Chapter 15: Rulings and Cases

EXPLANATION OF CONTENTS

Please Note. This chapter is a collection of selected cases, Revenue Rulings, Revenue Procedures, Treasury Regulations, Announcements, and Letter Rulings that have been issued during the past year, through approximately September 1, 2003. Since they appear in a condensed version, they should not be relied on as a substitute for the full documents. A full citation appears at the end of each item. This is not meant to be a comprehensive coverage of all tax law changes or explanations. It is intended to report the rulings and cases that are likely to be of interest to the average tax professional.

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

Substantial Authority

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

Evaluation of Authorities. There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment.

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- All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists.
- The weight of authorities is determined in light of the pertinent facts and circumstances. There may be substantial authority for more than one position with respect to the same item.
- Because the substantial authority standard is an objective standard, the **taxpayer's belief** that there is substantial authority for the tax treatment of an item **is not relevant** in determining whether there is substantial authority for that treatment.

Nature of Analysis. The weight accorded an authority depends on its relevance and persuasiveness, and the type of document providing the authority. For example, a case or Revenue Ruling having some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts, or is otherwise inapplicable to the tax treatment at issue. An authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts. The weight of an authority from which information has been deleted, such as a private Letter Ruling, is diminished to the extent that the deleted information may have affected the authority's conclusions. The type of document also must be considered. For example, a Revenue Ruling is accorded greater weight than a private Letter Ruling addressing the same issue. Private rulings, technical advice memorandums, general counsel memorandums, Revenue Procedures and/or actions on decisions issued prior to the Internal Revenue Code of 1986, generally must be accorded less weight than more recent ones. There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.

The following are considered authority for purposes of determining whether there is substantial authority for the tax treatment of an item:

- Applicable provisions of the Internal Revenue Code and other statutory provisions
- Temporary and final regulations construing such statutes

Note. Proposed regulations present a tentative IRS position which may be changed when temporary and/or final regulations are issued.

- Revenue Rulings
- Revenue Procedures
- Tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties
- Federal court cases interpreting such statutes
- Congressional intent as reflected in committee reports
- Joint explanatory statements of managers included in congressional conference committee reports, and floor statements made prior to enactment by one of a bill's managers
- General explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book)
- Private Letter Rulings and technical advice memoranda issued after October 31, 1976
- Actions on decisions and general counsel memoranda issued after March 12, 1981
- IRS information or press releases, and notices, announcements, and other administrative pronouncements published by the Service in the Internal Revenue Bulletin

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Internal Revenue Code. The provisions of the Internal Revenue Code are binding in all courts except when the provisions violate the United States Constitution.

Treasury Regulations (Income Tax Regulations). The regulations are the Treasury Department's official interpretation and explanation of the Internal Revenue Code (IRC). Regulations have the force and effect of law unless they are in conflict with the statute they explain.

Revenue Rulings. The IRS is bound by the position taken in Revenue Rulings. Revenue Rulings that interpret Treasury Regulations are entitled to substantial deference.

Letter Rulings and Technical Advice Memoranda. These are IRS rulings directed at a particular taxpayer. Private letter rulings are issued for a fee. The IRS is only bound to the ruling for the particular taxpayer that requested the ruling. TAM's are issued in response to a request for a legal opinion.

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

General Council Memorandum (GCM). These detail the legal reasoning behind the issuance of a Revenue Ruling.

Service Center Advice (SCA). These SCA'a are issued by the IRS in response to a question coming from an IRS Service Center. There are two types of SCAs: routine and significant. A Routine SCA is answered by district counsel and is not coordinated with the National Office. A Routine SCA is not issued to the public. A Significant SCA (SSCA), on the other hand, is only issued with the approval of the National Office. An SSCA is not legal advice and only addresses the interpretation or application of the internal revenue laws. SSCA's are made public, but any information identifying the taxpayer is deleted.

JUDICIAL SYSTEM FOR TAX DISPUTES

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

1. File a petition in the Tax Court without paying the tax.
2. Pay the tax and file a claim of refund. If the IRS rejects the claim of refund, the taxpayer can file a suit in the Federal District Court or the Claims Court.

The U.S. Tax Court is a federal court of record established by Congress under Article I of the Constitution in 1942. It replaced the Board of Tax Appeals. Congress created the Tax Court to provide a judicial forum in which affected persons could dispute tax deficiencies determined by the Commissioner of Internal Revenue prior to the payment of the disputed amounts. The Tax Court is located at 400 Second Street, N.W., Washington, D.C. 20217. Although the court is physically located in Washington, the judges travel nationwide to conduct trial in various designated cities.

The Tax Court is composed of 19 judges acting as "circuit riders." This is the only forum in which a taxpayer can contest a tax liability without first paying the tax. However, jury trials are not available in this forum. More than 90% of all disputes concerning taxes are litigated in the Tax Court.

The jurisdiction of the Tax Court was greatly expanded by RRA 98. The jurisdiction of the Tax Court includes the authority to hear tax disputes concerning notices of deficiency, notices of transferee liability, certain types of declaratory judgment, readjustment and adjustment of partnership items, review of the failure to abate interest, administrative costs, worker classification, relief from joint and several liability on a joint return, and review of certain collection actions. Furthermore, this court also has limited jurisdiction under IRC §7428 to hear an appeal from an organization that is threatened with the loss of its tax-exempt status. Under IRC §7478, the Tax Court can also issue a declaratory judgment for a state or local government that has failed to get a tax exemption for a bond issue.

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The IRS issues a statutory notice of deficiency in tax disputes in which the Service has determined a deficiency. In cases in which a deficiency is not at issue, the IRS will issue a notice of final determination. A notice of final determination will be issued in the following types of tax disputes:

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

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

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

Cases are scheduled for trial as soon as practical (on a first-in, first-out basis) after the case becomes at issue, when the parties come to a point in the pleadings which is affirmed on one side and denied on the other. When a case is scheduled, the parties are notified by the court of the date, time, and place of trial. The vast majority of Tax Court cases are settled by mutual agreement of the parties without the necessity of a trial.

However, if a trial is conducted, in due course a report is ordinarily issued by the presiding judge setting forth findings of fact and an opinion. The case is then closed in accordance with the judge's opinion by entry of a decision stating the amount of the deficiency or overpayment, if any.

The Chief Judge of the Tax Court decides which opinions will be published. The Chief Judge can also order a review by the full court of any decision within 30 days. Published decisions are reported in the *Reports of the Tax Court of the United States*. Unpublished opinions are reported as Memorandum Decisions by tax service publishers. Both the published and unpublished opinions may be found on the United States Tax Court Web site at **www.ustaxcourt.gov.**

Any decision of the Tax Court can be appealed to the appropriate Circuit Court of Appeals. A final appeal can be made to the Supreme Court, but since its jurisdiction is discretionary, the court hears relatively few tax cases. Many of these court transcripts can be accessed on-line at www.uscourts.gov.

The taxpayer can choose to file a refund suit in the Claims Court or the Federal District Court once the taxpayer has paid the deficiency. In both courts, decisions of the Tax Court are not binding. The Claims Court sits as a single judge. A jury trial is available only in the Federal District Court. Many federal court opinions can be accessed on line at **www.uscourts.gov.**

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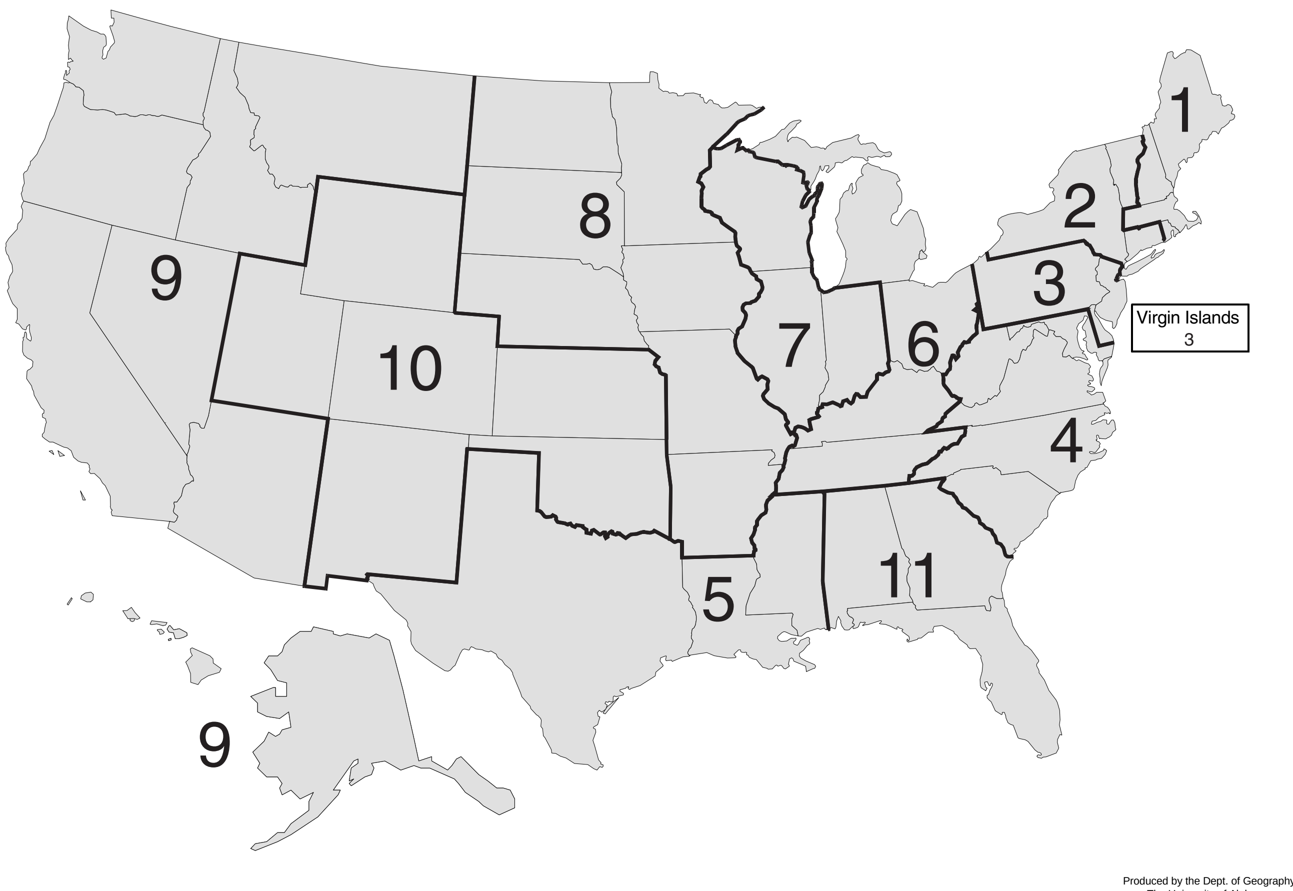
The 13 judicial circuits of the United States are constituted as follows:

Circuits	Hears Appeals from Federal Distric Courts and U.S. Tax Court Cases Originating in:
D. C.	U.S. Tax Court cases originating in D.C., Federal Administrative agencies, and Federal District Court cases for the District of Columbia
1st	Maine, Massachusetts, New Hampshire, Puerto Rico, Rhode Island
2d	Connecticut, New York, Vermont
3d	Delaware, New Jersey, Pennsylvania, Virgin Islands
4th	Maryland, North Carolina, South Carolina, Virginia, West Virginia
5th	District of the Canal Zone, Louisiana, Mississippi, Texas
6th	Kentucky, Michigan, Ohio, Tennessee
7th	Illinois, Indiana, Wisconsin
8th	Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, South Dakota
9th	Alaska, Arizona, California, Northern Hawaiian Islands, Idaho, Montana, Nevada, Oregon, Washington, Guam
10th	Colorado, Kansas, New Mexico, Oklahoma, Utah, Wyoming
11th	Alabama, Florida, Georgia
Fed.	Any federal case involving subject matter within its jurisdiction; U.S. Court of Federal Claims; U.S. Court of International Trade

Federal Judicial Circuits and Districts



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ACCOUNTING

Accounting Period

IRS Notice 2002-75 (November 6, 2002)
IRC §442

☞ IRS Eases Automatic Approval Process for Individuals Seeking to Change Accounting Period

The automatic approval process is detailed in Chapter 2, Small Business Issues in this workbook.

Other Rulings and Cases

Rev. Proc. 2003-34 (April 8, 2003)
Change in accounting period, change in: Carrybacks: Net operating losses: Capital loss: Short period.

AGRICULTURAL ISSUES

CRP Payments

Revenue Ruling 2003-59 (June 16, 2003)
IRC §126(a)(9)

☞ CRP Cost-Sharing Payments Qualify for IRC §126 Exclusion

The annual rental payments received under the Conservation Reserve Program (CRP) by landowners are **not** excludable from gross income. However, in this revenue ruling, the IRS determined the CRP is substantially similar to the type of programs described in IRC §126(a)(1) through (8). Therefore, since CRP qualifies as a small watershed program under Department of Agriculture rules, **any cost-sharing payments received by landowners under CRP are eligible for the gross income exclusion permitted under IRC §126(a)(9)**.

> **Note.** See pages 125-127 in the *2001 University of Illinois Farm Income Tax Workbook* and Chapter 4 in IRS Pub. 225, *Farmer's Tax Guide* for details on calculating the exclusion under IRC §126 for cost-sharing payments. Also, see Chapter 6, Agricultural Issues, Issue 7 in this workbook for more information on CRP payments.

Inventory Valuation

Treasury Decision 9019 (October 25, 2002)
IRC §471

☞ Unit-Livestock-Price Method of Accounting Liberalized 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.

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The new regulations also clarify that a livestock producer, 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.

CRP Payments

IRS Legal Memorandum (ILM) 200325002 (June 20, 2003)

IRC §1402(b)

☞ CRP Payments for Purposes of SE Tax

This ILM has received much national publicity. In a rather surprising ruling, the IRS stated that annual Conservation Reserve Program (CRP) payments are subject to self-employment tax, even for a landowner who was not previously engaged in a farming business. The ILM addressed two scenarios.

> **Scenario 1.** Individual A, an operating farmer, enrolled his farmland in the CRP and fulfilled his contractual obligations to plant and maintain permanent grass or pasture on it. He reported the CRP payments as rental income on Schedule E and did not pay self-employment tax on the income.

ILM ruling for Scenario 1. The farmer must report the CRP payments on Schedule F subject to self-employment tax.

> **Scenario 2.** Individual B, purchased farmland that had been enrolled in the CRP by its previous owner. As the new owner, B agreed to continue and assume all USDA obligations of the CRP contract. The terms were identical to those for the farmer in Scenario 1. B reported the CRP payments on Form 4835 (Farm Rental Income and Expenses) and did not pay self-employment tax on the income.

ILM ruling for Scenario 2. B must report the CRP payments on Schedule F subject to self-employment tax.

Observations. According to the Chief Counsel of IRS:

- The CRP payments in both scenarios are not excludible from self-employment tax as rentals from real estate.
- Rent is defined as "consideration paid for the **use or occupancy** of property (especially real property)." [1]
- Under a CRP contract, the USDA does **not** obtain the right to "occupy" the land enrolled in the CRP.
- Participation in a USDA land diversion program and devotion of such land to conservation purposes will be treated as material participation in the operation of a farm.
- IRS Pub 225, *Farmer's Tax Guide*, and the Instructions for Schedule F are referred to in the ILM.

Note. See Issue 2 in Chapter 6, Agricultural Issues for more coverage of CRP payments.

Other Rulings and Cases

Chief Counsel Advice 200242010 (July 08, 2002)

Capitalization and inclusion in inventory costs of certain expenses, Exceptions, Farmers; General rule for methods of accounting (Permissible versus not permissible), Clearly versus not clearly reflecting income.

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ALTERNATIVE MINIMUM TAX

AMT

David M. Marx v. Commissioner, TC Summary Opinion 2003-23 **(March 19, 2003)**
IRC §§56 and 68

☞ High-Income Taxpayer With Large Capital Gain Owes AMT

Facts. David Marx, a programmer who worked at Sun Microsystems, Inc, timely filed his 1999 Form 1040. He reported the following items of gross income:

Wages, line 7	$ 117,516
Interest, line 8a	3,502
Ordinary dividends, line 9	1,273
Capital gains, line 13 (on the sale of option acquired company stock)	893,469
Adjusted gross income reported	**$1,015,760**

He did not claim the $2,750 personal exemption deduction because it was completely phased out under IRC §151(d). He calculated his allowable 1999 itemized deductions as shown below.

State and local income taxes	$9,153
Personal property taxes	97
Total allowable itemized deductions before the required IRC §68 reduction	$9,250
Less: Reduction required by IRC §68	(7,400)
Allowable itemized deductions after the required reduction	**$1,850**

As a result, the taxpayer claimed the $4,300 standard deduction allowed for 1999 for single individuals. He then computed his tax liability using the maximum capital gains rate method as shown in Part IV of the 1999 Schedule D. That computation is shown below.

Adjusted Gross Income	$1,015,760
Less: Standard deduction	(4,300)
Taxable income	1,011,460
Total regular tax before considering any potential AMT liability	**$ 210,050**

David did not attach Form 6251, *Alternative Minimum Tax*, to his 1999 Form 1040. After processing the return, the IRS service center sent him a tax notice which showed he owed an additional $439 of alternative minimum tax (AMT) for 1999.

Issue. Whether the taxpayer had a $439 AMT liability in addition to his regular reported income tax liability of $210,050.

Analysis. Under IRC §559(a), the AMT is applicable only if, and to the extent that, the "tentative minimum tax" exceeds the taxpayer's regular tax. The taxpayer does not dispute that he is subject to the AMT, rather he argues that he has no AMT liability.

The taxpayer bases his argument on his belief that the Code allows him to claim the standard deduction for regular tax purposes and use his unreduced itemized deductions of $9,250 to compute AMT liability. Using this method of computing of the "tentative minimum tax" will result in zero AMT liability on Form 6251.

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Holding. The taxpayer's argument is based on his narrow and incorrect interpretation of the Code. He misunderstands the application of IRC §56(b)(1)(F). **Because the taxpayer claimed the standard deduction in computing taxable income for regular tax purposes, he is required to use the standard deduction amount when determining alternative minimum taxable income (AMTI) for AMT calculation purposes.** Consequently, he is liable for the $439 of AMT as determined in the IRS service center notice.

Notes.

1. The reason that high-income taxpayers with large capital gains occasionally owe AMT is due to the difference between regular tax rates on long-term gains and the AMT tax rate on AMTI. Specifically, David Marx, used **the 20% maximum tax rate** to compute his regular tax on his large long-term gain. He was entitled to use the same 20% rate to compute AMT on that gain in Part IV (page 2) of his 1999 Form 6251.

   However, when computing his AMT liability, **he was not entitled to the $33,750 AMT exemption amount (single filing status) on line 22 of his 1999 Form 6251.** That is due to the phase out of the AMT exemption amount for high-income taxpayers. Consequently, his entire 1999 AMTI was taxed at a 26% rate. His tentative minimum tax was $439 greater than his regular tax of $210,050.

2. See Chapter 1, Individual Taxpayer Problems, Problem 4, **Example 13** for more information on how AMT may impact high-income taxpayers who have large capital gain income.

3. The Jobs and Growth Tax Relief Reconciliation Act of 2003 could cause more taxpayers like David Marx to owe AMT for 2003-2008. This is due to the interplay between the new 15% maximum capital gains tax rate and the tentative minimum tax calculation for high-income taxpayers who are denied an AMT exemption on Form 6251. See Chapter 16, New Legislation for more details.

Other Rulings and Cases

Moore v. Commissioner, TC Memo 2002-196, **84 TCM 164 (August 7, 2002)**
Alternative Minimum Tax: Exemption amount: Application of tax.

AMORTIZATION AND DEPRECIATION

Gas Station Property

Revenue Ruling 2003-54 (May 8, 2003)
IRC §§168, 446 and 481

☞ **Stand-Alone Gasoline Pump Canopies Are 5-year MACRS Property**

Stand-alone gas station canopies are in Asset Class 57.0 and have a recovery period of:

- 5 years under the MACRS General Depreciation System (GDS).
- 9 years under the MACRS Alternative Depreciation System (ADS).

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However, supporting concrete footings used to anchor the canopies are land improvements in Asset Class 57.1 and have a recovery period of:

- 15 years under the MACRS General Depreciation System (GDS).
- 20 years under the MACRS Alternative Depreciation System (ADS).

Change in Accounting Method. Any change in a taxpayer's depreciation of gasoline pump canopies or concrete footings to conform to this revenue ruling is a change in the method of accounting.

If a taxpayer wants to change the MACRS life of canopies or footings owned at the beginning of the year of change (and for which the taxpayer has used a different MACRS life in at least two taxable years immediately preceding the year of change), an automatic consent is available.

The automatic consent provisions apply, with no user free, by attaching Form 3115, *Application for Change in Accounting Method*, to the return for the year of change. **At the top of Form 3115, write "Automatic Change Filed Under Rev. Rul. 2003-54."**

> **Note.** See Chapter 2, Small Business Issues, Issue 5 for complete details on automatic consents to a change in the method of accounting under the provisions of Rev. Proc. 2002-9 and, as modified, by Rev. Proc. 2002-19.

30% Depreciation Allowance

Revenue Procedure 2003-50 (June 27, 2003)

IRC §§167, 168, 179, 446, 461 and 1400L

☞ Taxpayers Have Opportunity to Revise their 30% Allowance and IRC §179 Election for 2001

Section A: Changes to the special 30% depreciation allowance general rule.

Revenue Procedure 2003-50 **amplifies and modifies Rev. Proc. 2002-33**, which provided relief for taxpayers who had **timely filed a fiscal year (if it included September 11, 2002) or 2001 calendar year return before June 1, 2002**.

> **Note.** See pages 49-50 in the *2002 University of Illinois Income Tax Workbook* for details on Revenue Procedure 2002-33.

The Treasury Department and the IRS decided to extend the relief provided in Rev. Proc. 2002-33 to **any taxpayer** who timely filed a return for the tax year that includes September 11, 2001. Therefore, **any taxpayers** who **timely filed** such a return **on or after June 1, 2002** are now eligible for the same type of relief previously extended to taxpayers who timely filed before June 1, 2002.

Example 1. Chris, who requested an automatic extension on Form 4868, **timely filed his 2001 Form 1040 on August 14, 2002**. He was unaware of the 30% depreciation allowance rules. Therefore, even though he did acquire a new business copy/fax machine in November 2001 for $7,000, he did not claim either the 30% depreciation allowance or the §179 expense deduction on it.

Example 1 Tax Result. Per Rev. Proc. 2003-50, Chris may now file an amended **2001** return on Form 1040X to claim the 30% depreciation allowance on the business property he acquired in November 2001. He must include the following at the top of the 2001 Form 1040X: **"Filed Pursuant to Rev. Proc. 2003-50." The deadline for doing this is on or before December 31, 2003.**

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Example 2. Assume the same facts as **Example 1**. In addition, Chris requested an automatic extension for his **2002** Form 1040. He files his **2002** return on or after July 22, 2003.

Example 2 Tax Result. Per Rev. Proc. 2003-50, Chris may file Form 3115 with his timely filed **2002** Form 1040 that he files on or after July 22, 2003. This allows Chris to claim the 30% depreciation allowance on the copy/fax machine on his 2002 Form 4562 by using the "catch-up" depreciation rules.

Example 3. Assume the same facts as **Example 1** and **Example 2 except** Chris filed his **2002** Form 1040 on or before July 21, 2003.

Example 3 Tax Result. In that case, Chris may file an amended **2002** return on Form 1040X **before December 31, 2003** with a Form 3115 attached to it. He must include the following at the top of the 2002 Form 1040X: **"Filed Pursuant to Rev. Proc. 2003-50."** This allows Chris to claim the 30% depreciation allowance on the copy/fax machine on his 2002 Form 4562 by using the "catch-up" depreciation rules.

Election Not to Deduct the 30% Depreciation Allowance. The relief discussed in the prior section does **not** apply to any taxpayer who:

- Timely filed the tax return for the year that included September 11, 2001, and
- Made the election not to deduct the 30% depreciation allowance. **Example.** The taxpayer wrote on the Form 4562 "Not deducting the 30% depreciation."

> **Note.** The same rule applies to taxpayers who made the **"deemed election"** not to deduct the 30% depreciation allowance. **Example.** For taxpayers who filed their 2000 or 2001 tax returns **before June 1, 2002**, no specific election was made not to deduct the 30% depreciation although regular depreciation was claimed.

Section B: Changes to selection of IRC §179 property.

This portion of Rev. Proc. 2003-50 has the greatest impact on taxpayers and their preparers because there appears to be confusion concerning the interaction of the IRC §179 deduction and the 30% depreciation allowance rules for property acquired after September 10, 2001. It allows the opportunity to change the selection of IRC §179 property on 2001 calendar year and fiscal year tax returns that included September 11, 2001. This portion of the Rev. Proc. applies to:

- Taxpayers who timely filed their tax return for the tax year that included September 11, 2001 and who
- Made an IRC §179 election on it, but only if the following **three** conditions are met for that return:
  1. No 30% depreciation allowance was claimed or there was no election made not to claim the allowance.
  2. There was an election made on Form 4562 to claim the IRC §179 expense deduction for property placed in service after September 10, 2001.
  3. The taxpayer now wants to claim the 30% depreciation allowance for that **same** property and select **different** property on which to take the IRC §179 expense deduction.

Example 4. Beth owns a consulting business. The three conditions shown above apply to Beth's 2001 Form 1040. She claimed the maximum $24,000 IRC §179 deduction on **new** office equipment she bought in **October 2001.** She also bought other **used** depreciable business property in **March 2001** and claimed no IRC §179 expense deduction on it. That property was in a **different MACRS class** than the new office equipment she bought in October 2001.

Example 4 Tax Result. Per Rev. Proc. 2003-50, Beth can switch her IRC §179 expense deduction to the used property she acquired in March 2001. She can then claim the 30% depreciation allowance on the new office equipment that she acquired after September 10, 2001. She must file an amended 2001 tax return on Form 1040X **on or before December 31, 2003** in order to make this switch. She must write **"Filed Pursuant to Rev. Proc. 2003-50"** at the top of the amended return.

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Mid-Quarter Convention

IRS Notice 2003-45 (June 27, 2003)

IRC §168

☞ Taxpayers Given Automatic Extension to Elect Out of Mid-Quarter Convention for Some 2001 Acquisitions

An **automatic extension** of relief from the mid-quarter depreciation convention is available. The extension operates similarly to the one granted in Revenue Procedure 2003-50. This extension affects business taxpayers whose 3rd or 4th quarters included September 11, 2001 and who timely filed tax returns for their tax years that included September 11, 2001.

If those taxpayers did **not make an election out of the mid-quarter convention**, they may do so automatically prior to December 31, 2003. Notice 2003-45 amplifies the tax relief granted in Notice 2001-70 and Notice 2001-74.

> **Example.** Amanda, a self-employed photographer, **timely filed** her 2001 and 2002 tax returns. Even though she bought more than 40% of the cost of 2001 depreciable assets in the last quarter of 2001, she did **not** take advantage of Notice 2001-70 to elect out of the mid-quarter convention rule. Therefore, **she used the mid-quarter convention rule for all depreciable business assets she acquired in 2001.**
>
> Notice 2003-45 grants Amanda another chance to elect out of the mid-quarter convention rule for her 2001 assets. **She may file amended 2001 and 2002 tax returns by December 31, 2003 and use the half-year convention for all of her 2001 depreciable assets.**

> **Note.** IRS Notices 2001-70 and 2001-74 can be found in the *What's New Supplement* to the 2001 *University of Illinois Farm Income Tax Workbook* dated December 19, 2001.

