

Chapter 6: 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 September 6, 2002. 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.

Chief Counsel Advice (CCA). 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

6

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

Cash Method

Notice 2001-76

I.R.C. §448

 **Cash Method Relief Expanded for Some Businesses**

- The higher limit of \$10 million comes with certain conditions.
- A \$1 million general exception and a I.R.C. §448(b)(3) \$5 million cap on gross receipts for C corporations exists.

Purpose. The IRS issued a proposed Rev. Proc. that would allow some businesses with average annual gross receipts of up to \$10 million to use the cash method of accounting.

Note. The IRS had granted such relief under Rev. Proc. 2001-10 whereby taxpayers with **average annual gross receipts of \$1 million or less** may be able to use the cash method. And, in contrast to this latest guidance, those taxpayers did not have to be concerned about what level of retail business they might have conducted.

Background. These proposed rules generally **exclude** retailers, wholesalers, manufacturers, miners, and some other taxpayers unless they are **principally involved** in a service type business or otherwise perform certain kinds of custom manufacturing. Furthermore, the rules would benefit service businesses, even if they also sold related products. Examples of service businesses that could benefit from using the cash method of accounting under these proposed procedures are:

1. A plumbing business that sold plumbing supplies, provided the service portion of the business generated the majority of its gross receipts.
2. A retail clothing store that also provides alteration services. Although retail sales are its principal business activity, the cash method could still be used for the alterations portion of the business, if separate books are maintained for retail sales.

Larger C Corporations. The proposed rules would **not** apply to certain businesses that are otherwise **required to use an accrual method** (under I.R.C. §448(b)(3)), this includes C corporations, or partnerships with C corporation owners with gross receipts in excess of \$5 million, except qualified Personal Service Corporations. As a result, flowthrough entities such as partnerships, LLCs, and S corporations, would be able to use this new exception. For example, if a C corporation with from \$5 to \$10 million of gross receipts were to make an S election, the company could possibly switch to the cash method of accounting for tax purposes.

Note. Some of the issues that remain unclear include:

1. What exactly should be defined as a **principal activity**?
2. How should gross receipts be distinguished from various businesses when the provision of services is linked to the provision of property?
3. The examples in Notice 2001-76 should be modified to make it clear they do not apply to C corporations with gross receipts in excess of \$5 million; and
4. Whether the testing for a principal business activity is done on a one-year or longer-term basis period.

Effective Date. Once finalized, the Rev. Proc. would be effective for **tax years ending on or after December 31, 2001.**

Cash Method

Revenue Procedure 2002-28 (modifies Notice 2001-76 shown above)

I.R.C. §448

☞ **IRS Finalizes Guidance for More Small Businesses to Use Cash Method**

Background. The IRS has issued more guidance regarding the use of the cash method by small companies. Companies with average annual gross receipts of less than \$10 million can use the cash method of accounting even if they have inventories, provided their principal business activity did not involve certain mining activities, manufacturing, wholesale or retail trade, or information industries.

Cash Method Not Available. This liberalization in using the cash method does **not** apply to:

1. C corporations, or
2. Partnerships with a C corporation partner, if their average gross receipts exceed \$5 million.

These entities are barred from using the cash method by I.R.C. §448.

“Dual Principal Activity Test”. In response to practitioner concerns, Rev. Proc. 2002-28 adopts a dual principal business activity test using either:

1. Gross receipts for its **prior** tax year, or
2. Average annual gross receipts for its **three most recent prior tax years.**

Additional Guidance. There are numerous examples and a flowchart illustrating the various rules and guidelines.

Effective Date. Rev. Proc. 2002-28 is effective for tax years ending **on or after December 31, 2001.** However, the IRS will **not** challenge a taxpayer’s use of the cash method, or a failure to account for inventories for a trade or business in an earlier tax year, if the taxpayer would **have otherwise qualified under these new guidelines.**



Change in Accounting Method

Revenue Procedure 2002-9

I.R.C. §446

☞ **Procedure for Automatic Changes in Accounting Method Updated Again**

Rev. Proc. 2001-10 Modified. The IRS once again **updated and superseded** the rules in Rev. Proc. 99-49 for obtaining **automatic consent** to change a method of accounting described in the appendix of the Rev. Proc.. This Rev. Proc. modifies the automatic consent procedures described in Rev. Proc. 2001-10.

Effective Date. Subject to transition rules, this Rev. Proc. is effective for tax years ending on or after December 31, 2001.

Significant Changes. Practitioners would probably be most interested in:

- I.R.C. §5.01 of the **Appendix** which deals with the change from the cash or hybrid method to the accrual method, or
- I.R.C. §5.05 of the **Appendix** which deals with small taxpayers seeking to change to the overall cash method. All of the situations for which an automatic change in accounting will be granted by the IRS are outlined in the Appendix of this Rev. Proc.. If a taxpayer qualifies for this automatic change in accounting, the \$1,200 filing fee is waived.

Note. Changes in accounting generally require Form 3115, Application for Change in Accounting Method. The original Form 3115 must be attached to a timely filed (including extensions) original tax return for the year of the change. A copy of Form 3115 must be mailed to the IRS national Office no later than when the original return is filed. See the Instructions for Form 3115 for full details.

Catch-up Depreciation. Rev. Proc. 2002-9 is the latest guidance available where a taxpayer is claiming catch-up depreciation, such as when an asset is misclassified upon originally being placed into service.

Change of Accounting Methods

Revenue Procedure 2002-19 (modifies Rev. Proc. 2002-9 shown above)

I.R.C. §446

IRS Modifies Procedures for Change of Accounting Method

Purpose. The IRS has **modified** Rev. Proc. 97-27 and Rev. Proc. 2002-9 in order to provide new procedures for obtaining advance consent for a change of accounting method.

Background. Under Rev. Proc. 2002-19, a change in method of accounting will be allowed **at least prospectively**, but **without audit protection**, if the method to be changed is an issue pending for a tax year under examination or an issue under consideration by **either** an appeals office or a federal court. This would permit a taxpayer currently under examination who could **not** otherwise request a voluntary change in the method of accounting to do so (but, without audit protection).

Negative I.R.C. §481(a) Adjustment. The revised procedures also address whether a change in method results in a taxpayer-favorable adjustment such as a **negative** I.R.C. §481(a) adjustment. If that is the case, the **entire** amount must be taken into account in the year of change.

Note. The new requirement that an **entire** negative I.R.C. §481(a) adjustment be taken into account in the year of change, represents an extremely taxpayer friendly change. **The previous requirement was that any negative adjustment in the taxpayer's favor in excess of \$25,000 must be spread over a 4-year period.**

Example. ABC, Inc., a calendar year S corporation, becomes a new client for your CPA practice. A careful analysis of the depreciation schedule reveals that a high cost asset was omitted from the depreciation schedule. You use the rules of Rev. Proc. 2002-19 to obtain an automatic consent to claim \$26,000 of **catch-up depreciation** on the omitted asset on ABC Corporation's **2002** Form 1120.

Prior to Rev. Proc. 2000-19, this \$26,000 **negative** adjustment in ABC's favor would be required to be spread ratably over the corporation's 2002-2005 tax returns. Therefore, \$6,500 ($\$26,000 \div 4$) of catch-up depreciation could be deducted on ABC's 2002, 2003, 2004 and 2005 Forms 1120. However, due to the change sanctioned by Rev. Proc. 2002-19, the **entire** \$26,000 of "catch-up depreciation" can be deducted on ABC's 2002 Form 1120.

Note. With the liberalization of the NOL carryback period from two to five years, the ability to deduct a negative adjustment in the current year will mean the deduction could affect six tax years (the current year and five carryback years).

Effective Date. Generally, Rev. Proc. 2002-19 is effective for tax years ending **on or after December 31, 2001.**

Note. See pages 123-132 in the *1997 Farm Income Tax Workbook* for complete details regarding catch-up depreciation. Remember, Rev. Proc. 2002-19 modified Rev. Proc. 97-37 shown in the 1997 workbook, so any negative adjustment, not just those \$25,000 or less, will be entirely taken into account for the year of change.

Accounting Methods

Revenue Procedure 2002-54 (modifies Rev. Proc. 2002-19 shown above)

I.R.C. §446

IRS Modifies Procedures for Change of Accounting Method

Pending Requests. The IRS is attempting to deal with negative adjustments on requests that were pending as of March 14, 2002.

Consent Agreements. Rev. Proc. 2002-54 provides that companies that have received consent agreements may elect to apply the one-year adjustment period if:

1. The consent agreement is for a change in method of accounting for a year of change ending **after** December 30, 2001; and
2. The agreement does **not** reflect a one-year adjustment period.

If the company has signed and returned the consent agreement, it must write “**Election to Apply 1-Year Adjustment Period**” at the top of the first page of a copy of the consent agreement. The copy should be attached to **either** its timely filed original federal income tax return or an amended federal income tax return that reflects the adjustment period. If the company has **not** yet signed and returned the consent agreement, it should contact the national office to request the issuance of a consent agreement that reflects the adjustment period.

Effective Date. Rev. Proc. 2002-54 is effective for tax years ending after December 30, 2001.

Accounting Method (unacceptable)

Stewart L. and Patricia A. Welch v. Commissioner, T.C. Memo 2002-84 dated Mar. 29, 2002, CCH Dec. 54,700(M)

I.R.C. §446(b)

Taxpayer Unable To Prove Source of Cash Hoard

Facts. Stewart and Patricia Welch operated a cash sales business at various flea markets. An indirect examination method was used by the IRS to determine the Welchs under reported their gross receipts for three tax years. Although they had received a prior substantial worker’s compensation settlement, they could not prove it was a source of funds spent during the years of exam.

Analysis. The burden is on the taxpayers to explain the source of funds that allowed them to spend more than their known sources of income. Contrary to their testimony that the prior worker’s compensation settlement also provided them with a cash hoard, little remained of it. The taxpayers also contended they had received loans and gifts from family members. However, they could not prove it with documentary evidence.

Holding. The Tax Court agreed with the IRS’s assessment of tax on the unreported flea market income. The IRS also assessed an accuracy-related negligence penalty which the court did not uphold. The Tax Court held that the IRS did not meet its burden of proof in addressing the qualifications of their tax preparer or whether the underreporting was attributable to their reliance on his advice.

Accounting Method (unacceptable)

Barbara Bacon, Appellant, v. Commissioner, CA-3 (3rd Circuit Court of Appeals), 2001-2 USTC ¶150,686, Affirming the Tax Court, T.C. Memo 2000-257, 80 TCM 219, CCH Dec. 54,003(M)

I.R.C. §§446 and 6663

Indirect Examination Method Was Properly Used and the Civil Fraud Penalty Was Upheld

Facts. Robert and Barbara Bacon were the shareholders in Radtam Inc., an S corporation restaurant/bar establishment. They filed joint returns for the four years in question, **1988-1991**. On their four Forms 1040 for 1988-1991, the only income they reported from the corporation was Form W-2 wages. In addition, they reported income and expenses from real property rental on Schedule E.

During the four-year period, the total of their reported AGIs was **\$331,656**. However, gross deposits to their personal bank accounts during the four-year period were about **\$3.8 million**. Included in deposits to their personal bank accounts were **cash deposits of almost \$600,000**. In addition, **corporate checks of almost \$1.5 million** were deposited to their personal accounts.

During the four years in question, seven parcels of rental real estate were purchased in Barbara Bacon's name. The total purchase price of the seven properties was about **\$2.5 million**. The corporate books and records furnished by Mr. And Mrs. Bacon to their accountant omitted the existence of a substantial corporate savings account. Only after the IRS began its examination was information regarding this account disclosed to their accountant.

When initially questioned by the IRS special agents about the income discrepancies, they deceitfully invented a false explanation. They told the special agents that they were each receiving extensive secret cash gifts from a grandparent who they had never met.

Issues.

1. Whether the IRS properly used the bank deposits method to reconstruct taxable income on the individual income tax returns.
2. Whether civil fraud penalty under I.R.C. §6663 was properly assessed against Barbara Bacon.

Analysis.

Issue 1. Under I.R.C. §6001, taxpayers are required to maintain adequate records to permit the IRS to determine their tax liabilities. When a taxpayer fails to do this, the **IRS may reconstruct income in any reasonable manner**. The bank deposit method is one way to reconstruct income.

Issue 2. The IRS has the initial burden of proving by clear and convincing evidence that some portion of an underpayment of income tax is due to fraud. In the case of a joint return, a fraud penalty is not imposed on a spouse unless some portion of the underpayment is attributable to his/her fraudulent conduct.

Holding.

Issue 1. It is well established that the IRS's deficiency determinations are generally presumed correct and that the taxpayers have the burden of proof in contesting such determinations. In unreported income cases, this normal presumption of correctness applies provided the determination is not without rational foundation.

In this case there was considerable evidence connecting the Bacons with a tax-generating activity that formed a likely cash source of unreported income. It was plainly evident from the third-party record obtained by the IRS that the taxpayers had significant unreported income. In addition, it is clear that the taxpayers had not maintained accurate records from which their true taxable income could be reconstructed. **Therefore, we (the 3rd Circuit Court of Appeals) affirm the Tax Court in finding that the IRS bank deposit method accurately reconstructed the taxpayers' taxable income for the years 1988-1991.**

Issue 2. The Tax Court looked to whether certain "badges of fraud" were present on the part of both taxpayers, Mr. And Mrs. Bacon. **Mrs. Bacon's conduct, listed below, leads us to affirm the imposition of the civil fraud penalty under I.R.C. §6663 on her.**

1. She was present at an interview with IRS special agents during which false statements were made regarding annual cash gifts. She made no attempt to correct her spouse's fraudulent statements regarding gift income.
2. She had extensive dealings in the case. An example was applying significant cash payments toward the purchase of real estate acquired in her name.

AGRICULTURAL ISSUES

Farm Income Averaging

Treasury Decision 8972

I.R.C. §1301

Final Regulations Issued Clarifying Farm Income Averaging Method

Purpose. Final regulations have been issued which discuss the I.R.C. §1301 election to average farm income in computing a taxpayer's overall tax liability.

Changes to Proposed Regulations. In response to comments, the final regulations:

1. Permit wages paid by an S corporation (but **not** a C corporation) to a shareholder to qualify as income from a farming business.
2. Provide that rental income based on a tenant's production can be treated, subject to an anti-abuse rule, as income from a farming business. However, this applies only if the landlord's share of a tenant's production is set in a **written rental agreement** before the tenant begins significant activities.
3. Allow taxpayers to make a late election, change an election, or revoke an election subject only to the statutes of limitation on filing a claim for credit or refund.
4. Permit use of a **negative amount for a base year's taxable income** if adjustments are made for items (such as net operating losses) that may provide a tax benefit in another tax year.

Note. The provision that a **negative** amount could be used for a base year had been an especially controversial issue since the IRS had initially denied this benefit. Farmers are permitted to carry back all or a portion of their farm income to three prior tax years. The cumulative tax liability for those years is recalculated using the carrybacks. The resulting sum of extra tax due for each of the prior three years is then added to the tax due on the remaining income for the current tax year. Currently, losses in carryback years may be considered when using averaging. Therefore, returns for farming clients should be examined for possible amendment.

Crop Shares. Income from crop shares will also qualify for averaging. However, after 2002, crop share agreements **must be in writing** and terms identified **before** production begins.

S Corporation Wages. Finally, farmers will be allowed to treat wages paid by their S corporations as farm income. However, wages paid by regular C corporations in the farming business do **not** qualify.

Effective Date. Reg. §1.1301-1 is generally effective for tax years beginning **after** December 31, 2001, although taxpayers can rely on these rules in computing prior years' tax liability.

Note. See Issue 7 in Chapter 4: Agricultural Issues for more details on this topic.

AMORTIZATION AND DEPRECIATION

Mid-Quarter Convention

Notice 2001-74

I.R.C. §168(d)(3)

Broadened Relief from Mid-Quarter Convention for Year-end Purchases

Background. Generally, if **more than 40%** of assets are first used in the final quarter of the tax year; those assets receive only 1½ months of depreciation instead of the normal six months. The IRS had previously waived this requirement for firms that exceeded the 40% test, if the third quarter of their 2001 tax year included September 11, 2001 (Notice 2001-70).

Notice 2001-70. This guidance simply required that those taxpayers desiring relief from the imposition of the mid-quarter convention write **Election under Notice 2001-70** across the top of Form 4562, Depreciation and Amortization. The intent of the notice was to provide taxpayers guidance for how to make the election until the Treasury issued the necessary regulations. **It appeared that only those taxpayers “affected by the September 11, 2001 terrorist attack” would be granted this additional disaster relief.**

Affected? An important issue is what is meant by being “affected” by the attacks. It is fairly clear that Notice 2001-70 is intended for those taxpayers who were affected, either directly or indirectly, by the attacks. Nevertheless, the probability is the IRS lacks the resources and political willpower to contest these elections on Form 4562.

Time Frame Expanded. Since Notice 2001-70 specifically applied to taxpayers, where September 11, 2001 was included in the third or fourth quarter, only **calendar yearend** firms, and those with 2001 fiscal years ending in January or February 2002, could benefit. With the release of Notice 2001-74, more businesses will qualify. This **same** relief is extended to taxpayers with fiscal tax years ending in September, October or November 2002.

BANKRUPTCY AND INSOLVENCY

Discharge of Indebtedness Income

George M. Earnshaw v. Commissioner, T.C. Memo 2002-191, CCH Dec. 54,830(M) dated Aug. 5, 2002

I.R.C. §61

Form 1099-C from Credit Card Company Results in Cancellation of Indebtedness Income

Facts. George Earnshaw had a MasterCard account with MBNA. Following a dispute regarding late fee charges, MBNA offered to settle the \$32,567 balance of his account for a payment of \$12,700. He agreed to this proposal and sent MBNA his check for \$12,700 in January 1998.

In January 1999, MBNA sent Mr. Earnshaw a 1998 Form 1099-C, Cancellation of Debt, in the amount of \$19,867. However, Mr. Earnshaw returned the 1099-C to MBNA with a cover letter in which he stated among other things:

“The debt was never ‘forgiveness’ of anything, but as you know a compromise of many issues of a vague, doubtful and disputed claim. After considerable negotiations, a settlement was effected of \$12,700. This was to save us a lawsuit and legal expense, as well as an equitable conclusion to your improper handling of my account.”

Mr. Earnshaw attached the following statement to his 1998 tax return:

“No amounts pursuant to the attached 1099-C have been included in income. The cancellation should be characterized as a compromise of a doubtful and disputed claim.”

The IRS service center later sent Mr. Earnshaw a notice of deficiency in the amount of \$3,514 for 1998 for failure to report the \$19,687, 1099-C Cancellation of Debt Income.

At the Tax Court, Mr. Earnshaw contented that he did not have any cancellation of indebtedness income. Rather, he insisted that his settlement with MBNA reflected a compromise of a disputed liability. Therefore, the contested liability doctrine should apply.

Issue. Whether the taxpayer realized discharge of indebtedness income under I.R.C. §61.

Analysis. The question in this case is whether a debt existed in the amount of \$32,567 before the settlement was reached. That was the starting point for MBNA's calculation to determine the Form 1099-C amount of \$19,867. The fact that Mr. Earnshaw was not insolvent at the time of the settlement precluded an application of I.R.C. §108(a)(3). That code section provides that income from the discharge of indebtedness is excluded from income when a taxpayer is insolvent.

Holding. On the facts presented, we (the Tax Court) do not totally agree with either party. We hold that the undisputed balance of the taxpayer's MBNA account on June 1, 1996 was \$28,838.

Undisputed balance on June 1, 1996	\$28,838
Plus: Cash advance received August 12, 1996	1,200
Plus: Cash advance fee on August 12, 1996	10
Less: 9 payments made subsequent to August 12, 1996	(4,250)
Less: Settlement payment made in January 1998	(12,700)
Balance-Amount of cancelled debt after settlement	\$13,098

Therefore, we conclude that the amount of petitioner's (Mr. Earnshaw's) cancellation of indebtedness income in 1998 is \$13,098, not \$19,867 as reported on Form 1099-C.

Discharge of Indebtedness Income

G.E. Toberman v. Commissioner, CA-8 (8th Circuit Court of Appeals), 2002-1 USTC ¶150,529(CCH), CCH Dec. 53,959(M) I.R.C. §108

Tax Court's Finding That Taxpayer Was Solvent Reversed by Appeals Court

Facts. From 1986 through 1993, the taxpayer controlled extensive business interests. Among them, were two wholly-owned S corporations. No tax returns were filed after the 1990 Form 1120S for one corporation and the 1991 return for the other. Two shareholder loans to Toberman were shown on the balance sheets of the two corporations, one for over \$2 million and another for about \$600,000. Toberman filed for bankruptcy in 1990, but the proceedings were dismissed by the court for various reasons. For 1993, the IRS determined that the forgiveness of these two outstanding loans constituted discharge of indebtedness income to the taxpayer. The Tax Court upheld the IRS in its assessment of \$1,194,503 of income tax and \$238,901 of penalties. Toberman's 1993 return reported a net operating loss carryforward of \$3,992,234 and no discharge of indebtedness income.

Analysis and Holding. The 8th Circuit Court of Appeals found that Toberman did indeed have some net worth. He, in fact, stated as much on an information form filed with the IRS as part of these proceedings. Yet, the 8th Circuit, in reversing the Tax Court, found that "the record contained numerous notices of judgment against Toberman." The judgments alone amounted to over \$3.6 million, while the IRS brief listed his net worth at \$389,650. Therefore, **the Appeals Court was satisfied that he was insolvent.** And, in chastising the Tax Court, it stated that the lower court's demand for "explicit proof that recent judgments remained unsatisfied was wholly unreasonable."

