 instructions, or otherwise record the computation and information necessary to complete the worksheet; (3) not know or have reason to know that any information used by the preparer in determining eligibility for, and the amount of, the EIC is incorrect; and (4) retain for three years the checklist and worksheet (or alternative records), and a record of how and when the information used to determine eligibility for, and the amount of, the EIC was obtained by the preparer.

On December 21, 1998, temporary regulations (T.D. 8798, 1999-1 C.B. 804) under I.R.C. §6695(g) were published. The requirements set forth in the temporary regulations were substantially similar to those in Notice 97-65. After consideration of the one comment received, the proposed regulations under I.R.C. §6695(g) were adopted without change.

Effective Date. These regulations are **effective October 17, 2000.**

[T.D. 8905, 2000-44 I.R.B. 435 (October 16, 2000)]

DIVORCE ISSUES

Berry v. Commissioner
[I.R.C. §§71 and 215]

> ☞ **Taxpayer cannot deduct former wife's attorney's fees as alimony.**

Facts. During divorce proceedings, **an Oklahoma court ordered taxpayer to pay his ex-wife's attorney's fees.** The order did not state whether taxpayer would be liable for the payment if his ex-wife died before the amount was paid, and state law on the issue was not explicit. Taxpayer claimed the attorney's fees as alimony paid on his tax return. The IRS disallowed the deduction.

Issue. Whether taxpayer would remain liable for his ex-wife's attorney's fees if she died before the payment was made, which would disqualify the payments as alimony under I.R.C. §71(b)(1)(d).

Analysis. I.R.C. §71(b) defines "alimony or separate maintenance payment" as any payment in cash if there is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse.

The taxpayer argued that under state law, a divorce proceeding terminates on the death of one of the spouses. Since the divorce court's order was only temporary, he contended his liability to make the fee payments would have terminated on his ex-wife's death.

In *Mabry v. Baird*, 203 Okla. 212 (1950), the trial court had entered a final divorce decree reserving the wife's claim for attorney's fees. The Oklahoma Supreme Court held that the trial court had jurisdiction to enter an order awarding attorney's fees to the legal representative of the deceased wife.

Holding. The Tax Court concluded that the Supreme Court of Oklahoma would hold that taxpayer would remain liable for the attorney's fees that the state court awarded taxpayer's ex-wife even if she had died before entry of a final divorce decree, which disqualified the payments as alimony under I.R.C. §71(b)(1)(d).

[*Berry v. Commissioner*, 80 T.C.M. (CCH) 825 (2000)]

Zinsmeister v. Commissioner
[I.R.C. §§71 and 215]

> ☞ **Taxpayer was allowed to deduct first mortgage payments and miscellaneous expenses, but not legal expenses, as alimony payments.**

Facts. Taxpayer and his wife, both Minnesota residents, were divorced in 1994. **Taxpayer made various court-awarded payments to his ex-wife,** including maintenance payments, first and second mortgage payments, and miscellaneous expense payments, which included such items as auto repairs, veterinarian fees, insurance, child's graduation expenses, child's broken trombone, child's dental work, contacts, safety glasses and shoes, real estate taxes, and her attorney's fees. The taxpayer and spouse were liable for the first mortgage, however, the taxpayer was the only liable party on the second mortgage.

The divorce decree stated that the obligation for maintenance payments would terminate at the death or remarriage of the wife and that the maintenance payments would be deductible by the husband and taxable to the wife. As part of the divorce decree the wife received the residence subject to a lien in favor of the taxpayer payable by July 1, 1996. The wife was ordered to immediately refinance for an amount sufficient to satisfy the first mortgage and the amount of taxpayer's lien.

The taxpayer deducted all court-ordered payments, except for child support payments, made to his ex-wife as alimony payments. He also deducted the payment to pay the balance on the second mortgage. The IRS allowed only the court-awarded maintenance payments as alimony.

Issue. Whether the mortgage payments and miscellaneous expense payments satisfy the requirements of I.R.C. §71(b)(1)(A), made on behalf of the spouse, and (D), terminate at her death, as alimony paid and deductible by the taxpayer.

Analysis and Holding. I.R.C. §71(b)(1)(A) and (D) define "alimony or separate maintenance payment" as any payment in cash if such payment is received by (or on behalf of) a spouse under a divorce or separation instrument and there is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse. Under I.R.C. §71(c) alimony does not include any payments which are fixed under the divorce instrument as payable for the support of the children.

The IRS claimed that most of the payments were made for the benefit of the taxpayer, and not on behalf of the spouse. The court concluded that the attorney's fees were made on behalf of spouse [*Hopkinson v. Commissioner*, 77 T.C.M. (CCH) 1968 (1999)]. However, the court concluded that **since the state court separately identified the payments for the children's expenses, broken trombone, graduation expenses and dental work, the order fixed those amounts as child support** under I.R.C. §71(c).

The court noted that when a divorce court orders one spouse to make payments on a mortgage for which both spouses are jointly liable, a portion of such payments discharges the legal obligation of the other spouse, and accordingly, one-half of the mortgage payment is includable in the gross income of the payee spouse and deductible by the payor spouse [*Taylor v. Commissioner*, 45 T.C. 120 (1965)]. Therefore, the court concluded that the taxpayer could deduct one-half of the first mortgage payments, home insurance premiums, and real estate taxes.

However, the court concluded that since only the taxpayer was liable on the second mortgage and held a lien on the residence, the wife did not benefit by the second mortgage payments paid by taxpayer. Therefore, they were not deductible as alimony by taxpayer.

In determining whether payments made by taxpayer meet the requirements of I.R.C. §71(b)(1)(D), the court looked to Minnesota state law. Under Minnesota law, a suit for divorce abates when either spouse has died; however, Minnesota law expressly provides that an award of attorney's fees survives the underlying action for a divorce. The court pointed out that Minnesota law provides that the obligation for payment of the miscellaneous expenses, with the exception of the attorney's fees, would have ended at the death of the spouse.

Therefore, the court concluded that one-half of the first mortgage payments, **one-half of the insurance premiums, one-half of the real estate taxes, and all the miscellaneous expenses, except for the legal fees and those designated as child support, would be deductible as alimony in the year paid.**

[*Zinsmeister v. Commissioner*, 80 T.C.M. (CCH) 774 (2000)]

Egelhoff v. Egelhoff
[I.R.C. §401(k)]

> ☞ **State law that revoked ex-wife's standing as beneficiary is preempted by ERISA, and children receive nothing.**

Facts. Husband died shortly after divorcing his wife without changing beneficiary on his life insurance and 401(k) plan. State law provides that the designation of a spouse as the beneficiary of a nonprobate asset, defined to include a life insurance policy or employee benefit plan, is revoked automatically upon divorce. Without a named beneficiary, the proceeds would go to the children as heirs under state law. The children sued, and the trial courts determined that both the insurance policy and benefit plan should be administered in accordance with ERISA and, therefore, go to the ex-wife as beneficiary. The Washington Court of Appeals reversed the trial court, concluding that the statute was not preempted by ERISA. The State Supreme Court affirmed, holding that the statute, although applicable to employee benefit plans, does not refer to or have a connection with an ERISA plan that would compel preemption under that statute.

Issue. Whether the state statute has a connection with ERISA plans and is therefore expressly preempted.

Analysis. ERISA's preemption section, 29 U.S.C. §1144(a), states that **ERISA "shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan"** covered by ERISA. A state law relates to an ERISA plan "if it has a connection with or reference to such a plan" [*Shaw v. Delta Air Lines, Inc.*, 463 U.S. 85]. The U.S. Supreme Court further noted that the state statute has an impermissible connection with ERISA plans, as it binds plan administrators to a particular choice of rules for determining beneficiary status. In addition, the Supreme Court noted, the state statute also has a prohibited connection with ERISA plans because it interferes with nationally uniform plan administration.

The Supreme Court rejected the state court's arguments: that the state statute allows employers to opt out; that it involves areas of traditional state regulation; and that if ERISA preempts this statute, it also must preempt the various state statutes providing that a murdering heir is not entitled to receive property as a result of the killing.

Holding. The United States Supreme Court held that the state statute has a connection with ERISA plans and is therefore expressly preempted.

[*Egelhoff v. Egelhoff*, 121 S.Ct. 1322 (Sup. Ct.) *rev'g and remanding* 139 Wash. 2d 557, 989 P. 2d 80]

WSB Liquidating Corp. v. Commissioner
[I.R.C. §162]

> ☞ **Pension payments in lieu of alimony are not deductible by corporation.**

Facts. A couple established taxpayer in 1967 and in 1984 they divorced. In 1989, the wife retired from the business and executed two agreements with the husband. One of the agreements was a property settlement between the husband and wife, but made specific reference to the pension agreement, which provided that the corporation would pay the wife $375 per week. The settlement agreement provided that the payments were in lieu of alimony. The corporation issued Forms W-2 to the wife reporting the payments as employee compensation and claimed a deduction. The wife reported no alimony income and the husband deducted no alimony. The corporation had

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retained earnings and never paid any dividends. In 1997, the corporation sold all its assets and changed the name to WSB Liquidating Corp. The couple released the corporation from the pension agreement in 1997, and the corporation was liquidated and dissolved in 1998. The IRS audited the corporation and disallowed the pension deductions for 1993–1995.

Issue. Whether the payments made by taxpayer to wife were deductible under I.R.C. §162 as ordinary and necessary business expenses or nondeductible payments.

Analysis. The taxpayer argued that the payments should be deductible business expenses because they were for a severance package for past services for which she was underpaid and had a business purpose of inducing the wife's retirement. The IRS argued that the payments lacked a business purpose because they were either payments that satisfied the husband's alimony obligation or, alternatively, were constructive dividends to the wife.

The court found that even though the pension agreement states that the wife had been underpaid, there was no evidence to support this claim. Further, the court concluded that **the settlement agreement supported the IRS's argument that the payments were alimony and not deductible as compensation**. The court agreed with the IRS that the payments were a constructive dividend but did not allocate between alimony and constructive dividend since neither were deductible by the corporation.

Holding. The Tax Court held that the payments by the corporation to the wife were nondeductible by the corporation.

[*WSB Liquidating Corp. v. Commissioner*, 81 T.C.M. (CCH) 1007 (2001)]

Estate of Goldman v. Commissioner
[I.R.C. §71]

> ☞ **Monthly payments made to ex-wife were property settlement payments, not deductible as alimony.**

Facts. Goldman and Parker were married in 1974, separated in 1983, and divorced in 1985. As part of the divorce, the couple executed a property settlement agreement. The section of the agreement entitled Disposition of Marital Property and Separate Property, stated that Goldman would pay Parker $20,000 per month for a period of 240 months and that the agreement would terminate upon Parker's death. However, the obligation would survive Goldman's death and be a lien against his estate. The agreement also stated that the transfers of property should be reported as a nontaxable event according to I.R.C. §1041. Under the section of the agreement entitled Spousal Support Waiver, it is stated "Plaintiff (Parker) waives her right to spousal support from Defendant (Goldman)."

Goldman deducted the payments as alimony, but Parker did not report the payments as income. Goldman died in 1995. The IRS audited Goldman in 1996 for the years 1992–1994 and determined that the payments were not deductible as alimony.

The Tax Court found the substance of the monthly payments under the "clear, explicit and express direction" of the Agreement was both a division of property, and subject to the provisions of I.R.C. §1041 (nontaxable). To reach that conclusion, the Tax Court accepted the parties' stipulations to three of the four objective factors set forth under I.R.C. §71(b) and determined the Agreement contained a "nonalimony designation" incapable of satisfying the requirement of I.R.C. §71(b)(1)(B).

Issue. Whether the monthly payments as part of a divorce agreement satisfy the requirements of I.R.C. §71(b)(1) or should be treated as a nontaxable property settlement under I.R.C. §1041.

Analysis. I.R.C. §71(b)(1)(B) defines alimony or separate maintenance payments as any payment in cash if the divorce or separation instrument does not designate such payment as a payment which is not includable in gross income under this section and not allowable as a deduction under I.R.C. §215.

I.R.C. §1041 provides that no gain or loss is recognized on a transfer of property from an individual to a spouse or former spouse, if the transfer is incident to the divorce.

After reviewing the agreement in terms of state law, the court concluded that **there was no indication that the parties intended the payments to be anything other than a division of marital property**.

Holding. The Tenth Circuit affirmed the Tax Court's conclusion that the disputed payments do not constitute alimony under I.R.C. §71(b)(1).

[*Estate of Goldman*, unpublished 2001-1 USTC ¶50,142 (10th Cir. 2000) *aff'g* 112 T.C. 317 (1999)]

LTR 200050046
[I.R.C. §72]

☞ **Change in equal periodic payments from IRA will not result in penalty to owner when change was caused by divorce.**

Facts. Taxpayer took substantially equal periodic distribution from his IRA before reaching age 59½. The annual payments were based on his and his wife's life expectancies. As part of a divorce agreement, the couple plan to divide the IRA with one-third of the IRA's value transferred to a new IRA for the wife in 2000.

The taxpayers propose the following changes:

1. The husband proposes taking two-thirds of the previous annual payments in 2001 and 2002;
2. In 2002, the husband will reach the age of 59½ and plans to change the method and amount of distribution of his IRA share.
3. The wife plans to take no distribution in 2000, but in 2001 or 2002 she plans to begin taking periodic payments based on her life expectancy.

Issue. Whether the three proposed changes to the IRA periodic payments and the division of an IRA as part of a divorce settlement will result in the imposition of the additional 10% tax under I.R.C. §72(t).

Analysis and Holding

1. The IRS concluded that the husband's one-third reduction in the original periodic payments was reasonable since the IRA will be reduced by one-third under the divorce agreement. Therefore, the payments would not be subject to the 10% penalty tax under I.R.C. §72(t).
2. The IRS concluded that since the husband would have taken his fifth annual payment and reached age 59½, under I.R.C. §72(t)(4)(A), he could alter the payments without incurring a penalty for substantial modification.
3. The IRS concluded that after the divorce the wife's IRA will be her property and she will not be required to conform to husband's IRA periodic payment scheme. Therefore, skipping a distribution in 2000 or later altering the payments would constitute an I.R.C. §72(t)(4)(A) substantial modification of husband's periodic payments and will not result in the imposition of the 10 percent tax under I.R.C. §72(t)(1) on wife.

[LTR 200050046 (September 18, 2000)]

Practitioner Note. An additional private letter ruling, LTR 200052039 (October 2, 2000), is basically the same as the above letter ruling, with an added comment by the IRS regarding proposed change number 3. The IRS commented, "Notice 89-25, 1989-1 C.B. 662, Question and Answer-12, lists three methods by which periodic payments from either a qualified plan or an IRA will comply with the requirements of I.R.C. §72(t)(2)(A)(iv). However, **these three methods are not the sole methods of complying with said Code section** . . . . In the Service's view, such method (described in proposed change number 3 in this ruling) is in conformity with the requirements of IR.C. §72(t)(2)(A)(iv)."

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

☞ **Taxpayer was required to report her half of the gain from sale of property even though her share of proceeds was not received from ex-husband until four years later.**

Facts. Taxpayer and spouse were married in 1972 and separated prior to or during 1991, with divorce proceedings filed during that year, and divorce decree was final in 1998. In 1979, taxpayer and spouse purchased a townhouse, which was used as a residence for a short time, then rented. In 1994, the townhouse was sold but neither taxpayer nor spouse attended the closing. The check was made payable jointly to the taxpayer and spouse and mailed to the spouse. The spouse deposited the proceeds check in a joint account (without taxpayer's endorsement) with a credit union of which the spouse was a member. The account had been established years before in connection with a loan made by the spouse. It was not clear whether the taxpayer was even aware of such account. The spouse directed the bank to deduct the loan from the joint account, then took withdrawals of less than $10,000 increments until all proceeds had been transferred to an account in the spouse's name.

In 1998, as part of the final divorce decree, the spouse was ordered to pay taxpayer for her share of the sale of the residence. **The divorce decree specifically stated that the taxpayer "should not have to pay" any federal income tax attributable to the sale of the townhouse.** The taxpayer filed her 1994 income tax return late and did not report the sale

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of the residence on her return. The IRS determined a deficiency in tax and imposed an I.R.C. §6651(a)(1) penalty.

Issues

Issue 1. Whether taxpayer's share of the gain realized from the sale of property jointly owned with her former spouse must be included in her 1994 income.

Issue 2. Whether taxpayer had reasonable cause for her failure to file a timely 1994 federal income tax return to avoid the I.R.C. §6651(a)(1) penalty.

Analysis. Taxpayer argued that she should not have to report any gain on the residence since the divorce decree so stated. The court noted, citing *Aquilino v. United States*, 363 U.S. 509 (1960), that state law determines the property ownership of a taxpayer and federal law controls the federal income tax consequences of transactions involving the property. Since the divorce court did not adjust taxpayer's preexisting ownership interest in the townhouse, taxpayer's gain on the sale of the townhouse cannot be excluded from her income.

Taxpayer argued that she should not have to include the gain in 1994 because she had not received any of the proceeds at the end of 1994. However, the court pointed out that a substantial amount of the proceeds was used to satisfy the mortgage on the residence. The court concluded that it was taxpayer's choice not to attend the closing. Citing *Loose v. United States*, 74 F.2d 147 (8th Cir. 1934), the court stated, "income is received or realized when it is made subject to the will and control of the taxpayer and can be, except for his own action or inaction, reduced to actual possession."

I.R.C. §6651(a)(1) provides for a penalty tax of 5% of tax shown on return for each month or fraction of a month of failure to file, up to a maximum of 25% of the tax. This penalty is applicable unless the taxpayer can demonstrate that the failure is due to a reasonable cause and not due to willful neglect. The court noted that the taxpayer did not explain why the return was late and nothing in the record suggests that the failure to timely file was due to reasonable cause and not due to willful neglect.

Holding

Issue 1. The Tax Court held that taxpayer's share of the gain realized from the sale of property jointly owned with her former spouse must be included in her 1994 income.

Issue 2. The Tax Court held that taxpayer did not have reasonable cause for her failure to file a timely 1994 federal income tax return and the I.R.C. §6651(a)(1) penalty tax should be imposed.

[*Zimmerman v. Commissioner*, T.C. Summary Opinion 2001-13]

EMPLOYMENT TAX ISSUES

IR 2000-83
[I.R.C. §3501]

> ☞ **The threshold for paying employment taxes on a quarterly basis is increased from $1,000 to $2,500 beginning January 1, 2001.**

The IRS ended monthly tax deposit requirements for about 1 million small businesses. **Beginning January 1, 2001, many small businesses were allowed to make employment tax payments on a quarterly basis, rather than monthly**.

Under the new rules, the IRS will allow business to make payments on a quarterly basis, instead of monthly, if they have less than $2,500 in quarterly employment taxes. This replaces the current standard, which allows quarterly payments only if businesses have less than $1,000 in quarterly employment taxes. Previously, the threshold had been $500 and was raised to $1,000 on June 17, 1998.

Small businesses with employment taxes that are less than $2,500 per quarter may pay the employment taxes when they file Form 941, Employer's Quarterly Federal Tax Return. Only employers with employment taxes of $2,500 or more per quarter must deposit the tax with an authorized financial institution.

[IR 2000-83 (November 28, 2000)]

> **Practitioner Note.** See also Temp. Reg. §31.6302-1T(f)(4) for these guidelines.

Prop. Reg. §31.6205-1(a)(6)
[I.R.C. §6205]

> ☞ **Taxpayers may post cash bond to stop interest accruals when petitioning the Tax Court in matters of worker reclassification.**

Proposed regulations under I.R.C. §6205 provide guidance on interest-free corrections of employment tax underpayments resulting from worker reclassifications. With the extension of Tax Court jurisdiction to employment status determinations, an error will be considered to be ascertained when all internal appeals have been exhausted. A cash bond may be posted to stop interest accruals if a taxpayer wants to receive a determination letter so he or she can petition the Tax Court.

Effective Date. Prop. Reg. §31.6205-1(a)(6) **will apply to determination notices issued after March 18, 2001**. Supplementary information in the announcement states that taxpayers may rely on the proposed regulations.

Neeley v. Commissioner
[I.R.C. §§6501, 6663, and 7436]

> ☞ **Tax Court ruled that fraud elements for employment taxes are the same as those for income taxes.**

Facts. Taxpayer operated an air conditioning company as a sole proprietor. In 1992, during a very busy time for the company, he hired three individuals and at their insistence agreed to payment in cash. **Taxpayer informed them that they would receive a Form 1099 because he believed payment in cash was okay as long as he filed this form**. In an audit conducted in 1995, the IRS determined that the workers should have been classified as employees.

On June 11, 1998, the IRS mailed to taxpayer a Notice of Determination Concerning Worker Classification under I.R.C. §7436 in which IRS determined that (1) the workers were employees of the company for purposes of federal employment taxes, and (2) taxpayer was not entitled to "safe harbor" relief provided by §530 of the Revenue Act of 1978, Pub. L. 95-600, 92 Stat. 2763, 2885. IRS also asserted an I.R.C. §6663 fraud penalty with respect to such additional taxes.

Issue. Whether the period of limitations on assessment expired prior to the issuance of IRS's notice of determination.

Analysis. Taxpayer contended that the assessment of any additional employment tax liability was barred by the statute of limitations under I.R.C. §6501, as the notice of determination was issued after the general 3-year period of limitations provided by I.R.C. §6501(a). IRS contended that the general limitations period under I.R.C. §6501(a) did not apply in this case, claiming that the employment tax returns at issue were false and fraudulent with an intent to evade tax and that the period of limitations thereby remained open pursuant to I.R.C. §6501(c)(1). The court concluded that whether IRS's notice of determination was timely issued depended on whether taxpayer committed fraud in the filing of the employment tax returns.

The court noted that this was the first instance for the Tax Court to determine whether a taxpayer committed fraud in the employment tax context. The court concluded that the determination of fraud for purposes of the period of limitations on assessment under I.R.C. §6501(c)(1) is the same as the determination of fraud for purposes of the penalty under I.R.C. §6663, [*Rhone-Poulenc Surfactants & Specialties v. Commissioner*, 114 T.C. 533 (2000)]. Fraud is defined as an intentional wrongdoing designed to evade tax believed to be owing [*Edelson v. Commissioner*, 829 F.2d 828 (9th Cir. 1987), affirming T.C. Memo. 1986-223]. The court noted that the IRS bore the burden of proving fraud and had to establish it by clear and convincing evidence under I.R.C. §7454(a); Rule 142(b). The court instructed that in order to satisfy the burden of proof, the IRS must show that (1) an underpayment in tax existed, and (2) the taxpayer intended to conceal, mislead, or otherwise prevent the collection of taxes [*Parks v. Commissioner*, 94 T.C. 654 (1990)].

The court determined that the IRS had not even established, let alone on a clear and convincing basis, that taxpayer intended to conceal, mislead, or otherwise prevent the collection of taxes.

Holding. The Tax Court held that the period of limitations on assessment expired prior to the issuance of IRS's notice of determination.

[*Neeley v. Commissioner*, 116 T.C. 79 (2001)]

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Notice 2001-14
[I.R.C. §§421, 422, 424, 3401, and 6041]

☞ **IRS won't assess employment taxes on incentive stock options or employee stock purchase plan options exercised before 2003.**

Purpose. This notice provides that, in the case of any statutory option exercised before January 1, 2003, the IRS will not assess FICA tax or FUTA tax on the exercise of the option and will not treat the disposition of stock acquired by an employee pursuant to the exercise of the option as subject to income tax withholding.

This notice obsoletes Rev. Rul. 71-52, 1971 C.B. 278. The notice announces the intent to issue further administrative guidance to clarify current law with respect to FICA tax and FUTA tax on statutory options, and to address the issue of whether the disposition of stock acquired by an employee with the exercise of an option will be subject to income tax withholding. This notice invites public comment on the guidance.

Background. Rev. Rul. 71-52 addressed the FICA, FUTA, and income tax withholding consequences of exercising qualified stock options under former I.R.C. §422, which has been amended. Notice 87-49, 1987-2 C.B. 355 addressed potential inconsistencies among I.R.C. §83, the revised version of I.R.C. §422, and Rev. Rul. 71-52. Notice 87-49 also indicated that the issues were under reconsideration.

Explanation. The IRS concluded that Rev. Rul. 71-52 doesn't apply to either the exercise of statutory options or the disposition of the stock so acquired. Notice 87-49 is modified to the extent that it is inconsistent with this notice. **The IRS indicated that it will honor otherwise allowable adjustments and refund claims for employment taxes already paid.** The IRS pointed out that the lack of an income tax withholding requirement will not relieve employees of their obligation to include compensation resulting from a stock disposition in income nor relieve employers of their reporting obligation.

Effective Date. The notice applies if the exercise occurs on or after January 18, 2001, and before 2003. However, employers may choose to apply the notice provisions to options exercised before publication.

[Notice 2001-14, 2001-6 I.R.B. 516 (January 18, 2001)]

United States v. Cleveland Indians Baseball Company
[I.R.C. §§3401 and 3402]

☞ **Supreme Court rules back pay is subject to FICA tax in year it is paid, rather than when wages were earned.**

Facts. Under a grievance settlement agreement, taxpayer, Cleveland Indians Baseball Company, owed 8 players back pay for wages due in 1986 and 14 players back pay for wages due in 1987. Taxpayer paid the back wages in 1994. Both tax rates and the amount of the wages subject to tax have risen over time. Consequently, allocating the 1994 payments back to 1986 and 1987 would generate no additional FICA or FUTA tax liability for the taxpayer and its former employees, while treating the back wages as taxable in 1994 would subject both the taxpayer and the employees to significant tax liability. The taxpayer paid its share of employment taxes on the back wages according to 1994 tax rates and wage bases. After the IRS denied its claims for a refund of those payments, the Company initiated action in District Court. The Taxpayer relied on Sixth Circuit precedent holding that **a settlement for back wages should not be allocated to the period when the employer finally pays but to the periods when the wages were not paid as usual.** The District Court, bound by that precedent, entered judgment for the Taxpayer and ordered the Government to refund FICA and FUTA taxes. The Sixth Circuit affirmed.

Issue. Whether, under the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA), the back wages should be taxed by reference to the year they were paid (1994) or, instead, by reference to the years they should have been paid (1986 and 1987).

Analysis. The Social Security tax provision, I.R.C. §3111(a), prescribes tax rates applicable to "wages paid during" each year from 1984 onward. The Medicare tax provision, I.R.C. §3111(b)(6), sets the tax rate "with respect to wages paid after December 31, 1985." And the FUTA tax provision, I.R.C. §3301, sets the rate as a percentage "in the case of calendar years 1988 through 2007 . . . of the total wages . . . paid by [the employer] during the calendar year." I.R.C. §3121(a) establishes the annual ceiling on wages subject to Social Security tax by defining "wages" to exclude any remuneration "paid to [an] individual by [an] employer during [a] calendar year" that exceeds "remuneration . . . equal to the contribution and benefit base . . . paid to [such] individual . . . during the calendar year with respect to which such contribution and benefit base is effective." I.R.C. §3306(b)(1) similarly limits annual wages subject to FUTA tax. The IRS argued that the meaning of this language is plain, that **wages should be taxed according to the calendar year they are in fact paid, regardless of when they should have been paid**.

However, the taxpayer argued that *Social Security Bd. v. Nierotko,* 327 U.S. 370, undermined the IRS's plain language argument. In *Nierotko,* the court concluded that, for purposes of determining a wrongfully discharged worker's eligibility for Social Security benefits a back pay award had to be allocated as wages to calendar quarters of the year "when the regular wages were not paid as usual."

With these conflicting arguments, the court deferred to the IRS's interpretations, stating, "The court does not sit as a committee of revision to perfect the administration of the tax laws. Instead, it defers to the Commissioner's regulations as long as they implement the congressional mandate in a reasonable manner." [*United States v. Correll,* 389 U.S. 299].

Holding. The Supreme Court held that back wages are subject to FICA and FUTA taxes by reference to the year the wages are paid.

[*United States v. Cleveland Indians Baseball Company*, 121 S.Ct. 1433 (2001) *rev'g unpublished* 2001-1 USTC ¶50,469 (6th Cir. 2000)]

Practitioner Note. In a similar case, *San Francisco Baseball Associates L.P. v. United States*, 88 F. Supp. 2d 1087 (D.Calif. 2001), the U. S. District Court of California decided that as back pay, the **payments were taxable in the year when the regular wages should have been paid**, citing *Bowman v. United States*, 824 F.2d 528 (6th Cir. 1987) that cited *Social Security Bd. v. Nierotko*, 327 U.S. 358 (1946). Note that **this case was decided before the Supreme Court's decision in *United States v. Cleveland Indians Baseball Co.***

ENVIRONMENTAL EXPENDITURES

LTR 200108029
[I.R.C. §§61, 162, and 263]

☞ **Environmental cleanup costs must be capitalized when property was already polluted at the time of its purchase.**

Facts. Taxpayers purchased property that contained a dry-cleaning business. Several years later, the State Department of Environmental Conservation (DEC) ordered taxpayers to dispose of an old dry-cleaning machine and its contents. On order from DEC, taxpayers tested the soil and found that the soil was contaminated with perchloroethylene (PCE). Tests conducted over a period of seven years determined that the groundwater was also contaminated. In cleaning up the contamination, taxpayers incurred costs for consultants, testing, supplies, equipment, labor, and legal fees. **Taxpayers elected to expense the cost of the cleanup since they did not anticipate the extent of the problem or expect any insurance reimbursement**. They didn't begin receiving any insurance proceeds until year two of the cleanup.

Issues

Issue 1. Whether the costs incurred by the taxpayers to clean up land and treat contaminated groundwater are capitalizable under I.R.C. §263.

Issue 2. Whether insurance proceeds received by the taxpayers are treated as a reduction of basis and taxable only if their basis in the land is reduced below zero.

Analysis. The IRS noted that the appropriate test for determining whether expenditures increase the value of the property is to compare the status of the asset after the expenditure with the status of that asset before the condition arose that necessitated the expenditure [Rev. Rul. 94-38, 1994-1 C.B. 35, citing *Plainfield Union Water Co v. Commissioner*, 39 T.C. 333 (1962)].

Holding

Issue 1. The IRS concluded that the costs incurred by the taxpayers to clean up land and treat contaminated groundwater are capitalizable under I.R.C. §263.

Issue 2. The IRS concluded that insurance proceeds received by the taxpayers are treated as a reduction of basis and taxable only if their basis in the land is reduced below zero.

[LTR 200108029 (November 24, 2000)]

ESTATE AND GIFT TAX

Knight v. Commissioner
[I.R.C. §§2511, 2512, and 2704]

> ☞ **Tax Court found a family limited partnership valid but reduced the discounts allowed to value the interests.**

Facts. Taxpayers owned a family ranch and two homes in which their son and daughter lived without paying rent. Taxpayers formed a family limited partnership (FLP) and conveyed the ranch, the two homes, and other investment assets to it. The fair market value of the FLP assets on the date the assets were transferred was approximately $2 million. **Taxpayers established trusts for the son and daughter and gave interests in the FLP to each trust**. Taxpayers filed federal gift transfer tax returns for the year of the transfers and reported a gift of 22.3% interest in the FLP to each child's trust.

The IRS audited the returns and determined a tax deficiency.

Issues

Issue 1. Whether the partnership was disregarded for federal gift tax purposes.

Issue 2. Whether the fair market value of taxpayers' gifts was the value of the assets in the partnership reduced by portfolio, minority interest, and lack of marketability discounts totaling 44%.

Issue 3. Whether the fair market value of each of taxpayers' gifts to each children's trust on December 28, 1994, was $263,165 as taxpayers contend, $450,086 as IRS contends, or some other amount.

Issue 4. Whether I.R.C. §2704(b) applied to the transfer.

Analysis. The IRS argued that the FLP should be disregarded and that the FMV of each of the gifts was $450,000, or 22.3% of the FMV of the assets transferred to the FLP. The taxpayers argued that the FLP should be recognized, since it was recognized by the state of Texas, and that a 10% portfolio discount, a 10-percent minority-interest discount, and a 30% lack-of-marketability discount should apply, for an aggregate discount of 44%, which would result in a gift value of $263,000.

The court applied the willing-buyer, willing-seller test, refusing to disregard the FLP; the court concluded that a hypothetical buyer or seller wouldn't disregard it. The court refused to accept the taxpayers' aggressive 44% discount, rejecting the portfolio discount since the evidence was not convincing as to why the partnership's mix of assets would not be attractive to a buyer. The court found the support for the other two discounts unconvincing; however, the court concluded **that a 15% discount should apply because the investment policy of the FLP was consistent with that of a closed-end bond fund in that bond fund investors have little influence over investment strategies**.