Oil and Gas Depletion Rate

IRS Notice 2003-44 (July 11, 2003)

IRC §613A(c)(6)

☞ 2003 Percentage Depletion Rate for Marginal Oil and Natural Gas Properties

The percentage depletion for marginal production of oil and natural gas will remain at **15% for 2003**. The reference price as determined under IRC §29(d)(2)(C) for the 2002 calendar year is $22.51 per barrel for domestic crude oil.

Leasehold Improvements

***Michael A. and Frances Y. McGrath v. Commissioner, TC Memo 2002-231,* 84 TCM 310 (September 18, 2002)**

IRC §§162, 167, 179 and 263

☞ Leasehold Improvements Must Be Capitalized

Facts. In August 1995, the taxpayers signed a 5-year lease with a shopping center in Tupelo, MS for their newly acquired T. J. Cinnamon franchise bakery business. At the time they signed the lease, their leased store space consisted of a dirt floor enclosed by temporary partitions and had no utilities. Per the terms of the lease, the taxpayers were obligated to complete construction of the store space at their own expense.

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The fixed minimum rent per the lease for the store space was $26,312 per year. However, the rent payment was waived for six months following the date the bakery was first open to the public. Prior to the opening in early December 1995, **the taxpayers spent $111,195 to complete the store space construction**. That figure does not include the cost of furniture, fixtures and equipment in the amount of $15,782, which the taxpayers depreciated as 7-year property under MACRS.

On their joint 1995 return, the taxpayers deducted the entire $111,195 cost of store construction as a repair expense on Schedule C. They did not make any IRC §179 election on their 1995 Form 4562. However, an IRS exam determined that the $111,195 should be properly classified as follows:

- **$18,739 as payments made in lieu of rent** for the 6-month period December 1995 through May 1996 (the 6-month rent waiver period as agreed to in the lease)
- **$92,456 as leasehold improvements with a depreciable MACRS life of 39 years** (for nonresidential real property)

Issues.

1. Whether the taxpayers may deduct under IRC §162 (ordinary and necessary business expenses) the $111,195 cost of permanent improvements to the leased store space.
2. Whether the taxpayers may now elect to expense IRC §179 property.

Analysis for Issue 1. Although IRC §162 allows a deduction for ordinary and necessary business expenses, IRC §263 provides that capital expenditures are not currently deductible. Where the owner of real property enters into a long-term lease, under which the lessee is to construct at his own cost a building on the property, the lessee, not the lessor, is entitled to a deduction for depreciation.[2]

The lessee's right to depreciation deductions is not altered by the fact that, under local law, legal title to the improvements belongs to the lessor.

Analysis for Issue 2. The taxpayers contend that if this court upholds the IRS determination that the $111,195 is not deductible as a repair expense, they will need to file an amended 1995 return to make the IRC §179 election for the $15,782 cost of furniture and equipment. To the contrary, the IRS argues that since the taxpayers failed to make a valid IRC §179 deduction on their timely filed 1995 tax return, it is too late for them to do so now. The IRS relies on Reg. §1.179-5, which states:

> **Election.** The election under IRC §179 shall be made on the taxpayer's **first return** for the taxable year to which the election applies (whether or not the return is timely) **or on an amended return filed within the time prescribed by law (including extensions)** for filing the return for such taxable year [emphasis added].

Holding for Issue 1. The lease contract does not show that the taxpayers and the owner of the shopping mall intended to treat the entire $111,195 cost of the building improvements as a rent substitute. Rather, the lease clearly provides for only a 6-month rent waiver following the first day the bakery was opened to the public. The Tax Court held that:

- The cost of the building improvements were deductible as a "rent substitute" only to the extent of $18,739.
- The remaining $92,456 cost of the building improvements represented a capital expenditure under IRC §263 and must be depreciated over its appropriate useful life.

Holding for Issue 2. The Tax Court held that the time to file an amended 1995 tax return to modify an IRC §179 election had passed. This issue was previously addressed by this Court in *Patton v. Commissioner*.[3] The Tax Court concluded in *Patton* that it was the taxpayer's misclassification of assets, rather than the examination determination of the IRS, that created the need to modify the taxpayer's IRC §179 election. Consequently, the Court held in *Patton* that it was not an abuse of discretion for the IRS to refuse to allow the taxpayer to modify his IRC §179 election.

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Mobile Home Depreciation

***Jesse E. and Marjorie A. Rupert v. Commissioner,* 5th Cir. Ct. of Appeals, 2003-1 USTC ¶50,486 (May 29, 2003)**
IRC §167

☞ Rented Mobile Home Is 27½-Year Life MACRS Property

> **Note.** This Appeals Court decision affirms the decision reached in the Tax Court.[4]

Facts. Mr. Rupert converted a mobile home which he acquired in 1982 from personal use to rental property in 1991. Although the property was rented to a related party, the rents were at arms length and the rents received were based on fair rental rates. Mr. Rupert depreciated the mobile home under the ACRS method using a 10-year life. The IRS, in examination, switched it to a 27½-year life under MACRS .

Holding. The ACRS method does not apply to any property placed in service after December 31, 1986. Accordingly, the taxpayer must use a 27½-year life under **MACRS** to depreciate the mobile home since it was held for the production of income and placed in service in 1991.

Covenant Not to Compete

***Frontier Chevrolet Company v. Commissioner,* 9th Cir. Ct. of Appeals, 2003-1 USTC ¶50,490 (May 28, 2003)**
IRC §197

☞ Covenant Not to Compete Is IRC §197 Intangible, Amortizable Over 15 Years Rather than 60 Months

> **Note.** This Appeals Court decision affirms the decision reached in the Tax Court.[5]

Facts. In 1987, Roundtree Automotive Group, Inc. ("Roundtree"), which was engaged in the trade or business of purchasing and operating automobile dealerships, purchased all of Frontier's stock. Frank Stinson ("Stinson") was President of Roundtree and was involved in Frontier's management from 1987 to 1994.

From 1987 to 1994, Roundtree allowed Dennis Menholt, the executive manager of Frontier, to purchase 25% of Frontier's stock. On July 31, 1994, Roundtree owned 75% and Menholt owned 25% of Frontier's stock.

Frontier entered into a "Stock Sale Agreement" with Roundtree on August 1, 1994. Per the agreement, **Frontier redeemed its stock owned by Roundtree for $3.5 million.** As a result, Menholt became the sole shareholder of Frontier.

Roundtree, Stinson, and Frontier also entered into a 5-year covenant not to compete that was related to the stock redemption. The covenant stated that "Roundtree and Stinson shall not compete with Frontier in the car dealership business for five years." **Under terms of the covenant, Frontier agreed to pay Roundtree and Stinson $22,000 per month for 60 months, or a total of $1.32 million.**

On its original 1994, 1995, and 1996 Forms 1120, Frontier amortized the covenant over 15 years. However, in 1999, Frontier filed claims for refund for the three years alleging that the covenant payments should be amortized over 60 months, the life of the covenant.

Issue. Whether the taxpayer (Frontier) must amortize the noncompetition agreement payments to Roundtree over 15 years under IRC §197.

Analysis. IRC §197(a) provides that "A taxpayer shall be entitled to an amortization deduction with respect to any IRC §197 intangible." The deduction is amortized ratably over a 15-year period beginning with the month in which the

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intangible is acquired. **An "amortizable IRC §197 intangible" is any intangible acquired by a taxpayer after August 10, 1993 and held in connection with the conduct of a trade or business.**[6] A covenant not to compete entered into in connection with a direct or indirect acquisition of an interest in a trade or business is an IRC §197 intangible.[7]

Frontier argued that it did not acquire an interest in a trade or business because, both before and after the stock redemption, Frontier was engaged in the same trade or business and it acquired no new assets.

Holding. The 9th Cir. Ct. of Appeals agreed with the Tax Court that Frontier's stock redemption was an indirect acquisition of an interest in a trade or business under IRC §197. Legislative history made it clear that "an interest in a trade or business includes not only the assets of a trade or business, but also stock in a corporation engaged in a trade or business."[8] Therefore, **Frontier must amortize the noncompetition agreement payments over 15 years**.

Goodwill

Letter Ruling 200243002 (July 16, 2002)

IRC §197

☞ Goodwill Fails to Qualify as Amortizable Intangible

The taxpayer requested that the IRS classify self-created goodwill of a corporation as an amortizable intangible asset. However, the IRS determined that IRC §197 did not change the traditional treatment of goodwill. Therefore, the goodwill qualified as a capital asset rather than an IRC §1231 asset.

The IRS determined that goodwill which was either self-created or purchased before the enactment of IRC §197 in 1993 was not amortizable under IRC §197.

Other Rulings and Cases

***Commissioner v. Brookshire Brothers Holding, Inc. and Subsidiaries,* 5th Cir. Ct. of Appeals, 2003-1 USTC ¶50,214 (January 29, 2003)**

Methods of accounting: Changes of accounting methods: Depreciation: MACRS: Gas station: Year of change: Closed year.

***Durham Farms et al., v. Commissioner,* 9th Cir. Ct. of Appeals, 2003-1 USTC ¶50,391 (March 21, 2003)**

Depreciation: Farm and ranch properties: Ownership.

U.S. District Court, East. Dist. Mich., So. Div., Saginaw Bay Pipeline Company, a Partner of Saginaw Bay Area Limited Partnership, CMS Saginaw Bay Company, a Partner of Saginaw Bay Area Limited Partnership, Saginaw Bay Lateral Company, a, (Aug. 23, 2001); Appealed and reversed

***Cortland F. and Jean M. Langdon, Bemidji Distributing Co., Inc., v. Commissioner,* 8th Cir. Ct. of Appeals, 2003-1 USTC ¶50,244 (February 14, 2003)**

Allocation of purchase price: Intangible asset: Covenant not to compete.

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BAD DEBT

***Charles J. and Hyla Portaluppi v. Commissioner, TC Summary Opinion 2002-106* (August 12, 2002)**
IRC §166 and 6001

☞ Court Refuses to Allow Bad Debt Deduction When Amount of Loss Not Substantiated

Facts. The Portaluppis formed a sole proprietorship in 1988. In 1989, they incorporated the business as a C corporation. The Portaluppis were the sole shareholders of the corporation which primarily provided roof and general repair work for the U.S. Army Corps of Engineers. The corporation was dissolved in June 1991.

The taxpayers asserted they initially contributed $25,000 of borrowed funds when they started the sole proprietorship. By March 1989 they contributed an additional $97,000 which was prior to the incorporation. From March 1989 through September 1990 they contributed an additional $173,000 to the capital of the corporation.

The taxpayers used the same checking account for the sole proprietorship as they used for the corporation. As proof of the contributions, they could only provide the checkbook register. It began with the initial $25,000 deposit made on September 15, 1988 and ended on September 28 of an unspecified year. The register showed that nonsequentially numbered checks were written on the account. The taxpayers did not provide copies of cancelled checks or underlying documents supporting the checks.

Also, the taxpayers did not file a corporate tax return for the corporation because they contended there was never a profit. In addition, they did not report any income received or deduct any of the expenses of the sole proprietorship or corporation. However, they did report a business loss deduction of $35,000 on their jointly filed Form 1040 for 1995. While they deducted the loss on line 12 of Form 1040, they did not attach a Schedule C to the return.

Analysis and Holding. Due to the lack of records, the Tax Court held that the loss was not deductible. The Court mentioned that the taxpayers did not argue that they were entitled to a worthless stock deduction under IRC §165(g), that the loss represented a deductible bad debt deduction under IRC §166, or any other theory.

Observation. If the taxpayers had kept adequate records, filed corporate tax returns, or had professional representation at their hearing, the results may have been different.

Note. Pursuant to IRC §7463(b), this court opinion may not be treated as precedent for any other case.

BANKRUPTCY AND INSOLVENCY

Cancellation of Debt Income
Service Center Advice 200235030 (June 3, 2002)
IRC §§61 and 1341

☞ Taxpayer Reporting Form 1099-C Income Can File for a Refund when Prior Debt Is Repaid

The taxpayer was entitled to a refund regarding cancellation of debt income reported in a prior year when the Form 1099-C amount was later repaid.

The Service Center indicated that at the time the Form 1099-C was issued, it was not clear whether the cancelled debt would be repaid. Therefore, the taxpayer reported the 1099-C amount as income. However, payment of the debt in a future year supports the conclusion that the 1099-C amount was not taxable.

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IRS Levies

***Richard G. Rousey v. Jill R. Jacoway (In re Rousey)* 283 B.R.265 (Bankruptcy Appellate Panel 8th Cir.) (September 13, 2002)**

IRC §6331

☞ Bankruptcy Creditors Were Allowed to Seize IRA Accounts

The Eighth Circuit Bankruptcy Appeals Court agreed that the IRA accounts of the Rousey's could be seized by their creditors. They based their opinion on four major factors:

1. The IRAs did not qualify as "similar plans or contracts" under 11 U.S.C. §522(d)(10)(E) since the Rousey's had the unfettered ability to withdraw funds from their accounts.
2. The Rousey's did not meet any of the three main requirements to claim an exemption. Payments are exempt only if they are:
   a. Received pursuant to a pension, annuity, or similar plan or contract;
   b. On account of illness, disability, death, age, or length of service;
   c. Reasonably necessary for the debtor's support or for the support of a dependent of the debtor.
3. The IRAs are not similar to a pension because the Rousey's did not make contributions after the initial contribution to establish the account. The initial contribution was a rollover from an employer account. At the time of the rollover, the Rousey's had complete control of the money and were not required to transfer it to an IRA.
4. The investment only returns the initial investment plus earned interest. Investments that compute payments based on the owner's life expectancy and terminate upon death are more likely to be exempt.

> **Note.** If the facts were different, a different decision might have been reached.

BUSINESS EXPENSES

Standard Meal Rate Available to Day Care Providers

Revenue Procedure 2003-22 (February 24, 2003)

IRC §§162 and 6001

☞ Family Day Care Providers May Use Standard Rate to Deduct Food Cost

Purpose. To provide family day care providers with an optional standard meal and snack rate to use in computing the deduction for food provided to eligible children.

Background. Day care providers can deduct the cost of food provided to eligible children. However, because some of the food may be consumed by the provider or their family, it is often difficult to determine the amount that is deductible. Under IRC §§162 and 6001, the provider must substantiate the deduction.

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A "family day care provider" (Provider) is a taxpayer engaged in the trade or business of providing family day care. "Family day care" (Day Care) is child care provided to eligible children in the home of the family day care provider that is:

- non-medical,
- does not involve a transfer of legal custody, and
- generally lasts for less than 24 hours each day.

"Eligible children" (Child) are unemancipated minors receiving family day care in the home of a Provider. They do not include children who are full-time or part-time residents in the home or children whose parent(s) or guardian(s) are residents in the same home.

Ruling. Providers may compute the deductible cost of each meal or snack actually purchased or served to Child during the time when Day Care is provided by using the standard meal and snack rates provided. The standard rates may be used for a maximum of one breakfast, one lunch, one dinner, and three snacks per Child per day. The Provider can only deduct the costs that are not reimbursed.

The Provider must choose between the standard rate and actual costs. They must consistently use the same method to compute their deduction. To substantiate their deduction the Provider must maintain records. The records should include the name of Child, dates and hours of attendance in Day Care, and the type and quantity of meals and snacks served.

The standards meal and snack rates in effect on December 31, 2002 for states other than Alaska and Hawaii are:

- Breakfast $0.98
- Lunch/Dinner $1.80
- Snack $0.53

The standard rates do not include non-food items such as containers, paper products, or utensils. The allowance amounts for future years can be found online under Program Basics at www.usda.gov/chd/care.

Record Keeping Requirements. To satisfy the record keeping requirements of IRC §6001, family day care providers who use the standard meal and snack rates must maintain the following records:

- The name of each eligible child
- Dates and hours of attendance in the family day care facility
- The type and quantity of meals and snacks served

This information may be recorded in the meal and snack log provided in the Appendix of the revenue procedure.

> **Note.** The weekly log and year-end summary log in the Appendix are well designed and serve to comply with the record keeping requirements. Practitioners may want to copy these logs and provide them to their family day care provider clients.

Effective Date. For years beginning after December 31, 2002.

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Rent Expense

Michael and Julie H. Chin v. Commissioner, TC Memo 2003-30, **85 TCM 814 (February 6, 2003)**

IRC §162

☞ Surgeon's Rent Payments to His Mother Are Not Deductible on Schedule C

Facts. Dr. Chin, a surgeon, conducted his self-employed medical practice from three leased offices located in Riverside County, CA. The rental payments he made for these three properties are shown in the following chart.

Tax Year	Amount of Rent Paid and Deducted on Schedule C
1994	$31,760
1997	24,039

In addition, Dr. Chin paid and deducted the following rent paid to his mother for an office in a commercial building she owned.

Tax Year	Amount of Rent Paid and Deducted on Schedule C
1994	$52,000
1997	48,000

The office building owned by Dr. Chin's mother was located in Sherman Oaks, CA, 70 miles west of Riverside County where he conducted his medical practice. Skin Service Club, Inc., a C corporation, was formed by Dr. Chin and his brother in 1991. It allegedly conducted business in the commercial building owned by the mother. However, the corporation, which was dissolved in 1996, reported no gross receipts and minimal expenses on its 1994 Form 1120.

In its examination, the IRS disallowed the rent paid to Dr. Chin's mother contending that he conducted no business in his mother's building during the two years in question. The additional tax assessment was about $22,000 for each of the two tax years.

Issue. Whether the $52,000 and $48,000 rent paid by Dr. Chin to his mother constitutes an ordinary and necessary business expense under IRC §162(a)

Holding. The Tax Court held that Dr. Chin did not conduct any business activity in the building owned by his mother during 1994 and 1997. Although Dr. Chin's rent payments reflected his generosity to his family, they fell short of the IRC §162 standard of deductibility.

> **Note.** The IRS contended the rent payments were in substance a redistribution of income from Dr. Chin, who was in the 39.6% tax bracket, to his mother, who was in a lower tax bracket. The Tax Court agreed.

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Gambling Loss

***Calvin and Carol Neymeyer v. Commissioner, TC Summary Opinion 2002-120* (September 18, 2002)**

IRC §162

☞ Sporadic Gambling Activity Does Not Constitute a Trade or Business

Facts. Carol Neymeyer, a housewife from Clinton, IA, enjoyed occasional Las Vegas "gambling vacation trips" she and her husband took. In 1998, convinced that she could "make some money" gambling, she began playing slot machines at the local riverboat casino. She made 66 daily trips to the local casino during the period from January 1, 1998 through mid-September 1998. On two occasions, she had sufficient winnings for the casino to issue 1998 Forms W-2G. **The two W-2Gs were in the amounts of $2,500 and $2,000.**

In September 1998, Carol "looked at her records" and realized that she was going in debt by taking cash advances from her credit cards while at the casino. Consequently, she decided to quit gambling, get a job, and pay off the accumulated debt. She also destroyed her gambling notebook that contained a record of her winnings and losses.

On their joint 1998 tax return, the taxpayers:

- Did not report the $4,500 of W-2G winnings
- Claimed the standard deduction of $7,950 (Calvin was age 67 in 1998)

In its examination report, the IRS included the $4,500 winnings in AGI and increased the taxable amount of Social Security benefits the taxpayers received. The additional tax assessed by the IRS for 1998 was $1,065.

At the Tax Court, the taxpayers argued that Carol was entitled to deduct her considerable gambling losses as trade or business expenses under IRC §162.

Analysis. The initial issue is whether Carol's gambling activity constituted a trade or business. If it was, her gambling losses, to the extent of her gambling winnings, would be deductible in arriving at AGI. If not, her losses would be deductible only as an itemized deduction on Schedule A. To be engaged in a trade or business within the meaning of IRC §162(a), an individual must be involved in the activity in a continuous and regular manner with the primary purpose of income and profit.[9]

Holding. The Tax Court did **not** find that Carol's gambling activity was continuous or regular. Rather, her activity more resembled a diversion. As held in the 1987 *Groetzinger* Supreme Court decision, **"a sporadic activity, hobby, or an amusement diversion does not qualify as a trade or business."**

The court was willing to assume that Ms. Neymeyer lost more than she won. However, her allowed losses were limited to her winnings. **The standard deduction claimed of $7,950 exceeded the $4,500 amount of allowable gambling losses**. Therefore, the taxpayers were not entitled to a separate deduction for the allowable gambling losses.

> **Note.** See Chapter 1, Individual Taxpayer Problems, Problem 7 for a thorough analysis of the gambling loss issue.

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Business Expenses

Fabian Vaskman v. Commissioner, **5th Cir. Ct. of Appeals, 2003-1 USTC ¶50,126 (November 21, 2002)**

IRC §§162, 274, and 280A

☞ Translator's Business Expenses

Note. This Appeals Court decision affirms the decision reached in the Tax Court.[10] See page 375 in the *2002 University of Illinois Income Tax Workbook* for an analysis of this case.

Facts. The taxpayer resided in Houston, TX in a one-bedroom apartment. He was a self-employed Russian translator. He spent November 1996 through January 7, 1997 in Kazakhstan working on a project for Davis Petroleum. He was paid $19,244 for this assignment on January 27, 1997. He had no other business clients in 1997. In addition to his sporadic translator business duties, he was pursuing a doctoral degree in U. S. history with the History Department of the University of Houston in 1997.

On his 1997 Schedule C, he reported the following:

Gross Receipts (from Davis Petroleum)			$19,244
Less Expenses:			
Car expenses	$2,048	(80% business use)	
Depreciation (on car)	1,325		
Legal and professional	500		
Office expense	400		
Davis Petroleum expenses	2,744		
Cellular telephone	715	(100% business use)	
Continuing education	1,550	(U. of Houston fees)	
Tax preparation	248		
Office-in-home (Form 8829)	5,280	(80% business use)	(14,810)
Schedule C net profit			**$ 4,434**

Upon examination, the IRS disallowed the following Schedule C business expenses:

- All of the $1,325 car depreciation
- All of the $715 cell phone expense
- All of the $1,550 education expense
- $3,692 of the $5,280 office-in-home expense (the IRS allowed 25% of the apartment rent of $6,350)

Issues. Whether the taxpayer is entitled to any of the disallowed expenses.

Analysis. Both the automobile and the cellular phone are items of **listed property** under IRC §280F(d)(4)(A). By virtue of the strict substantiation requirements of IRC §274(d)(4), no deduction is allowable for any listed property expenses on the basis of any approximation or the unsupported testimony of the taxpayer.[11]

Regarding the claimed office-in-home expense of $5,280, the taxpayer admitted that the 80% business use figure was an estimate. He sought to justify that percentage through testimony such as:

- "Even the bed is being used when I'm translating."
- "I keep my staples in the bathroom."

In order to deduct any office-in-home expenses, a taxpayer must show that the office is used "exclusively on a regular basis" under IRC §280A(c)(1).

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Holding. Since the 5th Circuit Court of Appeals upheld the Tax Court's determination on every contested issue, the holding uses the language of the Tax Court rather the language of the Appeals Court.

- Since the taxpayer has submitted no business automobile log or other evidence to verify his claimed 80% business use, he is entitled to no deduction for depreciation of $1,325.

Note. The Tax Court judge noted that the taxpayer probably was not entitled to deduct the $2,048 of car expenses other than depreciation. But since the IRS did not address this issue in the examination, neither would the Tax Court.

- Similarly, because there is no documentary evidence to prove the taxpayer's claimed $715 cost of his cellular phone, no deduction is allowable.
- Regarding the disallowance of $3,692 of the claimed $5,280 office-in-home expense, the Tax Court concluded there was no persuasive evidence that more than 25% of the taxpayer's apartment was used "exclusively on a regular basis" in 1997. Therefore, the Court sustained the position of the IRS that the taxpayer's allowable office-in-home deduction was $1,588.
- Regarding the disallowance of the claimed $1,550 education expense, the Court concluded that there was no direct relationship between the taxpayer's course of study in U.S. history and his job skills as a Russian translator. Consequently, none of the expense was deductible.

Tax Home

William J. McNeil v. Commissioner, TC Memo 2003-65, **85 TCM 989 (March 6, 2003)**

IRC §162(a)(2)

☞ Over-the-Road Truck Driver Had No Tax Home

Facts. Mr. McNeil was a self-employed owner/operator of a long-haul, over-the-road truck during 1998 and 1999, the years in question. **He was on the road 360 days in 1998 and approximately 345 days in 1999.** In 1998, he spent 5 days at a house in Green Bay, Wisconsin, which a fellow trucker driver owned. During April 1998, he agreed to buy a friend's used mobile home in Bonne Terre, Missouri, by making installment payments. He made payments of about $1,000 per year before receiving title to the mobile home in 2001.

In 1998 and 1999, Mr. McNeil paid no utilities or repair expenses for the mobile home. In 1998, he stopped at the mobile home only for a few hours while his truck was reloaded. In 1999, he spent about 20 days at the mobile home.

Mr. McNeil deducted the following expenses on his 1998 and 1999 Schedules C:

Tax Year	Lodging Expense	Meal Expense
1998	$8,006	$6,840
1999	5,799	5,760

The IRS disallowed all the claimed travel expenses.

Issue. Whether the taxpayer is entitled to deduct travel expenses as ordinary and necessary business expenses under IRC §162(a)(2).

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Analysis. A deduction is allowed for "traveling expenses (including meals and lodging other than amounts which are lavish or extravagant) **while away from home** in pursuit of a trade or business."[12]

"Home" generally refers to the taxpayer's principal place of employment, if he has one; otherwise, he may treat as his tax home a permanent residence at which he incurs substantial continuing living expenses.

If, however, a taxpayer "is constantly on the move due to his work, he is never 'away' from home."[13] Lacking a tax home, a taxpayer is entitled to no business deduction for traveling expenses under IRC §162.[14]

Holding. During the tax years 1998 and 1999, the taxpayer had no principal place of business, nor did he incur substantial living expenses at a permanent residence. His stays at the Green Bay house (5 days in 1998) and the Missouri mobile home (about 20 days in 1999) were sporadic and brief. Apart from the $1,000 annual payments on the mobile home, he had no substantial continuing living expenses in either 1998 or 1999. Rather, the taxpayer was constantly on the move due to his work. **Consequently, he had no tax home within the meaning of IRC §162(a)(2) and was not entitled to the claimed deductions for meals and lodging.**

FSAs and HRAs
Revenue Ruling 2003-43 (May 6, 2003)
IRC §§105, 106, and 125

☞ Employers May Issue Credit or Debit Cards to Employees to Pay for Medical Expenses

Employers may issue restricted credit cards to employees to pay for medical expenses available under either a:

- Health **flexible spending arrangement (FSA)** under a salary reduction election of an employer's IRC §125 cafeteria plan, or
- **Health reimbursement arrangement (HRA)** funded entirely by the employer.

Rev. Rul. 2003-43 provides the following example. Employer X sponsors a major medical plan, a health FSA, and an HRA for employees. In conjunction with the FSA and HRA, Employer X has entered into an agreement with a bank to issue to each participating employee a credit card with individual limits equaling the coverage available in the health FSA or HRA.

