2002 Income Tax School What's New Supplement

ACCOUNTING

Accounting Period

Notice 2002-75
I.R.C. §442

☞ **The IRS eases automatic approval process for individuals seeking to change accounting period.**

Normally a taxpayer must receive IRS permission to change tax years, once a tax year has been established. The IRS has updated its exclusive automatic approval process for individuals who file a fiscal year return and wish to switch to a calendar year. This will be the first procedure change in 30 years. The process is similar to what is used by corporations and pass-through entities. This process can be found in Rev. Proc. 2002-27 and 2002-38.

The new procedure will be the exclusive means for individuals who want to change to a calendar year. However it will **not** apply to:

- Newly married taxpayers, when one spouse is permitted to change to the accounting period of the other spouse or
- Individuals with an interest in a pass-through entity that meets any of the following criteria:
    1. The pass-through entity would be required to change its taxable year to the new calendar year of the individual or
    2. The pass-through entity is a fiscal year partnership that is owned equally by two partners, one or both of whom are individuals, and the individual and the partnership both want to change to the new calendar taxable year of the other 50-percent partner or
    3. The new calendar taxable year of the individual would result in no change in or less deferral of income from the pass-through entity than the present taxable year on the individual or
    4. For pass-through entities that do not qualifying for the exceptions, the pass-through entity has been in existence for at least three taxable years and the interest is *de minimis*.

> **Note.** If an individual does not meet the criteria in the procedure, they must have written approval of the IRS to change accounting periods. These taxpayers should consult Rev. Proc. 2002-39.

Taxpayers wishing to use this procedure will be required to file Form 1128. Application To Adopt, Change, or retain a Tax Year. The effective date is after the comment period for the procedure which ends January 6, 2003. The IRS is expected to publish the procedure shortly after the comment period.

Form **1128**

(Rev. April 2000)
Department of the Treasury
Internal Revenue Service

Application To Adopt, Change, or Retain a Tax Year

▶ **Instructions are separate.**

OMB No. 1545-0134

Part I **General Information** (All applicants must complete this part and sign on page 4. See page 2 of instructions.)

Please Type or Print

Name of applicant (If a joint return is filed, also give spouse's name.)	**Identification number** (See page 2 of instructions.)
Number, street, and room or suite no. (If a P.O. box, see page 2 of instructions.)	Service Center where income tax return will be filed
City or town, state, and ZIP code	Applicant's area code and telephone number/Fax number ( ) / ( )
Name of person to contact (If not the applicant, attach a power of attorney.)	Contact person's area code and telephone number/Fax number ( ) / ( )

1 Check the appropriate box(es) to indicate the type of applicant filing this form (see page 2 of instructions).

- ☐ Individual
- ☐ Partnership
- ☐ Estate
- ☐ Domestic corporation
- ☐ S corporation
- ☐ Personal service corporation (PSC)
- ☐ Cooperative (sec. 1381(a))
- ☐ Possession corporation (secs. 936 and 30A)
- ☐ Controlled foreign corporation (CFC) (sec. 957)
- ☐ Foreign personal holding company (sec. 552)
- ☐ Foreign sales corporation (FSC) or Interest-charge domestic international sales corporation (IC-DISC)
- ☐ Specified foreign corporation (SFC) (sec. 898)
- ☐ Passive foreign investment company (PFIC) (sec. 1297)
- ☐ Other foreign corporation
- ☐ Tax-exempt organization
- ☐ Homeowners Association (Sec. 528)
- ☐ Other .... (Specify entity and applicable Code section)

2a Approval is requested to (check one) (see page 3 of the instructions):

☐ Adopt a tax year ending ▶ ....
(Partnerships and PSCs: Go to Part III after completing Part I.)

☐ Change to a tax year ending ▶ ....

☐ Retain a tax year ending ▶ ....

b If changing a tax year, indicate the date the present tax year ends. ▶ ....

c If adopting or changing a tax year, indicate the dates of the first return or short period return that will be required to be filed for the tax year beginning ▶ , 2000, and ending ▶ , 20 .

3a Is the applicant's present tax year, as stated on line 2b above, the same tax year for both Federal income tax and financial reporting purposes? . . . . ▶ ☐ **Yes** ☐ **No**

b If "No," attach an explanation.

4 Indicate the applicant's present overall method of accounting.

☐ Cash receipts and disbursements method

☐ Accrual method

☐ Other method (specify) ▶

5 State the nature of the applicant's business or principal source of income.

6 Is **Form 2848**, Power of Attorney and Declaration of Representative, attached to this application? . ▶ ☐ **Yes** ☐ **No**

7 Does the applicant request a **conference of right** at the IRS National Office if the IRS proposes to disapprove the application? . . . . ▶ ☐ **Yes** ☐ **No**

8 Enter amount of **user fee** included with this application. (See page 3 of the instructions.) . . . . ▶ **$**

For Privacy Act and Paperwork Reduction Act Notice, see page 1 of separate instructions. Cat. No. 21115C Form **1128** (Rev. 4-2000)

Part II **Expeditious Approval Request** (If the answer to any of the questions below is "Yes," file Form 1128 with the IRS Service Center where the applicant's income tax return is filed. **Do not** file with the National Office. **Do not** include a user fee. **Do not** complete Part III. See page 3 of instructions.)

		Yes	No
1	**Rev. Proc. 2000-11.** Is the applicant a corporation (including a homeowners association (section 528)) described in section 4 of Rev. Proc. 2000-11, 2000-3 I.R.B. 309, that is requesting a change in a tax year **and** is not precluded from using the expeditious approval rules under section 4.02 of Rev. Proc. 2000-11? ▶		
2a	**Rev. Proc. 87-32.** Is the applicant a partnership, S corporation, or PSC that is requesting a tax year under the expeditious approval rules in section 4 of Rev. Proc. 87-32, 1987-2 C.B. 396 **and** is not precluded from using the expeditious approval rules under section 3 of that revenue procedure? ▶		
b	Is the applicant a partnership, S corporation, or PSC that is requesting a tax year that coincides with its natural business year as defined in section 4.01(1) of Rev. Proc. 87-32, **and** the tax year results in no greater deferral of income to the partners or shareholders than the present tax year? ▶		
c	Is the applicant an S corporation whose shareholders own more than 50% of the shares of the corporation's stock (as of the first day of the tax year to which the request relates) **and** the shareholders have the same tax year the corporation is requesting? ▶		
d	Is the applicant an S corporation whose shareholders own more than 50% of the shares of the corporation's stock (as of the first day of the tax year to which the request relates) **and** the shareholders have requested approval to concurrently change to the tax year that the corporation is requesting? ▶		
3	**Rev. Proc. 66-50.** Is the applicant an individual requesting a change from a fiscal year to a calendar year under Rev. Proc. 66-50, 1966-2 C.B. 1260? ▶		
4	**Rev. Proc. 85-58 or 76-10.** Is the applicant a tax-exempt organization requesting a change under Rev. Proc. 85-58, 1985-2 C.B. 740, or Rev. Proc. 76-10, 1976-1 C.B. 548? ▶		

Part III **Ruling Request** (All applicants requesting a ruling must complete Section A and any other section that applies to the entity. See page 4 of the instructions.)

SECTION A—General Information

		Yes	No
1a	In the last 6 years has the applicant changed or requested approval to change its tax year? (See page 4 of instructions.) ▶ If "Yes" and a ruling letter was issued granting approval to make the change, attach a copy of the ruling. If a copy is not available, attach an explanation and give the date the approval was granted. If a ruling letter was not issued, explain the facts and give the date the change was implemented. If the requested change was denied or not implemented, attach an explanation.		
b	If a change in tax year was granted within the last 6 years, attach a statement explaining why another change in tax year is necessary fully describing any unusual circumstances.		
2	Does the applicant or any related entities have any accounting method, tax year, ruling, or technical advice request pending with the National Office? ▶ If "Yes," attach a statement explaining the type of request (method, tax year, etc.) and the specific issues involved in each request.		
3	Enter the taxable income* or (loss) for the 3 tax years immediately before the short period and for the short period. If necessary, estimate the amount for the short period. Short period $ ______ First preceding year $ ______ Second preceding year $ ______ Third preceding year $ ______ **Individuals, enter adjusted gross income. Partnerships and S corporations, enter ordinary income. Section 501(c) organizations, enter unrelated business taxable income. Estates, enter adjusted total income. All other applicants, enter taxable income before net operating loss deduction and special deductions.*		
4a	Is the applicant a U.S. shareholder in a CFC? ▶ If "Yes," attach a statement for each CFC providing the name, address, identification number, tax year, the percentage of total combined voting power of the applicant, and the amount of income included in the gross income of the applicant under section 951 for the 3 tax years immediately before the short period and for the short period.		
b	Will each CFC concurrently change its tax year to conform with the tax year requested? If "No" to line 4b, attach a statement explaining why the CFC will not be conforming to the tax year requested by the U.S. shareholder.		