A dissenting opinion claimed that proper focus of the valuation should have been on the assets transferred by the donors.

Holding

Issue 1. The Tax Court held that **the partnership was not disregarded for federal gift tax purposes**.

Issue 2. The Tax Court held that **discounts totaling 15%, not 44%, applied**.

Issue 3. The Tax Court held **the fair market value of each of taxpayers' gifts to each children's trust on December 28, 1994 was $394,515**.

Issue 4. The Tax Court held that **I.R.C. §2704(b) did not apply**.

[*Knight v. Commissioner*, 115 T.C. 506 (2000)]

> **Practitioner Note.** In a similar case, *Estate of Strangi v. Commissioner,* 115 T.C. 478 (2000), the Tax Court held that (1) a family limited partnership (FLP) was valid under state law and was recognized for estate tax purposes; (2) I.R.C. §2703 didn't apply to the agreement (the FLP was not a restriction on the sale or use of property that should be disregarded); and (3) the transfer of assets to the partnership was not a gift; however, (4) the discount allowed to value the partnership interests was reduced from an overall discount of 31% to an overall discount of 19%.

Estate of Jones v. Commissioner
[I.R.C. §§2512 and 2704]

> ☞ **Transfer to family limited partnership was not a gift and not subject to I.R.C. §2704(b).**

Facts. A Texas cattle rancher had one son and four daughters. Rancher owned the surface rights to two ranches: R1 and R2. His children owned the surface rights to another ranch, R3, which they inherited from an aunt. In 1995, rancher formed two family limited partnerships: LP1 with his son and LP2 with his daughters. Rancher contributed R1 for a 95.5389% limited partnership interest in LP1. Son contributed his interest in R3 for a 1% general partnership interest and a 3.4611% limited partnership interest in R1. Rancher made a gift of 83.08% limited partnership in LP1 interest to son and contributed the surface estate of R2 for an 88.178% limited partnership interest in LP2, and the daughters contributed their interest in R3 for the remaining interests in LP2. Rancher also gave each daughter a 16.915% interest in LP2.

Under both partnership agreements, the partners have a right of first refusal before any partner may transfer an interest in either partnership to anyone other than rancher or a lineal descendant. The limited partners are not permitted to withdraw from the partnership, receive a return of contribution to capital, or receive distributions in liquidation, except on dissolution, winding up, and termination of the partnership. The term of each partnership is 35 years.

The rancher filed gift tax returns, which included a valuation report. In determining the net asset value, the appraiser applied a secondary market discount, lack of marketability discount, and built-in capital gains discounts. **The overall discounts applied were 66% to LP1 and 58% to LP2. The IRS determined that the transfer of assets on formation of the partnerships, rather than the partnership interests, were taxable gifts under I.R.C. §2512(b) and allowed no discounts.**

Issues

Issue 1. Whether the transfers of assets on formation of the partnerships were taxable gifts pursuant to I.R.C. §2512(b).

Issue 2. Whether restrictions on liquidation of the partnerships should be disregarded for gift tax valuation purposes pursuant to I.R.C. §2704(b).

Issue 3. What is the fair market value of interests in the partnerships transferred by gift after formation?

Analysis

Issue 1. In *Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000), the court concluded that, because the taxpayer received a continuing interest in the family limited partnership and his contribution was allocated to his own capital account, the taxpayer had not made a gift at the time of contribution.

Issue 2. I.R.C. §2704(b) generally states that, where a transferor and his family control a partnership, a restriction on the right to liquidate the partnership shall be disregarded when determining the value of the partnership interest that has been transferred by gift or bequest if, after the transfer, the restriction on liquidation either lapses or can be removed by the family. Treas. Reg. §25.2704-2(b) provides that an applicable restriction is a restriction on "the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction." The court noted that the current situation is similar to the one in *Kerr v. Commissioner*, 113 T.C. 449 (1999), in which the court concluded that the partnership agreements in *Kerr* were not more restrictive than the limitations that generally would apply to the partnerships under Texas law.

Issue 3. The court compared the IRS's appraisals to the taxpayer's expert's appraisals of the partnership interest. The court agreed with the IRS that the gift of the partnership interests to the children was not subject to additional lack of marketability discounts for built-in capital gains, concluding that the buyer and seller of the partnership interest would negotiate with the understanding that an election would be made under I.R.C. §754, and the price agreed upon would not reflect a discount for built-in gains.

Holding

Issue 1. The Tax Court concluded that the transfers of assets on formation of the partnerships were not taxable gifts pursuant to I.R.C. §2512(b).

Issue 2. The Tax Court concluded that I.R.C. §2704(b) did not apply.

Issue 3. In determining the fair market value of interests in the partnerships transferred by gift after formation, **the Tax Court allowed a 40% secondary market reduction discount and an 8% lack of marketability discount.**

[*Estate of Jones v. Commissioner*, 116 T.C. 121 (2001)]

Estate of Gribauskas v. Commissioner
[I.R.C. §§2031, 2033, 2039, and 7520]

> ☞ **Estate must include lottery payments valued as annuity under the I.R.C. §7520 tables.**

Facts. Taxpayer and his wife won a state lotto prize to be paid in 20 annual installments, which began in 1992. The couple divorced after receiving the first annual installment, and the prize was divided equally between taxpayer and wife. Taxpayer died in 1994, and under state law his estate will receive the remaining 18 annual installments. On the estate tax return, the price was reported as an unsecured debt obligation due from the state, reporting a present value of $2,603,661 under I.R.C. §2033. The IRS determined a value of $3,528,058, using the annuity tables under I.R.C. §7520.

Issue. Whether lottery payment installments must be valued using the actuarial tables under I.R.C. §7520.

Analysis. The court noted that the parties agreed that the value of the installments should be includable in the gross estate, and the proper method of valuing the installments is to discount the stream of payments to their present value as of the date of death. However, taxpayer argued that the installment payments did not constitute an annuity because they failed to meet the requirements of I.R.C. §2039(a), and should be valued under a willing-buyer, willing-seller standard using a discount rate of 15% for risk, inalienability, illiquidity, and lack of marketability.

The court noted that it was not necessary to determine whether the installments were includable under I.R.C. §2039 and I.R.C. §2033, but it needed to determine whether the meaning of "annuity" was a standalone term for purposes of I.R.C. §7520. The court concluded that since the asset was derived from the state's promise to make a series of fixed payments, the right to the installment was not dependent on a given asset, and the amount was not subject to market fluctuation, **the installments were an annuity under I.R.C. §7520**.

Taxpayer argued that because of the unsecured nature of the installments, the lack of corpus, and the inability to assign the interest, the tables under I.R.C. §7520 produce an unreasonable result. Taxpayer relied on a case involving almost identical facts, *Estate of Shackelford*, 1999-2 USTC (CCH) ¶60,356 (D. Cal. 1999), in which a district court concluded that departure from the actuarial tables was warranted because failure to account for lack of liquidity of the price rendered tabular valuation unreasonable. The Tax Court disagreed with the district court, concluding that, 1) case law offers no support for considering marketability in valuing annuities, 2) deviation from the tables for nuances in a case would unjustifiably weaken the congressional intent of I.R.C. §7520, which favored standardized actuarial valuation, 3) the annuity, a fixed stream of payments, is distinct from interests that are subject to market fluctuations, and 4) Treas. Reg. §20.7520-3(b)(1)(ii) provides an exception to use of the tables, under I.R.C. §7520, where the facts show a clear risk that the payee will not receive the anticipated return, which would not apply to this annuity, which is backed by the full faith and credit of a state government.

Holding. The Tax Court held that lottery payment installments must be valued using the actuarial tables under I.R.C. §7520.

[*Estate of Gribauskas v. Commissioner*, 116 T.C. 142 (2001)]

Estate of McMorris v. Commissioner
[I.R.C. §2053]

> ☞ **A decedent's estate was allowed to claim an estate tax deduction for income taxes owed at time of death, even though they were later refunded.**

Facts. Husband died in 1990 and wife inherited stock valued at approximately $1.7 million per share. The stock was redeemed for $2.2 million per share. When wife died in 1991, her estate claimed a deduction for federal and state income tax liabilities largely due to the gain on redemption of the stock. In 1994, the IRS issued a deficiency to husband's estate valuing the stock at $3.6 million per share. After negotiations, the parties agreed on a value of $2.5 million per share. As a result of this change in wife's basis in the stock redeemed, her taxable gain was eliminated and she realized a loss. Her estate filed an amended return seeking a refund. The IRS determined a tax deficiency in wife's estate tax return disallowing the deduction for federal and state income taxes. **The Tax Court held that the IRS properly considered an event occurring after death in disallowing the estate's deduction for payment of federal and state income taxes owed at the time of death**.

Issue. Whether events occurring after death may be considered in valuing a claim against the estate deduction.

Analysis. The Tenth Circuit concluded that the date-of-death valuation rule of *Ithaca Trust Co. v. United States*, 279 U.S. 151 (1929), which states that post-mortem events may not be considered in valuing an estate tax charitable deduction, was controlling and extended to apply to the deduction for the tax debt claimed by the decedent's estate under I.R.C. §2053(a)(3). According to the Tenth Circuit, the arguments for not extending the rule to claims against an estate were unpersuasive, and adoption of the rule and its bright line approach fostered greater certainty in estate administration, a laudable policy objective. Rejecting the IRS's claim, the court found that it was not bound by the decision in *Jacobs v. Commissioner*, 3 F.2d 233 (8th Cir. 1929).

Holding. The Tenth Circuit reversed the Tax Court's decision that events occurring after death may be considered in valuing a claim against the estate deduction.

[*Estate of McMorris v. Commissioner*, 243 F.3d 1254 (10th Cir. 2001) reversing and remanding 77 T.C.M. (CCH) 1552 (1999)]

Estate of Rosano v. Commissioner

[I.R.C. §§2033, 2503, and 2511]

> ☞ **Checks written by decedent but not paid until after death were not completed gifts; therefore, they were included in gross estate.**

Facts. Decedent attempted to decrease the amount of money in her taxable estate by making gifts of less than $10,000 to numerous relatives and friends. **Decedent wrote checks to relatives and friends, but the checks were not paid until after her death**. The executor did not include the amount of the checks in the value of the estate. The IRS determined that the checks should be included in the value of the estate and determined a deficiency in the estate tax liability. The District Court agreed with the IRS.

Issue. Whether checks that were written by decedent before death but paid after decedent's death were "completed gifts."

Analysis.. The Second Circuit noted that federal law provides that a gift is completed when the donor has parted completely with dominion and control over the gift. To determine whether decedent parted with dominion and control, the court turned to state law. The court found that under New York state law, decedent had the ability, at any time until the checks were paid, to order that payment on the checks be stopped. Therefore, the court concluded that she retained dominion and control over the checks at the time of her death, and the gifts were not completed.

The court then considered the estate's argument that the checks should be considered to have been paid on the date they were delivered by decedent to the donees, rather than on the date they were actually paid. Under this variation of the doctrine of "relation-back," which generally is applied in cases involving charitable donations, checks delivered to donee charities prior to a decedent's death but not paid until after the decedent's death may be considered completed on the date of delivery. *Estate of Belcher v. Commissioner*, 83 T.C. 227 (1984). In a recent case, *Metzger v. Commissioner*, 38 F.3d 118 (4th Cir. 1994), this doctrine was extended to the non-charitable donation context, to govern whether a gift was made within a year in which it would be exempt from the gift tax, but in that case the donor was alive at the time the checks were paid. The court noted that the estate has pointed to no court that has allowed payment to relate back to the date of delivery if the donor was deceased on the date of actual payment and the donee was not a charitable entity. The Second Circuit concluded that it would not apply the doctrine where gifts are made to a non-charitable donee and the donor died prior to the date of payment.

Holding. The Second Circuit affirmed the District Court's decision that **checks written by decedent before death but paid after decedent's death were not completed gifts.**

[*Estate of Rosano v. Commissioner*, 245 F.3d. 212 (2nd Cir. 2001) affirming 67 F. Supp. 2d 113 (D. NY. 1999)]

Shepherd v. Commissioner

[I.R.C. §2511]

> ☞ **Tax Court allows 15% minority discount on indirect gifts.**

Facts. Taxpayer and his wife have two adult sons. Taxpayer owned 9,000 acres of land that was leased under a 66-year timber lease and 50% of the stock of three local banks. On August 1, 1991, **taxpayer executed a family partnership agreement, and along with his wife executed two deeds transferring the land to the partnership**. The sons did not execute the partnership agreement until the next day. On September 9, 1991, taxpayer transferred the bank stock to the partnership. Taxpayer reported gifts to each son of 25%

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interest in the land and the bank stock on his 1991 gift tax return. Taxpayer valued the land at $400,000 and the stock at $792,386 after a 15% minority discount, resulting in a gift value for each son of $298,097. The unified credit more than offset the gift tax liability; therefore, no gift tax was due with the return.

The IRS determined that the fair market value of the 50% interest in the land was $639,300 and issued a gift tax deficiency notice. However, the IRS did not question the value of the bank stock.

Issues

Issue 1. Determine the characterization, for gift tax purposes, of taxpayer's transfers of real estate and stock into a family partnership of which taxpayer is 50% owner and his two sons are 25% owners.

Issue 2. Determine the fair market value of the transferred real estate interests and the amount, if any, of discounts for fractional or minority interests and lack of marketability that should be recognized in valuing the transferred interests in the real estate and stock.

Analysis and Holding

Issue 1. Taxpayer argued that the gifts of the land were two gifts of partnership interests and that the gift of the bank stock represented indirect gifts bestowed through enhancements of the previously gifted partnership interests, contending that these gifts should be valued allowing a 33.5% minority and marketability discount applicable to each son's 25% partnership interest. The IRS argued that the gift was not the partnership interests; rather, it was indirect gifts of real estate by means of the transfer to the partnership or direct gifts of real estate done before the partnership existed. Agreeing with taxpayer, the court found that on August 1, 1991, there was no completed gift because there was no donee and taxpayer had not parted with dominion and control over the property. However, the court disagreed with taxpayer's argument that his gifts to his sons of interests in the leased land represented gifts of minority partnership interests because the creation of the partnership (and therefore the creation of the sons' partnership interests) preceded the completion of petitioner's gift to the partnership. The Tax Court explained that to adopt petitioner's contention would require the court to recognize the existence, however fleeting, of a one-person partnership, which is contrary to state law. The court also disagreed with taxpayer's contention that the transfers should be characterized as enhancements of the son's interests.

The court rejected taxpayer's argument that the gift tax must be measured by the "value of the property in gratuitous transit" and that to value it otherwise would be a direct tax in contravention of the constitutional restraint on the imposition of direct taxes. The court noted that excise taxes such as the gift tax have been held constitutional since the foundation of the government. However, **the court determined that the gifts to the sons were indirect and not direct gifts of an undivided 25% interest in the land and the bank stock** as the IRS contended.

Issue 2. After comparing the parties' experts, the court held that the value of the land was $757,064 and that the indirect gift of the land was $189,266 for each son or $160,876 after a 15% discount. The court agreed with the taxpayer that **both the land and the stock were subject to a 15% minority discount**.

[*Shepherd v. Commissioner,* 115 T.C. 376 (2000)]

Estate of True v. Commissioner

[I.R.C. §§2031, 2512, 7872, 6662, 6664, and 7872]

> ☞ **Buy-sell agreements were not controlling for estate and gift tax purposes.**

Facts. True died on June 4, 1994, leaving the residue of his estate to a trust in his name. Upon True's death, his wife and three sons were appointed as first successor trustees. True worked in the oil and gas business from 1938 until his death. True owned and operated many business, including an oil company, pipeline company, marketing company, trucking company, cattle ranches, and dude ranch, among several others.

On June 30 and July 1, 1994 wife gave notice to her sons that she wanted to sell her interests in 22 True companies. The buy-sell agreements governing transfers of interests in the companies provided that, upon giving this notice, wife became required to sell, and the sons became required to buy, her interests. The buy-sell agreements gave the sons 6 months to consummate the sale and payment was made to wife on September 30, 1994. The IRS determined that this deferred payment arrangement was a "below-market gift loan" subject to I.R.C. §7872, which gave rise to a taxable gift from wife to her sons. The IRS also imposed valuation understatement penalties under I.R.C. §662(a), (g), and (h).

Issues

Issue 1. Whether the book value price specified in the buy-sell agreements control estate and gift tax values of the interests in the True companies.

Issue 2. If the True family buy-sell agreements do not control values, what are the estate and gift tax values of the interests in the True companies?

Issue 3. Whether wife made gift loans when she transferred interests in the True companies to her sons in exchange for interest-free payments received approximately 90 days after the effective date of the transfers.

Issue 4. Whether taxpayers are liable for valuation understatement penalties under I.R.C. §6662(a), (g), and (h).

Analysis and Holding

Issue 1. Under *Lauder Estate v. Commissioner*, 64 T.C.M. (CCH) 1643 (1992), a formula price under a buy-sell agreement is binding for estate tax valuation purposes if (1) the offering price was fixed and determinable under the agreement; (2) the agreement was binding on the parties both during life and after death; (3) the agreement was entered into for bona fide business reasons; and (4) the agreement was not a substitute for a testamentary disposition. The Tax Court held that, **for both estate and gift tax purposes, the buy-sell agreements were substitutes for testamentary dispositions and, therefore, did not control the values for gift or estate tax purposes.** In addition, the court held that the restrictive provisions of the buy-sell agreements were disregarded in determining fair market value for estate tax purposes.

Issue 2. In considering the value of the oil company, the court accepted the IRS's marketable minority values; however, the court agreed with the taxpayers' experts and granted a 30 percent marketability discount. The court accepted the IRS's net asset value method marketable minority value for the pipeline and assigned a 27% marketability discount to the wife's interest. The court accepted, with reservations, the parties agreed-on value of marketable minority value of the marketing company's total equity and accepted the taxpayers' expert's marketable minority value; however, the court allowed only the IRS's suggested 10% marketability discount from the marketable minority value. The court accepted the taxpayers' expert's equity value for the trucking company and assigned a 30% marketability discount to wife's interest in the trucking company. The court rejected the taxpayers' proposed minority and marketability discounts for the cattle ranches and applied a 15% minority and 30% marketability discount. The court applied a 30% marketability discount to the interest in the dude ranch.

Issue 3. The court concluded that, for federal income tax purposes, wife sold her interests on June 30 and July 1, 1994. The court held that even though no part of the sales price would be treated as interest or original issue discount under I.R.C. §§483 and 1274, **the deferred payment arrangement was a below-market loan under I.R.C. §7872(e)(1)(B) and was a gift loan** and not a transaction in the ordinary course of business.

Issue 4. Finding that taxpayers did not rely, in good faith, on professional appraisals or obtain professional advice on the effects of the decisions in the prior gift tax cases and did not exercise ordinary business care and prudence in attempting to assess the proper estate and gift tax liabilities, the court held that the reasonable cause exception did not apply and taxpayers were liable for valuation understatement penalties under I.R.C. §6662(a), (g), and (h).

[*Estate of True v. Commissioner*, 82 T.C.M. (CCH) 27 (2001)]

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LTR 200132004

[I.R.C. §§2053 and 2056]

> ☞ **An estate was denied a marital deduction following 33 years of cohabitation since the couple was not married.**

Facts. While married to others, the decedent and A began 33 years of cohabitation. **A used decedent's surname and there was evidence that the couple presented themselves as married**. The couple had no children together. A had a stroke and decedent allegedly told A and her caretakers that she could return to his home after rehabilitation. However, six months later he refused to allow her return. Sometime after, A suffered another stroke with a resulting complete mental impairment. The decedent subsequently died after being ill with a degenerative disease. **There was no provision for A in his will.** A's guardians filed an election for her to take a statutory spousal share of the estate. In addition, A's guardians filed suit for damages, alleging that decedent was liable to A for the tort of intentional infliction of emotional distress, claiming that his refusal to allow A to return to his house caused her complete and permanent mental collapse. The parties reached a settlement of both claims. The executrix of the estate asserts that the settlement amount is an allowable deduction under I.R.C. §2056(a), as an amount passing to decedent's spouse, or alternatively, under I.R.C. §2053(a), as a claim against the estate.

Issues

Issue 1. Should a marital deduction be allowed under I.R.C. §2056(a) for payments made for settlement of claim that A was decedent's common law wife and, therefore, entitled to an elective share of his estate?

Issue 2. Alternatively, should the payment be deductible under I.R.C. §2053(a), as a claim against decedent's estate for alleged tortuous conduct prior to his death?

Analysis

Issue 1. I.R.C. §2056(a) provides that the value of the taxable estate shall . . . be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse. Treasury Regulation §20.2056(c)-(2)(d)(2) provides that if, as a result of the controversy involving the decedent's will, a property interest is assigned or surrendered to the surviving spouse, the interest so acquired will be regarded as having "passed from the decedent to his surviving spouse" only if the assignment or surrender was a "bona fide recognition of enforceable rights of the surviving spouse in the decedent's estate." In *Estate of Carpenter v. Commissioner*, 52 F.3d 1266, and other cases, it has been determined that **a payment pursuant to a settlement agreement will constitute a bona fide recognition of enforceable rights of the surviving spouse in the decedent's estate only if the settlement is based on an enforceable right under state law properly interpreted.**

After considering state law, the IRS concluded that the supreme court of the state would not recognize the couple's relationship as a common-law marriage.

Issue 2. I.R.C. §2053(a)(3) provides that the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts for claims against the estate as are allowable by the laws of the jurisdiction. **A claim against the estate, in general, whether based in tort or otherwise, will be allowed as a deduction under I.R.C. § 2053(a)(3) only if the claim is enforceable under state law** [see *United States v. Stapf*, 375 U.S. 118 (1963)].

The IRS concluded that the facts giving rise to A's claim had not been developed for this technical advice request. To support that A had an enforceable claim under state law, the IRS suggested consideration may be given to the status of the litigation at the time of settlement (e.g., whether the defendant filed a motion to dismiss the action that was denied by the court, and the basis for such denial).

Holding

Issue 1. The IRS held that a marital deduction was not allowed for the amount payable under settlement agreement.

Issue 2. The IRS held that whether the payment is deductible under I.R.C. §2053(a) is dependent on whether the facts as developed would support a recovery under state law, and that the factual development was within the jurisdiction of the field office.

[LTR 200132004 (April 25, 2001)]

FILING STATUS

Guadalupe Mares v. Commissioner
[I.R.C. §§2, 32, 151, and 152]

> ☞ **Taxpayer was denied dependency exemption for her siblings since she did not provide more than half of their support.**

Facts. The taxpayer lived in the home of her parents. Her father paid the monthly mortgage payments of $413, but the taxpayer paid some or all of the utilities, which averaged $250 to $300 per month. The taxpayer's wages for the year were $11,945 and she received a tax refund of $1,400. Her father was not employed during the year but received $4,918 in social security benefits. Her mother was unemployed except for earning an undisclosed amount for babysitting. Her mother received $3,787 of food stamps during the year. The taxpayer purchased clothing and school supplies for her three siblings, all of whom were students during the year. She also purchased food and other household products consumed by her family.

Taxpayer **claimed head of household status and claimed dependency exemptions for her mother and her three siblings,** two of whom she reported as foster children. She claimed an earned income credit computed by treating the two "foster children" as qualifying children. The IRS changed her filing status to single and disallowed the dependency exemptions and the earned income credit.

Issues

Issue 1. Was the taxpayer entitled to claim dependency exemption deductions for her siblings and her mother?

Issue 2. Was the taxpayer qualified as head of household?

Issue 3. Was the taxpayer entitled to an earned income credit?

Analysis and Holding

Issue 1. Under Treas. Reg. §1.152-1(a)(2)(i), the term support includes food, shelter, clothing, medical and dental care, education, and the like. Although the court found that the taxpayer contributed generously to the support of her family, due to the amount of the mortgage payments made by her father and the amount of public assistance received by her mother, the **court was not convinced that the taxpayer contributed over one-half of the support** for any of the dependents claimed. The Tax Court held that the taxpayer was not entitled to claim dependency exemptions deductions for her siblings and her mother.

Issue 2. Since taxpayer was not entitled to claim dependency deductions for her siblings and her mother, under I.R.C. §2(b)(1)(A)(ii), the Tax Court held that **she did not qualify as head of household.**

Issue 3. The Tax Court found that since the taxpayer's siblings are not her children, descendants of her children, her stepchildren, or eligible foster children, and she does not claim to have cared for them as her own children, **she was not entitled to an earned income credit**.

[*Guadalupe Mares v. Commissioner*, 82 T.C.M. (CCH) 424 (2001)]

CCA 200130036

[I.R.C. §6654]

☞ **Filing separate returns showed spousal agreement for allocation of joint estimated tax payment.**

Facts. The taxpayers, a married couple, filed a joint return for 1998 and reported an overpayment to be credited to their 1999 estimated tax. The taxpayers filed separate returns for 1999, and the husband claimed the entire amount of the overpayment as estimated tax on his 1999 return. The wife claimed none of it on her separate 1999 return. Later, however, she wanted to have part of the credit allocated to her.

Issue. Can the wife, after filing a return claiming none of the joint previous year's overpayment credited to estimated tax, later have part of the credit allocated to her?

Analysis and Holding. The IRS explained that the proper method of apportioning the amount in dispute depends on whether it is treated as a joint estimated tax payment for 1999, or an overpayment from 1998. The IRS pointed out that once the spouses elected to credit the overpayment to the next year's estimated tax, it ceased to be an overpayment and became an estimated tax payment. However, it also had to be determined whether the parties had agreed on its allocation. **If there was no spousal agreement, the payment must be allocated in proportion to their separate tax liabilities in 1999**. The IRS determined that the 1999 returns as filed showed that an agreement existed. According to Rev. Rul. 76-140, 1976-1 C.B. 376, **the wife has the burden of proving that no agreement existed** if she wants part of the credit allocated to her.

[CCA 200130036 (May 25, 2001)]

GAINS AND LOSSES

LTR 200111013
[I.R.C. §§351 and 368]

> ☞ **Conversion from mutual insurance company to stock insurance company qualifies as Type E reorganization.**

Facts. Taxpayer is incorporated as a mutual insurance company. The policyholders hold proprietary interests but not stock. **Taxpayer plans to convert to a stock life insurance company**.

Issue. Whether the conversion of a mutual life insurance company to a stock life insurance company will qualify under I.R.C. §368(a)(1)(E).

Analysis and Holding. The IRS held that the conversion of the mutual life insurance company to a stock life insurance company will qualify under I.R.C. §368(a)(1)(E).

Company membership interest holders will recognize no gain or loss on exchanging the Company membership interests for Company stock under I.R.C. §354(a)(1).

The **basis of Company membership interests is zero** under Rev. Rul. 71-233, 1971-1 C.B. 113 and Rev. Rul. 74-277, 1974-1 C.B. 88. The basis of the Company stock received in exchange for Company membership interests will equal the basis of the Company membership interests surrendered, therefore, zero under I.R.C. §358(a)(1).

The **holding period of Company stock** received in exchange for Company membership interests **will include the period the holder held such Company membership interests** under I.R.C. §1223(1).

No gain or loss will be recognized by Company on the issuance of Company stock in exchange for company Membership Interests under I.R.C. §1032(a).

[LTR 200111013 (December 8, 2000)]

> **Practitioner Note.** See also LTR 200052015 (September 27, 2000) for a similar ruling **of a mutual insurance conversion to a stock insurance company that qualified as a Type E reorganization**. No gain or loss was recognized by the parties as a result of the transactions, and the holding period of the transferred assets remained the same.

Pine Creek Farms, Ltd. v. Commissioner
[I.R.C. §§1221 and 6662]

> ☞ **Losses on the sale of hog futures were capital losses since taxpayer was not sufficiently engaged in the hog business.**

Facts. Taxpayer raised corn, soybeans, and cattle and used its corn and soybean crops either to feed its cattle, which it raises and markets, or to sell to two other corporations, which have a common shareholder with taxpayer. One of these corporations raised piglets and sold them to the other corporation, which raised them to maturity and sold them at market. Taxpayer also sold grain to the other two corporations to feed the pigs. Prior to incorporating, the common shareholder had a commodities hedging account, which was transferred to taxpayer. The other two corporations did not have a commodities account; however, the common shareholder claimed that he maintained one account for all three corporations to simplify the record keeping and tax reporting. Taxpayer was involved in numerous futures transactions for corn, soybeans, cattle, and hogs and deducted the hedging expenses as an ordinary loss. The **IRS disallowed the losses related to hog futures on grounds that taxpayer was not engaged in the production of hogs.**

Issues

Issue 1. Whether losses incurred by taxpayer on the sale of hog futures are capital losses or ordinary losses.

Issue 2. Whether taxpayer is liable for the accuracy-related penalty under I.R.C. §6662(a).

Analysis and Holding

Issue 1. Under Treas. Reg. §1.1221-2(a) and (b), the term *capital asset* does not include property that is part of a hedging transaction, which is defined as a transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business primarily to reduce risk of price changes or currency fluctuations with respect to ordinary property that is held or to be held by the taxpayer. In *Myers v. Commissioner*, 52 T.C.M. (CCH) 841 (1986), it was concluded that Myers had little, if any, reason to hedge soybean and feeder cattle since he did not produce soybeans or feeder cattle, and Myers's hedging transactions were held to be capital losses.

The court concluded that **the taxpayer failed to prove a direct relationship between its production of corn or soybeans, which were the basis of its business, and the hog futures in which it dealt**. Further, the court found that taxpayer failed to establish that there was a close relationship, or any relationship, between the price of corn or soybeans and the price of hog futures, and that the hog futures transactions did not reduce the risk of price changes or currency fluctuations regarding taxpayer's ordinary property. Therefore, the Tax Court held that **the losses incurred by taxpayer on the sale of hog futures were capital losses.**

Issue 2. Finding that taxpayer reasonably relied on its accountant's advice in characterizing the losses as ordinary, the Tax Court held that taxpayer was not liable for the accuracy-related penalty under I.R.C. §6662(a).

[*Pine Creek Farms, Ltd., v. Commissioner*, 82 T.C.M. (CCH) 181 (2001)]

GAMBLING INCOME AND LOSSES

Rodriguez v. Commissioner
[I.R.C. §§61, 165, 6651, and 6662]

> ☞ **Deduction for gambling losses disallowed because taxpayer had no records to substantiate the amount of the losses.**

Facts. Taxpayer was a gambler who ran an illegal bookmaking business and was arrested by the FBI while acting as a middleman in a cocaine sale. **Taxpayer was paid a lump sum payment of $100,000 by the FBI, which he failed to report on his tax return**. Taxpayer reported gambling winnings, but only to the extent of W-2 amounts reported. Taxpayer reported gambling losses but had no records to substantiate the losses. Taxpayer also filed his return late.

Issues

Issue 1. Whether taxpayer is entitled to a deduction for gambling losses even though he cannot substantiate the amount.

Issue 2. Whether taxpayer is entitled to exclude a portion of the lump sum payment received from the FBI for serving as an undercover informant in order to obtain a reduced sentence.

Issue 3. Whether taxpayer is liable for the accuracy-related penalty under I.R.C. §6662(a).

Issue 4. Whether taxpayer is liable for the failure to file a timely return penalty under I.R.C. §6651(a)(1).

Analysis and Holding

Issue 1. I.R.C. §165(d) allows taxpayers to deduct losses from wagering transactions to the extent of the gains from such transactions, and also requires taxpayers to prove that the amount of such wagering losses claimed as a deduction does not exceed taxpayers' gains from wagering transactions. The court found that there was no evidence in the record that provided a basis for determining or even guessing the amount of unreported gambling winnings earned by taxpayer during the year at issue. Accordingly, the court found that taxpayer had failed to prove that the gambling losses claimed as a deduction did not exceed the gains from such transactions, as required by I.R.C. §165(d), and disallowed the gambling losses claimed.

Issue 2. Taxpayer claimed that he was paid in part for his property that was seized as part of the investigation, in part for refusing to join the witness protection program and for relocation expenses for his family. The court found that **taxpayer had shown no proof that he had incurred any expenses and held that he was not entitled to exclude any of the lump sum payment**.

Issue 3. The court held that the taxpayer was liable for the accuracy-related penalty.

