Chapter 13: 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, 2004. 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.

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

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

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

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.

Tax Court Summary Opinions. Cases decided under the Small Case Procedures cannot be appealed by either the taxpayer or the IRS. Without the appeals process, incorrect legal interpretations by the Tax Court cannot be challenged. Therefore, the Tax Court's decision is only binding on that particular case. However, reviewing the cases can still be useful since they explain the IRS's arguments, the taxpayer's arguments, and the Tax Court's reasoning.

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.

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 simplified petition and procedure rules which allow the taxpayer to 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.

Effective June 1, 2004, the United States Tax Court has a court room available which contains a variety of electronic technology equipment. This court room can be used to conduct Court proceedings. Guidelines for use can be found at **www.ustaxcourt.gov.** The courtroom is available for **parties that jointly request** that proceedings be conducted in the room and the Court grants requests by written order. Requests can be made by a written "Joint Motion to Calendar in the electronic (North) Courtroom" or can be orally requested through the judicial officer having jurisdiction. Prior to using the Court's equipment, users must be trained by the Tax Court personnel and must complete a Technology Equipment Request Form. Courtroom hours are 8:00 a.m. to 4:30 p.m. Eastern Time, Monday through Friday, excluding legal holidays in the District of Columbia.

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.**

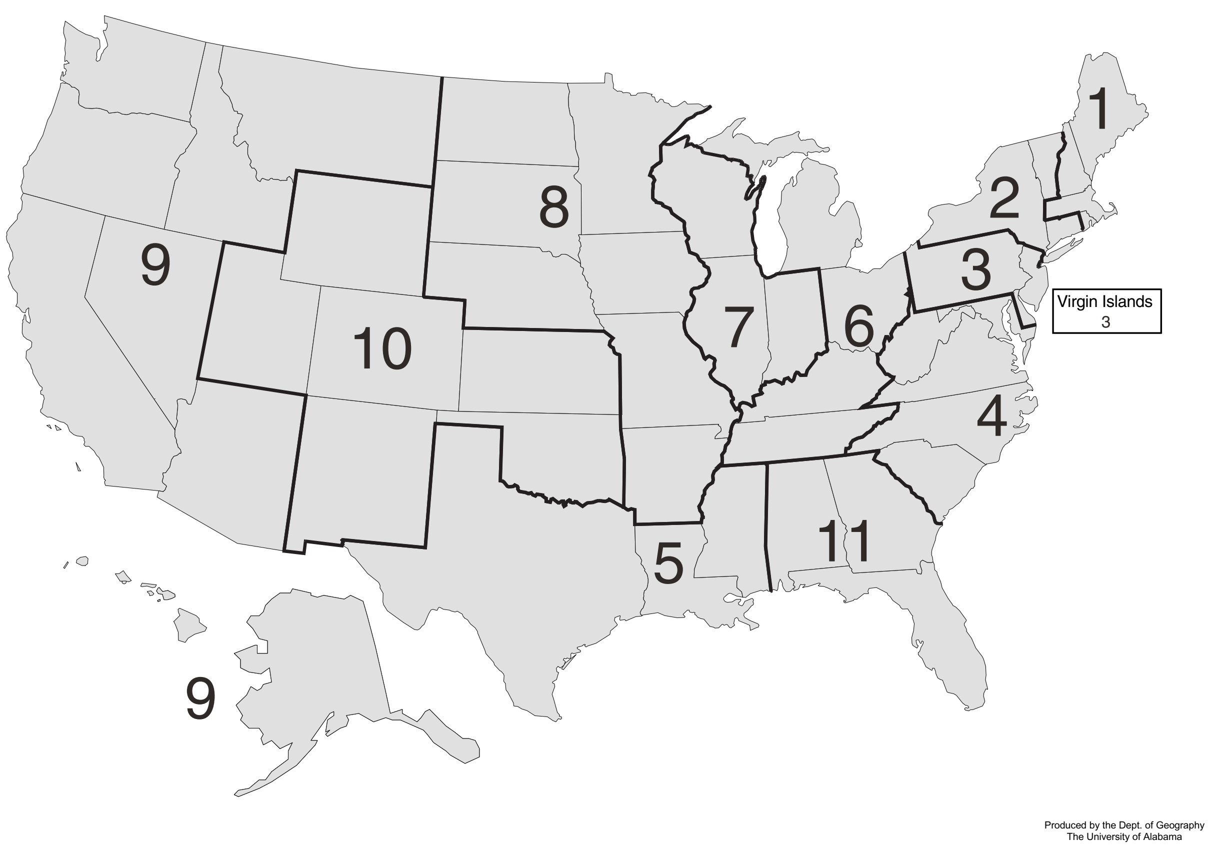
Any decision of the Tax Court can be appealed to the appropriate Circuit Court of Appeals. A final appeal can be made to the Supreme Court, but since its jurisdiction is discretionary, the court hears relatively few tax cases. Many of these court transcripts can be accessed online at **www.uscourts.gov.**