Note. The 8th Circuit reversal provides guidance on how to prove insolvency. This case involves a fairly common fact pattern for closely-held clients; substantial outstanding company/shareholder loans with little proof as to their legitimacy.

Discharge of Indebtedness Income

Treasury Regulation §1.6050 P-2

I.R.C. §6050P

Proposed Regulations on Discharge of Indebtedness Income Issued

Purpose. Proposed regulations have been released on the reporting requirements for discharge of indebtedness income. They deal with the information reporting guidelines of I.R.C. §6050P for entities which are formally engaged in the trade or business of lending money.

Lending Money Defined. The proposed regulations apply to trades or businesses which lend money on a regular and continuing basis.

Safe Harbors. The proposed regulations provide **three safe harbors** when lending money is not considered a significant trade or business.

- The **first** safe harbor provides that an organization that **was not** subject to the I.R.C. §6050P information reporting requirements in the previous calendar year would **not** fall under these newly-issued proposed regulations.
- The **second** safe harbor applies to an organization that **was** required to report under I.R.C. §6050P for the previous calendar year. Nevertheless, such organizations will **not** be considered to have “a significant trade or business of lending money” for the current year if for **each** of the three previous years its gross income from lending money is **less than both** 10% of the organization’s gross income and \$3 million.
- The **third** safe harbor applies to newly-formed organizations that are not “formed or used for holding loans acquired by an entity subject to reporting.” An organization without a prior year is considered **not** to have a significant trade or business of lending money, even if the organization now lends money on a regular and continuing basis.

General Exception. In addition to the three safe harbors, the proposed regulations provide a **general exception** for those businesses providing **nonfinancial goods or services** to customers in the normal course of their trade or business. For example, businesses which extended credit to customers purchasing goods or services from it would **not** be considered to be in the business of lending money.

Effective Date. The proposed regulations are effective until the final regulations are published in the Federal Register. However, the IRS has stated that the proposed regulations may be relied upon for guidance for prior tax periods.

BUSINESS EXPENSES

Tire Costs

Revenue Procedure 2002-27

I.R.C. §263A

IRS Issues Safe Harbor for Expensing Cost of Tires

Background. Previously, Rev. Proc. 68-134 (following Rev. Proc. 59-249 and the result reached in *Tompkins v. Commr.*, 47 B.T.A. 292 (1942)) had held that the recovery of the cost of short-lived truck tires and tubes should **not** be associated with the depreciation of much longer-lived trucks since the tires and tubes are easily separable from the truck and are not part of the truck's mechanism. Therefore, if the tires were consumable in less than one year, their cost could be currently deducted. Otherwise, they had to be capitalized and their cost recovered through depreciation deductions as a separate asset, whether or not they were new or replacement tires.

New Safe Harbor. For both new and replacement business tires, the IRS decided to issue a safe harbor which the IRS calls the original tire capitalization method. **New tires** can be depreciated using the **same** depreciation method, recovery period, and convention applicable to the vehicle that would normally be 5-year MACRS for most cars and trucks and 3-year MACRS for over-the-road tractors. The cost of **replacement tires** can be **deducted fully** in the year they are installed on the vehicle.

Note. This issue should arise only where a I.R.C. §179 immediate expensing election is otherwise **not** available for the replacement tires or to the extent the cost cannot be written off under the new special 30% depreciation rules.

Effective Date. Rev. Proc. 2002-27 is effective for tax years ending **on or after December 31, 2001.**

Storage Tanks

I.R.C. §162

Properly Handling Replacement Costs of Storage Tanks

The IRS has ruled that the costs of **replacing** underground gasoline tanks are **not** currently deductible. Rather, the removal and replacement expenses **must be capitalized**. Conversely, costs incurred to clean and dispose of old tanks can be **currently deducted**. The same is true with soil cleanup costs to remedy pollution from tanks that leaked.

Smallwares

Revenue Procedure 2002-12

I.R.C. §446

Safe Harbor Provided for Purchases of Restaurant and Bar Smallwares

The IRS has provided restaurants and bars with a favorable safe harbor method of accounting for the cost of smallwares, such as pots, pans, dishes, and glassware. It also provided procedures for obtaining automatic consent to change to the smallwares method. There are 10 categories of smallwares listed, including the normal glassware, flatware, dishes,

pots, pans, salt and pepper shakers, and small appliances costing under \$500 each. The tax result is such costs can be expensed currently, although the taxpayers might otherwise use the accrual method of accounting.

Effective Date. These rules are effective for tax years ending on or after December 31, 2001.

Business Expenses

Robert M. and Nancy I. Stewart v Commissioner, T.C. Memo 2002-199, CCH Dec. 54,839(M) dated August 8, 2002
I.R.C. §162

Management fees were not ordinary and necessary business expenses

Facts. Robert Stewart owned a profitable San Jose, CA real estate agency, which he operated as a sole proprietor. In 1984, he formed a corporation, R.M. Stewart, Inc. He was its sole shareholder and director. The corporation was engaged in real estate development.

In 1984, the newly formed corporation and Robert Stewart entered into a management agreement, which stated:

“The purpose of this agreement is to establish a management agreement for Robert Stewart’s real estate agency. R.M. Stewart, Inc. is by this agreement to have full management control over the real estate office. R.M. Stewart, Inc is to be paid an annual retainer of \$48,000. This agreement is to be reviewed every three years or sooner.”

The agreement was signed by Robert Stewart with the notation: “For both R.M. Stewart, Inc. and Robert M. Stewart”.

The agreement was modified twice. It was modified once in 1987 when the annual retainer was raised to \$84,000, and again in 1990 when the fee was raised to \$120,000.

The general management functions of the sole proprietorship consisted of running the business; training and supervising managers and salespersons; reviewing accounts receivable and accounts payable; motivating salespersons; and reviewing property sales contracts. **Robert Stewart performed all of these management functions in 1995 and 1996, the year in question. There was no written agreement between the corporation and Mr. Stewart regarding any services he was to provide as an employee of the corporation. In addition, Robert Stewart was not paid by the corporation as an employee, independent contractor, or executive in 1995 or 1996.**

The sole proprietorship (real estate agency) paid the corporation management fees of \$120,000 in 1995 and \$100,000 in 1996. The IRS determined that these fees **were not ordinary and necessary business expenses or were not paid for the purpose designated.** At Tax Court, Mr. Stewart argued that the management fees were “classic ordinary and necessary business expenses provided under a binding and written contract.” He also contended the corporation performed the management services as a separate taxable entity for the sole proprietorship.

Issue. Whether the management fees were ordinary and necessary expenses under I.R.C. §162.

Analysis. Definitions of the term “ordinary and necessary” include the following, taken from court cases:

- Common or frequent in occurrence
- Appropriate and helpful

Holding. We (the Tax Court) agree that management services provided to the real estate agency were ordinary and necessary to that business. We also agree that Mr. Stewart incorporated R.M. Stewart, Inc., for legitimate business reasons and that it was a separate taxable entity. **However, we disagree that the payments to R.M. Stewart, Inc., were expenses paid for management services performed by that entity or its employees.**

As a general matter, the income and expenses of a sole proprietorship are the income and expenses of the individual who owns the business. The sole proprietorship, unlike the corporation, was not a separate taxable entity from Mr. Stewart. **Any payments from his real estate agency that were paid for services he performed are not deductible.**

Transactions between related taxpayers are subject to close scrutiny. **Mr. Stewart has not proven that the corporation rendered any management services to the sole proprietorship.** Therefore, we cannot agree that the payments of \$120,000 in 1995 and the \$100,000 in 1996 are deductible business expenses.

Alternative Minimum Tax

Lawrence Moore v. Commissioner, T.C. Memo 2002-196, CCH Dec.54,835(M) dated August 7, 2002

I.R.C. §§55 and 56

☞ Large Unreimbursed Business Expenses Create AMT Liability

Facts. Lawrence Moore was employed in 1999 as a sales man for an electrical supply firm. His 1999 Form 1040 showed the following:

AGI (includes \$54,819 of wages)	\$55,207
Itemized deductions	(44,323)
Personal exemption	(2,750)
Taxable Income	\$8,134
Tax from Tax Table (single filing status)	1,219
Income tax withheld	6,197
Overpayment (refunded to taxpayer)	4,978

Mr. Moore **did not attach Form 6251**, Alternative Minimum Tax, to his 1999 Form 1040. The IRS service center sent him a notice of deficiency in the amount of \$4,233 in March 2001. The notice contained this statement:

“You are liable for alternative minimum tax of \$4,233 under section 55 of the Internal Revenue Code.”

At Tax Court, Mr. Moore represented himself. His contention was that the **26% AMT tax rate** could be applied only to his regular taxable income of \$8,134, not to the excess of his alternative minimum taxable income over the \$33,750 AMT exemption amount.

Issue. Whether the \$4,233 alternative minimum tax (AMT) assessment was correct.

Analysis. The Tax Reform Act of 1986, which expanded the AMT for individuals, significantly amended the previous AMT rules. These changes were made to **establish a floor for tax liability, so that a taxpayer will pay some tax regardless of the tax benefits otherwise available to him under the regular income tax rules.**

Included in taxpayer's \$44,323 total of itemized deductions were the following:

State and local taxes (income and real estate)	\$4,999
Unreimbursed employee business expenses from Form 2106 (after applying the 2% AGI floor)	\$38,836

The AMT is paid only if, and to the extent, it **exceeds** the taxpayer's regular income tax [I.R.C. §55(a)]. The starting point in computing AMT liability is determining the **alternative minimum taxable income (AMTI)**. To determine AMTI, certain **adjustments** and **tax preference items** must be added to the regular taxable income. Although taxpayer had no items of tax preference in 1999, the adjustments must be considered in arriving at AMTI.

Computation of the 1999 AMT liability of \$4,233:

Regular taxable income	\$8,134
Plus: Miscellaneous itemized deductions	38,836
Plus: State and local taxes	4,999
Plus: Personal exemption	2,750
Alternative minimum taxable income (AMTI)	\$54,719
Less: Exemption amount (single filing status)	(33,750)
Excess of AMTI over exemption amount	\$20,969
Tentative Minimum tax (\$20,969 × 26%)	\$5,452
Less: Regular tax	(1,219)
Alternative minimum tax	\$4,233

Holding. “This court has considered all of the arguments advanced by the petitioner (Mr. Moore), and has found them to be irrelevant or without merit.”

CAPITAL ASSETS

Signs

Chief Counsel Advice 200203009

I.R.C. §168

Signs Are 15-Year Land Improvements

In *Walgreen Co. and Subsidiaries*, TC Memo 1996-374 (1996), the Tax Court determined that ADR Asset Class 57.0 (5-year property) was found to include **restaurant decor items** such as a decorative canopy system along with its related concrete foundation, concrete piers, lumber, and attached signs. However, in this Field Service Advice, the IRS ruled that **outdoor signs** must be written off as **15-year land improvements**. A casino constructed a large pylon sign on its property to draw attention to its gambling and hotel complex. **The sign was not attached to the building.** The casino had argued that the entire cost of the sign should be deducted over five years. According to the IRS advice, this treatment applies **only** to the sign’s electronic circuitry.

Luxury Car Limitations

Revenue Procedure 2002-14

I.R.C. §280F

IRS Provides Limits on Depreciation Deductions for Autos

Special 30% depreciation allowance provides an extra \$4,600 in addition to the normal \$3,060 first year amount for **2002**.

Purpose. The IRS has provided the limitations on depreciation deductions for owners of passenger automobiles and light trucks first placed in service during calendar year **2002**, as well as separate limitations on electric automobiles. The Rev. Proc. also provides the amounts lessees of passenger automobiles and electric automobiles, first leased

during calendar year **2002**, must include in income, along with the maximum value of employer-provided autos for which the vehicle cents-per-mile valuation rule may apply.

2002 Amounts. The depreciation limitations for automobiles first placed in service in 2002 are:

- \$3,060 for the first tax year,
- \$4,900 for the second tax year,
- \$2,950 for the third tax year, and
- \$1,775 for each succeeding tax year

For electric automobiles placed in service in calendar year 2002, the depreciation limitations are \$9,180 for the first tax year; \$14,700 for the second tax year; \$8,750 for the third tax year; and \$5,325 for each succeeding tax year.

For autos first made available in 2002 to any employee for personal use, the vehicle cents-per-mile valuation rule under Reg. §1.61-21(e) may be used if the value of the auto on the date the employer first makes it available does **not exceed \$15,500**.

Note. Leasing a luxury car for business purposes should be more advantageous. For any leased car whose value is over \$15,500, if the lease is first entered into during 2002, an annual income inclusion must be reported to offset the rental deduction. The **2002** income inclusion is **50% less** than the 2001 figure.

With the special 30% depreciation allowance, an additional **\$4,600** may be deducted for business autos placed in service after September 10, 2001 but before 2003. This assumes 100% business use.

Note. See Chapter 1: New Tax Legislation for more information.

Capital Improvements

Letter Ruling 200229014

I.R.C. §1016

Costs to Prevent Shoreline Erosion Must Be Capitalized

To stem continual shoreline erosion in front of his home, the taxpayer erected a new bulkhead and established a bluff of land. When the home was sold, the taxpayer asked how these costs should be treated for tax purposes.

The IRS ruled that the costs were capital in nature, and should be added to the basis of the home. Under Reg. §1.1016-2, the basis of property must be adjusted for any expenditure properly chargeable to the capital account, including the cost of improvements and betterments made to the property.

Note. Although the improvements were built on public land, not on his land, their costs could be added to the home's basis.

CAPITAL GAINS AND LOSSES

Home Gain Exclusion

IRS Information Letter 2001-0170

I.R.C. §121

☛ Land Adjacent to Home Might Qualify for Exclusion

Under the rollover provisions of former I.R.C. §1034, gain on the sale of **land adjacent to a principal residence** could escape tax if, within a 24-month period, a taxpayer also sold the land on which the house was located and purchased a more expensive replacement residence. Effective May 7, 1997, Congress changed the law by providing an exclusion of up to \$500,000 on the sale of homes that meet the two-out-of-five dual ownership and use tests on the date of sale.

Now, in an unofficial information letter, the IRS has suggested the gain from the sale of land adjacent to the principal residence **may** be eligible for the new exclusion. The key is whether the land is sold as part of a series of transactions that includes the sale of the home itself. To qualify, the land must be used residentially in at least two of the five years before sale. In addition, that use must coincide with the two years that the house was occupied as the principal residence. But, gain on land will be taxed if the home is not sold “as part of the overall transaction.”

Planning Pointer. It is suggested that the home and the surrounding land be placed for sale at the same time. Hopefully a sole buyer could be found for both properties. If that were the case, it would appear the requirement of this information letter would be met.

Wash Sales

IRS Information Letter 2001-0218

I.R.C. §1091

☛ Day Traders Remain Subject to Wash Sale Rule

The wash sale rules prohibit the deduction of a loss on the sale of a security if the same security was acquired within 30 days **before or after** the sale. An IRS regulation that permitted an exception for day traders is out of date according to this information letter. Only dealers are specifically excepted from the wash sale rule. Dealers are those who normally purchase or sell securities for customers in their day-to-day activities. However, **day traders do not qualify as dealers**, even if they trade frequently, since they do so for their personal accounts.

Mutual Insurance Companies

IRS Information Letter 2002-0057

I.R.C. §368(a)

☛ IRS Rules on Tax Effect of Demutualizing Insurance Company

A mutual insurance company converted itself into a stock company owned by the shareholders. In the conversion, the policy owners received shares in the new corporation. The IRS has ruled that the stock received will have a **zero basis**. As a result, if and when the policyholders sell the stock, **all** of the proceeds will be taxed as capital gains.

I.R.C. §1231 Losses

Bill L. Turner v. Commissioner, T.C. Summary Opinion 2002-60 (May 28, 2002)

I.R.C. §1231

Loss on Sale of Residence Nondeductible

Personal residence becomes a rental property for purposes of deducting a loss on its sale.

Facts. Bill Turner purchased a personal residence in 1983 for \$295,000. In 1994, he decided to sell the house and move. His realtor suggested he make some repairs and upgrades to the home in order to make it more valuable. Mr. Turner decided not to make the renovations and listed the house for \$288,000 until July 1994. He vacated the home in May 1994. The home did not sell by the end of the listing period, so he took it off the market and made the suggested repairs.

From June through August 1994, Mr. Turner replaced carpets, added tile to the entryway, installed new counter tops, removed wallpaper, installed vinyl flooring, replaced drywall and painted the interior and exterior of the house. In October 1994, he decided to sell the house regardless of market conditions. He listed the property for \$275,000 and received a full price offer within one week. The purchasers paid \$500 to occupy the home one week early. Mr. Turner reported an ordinary loss of \$35,428 on the sale of the home on the 1994 Form 4797.

Analysis. The IRS disallowed the loss since it resulted from the sale of a personal residence. The loss on the sale of a personal residence is not deductible unless the taxpayer has converted it to a rental property. **The taxpayers agreed the \$500 was additional sales proceeds paid at closing rather than rent.**

The Tax Court listed three reasons to hold that the property was not converted to rental property:

1. Taxpayers actually occupied the property as their personal residence.
2. The property was not occupied from the time they vacated it until its sale and was therefore available to the taxpayers during that time.
3. The property was unavailable for rent during the period because of the extensive renovations taking place.

Holding. The court agreed with the IRS and the loss was disallowed.

CORPORATIONS

Recharacterization Rules

Robert W. Blewett v. Commissioner, T.C. Summary Opinion 2001-174

I.R.C. §469

Net Rental Losses to Closely-Held Corporation Considered Nonpassive

- Rental income of **less than 2%** of property's basis or value, whichever is lower, resulted in a nonpassive loss.
- Rental activity considered **incidental** to trade or business in which taxpayer materially participated.

Facts. In 1976, Robert Blewett (taxpayer) and his brother, Don, organized Highland Enterprises, Inc. (Highland), a C corporation. Robert and his brother each owned 50 percent of the stock of Highland during 1996. In 1996, Highland was engaged in two separate businesses: a general heavy construction business and a real estate sales business. During 1996, both taxpayer and his brother worked full-time for Highland. Because of Highland's poor financial condition,

the company was unable to lease or purchase equipment on credit. Therefore, taxpayer and his brother purchased the necessary equipment in their names and leased it to Highland in 1996.

There is no dispute that taxpayer and his brother were engaged in the trade or business of equipment leasing in 1996. The results were reported on Schedule C instead of Schedule E. There was no written rental agreement with Highland.

The corporation made the following equipment rental payments to the brothers:

Year	Paid to Robert (taxpayer)	Paid to Don (brother)
1995	\$69,600	\$40,091
1996	none	56,263

At Tax Court, Robert Blewett (taxpayer) testified that due to Highland's cash flow problems, he was paid no rental income in 1996. He stated "You pluck all the feathers off that bird, and it's not going to lay any more eggs." Therefore, Robert (taxpayer) reported a net loss on his 1996 equipment rental Schedule C of \$50,033 as he deducted expenses but reported no income.

Issue. Whether the \$50,033 reported loss was from a **rental activity** and therefore subject to the passive loss rules under I.R.C. §469.

Analysis. I.R.C. §469(a)(1) limits the deductibility of losses from certain passive activities. Generally, a passive activity includes the conduct of a trade or business in which the taxpayer does **not** materially participate. **However, a rental activity is generally treated as a passive activity without regard to whether the taxpayer materially participates** [I.R.C. §469(c)(1), (2), (4)]. A **rental activity** is defined as "any activity where payments are principally for the use of tangible property" [I.R.C. §469(j)(8)]. Robert Blewett (taxpayer) and the IRS agreed that his equipment leasing activity constituted a **rental activity**. As such, the loss from that activity is passive in nature, unless one of the exceptions listed in the regulations applies.

Robert Blewett asserted that his 1996 leasing activity should not be treated as a rental activity because it qualified under an **exception** pursuant to Reg. §1.469-1T(e)(3)(iv)(C).

This exception applies if rental income is "**incidental.**" In order to meet the "**incidental**" test, Robert Blewett had to meet the following tests:

1. His 1996 rental income had to be **less than 2%** of the lower of the equipment's cost basis or fair market value.
2. He had to own an interest in Highland, the closely held corporation which rented his equipment in 1996.
3. The equipment must have been predominantly used by Highland **either** in 1996 (the current year) or in two of the five years prior to 1996 (the years 1991-1995).

The IRS argued that taxpayer **did not qualify for this "incidental"** exception because his Schedule C rental activity and the business activity which rented the equipment (highland) were not conducted by the same entity.

Holding. The Tax Court concluded that taxpayer was entitled to treat the leasing activity as **incidental** to Highland's trade or business activities. Consequently, his leasing activity was not classified as a rental activity [Reg. §1.469-1T(e)(3)(ii)(D)].

In order to deduct his \$50,033 Schedule C rental loss for 1996, Robert Blewett had to meet the material participation standard under I.R.C. §469(c)(1). The IRS admitted that he worked full-time for Highland in 1996. The regulations under I.R.C. §496 permitted Robert to aggregate his activity in the C corporation with his own for purposes of meeting the material participation test. He easily met the 500-hour materials participation test.

Observation. The taxpayer chose to report the rental activity as a **trade or business** on Schedule C instead of on Schedule E. As a result, the \$50,033 loss could be used to reduce any potential self-employment tax liability. Whether the rental activity amounted to a trade or business is a question of facts and circumstances.