[*Rodriguez v. Commissioner*, 81 T.C.M. (CCH) 115 (2001)]

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GROSS INCOME

Foster v. Commissioner
[I.R.C. §§61, 104, 212, 6651, and 7430]

> ☞ **Eleventh Circuit ordered IRS to pay taxpayer's litigation costs.**

Facts. Taxpayer sued an insurance company for selling her a Medicare supplemental policy when she did not have Medicare coverage. She won compensatory damages, punitive damages, and post-judgment interest. Before filing the complaint, she signed a contingency fee agreement, which included 50% of post-judgment interest. After the trial but before the appeal, she signed an agreement, which would give the attorneys the other 50% of post-judgment interest. Taxpayer did not include any of the judgment in income. The District found that punitive damages were taxable income, that the portion of post-judgment interest paid to the taxpayer's attorneys constituted taxable income as it was not part of the original pre-trial contingency fee agreement, and that the position of the IRS in this litigation was substantially justified.

Issues

Issue 1. Whether punitive damages are taxable.

Issue 2. Whether fees paid to attorneys based on a post-judgment, pre-appeal fee agreement must be included in gross income.

Issue 3. Whether the position of the IRS in this litigation was substantially justified.

Analysis. The court rejected taxpayer's argument that the punitive damages were excludable under I.R.C. §104(a)(2); however, **the court held that the attorney's portion was excludable**.

The District Court relied on the assignment of income principle when it held that the post-judgment interest was includable in income. The Eleventh Circuit rejected the District Court's argument, finding that *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959), controlled. In *Cotnam v. Commissioner*, it was held that contingent attorney's fees subject to Alabama law are not subject to tax under the anticipatory assignment of income doctrine since before judgment or settlement a claim is of uncertain value, and the lawyer's services are necessary to convert that claim into value to the taxpayer. The court noted that before the appeals process it was uncertain how much, if any, she would be awarded and the length of the appeals process affected the calculation of the post-judgment interest.

The court noted that while the IRS was litigating this case, the IRS was seeking to get *Cotnam* overturned in another case, but the Eleventh Circuit denied IRS's request for an initial hearing *en banc*. The court then noted that because an *en banc* panel is necessary to overrule a precedential case, IRS should have known that the Eleventh Circuit was not inclined to overrule *Cotnam*. The court remarked that the IRS should not expect taxpayers to fund a crusade to change the law.

Holding

Issue 1. The Eleventh Circuit affirmed the District Court's decision that the punitive damages were taxable.

Issue 2. The Eleventh Circuit reversed the District Court's decision and held that fees paid to attorneys based on a post-judgment, pre-appeal fee agreement was not includable in gross income.

Issue 3. The Eleventh Circuit reversed and remanded the District Court's decision and held that the position of the IRS in this litigation was not substantially justified; therefore, the IRS must pay taxpayer's litigation costs.

[*Foster v. Commissioner*, 249 F.3d. 1275 (11th Cir. 2001) *aff'g, rev'g,* and *remanding* 106 F. Supp. 2d 1234 (D. Ala. 2000)]

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

> ☞ **Wrongful termination award is includable in income with attorney's fees deductible as itemized deductions subject to 2% floor.**

Facts. Taxpayer won a wrongful termination suit after being discharged from her job. Taxpayer received the award net of taxes and then paid her attorney. Taxpayer excluded the amount awarded that was not paid on account of past wages, instead reporting it as self-employment income on Schedule C (Form 1040). Taxpayer reported as wages only the portion of the award for past wages. Taxpayer deducted the attorney fees and litigation costs, proportionate to the portion of award reported on Schedule C (Form 1040) and the remaining attorney fees and litigation costs were deducted as miscellaneous itemized deductions. The

IRS determined that the entire award should have been included as wages and the attorney fees and litigation costs were deductible only as miscellaneous itemized deductions. **The Tax Court held that the award of damages was fully includable in income, because under state law, attorney's fees are subordinated to the claimant's rights in the recovery and do not reduce the includable amount.**

Issue. Whether taxpayer was entitled to exclude from gross income any amount for costs and contingent legal fees incurred in securing judgment for lost wages and benefits from wrongful termination.

Analysis. Relying on *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959), taxpayer contends that she is entitled to exclude the portion of the settlement that they "assigned" to the attorney. In *Cotnam*, the Fifth Circuit concluded that the taxpayer did not have to include the attorney's fee in income because Alabama state law 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 Michigan state law was similar to the Alabama lien in *Cotnam*.

Distinguishing this case from *Cotnam* and *Estate of Clarks*, the Ninth Circuit concluded that Alaska state law, applicable in this case, did not give the attorneys a superior lien or ownership interest in judgments of their clients. Therefore, taxpayer retained all proprietary rights in her claim against her former employer, subject to a statutory lien held by the attorneys on any proceeds derived from the claim. The court noted that an assignment involving a contingent amount will not permit the amount to escape taxation by preventing the earnings from vesting in the person who earned it.

Holding.. The Ninth Circuit affirmed the Tax Court's decision that the taxpayers were not entitled to exclude any of the costs and contingent legal fees from income.

[*Coady v. Commissioner*, 213 F.3d 1187 (9th Cir. 2000) *aff'g* 76 T.C.M. (CCH) 257 (1998), *cert. denied,* April 16, 2001]

> **Practitioner Note.** In *Kenseth v. Commissioner,* 2001-2 USTC ¶50,570 (7th Cir. 2001) *aff'g* 114 T.C. 399 (2000), the 7th Circuit held that attorney's fees paid out of an age discrimination settlement were includable in income of the taxpayer, and that the legal fees were deductible as an itemized deduction and not excluded from income.
> See also *Griffin v. Commissioner*, 81 T.C.M. (CCH) 972 (2001) and *Nelson v. Commissioner*, T.C. Summary Opinion 2001-44, for two other cases involving contingent attorney fees.

Fullman v. Commissioner

[I.R.C. §61]

> ☞ **Taxpayer's income from playing organ at church services is not excludable.**

Facts. Taxpayer received amounts from two churches for playing the organ during church services. One church issued a Form W-2, Wage and Tax Statement, and the other church issued a Form 1099-MISC to the taxpayer. Taxpayer failed to report the amounts as income. The IRS determined a deficiency for unreported income.

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Issue. Whether amounts received from churches for playing an organ during services were taxable under I.R.C. §61.

Analysis. I.R.C. §61(a) provides that "gross income means all income from whatever source derived, including . . . Compensation for services." While limited exclusions from gross income are provided by the Code, under *Wilson v. Commissioner*, 22 T.C.M. (CCH) 914 (1963) *aff'd,* **there is no exclusion for income received by individuals from a church or other charitable organization for services.**

Holding. The Tax Court held that amounts received from churches for playing an organ during services are taxable under I.R.C. §61.

[*Fullman v. Commissioner*, 80 T.C.M. (CCH) 644 (2000)]

Swaringer v. Commissioner
[I.R.C. §§102. 162, 262, 280F, 274, and 6662]

> ☞ **Minister could not exclude amounts received from members of his congregation as gifts.**

Facts. Taxpayer's wife was employed as a secretary and was paid a salary of $44,271 in 1995. Taxpayer was the pastor of a church. The parties stipulated that taxpayer was self-employed. **Taxpayer was paid from the "offerings" of the congregation.** On Schedule C (Form 1040), Profit or Loss From Business, relating to taxpayer's ministry, he reported $28,600 as income from the church. **Neither taxpayer nor the church maintained records of the "offerings."** IRS used a bank deposits analysis to verify taxpayers' income. That analysis showed unexplained bank deposits of $24,316, but in concession the IRS reduced the amount by $2,343. Taxpayer testified that, of the remaining unexplained bank deposits, $1,000 was a loan from an individual and the remainder constituted nontaxable gifts from parishioners of the church. According to taxpayer, on occasions such as his birthday, Father's Day, and Christmas, parishioners would give him money as gifts. On Schedule C (Form 1040) taxpayer claimed deductions of $24,574. Of this amount, IRS disallowed $19,271.

Issues

Issue 1. Whether taxpayer had unreported income in the amount determined by the IRS through bank deposits analysis or whether the amounts were nontaxable gifts as claimed by taxpayer.

Issue 2. Whether taxpayer was entitled to Schedule C deductions in amounts greater than those determined by IRS.

Issue 3. Whether the negligence penalty was applicable.

Analysis. The court noted that the evidence strongly suggested that the transfers were not gifts within the meaning of I.R.C. §102(a), but arose out of petitioner's relationship with the members of his congregation presumably because they believed he was a good minister and they wanted to reward him.

The court concluded that taxpayer did not have adequate substantiation of the expenses disallowed by IRS, and that negligence includes any failure by taxpayer to keep adequate records or to substantiate items property.

Holding

Issue 1. The Tax Court held **that taxpayer had unreported income in the amount determined by the IRS through bank deposits analysis.**

Issue 2. The Tax Court held that taxpayer was not entitled to Schedule C deductions in amounts greater than those determined by IRS.

Issue 3. The Tax Court held that the negligence penalty was applicable.

[*Swaringer v. Commissioner*, T.C. Summary Opinion 2001-37]

CCA 200108042
[I.R.C. §132]

> ☞ **Non-monetary recognition awards with a fair market value of $100 do not qualify as de minimis fringe benefits.**

Issue. Whether non-monetary recognition awards having a fair market value of $100 qualify as de minimis fringe benefits.

Analysis. An employee's wages do not include the value of a de minimis fringe benefit. This benefit is any property or service provided to an employee that has so little value (taking into account how frequently similar benefits are provided) that accounting for it would be unreasonable or administratively impracticable. Cash, no matter how little, is never excludable as a de minimis fringe, except for occasional meal money or transportation fare.

Holding. The IRS concluded that non-monetary achievement awards having a fair market value of $100 would *not* qualify as de minimis fringes and, consequently, would constitute salary and wages.

[CCA 200108042 (December 20, 2000)]

Henry v. Commissioner
[I.R.C. §104]

> ☞ **Settlement payments from chemical company for damage to plants were not excludable from gross income.**

Facts. An orchid grower won a settlement against a chemical company whose fungicide damaged his plants. The Tax Court concluded that the full settlement was taxable. The Eleventh Circuit remanded the decision back to the Tax Court in light of their decision in *Fabry v. Commissioner*, 223 F.3d 1261 (11th Cir. 2000), *rev'g* 111 T.C. 305 (1998).

Issue. Whether taxpayers are entitled to exclude from gross income a portion of the settlement under I.R.C. §104(a)(2) for damage to business reputation.

Analysis. I.R.C. §104(a)(2) provides that, in general, gross income does not include the amount of any damages (other than punitive damages) received on account of personal physical injuries or physical sickness.

In *Fabry*, the Eleventh Circuit, reversing the Tax Court's decision, concluded that since the taxpayer had established and the IRS had conceded that part of their settlement was paid as damages for injury to their business reputation, which were received on account of personal injuries, as required by *Commissioner v. Schleier*, 515 U.S. 323 (1995), the amount was excludable from gross income under I.R.C. §104(a)(2).

However, in *Henry v. Commissioner*, 77 T.C.M. (CCH) 2209 (1999), the **Tax Court found that taxpayer "has failed to establish that all or any portion of the . . . total settlement amount, or the . . . settlement payment, was paid by reason of or because of, the loss of the plaintiffs' business reputation or the loss of their reputation as orchid growers."**

Holding. On remand, the Tax Court held to their original decision, concluding that the taxpayers were not entitled to exclude from gross income a portion of the settlement under I.R.C. §104(a)(2) for damage to business reputation.

[*Henry v. Commissioner*, 81 T.C.M. (CCH) 1498 (2001)]

LTR 200042027
[I.R.C. §117]

> ☞ **Medical research training grants modeled after NRSA are not excludable from income but are not subject to social security taxes.**

Facts. Taxpayer is a tax-exempt nationally recognized center for research and treatment. Taxpayer pays participants in their training programs (postdoctoral fellows) stipends to help defray general living expenses during their periods of training.

Issue. What is the proper federal income tax treatment, including any reporting and/or withholding obligations, for certain stipends paid by the taxpayer to individual in connection with research training programs?

Analysis. Scholarship receipts that exceed expenses for tuition, fees, books, supplies, and certain equipment are not excludable from a recipient's gross income under I.R.C. §117. The IRS noted that fellowship stipends made to non-degree candidates for general living expenses are a typical example of includable scholarship amounts. I.R.C. §117(c) provides that the exclusion for qualified scholarships does not apply to amounts representing payment for teaching, research, or other services by the student required as a condition for receiving the qualified scholarship or fellowship. Amounts includable under I.R.C. §117(c) are considered wages subject to withholding and reporting requirements under I.R.C. §3401(a).

In Rev. Rul. 83-93, 1983-1 C.B. 364, **the IRS does not regard the research and research training activities sponsored by institutional NRSA awards as constituting the performance of services,** which allows recipients to exclude amounts for qualified tuition and related expenses.

The IRS concluded that taxpayer's grants are substantially similar, if not identical, to the NRSA awards program.

Holding. The IRS held that the stipends are not wages for purposes of I.R.C. 3401(a) and are not subject to withholding of income taxes, FICA, or Federal Unemployment Tax. Taxpayer is not required to file Forms W-2 or any information returns under I.R.C. §6041. Further, the amounts are not subject to self-employment taxes. The IRS noted that if participants are degree candidates, the grants will ordinarily be excludable from the recipients' gross incomes to the extent of their qualified tuition and related expenses. The IRS pointed out that in the case of non-degree candidates, the entire amount of scholarship or fellowship awards is includable in gross income.

[LTR 200042027 (July 25, 2000)]

> **Practitioner Note.** See also LTR 200113020 (December 27, 2000) for a similar ruling.

8

LTR 200049007

[I.R.C. §61, 117, 501, 3121, 3306, and 3401]

> ☞ **Scholarships provided to employees' children are income to the employee if guidelines in Rev. Proc. 76-47 are not met.**

Facts. The taxpayer is a voluntary employees' beneficiary association (VEBA) under I.R.C. §501(c)(9) and was created in 1945 under a collective bargaining agreement with the employers in a particular industry. Employers contribute a specified percentage of gross payroll, on a monthly basis, to fund the VEBA. VEBA funds are used to pay life, sickness, accident, and other benefits to members. Members of the VEBA are the bargaining-unit employees (and their dependents) of the participating employers.

In 1974, the taxpayer created the scholarship program to provide scholarships to the children of its employee-members for undergraduate studies. The program is an activity of the VEBA and not a separate fund or organization. All applicants receive scholarships. However, applicants are ranked in order of need, and the amount of the individual awards varies greatly depending on need. Some applicants receive an additional award, based on grades. Except in certain layoff situations, if an employee's employment, and therefore participation in the VEBA, terminates, the scholarship grant ceases. Tuition paid for the current term does not have to be refunded, but any remaining grant is canceled and the student is not eligible to apply for further grants. Taxpayer requested that the holding under this ruling, if adverse, be applied without retroactive effect since they previously received a favorable determination that it qualified as a VEBA and that the benefits under the scholarship program would not jeopardize its status. However, the issue of whether there was any FICA or withholding obligation on the scholarship benefits was not addressed in the previous determination.

Issue

Issue 1. Whether certain educational benefits provided by the taxpayer are qualified scholarships excluded from gross income under I.R.C. §117(a) and whether the benefits are excluded from wages for purposes of the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA) and income tax withholding.

Issue 2. If the benefits are subject to employment taxes, whether the taxpayer is entitled to relief under I.R.C. §7805(b).

Analysis and Holding

Issue 1. To be accorded scholarship treatment under I.R.C. §117, educational grants awarded in an employment context must generally be shown to fall outside the pattern of employment. Rev. Proc. 76-47, 1976-2 C.B. 670, provides guidelines for determining whether grants made by private foundations under employer-related scholarship programs to employees and/or children of employees will be treated as scholarships or fellowship grants subject to the provisions of I.R.C. §117(a).

In the present case, **the IRS concluded that the taxpayer's awards program fell significantly short of the facts and circumstances needed to evidence that the program falls outside the pattern of employment.** The IRS noted that, in particular, the awards are made to all applicants, an outcome that does not begin to satisfy either of the percentage tests in Rev. Proc. 76-47. Additionally, the IRS found that the program did not pass the substitute facts and circumstances analysis because there was great probability that a grant would be available to any applicant. Furthermore, the IRS found that the program did not satisfy the requirement that a grant not be terminated simply because the employee terminates employment. The **IRS concluded that the scholarships were not excludable from gross income under I.R.C. §117(a), but, rather, are wages for FICA, FUTA, and income tax withholding purposes.**

Issue 2. I.R.C. §7805(b) provides that the Secretary may prescribe the extent, if any, to which any ruling or regulation relating to the internal revenue laws may be applied without retroactive effect. The IRS determined that since no ruling was issued to the taxpayer on the issues presented here, I.R.C. §7805(b) does not apply to limit the retroactive effect of the previous conclusion.

[LTR 200049007 (July 21, 2000)]

LTR 200108010
[I.R.C. §§61, 104, 105, 106, 152, 501, 3102, 3121, 3306, 3401, and 3402]

☞ **Non-spouse domestic partner must be employee's dependent to exclude health coverage provided to the partner from employee's wages.**

Facts. The fund is structured as a voluntary employees' beneficiary association (VEBA), as defined by I.R.C. §501(c)(9). The IRS previously issued the Fund a determination letter that ruled that health coverage provided to nondependent, nonspousal domestic partners of employees is wages to the employee for employment tax purposes and that a fund providing the coverage is the employer for employment tax purposes [LTR 9850011 (September 10, 1998)].

Under the Trust Agreement, the fund receives contributions from employers having collective bargaining agreements with the Union. Contributions to the fund by employers are required under the terms of their respective collective bargaining agreements. Employer contributions are remitted to the fund to support all benefit programs and to satisfy the administrative expenses of the fund. An employer's contributions to the fund remain the same regardless of whether a participant elects single or family coverage.

The fund pays benefits from the general assets of the fund. Contribution rates for each plan unit are calculated actuarially at the direction of the trustees to support the benefits for each respective plan unit, although the fund's assets are pooled and the fund is liable for all expenses of all of its constituent plan units. It is estimated that the maximum annual cost of providing domestic partner coverage including employment taxes will be less than 3.31% of the fund's annual benefit expenditures.

Issues

Issue 1. What are the employment tax consequences to the fund of providing health coverage to nondependent, non-spousal domestic partners of employees of participating employers.

Issue 2. Whether the fund, as the entity in control of providing the coverage, is the employer for purposes of employment taxes.

Issue 3. What is the effect of such coverage and related employment tax liabilities on the fund's exempt status under I.R.C. §501(c).

Analysis and Holding

Issue 1. The IRS noted that employer-provided coverage under an accident or health plan for personal injuries or sickness incurred by individuals other than the employee, his or her spouse, or his or her dependents is not excludable from the employee's gross income under I.R.C. §106. In addition, reimbursements received by the employee through an employer-provided accident and health plan are not excludable from the employee's gross income under I.R.C. §105(b) unless the reimbursements are for medical expenses incurred by the employee, his or her spouse, or his or her dependents. However, reimbursements that are not excludable under I.R.C. §105(b) may be excludable under I.R.C. §104(a)(3) if they are attributable to employer contributions that were included in the employee's income.

I.R.C. §§152(a)(1)–(8) define a dependent as an individual who: (1) receives more than half of his or her support from the taxpayer and (2) is related to the taxpayer. It is not expected that a nonspousal domestic partner will meet the relationship tests under these sections. I.R.C. §152(a)(9) defines a dependent as an individual who: (1) receives more than half of his or her support from the taxpayer for the year, and (2) who has the home of the taxpayer as his or her principal abode and is a member of the taxpayer's household during the entire taxable year of the taxpayer. I.R.C. §152(b)(5) provides that an individual is not considered a member of the taxpayer's household if the relationship between the individual and the taxpayer is in violation of local law.

The IRS concluded that the excess of the fair market value of the coverage provided by the fund to a domestic partner who is not a dependent of the employee over the amount paid by the employee for such coverage, is includable in the income of the employee and is wages for FICA, FUTA, and income tax withholding purposes. The amount of employee FICA attributable to the coverage that is paid by the fund on the employee's behalf is also includable in the employee's income and is wages for employment tax purposes. Therefore, the grossed-up amount determined under Rev. Proc. 81-48, 1981-2 C.B. 623, is the amount includable in the gross income of the employee by reason of the health coverage for a domestic partner and is the amount of the employee's wages for FICA, FUTA, and income tax withholding purposes.

Issue 2. The IRS concluded that the fund is the employer for purposes of the employment taxes on the amount of wages that results from the coverage provided to an employee's nondependent domestic partner. Thus, the fund is required to withhold income tax and the employee portion of the FICA tax. The fund must also pay the employer portion of the FICA tax and the FUTA tax.

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Issue 3. The IRS noted that under Treas. Reg. §1.501(c)(9)-3(c), sick and accident benefits may not be provided to a member's other "designated beneficiaries" (individuals who are not a member's dependents) and a VEBA would lose its exempt status if it systematically and knowingly provided more than a "de minimis" amount of nonqualifying benefits.

The IRS concluded that the fund's operations with respect to health coverage provided to nondependent, nonspousal domestic partners would be no more than de minimis and, therefore, would not adversely affect the fund's exempt status.

[LTR 200108010 (November 17, 2000)]

INFORMATION REPORTING

Notice 2000-62

[I.R.C. §§25A, 221, 6050S, 6721, and 6722]

☞ **No additional reporting requirements for student loan interest in 2001.**

Purpose. This notice announces that eligible educational institutions and certain persons who receive payments of student loan interest may continue to report the same information under I.R.C. §6050S for the year 2001 as required for years 1998, 1999, and 2000. Notice 97-73, 98-7 (I.R.B. 1998-3, 54), Notice 98-46 (I.R.B. 1998-36, 21), Notice 98-54 (I.R.B. 1998-46, 25), Notice 98-59 (I.R.B. 1998-49, 16), and Notice 99-37 (I.R.B. 1999-30, 124) are modified.

Background. The legislative history to I.R.C. §6050S reflects that Congress intended that no additional reporting (beyond what is currently required in Notice 97-73) would be required of institutions until final regulations are issued under §6050S. In addition, Congress intended that the final regulations would have an effective date that gives institutions sufficient time to implement additional required reporting.

Discussion. On June 16, 2000, the Treasury Department and the Service issued proposed regulations under §6050S. The regulations propose reporting under §6050S beyond that required in Notice 97-73 (as modified) and Notice 98-7 (as modified). The regulations are proposed to be applicable for information returns required to be filed, and statements required to be furnished, after December 31, 2001. The proposed regulations are expected to be finalized in 2001. After receiving numerous comments indicating the proposed applicability date does not provide sufficient lead time for institutions and payees to comply, the Treasury Department and the IRS have decided that **reporting requirements for 2001 will be the same as those for previous years.**

Requirements for 2001. For the year 2001, eligible educational institutions will be required to file Forms 1098-T that include the same information required by Notice 97-73 (as modified). Similarly, payees will be required to file Forms 1098-E that include the same information required by Notice 98-7 (as modified). Forms 1098-T and Forms 1098-E for the year 2001 must be filed by February 28, 2002, if filed on paper or by magnetic media, or by April 1, 2002, if filed electronically. In addition, by January 31, 2002, institutions and payees must furnish statements containing the same information they report on Forms 1098-T and 1098-E to the individuals named on the information returns.

Although not required, institutions and payees that are able to do so are encouraged to report the additional information described in the proposed regulations for the year 2001, in order to assist taxpayers in calculating any educational tax credit under I.R.C. §25A and any student loan interest deduction under I.R.C. §221. No penalties will be imposed under I.R.C. §6721 or I.R.C. §6722 prior to the issuance of the final regulations for any failure to file correct information returns or to furnish correct statements required under I.R.C. §6050S for the year 2001. Even after the final regulations are issued, no penalties will be imposed under I.R.C. §6721 or I.R.C. §6722 for 2001 as long as the institution or payee made a good faith effort to file information returns and furnish statements in accordance with either this notice or the proposed regulations.

[Notice 2000-62, 2000-51 I.R.B. 587]

LTR 200106032 (November 13, 2000)

[I.R.C. §6041]

☞ **Funeral homes are not required to issue information returns for cash advances paid to third-party service providers.**

Facts. Taxpayer operates funeral homes. In addition to the business operations of the funeral home, the taxpayer serves as a liaison between the families of the deceased and providers of other various services. Additional services or items for which families often incur additional expenses include: gratuities to clergy, special music, death notices, hairdressers or barbers, florists, transportation, long distance telephone charges, copies of certified documents and professional fees to other funeral directors. For the convenience of the families of the deceased it is a common practice in the funeral industry for the funeral home to prepay the providers of these other services (i.e., to make cash advances). Cash advances are separately enumerated on the standard funeral contract, which reflects that the funeral home does not provide this accommodation for profit. The funeral home is reimbursed dollar for dollar for the accommodation. The funeral home operator does not negotiate the price for these services and does not direct or inspect the work that is done by third-party providers.

Issue. Do the reporting requirements under I.R.C. §6041(a) apply to cash advances by the funeral home to third-party service providers?

Analysis. Treas. Reg. §1.6041(a)(1)(i) requires every person engaged in a trade or business to make an information return reporting payments in the course of that trade or business to another person of fixed or determinable salaries, wages, commissions, fees, and other forms of compensation for services totaling $600 or more in a calendar year, unless specifically excluded under Treas. Reg. §1.6041-3.

Holding. Pursuant to Treas. Reg. §1.6041-3(d), telephone, freight, and similar charges are excluded from reporting requirements. Since the funeral home performs no management or oversight function and has no significant economic interest as contemplated by the so-called "middleman" regulations (Prop. Reg. §1.6041-1(e)), it is not required to issue information returns for cash advances for clergy, special music, death notices, hairdressers or barbers, florists, copies of certified documents, and professional fees to other funeral directors.

INNOCENT SPOUSE

IR 2001-23 (February 20, 2001)
[I.R.C. §6015]

> ☞ **IRS initiates series of steps to protect innocent spouses who are victims of domestic violence.**

Taxpayers who are victims of domestic violence and fear that filing a claim for innocent spouse relief would result in retaliation should write the term "Potential Domestic Abuse Case" on the top of their Form 8857. They should also explain their concerns in a statement attached to the form, in addition to explaining why they should qualify for innocent spouse relief. These steps will alert the IRS to the sensitivity of the taxpayer's situation and the information provided. IRS employees working innocent spouse cases will receive special training on how to properly handle abuse cases. IR 2001-23 contains several safeguards designed to protect victims of domestic violence who apply for innocent spouse relief.

King v. Commissioner
[I.R.C. §§183 and 6015]

> ☞ **IRS is not able to prove that taxpayer knew her ex-husband lacked profit motive in his cattle-raising activity.**

Facts. Kathy King and Curtis Freeman were married in 1982. Curtis conducted a cattle-raising activity for several years. **Kathy knew the activity was not profitable**, but both she and Curtis had expectations that it would become profitable. Kathy maintained or kept records of sales, purchases and expenses of the cattle-raising activity. Kathy and Curtis separated in May 1993, and reported a net loss of $27,397 from the cattle-raising activity on the Schedule C (Form 1040) of their joint income tax return for 1993. They were divorced in May 1995. In December 1996, the **IRS disallowed the cattle activity loss claimed on the 1993 return on the basis that it was not an activity engaged in for profit under I.R.C. §183**. Kathy contended that she was entitled to relief from joint liability under I.R.C. §6013(e). After the case was tried and taken under advisement, I.R.C. §6013(e) was repealed and was replaced with I.R.C. §6015, which retroactively applies to this case. In *King v. Commissioner* [115 T.C. No. 8 (August 10, 2000)], the court held that Curtis, objecting to Kathy's relief under I.R.C. §6015(b), had the right to intervene in his ex-wife's deficiency proceeding.

Issue. Whether taxpayer is entitled to relief from joint liability under I.R.C. §6015(c).

Analysis. I.R.C. §6015(c) relieves certain joint-filing taxpayers by making them liable only for those items of which they had actual knowledge, rather than being liable for all items reportable on the joint return. In effect, this approach is intended to treat certain spouses as though they had filed a separate return. This is a departure from predecessor I.R.C. §§6013(e) and 6015(b), where the intended goal was to permit relief only if the relief-seeking spouse did not know or had no reason to know of an item.

In determining whether the taxpayer had actual knowledge of an improperly deducted item on the return, more is required than the taxpayer's knowledge that the deduction appears on the return or that

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her former spouse operated an activity at a loss. The court noted that the question in this case is not whether the taxpayer knew the tax consequences of a not-for-profit activity, but whether she knew or believed that her former spouse was not engaged in the activity for the primary purpose of making a profit. The court was satisfied the taxpayer only knew the activity wasn't profitable but hoped it would become profitable. The court held the **IRS did not prove the taxpayer knew that her former spouse did not have a primary objective of making a profit with his cattle-raising activity.**

Holding. The court held that the taxpayer is entitled to relief from the tax liability under I.R.C. §6015(c). Since the activity was an activity attributable solely to her former spouse, the relief extends to the full amount of the deficiency.

[*King v. Commissioner*, 116 T.C. 198 (2001)]

> **Practitioner Note.** See also *Mitchell v. Commissioner,* 80 T.C.M. (CCH) 590 (2000), where the court held that taxpayer was not entitled to relief under I.R.C. §6015(b), (c), or (f).
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> See also *Culver v. Commissioner,* 116 T.C. 189 (2001), where the court held that the taxpayer qualified for relief under I.R.C. §6015(c).

Fernandez v. Commissioner

[I.R.C. §6015 and Tax Court Rule 52]

> ☞ **The Tax Court has jurisdiction to review claims for relief under §6015(f) if requirements of §6012(e) have been met.**

Facts. In March 1999, Diane Fernandez submitted to the IRS a request for relief from joint and several liability for tax year 1988 under I.R.C. §6015(b), (c), and (f). The IRS advised the taxpayer that she was not entitled to relief because she "had actual and constructive knowledge of the capital gains and the tax underpayment. In addition, she had received a significant financial benefit when she received sales proceeds of $19,532 in tax year 1988." The taxpayer petitioned the Tax Court to review the IRS' denial of relief. Ms. Fernandez asserted that the IRS failed to consider the following facts: (1) she was not in control of the marital finances, which were one of the governing factors in the preparation of the 1988 jointly filed income tax return and (2) the house in question was owned exclusively by the taxpayer's former spouse. The taxpayer had neither a proprietary nor a financial interest in the house. The IRS filed a motion to dismiss for lack of jurisdiction and to strike as to relief sought under I.R.C. §6015(f) and to strike the allegations of fact by the taxpayer.

Issues

Issue 1. Whether the Tax Court has jurisdiction to review the denial of a request for innocent spouse relief pursuant to I.R.C. §6015(f).

Issue 2. Whether certain allegations of fact asserted in the petition are relevant to the taxpayer's petition for innocent spouse relief.

Analysis. The IRS asserted that since I.R.C. §6015(e)(1) contains the phrase "in the case of an individual who elects to have subsection (b) or (c) apply," the language of the statute limits the court's jurisdiction to the review of an election made under subsection (b) or (c). Therefore, the Tax Court does not have jurisdiction to review relief under subsection (f). The court concluded that the statutory language of I.R.C. §6015(e)(1) gave it jurisdiction to review all claims for innocent spouse relief under I.R.C. §6015, including claims for equitable relief under I.R.C. §6015(f).

Holding. The court held that it has jurisdiction to review a request for innocent spouse relief under I.R.C. §6015(f) as long as the required election has been made under I.R.C. §6015(b) or (c), and a timely petition has been filed with the court. The court held that the taxpayer's statements of fact were relevant to the issue of innocent spouse relief and denied the IRS's motion to strike.

> **Practitioner Note.** The IRS now agrees that the Tax Court's interpretation of I.R.C. §6015(e)(1)(A) was reasonable and it will no longer contest the Tax Court's jurisdiction to review claims for equitable relief under section 6015(e)(1)(A), if the requirements of section 6015(e) have been met [AOD 2000–06, June 5, 2000].

[*Fernandez v. Commissioner*, 114 T.C. 324 (2000)]

Vetrano v. Commissioner

[I.R.C. §6015]

> ☞ **Court denies request to dismiss innocent spouse claim without prejudice.**

Facts. In a previous case involving the taxpayers, the Tax Court held that Mr. Vetrano had unreported income in 1991, 1992, and 1993 from his business of dealing in used automobile parts, consisting primarily of payments from a company referred to as BMAP. [See *Vetrano v. Commissioner*, 79 T.C.M. (CCH) 1853 (2000).] The court also held that the taxpayers had received an unreported payment from Camden City Probation in 1993. The court held that the tax returns were subject to the fraud penalty under I.R.C. §6663 and that some part of the underpayment for 1993 was due to the fraud of Mrs. Vetrano. The court did not consider Mrs. Vetrano's claim for relief under former I.R.C. §6013(e) and I.R.C. §6015 in order to give her an opportunity to support her claim of eligibility under I.R.C. §6015.