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SECTION A—General Information *(Continued from page 2.)*

		Yes	No
5a	Is the applicant a U.S. shareholder in a PFIC as defined in section 1297? ▶		
	If "Yes," attach a statement providing the name, address, identification number and tax year of the PFIC, the percentage of interest owned by the applicant, and the amount of distributions or ordinary earnings and net capital gain from the PFIC included in the income of the applicant.		
b	Did the applicant elect under section 1295 to treat the PFIC as a qualified electing fund? ▶		
6a	Is the applicant a member of a partnership, a beneficiary of a trust or estate, a shareholder of an S corporation, a shareholder of an IC-DISC, or a shareholder of a FSC? ▶		
	If "Yes," attach a statement providing the name, address, identification number, type of entity (partnership, trust, estate, S corporation, IC-DISC, or FSC), tax year, percentage of interest in capital and profits, or percentage of interest of each IC-DISC or FSC and the amount of income received from each entity for the first preceding year and for the short period. Indicate the percentage of gross income of the applicant represented by each amount.		
b	Will any partnership concurrently change its tax year to conform with the tax year requested? ▶		
c	If "Yes" to line 6b, has any Form 1128 been filed for such partnership? ▶		
7	Attach an explanation providing the reasons for requesting the change in tax year, as required by Regulations section 1.442-1(b)(1). **If the reasons are not provided, the application will be denied.** If requesting a ruling based on a natural business year, provide the information required by Rev. Proc. 87-32 and/or Rev. Proc. 74-33, 1974-2 C.B. 489. (See page 4 of the instructions.) **Note:** *Corporations wanting to elect S corporation status should see line 2 in Section B below and the instructions.*		

SECTION B—Corporations (other than S corporations and controlled foreign corporations)

		Yes	No
1	Enter the date of incorporation. ▶		
2a	Does the corporation intend to elect to be an S corporation for the tax year immediately following the short period? ▶		
b	If "Yes," will the corporation be going to a permitted S corporation tax year? If "Yes," you can file expeditiously. Go to Part II, Question 1, and check "Yes." Then complete the signature area on page 4. If "No," to line 2b, complete the rest of this application.		
3	Is the corporation a member of an affiliated group filing a consolidated return? ▶		
	If "Yes," attach a statement providing **(a)** the name, address, identification number used on the consolidated return, the tax year, and the Service Center where the applicant files the return, **(b)** the name, address, and identification number of each member of the affiliated group, **(c)** the taxable income (loss) of each member for the 3 years immediately before the short period and for the short period, and **(d)** the name of the parent corporation.		
4	Personal service corporations (PSCs):		
a	Attach a statement providing each shareholder's name, type of entity (individual, partnership, corporation, etc.), address, identification number, tax year, percentage of ownership, and the amount of income such shareholder received from the PSC for the first preceding year and for the short period.		
b	If the PSC is using a tax year other than the required tax year, indicate how it obtained its tax year ("grandfathered" tax year, section 444 election, or ruling letter from the IRS National Office). ▶		
c	If the PSC received a ruling, indicate the date of the ruling and attach a copy of the ruling letter. ▶		
d	If the corporation made a section 444 election, indicate the date of the election. ▶		

SECTION C—S Corporations

		Yes	No
1	Enter the date of the S corporation election. ▶		
2	Is any shareholder applying for a corresponding change in tax year? ▶ If "Yes," each shareholder requesting a corresponding change in tax year must file a separate Form 1128 to get advance approval to change its tax year.		
3a	If the corporation is using a tax year other than the required tax year, indicate how it obtained its tax year ("grandfathered" tax year, section 444 election, or ruling from the IRS National Office). ▶		
b	If the corporation received a ruling, indicate the date of the ruling and attach a copy of the ruling letter. ▶		
c	If the corporation made a section 444 election, indicate the date of the election. ▶		
4	Attach a statement providing each shareholder's name, type of shareholder (individual, estate, qualified subchapter S Trust, electing small business trust, other trust, or exempt organization), address, identification number, tax year, percentage of ownership, and the amount of income each shareholder received from the S corporation for the first preceding year and for the short period.		

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SECTION D—Partnerships (See page 4 of instructions.)

		Yes	No
1	Enter the date the partnership's business began. ▶		
2	Is any partner applying for a corresponding change in tax year? ▶		
3	Attach a statement providing each partner's name, type of partner (individual, partnership, estate, trust, corporation, S corporation, IC-DISC, etc.), address, identification number, tax year, and the percentage of interest in capital and profits.		
4	Is any partner a shareholder of a PSC as defined in Temporary Regulations section 1.441-4T(d)(1)? ▶ If "Yes," attach a statement providing the name, address, identification number, tax year, percentage of interest in capital and profits, and the amount of income received from each PSC for the first preceding year and for the short period.		
5a	If the partnership is using a tax year other than the required tax year, indicate how it obtained its tax year ("grandfathered" tax year, section 444 election, or ruling letter from the IRS National Office). ▶		
b	If the partnership received a ruling, indicate the date of the ruling and attach a copy of the ruling letter. ▶		
c	If the partnership made a section 444 election, indicate the date of the election. ▶		

SECTION E—Controlled Foreign Corporations (See page 4 of instructions.)

		Yes	No
1	Attach a statement for each U.S. shareholder (as defined in section 951(b)) providing the name, address, identification number, tax year, percentage of total value and percentage of total voting power, and the amount of income included in gross income under section 951 for the 3 tax years immediately before the short period and for the short period.		
2a	Is the applicant a CFC requesting a revocation of its 1-month deferral election that was made under section 898(c)(1)(B) **and** change its taxable year to the majority U.S. shareholder year (as defined in section 898(c)(1)(C))? ▶		
b	If "Yes," to line 2a, go to Part II, question 1. If "No," to line 2a, complete the rest of application (see instructions).		

SECTION F—Tax-Exempt Organizations

		Yes	No
1	Enter the type of organization: ☐ Corporation ☐ Trust ☐ Other (specify) ▶		
2	Enter the date of organization. ▶		
3	Enter the code section under which the organization is exempt. ▶		
4	Is the organization required to file an annual return on Form 990, 990-C, 990-PF, 990-T, 1120-H, or 1120-POL? ▶		
5	Enter the date the tax exemption was granted. ▶ .... Attach a copy of the ruling letter granting exemption. If a copy of the letter is not available, attach an explanation.		
6	If the organization is a private foundation, is the foundation terminating its status under section 507? ▶		

SECTION G—Estates

1 Enter the date the estate was created. ▶

2 Attach a statement providing:

a Name, identification number, address, and tax year of each beneficiary and each person who is an interested party of any portion of the estate.

b Based on the adjusted total income of the estate entered in Part III, Section A, line 3, attach a statement showing the distribution deduction and the taxable amounts distributed to each beneficiary for the 2 tax years immediately before the short period and for the short period.

SECTION H—Passive Foreign Investment Company

Attach a statement providing each U.S. shareholder's name, address, identification number, and the percentage of interest owned.

Signature—All Applicants (See **Who Must Sign** on page 2 of instructions.)

Under penalties of perjury, I declare that I have examined this application, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete. Declaration of preparer (other than applicant) is based on all information of which preparer has any knowledge.

Applicant's name (print or type)

Signing official's name (print or type) | **Title**

Applicant or signing official's signature (officer of parent corporation, if applicable) | **Date**

Firm or preparer (print or type) preparing the application

Signature of individual (other than applicant or signing official) preparing the application | **Date**

Form **1128** (Rev. 4-2000)

AGRICULTURAL ISSUES

Peanut Quota

Notice 2002-67, 2002-42 and IRB 2002-103

I.R.C. §§1231 and 1001

☞ **Peanut quota payments generally yield capital gain.**

The Department of Agriculture repealed the peanut marketing quota program and will make payments to the quota holders. This IRS notice explains the tax treatment of the payments. Most farmers will be able to treat the payment as capital gain income, which makes it available to reduce capital losses.

The program pays the quota holder 11¢ per pound of quota for five years. The holder also has the right to ask for a single payment in any one year. The terms of the payments will be set in a contract between the quota holder and the USDA.

According to the notice, payments will be subject to income tax. If the amount paid is greater than the holders adjusted basis in the quota, the holder has a taxable gain. If the amount is less, he has a deductible loss.

The basis for the quota depends on how the quota came into the hands of the holder. Following are four ways the quota could have been obtained:

- If it was derived from an original grant from the government, it has a zero basis.
- If it was purchased the basis is the purchase price.
- If the quota was received by gift, the basis is the basis of the donor and
- If it was inherited, it is the fair market value of the deceased, valued at the date of death.

The gain from the quota will be included in gross income in the year payment is received. This can occur in one year or it can be reported on the installment sale method if payments are received over the five year period.

If the quota holder used the quota in his trade or business, and on May 13, 2002 his holding period was more than one year, the sale will be a I.R.C. §1231 sale and will be reported on Form 4797. Assuming the holder has no other I.R.C. §1231 transactions the gain will be a long-term capital gain and any loss will be treated as an ordinary loss. If the quota was held for investment purposes, any gain or loss is a capital loss.

Inventory Valuation

T.D. 9019

I.R.C. §471

☞ **Liberalized unit-livestock-price method of accounting for accrual method farmers.**

The IRS has finalized the regulations for the unit-livestock-price method that were published on February 4, 2002. The old regulations required taxpayers to reevaluate their unit prices and adjust them upwards to reflect the increased cost of livestock production. The new regulations allow for either an upward or a downward change in value. This is a major improvement, since the old law only allowed for increases in value.

The new regulations also clarify that a livestock raiser, who uses the unit-livestock-price method, may elect to remove from inventory, after maturity, an animal used for draft, breeding, or dairy purposes and treat the inventory cost of the animal as an asset subject to depreciation.

These regulations are effective for taxable years ending after October 28, 2002.

> **Note.** The new regulations do not give a safe-harbor price for valuing the livestock inventory.

Self-Employment Income

***Howard Hillman v. U.S.,* U.S. District Court, Dist. S.D.,. CIV. 01-4124, (09/11/02)**

I.R.C. §§1402 and 7402

☞ **Court rules taxpayer in business of raising and selling breeding cattle and denies capital gain treatment.**

The Hillman's owned and operated an Angus farm in South Dakota. Each year they had an auction where they sold approximately 120 bull calves. They also sold 36 to 46 heifer calves at the same sale. While they reported the sale of the bulls on Schedule F, they contended the heifers were cull animals and reported their sale on Form 4797, hence avoiding self employment tax.

The court ruled the heifers constituted self employment income based of the fact the heifers were culled only one month prior to the annual sale. If they were truly culls, they would have been sold as soon as it was determined they should not be in the herd.

While the Hillman's contended the heifers did not measure up to their standards, the sale ads advertised them as being "at the top of their breed" and being "some of their best heifers".

> **Observation.** The courts have had a difficult time determining whether an animal is a cull or is really being held for sale. In one case, the court ruled that when the number of animals culled from the breeding herd depended entirely on the number of prospective purchasers, the animals were held primarily for sale and should be reported on the Schedule F.

AMORTIZATION AND DEPRECIATION

Goodwill

LTR 200243002

I.R.C. §197

☞ **Goodwill fails to qualify as amortizable intangible.**

The taxpayer requested that the IRS consider the goodwill and going concern value of a business to be an amortizable intangible asset. The IRS determined that nothing in I.R.C. §197 changed the traditional treatment of goodwill and going concern value if the intangibles do not qualify for amortization. Therefore, the assets qualify for capital gain treatment rather than being I.R.C. §1231 assets.

In this case, the goodwill was either self-created or acquired before the enactment of I.R.C. §197. Therefore it did not qualify as amortizable under I.R.C. §197.

> **Note.** This may be the first time the IRS has ruled to this effect.