Unreasonable Compensation

***Veterinary Surgical Consultants P.C.*, 117 TC No. 14, CCH Dec. 54,527**

I.R.C. §3121

S Corporation Payments Were Wages

Facts. Veterinary Surgical Consultants, P.C. was an S corporation whose only business was providing consulting and surgical services to veterinarians. Dr. Sadanaga was the company's sole shareholder and served as its president and only corporate officer. All of the corporation's income was generated from services provided by Dr. Sadanaga.

Instead of receiving a regular salary from the company, Dr. Sadanaga withdrew money from the corporation's bank account at his discretion.

The corporation reported the amounts it paid to Dr. Sadanaga as distributions other than dividends paid from accumulated earnings and profits. Veterinary Surgical Consultants, P.C. did not issue a Form 1099-MISC or a Form W-2 to Dr. Sadanaga for 1994, 1995, or 1996. Nor did the company file a Form 941 or a Form 940.

Dr. Sadanaga reported the K-1 amounts for each year as nonpassive income on Schedule E. IRS treated his entire S corporation withdrawals as wages subject to FICA and FUTA.

Issue. Whether Dr. Sadanaga received wages from the S corporation equal to his corporate withdrawals.

Analysis. I.R.C. §3121(d)(1) statutorily defines an employee as “**any officer of a corporation**”. Compensation received by corporate officers is automatically considered wages. At Tax Court, the corporation argued that it qualified for Section 530 (of the 1978 Revenue Act) relief since it had consistently treated the withdrawals as distributions from accumulated earnings and profits.

Holding. The Tax Court rejected the corporation's argument for Section 530 relief. Consistency is immaterial if the consistent position taken is not reasonable. The court labeled the corporation's position that the withdrawals were paid from earnings as a “**subterfuge for reality.**” Rather, they constituted wages paid.

Note. This is a favorite issue of IRS examiners. S corporations must pay reasonable salaries to shareholder/employees. In many cases, the shareholder/employee is also a corporate officer.

Suspended Losses

Chief Counsel Advice 200223052

I.R.C. §1366

Corporate Merger Allowed S Corp. Shareholder to use Suspended Losses

S corporation losses suspended due to insufficient stock basis allowed against shareholder's C corporation stock basis after tax-deferred merger of the two companies

Facts. The shareholder's S corporation was merged into a C corporation in which he also owned shares. The merger qualified as a Type A reorganization under I.R.C. §368(a)(1)(A). Prior to the merger, the shareholder's basis in his S corporation was zero. At the same time, his basis in the C corporation stock was \$100. There were also \$150 in suspended losses attributed to the lack of basis rather than the I.R.C. §469 passive loss rules. Two separate blocks of stock existed (after the merger). The stock that he had always owned in the C corporation, with a basis of \$100, and the other, the new C corporation stock that he received for his S corporation stock as a result of the merger. He substituted his "old" S corporation basis of zero to the new stock. After the merger, and during the post-termination transition period (PTTP), he did not make any contributions to, nor did he receive any distributions from, the C corporation.

Issue. The FSA addressed whether the shareholder can take the suspended losses from the former S corporation and offset them against the \$100 historical basis that he had in his original shares of the C corporation. The new C corporation shares, as a result of the merger, have his old zero basis of the S corporation shares. The IRS agreed to the basis exchange. However, the \$100 basis in the old C corporation shares would have to be reduced to zero and the shareholder would still have \$50 carryover suspended loss which would expire at the end of the PTTP.

Analysis. A former S corporation shareholder may obtain additional C corporation basis, during the post-termination transition period by making a capital contribution. The suspended losses from the former S corporation can be taken against any basis that already exists in what is now C corporation stock. The basis being used is attributable to C corporation shares of an entity that already existed. Yet, since a tax-deferred merger (reorganization) occurred, the remaining entity is considered, in part, to be a continuation of the old company. The purpose behind I.R.C. §1366(d)(1) is to prevent shareholders from using losses that are not related to any corresponding economic outlays. Here, the shareholder made economic outlays in the form of his investment in the acquiring C corporation. Thus, the shareholder was allowed to use \$100 of this historic basis to offset up to \$100 of his former S corporation losses, with the remaining \$50 being permanently disallowed, once the PTTP had expired.

Holding. The shareholder of a target S corporation, who simultaneously was a shareholder of the acquiring C corporation, was allowed to use his suspended losses from the S corporation against the historic basis in the C corporation stock. However, he also had to reduce his historic basis in that C corporation stock by the amount of losses taken. To the extent that the suspended losses exceed the C corporation stock basis, the excess would permanently be disallowed.

CREDITS

EITC

Rafael Barajas, T.C. Summary Opinion 2002-59 (May 28, 2002)

I.R.C. §32

Brother Allowed to Claim EITC for Siblings

Facts. Mr. Barajas lived in an apartment with his mother and three younger siblings. He was employed and furnished the financial support for the family. He paid the rent and the household bills. His mother suffered from cancer, was on crutches and could not speak English. Rafael assisted the siblings with their homework and assisted with their discipline. The mother set the house rules but expected Rafael to enforce the rules. An IRS exam resulted in disallowance of the earned income credit of \$4,562.

Analysis. To qualify the taxpayer for the earned income credit, a qualifying child must meet the residency, relationship and age tests. The only way the relationship test for siblings can be satisfied is for them to qualify as eligible foster children. To meet that test, the brother or sister must be an individual who the taxpayer "cares for as his/her own child." While the code and regulations do not define this term, the courts have determined that furnishing financial support alone does not meet the "care for as his/her own child" requirement.

Holding. The court held for the taxpayer. The taxpayer served as the father figure for his siblings and helped in their discipline.

DEDUCTIONS

Qualified Appreciated Stock

John C. and Tate M. Todd v. Commissioner, 118 TC No. 19, CCH Dec. 54,721 dated April 19, 2002

I.R.C. §170

No Appraisal for Non-Publicly Traded Stock Results in Deduction Limitation

It's important to read Form 8283 instructions carefully.

Facts. John and Tate Todd created the Todd Family Foundation on December 21, 1994. It was a Colorado nonprofit corporation established to support charities. John Todd owned 7% of the common stock of Union Colony Bancorp (UCB), a bank holding company that owned all of the stock of Union Colony Bank of Greely, CO. On December 27, 1994, Mr. Todd transferred 6,350 shares of UCB to the newly created foundation.

On the transfer date, shares of UCB were not listed on the New York Stock Exchange, the American Stock Exchange or any city or regional stock exchange. Nor were the shares regularly traded in the national or any regional over-the-counter (OTC) market for which published quotations are available.

Taxpayers attached a Form 8283, Noncash Charitable Contributions, to their joint 1994 Form 1040. Only Section A on page 1 of the Form 8283 was completed. **Section B, The Appraisal Summary on page 2 of Form 8283, was blank.** The instructions for Form 8283 state:

Which Sections to Complete

If you must file Form 8283, you may need to complete Section A, Section B, or both, depending on the type of property donated and the amount claimed as a deduction.

Section A. Include in Section A only items for which you claimed a deduction of \$5,000 or less per item. Also, include the following **publicly traded securities**, even if the deduction is more than \$5,000:

- Securities listed on an exchange in which quotations are published daily
- Securities regularly traded in national or regional over-the-counter markets for which published quotations are available
- Securities that are shares of a mutual fund for which quotations are published on a daily basis in a newspaper of general circulation throughout the United States

The following information was shown on Part 1, Information on Donated Property, **in Section A** on page 1 of taxpayers' 1994 Form 8283:

Date of Contribution	Donor's Cost or Adjusted Basis	FMV	Method used to determine FMV
Dec. 27, 1994	\$33,338	\$533,847	Sales of other shares at the same time

Because of the contribution limitations, taxpayers claimed the following as deductions on Schedule A for the donation of the 6,350 shares of UCB to the Todd Family Foundation:

Year	Charitable Contribution Deduction
1994	\$88,879
1995	152,692
1996	221,066
1997	56,906
Total	\$519,543

In an examination of taxpayers' 1994-1997 returns, the IRS disallowed all of the contributions shown above except \$33,338 (the cost basis), which was allowed for 1994.

Issue. Whether the allowable contribution deduction for the donation of the stock is the fair market value at the time of the donation or the lower cost basis.

Analysis. I.R.C. §170(e)(5)(B) defines qualified appreciation stock as follows:

“Qualified appreciation stock means any stock of a corporation

- for which (as of the date of contribution) market quotations are readily available on an established securities market, and
- which is capital gain property.”

Before and throughout 1994, the procedure for someone wishing to purchase or sell shares of UCB was to contact an officer of the bank or a local stockbroker specializing in shares of UCB. The bank or broker would try to match a potential seller with a potential buyer. That could provide difficult, since UCB shares were not frequently sold.

Holding. The Tax Court agreed with the IRS that the shares were not qualified appreciated stock, and also agreed that taxpayers failed to comply with the appraisal requirements of I.R.C. §170.

Note. The Tax Court rejected the Todd's argument that the market quotations requirement was satisfied because Bancorp shares were “occasionally traded by Gill & Associates. Gill is a local broker who was a member of the National Association of Securities Dealers who acted as a placement agent for certain of the sales of the shares. Merely setting the price was not the same as the stock being formally traded on an exchange.

Donated Vehicles

IRS News Release IR-2001-112

I.R.C. §170

Audit Program to Focus on Vehicle Donations

- Valuation must be objective and realistic.
- The charity must be eligible and the donated vehicle must be used for a tax exempt purpose.
- The required documentation, Form 8283 and transfers of title and registration must be completed.

The IRS and state charity officials issued a consumer alert to assist taxpayers in avoiding potential pitfalls when donating their cars to charity. Taxpayers should:

1. Ensure the organization is a qualified charity,
2. Examine state filings for more information,
3. Ask questions about how the donated vehicle will be used,
4. Itemize their deductions in order to benefit,
5. Calculate and deduct only the vehicle's true fair market value, and
6. Document the charitable contribution deduction.

Note. The IRS is concerned many taxpayers are inflating the true fair market value of their vehicles. Some advertisements for these programs even promise tax breaks for non-itemizers, which is incorrect. As a result, the IRS has stated it will continue its audit program in this area.

Weight Loss Programs Revenue Ruling 2002-19 I.R.C. §213

Obesity May Be a National Health Problem

IRS to allow itemized deductions and payments from flexible spending accounts for some weight loss programs which treat obesity

The IRS now allows a medical deduction for participating in a weight-loss program (this would include the cost of prescription drugs) as treatment for a specific disease which has been diagnosed by a doctor. However, the cost of diet food will continue to be nondeductible. No deduction is allowed for cosmetic weight-loss programs since these are intended to improve a person's general health or appearance. Amended returns can be filed for open years to claim the deduction.

Note. See Chapter 9: Itemized Deductions for more information and examples explaining this Revenue Ruling.

Law School Costs

Stephen and Sara Galligan v. Commissioner, T.C. Memo. 2002-150, CCH Dec. 54,785(M) dated June 13, 2002
I.R.C. §162

IRS Disallows Law School Tuition as Education Expense

Facts. Sara Galligan was an academic and law librarian for 25 years. Her duties consisted of legal research, and overall management and administration of the law library. She attended law school, received her law degree, and was admitted to the bar. Sara deducted her costs of law school. The IRS disallowed them contending that the education was not required by her employer and did not qualify her for a new occupation.

Analysis. While the education improved her law librarian skills, it was not a requirement of the job. Her job description called for a law degree or at least two years experience as a law librarian. I.R.C. §162 allows a deduction for ordinary and necessary expenses in carrying on a trade or business. To be deductible the education must meet at least one of the following two tests:

- The education is required by the employer or by law to keep the employee's present salary, status, or job. The required education must serve a bona fide business purpose of the employer.
- The education maintains or improves skills needed in the employee's present work.

However, even if the education meets one or both of the above tests, it is not qualifying education if it:

- is needed to meet the minimum education requirements of the employee's present trade or business, or
- is part of a program of study that will qualify the employee for a new trade or business.

Holding. The Tax Court agreed with the IRS. The education qualified the taxpayer to enter the practice of law if she chose.

Rebate Programs
Letter Ruling 200228001
I.R.C. §170

Charitable Contributions Made Through Credit Card Programs

- Rebate, but not fixed percentage programs, can produce deductible charitable contributions.
- Even with rebate programs, taxpayer must make affirmative election to donate proceeds.

Background. A number of credit card companies offer taxpayers a chance to indirectly make charitable contributions, usually through a rebate based on a percentage of purchases made on the card.

Purpose. This letter ruling clarifies that **the method selected for making the contributions** can effect **whether a tax deduction will be granted or not.**

Analysis. Under a rebate program, the rebate can be paid either to a designated charity or the card holder. If the rebate is paid to the charity, the transfer must be **irreversible**. The charity must be furnished with the amount of the donation and the cardholder's name and address. This permits the charity to substantiate to the donor gifts in excess of \$250 in a timely manner. The card holder must be given the choice to receive the rebate in cash or to make a donation.

Conclusion. Rebate programs can qualify for charitable contributions purposes if certain procedures are met. However, contributions made through a basic point system are **not** deductible. The reason is a fixed percentage of the purchases are donated to the charity with no choice by the card holder to receive a cash rebate.

Constructive Payment

Chief Counsel Advice 200225030

I.R.C. §164

☞ State Tax Deduction Allowed for Taxes Paid by Company

Constructive treatment as wages means employees are entitled to offsetting itemized deductions for deemed payment of state income taxes by the employer.

An employee failed to pay his state income taxes. The employer decided to pay them for the employee. The company properly treated the paid taxes as additional wages and included them on the employee's W-2 form. The IRS agrees that the taxes could be deducted as an itemized deduction by the employee and deducted as compensation by the employer.

DEPENDENCY ISSUES

Dependent Exemption

Matthew K. Morgan v. Commissioner, T.C. Summary Opinion 2002-2 dated March 11, 2002

I.R.C. §151

☞ No Evidence That Taxpayer Provided Over One-Half Of Support For Mother.

Facts. Matthew Morgan moved into his ailing mother's apartment in January 1997 to help with her care. He married in October 1997 and moved out of her apartment, although his 1997 return indicated she had lived with him the entire year. He claimed his mother as a dependent on his 1997 tax return. Mr. Morgan contended that he furnished over one-half of her support for 1997. The mother's only source of 1997 income was \$8,820 of Social Security benefits and Medicare benefits estimated as less than \$200/month. Matthew reported 1997 wages of \$44,799. The IRS disallowed the mother's exemption as the chief support test was not met.

Analysis. I.R.C. §152 defines the term dependent as certain individuals over half of whose support was received from the taxpayer during the calendar year. The determination of whether the support test is met involves analyzing support items and establishing dollar amounts for them.

Holding. Because Social Security benefits are included in the computation of total support, the taxpayer must, at a minimum, show that he provided more than \$8,820 towards his mother's support. While the court agreed that Matthew did provide support for his mother, it could not determine the amount he furnished. He could not provide any documentation to prove the amount of his support. In addition, the mother's total support figure for 1997 was unknown since she died that year and her records were misplaced.

Note. The computation for determining whether the support test has been met can be time consuming. Table 5 from IRS Pub. 501, *Exemptions, Standard Deduction, and Filing Information* is shown below.

Table 5. **Worksheet for Determining Support**

Funds Belonging to the Person You Supported	
1) Total funds belonging to the person you supported, including income received (taxable and nontaxable) and amounts borrowed during the year, plus the amount in savings and other accounts at the beginning of the year	\$
2) Amount used for support	\$
3) Amount used for other purposes	\$
4) Amount in savings and other accounts at end of the year	\$
(The total of lines 2, 3, and 4 should equal line 1)	
Expenses for Entire Household (where the person you supported lived)	
5) Lodging (Complete item a or b)	
a) Rent paid	\$
b) If not rented, show fair rental value of home. If the person you supported owned the home, include this amount in line 19.	\$
6) Food	\$
7) Utilities (heat, light, water, etc. not included in line 5a or 5b)	\$
8) Repairs (not included in line 5a or 5b)	\$
9) Other. Do not include expenses of maintaining home, such as mortgage interest, real estate taxes, and insurance.	\$
10) Total household expenses (Add lines 5 through 9)	\$
11) Total number of persons who lived in household	
Expenses for the Person You Supported	
12) Each person's part of household expenses (line 10 divided by line 11)	\$
13) Clothing	\$
14) Education	\$
15) Medical, dental	\$
16) Travel, recreation	\$
17) Other (specify)	
	\$
18) Total cost of support for the year (Add lines 12 through 17)	\$
Did You Provide More Than Half?	
19) Amount the person provided for own support (line 2, plus line 5b if the person you supported owned the home)	\$
20) Amount others provided for the person's support. Include amounts provided by state, local, and other welfare societies or agencies. Do not include any amounts included on line 1.	\$
21) Amount you provided for the person's support (line 18 minus lines 19 and 20)	\$
22) 50% of line 18	\$
Is line 21 more than line 22?	
Yes. You meet the support test for the person. If the other exemption tests are met, you may claim an exemption for the person.	
No. You do not meet the support test for the person. You cannot claim an exemption for the person unless you can do so under a multiple support agreement. See <i>Multiple Support Agreement</i> later in this publication.	

Dependency Exemption

Chief Counsel Advice 200224005

I.R.C. §151

IRS Pub. 501, Exemptions, Standard Deduction, and Filing Information, Contains Mistake

Flowchart in publication misleading—divorce decree must unequivocally award noncustodial parent the dependency exemption

The error involves a chart on page 16 of the publication. It indicates that if a custodial parent fails to sign a Form 8332, which releases the dependency exemption to the noncustodial parent, the other parent can still take the exemption if a post-'84 court decree expressly awards it to that parent. That statement is **not** entirely correct. The parent with custody must have signed the order, and the decree must have all data otherwise required on Form 8332...child's name, tax years involved, etc. The IRS has indicated the mistake will be corrected in the 2002 edition of the publication.

Dependency Exemption

Steven G. Wilkerson v. Commissioner, T.C. Summary 2002-37

I.R.C. §151

Support Test for Dependent Must Be Substantiated

Dependent fails to meet relationship, member of household and support tests.

Facts. In 2000, Steven Wilkerson claimed a dependency exemption deduction for a child, Christopher Simon (Christopher), who was identified on the return as his son. He also claimed an earned income credit and a child care credit based on Christopher as the qualifying person. He also claimed head-of-household filing status.

The claimed dependent, Christopher, was born on April 21, 1987. His birth certificate did not list a father. The mother listed on the certificate was Sonja Michelle Simon. The taxpayer was never legally married to Sonja, although the two had lived together for several years. That arrangement resulted in the birth of one son, who was not claimed by the taxpayer as a dependent on his 2000 tax return. At the time Christopher was born, taxpayer and Sonja were no longer living together.

During 2000, Steven lived with his mother in a house owned by his brother. The monthly mortgage payment on the house was \$750. Steven stated he paid \$300 per month for his part of it, paid one of the utility bills each month, and contributed a small amount for the household food budget. The remainder of Christopher's support was paid by the Steven's mother. Christopher did not live with Steven all of 2000, as Christopher was "in and out of the house" throughout the year. Steven estimated that Christopher lived with him in his brother's house for at least six months in 2000.

No formal evidence was submitted to the court establishing the exact amount of time Christopher lived with Steven during 2000. In addition, no evidence was presented to establish the amount of support Steven actually provided for Christopher in 2000. However, neither Steven's mother, nor Sonja could provide any records regarding Christopher's support.

Issues. The issues for decision are:

1. Whether taxpayer is entitled to a claimed dependency exemption deduction under I.R.C. §151
2. Whether taxpayer is entitled to head-of-household filing status under I.R.C. §2(b)

3. Whether taxpayer is entitled to the earned income credit under I.R.C. §32(a)
4. Whether taxpayer is entitled to the child care credit under I.R.C. §21

Analysis. I.R.C. §151(c) allows taxpayers to deduct an annual exemption amount for each dependent as defined in I.R.C. §152. Under I.R.C. §152(a), the term “dependent” means **certain individuals over half of whose support was received from the taxpayer during the taxable year**. Eligible individuals who may be claimed as dependents include, among others, a son or stepson of the taxpayer.

In order to claim an exemption for a dependent, the dependent must meet all five of the following tests:

1. Member of household or relationship test
2. Citizen or resident test
3. Joint return test
4. Gross income test
5. Support test

In order to meet the first test, the dependent must **either**:

- live with the taxpayer for the **entire year** as a member of the taxpayer’s household, or
- be related to the taxpayer in the eight ways enumerated in I.R.C. §152.

A special rule applies to foster children. A foster child must live with the **taxpayer** as a member of the household for the **entire year** to qualify as a dependent.

In order to meet the fifth test, the **support** test, the total **support amount for the year must be known**. If the total support amount is not established, it is generally impossible to conclude that any taxpayer has furnished more than 50% of the support for the dependent.

Holding. The Tax Court judge was not convinced that Christopher was the taxpayer’s son or stepson. Therefore, the **relationship** portion of the first test was **not** met. Since Christopher did not live with taxpayer for the **entire year of 2000**, the **member of the household** portion of the first test was **not** met either.

In addition, the total support amount for 2000 was unknown. Therefore, the support test was not met. As a result, the Tax Court upheld the IRS determination which negatively answered the four issues previously shown.

DIVORCE ISSUES

Social Security Benefit

Thomas W. McAdams v. Commissioner, 118 T.C. No. 24

I.R.C. §86

Court Declines to Explore the Quality of a Marriage

The married filing separately and **lived apart** standard for calculating taxable Social Security benefits was not met.

Facts. Thomas McAdams and his wife were estranged, but not legally separated or divorced in 1998. During that year, Mrs. McAdams lived in her home in Boise, Idaho. Thomas stayed at the Boise home more than 30 days in 1998, but the couple kept separate bedrooms. Their children also lived in Boise. Thomas used the Boise address as his mailing address and also stored items there. For seven months in 1998, Thomas lived in Alaska, and the rest of the year he lived and traveled in the West.