Issues

Issue 1. Whether to grant the taxpayer's request to withdraw from the case, without prejudice, the taxpayer's elections for relief under I.R.C. §6015(b) and (c).

Issue 2. Whether taxpayer is entitled to innocent spouse relief under I.R.C. §6015(b).

Issue 3. Whether taxpayer is eligible for relief under I.R.C. §6015(c) as of the date of her election or as of some later date.

Analysis and Holding

Issue 1. By asking to withdraw this issue without prejudice, Mrs. Vetrano was attempting to preserve her right to elect relief under I.R.C. §6015(b) or (c) at a later time. The court stated that **an individual who has participated meaningfully in a court proceeding is precluded from electing relief under I.R.C. §6015(b) or (c) for the same taxable year after the decision of the court becomes final,** whether or not the individual's qualification for relief under I.R.C. §6015(b) or (c) was an issue in the prior proceeding. See I.R.C. §6015(g)(2). The court denied Mrs. Vetrano's request to withdraw, without prejudice, the issue of her qualification for relief under I.R.C. §6015(b) and (c).

Issue 2. An individual seeking relief under I.R.C. §6015(b) must establish "that in signing the return he or she did not know, and had no reason to know" that there was an understatement attributable to the erroneous items of the other spouse. **The court agreed with the IRS that Mrs. Vetrano knew of the portion of the understatement attributable to the payments received from BMAP.** As to the remainder of the understatement, the taxpayers failed to introduce any evidence that Mrs. Vetrano did not know and had no reason to know of the unreported payment from Camden City Probation. The court held that **Mrs. Vetrano was not eligible for relief under I.R.C. §6015(b) for any part of the understatement.**

Issue 3. I.R.C. §6015(c)(3)(A) imposes certain conditions for eligibility to elect relief under that subsection. To meet the first condition, the taxpayer must prove that he or she is no longer married to, or is legally separated from, the person with whom the joint return was made, or must prove that he or she was not a member of the same household with such individual during the 12-month period ending on the date the election is filed. The taxpayer presented a copy of the divorce complaint, which was filed 12 days before the date of the taxpayers' post-trial brief for this case. The court held that Mrs. Vetrano was not eligible to make the election under I.R.C. §6015(c), because there was no evidence that she was legally separated or divorced on the date of her election, nor was there evidence to show that she had not been a member of the same household as Mr. Vetrano during the 12-month period ending on the date of her election. The court noted that if Mrs. Vetrano became eligible to elect relief under I.R.C. §6015(c) after the date of the first election, she would have to file a second election. Mrs. Vetrano did not choose to make a second election.

[*Vetrano v. Commissioner*, 116 T.C. 272 (2001)]

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Von Kalinowski v. Commissioner

[I.R.C. §6015]

> ☞ **Wife had constructive knowledge of husband's tax shelter investments and was not entitled to relief.**

Facts. Julian and Penelope Von Kalinowski have been married since 1980. The IRS determined deficiencies for 1981 and 1982 based upon the distributive shares of several partnerships in which Mr. Von Kalinowski had invested. These tax shelter investments generated combined losses of $368,675 and $228,133 for 1981 and 1982, respectively.

Issue. Whether taxpayer's wife is entitled to relief from joint and several liability under I.R.C. §6015(b)(1).

Analysis. To qualify for relief under I.R.C. §6015(b)(1), a taxpayer must establish that: (1) a joint return was made under I.R.C. §6013; (2) there was an understatement of tax attributable to erroneous items of the other spouse; (3) at the time of signing the return, the spouse seeking relief did not know and had no reason to know of such understatement; and (4) taking into account all the facts and circumstances, it is inequitable to hold the spouse seeking relief liable for the deficiency in tax attributable to the understatement. **Failure to meet any one of the requirements prevents a spouse from qualifying for relief under I.R.C. §6015(b)(1).** Mrs. Von Kalinowski met the first two requirements. The court was also satisfied that she lacked actual knowledge of the understatement, because she consistently signed tax returns without reviewing their contents. The court next addressed whether Mrs. Von Kalinowski had reason to know of the understatement. In determining whether a spouse had reason to know, the courts consider the following factors: (1) the spouse's level of education; (2) the spouse's involvement in the family's business and financial affairs; (3) the presence of expenditures that appear lavish or unusual when compared to the family's past levels of income, standard of living, and spending patterns; and (4) the culpable spouse's evasiveness and deceit concerning the couple's finances. A couple of factors supported a finding that Mrs. Von Kalinowski lacked constructive knowledge of the understatement. First, she had no role in the couple's finances beyond making payments for household expenses. At no time was she aware of her husband's participation in the tax shelter investments. Second, the couple's affluent lifestyle did not change during the tax years in question. However, other factors supported a finding that Mrs. Von Kalinowski possessed constructive knowledge of the understatement. She was well educated and ran her own business. The court found that her business experience was certainly sufficient to provide an understanding of what it meant for a business to incur a profit or a loss. The court found that the size of the losses claimed on the tax return should have alerted Mrs. Von Kalinowski to question their legitimacy. Thus, the **court found that Mrs. Von Kalinowski possessed constructive knowledge of the understatement for purposes of I.R.C. §6015(b)(1)(C)**. The taxpayer argued that it was inequitable to hold her liable for the deficiency because of the possibility that her husband might not pay the deficiencies or he might die and disinherit her. The court noted that this hypothetical hardship is not sufficient to satisfy the requirements of I.R.C. §6015(b)(1)(D). The imposition of joint and several liability must be inequitable in its present terms.

Holding. The court held that Mrs. Von Kalinowski is not entitled to relief under I.R.C. §6015(b)(1) because she failed to satisfy the requirements of I.R.C. §6015(b)(1)(C) and (D).

[*Von Kalinowski v. Commissioner*, 81 T.C.M. (CCH) 1081 (2001)]

Prop. Reg. 106446-98
[I.R.C. §§6013 and 6015]

> ☞ **IRS has issued proposed regulations to explain innocent spouse relief under I.R.C. §6015.**

IRS has issued proposed regulations containing detailed guidance on the three types of relief from joint and several liability under I.R.C. §6015. The regulations reflect changes in the law made by the IRS Restructuring and Reform Act of 1998.

INTEREST

Ritter v. Commissioner
[I.R.C. §163]

> ☞ **Taxpayer not allowed to deduct investment interest since he could not treat rental income as investment income.**

Facts. Around 1990, Douglas Ritter began purchasing silver coins as an investment. He borrowed money from a bank to finance the purchases and the bank held the coins. Ritter and his wife also owned at least eight rental apartments. They did not employ a real estate agent to manage any aspect of the apartments. Mr. Ritter handled the advertising for the apartments, and did all the maintenance, including painting, plumbing repairs, etc. He spent at least 30 hours a week managing the apartments. During 1996, Ritter paid the bank $4,656 in interest on the loans used to purchase the silver coins. The taxpayer received no investment income from his investment in silver coins during 1996. The taxpayer and his wife reported no income from dividends, interest, royalties, or annuities. On their Schedule A (Form 1040) for 1996, the taxpayers deducted $4,656 as investment interest. The IRS disallowed the deduction.

Issue. Whether taxpayer is entitled to an itemized deduction for investment interest paid on a loan to purchase silver coins.

Analysis. I.R.C. §163(d)(1) limits a noncorporate taxpayer's deduction for investment interest to the net investment income of the taxpayer for the taxable year. Net investment income is defined as the excess of investment income over investment expenses (§163(d)(4)(A)). Investment income is the sum of the gross income from property held for investment plus the ordinary gain attributable to the disposition of such property (§163(d)(4)(B)).

The IRS maintained the taxpayers' investment income for 1996 was zero, so they could not deduct any investment interest. The taxpayers argued the net rental income received and reported on Schedule E constituted investment income. The court held that **in order for the rental properties to be considered "held for investment," the properties must be held in a trade or business activity with respect to which the taxpayer does not materially participate.** The court found that the taxpayer did materially participate in the rental activities. Thus, the rental properties are not properties held for investment and the income from them is not available to offset the taxpayers' investment interest.

Holding. The court held that the taxpayer was not entitled to an itemized deduction for investment interest because he had no investment income.

[*Ritter v. Commissioner,* T.C. Summary Opinion 2001-57 (April 17, 2001)]

Rosser v. Commissioner

[I.R.C. §§162, 163, 172, 6651, and 6662]

> ☞ **Interest on loans used to acquire and renovate nursing homes constitutes trade or business interest.**

Facts. Thomas Rosser operated a sole proprietorship that provided financial services. Through a general partnership, and in conjunction with his wife, Rosser acquired a building that housed the financial services proprietorship. Rosser also managed the building. During 1985 and 1986, Rosser and his then-spouse purchased two nursing homes. These purchases were financed through loans from a bank, the sellers, and various financial services clients. Ownership of the nursing homes was transferred by Rosser to two S corporations he owned. After the transfers, he remained responsible for repaying the loans. In October 1987, Rosser and his former wife took out a loan from a bank to repay one of the seller-financed acquisition loans and to renovate one of the nursing homes.

Rosser bought the nursing homes so that he could earn income from operating them and to provide a job for his then-spouse. **During 1993 and 1994, he spent about 97% of his time managing the nursing homes and about 3% of his time on financial services.** During 1992 and 1993, Rosser also borrowed money to invest in a limited partnership, to pay another person's car lease, to pay another person's debt, and to establish a trust for another person. He deducted the interest for these loans on the 1993 Schedule C for the financial services proprietorship. On his 1994 return, Rosser claimed NOLs, but he did not file appropriate documentation with his return nor did he make the election under I.R.C. §172(b)(3). In January 1996, he faxed the IRS a statement in which he claimed the NOLs were from carryovers from 1993 and 1991.

Issues

Issue 1. Whether interest the taxpayer paid for loans used to acquire, renovate, and operate two nursing homes and to buy interests in a building and some partnerships is trade or business interest.

Issue 2. Whether taxpayer may deduct net operating losses in 1994 that were carried forward from 1991 and 1993.

Issue 3. Whether taxpayer is liable for additions to tax under I.R.C. §6651(a) for failure to file timely income tax returns for 1993 and 1994.

Issue 4. Whether taxpayer is liable for the penalty under I.R.C. §6662(a) for substantial understatement of tax for 1993 and 1994.

Analysis and Holding

Issue 1. The IRS argued that interest on loans used to buy, renovate, and operate the nursing homes was not trade or business interest, because the taxpayer held the nursing homes as investments. The court noted that a taxpayer must have substantial investment intent in acquiring and holding the property. A taxpayer lacks substantial investment intent if the taxpayer acquires a business solely to provide employment for himself. **The court held that the taxpayer could deduct the interest that he paid in 1993 and 1994 relating to loans he used for the nursing homes under I.R.C. §162(a) and I.R.C. §163(a).** Next, the IRS argued that the taxpayer could not deduct the interest because it was an expense of the S corporations. The court did not agree, because the interest related to the taxpayer individually. He was personally liable to pay the interest.

The court held that the interest the taxpayer paid to acquire the car lease, retire the obligation, and establish a trust was not trade or business interest.

The court held that the interest paid in 1993 and 1994 relating to the financial services building partnership and the limited partnership was not trade or business interest because they were held for investment. The record was not clear about the extent to which he participated in the partnerships.

Issue 2. A taxpayer must carry a net operating loss back 3 years and carry it forward 15 years [I.R.C. §172(b)(1)(A)]. A taxpayer may elect to forgo the carryback period [I.R.C. §172(b)(3)]. **When a taxpayer does not elect to forgo the carryback period, the taxpayer may carry losses forward only to the extent they exceed the modified taxable income for the carryback years even if the taxpayer did not carry back operating losses for those years.** Mr. Rosser did not elect to forgo the carryback period for 1991 or 1993. He offered his tax returns for 1990–1993 as evidence. The court noted that a tax return does not establish a taxpayer had income and losses in the amounts reported on the return. Thus, the court held that Mr. Rosser did not establish the amount of his 1991 or 1993 net operating loss, or that his income in the carryback years before 1991 or 1993 did not fully offset any net operating loss. **The court held that the taxpayer could not carry any losses forward to 1994.**

Issue 3. The taxpayer did not show that he had reasonable cause for failing to file timely returns. He offered no evidence and made no argument on this issue. Thus, the court held the taxpayer liable for the penalty under I.R.C. §6651(a).

Issue 4. The taxpayer argued that the IRS could not assert the accuracy-related penalty under I.R.C. §6662, because they had conceded at trial that negligence was not an issue in this case. The court agreed with the IRS that the accuracy-related penalty applied to this taxpayer because there was a substantial understatement of tax, not because of negligence. The court concluded that the taxpayer was liable for any part of the underpayment for 1993 and 1994 to the extent that it exceeded the greater of 10% of the tax required to be shown on the return, or $5,000.

[*Rosser v. Commissioner,* 81 T.C.M. (CCH) 1467 (2001)]

Roundtree Cotton Co., Inc., v. Commissioner
[I.R.C. §7872]

☞ **Below-market interest rules apply to loans by closely held corporations to minority shareholders.**

Facts.. The taxpayer, a cotton brokerage corporation, made interest-free loans directly and indirectly to a variety of other entities in which shareholders of the taxpayer owned an interest. During an audit, the **IRS determined that the interest foregone on the interest-free loans should be imputed to the taxpayer pursuant to I.R.C. §7872.** Accordingly, the IRS increased the taxpayer's income for the taxable years of 1994 and 1995. The taxpayer petitioned the Tax Court. The Tax Court ruled in favor of the IRS [113 T.C. 422] and the taxpayer appealed.

Issue. Whether Tax Court erred in its determination that the provisions of I.R.C. §7872 imputed interest apply where a taxpayer makes loans to its minority shareholders and to entities owned in part by its shareholders and in part by other members of the same family.

Analysis. The taxpayer's primary argument was that I.R.C. §7872 applies only to loans by a corporation to its majority shareholder or to loans by a corporation to an entity in which one of the lending corporation's shareholders owns a majority interest. In this case, **none of the recipients of the loans in question were majority shareholders of the taxpayer, nor did any of recipient entities have a majority shareholder who was also a shareholder of the taxpayer.** Thus, the taxpayer contended that I.R.C. §7872 could not apply to its loans.

I.R.C. §7872(c)(1)(C) makes §7872 applicable to "Any below-market loan directly or indirectly between a corporation and any shareholder of such corporation." Applying traditional rules of statutory construction, the Tax Court held, and the Tenth Circuit agreed, that the language of I.R.C. §7872 was broad enough to encompass the facts of this case.

Holding. Affirming the Tax Court, the Tenth Circuit held that the interest-free loans made by the taxpayer are subject to the imputation rules of I.R.C. §7872.

[*Roundtree Cotton Co., Inc., v. Commissioner,* 2001-1 USTC ¶50,316]

IRS MSSP AUDIT TECHNIQUE GUIDES

Lawsuit Awards. The guide contains examination techniques for lawsuit awards and settlements. The guide explains how to identify tax returns with lawsuit payment issues. It also contains suggestions for conducting examinations, explanations of applicable terminology, synopses of related court cases, and samples of pertinent forms.

Auto Dealerships. The guide contains examination techniques for auto dealerships. The guide looks at new and used car dealerships, after-sale financial products sold by dealerships, and accounting and inventory methods.

Business Consultants. The guide contains examination techniques for business consultants. The guide outlines common practices of the market and identifies potential issues that may arise when conducting audits of individuals who work as business consultants. The guide identifies personal travel, meals and entertainment, and reimbursed expenses as potential audit issues.

Shareholder Loans. The guide contains examination techniques for shareholder loans. The guide explains how to determine whether a debt is bona fide and contains examples of below-market terms and demand loans. The guide also contains synopses of relevant court cases.

Farm Hobby Losses. The guide contains examination techniques for farm hobby losses with cattle operations and horse activities. The guide outlines relevant issues for examiners to consider when determining whether a horse or cattle operation is engaged in for profit. The guide also contains a market segment definition and overview, examination techniques, synopses of supporting law, and a sample initial interview.

Commercial Banking. The guide outlines common practices of the industry and contains information on nonperforming loans, covenants not to compete, loan swaps, and international tax issues. The guide remains unchanged from the 1997 version except for the added revised material on automobile lease payments.

IRS PROCEDURES: ADDRESS AND MAILING ISSUES

Rev. Proc. 2001-18
[I.R.C. §§6110, 6212, 6303, 6325, 6331, 6332, 6901, 7603, and 7609]

☞ **Procedures for informing IRS of a change of address are released.**

Purpose. This revenue procedure explains how a taxpayer is to inform the IRS of a change of address. The IRS uses the taxpayer's address of record for the various notices that are required to be sent to a taxpayer's "last known address" under the Internal Revenue Code and for refunds of overpayments of tax. This revenue procedure amplifies and supersedes Rev. Proc. 90-18, 1990-1 C.B. 491.

Scope. The IRS generally will use the address on the most recently filed and properly processed return as the address of record. However, the IRS may update the taxpayer's address of record by using the United States Postal Service's (USPS) National Change of Address database (NCOA database) in accordance with Treas. Reg. §301.6212-2 (effective January 29, 2001).

Procedures. If a taxpayer no longer wishes the address of record to be the one shown on the most recently filed tax return, clear and concise written notification of a change of address should be sent to the IRS Center serving the taxpayer's old address or to the Customer Service Division in the local area office. Form 8822 may also be used for the purpose of providing clear and concise written notification. In addition, a taxpayer may change the address of record by clear and concise oral notification made directly to an IRS employee who initiated contact with the taxpayer on an active account.

Processing. A 45-day period normally should be allowed for changes to be processed. When address changes are made on Form 1040 returns filed after February 14 and before June 1, the IRS has until July 16 to post the changes.

Areas Not Covered. This revenue procedure does not apply to the notice requirements under I.R.C. §6221 through I.R.C. §6234 and I.R.C. §6037(c) concerning the tax treatment of partnership and S corporation items. The procedures also do not apply to employee plans Forms 5500 and 5330.

Effective Date. This revenue procedure is effective February 20, 2001.

[Rev. Proc. 2001-18, 2001-8 I.R.B. 708]

T.D. 8939
[I.R.C. §6212]

> ☞ **Final regulations define "last known address" for mailing notice of deficiency and other notices from the IRS.**

Treas. Reg. §301.6212-2 defines "last known address" for mailing notice of deficiency and other notices from the IRS.

Explanation. Generally, a taxpayer's last known address is the address that appears on the taxpayer's most recently filed and properly processed federal tax return, unless the IRS is given clear and concise notification of a different address. Further information on what constitutes clear and concise notification of a different address and a properly processed federal tax return can be found in Rev. Proc. 90-18 (1990-1 C.B. 491) or in procedures subsequently prescribed by the IRS. Change of address information that a taxpayer provides to a third party, such as a payor or another government agency, is not clear and concise notification of a different address for purposes of determining a last known address under this section.

The IRS will update taxpayer addresses maintained in IRS records by referring to data accumulated and maintained in the United States Postal Service (USPS) National Change of Address database that retains change of address information for 36 months (NCOA database). Generally, if the taxpayer's name and last known address in IRS records match the taxpayer's name and old mailing address contained in the NCOA database, the new address in the NCOA database is the taxpayer's last known address, unless the IRS is given clear and concise notification of a different address.

The address obtained from the NCOA database is the taxpayer's last known address until the taxpayer files and the IRS properly processes a federal tax return with an address different from the address obtained from the NCOA database, or the taxpayer provides the IRS with clear and concise notification of a change of address that is different from the address obtained from the NCOA database.

Effective Date. Generally, this notice is **effective on January 21, 2001.**

[T.D. 8939, 2001-12 I.R.B. 899 (January 11, 2001)]

Corkrey v. Commissioner
[I.R.C. §7430]

> ☞ **Taxpayer's request for administrative costs was denied because he did not timely file his returns or respond to IRS notices.**

Facts. The Social Security Administration (SSA) sent the IRS inaccurate information showing that, during 1987, the taxpayer received $35,100 for teaching a scuba diving course. In fact, the taxpayer received $351. The taxpayer did not file a return for 1987 or 1988. On the basis of the information from the SSA, the **IRS issued** a **notice of deficiency**, to which the **taxpayer did not respond**. The IRS attached a lien to the taxpayer's bank account. During 1996, the taxpayer was unable to obtain a loan because of the tax lien and outstanding balances due to the IRS. The taxpayer hired an accountant to prepare his tax returns for 1987 and 1988. The IRS received these returns on January 9, 1997. The taxpayer filed his 1987 return as married filing jointly, but his ex-wife did not sign the return and refused to sign a declaration that the 1987 return was true and accurate. The 1988 return contained significant errors. Eventually, the taxpayer hired an attorney to assist him. On April 14, 1997, the taxpayer provided the IRS will all of the information needed to process the returns. On May 30, 1997, the IRS issued refund checks to the taxpayer for the 1987 and 1988 taxable years. The IRS abated for reasonable cause additions to tax for late filing and negligence that had been assessed for 1987 and 1988. **Pursuant to I.R.C. §7430, the taxpayer made an administrative claim for costs associated with filing and correcting his 1987 and 1988 tax returns.**

Issue. Whether taxpayer may recover costs associated with the preparation and filing of his 1987 and 1988 tax returns under I.R.C. §7430.

Analysis. A decision for administrative costs incurred in connection with an administrative proceeding may be awarded under I.R.C. §7430(a) only if a taxpayer: (1) is the "prevailing party," (2) did not reasonably protract the administrative proceedings, and (3) claimed reasonable administrative costs. A taxpayer must satisfy each of the requirements to be awarded administrative costs. A taxpayer is not the prevailing party if the IRS can establish that its position was substantially justified. While the fact that the IRS loses or concedes the case may be a relevant factor to consider, it is not conclusive as to whether the taxpayer is entitled to an award of administrative costs.

The taxpayer argued that the IRS is not substantially justified if the erroneous assessment is based on a disputed "information return." The court noted that the taxpayer failed to file timely returns for 1987 and 1988, failed to correspond with the IRS, failed to advise the IRS of a dispute prior to the notices of deficiency, and failed to respond to the notices of deficiency and five separate requests from the IRS. The court also noted that, had the taxpayer timely filed his returns or responded promptly to any of the notices, the entire matter could have been disposed of without issuing a statutory notice.

Holding. The court held that the taxpayer's costs incurred in preparing and correcting his tax returns were not recoverable. The court also held that the taxpayer could not recover any administrative costs incurred after the taxpayer provided the information necessary to process the return, because the IRS processed the taxpayer's return within a reasonable period of time after receiving the information.

[*Corkrey v. Commissioner*, 115 T.C. No. 29 (October 24, 2000)]

CC 2001-019
[I.R.C. §§6511, 6532, 7502, and 7503]

> ☞ **IRS will apply timely mailed, timely filed rule to a claim for credit or refund on a late-filed return.**

Purpose. This notice announces a change in the IRS's litigating position concerning the application of I.R.C. §7502(a) to a claim for credit or refund made on a late-filed original income tax return.

Background. I.R.C. §7502(a) generally provides that a return, claim, statement, or other document postmarked on or before the due date of the document will be treated as filed on the postmark date if the document is received after the due date. Prior to *Weisbart v. United States,* 222 F.3d 93 (2d Cir. 2000), it was the IRS's position that I.R.C. §7502(a) did not apply to a claim for refund filed on a delinquent original return postmarked three years after the due date of the return.

Change in Position. The IRS will no longer argue that I.R.C. §7502(a) does not apply under facts such as those in *Weisbart.* The IRS will apply the timely mailing/timely filing rule of I.R.C. §7502(a) in such cases and treat claims for refund included on delinquent original returns as filed on the date of mailing for purposes of I.R.C. §6511(b)(2)(A). Although *Weisbart* involved an individual return, the IRS will also apply I.R.C. §7502 to claims for credit or refund on other delinquent returns, including corporate returns, quarterly federal excise tax returns, heavy vehicle use tax returns, and estate tax returns.

T.D. 8932
Treas. Reg. §§301.7502-1 and 301.7502-2
[I.R.C. §7502]

> ☞ **Final regulations on timely mailed is timely filed rules are issued.**

This document contains final regulations relating to timely mailing treated as timely filing and paying under I.R.C. §7502. The regulations generally reflect changes to the law made since 1960. In addition, the regulations provide that the date of an electronic postmark will be the filing date under certain circumstances. The regulations affect taxpayers who file documents or make payments or deposits.

Revisions. The postmark date on a claim for credit or refund on a late-filed return will be used to determine timeliness. This is consistent with the opinion in *Weisbart v. United States,* 222 F.3d 93 (2d Cir. 2000). Automatic reconsideration will be given to returns filed for 1995 and later years. However, taxpayers whose two-year period for filing a refund suit would expire before June 30, 2001, should (a) file a request for reconsideration (notated "Weisbart Claim" at the top of the first page) with the appropriate IRS Service Center and (b) file a refund suit to preserve their legal rights. Taxpayers whose two-year period expires after June 30, 2001, and who have not received a refund by that date, should file claims for reconsideration with the appropriate IRS Service Center.

Effective Date. These regulations are effective January 11, 2001.

[T.D. 8932, 2001-11 I.R.B. 813]

Estate of Cranor
[I.R.C. §§6213 and 7502]

> ☞ **Petition was properly addressed even though "Hold" box was erroneously marked.**

Facts. The attorney for an estate deposited an envelope containing a petition to the Tax Court with FedEx on the 87th day after the IRS mailed the notice of deficiency. The envelope bore the correct name, address, and ZIP code for the Tax Court, but the attorney marked an incorrect "hold" box on the FedEx airbill. FedEx held the envelope at a FedEx office rather than delivering it and later returned it to the sender. The attorney promptly re-sent the petition with FedEx, and the petition was delivered to the Court on the 101st day after the notice of deficiency was sent.

Issue. Whether a petition sent to the court by a private delivery service under I.R.C. §7502(f) was timely filed for purposes of I.R.C. §7502(a)(2)(B).

Analysis. For the taxpayer to qualify under I.R.C. §7502(a), **the envelope must have been timely sent, been properly addressed, and have the correct postage.** I.R.C. §7502(a) provides that the date of the postmark stamped on the envelope in which the document is *mailed* shall be the date considered for purposes of the "timely mailing is timely filing" rule. The court held that I.R.C. §7502(a) does not require that the qualifying envelope be the envelope in which the petition is *received*, nor does I.R.C. §7502(a) bar application of the "timely mailing is timely filing" rule if a petition contained in a properly addressed envelope is returned to, and remailed by, the taxpayer.

The IRS contended the envelope containing the petition was not properly addressed because of the "Hold" box marked on the FedEx airbill. Applying the dictionary meaning of "address," the **court concluded the "Hold" box on the airbill was not part of the address of the Tax Court**. The envelope bore the correct name, address, and ZIP code of the Tax Court.

Holding. The court held that the petition was timely sent and thus timely filed.

[*Estate of Cranor v. Commissioner*, 81 T.C.M. (CCH) 1111 (2001)]

IRS PROCEDURES: LEVIES AND LIENS

Notice 2000-47
[I.R.C. §6331]

> ☞ **IRS provides tables that show the amount of an individual's income that is exempt from a notice of levy used to collect delinquent tax in 2001.**

The IRS has released tables used in computing the amount of an individual's income that will be exempt from a notice of levy to collect delinquent tax in 2001. These tables are also printed in Publication 1494. These tables show the amount exempt from a levy on wages, salary, and other income. For example:

1. A single taxpayer who is paid weekly and claims three exemptions (including one for the taxpayer) has $254.81 exempt from levy.
2. If the taxpayer in number 1 is over 65 and writes 1 in the "Additional standard deduction" space on Parts 3, 4, and 5 of the levy, $275.96 is exempt from this levy ($254.81 plus $21.15).
3. A taxpayer who is married, files jointly, is paid bi-weekly, and claims two exemptions (including one for the taxpayer) has $515.38 exempt from levy.
4. If the taxpayer in number 3 is over 65 and has a spouse who is blind, this taxpayer should write 2 in the "Additional standard deduction" space on Parts 3, 4, and 5 of the levy. The $584.61 is exempt from the levy ($515.38 plus $69.23).

[Notice 2000-47, 2000-46 I.R.B. 480]

IRS PROCEDURES: PENALTIES

Rev. Proc. 2001-11
[I.R.C. §§6662 and 6694]

> ☞ **IRS updates guidance on reducing understatement of tax penalty and avoiding preparer penalty.**

Purpose. This revenue procedure updates Rev. Proc. 99-41, 1999-46 I.R.B. 566, and identifies circumstances under which the disclosure on a taxpayer's return of a position with respect to an item is adequate for the purpose of reducing the understatement of tax under I.R.C. §6662(d) (relating to the substantial understatement aspect of the accuracy-related penalty), and for the purpose of avoiding the preparer penalty under I.R.C. §6694(a) (relating to understatements due to unrealistic positions). This revenue procedure does not apply to any other penalty provision (including the negligence or disregard provisions of the I.R.C. §6662 accuracy-related penalty).

Changes from Rev. Proc. 99-41. The following will no longer constitute adequate disclosure for purposes of reducing the understatement of income tax under I.R.C. §6662(d) and avoiding the preparer penalty under I.R.C. §6694(a): The completion of Schedule M (Form 5471), Transactions Between Controlled Foreign

Corporation and Shareholders or Other Related Persons, lines 19 and 20; and Form 5472, Part IV, Monetary Transactions Between Reporting Corporations and Foreign Related Party, lines 7 and 18.

Procedure. This revenue procedure provides a list of specific items for which the additional disclosure of facts relevant to, or positions taken with respect to, is unnecessary provided that the applicable tax return forms and attachments are completed in a clear manner and in accordance with their instructions.

Effective Date. This revenue procedure applies to any return filed on 2000 tax forms for a taxable year beginning in 2000, and to any return filed on 2000 tax forms in 2001 for short taxable years beginning in 2001.

[Rev. Proc. 2001-11, 2001-2 I.R.B. 275]

LTR 200105062 (December 21, 2000)

[I.R.C. §6654]

> ☞ **Taxpayers who exclude income from conversion of traditional IRAs to Roth IRAs in their estimated tax payments are subject to penalty.**

Facts. The IRS has received a significant number of requests for abatement of an estimated tax underpayment penalty for the 1999 tax year from taxpayers who failed to include the income recognized from the conversion of traditional IRAs to Roth IRAs in their estimated tax payments.

Issue. Whether the IRS may abate the estimated tax penalty when it is caused by additional income resulting from a rollover from a traditional IRA to a Roth IRA.

Analysis. Absent a waiver, a taxpayer who converts from a traditional IRA to a Roth IRA must include the income realized as a result of the conversion in his or her estimated tax calculations. **I.R.C. §6654(e)(3) limits the waiver of the estimated tax penalty to those situations in which the underpayment is the result of "casualty, disaster, or other unusual circumstances."** The waiver provisions do not apply to this situation.

Conclusion.. The IRS may not abate the estimated tax penalty if the underpayment is the result of the conversion from a traditional IRA to a Roth IRA.

FSA 200104006 (September 15, 2000)

[I.R.C. §§6501 and 6663]

> ☞ **Fraudulent intent of return preparer may not be imputed to the taxpayer.**

Facts. The taxpayer, a truck driver, heard from another truck driver that a return preparer was able to obtain huge tax refunds for truck drivers based on their diesel fuel purchases. The truck driver sought out the services of the return preparer for several tax years. The **return preparer was experienced and knew that the taxpayer was not entitled to the diesel fuel excise tax credit upon which each of the refunds was based.** The return preparer was subsequently prosecuted for preparing false returns with respect to the taxpayer and several other truck drivers. The IRS proposes to issue a notice of deficiency to the taxpayer for the tax years in question, disallowing the diesel fuel excise tax credit. The fraud penalty of I.R.C. §6663 will not be asserted against the taxpayer. However, the IRS proposes to assert the fraud of the return preparer as a defense in the event the taxpayer raises the statute of limitations as a bar to the assessment.

Issue. Whether the fraud of a return preparer can be used as the basis for holding the statute of limitations open pursuant to I.R.C. §6501(c)(1).

Analysis. I.R.C. §6501 provides that, except as otherwise provided, tax must be assessed within 3 years after the return was filed, whether or not such return was filed on or after the date prescribed. As an exception to the general rule, §6501(c)(1) provides that in the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time.

The Fifth Circuit of the Court of Appeals has stated that **fraud implies bad faith, intentional wrongdoing, and a sinister motive. It is never imputed or presumed**. An individual taxpayer may act independently of the return preparer, and the taxpayer's intent may differ from that of the return preparer.

Conclusion. The fraudulent intent of the return preparer is insufficient to make I.R.C. §6501(c)(1) applicable.