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 online at **www.uscourts.gov.**

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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AGRICULTURAL ISSUES

Fringe Benefits

***Ricky and Suzetta J. Schmidt and Hillside Dairy, Inc. v. Commissioner (consolidated cases),* TC Memo 2003-325, November 25, 2003**

IRC §§106, 119, 162 and 262

☞ Split Decision for Farm Corporation and its Shareholders

Facts. Ricky Schmidt, a South Dakota farmer, incorporated his farming operation in January 1993. He transferred the following property to the corporation, Hillside Dairy, Inc. on the date of incorporation:

- 202 acres
- Farmhouse residence
- Various farm buildings including a dairy barn, grain bins, and machine sheds
- Farm equipment
- One-half ownership in approximately 35 dairy cows

Hillside Dairy, Inc. was organized primarily to raise grain and operate a dairy. Ricky Schmidt and his wife, Suzetta, were the sole shareholders, officers, and directors. The corporation leased the land, house, and farm buildings to Mr. Schmidt under a written lease agreement dated December 1, 1995. The initial term of the lease was one year (December 1, 1995 to November 30, 1996). A clause in the lease stated that it continued on a year-to-year basis unless cancelled.

Terms of the written lease included the following:

- Mr. Schmidt was required to pay $6,000 annual rent to the corporation for the use of "the building site and improvements."
- The corporation was entitled to receive income from the sale of crops grown on the land and federal agricultural subsidy payments.

> **Note.** It is unclear from the court transcript if the lease of the farmland was a typical crop-share type of lease where Mr. Schmidt, as tenant, would receive a share of the crops produced in exchange for his labor. However, it is reasonable to assume that the lease was a crop-share type of lease.

- The corporation agreed to furnish the fertilizer, chemicals, and seed for the crop production and all tools and farm machinery.
- Mr. and Mrs. Schmidt agreed to furnish all necessary labor to operate and farm the corporate-owned farmland and to maintain the other corporate property.

Following the incorporation, the Schmidts and their two children continued to use the farmhouse as their residence. The corporation paid for the following expenses:

- All food consumed by the Schmidt family at the residence
- The utilities, property tax, and insurance for the residence
- The cost of some of the meals consumed by the Schmidt family at restaurants
- All medical expenses of the Schmidt family under a written medical reimbursement plan that covered "all employees and officers executing management responsibilities" and their spouses and dependents

The bylaws of the corporation contained the following articles/resolutions:

1. **Repayment of Disallowed Expenses.** "Any expense paid by the corporation which is finally determined to be a personal expense of any officer or employee and disallowed as a corporation expense shall be repaid by the officer or employee to the corporation within 24 months of the final determination by the IRS with interest at 3% below the New York prime rate on the date of final determination."
2. **Resolution.** "It is resolved that the corporate officers and employees shall be required to live at the worksite of the corporation to ensure security for the corporation property and operations. The officers and employees shall be required to live on the worksite to supervise the care and feeding of the livestock of the corporation. The corporation shall supply said officers and employees all of their food and lodging while living at said worksite. That all officers and employees shall be considered on duty when at the worksite and therefore entitled to such benefits."

The corporation adopted a fiscal year ending on November 30. **Mr. Schmidt was the sole employee of the corporation and received the following cash salary during the years in question, 1995–1997:**

Year	Cash Salary Received by Mr. Schmidt
1995	$750
1996	200
1997	200

The Forms 1120 for Hillside Dairy reported total income and deductions for the three fiscal years in question:

	Ended 11/30/95	Ended 11/30/96	Ended 11/30/97
Total income	$54,988	$68,465	$57,679
Total deductions	54,987	68,465	63,215
Total income/loss	$ 1	$ 0	($ 5,536)

Included in the total deductions figures were the following items for food, lodging, and medical expenses provided and deducted by the corporation (amounts are rounded):

	Ended 11/30/95	Ended 11/30/96	Ended 11/30/97
Food and lodging:			
Property tax, house	$ 523	$ 400	$ 388
Insurance, house	0	120	132
Food for the family of four	6,724	8,760	8,161
Utilities, house	2,567	2,439	2,557
Depreciation, house	1,667	1,667	1,667
Dining out meals	994	1,338	1,369
Total food and lodging expenses	**$12,475**	**$14,724**	**$14,274**
Medical:			
Medical insurance	$ 2,052	$ 2,286	$ 1,586
Medical expense reimbursements	0	978	1,985
Total medical expenses	**$ 2,052**	**$ 3,264**	**$3,571**

In addition to leasing the corporation's farmland, Mr. Schmidt farmed land owned by others plus 80 acres that he did not convey to the corporation. He also had a dairy operation separate from that of the corporation and did custom work for other farmers. All of these activities were reported on Schedule F for the years in question. The three Schedules F reported net profits of $7,818, $2,843, and $72 respectively for 1995, 1996, and 1997.