During 1998, he stayed at the Boise home about 30 days, parked the trailer in the driveway, and slept in the house. Thomas received military retirement pay and Social Security benefits and filed a 1998 income tax return as married-filing-separately. When he completed the Social Security Benefits worksheet, he listed \$25,000 as his base amount **because he believed he lived apart from his wife for the entire year.** On his 1998 return he reported the SSA benefits received but reported zero taxable benefits. The IRS issued a deficiency notice reducing his base amount to zero. The tax result was that \$9,218 of his SSA benefits was taxable.

Issue. Whether the taxpayer **lived apart** from his wife and therefore qualified to use a \$25,000 base amount on the Social Security Benefits Worksheet in the 1998 Form 1040 Instructions.

Analysis and Holding. Thomas contended that he **lived apart** from his wife 1998. His theory was that he **merely visited** his wife for approximately 30 days during the year. The Tax Court did not agree. Rather, living apart means **living in separate residences** every day of the year. Since Thomas did not satisfy this requirement, the IRS deficiency was correct.

EMPLOYMENT TAX ISSUES

Health Reimbursement Arrangements
Revenue Ruling 2002-41, Notice 2002-45
I.R.C. §§105 and 106

Health Reimbursement Arrangements Guidance Provided

The IRS has provided guidance for health reimbursement arrangements (HRAs) which are expected to be widely used by employers.

Health reimbursement arrangements (HRAs) can be established by employers in conjunction with a major medical plan that provides for high-deductible medical coverage. An HRA is similar to an Archer Medical Savings Account (MSA); however, it is more flexible. Many health insurance experts are predicting that HRAs could be the most popular trend in health coverage since health maintenance organizations (HMOs).

Key features of **HRAs** include:

1. The plan must be funded solely by the employer and cannot be funded by salary reductions of employees.
2. The only benefit an HRA plan may provide is reimbursement of substantiated medical expenses for employees and their family members
3. A maximum reimbursement amount must be established for each coverage period, which is usually a calendar year. Any unused portion of the annual reimbursement limit can be carried over to later years. In other words, the “use-it-or-lose-it” rule does not apply.

Note. Employers hope that the carryforward feature will encourage employees to be more cautious and judicial in deciding which medical expenses are to be reimbursed. If this expectation materializes, employers may be able to reduce their overall health expenses.

4. The HRA employer reimbursements made to employees are tax-free fringe benefits.
5. Employers may continue HRA plans for former employees, including retirees.

Revenue Ruling 2002-41 provides two informative factual situations. The Notice and the Revenue Ruling are contained in Internal Revenue Bulletin 2002-28.

Trust Fund Recovery Penalty

***U.S. v. Mitchell*, No. 00-45, District Court, N.J., 2002-2 USTC ¶50,537(CCH)**

I.R.C. §6672

President's Resignation Does Not Shield Him from Trust Fund Penalty

Subsequent resignation had no effect if responsible person withheld payroll taxes that were not paid to government.

Analysis and Holding. A District Court determined that the taxpayer, president of his company, was a **responsible person** and thus was subject to the trust fund recovery penalty. It was irrelevant that the taxpayer submitted a resignation in an attempt to shield himself from liability for the unpaid employment taxes. He was the responsible person during the time the noncompliance occurred.

Trust Fund Recovery Penalty

***U.S. v. Adam*, No. 01-10445, CA-5 (5th Circuit Court of Appeals), 2002-2 USTC ¶50,502(CCH)**

I.R.C. §7202

6-Year Statute of Limitations Applied to Missing Payroll Taxes

The 5th Circuit **affirmed** a District Court's decision which held that the 6-year statute of limitations should apply to a responsible person who **willfully** failed to account for, and pay, payroll taxes.

Auto Salespeople

Revenue Procedure 2001-56

I.R.C. §132

Use of Dealer Car Has Restrictions for Treatment as a Tax-free Fringe

- It is critical to have a written policy in place which limits personal use.
- New inclusion table for calculating Form W-2 wage implications.
- Must be a full-time salesperson to receive tax benefits.

Use of dealer cars by sales staff can be a tax-free benefit provided certain guidelines and restrictions are met. The IRS has developed a specific list of rules that dealers can apply to determine if the value of car use by full-time salespeople may be excluded. These new procedures will minimize controversies that arise when car dealers are audited. They can be adopted by dealerships for the 2002 tax year.

The most important restriction is that the dealer must have a **written policy limiting personal use** of dealer autos to avoid a taxable fringe benefit. The restriction is defined as up to 10 miles a day, **disregarding** commuting. In addition, the cars must be driven only within the local sales area. Consequently, the dealer cars cannot be used on vacation trips or by other family members. Employees must substantiate the usage of the automobiles. For these purposes, the IRS drafted a model agreement that dealers can adopt.

Note. The IRS created a new inclusion table that dealers can use to calculate the amount of income they must add to an employee's W-2 wages for each day of **personal use**. Normal withholding rules apply to the inclusion amounts. For the complete details, see Rev. Proc. 2001-56.

The daily amount to be added to a full-time salesperson's wages for personal use is:

Value of Dealer Auto	Daily Inclusion Amount
\$0 – \$14,999	\$3
\$15,000 – \$29,999	6
\$30,000 – \$44,999	9
\$45,000 – \$59,999	13
\$60,000 – \$74,999	17
\$75,000 and above	21

Medical Residents

Chief Counsel Advice 200145040

I.R.C. §3121(b)(10)

Medical Residents' Pay Not Always Exempt From FICA Taxes

Background. By law, the wages of students employed by a school, college or university are **not** subject to employment taxes. Currently, the IRS is flooded with refund claims from hospitals for payroll taxes on the wages of their medical residents. However, teaching hospitals which are **not officially** connected to a medical school are **ineligible** for the FICA exclusion according to this CCA.

Job vs. Schooling. Hospitals are **not** technically considered to be schools because their primary purpose is to provide patient care. The IRS admits the result might be different if a hospital is closely associated with a university. In that case, the pay of its medical residents would not be subject to FICA taxes.

Medical Residents

Chief Counsel Advice 200212029 (modifies CCA 2001450-40 shown on previous page)

I.R.C. §3121(b)(10)

Medical Residents Subject to Employment Taxes

Background. The IRS concluded the services provided by medical residents are not incident to and for the purpose of pursuing a course of study. As a result, residents should **not** be entitled to the student exception for FICA since they are engaged in a structured form of on-the-job training.

Recent Litigation. Based on an 8th Circuit case (*Minnesota v. Apfel*, 151 F.3d 742) regarding medical residents and their status as students, the IRS has been receiving numerous refund claims for FICA taxes paid by medical residents claiming the student FICA exception. In that case, the 8th Circuit upheld a lower court's decision that medical residents were in fact **students** since they were:

1. Enrolled at the university,
2. Paid tuition, and
3. Were registered for approximately 15 credit hours each semester.

Analysis. Generally, employment taxes can apply to such situations in one of two ways:

1. A medical resident's wages can be subject to FICA under a specific agreement between the state and the Social Security Administration in order to secure coverage for retirement.
2. If a specific agreement is not in place, I.R.C. §§3101–3126 controls. I.R.C. §3121(b)(7)(F) states that state and local government employees are covered under FICA unless they participate in a retirement system that provides them with minimum retirement benefits that are comparable to those provided under the Social Security system.



Disguised Wages

Shotgun Delivery, 9th Circuit Court of Appeals., 00-15495

I.R.C. §3121

District Court Decision Upheld on Disguised Wages to Delivery Drivers

Nonaccountable auto expense allowances are wages.

Facts. A courier service paid its drivers an auto expense allowance for point-to-point deliveries. The allowance was based on a percentage of the customer's fee rather than a fixed cents-per-mile. As such, they were made under a **nonaccountable** plan and were **reclassified by the IRS as wages**.

Analysis. Crucial to the court's decision was the fact that the drivers were not required to keep logs of the miles driven or to return excess reimbursements.

Holding. In affirming the District Court's decision, the Appeals Court stated that the allowance arrangement was an abusive nonaccountable plan.

Notes.

1. One interesting point in this case is that the taxpayer relied on its accountant's advice in devising the allowances. As a result, the Appeals Court reversed the District Court and removed the failure to pay penalty. Since the delinquent payroll taxes, interest and penalties exceeded \$450,000, this was a substantial benefit to the taxpayer.
2. See pages 619-20 in the *2000 Farm Income Tax Workbook* for a thorough analysis of the original District Court case decision.

Disguised Wages

Revenue Procedure 2002-35

I.R.C. §§3121 and 3401

Rental Payments to Employees Using Own Property to Perform Tasks

The IRS insists accountable plan rules must be followed to avoid rental income from being reclassified as wages.

Background. Some employees, such as truck drivers, couriers, carpenters, builders and auto mechanics, use their own tools or equipment in performing tasks or otherwise providing services to their employers. Attempts have been made to characterize some of the compensation paid to these employees as rental income for the use of their tools or other equipment. This approach was based on Rev. Rul. 68-624. The IRS has formally revoked that ruling. However, employment taxes are not applicable if the rental income is paid under an accountable plan.

Rev. Rul. 2002-35. In this latest update on the topic, the IRS uses **two examples** to distinguish whether **wages** or **legitimate rents** have been paid. The first involves a welder and a heavy equipment mechanic employed in the pipe-line construction industry. These **employees** must provide their own equipment, including a truck with extensive rigging, which is maintained and insured by one of the employees. However, the underlying facts revealed that strict adherence to the normal **accountable plan** rules were **not** followed. As a result, **all payments made to these employees were treated as wages** subject to employment taxes and withholding rules.

Observation. The IRS avoided any discussion as to whether a **separate** rental arrangement existed. The IRS says that the ruling is not intended to provide guidance regarding the treatment of payments for equipment, including vehicles, provided by independent contractors.

Effective Date. Rev. Rul. 2002-35 applies to payments made **after October 13, 1988**, the date that accountable plans were adopted. A transitional rule applies to employers who actually made **rental payments separate from wages** for the use of employee-provided equipment and who reported the payments on timely issued Form 1099-MISCs **for calendar years beginning before January 1, 2002**. These employers may **continue** to use this method for tax years ending **on or before December 31, 2002**.

Worker Classification

***Ewens and Miller, Inc.*, 117 TC No. 22, CCH Dec. 54,561**

***N. Louisiana Rehabilitation Center, Inc.*, District Court, LA, 2002-1 USTC ¶150,106**

I.R.C. §3121

IRS Continues to Contest Worker Classifications

Background. This contentious issue of employee vs. independent contractor continues to be raised in IRS examinations. In two recent cases, discussed below, the IRS had mixed results, winning one while losing the other.

Bakery Attempts to Limit Its Liability. In the first case (*Ewens and Miller*, 117 TC No. 22), a bakery erroneously misclassified its workers as independent contractors, according to the Tax Court. The company had converted its **entire** workforce to contractor's status to eliminate its employment tax liability. The company's excuse for the conversion was that several employees had left walnut shells in cookies and nails in brownies. The Tax Court determined the company "had no reasonable basis in the tax law to justify the switch."

Medical Clinic Relies on Its Advisors. In the second case (*N. Louisiana Rehabilitation Center*, Dist. Ct., LA.), a clinic relied on its tax advisers and consistently treated its doctors as independent contractors. Forms 1099-MISC were issued each year. The District Court barred the IRS from reclassifying the workers as employees.

Congress Steps In. In the bakery case, the IRS determined that workers should be treated as employees. After the Tax Court decision, Congress amended **I.R.C. §7436(a)** to give the Tax Court retroactive jurisdiction to hear employment tax cases. This legislation was contained in the Community Renewal Tax Relief Act of 2000.

Note. See Issue 8 in Chapter 3: Small Business Issues for the new IRS guidelines for determining employee vs. independent contractor status.

Worker Classification

Notice 2002-5 (modifies and supercedes Notice 98-43)

I.R.C. §7436

Guidance on Tax Court Review of Employment Tax Determinations

Purpose. The IRS has provided guidance on how employers may petition for Tax Court review of employment tax determinations under **I.R.C. §7436**. Attached to Notice 2002-5 is a new "Notice of Determination Concerning Worker Classification." For employers whose workers are the subject of an employment tax determination, the Notice of Determination will be the "determination" that is a prerequisite to invoking the Tax Court's jurisdiction under I.R.C. §7436.

Trust Fund Recovery Penalty

***Dogwood Forest Rest Home, Inc.*, District Court, N.C., 2002-1 USTC ¶150,194**

I.R.C. §7501

Owner Still Responsible When CPA Failed to Handle Payroll Taxes Properly

Facts. The owner of a rest home corporation thought he had his tax matters resolved when he delegated all recordkeeping, tax return filings and payroll tax deposits to his CPA. But, when the CPA failed to comply with employment tax requirements, the IRS assessed the trust fund recovery penalty against the owner.

Holding. The District Court agreed with the IRS, finding the owner did **not** have a reasonable cause for the untimely deposits and unfiled tax returns since he ultimately had control over the CPA's work but elected not to exercise it. The court was aware that the owner had no knowledge of the three years of unfiled returns and unpaid tax until an IRS revenue officer visited him at his office.

Withholding Requirements

CC Action on Decision 2001-08

I.R.C. §3121

☞ **IRS Refuses to Acquiesce in Early Retirement Case**

Background. North Dakota State University (NDSU) offered early retirement payments to tenured faculty members and administrators whose age plus years of service equaled 70 years. Under the retirement agreement, tenured faculty members agreed to give up their tenure rights, and administrators agreed to give up their notice of termination rights.

Before 1991, NDSU withheld FICA taxes from both types of early retirement payments. Then, NDSU requested advice from the local IRS office and the Social Security Administration (SSA) as to the taxability of the payments. The SSA advised NDSU that a payment to secure the release of an unexpired contract of employment should **not** be considered wages. Thereupon, NDSU ceased withholding FICA taxes from the early retirement payments. The IRS countered that the payments were taxable wages, so NDSU paid the tax assessments and sought a refund.

Analysis. The 8th Circuit Court of Appeals found that under the retirement program, the tenured faculty received money in exchange for their contractual and constitutional rights to tenure, and therefore the money should **not** be subject to FICA. The IRS is now confirming that it disagrees with that analysis that tenure is **not** similar to the employment rights described in Rev. Rul. 75-44. In addition, the IRS disagrees with the court's reliance on Rev. Rul. 58-301 as support for its conclusion that payments to relinquish rights under the contract should **not** be considered wages for FICA purposes.

Holding. The IRS has refused to acquiesce in *North Dakota State University v. U.S.*, 84 F. Supp. 2d 1043, (N.D. 1999), *aff'd*, 255 F.3d 599 (8th Cir. 2001).

Note. The IRS admitted that it does recognize the precedential effect the decision will have on cases that may be appealed to the 8th Circuit (AR, IA, MN, MO, NE, ND, and SD). Thus, it will follow any case in that circuit with the **same** facts. Outside those states, it will continue to contest the issue.

Payment In-kind

Highway Farms, Inc. v. U.S., District Court, IA(2002), 2002-1 USTC ¶150,281(CCH)

I.R.C. §3121(a)(8)(A)

☞ **Payment In-kind of Hogs Treated as Disguised Cash Bonuses**

Facts. The family farm corporation gave the hogs to two of its officers as a bonus a few days before the animals went to market. The corporation marketed the hogs for the officers and gave the net sales proceeds to them.

Holding. The court determined that the hog bonuses were **not bona fide transactions with economic substance**. Instead, the court agreed that they were disguised cash transfers whose sole purpose was tax avoidance. Therefore, the value of the hogs was wages to the officers and subject to FICA tax.

Notes.

1. The District Court determined the transaction lacked economic substance in spite of extensive paperwork documenting it. Two factors were instrumental in influencing the district court's decision. They were:
 - The officers' hogs were intermingled with the corporate-owned hogs on the corporate truck when marketing occurred.
 - The officers were the **only** corporate employees who were paid in-kind.
2. See Issue 8 in Chapter 4: Agricultural Issues for complete details on this issue.

Tips

***U.S. v. Fior D'Italia Inc.*, U.S. Supreme Court (June 17, 2002), 89 AFTR 2d 2002-2883, 2002-1 USTC ¶150,261 (CCH) I.R.C. §3401**

IRS Allowed To Use Estimated Method to Determine Tip Income

Background. In a significant defeat to the restaurant industry, the Supreme Court determined that the IRS has broad powers to collect FICA taxes on estimated cash tips. The Court sanctioned the authority of the IRS to estimate the amount of cash tips received by employees **based on a reasonable method**. This estimate would then be used to also determine the employer's share of any FICA taxes.

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 tax 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% for 1991** and **14.20% for 1992**. 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 Forms 4070. Fior challenged the assessment method in district court, arguing that it exceeded the IRS's authority.

The IRS appealed to the 9th Circuit Court of Appeals. The 9th Circuit upheld the district court decision in 2001. The IRS then appealed to the Supreme Court.

Analysis. The Supreme Court rejected the restaurants' contentions which are summarized below:

1. Any FICA tax assessment against it should be based on **each** employee's computation of tips received, not on an estimate.
2. The estimate method used by IRS tended to overstate the amount of employee tips. The restaurant contended that cash customers generally leave smaller tips compared to customers who charge.
3. The estimate method used by the IRS can result in FICA tax on tips that are exempt from FICA:
 - a. Part-time employees who do not receive \$20 per month in tips.
 - b. Tips received by employees whose tips plus wages exceed the annual FICA wage base.
4. The estimate method used by the IRS is unfair.

Holding. Reversing the 9th Circuit, the Supreme Court, in a 6-3 vote, agreed with the IRS that its aggregate estimation method is reasonable and therefore legal.

Social Security Wage Base

I.R.C. §§1402 and 3401

☞ Social Security Wage Base for 2003

Note. The official confirmation of the information shown below will be released via a Social Security Administration News Release and Fact Sheet in mid-October 2002 (after this book is printed).

The Social Security wage base will rise \$2,400 to \$87,300 for 2003. This is the smallest dollar increase since 1995. Several factors, including the sluggish economy, have contributed to the modest \$2,400 increase from the 2002 wage base figure. The FICA and Medicare tax rates remain unchanged for 2003.

ESTATE AND GIFT

Statute of Limitations

Chief Counsel Advice 200221010

I.R.C. §6501

☞ Properly Disclosing Gift Critical for Running Statute of Limitations

This Chief Counsel advice determined that because the taxpayer did **not** disclose certain gifts “in a manner adequate to apprise the IRS of the nature and amount of the gifts,” the period of limitations for assessing gift tax should be held open **indefinitely**.

Joint Tenancies

Therese Hahn v. Commissioner, 110 T.C. 140 (1998); Action On Decision, CC 2001-06

I.R.C. §2031

☞ IRS Conceding on Issue of Joint Tenancies Set Up Before 1977

Facts. Mr. Hahn and his wife jointly owned shares of a co-op apartment at the time of his death in 1991. His wife reported 100% of the date-of-death fair market value of the shares on his estate tax return. She later reported no gain from her 1993 sale of the shares since the sales price equaled the stepped-up basis. The IRS countered that a gain should be recognized since her basis was equal to 50% of the date-of-death value.

Analysis. TRA'96 added I.R.C. §2040(b)(1), which creates an **automatic rule** whereby 50% of the value of a “qualified joint interest” is includible in the decedent’s gross estate, **effective for joint interests created after 1976**. However, in several court cases, surviving spouses relied on the **contribution rule** rather than the 50% rule favored by the IRS. All of these court cases involved joint tenancies **created prior to 1977**. Therese Hahn relied on this **contribution rule** as explained in the **Facts**. Her position prevailed at Tax Court in 1998.

Result of CC 2001-06. The IRS announced it acquiesced to the *Hahn* Tax Court decision. Consequently, the IRS will **no longer challenge the contribution rule for joint tenancies created prior to 1977**.

Notes.

1. The result of this change in position by the IRS can result in sizable tax savings for surviving spouse. When they later sell the inherited asset, their basis will be 100% of the date-of-death fair market value. Of course, this tax benefit will affect only those surviving spouses who can prove that the deceased spouse contributed 100% of the funds to acquire the jointly-owned asset.
2. See Issue 9 in Chapter 4: Agricultural Issues for complete details on this important IRS Chief Council Advice.

Co-ownership of Property

Revenue Procedure 2002-22 (supercedes Rev. Proc. 2000-46)

I.R.C. §1031

IRS to Rule on Undivided Fractional Interests in Rental Realty

Purpose. This Rev. Proc. specifies the conditions under which the IRS will consider a request for a ruling that an **undivided fractional interest** in rental real property will not be considered an interest in a business entity, thereby making it **eligible** for a like-kind exchange.

Analysis. Under Reg. §§1.761-1(a), 301.7701-1 and 310.7701-3, the definition of a partnership for federal tax purposes does **not** include **mere co-ownership of property where the owners' activities are limited to keeping the property maintained, in repair, rented or leased.** Nevertheless, many courts have held that a partnership for federal tax purposes is broader in scope than the common law meaning of partnership and therefore could include co-ownership arrangements **not** commonly classified as such under state law.

As a result, co-owners of business or investment property have continued to inquire, for example, whether they could exchange an interest in land for a one-fifth interest in a strip shopping mall. The tax detriment is that the gain could **not** be deferred if the co-ownership arrangement received or relinquished in the exchange is treated as a partnership for federal income tax purposes.

Holding. If certain conditions are met, it is possible for co-owners of property which is not considered to be partnership property, to qualify for a like-kind exchange.

Notes.