8

United States v. Newell
I.R.C. §§61 and 7203]

> ☞ **Taxpayer failed to shift burden of tax liability to a dummy corporation in Bermuda.**

Facts. Donald Newell, the taxpayer, was president and 50 percent shareholder of LPM, Inc., a large commodity trader organized as a subchapter S corporation. In 1993, irate that the Clinton administration was planning to increase tax rates for high earners like himself, Newell established a Bermuda corporation, LPM, Ltd., to which he planned to funnel income that would otherwise be received by LPM, Inc. LPM, Ltd. was to be a dummy corporation with no purpose other than to receive income intended for LPM, Inc.

A client of LPM, Inc. had made a contract for which it owed more than $1.3 million for services that LPM, Inc. had rendered to it in 1993. Newell, directed the client to send the money to one of LPM, Ltd.'s bank accounts in Bermuda. When the controller of LPM, Inc. asked Newell where the money was, he was evasive and when the controller recorded the receipt anyway, he told her to remove it from LPM, Inc.'s books. Newell also lied to two outside accountants about the income.

The taxpayer was convicted of willfully filing false federal income tax returns for both himself and LPM, Inc. He was sentenced to 30 months in prison and fined $60,000. He appealed on the basis that the government was allowed to proceed on an "assignment of income" theory without having disclosed it in the indictment, without a jury instruction on it, and without proving it beyond a reasonable doubt.

Issues

Issue 1. Whether the IRS was obliged to prove that LPM, Inc. had not assigned its contract to LPM, Ltd.

Issue 2. Whether failure by the IRS to give the taxpayer written notice of its intention to offer the Bermuda records into evidence resulted in their automatic exclusion.

Issue 3. Whether the imposition of a heavier sentence due to the use of sophisticated means was appropriate.

Analysis. The taxpayer argued that if LPM, Inc. assigned its contract with the client to LPM, Ltd., the income generated by that contract would be taxable income to the assignee, not to LPM, Inc. The court noted that in order to shift the tax liability to the assignee, the assignor must either assign the duty to perform along with the right to be paid or must have completed performance before he assigned the contract. The court also noted that the assignment of income doctrine presupposes two parties, an assignor and an assignee, where in this case there was only one. The assignment was a sham. The court stated that even if there had been an assignment, it would not let Newell off the hook. It was the taxpayer, not the contract, or the assignee, that produced the income.

The court noted that the consequence of the IRS's failure to give Newell written notice of its intention to offer the Bermuda records into evidence was not automatic exclusion from the evidence. The remedy for this violation was for the taxpayer to object at trial on the ground of prejudice, which he did. The court denied the objection because the failure to notify Newell did not harm his defense. The foreign records in question were Newell's own records and he knew the IRS was going to use them to illuminate the nature and purpose of the dummy corporation.

The sentencing guidelines provide for a heavier sentence in a tax case if "sophisticated means were used to impede discovery of the existence or extent of the offense." The commentary to the guideline uses "hiding assets or transactions, or both, through the use of fictitious entities, corporate shells, or offshore banking accounts" as the paradigmatic example of sophisticated concealment. The court noted that it was an exact description of this case.

Holding. Affirming an unreported district court opinion, the Seventh Circuit held that the assignment of income not yet generated, as distinguished from the assignment of an income-generating contract or property right, did not shift the burden of tax liability from the taxpayer. Further, the government was not required to prove that the contract had not been assigned to the foreign country or to disprove every possibility that might exonerate the taxpayer. The imposition of a heavier sentence was appropriate due to the use of sophisticated means of concealment.

[*United States v. Newell*, 239 F.3d 917 (7th Cir. 2001)]

Johnson v. Commissioner
[I.R.C. §6673 and
Tax Court Rules 13, 104, and 123]

> ☞ **Taxpayer's attorney ordered to pay additional time and travel expenses of IRS.**

Facts. The IRS determined deficiencies and accuracy-related penalties under I.R.C. §6662(a) with respect to Federal income taxes of Shirley Johnson for 1996 and 1997. The deficiencies and penalties were attributable to adjustments related to Johnson's receipt of income from NJSJ Asset Management Trust (NJSJ Trust). The IRS also determined deficiencies and accuracy-related penalties under I.R.C. §6662(a) with respect to NJSJ Trust's tax liability for 1996 and 1997. Those deficiencies were attributable to the IRS's disallowance of Schedule C, expenses, charitable contributions, and an income distribution deduction claimed by NJSJ Trust.

Johnson filed petitions in these cases, individually and as trustee of the NJSJ Trust, on April 5, 1999. Houston, Texas, was designated by the taxpayer as the place of trial, although Johnson resided in Indiana. Joe Izen, counsel for the taxpayer, resided in Texas. The cases were first set for trial in Houston, Texas, on October 25, 1999. Although the taxpayer responded to the IRS's interrogatories and requests, the responses mostly consisted of the words, "Fifth Amendment" in lieu of the requested information. Both sides filed more motions. The cases were continued and trial was set for May 3, 2000, in Washington, D.C. The taxpayer and Izen failed to comply with discovery requests and motions by the IRS to compel responses. The IRS filed a motion to impose sanctions.

Issues. Whether court should grant IRS's motions to dismiss these cases for lack of prosecution and whether the court should penalize the taxpayer's attorney under I.R.C. §6673(a)(2)(A).

Analysis. The taxpayers (Johnson and NJSJ Trust) never fully complied with the outstanding discovery orders, were not prepared for trial, and Johnson indicated through Izen that she wanted to withdraw her petition. The court stated that petitions cannot be "withdrawn" without decisions against the petitioners. The court noted that dismissal of the petitions and entry of decisions against the taxpayers was not an unjust result. The court stated the evidence indicated that the taxpayer never intended to try these cases on the merits.

The **court noted Izen's long history of involvement with sham trusts**, both as counsel of record and as counsel rendering an opinion on which taxpayers unfortunately relied. The court reviewed several cases in which Izen was counsel and noted his chronic failure to comply with discovery orders or court rules. The court noted that in view of Izen's express admissions that he was responsible for the failure to comply with discovery orders, an award under I.R.C. §6673 was fully justified. He "multiplied the proceedings unreasonably and vexatiously."

Holding. The court held that petitions by the taxpayer, individually and as trustee, are dismissed for lack of prosecution. The court ordered the taxpayer's attorney to reimburse the IRS for 57.25 hours @ $150, or $8,587.50 plus $807.06 in travel expenses.

[*Johnson v. Commissioner*, 116 T.C. 111 (2001)]

Lund v. Commissioner
[I.R.C. §§1 and 6662]

> ☞ **Computer programmer's trust was a tax avoidance sham.**

Facts. Lund, a computer programmer, operated Lund Performance Solutions (LPS), a sole proprietorship. LPS provided consulting services, software development, and Unix training relating to the HP 3000 series of computers. On May 19, 1993, with assistance from an organization called Bigelow Charter, **Lund formed Zero Gee as a trust, and transferred his 100 percent ownership of LPS in exchange for 100 percent of the beneficial interest in Zero Gee.** In connection with the transfer of LPS to Zero Gee, Lund did not consult with an accountant or an attorney. On July 1, 1994, Sun Federal replaced Bigelow Charter as the corporate trustee of Zero Gee. Under terms of the trust document, the trustees of Zero Gee were to manage, operate, and control Zero Gee for the benefit of the beneficiaries. However, the trustees were not involved in any significant way in the management, operations, and control of Zero Gee or LPS. Zero Gee paid Sun Federal a total of only $3,600 a year for Sun Federal's alleged services as trustee.

For 1994, 1995, and 1996, **distributions equal to the total net income of the trust were claimed as income distribution deductions** to the named beneficiaries of the trust, and no taxable income was reported for the trust. Lund and his wife did not report as income on their joint tax returns any of the amounts represented by the income distribution deductions claimed on the trust's Federal income tax returns. The IRS determined that the Zero Gee trust

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lacked economic substance and charged the taxpayers with the entire reported net income of the trust for 1994, 1995, and 1996.

Issues

Issue 1. Whether trust established by the taxpayers lacks economic substance and should be disregarded for tax purposes.

Issue 2. Whether taxpayers are liable for the negligence component of the accuracy-related penalty under I.R.C. §6662.

Analysis. The following factors are generally considered in deciding, whether, for income tax purposes, a purported trust is to be treated as lacking economic substance: (1) whether the taxpayer's relationship, as grantor, to the property differed materially before and after the trust's formation; (2) whether the trust had an independent trustee; (3) whether an economic interest passed to other beneficiaries of the trust; and (4) whether the taxpayer honored restrictions imposed by the trust or by the law of trusts. The court noted the taxpayers continued to treat the assets as their own, conducted business in the same manner as they had prior to the transfers, and applied for bank loans and credit without approval of the purported trustees, and the purported beneficiaries of the trust failed to have any meaningful role in the management of the trust. The taxpayers presented no evidence that the trust was formed for any reason other than tax avoidance. The court held that the trust was a sham for federal tax purposes.

Holding. The court held that the trust established by the taxpayer lacked economic substance and that the net income of the trust was taxable to the taxpayer. The court held that because the taxpayers failed to consult with an attorney or accountant regarding the trust, they negligently disregarded the tax laws and were liable for the accuracy-related penalties under I.R.C. §6662(a).

[*Lund v. Commissioner*, 80 T.C.M. (CCH) 599 (2000)]

Temple v. Commissioner
[I.R.C. §§61, 446, 6654, and 6663]

☞ **Veterinarian who funneled income through a variety of trusts and companies was liable for fraud and frivolous position penalties.**

Facts. During the years at issue, 1988–1992, the taxpayer, a veterinarian, operated a veterinary clinic out of his residence. He also bred and sold llamas and birds. The taxpayer deposited receipts from these transactions into a variety of bank accounts held in a variety of names. Sometimes the checks were payable to Dr. Temple, but the majority of the checks were payable to Plume Enterprises. Some of the accounts were fashioned as trustee accounts, but all funds deposited in the accounts were based on payments the taxpayer received for veterinarian services and from the sale of animals. His wife had signatory authority over most of the accounts. Oil and gas drilling sites were located on two of the taxpayer's properties. He transferred his interest in the oil and gas leases to a trust for a total of $10.

The taxpayer failed to file Federal income tax returns for 1988, 1989, 1990, 1991, and 1992. The IRS computed the taxpayer's business gross receipts based on deposits made to bank accounts which the taxpayer controlled during those years, taking into account transfers and nontaxable items.

Issues

Issue 1. Whether taxpayer had unreported income from veterinary services, the sale of animals, and oil and gas royalties.

Issue 2. Whether taxpayer is liable for additions to tax for fraud under I.R.C. §§6653(b)(1) and 6651(f).

Issue 3. Whether taxpayer is liable for failure to pay estimated tax under I.R.C. §6654(a).

Issue 4. Whether taxpayer is liable for the penalty under I.R.C. §6673 for taking a frivolous and groundless position.

Analysis and Holding

Issue 1. The taxpayer argued that the income was received by, and deposited into bank accounts of irrevocable trusts. He asserted that the IRS improperly imputed gross income received by a trust to him and improperly failed to recognize the trust as a separate entity. However, the taxpayer did not provide copies of any trust agreements, nor did he or his wife testify at trial. The court noted that the taxpayer earned the income, he and his wife exercised total dominion and control over the funds, and they expended the funds for their personal expenses. The court stated that once they peered through the layers of nominee accounts through which the funds were channeled, the taxpayer remained in control of the funds. The court held that the taxpayer had unreported taxable income from veterinary services, sale of livestock and royalties for the years 1988–1992.

Issue 2. The IRS argued that the following factors of fraud were present in this case: (1) a substantial and consistent understatement of income; (2) extensive dealings in cash; (3) use of nominee accounts; (4) failure to cooperate with revenue agents; and (5) taxpayer's level of education. The court sustained the IRS's determination of fraud for each year in issue. The penalties under I.R.C. §§6651(f) and 6653(b)(1) totaled $70,193.

Issue 3. The addition to tax for failure to pay estimated tax is mandatory unless one of the exceptions in I.R.C. §6654(e) applies. The taxpayer did not offer any evidence that he had paid estimated tax for 1988, 1989, 1990, 1991, and 1992. The court held the taxpayers liable for penalties for failure to pay estimated tax.

Issue 4. The court imposed a $5,000 penalty under I.R.C. §6673 because the taxpayer persisted in the frivolous position that he was entitled to avoid tax liability because his income was assigned to a series of trusts.

[*Temple v. Commissioner*, 80 T.C.M. (CCH) 611 (2000)]

V&V Construction Company v. United States

[I.R.C. §§3402 and 3406]

> ☞ **Construction company liable for penalties on backup withholding.**

Facts. V&V, a partnership, was a general contractor in the business of remodeling small commercial and residential projects. Subcontractors performed most of the remodeling work. During a review, an IRS agent became aware and verified that **V&V had not filed any Forms 1099 with respect to subcontractors and independent contractors** to whom payments for services had been made during 1988–1990. The agent imposed a penalty under I.R.C. §6722 for failing to file Forms 1096 and 1099. The agent also determined that **V&V should have backup withheld 20 percent of all the payments it made to subcontractors in 1988–1990** pursuant to I.R.C. §3406. V&V challenged the agent's assessment. The parties agreed that payments made to 11 of the subcontractors were reported on the individuals' tax returns and that V&V was not liable for withholding taxes from their payments. However, one subcontractor, J.B. Johnson, claimed that he had reported payments from V&V as income on his returns, but the IRS appeals office rejected his statement, because it conflicted with his testimony in a separate case involving V&V [see 75 T.C.M. 2379 (1998)]. The appeals office found that V&V was liable for the withholding tax on payments made to Johnson and that it was also liable for penalties and interest on all the payments made because it failed to file the forms required under I.R.C. §3406. V&V paid part of the penalties and sought a refund.

Issue. Whether taxpayer was liable for penalties and interest assessed against them for their failure to pay backup withholding on some of their subcontractors.

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Analysis. The taxpayers alleged that they should not be subject to the penalties and interest assessed against them for their failure to pay backup withholding of some of their subcontractors. The taxpayers did not dispute that twelve subcontractors that the taxpayers engaged fell within I.R.C. §3406 and that the twelve subcontractors had not furnished their TINs prior to receiving payment from the taxpayers. The taxpayers also admitted that they did not withhold 20% of the subcontractors' reportable payments pursuant to I.R.C. §3406. **The taxpayers argue they were properly fined pursuant to I.R.C. §6722 for their failure to furnish certain statements to the IRS, and the backup withholding of I.R.C. §3406 was never triggered because the payees did furnish their TINs in 1990 or 1991 when the taxpayers asked for the TINs in conjunction with the IRS audit.** In other words, the taxpayers alleged that

I.R.C. §3406 is triggered only when the payee fails to cooperate and will not furnish their TINs. The court noted that under the taxpayer's interpretation of I.R.C. §3406, an employer would never be required to backup withhold if he never asked the employee to furnish his or her TIN. The court concluded that V&V violated I.R.C. §3406 when the 12 subcontractors didn't furnish their TINs when paid. Even though **V&V wasn't liable for the 20% assessment for 11 of the subcontractors, the court held that I.R.C. §3402 allows for penalties and interest even if the workers paid the required taxes.**

Holding. The court held V&V liable for penalties and interest for payments to the 11 subcontractors. The court held V&V liable for the 20% backup withholding and penalties and interest assessed regarding payments to Johnson.

[*V&V Construction Company*, 2001-1 USTC ¶50,403]

The Nis Family Trust v. Commissioner

[I.R.C. §§6662, 6673, and 7491;
Tax Court Rule 120]

> ☞ **Tax Court penalized taxpayers and attorney for frivolous arguments and delays.**

Facts. Frank (Hae-Rong) Ni was the trustee for the Nis Family Trust and the Nis Venture Trust. **For tax year 1995, the IRS disallowed various deductions of the trusts for failure to substantiate.** The disallowed deductions included fiduciary and attorney's fees, charitable contributions, exemption deduction, cost of goods sold, income distribution deduction, and an S corporation loss. On the 1995 joint return for Hae-Rong and Lucy B. Ni, the IRS increased their gross income by $439,230 based on the alternative grounds that (1) the trusts were shams with no economic substance, (2) the trusts were grantor trusts, (3) under the assignment of income doctrine, the taxpayers were taxable on the income and deductions of the trusts, or (4) if the trusts were recognized for tax purposes, I.R.C. §§652 and 662 functioned to increase the gross income of the taxpayers.

The taxpayers filed a separate petition in each one of the consolidated cases. The taxpayers' response consisted mostly of tax-protester style arguments about the application of the tax and the ability of the federal and state governments to tax.

Issues

Issue 1. Whether to grant the IRS' motions for judgment on the pleadings for the deficiencies.

Issue 2. Whether I.R.C. §7491 adds to the IRS's burden of proof for a judgment on the pleadings.

Issue 3. Whether taxpayers are liable for penalties under I.R.C. §6662(a) for negligence and substantial understatements of tax.

Issue 4. Whether taxpayers are liable for penalties under I.R.C. §6673(a)(1) for delaying the proceedings and taking groundless and frivolous positions.

Issue 5. Whether taxpayers' attorney is liable for excessive costs under I.R.C. §6673(a)(2).

Analysis and Holding

Issue 1. The court noted that the taxpayers had failed to address any of the adjustments made in the notices of deficiency, raising only meritless tax-protester arguments. The court held that the taxpayers conceded those adjustments and it entered a judgment for the IRS.

Issue 2. I.R.C. §7491 provides that, in any court proceeding, the burden of proof as to any factual issue is on the IRS when the taxpayer, who has satisfied certain other requirements, produces credible evidence with respect to that issue. The court noted that in this case, the IRS had shown that there were no material facts in dispute. There were **only legal issues for the court to decide, so burden of proof, and thus I.R.C. §7491, were irrelevant.**

Issue 3. The court noted that by their own deemed admissions, the **taxpayers failed to exercise** the **due care** of a reasonable and ordinarily prudent person under like circumstances. For example, the taxpayers both admitted that the trusts were shams created primarily for income tax purposes. The court granted a partial summary judgment to the IRS on the accuracy-related penalties based on either the taxpayers' negligence or their substantial understatements of tax.

Issue 4. The court found that the taxpayers' positions were frivolous and noted its belief that the taxpayers instituted and maintained these proceedings primarily for delay. The court ordered the taxpayers to pay penalties under I.R.C. §6673(a)(1) totaling $30,500 for their various petitions.

Issue 5. The court held that the taxpayers' attorney acted in bad faith by aiding the taxpayers in a strategy of noncooperation and delay, making additional meritless tax-protester arguments, making meritless motions and responses to motions, and abusing the court's subpoena power. The IRS only requested costs for excess attorneys' fees and not for expenses. **The court held that $10,643.75 was a reasonable amount for the taxpayers' attorney to pay the IRS, because of her unreasonable and vexatious multiplication of the proceedings.**

[*The Nis Family Trust v. Commissioner*, 115 T.C. 523 (2000)]

IRS PROCEDURES: REPORTING

Rev. Proc. 2001-26
[I.R.C. §§3501 and 7513]

☞ **IRS announces significant changes to Forms W-2 and W-3 for 2001.**

Purpose. This revenue procedure provides the general rules for filing, and IRS and Social Security Administration requirements for reproducing, paper substitutes for Form W-2, Wage and Tax Statement, and Form W-3, Transmittal of Wage and Tax Statements, for amounts paid during the 2001 calendar year. A substitute Form W-2 or W-3 must conform to the specifications in this revenue procedure to be acceptable to the IRS and SSA. No IRS office is authorized to allow deviations from this revenue procedure. Rev. Proc. 2000-23, 2000-21 I.R.B. 1018 is superseded.

Some of the Significant Changes

1. The width of Forms W-2 and W-3 increases from 6.5 inches to 8 inches to accommodate widened boxes, specifically state/local wage and tax information.
2. The preferred font for all data entries on Forms W-2 and W-3 is 12-point Courier.
3. The former box 12 of Form W-2 (Benefits included in Box 1) is deleted and reformatted as boxes 12a, 12b, 12c, and 12d for enhanced scanning of four entries for SSA processing. A new code, "V" for Employee Stock Option, is added (see the following item).

[Rev. Proc. 2001-26, 2001-17 I.R.B. 1093]

Announcement 2000-97
[I.R.C. §§421, 3501, and 6011]

☞ **IRS announces a new code, Code V, for use in box 12 on 2001 Forms W-2.**

The IRS has announcedI.R.C. a new code for use in box 12 of the 2001 Form W-2 (box 13 on the 2000 W-2). Code V—Income from the exercise of nonstatutory stock option(s), will be used to identify the amount of compensation related to the exercise of an employer-provided nonstatutory stock option(s). Employers are currently required to report the excess of the fair market value of the stock received upon exercise of the option over the amount paid for that stock in boxes 1, 3, and 5. Now the information must also be shown in box 12, using Code V.

[Announcement 2000-97, 2000-48 I.R.B. 557]

T.D. 8942
[I.R.C. §§6041, 6050S, 6051, and 6724]

☞ **Forms W-2, 1098-T, and 1098-E may be sent electronically to recipients.**

Background. These temporary regulations provide guidance regarding the electronic furnishing of specified statements (Forms W-2, 1098-T, and 1098-E). Written statements required by I.R.C. §§6041(d), 6050S(d), and 6051 may be furnished in an electronic format in lieu of a paper format. In addition, the temporary regulations provide furnishers with a method of furnishing these statements electronically using website technology.

Consent. A recipient must have affirmatively consented to receive the statement electronically and must not have withdrawn that consent before the statement is furnished. The consent must be made electronically in a manner that reasonably demonstrates that the recipient can access the statement in the electronic format in which it will be furnished to the recipient.

Posting. The temporary regulations generally require the furnisher to post the statements on a website accessible to recipients on or before January 31 of the year following the calendar year to which the statements relate. The furnisher must notify the recipient that the statement is posted on a website on or before January 31 of the year following the calendar year to which the statement relates. The notice may be delivered by mail, by electronic mail, or in person and must provide instructions to the recipient on how to access and print the statement.

Retention. The furnisher must maintain access to the statements on the website through October 15 of the year following the calendar year to which the statements relate.

Applicability Date. These regulations apply to statements required to be furnished to recipients under I.R.C. §6041(d), §6050S(d), and §6051 after December 31, 2000.

Effective Date. These regulations are effective February 14, 2001.

[T.D. 8942, 2001-13 I.R.B. 929]

Announcement 2001-21
[I.R.C. §220]

> ☞ **The IRS announces reporting and filing requirements for Archer MSAs.**

The IRS advises trustees and custodians of medical savings accounts of the requirement to file Form 8851, Summary of Archer MSAs, and changes for magnetic and electronic filing. Public Law 106-554, enacted December 21, 2000, changed the name of medical savings accounts to Archer MSAs, extended the Archer MSA program through 2002, and reinstated the reporting requirement for trustees and custodians of Archer MSAs.

[Announcement 2001-21, 2001-9 I.R.B. 752]

Notice 2001-7
[I.R.C. §6045]

> ☞ **Regulations for reporting payments to attorneys are delayed.**

The IRS intends to further delay the effective date of the regulations proposed under I.R.C. §6045(f) governing the reporting of payments of gross proceeds to attorneys. Payments of gross proceeds to attorneys made after December 31, 1997, are and continue to be reportable on Form 1099-MISC pursuant to §6045(f); only the effective date of the regulations that interpret §6045(f) will be delayed. Taxpayers may continue to rely on the notice of proposed rulemaking (NPRM) as a safe harbor providing a reasonable interpretation of the statute. Notice 99-53, 1999-46 I.R.B. 565 is modified, and as modified, is superseded.

[Notice 2001-7, 2001-4 I.R.B. 374]

IRS PROCEDURES: TIPS

Fior D'Italia, Inc. v. United States
[I.R.C. §§3401, 6053, and 6201]

> ☞ **IRS may not estimate tips to make employment tax assessments.**

Facts. In 1991 and 1992, Fior D'Italia, an upscale Italian restaurant, reported aggregate tips that were significantly less than the tips that appeared on its credit card charge slips. The IRS assessed the taxpayer for additional FICA taxes on what it deemed was unreported tip income for those years. To determine what Fior owed, the IRS used the following calculation: it divided total tips charged on credit cards by total credit card receipts, which yielded an average tip rate of 14.49% and 14.20% for 1991 and 1992, respectively. It then applied this tip rate to the restaurant's gross receipts to get a presumed tip total for the year. **The IRS assessed Fior additional FICA taxes on the difference between its presumed total and the amount of tips Fior's employees had reported.** The IRS did not readjust the FICA or income tax liability of the various employees who may have understated tip income on their 4070 forms. Fior challenged the assessment method in district court, arguing that it exceeded the IRS's authority. The **district court agreed with the taxpayer** [21 F.Supp.2d 1097 (N.D. Cal 1998)]. **The IRS appealed.**

Issue. Whether the district court erred in holding that the IRS's method for calculating a restaurant's share of Social Security taxes on its employee's tip income was not valid.

Analysis. The court noted that for the IRS's aggregate assessment method to precisely equal the tips on which the employer's FICA tax is calculated, (1) the cash tipping rate must be exactly the same as the tipping rate on charge slips, and (2) total tips received must be distributed among employees so that none falls outside the wages band. (The following two provisions define the "wages band." I.R.C. §3121(a)(12)(B) excludes all cash tips received by an employee if the amount is less than $20 in a given month. Also, all salary plus tips that exceeds the Social Security wage base for the year is excluded.) **Neither condition will hold true in most cases. Charged tips generally exceed cash tips.** Also, charged tips paid to employees may be less than appears on credit card receipts, because some employers pass on to employees the 3% fee assessed by credit card companies. Many employees engage in tip sharing. That is, the waiters share tips with the table bussers, bartenders, and other employees. The court noted there is no way to tell how many table bussers made less than $20 per month.

The court also noted that while I.R.C. §446 gives the IRS broad authority to use estimates in making income tax assessments, it does not apply to the collection of FICA taxes. The court then explained there is no way to determine the employer's FICA tax liability without making an employee-by-employee determination of the taxable tips each has earned. An aggregate assessment based on inaccurate estimates forces the employer to pay the price for its employees' dereliction and is not the best way for the IRS to proceed.

Holding. Affirming a district court, the Ninth Circuit held that the IRS's estimate of cash tips was properly rejected.

[*Fior D'Italia, Inc. v. United States,* 242 F.3d 844 (9th Cir. 2001)]

Notice 2001-1
[I.R.C. §6053]

> ☞ **IRS provides guidance on obtaining approval of employer-designed tip reporting programs (EmTRAC) for the food and beverage industry.**

The IRS has set forth requirements and procedures for obtaining approval of an employer-designed Tip Reporting Alternative Commitment (EmTRAC) program. The EmTRAC program is available only to employers in the food and beverage industry that have employees who receive both cash and charged tips. **The IRS has also developed a pro forma letter that an employer must use to request approval of its EmTRAC program.** Notice 2000-21, 2000-19 I.R.B. 967 is superseded.

Background. In 1993, the IRS introduced its Tip Rate Determination/Education Program (TRD/EP), which is designed to enhance tax compliance among tipped employees through taxpayer education and voluntary advance agreements instead of traditional audit techniques. The 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. The agreements also set forth an understanding that both the employer and employees who comply with the terms of the agreement will not be subject to challenge by the Service.

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 December 31, 2005, the IRS may terminate prospectively the TRD/EP and all EmTRAC programs.

[Notice 2001-1, 2001-2 I.R.B. 261]

Announcement 2001-1
[I.R.C. §6053]

> ☞ **Final versions of pro forma TRAC and TRDA agreements are available on the IRS Web site and at IRS offices.**

The IRS has finalized pro forma Tip Rate Determination Agreements (TRDA) and Tip Reporting Alternative Commitment (TRAC) agreements for use in its Tip Rate Determination/Education Program (TRD/EP). Final versions of these agreements are available on the IRS Web site at http://www.irs.gov/bus_info/msu-info.html/. They can also be obtained from any IRS office.

[Announcement 2001-1, 2001-2 I.R.B. 277]

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CCA 200103070 (November 24, 2000)
[I.R.C. §§45B and 3401]

> ☞ **Employer social security credit under I.R.C. §45B should be claimed by entity that has control of the payment of wages.**

Issue. Which entity is entitled to the I.R.C. §45B credit when a restaurant obtains its tipped employees from a leasing organization?

Analysis. A component of the general business credit is the employer social security credit determined under I.R.C. §45B. I.R.C. §45B(a) provides that, for purposes of I.R.C. §38, the employer social security credit determined under I.R.C. §45B for the taxable year is an amount equal to the excess employer social security tax paid or incurred by the taxpayer during the taxable year. I.R.C. §45B(b) defines the "excess social security tax" as tax paid by an employer under I.R.C.

§3111. Thus, the **IRS believes the language of I.R.C. §45B requires that the taxpayer entitled to the credit be the employer on whom I.R.C. §3111 imposes the employer portion of the FICA tax.**

In this particular situation, the IRS thinks the restaurant rather than the leasing agency is likely to be the employer, but this may not always be so. I.R.C. §3401(d)(1) provides that the **term "employer" does not apply if the person for whom the individual performs the services does not have legal control of the payment of wages**. When a leasing organization merely acts as an agent of the employer, providing payroll and other services without legal responsibility for payment of the wages, the leasing organization is not the employer pursuant to I.R.C. §3401(d)(1). Leasing agencies have on occasion been found to be the common-law employer of their workers.

Holding. The I.R.C. §45B credit should be claimed by the employer. This will be the common-law employer, unless the leasing company has control of the payment of the wages and thus is an I.R.C. §3401(d)(1) employer.

IRS REPORTING: MISCELLANEOUS

Revenue Proc. 2001-1

> ☞ **The IRS has revised its procedures for issuing revenue rulings, letter rulings, and determination and information letters.**

Purpose. The IRS has published **revised procedures for issuing ruling letters, determination letters, and information letters on specific issues** under the jurisdiction of the associate chief counsel (corporate), the associate chief counsel (financial institutions and products), the associate chief counsel (income tax and accounting), the associate chief counsel (international), the associate chief counsel (passthroughs and special industries), the associate chief counsel (procedure and administration), and the division counsel/associate chief counsel (tax-exempt and government entities). **These procedures instruct taxpayers and their representatives on the proper method for submitting requests for guidance and detail the steps that are to be taken to facilitate efficient handling of such requests.** A sample request for a letter ruling was included. The IRS notes that the offices and titles in the Rev. Proc. are based on the current organization of the IRS, which includes four operating divisions. Rev. Proc. 2001-1 supersedes Rev. Proc. 2000-1, 2000-1 I.R.B. 4, and modifies Notice 97-19, 1997-1 C.B. 394; Rev. Proc. 96-13, 1996-1 C.B. 616; and Rev. Proc. 84-37, 1984-1 C.B. 513.

Effective Date. With some exceptions, this revenue procedure is effective January 15, 2001.

[Rev. Proc. 2001-1, 2001-1 I.R.B. 1]

Landry v. Commissioner
[I.R.C. §§6330, 6511, and 6513]

> ☞ **Taxpayer may not use overpayments first claimed on returns filed more than 3 years late.**

Facts. The taxpayer was educated as an accountant and prepared and filed his own tax returns. For tax years 1989 through 1998, he filed joint tax returns with his wife. His returns for 1990, 1991, and 1992 were filed on or about April 15, 1997. His returns for 1993, 1994, 1995, and 1996 were filed no earlier than June 1997. The taxpayers' 1997 return was filed in April 1999. When he filed his returns, the **taxpayer indicated that overpayments from withholding or carried-over estimated tax payments from prior years should be applied to the estimated tax for the following year.** The IRS applied the overpayments as directed by the taxpayer except in instances where the overpayments claimed by the taxpayer as credits had been deemed paid more than 3 years before the return was filed claiming a credit for that amount. **The notice of determination detailed the application of the various amounts and those that were not credited to the taxpayer's account because of late filing of his returns.**

Issue. Whether taxpayer may apply excess withholding from years for which returns were filed more than 3 years late.

Analysis. The taxpayer contended that it was unjust for the IRS not to apply all of his overpayments to his outstanding tax liabilities, because he consistently paid his taxes early by not claiming refunds until the time that he belatedly filed his returns. The court was bound by the strict terms of I.R.C. §6511(b) limiting refunds or credits for overpayments to those properly claimed within 3 years of the date paid. Payments made by withholding from wages are deemed paid on the 15th day of the 4th month following the close of the tax year. To the extent that overpayments were designated as estimated tax payments for a subsequent year, they were deemed made on the last day for filing the return.

Holding. The court held the taxpayer was not entitled to credit for an amount paid or deemed paid more than 3 years before a return claiming a credit of that amount was filed.