BANKRUPTCY AND INSOLVENCY

COD Income

SCA 200235030

I.R.C. §108

☞ **Taxpayer reporting COD income can file for a refund when prior debt is repaid.**

The taxpayer could recover taxes associated with cancellation of debt (COD) income reported in a prior year under the "claim of right" doctrine when they later repaid the debt.

The SCA indicated at the time the Form 1099-C was issued, it was not clear whether the amounts would be repaid. Therefore, the 1099-C was filed in error and the taxpayer was entitled to file for a refund. Payment of the debt in a future year would support the conclusion that the original amount reported should not have been included in income.

IRS Levies

***Rousey v. Jacoway* (In re Rousey) (B.A.P. 8th Cir.), 190:K–22 (10/01/02)**

I.R.C. §6331

☞ **Bankruptcy creditors can levy and seize IRA assets.**

An Appeals Court decided that IRA assets can be used to satisfy creditor liens where the taxpayer has filed for bankruptcy protection. According to the court, the owner of an IRA "did not face significant restrictions" against withdrawing funds from their accounts. Even though they were under age 59$^{1}/_{2}$, they were only faced with the 10% penalty.

The Rousey's filed a voluntary Chapter 7 bankruptcy petition and Jacoway was appointed trustee in the case. The debtors elected to use the bankruptcy exemptions provided by 11 U.S.C. I.R.C. §522(b)(1) and found in 11 U.S.C. I.R.C. §522(d). They contend their IRA accounts are exempt from creditors. 11 U.S.C. I.R.C. §522(b) permits a debtor to choose between the bankruptcy exemptions provided in I.R.C. §522(d) and the exemptions under state law

Note. Expect a Supreme Court review since two other Appeals Courts have disagreed with this decision in previous cases. Under a 1992 court decision, creditors are not permitted to seize assets held in qualified retirement plans.

Note. The conclusion reached depends upon state law and exemptions allowed under bankruptcy regulations.

BUSINESS EXPENSE

Interest Expense

***Edward A. Robinson III v. Commissioner* , 119 TC No. 4 (09/05/02)**

I.R.C. §62, 162 and 163

☞ **Interest on business tax deficiency isn't deductible.**

The Tax Court has reversed its previous rule that interest paid on a taxpayer's underpayment of taxes is not deductible under I.R.C. §163(h) even if the tax liability on which the interest was paid arose within a business. This brings the Tax Court in line with five Circuit Court of Appeals and overrules the decision in *Redlark v. Comm, 106 TC 31 (1996).*

This case involves an attorney who reported a profit on his legal practice in 1987. Upon audit, the IRS found an underpayment of tax. In 1994, the IRS seized real property belonging to the taxpayer and his spouse to collect the underpayment. The property was sold in 1995 and the IRS applied the proceeds to the underpayment plus the accrued interest. **The interest on the underpayment was deducted on the 1995 Schedule C of the taxpayer.** The IRS denied the interest deduction under Temp. Reg. §1.163-9T(b)(2)(i)(A).

The taxpayer argued that the interest was deductible under I.R.C. §163(h)(2)(A) because it was "properly allocable to a trade or business". All of the income on the return came from the business. The taxpayer based his argument on the *Redlark* decision. The IRS, on the other hand, based its decision on the opinions of the five Circuit Courts.

> **Note.** If the law practice was incorporated, the interest would have been deductible since a corporate taxpayer would have no personal expenses.

Entertainment Expenses

Churchill Downs, Inc. **(2000) 115 TC 279 (09/26/00)**
I.R.C. §274

☞ **Appellate Court agrees half of racetrack operator's entertainment costs disallowed.**

The Sixth Circuit affirmed the Tax Court's decision in the Churchill Downs case. Here a racetrack operator attempted to deduct 100% of its cost in hosting special entertainment events in connection with its races. It hosted the Sport of Kings Gala, the Kentucky Derby Winner's Party, hospitality tents and other functions in connection with the Kentucky Derby.

The taxpayer argued these were not entertainment expenses, subject to the 50% limitation based on two exceptions in I.R.C. §274(e)(7 and 8). The first is an exception made for goods and services available to the general public. The second is an exception for goods and services which are sold by the taxpayer in a bona fide transaction for an adequate and full consideration.

The Appellate Court agreed with the Tax Court that the first exception did not apply because the events where the expenses were incurred were invitation only events and were not open to the general public. Only selected horsemen, media officials, local dignitaries and track employees were invited to attend. The court could not distinguish between normal entertainment of selected clients and what the racetrack did and determined the 50% limitation applied. They noted only the race itself was open to the general public.

The court ruled the second exception did not apply because the racetrack did not sell the food and beverages, it gave it away.

Deductible Repairs

Campbell v. Commissioner, **T.C. Summary Opinion 2002-117**
I.R.C. §162

☞ **Roof repair results in a current deduction.**

Expenses incurred to maintain assets in suitable operating condition, rather than to extend their useful life remain eligible for a current deduction.

In this case the taxpayer owned rental property. The roof leaked and was causing damage to the interior walls. Hence, they hired a company to remove the existing roof and install fiberglass sheets and hot asphalt. They also replaced the damaged drywall. The costs were deducted as a current operating expense, but the IRS ruled they should be capitalized and depreciated.

However, the Tax Court ruled with the taxpayer. They found the costs to be incidental and did not materially add to the value of the property, add to its life, or make it adaptable to another use. The Court did agree that repairs in the nature of a replacement made to arrest deterioration and prolong the life of a structure should be capitalized.

Legal Fees

***Eric Test and Odelia Braun v. Commissioner,* TC Memo 2000-362, 80 TCM 766 (9th Cir.)**

I.R.C. §§67 and 162

☞ **Legal fees incurred as an employee deductible on Form 2106.**

The taxpayer incurred legal fees in connection with her employment. The court ruled these fees were only deductible on Schedule A, subject to the 2% miscellaneous expense deduction. The fees are treated as any fees associated with a trade or business. In this case, the trade or business is that of being an employee. Similarly, bad debts of an employee belong on Form 2106 as well.

The taxpayer was a doctor who worked as the director of a medical unit (CPRT) at the University of California. Part of her duties included implementing practices designed to improve emergency response treatment for patients suffering from cardiac arrest. Braun had developed an outstanding reputation for the work she was performing in the San Francisco area. She trained people from the private sector regarding how to treat cardiac arrest victims. One of her projects was working with the San Francisco Giants organization. She trained ushers at Candlestick Park to recognize emergencies and to communicate the occurrence of an emergency to the paramedics and emergency response teams located throughout the stadium.

She was in the process of forming a corporation, SLS, to develop her own practice to work with the private sector. She also developed a business plan in an effort to start her own practice.

She was on the verge of obtaining funding when her hospital employer began an audit of her unit. At the same time the San Francisco Chronicle and the San Francisco Examiner published several articles referencing CPRT and the State audit. Braun was concerned that the audit would jeopardize her opportunity to establish her own practice and sought legal advice. She incurred legal fees of $87,300. She deducted $70,611 of these fees on her Schedule C when she filed her tax return. The IRS contended the fees were related to her job as an employee of the university. The Tax Court agreed and she appealed the decision.

The court based its opinion on the fact that all of the legal bills referenced Braun's work with CPRT and her efforts to protect her reputation. The legal expenses were incurred in response to an event that was not part of SLS' business, but, rather, was part of Braun's employment.

The Appeals Court affirmed the Tax Court decision.

Restorative Payments

PLR 200241046

I.R.C. § 162

☞ **Payments made to restore lost value in retirement plan deductible as business expense.**

Some companies are considering making payments into their defined benefit plans to prevent lawsuits due to poor investment decisions by plan administrators. This letter ruling addresses five issues regarding Restorative Payments.

1. Whether the Restorative Payments will be deductible in full by Employer A pursuant to I.R.C. §162? Since the purpose of the payments is to offset the lost value in the participants plans, the IRS will allow the payments to be treated as a business deduction.

2. Whether the Restorative Payments will not constitute employer "contributions" or amounts subject to the provisions of I.R.C. §§404, 415 or 4972?.

3. Whether the Restorative Payments will not adversely affect the qualified status of Plan X under I.R.C. §401?
4. Whether the Restorative Payments will not violate non-discrimination rules of I.R.C. §401(a)(4) and will not be "annual additions" under I.R.C. §415?
5. Whether the Restorative Payments will not, when made to the Plan, result in taxable income to affected Plan X participants or beneficiaries?

The author of the letter ruling referred the reader to Revenue Ruling 2002-45 for answers to questions 2 through 5.

CAPITAL GAINS AND LOSSES

Investment Interest

Lenehan v. Commissioner, **T.C. Summary Opinion 2002-124**
I.R.C. §163

☞ **Long-term capital loss carryovers must be included when calculating "Net Investment Income" for Form 4952 purposes.**

This is important in determining the amount of investment interest that can be deducted on Schedule A or deducted on Schedule E.

In the *Lenehan* case, the taxpayer filed Form 4952 on which he listed $54,061 of net investment income. This included $5,044 of interest and dividends and a $49,017 net gain on property held for investment. Total investment interest expense amounted to $26,721. The taxpayers did not include a long-term capital loss carryover of $141,621 in making the calculation. If the $141,621 long-term capital loss carryover had been included, there would have been no long-term capital gain and the election would have been limited to $5,044 of interest and dividends. The taxpayer's taxable income would increase by $21,677.

The Tax Court agreed with the IRS that the long-term capital loss should have been included.

Capital Gain Rate

Heatley v. Commissioner, **U.S. District Court M.D. Fla Case No. 6:01-cv-1044-Orl-22DAB**
I.R.C. § 1(h)

☞ **Marginal tax rate for net capital gains for taxpayers otherwise in 10% or 15% brackets.**

Mr. Heatley, an 80 year old taxpayer, prepared his own 2000 tax return. In 2000, he sold Walt Disney Corporation stock for $442,827 in which his basis was $10,764. Knowing he would owe income tax on the long-term gain, Heatley sent a check for $43,204 to the IRS along with a letter explaining the transaction. In September, realizing that the gain might be taxed at a 20 % rate, he sent an additional $43,204 payment to the IRS. These two payments were in addition to his $800 quarterly payments.

When Heatley filed his 2000 tax return in February 2001, he reported taxable income of only $37,512. He calculated a tax of $5,629 and an amount due of $209. He did not include a Schedule D for the $432,063 capital gain. After processing the tax return, the IRS sent Heatley a notice stating he had an overpayment of $86,409. Heatley responded that he was sure he owed at least $43,204.