Employer X requires each employee to certify upon enrollment in the two plans that the credit card will only be used for eligible medical expenses. In addition, each employee must certify that any medical expense paid with the card has not been reimbursed. The credit card is usable only at a merchant or service provider with a specified Merchant Code relating to health care.

Employer X agrees to be liable to the bank for all charges made with the credit card. When the card is used at the point-of-sale, the merchant or service provider is paid the full amount of the charge by the bank.

Note. One of the employer advantages of utilizing a system similar to the facts shown in the example is that **substantiation time and paperwork are minimized**.

See Situations 1 and 2 in the Revenue Ruling, which are not discussed, for more details. Also see IRS Notice 2002-45, Rev. Rul. 2002-80, Rev. Rul. 2002-41 and pages 312-313 in the *2002 University of Illinois Income Tax Workbook*.

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Interest Expense

Edward A. and Diane R. Robinson III v. Commissioner, **119 TC 44 (September 5, 2002)**
IRC §§62, 162 and 263

☞ Interest on Schedule C Tax Deficiency Is Personal and Not Deductible

Facts. The taxpayer, an attorney, reported a profit for his self-employed law practice in 1987. Upon audit, the IRS found unreported income. In 1994, the IRS seized real property belonging to the taxpayer and his spouse to collect the tax deficiency. The property was sold in 1995 and the IRS applied the proceeds to the deficiency plus the accrued interest owed. **The taxpayer deducted the interest on his 1995 Schedule C.** The IRS denied the interest deduction under Temp. Reg. §1.163-9T(b)(2)(i)(A).

Analysis. The taxpayer argued that the interest was deductible under IRC §163(h)(2)(A) because it was "properly allocable to a trade or business". All of the income on the return came from the Schedule C business. The taxpayer based his argument on the *Redlark v. Commr.*[15] decision. The IRS, on the other hand, based its decision on the opinions of the five Circuit Courts.

Holding. The Tax Court reversed its previous decision reached in *Redlark*. Therefore, **the Tax Court now agrees with five Circuit Courts of Appeals (4th, 6th, 7th, 8th, and 9th) that interest paid on all individual income tax deficiencies is personal interest and not deductible.**

> **Note.** If the law practice qualified for corporate tax treatment, the interest would have been deductible since a corporate taxpayer would have no personal expenses.

Deductible Repairs

Nevia Campbell v. Commissioner, TC Summary Opinion 2002-117 **(September 6, 2002)**
IRC §§162 and 263

☞ Replacement Roof Repair Results in a Current Deduction

Facts. The taxpayer's rental property had a leaky roof that was causing damage to the interior walls. Therefore a roofing contractor was hired to remove the existing roof, install fiberglass to replace damaged drywall, and apply hot asphalt. The taxpayer deducted these costs as a current operating expense, but the IRS ruled the expense should be capitalized and depreciated.

Holding. The Tax Court agreed with the taxpayer. The court determined that the repairs did not materially add to the value of the property, add to its life, or make it adaptable to another use. Thus, the repairs were in the nature of a replacement made to arrest deterioration and were currently deductible.

> **Note.** See Chapter 13, Depreciation for more information on the *Nevia* court case.

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Legal Fees

Eric Test and Odelia Braun v. Commissioner, **9th Cir. Ct. of Appeals, 2002-2 USTC ¶50,692 (October 1, 2002)**
IRC §§67 and 162

☞ Legal Fees Incurred as an Employee Are Deductible on Form 2106

Note. This Appeals Court decision affirms the decision reached by the Tax Court.[16] See pages 374-375 in the *2001 University of Illinois Farm Income Tax Workbook* for an analysis of this case.

Facts. Odelia Braun, a medical professor at the University of California at San Francisco, was the director of the university's CPRT medical unit. Part of her duties included implementing practices to improve emergency response treatment for patients suffering from cardiac arrest.

Dr. Braun was in the process of forming a corporation to work with the private sector. She also developed a business plan to start her own medical practice. However, the state of California conducted an audit of the CPRT medical unit. Two local newspapers published negative articles concerning the audit.

Dr. Braun was concerned the publicity would jeopardize her opportunity to establish her corporation and her private medical practice. She sought legal advice and incurred legal fees which she paid in 1994. She deducted $87,300 of legal fees on her 1994 Schedule C.

In an examination, the IRS switched the legal fees to Schedule A as an unreimbursed employee business expense subject to the 2% AGI limitation. The additional tax assessed by the IRS was $24,647.

Issue. Whether legal fees were deductible as an ordinary and necessary business expense on Schedule C.

Analysis. In similar circumstances, the Supreme Court held that **"the origin and character of the claim with respect to which an expense was incurred is the controlling basic test of whether the expense was 'business' or 'personal'."**[17]

Holding. The Tax Court agreed with the IRS that Dr. Braun's legal fees were deductible as unreimbursed employee business expenses. While it may be true that she would not have contacted her attorneys but for her concern for her Schedule C business, the Tax Court was required to look to the origin of the underlying claim, not the consequences. **The Tax Court correctly determined that the state audit, which was the event that caused the legal fees, was related to Dr. Braun's duties as an employee.**

Other Rulings and Cases

Perry H. Kay, Sr. v. Commissioner, TC Memo 2002-197, **84 TCM 166, (August 8, 2002)**
Deductions: Unreimbursed employee expenses: Evidence.

Valentina Perrah v. Commissioner, TC Memo 2002-283, **84 TCM 547 (November 18, 2002)**
Deductions; Business expenses: Substantiation: Travel and meal expenses: Tax Court Rules: Burden of proof.

Joe D. and Maura F. White v. Commissioner, TC Summary Opinion 2003-18 **(March 12, 2003)**
Deductions: Ordinary and necessary expenses of a trade or business: Home office: Dwelling unit: Principal place of business: Car and truck expenses: Commuting expenses.

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CAPITAL GAINS AND LOSSES

Capital Gain Rate

***Frank Heatley et ux., v. Commissioner,* U.S. District Court, Middle District FL 90 AFTR 2d(RIA) 7697 (September 18, 2002)**

IRC §§1(h), 61 and 7422

☞ Taxpayer's Strategy to Obtain a 10% Tax Rate on Large Capital Gain Fails

Facts. Mr. Heatley, an 80-year-old taxpayer, prepared his own 2000 tax return. In 2000, he sold Walt Disney Corporation stock for $442,827 resulting in a long-term gain of $432,063. Thinking he would owe a 10% tax rate on the gain, Heatley sent a check for $43,204 to the IRS in July 2000 along with a letter explaining the payment. In September 2000, realizing that the gain could be taxed at a 20% rate, he sent an additional $43,204 payment to the IRS. These two payments which totaled $86,408, were in addition to his $800 quarterly estimated tax payments.

When Heatley timely filed his 2000 tax return, he reported taxable income of only $37,512. He calculated a total tax of $5,629 and a balance due of $209. He did not attach a Schedule D to his 2000 tax return. After processing the return, the IRS sent Heatley a notice that showed an overpayment of $86,409. Heatley responded by stating he was sure he owed at least $43,204 which was 10% of the $432,063 long-term gain. However, the IRS determined that Heatley's correct balance due was $792 after the correct 20% tax rate was applied to the stock sale gain. He paid the $792 and filed a suit for refund in District Court contending the capital gain should be taxed at a 10% rate.

Holding. The District Court agreed with the IRS that the gain was subject to a **20%** capital gains tax rate. Mr. Heatley unsuccessfully argued that since the "last dollar" of his reported taxable income, without the gain, fell within the 15% bracket, all of the gain should be taxed at the lower **10%** rate.

Non-Filer's Investment Activity

***Claudia J. Miner v. Commissioner, TC Memo 2003-39,* 85 TCM 845 (February 24, 2003)**

IRC §§163, 6651, 6654 and 7491

☞ Non-Filer Investor Entitled to Deduct Margin Interest

Facts. Claudia Miner failed to file tax returns for 1996-1998 even though she had substantial investment income during the three years. Based on its transcript of various Forms 1099 information returns, the IRS assessed the following tax and penalties against the taxpayer:

Tax Year	Additional Tax	Failure to Timely File Penalty
1996	$30,520	$6,867
1997	27,011	6,077
1998	35,140	7,907

Her income according to the Form 1099 information and the margin interest she paid for the three-year period is shown below. The dividend income figure shown includes capital gain distributions.

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Tax Year	Interest Income	Dividends	Gross Stock Sales	Margin Interest Paid
1996	$15,696	$18,321	$47,577	$1,738
1997	12,684	29,371	68,000	1,884
1998	8,661	44,690	83,000	3,764

Issues.

1. Whether the examination reports sent to the taxpayer by the IRS were arbitrary and not entitled to a presumption of correctness.
2. Whether the failure to file penalty under IRC §6651 was properly applied.
3. Whether the taxpayer is entitled to deduct margin interest as investment interest on Schedule A.

Analysis for Issue 1. The taxpayer contends that the examination reports were arbitrary because the IRS did not establish or consider her cost basis in the securities she sold during the three years in question. She further contends that the IRS produced no reliable evidence that she received unreported income in the period 1996-1998.

Analysis for Issue 3. The IRS contends that no deduction is allowed for margin interest because the taxpayer was an investor and not a trader. Therefore, the margin interest is not deductible as a trade or business expense.

Holding for Issue 1. The examination reports were based on third-party information returns, the accuracy of which the taxpayer does not dispute. The IRS has no duty to investigate information returns from third-party payors that are not disputed by a taxpayer. The IRS issued the examination reports without knowing the taxpayer's cost bases in the securities sold **because she failed to file returns as required** for 1996-1998. The examination reports are not arbitrary or unreasonable because of the failure of the IRS to obtain all the facts **if the failure is caused by the taxpayer**. Therefore, the Tax Court held that the examination reports issued by the IRS were not arbitrary or unreasonable.

Holding for Issue 2. The Court held that the failure to file was due to willful neglect by the taxpayer rather than due to reasonable cause. Therefore, the failure to file penalty under IRC §6651 was appropriate.

Holding for Issue 3. The margin interest paid by the taxpayer was **investment interest which she may deduct** under IRC §163(h)(2)(B) to the extent of her net investment income for 1996-1998.

Assignment of Lottery Payments

Peter U. and Mary M. Boehme v. Commissioner, TC Memo 2003-81 **(March 20, 2003)**

IRC §§74, 163 and 1221

☞ Right to Receive Future Annual Lottery Payments Does Not Constitute a Capital Asset

Facts. In 1991, Mary Boehme won $1.5 million from the Colorado State Lottery, which was to be paid over a 25-year period in annual payments commencing October 10, 1991. In order to make the 25 lottery payments, the Colorado State Lottery purchased an annuity and named Mary as the beneficiary.

In July 1995, Mary pledged 12 future lottery payments as collateral for a $186,000 loan. Mary and her husband, Peter used $100,000 of the $186,000 loan proceeds to improve their personal residence. They spent the remaining $86,000 for miscellaneous personal needs. However, the $186,000 loan was not secured (mortgaged) by the residence.

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In April 1996, the taxpayers needed more money, so they executed a "Lottery Prize Assignment Agreement" with Woodbridge Financial Co. (Woodbridge). **The 12 future lottery payments, which amounted to $664,000, were assigned to Woodbridge in return for a lump-sum payment of $400,000.** The terms of the agreement follow.

Lump-sum payment made by Woodbridge to Mary in 1996		$400,000
Less:		
1) Repayment of the original 1995 loan	$186,000	
2) Interest and early payment penalty on original 1995 loan	64,000	
		(250,000)
Remaining amount of the lump-sum payment kept by Mary in 1996		**$150,000**

The taxpayers did not report the $400,000 lump-sum payment as "Other income" on line 21 on their 1996 Form 1040. However, they did report a $264,000 long-term capital loss on their 1996 **Schedule D** as follows.

7 Net short-term capital gain or (loss). Combine lines 1 through 6 in column (f). 7

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-5 of the instructions)	(e) Cost or other basis (see page D-5 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)	(g) 28% rate gain or (loss) * (see instr. below)
8	Lottery Payment	1991	04/30/1996	400,000	664,000	(264,000)	

Issues.

1. Whether the $400,000 lump-sum payment received in return for the assignment of future annual lottery payments constitutes the sale of a capital asset within the meaning of IRC §1221.

2. Whether the $64,000 interest and early payment penalty which was withheld from the $400,000 lump-sum payment constitutes personal interest or qualified residence interest.

Analysis for Issue 1. The question of whether the right to receive future lottery payments constitutes a capital asset has previously been addressed by the Tax Court.[18] The court held in that decision that it does not. Rather, any present income received in exchange for that right must be characterized as ordinary income.

In addition, **IRS Letter Ruling 199945008**, which was issued July 29, 1999, reached the same conclusion.

Analysis for Issue 2. IRC §163(h)(2)(D) provides that "qualified residence interest" is an exception to the general rule of disallowance of a deduction for personal interest. However, in order to qualify as deductible residence interest, the indebtedness must be **secured by the residence**.[19] That requirement was not met for the $100,000 of 1995 loan proceeds which were used to improve the taxpayers' principal residence.

Holding for Issue 1. The $400,000 lump-sum payment constitutes ordinary income for 1996. In addition, the $264,000 long-term capital loss claimed on the 1996 Schedule D is invalid and should be ignored.

Holding for Issue 2. The $64,000 interest and early payment penalty does not meet the definition of "qualified residence interest." Instead, it represents nondeductible personal interest.

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Other Rulings and Cases

Charles Johns v. Commissioner, TC Memo 2003-140, **85 TCM 1318 (May 19, 2003)**
Ordinary income: Capital assets: Lottery winnings: Assignment of rights

David K. and Elizabeth Simpson v. Commissioner, TC Memo 2003-155, **85 TCM 1421 (May 28, 2003)**
Capital assets: Prizes and awards: Lotteries: Sale or exchange: Assigned claims.

IRS Letter Ruling 200307062 (October 31, 2002)
Distributions of property. Determination of amount of and recognition of gain or loss.

Robert K. and Dawn E. Lowry v. Commissioner, TC Memo 2003-225 **(July 30, 2003)**
Real estate: Recognition of gain: Year of recognition: Fact-finding: Penalties, civil: Accuracy-related: Negligence: No evidence of reliance on professional advice.

CASUALTY LOSS

Deductions
Perry H. Kay, Sr. V. Commissioner, TC Memo 2002-197, **84 TCM 166 (August 8, 2002)**
IRC §165

☞ **Casualty Deduction Denied When Taxpayer Could Not Substantiate FMV of Property Prior to Casualty or His Cost of Repair**

Facts. The roof and several rooms of the Mr. Kay's home were damaged by a rain and wind storm. The damage was reported to the insurance company that settled the claim for $857. Mr. Kay later had a contractor replace a rotten deck and install a new roof on the home. When he filed his tax return, he claimed a casualty loss deduction on Schedule A for $5,151(rounded).

Analysis. The Court agreed that personal casualty losses are deductible as an itemized deduction if they exceed $100 and 10% of the taxpayer's adjusted gross income. If property is only partially destroyed, the amount of the loss can be determined in one of two ways:

1. By computing the difference between the FMV of the property prior to the casualty and immediately after the casualty. The deductible loss cannot exceed the adjusted basis of the property. This is the FMV approach.
2. The cost of repair approach is also acceptable as evidence of the loss in value of the property. To use the cost of repair approach the taxpayer must show the:
   - Repairs are necessary to restore the property to its condition immediately prior to the casualty,
   - Cost of the repairs was not excessive,
   - Repairs are only for the damages suffered, and
   - Value of the property after the repairs does not exceed the value of the property immediately before the casualty.

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Holding. The Tax Court did not accept the FMV approach since the taxpayer did not present an appraisal showing the value of the property prior to the casualty. While the taxpayer testified he spent over $4,000 to repair the damage to the property, he could only produce evidence of spending $2,588. After subtracting the insurance claim of $857, he was left with a net out-of-pocket expense of $1,731. Since $1,731 minus the $100.00 limitation or $1,631 was less than 10% of the taxpayer's adjusted gross income, no deduction was allowed.

Note. This case demonstrates the importance of having adequate records when claiming a casualty loss.

CORPORATIONS

Advanced Litigation Expenses

J.M.A. & Associates, P.C. v. Commissioner, TC Memo 2003-187, **85 TCM 1550 (June 30, 2003)**
IRC §162

☞ A Personal Service Law Corporation Denied Deductions for Litigation Expenses Advanced on Behalf of Clients

Facts. The law firm, located in Oklahoma City, specialized in representing victims of personal injury and product liability cases on a contingent fee basis. Under the terms of the firm's contingent fee contracts with its clients, the clients agreed to pay the firm litigation costs advanced by the firm if a recovery was eventually obtained. If no recovery was obtained, the clients were not obligated to reimburse the law firm for litigation costs it had advanced.

The following chart reflects the facts concerning the advanced litigation costs in the fiscal years ending November 30, 1994 and November 30, 1995:

Tax Year Ended	Total Advances	Advances Deducted for Client Matters Unresolved at Yearend
Nov. 30, 1994	$ 737,652	$705,647
Nov. 30, 1995	1,069,275	629,834

In its examination, the IRS disallowed the advances that were deducted as ordinary and business expenses. **The IRS contended that the disallowed advances constituted loans to the firm's clients, not deductible business expenses.** The additional tax assessed was about $265,000 for fiscal year 1994 and $221,000 for fiscal year 1995.

Issue. Whether the law firm is entitled to ordinary and necessary business expense deductions for litigation costs it advanced on behalf of its contingent fee clients.

Analysis. Generally, litigation costs advanced by lawyers on behalf of their contingent fee clients who are obligated by contract to repay the costs if recovery is obtained are treated as **loans.**[20]

Upon resolution of the contingent fee matters, at that time, if the lawyers do not receive repayment of the litigation costs advanced, the lawyers are entitled to deduct the unpaid portion as **bad debts**.

Holding. The Tax Court concluded that the litigation costs in dispute were to be treated, in the year advanced, as **loans** rather than as ordinary and necessary business expenses.

Note. This was a consolidated Tax Court case in conjunction with *John M. and Carolyn Merritt v. Commissioner*.

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Unreasonable Compensation

Devine Brothers, Inc. v. Commissioner, TC Memo 2003-15, **85 TCM 768 (January 16, 2003)**

IRC §162(a)(1)

☞ Low Prior Salary Years Help Defend Unreasonable Compensation Issue

Facts. Richard Devine, who had an engineering degree, worked in the family heating and air conditioning business in Pennsylvania for 40 years. Over time, he acquired all the stock of the company and helped the business survive a severe cash flow crisis in the late 1970s caused by the bankruptcy of a larger client. Following this near disaster, Mr. Devine scaled back the company operations and became the sole employee of the corporation. During these lean times, Mr. Devine was underpaid since the bonding company required Devine Brothers, Inc. build retained earnings and retain 10% of its revenue in cash. Each year, under Richard Devine's guidance, the corporation increased its bonding capacity.

As the business prospered, Mr. Devine brought his son into the business and eventually sold him all of the shares of stock in the corporation. **During the fiscal year ending February 28, 1994, Richard Devine's annual salary was $51,663. In the following fiscal year, his salary jumped to $260,378.** The huge increase in salary became an IRS examination issue.

In its exam of the Form 1120 for the year ending February 28, 1995, the IRS determined that $65,000 of his salary was unreasonable. In its exam report, the IRS stated, "The taxpayer's annual salary, after the $65,000 disallowance, falls in the range paid to CEOs of comparable companies in the same type of industry."

Issue. Whether the $260,378 salary paid to Richard Devine was reasonable and allowable as an ordinary and business expense under IRC §162(a)(1).

Analysis. A deduction is allowed for a reasonable allowance for salaries or other compensation for personal services actively rendered under IRC §162(a)(1). A two-part test is provided in Treas. Reg. §1.162-7(a):

1. Whether the payment was purely for services rendered, and
2. Whether the amount paid was reasonable.

Whether a salary represents reasonable compensation is a question that must be decided on the particular facts and circumstances. Various relevant factors have been addressed in previous court cases. These factors include:

1. The employee's qualifications;
2. The nature, extent, and scope of the employee's work;
3. The size and complexities of the business;
4. The comparison of salaries paid with gross income and net income;
5. The prevailing economic conditions;
6. Comparison of salaries with distributions to shareholders;
7. The prevailing rates of compensation paid for comparable positions in comparable concerns;
8. The salary policy of the taxpayers as to all employees; and
9. The amount of compensation paid to the particular employee in previous years.

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Holding. The Tax Court considered all of these factors in deciding whether Mr. Devine's salary was reasonable. The court noted the IRS offered no explanation for its arbitrary adjustment of $65,000. Further, the court observed that **the lack of adequate compensation paid in prior years can justify additional salary in later years.** The Court was impressed by his turnaround of his business, and that he was prevented from obtaining an adequate salary in earlier years due to bonding company restrictions. **Therefore, the Tax Court held that the entire $260,378 salary was reasonable and deductible.**

> **Note.** Reasonable compensation issues are very difficult for the IRS to prove. This is especially true for any court proceedings involving IRS examinations commencing **after July 22, 1998**. IRC §7491 shifted the burden of proof to the IRS in most court cases where taxpayers produce credible evidence and cooperate in the exam.

§1244 Stock

***T.P. and Najieh R. Crigler v. Commissioner, TC Memo 2003-93*, 85 TCM 1091 (March 28, 2003)**
IRC §§165, 1244 and 6662

☞ IRC §1244 Small Business Stock Loss Deduction Denied to Shareholder of an Investment Company

Facts. T.P. Crigler, the sole shareholder, incorporated his fiberglass manufacturing company, FabuGlass, in 1981. After experiencing serious business problems in 1985 and 1986, the company ceased its manufacturing operations. The company purchased $922,000 of securities in 1989. **During the 5-year period from 1990-1994, the corporation derived the majority of its income from renting its buildings and trading stocks and bonds.**

During the same 5-year period, 1990-1994, the corporation reported net losses from trading securities of over $1.5 million. The 1990-1995 Forms 1120 of FabuGlass reported that it was an investment company in the Principal Business Activity section of Schedule K. The Principal Business Activity code reported for those six years was 523110, Investment Banking & Securities Dealing.

On their joint 1995 Form 1040, the taxpayers deducted the maximum $100,000 ordinary loss under IRC §1244 for the husband's worthless small business stock in FabuGlass. The reported basis of the stock in Part II of the 1995 Form 4797 was $335,000.

In an exam, the IRS disallowed the $100,000 loss and determined that the taxpayers owed the following amounts regarding their 1995 Form 1040:

- Additional income tax of $19,675
- Accuracy-related negligence penalty of $3,935

Issues.

1. Whether the taxpayers may deduct an ordinary loss of $100,000 under IRC §1244 for worthless stock in FabuGlass Corporation.
2. Whether the taxpayers are liable for the accuracy-related penalty for negligence under IRC §6662.

Analysis for Issue 1. Generally, when corporate stock becomes worthless, the loss is a capital loss. However, an individual who owns worthless stock that qualifies as IRC §1244 "small business stock" may treat up to $50,000 ($100,000 in the case of a joint return) of the loss as an ordinary loss under IRC §1244. Such stock meets the definition of IRC §1244 stock if it is stock of a domestic corporation that meets **three** requirements:

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1. At the time the stock is issued, the corporation had not received money or other property in excess of $1 million for its stock as a contribution to capital or as paid-in surplus.[21]
2. The stock was issued for money or other property (other than stock or securities).[22]
3. The corporation, during its five most recent tax years ending before the date of the loss was sustained, derived **more than 50%** of its aggregate gross receipts from sources **other than**:
   - Royalties
   - Rents
   - Dividends
   - Interest
   - Annuities
   - Sales of stocks or securities[23]

The burden of proof is on the taxpayers to show that the husband's FabuGlass stock qualified as IRC §1244 stock in 1995, the year of the alleged worthlessness.

Analysis for Issue 2. A taxpayer may be relieved of liability for the accuracy-related penalty if the taxpayer shows that he had reasonable cause and acted in good faith. Reliance on the advice of a tax professional may constitute reasonable cause.[24] To establish good faith reliance on the advice of a competent adviser, a taxpayer must show that he provided the return preparer with complete and accurate information and an incorrect return resulted from the preparer's mistake.[25]

Holding for Issue 1. The Tax Court held that FabuGlass did not meet the third requirement. **FabuGlass was not an operating company in 1990-1994.** Consequently, the taxpayers **could not deduct** an ordinary loss of $100,000 under IRC §1244 for 1995.

Holding for Issue 2. Although the taxpayers contended that they gave the preparer of their 1995 tax return complete and accurate information to prepare the return properly, they did not prove it. There was no evidence that the taxpayers gave their accountant information showing that the husband's FabuGlass stock qualified under IRC §1244. The Tax Court concluded that the taxpayers were liable for the accuracy-related negligence penalty for 1995.

Observations.

1. The Court did not have to rule on whether the stock actually became worthless in 1995. As an alternative position, the IRS contended that it did not.
2. The Court also noted that the taxpayers' evidence and testimony regarding the reported $335,000 basis in FabuGlass stock was insufficient. It was impossible for the Court to determine that important fact.

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Gain on Incorporation

***Seggerman Farms Inc., et al. v. Commissioner,* 7th Cir. Ct of Appeals, 2002-2 USTC ¶50,728 (October 24, 2002)**
IRC §§351 and 357

☞ Liabilities in Excess of Property's Basis Cause Gain Upon Incorporation

Facts. 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.

Analysis. IRC §351 allows a tax-free transfer of assets into a corporation provided certain requirements are met. However, if the basis of the assets transferred are less than the amount of liabilities transferred, IRC §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.

Holding. The Tax Court held that even though the shareholders remained personally liable for the debt, they must recognize taxable income under IRC §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.

> **Note.** Additional information can be found in the *2001 University of Illinois Farm Income Tax Workbook* on pages 361-362 and in Problem 7 in the Supplement to the Agricultural Issues Chapter.

Other Rulings and Cases

***Charlotte's Office Boutique, Inc. v. Commissioner,* 121 TC —, No. 6. (August 4, 2003)**
Self-employment taxes: Withholding: Safe harbor: Tax Court: Jurisdiction: Determination of employee status: Self-employment taxes: Withholding: Corporate officers: Penalties, civil: Addition to tax: Failure to file: Form 941: Reasonable cause: Failure to.

***Bernardus A.P. and Klazina W. Dobbe v. Commissioner,* and *Holland America Bulb Farms Inc., v. Commissioner,* 9th Cir. Ct. of Appeals, 2003-1 USTC ¶50,377 (March 19, 2003)**
Gross income: Constructive dividends: Definition of dividend: Deductions: Business expenses: Ordinary and necessary.

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CREDITS

Child's Age
Revenue Ruling 2003-72 (July 18, 2003)
IRC §§21, 23, 24, 32, 129, 131, 137, and 151

☞ Uniform Method of Determining When a Child Attains a Specific Age

For each code section shown above, a credit, exclusion, or deduction is allowed to the taxpayer, provided, among other requirements, a child had **not** attained a specific age. For each of the eight provisions shown above, **a child attains a given age on his or her birthday**.

> **Example.** Samantha, the daughter of Brent and Sandra, was born on January 1, 1987. Samantha will attain age 17 on January 1, 2004. Therefore, Brent and Sandra are eligible for the maximum $1,000 child tax credit for her (including the $400 advance payment) on their joint 2003 return.