In an examination, the IRS disallowed all of the claimed food and lodging and medical expenses. The position of the IRS was that the corporation failed to establish that the expenses were ordinary and necessary under IRC §162. The IRS contended the disallowed expenses constituted the Schmidt family's personal living expenses. As a result, the IRS treated the disallowed corporate expenses as constructive dividends on the Schmidt's 1995, 1996, and 1997 Forms 1040.

Issue. Whether the amounts paid by Hillside Dairy, Inc. to provide medical care, food, and lodging to its shareholders (Mr. and Mrs. Schmidt) and their children are (A) constructive dividends, or (B) expenses that are both deductible by the corporation and excludable as tax-free fringe benefits to the Schmidts.

Analysis and Holding for Food and Lodging Expenses. IRC §119 provides that meals and lodging are excludable to an employee if they are provided for the employer's convenience on the business premises of the employer. However, the employer, Hillside Dairy, Inc., **leased** the farmland, farm buildings, and the farm residence to the Schmidts under terms of the written lease.

The court concluded these expenses were not employer-related expenses. Rather, Mr. Schmidt contracted to perform farm labor as a tenant, not as an employee of the corporation. Therefore, the food and lodging expenses were neither deductible by the corporation nor excludable on the Schmidt's Forms 1040.

The court split the food and lodging expenses, disallowing a portion and allowing a portion to be deducted by the corporation and excluded by the Schmidts as follows:

1. Expenses disallowed to the corporation and treated as constructive dividends to the Schmidts:
   - Food for the family of four
   - Dining out meals
   - Utilities (house)

> **Note.** The total of these disallowed expenses was $10,285, $12,537, and $12,087 respectively for the fiscal years ending November 30 of 1995, 1996 and 1997.

2. Expenses allowed to the corporation and excluded on the Forms 1040 of the Schmidts:
   - Property taxes (house)
   - Insurance (house)
   - Depreciation (house)

> **Note.** The total of these allowed expenses was $2,190, $2,187, and $2,187 respectively for the fiscal years ending November 30 of 1995, 1996 and 1997. The court allowed these expenses because they were related to the ownership of the house. The corporation was the house owner.

The court ignored the **repayment of disallowed expenses** section in the corporate bylaws. It noted that "the conclusion is inescapable that the (disallowed) expenses constituted distributions by Hillside Dairy to the Schmidts."

Analysis and Holding for Medical Expenses. An employee's gross income does not include employer-provided medical insurance coverage.[1] These medical benefits must be received under a "plan for employees."[2] The court held that the corporation's written medical reimbursement plan did meet the "plan for employees" requirement since Mr. Schmidt was an employee. Also, the court noted that "plans limited to employees who are also shareholders are not per se disqualified under IRC §105(b)."[3]

The IRS contended that Mr. Schmidt's extremely low cash salary and the fact that he was also a shareholder were factors that should be considered. The IRS contended that Mr. Schmidt was under-compensated for the services he provided as an employee of the corporation.

The court concluded that the medical payments made by the corporation for the benefit of the Schmidt family were made under a "plan for employees" rather than a "plan for shareholders." Therefore, the medical costs were allowable as ordinary and necessary business expenses to the corporation and were excludable from the Schmidts' gross income.

Farmland Rental

***Gerald E. and Dorothy Johnson v. Commisioner*, TC Memo 2004-56, March 9, 2004**
IRC §1402

☞ Shareholder Lease of Farmland to Closely-Held Corporation Not Subject to SE Tax

Facts. Gerald Johnson began farming in Minnesota in 1962. Prior to 1989, Mr. and Mrs. Johnson owned 537 acres of farmland. In addition to farming the jointly owned 537 acres, Mr. Johnson rented 493 acres from other landowners.

In October 1989, the taxpayers incorporated their farming activity by forming G. E. Johnson, Inc. Mr. and Mrs. Johnson each owned 50% of the stock in the new corporation. During 1993, 1994, and 1995, the corporation farmed 1,813 acres of land, 617 acres of which were owned by the Johnsons. The remaining 1,196 acres were rented from other landowners.

During the three years in question (1993-1995), there was no written employment or rental agreements between the corporation and the Johnsons. The only corporate wages reported by the taxpayers on their joint Forms 1040 during the three-year period was $1,000. This $1,000 of corporate wages was paid to Mr. Johnson during 1994.

The taxpayers reported the following on Schedule E of their Forms 1040 for the cash rental of their farmland to the corporation during the three years in question:

Year	Rental Income	Rental Expenses	Net Rental Income
1993	$ 66,715	$34,265	$32,450
1994	60,000	31,240	28,760
1995	104,878	32,018	72,860

No self-employment tax was paid by either Mr. or Mrs. Johnson on their three Forms 1040 for 1993, 1994, or 1995.