[*Landry v. Commissioner*, 116 T.C. 60 (2001)]

Olpin v. Commissioner
[I.R.C. §§6012, 6013, and 6061]

> ☞ **IRS cannot reject unsigned return as invalid more than a year after accepting, processing, auditing, and using the return.**

Facts. Mr. and Mrs. 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 Mrs. Olpin, the IRS filed a proof of claim asserting a tax liability for the 1995 tax year, based on unreported income for Mr. Olpin and on an unsigned joint tax return for 1995. In February 1998, at the urging of the IRS, Mrs. Olpin signed and filed a 1995 tax return using the filing status of married filing separately. The IRS amended its bankruptcy proof of claim to state that she owed no back taxes for the 1995 tax year.

The IRS had recorded its receipt of the joint return in 1996, but in 1998 it reversed its original processing of the return to reflect that Mr. Olpin had not filed a valid return. In August 1998, the IRS told Mr. Olpin that he had not filed a valid 1995 return because of the lack of signatures. When Mr. Olpin met with IRS agents on two occasions and asked to sign the original return in order to correct the problem, the agents refused to let him. The IRS also told him that he could not file a joint return that did not include Mrs. Olpin's signature. By this time however, Mrs. Olpin refused to sign a joint return because she had been released from joint tax liability for 1995. The notice of deficiency in 1999 was based on a refiguring of Mr. Olpin's taxes under a married filing separately status. He challenged the deficiency in the Tax Court [78 T.C.M. (CCH) 1254 (1999)]. The Tax Court held that the taxpayer did not file a valid 1995 return and must compute his tax on the basis of a married individual filing separately.

Issue. Whether IRS waived its assertion that no valid return had been filed when it refused to allow the taxpayer to sign his otherwise valid and processed tax return after he was notified of his failure to sign his return.

Analysis. The taxpayer argued that the IRS's usual practice when it receives an unsigned return that is valid in all other respects is either to return it to the taxpayer for signature and resubmission or to send a letter requesting the taxpayer sign a jurat under penalty of perjury that will become a permanent part of that return. The taxpayer established that the IRS did not send the return back to him either in 1996, when it processed the return, or in 1997, when it reviewed the return, and continued to treat it as a valid return by accepting his payments. **The court noted that the IRS accepted, processed, audited, and used the Olpins' joint return for at least a year after notifying Mrs. Olpin of the signature omission.** It was undisputed that, if the tax forms had been returned to Mr. Olpin at any time, he would have signed and resubmitted them.

Holding. Reversing the Tax Court, the Tenth Circuit held that the IRS may not deny a taxpayer the right to sign his original return and simultaneously declare that the original return is invalid for lack of a signature.

[*Olpin v. Commissioner*, 237 F.3d 1263 (10th Cir. 2001)]

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AOD 2001-02 (February 26, 2001)
[I.R.C. §6672]

> ☞ **IRS has non-acquiesced to court decision that held treasurer did not qualify as responsible person for unpaid employment taxes.**

The IRS has non-acquiesced to the First Circuit Court of Appeals decision in *Vinick v. United States* [205 F3d 1 (1st Cir. 2000)].

Facts. . Vinick, a CPA who was also the treasurer and part-owner of a bronze foundry, did not qualify as a responsible person liable for the trust fund recovery penalty, because he exercised no decision-making authority regarding which of the entity's creditors received payment. The government failed to establish that he had any involvement in the foundry's day-to-day operations during the calendar quarters when withholding taxes were unpaid. His bare titular authority as treasurer, his status as a shareholder, and his unexercised check-signing authority were insufficient to render him a responsible person. The mere fact that he was authorized to countersign checks did not establish that he controlled the management and disbursement of corporate funds.

Issue. Whether actual, exercised authority over a company's financial matters, including the duty and power to determine which creditors to pay, is necessary for a finding that a taxpayer is a responsible person under I.R.C. §6672.

Discussion. I.R.C. §6672 makes officers, employees, or other persons involved in a business personally liable for a penalty equal to the amount of the delinquent taxes, if they are responsible for the collection and payment of trust fund taxes and they willfully fail to collect or pay the tax. The IRS noted that the First Circuit's requirement that a responsible person possess "actual, exercised authority" over a company's financial affairs is a departure from prior First Circuit precedent. See *Harrington v. United States,* 504 F.2d 1306, 1315 (1st Cir. 1974) and *Thomsen v. U.S.,* 887 F.2d 12, 16 (1st Cir. 1989). In its original draft, the First Circuit stated that courts should be precluded from considering evidence outside the quarters at issue in determining whether a taxpayer was a responsible person. This holding is contrary to the IRS's position. Later, the First Circuit added a footnote clarifying that it meant to say, "it would be erroneous based solely on evidence from one quarter automatically to conclude that a person is responsible in another quarter."

Conclusion. The IRS will not follow the statement in *Vinick* that "actual, exercised authority" over a company's financial affairs is necessary for a finding of responsibility under I.R.C. §6672. Instead, the IRS will continue to follow *Harrington* and *Thomsen* in cases appealable to the First Circuit.

T.D. 8918
[I.R.C. §6302]

> ☞ **IRS removes Federal Reserve banks as authorized depositaries for Federal tax deposits.**

This document contains temporary regulations relating to the deposit of Federal taxes pursuant to I.R.C. §6302. **The regulations remove Federal Reserve banks as authorized depositaries for Federal Tax deposits.** The regulations affect taxpayers that make Federal tax deposits using paper Federal Tax Deposit (FTD) coupons (Form 8109) at Federal Reserve banks.

Discussion. The overwhelming majority of Federal Tax Deposits (FTDs) are now received electronically. The Treasury Department has developed an array of **other deposit options that are more convenient for taxpayers to use, and more economical to process, than deposits with Federal Reserve banks.** For example, taxpayers may use their touch-tone telephone or personal computer to make deposits 24 hours a day through the Electronic Federal Tax Payment System (EFTPS). For those taxpayers who still prefer paper coupons over electronic deposits, there are now more than 10,000 financial institutions nationwide that are designated as TT & L depositaries where taxpayers may make FTD deposits using paper coupons. To mitigate any difficulties for those taxpayers who do not have an account with an authorized financial institution and who do not wish to use EFTPS, the Treasury Department has authorized a financial agent to receive and process FTD payments through the mail.

Applicability Date. Federal Reserve banks are not authorized depositaries for Federal tax deposits made after December 31, 2000.

Effective Date. These regulations are effective December 26, 2000.

[T.D. 8918, 2001-4 I.R.B. 372]

Flood v. Commissioner
[I.R.C. §§165, 166, 446, 1001, 6662, and Tax Court Rule 34]

> ☞ **IRS uses source and application of funds method to reconstruct taxpayer's income.**

Facts. Glenn Flood, the taxpayer, owned and operated FAP, a sole proprietorship. FAP consisted of the wholesale and retail sale of auto parts, a wrecker service, and the sale of junk cars to a scrap metal dealer. **The taxpayer did not create an invoice for every sale and he did not deposit all proceeds from sales into his business or personal bank accounts.** He also accumulated cash at his residence.

The taxpayer's father and stepmother owned an auction company. The taxpayer cosigned and made payments on several bank loans that were for the benefit of his father and the auction. The total amount advanced to his father was $107,036. In 1992, a fire completely destroyed the auction, and the taxpayer's father and stepmother claimed a casualty loss deduction of $55,825 on their 1992 tax return.

The taxpayer also owned another wrecker service called Glenwood Wrecker Service. Glenwood initially operated as a sole proprietorship. Glenwood became a partnership in 1988 with the taxpayer's brother-in-law, Hammontree, joining as the other partner. In order to pay for his one-half interest in Glenwood, the taxpayer and Hammontree orally agreed that Hammontree would manage, and receive a salary from Glenwood, and pay the taxpayer from Hammontree's half of the profits. In 1989, Glenwood became incorporated. Also in 1989, the taxpayer and Hammontree agreed that $29,789 should be removed from the corporation by Hammontree and paid to the taxpayer in payment for Hammontree's one-half interest in the business. In July 1992, the taxpayer sold his one-half interest in Glenwood to Hammontree. The taxpayer and his wife reported a capital gain from the sale of Glenwood stock in the amount of $19,344 on their 1992 return. During the examination, the IRS determined that the $29,789 received by the taxpayer was a distribution from Glenwood reducing taxpayer's basis in Glenwood. The IRS determined deficiencies and penalties on the taxpayer and his spouse's joint returns for 1991, 1992, and 1993.

Issues

Issue 1. Whether taxpayers' 1991, 1992, and 1993 income was underreported.

Issue 2. Whether taxpayers are entitled to a 1992 bad debt deduction under I.R.C. §165.

Issue 3. Whether taxpayers are entitled to a 1992 casualty loss deduction under I.R.C. §165.

Issue 4. Whether taxpayers' 1992 gain from the sale of a wrecker service was understated.

Issue 5. Whether taxpayers are liable for the accuracy-related penalty under I.R.C. §6662(a) for 1991, 1992, and 1993.

Analysis and Holding

Issue 1. By using the source and application of funds method, the IRS determined the taxpayers had unreported income. To compute unreported income using this method, the funds used were identified through the taxpayers' expenditures during the tax year and then compared with the taxpayers' total available funds from all sources during the tax year. Where expenditures exceeded known available funds, the difference was determined to be income. The IRS excluded funds that were accumulated during prior years. The taxpayer argued that the IRS's determination of their income was overstated because the IRS used too small an amount of cash on hand in the computation. The only evidence the taxpayers offered on this point was their oral testimony. **The court upheld the IRS's reconstruction of the taxpayers' income.**

Issue 2. The taxpayers were not entitled to a bad debt deduction because they failed to establish the existence of bona fide debt. The court noted that the transaction lacked formality and even if they had proved the existence of bona fide debt, they failed to show worthlessness in the tax year at issue.

Issue 3. The taxpayers did not raise the issue of the casualty loss in their petition and thus, the court would not address it because it was not timely raised. However, the court noted that they failed to show that they had an ownership interest in the property and that another relative had already claimed a casualty loss for the entire value of the property.

Issue 4. The court held that the taxpayers did not understate their capital gain from the sale of a wrecking business, because amounts received did not constitute a corporate distribution. Rather, the amounts received were characterized as payment by the other shareholder for his one-half ownership in the business pursuant to an oral agreement.

Issue 5. The taxpayers were liable for the accuracy-related penalty for negligence because they did not maintain books or records for their sole proprietorship. They also failed to inform their return preparer that certain sales were omitted from the invoices and sales proceeds were not always deposited into the taxpayers' personal or business bank account.

[*Flood v. Commissioner*, 81 T.C.M. (CCH) 1175 (2001)]

ITEMIZED DEDUCTIONS

Zipkin v. United States
[I.R.C. §213]

> ☞ **The cost of construction of special features required by a medical condition is deductible in the year the home is placed in service.**

Facts. Mrs. Zipkin suffers from Multiple Chemical Sensitivity Syndrome. Her physician recommended that the Zipkins build a home made of steel, concrete, and other special components that also included special ventilation and filtering systems. In September 1992, the taxpayers entered into a contract with an architect to design such a home. In September 1993, the taxpayers entered into a contract with a company to build the home. The contract called for progress payments. From July 1992 to December 1994, the taxpayers paid $1,216,230 for various costs related to the construction of their residence. The construction costs directly related to Mrs. Zipkin's medical condition exceeded the fair market value of the home by $645,659. The taxpayers filed an amended return for 1995 seeking a refund based on medical expense deductions of $755,231. The IRS allowed a partial refund based on medical expense deductions that were actually paid in 1995. Construction costs that were paid in 1992, 1993, and 1994 were disallowed.

Issue. What is the proper medical expense deduction for the tax year 1995?

Analysis. I.R.C. §213(a) provides that a taxpayer may take, as a deduction, ordinary and necessary medical expenses paid or incurred during the taxable year. The Internal Revenue Service Regulations further provide that:

> a capital expenditure for the permanent improvement or betterment of property which would not ordinarily be for the purpose of medical care may, nevertheless, qualify as a medical expense to the extent that the expenditure exceeds the increase in value of the related property, if the particular expenditure is directly related to medical care.

The taxpayer argued that the expenses incurred for the construction of the home should be considered prepayments for medical care, as the home provided no medical benefit to Mrs. Zipkin until it was proved habitable by Mrs. Zipkin. The taxpayer also asserted that the amount of deduction could not be determined until after the home was completed and the home's fair market value could be ascertained. The IRS argued that Zipkin was legally obligated to make the progress payments in the tax years before 1995, because she entered into a contract to build a home that she could live in. Whether or not the contractor had met the terms of the contract was not established until 1995, when the home became habitable. The IRS noted that if the home were proven to be uninhabitable, the Zipkins could have sued the contractor for breach of contract and would not be legally obligated to pay the contractor.

Holding. The court agreed with the taxpayer that the deduction for medical expenses incurred in the construction of the Zipkin's home is properly taken in the year the home became inhabitable, which was 1995. The correct amount of the deduction was $645,659.

[*Zipkin v. United States*, 2000-2 USTC ¶50,863 (D. Minn. Oct. 18, 2000)]

Henderson v. Commissioner
[I.R.C. §213]

> ☞ **Taxpayers cannot deduct depreciation as medical expense for specially equipped van.**

Facts. The Henderson's son, Bradley, suffers from spina bifida and is confined to a wheelchair. In 1991, the Hendersons paid $26,000 to purchase a van for the sole purpose of transporting Bradley. Acting upon the recommendation of Bradley's doctor in 1992, the Hendersons paid $4,406 to modify the van by installing an automatic wheelchair lift and raising the roof of the van. On the recommendation of their CPA, the Hendersons deducted the cost of the van and the conversions at a rate of $5,500 per year for 1991–1995. Upon audit of the 1994 and 1995 tax returns, the IRS denied the depreciation deduction for both years.

Issue. Whether taxpayers are entitled to deduct depreciation as a medical expense under I.R.C. §213.

Analysis. The IRS conceded that the expense of $4,406 to convert the van was deductible for 1992, the year in which it was paid. This was less than the $5,500 deduction actually taken by the taxpayers for 1992. However, the only years at issue in this case were 1994 and 1995. The IRS argued that depreciation is not an "expense paid" or "amount paid" and thus, is not deductible as a medical expense under I.R.C. §213.

Holding. The court held that the taxpayers were not entitled to deduct depreciation as a medical expense deduction under I.R.C. §213 in either 1994 or 1995.

[*Henderson v. Commissioner*, 80 T.C.M. (CCH) 517 (2000)]

Jennings v. Commissioner

[I.R.C. §§170 and 6662]

> ☞ **Taxpayer cannot deduct unsubstantiated charitable contributions.**

Facts. Stanley Jennings claimed $94,510 in charitable contributions from 1994 to 1996 on his federal income tax returns. Among Jennings' claims were an organ speaker for a church, cash, and inspirational or self-help articles he wrote and gave to a publication. Sometime between 1990 and 1995, Jennings called his local IRS office and was told by a problem resolution officer that he could deduct charitable contributions on Schedule A (Form 1040) of his returns, but that he must prove his contributions. Jennings' response was, "Well, I'm going to try anyway and see what happens." The IRS disallowed the deductions and imposed accuracy-related penalties.

Issues

Issue 1. What amount may the taxpayer deduct as a charitable contribution for the tax years in question.

Issue 2. Whether taxpayer is liable for the accuracy-related penalties under I.R.C. §6662(a).

Analysis. The taxpayer contended that he could deduct charitable gifts of cash without any documentary proof. The court disagreed, citing Treas. Reg. §1.170A-13(a)(1). A taxpayer with no canceled checks or receipts must verify charitable contributions with other reliable written records showing the name of the donee, the date, and the amount of the contribution. Factors showing whether a document (other than check or receipt) is adequate to substantiate a charitable gift include the contemporaneous nature of the writing, the regularity of the recordkeeping, and, for small contributions, the existence of any written document or other evidence from the donee organization which shows that it received the gift even if it is not a receipt, such as a button, emblem, or other token regularly given by the organization to a donor (Treas. Reg. §1.170A-13(a)(2)(i)).

Among the evidence Jennings presented in court was an undated 3" × 3" paper, on which he had written "Tithes/(illegible word) $6,074, 1989 Tabernacle of God." The court found no evidence that Jennings prepared the paper or when it was prepared. Jennings also presented his check register, which showed dates and amounts of withdrawals, but the court noted that the register did not show dates and amounts of contributions. Jennings also failed to show the donees were organizations described in I.R.C. §170(c) during the years at issue. The court also found that Jennings could not deduct amounts for articles he contributed to a publication because the publication was not listed among I.R.C. §170(c) organizations in IRS Publication 78 and because he failed to determine the fair market value of the articles he submitted. The only evidence Jennings could present for the organ speaker was a 1989 receipt for the purchase, but he had no evidence that he contributed it to the church or if he did, when he contributed it. The court also found that Jennings could not deduct charitable contributions he made from 1977 to 1993 and carried over to 1994, 1995 and 1996, again because he neither substantiated them nor showed that the excess contributions were available to be carried over. Finally, the court held that Jennings was liable for accuracy-related penalties for negligence and substantial underpayment of tax, because the IRS problem resolution officer had told him that he had to substantiate his charitable deductions.

Holding. The court held that the taxpayer could not deduct any amount as charitable contributions for 1994, 1995, or 1996 or any excess charitable contributions carried over to 1994, 1995, or 1996. The court also concluded that the taxpayer was liable for the accuracy-related penalty under I.R.C. §6662(a) for each of the years in issue.

[*Jennings v. Commissioner*, 80 T.C.M. (CCH) 783 (2000)]

LTR 200115032 (February 12, 2001)

[I.R.C. §212
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> ☞ **Credit card fee for charging taxes is not deductible**

Issue. Whether an individual may deduct a fee charged by a credit card company for using a credit card to pay the individual's personal income taxes.

Discussion. Congress intended to allow a deduction to an individual in connection with determining the extent of an income tax liability or in contesting a tax liability. Thus, expenses paid or incurred by a taxpayer for tax counsel, tax return preparation or in contesting a tax liability are deductible. However, the IRS does not support a broader interpretation of I.R.C. §212 to allow a deduction for the expenses involved in paying that liability once it has been determined.

Conclusion. No deduction is allowed under I.R.C. §212(3) for a fee charged by a credit card company for using a credit card to pay the individual's personal income taxes; rather the fee is considered a nondeductible personal expense under I.R.C. §262.

LEASES

Rev. Rul. 2001-20
[I.R.C. §110]

> ☞ **Lessee may exclude from income the portion of construction allowance spent on qualified long-term real property.**

Facts. Retailer X signs a 10-year lease agreement to lease retail space located in Y's newly constructed shopping center. A portion of the lease agreement provides that Y will give X a construction allowance of $1 million for the retail space. The lease agreement provides that, to the extent the $1 million construction allowance is spent on qualified long-term real property, it is for the purpose of constructing or improving qualified long-term real property for use in X's business at the retail space. During the taxable year, X receives the $1 million construction allowance and spends $800,000 on qualified long-term real property and $100,000 on I.R.C. §1245 property for the leased retail space. X is permitted to keep any excess over the amount it actually spends improving the retail space.

Issue. Whether a lease agreement must provide that an entire construction allowance is for the purpose of constructing or improving qualified long-term real property in order to satisfy the purpose requirement under Treas. Reg. §1.110-1(b)(3).

Analysis. I.R.C. §110(a) provides a safe harbor excluding from gross income any amount received in cash (or treated as a rent reduction) by a lessee from a lessor under a short-term lease of retail space as long as it is for the purpose of the lessee's constructing or improving qualified long-term real property for use in the lessee's trade or business at the retail space. However, the lessee may not exclude the excess of the amount received over the amount actually expended. I.R.C. §110(c)(1) defines "qualified long-term real property" as nonresidential real property which is part of the retail space and which reverts to the lessor at the termination of the lease. Qualified long-term real property does not include property qualifying as I.R.C. §1245 property. Section 110(c)(2) defines "short-term lease" as a lease agreement of retail space for 15 years or less.

Under the purpose requirement in Treas. Reg. §1.110(b)(3), an amount is excluded from income only to the extent that the lease agreement expressly provides that the construction allowance is for the purpose of constructing or improving qualified long-term real property. The intent of this requirement is to ensure that the lessor and the lessee take consistent tax positions. The requisite provision serves as an acknowledgment by the lessor and the lessee that, to the extent the construction allowance is spent on qualified long-term real property, the improved or constructed property will be treated as owned by the lessor.

Holding. The purpose requirement under Treas. Reg. §1.110-1(b)(3) does not require a lease agreement to provide that the entire construction allowance is for the purpose of constructing or improving qualified long-term real property. However, only the $800,000 qualifies as a qualified lessee construction allowance that may be excluded from income under I.R.C. §110(a).

[Rev. Rul. 2001-20, 2001-18 I.R.B. 1143]

Rev. Proc. 2001-28
[I.R.C. §§162, 168, 1001, 1101, and 1245]

> ☞ **The IRS issues guidance on advance rulings for leveraged lease transactions.**

Purpose. This revenue procedure provides guidelines that the IRS will use for advance ruling purposes in determining whether certain transactions purporting to be leases are, in fact, leases for federal income tax purposes. Rev. Proc. 2001-28 modifies and supersedes Rev. Proc. 75-21, 1975-1 C.B. 715, Rev. Proc. 76-30 1976-2 C.B. 647; and Rev. Proc. 79-48, 1979-2 C.B. 529. Newly issued Rev. Proc. 2001-29, 2001-19 I.R.B. 1160, sets forth the information and representations a taxpayer must furnish when requesting an advance ruling under Rev. Proc. 2001-28.

Scope. This revenue procedure applies to leveraged lease transactions. The procedure clarifies the circumstances in which an advance ruling recognizing the existence of a lease ordinarily will be issued. These guidelines do not define, as a matter of law, whether a transaction is or is not a lease for federal income tax purposes.

Guidelines. Unless other facts and circumstances indicate otherwise, **for advance ruling purposes only, the IRS will consider the lessor in a leveraged lease transaction to be the owner of the property and the transaction a valid lease if all the guidelines of this revenue procedure are met.** If all of the guidelines are not met, the IRS will nevertheless consider ruling in appropriate cases on the basis of all the facts and circumstances. Some of the guidelines concern the following: (1) minimum unconditional "at risk" investment; (2) lease term and renewal options; (3) purchase and sale rights; (4) investments by the lessee; (5) no lessee loans or guarantees; and (6) profit requirement. Other considerations include the uneven rent test and limited use property.

Effective Date. This revenue procedure is effective May 7, 2001.

[Rev. Proc. 2001-28, 2001-19 I.R.B. 1156]

LTR 200046020 (August 17, 2000)
[I.R.C. §168]

> ☞ **Mileage-based depreciation method can be used by vehicle leasing business**

Facts. The taxpayer is in the business of leasing vehicles to corporate fleet users under operating lease arrangements. The leases are for one year with automatic monthly renewals after the first year. The average lease lasts 32 months and the average number of miles logged by a leased vehicle is 67,000. Upon termination of the lease, the taxpayer sells the vehicle. Information submitted by the taxpayer indicates the useful life of a leased vehicle depends in large part on the number of miles the vehicle is driven. The taxpayer asserts that depreciation of its leased vehicles is not adequately measured by the time-based depreciation methods of I.R.C. §168.

Issue. Whether taxpayer may elect under I.R.C. §168(f)(1) to use a method of depreciation that is not time-based.

Analysis. I.R.C. §168(f)(1) provides that I.R.C. §168 shall not apply to any property if the taxpayer elects to exclude the property from the application of I.R.C. §168 and, for the first taxable year for which a depreciation deduction would be allowable, the property is properly depreciated under the unit-of-production method or any method of depreciation not expressed in a term of years (other than the retirement-replacement-betterment method or similar method). Treas. Reg. §301.9100-7T(a) requires the taxpayer to make the election under I.R.C. §168(f)(1) for the first taxable year in which the property is placed in service.

Conclusion.. The taxpayer's mileage-based depreciation method is an acceptable method of computing depreciation under I.R.C. §167(a) and I.R.C. §168(f)(1) for the taxpayer's leased vehicles with a cost of $35,000 or less subject to several terms and conditions.

LIKE-KIND EXCHANGES

Rev. Proc. 2000-37
[I.R.C. §1031]

> ☞ **IRS announces safe harbor for reverse like-kind exchanges.**

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Purpose. This revenue procedure provides a safe harbor for reverse like-kind exchanges. Under the safe harbor, the IRS won't challenge either the qualifications of the property as replacement property or the treatment of the exchange accommodation titleholder as the beneficial owner if the property is held in a "qualified exchange accommodation arrangement" (QEAA).

Background. The preamble to Treas. Reg. §1.1031(k)(1) states that the deferred exchange rules under I.R.C. §1031(a)(3) do not apply to reverse-*Starker* exchanges, that is, exchanges where the replacement property is acquired before the relinquished property is transferred (see *Starker v. United States*, 602 F.2d 1341). Since the promulgation of the final regulations, **taxpayers have engaged in a wide variety of transactions, including "parking" transactions, to facilitate reverse like-kind exchanges.** Parking transactions are designed to "park" the desired replacement property with an accommodation party until such time as the taxpayer arranges for the transfer of the relinquished property to the ultimate transferee. Once such a transfer is arranged, the taxpayer transfers the relinquished property to the accommodation party in exchange for the replacement property, and the accommodation party then transfers the relinquished property to the ultimate transferee. In parking arrangements, taxpayers attempt to arrange the transaction so that the accommodation party has enough of the benefits and burdens relating to the property to be treated as the owner for federal income tax purposes, thereby enabling the taxpayer to accomplish a qualifying like-kind exchange.

Scope. No inference is intended with respect to the federal income tax treatment of the following: (1) arrangements similar to those described in this revenue procedure that were entered into prior to the effective date of this revenue procedure; (2) "parking" transactions occurring before or after the effective date of this revenue procedure that do not satisfy the terms of the safe harbor describe in this revenue procedure. The provisions of this revenue procedure apply only in the limited context described herein.

Qualified Exchange Accommodation Arrangements.

Property is held in a QEAA if all of the following requirements are met:

1. Title must be held by an exchange accommodation titleholder, who is not the taxpayer and is subject to federal income tax, at all times from the date of acquisition until the property is transferred.
2. At the time title is transferred to the exchange accommodation titleholder, it must be the taxpayer's bona fide intent that the property is either replacement or relinquished property in an exchange that qualifies for nonrecognition.
3. No later than 5 business days after the transfer of title, the taxpayer and the exchange accommodation titleholder enter into a written agreement that the property is being held to facilitate an exchange under I.R.C. §1031.
4. No later than 45 days after title is transferred, the relinquished property is properly identified.
5. No later than 180 days after the transfer of title to the exchange accommodation titleholder, the property is transferred as either replacement or relinquished property.
6. The combined time period that the relinquished property and the replacement property are held in QEAA does not exceed 180 days.

Effective Date. Rev. Proc. 2000-37 is effective for QEAAs entered into with an exchange accommodation titleholder that acquires ownership of the property after September 14, 2000.

[Rev. Proc. 2000-37, 2000-40 I.R.B. 308]

Bundren v. Commissioner

[I.R.C. §§1031 and 6662]

☞ **Taxpayers' calculation of adjusted basis in residence converted to rental property was incorrect.**

Facts. In 1994, the taxpayers, a doctor and his wife, converted their personal residence, acquired in 1982, to rental property when the fair market value (FMV) was less than the adjusted basis of $233,130. **After renting the property for a few months, the taxpayers transferred the old property in exchange for rental property in a different location in an I.R.C. §1031 like-kind exchange**. The contract sales price for the old property was $134,500. The contract sales price of the new property was $67,500, and the mortgage balance on the old property of $126,075 was paid off as part of the transaction. In calculating their adjusted basis in the new property for purposes of determining depreciation deduction, taxpayers reported an adjusted basis of $147,206 for the new property, claiming the fair market was $217,450. In 1996, the taxpayers sold the new property for $61,600 and incurred closing costs of $10,668. The IRS determined that the taxpayers' basis in the new property was $67,500.

Issue

Issue 1. Determine the adjusted basis of the rental property immediately after it was acquired in an I.R.C. §1031 like-kind exchange.

Issue 2. Whether the taxpayers are liable for accuracy-related penalties under I.R.C. §6662.

Analysis and Holding

Issue 1. Both parties agreed the exchange qualified for treatment as a like-kind exchange under I.R.C. §1031. Therefore, according to I.R.C. §1031(d), the adjusted basis in the new property after the exchange was (1) taxpayers' carryover basis in the old property immediately before the exchange, decreased by (2) any money (boot) they received in the exchange, and adjusted for (3) any gain or loss recognized on the exchange. "FMV" is defined as "the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts" [*Gresham v. Commissioner*, 79 T.C. 322 (1982), *aff'd*, 52 F.2d 518 (10th Cir. 1985)].

The IRS claimed that the FMV of the old property at the time of the conversion was $134,500, the same as the contract price in the like-kind exchange since it was only a few months later. The taxpayers claimed the FMV was $217,450 (reflected in their 1995 return) or alternatively, $200,000, but offered no credible evidence to support either.

The IRS determined the taxpayers received boot in the exchange, representing the difference between the $134,500 sales price of the old property and the $67,500 sales price of the new property. The taxpayers computed the basis of the new property by treating as boot $70,244. The court conceded that the taxpayers received the smaller amount of $67,000 as boot.

The Tax Court determined that taxpayers' adjusted basis of the new property immediately after the exchange was $78,168 ($134,500 carryover basis in the old property less $67,000 boot received in the exchange, plus the $10,668 in closing costs that IRS conceded should be added to the basis). [Note: It appears this is in error since the $10,668 in closing costs was paid in connection with the sale of the property; only $1,090.41 was paid in connection with the exchange. The additional $10,668 would reduce the gain on the sale of the property and would not be included in the calculation of adjusted basis immediately after the exchange, which would be used to calculate depreciation.]

Issue 2. I.R.C. §6664(c) provides that no penalty shall be imposed under I.R.C. §6662(a) if it is shown that there was reasonable cause and that the taxpayer acted in good faith. Under Treas. Reg. 1.6664-4(b)(1), whether a taxpayer acted with good faith depends upon the facts and circumstances of each case. Reliance on the advice of a professional tax adviser constitutes reasonable cause and is in good faith if, under all the circumstances, the reliance was reasonable and the taxpayer acted in good faith. Reliance on a tax adviser or return preparer may be reasonable and in good faith if the taxpayer establishes that (1) the adviser or return preparer had sufficient expertise to justify reliance; (2) the taxpayer provided necessary and accurate information; and (3) the taxpayer actually relied in good faith on the adviser's or return preparer's judgment [*Sather v. Commissioner,* 78 T.C.M. (CCH) 456 (1999)]. Since 1982, taxpayers relied on the advice and accounting services of their CPA. He attended the closing of the exchange and reviewed the documents.

The Tax Court concluded that based on the evidence, the relative complexity of the tax issues involved and taxpayers' lack of experience or training in such matters, the taxpayers' reliance was reasonable and in good faith, and the accuracy-related penalty should not be imposed.

[*Bundren v. Commissioner,* 81 T.C.M. (C C H) 947 (2001)]

DeCleene v. Commissioner

[I.R.C. §§1001, 1031, and 6662]

☞ **Reverse exchange does not qualify as like-kind exchange.**

Facts. Donald DeCleene has owned and operated a trucking/truck repair business since 1969. In 1976 and 1977, DeCleene purchased property on McDonald Street for his business operations. In 1993, Donald and his wife worked as employees of DeCleene Truck Repair and Refrigeration, Inc. (Refrigeration). Donald served as president of Refrigeration. Through December 29, 1993, Refrigeration rented the McDonald Street property from the taxpayer as its business premises.

In 1992, DeCleene was looking for land to which he could move his business. On September 30, 1992, he purchased several acres of unimproved real property on Lawrence Drive. After he acquired the Lawrence Drive property, the Western Lime and Cement Co. (WLC) expressed an interest in buying the McDonald Street property. DeCleene's accountant suggested that he could structure a like-kind exchange in which he would quitclaim the Lawrence Drive property to WLC, after which WLC would convey back to DeCleene the Lawrence Drive property with a new building built thereon to DeCleene's specifications, in exchange for the McDonald Street property.

On September 24, 1993, WLC made an offer for the Lawrence property for $142,400. DeCleene quitclaimed title to the property to WLC, and WLC gave him a fully nonrecourse, non–interest-bearing one-payment note and mortgage on the property. The note and mortgage were due on the earlier of closing of an exchange transaction between WLC and DeCleene or six months from the date of the note. On December 29, 1993, after the Lawrence property building was substantially complete, DeCleene formally assumed WLC's nonrecourse note of September 24 and conveyed the McDonald property to WLC by warranty deed. In the exchange agreement, DeCleene and WLC agreed that the Lawrence and McDonald properties each had a value of $142,400.