> **Note.** This uniform rule for determining the age of a child is not the same as the rule used to determine the age seniors attain age 65. An individual born on January 1, 1939 is considered to attain age 65 on December 31, 2003 and is therefore eligible for the additional standard deduction on his 2003 tax return.

Earned Income Credits
***LaTanya Haywood v. Commissioner, TC Memo 2002-258,* 84 TCM 442 (October 8, 2002)**
IRC §§32 and 151

☞ IRS Denies Exemption Deduction and EIC for Son in Prison

Facts. LaTanya Haywood filed her 1999 federal income tax return and claimed an exemption and the related earned income tax credit for her 21-year old son, Brandon. However, Brandon was not a member of her household at any time during the 1999 tax year since he had been incarcerated by the State of Missouri since 1995. LaTanya based her claim on the fact that she had sent money to her son for incidentals. Although she had no records to prove her contention, the Tax Court assumed she contributed $1,300 in 1999 for Brandon's incidentals.

Issue. Whether the taxpayer was entitled to claim Brandon's exemption and the related earned income credit for him.

Holding. The Tax Court stated that Ms. Haywood was not required by the State of Missouri to provide for her son's support while in prison. Further, even when considering the $1,300 of support she provided, it would not constitute over one-half the son's total support for the year. Therefore, the exemption deduction and earned income tax credit were properly denied.

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Earned Income Credit Initiative

IRS News Release IR-2003-78 (June 13, 2003)
IRS Fact Sheet 2003-14 (related to the News Release)
IRS Announcement 2003-40 (related to the News Release)
New 2003 Form 8836 (related to the News Release)
IRS News Release IR-2003-97 (August 5, 2003)
IRC §32

☞ IRS Announces New Initiative to Reduce Erroneous Earned Income Credit Refunds

> **Note.** This issue is covered in the EITC section found in Chapter 14, IRS Update.

Forms 8885 and 1099-H

Treasury Department News Release JS-443 (May 29, 2003)
IRC §35

☞ Maine Is First State where Residents Can Qualify for the New Advance Health Coverage Tax Credit in a Pilot Program

Taxpayers who lose their jobs due to trade agreements are eligible for a health insurance credit. This new tax credit was included in the Trade Adjustment Assistance (TAA) legislation passed in 2002. This program was created by Congress to aid workers whose jobs are negatively impacted by imports.

The new fully refundable credit, which is clamed on **Form 8885**, *Health Coverage Tax Credit*, is equal to 65% of the cost of health insurance premiums paid by the displaced workers. About 2,800 Maine displaced workers are estimated to qualify for new **advance** government credit payment. These displaced Maine workers will be required to pay only 35% of their health insurance premiums to a transaction center, which will add the 65% advance credit payment portion and remit the full premium to the insurance company. This advance credit payment aids unemployed workers who can't afford to pay 100% of the premium and can't wait until they file their 2003 tax returns to receive the full credit on Form 8885. A blank Form 8885 follows.

Maine residents will participate in the new advance credit payment program in July 2003. Residents of other states are eligible to participate beginning in August 2003. A new form, the **2003 Form 1099-H**, will be issued to report the advance credit payment to recipients.

The toll-free number to verify eligibility is 1-866-628-4282. More information on a particular state can be found at the HCTC website at www.irs.gov, enter keyword HCTC.

> **Note.** For more information on this new credit, see pages 55-56 in the *2002 University of Illinois Income Tax Workbook* and the General Instructions on page 2 of the 2003 Form 8885.

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Form **8885**

Department of the Treasury
Internal Revenue Service

Health Coverage Tax Credit

▶ Attach to Form 1040 or Form 1040NR.

OMB No. 1545-1807
2003
Attachment Sequence No. 134

Name of recipient (if both spouses are recipients, complete a separate form for each spouse) | **Recipient's social security number**

Before you begin: See **Definitions and Special Rules** beginning on page 2.

Draft as of 8/11/2003

CAUTION

Do not complete this form if you can be claimed as a dependent on someone else's 2003 tax return.

Part I Complete This Part To See if You Are Eligible To Take This Credit

1 Check the boxes below for each month in 2003 that **all** of the following statements are **true** on the **first day** of that month.

- You were an eligible trade adjustment assistance (TAA) recipient, alternative TAA recipient, or Pension Benefit Guaranty Corporation (PBGC) pension recipient.
- You were covered by a qualified health insurance plan for which you paid the premiums.
- You were **not** entitled to Medicare Part A or enrolled in Medicare Part B.
- You were **not** enrolled in Medicaid or State Children's Health Insurance Program (SCHIP).
- You were **not** enrolled in the Federal Employees Health Benefits Program or eligible to receive benefits under the U.S. military health system (TRICARE/CHAMPUS).
- You were **not** imprisoned under Federal, state, or local authority.
- You were **not** covered by, or eligible for coverage under, any employer-sponsored health insurance plan (see instructions on page 3).

☐ January ☐ February ☐ March ☐ April ☐ May ☐ June

☐ July ☐ August ☐ September ☐ October ☐ November ☐ December

Part II Health Coverage Tax Credit

2 Amount paid for qualified health insurance coverage for all months checked on line 1 (see instructions on page 4). Include advance payments, if any, from Form 1099-H, box 1 . . .	**2**	
3 Enter the total amount of any **(a)** Archer MSA distributions used to pay amounts included on line 2 and **(b)** National Emergency Grants you received for health insurance in 2003 . . .	**3**	
4 Subtract line 3 from line 2. If zero or less, **stop;** you cannot take the credit	**4**	
5 Multiply line 4 by 65% (.65) and enter the result	**5**	
6 Advance payments, if any, from Form 1099-H, box 1	**6**	
7 **Health coverage tax credit.** Subtract line 6 from line 5. If zero or less, enter -0-. Also include on Form 1040, line 67, or Form 1040NR, line 62, and check box **c** on that line	**7**	

Note. You **must** attach invoices and proof of payment for any amounts included on line 2 for which you did not receive an advance payment (see instructions on page 4).

For Paperwork Reduction Act Notice, see page 4. Cat. No. 34641D Form **8885** (2003)

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Hope Credit

Field Service Advice 200236001 (September 6, 2002)

IRC §§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 is allowable to the parents of the taxpayer/student during the tax year, the taxpayer/student's personal exemption amount is zero.
2. Because the taxpayer/student's dependency exemption is not claimed on his parent's return, the student is entitled to claim an education credit on his own return (assuming he meets all eligibility requirements.)

The education credits could be phased out on the parent's return due to the high modified AGI. This strategy will yield no tax benefit if the student does not have sufficient taxable liability against which the education credit(s) may be claimed.

Disabled Access Credit

David B. and Janis Hubbard v. Commissioner, TC Memo 2003-245 **(August 14, 2003)**

IRC §44

☞ Automatic Refractor Purchased by Optometrist Qualifies for Disabled Access Credit

Facts. Prior to 1997, Dr. Hubbard, an optometrist in rural Nevada, used a manual refractor to test the vision of his patients. In this process, a patient would sit in an examination chair behind a manual refractor, view vision charts, and answer questions. On disabled patients, he was occasionally unable to perform this service due to several circumstances related to the disability of the patient. Therefore, he was not able to treat a number of disabled patients and instead referred them to other optometrists located 120 miles away.

In 1997, in order to increase his ability to treat disabled patients, Dr. Hubbard purchased a $13,000 automatic refractor and a $4,500 height-adjustable rotary stand on which to place it. On the 1997 joint tax return, a $5,000 disabled access credit was claimed on Form 8826. In its examination, IRS disallowed the credit in full.

> **Note.** Dr. Hubbard's 1997 gross receipts were about $587,000.

Analysis. The Americans with Disabilities Act of 1990 (ADA) prohibits discrimination against disabled individuals in the full and equal enjoyment of goods and services. IRC §44(a) provides "eligible small businesses" with an income tax credit equal to:

- 50% of "eligible access expenditures" exceeding $250 and up to $10,250.
- The amount of the credit is limited to $5,000 per year.

"Eligible small businesses" are those with gross receipts less than $1 million **or** with less than 30 employees in the preceding tax year.

In *Fan v. Commissioner,*[26] a disabled access credit claimed by a dentist for an intraoral camera system was disallowed. In *Fan*, the Tax Court reasoned that the dentist was already in compliance with ADA through the use of handwritten notes to communicate with hearing impaired patients. In addition, Dr. Fan had always been able to treat disabled patients. In that decision, the Tax Court noted that the camera system had a general applicability and usefulness to all of his dental patients.

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Holding. Dr. Hubbard was not able to provide vision testing services to some disabled patients. The fact that the automatic refractor was also used by him to treat nondisabled patients is not fatal to his entitlement to the disabled access credit. The Tax Court found no exclusive use or benefit test in IRC §44(a).

Therefore, the Court concluded that Dr. Hubbard purchased the equipment in order to treat disabled patients and to comply with the ADA legislation. The Court also noted that in light of the size of his practice compared to the cost of the equipment—the purchase of the equipment was reasonable and necessary. **The taxpayers were entitled to the claimed $5,000 IRC §44 disabled access credit.**

DEDUCTIONS

Gifted Stock Warrants
Gerald A. and Henrietta V. Rauenhorst v. Commissioner, **119 TC 157 (October 7, 2002)**
IRC §170

☞ Contribution of Stock Warrants to Charity Was Not an Anticipatory Assignment of Income

Facts. The taxpayers owned warrants in a corporation. Another corporation announced it was going to purchase all of the taxpayer's warrants and merge the companies. Just prior to the merger, the taxpayers assigned their ownership rights in the warrants to four charitable organizations. This permitted them to avoid a large capital gain.

Analysis. 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.

Holding. 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 taxpayers were not liable for the $1.3 million deficiency and $250,000 accuracy related penalties.

Medical Expense
IRS Pub. 502, *Medical and Dental Expense* (Revised 2002)
IRC §213

☞ IRS Publication Takes Restrictive View on Certain Medical Deductions for Weight-Loss Programs

The *2002 University of Illinois Income Tax Workbook* discusses Rev. Rul. 2002-19 on pages 306 and 437-438. Since the workbook's publication, the IRS has issued Pub. 502 which takes a more 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 could affect 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. IRS 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 cannot include membership dues in a gym, health club, or spa.**"

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Medical Costs

Robert and Martha Emanuel v. Commissioner, TC Summary Opinion 2002-127 **(October 3, 2002)**

IRC §213

☞ Swimming Pool Maintenance Expenses Were Allowable Medical Expenses

Facts. Robert Emanuel was injured in an accident and received 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, the taxpayers' child was severely mentally retarded, physically handicapped and required constant attention. The state court had awarded additional attendant care benefits and the taxpayers hired a care taker who worked at least 10 hours per day. The cost of the caretaker was also deducted as a medical expense.

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

Percentage Disallowance for Meals and Entertainment

Chief Counsel Advice 200317016 (January 17, 2003)

IRC §274

☞ Trucking Company that Uses Leased Employees Not Subject to Percentage Disallowance for Meals and Entertainment; Leasing Company Must Make Adjustment

Purpose. Taxpayer wants to determine who is subject to the percentage disallowance under IRC §274 (n).

Background. Lessee, a trucking company, leases all of its employees (Workers) through Lessor, a leasing company. The agreement between Lessee and Lessor states the Workers will be considered employees of Lessor in all respects. **The agreement provided the Lessee would pay "compensation" to Lessor weekly for services provided by Workers. The lease did not label any part of the payment as "per diem."**

Lessee did not have any agreement with Lessor to pay per diem and had no part in setting per diem rates. Lessee typically hired all of Lessor's Workers and found new Workers and referred them to Lessor for employment. The Lessee determined the method of calculating Workers pay and pay rate. They also furnished equipment, furnished assignments, and day-to-day direction. The Lessor provided manuals, safety training, monthly newsletters, and periodic safety seminars.

Lessee paid Lessor a fee based on the Workers compensation times a fixed percentage, generally in the range of 115% to 125%.

Ruling. Lessor was responsible for paying Workers "gross compensation". Lessor reimbursed Workers for their food and beverage expenses. Lessor allocates Workers gross pay between wages and per diem and filed the wages on Form 941. Therefore, **Lessor is responsible for the percentage disallowance of the meals and entertainment amount.**

Other Rulings and Cases

JHK Enterprises, Inc., a California Corporation v. Commissioner, TC Memo 2003-79, **85 TCM 1032 (March 18, 2003)**

Deductions: Losses: Abandonment losses: Evidence: Penalties, civil: Failure to file: Burden of proof: No shift in burden of proof.

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DEPENDENCY ISSUES

Foster Children

Etta James Linton, TC Memo 2003-160, **85 TCM 1436 (June 2, 2003)**
IRC §§2, 32, and 152

☞ Head of Household Filing Status, Exemptions, and EIC Disallowed for Children in Foster Homes

Facts. Etta Linton, a single individual, had two sons, Frankie and Avery Linton, who each resided with foster parents all of 2000. Etta's sons visited with her approximately twice a week but were not permitted to stay overnight at her home. On her 2000 tax return, she:

- Filed as unmarried head of household
- Claimed dependency exemptions for Frankie and Avery
- Claimed the earned income credit by listing Frankie and Avery as qualifying children

In its examination of Ms. Linton's 2000 return, the IRS switched the filing status to single, disallowed the two exemptions and the claimed earned income credit, and assessed a deficiency of $4,037.

Analysis and Holding. The Tax Court found the taxpayer's arguments to be irrelevant, moot, or without merit. Consequently, the tax determination made by the IRS was upheld.

Other Rulings and Cases

Richard J. Meyer III v. Commissioner, TC Memo 2003-12, **85 TCM 760 (January 13, 2003)**
Dependency exemptions: Release of claim to exemptions: Child tax credit: Qualifying child.

Taylor Brinson v. Commissioner, TC Summary Opinion 2003-89 **(July 16, 2003)**
Dependency exemption deduction: Foster child.

Robert James Mentzel, Jr. v. Commissioner, TC Summary Opinion 2003-38 **(April 21, 2003)**
Dependency exemption: Child tax credit: Head of household: Dependency exemption test: Burden of proof.

Michael Kevin & Vickie P. Boltinghouse v. Commissioner, TC Memo 2003-134, **85 TCM 1277 (May 13, 2003)**
Dependency exemption: Children of divorced parents: Noncustodial parent: Agreements on exemptions: Separation agreement: Form 8332.

DIVORCE ISSUES

QDROs

Edward A. Bougas III v. Commissioner, TC Memo 2003-194, **86 TCM 9 (July 2, 2003)**
IRC §§72(t) and 414(p)

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☞ Taxpayer Liable for IRA Early Distribution Penalty

Facts. Edward and Kathleen Bougas were divorced in 1998 in New Jersey. The divorce decree ordered Edward to pay the following amounts:

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- A lump-sum tax-free payment of **$150,000** to Kathleen, his ex-wife
- **$46,741** of various credit card debt incurred by Kathleen
- Kathleen's attorney fee of **$10,000**

The divorce decree contained a provision stating that Edward's 401(k) plan and his IRA "shall be his sole and exclusive property, free and clear of any claims by Ms. Bougas." **There was no provision in the divorce decree dictating that Edward must pay the ordered obligations from his IRA funds.** Rather, he was free to pay the ordered amounts from whatever sources he had available.

Because his resources were limited, Edward received a $250,000 IRA distribution in March 1998 which he deposited in his checking account. He then paid the 3 ordered amounts, including the $150,000 to his ex-wife, by check. Edward reported the $250,000 IRA distribution as taxable income on his 1998 tax return; however, he did not file Form 5329 to report the 10% early withdrawal penalty.

In its examination, the IRS assessed the IRA early distribution penalty of $25,000.

Issue. Whether the taxpayer is liable for the 10% IRA early distribution penalty.

Analysis. There is an exception to the penalty under IRC §72(t)(2)(C) if IRA distributions are made to an **"alternate payee"** pursuant to a qualified domestic relations order **(QDRO).**

Holding. No funds were transferred by Edward's IRA plan administrator to an alternate payee in response to a QDRO. **The divorce decree failed to name Ms. Bougas as an alternate payee, failed to specify clearly an amount or percentage of his IRA that was to paid by the plan to Ms. Bougas, and failed to create or recognize any rights of her to receive any portion of Edward's IRA.**

Clearly, the divorce decree did not substantially comply with IRC §414(p) requirements. **Therefore, the taxpayer was liable for the $25,000 10% early withdrawal penalty since he was under age 59½.**

Form 8332 Substitute
Michael R. Loffer v. Commissioner, TC Memo 2002-298, **84 TCM 618 (December 4, 2002)**
IRC §§24, 151 and 152(e)(2)

☞ Copy of Divorce Decree Not a Valid Substitute for Form 8332

Facts. Michael Loffer and his former wife were divorced on 1994. At the time of the divorce, they had two minor children, Samantha and John. The divorce decree provided:

"It is further ordered, adjudged, and decreed that the parties shall each be entitled to claim one of the two minor children as a dependent for federal and state income tax purposes so long as there are two children who can be claimed, commencing 1993 and each year thereafter. The parties shall execute and exchange any IRS document required to claim the dependent children on or before February 1 of each year."

For all of 1998, the tax year in question, Samantha, who was 13 years old, resided with her mother. John, who was 18 years old, resided with his mother for the first four months of 1998. He left his mother's residence in May when he obtained a job and his own apartment.

Both Michael and his ex-wife claimed Samantha's exemption and the $400 child tax credit for her on their separate 1998 tax returns. Neither claimed John as a dependent on their 1998 returns. Michael did **not** attach Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents* to his 1998 return. **Instead, he attached a copy of pertinent portions of the divorce decree to his return.**

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In an audit of Michael's 1998 return, the IRS disallowed the exemption of Samantha and the $400 child tax credit for her.

Issue. Whether the taxpayer is entitled to Samantha's dependency exemption and to a child tax credit for her.

Analysis. A custodial parent may release the right to a dependency exemption by declaring in a written statement that he will not claim the child as a dependent for a particular year.[27] If the custodial parent releases his right to a dependency exemption, the noncustodial parent may claim the exemption if the written release statement is attached to the noncustodial parent's tax return.[28]

A properly completed and filed Form 8332 will entitle a noncustodial parent to the dependency exemption. A written statement other than a Form 8332 that conforms to the substance of Form 8232 will also be sufficient to release the exemption to the noncustodial parent.

Michael contended that the portion of the divorce decree that he attached to his 1998 return substantially conformed to Form 8332. However, the IRS did not agree with that position.

Holding. The Tax Court agreed with the IRS that the divorce decree at issue did not substantially conform to Form 8332. Although the taxpayer's ex-wife signed the decree, it was not indicated in the decree which child the taxpayer was to claim as a dependent. Furthermore, no specific tax year was mentioned in the decree. Consequently, the taxpayer was **not** entitled to the claimed dependency exemption for Samantha for 1998. As a result, he also was not allowed the $400 child tax credit with respect to Samantha.

Form 8332
***Joann Bramante v. Commissioner, TC Memo 2002-228,* 84 TCM 299 (September 12, 2002)**
IRC §§24, 151 and 152

☞ Beware! Form 8332 Is a Binding Document

Facts. Under a judgment for divorce on December 6, 1993, Joann Bramante was awarded custody of her two minor children. The divorce decree made no reference to the dependency exemption deductions for the children; however, her ex-husband was ordered to contribute $268 bi-weekly child support.

Since Joann did not have sufficient income to owe any federal income tax in the years 1994 through 1997, she did not claim exemption deductions for her two children. However, her ex-husband was gainfully employed and he claimed the children as dependents on his tax returns during this period. The accountant for Joann's ex-husband properly advised his client that he would need a release of the exemptions from Joann on Form 8332. The accountant prepared the Form 8332, which has two parts:

- Part I for releasing the exemptions for the current year (1994);
- Part II for the release of the exemptions the tax years 1995 to 2013.

The ex-husband was able to convince Joann to sign both parts of Form 8332.

Joann returned to work full time in November, 1997. On her 1998 income tax return she claimed dependency deductions for her two children and the child tax credit for them. She attached a written statement to her return, which said, "I have not authorized the use of my children to be claimed as a dependent on someone's tax return." However, Joann apparently did not inform her ex-husband of her disavowal of the Form 8332 since he also claimed the children as dependency exemptions on his 1998 income tax return.

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Issues. Which taxpayer is entitled to the exemption deductions for the year 1998, and whether the provisions of Form 8332, releasing the exemption deductions for both children for future years, can be revoked.

Analysis. In post 1984 situations involving dependents whose parents are divorced or separated, IRC §152(e)(1) provides that the parent having custody for the greater portion of the calendar year is treated as providing over one-half the support of the children. A non-custodial parent may be treated as providing over half of the total support if the two tests under IRC §152(e)(2) are met.

- The custodial parent signs a written declaration (Form 8332) that the children will not be claimed as dependents in either the current year or for all future years, and
- The non-custodial parent attaches this Form 8332 to his return.

Holding. The Tax Court found that Joann properly executed Form 8332 and thus released her right to claim exemption deductions for her two children for the tax years 1995 thru 2013. The language of the statute is clear in this area. Joann's arguments that the social security numbers were not entered on Form 8332, and that her ex-husband had dated the form were ignored. She signed the form releasing the exemptions and she was bound by its terms.

> **Note**. It is suggested that tax preparers should advise their custodial parent clients to release the exemption(s) on a yearly basis only. This strategy prevents adverse outcomes as shown in this case. It also provides some degree of leverage for the custodial parent to ensure the non-custodial parent continues to pay child support and/or maintenance as required.

Alimony and Separate Maintenance Payments

Letter Ruling 200246029 (August 20, 2002)

IRC §§71 and 215

☞ Divorce Decree Silent as to Tax Treatment: Lump-Sum Payment Resulted in Alimony

Background. Taxpayer and spouse were divorced under state law. The Court Order provides taxpayer will pay former spouse "as support and maintenance such sums of money as set out in Paragraph 16 of the aforesaid Separation Agreement pursuant to the terms and conditions therein contained."

The Separation Agreement required the taxpayer to pay monthly alimony to the former spouse until she died, a further court order was issued, she remarried, or until a named date. The agreement also stated that if Taxpayer paid alimony through the named date, then Taxpayer "has the option to a lump-sum settlement or to continue paying alimony as aforesaid or until such time as he chooses to exercise the option to pay the lump-sum settlement."

Neither the Court Order nor the Separation Agreement excluded any of the support and maintenance payments from the former spouse's income or precluded Taxpayer from taking alimony deductions. Taxpayer decided to make the lump-sum payment and wished to deduct it as alimony.

Ruling. The IRS ruled Taxpayer's lump-sum payment constituted alimony and that he could deduct it for federal income tax purposes. All of the requirements of IRC §71(b) were met. There was no recapture since the recapture rule only applies when payments are reduced in the first three years.

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Other Rulings and Cases

***Nancy L. and Richard A. Cafarelli v. Commissioner, TC Memo 1994-265,* 67 TCM 3077 (June 9, 1994)**
Dependency exemption: Written declaration: Divorce decree.

***Phil E. Anderson v. Commissioner, TC Summary Opinion 2002-103* (August 06, 2002)**
Dependency exemption: Divorced parents: Dependent of another taxpayer: Support.

EMPLOYMENT TAX ISSUES

Social Security Wage Base

OMB Projection of 2004 Social Security Wage Base
IRC §§1402 and 3401

☞ Social Security Wage Base for 2004

The **2004** Social Security Wage base will be **$87,900**, a $900 increase from the 2003 figure.

> **Note.** The official confirmation of the projected figure shown above was released on October 16, 2003 via a Social Security Administration News Release.

Trust Fund Recovery

***United States v. Steven Lindsey, et al,* 10th Cir. Ct. of Appeals, 2002-2 USTC ¶50,698 (October 7, 2002)**
IRC §6672

☞ Corporate Officer Was Responsible Person Despite Not Having Check-Signing Authority

Facts. Steven Lindsey was a founder and 50% shareholder of Transport Financial Services (TFS). TFS leased truck drivers to Clearwater Trucking Company, another company owned by the same shareholders. Lindsey was president of Clearwater and vice president of TFS. Before TFS was created, all the truck drivers who became TFS employees were Clearwater employees.

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 from Clearwater to TFS. Therefore, **he had substantial control over the financial affairs of and the decisions made by TFS**. When Clearwater ran into financial difficulties, it favored other creditors over TFS resulting in TFS's failure to meet its employment tax obligations.

Issue. The Tenth Circuit was faced with this question: Is check-signing authority on a corporate account a necessary requirement in order to demonstrate personal responsibility and willfulness under IRC §6672?

Analysis. The IRS can seek to collect a 100% penalty tax assessment from a "responsible person" under IRC §6672, if he fails to deposit payroll taxes for an employer. **A responsible person is anyone responsible for collecting, accounting for, and depositing any tax, and who willfully fails to perform these responsibilities.**

Holding. The Tenth Circuit upheld the Utah District Court decision that an individual could be a responsible person under IRC §6672 even though he did not have authority to sign checks for the corporate employer. The Court held that check-signing authority was not a necessity.

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Household Employees
Social Security and Medicare Wage Threshold for 2003
IRC §3402(p)

☞ Nanny Tax Threshold Rises to $1,400 for 2003

2003 cash remuneration of less than $1,400 paid to a household employee is exempted from the reporting and paying of social security and Medicare taxes. This is an increase from $1,300 in 2002.

Note. The threshold applies to **each** household employee, not to a group of employees.

Company Trips
***Townsend Industries, Inc., v. United States,* U.S. District Court, Southern District IA, 2002-2 USTC ¶50,697 (August 21, 2002)**
IRC §§132, 162, 274, and 3401

☞ Cost of Company-Paid Fishing Trips Held to be Wages to Employees

Facts. Townsend Industries regularly took its employees on a company-paid fishing trip. The corporation 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 Altoona, Iowa, conducts an annual sales meeting at its headquarters. Employees attend meetings on Monday and Tuesday at which a variety of topics are discussed. On Wednesday, the company sponsors a fishing trip to a resort in Canada that concludes on 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.

Issue. The District Court had to decide if costs associated with the trip qualified as a working condition fringe benefit under IRC §132(a)(3).

Analysis and Holding. The Court evaluated the ordinary and necessary requirement and based its decision on two primary factors:

1. The lax attendance policy for the trip. Although all employees were invited to attend, a significant number did 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 was certain that a specific benefit would result.

The District Court determined the cost of these trips were wages to the employees and subject to employment taxes. The Court indicated that even though employee morale might benefit, the cost of the trips constituted wages. As a result, the company was liable for $58,500 in additional employment taxes in 1996 and 1997.

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Worker Classification

***Joseph M. Grey Public Acct., P.C. v. Commissioner,* 119 TC 121 (September 16, 2002)**
IRC §3121(d)(1)

☞ Tax Court Rules Against Shareholder/Officer of S Corporation Who Was Not Paid a Salary

Facts. Joseph Grey was the sole shareholder and president of his accounting firm which was operated as a professional corporation. As an officer/employee, he performed the following services for the corporation:

- 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 receiving fixed salary payments for his services. The corporation issued Mr. Grey Forms 1099-MISC for 1996 and 1997. However, the IRS treated the entire S corporation profit for the two tax years as wages and assessed additional employment taxes against the S corporation.

Issue. Whether Mr. Grey was a statutory employee under IRC §3121(d)(1) whose remuneration was subject to federal employment taxes.