The IRS determined that Heatley owed additional tax of $792. He paid it and filed a claim for refund contending the capital gain should be taxed at a 10% rate.

The District Court agreed with the IRS that the gain was subject to a 20% capital gains rate. The taxpayer unsuccessfully argued that since the "last dollar" of the non-capital gain income fell within the 15% bracket, all of the gain should be taxed at the lower 10% rate.

CORPORATIONS

Gain On Incorporation

Seggerman Farms Inc., et al. v. Commissioner, **T.C. Memo 2001-99 (7th Cir.)**
I.R.C. §351 and 357

☞ **Liabilities in excess of property's basis cause gain on incorporation.**

I.R.C. §351 allows a tax free transfer of assets into a corporation or partnership as long as certain requirements are met. However if the basis of the assets transferred are less than the amount of liabilities transferred, I.R.C. §357 provides that the difference is taxable.

It does not matter if the transferor maintains 80% control of the transferee entity or remains liable on the debt. This is similar treatment to cancellation of indebtedness, however there are no exceptions to reporting this amount as taxable income.

In this case, the shareholders transferred property to the corporation subject to liabilities in excess of their basis. After the incorporation, the new corporation refinanced the debts, but the shareholders remained personally liable for the assumed debt. None of the loan proceeds were distributed to the shareholders. Consequently, the shareholders argued that they were not relieved of any debt and gain should not be recognized on the transfer.

The Tax Court held that even though the shareholders remained personally liable for the debt, they must recognize taxable income under I.R.C. §357(c). The court determined the shareholders did not contribute loan receivables or personal notes to the corporation to cover the difference between the basis and the liabilities transferred. They ruled a guarantee is not the same as incurring indebtedness to the corporation, since a guarantee is only a promise to pay if certain events do not occur.

The Ninth Circuit allowed the transfer of a note to the company for the amount of the excess in *Peracchi (81 AFTR 2d 98-1754*. The argument is that this conforms to the Supreme Court's decision in *Crane (331 U.S. 1 (1947).*

Note. Additional details can be found in the 2001 Illinois Farm Income Tax School Workbook on page 361.

CREDITS

Hope Credit

FSA 200236001
I.R.C. §§25A, 151, and 152

☞ **Coordination of the HOPE and Lifetime Learning Credit with the dependency exemption clarified.**

This FSA examines the relationship between the HOPE and the Lifetime Learning credits and the requirement for claiming a dependent. The FSA comes to two conclusions:

1. Because a dependency exemption was allowable to the parents of the taxpayer/student during the year in issue, the taxpayer's personal exemption amount is zero.
2. Because the taxpayer/student was not allowed (claimed) as a dependent by his parents, the taxpayer is entitled to claim a Hope Scholarship Credit on his own return for that year (assuming he meets all other relevant eligibility requirements.)

Note. This could happen because the credit or exemption would be phased out due to the taxpayers high AGI.

Observation. This tax strategy will yield no benefit if the student does not have sufficient taxable income to benefit from the credit offset.

DEDUCTIONS

Anticipatory Assignment Of Income

Rauenhorst v. Commissioner, **119 T.C. No. 9**

I.R.C. §170

☞ **Contributions of stock to charity is not an anticipatory assignment of income.**

The taxpayers were the sole partners in a partnership. In addition they owned warrants in a corporation. A second corporation had announced they were going to purchase all warrants and merge the companies. Just prior to the merger, the taxpayers assigned their ownership rights in the warrants to four charitable organizations. This allowed them to avoid a large capital gain.

Under Rev. Rul. 78-197, when a charitable gift of stock is made, the proceeds from the sale will be considered income to the donor only in situations where the charity is required to sell the gifted stock at the time the gift is made.

The IRS argued it was not bound by Rev Rul 78-197. The Tax Court noted that it is not bound by revenue rulings, but this one had been in existence for over 25 years, had not been revoked and had been cited by the IRS in numerous private rulings. Consequently, the taxpayer was not liable for the $1.3 million of deficiency and $250,000 of accuracy-related penalties.

Medical Expense

Pub. 502

I.R.C. §213

☞ **IRS publication takes restrictive view on medical deductions for weight-loss programs.**

The 2002 Farm Tax School Workbook discusses Revenue Ruling 2002-19 on page 306. Since the workbook's publication, the IRS has issued Pub 502 which takes a restrictive view on the deduction.

The ruling raised questions on whether deductions can be taken by taxpayers who use the services of gyms and spas to lose weight. Since this is a medical deduction limited by the 7.5% AGI limitation, it may not be a large deduction for many taxpayers. However, since medical expenses can receive a "before tax" deduction as a part of a flexible spending account, it will effect many more taxpayers.

Under the terms of the ruling, uncompensated amounts paid by individuals for participation in a weight-loss program as treatment for a specific disease diagnosed by a physician qualify as a medical expense. Pub. 502 now states "You can include in medical expenses amounts you pay to lose weight for a specific disease diagnosed by a physician (such as obesity, hypertension, or heart disease). This includes fees you pay to join a weight reduction group and attend periodic meetings. But you can not include membership dues in a gym, health club, or spa."

Note. The ruling is applicable to all open tax returns or returns that can still be amended.

Donations

Rev. Rul. 2002-67

I.R.C. §170

☞ Deduction for autos donated to charity's agent allowed.

This ruling allows individuals to claim a charitable deduction for automobiles donated to a charity's agent. The ruling says the agent's written acknowledgment substantiates the gift and explains when an auto may be valued with reference to an established price guide.

Many of the charitable car solicitation programs are run by for-profit organizations. The IRS has three potential issues with these programs, regardless of whether the auto is given to the charity or the for-profit business that runs the donation program:

- Is the gift adequately substantiated? Requirements for gifts of $250 or more require a description of the donated property or the amount of cash donated.
- Is the donor receiving any goods or consideration for the donation? If the donation is in the form of goods, a description and good-faith estimate of their value is required.
- Is the auto fairly valued?.

The revenue rule uses two situations to illustrate an acceptable donation program.

Interest

IR 2002-114

I.R.C. §163

☞ Not all mortgage refinancing expense can be deducted.

Due to the lowest home interest rates in 30 years, taxpayers are rushing to refinance their home mortgages. In this announcement, the IRS is reminding taxpayers that not all refinancing expenses are tax deductible. Some taxpayers are doing "cash-out" refinancing. "Cash-out" refinancing is where a taxpayer takes part of his home equity in cash at the time of the new loan.

Example: Fred has an existing mortgage of $95,000, but his house has a value of $150,000. Fred takes a $125,000 mortgage and receives $30,000 from the lender.

Points on an original mortgage are deductible as interest if they are charged solely for:

- Loan origination fees
- Processing fees
- Maximum loan charges or premium fees.
- They are not deductible if used for:
- Appraisal fees
- Credit investigation charges
- Recording fees
- Inspection fees.

Refinance points are not like original mortgage points. The points paid on a straight refinancing are deductible over the term of the loan. Traditionally, the IRS has viewed refinancing points as not paid in connection with the purchase or improvement of a residence when the proceeds are used solely to repay the existing debt.

Observation. There are estimates that more than 1/2 of all refinancing is resulting in "cash-outs". This may amount to over $100 billion in 2001.

Note. The portion of the points attributable to home improvements are immediately deductible. However, these points must be paid from separate funds.

The tax deduction for refinancing points is calculated by dividing the amount of points by the number of payments in the term of the loan.

Example: Joe pays $1,000 in refinancing points. The term of his loan is 15 years. His monthly deduction is $5.56 or $66.72/year. This is computed by dividing $1,000 by 180.

Caution. If the taxpayer is refinancing for a second time, any non-deducted points from the previous refinancing are immediately deductible.

Clean Fuel Deduction

IR-2002-97

I.R.C. §179A

☞ Clean fuel deduction allowed for two more hybrid cars.

The Honda Civic Hybrid for 2003 and the Honda Insight for 2000, 2001 and 2002 now qualify for the $2,000 deduction in the year the vehicle is first placed into service. The deduction is to help cover the incremental cost of buying a motor vehicle that is fueled by a clean-burning fuel. The write-off is taken against adjusted gross income. There are phase-out provisions that can reduce the amount of the deduction.

The Toyota Prius for model years 2001 through 2003 also qualify for the deduction.

Additional information on the clean fuel deduction can be found on page 565 of the 2002 Farm Income Tax School Workbook.

Medical Costs

***Emanuel v. Commissioner,* T.C. Summary 2002-127**

I.R.C. §213

☞ Swimming pool expense and YMCA costs were deductible medical expenses.

Tax Court agreed with taxpayers that their swimming pool was used for medical purposes and any personal use was minimal. Their deduction included the cost of chemicals, equipment and electricity and the cost of therapeutic classes taken at the YMCA.

The taxpayer was injured in an accident and was receiving workers' compensation benefits. He was not able to walk on his own for a hundred feet or stand more than a few minutes. He could not care for himself and relied on his wife for assistance with showering, dressing, eating and exercising.

In addition, their child was severely mentally retarded and physically handicapped. He also required constant attention. The state court had awarded additional attendant care benefits and the taxpayer hired a care taker who worked at least 10 hours per day. The cost of the caretaker was also taken as a medical deduction.

DEPENDENCY ISSUES

Dependency Exemption

***Reiss v. Commissioner,* T.C. Summary 2002-112**

I.R.C. §151

☞ **Dependency exemption disallowed despite language in divorce decree.**

Based on language in the divorce decree, the taxpayer was entitled to the dependency exemption. However, the IRS denied the exemption because the ex-spouse refused to sign Form 8332. The Tax Court agreed with the IRS even though it was sympathetic to the taxpayer. They based their ruling on the fact Congress implemented the custodial parent plan to reduce disputes regarding dependency exemptions.

The Court said it could not enforce the decree and the taxpayer would need to go back to the Family Court which approved the initial divorce decree if he wanted satisfaction.

EMPLOYMENT TAX ISSUES

Penalties

***U.S. v. Steven Lindsey,* 2002-2 USTC**

I.R.C. §6672

☞ **Corporate officer was responsible despite not having check-signing authority.**

The Tenth Circuit upheld a decision that an individual could be a responsible party for the liability for unpaid employment taxes even though he did not have authority to sign checks for the employer.

The IRS can seek to collect a 100% penalty tax from a "responsible person" if they fail to deposit payroll taxes for an employer. A responsible person is anyone responsible for collecting, accounting for, and depositing any tax, who willfully fails to perform these responsibilities.