1. Another disadvantage, besides the inability to qualify for a like-kind exchange if a partnership interest is involved, is that the partnership activity should be reported on Form 1065.
2. In this Rev. Proc., the IRS established:
 - a limit of up to 35 co-owners, and
 - the precondition that the co-owners actually possess the right to partition the property.

Disclaimers

Thomas J. Walshire v. U.S., 89 AFTR 2d 2002-2215 CA-8 (8th Circuit Court of Appeals) 2002-1 USTC ¶60,439 (CCH), May 1, 2002
I.R.C. §2518

Taxpayers Must Disclaim All or Nothing

Facts. A decedent previously disclaimed the **remainder interest** in his brother's estate but retained the income from the property for his lifetime under Reg. §25.2518-3(b). When the check for the sale of the brother's property was received, it was made jointly in the name of the decedent and his children. The inheritance was used to purchase certificates of deposit from which the decedent received the interest income. Upon his death, the executor of his estate tried to exclude the value of the certificates from the decedent's estate.

Analysis. Reg. §25.2518-3(b) does not permit a **horizontal** division of property that is retaining a life interest while disclaiming the remainder interest. **While an undivided portion may be disclaimed, it must be** a vertical division. By definition, an **undivided** interest includes all of the rights associated with a fee interest and does not include an interest solely in the remainder.

Holding. The court held that the decedent did not make a qualified disclaimer and included the value of the certificates in the decedent's estate for federal estate tax purposes.

GROSS INCOME

Contingent Attorney Fees

Nancy J. Hukkanen-Campbell, CA-10 (10th Circuit Court of Appeals), 2002-1 USTC ¶150,351 (CCH), CCH Dec. 53,909 (M)
I.R.C. §61

Entire Award for Discrimination Must Be Included in Gross Income

- Entire award includible in gross income
- Miscellaneous deduction subject to 2% of AGI threshold
- Itemized deduction causes large AMT liability

Facts. Nancy Hukkanen-Campbell was awarded \$150,000 in a sexual harassment suit against her former employer. The judgment check from the defendant showed joint payees, Nancy and her attorney. The attorney's fee was \$73,400. Nancy kept the remainder of \$76,600. On her 1996 tax return, she reported only \$76,600 as gross income.

The IRS determined the entire \$150,000 award was includable in her gross income. The additional tax on the unreported \$73,400 was \$37,477, consisting of:

- \$20,075 of regular income tax
- \$17,402 of alternative minimum tax (AMT)

According to the IRS, Nancy owed AMT because her \$73,400 legal fee, most of which was allowable as a miscellaneous itemized deduction, **was not deductible for AMT purposes.**

The Tax Court agreed with the IRS and the taxpayer appealed the decision to the 10th Circuit Court of Appeals.

Issue. Whether the \$73,400 attorney's fees are includible in income under the assignment-of-income doctrine.

Analysis. The assignment-of-income doctrine was established by the Supreme Court in 1930. It holds that taxpayers can't assign income, to which they are legally entitled, to a third party without first paying tax on it.

The Tax Court, in the *Eldon R. and Susan M Kenseth* [114 T.C. No. 26 (May 24, 2000) (CCH Dec. 53,895)] decision, adopted the shotgun approach of I.R.C. §61 regarding this issue. According to the Tax Court, I.R.C. §61 is to be interpreted literally. In other words, gross income means **all** income from whatever source derived. In the *Kenseth* decision, the Tax Court held that **state lien statutes are irrelevant** in deciding the issue.

Five Federal Appeals Courts (the 3rd, 4th, 7th, 9th and Federal Circuits) agree with the Tax Court position. Three Federal Appeals Courts (the 5th, 6th, and 11th Circuits) hold that state law must be examined to determine if attorneys have a superior lien or ownership right in judgment of their clients.

Holding. The 10th Circuit Court of Appeals agree with five other Federal Appeals Courts and the Tax Court in this case. The court noted that the judgment was awarded to Nancy for her benefit, not to her attorney.

Note. See pages 321-323 in the *2001 Farm Income Tax Workbook* for a thorough discussion of this highly litigated issue. It is likely that the Supreme Court will settle this argument.

Property Tax Reduction Programs

Letter Ruling 200227003

I.R.C. §61

Property Tax Reduction Programs Create Taxable Income

These programs may create unexpected tax results for senior citizens.

Background. In a program that is becoming increasingly popular, cities and towns across the country are granting reductions in their property tax bills in return for volunteer services. Now, the IRS is making it clear that such arrangements will result in taxable income to these senior citizens. One example is Massachusetts where local municipalities have established programs which permit senior citizens to volunteer their services and receive up to a maximum \$500 in property tax rebates. This is calculated by multiplying the minimum wage rate by up to 60 hours of service each year. Under state law, these reductions are exempt from income and employment taxes.

Holding. In two separate advices (CCA 200025050 & 200132035), the Office of Chief Counsel has concluded that the reductions result in taxable income to the volunteers. In addition, they are subject to employment taxes.

Loans vs. Compensation

Antonio and Joyce Rosario, T.C. Memo 2002-70, CCH Dec. 54,683(M) dated March 26, 2002

I.R.C. §61

Guaranteed Payments Advanced to Surgeon Treated as Loans

Court agrees employee loan is a loan.

Facts. In order to entice Dr. Rosario, an orthopedic surgeon, to locate in their community, the local hospital guaranteed that his medical practice would generate \$400,000. Per the terms of the signed agreement, the hospital agreed to loan him the difference between \$400,000 and his annual net income.

In 1995, when the net income from his practice was only \$157,000, Dr. Rosario received a \$243,000 loan from the hospital. The agreement contained this clause:

“If and when you cease to practice medicine in Washington County, it is agreed that all outstanding loans will be repaid in full.”

When Dr. Rosario moved to another state in November 1998, the hospital tried to enforce the loan repayment clause in the agreement. As a result, Dr. Rosario assigned the outstanding accounts receivable of his practice to the hospital as partial payment of the loan balance. However, the value of the receivables declined substantially, and the hospital demanded immediate payment from him.

Issue. Whether the \$243,000 amount advanced by the hospital constituted a loan or gross income under I.R.C. §61.

Analysis and Holding. The Tax Court determined the \$243,000 was a **legitimate loan** for the following reasons:

1. A promissory note was executed which bore interest and required a balloon payment.
2. The hospital maintained a schedule of all payments made to and received from Dr. Rosario.
3. The hospital’s intent to enforce repayment was proven by the filing of a lawsuit in U.S. District Court to collect the unpaid loan balance.

INNOCENT SPOUSE

Innocent Spouse

Kathryn Cheshire v. Commissioner, 5th Circuit Court of Appeals, 89 AFTR 2d 2002-900, 2002-1 USTC ¶150,222 CCH Dec. 54,028

I.R.C. §6015

No Relief for Spouse with Actual Knowledge of Understatement

Facts. Kathryn and David Cheshire were divorced in 1994. They filed a 1992 joint tax return. In 1992 David received a \$229,924 retirement distribution of which \$42,183 was rolled over. The \$187,741 balance represented taxable income; however, only \$56,150 was reported as a taxable distribution.

Kathryn was aware of the retirement funds. Several large disbursements were made from their joint checking account in 1992. They paid off the couple’s home mortgage, purchased a car, and used the funds for living expenses. David prepared the couple’s joint 1992 return, and Kathryn questioned him about the tax ramifications of the retirement distributions. He falsely told her he had consulted a CPA and was advised to use the proceeds to pay off the mortgage. Kathryn accepted that and signed the return.

In August 1994, Kathryn received a letter from the IRS saying it had **not** received the joint 1992 return. On advice from a CPA, Kathryn immediately filed the return. The IRS later sent David and Kathryn a deficiency notice.

The IRS determined that **\$187,741 should have been reported** as a taxable distribution, **rather than the \$56,150 reported** on the delinquent 1992 joint return.

At Tax Court, Kathryn conceded that the correct taxable distribution was **understated by \$131,591** as shown in the the IRS notice of deficiency. However, she requested innocent spouse relief from the additional tax due on the \$131,591. The Tax Court denied her request.

Issue. Whether Kathryn was entitled to innocent spouse relief.

Analysis. Innocent spouse relief can be granted if the requesting spouse can prove the following:

- At the time the return is signed, the spouse **did not know or had no reason to know** that tax was understated [I.R.C. §6015(b)(1)(C)].

Note. The code section cited above refers to **regular** innocent spouse relief, not to the **separate liability** relief available to spouses who are no longer married. Kathryn argued that she was entitled to **separate liability** relief. If true, she could have relied on the less strict **actual knowledge** test.

Holding. Both the Tax Court and the 5th Circuit Court of Appeals agreed with the IRS and denied Kathryn innocent spouse relief. She was aware of the \$229,924 retirement distribution. She also knew how the \$187,741 balance that was not rolled over was spent. Therefore, she did **know or had reason to know** that the joint 1992 tax liability was understated. Consequently, she did not qualify for the “regular” innocent spouse relief.

The 5th Circuit Court of Appeals explained that Kathryn may have **mistakenly believed** that the portion of the \$187,741 that was used to pay off the mortgage was not taxable. However, the court determined that ignorance of tax law cannot be used to satisfy the requirements for **regular** innocent spouse relief.

The court also determined that Kathryn did not qualify for **separate liability relief** either. The reason given was that she had **actual knowledge** of the retirement distribution and how it was spent.

Finally, Kathryn did not qualify for the third type of relief, **equitable relief**. This was due to the fact that she **significantly benefited** from the large understatement of the joint 1992 tax liability. When she and David were divorced in 1994, she received the car and the residence. The car was purchased with a portion of David’s retirement distribution. The value of the residence she received was greater because part of the untaxed distribution was used to pay off the home’s mortgage.

Note. See pages 422-434 in the *1999 Farm Income Tax Workbook* for extensive coverage of the complex innocent spouse rules.

Innocent Spouse Relief

Patricia Mora, 117 TC No. 23 (Tax Ct.), CCH Dec. 54,565

I.R.C. §6015

Standard for Innocent Spouse Relief Discussed

Facts. Mr. Mora invested in a tax shelter which produced substantial losses claimed on the couple’s joint return. After her divorce, Pat Mora sought innocent spouse relief.

Analysis and Holding. Although Pat Mora **had reason to know** of the substantial tax understatement on their joint return, the Tax Court concluded she was entitled to **separate liability** innocent spouse relief. The court’s reasoning was she did not meet the **actual knowledge** test contained in I.R.C. §6015(c)(3)(C). The burden of proof for the “actual knowledge” test is on the IRS to show that it has been met by the taxpayer.

The Tax Court decided at the time she signed the return, she did **not have actual knowledge** of the tax shelter loss that produced the tax deficiency. Mr. Mora made the decision to invest in the tax shelter partnership. Pat did **not** sign any of the partnership documents presented as evidence in the trial.

Note. See pages 422-434 in the *1999 Farm Income Tax Workbook* for extensive coverage of the complex innocent spouse rules. Pages 432-434 explain the provisions of I.R.C. §6015(c), **Separate Liability Relief**, which is the basis for the Tax Court's decision in this case. Also, additional information is available in IRS Pub. 971, *Innocent Spouse Relief*.

Innocent Spouse Treasury Decision 9003 I.R.C. §6015

Final Regulations on Innocent Spouse Relief

Background. The IRS issued final regulations that contain guidance on innocent spouse relief under I.R.C. §6015. T.D. 9003 adopts the proposed regulations (Reg. §1.6015), published on January 17, 2001 with modifications.

Summary of Changes. Some of the more significant modifications include:

1. The final regulations adopt a **knowledge standard** for I.R.C. §6015(b) relief that is **consistent** with the knowledge standard developed under former I.R.C. §6013(e). In response to comments, the final regulations **eliminate** the exception in Reg. §1.6015-1(g)(3) of the proposed regulations that treated interest and dividend income from the **same** source as **one** item.
2. The **actual knowledge limitation** in Reg. §1.6015-3(c)(2) will **not** apply if a requesting spouse was the victim of domestic abuse before the return was signed and it is concluded that the spouse did **not** challenge the treatment of any items on the return for fear of further abuse.
3. The proposed regulations provide that innocent spouse relief is not available if a requesting spouse signed a closing agreement or entered into an offer-in-compromise with the IRS for the **same** tax year for which he/she sought relief.
4. Reg. §1.6015-7 of the final regulations follows the changes made to I.R.C. §6015 that were made for waivers and the 90-day period for filing a Tax Court petition. Now, the IRS says it will **not** begin any collection activities against a requesting spouse on the filing of a notice of appeal unless “the expiration of the statute of limitations on collection is imminent,” or “the collection will be jeopardized by delay.”

Effective Date. These final regulations are effective July 18, 2002.

Innocent Spouse Announcement 2002-74 I.R.C. §6015

IRS Revises Pub. 971 on *Innocent Spouse Relief*

In addition to information on the IRS website, this publication provides guidance for obtaining tax relief.

The IRS announced that Publication 971, *Innocent Spouse Relief (And Separation of Liability and Equitable Relief)*, revised June 2002, is now available. This revision replaces the April 2000 version. The publication discusses innocent spouse relief initiatives which protect individuals whose spouses violate tax laws without their knowledge.

Note. A copy of the publication may be obtained by calling 1-800-TAX-FORM (1-800-829-3676). The publication is also available on the IRS website at *www.irs.gov*.

IRS PROCEDURE — AUDITS

Ruling Requests

Chief Counsel Advice 200225013

☛ Ignoring Results of Private Letter Ruling Request III Advised

The IRS often follows-up to determine if ruling advice is followed.

Background. A company had submitted a request for a private letter ruling in its attempt to deduct environmental cleanup costs more rapidly. To accomplish this, permission was needed from the IRS to change its accounting method. However, the IRS denied the request. Nevertheless, the firm proceeded to deduct the costs using a variation of the accounting method that the government had not approved.

IRS Follow-up. The IRS conducted a follow-up audit and discovered the company's noncompliance with the letter ruling. The deductions for the cleanup costs were denied. This advice to field agents reminds them to be attentive to situations where a taxpayer requests a letter ruling and then withdraws, or receives an adverse ruling.

Compliance Study

Fact Sheet FS-2002-07

I.R.C. § 7804

☛ National Compliance Study Announced — A Return to TCMPs?

In a fact sheet, the IRS announced a program to measure taxpayer compliance. The National Research Program (NRP) will measure filing, payment, and reporting compliance by taxpayers. Payment compliance data will be generated annually, while reporting compliance surveys will be conducted every three years. The data will then be used to update the formulas used for selecting returns for audit which are outdated.

Note. The first stage of the study is scheduled to begin in September 2002, and will focus on individual taxpayers. Initially, the NRP will involve less than 50,000 audits from the 132 million individual returns filed. This new NRP process will gather information through:

1. Information already provided to the IRS,
2. Correspondence with taxpayers,
3. Partial audits, instead of the line-by-line auditing approach of the previous TCMP, and
4. Approximately 2,000 calibration audits (line-by-line exams, but with less-strict documentation).

IRS PROCEDURES — ELECTRONIC FILING

Electronic Filing

G.A. Michael v. U.S., No. 00-2182 CA-6 (6th Circuit Court of Appeals), 2002-1 USTC ¶150,454

I.R.C. §6011

Delinquent Tax Preparer Not Allowed to Participate in IRS's Electronic Filing Program

Facts. In 1995, Mr. Michael was assessed 35 separate return preparer penalties for recklessly or intentionally disregarding rules or regulations. He paid a portion of the penalties and filed suit against the government, seeking a refund of the amount paid, along with an abatement of the unpaid penalties. The case was later settled when Michael agreed to pay \$1,000 per return for nine of the returns and \$250 per return for the remaining 26 returns, plus interest.

In 1997, an order of dismissal was entered, stating that either party could reopen the matter within 60 days of the date of the order to enforce the settlement agreement. **Michael did not** pay the settlement amount of \$15,500, but the IRS did not reopen the matter within the 60-day period to enforce payment.

In 1998, Michael applied to the electronic filing program and on his application stated that no preparer penalties had been assessed against him. In 1999, the IRS rejected his application. All administrative appeals that Michael pursued were dismissed. He then sued in District Court and lost. The 6th Circuit Appeals Court affirmed the District Court decision in 2002.

Analysis & Holding. In **affirming** the District Court, the 6th Circuit determined that the IRS did not act “arbitrarily or capriciously” when it denied Michael permission to participate in the government’s electronic filing program.

Electronic Filing

IRS News Release 2002-53

I.R.C. §6011

IRS declares the 2001 filing season a success for electronic filing

The IRS set new records for processing returns and conducting electronic transmissions. As of April 19, 2002, nearly 45.8 million taxpayers had e-filed, breaking the 40.2 million record for all of 2001. Americans filed more than 9.1 million returns from their home computers, a 34% increase over the prior year. The IRS also set new records for direct deposits and electronic payments.

The 45.8 million returns were composed of the following:

Telefile	4,158,000
Computer prepared by tax professionals	32,475,000
Computer self-prepared	9,145,000

IRS PROCEDURES — MISCELLANEOUS

Attorney's Work Product Privilege

Jeffrey and Virginia M. Hambarian v. Commissioner, 118 TC No. 35, CCH Dec. 54,784 dated June 13, 2002
I.R.C. §6103

Tax Court Restricts Use of Work Product Privilege Doctrine by Taxpayer's Attorney

Facts. The taxpayers had been indicted on various criminal charges. As a result, the IRS initiated an exam since it had reason to believe that the taxpayers had fraudulently understated their income.

As part of the pretrial criminal proceedings, the taxpayer's defense attorney selected 100,000 photocopy documents from the county states attorney who was prosecuting the taxpayers. The defense attorney converted the voluminous photocopies to searchable computer files.

When the IRS requested the searchable computer files, the taxpayers refused to surrender them.

Issue. Whether the files of the taxpayer's defense attorney are protected by the work product privilege doctrine.

Analysis and Holding. The Tax Court determined that the mere selection by the taxpayer's attorney of certain documents from a much larger group of papers did **not** automatically convert the selected documents into a protected work product.

6

Payments to Attorneys

Proposed Regulation §1.6045-5

I.R.C. §§6041 and 6045

Reporting Requirements for Payments Made to Attorneys are Outlined

- The controversial delivery rule has been eliminated.
- Payments of \$600 or more, even to corporate entities, must be reported on Form 1099-MISC.

Background. The IRS has issued proposed regulations outlining reporting requirements for payments to attorneys. The IRS had previously published proposed regulations (Reg. 105312-98) under I.R.C. §§6041 and 6045(f), but after considering comments decided to amend and re-propose the regulations. The new proposed regulations incorporate the guidance in Reg. 105312-98 with some modifications.

Note. The IRS received many suggestions to eliminate the delivery rule in the old proposed regulations. That rule required information reporting of payments delivered to a nonpayee attorney, if the payor had reasonable belief that that attorney received the check for the performance of legal services. The IRS agreed and waived the rule. As a result, the new proposed regulations provide that a payment to an attorney, in the case of a payment by check, means a check on which the attorney is named **as a sole, joint, or alternative payee.**

2002 Workbook

Payor Defined. The proposed regulations define a payor under I.R.C. §6045(f) as a person who makes a payment if that person is an obligor on the payment, or the obligor's insurer or guarantor. A payor includes the following:

- An individual (or entity) that pays a settlement to an attorney of a client who instituted a tort, contract, legal violation, or worker's compensation claim against the individual (or entity)
- An individual's (or entity's) insurance company if the insurer pays the settlement to the attorney

De Minimis Rule. The proposed regulations also provide an annual minimum reporting floor of \$600.

Aggregation Rule. Payors may file a **single** reporting form (currently Form 1099-MISC) that **aggregates** annual payments to an attorney for all clients or **separate** forms for **each** payment. Furthermore, the proposed regulations clarify that payments to an attorney for services clearly unrelated to the practice of law are **not** subject to reporting under I.R.C. §6045(f).

See box 14 on the 2002 Form 1099-MISC shown below.

CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no.		1 Rents		OMB No. 1545-0115 2002 Form 1099-MISC	Miscellaneous Income
		\$	2 Royalties		
		\$	3 Other income		
PAYER'S Federal identification number		RECIPIENT'S identification number		4 Federal income tax withheld	Copy B For Recipient
				\$	
RECIPIENT'S name		5 Fishing boat proceeds	6 Medical and health care payments	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.	
		\$	\$		
Street address (including apt. no.)		7 Nonemployee compensation	8 Substitute payments in lieu of dividends or interest		
		\$	\$		
City, state, and ZIP code		9 Payer made direct sales of \$5,000 or more of consumer products to a buyer (recipient) for resale <input type="checkbox"/>	10 Crop insurance proceeds		
		\$	\$		
Account number (optional)		11	12		
		13 Excess golden parachute payments	14 Gross proceeds paid to an attorney		
15		16 State tax withheld	17 State/Payer's state no.	18 State income	
		\$	\$	\$	
		\$	\$	\$	

Form **1099-MISC** (keep for your records) Department of the Treasury - Internal Revenue Service

Effective Date. The new regulations would apply to payments during the first calendar year that begins at least two months after publication of final regulations.

Accountant-Client Privilege

W. Cavallaro v. U.S., No. 01-2237 CA-1 (1st Circuit Court of Appeals) 2002-1 USTC ¶50,330 (CCH)

I.R.C. §7602

☞ **1st Circuit Affirms No Accountant-Client Privilege**

The First Circuit affirmed a District Court's decision which held that documents held by the taxpayer's accountant were not protected by the attorney-client privilege. The accounting firm provided accounting and tax services, not legal advice. The firm merely assisted the taxpayer's attorneys.