Holding. The Tax Court determined that as an officer who performed numerous services for the S corporation, Mr. Grey was automatically classified as an employee under IRC §3121(d)(1) and Treas. Reg. §31.3121(d)-1(b). Therefore, the IRS assessment of corporate employment tax liability was upheld.

> **Note.** Ironically, Mr. Grey was the accountant for the client in *Veterinary Surgical Consultants, P.C. v. Commr*. 117 TC 141 discussed on page 302 of the *2002 University of Illinois Income Tax Workbook*.

Other Rulings and Cases

***Kevin and Bridget Naughton v. Commissioner, TC Memo 2002-222,* 84 TCM 275 (September 4, 2002)**
Business deductions: Substantiation: Independent contractor: Employer-employee relationship, classification of: Physician: Notice of deficiency: Validity of notice.

Rev. Rul. 2002-80 (December 8, 2002)
Exclusions from income: Accident and health plans: Medical expenses: Advance reimbursements: Loans.

***Robert E. and Yvonne R. Kovacevich v. Commissioner, TC Memo 2003-161,* 85 TCM 1438 (June 3, 2003)**
Gross income: Evidence: Pension plan distributions.

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ESTATE AND GIFT

Gifts of Future Interests

***Albert J. Hackl, Sr. and Christine M. Hackl v. Commissioner,* 7th Cir. Ct. of Appeals, 2003-2 USTC ¶60,465 (July 11, 2003)**
IRC §2503(b)(1)

☞ Gifts of Shares in a Tree Farm LLC Not Gifts of Present Interests and Not Qualified for Annual Gift Tax Exclusions

Facts. Albert Hackl, a retired businessman, wanted a post-retirement hobby that would allow him to remain active. He bought two Florida tree farms in 1995 for about $4.5 million and contributed them, as well as about $8 million in cash and securities, to Treeco, LLC, an Indiana limited liability company.

Albert and his wife, Christine, initially owned all of Treeco's voting and nonvoting shares of stock. Soon after the creation of the LLC, Mr. and Mrs. Hackl began annual transfers of voting and nonvoting shares of the LLC to their children, their children's spouses, and a trust established for the benefit of their grandchildren. The gifts of the LLC shares were treated as excludable gifts which qualified for the annual $10,000 gift tax exclusion.

In an examination of the gift tax returns, the IRS determined the gifts did not qualify for the annual exclusion and assessed a gift tax deficiency of about $400,000. The Tax Court agreed with the IRS and the taxpayers appealed.

Analysis. Under IRC §2503(b)(1), a donor does not pay gift tax on the first $10,000 of gifts made to any person, **"other than gifts of future interests in property."**

IRS position. The LLC's operating agreement gave Albert Hackl firm control of the company. It provided the following:

- Mr. Hackl served as the LLC's manager for life and could dissolve the company.
- He controlled any financial distributions and the LLC members needed his approval to withdraw cash.
- LLC members could sell their shares only with his consent.
- If a member sold LLC shares without Mr. Hackl's consent, the buyer would receive the shares' economic rights but not any membership or voting rights.

According to the IRS, the significant restrictions imposed by the LLC operating agreement resulted in gifts that lacked realistic present economic benefits. Rather, the gifts of the LLC shares represented gifts of **future** interests.

Taxpayers' position. IRC §2503(b)(1) automatically allows the gift tax exclusion for the gifts of their LLC shares. The Tax Court, which relied on a Treasury regulation definition of future interest and prior case law, should have relied solely on the plain language contained in the Internal Revenue Code.

Holding. The 7th Circuit Court agreed with the Tax Court. **Treeco's operating agreement clearly prevented the donees from realizing any substantial present economic benefit from their gifted LLC shares.** Internal Revenue Code provisions dealing with exclusions are matters of legislative grace that must be narrowly construed.

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Income in Respect of a Decedent

Letter Ruling 200203010 (September 19, 2002)

IRC §§691 and 2031

☞ No Lack of Marketability Discount Allowable for Accrued Interest on Series E Bond

Purpose. In determining the FMV of a Series E bond for estate purposes, should a marketability discount be calculated for the interest that has accrued from the date of purchase to the date of maturity?

Background. Decedent died on Day 1 in Year 2. The date of death value of the bonds is $A, which represents $B, the purchase price plus $C, the accrued interest. The bonds passed to the decedent's revocable trust under the terms of her will. **On the estate tax return, the representative included $D in the gross estate, representing the date of death value of the bond less a lack of marketability discount.**

The representative argued that a buyer would discount the value of the bonds because of the built-in tax liability associated with them.

Ruling. The IRS ruled that, by law, the United States government is the only possible buyer of the bonds. They will pay the value of the bonds, including interest at any time. **Therefore, no marketability discount is allowable on the estate tax return.**

Family Limited Partnerships

***Estate of Theodore R. Thompson v. Commissioner, TC Memo 2002-246* (September 26, 2002)**

IRC §§704, 2001, and 2036(a)

☞ Tax Court Requires Value of FLPs To Be Included in Gross Estate, but Upholds the Validity of the FLPs

Facts. Theodore Thompson (Theodore) established two family limited partnerships in 1993, one for the benefit of his son and his family; the other for his daughter and her family. He also set up two corporations to act as the general partners for the FLPs. The FLPs were established based on the recommendation of a financial planner and an insurance agent. Some of the correspondence between the planners, the taxpayer, and the taxpayer's heirs was used in Tax Court to the detriment 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, while daughter Betsy and her husband each owned 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 owned 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 Theodore's assets were transferred to the partnerships, he 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 value of the assets in each of the FLPs was only slightly changed from the value of the contributed assets. The IRS produced correspondence at Tax Court that proved

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Betsy and Robert agreed to make withdrawals money from the FLPs and deposit them in Theodore's personal account in order to allow him to pay for his personal needs. The court documents showed other transactions which indicated the FPLs were not valid businesses but were established solely to avoid estate taxes.

Issue. Whether the full FMV of the FLPs were includible in the gross estate of the decedent, Theodore Thompson.

Analysis and Holding. The Tax Court stated, "In this case, the circumstances surrounding establishment of the partnerships 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."[29] The Court further stated, "**Here, decedent's outright transfer of the vast bulk of his assets to the partnerships 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 owed an additional $707,054 of federal estate tax.

> **Note.** Tax professionals and attorneys should read the details of this case if they have clients who want to establish FLPs. This case demonstrates that IRC §2036(a) is a strong weapon that the IRS may use to defeat the estate tax savings of FLPs. See Chapter 10, Estate Tax for a section on recent developments in Family Limited Partnerships.

GROSS INCOME

Inadequate Records

James Joseph, Jr. v. Commissioner, TC Memo 2003-19, **85 TCM 786 (January 21, 2003)**
IRC §§61 and 446

☞ Delinquent Tax Preparer's Gross Receipts Reconstructed in Exam

Facts. James Joseph, a self-employed tax return preparer from rural Louisiana, began his tax practice in 1980. For the tax years 1992-1994, he generally filed his low income clients' tax returns electronically through banks with the IRS. During the years in question, 99% of his tax clients claimed refunds.

Mr. Joseph arranged refund anticipation loans (RALs) for clients for whom he electronically filed returns. The banks approved the RALs in the amount of the client's anticipated refund, less fees for the bank and Mr. Joseph. The banks paid Mr. Joseph $30 for each RAL. In addition, several banks paid him his tax preparation fee from the RAL proceeds. The bank issuing the RAL received the refund from the IRS.

Mr. Joseph kept poor records of his tax preparation fees. He filed his 1992 return on April 26, 1993, and his 1993 return on June 20, 1994 even though he had not requested any extensions. In addition, he paid no estimated taxes for the tax years 1992-1994.

Due to Mr. Joseph's lack of records and complete lack of cooperation during the exam, the revenue agent used the IRS computer records to identify returns he prepared based on his name and social security number. From this computer printout, the examiner determined that Mr. Joseph filed the following number of returns:

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Tax Year	Number of Tax Returns Prepared
1992	726
1993	756
1994	700

The revenue agent mailed a questionnaire to all of the clients asking them how much they paid Mr. Joseph to prepare their returns. Based on 151 responses, the revenue agent determined that Mr. Joseph received an **average return preparation fee of $25 for 1992, $28 for 1993, and $26 for 1994**. In addition, the examiner determined that Mr. Joseph received a **$30 RAL fee** from a bank **for each return** he filed during 1992-1994. Based on these assumptions, the examiner computed the following gross income adjustments:

Tax Year	Gross Receipts Reported	Gross Receipts As Corrected	Unreported
1992	$ 4,695	$39,820	$35,125
1993	13,601	43,848	30,247
1994	22,895	39,200	16,305

Issues.

1. Whether the taxpayer had unreported income for 1992-1994.
2. Whether the taxpayer was liable for the failure to timely file his 1992 and 1993 returns under IRC §6651(a)(1).
3. Whether the taxpayer was liable for the accuracy-related negligence penalty under IRC §6662 for 1992-1994.

Analysis for Issue 1. Prior court decisions have determined that in cases involving unreported income, the IRS determination of it is entitled to a presumption of correctness, provided that it is supported by predicate evidence.[30]

Since the taxpayer provided no records to the IRS examiner, the IRS may use any reasonable method to reconstruct the taxpayer's income.[31]

Holding for Issue 1. The Tax Court held that the unreported income determination made by the IRS was amply supported by sufficient predicate evidence. However, the Court disagreed with the average return preparation fee number used by the IRS for the tax years 1992 and 1993. Based on the information the IRS examiner received from respondents to the questionnaire, the Court decided the proper number to use was $17 for 1992 and $21 for 1993. The Tax Court agreed with the $26 average tax preparation fee number for 1994 and the $30 RAL fee for each return for 1992-1994.

As a result, the Tax Court concluded that the taxpayer's unreported income amount for 1992 and 1993 should be reduced to:

Tax Year	Corrected Amount of Unreported Income
1992	$29,123
1993	24,715

Holding for Issues 2 and 3. The Tax Court agreed that the taxpayer was liable for the failure to timely file his 1992 and 1993 tax returns. In addition, he was liable for the negligence portion of the accuracy-related penalty.

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Insurance Agent Commissions

Everett J. Diers v. Commissioner, TC Memo 2003-229, **86 TCM 207 (July 31, 2003)**

IRC §§61, 274, and 280A

☞ Insurance Agent Fails to Report Renewal Commissions Received After Termination

Facts. From 1988 through 1994, Edward Diers worked as self-employed insurance agent for American Life Insurance Co. (American). He received advance commissions and loans from American for business expenses. In 1994, when he quit working for American, he had an obligation to repay the company for commission advances and loans.

In 1994, American sued Mr. Diers for the outstanding advances and loans. In a settlement agreement, the company agreed to look exclusively to renewal commissions due him to satisfy the outstanding loan balance. In exchange, he released all claims and rights to his future renewal commissions.

On his timely filed 1996 tax return, he reported the following on his insurance agent Schedule C:

Gross Receipts (per Form 1099-MISC from his new insurance company)	$5,796
Less: Automobile expense (36,000 total miles × 90% business use × 27.5¢)	(8,910)
Less: Office in Home expense ($250 per week paid to girlfriend in cash)	(3,600)
Schedule C net loss reported	**($6,714)**

He failed to include in gross receipts the 1996 Form 1099-MISC from American in the amount of $26,738 for the renewal commissions which were credited to his outstanding loan balance. Mr. Diers claimed he never received the 1099 form from American due to a move. In its examination report, the IRS:

- Added the omitted $26,738 Form 1099-MISC amount to Schedule C gross receipts.
- Disallowed the automobile expense of $8,910 and the home office expense of $3,600.

Analysis for the Unreported Income Issue. Mr. Diers contended that the settlement agreement provided for **forgiveness of the debt** to American in exchange for American's right to keep his future renewal commissions. The IRS contended that that he must **recognize income** from the renewal commissions which American credited to his outstanding advances and loans.

Holding for the Unreported Income Issue. When the commissions Mr. Diers earned after his departure from American were credited to his account, his obligation to repay the advances and loans was reduced by those amounts. **Consequently, the reduction of that obligation constituted the receipt of taxable income.** See *Newmark v. Commissioner*, 2nd Cir. Ct. of Appeals, 63-1 USTC ¶ 9163 (1962), affirming *TC Memo 1961-285*.

Analysis for the Automobile Expense Issue. Mr. Diers claims that he recorded the annual mileage on December 31 of each year which was about 36,000. He then took 90% of the total mileage for business use. However, he submitted no documentation or receipts to substantiate any of the $8,910 of business expenses he deducted.

Holding for the Automobile Expense Issue. Under IRC §274(d), automobile expenses are not deductible as a business expense unless the taxpayer meets strict substantiation requirements. These include adequate records of the amount of the expense, the time and place of the automobile's use, and the business purpose of its use. **Since the record keeping requirements were not met, we hold that the taxpayer is not entitled to deduct any business mileage expense.**

Analysis and Holding for the Office in Home Expense. Mr. Diers testified (at Tax Court) that he paid $250 per week to his girlfriend to reside in her home. However, he failed to provide any proof beyond his testimony that the weekly payments were made for his trade or business purposes. **Therefore, he failed to substantiate any home office expenses and was entitled to no deduction.**

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Emotional Distress Award

***Tonia V. Cates v. Commissioner, TC Summary Opinion 2003-15* (February 28, 2003)**

IRC §104(a)(2)

☞ Award for Emotional Injuries Not Excludable

Facts. Tonia Cates was hired by Rockford Memorial Health Services Corp. (Rockford) in December 1992. In March 1995, she received an unfavorable performance evaluation and was placed on a 90-day performance improvement plan. The taxpayer, contending that she was exposed to racially offensive jokes and slurs, asked to be transferred to an assignment under a different supervisor. That request was refused. Instead Rockford terminated her employment in April 1995, after 53 days of her 90-day probationary period.

In 1997, the taxpayer filed a complaint in U.S. District Court, as a member of a class action suit against Rockford. In the complaint, **she alleged that Rockford violated her rights under Title VII of the Civil Rights Act of 1964** (as amended in 1991). She was eventually awarded the following by Rockford in 1998 via a settlement agreement to resolve her lawsuit:

- $10,000 in back pay
- $35,000 for compensatory damages for **"emotional injuries."**

On her 1998 tax return, Tonia reported the $10,000 back pay but excluded the $35,000 award for emotional injuries. **She contended that her emotional distress was due to physical sickness, and as such, was excludable under IRC §104(a)(2).**

Issue. Whether the taxpayer may exclude from gross income payments received from her former employer under a settlement agreement.

Analysis. IRC §104(a)(2) excludes from gross income **"the amount of any damages (other than punitive damages) received (whether by suit or agreement) on account of personal physical injuries or physical sickness."**

In addition, IRC §104(a) clearly states that **"emotional distress shall not be treated as a physical injury or physical sickness."** The Joint Committee Report provides "that the term emotional distress includes physical symptoms (e.g., insomnia, headaches, and stomach disorders) which may result from such emotional distress."[32] Where amounts are received under a settlement agreement, as was true in this case, **the nature of the claim that was the actual basis for settlement controls whether such amounts are excludable under IRC §104(a)(2)**.[33] Determination of the nature of the claim is a factual inquiry, and is generally made by reference to the settlement agreement. An important factor in determining the validity of the agreement is the "intent of the payor" in making the payment.[34]

Holding. The settlement agreement that the taxpayer signed stated: "[Rockford] shall pay to [taxpayer] in settlement of [taxpayer's] claim for compensatory damages for **emotional injuries** [emphasis added] the gross amount of $35,000." The Tax Court held that the $35,000 award was **not excludable** under the plain language of IRC §104(a)(2).

> **Note.** For a similar case with the same tax result, see *Michael T. and Lori L. Prasil v. Commissioner.*[35] The only factual difference between the *Prasil* and the *Cates* decision is that Lori Prasil was awarded $7,650 in a sexual harassment lawsuit against her former employer.

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Volunteer Firefighters

Revenue Ruling 2003-47 (May 1, 2003)

IRC §§451, 457(e)(11) and 3401

☞ Volunteer Firefighters Can Receive Annual Credits of Up to $3,000 Per Year for Service

Volunteers of a governmental fire department can receive annual credits of up to $3,000 in the form of service awards. These credits, when paid, are taxable to the volunteers; however, they are not considered wages. Therefore, they are not subject to FICA taxes.

Parsonage Allowance

Letter Ruling 200318002 (January 7, 2003)

IRC §§107 and 1402

☞ Teachers and Staff of Elementary School Operated by Church Do Not Qualify for Excludable Parsonage Allowance

Facts. The church operated school offers a preschool, kindergarten, and grade school (through eighth grade) curriculum. Teachers and administrative staff are not required to attend a bible college or a divinity program nor are they required to be members of the church. However, they are **commissioned** as ministers of the gospel on the date they begin their school duties. The school board resolved to have teachers and administrative staff receive a parsonage allowance that was excludable for income tax purposes under IRC §107.

The duties of the teachers and staff do **not** include the following duties normally performed by "ministers of the gospel" (the term used in IRC §107) as listed in the regulations under IRC §107.

- Conduct the sacrament of communion
- Baptism
- Marriage
- Conduct worship services
- Perform funeral services

Ministers of the church that operated the school are either ordained or licensed, not commissioned.

Issue. Whether the teachers and administrative staff of the school qualify as "ministers of the gospel" and are therefore entitled to a parsonage allowance exclusion under IRC §107.

Holding. The teachers and administrative staff hired by the school do **not** meet the definition of "ministers of the gospel" since none of their duties are equivalent to services performed by a church minister. **Therefore, they do not qualify for a parsonage allowance exclusion.**

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Viatical Settlements

Revenue Ruling 2002-82 (December 4, 2002)
IRC §101

☞ **Circumstances Explained When a Viatical Settlement Provider Will Be Treated as Licensed by a State**

The viatical settlement provider must be treated as licensed by a state in order for the settlement to be excludable when the insured is either terminally or critically ill.

Purpose. To help the policy owner determine if the viatical settlement payments under a life insurance contract are excludable from gross income.

Background. Amounts received under a life insurance contract are excluded from gross income under IRC §101(a)(1) by reason of the death of the insured. **If the insured is either terminally ill or chronically ill, amounts received under the life insurance contract (whether or not the recipient is also the insured) may be treated under IRC §101(g) as amounts received by reason of death of the insured and excluded from gross income.**

If the issuing insurance company makes the payment to the owner of the life insurance contract, the availability of the exclusion depends upon whether the insured meets the definition of either terminally ill or chronically ill. If the life insurance contract is sold or assigned, the buyer of the contract must qualify as a viatical settlement provider under IRC §101(g)(2)(B) in order for the owner to exclude all or a portion of the amounts received from gross income.

Ruling. A viatical settlement provider is defined as any person regularly engaged in the business of purchasing or taking assignments of life insurance contracts on the lives of terminally or chronically ill persons. **The provider must satisfy one of two alternative tests.**

- If the insured lives in a state that requires licensing of providers, the buyer must be so licensed.
- If the insured lives in a state that does not require licensing, the provider must meet the requirements set forth by the National Association of Insurance Commissioners in the Viatical Settlements Model Act and Model regulations to be considered licensed.

In some states, the licensing program may not be fully operational upon the effective date of the licensing statute.

If the state establishes an interim program granting temporary authority to providers or blanket authority to all providers, the providers will be treated as being licensed in that state. However, if the state enacts licensing requirements, and the regulatory authorities do not permit providers to engage in business in that state until licenses are granted, providers doing business in the state are not considered as licensed.

> **Example.** The regulatory authority of State A has issued a letter to Buyer granting temporary authority to engage in business while its license is pending. If State A decides not to issue Buyer a license, it will revoke the temporary authority.
>
> The licensing statute is effective in State B, but procedures are not yet in place. However, a public notice has been issued that authorizes all viatical providers to engage in business within the state until further notice.
>
> The licensing statute is effective in State C, but procedures are not in place. The regulatory authority have neither licensed providers not even granted temporary permission for providers to engage in business in State C until licensing procedures are in place.
>
> The Buyer is treated as licensed in State A and in State B. Buyer is not considered licensed in State C.

Effective Date. The revenue ruling is effective for all amounts received on or after January 1, 1997. However the provider will be considered as meeting the requirements of IRC §101(g)(2)(B)(i)(II) for sales entered into before June 1, 2003, to residents of any state that requires licensing, but neither issues temporary authority nor blanket authority to providers.

Note. See Chapter 8, Elder Taxation for additional information on viatical settlements.

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Accrual Method Of Accounting, Deposit

***Tampa Bay Devil Rays, Ltd. v. Commissioner, TC Memo 2002-248,* 84 TCM 394 (September 30, 2002)**

IRC §§446 and 451

☞ Advance Ticket Sales Not Accrued and Included in Income Until First Game Played

Facts. The Tampa Bay Devil Rays partnership was awarded a new baseball franchise in 1995. It immediately began selling tickets although the first game would not be played until 1998. The team received deposits on tickets and on private suites which would be repaid if it did not play in 1998. In 1996, the partnership received a $125,000 sponsorship fee for a game to be played in St. Petersburg during the 1998 season. These funds were used to pay general operating expenses.

On its 1995 and 1996 returns, the partnership **did not report** any of the income from the deposits for advance sales of tickets and suites. Instead it reported the income in 1998 when the Devil Rays began their first season. The 1995 and 1996 partnership returns reported general operating and overhead expenses and expenses related to its minor league activities.

The partnership capitalized the $130 million franchise fee and amortized the portion allocated to player contracts. No accrual deductions were taken in 1995 or 1996 for anticipated expenses directly related to the games to be played in 1998. In addition, no expenses were claimed for the cost of marketing the advance tickets and private suites.

Analysis and Holding. The Tax Court noted that generally an accrual basis taxpayer that receives payments for services, performed in the future without restriction as to use, must 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. However, **the Court concluded that the Devil Rays could defer the advance ticket sale revenue until 1998.** The reason given was that the deferral **more accurately reflected income** by matching the significant revenue to the large expenses incurred in the initial season.

In contrast, the Court held that the $125,000 sponsor fee should have been accrued and reported as income **when received in 1996.**

Unreported Income

***Robert M. Johnson, et ux. v. Commissioner, TC Memo 2002-239,* 84 TCM 347 (September 24, 2002)**

IRC §61

☞ The IRS Can Use Bank Deposits Analysis Method to Prove Income

Facts. The taxpayer, an attorney, 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 for the tax years in question. In an examination, the IRS examiner used a bank deposits analysis to verify income. The IRS determined that gross receipts reported on the returns were substantially understated. The taxpayer's accountant prepared records showing that some of the understatement resulted from nontaxable transfers from other bank accounts. However, due to inadequate records, the exact amount of the transfers could not be determined.

Analysis and Holding. The Tax Court held that the bank deposits analysis method has been sustained repeatedly by the courts as a means of determining the correct amount of income. Therefore, since the taxpayer had obviously failed to report his true gross receipts due to inadequate records, the Court upheld and approved the additional tax assessments.

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Contingent Legal Fees

Chief Counsel Advice 200246003 (August 1, 2002)

IRC §§61, 201, and 265

☞ Portion of Punitive Damage Award Paid to State and Attributable Attorney Fee Excludable from Gross Income

Purpose. Taxpayer requested a ruling to determine the amount of punitive damage award to include in gross income.

Background. Spouse filed a wrongful death action against a helicopter manufacture after her husband was killed in a crash. Co-plaintiffs included her children and her husband's parents. The defendants appealed a jury verdict and the co-plaintiffs agreed to a settlement of $X in compensatory damages and $Y in punitive damages. Post and pre-judgment interest accrued on the award. There was a contingent fee contract with the attorney in which his fee would be deducted from the punitive damages that were awarded.

State law provided that 50% of any final punitive judgment, after attorney fees, go to the state. The state did collect its share of the award.

Ruling. The IRS advice given was that the portion of the award paid to the state and the attorney fees attributed to that amount could be excluded from the recipients' gross income. The remainder of the punitive award and attorney fees must be included in the recipients' gross income. The advice was based on numerous court decisions which hold that income is taxable to the party who is entitled to it and that tax liability may not be avoided by assignment of part of the award to a law firm.

> **Observation.** This matter of contingent attorney fees has been widely litigated. Not all circuits agree with the IRS. The appellate courts are split five to three in favor of the IRS on contingency fees. The Fifth, Sixth and Eleventh Circuits have ruled in favor of the taxpayers. See pages 321-323 in the *2001 University of Illinois Farm Income Tax Workbook* for thorough coverage of this contentious issue.

Medical Reimbursement Plans

Revenue Ruling 2002-58 (January 1, 2002)

IRC §§61 and 105

☞ Reimbursements for Medical Expenses Incurred Prior to Creation of IRC §105 Plan Includible in Gross Income

Background. Employer establishes a self-insured medical expense reimbursement plan on December 1, 2002. The plan provides that its effective date is January 1, 2002. A participating employee is eligible for reimbursement of medical expenses for the employee, their spouse, and their dependents for expenses incurred since January 1, 2002. The employee enrolls in the plan at the time of its establishment on December 1, 2002.

Ruling. The IRS ruled that any reimbursed medical expenses incurred **prior to** the establishment of the plan must be included in the gross income of the employee. It based the ruling on two prior court cases; *American Family Mutual Insurance Co. v. United States,* U.S. District Court of WI (1992), 93-1 USTC ¶50,025 and *Wollenberg v. United States,* U.S. District Court of NE (1999), 2000-1 USTC ¶50,156.

> **Note.** See pages 631-632 in the 2000 *University of Illinois Farm Income Tax Workbook* for coverage of the *Wollenberg* District Court case. Walter Wollenberg was a Nebraska farmer.

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Other Rulings and Cases

***Fawzi and Dolores Tay Assaad v. Commissioner, TC Memo 2003-171,* 85 TCM 1478 (June 11, 2003)**
Deductions: Net operating loss: Substantiation: Real property.

INNOCENT SPOUSE

Equitable Relief

***Tracy J. August v. Commissioner, TC Memo 2002-201,* 84 TCM 183 (August 12, 2002)**
IRC §6015(f)

☞ IRS Abused Its Discretion in Denying Equitable Innocent Spouse Relief

Facts. The taxpayer was 15 years old when she married Michael August in 1980. They were divorced in May 1994. Michael and Tracy filed joint returns for 1990, 1992, and 1993, the tax years in question. Michael was a self-employed carpet installer during the years they were married. The total tax liabilities for the tax years 1990, 1992, and 1993 had not been fully paid as of the date of the divorce in 1994 and they remained unpaid through 1998.

Tracy August filed Form 8857, Request for Innocent Spouse Relief, in March 1999 for the three tax years in question. She applied for **equitable relief** and marked the box on line 5 on Form 8857 (Revised December 1998). She also attached the following statement [unedited] to the Form 8857:

"My ex-husband had all the money for our taxes to be paid before our divorce and instead he used approx $13,000 for an attorney for our divorce. He is living as they say "High on the hog." Since our divorce he has bought a new work van, all brand new appliances, fax machine. All I have is a van 79 Dodge that is valued at $700 and does not run most of the time.

I have applied for disability do to post traumatic stress disorder, obsessive compulsive disorder, panic attacks, anxiety attacks, and borderline personality disorder. I'm basically homeless, and living off family and friends. Please consider taking me off his account for the years owed. For I had no part of his business or knowledge he did no pay off taxes until after our divorce. I filed a joint return but I thought as a dependent and his wife I was suppose to. I never benefited at all from his business. If you were to audit him his lifestyle exceeds what he claims on taxes."