In this case, Steven Lindsey was a founder and 50% shareholder of TFS. TFS leased truck drivers to Clearwater, another company owned by the same shareholders. Lindsey was president of Clearwater and vice president of TFS. TFS had no expenses or financial obligations other than the employment taxes. While Lindsey did not have signature authority for TFS, he authorized all lease payments by Clearwater to TFS. Hence, he had substantial control over TFS. When Clearwater ran into financial difficulties, they favored other creditors over TFS which resulted in TFS failing to meet its payroll tax obligations.

The Tenth Circuit was faced with the question, is check-signing authority a necessary requirement to avoid having personal responsibility and willfulness in meeting the payroll tax obligation? The court decided check-signing authority was not conclusive.

Employment Taxes

Social Security Contribution and Benefit Base for 2003

I.R.C. §3402(p)

☞ **Nanny tax thresholds rises to $1,400 for 2003.**

Cash remuneration paid to a household employee of less that $1,400 will not require employment taxes. This is an increase from $1,300 in 2001 according to a Social Security Administration announcement.

Note. The dollar limit applies to each household employee, not to a group of employees.

Company Trips

Townsend Industries v. U.S. **No. 4-01-CV-10176 (S.D. Iowa)**

I.R.C. § 61

☞ **Company paid fishing trips held to be wages.**

Townsend Industries regularly took their employees on a company paid fishing trip. They argued that the trip was a part of its "me too" business philosophy which encouraged employees to be a part of the company team.

The taxpayer, located in Iowa conducts an annual sales meeting at its headquarters. Employees arrive over a weekend and attend meetings on Monday and Tuesday. A variety of topics are discussed at these meetings. On Wednesday the company sponsors a fishing trip to a resort in Canada that runs through Saturday. All employees, including the factory workers, are encouraged to go on the trip.

Employees are assigned to various boats by the company officials. They believe the interaction between the employees in a relaxed environment will motivate employees to perform their jobs better. Employees indicated they spend between one and fours hours each day discussing company business.

The District Court had to decide if costs associated with the trip were a working condition fringe benefit. They evaluated the ordinary and necessary requirement in making their decision. They based their decision on two primary factors:

1. The lax attendance policy for the trip. While all employees are invited to attend, a significant number do not participate in the trip.
2. The disconnect between the sales meeting and the fishing trip. The court acknowledged that while business was discussed on the trip, it was not conducted in an organized and monitored environment where the company is certain that an agenda is followed and discussions continue.

The District Court determined the cost of these trips were in fact wages to the employees and subject to payroll taxes. The court indicated that even though morale might benefit, the cost was still taxable to the employee. As a result, the company was liable for $58,000 in additional employment taxes.

Note. The costs of the two days of sales meetings was not an issue in the case.

Observation. It is important to have a planned agenda to avoid this challenge.

Back Pay

LTR 200244004

I.R.C. §3121

☞ **Employment discrimination settlement, reasonably allocated to emotional distress, is payroll tax-free.**

This letter ruling addresses whether employment taxes must be withheld on the payment to a former employee to settle an employment discrimination case to the extent the payment was reasonably allocated to emotional distress. The IRS says no withholding is necessary nor was withholding on payments allocated to attorney's fees and paid directly to the attorney.

Under I.R.C. §104(a)(2), gross income does not include damages, other than punitive damages, received on account of physical injuries or physical sickness. However, emotional damages are not included except to the extent of amounts paid for medical care. Any damages excluded from gross income are not subject to employment taxes.

> **Note.** While the attorney portion is not subject to payroll taxes, in some jurisdictions it would be included in the taxpayer's gross income. It can then be deducted as a miscellaneous deduction subject to the 2% limitation.

Worker Classification

***Evans Publishing, Inc.* (2002) 119 TC No. 14**

I.R.C. §§7436, 6214 and 7605

☞ **Tax Court may determine the IRS' later claim that individuals were employees.**

The Tax Court ruled in favor of the IRS in a prolonged procedural dispute involving whether spousal shareholders were employees of their corporation and if so, whether their loans were disguised wages. These were issues that were not initially raised by the IRS.

The IRS issued the company a Notice of Determination Concerning Worker Classification Under I.R.C. §7436. They determined the company's sales and graphics personnel should be treated as employees for 1993, '94, and '95 and made adjustments to the employment taxes for those years. The company took the IRS to Tax Court to dispute its determination of status and the amount of taxes and penalties assessed. The IRS moved to dismiss issues concerning the amount of taxes and penalties owed. The company later responded that it wanted to amend its petition disputing the employment classification but not the taxes and penalties owed. The Tax Court allowed the amended petition.

The IRS answered the amended petition and stated that the shareholders were employees of the company and were not entitled to I.R.C. §530 relief. They said the company compensated them through the payment of commissions and wages disguised as shareholder loans. In the meantime Congress passed the Community Renewal Tax Relief Act of 2000 which retroactively amended I.R.C. §7436 to provide the Tax Court with jurisdiction to decide the correct amounts of employment taxes relating to the IRS's determination of worker classification. Hence, the company again filed a petition to dispute the amount of taxes and penalties.

The Tax Court allowed the second petition. The IRS' answer to the second petition claimed that the shareholders were employees and that I.R.C. §530 relief was not available. A hearing was held to determine if the Tax Court had jurisdiction over the additional individuals, the shareholders, and the additional amounts raised by the IRS. The Tax Court showed that it was well established that they had jurisdiction to review the additional taxes asserted by the IRS before the hearing or rehearing. The court agreed additional taxes were due.

> **Note.** Congress gave the Tax Court jurisdiction to decide the correct amounts of employment taxes relating to determinations about worker classification in 2000.

Inadequate Compensation

***Grey Public Acct., P.C. v. Commissioner,* T.C. No. 5**

I.R.C. §3121

☞ **Tax Court rules against taxpayer in inadequate compensation case.**

Once again, the Tax Court has agreed that S corporation shareholder-employees need to receive an adequate salary. In this case, the taxpayer tried to prove that they were an independent contractor and hence were issued a Form 1099 MISC instead of a W-2.

The taxpayer was the sole shareholder and officer of his accounting firm. The Tax Court ruled he was not an independent contractor. They based this on the following facts. He:

- Solicited business for the firm.
- Ordered all of the company supplies.
- Made verbal and written agreements with vendors for the firm.
- Managed the firm's finances.
- Collected monies owed to the firm.
- Managed the company.
- Provided all of the accounting functions for the firm.
- Obtained clients and maintained client satisfaction.

In addition, he was the only person to have signature authority over the firm's checking account. He wrote personal checks from the company's business account rather than taking fixed payments for his services.

Ironically, he was the accountant for the client in (*Veterinary Surgical Consultants, P.C. v. Comm. 117 T.C. 14*) discussed on page 302 of the 2002 Farm Income Tax School Workbook.

Medical Reimbursement Plans

Rev. Rul. 2002-58

I.R.C. §105

☞ **I.R.C. §105 plan payments made before plan is established will be taxable to employee.**

The IRS has taken a firm stand against medical reimbursement plan payments made for services received prior to when the plan was established. These payments will be treated as taxable fringe benefits to the recipients. Consequently, they will be subject to the normal employment taxes.

This is a major change from what one national firm had been advising clients in past years.

Tips

I.R.C. § 3401

☞ **The IRS will use the results of *Fior D'Italia* for upcoming audits.**

The Supreme Court decision in Fior D'Italia has given the IRS the authority to use the extrapolation method with impunity. This allows the IRS to more easily assess penalties for missed tips.

It also gives the restaurant owner an incentive to oversee tip pick-up by servers more carefully. In the *Fior D'Italia* case the IRS was allowed to extrapolate the amount of tips received by examining credit card receipts rather than auditing each server individually.

The IRS' recent audit emphasis and its Supreme Court victory in *Fior D'Italia* may provide an incentive for employers to enter into tip rate determination agreements (TRDAs) or tip reporting alternative commitment (TRAC) agreements. In addition to the food service industry, taxicab and limo companies, car wash operations, cosmetologists, barbers and employees in the gaming industry may enter into TRDAs and TRACs.

The IRS has announced it will use this method when appropriate, but has said it will not use it routinely.

ESTATE AND GIFT

Family Limited Partnerships

Theodore R. Thompson v. Commissioner, **(2002) TC Memo 2002-246**

I.R.C. §§2001, 2036 and 704

☞ **Tax Court requires value of family limited partnership (FLP) be included in gross estate, but does uphold the validity of the FLP.**

The IRS often challenges the validity of a FLP. In this case they ruled the FLP was valid but its value was still taxable in the federal estate. They required that the assets that were transferred into a family limited partnership be included in the estate of the transferor. In addition, they included the appreciation of these assets and the new assets that were acquired by the partnership. The court used I.R.C. §2036 to include the value of the FLP in the estate

Theodore Thompson (Theodore) established two family limited partnerships in 1993. He also set-up two corporations to act as the general partners for the FLPs. The FLP were established based on the recommendation of a financial planner and an insurance agent. Unfortunately, some of the correspondence between the planners, the taxpayer and the taxpayer's heirs was used in court to the disadvantage of the taxpayer's estate.

Theodore had two children, Betsy Turner (Betsy) and Robert Thompson (Robert). Theodore was a successful businessman prior to his retirement, but the majority of his assets consisted of cash and securities at the time the FLPs were formed. One of the FLPs was named Thompson Partnership with Thompson Corporation as the general partner. The other FLP was Turner Partnership with Turner Corporation as the general partner. Theodore's assets were equally divided between the two FLPs.

Theodore owned 490 shares of Turner Corporation with Betsy and her husband each owning 245 shares. A tax-exempt organization owned 20 shares. After the assets were contributed to Turner Partnership, Theodore owned a 95.4% limited interest, Betsy's husband a 3.54% limited interest and Turner Corporation owned the remaining 1.06% as the general partner.

After Thompson Corporation was formed, Theodore held 490 shares, Robert held 490 shares and an unrelated party held 20 shares. Both Theodore and Robert contributed assets to the FLP. At formation Theodore held 62.27% as a limited partner, Robert held 36.72% as a limited partner and Thompson Corporation held 1.01% as the sole general partner.