Timely Filed Returns

R. J. Sorrentino, District Court, CO, 2002-1 USTC ¶50,227 (CCH)

I.R.C. §7502(a)(1)

☞ **Certified Mail Always Best for Proof of Mailing**

Facts. A 1994 return was filed by Mr. Sorrentino on March 3, 1998. When he did not receive his refund, he contacted the IRS and was informed that the 1994 return was never received. Therefore, he mailed a photocopy of the return to the IRS on October 2, 1998, but by then the statute had expired. Consequently, the IRS treated the photocopy as the original return and refused to pay the refund.

Holding. The taxpayer was successful in convincing the District Court that he had filed the original timely. The District Court reasoned that the IRS could not refute the presumption of delivery.

Note. Other courts have disagreed with this rationale holding that if the IRS claims the return was not filed, **only registered or certified mail** can prove timely filing.

Filing Extensions

IRS News Release IR-2002-34

I.R.C. §7508

☞ **IRS Announces Options for Requesting Filing Extensions**

The IRS has announced that automatic four-month return filing extensions are available either electronically, via phone, or by mailing Form 4868 to Service Centers. The phone number for requesting an extension is **1-888-796-1074**. Taxpayers will receive a confirmation number to signify the extension request has been granted. If a payment is to be made by phone, taxpayers will need to supply the appropriate bank routing number and account number for the source of funds, in addition to their 2000 AGI as a means of verifying their identity.

Filing Requirements

IRS News Release IR-2002-48

I.R.C. §§1361 and 6012

☛ **Smaller Corporations No Longer Need to File Schedules L, M-1 & M-2**

For tax years beginning in 2002, C corporations with **less than \$250,000 of gross receipts and less than \$250,000 in assets** will no longer be required to complete Schedule L, Schedule M-1 and Schedule M-2. For smaller S corporations, Schedules L and M-1 have been dropped. The IRS stated that although this could save 2.6 million small businesses an estimated 61 million staff hours, these companies would still have to maintain records detailing assets, liabilities, equity accounts and adjustments used to arrive at taxable income.

Note. Although these entities are not required to complete the balance sheet, many tax professionals will find this is valuable information if the entities ever terminate.

Adequate Disclosure

Revenue Procedure 2001-52

I.R.C. §§6662 and 6694

☛ **Adequately Disclosing a Client's Position on Return**

Purpose. The IRS has issued its **annual** Rev. Proc. identifying the circumstances when **disclosure of a position on a taxpayer's return** is sufficient to:

1. Reduce the I.R.C. §6662(d) substantial understatement component of the accuracy-related penalty, and
2. Avoid the I.R.C. §6694(a) preparer penalty for understatements due to unrealistic positions.

Note. This Rev. Proc. does **not** apply to any other penalty provision. It applies to returns filed on a 2001 tax form for a tax year beginning in 2001, and to returns filed on a 2001 tax form in 2002 for short tax years beginning in 2002.

Adequate Disclosure Defined. Adequate disclosure on the return can be as basic as completing line numbers on Schedules A, C and F. However, the numbers entered on the various schedules **must be verifiable**. A number is **verifiable** if, on audit, the taxpayer can **demonstrate the origin of the number**, even if that number is not ultimately accepted by the IRS, and the taxpayer can show good faith in entering the number on the return.

Conclusion. If the substantial understatement penalty is proposed in an exam, a careful analysis of the Rev. Proc. is recommended. The result could produce the adequate disclosure necessary to thwart the assessment of the penalty.

Tax Refunds

IRS News Release IR-2002-70

I.R.C. §7804

☛ **IRS Testing Internet Program for Checking Status of Refunds**

Instant access to refund status questions coming in 2003

On the IRS Web site. The IRS web site will permit taxpayers expecting a 2002 refund to ascertain the status of it. The program is supposed to be fully operational in time for the 2003 filing season. Specifically, taxpayers will be able to:

1. Find out if their tax return has been processed and when their refund will be mailed or direct deposited;
2. See if there is any problem with their refund; and
3. Find out if their check was returned to the IRS as undelivered.

The web site address is *www.irs.gov*

Circular 230

Treasury Decision 9011

Reg. §§10.0-10.32, 10.34 and 10.50-10.93

Circular 230 Standards of Practice Modified

Final regulations require practitioners to return clients' records on request.

Return of Client Records. The major change made by these final regulations is the requirement that a practitioner return a client's records upon request, even if there is a fee dispute. The application of this rule is restricted to records that are necessary for the client to comply with his/her federal tax obligations. In response to feedback, the term "records of the client" is defined to **exclude** items such as returns or other documents prepared by the practitioner that are withheld pending the client's payment of fees.

Duty to Inform Client. Under §10.21 of Circular 230, the final regulations **modify the existing duty** to advise a client promptly of any noncompliance, error, or omission with regard to a particular tax item. That duty is now expanded to require an **explanation of the consequences of the situation**.

Due Diligence. Regarding the exercise of due diligence, the final regulations clarify that a practitioner is presumed to have met this requirement in situations where he/she relies on the work product of another person and has otherwise used reasonable care in engaging, supervising, training, and evaluating such person.

IRS PROCEDURES — PAYMENTS

Overpayments

Rodney L. Burr v. Commissioner, T.C. Memo. 2002-69, CCH Dec. 54,682(M)

I.R.C. §6402

Taxpayer Limited in Applying Refund for Late-Filed Returns to Future Tax Years

Facts. Rodney Burr failed to file timely tax returns for 1994-1996. The IRS issued deficiency notices for his 1995-1996 taxes based on third-party information.

When his 1994 return showed a \$1,700 overpayment, he asked that it be applied to his 1995 estimated tax. When this was done, Burr's 1995 return showed the \$1,700 overpayment credit applied from 1994. This resulted in another overpayment of \$250, which Burr wanted to credit to his 1996 estimated tax. His 1996 return, even after applying all credits, including the 1995 credit refund of \$250, showed \$1,400 due.

The IRS accepted Burr's 1994 and 1995 returns as filed and did **not** assess tax liabilities. But, the IRS assessed a tax liability against him for 1996. Burr argued that he overpaid his 1995 taxes by \$250 and that the overpayment should have been credited as an estimated payment for 1996. The IRS argued that the credit Burr sought was "time-barred when he first claimed it."

Analysis and Holding. The Tax Court agreed with the IRS. The court determined Burr could not credit his 1994 overpayment against his estimated 1995 tax because he failed to timely claim the credit. The court rejected Burr's argument that the IRS should have credited the \$1,700 overpayment from 1994 against his 1995 liability under I.R.C. §6214(b). The court instead held that the I.R.C. §6402 provision on credits should govern the case.

As a result, the court determined because it found no overpayment for 1995, Burr could not claim that a \$250 overpayment from 1995 should have been credited against his 1996 liability. The court concluded that Burr had a deficiency for 1996.

The court also found no evidence of misconduct by the IRS or that it improperly asserted deficiencies against Burr for 1995-1996. However, the court determined Burr should not be held liable for an addition to tax for failure to timely pay his 1995-1996 taxes. Instead, he was only liable for penalties for failure to file timely returns and to pay estimated taxes.

Conclusion. The Tax Court, in sustaining filing penalties imposed by the IRS, determined that an individual did not have an income tax overpayment for 1995 that could be applied to his 1996 estimated taxes since the return with the overpayment was filed more than three years after its original due date.



Application of Payments

Revenue Procedure 2002-26

I.R.C. §6311

IRS Restates Its Position With Regard to Partial Payments

Purpose. This Rev. Proc. is intended to **update and restate** the IRS's position for the receipt of a partial payment where there is an outstanding tax liability, plus the accompanying interest and penalties for one or more tax years.

Taxpayer Instructs. If there are outstanding multiple tax liabilities and the taxpayer voluntarily makes a partial payment that is accepted by the IRS, and the taxpayer also supplies specific instructions about how the payment is to be applied, the IRS will respect those instructions.

No Taxpayer Designation. In the absence of written instructions, the IRS will apply the payment to satisfy any outstanding liabilities for successive periods in **descending order** of priority until the payment is fully absorbed.

Offers In Compromise. For situations where an Offer In Compromise exists, the terms of the agreement will be adhered to. The IRS included a reminder that any interest owed by individual taxpayers will normally be treated as a nondeductible personal interest.



Failure to File Penalty
Revenue Procedure 2001-58
I.R.C. §6656

 **IRS Outlines How Deposits Are Credited for Penalty Purposes**

It is important to specifically designate how payment is to be applied to outstanding liabilities or the IRS will determine this.

Purpose. The procedure explains how the IRS will credit federal tax deposits to determine whether a failure-to-deposit penalty under **I.R.C. §6656** should be applied.

Background. This issue arises when sufficient deposits were **not** made to satisfy the cumulative deposit obligations as of at least one deposit due date. Generally, the IRS will apply deposits to the **most recently** ended deposit period(s) and will apply any excess to later deposit periods.

Taxpayer Designates. As an alternative, depositors who receive a penalty notice may, within 90 days of the date of the notice, contact the IRS and designate the deposit period(s) to which the deposit or credit should be applied.

Effective Date. The new rules apply to **deposit periods beginning after December 31, 2001.**

6

Credit Card Payments
IRS News Release IR-2002-36

 **Visa Joins IRS Credit Card Program**

The IRS announced Visa joined the list of credit cards that taxpayers may use to pay their federal taxes. Also, the IRS said it expanded the credit card program to include installment agreement payments for tax year 1998 or later, and extension-related payments for taxpayers who live outside of the United States and Puerto Rico.

Note. In making the announcement, Visa was responding to customer demand for the convenience of charging taxes to their credit card. However, this convenience comes with a price equal to 2.5% of the taxes charged. Taxpayers must pay this fee even if the card balance is paid off within the billing cycle. For example, on a \$10,000 tax, the fee will be \$250.

IRS Installment Option. With the higher interest rates charged by most credit cards, taxpayers would benefit more by paying a \$43 fee to the IRS to initiate an installment payment arrangement on Form 9465. The current IRS interest rate of 6%.

Credit Card Intermediaries. To pay taxes by credit card, taxpayers have the choice of two companies:

Official Payments, www.officialpayments.com, or 800-272-9829 which accepts MasterCard, Discover, Visa and American Express or

Phone Charge, www.1888alltax.com, 888-255-8299 which accepts MasterCard, Discover and American Express but currently not Visa.

Tax Payments

IRS News Release IR-2001-71

I.R.C. §6011

☞ Online Tax Payment System Expanded by IRS

All federal taxes can be paid via the Internet by both individuals and businesses. Payers will receive receipts showing which taxes were paid. The system can also be used to schedule estimated taxes and to pay tax due on 1040s.

Note. Taxpayers may enroll at the website *www.eftps.gov*.

IRS PROCEDURES — PENALTIES

Information Returns

IRS Legal Memo 200142021

I.R.C. §6501

☞ Penalties for Failure to File Form 1099s

Background. I.R.C. §§6721 and 6722 authorize penalties for the failure to provide the IRS and the payee with most information returns. But, neither the Code nor the regulations provide a statute of limitations for assessing these penalties. However, I.R.C. §6671(a) states that these penalties should be assessed and collected in the **same manner as taxes**. Under I.R.C. §6501, tax must be assessed within three years after the return was filed, **or at any time if a return is not filed**.

No Statute of Limitations. While technically avoiding the issue of whether an information return is a return within the meaning of I.R.C. §6501, this IRS legal memo reaches the conclusion that even if an information return is a return within the meaning of I.R.C. §6501, **the statute of limitations on assessment has not expired since no return was filed**.

LIFE INSURANCE

Split Dollar Life Insurance

Notice 2002-8 (dated January 3, 2002)

I.R.C. §61

☞ Updated Guidance for Split-dollar Life Insurance Arrangements

Note. A year after issuing the controversial Notice 2001-10 on split-dollar life insurance, the IRS revoked the notice and reissued interim guidance. While Notice 2002-8, is not a complete reversal of last year's guidance, it includes changes that reflect an acknowledgment of feedback which Notice 2001-10 generated. When it was first released last January 9, Notice 2001-10 was intended to be interim guidance. The notice's apparent attempt at an immediate effective date, along with the upending of 35 years of settled rules on the taxation of split-dollar life insurance arrangements between employers and their employees, initiated tremendous feedback to the IRS and Treasury.

Purpose. The IRS issued Notice 2002-8 which is intended to provide interim guidance on the tax treatment of split-dollar life insurance, as well as to revise the rules for valuing current life insurance protection.

Background. In this new guidance, the IRS:

1. Revokes Notice 2001-10;
2. Announces that proposed regulations will be issued providing comprehensive guidance on the federal income tax treatment of various split-dollar life insurance arrangements;
3. Outlines rules expected to be included in these new regulations, and the expected effective date of those regulations; and
4. Provides guidance on the valuation of current life insurance protection under split-dollar life insurance arrangements, qualified retirement plans, and employee annuity contracts.

Application. The IRS says it intends to issue proposed regulations, requiring the taxation of parties to a split-dollar life insurance arrangement under one of two mutually exclusive approaches:

1. Either the economic benefits of a split-dollar life insurance arrangement generally are treated as transfers to the benefited party, or
2. Payments by the sponsor under a split-dollar life insurance arrangement generally are treated as a series of loans to the benefited party.

For arrangements entered into **before** the effective date of future guidance, taxpayers may use the premium rate table in **Notice 2002-8** to determine the value of current life insurance protection on a single life. Also, Rev. Rul. 55-747, remains **revoked**. The P.S. 58 rates may be used for split-dollar arrangements entered into before January 28, 2002, if the contract provides that those rates will be used.

For periods after December 31, 2003, the IRS will not consider an insurer's published premium rates to be available to all standard risks who apply for term insurance unless specific conditions are met. This applies to arrangements entered into after January 28, 2002 and before the effective date of future guidance. For split-dollar arrangements entered into before the final regulations are published, it will **not**:

1. Treat a service recipient as having made a transfer of a portion of the cash surrender value (CSV) of a life insurance contract to a service provider solely because the CSV exceeds the portion payable to the service recipient;
2. Challenge reasonable efforts to comply with the requirements of I.R.C. §§ 1271-1275 and 7872 if the parties treat payments to the sponsor as loans; or
3. Treat an arrangement as having been terminated if the value of current life insurance protection is treated as an economic benefit provided to a sponsor and if the parties continue to report the protection as an economic benefit.

Conclusion. Last year, the IRS stated that it was planning to tax more of the benefits under split-dollar arrangements. However, **the basic tax treatment of split-dollar life insurance arrangements will not be changed until the IRS issues final regulations.** Under these **future** rules, taxation of the benefits to be derived under the policy will basically hinge on who owns the policy.

If the **employer** is considered to be the owner, the employee will owe tax on value of the coverage. If the **employee** owns the policy, premiums paid by the employer will be treated as loans and the employee will owe tax under the imputed interest rules.

Nevertheless, some restrictions are going into effect earlier. **A higher premium table must be used to value the insurance protection, unless use of the old rates was required by a policy written before January 28, 2002.** Complete details of all the requirements can be found in Notice 2002-8.

Split Dollar Life Insurance

Treasury Regulation §1.61-22 (updates and modifies Notice 2002-8 shown above)

IRS Issues Proposed Regulations on Split-Dollar Life Insurance

New rules provide either an **economic benefit approach** or a **loan approach** in determining tax consequences from such arrangements.

Explanation of Revisions and Summary of Comments

Definition. The IRS has issued proposed regulations that provide guidance on the income, employment, and gift taxation of split-dollar life insurance arrangements. Under the proposed regulations, a split-dollar life insurance arrangement is defined as:

Any arrangement (that isn't part of a group term life insurance plan) between an owner of a life insurance contract and a nonowner of the contract under which either party pays all or part of the premiums, and one of the parties paying the premiums is entitled to recover a portion of those premiums and that recovery is to be made from, or is secured by, the proceeds of the life insurance contract.

Performance of Services. A special provision is contained in the new regulation which applies when an arrangement is entered into for the performance of services. Under that rule, a split-dollar life insurance arrangement is:

Any arrangement between an owner and a nonowner under which an employer or service recipient pays any portion of the premiums, and the beneficiary of a portion of the death benefit is designated by the employee or service provider or is a person whom the employee or service provider would reasonably be expected to name as beneficiary.

The rule applies to arrangements between a corporation and its shareholder. Under the arrangement, the corporation pays, directly or indirectly, a portion of the premiums. Also, the beneficiary of a portion of the death benefit is a person designated by, or would be reasonably expected to be designated by, the shareholder. Nevertheless, the rule does not apply to an insurance contract purchase in which the only parties to the arrangement are the policy owner and a life insurance company that is acting in its capacity as issuer of the contract.

Economic Benefit vs. Loan Approach. Regarding the taxation of split-dollar life insurance arrangements, the proposed regulations also provide two mutually exclusive approaches, the **economic benefit approach** and the **loan approach**. Under the economic benefit approach, an owner is treated as providing economic benefits to a nonowner.

Economic Benefit Approach. The economic benefit approach is intended to govern the taxation of endorsement arrangements. Additionally, the economic benefit approach applies if the arrangement is entered into:

1. For the performance of services, and the employee or service provider is not the owner; or
2. Between a donor and a donee, and the donee is not the owner.

Loan Approach. Under the loan approach, the nonowner is treated as lending premium payments to the owner. Except for specified arrangements, the loan approach applies to any split-dollar loan. The loan approach will also govern the taxation of collateral assignment arrangements.

Effective Date. Although these regulations are proposed to be effective for arrangements entered into after the date that the final regulations are published, taxpayers may rely on them in the interim, if all parties to the arrangement treat the transaction in a consistent manner. Otherwise, the rules set out in Notice 2002-8 may be used.

LIKE-KIND EXCHANGES

Related Parties

Letter Ruling 200137003

I.R.C. §1031

☞ Like-Kind Exchanges Between Related Parties

It is acceptable to contemplate a future sale, provided the sale occurs after the 2-year waiting period.

I.R.C. §1031 generally provides for deferral of gain on a like-kind exchange, if certain requirements are met. However, if the original exchange was between **related parties** and if **either** of the parties sells the property received in the exchange within two years, the original exchange retroactively becomes a taxable event. In this letter ruling, the IRS states that sales made **after the two-year waiting period** are permissible. Thus, these sales will not cause retroactive recognition of gain. This is true even if a sale which occurs after two years was originally contemplated when the like-kind exchange first took place.

Note. See Issue 6 in Chapter 3: Small Business Issues for more details on the special rules for exchanges between related parties.

Starker Exchange

Letter Ruling 200211016

I.R.C. §1031

☞ Deferred Exchange Deadlines Can't Be Waived

Events out of a taxpayer's control provide no excuse for missing like-kind exchange deadlines.

The IRS reiterated there are no alternatives when a taxpayer fails to comply with the Starker like-kind exchange deadlines. In this situation, a qualified intermediary had its assets frozen after a state agency seized control of the firm. As a result, the taxpayer could not gain access to the escrow funds in order to complete the exchange. Consequently, the original transfer became taxable.

Note. See pages 543–45 in the *2000 Farm Income Tax Workbook* for a thorough discussion of the strict 45-day and 180-day rules.

Regular Like-Kind Exchanges

Treasury Decision 8982

I.R.C. §1031

Banks Allowed to Provide Services for Regular Like-Kind Exchanges

Banks are allowed to act as qualified intermediaries.

Background. Financial institutions already have the ability to serve as exchange accommodation titleholders (EATs) for reverse like-kind exchanges under Rev. Proc. 2000-37.

Use of SMLLCs. Normally, to qualify as a qualified intermediary (QI), the person or company cannot otherwise provide investment banking or brokerage services during the two-year period leading up to the date of a **regular** like-kind exchange. Now, banking regulators have given permission to a bank's proposal to set up **separate** one-member limited liability companies (SMLLCs), which are ignored for federal tax purposes, to act as QIs. In this capacity, they can hold title, with all of the benefits and burdens of ownership, to replacement realty until the exchange is completed.

Note. See pages 335-338 in the *2001 Farm Income Tax Workbook* for complete details on reverse like-kind exchanges.

Reverse Like-Kind Exchanges

Letter Ruling 200148042

I.R.C. §1031

IRS Approves Reverse Like-Kind Exchange Tax Strategy

Serves to minimize or eliminate duplicate transfer taxes

Reverse exchanges normally involve a seller acquiring the qualified replacement property **before** the original property is sold. In a reverse like-kind exchange, title to the realty is held by an exchange accommodation titleholder (EAT) until the exchange is actually completed. In this letter ruling, the IRS ruled that an EAT can act as a customer's agent for state law purposes so local transfer taxes could be avoided.

NET OPERATING LOSS

NOL Carryback

Revenue Procedure 2002-40

I.R.C. §172

Switch to 5-Year NOL Carryback Available Until October 31, 2002

- Original election to forgo carryback period can be revoked and new 5-year rule used.
- Election to forgo new 5-year carryback period can also be made.
- Note deadline for making these changes.

October 31st Deadline. The IRS has provided qualifying taxpayers who filed returns for a tax year ending during 2001 or 2002 without electing the five-year net operating loss carryback with a limited opportunity to do so. They may apply for a tentative carryback adjustment if they act **before November 1, 2002.**

Can Revoke Previous Election. Taxpayers who incurred a net operating loss in a tax year ending during 2001 or 2002 and elected under **I.R.C. §172(b)(3)** to **forgo** the NOL carryback period can revoke their elections and use the five-year carryback period instead.

Extension Deadline Waived. Those taxpayers, as well as taxpayers who used a two-year carryback period, can file an application for a tentative carryback adjustment using a five-year NOL carryback period even if the 12-month period for filing the application has expired. A revocation and/or application for tentative carryback adjustment must be made before November 1, 2002.