In 1998, the IRS determined that the net rental income amounts shown above were subject to self-employment tax under IRC §1402(a)(1).

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1. IRC §106
2. IRC §105(e)
3. *Larkin v. Commr.*, 48 TC 629, July 31, 1967, affirmed by 1st Cir. Ct. of Appeals, 394 F. 2d 494, 68-1 USTC ¶9362, May 8, 1968

Immediately before the Tax Court trial, the taxpayers conceded that $44,878 of the $104,878 1995 rental income was in fact not rental income. Therefore, it was agreed between the taxpayers and the IRS that $44,878 was subject to self-employment (SE) tax on the 1995 Form 1040.

> **Note.** In effect, it was agreed that $44,878 was disguised compensation paid to Mr. Johnson in 1995 rather than actual rent paid for farmland.

Issue. Whether the 1993 and 1994 net rental income amounts of $32,450 and $28,760 and the modified 1995 net rental amount of $27,982 ($60,000 – 32,018) are subject to SE tax under IRC §1402(a)(1).

Analysis. The Tax Court took into consideration the fact that the 8th Circuit had reversed and remanded the Tax Court's prior decisions in three other similar cases. In those three prior cases, the Tax Court agreed with the IRS that SE tax was due. **It was indisputable that the 8th Circuit in the *McNamara* case[4] created a judicial exception for fair rental value when the landowner has two independent arrangements with the lessee (the corporation in this case) for rent and wages and there is no nexus between the two arrangements.**

Position of the Taxpayers. The taxpayers contended that they did receive fair market rental payments from the corporation during 1993, 1994, and 1995, after the $44,787 reduction to the 1995 reported rental income. Although this may result in little or no other compensation (wages) being paid to the taxpayers for services rendered to the corporation, this fact does not establish the required nexus between the oral rental agreement and the oral compensation agreement.

Therefore, **the corporation's obligation to make rental payments is separate and distinct from the taxpayers' material participation in the corporation's farming operation.** The taxpayers relied on the opinion of the 8th Circuit in *McNamara* which stated: **"Rents that are consistent with market rates very strongly suggest that the rental arrangement stands on its own as an independent transaction and cannot be said to be part of an 'arrangement' for participation in agricultural production."**

Position of the IRS. The taxpayers failed to meet the 8th Circuit's exception because they failed to enter into a separate employment agreement with the corporation. The taxpayers' classification of all funds received from the corporation as rent and none as wages demonstrates that there were no independent arrangements for (1) real estate rentals and (2) compensation for services.

In addition, the IRS asked the Tax Court in arriving at its decision to consider the following factors:

- The strict scrutiny that should be applied to related-party transactions, and that
- The exceptions from SE tax under IRC §1402(a)(1) are narrowly construed.

Holding. The Tax Court agreed with the taxpayers and held that the net rental income for 1993 and 1994 and the modified net rental income for 1995 were not subject to SE tax. The court stated "the rents were not derived under an arrangement within the meaning of IRC §1402(a)(1) and Treas. Reg. §1.1402(a)-4(b)(2)."

> **Note.** As shown in the recent *Solvie* Tax Court case,[5] the most important fact in deciding this issue is whether the rent paid is fair market rent. In the *Solvie* case, the rent paid by the corporation for a hog barn was too high with the result that SE tax was due on the shareholder's net rental income.

4. *McNamara v. Commr.*, 8th Cir. Ct. of Appeals, 263 F. 3d 410, 2001-1 USTC ¶50,188, December 29, 2000

5. *Jerre J. and Paulette M. Solvie v. Commr.*, TC Memo 2004-55, March 9, 2004

ALTERNATIVE MINIMUM TAX

Incentive Stock Options

Letter Ruling 200338010, September 19, 2003

IRC §§55 and 83

☞ AMTI includes ISO Transfers

Purpose. To determine when compensation income attributable to the exercise of certain incentive stock options (ISOs) are includible in alternative minimum taxable income (AMTI).

Facts. Taxpayer received ISOs in Year 1 on August 27 and November 18 subject to lock-up agreement restrictions. On May 5 of Year 2, the company sold common stock in an initial public offering. Taxpayer and other company insiders were not allowed to sell their options during the lock-up period which ran from May 5 through November 2 of Year 2. Taxpayer exercised some of his ISOs in July, August, and November of Year 2 and April, June, and August of Year 3. Taxpayer sold the shares acquired through the ISOs in August and December of Year 3.

On the tax return for Year 2, Taxpayer reported a tax preference item of $500,000 attributable to the ISOs and a total alternative minimum tax (AMT) liability of $151,000. Subsequently, on May 29 of Year 4, the company filed for bankruptcy.

Taxpayer then filed an amended return on October 16 of Year 4 requesting a $148,758 refund. Taxpayer contended the prior AMT preference amount of $500,000 should be reduced to zero since his restricted stock eventually became worthless.