Prior to forming the FLPs, the financial advisors had sent letters to Betsy and Robert advising them that if the assets were transferred into the partnerships, Theodore would still have control over them and be able to withdraw whatever funds he needed for his care. In fact, when Theodore died in 1995, the majority of the assets in each of the FLPs were the same as had been originally contributed. The IRS produced correspondence in court where Betsy and Robert agreed to withdraw money from the FLPs to put into Theodore's personal account to pay for his personal needs. The court records show other transactions which indicate the FPLs were not valid businesses but were only established to avoid estate taxes.

The Court stated, "In this case, the circumstances surrounding establishment of the partnership show that, at the time of the transfer, there was an implied agreement or understanding that decedent would retain the enjoyment and economic benefit of the property he had transferred." The court further stated, "Here, decedent's outright transfer of the vast bulk of his assets to the partnership would have depleted him of the assets needed for his own support. Thus, the transfers from the partnerships to decedent can only be explained if decedent had at least an implied understanding that his children would agree to his requests for money from the assets he contributed to the partnerships, and that they would do so for as long as he lived."

Because of the way the business was managed, the Court also agreed with the IRS and refused to acknowledge the 40% discount taken for lack of marketability and lack of control. The court ruled that the estate for Theodore owed an additional $707,054 of estate tax.

> **Note.** Tax professionals and attorneys should read the details of this case if they have clients with FLPs. It is an excellent example of what not to do in operating a FLP.

GROSS INCOME

Accrued Income

FSA 200236003

I.R.C. §451

☞ **Insurance proceeds do not accrue while amount of claim is in dispute.**

Taxpayers are not required to accrue the proceeds from business interruption insurance until the litigation between the taxpayer and the insurance carrier is resolved.

The taxpayer suffered a loss and submitted a claim to his insurance carrier. The carrier paid for the losses, but did not settle on the business interruption claim. The taxpayer included the insurance proceeds and an accrued amount for the business interruption in gross income when filing his tax return.

Three years after the claim, the insurance company still had not settled. Consequently, the taxpayer amended his return to reduce gross income by the accrued business interruption amount.

The IRS ruled that in situations of this kind there are no hard and fast rules and that they must be settled on the facts and circumstances of the case. They must look at the insurance policy and examine the provisions and other evidence to see if and to what extend the insurance carrier has acknowledged liability. They acknowledged, in this case, that a dispute did exist between the taxpayer and the insurance carrier. As a result, the amount of the claim could not be determined and the accrual was not to be included in gross income.

Accrual Method Of Accounting, Deposit

***Tampa Bay Devil Rays, Ltd.*, TC Memo 2002-248**

I.R.C. §§446 and 451

☞ **Advance ticket sales did not have to be accrued and included in income until the first game was played.**

The Tampa Devil Rays partnership was awarded a new baseball franchise in 1995. They immediately began selling tickets even though the first game would not be played until 1998. They received deposits on tickets and on private suites which would be repaid if they did not play in 1998. In 1996, they received a sponsorship fee for a game to be played in St. Petersburg during the '98 season. These funds were used to pay general operating expenses.

On its '95 and '96 returns, the partnership did not include any of the income from the deposits for advance sales of tickets and suites. Instead they reported the income in 1998. The '95 and '96 returns reported general operating and overhead expenses and expenses related to their minor league activities.

They capitalized the $130 million franchise fee and amortized the portion allocated to player contracts. No accrual deductions were taken in '95 or '96 for anticipated expenses directly related to the games to be played in 1998. They did not claim any expenses for the cost of marketing the advance tickets and private suites.

The Tax Court pointed out that generally an accrual basis taxpayer that receives payments for services, performed in the future without restriction as to use, has to report those payments as income when received. The rule applies even if the company may have to repay some of the money in the future.

The Tax Court based its decision on *Artnell Co. v. Comm,. 400 F. 2d 981 (1968)*. This is a similar case involving the Chicago White Sox. Consequently, the Court ruled in favor of the taxpayers.

Unreported Income

***Robert M. Johnson, et ux. V. Commissioner,* (2002) TC Memo 2002-239**

I.R.C. §61

☞ **The IRS uses bank deposits analysis as proof of income.**

The taxpayer is an attorney who had offices in five Florida cities. He specialized in DUI cases and traveled between the cities, appearing in court for his clients.

At the time of the audit, the taxpayer was divorced, but had filed a joint return with his spouse in the years in question. On audit, the examiner used the bank deposits method to reconcile income. He determined that the gross income reported on the returns was understated. The taxpayer's accountant prepared records showing that part of the unreported income came from transfers between the bank accounts. However, due to inadequate records the exact amount could not be determined.

The Tax Court ruled that the bank deposits method has long been sustained by the courts as a means of computing unreported income.

Legal Fees

***Peaco v. Commissioner,* U.S. Court of Appeals, 3rd Circuit, 00-2154, 9/27/2002**

I.R.C. §104(a)(2)

☞ **Tax Court includes only net discrimination award in gross income.**

The taxpayer was awarded $584,000 in an age discrimination case. They did not include any of the award in gross income when they filed their 1995 tax return, believing it was not taxable. They contend the award was for "pain and suffering."

The Tax Court ruled the award was taxable, but allowed the taxpayer to reduce the award by the $84,000 paid to their lawyer.

INNOCENT SPOUSE

Innocent Spouse

***Kathryn Cheshire v. Commissioner,* 5th Circuit Court of Appeals,**

I.R.C. §6015

☞ **Supreme Court refuses to review case denying innocent spouse relief for woman who believed omitted item wasn't taxable.**

This case is detailed on page 324 of the *2002 Farm Income Tax School Workbook.*

Innocent Spouse

***Craig A. Penfield, et al. v. Commissioner,* (2002) TC Memo 2002-254**

I.R.C. §6015

☞ **Tax Court agrees with The IRS that knowledge of omitted income weakens case for innocent spouse treatment.**

Taxpayer filed a joint return with his spouse in 1997. He failed to report $45,410 of income of which $43,783 came from a pension distribution. At the time the IRS determined the deficiency, the taxpayers were divorced. The husband claimed innocent spouse treatment because he was suffering from mental illness and the tax would cause extreme financial hardship. The Social Security Administration classified the taxpayer as disabled in 1998.

During 1997, the taxpayers often ate lunch together. They went to the bank together and they opened joint bank accounts. They frequently talked about money. Penfield wrote checks from both the joint household accounts and a small business account.

During the course of the case, the court found Penfield had expressed concern that the pension was not guaranteed by the FDIC. His spouse testified he bugged her until she finally agreed to withdraw the funds. Penfield testified he did not know about the pension fund in question. The Tax Court though, did not find Penfield's testimony credible.

Penfield also contended paying the tax would impose severe financial hardship. After comparing the income available to the taxpayer with his financial needs, the Court decided the taxes did not impose extreme financial hardship.

Innocent Spouse

***Ferrarese v. Commissioner,* T.C. Memo 2002-249**

I.R.C. §6015(f)

☞ **The IRS abused its discretion when it denied innocent spouse relief.**

The Tax Court permitted taxpayer to receive innocent spouse relief even though, prior to signing the tax return, she knew that her husband had embezzled monies from his employer. The couple had been married for 31 years. Their sole income was from Social Security benefits of $1,540 per month. However, the benefits were not high enough to meet their monthly expenses.

Their income was supplemented by regular cash gifts from their children. The husband suffered from congestive heart failure. To supplement their income, the husband embezzled monies from his employer from 1975 to 1983. Upon discovery in 1984, he was fired from his job. The wife agreed to her husband signing her name to the 1983 tax return. Since the embezzled funds were never included in gross income, the IRS assessed deficiencies in 1981, 1982, and 1983.

In 1993, the Tax Court determined the wife was entitled to innocent spouse treatment for both 1981 and 1982. The Court based its determination of the fact she did not know, or have reason to know, about the money when she signed the '81 and '82 tax returns. Since she did not benefit from the funds, it would be inequitable to hold her liable for deficiencies for those tax years. On the other hand, the court held her liable for the 1983 tax for the same reasons.

In 2000, she filed Form 8857 requesting innocent spouse relief. The service denied this request. Next, she filed a petition with the Tax Court seeking a review of the IRS position under I.R.C. §6016(e)(1) arguing she should qualify under I.R.C. §6015(f) and the IRS abused its discretion in denying her request for relief. The IRS argued she would not suffer economic hardship, if relief was denied, since she shared a bank account and credit card with her husband and that her children would continue to pay some of her monthly bills. They also pointed out that the Tax Court had found she had benefited from the embezzled monies.

The Tax Court agreed with the wife that she should be granted relief under I.R.C. §6015(f). I.R.C. §6015(f) states that "all facts and circumstances need to be taken into account in determining whether equitable relief is appropriate." In addition, Rev. Proc. 2000-15 shows a list of factors that the IRS will evaluate in deciding whether equitable relief should be granted. Given the facts presented, the Tax Court decided the wife would suffer economic hardship if relief was not given. She would have been required to sell the condo unless relief was granted.

Innocent Spouse

***Raymond v. Commissioner,* T.C. No. 11**
I.R.C. §6015(f)

☞ **Taxpayers must have filed a joint return in order to claim innocent spouse relief.**

While I.R.C. §6015(f) does not specifically say that a joint return must be filed to claim innocent spouse treatment, the Tax Court has determined a joint return is required. They based their finding on IRS procedures that stipulate this as a prerequisite as well as on the legislative history behind the enactment of the code.

IRS PROCEDURES –MISCELLANEOUS

Entity Classification

Rev. Proc. 2002-59
I.R.C. §7701

☞ **Guidance for newly formed entity requesting relief for a late initial classification election filed by the due date of its first tax return.**

An eligible entity can elect to change its classification under the default rules of Reg. 301.7701-3(b) or to change its classification by filing Form 8832. An initial classification election is an election by an eligible entity, newly formed under local law, to be classified effective on the date of its formation as other than its default classification. The time for filing the late election is extended from 6 months to the due date of the return (excluding extensions) of the entity's desired classification for the year of the entity's formation.

An entity can obtain relief from a late initial classification election if:

- The newly formed entity did not receive its desired classification as of its formation date because Form 8832 was not timely filed.
- The due date of the return for the taxable year starting with the date of the entity's formation has not passed and
- The entity has reasonable cause for failing to timely make the initial entity classification election.

On or before the due date of the initial return the taxpayer must file a signed Form 8832 with the applicable service center. "Filed pursuant to Rev. Proc. 2002-59" should be written across the top of the form.