Relinquish 5-year Carryback. Taxpayers who filed returns for a tax year ending in 2001 or 2002, and who **neither** elected to forgo the carryback period, nor used the two-year carryback period, can elect to relinquish the five-year carryback period (and thereby retain the ability to use the two-year carryback period) if they act by October 31, 2002.

Required Form. A corporation that wants to use **either** the five-year or two-year carryback period must file a Form 1139, "Corporation Application for Tentative Refund," or Form 1120X, "Amended U.S. Corporation Income Tax Return." Individuals must file a Form 1045, "Application for Tentative Refund," or Form 1040X, "Amended U.S. Individual Income Tax Return," and estates or trusts must file a Form 1045, or amended Form 1041, "U.S. Income Tax Return for Estates and Trusts."

NON-PROFIT ORGANIZATIONS

Unrelated Business Income

Letter Ruling 200230005

I.R.C. §512

Auto Solicitation Program Allowed as a Fund Raiser

Purpose. The IRS ruled that a charity could enter into an arrangement with an independent limited liability company (LLC) so the LLC could solicit auto donations as an agent of the charity. In return, when a donated auto was subsequently sold, the proceeds would be split between the two parties. Administratively, the LLC would provide appraisals to the donors, along with confirmation of the gift.

Holding. This arrangement will **not** jeopardize the tax-exempt status of the charity. The proceeds from the sales of the donated cars would not be considered unrelated business income to the charity.

NOT FOR PROFIT ACTIVITIES

Hobby Loss

John G. and Janice E. Parker, v. Commissioner, T.C. Memo. 2002-76, CCH Dec. 54,691(M) dated March 27, 2002
I.R.C. §183

☞ Commercial Pilot's Flying Business Considered Hobby

The taxpayer could not establish a profit motive for part-time airplane maintenance business.

Facts. John Parker was a licensed airplane pilot and mechanic who built, improved, and flew four of his small airplanes in air shows from 1994 to 1996. When not flying for a commercial airline, Parker spent many hours each week working on his own airplanes. He developed and installed a direct ignition system in one of his airplanes and sold six of them for use in experimental aircraft. He also leased property on which he constructed an airplane hangar allowing him to work on his airplanes. Parker claimed losses and deducted expenses from his airplane activities, but the IRS disallowed them and also asserted accuracy-related penalties.

Analysis and Holding. The Tax Court determined Parker did **not** engage in his airplane activities for profit and therefore should **not** be entitled to deduct related expenses or to claim losses. Other than flight logs and a business license, Parker provided little evidence to the court. He failed to submit evidence of a business plan, payroll records, sales contracts, or other records that would show he intended to make a profit. The Tax Court determined that his activity with small, private airplanes was **not** a legitimate profit-oriented business. Therefore, he was prohibited from claiming losses on his tax returns.

However, the court did decline to sustain the IRS's imposition of accuracy-related penalties, finding that Parker had "reasonable cause to consider his activities to be for profit."

Business Expenses

Jeffery Tamms v. Commissioner, T.C. Memo 2001-201, 82 TCM 363, CCH Dec. 54,435(M) dated August 1, 2001
I.R.C. §183

☞ Photography activity was engaged in for profit and losses were allowed

Facts. Jeffery Tamms, a Milwaukee resident, was employed full time as a computer specialist. He also operated a small photography business out of his home. The business had no employees. The business reported net losses on Schedule C from 1982, when it began, through 1994. The reported Schedule C net losses for the years in question were:

Year	Gross Receipts	Expenses	Net Schedule C Losses
1993	\$6,060	\$15,066	(\$9,006)
1994	7,019	17,544	(10,525)

Beginning in 1993, Mr. Tamms began to expand his business by producing photography exhibitions. He produced an annual exhibition in 1993, 1994 and 1995 for the Wisconsin Area Camera Club Organization (WACCO). Beginning in 1996 and continuing through 2000, he produced four exhibitions each year for WACCO and another professional organization, the Wisconsin International Exhibition of Photography. The exhibition segment of his business consistently produced modest net profits for Mr. Tamms beginning in 1994.

The 1995, 1996, 1997 and 1998 Schedule Cs of Mr. Tamms reported net profits ranging from a low of \$108 to a high of \$1,226. These returns were filed **after** the IRS commenced its examination.

The IRS disallowed the 1993 and 1994 net Schedule C losses since it contented the photography activity was not engaged in for profit under I.R.C. §183.

Issue. Whether taxpayer's photography business was entered into with an objective of making a profit within the meaning I.R.C. §183.

Analysis. The taxpayer bears the burden of establishing that his/her activities are engaged in for profit. To carry this burden, the taxpayer must show that he/she had a good faith expectation of profit. This expectation however, need not be reasonable [*Burger v. Commissioner*, 7th Cir. 1987, 87-1 USTC ¶9137, 809 F.2d 355, 358].

The regulations under I.R.C. §183 provide a nonexclusive list of **nine factors** to be considered in determining whether an activity is engaged in for profit.

Holding. We (the Tax Court) conclude that taxpayer had a good faith expectation of profit from his Schedule C activity. In reaching this conclusion, we view the following factors as being particularly persuasive.

1. Taxpayer carried on his activity in a **businesslike manner**, keeping as the IRS admitted in its brief, "fairly extensive financial records."
2. Taxpayer responded to the lack of profitability in earlier years by **developing a successful business plan** to expand the business activities by producing photography exhibitions.
3. As a result of this business plan, the activity has reported modest Schedule C net profits since 1995.
4. Although taxpayer enjoys photography, we do not believe that personal gratification was taxpayer's primary motivation for producing multiple photography exhibitions each year.

On balance, we believe that the factors described above outweigh other factors that admittedly suggest the absence of a profit motive. Chief among these contrary factors is the long history of losses for the years 1982-1994. However, since 1995, taxpayer has reported small Schedule C net profits.

Activities Not-For-Profit

R. L. Heidrick, T.C. Summary Opinion 2002-115 dated September 3, 2002

I.R.C. §183

Court declares gold-mining activity a hobby.

Court once again refers to the 9 factor test in making its determination.

Facts. R.L. Heidrick was employed as a deck engineer and hydraulic equipment operator for a dredging and construction company. He began searching for gold using a pan, shovel and pick in 1982. In 1989, using the knowledge he gained in his job, he began to mine for gold in rivers and streams in the mountain foothills. He mined mostly on weekends and some nights and during layoff periods. Mr. Heidrick read mining literature and attended some meetings with others interested in gold mining, but had no formal training in the field.

He mined approximately 39 days in 1994 and 37 days in 1995. After identifying a prospecting site, he would haul his heavy dredging equipment to the site. He was a certified scuba diver and would dive to depths of 25 to 30 feet and operate the equipment for up to 8 to 10 hours. He would then screen the mud, gravel and other material from the river using a sluice box. Mr. Heidrick would refine the material from the sluice box at his home and garage.

He kept the gold in 1, 2 or 3 ounce vials. The vials were stored in an ammunition box buried underwater near his mining sites. In 1995, Mr. Heidrick brought his gold home to weigh it. Unfortunately it was stolen from his desk drawer. He estimated the value of the stolen gold to be \$32,000, according to the police report he filed.

Mr. Heidrick reported the following on his gold mining Schedule C:

Year	Gross Receipts	Net Loss
1994	\$770	(\$18,164)
1995	1,540	(54,413)
1996	585	(11,481)

He filed his 1994 and 1995 tax returns on April 17, 1997. While his activity involved time, effort, money and risk, the IRS determined the gold mining activity was not an activity engaged in for profit under I.R.C. §183(a).

Issue. Whether the taxpayer's gold mining business was an activity engaged in for profit under I.R.C. §183.

Analysis. The Tax Court determined that the following factors weighed heavily against the taxpayer:

1. He did not keep a general ledger or other formal records.
2. He could produce no evidence to show how many days he devoted to the activity in 1996.
3. He did not maintain any contemporaneous written record of the timing, location, and amount of gold he recovered, which the court noted was "hardly businesslike."
4. When he sold small amounts of gold, he kept no receipts from the buyers.
5. He reported a 1997 net Schedule C loss of \$14,486. He also had losses in 1998-2000. He never realized a profit from the activity in any year.
6. He had considerable other income from his regular employment. The gold mining activity losses sheltered substantial portions of his wage income during the years in question.

Holding. The Tax Court upheld the IRS and ruled the business was not engaged in for profit. The court also upheld the failure to file and accuracy related penalties.

PASSIVE ACTIVITIES

Passive Activities

Bruce and Judy Bailey, T.C. Memo. 2001-296 (CCH) Dec. 54,541(M) dated November 7, 2001

I.R.C. §469

Detailed Records Required to Qualify as Real Estate Professional

The 750-hour and the more than 50% of total personal services tests are strictly enforced.

Facts. During 1996 and 1997, Bruce and Judy Bailey owned the following California real estate:

1. A condominium located at Arapaho Way, Indian Wells (Indian Wells condominium)
2. A unit in a planned unit development located at Arapaho Drive, Indian Wells (Indian Wells unit)

3. **Two** four-plex buildings located at Elderwood Court, Riverside (Elderwood properties)
4. A single-family house located at Caribou Drive, Lake Arrowhead (Lake Arrowhead property)

The Baileys filed an election with their 1994 tax return in 1994 to treat all interests in rental real estate as a **single** rental real estate activity under I.R.C. §469(c)(7)(A). Judy Bailey kept daily calendars for 1996 and 1997 regarding activities conducted in her law practice and for real estate management. In preparation for trial, she prepared a separate **summary report** of those two calendars. Each summary report provided an **estimate** of the total number of hours she spent on management duties for each rental property and gave a general description of those duties. **A summary report of her law practice activities estimated that she spent 876 hours in the practice of law in 1997.**

Analysis. The court ruled on the following analysis: I.R.C. §469 generally disallows any passive activity loss for the taxable year. I.R.C. §469(a).

1. A passive activity loss is defined as the excess of the aggregate losses from all passive activities for the taxable year over the aggregate income from all passive activities for that year. I.R.C. §469(d)(1).
2. A passive activity is any trade or business in which the taxpayer does **not** materially participate. I.R.C. §469(c)(1).
3. Rental activity is treated as a **per se passive activity** regardless of whether the taxpayer materially participates. I.R.C. §469(c)(2),(4).
4. Under I.R.C. §469(c)(7)(B), the rental activities of a taxpayer in the real property business (**a real estate professional**), are **not** per se passive activities under I.R.C. §469(c)(2). The activities of a **real estate professional** are treated as trade or business activities subject to the material participation requirement of I.R.C. §469(c)(1). See also Reg. §1.469-9(e)(1).
5. Under I.R.C. §469(c)(7)(B), a taxpayer qualifies as a **real estate professional** whose activity **is not a passive activity** under I.R.C. §469(c)(2) if **both** of the following tests are met:
 - a. **More than one-half** of the personal services performed in all of the trades or businesses of the taxpayer during the year are performed in **real property** trades or businesses in which the taxpayer materially participates.
 - b. The taxpayer performs **more than 750 hours** of services during the year in real property trades or businesses in which the taxpayer materially participates.

At Tax Court, Judy Bailey was faced with the problem of convincing the court that she met **both** of the tests shown above for **real estate professionals**. The first test, the **more than 50% of personal services of all of her trades and businesses**, proved the most difficult. In her summary report of 1997, she estimated that she spent **876 hours practicing law**. In order to meet the first test, she had to convince the court that she spent **more than 876 hours** materially participating in the management of the five rental properties.

In her 1997 summary report, she estimated that she spent **827 hours** managing the first four rental properties listed under Facts. **She realized that she would fail the first test based on her estimated hours** (876 law practice hours compared to 827 real estate management hours). Therefore she tried to satisfy the first test by counting the hours she spent managing the single-family house (Lake Arrowhead property).

However, the single-family residence could not be considered rental property since its **average rental period was seven days or less** [Treas. Reg. §1.469-9(b)(3)]. **As a result, Judy Bailey failed the first test, the more than 50% of total personal services test.**

Although the second test became moot, the Tax Court decided that the 750-hour test was not met either. The court was not impressed with her summary report for 1997 which reported 827 hours spent managing the first four rental properties. **The Tax Court referred to her purported 827 hour estimate as “an unreliable ballpark guesstimate.”** In essence, the Tax Court simply did not believe in or rely on her 1997 summary report.

Holding. The taxpayer (Judy Bailey) does not qualify as a “real estate professional” under I.R.C. §469(c)(7)(B). Therefore, the rental real estate losses claimed on the taxpayer’s 1997 federal income tax return are passive losses under I.R.C. §469(c)(2).

Passive Activity Losses

Notice 2002-29

I.R.C. §469

☞ **Deemed Sale Election Is Not a Disposition for Purposes of I.R.C. §469(g)(1)(A)**

While gain included in income may be passive activity gross income that is allowed to offset passive activity deductions, it does not affect the passive activity losses disallowed under I.R.C. §469.

This notice clarifies the uncertainty of making a **deemed sale** election for passive activity purposes. Some tax professionals thought that making the election and reporting the gain would allow it to be used against prior suspended losses for the activity. This would occur under existing laws if the passive activity property was **actually** sold to an unrelated party. However, the technical correction to I.R.C. §311(e) of the Taxpayer Relief Act of 1997 (TRA97) states that making the mark-to-market election is **not** a disposition for purposes of freeing-up the suspended losses under I.R.C. §469(g)(1)(A).

New Text

PRINCIPAL RESIDENCE

Sale of Residence

Treasury Department News Release PO-3368 (dated August 22, 2002)

I.R.C. §121(c)(2)(B)

☞ **Definition of Unforeseen Circumstances Issued for Sale of Residence**

The long-awaited definition of unforeseen circumstances regarding principal residence sales is prematurely announced.

The IRS announced that the upcoming release for final regulations for I.R.C. §121 will include the following qualifying situations as **unforeseen circumstances**.

- Man-made disasters
- Death of the taxpayer’s spouse
- Acts of war

Taxpayers may qualify for a **reduced maximum exclusion** of less than \$250,000 (\$500,000 for married taxpayers) if they do **not** meet the two-out-of-five dual ownership and use tests under certain circumstances. The **reduced maximum exclusion** (also called the prorated exclusion) is available when the dual tests are not met if the home is sold due to:

1. A change in place of employment,
2. Health, or
3. Unforeseen circumstances **to the extent provided in regulations.**

It is clear from the plain language of I.R.C. § 121(c)(2)(B) that the only **qualified unforeseen circumstances** are those that are included in the regulation issued by the IRS.

Example using definitions included in the IRS Notice 2002-60

Facts. Ray and Susan Jennings bought their principal residence in Phoenix, AZ on June 20, 2001. Ray sold it on June 19, 2002 following the death of Susan. Ray's gain on the sale was \$80,000.

Question. How much of Ray's \$80,000 gain is taxable on the 2002 joint return of Ray and his deceased wife Susan?

Answer. None. Ray owned and used the home for 365 days. Therefore, his **reduced maximum exclusion** is \$250,000 computed as follows:

$$50\% (365 \text{ days} \div 730 \text{ days in a 2-year period}) \times \$500,000 = \$250,000$$

See IRS Pub. 523, *Selling Your Home*, for the **Reduced Maximum Exclusion Worksheet**.

RETIREMENT

6

Roth IRA Conversions

Significant Service Center Advice 200148051

I.R.C. § 408A

Extra Income Uncovered Upon Audit Can Invalidate Roth Conversion

- \$100,000 cap exceeded after additional income uncovered in audit
- Roth conversion retroactively disallowed
- Imposition of interest and penalties occurred
- Acceleration of income recognition occurred

Facts. Anticipating that his AGI would be under \$100,000, a taxpayer converted his traditional IRA to a Roth in 1998 and spread the taxable income over his 1998-2001 returns. The IRS later audited his 1998 return and discovered that he had failed to report the income from Forms 1099-DIV. When those amounts were properly included in gross income, the taxpayer's 1998 AGI slightly exceeded the \$100,000 ceiling for converting to a Roth. However, at that point, the time limit for recharacterizing the Roth back to an IRA had expired.

Holding. As a result, two penalties were assessed against the taxpayer by the IRS in this service center advice. First, it imposed a 6% penalty for an excess contribution to the Roth. In addition, a 10% penalty was included since the taxpayer had **not** yet reached age 59½. Finally, the four-year spread of income was not allowed, resulting in **all** of the income being taxed in 1998.

Note. This case shows that making a timely recharacterization is vital. If the deadline for doing so has passed, the IRS has granted additional time to do so via numerous private letter rulings. See the following topic for details.

Roth IRA Conversions

Letter Rulings 200213030, 31, and 34

I.R.C. §408A

IRS Grants Extensions for Reconversions of Roth IRAs

Distinction is made where tax professional was to blame as opposed to a subsequent audit correction.

On numerous occasions, the IRS has granted taxpayers extensions to recharacterize their converted Roth IRAs back to traditional IRAs. In the three letter rulings cited above, the taxpayers converted their traditional IRAs to Roth IRAs but were **not** advised by their accountants of the \$100,000 AGI limitation. The IRS ruled that since they had acted reasonably and in good faith, they were entitled to an additional 6-month extension from the ruling date to recharacterize their Roth IRA back into a traditional IRA.

Required Minimum Distribution

Treasury Decision 8987, Notice 2002-27, IRS News Release IR-2002-50

I.R.C. §§72, 401, 403, 408 and 457

IRA Trustees Required to Advise of IRA Minimum Distributions

- Starting in 2003, IRA trustees must provide some assistance.
- By January 31, portion of prior year's December 31 IRA balance required to be withdrawn must be identified.

Beginning with any required minimum distributions (RMDs) to be made in 2003, IRA trustees will either have to provide statements to IRA owners or offer to calculate the actual RMD amount. The statements are due by January 31, 2003. However, mandatory reporting to the IRS is delayed until 2004.

Required Minimum Distribution

Revenue Procedure 2002-29 (modifies Rev. Proc. 2002-20 and 2002-6)

I.R.C. §401(a)(9)

Model Plan Amendments for Complying with MRD Regulations

Background. The IRS announced that qualified retirement plans generally **must be amended** by the end of the first plan year beginning on or after January 1, 2003, to comply with the new minimum required distribution (MRD) regulations and provided model plan amendments to satisfy that requirement.

Note. The appendix to Rev. Proc. 2002-29 provides two model plan amendments to facilitate the amendment of qualified plans to comply with the new MRD regulations. The model amendments may be adopted by master and prototype plan sponsors and volume submitter practitioners and also by sponsors of individually designed plans. The model amendments are “snap-on” amendments that work with a plan's existing distribution provisions by superseding those that are inconsistent with the provisions of the model amendment and retaining those that are not.

Effective Date. Rev. Proc. 2002-29 is effective June 17, 2002.

Note. More information on the minimum distribution rules may be found in Chapter 7: Retirement.

Early Withdrawals

Ray C. and Bernadette B. Baas, TC Memo. 2002-130, CCH Dec. 54,758(M) dated May 29, 2002

I.R.C. §72(t)

☛ **Early IRA Distribution by Jailed Taxpayer Resulted in 10% Penalty Plus Taxes**

Voluntary decision to use early withdrawal of retirement plan assets to pay back child support and alimony caused imposition of 10% penalty, along with associated income taxes.

Facts. Ray Baas was sent to jail when he failed to pay back child support and alimony. While incarcerated, Ray decided to satisfy the \$10,000 child support and alimony arrearages by withdrawing \$11,751 from his IRA.

Analysis and Holding. The early withdrawal resulted in the imposition of the I.R.C. §72(t) 10% penalty in addition to the income taxes due on it. The court did not accept Ray's argument that he was forced to make an involuntary withdrawal such as in *Larotonda* [89 TC 287 (1987)], where the the IRS levied a taxpayer's IRA, forcing an early distribution. The court determined that Ray's decision was voluntary, consequently there should be no waiver of the early withdrawal penalty.

Inherited IRA

Letter Ruling 200228023

I.R.C. §402(c)(1)

☛ **Distribution From Inherited IRA Is Taxable to Son**

A son inherited his mother's IRA and took a complete distribution from it. He rolled over the funds into two separate IRAs in his own name.

However, only a **surviving spouse** is allowed to treat an inherited IRA as his/her own IRA. This ruling was requested in the hope that the IRS would permit him to correct his mistake. However, the IRS ruled that the total distribution was taxable since the rollover was invalid.

Form 5500

Notice 2002-24

I.R.C. §6039D

☛ **Certain Fringe Benefit Plans No Longer Need to File Schedule F of Form 5500**

Annual Information Returns. Many companies maintain fringe benefit programs under I.R.C. §§125, 127 or 137 (cafeteria plans, educational assistance or adoption assistance programs). They no longer are required to file Schedule F, Fringe Benefit Plan Annual Information Return, with a completed Form 5500.

Note. The change applies to all plan years for which returns have not been filed, but does not impact annual reporting requirements under Title I of ERISA. It also does not relieve administrators from the general requirement of filing Form 5500 and any schedule other than Schedule F.

Model Pension Plans Announcement 2002-49 I.R.C. §401

☞ **Deadline Extended for Use of Existing Model IRAs, SEPs and SIMPLE IRAs**

Originally, **Rev. Proc. 2002-10** set a deadline of June 1, 2002 whereby existing model IRAs, SEPs and SIMPLE IRAs could no longer be used. In response to practitioner concerns, the deadline was extended to October 1, 2002.

TAX FRAUD

Refund (erroneous)

***U.S. v. Crystal Foster, et al.*, U.S. District Court, VA (Jan. 16, 2002), 2002-1 USTC ¶50,263 (CCH)**
I.R.C. §7405

☞ **Government Entitled To Recover Erroneous Refund.**

Taxpayer provided the name of a non-existent regulated investment company when questioned about the company from which she claimed a tax payment on Form 2439.