In August 1999, Michael August sent a letter to the IRS objecting to his ex-wife's Form 8857 request. As a result, the IRS requested additional financial information from the taxpayer in order to determine whether to grant her relief. Since she did not respond to the IRS request, relief was denied under the criteria outlined in Rev. Proc. 2000-15.

Issue. Whether the IRS abused its discretion in denying the taxpayer innocent spouse relief under IRC §6015(f).

Analysis. Generally, spouses filing a joint tax return are each fully responsible for the accuracy of their return and for the full tax liability.[36] However, IRC §6015 provides exceptions to this general rule in certain circumstances. Specifically, IRC §6015(f) and Rev. Proc. 2000-15[37] provide that the IRS may grant **equitable relief for any unpaid tax** if the following requirements are met by the requesting spouse:

1. At the time of the request, the requesting spouse is no longer married to the nonrequesting spouse.[38]
2. When the requesting spouse signed the joint return(s), that spouse had no knowledge or reason to know that the tax due would not be paid.[39]
3. The requesting spouse would suffer economic hardship if relief was not granted.[40]
4. Taking into account all the facts and circumstances, it would be inequitable to hold the requesting spouse liable for any unpaid tax.[41]
5. The requesting spouse is not eligible for the two other types of innocent spouse relief.[42]

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Holding. Taking into account all the facts and circumstances, the Tax Court concluded that the taxpayer satisfied each of the three conditions contained in Rev. Proc. 2000-15. The Court found the taxpayer to be credible after observing her appearance and demeanor at trial. On the basis of her limited education, marriage at age 15, history of mental illness, and dependence on her ex-husband for all tax matters, the Tax Court decided it would be inequitable to hold her liable for the unpaid taxes. Consequently, **the Court held that the IRS abused its discretion in denying the taxpayer's claim for relief under IRC §6015(f).**

> **Note.** Rev. Proc. 2000-15 was superceded by Rev. Proc. 2003-61. See the analysis under Rev. Proc. 2003-61 on page 604. See pages 422-34 in the *1999 University of Illinois Farm Income Tax Workbook* for a thorough analysis of how to properly prepare an innocent spouse relief request on Form 8857.

Equitable Relief
***Craig A. Penfield, et al. v. Commissioner, TC Memo 2002-254,* 84 TCM 424 (October 7, 2002)**
IRC §6015

☞ Knowledge of Omitted Income Prevents Equitable Innocent Spouse Relief

Facts. Craig Penfield filed a 1997 joint return with his wife. They failed to report $45,410 of income of which $43,783 resulted from a pension distribution. When the IRS examined the return, the Penfields were divorced. Craig claimed equitable relief under the innocent spouse provisions of IRC §6015 because he was suffering from mental illness and payment of the additional tax would cause him financial hardship. In 1998, the Social Security Administration classified Mr. Penfield as disabled.

During 1997, Craig and his wife 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.

The Tax Court determined that sometime in 1997, Craig expressed concern to his wife that the pension was not guaranteed by the FDIC. This opinion was caused by his wife's testimony that "He bugged me until I finally agreed to withdraw all of the pension funds." Craig Penfield had testified previously that he did not know about the pension fund in question. Therefore, the Tax Court did not find Craig Penfield's testimony credible.

Analysis and Holding. After hearing conflicting testimony and judging the evidence, the Tax Court upheld the IRS determination that denied equitable innocent spouse relief to Mr. Penfield. After evaluating the income available to Craig compared to his financial needs, the Court decided that the additional tax due on the unreported pension distribution did not impose financial hardship on him.

Equitable Relief
***Ranie M. Raymond v. Commissioner,* 119 TC 191 (October 22, 2002)**
IRC §§6015(f) and 6330

☞ Taxpayers Must File a Joint Return in Order to Claim Innocent Spouse Equitable Relief

While IRC §6015(f) does not specifically say that a joint return must be filed to claim innocent spouse equitable relief, the Tax Court determined that a joint return is required. It based its finding on:

- IRS procedures that stipulate that a joint return is a prerequisite, and
- The legislative history behind the enactment of the code.

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Equitable Relief

Revenue Procedure 2003-61 (July 24, 2003)

IRC §6015(f)

☞ IRS Issues New Guidelines for Equitable Relief Under Innocent Spouse Rules

This revenue procedure supersedes Rev. Proc. 2000-15 and provides new guidelines for qualifying for equitable relief under the innocent spouse provisions of IRC §6015(f). Equitable relief, which is often referred to as "economic hardship" relief, may be granted by the IRS if the other two types of innocent spouse relief are not available. Rev. Proc. 2003-61 addresses two main topics:

- It broadens the availability of refunds to the requesting spouse if equitable relief is granted.
- It revises the weight given to the "knowledge or reason to know" condition explained previously in Rev. Proc. 2000-15.

The revenue procedure provides different treatment to **underpayment cases** and **tax deficiency cases**.

- An **underpayment innocent spouse case** involves the situation where the tax liability was correctly reported on the joint return but full payment was not made to the IRS.
- A **tax deficiency case** involves the situation where the IRS assesses additional tax on the joint return in an examination due to unreported income or overstated expenses, or both.

Revised "reason to know" requirements for both underpayment and tax deficiency cases. The IRS will now evaluate the following nonexclusive facts or situations in determining whether to grant equitable relief:

1. The requesting spouse's education level.
2. The requesting spouse's degree of involvement in the activity that produced the tax liability.
3. The requesting spouse's expertise in business or financial affairs.

Note. Practitioners who intend to request equitable relief on Form 8857 for an innocent spouse client should read and analyze Rev. Proc. 2003-61. The provisions of the revenue procedure will become effective for Forms 8857 filed on or after November 1, 2003. It is assumed that the Form 8857 Instructions will be revised to explain these new guidelines. The new rules shown in the revenue procedure will also apply to pending equitable relief requests for which no preliminary determination letter has been issues as of November 1, 2003.

Other Rulings and Cases

***Connie A. Washington v. Commissioner,* 120 TC —, No. 9, 120 TC 137 (April 21, 2003)**

Income tax returns: Innocent spouse relief: Equitable relief: IRS denial, abuse of discretion: Evidence: Refunds and credits: Equitable considerations.

***Cynthia Emery Weight v. Commissioner, TC Memo 2003-214,* 86 TCM 98 (July 16, 2003)**

Innocent spouse relief: Joint tax liability: Equitable relief: Failure to file.

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IRS PROCEDURE — AUDITS

EITC
Budget of the United States Government 2004
IRC §32

☞ Greater EITC Compliance One of IRS Goals in Fiscal Year 2004

The earned income tax credit compliance initiative is a part of the fiscal year 2004 budget. The earned income credit has been abused in the past. For 1999 returns, it was determined that more the $1 in every $4 of claimed EITC should not have been paid. During 2001, the IRS was able to prevent $1.169 billion in erroneous EITC payments. The 2004 budget has increased the EITC compliance program funding level from $146 million to $251 million.

IRS PROCEDURES — ELECTRONIC FILING

Free File
IRS News Release IR-2003-6 (January 16, 2003)
IRC §§6011 and 7513

☞ IRS Announces Free Website for Electronic Filing

The IRS announced the initiation of its Free File website for electronic filing. Free File is intended to be easy, fast, and secure, and is expected to save the IRS and taxpayers money while allowing for faster refunds. The Free File Alliance agreement is with a consortium of tax software companies and requires they provide free services for at least 60% of U.S. taxpayers during each filing season. Free File can be accessed at www.irs.gov or through www.firstgov.gov.

Free File
IRS News Release IR 2003-83; (June 30, 2003)
IRC §§6011 and 7513

☞ Free File Program Successful

The IRS reminded taxpayers that they can file their extended tax returns through the Free File website until October 15, 2003. The IRS announced that more than 2.73 million taxpayers had filed their returns for free through the Free File Program prior to April 15, 2003.

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IRS PROCEDURE — MISCELLANEOUS

Operation Iraqi Freedom

IRS Notice 2003-21 (April 10, 2003)

IRC §§2, 112, 692, 2201, 3401, 4253, 6013, and 7508

☞ Q & As Provided to Members of Armed Forces Involved in Operation Iraqi Freedom

In an 11-page 37 Q & A format, the IRS provides extensive tax information for military and support personnel involved in the Iraq war. This can be found in Internal Revenue Bulletin 2003-17. Similar information can be found on the IRS website at www.irs.gov. Search for "Armed Forces" on the site.

The IRS has a special e-mail address—combatzone@irs.gov—for taxpayers who are in a combat zone to send questions related to filing and payment issues. Taxpayers within the USA may seek assistance by calling the IRS at 1-800-829-1040 (toll-free). Taxpayers outside the USA may contact the IRS in Philadelphia at (215) 516-2000 or via fax at (215) 516-2555 (these are not toll-free numbers).

Another good source of information for military clients is IRS Pub. 3, *Armed Forces' Tax Guide*. An example of a problem that can arise when preparing 2003 returns for a client in a combat zone follows.

Facts. Jim, who is in the Army, is serving in Iraq during the 2004 filing period for 2003 tax returns. He has not sent a power of attorney Form 2848 to his wife, Karen, to permit her to handle filing responsibilities for their joint 2003 tax return. Karen has all the needed information to file a joint 2003 return which will claim a sizable refund.

Question. What may Karen do to timely file their joint 2003 return without Jim's signature?

Answer. The IRS will accept Karen's written explanation that Jim is serving in a combat zone. She will sign the joint return for Jim and attach her written explanation to it.[47]

Offers-In-Compromise

Treasury Decision 9086 (August 14, 2003)

IRS News Release IR-2003-99 (August 15, 2003)

IRC §7122 (Final Regulations)

☞ $150 Fee Required for Filing Most Offers-in-Compromise

Effective November 1, 2003, the IRS will charge a $150 filing fee for most offers-in-compromise. This is an attempt to stop many of the frivolous offers the IRS receive. The fee will not apply if a taxpayer's income is below federal poverty guidelines or if the offer is based solely on doubt as to liability.

Form 656-A will provide information and instructions regarding waiver of the $150 filing fee. The fee will not be refunded if a processable offer is rejected or withdrawn, but a replacement offer can be submitted without another fee.

The imposition of the fee will not change the net amount paid by a taxpayer to reach a compromise. This is because the $150 fee will be applied to the offer amount the IRS determines to be acceptable. The IRS stresses that it will work closely with taxpayers to perfect incomplete or inadequate offers before rejecting them.

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Court Costs

***Antonio and Joyce Rosario v. Commissioner, TC Memo 2002-247,* 84 TCM 392 (September 26, 2002)**

IRC §7430

☞ Surgeons Fails to Win Court Costs Suit

The *Rosario* income tax case was discussed on pages 323- 324 of the *2002 University of Illinois Income Tax Workbook*. This second Tax Court case involved Antonio Rosario filing suit against the IRS to recover legal fees he incurred while successfully defending that he and his wife were not liable for income tax on an alleged loan made by his hospital employer. **In the court costs suit, the Tax Court determined that the language in his agreement with the hospital was sufficiently confusing. Therefore, the Court held that the IRS was justified in its attempt to include the loan amount as business income.**

A taxpayer can be awarded litigation costs and administrative expenses under IRC §7430 for involvement in any administrative or court preceding that is brought by or against the United States. 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 IRC §7430(c)(4)(B), the IRS can and did establish its position was substantially justified.**

Entity Classification

Revenue Procedure 2002-59 (September 29, 2002)

IRC §7701

☞ 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, *Entity Classification Election*, 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. Treas. 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.

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Signature Authorization

Service Center Advice 200236043 (July 26, 2002)

IRC §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.

Note. See Chapter 4, Ethics, for more information concerning unenrolled return preparers.

Statute of Limitations

***Thomas Walther v. United States,* U.S. Court of Claims, 2002-2 USTC ¶50,668 (September 12, 2002)**

IRC §6532

☞ Attorney's Inability to Timely File Complaint Not Accepted

Facts. The taxpayer's 1987 refund claim of $40,000 was disallowed by the IRS due to the two year statute of limitations. The taxpayer's attorney, who contested the IRS disallowance of the claim, prepared a complaint for the U.S. Court of Claims. The attorney gave the complaint to a colleague to deliver to the Court of Claims in Washington, on April 5, 2002, the last day for filing. When the colleague tried to deliver the compliant 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 complaint by Federal Express on April 8, 2002. Once received, the Court of Claims determined that the complaint was not timely filed and dismissed the case. The taxpayer contested the court's disallowance.

Analysis and Holding. The Court of Claims 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 of Claims referenced the fact the taxpayer provided no reason why he preferred the use of a colleague over a mail service, other than he would be in Washington that day. The court 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.

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IRS PROCEDURE — PAYMENTS

Refunds (erroneous)

Carolyn Pollard v. Commissioner, TC Summary Opinion 2003-40 **(April 22, 2003)**

IRC §1

☞ IRS Entitled to Recover Erroneous Refund Issued for Fictitious Payments Claimed on Form 2439

Facts. Carolyn Pollard filed her 1997 Form 1040 and showed no taxable income. She showed the following payments on the return:

Federal income tax withheld (Form W-2)	$ 408
Earned Income Credit	3,210
Tax paid by "Black TAX" regulated investment company (Box 2, Form 2439)	8,041
Total payments reported on Carolyn's 1997 Form 1040	**$11,659**

She attached a 1997 Form 2439, *Notice to Shareholder of Undistributed Long-Term Capital Gains* to her return. Details regarding the Form 2439 follow.

Name of regulated investment company	Black TAX
FEIN of Black TAX regulated investment company	omitted
Total undistributed long-term capital gains (Box 1a, Form 2439)	$43,204
Tax paid by regulated investment company (Box 2, Form 2439)	8,041

Carolyn claimed the $8,041 as "Other payments" on line 59 on page 2 of her 1997 Form 1040. However, she omitted the $43,204 of capital gains on line 13 on page 1 of her return.

On May 11, 1998, the IRS issued Carolyn a refund check in the amount of $10,659 after a $1,000 processing reduction to the $3,210 of claimed earned income credit. **The IRS later issued a notice of deficiency for $8,041, the amount shown in Box 2, Form 2439 and on line 59 on her 1997 Form 1040.**

Analysis. At the Tax Court hearing, Carolyn admitted she was not entitled to the $8,041 of fictitious tax payments allegedly made by the fictitious regulated investment company. She argued, however, that claiming the tax payments was only "halfway" her fault because the IRS should have "told me that there was no such Black tax" credit.

Holding. "There is no requirement for the IRS to advise citizens of every scam and con devised by those seeking to avoid the lawful payment of federal income taxes. Taxpayers bear the responsibility for paying the correct amount of tax and, especially, to verify any scheme that seems too good to be true."

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IRS PROCEDURE — PENALITIES

Substantial Understatement of Tax Penalty

***Lewis P. and Judy H. Larson v. Commissioner, TC Memo 2002-295,* 84 TCM 608 (December 2, 2002)**

IRC §§6662(a) and (b)(2)

☞ Taxpayer Fails to Fool IRS Computer Matching Program

Facts. Mr. and Mrs. Larson prepared and filed their joint tax return for 1999 which reported the following income:

Wife's wages from church (Form W-2)	$ 175
Husband's wages from Telepad Corp (Form W-2)	10,000
Husband's wages from Windermere Corp (Form W-2)	63,233
Husband's Schedule C gross income (2 Forms 1099-MISC)	4,392

Mr. Larson computed his Schedule C gross income as follows:

- Form 1099 MISC from Data Search in the amount of $2,500
- Form 1099 MISC from Windermere which he **interpreted** to be $1,892

The Form 1099 MISC from Windermere, which was in the amount of $21,891.95, contained a printing alignment error which placed the first digit "2" on top of the dollar sign on the form. Mr. Larson ignored this obscured 2, and reported only $1,892 as a portion of the Schedule C gross income figure of $4,392. The IRS matching program detected the error and additional tax and the substantial understatement of tax penalty under IRC §6662(b)(2) was assessed.

Issue. Whether the taxpayers were liable for the substantial understatement of tax penalty.

Holding. The Tax Court agreed with the IRS in its assertion of the penalty for substantial understatement of tax since the **taxpayers omitted 82% of Schedule C gross income**. The taxpayers failed to prove that there was reasonable cause for and that they acted in good faith with respect to the understatement of tax.

Penalties

Revenue Procedure 2002-66 (October 20, 2002)

IRC §§6662 and 6694

☞ Circumstances Identified Where Disclosure on Return Can Negate 20% Substantial Understatement of Tax Penalty and Return Preparer Penalty

This revenue procedure, which is updated annually, provides circumstances where simply disclosing an item on the return is sufficient to avoid both the:

- 20% substantial understatement of tax penalty under IRC §6662(d), and
- Return preparer penalty under IRC §6694(a).

Rev. Proc. 2002-66 applies to any return filed on **2002** tax forms for a taxable year beginning in 2002. The revised revenue procedure that applies to **2003** returns will be issued sometime in October 2003 after publication of this workbook.

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Some IRS examiners are not aware of this exception to the penalties. For example, some examiners automatically assess the 20% substantial understatement of tax penalty without considering this liberal exception provision. Therefore, preparers can and should consider this revenue procedure if the penalty become an IRS audit issue.

There is one important requirement that must be met in order to take advantage of the potential relief granted. **The money amounts entered on the forms must be verifiable.**

> **Note.** A number is verifiable on audit if the taxpayer can demonstrate the origin of the number, even if that number is not accepted by IRS. In addition, the taxpayer must be able to show good faith in entering that number on the appropriate form.

Examples of adequate disclosure of an item on the return.

For Itemized Deductions on Schedule A. In most cases, a taxpayer can simply report the number on the correct line on Schedule A and attach any required supporting information. **Example.** For a cash contribution exceeding $500, line 15-18 on Schedule A is completed and Form 8283, *Noncash Charitable Contributions*, is properly completed and attached.

For Employee Business Expenses. Line 20 of Schedule A is completed and Form 2106 is attached.

For Repair Expenses on Schedules C or F. The taxpayer can report the repair number on the proper line on Schedule C or F. However, this exception to the penalty does not apply to any repair expenses that are properly categorized as capital expenditures of personal expenses.

ITEMIZED DEDUCTIONS

Temporary Employment Expenses

***Richard M. Brockman v. Commissioner, TC Memo 2003-3,* 85 TCM 733 (January 7, 2003)**
IRC §162

☞ Automobile Salesman Entitled to Business Mileage for a 4-Month Temporary Job

Facts. Richard Brockman was employed as a Honda salesman at a dealership in Concord, CA during the first 6 months of 1998 and lived nearby. However, due to a disagreement with the general manager of the Concord dealership, he was transferred to a dealership in Colma, CA from the middle of June through October 12, 1998.

When he was transferred, the personnel manager of the company told Mr. Brockman that he could return to the Concord dealership when the troublesome general manager departed. However, after working at the Colma dealership, Mr. Brockman quit working for the company in October 1998. While working in Colma, he made 97 round trips of 128 miles from his home near Concord.

On his 1998 tax return, he reported his employee business expenses as a car salesman on a Schedule C that showed his principal business was "Online publishing." He reported no income and showed the following expenses on the Schedule C:

Car expense (21,545 business miles @ 32.5¢ plus toll fees)	$ 7,552
Utilities	944
Depreciation	1,805
Meals ($1,269 × 50%)	634
Other expenses	587
Schedule C net loss reported	**$11,522**

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He filed as head of household and claimed the standard deduction of $6,250. In examination, IRS disallowed all of the claimed Schedule C expenses and assessed additional tax of $3,248.

Analysis and Holding. The Tax Court concluded that Mr. Brockman's employment at the Honda dealership in Colma during mid-June through October 12, 1998 was a **temporary job**. The court relied on Rev. Rul. 99-7 in reaching its conclusion. However, the court calculated Mr. Brockman's allowable auto expense in driving from his home to Colma in the following manner:

97 round trips @ 128 miles per trip = 12,416 miles

12,416 business miles @ 32.5¢ = $4,035

Regarding the other expenses claimed on the Schedule C, the Tax Court concluded that Mr. Brockman failed to substantiate any of those expenses for his "alleged online publishing activity." **The court noted that he failed to prove that he was engaged in a trade or business other than his employment as a car salesman in 1998.**

As a result, the allowable $4,035 automobile expense, which was properly deductible as an employee business expense on Schedule A, was less than the claimed standard deduction of $6,250. Consequently, the Tax Court allowed the IRS and Mr. Brockman to jointly determine if it was more advantageous for him to claim itemized deductions or retain the standard deduction [under the Tax Court computation Rule 155].

Education Expense
Yuanquiang Zhang v. Commissioner, TC Summary Opinion 2003-58 **(May 20, 2003)**
IRC §162(a)

☞ Nonresident Alien Denied Cost of Obtaining M.B.A. Degree

Facts. Mr. Zhang had three degrees, a bachelor's in engineering, a bachelor's in economics, and a master's in international trade. From January 1997 through June 1999, he was employed as a consultant in the Beijing, China office of Anderson Consulting. In that capacity, he helped foreign companies develop joint venture strategies for operations in China.

In the fall of 1999, he commenced studies as a full-time student in the M.B.A. degree program at Massachusetts Institute of Technology (MIT). After obtaining the M.B.A. in June 2001, he began to work for Morgan Stanley as an investment banker. During 2000, the tax year in question, he was employed for only 10 weeks during the summer in a temporary position for which he received academic credit from M.I.T.

Mr. Zhang filed a 2000 Form 1040NR, U.S. Nonresident Alien Income Tax Return. He reported his wages from his temporary summer job and significant investment income. In addition, he claimed the following miscellaneous itemized deductions:

- M.B.A. tuition of $29,860
- Books and school supplies of $2,286
- Travel to school expenses of $552
- Computer depreciation of $495

In an examination, the IRS disallowed all of the claimed deductions shown above and assessed additional tax of $6,437.

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Issue. Whether the taxpayer is entitled to deduct as trade or business expenses various costs incurred in connection with his M.B.A. degree program.

Analysis. To be deductible, education expenses must be for education which meets **at least one** of the following two tests:

1. **Maintains or improves skills** required in the taxpayer's present occupation.[43]
2. **Is required by the taxpayer's employer or by law** to keep the taxpayer's present employment, status, or salary.[44]

However, even if the education meets one or both of the above tests, the expenses are **not** deductible if the education:

1. Is required in order to meet the **minimum educational requirements** for the taxpayer's present trade or business[45] or
2. Is part of a program that will **qualify the taxpayer for a new trade or business**.[46]

Holding. The Tax Court found that the M.B.A. program did not serve to maintain or improve skills required by Mr. Zhang's employment. The courses which he completed as part of the M.B.A. program were varied and extensive. While the M.B.A. program did focus on "business administration," it was nonetheless a generalized field of study which provided an education in a number of areas not applicable to Mr. Zhang's past, present, or future employment.

The Court's finding was reinforced by the fact that Mr. Zhang was not employed on a permanent or indefinite basis while he was enrolled in the M.B.A. program. His only employment during 2000 was a temporary summer job. In addition, he left his position in Beijing and did not express an intent to return to it following the completion of the M.B.A. program.

In addition, Mr. Zhang's 2000 education expenses were not required by his only employer. Because the education expenses did not fall under either category of deductible expenses under the regulations, **the Tax Court upheld the tax determination made by the IRS**.

Investment Interest

William Lenehan III and Barbara Lenehan v. Commissioner, TC Summary Opinion 2002-124 **(October 2, 2002)**
IRC §163

☞ Capital Loss Carryover Must Be Considered When Calculating Investment Interest Deduction

Facts. The taxpayers reported the following on their **1997 Schedule D**:

Net short-term capital gain, Part I, Schedule D		$ 49,017
Long-term capital gains realized in 1997, Part II, Schedule D	65,721	
Long-term capital loss carryover to 1997, Part II, Schedule D	(141,621)	
Net long-term capital loss, Part II, Schedule D		**($75,900)**

On line 4b on their 1997 Form 4952, Investment Interest Expense Deduction, the taxpayers ignored the $141,621 capital loss carryover in calculating the net gain from disposition of property held for investment. Line 4b is "Net gain from the disposition of property held for investment."

By ignoring the long-term capital loss carryover, the taxpayers were able to deduct **all** of their $26,721 of investment interest on their 1997 Schedule A. However, that tax benefit was partially lost when the IRS examined their 1997 joint return. The IRS determined that the correct deduction was **limited to their net investment income of $5,044** and assessed an additional tax of $6,062.

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Issue. Whether investment income, as defined by IRC §163(d)(4)(B), includes a long-term capital loss carryover for purposes of calculating the limitation on the investment interest expense deduction.

Analysis. In his discussion, the Tax Court judge performed an exhaustive study of the underlying framework and legislative history of IRC §163(d).

Holding. The taxpayers selectively chose to include the loss carryover when it placed them in a better tax position. They included the loss carryover for purposes of calculating the $3,000 capital loss deduction. But they ignored it for purposes of calculating the investment interest deduction. **The Tax Court held that any capital loss carryover was an integral part of the equation in calculating investment income under IRC §163(d)(4)(B).** Were the carryover not included, the taxpayers would receive a double tax benefit, which is clearly not permitted.

Medical Expenses
Revenue Rulings 2003-57 and 2003-58 (May 15, 2003)
IRC §213

☞ Clarification Regarding Deductibility of Various Health Care Expenses

The following expenses qualify as deductible medical expenses under IRC §213:

- Breast reconstruction surgery following mastectomy surgery for cancer treatment.
- Laser eye surgery including LASIK and radial keratotomy.
- Medical equipment, supplies, or diagnostic devices that may be purchased without a prescription: **Examples.** Crutches, bandages, blood sugar testing devices.

The following expenses are **not** deductible as medical expenses:

- Cost of medicines that may be purchased without a prescription **even if** their use is recommended by a physician: **Examples.** Aspirin, ibuprofen.
- Teeth whitening procedures since they are directed at improving appearance.

Flexible Spending Accounts
Revenue Ruling 2003-102 (September 4, 2003)
IRC §105(b)

☞ Employer Reimbursements for Non-Prescription Medicine and Drugs Excludable from Income Under IRC §105(b)

The IRS announced that employer reimbursements made under a Flexible Spending Account (FSA) for **non-prescription drugs and medicines** will be excluded from income. Amounts paid by an employee for dietary supplements that are merely beneficial to the general health of the employee or his family are neither reimbursable nor excludable from gross income. Therefore, such items as pain relievers, allergy medicine, cold medicine, and antacids may be reimbursed.

While these items are now covered under an FSA, they are still **not** deductible as an itemized deduction.

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Donation of Automobiles

Revenue Ruling 2002-67 (November 6, 2002)

IRC §170

☞ Donation of Automobile to Agent of Charity Is Eligible for Deduction

This ruling allows individuals to claim a charitable deduction for automobiles donated to an agent of a charity. It also clarifies that the agent's written acknowledgment substantiates the gift and explains when an auto may be valued by using an established used car pricing guide.

Many of the charitable car solicitation programs are administered by for-profit organizations. The IRS has three potential issues with these programs, regardless of whether the auto is given to a charity directly or to a for-profit agent of the charity:

- 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 ruling contains two situations to explain how a taxpayer should attempt to arrive at the correct FMV of the donated auto for charitable contribution purposes. Following is a synopsis of the explanations:

1. The "Blue Book" value of the car cannot be used if the auto's true condition is not listed in the valuations.

   Example. Beth donates a 1992 Volvo in poor condition with 210,000 miles to an agent of her charity. The "Blue Book" shows values only for autos in excellent and average condition. Therefore, neither the charity's agent nor Beth can use the "Blue Book" to value the auto.