Analysis. IRC §55 imposes an AMT upon certain tax preference items such as ISOs. For purposes of computing AMTI, IRC §56(b)(3) provides that §421 shall not apply to the transfer of stock acquired under the exercise of an ISO. IRC §83(a) property is not taxable until it is "transferred" to and "substantially vested" in the service provider. IRC §83(c)(1) provides that if the sale of property within six months after the purchase of the property could subject a person to suit under §16(b) of the Securities Exchange Act of 1934, the person's rights in the property are treated as subject to a substantial risk of forfeiture. Therefore, the rights in the property are not transferable until the **earlier** of (1) the expiration of the six-month period, or (2) the first day on which the sale of the property at a profit will not subject the person to suit under §16(b).

Conclusion. The IRS concluded that §16(b) did not impose a substantial risk of forfeiture on the shares since the §16(b) periods expired before the taxpayer first exercised his ISOs and the shares were transferred to him. The IRS also examined the taxpayer's legal lack of ability to sell his options during a specified period of time and concluded the taxpayer **would not have been subjected to a substantial risk of forfeiture**.

The IRS also concluded the spread amount when he exercised the options in Year 2 was properly includable in his AMTI. **Therefore, no reduction of the original $151,000 AMT liability in Year 2 is warranted**.

> **Note.** IRS Letter Ruling 200338011 involved a nearly identical situation except the executive involved also had to receive permission from the corporation's compliance officer before trading in company shares.

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AMT

***Scott William Katz v. Commissioner,* TC Memo 2004-97, April 7, 2004**

IRC §55

☞ AMT Assessment is Valid

Facts. The taxpayer, who filed his 2000 tax return as married filing separately, reported:

AGI	$45,834
Less: itemized deductions	(54,276)
Less: exemption	(2,800)
Taxable income	0

The taxpayer did not attach Form 6251 to his 2000 return. The IRS Service Center determined that $4,214 of AMT was due. The taxpayer did not agree.

Issue. Whether the assessment of AMT was correct.

Analysis and Holding. The taxpayer's plea to the court was that "Congress did not intend the AMT to apply to low or middle-income taxpayers like me." The Tax Court judge agreed that the $4,214 assessment of AMT was correct and noted: "Congress did give some considerations to the treatment of lower-income people. The relief Congress chose is embodied in IRC §55(d), which provides an exemption amount of $22,500 for Mr. Katz for 2000."

> **Note.** See the Chapter 8, AMT chapter for in depth coverage of AMT.

AMORTIZATION AND DEPRECIATION

Depreciation

Treasury Decision 9146, August 4, 2004

IRC §179

☞ Change in Election to Expense Under IRC §179

The IRS released regulations which allow taxpayers, who purchased assets qualifying for the IRC §179 expensing deduction in years beginning in 2003, 2004 and 2005, to amend returns and either elect to take the deduction or revoke a previous deduction.

IRC §179 only allows taxpayers to claim a §179 deduction on an original tax return. The deduction can be taken even if the return is not timely filed. However, the deduction or lack of deduction can only be changed on an amended return up to the original filing deadline including extensions.

The regulations issued on August 4, 2004 do not follow the Code. Instead, amended returns are permitted to either elect or revoke the expensing deduction. In order to file the amended return, the taxpayer must specify the property and the amount of the property's cost that is being taken into account. Once a return is amended, the election is irrevocable. However it is only irrevocable for the property and amount specified on the amended return.

Example 1. Charles purchased a backhoe for $80,000 in 2003. He elects to expense $50,000 on the 2003 return. When the return is audited in 2005, the IRS disallows $25,000 of deductions. Under the new regulations, Charles can elect to claim up to an additional $30,000 of §179 deduction on the backhoe. However, he must recalculate the original regular depreciation deduction.

Example 2. Selma purchases a 15 passenger van for her transportation business. The van costs $50,000 and she elects to expense $10,000 on her 2003 tax return. In 2004, Selma discovers unreported deductions of $12,000 due to an accounting error. She amends her 2003 return and revokes the election and deducts the regular depreciation instead. In 2005, the IRS examines the 2003 return and disallows $20,000 of deductions. While Selma can no longer claim the original $10,000 of §179 deduction, she can claim up to $40,000 of §179 on the remaining cost of the van, subject to the normal limits based on net profits and total purchases.

Note. The IRS made this regulation change to comply with the Committee Report on the 2003 Act. The Report indicated taxpayers should have maximum flexibility in making and revoking §179 elections on amended returns without IRS consent. Taxpayers must remember this change applies **only** for tax years beginning in 2003, 2004 and 2005.

Oil and Gas Depletion Rate

IRS Notice 2004-48, July 26, 2004
IRC §613A(c)(6)(C)

☞ 2004 Percentage Depletion Rate for Marginal Oil and Gas Properties

The percentage depletion for marginal production of oil and natural gas remains at **15% for 2004.** The reference price as determined under IRC §29(d)(2)(C) for the 2003 calendar year is $27.56 per barrel for domestic crude oil. The 15% rate applies to both independent producers and individual royalty owners.