This revenue procedure applies to all ruling requests pending in the National Office on 9/30/02 and all ruling requests received after that date.

Archer MSA

IRS Announcement 2002-90

I.R.C. §220

☞ Archer MSAs – limitation on number of participating taxpayers.

Congress has again extended the sign-up period for MSAs. They will continue to be available through the end of 2002.

Archer MSAs are accounts established to pay the medical expenses of an individual and their dependents. The eligible individual must participate in a "high deductible" health plan sponsored by a small employer and self-employed individuals.

MSAs were established in 1997 and were scheduled to terminate when 750,000 individuals enrolled in the plan. The IRS projects that 59,000 will claim MSA deductions on their 2002 tax return.

Social Security Wage Base

Social Security Contribution and Benefit Base for 2003

http://www.ssa.gov/OACT/COLA/cbb.html

☞ Social Security wage base will increase to $87,000 for 2003.

The Social Security Administration has announced that the wage base will increase to $87,000 for 2003. This is an increase from $84,900 in 2002 or a 2.4% increase.

In 2003, an employee and his employer will each have to pay $130.20 more in Social Security taxes.

Applicable Federal Rates

Rev. Rul. 2002-61

I.R.C. §§42 , 280G , 382 , 412 , 467 , 468 , 482 , 483 , 642 , 807 , 846 , 1288 , 7520 and 7872

☞ Applicable federal rates for October 2002.

	Annual	Semiannual	Quarterly	Monthly
Short-term	2.03%	2.02%	2.01%	2.01%
Mid-term	3.46%	3.43%	3.42%	3.41%
Long-term	4.90%	4.84%	4.81%	4.79%

Applicable Federal Rates

Rev. Rul. 2002-74

I.R.C. §§42 , 280G , 382 , 412 , 467 , 468 , 482 , 483 , 642 , 807 , 846 , 1288 , 7520 and 7872

☞ **Applicable federal rates for November 2002.**

	Annual	Semiannual	Quarterly	Monthly
Short-term	1.82%	1.81%	1.81%	1.80%
Mid-term	3.06%	3.04%	3.03%	3.02%
Long-term	4.60%	4.55%	4.52%	4.51%

Applicable Federal Rates

Rev. Rul. 2002-81

I.R.C. §§42 , 280G , 382 , 412 , 467 , 468 , 482 , 483 , 642 , 807 , 846 , 1288 , 7520 and 7872

☞ **Applicable Federal Rates for December 2002.**

	Annual	Semiannual	Quarterly	Monthly
Short-term	1.84%	1.83%	1.83%	1.82%
Mid-term	3.31%	3.28%	3.27%	3.26%
Long-term	4.92%	4.86%	4.83%	4.81%

Offers-In-Compromise

Prop. Reg. §300.3

I.R.C. §7122

☞ **Fee required for filing an offer-in-compromise.**

Beginning in 2003, the IRS will charge a $150 filing fee for an offer-in-compromise. This is an attempt to stop many of the frivolous offers they receive. There is an exception for lower income taxpayers. The IRS hopes that only serious offers will be presented.

This regulation will take effect 30 days after it is finalized. When a taxpayer submits an offer, the IRS is prohibited from continuing collection activities. It does not make any levies to collect taxes during the period it is evaluating the offer, for 30 days after rejecting an offer, and during the time an appeal takes place. Since this process can extend over many months or even years some taxpayers file an offer even though they know it will be refused.

If the fee is established, it will be taken out of the amount determined to be collectable and will be considered when determining if the offer is reasonable. The fee will not apply to cases based on doubt of liability, offers made by low income taxpayers, offers accepted to promote effective tax administration, and offers accepted based on doubt of collectibility.

Court Costs
TC Memo. 2002-247
I.R.C. §7430

☞ **Surgeons fails to win court costs.**

The *Rosario* case was discussed on page 323 of the *2002 Farm Tax School Workbook.*

This second case involved Antonio Rosario filing against the IRS to recover his legal fees from the previous suit where he successfully defended the fact that he was not liable for income tax on the loan made by his employer. The Tax Court determined that the language in the agreement with the hospital was sufficiently confusing to hold that the IRS was reasonable in challenging the taxpayer.

A taxpayer can be awarded litigation costs and administrative expenses under I.R.C. §7430 if involved in an administrative or court preceding that is brought against the government. The action must involve the determination of any tax, interest, or penalty under the tax code. In order to be awarded legal costs, the taxpayer must be the "prevailing party". Even though Dr. Rosario was the "prevailing party", under I.R.C. §7430(c)(4)(B) the IRS must establish its position was substantially justified.

Entity Classification
Rev. Proc. 2002-59
I.R.C. §301.7701

☞ **The IRS provides additional leeway for late initial entity classification elections.**

The IRS is granting quite a bit of leeway in accepting late elections to specify the type of entity. These are commonly called "check-a-box" elections. The election can be made by the extended due date of the "changed" entity's first tax return.

The effective date to file Form 8832 electing a change for an entity classification is due no more than 75 days prior to the date on which the election is actually filed. Reg. §301.7701-3 provides that an entity that does not otherwise have to be classified as a corporation (i.e. an LLC) may elect its classification for federal tax purposes by "checking-the-box" and filing Form 8832.

FSA 200237017 permits an entity to change its current classification by the same means. For example, a corporation may revoke its charter and become an LLC, immediately check the box and continue to file as a corporation for federal purposes. The IRS considers this to be an F reorganization.

To be eligible for this relief the following requirements must be met:

1. The newly formed entity failed to obtain its desired classification as of the date of its formation solely because of Form 8832 not being timely filed.
2. The due date of the federal return for the entity's desired classification (excluding extensions) for the taxable year beginning with the date of formation has not passed and
3. The entity has reasonable cause for failing to make a timely election for its entity classification.

IRS PROCEDURES –PENALTIES

Penalties

Rev. Proc. 2002-66

I.R.C. §§6662 and 6694

☞ **Preparers can limit understatement and preparer penalties.**

There are certain circumstances, which if identified on a tax return, will be deemed adequate to avoid understatement, accuracy-related and preparer penalties. These have been detailed in Rev. Proc. 2002-66. The new revenue procedure applies to any return filed on 2002 tax forms for a year beginning in 2002 and any return filed on a 2002 form for short years beginning in 2003.

For some deductions, a number is verifiable if the taxpayer can demonstrate the origin of the number and can show good faith in entering the number on the applicable form. The revenue procedure details the types of transactions and the required disclosure to avoid the penalties.

Dependency Exemption

***Latanya Haywood v. Commissioner,* (2002) TC Memo 2002-258**

I.R.C. §§35 and 151

☞ **Dependency exemption and EIC not allowed when child is in prison.**

The issues in this case are whether the taxpayer's child, Brandon, qualifies for the dependency exemption and the increased amount of earned income credit. With regard to the dependency issue, taxpayers may deduct an annual exemption amount for each dependent. The term "dependent" means certain individuals for whom the taxpayer furnishes over half of the support during the taxable year.

During 1999, the year in question, Brandon was a full-time inmate of either Missouri Eastern Correction Center or the prison facility at Cameron, Missouri serving a sentence for manslaughter. To qualify for the earned income credit, Brandon needed to live with his mother for over half of the year. Brandon was convicted in 1995 and did not live with his mother at any time in 1999. Consequently, the Tax Court denied both the dependency exemption and the earned income credit.

Signature Authorization

SCA 200236043

I.R.C. §6012

☞ **Unenrolled preparer can sign a taxpayer's return.**

An unenrolled tax preparer may only sign a return on behalf of a taxpayer if the preparer has a properly completed power of attorney that specifically authorizes him to sign the taxpayer's returns.

The power of attorney must be attached to the tax return.

Valid Return

FSA 200235002

I.R.C. §6011

☞ **"Estimated return" at top of Form 1040 not considered a valid return.**

The IRS decided taxpayers did not file a valid return because they did not provide sufficient information for the IRS to calculate the actual tax liability. Therefore, the taxpayers did not make an honest and reasonable attempt at preparing their tax return. In addition they did not make an attempt to file the return because they forwarded it to the examining agent rather than to a proper Service Center.

In this case, the IRS began examining the taxpayer's return because they did not file a return for the year. Eventually they provided the examining agent with a Form 1040 on which they wrote "estimated return" at the top. Attached to the return was a letter from the paid preparer which stated the return was estimated based on very limited information because of the unavailability of the couple's records. Since the return reported a zero tax liability, the examiner did not process the return. Hence the Service Center issued a statutory notice of deficiency for the tax year.

Company Aircraft

Rev. Rul. 2002-56

I.R.C. §61

☞ **Release of last half of 2002 rates for valuing personal use of company aircraft.**

The IRS has released the rates for the personal use on company aircraft for the last half of 2002. These rates are based on the Standard Industry Fare Level cents-per-mile rates and terminal charges. These rates are for noncommercial use of the aircraft.

Statute Of Limitations

***Walther v. U.S.,* S. Court of Federal Claims, 2-293 T, 9/12/2002**

I.R.C. §6532

☞ **Attorney's inability to timely file claim for refund not accepted.**

The taxpayer's refund claim of $40,000 was barred by the two year statute of limitations. The taxpayer's attorney prepared the claim and gave it to his agent to mail. The agent could not find a mail drop and sent it two days later which was two days after the filing deadline. The attorney gave the claim to a colleague to deliver to the IRS in Washington, on April 5, 2002, the last day for filing. When the colleague tried to deliver the claim to the Court, he found that the Court was closed. After searching for a mail drop, attempting to locate the court and asking people for directions, he finally resorted to mailing the claim by Federal Express on April 8, 2002. Once received, the Court of Federal claims determined that the claim was not timely filed and dismissed the case. The taxpayer contested the disallowance.

The Court cited former rule 3(b)(2) which listed three situations where it had authority to issue a corrective order to deem a complaint filed earlier than its actual filing date:

- A showing that the clerk's records were factually incorrect.
- Offering proof the complaint was mailed in advance of the last date allowed by the statute of limitations and
- Showing the complaint filing should properly be a date earlier than that shown by the clerk's records.

The Court referenced the fact the taxpayer provided no reason why he preferred the use of a colleague over a mail service, other than they would be in Washington that day. They also commented the taxpayer's attorney used questionable judgment in giving the complaint to a colleague and said that "a few simple steps would have saved the complaint from being filed late." Because of the short "filing window", the attorney should have taken some basic precautions to assure the complaint would be filed on time.