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On their 1993 return, the DeCleenes treated the transactions between themselves and WLC as a sale of the unimproved Lawrence Drive property and a like-kind exchange of the McDonald Street property for the improved Lawrence Drive property. The taxpayers reported a short-term capital gain on their quitclaim transfer of the Lawrence Drive property to WLC (described as a sale of "investment land" on their Schedule D), and they reported no gain or loss on the disposition of the McDonald Street property. The IRS computed a long-term capital gain on the sale of the McDonald Street property and contended that the taxpayers never sold the Lawrence Drive property.

Issues

Issue 1. Whether taxpayer's property on McDonald Street qualified as a like-kind exchange for the Lawrence Drive property.

Issue 2. Whether taxpayer is liable for the accuracy-related penalty under I.R.C. §6662(a).

Analysis. The court noted that the transactions in this case reflected the effort of the taxpayer and his advisers to implement a reverse exchange directly with WLC, without the participation of a third-party exchange facilitator. The court also noted that the preamble to the deferred-exchange regulations makes it clear that I.R.C. §1031(a)(3) and the regulations don't apply to reverse exchanges. (Rev. Proc. 2000-37 would not apply to this case because the exchange occurred in 1993.)

The court noted that DeCleene did more than merely locate and identify property as replacement property—he actually purchased it without an exchange facilitator, more than a year before the exchange. WLC did not acquire the benefits and burdens of ownership of the Lawrence property while it held title. DeCleene financed the construction and was at all times at risk for the property. The quitclaim of the Lawrence property by DeCleene to WLC was nothing more than a "parking" transaction with WLC.

In support of his claim that he exchanged the McDonald Street property for the improved Lawrence Street property, DeCleene pointed out that the improved Lawrence Drive property was different from the unimproved Lawrence Drive property that he acquired in 1992 and transferred to WLC in 1993. The court noted that this fact did not change its conclusion that in substance, DeCleene never disposed of the Lawrence Drive property and remained its owner during the 3-month construction period, because the transfer of title to WLC never divested DeCleene of beneficial ownership. The court held that the conveyance of the McDonald Street property to WLC was a taxable sale.

Holding.. The court held that the subject transactions did not qualify as a like-kind exchange. No penalty was imposed because the taxpayers relied in good faith on disinterested professional advisers who structured the transactions and prepared their return.

[*DeCleene v. Commissioner*, 115 T.C. 457 (2000)]

Rev. Proc. 2000-46
[I.R.C. §7701]

> ☞ **IRS won't issue advance rulings or determination letters on exchanges of undivided fractional interests in real property.**

Purpose. This revenue procedure amplifies Rev. Proc. 2000-3, 2000-1 I.R.B. 103, which sets forth those areas of the Internal Revenue Code in which the IRS will not issue advance rulings or determination letters until the issue is resolved through publication of a revenue ruling, revenue procedure, regulations, or otherwise.

Background. The IRS has become aware that taxpayers are taking the position that certain arrangements where taxpayers acquire undivided fractional interests in real property do not constitute separate entities for federal tax purposes. Therefore, the fractional interests may be the subject of tax-free exchanges under I.R.C. §1031(a)(1). The IRS intends to study further the facts and circumstances relevant to the determination of whether such arrangements are separate entities for federal tax purposes.

Procedure. Rev. Proc. 2000-46 adds the following to the "no rule" list of Rev. Proc. 2000-3: (1) whether an undivided fractional interest in real property is an interest in an entity that is not eligible for tax-free exchange under I.R.C. §1031(a)(1); and (2) whether arrangements where taxpayers acquire undivided fractional interests in real property constitute separate entities for federal tax purposes under I.R.C. §7701.

Effective Date. Rev. Proc. 2000-46 applies to all ruling requests, including any which are pending, after October 11, 2000. The IRS requests comments concerning this revenue procedure.

[Rev. Proc. 2000-46, 2000-44 I.R.B. 438]

Smalley v. Commissioner
[I.R.C. §§453 and 1031]

> ☞ **Sale of standing timber for real estate should be taxed in the year of receipt.**

Facts. After attending a seminar on timber exchanges presented by a well-known timber taxation expert and after consulting with his longtime C.P.A., the taxpayer decided to undertake an exchange of standing timber (Laurens County) for additional acreage containing standing timber. On November 29, 1994, the taxpayer entered into a series of agreements with Rayonier, Inc., whereby for a term of 2 years he granted Rayonier exclusive rights to cut and remove mature timber from his Laurens County land in return for $517,076. Most of the funds were received by an escrow agent. By three letters to the escrow agent on December 18 and 21 of 1994 and January 2, 1995, the taxpayer identified three replacement properties. Ownership of each of the three parcels was transferred to the taxpayer during February and March of 1995. The purchase of the properties used most of the escrow funds and the escrow agent paid the taxpayer the balance.

On his 1994 tax return filed jointly with his wife, the taxpayer characterized the subject transaction as a like-kind exchange of "Timber" for "Timber and Land," which resulted in a $496,076 gain deferred under I.R.C. §1031. The IRS determined a gain of $489,935, which was to be fully recognized in 1994, because the exchange didn't meet the requirements of I.R.C. §1031.

Issue. Whether taxpayer is required to recognize income in 1994 as the result of a deferred exchange that was entered into in 1994 and completed in 1995.

Analysis. The taxpayer argued that to continue his timber investment, he exchanged standing timber for standing timber that necessarily had to have land attached. He argued that under Georgia law, both the relinquished property and the replacement property are characterized as real property interests and thus, the transaction qualifies as a tax-deferred like-kind exchange under I.R.C. §1031. The IRS argued that under Georgia law, the 2-year timber cutting contract was personal property and thus not of like kind to the replacement property. The taxpayer raised an alternative argument that regardless of whether the transaction qualified as a like-kind exchange, he realized no gain in 1994 because he had no actual or constructive receipt of property in 1994.

The court noted that it was unnecessary to resolve whether the like-kind requirements were satisfied in this case. All that was necessary was to determine whether the taxpayer had a bona fide intent to acquire like-kind property before the end of the 180-day exchange period. The court noted the following factors supported a finding of bona fide intent: (1) the November 28, 1994 agreements expressly conditioned the transaction on "reasonable cooperation and a tax free exchange qualifying under I.R.C. §1031," (2) the taxpayer used a qualified escrow account and a proper escrow agent as required by Treas. Reg. §1.103(k)-1(g)(3); (3) the taxpayer identified and received the replacement properties within the 45-day and 180-day period required by I.R.C. §1031(a)(3); (4) the taxpayer testified credibly that he intended to have a like-kind exchange; and (5) in planning the transaction, the taxpayer relied on advice from a well-known timber taxation expert and his accountant. The court concluded that the taxpayer satisfied the bona fide intent test.

Holding. The court held that under Treas. Reg. §1.103(k)-1(j), the taxpayer had no actual or constructive receipt of property in 1994 for purposes of applying the installment sale provisions of I.R.C. §453. Thus, the taxpayer was not required to recognize any gain in 1994.

[*Smalley v. Commissioner*, 116 T.C. 450 (2001)]

PASSIVE INCOME

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Mowafi v. Commissioner
[I.R.C. §469]

> ☞ **Taxpayer is not exempt from passive loss rules because he failed both tests for real estate professional exception.**

Facts. During 1994 and 1995, the taxpayer worked for GTE as a director of research and the manager of its research and development facility. He generally worked for GTE a minimum of 40 hours per week. He was also involved with 17 rental real estate properties, devoting some of his personal time to maintaining and accounting for all of the rental properties. On his 1994 and 1995 tax returns, the taxpayer recognized losses from the rental properties of $115,977 and $92,037, respectively. The IRS determined that these were passive losses and could not be recognized due to I.R.C. §469.

Issue. Whether taxpayer qualifies as a real estate professional under I.R.C. §469(c)(7).

Analysis. Although all rental activities are passive, Congress enacted an exception for certain post-1993 rental activities (§469(c)(7)). Under this provision, the taxpayer will be considered a real estate professional, and the losses on his rental properties will not be considered passive, if the taxpayer can prove he meets the following two requirements: (1) He performed more than half of his personal services during the year in real property trades or businesses in which he materially participated, and (2) he worked more than 750 hours a year in those real estate activities. Temp. Reg. 1.469-5T(f)(4) provides the following methods of proof as evidence of the amount of personal time a taxpayer devotes to his rental properties: contemporaneous daily time reports, logs, or similar documents or any other reasonable means of establishing the extent of participation such as appointment books, calendars, or narrative summaries. Mr. Mowafi tried to meet his burden of proof by relying on his testimony at trial and noncontemporaneous logs which he prepared in connection with his audit. The court considered the taxpayer's logs along with his time cards at GTE, and noted that he claimed to have worked almost 24 hours in a day and on one occasion, even more than 24 hours. The court found that the taxpayer failed to carry his burden of proof.

Holding. The court held that the taxpayer could not recognize losses from his rental properties because he failed to prove that he met the real estate professional exception to the passive loss rules.

[*Mowafi v. Commissioner*, 81 T.C.M. (CCH) 1605 (2001)]

Hairston v. Commissioner
[I.R.C. §469]

> ☞ **Taxpayers who purchased equipment and leased it to their corporation are subject to the passive loss rules.**

Facts. Kenneth and Delores Hairston own and operate Hairston Inc., a C corporation engaged in the business of leasing heavy construction equipment to third parties. Hairston employs the couple full-time. Between 1993 and 1996, the couple purchased eight pieces of heavy equipment in their own names and leased it to Hairston, which subleased the equipment to customers. Hairston, Inc. assumed all responsibility for the taxpayers' equipment. Hairston was required to maintain the equipment, to provide insurance, and to collect and pay any taxes on the equipment. On their 1994 and 1995 tax returns, with regard to the lease of their equipment, the taxpayers claimed Schedule C ordinary deductions under I.R.C. §162, reported rental income from Hairston, and claimed net losses after depreciation of $58,899 and $38,499, respectively.

Issue. Whether taxpayer's equipment rental activity constitutes a passive activity under I.R.C. §469(c).

Analysis. A rental activity (except certain rental activity involving real estate) is generally treated as a passive activity whether or not the taxpayer materially participates. A rental activity is defined as any activity where payments are principally for the use of tangible property (Temp. Reg. §1.469-1T(e)(3)(i)). The taxpayers contend that their equipment rental activity qualifies for two exceptions from the definition of rental activity for the purposes of I.R.C. §469. First, rental activity will not be treated as such where the average period of customer use of the property is 30 days or less and where significant personal services are provided by or on behalf of the owner of the property in connection with making the property available for use by customers. Second, passive rental activity will not be treated as such where extraordinary personal services are provided are provided by or on behalf of the owner of the property in connection with renting the property to customers.

The court noted that the taxpayers' lease with Hairston was for an indefinite term over a number of years. Under Treas. Reg. §1.469-1(e)(3)(iii)(A) and (D), Hairston's right to use the couple's equipment is properly treated as one period of customer use extending for the entirety of each taxable year. The taxpayers argued that they had an agency, not a lease, relationship with Hairston. The court dismissed this argument based on the form of the lease agreement and state law. Thus, the court found that the average period of use exceeded 30 days.

The court found no credible evidence to support the taxpayers' claim that significant or extraordinary services were performed either by them or on their behalf as owners of the equipment. Under the terms of the lease agreement, the taxpayers had little or no responsibility for upkeep and maintenance of the equipment. The court noted that services of the taxpayers as officers and employees of Hairston in maintaining the equipment and handling the subleases to end users were unrelated to the obligations of the taxpayers as owners of the equipment.

Holding. The court held that the taxpayers' equipment rental activity constitutes a passive rental activity subject to the loss limitations of I.R.C. §469.

[*Hairston v. Commissioner*, 80 T.C.M. (CCH) 905 (2000)]

Hillman v. Commissioner

[I.R.C. §469]

> ☞ **Taxpayers can't offset passive management fee expenses against their related nonpassive management fee income.**

Facts. David Hillman owned Southern Management Corporation (SMC), an S corporation that provided real estate management services to approximately 90 pass-through entities involved in rental real estate partnerships. Hillman owned, either directly or indirectly, interests in each of the partnerships, but he did not materially participate in the partnerships. Thus, the management services of SMC were a nonpassive activity to the Hillmans and the rental partnerships were passive activities.

The **Hillmans treated their distributive share of the management fee deductions that passed through from the partnerships as a reduction of their income from the nonpassive management fees under I.R.C. §469(l).** The IRS disallowed the characterization of the management fee expense as nonpassive under Proposed Reg. §1.469-7, which provides that only lending transactions may be treated as self-charged. The Tax Court held that the Hillmans properly deducted the management fee expenses of the pass-through entities from the related management fee income they received through SMC [114 T.C. 103 (2000)].

Issue. Whether the Tax Court erred in allowing the taxpayers to deduct passive management fee expenses from their related nonpassive management fee income.

Analysis. The passive loss rules were designed to curtail the use of passive activity losses to offset unrelated portfolio income and income from nonpassive activities. However, the legislative history of I.R.C. §469 indicates that Congress recognized that it would be inappropriate to treat certain transactions between related taxpayers as giving rise to one type of expense and another type of income. To avoid this result, I.R.C. §469(l) requires the IRS to prescribe regulations to address these types of situations. In 1991, the IRS issued proposed regulations dealing only with self-charged lending transactions and did not address other self-charged income and deduction situations.

The IRS claimed that in the absence of regs addressing self-charged treatment for non-lending transactions, there was no justification for the offset. The Hillmans contended that the IRS's attempt to limit the scope of "self-charged items" was arbitrary, capricious, or manifestly contrary to the congressional intent behind I.R.C. §469. The Tax Court found that the taxpayer's situation was identical to that in the self-charged interest proposed regulations, except that management fees, rather than interest, were involved. The Tax Court said that the Service's failure to issue regulations couldn't deprive a taxpayer of a congressionally intended tax benefit.

The Fourth Circuit stated that "the threshold problem with the Hillmans' position is that nothing in the plain language of I.R.C. §469 suggests that an exception to I.R.C. §469(a)'s general prohibition against a taxpayer's deducting passive activity losses from nonpassive activity gains exists, where, as in the present case, the taxpayer essentially paid a management fee to himself." The court noted that under the plain meaning rule of statutory construction, a court's analysis must end with the statute's plain language, and the Hillmans did not meet any of the exceptions to the plain meaning rule.

Holding. Reversing the Tax Court, the 4th Circuit held that the taxpayers were not entitled to offset passive management deductions against nonpassive management income.

[*Hillman v. Commissioner*, 2001-1 USTC ¶50,354]

St. Charles Investment Co. v. Commissioner

[I.R.C. §§469, 1016, 1367, and 1371]

> ☞ **Taxpayer can carry over PALs from C corp years to S corp years.**

Facts. Prior to 1991, the taxpayer was a closely held C corporation engaged in the real estate rental business. The real estate rental activity was a passive activity as defined by I.R.C. §469(c). For each of the years 1988, 1989, and 1990, the taxpayer's passive activities generated passive activity losses (PALs), which are nondeductible but can be suspended and carried forward. Effective January 1, 1991, St. Charles elected to be taxed as an S corporation. Also in 1991, St. Charles sold several of its rental properties for which there existed suspended PALs. On its 1991 tax return, St. Charles identified the suspended PALs associated with the sold properties and claimed those deductions in full. St. Charles also reduced its cost basis with respect to the activities sold in 1991 to reflect the depreciation

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portion of the PAL deductions taken. The IRS disallowed the deduction of suspended PALs and the use of PALs for purposes of calculating the AMT. The IRS based its adjustments on I.R.C. §1371(b)(1), which prohibits an S corporation from carrying any "carryforward" from a year in which the corporation was a C corporation to a year in which the corporation is an S corporation. St. Charles petitioned the Tax Court challenging the IRS's adjustments. In addition, St. Charles argued that if the PAL deductions were disallowed, it should be able to readjust its cost basis in the sold properties upwards in order to reflect that the depreciation deductions had been disallowed. The Tax Court ruled in favor of the IRS on both issues [110 T.C. 46 (1998)].

Issue. Whether the tax court correctly applied I.R.C. §469 and §1371(b).

Analysis. The Tenth Circuit relied on the plain language of I.R.C. §§469 and 1371(b) rather than the legislative history and congressional intent. The court noted that it is a general rule of statutory construction that "if a statute specifies exceptions to its general application, other exceptions not explicitly mentioned are excluded." The court stated that because I.R.C. §1371's restrictions on carryforwards from a C year to an S year are not enumerated in I.R.C. §469, they have no effect on the operation of I.R.C. §469(b). The court further buttressed its position with I.R.C. §469(f)(2), which states, "If a taxpayer ceases for any taxable year to be a closely held C corporation or personal service corporation, this section shall continue to apply to losses and credits to which this section applied for any preceding taxable year in the same manner as if such taxpayer continued to be a closely held C corporation or personal service corporation, whichever is applicable." Thus, I.R.C. §469 applies to St. Charles's suspended PALs in 1991 as if St. Charles had continued in its C status. Because the Tenth Circuit held that St. Charles's suspended PALs associated with the activities disposed of in 1991 were fully deductible, the court did not need to address the issue of basis.

Holding. Reversing the Tax Court, the Tenth Circuit held that the taxpayer's suspended PALs from 1988, 1989, and 1990 are carried over to 1991. In addition, the suspended PALs associated with the activities disposed of in 1991 are fully deductible pursuant to I.R.C. §469(g)(1)(A).

[*St. Charles Investment Co. v. Commissioner*, 232 F.3d 773 (10th Cir. 2000)]

PRINCIPAL RESIDENCE

Prop. Reg. §§1.121-1-4 and 1.1398-3
[I.R.C. §121]

> ☞ **IRS publishes proposed regulations on excluding gain from sale of principal residence.**

The IRS has published proposed regulations on excluding gain from the sale of a principal residence. Please see pp. 519–522 in the *2000 Farm Income Tax School Workbook* for additional explanations and illustrations of excluding the gain from the sale of a principal residence.

Prop. Reg. §1.121-1: General Provisions

Prop. Reg. §1.121-1(b) does not specifically define the term "principal residence." In the case of a taxpayer using more than one property as a residence, the question of which residence is the principal residence depends upon all the facts and circumstances. However, the proposed regulation does add an important new presumption. That is, if a taxpayer alternates between two properties, the property that the taxpayer uses a majority of the time during the year will ordinarily be considered the taxpayer's principal residence. In Rev. Proc. 2000-3, 2000-1 I.R.B. 103, the IRS announced that it will not issue an advance ruling regarding whether a property qualifies as the taxpayer's principal residence.

To exclude the gain on sale of a principal residence, the taxpayer must have owned and used the residence for two out of the five years up to and including the date of sale. **The two-year period for ownership and use does not have to be concurrent or consecutive.** Prop. Reg. §1.121-1(c) provides that the ownership and use tests can be satisfied using either a number of months or a number of days tests (24 full months or 730 days). The regulations state that **a temporary absence for vacation or other seasonal absence, even when accompanied by rental of the residence, will qualify as a period of use.** Prop. Reg. §1.121-1(f) provides two examples of this provision. One of the examples is a two-month vacation period that would be included in calculating the period of use. The other example is a one-year sabbatical, which does not count as a period of use. Thus**, it is still unclear as to whether temporary absences**

greater than two months but less than a year will qualify as periods of use.

If a residence was used partially for residential purposes and partially for business purposes, only that part of the gain allocable to the residential portion is excludable under I.R.C. §121. Furthermore, the I.R.C. §121 exclusion does not apply to the extent that depreciation attributable to periods after May 6, 1997, exceeds gain allocable to the business-use portion of the property.

Prop. Reg. §1.121-2: Dollar Limitations on Exclusion

Prop. Reg. §1.121-2 contains the limitations on the exclusion of gain. Generally, up to $250,000 of the gain from the sale of a principal residence ($500,000 in the case of a joint return) is excludable from gross income. The gain exclusion is generally available for only one sale during any two-year period. **For joint returns, only one spouse has to meet the two-year ownership test, but both spouses must meet the two-year use test.** For joint returns where spouses sell residences each owned and used before their marriage, each spouse may use up to $250,000 exclusion if he or she separately satisfies the ownership and use tests for the respective residence and neither spouse meets the use requirement for the other spouse's residence.

Example. During 1999, H and W each sell a residence that each had separately owned and used as a principal residence before their marriage. The gain realized from the sale of H's residence is $200,000, and the gain realized from the sale of W's residence is $300,000. Assuming neither spouse meets the use requirement for the other spouse's residence, H and W may exclude up to $250,000 gain from the sale of each of their houses. W may not use H's unused exclusion to exclude gain in excess of her exclusion amount. Thus, they will have to recognize $50,000 of the gain realized on the sale of W's house.

Prop. Reg. §1.121-3: Partial Exclusion

Prop. Reg. §1.121-3 provides for a reduced exclusion amount where the taxpayer fails to meet the two-year ownership and use requirements or sells more than one principal residence within two years. A reduced exclusion may be available under such circumstances as a change in place of employment, health or unforeseen circumstances. The proposed regulations provide examples only for the circumstance of change in place of employment. The **proposed regulations do not identify specific unforeseen circumstances that will qualify a sale for the partial exclusion** provided in I.R.C. §121(c)(2)(B). The IRS and Treasury Department have requested written comments regarding what should qualify as an unforeseen circumstance for purposes of determining eligibility for the reduced exclusion.

Prop. Reg. §1.121-4: Special Circumstances

Prop. Reg. §1.121-4 contains rules for purposes of satisfying the ownership and use requirements under the following special circumstances: (1) property of a deceased spouse; (2) property owned by spouse or former spouse; (3) tenant-stockholder in cooperative housing corporation; (4) involuntary conversions; (5) determination of use during periods of out-of-residence care; (6) sales of remainder interests; (7) expatriates (no exclusion allowed); (8) election to have section not apply; and (9) residences acquired in rollovers under I.R.C. §1031.

Prop. Reg. §1.1398-3: Exclusion in Title 11 cases

The proposed regulations would add the exclusion to the list of tax attributes that an individual's bankruptcy estate may succeed to and take into account when computing the estate's taxable income in a Chapter 7 or 11 bankruptcy case. In light of its acquiescence in *In re Bradley* (AOD 1999-099), the IRS says it will not challenge a bankruptcy estate's use of the exclusion before the regulations' proposed effective date, provided the debtor would otherwise satisfy the I.R.C. §121 requirements.

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Taylor v. Commissioner

[I.R.C. §121]

> ☞ **Taxpayer who was making gradual transition from working in New Jersey to retirement in Florida can exclude gain from the sale of his residence in New Jersey.**

Facts. In 1969, the taxpayer, a truck driver, purchased a house located in New Jersey. By 1986, he was the sole owner and occupant of the house. In 1982, the taxpayer began a regular practice of visiting one of his sons in Florida during the winter months. In 1988, he purchased investment property in Florida. The taxpayer's son moved into one of the apartments and managed the Florida property for his father. Thereafter, when the taxpayer traveled to Florida for the winter months, he stayed with his son at the apartment. Sometime during 1991, the taxpayer decided to work as a truck driver in Florida during the winter months. He acquired a Florida commercial driver's license and also registered to vote in Florida so that he could vote in the November 1992 presidential election. As it turned out, the taxpayer made enough money during the winter months in Florida to stop working in New Jersey. The taxpayer stopped filing a New Jersey state income tax return and listed the Florida apartment as his address on his 1994, 1995, and 1996 Federal income tax returns.

From 1992 to 1996, although he no longer worked in New Jersey, the taxpayer returned to the New Jersey residence in the spring and remained there through the summer and part of the fall. During those years, he was the only occupant of the house. The utilities always remained in service and the house always remained furnished. In 1996, the taxpayer sold the house in New Jersey, and he did not include any of the gain from the sale in the income he reported on his 1996 return. In the notice of deficiency, the IRS determined that the taxpayer realized a gain on the sale that must be included in his income.

Issue. Whether gain realized on the sale of the taxpayer's residence is excludable from his gross income.

Analysis. According to the IRS, the New Jersey residence was not the taxpayer's principal residence after 1992. The IRS pointed out that at that time, the taxpayer held a Florida driver's license, had his truck registered in Florida, was registered to vote there, and spent significant amounts of time in Florida from that point on. The IRS also pointed out that starting in 1994, the taxpayer filed his Federal tax returns using a Florida address and did not file New Jersey state income tax returns after he stopped doing business in New Jersey.

The court noted that the factors relied upon by the IRS were certainly relevant but not determinative, particularly when weighed against the taxpayer's explanation for each event, his personal situation during the relevant periods, and his use of the New Jersey residence as his residence for the entire time that he owned it. The taxpayer was making a gradual transition from living and working in New Jersey to retirement in Florida. While he spent time at both locations, he never abandoned his New Jersey residence. The court held that the taxpayer used the New Jersey residence as his principal residence for the requisite period of time required by the regulations in effect at that time.

Holding. The court held that the taxpayer is entitled to exclude from his 1996 gross income the gain realized on the sale of the New Jersey residence.

[*Taylor v. Commissioner*, T.C. Summary Opinion 2001-17 (February 22, 2001)]

REASONABLE COMPENSATION

Pediatric Surgical Associates, P.C., v. Commissioner
[I.R.C. §§162 and 6662; Tax Court Rule 142]

> ☞ **Bonuses to owners are unreasonable to the extent they represent profits earned by non-owners.**

Facts. The taxpayer is a personal service corporation that provides pediatric surgical services in Fort Worth, Texas. During the audit years, the taxpayer employed approximately 20 individuals, including six pediatric surgeons. The shares of stock of the taxpayer were owned exclusively by four of the surgeons employed by the taxpayer. During the audit years, the taxpayer employed two surgeons who were not shareholders. The employment contracts of the shareholder surgeons provided for a fixed monthly salary plus monthly bonuses consisting of the available cash less amounts needed to pay the near-term expenses of the business. The nonshareholder surgeons received only a fixed monthly salary. The taxpayer deducted the amounts paid to the shareholder surgeons as officers' compensation. In its original notice, the IRS disallowed a portion of the deductions, claiming that the amounts were dividends rather than officers' compensation. Later the IRS reduced its proposed deficiencies to amounts that represented the taxpayer's profits that were attributable to services rendered by the nonshareholder surgeons.

Issues

Issue 1. Whether the revision of the deficiency by the IRS constitutes the raising of a new matter, thus shifting the burden of proof to the IRS.

Issue 2. Whether the deductions claimed by the taxpayer for salaries paid to the shareholder surgeons exceed reasonable allowances for services actually rendered.

Issue 3. Whether the taxpayer is liable for the accuracy-related penalty under I.R.C. §6662(a).

Analysis and Holding

Issue 1. Tax Court Rule 142 provides that the burden of proof shall be upon the taxpayer except with respect to any new matter, when the burden of proof will shift to the IRS. The court, citing previous cases, stated that a new theory that is presented to sustain a deficiency will be treated as a new matter only when it either alters the original deficiency or requires the presentation of different evidence. **The court held that the IRS had not raised a new matter; that is, the taxpayer clearly understood the IRS was challenging whether the disallowed amounts were bona fide officers' compensation.**

Issue 2. I.R.C. §162(a)(1) establishes a two-pronged test for determining whether a payment is deductible as compensation for services. The payment must be both reasonable and, in fact, purely for services. After the revision by the IRS, the reasonableness test was not disputed by either of the parties. The remaining issue was whether the amount paid to the shareholder surgeons was purely for their services. **The court held that the deductions for salaries paid to the shareholder surgeons exceeded reasonable allowances for services actually rendered by them and that such amounts were not deductible under I.R.C. §162(a)(1).**

Issue 3. The court imposed the accuracy-related penalty due to the negligence of the taxpayer. The court noted that the shareholder surgeons' utter indifference to the possibility that a portion of the annual prebonus profits might have been attributable to services by the nonshareholder surgeons justified the imposition of the accuracy-related penalty under I.R.C. §6662(a).

[*Pediatric Surgical Associates, P.C., v. Commissioner*, 81 T.C.M. (CCH) 1474 (2001)]

Eberl's Claim Service, Inc., v. Commissioner
[I.R.C. §§162 and 316]

> ☞ **Some of executive's compensation was not reasonable and constituted a disguised dividend.**

Facts. Kirk Eberl is the founder, president, and sole shareholder of the taxpayer, a Colorado corporation. For 1992 and 1993, the taxpayer deducted $4,340,000 and $2,080,000, respectively, for compensation to Kirk Eberl. The IRS challenged the amounts as excessive and asserted that a portion of the compensation constituted disguised dividend payments that should have been subject to taxation. The Tax Court found that the taxpayer could deduct compensation up to $2,340,000 and $1,080,000, but compensation in excess if those amounts would be unreasonable. The Tax Court supported its finding with the following factors: Eberl set his own compensation, which was not the result of an arm's length agreement; the corporation retained a minimal amount of earnings and distributed almost all profits to Eberl at the end of the year; and other employees did not receive year-end bonuses [77 T.C.M. (CCH) 2336 (1999)]. The court rejected the determination that the taxpayer was liable for a substantial understatement penalty, because the taxpayer reasonably believed the compensation was reasonable and believed his accountant agreed. The taxpayer appealed.

Issue. Whether part of executive's compensation was a disguised dividend.

Analysis. In assessing whether the amount for compensation expense was reasonable under I.R.C. §162(a)(1), the Tenth Circuit employed the traditional multi-factor test of reasonableness outlined in *Pepsi-Cola Bottling* [528 F.2d at 179]. Noting that the salary arrangement was between Eberl as a shareholder and Eberl as an employee, **the court found the compensation arrangement inherently suspect and thus possible to view as unreasonable on that ground alone.**

The taxpayer urged the court to set aside the traditional multi-factor test in favor of some form of the independent investor test to determine reasonableness of compensation. The court noted that absent *en banc* rehearing, it is bound to use the multi-factor approach by its previous decision in *Pepsi-Cola*.

Holding. The Tenth Circuit affirmed the Tax Court, concluding that some of the compensation was a disguised dividend.

[*Eberl's Claim Service, Inc. v. Commissioner*, 249 F.3d 994 (10th Cir. 2001)]

RETIREMENT PLANS AND IRAs

Announcement 2001-23
[I.R.C. §401]

> ☞ **IRS has released simplified minimum distribution rules for retirement plans.**

The IRS has released supplements to Publications 575 and 590, which simplify and provide guidance with respect to the calculation of minimum required distributions from qualified plans, IRAs, and other related retirement savings vehicles.

Procedures. For 2001, the minimum required distribution may be figured using either the new distribution rules or the old rules explained in Publications 575 and 590. For most people, the new simplified rules will result in lower minimum required distributions. If your required beginning date is April 1, 2001 (either because you attained age 70½ or retired in 2000), and you are taking your minimum required distribution for 2000 by April 1, 2001, do not use the new rules for figuring the distribution for 2000. Use the old rules in Publications 575 and 590.

A beneficiary does not have to be designated by the required beginning date. Under the new rules, everyone will use the current MDIB (Minimum Distribution Incidental Benefit) table unless an employee or IRA owner names a spouse who is more than 10 years younger as the sole beneficiary. Employees and IRA owners will recalculate each year based on the current year's age and the prior year's ending account balance. After death, minimum required distributions will be based on the designated beneficiary's life expectancy (not recalculated). The designated beneficiary must be determined by the end of the year following the year of death; if there is none, the employee's life expectancy in the year of death can be used in lieu of the immediate distribution rule. In case of death before the required beginning date and where there is no designated beneficiary, the five-year rule is still in effect. IRA trustees will be required to calculate the minimum required distribution annually, even if an IRA owner chooses to take the distribution from another account. A spouse must be named directly (not through a trust) as beneficiary of an IRA to elect to treat the IRA as his or her own.

[Announcement 2001-23, 2001-10 I.R.B. 791]

Czepiel v. Commissioner
[I.R.C. §§72, 402, and 408]

> ☞ **Taxpayer who liquidated IRAs to satisfy divorce judgment must include distributions in gross income.**

Facts. In a 1995 divorce judgment, Czepiel was ordered to pay his ex-wife $30,300. **In order to satisfy the judgment, he liquidated his IRAs (his only assets) and paid his former spouse.** In *Czepiel* [78 T.C.M. (CCH) 378 (1999)], the taxpayer argued that the divorce judgment was a qualified domestic relations order (QDRO), because the court had in effect ordered him to make the withdrawal, since the only funds he had were on deposit in his IRAs. Under a QDRO, the former wife of a plan participant is treated as the distributee of any distribution made to her [I.R.C. §402(e)(i)(a)]. The Tax Court agreed with the IRS that the divorce judgment was not a QDRO. The **court held that Czepiel must include the distributions from his IRAs in his gross income and he was liable for the early withdrawal penalty.** The taxpayer appealed.