Note. Until the price of domestic crude oil drops to below $20 per barrel, the 15% rate will remain in effect.

Depreciation Allowable

***Antonio B. Secapure v. Commissioner,* TC Memo 2004-18, January 28, 2004**
IRC §1016

☞ Allowable Depreciation Reduces Basis

Facts. The taxpayer bought the right to operate a Chevron gas station in 1988 for $65,000. The purchase contract allocated the $65,000 as shown:

Asset	Purchase Price
Tools, equipment, and office fixtures	$23,474
Goodwill	5,000
Leasehold right	21,526
Motor fuel	10,000
Inventory	5,000
Total purchase price in 1988	**$65,000**

The taxpayer did not purchase the building and land on which the Chevron station was located. He leased the station building from the seller.

In 1995, the taxpayer sold the right to operate the station for $200,000. Even though the taxpayer paid a preparer $1,375 to prepare his 1995 tax return, he never filed the completed return. The unfiled 1995 return did not report the sale of the Chevron station. In 1997, the IRS prepared and processed a substitute for return for the taxpayer's 1995 tax year. The IRS determined that the correct total tax on the 1995 substitute for return was $37,344. The largest item of gross income on the 1995 substitute return was a gain on the $200,000 sale of the right to operate the gas station.

Issue. Whether the basis of the Chevron station which was sold in 1995 was zero or $164,000 ($65,000 purchase price plus $99,000 improvements).

Analysis. The 1995 sales contract states that the taxpayer sold the Chevron gas station business, "including all improvements, fixtures, and equipment." In 1988, the taxpayer and the seller allocated $5,000 of the $65,000 purchase price to goodwill. Goodwill was not depreciable in 1988.[6]

The basis of depreciable property is reduced by the amount of allowable depreciation even if the taxpayer does not claim a depreciation deduction.[7]

Holding. The court concluded that the taxpayer had not shown that he had any remaining basis other than the $5,000 of goodwill purchased in 1988. His testimony regarding the alleged $99,000 of improvements was unconvincing. **Therefore, his adjusted basis for the 1995 sale was $5,000 rather than zero as the IRS had calculated.**

Depreciation

Treasury Decision 9133, June 25, 2004
IRC §280F

☞ Amended Return Opportunities May Exist for Some Taxpayers Before December 31, 2004

IRC §280F(a) limits annual depreciation deductions for passenger automobiles. Vans and light trucks are excluded from the definition of passenger automobile.

The IRS issued **temporary regulations** in 2003 which applied to property placed in service **on or after July 7, 2003.** These temporary regulations excluded from the definition of passenger automobile any truck or van that is a qualified non-personal use vehicle.

In the **final regulations** recently released by the IRS which expand the exclusion for certain vans and light trucks from the passenger automobile limitations, vehicles placed in service **before July 7, 2003** also qualify. However, the taxpayer must:

- Adopt that treatment in determining depreciation deductions on the his original return for the year in which the vehicle is placed in service, and
- Adopt that treatment on an amended return, filed for all applicable years, on or before December 31, 2004.

What Needs to be Done? By the end of 2004, preparers may either amend all open tax years or file a Form 3115, *Application for Change in Accounting Method,* to take advantage of some additional tax dollar savings.

Effective Date. These regulations are effective after June 25, 2004.

6. Treas. Reg. §1.167(a)-3
7. IRC §1016(a)(2) and Treas. Reg. §1.1016-3(a)(2)(i)

Like-Kind Exchanges

Treasury Decision 9115, March 1, 2004

IRC §§168, 179, 1031 and 1033

☞ IRS Issues Temporary and Proposed Regulations on Like-Kind Exchange or Involuntary Conversion Depreciation

Purpose. To provide temporary and proposed regulations for guidance to taxpayers on how to depreciate modified accelerated cost recovery system (MACRS) property acquired in a like-kind exchange or involuntary conversion.

Background. Notice 2000-4 was issued to eliminate the inconsistent treatments being used by taxpayers for property received in like-kind exchanges and involuntary conversions. **This notice provided a general rule that replacement MACRS property placed in service after January 3, 2000 is depreciated over the remaining recovery period of, and using the same depreciation method and convention as, the relinquished MACRS property.** The excess boot is treated as newly purchased MACRS property. **The general rule applies if the replacement property has the same or shorter recovery period, or the same or more accelerated depreciation method than the relinquished property.** Treasury Decision 9115 provides the temporary and proposed regulations for treatments provided in Notice 2000-4.

> **Note.** See pages 198–200 in the *2000 University of Illinois Farm Income Tax Workbook* for a thorough explanation of the depreciation changes mandated by Notice 2000-4, including examples. Notice 2000-4 is shown on page 605 of the same book.