   Beth must use some other method to value the auto. Other methods include:

   - Using a different pricing guide that lists the value of autos in poor condition.
   - Obtaining an appraisal from a reliable source.

2. As explained in two prior Letter Rulings (20023005 and 20023007), the best evidence would be the sales price the agent of the charity receives for the auto. In some cases, state law requires the charity to indicate the sales price figure on its official receipt sent to the donor, if known.

> **Observation.** One problem in this difficult valuation area is that agents of the charity often sell the donated auto for scrap value. When this happens, the true FMV of the auto is extremely small.

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Interest

IRS News Release IR 2002-114 (October 28, 2002)

IRC §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 refinances with a new $125,000 15-year mortgage in 2003 and receives $30,000 cash from the lender which he uses to pay for his daughter’s wedding. Since none of the $125,000 was used for home improvements, Fred must **amortize** any points paid on the refinancing over the **life of the loan.**

Assume Fred pays $2,000 of points on his refinancing mortgage and that he makes six monthly mortgage payments in 2003. His monthly amortization amount is $11.11, or $2,000 divided by 180 months. Therefore, Fred is entitled to deduct $67 ($11.11 × 6) on line 12 on his 2003 Schedule A. (Points not reported on Form 1098.)

However, the following refinancing expense are not deductible.

- Appraisal fees
- Credit investigation charges
- Recording fees
- Inspection fees.

Note. If the taxpayer is refinancing for a second time, any non-deducted points from the previous refinancing are immediately deductible on Schedule A. See pages 296-297 in the *2001 University of Illinois Farm Income Tax Workbook* for coverage of this issue.

LIKE-KIND EXCHANGES

Annuity Contracts

Revenue Ruling 2002-75 (November 10, 2002)

IRC §§72 and 1035

☞ Taxpayer Allowed to Consolidate Annuity Contracts

Purpose. To allow taxpayers to consolidate annuity contracts.

Background. Joe owns two annuity contracts issued by two different insurance companies. He wishes to transfer Contract 1 with Company A to Company B. He then wishes to transfer the cash value of Company A’s Contract 1 into Company B’s Contract 2. He wishes this to be a tax-free like-kind exchange.

Ruling. Since Joe never has received the cash value of Contract 1, he is allowed to make the tax-free exchange. His basis in Contract 1 will transfer into Contract 2.

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Related Party

Revenue Ruling 2002-83 (November 25, 2002)

IRC §1031

☞ Taxpayer Denied Non-Recognition Treatment Because Replacement Property Was Formerly Owned by Related Party

Background. Sally owns a building with a FMV or $150,000 and an adjusted basis of $80,000. Tom owns a development acreage with a FMV of $150,000 and a basis of $150,000. Both properties are held for investment. Sally and Tom are related.

Charles, an individual unrelated to either Sally or Tom, wishes to acquire the building from Sally. Sally enters into an agreement for the transfer of the building and the acreage with Tom, Charles, and a qualified intermediary (QI). QI is unrelated to Sally and Tom.

On January 3, 2003, Sally transfers the building to QI and QI transfers it to Charles for $150,000. On January 13, 2003, QI acquires the acreage from Tom, pays Tom the $150,000 sale proceeds from QI's sale of the building, and transfers the acreage to Sally. The timelines of the 45 and 180 day rules are met.

Analysis. Under IRC §1031(a)(1) no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment. Under IRC §1031(d) the basis of the property acquired is the same as the basis of the property exchanged, decreased by any money the taxpayer receives and increased by any gain the taxpayer recognizes.

There are special rules for exchanges between related parties. Under IRC §1031(f), a person exchanging property with a related party will not benefit from the nonrecognition rules if the related party disposes of the relinquished property or the taxpayer disposes of the replacement property within two years. The taxpayer must recognize any gain or loss in the year the disposition takes place.

To prevent taxpayers from circumventing this rule, IRC §1031(f)(4) provides that the nonrecognition rules do not apply if the taxpayer transfers the property to an unrelated party who in turn transfers the property to a related party within two years.

Issue. Is a taxpayer who transfers relinquished property to a qualified intermediary in exchange for replacement property formerly owned by a related party entitled to nonrecognition under IRC §1031, if the related party receives cash or non like-kind property?

Ruling. In this ruling, **Sally is using QI to circumvent the rules of IRC §1031. Therefore, she is denied IRC §1231(a)(1) nonrecognition treatment on her exchange.**

Water Rights

***Donald Wiechens et al., v. United States,* U.S. District Court of AZ, 2002-2 USTC ¶50,708 (September 11, 2002)**

IRC §1031

☞ Water Rights Did Not Qualify for Like-Kind Exchange of Farmland

Ruling. Water rights are a type of interest in real property but are not permanent enough to qualify for IRC §1031(a) like-kind treatment. The Arizona U.S. District Court agreed with the IRS even though the 50-year water rights were interests in real property under Arizona state statutes. However, the IRS did not consider them to be sufficiently similar to the fee simple interest in farmland that the taxpayer acquired in the exchange.

The position of the IRS is that water rights are not permanent enough to qualify as real estate under IRC §1031(a).

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> **Note.** This is one of a series of tax cases dealing with water rights within the Harquahala Valley Irrigation District in Arizona. The decision reached in these cases regarding whether water rights qualifies as a capital asset have been mixed.

Internet Provider as a Qualified Intermediary

Letter Ruling 200236026 (June 3, 2002)
IRC §1031

☞ Web-Based Intermediary Qualified as Qualified Intermediary

Background. Taxpayer's business requires him to periodically dispose of equipment and reinvest in like-kind properties. Taxpayer wants to categorize these transactions as non-taxable exchanges under IRC §1031.

QI, who is unrelated to the taxpayer, has developed a web-based business to facilitate online like-kind exchanges. Taxpayer is authorized to access the QI's website. Any agreements signed online are signed with a digital signature. The document and signature are maintained by QI and can not be modified without altering the digital signature.

Taxpayer's agreement with QI causes QI to open a segregated account for transactions with Taxpayer. The agreement:

1. Restricts the use of the proceeds from the sale of relinquished property to the purchase of like-kind replacement property.
2. Restricts the payment to Taxpayer of the sale proceeds and any interest credited to taxpayer on the proceeds.
3. Assigns to QI taxpayer's rights to sell relinquished property under sale agreements and rights to purchase replacement property under purchase agreements.

Ruling. Based on the facts presented in the ruling, the IRS agreed that the exchanges did qualify for nonrecognition treatment under IRC §1031.

Other Rulings and Cases

Rev. Proc. 2003-39 (May 7, 2003)
Gain or loss on property distributions: Nontaxable exchanges: Like-kind exchanges: Ongoing exchanges of tangible personal property: Single intermediary: Safe harbor.

Rev. Rul. 2003-56 (May 9, 2003)
Partnerships: Treatment of partnership liabilities: Like-kind exchanges

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NOT FOR PROFIT ACTIVITIES

Profit Motive

***Christopher J. Bush and Robin L. Pickering v. Commissioner,* 4th Cir. Ct. of Appeals, 2002-2 USTC ¶50,797 (November 27, 2002)**

IRC §§183 and 262

☞ Talent Agency and Daughter's Dance Contract Activity Lacked Profit Motive

Facts. In October 1996, the taxpayers formed a sole proprietorship, Aspiring Artists. The alleged purpose of the business was to manage and develop artistic talent. Jennifer Hummer, Robin's 18-year old daughter by a former marriage and an aspiring ballerina, signed a contract with this new business. The taxpayers contended that the contract was a legitimate talent agency agreement.

The contract provided that Jennifer:

- Would pay $488 a month to Aspiring Artists beginning in October 1996 to help pay for her tuition at Virginia School of Arts (VSA), an expensive fine arts prep school.
- Could pay less than the monthly $488 if the taxpayers determined she was "overburdened."
- Would pay 10% of her "gross dance-related income" to Aspiring Artists during the first 40 months of her ballet career.

In return, the new business would pay all of Jennifer's education and medical expenses.

The 1996 Schedule C reported the following:

Gross receipts (not verifiable)		$ 3,550
Less expenses:		
Mileage (including Jennifer's commuting expense to VSA)	$3,640	
Advertising	200	
Wages	525	
Cost of goods sold	150	
Depreciation	54	
Employee benefits	900	
Supplies	1,500	
Meals	900	
Utilities	500	
Education and medical	1,557	
Travel	7,871	
		(17,797)
Net Loss reported on the 1996 Schedule C		**($14,247)**

Upon examination, the IRS determined that the taxpayers' sole proprietorship was not profit motivated under IRC §183. The IRS disallowed the $14,247 excess of Schedule C deductions over Schedule C income. The additional tax assessed was $2,593.

Issue. Whether the taxpayers' talent agency business was entered into with an objective of making a profit within the meaning of IRC §183.

Analysis. In addition to relying on IRC §183, the IRS also contended that most of the disallowed Schedule C expenses were not deductible under IRC §262. Under IRC §262, no deduction is allowed for personal, living, or family expenses. The Tax Court, in its previous decision, explored the **nine factors** to be used in determining whether an activity is engaged in for profit.

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In addition, the court determined that the value of the contract signed by Jennifer was at best, speculative. The IRS disallowed $14,247 of the claimed Schedule C expenses. In order for the taxpayers to recoup that amount, Jennifer would need to earn more than $142,470 in the first 40 months of her dance career. And that presumes that the taxpayers would force their daughter to pay them 10% of her earnings under the terms of the contract once she began to earn money as a ballerina.

Holding. The 4th Circuit Appeals Court upheld the decision of the Tax Court that the taxpayer's business lacked the requisite profit motive.

Profit Motive

Robert and Diane Schwartz, TC Memo 2003-86, **85 TCM 1058 (March 25, 2003)**

IRC §183

☞ Sailboat Activity Is a Business, Not a Hobby

Facts. Robert Schwartz, a New York oncologist, had been involved in sailing and racing boats since the 1960s. In 1991, he purchased a used 50-foot racing sailboat (the *Diane*) for $350,000. The *Diane* needed extensive hull repairs and new sails. A mortgage was obtained for $485,000 to purchase and repair it.

At the time of the purchase, the taxpayers owned two other 25-foot sailboats which were used exclusively for pleasure and which were near their Islip, NY residence. However, the *Diane*, because of its vast size, was stored on dry dock in Jamestown, RI, a 5-hour drive from taxpayers' home.

On the advice of their tax attorney, the taxpayers formed an S corporation named Diane Racing and transferred the *Diane* to it. Mrs. Swartz was the sole shareholder. The taxpayers expected Diane Racing to be profitable through the following ways:

- Obtaining sponsorships that included advertisements on the *Diane*
- Chartering the *Diane*
- Reselling the *Diane* at a profit

Note. It appears that the *Diane* would be an unlikely candidate to attract charter groups since it lacked toilet, sleeping quarters, and kitchen facilities.

The S corporation reported substantial losses for the four tax years 1994-1997 and the flow-through losses were deducted on the taxpayers' individual tax returns for the same period. The IRS disallowed the claimed losses after determining that Diane Racing, the S corporation, was not an activity entered into for profit under §183. The assessed income tax deficiencies and penalties are shown below.

Tax Year	Additional Tax	Substantial Understatement of Tax Penalty (IRC §6662(d))
1994	$51,294	$10,259
1995	58,018	11,604
1996	45,101	9,020
1997	25,635	5,127

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Issue. Whether Diane Racing was an activity entered into for profit.

Analysis. In order to determine if an activity has the requisite profit-making motive, the nine subjective factors described in Treas. Reg. §1.183-2(b) must be evaluated. These nine factors are:

1. Whether the activity is conducted in a businesslike manner.
2. The time and effort expended in conducting the activity.
3. Whether the taxpayer has substantial income or net worth from other sources.
4. Whether the taxpayer, or advisors, have sufficient knowledge needed to successfully conduct the activity.
5. Whether the taxpayer has a history of making a profit in similar past activities.
6. The history of actual profits and losses of the activity.
7. The amount of occasional profits, if any, from the activity.
8. Whether there is a reasonable expectation that the assets used in the activity will appreciate in value.
9. Elements of personal pleasure or recreation.

Holding. After reviewing all the evidence, the Tax Court was convinced that the taxpayers had met their burden of proving that Diane Racing had an actual and honest objective of making a profit.

Note. The Tax Court seemed to place great reliance on a seldom quoted sentence of the regulations in finding in favor of Dr. and Mrs. Schwartz. That sentence, which is contained in Treas. Reg. §1.183-2(b)(6), states: **"If losses are sustained because of unforeseen circumstances which are beyond the control of the taxpayer, such losses would not be an indication that the activity is not engaged in for profit."** This sentence is contained in the explanation of factor #6 above, the history of actual profits and losses from the activity.

See Chapter 12, Schedule C for more information on Business versus Hobby activities.

Profit Motive
Jorge N. and Vivian Lopez v. Commissioner, TC Memo 2003-142, **85 TCM 1321 (May 20, 2003)**
IRC §§162 and 183

☞ Amway Dealership Lacked Profit Motive

Facts. Jorge Lopez, who worked full time as a petroleum engineer, and his wife Vivian were recruited by an "upline" Amway distributor in 1996. They had no prior experience with Amway or in running a business. During the course of their 4-year Amway distributorship, they relied on advice of celebrated "upline" Amway distributors. They also received unsolicited, independent advice from their accountant, but apparently the advice was negative.

Instead of attempting to sell Amway products at a profit to customers, Mr. and Mrs. Lopez chose to concentrate on developing a network of "downline" distributors. By the end of 1999, it appears that they had recruited between 10 and 25 "downline" distributors but had only two regular customers, their neighbor and Mrs. Lopez's mother. Consequently, their potential for profit was almost entirely dependent upon Amway's performance bonus program and the sales efforts of their "downline" distributors, over whom they had negligible control.

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Their 1998 and 1999 timely filed joint returns reflected the following regarding the Amway business:

Year	Gross Receipts	Gross Profit	Expenses	Net Schedule C Loss
1998	$7,139	$3,700	$22,088	($18,388)
1999	7,061	693	19,053	(18,360)

The IRS, in its examination report, disallowed all of the claimed Schedule C expenses on the basis that the Amway activity was not entered into for profit. However, the IRS allowed the expenses up to the amount of the reported gross profit as miscellaneous itemized deductions.

Issue. Whether the Amway activity was engaged in for profit as defined under IRC §183.

Analysis. The test under IRC §183 is whether the activity is entered into and conducted with the actual or honest objective of making a profit. The nine subjective and nonexclusive factors listed in the related regulations were explored by the Tax Court.

Holding. After careful consideration, the Tax Court was not persuaded that the taxpayers' primary purpose of engaging in the sale and distribution of Amway products was for income or profit. The manner in which Mr. and Mrs. Lopez conducted the business virtually precluded any possibility of realizing a profit.

They did not maintain records indicating that they had:

- Analyzed the existence of a potential market.
- Established how long it would take to recoup losses incurred.
- Determined what level of sales would be necessary for the business to become profitable.

It appeared that a substantial portion of the time the taxpayers spent of their Amway activity involved socializing with family and friends. Therefore, the Tax Court agreed with the determination made by the IRS.

Other Rulings and Cases

Timothy Thomas and Janice Kathleen Kuberski v. Commissioner, TC Memo 2002-200, **84 TCM 178 (August 12, 2002)**
Loss deductions: Profit motive: Horse breeding and racing.

William C. and Cheryl M. Fowler v. Commissioner, TC Memo 2002-223, **84 TCM 281 (September 6, 2002)**
Interest: Personal interest: Tax deficiency.

Larry Minnick and Charla Minnick v. Commissioner, TC Summary Opinion 2002-147 **(November 18, 2002)**
Nonprofit activities: Types of activities: Distributorship and direct marketing business: Amway.

Joyce E. Hastings v. Commissioner, TC Memo 2002-310, **84 TCM 663 (December 23, 2002)**
Reconstruction of income: Bank deposits: Failure to report income: Deductions: Nonprofit activities: Horse breeding: Penalties, civil: Failure to file: Failure to file within an extension period: Accuracy related penalty: Substantial.

Victor A. Prieto, et al., v. Commissioner, **9th Cir. Ct. of Appeals, 2003-1 USTC ¶50,376 (March 24, 2003)**
Nonprofit activities: Types of activities: Horse racing, breeding or showing.

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PASSIVE ACTIVITIES

Shareholder Equipment Rental

***Paul and Pauline D. Kessler, TC Memo 2003-185,* 85 TCM 1543 (June 26, 2003)**

IRC §469

☞ Losses Incurred by C Corporation Shareholders for Renting Equipment to Corporation Not Allowable Under Passive Activity Rules

Facts. Paul and Pauline Kessler were the sole shareholders of a C corporation, Pauline's Concrete Pumping, Inc. In 1987, they entered into a 10-year "Master Lease Agreement" with the corporation. The terms of the lease provided that the Kesslers would buy and lease eight trucks to the corporation. In return, the corporation would pay them rental income and all maintenance and insurance costs associated with the trucks. Mr. and Mrs. Kessler reported the following on their individual Schedules E for the years 1991-1993:

Year	Rental Income	MACRS Deduction on Trucks	Interest Expense	Schedule E Rental Loss
1991	$ 55,000	$171,980	None	($116,980)
1992	108,000	171,979	None	(63,979)
1993	184,702	183,478	$44,538	(43,314)

In its examination reports, The IRS disallowed the claimed rental losses under the passive loss limitations of IRC §469.

Issue. Whether the taxpayers' rental activity was a passive activity as defined by IRC §469.

Analysis. The temporary regulations provide **six exceptions** to the definition of rental activity. The taxpayers asserted that they qualified for either one or two of the following exceptions listed in the regulations:

1. The **incidental rental exception**[48]
2. The **extraordinary personal services exception**[49]

The regulations for the **incidental rental exception** provide the following tests in order to qualify:

Property Used in a Trade or Business. The rental of property shall be treated as incidental to a trade or business activity **if and only if**:

1. The taxpayer owns an interest in such trade or business activity during the tax year.
2. The property was predominantly used in such trade or business activity during the tax year or during at least two of the five tax years that immediately precede the tax year.
3. The gross rental income from the rented property for the tax year is **less than 2% of the lesser of**:
    - The unadjusted basis of the rented property, and
    - The FMV of the rented property.

Holding. Clearly, the third requirement for the **incidental rental exception**, gross rental income of less than 2%, has not been met. The taxpayers presented no evidence to establish either the unadjusted basis or the FMV of the rented property.

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Regarding the **extraordinary personal services exception**, the taxpayers have not provided personal services to the lessee corporation in their rental activity. Mr. and Mrs. Kessler, the shareholders, simply own and lease cement pumping equipment to the corporation. The lease is "net of all costs" to them. While Mr. and Mrs. Kessler clearly provide personal services in their capacity as employees of the corporation, they do not with respect to leasing equipment. **The services they provided as employees cannot be equated to services they provided in the rental activity since the lease agreement did not require them to perform services.**

> **Note.** See pages 446-47 in the *2001 University of Illinois Farm Income Tax Workbook* for an analysis of the *Hairston* case[50] which the Tax Court cited in this current decision. The tax result was identical regarding the alleged extraordinary personal service exception.

Real Estate Professional

Karl and Birgit Jahina v. Commissioner, TC Summary Opinion 2002-150 **(November 21, 2002)**
IRC §469

☞ Lack of Election to Treat All Real Estate Properties as a Single Passive Activity Results in Limitation of Rental Losses

Facts. Karl Jahina was employed full time in 1996 and 1997 as an engineer for a Los Angeles firm. His wife, Birgit, who had an MBA, was an accountant. She worked full time as the controller of ColorGraphics, Inc. all of 1996 and 1997. The taxpayers owned the following rental real estate properties during 1996 and 1997, the years in question. All of the properties were located in the greater Los Angeles area.

- Hermitage apartment building—14 rental units
- Coldwater apartment building—19 rental units
- Santa Anita apartment building—22 rental units
- Buffalo apartment building—25 rental units
- MoorPark apartment building – 29 rental units

Karl Jahina took no part in the rental real estate activity. However, Birgit Jahina was extensively involved in managing the five rental properties. She often worked early in the morning, prior to her controller duties for her employer, on various rental management activities. She performed the following management duties in 1996 and 1997:

- Obtained credit checks of potential renters
- Placed ads in local newspapers
- Reconciled gross rents every month
- Determined which renters were delinquent and sent them warning notices
- Filed eviction summonses and complaints in occasional court appearances
- Visited the properties regularly

Mrs. Jahina also kept some sketchy records of her time spent on rental management duties on her desk calendar. The taxpayers reported the following on their 1996 and 1997 Schedules E for the aggregate rental activity:

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Year	Gross Rental Income	Depreciation	Net Schedule E Rental Loss
1996	$767,000	$128,000	($128,167)
1997	811,000	153,000	(95,533)

In an examination of the 1996 and 1997 returns, The IRS disallowed the Schedule E losses under the passive loss limitation rules. The IRS assessed additional tax of $19,336 for 1996 and $26,084 for 1997.

Issues.

1. Whether Birgit Jahina qualifies as a **real estate professional** under IRC §469(c)(7).

2. Whether the passive loss rules of IRC §469 precludes the taxpayers from deducting rental real estate losses.

Analysis for Issue 1. Mrs. Jahina prepared summaries of her rental management activities for the revenue agent. **She contends that she spent 2,591 hours in 1996 and 2,639 hours in 1997 in these activities. This is more than the 1,800 hours she spent in each year working for her employer.** However, the IRS disputes the rental management hours and contends that she did not work more on these activities than she did for her employer.

There is also a dispute as to whether the taxpayers made the election under IRC §469(c)(7)(A) to treat the five rental properties as a single activity. If that election has not been made, Mrs. Jahina must qualify as a real estate professional for **each** rental property rather than aggregating her management activities for all five properties. **Therefore, if the election has not been made, Mrs. Jahina must prove that she met both of the following tests separately for each rental property:**

1. More than half of the personal services performed in trades or businesses by the taxpayer during the tax year are performed in real property trades or businesses.

2. The taxpayer performs more than 750 hours of services during the tax year in real property trades or businesses in which the taxpayer materially participates.[51]

Analysis for Issue 2. The most important fact in resolving whether the rental losses are limited by the passive loss disallowance rules is whether the election to treat all of the rental properties as a single activity has been made. It is not disputed that the taxpayers did not attach the required election to their joint 1996 tax return. The taxpayers contend that they did attach the election to their joint 1997 tax return. However, the 1997 return presented to the Tax Court by the IRS did not contain the election. In addition, Mrs. Jahina claims to have provided the election to the revenue agent sometime during the examination process.

Holding for Issues 1 and 2. The Tax Court held that the taxpayers **did not make a valid election** to treat their five rental properties as a single activity in either 1996 or 1997. "To make an election, a taxpayer must clearly notify the Commissioner of the taxpayer's intent to do so."[52] The taxpayers did not provide evidence and proof regarding the election issue.

As a result, the evidence fails to establish that Mrs. Jahina qualified as a real estate professional for **each** of the five rental properties considered separately. The two requirements of IRC §469(c)(7)(B) were not met for **any** of the rental properties individually. She did not perform more management activities on **any one** of the five rental properties than she worked for her employer. In addition, she did not satisfy the 750-hour statutory minimum for **any one** of them.

The Court held that Mrs. Jahina was **not** a real estate professional with regard to the taxpayers' rental properties during 1996 or 1997. Because she was not a real estate professional, the rental real estate activities of the taxpayers were treated per se passive under IRC §469(c)(2). Accordingly, the general disallowance rule concerning passive activity losses applies under IRC §469(a)(1)(A). The IRS was sustained on the rental loss disallowance issue for 1996 and 1997.

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Observations.

1. This Tax Court Summary Opinion received much attention and coverage. Many tax professionals have commented that since the issues are so important, the Tax Court should not have tried this case under the Small Tax Case procedures of IRC §7463 (disputes of $50,000 or less). Summary Opinion cases cannot be reviewed by another court and may not be treated as precedent.
2. **The election to treat all rental real estate properties as a single activity probably should be made if all of the properties generate tax losses**. Per Treas. Reg. §1.469-9(g)(3), the election is made "by filing a statement with the taxpayer's original tax return for the taxable year. This statement must contain a declaration that the taxpayer is a qualifying taxpayer [that the taxpayer qualifies as a real estate professional] for the taxable year and is making the election pursuant to IRC §469(c)(7)(A)."
3. The election is binding for the taxable year in which it is made and for all future years in which the taxpayer qualifies as a real estate professional, even if there are intervening years in which the taxpayer does not qualify as a real estate professional.[53]
4. See pages 344-46 in the *2002 University of Illinois Income Tax Workbook* for a thorough analysis of the *Bailey TC Memo* case which involves similar issues.

Other Rulings and Cases

Letter Ruling 200309021 (November 22, 2002)
LTR Report Number 1357, (March 5, 2003)
Election by small business corporation; Termination of election; Passive investment income.

PRINCIPAL RESIDENCE

Loss on Sale of Converted Residence

James V. and Laurie Abrams, TC Summary Opinion 2002-155 (December 19, 2002)
IRC §165

☞ Taxpayers Realized a Gain on Sale of Residence Converted to Rental Property

Facts. The taxpayers purchased a 4,200 square foot home in an exclusive section of Modesto, CA in March 1991 for $484,950. They added a swimming pool and extensive landscaping which cost an additional $70,000. Due to a substantial decline in the husband's salary, the taxpayers concluded they could no longer afford the $3,800 monthly mortgage payment. Therefore, in early 1995, they attempted to sell the house themselves for several months, but received no offers. During this time, the Modesto real estate market was in the midst of a 5-year downtrend. Sales of high-end homes were particularly sluggish.

In June 1995, they found a tenant who signed a one-year lease for the home with the lease period beginning July 1, 1995. The lease agreement required the tenant to pay the annual rent of $28,000 in advance. In addition, the lessee was given the right of first refusal or to receive a prorated refund of the prepaid rent if the home was sold prior to June 30, 1996, the end of the lease period.

The taxpayers vacated the home at the end of June 1995 and immediately listed the house for sale with a real estate broker for an **initial asking price of $484,900**. The taxpayers did not obtain an appraisal for their former personal residence prior to listing the home. Sales efforts were unsuccessful, which led to a reduction in the asking price over a 5-month period as follows:

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Date	Reduced Asking Price
July 12, 1995	$469,000
September 13, 1995	459,000
November 3, 1995	435,000

After the end of original lease term in June 1996, the lessee continued to rent the home on a monthly basis. **The house was finally sold for $435,000 to the lessee on December 27, 1996 via an installment land contract**.

For the tax year 1995, the taxpayers claimed MACRS depreciation of $6,000 on the rental house. **On their joint 1996 tax return**, **they reported a $39,000 ordinary loss on the sale on Form 4797**. The calculation of the $39,000 claimed loss is shown below.