IRS PROCEDURES –TAX FORMS

Schedule B

IR-2002-102

I.R.C. §6012

☞ **Change in reporting on Schedule B.**

Beginning in 2002, taxpayers with $1,500 or less of dividend and interest income are not required to file schedule B as an attachment to their Form 1040. However, they are still required to report the income on their tax return. They must continue to file the schedule if they have a foreign bank account.

The IRS estimates this will affect over 15 million taxpayers. Based on IRS time estimates this will save taxpayers 20 million hours of time in filing their tax returns. Additionally, 800,000 taxpayers will be able to use Form 1040EZ or TeleFile. Taxpayers with dividend income can not use Form 1040EZ.

Taxpayers who exclude interest on Series EE or I bonds issue after 1989 or receive interest or dividends as a nominee will continue to file Schedule B.

LIKE-KIND EXCHANGES

Water Rights

Wiechens v. U.S. **; U.S. District Court, Dist. Ariz., CIV. 00-1858-PHX-SMM, 9/11/2002**

I.R.C. §1031

☞ **Water rights did not qualify for like-kind exchange with real estate.**

Water rights are a type of interest in real property but are not permanent enough to qualify for like-kind treatment. The Tax Court agreed with the IRS even though the 50 year water rights were real property under state statutes. The IRS does not consider them to be substantially similar to farm land.

The IRS has deemed riparian rights are not permanent enough to be real estate.

> **Note.** This is one of a series of cases dealing with water rights within the Harquahala Valley Irrigation District in Arizona. The results of these cases regarding whether the sale of water rights is a capital assets have been mixed.

> In the *Wiechens* case, the court determined non-perpetual water rights, which had only a fifty year duration and were for a limited quantity of water were not like-kind to a fee-simple ownership in land.

Annuity Contracts
Rev. Rul. 2002-75
I.R.C. §1035

☞ **Consolidation of annuity contracts issuers is a tax-free exchange even if from different companies.**

In this ruling, the IRS allowed taxpayer to assign an annuity from one company to a different company. The second company then deposited the cash surrender value of the assigned annuity contract into a pre-existing annuity contract owned by the same taxpayer and issued by the second insurance company.

The IRS ruled the assignment of the contract was a tax-free exchange under I.R.C. §1035. The basis of the ruling was that the owner of the contracts was the same person and he had no access to the cash surrender value of the contract.

Like-Kind Exchange
Rev. Rul. 200283
I.R.C. §1031

☞ **Using qualified intermediary in a like-kind exchange does not avoid related-party resale rule.**

The IRS rules that a like-kind exchange between related taxpayers is a taxable event even if they use an unrelated qualified intermediary. Under the like-kind exchange rules, any exchange between related parties becomes taxable if either party disposes of the exchanged property within two years. There are exceptions for death, involuntary conversions and other non-tax-avoidance transactions.

I.R.C. §1031 treatment does not apply to an exchange that is part of a transaction structured to avoid the related party rules.

Like-Kind Exchange
LTR 200236026
I.R.C. §1031

☞ **Like-kind exchange accomplished through use of the internet allowed by the IRS.**

The IRS issued this letter ruling to a company that served as a qualified intermediary. They developed a web site in order to facilitate online like-kind exchanges, along with electronic or wire transfers.

The basic rules for a like-kind exchange remains the same in that the qualified intermediary will transfer a group of relinquished properties for a corresponding group of replacement properties. The IRS will treat these as separate and distinct like-kind exchanges. Therefore, the taxpayer will not have constructive receipt of any sale proceeds or of any property held by the qualified intermediary until they are actually transferred to him.

RETIREMENT

Retirement Distribution
Rev. Rul. 2002-62
I.R.C. §§72(t) and 402(a)

☞ **Some taxpayers may reduce early retirement payments penalty-free.**

Due to the value of retirement plans decreasing because of the decline in the stock market, The IRS is allowing some retirement plan participants to reduce the amount of their distributions. These taxpayers must be receiving fixed periodic payments. They cannot calculate the payments based on the current value of the plan at the end of each year rather than on the value of the plan when the payments were first commenced.

I.R.C. §72(t)(1) imposes a 10% penalty for plan withdrawals prior to age $59^1/_2$. However, I.R.C. §72(t)(2)(A)(iv) provides an exception to this penalty if the participant takes an early withdrawal that is a part of a series of substantially equal periodic payments. The payments must be made at least annually.

Payments can be made using one of three methods:

1. Required minimum distribution
2. Fixed amortization method
3. Annuitized method

Methods 2 and 3 create a payment that is fixed for the lifetime of the participant. If the payments are modified within 5 years from the starting date, the exception no longer applies and the entire amount of the distributions is liable for the 10% penalty.

The relief provided allows participants who deplete their account before the 5 years to not be liable for the penalty. It also allows a participant to make a one time election to switch to method 1. Participants who begin receiving payments in 2002 may make the change. If payments began prior to 2003, they can switch once to method 1.

IRA Distribution

***Ancira v. Commissioner,* 119 TC —, No. 6, 119 TC 135**

I.R.C. §408(d)(1)

☞ **No IRA distribution resulted when taxpayer acting merely as conduit.**

The taxpayer owned a self-directed IRA account. He decided he wanted to invest in the non-publicly traded stock of S.K.. While the trustee of the IRA agreed the investment was legal, they could not make the purchase themselves. Consequently, they issued a check made payable to S.K., but mailed it to the taxpayer so he could complete the transaction.

The trustee of the IRA did issue a Form 1099 R reporting the distribution. The IRS based its decision on the fact the taxpayer signed a distribution request, received the check and consequently should be taxed on the distribution which would also be subject to a 10% early withdrawal penalty.

The Tax Court commented, "We are not aware of any provisions of the [Code]. Applicable regulations or case law that prohibits a taxpayer from acting as a conduit for an IRA trustee under the circumstances presented here. We further note that it cannot be argued cogently that [the] taxpayer was in constructive receipt of the assets represented by the transaction."

Retirement Plans

Rev. Rul. 2002-73

I.R.C. §§401 , 403 , 408 , 409 , 410 , 411 , 414 , 415 and 501

☞ **The IRS limits ability to automatically change accounting for grace period contributions to 401(k) plans.**

The IRS has ruled that an employer can not claim a current-year tax deduction for a grace-period contribution to a 401(k) or defined contribution plan as matching contributions where the contributions are attributable to compensation earned by participants after the end of the current year. This applies even if the employer's liability to make a minimum contribution is fixed before the close of the current year. If the taxpayer wishes to change to a method consistent with Rev. Rul. 2002-46 he must apply for automatic approval under Rev. Proc. 2002-9.

TAX FRAUD

Tax Scams

Notice 2002-65

I.R.C. §1367

☞ **The IRS cautions taxpayers about tax scam involving S corporations.**

This scam involves the use of an S corporation. The corporation is formed and enters into straddles on foreign currencies. After the redemption by the other members, the corporation terminates the "loss leg" of the straddle, resulting in the losses flowing through to the remaining shareholder. Supposedly, the taxpayer can claim an immediate loss while deferring the offsetting gain with their original investment in the S corporation.

TRAVEL AND TRANSPORTATION EXPENSE

Per-Diem

Rev. Proc. 2002-63

I.R.C. §§162 and 274

☞ **The IRS issues simplified per-diem rates for travel after 9/30/02.**

Although the total rates are the same as those for the previous twelve months, the meals and incidentals (M&IE) portion of the simplified per-diems have changed slightly. The IRS has changed the definition of incidental expenses and has created a new incidental only per-diem for self-employed taxpayers and unreimbursed employees.

As with the prior rates, an employer may receive a per-diem and as long as it does not exceed the federal rate and the employee can substantiate time, place and business purpose for the expense. If he meets these requirements, the reimbursement is treated as if made to an accountable plan. Hence, it is not subject to income or payroll taxes.

The M&IE for a high-cost location remains at $204. This consists of $159 for lodging and $45 for meals. The rate was $204 for the prior year but consisted of $162 for lodging and $42 for meals. The M&IE for low-cost locations remains at $125, $90 for lodging and $35 for meals. The previous amount was $125 consisting of $91 for lodging and $34 for meals.

There are six new locations added to the high-cost locals and one location was dropped. The following cities have been added to the high-cost year-round list: Santa Monica, CA, Baltimore MD, Staten Island, NY, King of Prussia/Ft. Washington/Bala Cynwyd PA, Philadelphia PA, and Seattle WA. Palm Beach FL was deleted from the prior list.

A payer using the high-low method for employees must use it for all amounts paid for travel away from home within the continental United States (CONUS) during the calendar year, However they may reimburse an employees actual expenses, use the meals-only per diem method, or use the regular federal travel rate for travel outside on the US. A payer that used the high-low rates or the regular federal rate for the first three quarters of the year must continue to use that method until the beginning of 2003. However, a payer that used the high-low rates and high-cost localities may continue to use those rates through 12/31/02, if it does so consistently during this period for all employees reimbursed with the high-low per diem.

The employer must treat the M&IE portion as a meal and beverage expense, subject to the 50% limitation. For certain workers, this is 65% for 2002 and 2003.

The special rate for the transportation industry increased from $38 to $40 for a CONUS locality and from $42 to $45 for any location outside of the continental U.S.

The Rev. Proc. announces a new optional method for the incidental-expenses-only deduction. For post-September 30, 2002 away-from-home travel, employees and self-employeds may deduct $2 per day instead of actual expenses for ordinary and necessary travel expenses. This applies to individuals who do not incur meal expenses for a calendar day, or partial day, of travel away form home. The individual must only substantiate a time, location and business purpose for the travel. This method can not be used by payors that use a per-diem or meals-only per-diem method or by employees or self employed individuals who use the meals-only per-diem method. This deduction is not subject to the 50% limitation. The new definition does not include cleaning and pressing of clothes, laundry, lodging taxes or the cost of telephone calls.

Standard Mileage Rate

IR-2002-100 and Rev. Proc. 2002-61

I.R.C. §162

☞ **The IRS announces reduction in standard mileage rates for 2003.**

Even though fuel prices remain high, they had dropped when the IRS did its study. Therefore, the standard mileage deduction for 2003 is dropped to $.36 per mile for business use.

The other rates announced are:

- 14¢ per mile for charitable purposes. (This was not changed)
- 12¢ per mile for medical purposes and
- 12¢ per mile for moving.