The general rule does **not** apply if the replacement MACRS property has a **longer** recovery period or a **less accelerated depreciation method** than the relinquished property. Also, if the recovery period of the replacement MACRS is **longer** than that of the relinquished MACRS property, the taxpayer's exchanged basis in the relinquished MACRS property is depreciated beginning in the year of replacement over the remainder of the recovery period that would have applied to the replacement MACRS property. However, if the depreciation method of the replacement MACRS property is **less accelerated** than that of the relinquished property, then the taxpayer's exchanged basis in the relinquished MACRS property is depreciated beginning in the year of replacement using the less accelerated depreciation method of the replacement MACRS property.

Excess basis in the replacement MACRS property is treated as property placed in service by the acquiring taxpayer in the tax year actually placed in service or, if later, the tax year in which the relinquished MACRS property is disposed of. **Any excess basis is eligible for the §179 expense deduction.**

Deferred Exchanges. If the disposition of MACRS property occurs **prior to** acquisition of replacement property, the taxpayer is not allowed depreciation on the relinquished MACRS property for the period between disposal and acquisition.

Acquisition before Disposition. If replacement property is acquired prior to the disposition of the MACRS property, the taxpayer can depreciate the unadjusted basis of the replacement property until the MACRS property is relinquished.

Automobiles. If the replacement MACRS property is an automobile subject to the luxury auto depreciation limitation, the depreciation limitation is based on the date the vehicle is placed in service. The depreciation for the exchanged basis in the replacement MACRS property is limited to the allowable amount of the relinquished MACRS automobile had the transaction not occurred. Excess basis is limited to the luxury auto limitation for that tax year less depreciation allowed for the exchanged basis.

Additional First-Year Depreciation. The exchanged basis and excess basis of the replacement property are eligible for additional first-year depreciation deduction under IRC §168(k). For 50% bonus depreciation property disposed of in a like-kind exchange or involuntary conversion, the exchanged MACRS property is **ineligible** for additional first-year depreciation.

Election Out. Taxpayers may elect out of applying the temporary regulations. The taxpayer must treat the entire basis (both exchanged and excess basis) of the replacement MACRS property as being placed in service by the acquiring taxpayer at the time of replacement.

These regulations **do not apply** to property acquired to replace:

- Non-MACRS depreciated property.
- Excluded MACRS property via a valid election.
- Automobiles for which the taxpayer used the standard mileage rate method of deducting expenses.

Effective Date. The regulations are effective February 27, 2004.

Note. This regulation is covered in depth in Chapter 10, Issue 7, Depreciation.

Depreciation
Revenue Procedure 2004-20, March 29, 2004
IRC §§167, 168, 179 and 280F

☞ IRS Announces New Depreciation Limits for Business Autos, Light Trucks, and Vans Placed in Service in 2004

As a result of the current discounted car market, the **annual depreciation dollar caps** for vehicles are slightly lower for 2004. Annual depreciation dollar caps for **non-electric vehicles** that are subject to the luxury-auto limits of IRC §280F and placed in service after December 31, 2003 but before January 1, 2005 are shown in the table below.

	Annual Depreciation Limitations			
Vehicles Subject to Luxury Auto Limits	**Year 1**	**Year 2**	**Year 3**	**Year 4**
Autos (not qualified for bonus first-year depreciation)	$ 2,960	$4,800	$2,850	$1,675
Autos (qualified for bonus first-year depreciation)	10,610	4,800	2,850	1,675
Light trucks/vans (not qualified for bonus first-year depreciation)	3,260	5,300	3,150	1,875
Light trucks/vans (qualified for bonus first-year depreciation	10,910	5,300	3,150	1,875

If the business use of the vehicle is less than 100%, the dollar limits shown in the table must be reduced accordingly. For example, if a taxpayer buys a new auto in 2004 and uses it 60% for business, the first year dollar limit is $6,366 ($10,610 × 60%) if the auto is eligible for bonus first-year depreciation.

For **electric autos** placed in service during 2004, taxpayers can claim up to $8,880 if not eligible for bonus depreciation and $31,830 if eligible for bonus depreciation.

SUV's rated at more than 6,000 pounds gross (loaded) vehicle weight are exempt from the caps since they fall outside the IRC §280F(d)(5) definition of a passenger auto. Those vehicles used 100% for business may be expensed under §179, or a substantial amount may be depreciated in the year the vehicle is placed in service if it is eligible for bonus depreciation. **Congress is currently considering restrictions on deductions for heavy SUVs. If the law is changed, a limitation of $25,000 would apply effective for vehicles placed in service after February 2, 2004 or possibly a later date.**

Taxpayers who **lease** a business auto may deduct the portion of the lease for the actual business usage. For example, if a taxpayer uses a leased auto 75% for business and 25% for personal, the deduction on the tax return is **limited** to 75% of the lease payment plus 75% of the leased vehicle's operating expenses. To ensure that the luxury auto limitations are considered, taxpayers must include a certain amount in income during each year of the lease to partially offset the lease deduction.[8] The income inclusion amount varies depending on the FMV of the leased auto, year of the lease, and it is adjusted annually for inflation. (See Tables 7 and 8 of Rev. Proc. 2004-20 for non-electric vehicles and Table 9 for electric vehicles.)