Sale price		$435,000
Lower of FMV or actual cost on the July 1, 1995 conversion date	$480,000	
Less: MACRS depreciation allowed on their 1995 Schedule E	(6,000)	
Adjusted basis on date of sale in December, 1996	$474,000	(474,000)
Loss		**($ 39,000)**

However, an IRS exam concluded that the correct FMV of the house on the conversion date was only $435,000, the same as the eventual sales price in December 1996. Therefore, instead of a loss, the taxpayers realized a $6,000 gain computed as follows:

Sale price		$435,000
Correct FMV on conversion date (lower than actual cost)	$435,000	
Less: MACRS depreciation allowed	(6,000)	
Adjusted basis on date of sale	$429,000	(429,000)
Gain		**$ 6,000**

In the examination report, the IRS raised an alternative position that the $39,000 claimed loss should be disallowed as the temporary rental of the home was not an activity entered into for profit under IRC §183.

Issue. Whether the taxpayers have a deductible loss under IRC §165 or a recognized gain on the sale of their former personal residence.

Analysis. Although the Internal Revenue Code does not define the term "fair market value" (FMV) for purposes of IRC §165, the universally accepted definition is **the price the property would change hands between a willing buyer and a willing seller**, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

The taxpayers argue that the sales price of $435,000 in December 1996 is not an accurate reflection of the FMV in July 1995 because they were compelled to sell quickly at a distressed price. On the other hand, the IRS has submitted information from the county assessor's office which shows that the home's assessed value for real estate purposes for 1995 and 1996 was $400,000.

Holding. Given the evidence, **the Tax Court concluded that the FMV of the property on July 1, 1995 was $435,000**. Although the county assessor's appraisal of $400,000 was not conclusive proof of the true FMV, it was persuasive evidence that the taxpayers' $480,000 estimated FMV was overly inflated given the state of the Modesto real estate market in 1995. The fact that the house languished on the market with an asking price of $435,000 in November 1995 indicated that the true value of the house in July 1995 was substantially less than the taxpayers' estimate of $480,000. Consequently, the taxpayers have a $6,000 gain on the sale in 1996 as the IRS contended.

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Unforeseen Circumstances

IRS Information Notice 2003-0031 (March 31, 2002)

IRC §§121 and 1398

☞ Divorce Qualifies as "Unforeseen Circumstance" for Partial Exclusion on Gain on Sale of Residence

Background. The IRS in Information Notice 2003-0031, clarifies that the sale of a home as a result of divorce can qualify for a reduced exclusion even if the dual two year use and residency tests are not met. A divorcee who receives a residence as part of a property settlement, and sells the home before the 2-year period is met may qualify for the reduced exclusion under the "unforeseen circumstance" safe harbor.

> **Example.** Brandy, who was divorced in 2003, received the jointly owned principal residence as part of the property settlement. She and her ex-husband bought the home in January 2002 for $180,000. Brandy sold it exactly 18 months later in July 2003 for $270,000. Her gain on the sale, after deducting expenses of sale, was $80,000.

Her maximum exclusion under IRC §121 as a single taxpayer is $250,000. Her reduced maximum exclusion is $187,500, computed as follows:

$$\frac{18\text{ (months)}}{24\text{ (months)}} = 75\% \times \$250{,}000 = \mathbf{\$187{,}500}$$

Since Brandy's gain is less than $187,500, it is entirely excludable on her 2003 tax return.

> **Note.** See Chapter 1, Individual Taxpayer Problems, Problem 2 in this workbook for complete details on this topic.

Principal Residence

***James M. and Jean M. Guinan v. United States,* U.S. District Court of AZ, 2003-1 USTC ¶50,475 (April 9, 2003)**

IRC §121

☞ Taxpayer's Summer Home Not Qualified as Principal Residence

Facts. The taxpayers bought a 4500 sq. ft. home in Wisconsin in March 1993. They sold it on September 15, 1998 and reported the large gain on the sale on their 1998 Schedule D. However, in January 2001, they filed a 1998 Form 1040X which requested a $45,009 refund. The 1998 amended return reported that since the Wisconsin home qualified as their principal residence under IRC §121 at the time of the sale, the gain should have been excluded. After the IRS denied their requested refund, the taxpayers sued in the Arizona U.S. District Court to obtain the refund.

During the 5-year period prior to September 15, 1998, the taxpayers, who are retired, also owned homes in Georgia and Arizona. The Georgia home was owned in 1993 when the Wisconsin home was acquired. They sold the Georgia home in 1996, at which time they purchased an Arizona home. The taxpayers generally resided in their Wisconsin residence during the summer and fall months and at their Georgia or Arizona homes the rest of the year.

During the 5-year period ending on September 15, 1998, the date they sold the Wisconsin home, the taxpayers occupied their three homes for the following number of days:

Wisconsin home:	847 days **(47.5%)**	Georgia home:	563 days
		Arizona home:	375 days
			938 days **(52.5%)**

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Issue. Whether the taxpayers' Wisconsin home was their principal residence under IRC §121 at the time of its sale.

Analysis. In the case of a taxpayer using more than one home as a residence, whether a home is **used** as the taxpayer's principal residence depends on all of the facts and circumstances. If a taxpayer alternates between two homes, the home that is used for the majority of the time during the year ordinarily will be considered the principal residence. In addition to the taxpayer's actual use of the home(s), relevant factors to consider include, but are not limited to:

- The taxpayer's place of employment
- The principal place of abode of the taxpayer's family members
- The address listed on the taxpayer's federal and state tax returns, driver's license, automobile registrations(s), and voter registration card
- The taxpayer's mailing address for bills and correspondence
- The location of the taxpayer's banks
- The location of religious organizations and recreational clubs with which the taxpayer is affiliated

Mr. and Mrs. Guinan's own undisputed figures clearly show that, for the entirety of the 5-year period prior to the sale of the Wisconsin residence, they spent more time in the Georgia and Arizona homes combined than they did in the Wisconsin home (52.5% versus 47.5%, respectively).

Holding. The Arizona District Court held that the taxpayers' Wisconsin residence did **not** qualify as their principal residence under IRC §121. The other relevant factors, as opposed to the time of usage factor, taken as a whole, did not favor the taxpayer either. The Court noted the following regarding these other relevant factors during the 5-year period in question:

- The location where they registered their vehicles did not favor Wisconsin since they kept one car and two boats in Wisconsin and two cars at both their Georgia and Arizona homes.
- The taxpayers did not file Wisconsin state tax returns but they filed both Georgia and Arizona state tax returns.
- Neither taxpayer was registered to vote in Wisconsin but both were registered in Georgia and then in Arizona.
- Neither taxpayer had a Wisconsin driver's license but both had a Georgia license and then an Arizona license.

RETIREMENT

Retirement Plans

Revenue Ruling 2002-73 (October 16, 2002)
IRC §404

☞ **IRS Limits Ability of Employers to Automatically Change Accounting for Grace Period Contributions to 401(k) Plans**

The IRS has ruled that an employer **cannot 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, an application for automatic change in the method of accounting under Rev. Proc. 2002-9 must be made.

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Workers' Compensation Benefits

James E. and Ruth L. Norris v. Commissioner, **9th Cir. Ct. of Appeals, 2002-2 USTC ¶ 50,684 (September 20, 2002)**
IRC §§104 and 7442

☞ Federal Employees Retirement System (FERS) Payments Treated as Taxable Workers' Compensation Benefits

Facts. Mr. Norris was employed by the Federal Aviation Administration (FAA) as a pilot examiner from 1988 until early November of 1992. The first three years of his government employment were uneventful. During his fourth year with the FAA, he experienced several problems. First, his supervisor left and he found he was not compatible with his new boss. Then Mr. Norris became severely depressed and he alleged his depression resulted from discrimination from FAA supervisors and employees.

Mr. Norris, who had taken medical leave for a period of time, was deemed by his superiors to be unfit for the job. Mr. Norris was terminated from government service on November 2, 1992. He was granted social security disability benefits in 1994 and Federal Employees Retirement System (FERS) disability retirement benefits in 1995.

During the period following his separation from employment, Mr. Norris made several unsuccessful appeals for a reclassification of the FERS disability retirement to workers' compensation. He contended he "suffered from an emotional/psychiatric injury as a result of harassment and racial discrimination" in his workplace.

Perhaps to amplify his contention for workers' compensation treatment, the taxpayers' 1995 joint return did not report the full Form 1099-R amount for the $29,459 FERS disability payment. Instead the taxpayers reported a lesser taxable amount of $6,936. They attached a statement to the return disclosing that only $6,936 was taxable and that the balance of $22,523 was considered excludable workers' compensation payments.

Upon examination, the IRS determined that no portion of the $29,459 FERS disability payments was excludable and assessed a tax deficiency.

Issue. Whether payments received under FERS during 1995 are excludable from gross income under IRC §104(a)(1).

Holding. FERS retirement payments are not benefits under a workers' compensation act, and no amounts of FERS disability payments can be excluded from gross income. The Appeals Court agreed with the prior Tax Court holding in fully taxing the $29,459 amount of the 1995 FERS disability payments to Mr. Norris.

IRA Rollovers

Revenue Procedure 2003-16 (January 8, 2003)
IRC §§402 and 408

☞ Guidance Provided for Waiver of the 60-Day Rollover Requirement for IRAs and Qualified Plans

Background. To avoid the harsh results imposed when the 60-day rollover requirement is not met, most taxpayers utilize a direct trustee-to-trustee transfer from their IRAs or qualified plans to a new plan. Prior to a provision in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the IRS could waive the 60-day rollover deadline only in limited circumstances. However, a provision of EGTRRA permits the IRS more discretion to waive the 60-day rollover requirement.

Two Types of Waivers Permitted. Under Rev. Proc. 2003-16, two types of waivers of the 60-day deadline are sanctioned. They are:

- Automatic approval
- Hardship waiver via a letter ruling request with payment of the $90 user fee

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Automatic Approval. No letter ruling request is required and **automatic approval** is granted if the following conditions are met:

1. The rollover funds are actually received by the financial institution within the 60-day period.
2. The taxpayer gives instructions to deposit the rollover funds to an eligible retirement plan.
3. The failure to timely deposit the funds is due solely to an error by the financial institution.
4. The rollover funds are actually deposited to an eligible retirement plan within one year from the beginning of the 60-day rollover period.

Hardship Waiver. A waiver may be granted by the IRS following the application of a letter ruling request under the following circumstances:

The taxpayer can show that the failure to waive the 60-day deadline **"would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the [taxpayer]."** These events include:

- Errors made by the financial institution other than those described in the automatic approval waiver.
- Inability to complete a rollover due death, disability, hospitalization, incarceration, or postal error.

> **Note.** Letter Ruling 200327064 is an example of the IRS granting a hardship waiver under Rev. Proc. 2003-16. In the letter ruling, a waiver was granted to a couple whose investment manager withdrew funds from their IRAs without their knowledge and for his personal use. The taxpayers were allowed 30 days to replace the stolen funds.

Annuities

IRS Notice 2003-51 (July 9, 2003)

IRC §§72 and 1035

☞ Interim Guidance for Partial Exchange of Original Annuity Contract for a New One

Background. Many taxpayers exchange one annuity contract for another one in a IRC §1035 tax-free exchange. In the *Conway* Tax Court case,[54] the court ruled that a **partial exchange**, as opposed to a complete one, also qualified for IRC §1035 tax-free treatment.

Due to the complex rules of IRC §72(e), the IRS is concerned that **partial exchanges** of annuity contracts can result in tax-sheltered distributions from either the original (surviving) or the new annuity contracts. This opportunity exists if the cash surrender value of both the original and new annuities is substantially larger than the taxpayer's cost basis (investment in contract). This situation is common in partial exchanges. The IRS believes some taxpayers are using IRC §72(e) to gain an unintended tax advantage from receiving distributions from either the original or new annuities following a partial IRC §1035 tax-free exchange.

Interim Guidance General Rule. Pending the issuance of final regulations, the IRS has issued interim guidance on which taxpayers can rely. The **general rule**, subject to the exceptions shown later, is:

> **Distributions made within 24 months of the date of the partial tax-free exchange from either the original (surviving) or the new annuity contracts will be treated as an integrated transaction.**

In simpler terms, any distributions made within the 24-month period will be considered to have been made from the original annuity. **The tax result is a larger recognized gain than is currently determined under IRC §72(e).**

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Exceptions to the General Rule. If the taxpayer demonstrates that one of the conditions of IRC §72(q)(2) or any other similar life event occurred between the date of the partial exchange and the date of the distribution, the general rule is disregarded. These conditions include distributions made:

- After the taxpayer reaches age $59^1/_2$
- Due to a divorce
- Due to the loss of employment

Keogh Plan v. IRA

***Susan L. Rosetti v. Commissioner, TC Memo 2003-157,* 85 TCM 1427 (May 28, 2003)**

IRC §§401 and 408

☞ Keogh Plan Not Equivalent to IRA

Facts. In 1998, Susan Rosetti, who was employed by the Florida Department of Transportation, was covered under the Florida Retirement System (FRS) plan. Her 1998 wages were $43,209. She was a real estate agent but not active in this self-employment activity in 1998. During 1998, she made a $2,000 contribution to a Keogh plan that she established prior to her employment with the State of Florida. She deducted the $2,000 Keogh plan contribution as an IRA deduction on her 1998 tax return. In its examination report, the IRS disallowed the IRA deduction.

Analysis and Holding. Mrs. Rosetti made a contribution to a Keogh plan rather than an IRA. Although taxpayers with earned self-employment income are eligible to deduct Keogh plan contributions, she had none in 1998. Therefore, the $2,000 Keogh plan contribution she made is not deductible. Even if she had made an 1998 IRA contribution, it would not have been deductible because she

- Was married and filed a separate return.
- Was an active participant in the FRS plan.
- Earned more than $10,000 during 1998.

Drop in Value

Revenue Ruling 2002-62 (October 3, 2002)

IRS News Release IR-2002-104 (October 3, 2002)

IRC §§72, 401, 402, 408, 412 and 3405

☞ Taxpayers May Be Allowed to Change "Substantially Equal" Fixed Payments from Retirement Accounts that Decreased in Value

This ruling can benefit taxpayers who elected to take "substantially equal" payments from an IRA or an employer retirement plan before age $59^1/_2$. They now may be allowed to change the amount of their fixed payments without a 10% penalty in order to preserve their retirement savings.

> **Observation.** For those who were planning an early retirement and wanted to maximize their premature IRA or employer plan distributions, their fixed payments will be reduced. The ruling has the effect of reducing the interest rate on which the distribution is calculated as well as using a longer life expectancy.

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Purpose. To protect certain taxpayers from a 10% penalty on premature distributions from their IRAs or employer retirement plans.

Background. The drop in the stock market has reduced the value of many retirement plans. Some taxpayers who elected to take "substantially equal" fixed payments under IRC §72(t)(2) prior to age 59$^1/_2$ may find that their plan funds will be prematurely depleted. Under prior law, changing the amount of the "substantially equal" payment could result in a 10% penalty on all payments taken.

Under IRC §72(t)(2), taxpayers under age 59$^1/_2$ can begin drawing payments from their IRA or employer retirement plan, without penalty, if they take a series of "substantially equal" payments. However, if the amount of the payment was modified (other than by reason of death or disability) before the **later** of five years or before the taxpayer attains age 59$^1/_2$, a 10% penalty applied. Payments are considered substantially equal if calculated using one of three methods:

- Required minimum distribution method.
- Fixed amortization method.
- Fixed annuitization method.

Ruling. Taxpayers who chose either the **fixed amortization method** or the **fixed annuitization method** in a subsequent year may switch to the **required minimum distribution method** to determine the amount of the payment for the year of the switch and all remaining years. **Once the change is made, the required minimum distribution method must be used in all future years.**

Effective Date. For payments commencing on or after January 1, 2003. The ruling also applies to distributions that began in 2002.

> **Note.** Q and A 12 in IRS Notice 89-25 is modified by Rev. Rul. 2002-62.

IRA Distribution

***Robert Ancira v. Commissioner,* 119 TC 135 (September 24, 2002)**

IRC §408(d)(1)

☞ No IRA Distribution Resulted when Taxpayer Acting Merely as Conduit

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

The trustee of the IRA issued a Form 1099-R to Mr. Ancira reporting the distribution. However, Mr. Ancira did not report the transaction on his 1998 return. The IRS based its decision on the fact that Mr. Ancira signed a distribution request, and received the check. Consequently, the distribution, which was subject to the 10% early withdrawal penalty, was taxable.

Analysis and Holding. 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."**

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Other Rulings and Cases

Robert L. and Sara J. Helm v. Commissioner, TC Summary Opinion 2002-138 **(October 18, 2002)**
Social Security Benefits: Modified adjusted gross income: Roth IRA: Conversion: Inclusion in income.

TAX FRAUD

Tax Fraud

United States v. Francis F. Paul, **6th Cir. Ct. of Appeals, 2003-1 USTC ¶50,222 (January 23, 2003)**
IRC §7206

☞ District Court's Tax Fraud Conviction and Sentence Upheld

Facts. Francis Paul, a Michigan self-employed neurosurgeon, experienced many personal and business related problems during the late 1980s and early 1990s, due primarily to alcohol abuse. His practice steadily declined and he accumulated large debts. During the period 1988-1994, his IRS-related actions and decisions included the following:

- He failed to file his federal tax returns for four years.
- He filed employment tax returns but did not make any deposits or payments even though he withheld income and social security taxes from his employees.
- He failed to report approximately $180,000 of gross receipts from his relocated Idaho medical practice on his 1993 tax return.
- He paid his Idaho medical practice employees in cash.
- In May 1994, the IRS accepted an Offer-In-Compromise (OIC) from Dr. Paul. The accepted offer amount was $50,000 and the total IRS assessments, including penalties and interest, were $311,000. However, the IRS later discovered that the financial statements submitted with the OIC were false as they omitted the following assets:
    - The existence of the new Idaho medical practice
    - An interest in a Michigan residence
    - Five bank accounts in Idaho, Nevada, and Wyoming
    - An antique Packard automobile
    - A new $250,000 residence in Idaho Falls, Idaho

> **Note.** While involved with the IRS in the OIC process, he used a fake Nevada address and a Nevada driver's license to camouflage the existence of his new Idaho medical practice.

Issue. Whether the Michigan District Court's criminal fraud and tax evasion conviction and the resulting 54-month prison sentence were erroneous.

Analysis and Holding. After considering all the evidence and testimony, the 6th Circuit Court of Appeals determined that the District Court did not abuse its discretion or Dr. Paul's rights. Therefore, the conviction and sentence were affirmed.

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Offshore Payment Cards

IRS News Release IR-2003-58 (May 1, 2003)

IRC §§6011, 6652, 6663, and 6701

☞ IRS Reports Strong Response to Offshore Voluntary Compliance Initiative

More than $100 million of additional tax liability is expected to result from the Offshore Voluntary Compliance Initiative (OVCI) in which 1,253 taxpayers applied for settlements. The deadline for the initiative ended April 15, 2003. It was directed toward bringing taxpayers, who used offshore payment cards to hide income, back into compliance with the tax laws. Eligible taxpayers could avoid criminal prosecution and some penalties by voluntarily complying by the deadline.

In addition, the IRS identified 80 new promoters who will be investigated to track down offshore tax evaders. As of May 1, 2003, the IRS has begun audits of more than 1,000 offshore payment cardholders. More than 30 taxpayers have already been referred to the Criminal Investigation division of the IRS for possible prosecution.

Taxpayers who didn't come forward under OVCI still have an opportunity to file amended returns or follow the terms of the Voluntary Disclosure Initiative, which is detailed in IRS News Release IR-2002-135.

Illinois Land Trust

***United States v. Herbert and Carol Engh,* 7th Cir. Ct. of Appeals, 2003-1 USTC ¶50,500 (June 2, 2003)**

IRC §6321

☞ Fraudulent Conveyance of Home to Illinois Land Trust Upheld by Appeals Court

Note. This Appeals Court decision affirms the decision reached in a 1987 Northern Illinois U.S. District Court case.[55]

Facts. Herbert and Carol Engh were tax protesters who stopped filing returns from 1982 through 1987. Their protest actions and decisions included the following:

- Filing a false Form W-4 with American Airlines alleging to be exempt from income tax withholding
- Investment in offshore companies
- **A 1983 fraudulent conveyance of their principal residence to an Illinois land trust "for the benefit of their daughters" in order to frustrate the IRS efforts to collect a 1982 Form 1040 deficiency**

Herbert Engh also transferred his American Airlines retirement funds unto a limited partnership that invested in South American gold mines. He was convicted in 1991 on three counts of tax evasion and five counts of willful failure to file returns for which he served 28 months of a 48-month prison sentence.

After his release from prison, the IRS attempted to collect a $39,000 tax deficiency which the Engh's owed for their 1982 joint tax return. The IRS foreclosed a lien on the taxpayers' personal residence because the 1983 conveyance to the land trust was fraudulent under Illinois law.

Issue. Whether the 1983 conveyance of taxpayers' home to an Illinois land trust was fraudulent and therefore should be ignored for collection purposes.

Holding. The 7th Circuit Court of Appeals agreed with the prior District Court decision that the conveyance was fraudulent for the following reasons:

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- No consideration was given for the home which had significant value.
- The Enghs retained possession of the home, continuing at all times to live there and pay property taxes.
- The transfer was to family members (their daughters).
- The clear motivation for the conveyance was to avoid a creditor, namely the IRS.

> **Note.** The Appeals Court judges noted that "this case is a good example of why taxpayers should resist the false siren call of the tax protester movement."

Tax Scams

IRS Notice 2002-65 (September 25, 2002)

IRC §§165, 269 and 701

☞ IRS Cautions Taxpayers About Tax Scams 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 his original investment in the S corporation.

The IRS is aware of this and cautions taxpayers and their representatives that the alleged tax benefits flowing from these transactions are not allowable. The IRS intends to challenge the loss under IRC §165(c)(2) by asserting that the transaction was not entered into for profit. Penalties may be imposed on participants and promoters.

TRAVEL AND TRANSPORTATION EXPENSES

Per-Diem

Revenue Procedure 2002-63 (September 27, 2002)

IRC §§162 and 274

☞ IRS Issues Simplified Per-Diem Rates for Travel After September 30, 2002

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 employee may receive a per-diem. Provided it does not exceed the federal rate and the employee can substantiate time, place and business purpose for the expense, the reimbursement is treated as if made under 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 M&IE for low-cost locations remains at $125, $90 for lodging and $35 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.

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A payor 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 instead reimburse an employee's actual expenses, use the meals-only per diem method, or use the regular federal travel rate for travel outside of the U.S.

A payor that used the high-low rates or the regular federal rate for the first three quarters of 2002 must continue to use that method until the beginning of 2003. However, a payor that used the high-low rates and high-cost localities may continue to use those rates through December 31, 2002 provided 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 transportation workers, the limitation 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 current CONUS and ONCONUS rates can be found online at www.policyworks.gov/perdiem.

The revenue procedure 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. This applies to individuals who do not incur meal expenses for a calendar day, or partial day, of travel away from home. The individual must only substantiate a time, location and business purpose for the travel. This method cannot 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.

Note. For travel **after December 31, 2002,** the term **"incidentals"** includes tips given to porters, baggage carriers, bellhops and hotel maids. It does not include expenses for laundry, cleaning and pressing of clothing, lodging taxes, or the cost of telephone calls.

Other Rulings and Cases

Rev. Proc. 2002-61 (September 18, 2002)

Deductions: Employee business expenses: Travel expenses: Reporting and withholding reimbursements and allowances: Standard mileage rates: Charitable expenses: Medical expenses: Moving expenses.

Rev. Rul. 2003-25 (March 31, 2003)

Gross income: Fringe benefits: Employer-provided aircraft: Terminal charges: SIFL rates.

ENDNOTES

1 *Black's Law Dictionary* 1299 (7th edition 1999)

2 *Rosalie M. Schubert v. Commr.,* 4th Cir. Ct. of Appeals (1961), 61-1 USTC ¶9217, affirming 33 T.C. 1048 (1960)

3 *Patton v. Commr.,* 116 TC 206 (2001)

4 *TC Memo 2001-179*, 82 TCM 197 (July 19, 2001)

5 116 TC- No. 23, 116 TC 289 (May 14, 2001)

6 IRC§197(c)(1)

7 IRC §197(d)(1)(E)

8 House Conference Report 103-213, at 677 (1993)

9 *Commr. v. R.P. Groetzinger,* Supreme Ct. (1987) 87-1 USTC ¶9191

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10 *TC Memo 2001-165,* 82 TCM 19 (July 3, 2001)

11 *Robert R. Golden v. Commr., TC Memo 1993-602*, 66 TCM 1658

12 IRC §162(a)(2)

13 IRC §162(a)(2); *Deamer v. Commr.*, 8th Cir. Ct. of Appeals 1985, 85-1 USTC ¶9135, affirming TC Memo 1984-63

14 *Kroll v. Commr.,* 49 TC 557 (1968)

15 *Redlark v. Commr.,*106 TC 31(1996)

16 *TC Memo 2000-362,* 80 TCM 766 (2000)

17 *United States v. Don Gilmore,* Supreme Ct., 63-1 USTC ¶9285 (1963)

18 *James F. and Dorothy A. Davis v. Commr.*, 119 TC No. 1 (July 2002)

19 IRC §163(h)(3)(B)(i)(II)

20 *Canelo v. Commissioner,* 53 T.C. 217, 225-226 (1969), affirmed by the 9th Circuit, 71-2 USTC ¶9598 (1971)

21 IRC §1244(c)(1)(A)

22 IRC §1244(c)(1)(B)

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24 Treas. Reg. §1.6664-4(a)

25 *DeCleene v. Commr.,* 115 TC 457 (2000)

26 *Fan v. Commr.*, 117 T.C. 32 (2001)

27 IRC §152(e)(2)(A)

28 IRC §152(e)(2)(B)

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30 *Portillo v. Commr.*, 5th Cir. Ct. of Appeals 1991, 91-2 USTC ¶50,304, affirming in part TC Memo 1990-68

31 *M.L. Holland v. United States*, Supreme Ct. (1954), 54-2 USTC ¶9714

32 House Report 104-586 (1996), 1996-3 C.B. 331, 482

33 *United States v. Therese A. Burke*, Supreme Ct. (1992), 92-1 USTC ¶50,254

34 *Mason K. and Bernice A. Knuckles v. Commissioner*, 10th Cir. Ct. of Appeals (1965), 65-2 USTC ¶9629, affirming *TC Memo 1964-33*

35 *TC Memo 2003-100* (April 9, 2003)

36 IRC §6013(d)(3)

37 Rev. Proc. 2000-15 was superceded by Rev. Proc. 2003-61

38 Rev. Proc. 2000-15

39 Rev. Proc. 2000-15

40 Rev. Proc. 2000-15

41 IRC §6015(f)(1)

42 IRC §6015(f)(2)

43 Treas. Reg. §1.162-5(a)(1)

44 Treas. Reg. §1.162-5(a)(2)

45 Treas. Reg. §1.162-5(b)(2)

46 Treas. Reg. §1.162-5(b)(3)

47 IRS Pub. 3, *Armed Forces' Tax Guide*

48 Temp. Reg. §1.469-1T(e)(3)(ii)(D)

49 Temp. Reg. §1.469-1T(e)(3)(ii)(C)

50 *TC Memo 2000-386*, 80 TCM 905 (2000)

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51 IRC §469(c)(7)(B)

52 *Matti Kosonen v. Commr.*, *TC Memo 2000-107*, 79 TCM 1765

53 Treas. Reg. §1.469-9(g)(1)

54 *Conway*, 111 TC 350 (1998)

55 86 C 6376, April 20, 1987, 658 FSupp 698, 87-1USTC ¶9326

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