Issues

Issue 1. Whether taxpayer must include IRA distributions in his gross income for 1995.

Issue 2. Whether taxpayer is liable for the 10 percent additional tax under I.R.C. §72(t)(1) on early distributions of retirement income.

Analysis. Taxpayers are required to include amounts paid or distributed from an IRA in gross income [I.R.C. §408(d)(1)]. The court noted that the only exception that might apply to this taxpayer is I.R.C. §408(d)(6), which provides that the transfer of an interest in an IRA under a divorce or separation instrument is not taxable to the transferor. The problem in this case was that the taxpayer did not transfer his interest in his IRAs; rather, he received the distributions himself and then paid the funds to his ex-wife. Another requirement that must be satisfied in order to come within the exception in I.R.C. §408(d)(6) is that the **transfer of an individual's interest in an IRA must be made under a divorce or separation agreement** described in I.R.C. §71(b)(2)(A). Although a divorce judgment in family court would qualify, the judgment in Czepiel's case did not order the taxpayer to transfer his interest in his IRAs to his ex-wife. It simply ordered him to pay his ex-wife a sum of money.

The taxpayer argued that he was not liable for the early withdrawal tax because the family court had in effect required him to make those distributions and he therefore made them involuntarily. The court held that none of the statutory exceptions in I.R.C. §72(t) to the early withdrawal tax applied to this case.

Holding.]Affirming the Tax Court, the First Circuit held that the taxpayer must include IRA distributions in his gross income for 1995, and he was liable for the 10 percent early withdrawal penalty.

[*Czepiel v. Commissioner*, 2001-1 USTC ¶50,134]

Wade v. Commissioner
[I.R.C. §408]

> ☞ **Couple can't deduct IRA contributions because of active participant rule.**

Facts. Christina Wade was a part-time employee of the Michigan public school system during taxable year 1996. She was required to participate in the Michigan Public School Employees Retirement System (MPSERS). In order to qualify to receive benefits under the plan, the taxpayer had to earn at least 10 years of credited service and be at least 60 years old. If the taxpayer is unable to reach the 10-year minimum amount of service credit, then she will not receive any retirement benefits. During calendar year 1996, Wade worked 169.5 hours. Based upon the MPSERS calculation, she earned .083 years of service credit during 1996. In 1996, Christina and her husband each contributed $2,000 to their respective IRAs, claimed an IRA deduction of $4,000 on their joint return, and reported adjusted gross income of $77,142. The IRS determined that the taxpayers were not entitled to their IRA deduction pursuant to I.R.C. §219(g), because Christina was an active participant in her retirement plan and because she and her husband reported more than $50,000 in adjusted gross income.

Issue. Whether taxpayers are entitled to deduct $4,000 for contributions to their IRAs in 1996.

Analysis. The taxpayers contended that Christina was not an active participant in the MPSERS plan, because she earned only .083 years of service credit during 1996, and at that rate, **it would take over 120 years to accumulate the minimum 10 years of credited service to receive any benefits.** The court stated that it had previously held that a person could be an active participant even though his or her rights to plan benefits are forfeitable and those rights were, in fact, forfeited prior to becoming vested. The court noted that Wade had an even weaker case, because there was no evidence that she had forfeited her service credit with the MPSERS. The taxpayers then argued that Treas. Reg. §1.219-2(b) provides that an individual is not an active participant in a plan if his or her compensation for the plan year is less than the amount required to accrue a benefit under the plan. The court stated that this regulation refers to a plan that utilizes compensation levels to distinguish who is eligible to accrue benefits. The MSPERS plan clearly indicated Wade's eligibility was mandatory and automatic. It was the receipt of benefits that depended on minimum service credits and age requirement.

Holding. The court held that the taxpayers were not entitled to deduct their IRA contributions.

[*Wade v. Commissioner*, 81 T.C.M. (CCH) 1613 (2001)]

> **Practitioner Note.** See also *Neumeister v. Commissioner,* 248 F.3d 1151 (6th Cir. (2001) for a similar result. Neumeister was a Michigan schoolteacher and an active participant in the MPSERS. The Sixth Circuit, affirming the Tax Court, held that Neumeister was not entitled to an IRA deduction because he was an active participant in a plan as defined in I.R.C. §219(g)(5)(A) and his adjusted gross income exceeded the individual limit. The court rejected Neumeister's argument that he was employed by a local school board and not the state.

Nordtvedt v. Commissioner
[I.R.C. §§72 and 402]

> ☞ **Taxpayer may not increase basis in his retirement annuity to account for inflation.**

Facts. During his employment by Montana State University, the taxpayer made both mandatory and additional after-tax contributions to the Montana Teachers Retirement System (MTRS), a qualified defined benefit pension plan under §401(a). The taxpayer's nominal basis in his pension plan is $36,734. Since his retirement in 1988, the taxpayer has been receiving a gross pension payment of $26,213 annually. MTRS determined the taxable amount of his pension income received in 1996 was $24,843, based on the nominal value of his after-tax contributions and his age at retirement. The taxpayer reported $22,979 of his pension as subject to tax in 1996. The difference was due to the taxpayer's adjustment for inflation.

Issues

Issue 1. Whether taxpayer may increase the basis in his retirement annuity by an inflation factor to take into account inflation between the date of his contributions and the annuity starting date.

Issue 2. Whether taxpayer may further increase his basis to take into account the expected inflation over his actuarial life.

Analysis. There is no language in the statute, the regulations, or the legislative history permitting the determination of the taxable amount of a pension to be adjusted for inflation. The court reviewed *Hellermann v. Commissioner,* 77 T.C. 1361 (1981), where the taxpayers argued that gain realized from the sale of property should be adjusted for inflation occurring during the ownership of the property and the court disagreed. In that case, the court relied on the doctrine of common interpretation, noting that the **taxpayer's gain must be measured on the basis of the nominal gain on the sale of property, not on the basis of a gain reduced by an inflation factor, or the real gain in an economic sense**.

Holding. The court held that the taxpayer may not adjust the basis in his retirement annuity to account for inflation for purposes of calculating the amount subject to Federal income tax.

[*Nordtvedt v. Commissioner*, 116 T.C. 165 (2001)]

LTR 200051052 (September 29, 2000)
[I.R.C. §72]

> ☞ **Taxpayer's proposed method results in equal periodic payments not subject to 10 percent additional tax.**

Facts. The taxpayer is the owner of two IRAs that were merged into a third IRA on May 31, 1999. The taxpayer was age 58 in 1999. The taxpayer started taking distributions from IRA 3 in 1999 and calculated an annual distribution amount for 1999 by dividing the aggregated account balances of IRAs 1 and 2 as of December 31, 1998, by an age 58 annuity factor from Table S of IRS Publication 1457, using an assumed interest rate of 8 percent. The taxpayer proposes to calculate the annual distribution amount for succeeding years by dividing the account balance of IRA 3 as of December 31 of the prior year by an annuity factor from Table S, with such factor being derived by using the taxpayer's age in the distribution year and an interest rate equal to 120 percent of the federal mid-term rate for January of the distribution year (rounded down to the nearest tenth of a percent). All distributions will be taken from IRA 3.

Issue. Whether proposed distributions from an IRA are part of a series of substantially equal periodic payments and are therefore not subject to the 10 percent additional tax imposed by I.R.C. §72(t).

Analysis. I.R.C. §72(t)(2)(A)(iv) provides that the 10 percent tax on early distributions shall not apply to distributions which are 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 the joint lives (or joint expectancies) of such employee and his beneficiary. However, this exception from the 10 percent tax does not apply if the series of payments is subsequently modified (other than by reason of death or disability) before the later of (1) the close of the 5-year period beginning with the date of the first payment, and (2) the employee's attainment of age 59½. In that situation, the tax for the first taxable year in which modification occurs shall be increased by an amount equal to the tax which would have been imposed (except for the §72(t)(2)(A)(iv) exception) plus interest for the deferral period. Notice 89-25, 1989-1 C.B. 662, provides three methods for determining substantially equal periodic payments for purposes of I.R.C. §72(t)(2)(A)(iv). Two of these methods involve the use of an interest rate assumption which must be an interest rate that does not exceed a reasonable interest rate on the date payments commence.

Conclusion. The proposed method of determining periodic payments satisfies one of the methods described in Notice 89-25 and results in substantially equal periodic payments within the meaning of I.R.C. §72(t)(2)(A)(iv). Such payments will not be subject to the 10 percent additional tax unless the requirements of I.R.C. §72(t)(4) are not met.

Pena v. Commissioner
[I.R.C. §§72 and 408]

> ☞ **A loss in the value of an IRA does not make IRA distribution nontaxable.**

Facts. Mr. Pena was an attorney employed by Jaime Pena Professional Corporation. For Mr. Pena's benefit and with Mr. Pena as trustee, the corporation established a defined benefit single-employer plan, which was a qualified pension plan within the meaning of I.R.C. §401(a). The corporation made contributions to the plan on Mr. Pena's behalf, but Mr. Pena never made any contributions to the plan. The plan maintained a brokerage account, but Mr. Pena made the investment decisions. **During 1990, the plan was terminated and the proceeds of the brokerage account were rolled into an IRA with Mr. Pena serving as custodian**. Mr. and Mrs. Pena did not include any of the proceeds in their 1990 income. During 1996, the stock was sold at prices below what had been paid for it by the trust and the proceeds were distributed to the taxpayers, leaving nothing in the trust. Mr. Pena, who was 49 years old at the time, received distributions totaling $21,700. The taxpayers did not include any of the IRA distributions in their 1996 income and deducted investment losses on their 1996 Schedule D. In the notice of deficiency, the IRS determined the IRA distributions were includable in the taxpayers' 1996 income.

Issue. Whether certain distributions from an individual retirement account are includable in the taxpayers' 1996 income.

Analysis. The taxpayers did not address whether the IRA distributions were includable in their 1996 income. Their arguments related only to whether they were entitled to a deduction for investment losses sustained by the plan. Thus, the court considered the taxpayers to have conceded the correctness of the IRS's determination. Because the IRS did not challenge any of the deductions on the 1996 return, the court did not discuss the merits of the taxpayers' claim that the IRS erred by disallowing the deduction for investment losses.

Holding. The IRA distributions are includable in the taxpayers' 1996 income.

[*Pena v. Commissioner*, 81 T.C.M. (CCH) 1533 (2001)]

LTR 200040038 (July 13, 2000)
[I.R.C. §§401 and 408]

> ☞ **Beneficiaries may take IRA distributions over oldest beneficiary's life expectancy.**

Facts. A husband and wife each owned IRAs. Prior to his death, the husband had begun receiving annuitized distributions from his two IRAs based on his single life expectancy with the amount of the annuity recalculated annually. After his death, the wife rolled the husband's two IRAs into hers and began receiving distributions based on her single life expectancy. Approximately 70% of her IRA consisted of assets attributable to her husband. The wife named her two children as beneficiaries before the required beginning date of the rolled over IRAs. After their mother died, the two beneficiaries proposed to take a distribution of 30% of their mother's IRA and to distribute the 70% attributable to their father's IRA over the life expectancy of the oldest child.

Issue. Whether distributions of the amount attributable to their father's IRA over the life expectancy of the oldest child will meet the requirements of I.R.C. §401(a)(9) as applied to their mother's IRA by virtue of I.R.C. §408(a)(6).

Analysis. The mother designated her children as co-beneficiaries in a timely manner prior to the required beginning date for distributions of the inherited portion of her IRA (her husband's IRA). Therefore, had she chosen, she could have received distributions over the joint life expectancy of herself and her oldest designated beneficiary. Such distributions would have complied with the minimum required distribution rules. Instead, she chose to receive distributions over her single life expectancy, which accelerated her receipt of lifetime distributions. Even though her oldest child's life expectancy was not used in computing her distributions, it may be used to determine post-death required distributions to her beneficiaries.

Conclusion. The wife's election to accelerate distributions during her life won't preclude the beneficiaries from using the oldest beneficiary's life expectancy to compute the post-death distributions.

> **Practitioner Note.** See also LTR 200040039, LTR 200105063, LTR 200105065, LTR 200113032, LTR 200113033, LTR 200106045, LTR 200106046, and LTR 200104033 for IRA rulings on the life expectancy to use in minimum required distribution.

TRAVEL AND TRANSPORTATION EXPENSES

Rev. Proc. 2000-39
[I.R.C. §§62, 162, and 274]

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

Changes. Rev. Proc. 2000-39 (2000-41 I.R.B.) supersedes Rev. Proc. 2000-9 (2000-2 I.R.B 280) with respect to per diem allowances that are paid both (1) to an employee on or after October 1, 2000, and (2) for lodging, meal, and incidental expenses or for meal and incidental expenses paid or incurred for travel while away from home on or after October 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. Finally, this revenue procedure supersedes Notice 2000-48, 2000-37 I.R.B. 265.

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 taxable years beginning in 2000 or 2001, 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 under the key city name:

State	Key City	County or Other Defined Location
California	Palm Springs (January 1–May 31)	Riverside County
	San Francisco	San Francisco County
	Sunnyvale/Palo Alto/San Jose	Santa Clara County
	Tahoe City	Placer County
Colorado	Aspen (January 1–April 30)	Pitkin County
	Silverthorne/Keystone	Summit County
	Telluride (January 1–March 31)	San Miguel County
	Vail (July 1–March 31)	Eagle County
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 (January 1–April 30)	Monroe County
Idaho	Sun Valley	City limits of Sun Valley
Illinois	Chicago	Cook and Lake Counties
Louisiana	New Orleans/St. Bernard (January 1–May31)	Orleans, St. Bernard, Plaquemine, and Jefferson Parishes
Maryland (For the counties of Montgomery and Prince George's, see District of Columbia)	Ocean City (June 15–October 31)	Worcester County

State	Key City	County or Other Defined Location
Massachusetts	Boston	Suffolk County
	Cambridge	Middlesex County (except Lowell)
	Martha's Vineyard (June 1–October 15)	Dukes County
Michigan	Mackinac Island	Mackinac County
	Traverse City (June 1–September 30)	Grand Traverse County
Montana	Big Sky (November 1–April 30)	Gallatin County (except West Yellowstone Park)
New Jersey	Cape May (June 1–November 30)	Cape May County (except Ocean City)
	Ocean City (June 15–September 15)	City limits of Ocean City
	Piscataway/Belle Mead	Somerset and Middlesex Counties
	Princeton/Trenton	Mercer County
New York	The Bronx/Brooklyn/Queens	The boroughs of The Bronx, Brooklyn, and Queens
	Manhattan	The borough of Manhattan
	Nassau County/Great Neck	The borough of Nassau County
	Suffolk County	The borough of Suffolk County
	White Plains	City limits of White Plains
Pennsylvania	Hershey (June 1–September 15)	City limits of Hershey
	Philadelphia	Philadelphia County
Utah	Park City (December 15–March 31)	Summit County
Virginia (For the cities of Alexandria, Fairfax, and Falls Church, and the counties of Arlington, Fairfax, and Loudoun, see District of Columbia)	Wintergreen	Nelson County

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Transition Rules

A payor who used the per diem substantiation method of Rev. Proc. 2000-9 for an employee during the first nine months of calendar year 2000 may not use the high-low substantiation method of Rev. Proc. 2000-39 for that employee until January 1, 2001. A payor who used the high-low substantiation method of Rev. Proc. 2000-9 for an employee during the first nine months of calendar year 2000 must continue to use the high-low substantiation method for the remainder of calendar year 2000 for that employee. However, the payor described in the previous sentence may use the rates and high-cost localities published in Rev. Proc. 2000-9, in lieu of the updated rates and high-cost localities provided in this revenue procedure, for travel on or after October 1, 2000, and before January 1, 2001, if those rates and localities are used consistently during this period for all employees reimbursed under this method.

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 noon 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.
2. Such rate may be prorated using any method that is consistently applied and in accordance with reasonable business practice. For example, if an employee travels away from home from 9 A.M. one day to 5 P.M. the next day, a method of proration that results in an amount

equal to two times the federal M&IE rate will be treated as being in accordance with reasonable business practice (even though only 1½ times the federal M&IE rate would be allowed under the federal travel regulations).
[Rev. Proc. 2000-39, 2000-41 I.R.B. 340]

CCA 200105007 (September 28, 2000)
[I.R.C. §132]

> ☞ **Reimbursement for parking costs at nontemporary work locations is excluded from income.**

Issue. Whether reimbursement provided to employees for parking costs incurred at nontemporary work locations is excludable from gross income under I.R.C. §132(f).

Analysis. The costs of commuting to work, including parking, generally are nondeductible personal expenses under Treas. Reg. §§1.162-2(e) and 1.262-1(b)(5). However, Rev. Rul. 99-7, 1999-1 C.B. 361, provides that if a taxpayer has one or more regular work locations, the taxpayer may deduct under I.R.C. §162(a) the daily transportation expenses incurred in going between the taxpayer's residence and a temporary work location. A temporary work location is a work location that is realistically expected to last for one year or less in the absence of facts and circumstances indicating otherwise. **Under Rev. Rul. 99-7, costs for parking at any nontemporary work location are considered personal and are therefore nondeductible.**

The assistant chief counsel believes I.R.C. §132(a)(5), which provides that gross income does not include any benefit that is a qualified transportation fringe, is intended to provide a tax-free benefit for parking costs that are not deductible under I.R.C. §162(a). Qualified transportation fringes include qualified parking (I.R.C. §132(f)(1)), but the amount excludable for qualified parking may not exceed $175 per month (I.R.C. §132(f)(2)).

Holding. Reimbursement provided to employees for parking at a nontemporary work location is excludable from wages for income and employment tax purposes to the extent it does not exceed the statutory monthly limitation.

Johnson v. Commissioner
[I.R.C. §§162 and 274]

> ☞ **Ship's captain may deduct incidental expense portion of M&IE rates for incidentals he incurred while at sea.**

Facts. The taxpayer is a merchant seaman who captains a vessel that sails worldwide carrying equipment of the U.S. military. Johnson's work requires that he work continuously on or around the ship for long periods of time. He generally flies to and from the port where the ship is berthed. Johnson's employer provides him with meals and lodging while at work at no charge. Johnson pays his other expenses, incidental travel items, laundry, dry cleaning, and the cost of transportation from the ship to the location of various service providers. On his 1994 and 1996 tax returns, Johnson claimed miscellaneous itemized deductions of $3,784 and $3,654, respectively, for meals and entertainment (after applying the 50% limitation). Johnson had no receipts to support the deductions and calculated the amounts by using the full M&IE rate for each city to which he traveled. The deductions related solely to the incidental expenses Johnson paid during 1994 and 1996 while working on the ship. The IRS disallowed the deductions.

Issue. Whether taxpayer may deduct the cost of the incidental travel items he purchased while working away from his personal residence.

Analysis. The taxpayer claimed that he incurred the costs while working away from home on business and that applicable revenue procedures dispense with the need to substantiate the amounts of those costs in order to deduct them. The IRS asserted the taxpayer could not deduct those costs primarily because he had no tax home. Secondly, the IRS argued that the taxpayer did not prove he actually incurred the claimed expenses. Thirdly, the IRS asserted the taxpayer could not use the subject revenue procedures to ascertain the amounts, because those revenue procedures do not apply when only incidental expenses are incurred.

The **court disagreed with the IRS's assertion that the taxpayer had no tax home.** He had no principal place of employment, but he did have a permanent residence. Courts have held that an individual's tax home is generally the location of his or her principal place of employment. If an individual does not have a principal place of employment, the individual's permanent residence is generally deemed to be his tax home. Furthermore, the court noted that a taxpayer need not maintain a residence in a city in which he or she actually works in order to have a tax home for purposes of I.R.C. §162(a).

The court disagreed with the IRS that the taxpayer must introduce into evidence actual receipts of his incidental expenditures in order to deduct them. The applicable revenue procedure allows taxpayers to deduct a set amount of travel expenses incurred away from home in lieu of maintaining written records to substantiate the actual amount. The court noted that the taxpayer provided records that met the time, place, and business purpose requirements of Temp. Reg. §1.274-5T(b)(2). The court noted that if the taxpayer wants to take a deduction for his actual incidental expenses, he must be prepared to meet all of the substantiation requirements, especially including the written documentation as to the amounts of those costs (to the extent the expenditure is $75 or more).

The court disagreed with the IRS that the applicable revenue procedures apply only when both meal and incidental expenses are incurred or when meals alone are incurred. The court read the revenue procedures concerning M&IE to apply to three distinct situations: (1) where a traveling employee pays only for meals; (2) where a traveling employee pays for both meals and incidental expenses, and (3) where a traveling employee pays only for incidental expenses. The court agreed with the taxpayer that he is entitled to the claimed deductions, but disagreed with the amounts of the deductions.

Holding. The court held that the taxpayer was entitled to deductions for the incidental travel items but limited the deduction to the incidental expense portions of the applicable M&IE rates.

[*Johnson v. Commissioner*, 115 T.C. 210 (2000)]

> **Practitioner Note.** See also *Westling v. Commissioner,* 80 T.C.M. (CCH) 37 (2000), for a similar result.

Knelman v. Commissioner

[I.R.C. §§61, 162, 262, and 6662]

> ☞ **Commuting from Ohio to business in California is not deductible.**

Facts. During the 1980s, Barry Knelman operated a landscaping business in southern California as a sole proprietorship. In 1991, Knelman and his wife decided to move to Ohio and Barry decided to continue operating the business in California. Throughout 1994, the Knelmans maintained their residence in Ohio. Mr. Knelman spent more than six months in California during 1994, with each stay lasting approximately 14 days. The Knelmans deducted $2,035 for travel expenses and $1,330 for meals and entertainment expenses on their Schedule C for 1994. On audit, the IRS determined that the couple's 1994 federal income tax return failed to report $14,555 from the landscaping company and denied the $3,365 in Schedule C deductions for costs incurred traveling between Ohio and California.

Issues

Issue 1. Whether taxpayers failed to report $14,555 of Schedule C income for the 1994 tax year.

Issue 2. Whether taxpayers are entitled to deduct $2,035 for travel expenses and $1,330 for meals under I.R.C. §162.

Issue 3. Whether taxpayers are liable for the accuracy-related penalty under I.R.C. §6662(a).

Analysis and Holding

Issue 1. The court dismissed the taxpayers' reliance on tax-protest rhetoric as meritless and refused to spend much time on the taxpayers' argument that they were not required to pay any Federal income tax on the income from the landscaping business. The court held that the taxpayers underreported their income by $14,555 with regard to the landscaping business.

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Issue 2. I.R.C. §262 does not allow deductions for personal, living, or family expenses not otherwise expressly allowed. For example, commuting expenses between a taxpayer's home and place of business are personal expenses and, thus, not deductible. The fact that a taxpayer chooses to live a substantial distance from his place of business provides no exception to this general rule. **The court held that the taxpayers' travel and meals were nondeductible living expenses incurred as a result of their decision to live outside the state where their landscaping business is located.**

Issue 3. The court found that the taxpayers failed to report income, failed to maintain sufficient records to substantiate deductions and expenses, and failed to provide a reasonable explanation for why they should not be liable for accuracy-related penalties. The court held that the taxpayers were liable for an accuracy-related penalty for the underpayment of tax due to negligence.

[*Knelman v. Commissioner*, 80 T.C.M. (CCH) 280 (2000)]

Starr v. Commissioner
[I.R.C. §274]

> ☞ **Self-employed person cannot use per diem rate to substantiate lodging expenses.**

Facts. William K. Starr operated a sole proprietorship that provided hot air balloon rides to customers. For part of 1995, Starr resided and operated his business in Phoenix, Arizona. For the remainder of the year, he operated in Woodinville, Washington. He rented an apartment in Woodinville for 156 days while operating his business. On his Schedule C for 1995, Starr deducted lodging expenses of $18,720 based on a per diem rate of $120 per day for the 156 days he operated his business in Woodinville. The IRS only allowed a deduction for $5,595, the lodging expenses actually incurred and substantiated.

Issue. Whether a self-employed individual is entitled to use the Federal per diem rate to substantiate the amount of deductible lodging expenses.

Analysis. Lodging expenses that are incurred while traveling away from home in the pursuit of business are generally deductible under I.R.C. §162(a). However, under I.R.C. §274(d), the deduction is disallowed when a taxpayer fails to substantiate (1) the amount of the expense, (2) the time and place of travel, and (3) the business purpose for the expense. Under Rev. Proc. 94-77, 1994-2 C.B. 825, employees and self-employed individuals may use the Federal per diem rate to substantiate business meals and incidental expenses incurred while traveling away from home. However, the use of the Federal per diem rate to substantiate the amount of lodging expenses is available only to certain employer-employee reimbursement arrangements. The procedure excludes self-employed individuals from using the Federal per diem rate to substantiate the amount of their lodging expenses. Therefore, a self-employed individual must still prove the amount of lodging costs with documentary evidence.

Holding. The court held that a self-employed individual is not entitled to use the Federal per diem rate to substantiate the amount of lodging expenses. He is entitled to deduct lodging expense for the amounts substantiated under I.R.C. §274(d).

[*Starr v. Commissioner*, 80 T.C.M. (CCH) 429 (2000)]

Duncan v. Commissioner
[I.R.C. §§162, 274, 280A, and 6651]

> ☞ **Travel and home office expenses of self-employed trucker are disallowed.**

Facts. During 1994, the taxpayer was an independent, over-the-road truck driver. He contracted all of his hauling assignments through Knox Cartage, a Knoxville, Tennessee-based company, and all of his hauling assignments originated and terminated in Knoxville. He traveled approximately 130,000 miles hauling cargo throughout the continental United States during 1994. The taxpayer filed Form 4868 for his 1994 tax return, extending the filing date to August 15, 1995. He filed his 1994 return on August 24, 1995. On the 1994 Schedule C from his trucking activity, the taxpayer deducted $5,730 in lodging expenses and $2,255 in meal expenses. He calculated these amounts by multiplying the number of days he traveled in 1994 by the federal per diem rates for lodging and meals provided in Rev. Proc. 93-50. Even though the taxpayer maintained a log in which he recorded his hauling trips, including time, place, and business purpose, the IRS disallowed $5,576 of the lodging expenses because of lack of substantiation. The IRS agreed that the taxpayer was entitled to use and properly applied the optional per diem method of substantiating his meal and incidental expenses. However, the IRS disallowed $271 in meal expenses relating to 17 days in which the taxpayer stayed overnight in Knoxville, arguing that his home was in close proximity to Knoxville, and therefore, the taxpayer was not "away from home" within the meaning of I.R.C. §162. The IRS also disallowed a home office deduction because the taxpayer's home office was not used exclusively and regularly as his principal place of business.

Issues

Issue 1. What amount the taxpayer may deduct for travel expenses related to his trucking activity.

Issue 2. Whether taxpayer is entitled to a home office deduction under I.R.C. §280A in connection with his trucking activity.

Issue 3. Whether taxpayer is liable for an addition to tax under I.R.C. §6651(a) for failure to timely file his tax return.

Analysis and Holding

Issue 1. The taxpayer may not use the Federal per diem rates for lodging because he was self-employed. **The court held that the taxpayer's lodging**

expenses were not deductible, because the taxpayer did not keep records of the amounts of lodging expenses he actually incurred.

The taxpayer argued that on several occasions, Knox Cartage scheduled him to haul new cargo out of Knoxville immediately upon his return from other hauling trips. Thus, he incurred meal expenses because he did not have time to travel to his home, which was an hour from Knoxville. **The court noted that the term "home" for purposes of I.R.C. §162(a)(2) means the vicinity of the taxpayer's principal place of business rather than the personal residence of the taxpayer**, when the personal residence is not in the same vicinity as the place of employment. The court stated that Knoxville was clearly the taxpayer's principal place of business. Thus, any expenses incurred in the Knoxville area were not away from home. The court disallowed $271 in meal expenses.

Issue 2. Citing *Soliman* (506 U.S. 168, 175–177 (1993)), the court noted that where a taxpayer's business is conducted partly in the taxpayer's residence and partly at another location, two primary factors are considered in determining whether the home office qualifies under I.R.C. §280A(c)(1)(A) as the taxpayer's principal place of business: (1) the relative importance of the functions or activities performed at each business location, and (2) the amount of time spent at each location. The principal activities relating to the taxpayer's truck driving activity consisted of the delivery of cargo to various destinations throughout the United States. While the court was satisfied that the taxpayer utilized his home office space for the administrative duties related to his trucking activity, it found that the most important aspects as well as the substantial majority of the trucking activities were performed outside his home office. Thus, the court held that the taxpayer was not entitled to a home office deduction under I.R.C. §280(a).

Issue 3. I.R.C. §6651(a)(1) imposes an addition to tax for a taxpayer's failure to file a tax return on time, unless the taxpayer can establish that such failure is due to reasonable cause and not due to willful neglect. The taxpayer claimed that he relied upon his accountant to timely file his 1994 tax return. The Supreme Court has noted that it requires no special training or effort to ascertain a deadline and make sure that it is met. Failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent, and such reliance is not reasonable cause for late filing under I.R.C. §6651(a)(1). The court held the taxpayer was liable for the addition to tax under I.R.C. §6651(a)(1).

[*Duncan v. Commissioner*, 80 T.C.M. (CCH) 283 (2000)]

Churchill Downs, Inc., v. Commissioner
[I.R.C. §274]

> ☞ **Churchill Downs' cost for dinners, cocktail parties, breakfasts, and parties is subject to 50% limitation**

Facts. The taxpayer conducts horse races, including the Kentucky Derby, at its facilities. During 1994 and 1995, the taxpayer incurred $397,193 for entertainment expenses that were ordinary and necessary expenses under I.R.C. §162. The expenses included the cost of holding the Sport of Kings Gala, a brunch following the post position drawing for the Derby race, a week-long hospitality tent for the press, Kentucky Derby Winner's Party, the Breeders' Cup press reception cocktail party and dinner, and the Breeders' Cup press breakfast. The taxpayer deducted the full amount of expenses incurred in holding the above events. The IRS determined the expenses were only partially deductible under I.R.C. §274(n).

Issue. Whether taxpayer's claimed deductions for entertainment expenses are limited by I.R.C. §274(n)(1).

Analysis. Churchill Downs argued that they are in the entertainment business, and accordingly, should not be subject to the restrictions of I.R.C. §274(n) with respect to expenses they incur in the course of providing that entertainment product. The IRS argued that the deductions of the expenses are limited to 50% of the expenditures by I.R.C. §274(n). The court noted that a taxpayer's trade or business must be considered in determining whether the expenses in question are entertainment expenses. However, in the case of Churchill Downs, **the court found that the costs at issue were entertainment expenses that could not be categorized as "part of the entertainment product."** The court also rejected Churchill Downs' alternative argument that its expenses were excludable because they were used to pay for items available to the public and for entertainment sold to customers (exceptions to the restrictions imposed by I.R.C. §274(n)(1)). The court found that although the horse races were open to the public, the entertainment associated with them included invitation-only events for selected horsemen, Churchill Downs' employees, media representatives, and local dignitaries. The court saw no difference between the expenses at issue here and the normal entertainment of selected clients and suppliers, which is limited by I.R.C. §273(n).

Holding. The court held that the taxpayer's claimed deductions are limited by I.R.C. §274(n)(1).

[*Churchill Downs, Inc., v. Commissioner*, 115 T.C. 279 (2000)]

Sutherland Lumber-Southwest, Inc., v. Commissioner

[I.R.C. §§162 and 274]

> ☞ **Eighth Circuit affirms that deduction for providing plane for employee vacations is not limited to employees' 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. The Tax Court held that the corporation's expense deduction for providing the employees with nonbusiness flights on the company's plane was not limited to the income reported by the employee [114 T.C. 197 (2000)]. The IRS appealed.

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. Specifically, **I.R.C. §274(a) does not allow any deduction for an activity that constitutes entertainment, amusement, or recreation or a facility used for such purposes.** The IRS said that the vacation flights provided by Sutherland were a form of entertainment expense. 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).**

The IRS raised another 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 court noted 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 company's costs were less than the required income inclusion by the employee.

Holding. Affirming the Tax Court, the Eighth Circuit held that the corporation's expense deductions were not limited to the income reported by the employees.

[*Sutherland Lumber-Southwest, Inc., v. Commissioner*, 2001-2 USTC ¶50,503]

CASES, RULINGS, AND LETTER RULINGS

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