Facts. Crystal Foster's 2000 return reported wages of \$3,429 and zero tax liability. Line 64, Other Payments showed an X in the box for Form 2439. Foster attached a 2000 Form 2439 which reported \$500,000 in box 2, tax paid by the regulated investment company on undistributed long-term capital gains. The return showed she was entitled to a refund of \$500,000. The Form 2439 attached to the return did not show the name or address of a regulated investment company.

The IRS requested the name of the company issuing the Form 2439 and Crystal Foster responded with a letter which showed the company to be:

U.S. Department of Treasury
Black Capital Investments
Pennsylvania Ave., NW
Washington D.C.

After receiving this letter, the IRS processed the return and **issued a refund check in the amount of \$507,534.95** which included \$7,534.95 of interest. Foster deposited the check to her credit union checking account. Shortly thereafter, she and her husband Robert purchased a Mercedes for \$40,900, using \$25,000 of the refund and financing the balance.

Because Crystal Foster responded to the IRS with a letter that named a fraudulent investment company, she knew the refund had been fraudulently obtained.

Analysis. In order for the United States to prevail in an action to recover an erroneous refund the government must establish that:

- A refund of a certain sum was made,
- The government’s recovery action is timely, and
- The taxpayer is not entitled to the refund.

Holding. The government met all three tests and was entitled to recover the erroneous \$507,534.95 refund issued October 29, 2001.

Notes.

1. Prior to filing the district court suit on November 20, 2001, the IRS was able to recover \$266,598.21 of the erroneous refund.
2. It is sadly humorous that the IRS (a Treasury Department Agency) would accept and process a Form 2439 that showed the U.S. Treasury Department as the regulated investment company.

<input type="checkbox"/> VOID <input type="checkbox"/> CORRECTED (99)			
Regulated investment company or real estate investment trust's name, address, and ZIP code 	OMB No. 1545-0145 <div style="text-align: center; font-size: 2em; font-weight: bold;">2001</div> Form 2439	<div style="text-align: center; font-weight: bold;"> Notice to Shareholder of Undistributed Long-Term Capital Gains </div> <p style="text-align: center; font-size: 0.8em;"> For calendar year 2001, or other tax year of the regulated investment company or the real estate investment trust beginning _____, 2001, and ending _____, 20 _____ </p>	
Regulated investment company or real estate investment trust's identification number	1a Total undistributed long-term capital gains \$	<div style="font-weight: bold; font-size: 1.2em;">Copy A</div> <p style="font-size: 0.8em;"> Attach to Form 1120-RIC or Form 1120-REIT </p> <div style="font-weight: bold; font-size: 0.8em;"> For Instructions and Paperwork Reduction Act Notice, see back of Copies A and D. </div>	
Shareholder's identification number XXX-XX-XXXX	1b 28% rate gain \$		1c Qualified 5-year gain \$
Shareholder's name, address, and ZIP code Crystal Foster	1d Unrecaptured sec. 1250 gain \$		1e Section 1202 gain \$
	2 Tax paid by the regulated investment company or real estate investment trust on the box 1a gains \$ 500000		
Form 2439	Cat. No. 11858E	Department of the Treasury - Internal Revenue Service	

Disabled Access Credit
IRS News Release IR-2002-17
 I.R.C. §22

IRS Issues Warning of Schemes Promoting Use of Disabled Access Credit

The issue is whether the asset is equally adaptable for use by the general public.

Purpose. The IRS warned taxpayers to be aware of a fraudulent investment scheme that entices people to improperly use the Disabled Access Credit. In a typical scheme, unscrupulous promoters sell pay telephones to individual investors. The promoters incorrectly advise the investors that they can claim the Disabled Access Credit on their individual tax returns because the telephones have volume controls or are set low to the ground. However, to be eligible to claim the credit a taxpayer must have “a bona fide business and must have incurred expenses to bring the business into compliance with the Americans with Disabilities Act.”

Note. For more information on the credit, see the instructions for Form 8826, Disabled Access Credit, and Publication 334, *Tax Guide for Small Business*. Also see Issue 1 in Chapter 3: Small Business Issues for extensive coverage including examples with completed Form 8826.

Abusive Trusts

Securities and Exchange Commission v. Michael D. Richmond, et al.

Justice Department Sues Chicago-Based Tax Scheme Promoters

Note. The Treasury Department is waging an all-out war on tax shelters and avoidance schemes. The main focus is on companies which avoid disclosing their involvement in questionable transactions.

Audits. Agents will be inquiring about the existence of tax shelters in every audit they perform of **large and mid-size** businesses. Specifically, examiners will ask if the company has invested in **any of 14 listed tax shelters**. If uncovered, the auditors will request background documents for transactions, such as materials provided by promoters, internal memos, etc.

Tax Shelter Litigation. The Justice Department announced on March 4 that it has filed a civil suit to halt an alleged abusive tax scheme promoted by two Chicago-area men, Michael D. Richmond and Rex E. Black. The complaint alleges that Richmond, Black, and their related businesses — The Liberty Network, Liberty Estate Planning, The Liberty Institute, Fiduciary Management Group, National Council of Certified Estate Planners, Association for Certified Estate Planning Attorneys, and Eagle Publications Trust — have been selling sham trust packages that improperly reduce or eliminate their clients' federal income taxes.

The Justice Department release alleges that defendants Richmond and Black advise and encourage their clients to circumvent federal tax laws by transferring their houses and other assets to sham trusts. While the defendants describe these transfers as pass-through technology, the Justice Department has asserted that the defendants falsely advise customers that these trusts enable them to claim deductions for house payments, utilities, and other nondeductible personal expenses.

According to the criminal complaint, Richmond and Black allegedly recruited both agents and customers through the Internet and other educational programs conducted by their Liberty Institute.

Richmond and Black allegedly charge customers setup fees and other annual fees for tax return preparation, trustee services, and secretarial services. The IRS estimates that the revenue loss from the scheme exceeds \$9 million annually. Eileen J. O'Connor, assistant attorney general in charge of the Justice Department's tax division, commented, "The Internet makes selling tax scams remarkably easy." She went on to state, "the public should be on guard — using the word 'trust' doesn't make a scheme legitimate. Substantial civil and criminal sanctions may be imposed on those who participate in abusive trust schemes."

Note. A U.S. District Court Judge entered a summary judgment against Michael Richmond for \$11.5 million.

Tax Evasion

Lonnie D. Crockett, et al., v. United States, U.S. District Court, UT (May 31, 1999) 99-2 USTC ¶150,610 (CCH)
I.R.C. §§7602 and 7609

Note. This District Court case involved enforcement of third-party summonses which the taxpayer tried to halt.

Justice Department Announces Sentencing of Utah Tax Evader

Criminal Sentence. The Justice Department announced March 11, 2002, that Lonnie D. Crockett of Bountiful, Utah, was sentenced to 42 months in prison in connection with his conviction for marketing a federal income tax evasion scheme.

Prosecution Information. Crockett, 52, routed his clients' income through bank accounts in the names of trusts located in the United States and abroad in order to conceal income from the IRS. Crockett was ordered to pay a fine of \$67,500 and to serve a three-year term of supervised release after prison.

According to the attorneys prosecuting the case, Crockett admitted in his guilty plea that his clients — all medical doctors from northern California — began using his tax evasion system to cycle income from their medical practices through domestic and foreign bank accounts in an effort to conceal their funds from the IRS. Crockett “charged a fee for running client income through his system of bank accounts and then back to an account controlled by the client.”

Note. Crockett's clients have since been sentenced for their participation in the scheme.

6

Tax Evasion

Douglas P. Rosile, Sr. v. United States, 2002-2 USTC ¶150,566 (CCH)
I.R.C. §§6107, 6694, 6695, 6700, 6701, 7402, 7407 and 7408

Justice Department Sues Preparer of Bogus Tax Refunds

Background. The Justice Department on March 14, 2002, filed suit against Douglas P. Rosile Sr. of Florida for promoting a **tax refund scheme** allegedly used to underreport tens of millions of dollars of tax liability for almost 200 clients in 32 states. “The complaint alleges that all the bogus refund claims prepared by Rosile were based on the erroneous assertion that only income from foreign sources is subject to U.S. income tax,” according to the Justice Department release. This argument, commented Justice Department attorney Eileen J. O'Connor, “has been rejected out of hand by every judge who has examined it.” “Taxpayers who participate in this and other patently frivolous schemes risk substantial civil and criminal penalties,” warned O'Connor. “The Justice Department is committed to stopping abusive promoters who seek to bilk the U.S. Treasury.”

Note. Had Rosile's fraud gone undetected by the IRS, it would have resulted in a loss of over \$36 million for the Treasury. One refund claim alone was for \$7.3 million. In the complaint against Rosile, the court has been petitioned to order Rosile to provide his clients' identities and all related records.

TRAVEL AND TRANSPORTATION EXPENSES

Meals & Entertainment

Letter Ruling 200209028

I.R.C. §274

☞ **IRS Insists on Strict Substantiation of Meals & Entertainment**

Statistical sampling is not sufficient where details of meals and entertainment are required for applying the 50% disallowance rule.

Facts. The taxpayer had over 50,000 meals and entertainment in one year and had **automatically** applied the 50% limit to all of them. When sampling a number of these expenses, the taxpayer found that many of them would qualify for one of the exceptions that permit a 100% deduction. The company asked the IRS if it could use statistical sampling methods to determine which expenses had been erroneously subjected to the 50% disallowance rule.

Holding. The IRS concluded that the code and regulations permitted no such leniency and insisted that **each expense item** be substantiated so that it could be independently ascertained whether or not the 50% cap applied.

Per Diem Payments

Beech Trucking Company, Inc. v Commissioner, 118 TC No. 27, CCH Dec. 54,753 dated May 23, 2002

I.R.C. §§64, 274 and 3401

☞ **Trucking Corporation Per Diem Subject to Meal Limitation**

Facts. Taxpayer operated a trucking company using drivers it hired from an affiliated company. The drivers were paid 24 to 26 cents per mile which included 6.5 cents per mile as a per diem allowance. The drivers were not required to account for the allowance. The allowance was not separated between meal and incidental expenses (M&IE) and lodging. However, all of the trucks had sleeper cabs. The taxpayer deducted 80% of the allowances as business expenses. The IRS agreed that the per diem payment was an ordinary and necessary business expense but should be limited to 50% under I.R.C. §274(n). The limitation reduced taxpayer's deductions by \$251,885 in one year and \$286,878 in the other.

Analysis. Revenue Procedures 94-77 and 96-28 contain special rules for applying the I.R.C. §274(n) 50% limitation to per diem allowances. **If a per diem is paid only for M&IE**, an amount equal to the lesser of the per diem allowance for each calendar day or the Federal M&IE rate is treated as an expense for food and beverages and is thus subject to the 50% limitation (Rev. Proc. 96-28).

If the per diem is paid for lodging as well as M&IE, the payor must treat an amount equal to the Federal M&IE rate as an expense for food and beverages. When a per diem for lodging and M&IE is paid at a rate that is less than the Federal rate for M&IE, the payor may treat 40% of the per diem as the Federal M&IE rate. **Example:** if the total of the per diems equal \$100,000 and that is less than the Federal M&IE rate, the payer can treat \$40,000 as M&IE and the balance as lodging. Consequently the taxpayer would be entitled to deduct \$80,000 as a business expense [(50% × \$40,000) + \$60,000].

The IRS contends that the per diem is being paid **only for M&IE** and the entire amount is subject to the 50% limitation. Because the allowance is computed on the same basis as the driver's wages, the two revenue procedures treat the per diem allowance as being paid only for M&IE.

The taxpayer contends that because they **lease the employees**, they are **not** subject to the I.R.C. §274(n) limitation. They also argue that part of the payment is for lodging which is not subject to the 50% limitation.

The court used the following logic to determine whether the drivers were employees of the taxpayer or the affiliated company. Since the taxpayer had full control of the drivers, it was considered the employer. Such comments as, “we try to get our drivers home most weekends” and “we would try to get him as far out as we could in the early part of the week, and then start working him back toward the house,” indicate that the drivers were employees of the taxpayer rather than the affiliated company.

Holding. The Tax Court held for the IRS and subjected the entire per diem allowances to the 50% limitation.

Temporary vs. Indefinite Job Assignments

Teresita T. Diaz v Commissioner, T.C. Memo 2002-192, CCH Dec. 54,831(M) dated August 6, 2002

I.R.C. §162

Deductions for Auto Expenses to Temporary Job Sites Partially Allowed

Facts. Teresita Diaz was employed by Pleasant Care Corporation (PCC) as a nurse. She began to work for the company in the early 1990s at their facility in Stockton, CA. From that time through March 31, 1996, she lived and worked in Stockton. However, from April 1, 1996 through 2000, she was assigned to various company facilities outside Stockton. She did not work at PCC’s Stockton facility at any time during 1997.

In 1997, the year in issue, she was assigned to work at PCC facilities in the following cities:

Job Site	Number of Weeks	Round Trip Mileage from Stockton
Navoto	9	171
Napa	1	141
Ukiah	18	337
Yuba City	10	174

On her 1997 Form 2106, she reported that she drove 54,570 miles for business and claimed a **\$17,190** deduction ($54,570 \times 31.5¢$).

Issue. Whether the job assignments were temporary, and if so, what mileage expense is allowable.

Analysis. In Rev. Rul. 93-86, the IRS ruled if employment at a work location is **realistically expected to last (and does in fact last) for one year or less**, the employment will be treated as temporary in the absence of facts indicating otherwise. At the time of each assignment to PCC’s facilities at the four locations shown in the chart above, Ms. Diaz was assured that it would be temporary. PCC promised her that she would soon be reassigned to the Stockton facility, the city where she maintained her apartment during 1997.

The IRS disallowed the entire \$17,190 mileage deduction based on Rev. Rul. 94-47. In that ruling, the IRS stated: “A taxpayer may deduct daily transportation expenses incurred in going between the taxpayer’s residence and a **temporary** work location **outside** the metropolitan area where the taxpayer lives and normally works.”

The Tax Court rebuked the IRS because Ms. Diaz had clearly satisfied the requirements of Rev. Rul. 94-47. When working at the Ukiah facility, she lodged overnight with a co-worker at no expense and returned to her apartment in Stockton on the weekends.

However, the IRS submitted two of Ms. Diaz’s vehicle maintenance receipts for 1997 which showed that the vehicle was driven only a total of **48,490 miles** during the year. Based on that evidence and using the information shown in the chart above, the **Tax Court determined that Ms. Diaz had actually driven only 24,598 miles** to the temporary job sites in 1997.

Holding. The assignments to the four job sites were temporary. Based upon the evidence, taxpayer is entitled to a deduction on her 1997 Form 2106 of **\$7,748** (24,598 employee business miles × 31.5¢).

Note. See Problem 8 in Chapter 2: Individual Taxpayer Problems for more information on the temporary assignment issue.

New Ruling

The amounts for the various deductible costs for use of a car will be effective January 1, 2003, and are as follows:

- The standard mileage rates for the use of a car for business purposes is 36 cents a mile for all business miles driven, down from 36.5 cents a mile in 2002.
- The standard mileage rate for the use of a car when giving services to a charitable organization remains at 14 cents a mile.
- The standard mileage rate for the use of a car for medical reasons is 12 cents a mile, down from 13 cents a mile in 2002.
- The standard mileage rate to use when computing deductible moving expenses is 12 cents a mile, down from 13 cents a mile in 2002.

The primary reason for the mileage rate decreases is the decline in fuel prices during the study period, which ended on June 30, 2002. An independent contractor conducted the study on behalf of the IRS.

TRUSTS

Living Trusts

IRS Information Notice 2002-0039

I.R.C. §676

Tax-Free Transfer of Savings Bonds to Living Trust Allowed

In order to avoid probate, a husband desired to transfer E and EE bonds into a living trust over which he retained the power of revocation. Because the living trust would be treated as a grantor trust it is transparent from a tax standpoint. The grantor is treated as the owner of any assets held by such a trust. There would be no immediate tax consequences upon the transfer. Therefore, the bonds would not be taxed until the bonds were actually cashed in or otherwise reached maturity.

OTHER INFORMATION THAT'S NEW

IRS PROCEDURES — FORMS

Schedule E

The IRS to Revise Form 1040 Schedule E

The IRS announced it will make significant changes to Form 1040 Schedule E to incorporate suggestions received regarding the K-1 matching program. These changes will require taxpayers to report K-1 information **exactly** as it appears on the K-1 Form on their Schedule E. This type of reporting will enable an electronic matching process to occur rather than the cumbersome **manual process** that the IRS has been using.

IRS PROCEDURES — MISCELLANEOUS

K-1 Matching

Tax Talk Today (August 2002)

I.R.C. §§6222 and 7804

The IRS Stops Sending K-1 Mismatch Notices

Despite uncovering numerous discrepancies, the K-1 matching program has been put on hold.

Program Put on Hold. Bruce Elliott, host of Tax Talk Today, announced that the IRS has stopped issuing Schedule K-1 mismatch notices under its compliance initiative.

Note. See Chapter 12: IRS Update for complete coverage of the K-1 matching program.

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GAO Report

GAO Report Analyzes 2001 Advance Refund Program

Advance Refund Program was a major accomplishment, but not problem free.

2001 Advance Refunds. The General Accounting Office (GAO) recently released its findings regarding the IRS's implementation of the advance refund program. Although the program was described as a "major accomplishment," it still had some problems.

Erroneous Refund Notices. There was a "computer programming complication" that resulted in 523,000 taxpayers receiving notices telling them of larger refunds than they were otherwise entitled to receive. However, the IRS corrected the problem before any tax refunds were issued by sending correction notices to affected taxpayers.

Incorrect Addresses. 548,000 advance refund checks, valued at approximately \$174 million, were returned undeliverable due to incorrect addresses.

Rate Reduction Credit. The rate reduction credit also created problems during the 2002 tax-filing season. As of May 31, 2002, 6.5% of all individual tax returns had errors related to the rate reduction credit. Some taxpayers who had **received an advance refund**, and were **not** entitled to a credit, **claimed a credit anyway**. Other taxpayers who were **entitled to a credit**, either **failed to claim** it or **computed the amount incorrectly**.

Note. See Problem 1 in Chapter 2: Individual Taxpayer Problems, for extensive coverage of the rate reduction credit in 2001 returns.

TAX FRAUD

Tax Shelter

I.R.C. §274(h)(6)(C)

☞ **Cayman Islands Status as Offshore Tax Haven Coming to an End**

The IRS will be able to inspect banking records there in 2004, now that the Caymans and the U.S. have agreed to share tax information. Bank records will be open for inspection in 2004 for IRS criminal tax matters and in 2006 for civil tax investigations. A number of other Caribbean islands (Barbados, Bermuda, Costa Rica, Dominica, the Dominican Republic, Grenada, Guyana, Honduras, Jamaica, Saint Lucia and Trinidad and Tobago) and Canada, Mexico and all U.S. possessions have signed treaties with the U.S. which will give the IRS access to bank records in tax fraud cases.

Observation. The treaty contains a clause with regard to holding business meetings in the Caymans. The cost of attending business conventions in foreign countries generally is **not** deductible unless “it is as reasonable to meet there as in the U.S.” But, this reasonableness test is **waived** if country agrees to exchange tax data with the IRS. Conventions held in these Caribbean countries will qualify for the waiver in 2006 when the information exchange arrangement has been fully implemented.

Tax Shelter

I.R.C. §274(h)(6)(C)

☞ **Bahamas Will Share Tax Information With the U.S.**

The Bahamas have decided that it will share its tax data with the IRS in the near future. The islands now join the Cayman Islands and Antigua and Barbuda which have also chosen in recent months to drop laws protecting bank secrecy. Bank records will be open for inspection in 2004 for IRS criminal tax matters and in 2006 for civil tax investigations. As a result, the cost of attending business meetings in the Bahamas will be deductible in 2006 without regard to whether it’s “as reasonable to meet there as in the U.S.”.

Tax Shelter

I.R.C. §§7602 and 7609

☞ **Amex & MasterCard Agree to Turn Over Taxpayer Information Regarding Offshore Accounts**

In March 2002, the IRS announced that it had reached a settlement agreement with a major credit card company that will permit the IRS to identify and pursue tax evaders who have offshore banking accounts. In this latest victory in the IRS’s crackdown on offshore banking accounts, American Express Co. has agreed to provide information to the government about taxpayer accounts offshore in Caribbean countries. Under the agreement, it would obtain records of 1998 and 1999 transactions involving taxpayers with transactions in the U.S. and mailing addresses in Antigua and Barbuda, the Bahamas, or the Cayman Islands. Under a settlement agreement, the IRS will be able to obtain information identifying taxpayers with offshore accounts, such as driver’s license and passport numbers.

Comment. The agreement will cover card holders with accounts in the Cayman Islands, Antigua, and Barbados. And, a similar agreement with Visa International is expected to be filed soon in district court in California. MasterCard has already turned over information on more than 230,000 accounts in response to the government's request. Finally, many commentators believe that the IRS will turn its attention next to other credit card companies, such as Citigroup's Diners Club International, and processing companies such as First Data Corp.

In a related press release, Treasury Assistant Secretary for Tax Policy Mark A. Weinberger said, "The Treasury Department and the IRS are committed to combating tax evasion. I applaud the steps taken by the IRS in cracking down on the illegal use of offshore bank accounts to hide U.S. taxable income." He finished by commenting that recently released proposals made by the IRS and Treasury demonstrate the administration's commitment to pursuing tax evaders.

2002 Workbook