An employee's personal use of an employer-provided auto is treated as fringe benefit income which is valued using one of several methods. One of the methods is the **cents-per-mile valuation rule** which is computed using the mileage allowance rate of 37.5¢ per mile in 2004. This method is only available for use if the FMV of the auto does not exceed $14,800 in 2004. Other methods available include general valuation rules of Treas. Reg. §1.61-21(b) or special valuation rules of Treas. Reg. §1.61-21(d) (Automobile lease valuation) or Treas. Reg. §1.61-21(f) (Commuting valuation).

Note. See Chapter 10, Issue 7 for more information on automobiles subject to listed property limits.

BAD DEBT

Shareholder Loans to Corporation

Kenneth W. and Fayetta Graves v. Commissioner, **TC Memo 2004-140, June 15, 2004**
IRC §§62, 63, 67 and 166

☞ Shareholder Loans Were Business Bad Debts Deductible on Schedule A

Facts. Kenneth Graves was the sole shareholder-employee of a trucking company. The corporation experienced cash flow problems. In order to continue operating and meet the payroll for 26 employees, including himself, Mr. Graves personally loaned $86,000 to his corporation in 1995. The corporation petitioned for bankruptcy under Chapter 7 in July 1996, and it was approved by the bankruptcy court in December 1996. As a result, the shareholder loans were worthless at year-end of 1996.

The taxpayers deducted $86,000 as an ordinary loss in Part II of their 1996 Form 4797. The loss was fully deducted on the taxpayers' 1996 Form 1040, line 14 as "Other gains or (losses)." The IRS determined that the $86,000 was a business bad debt and treated it as a miscellaneous itemized deduction for 1996.

Issue. Whether the bad debt is deductible in arriving at AGI or as an itemized deduction in computing taxable income.

Analysis. The IRS agreed in its stipulations to the Tax Court that the loans were made by Mr. Graves "to maintain his employment" with his failed corporation. A business bad debt is deductible as an ordinary deduction in the year the debt becomes worthless.[9] It is well established that being an employee may be a trade or business for purposes of deducting bad debts.[10]

Position of the IRS. The $86,000 bad debt originated from the taxpayer's trade or business as a corporate employee. Under IRC §62, the business bad debts of employees are deductible on Form 2106, *Employee Business Expenses.* As such, they are deductible as miscellaneous itemized deductions, subject to the 2% of AGI limitation.

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8. IRC §280F(c)

9. IRC §166(a)(1)

10. *Trent v. Commr.*, 2nd Cir. Ct. of Appeals, 291 F.2d 669, 61-2 USTC ¶9506, March 27, 1961

Position of the Taxpayers. The $86,000 bad debt should have been claimed as a business expense on the 1996 Schedule C, not on Form 4797 as shown on the return.

Holding. The Tax Court held that Mr. Graves made the loans to maintain his employment with his trucking company rather than to protect his stock investment. The IRS had agreed to that fact before the trial began. Therefore, the $86,000 was a worthless business bad debt in 1996. **The court noted that Mr. Graves was not in the trade or business of lending money; rather, he was in the trade or business of operating his trucking company.**

The court agreed with the IRS that the business bad debt was properly deductible on Schedule A as an unreimbursed employee business expense.

Bad Debt

***David G. and Cynthia L. Lagraff v. Commissioner,* TC Summary Opinion 2003-150, October 14, 2003**

IRC §166

☞ Bad Debt Deduction Requires Prior Inclusion in Income

Facts. David Lagraff was a self-employed loan officer who worked for Anderson Mortgage Company (Anderson) from late 1998 through May 1999. In this capacity, he earned commissions for mortgage loans which he procured, funded, and closed. The contract he signed with Anderson stated:

"Upon termination, any loans procured but not funded or closed will become the property of Anderson and no compensation will be due David Lagraff."

In May 1999, Anderson terminated its relationship with Mr. Lagraff. He later contacted an attorney who wrote Anderson a letter. It stated that "Mr. Lagraff was due approximately $15,000 in commissions for loans that he worked on before his termination and which have, in fact, been funded and closed since his termination." Anderson refused to pay the requested additional $15,000 commission.

On their joint 1999 tax return, they attached a Schedule C to report Mr. Lagraff's business as a loan officer. On it, a $15,000 business expense was claimed for "bad debts from sales or services." **However, as cash-basis taxpayers, the $15,000 of alleged commissions due from Anderson had never been reported.** In an exam, the IRS disallowed the $15,000 bad debt deduction.

Issue. Whether the taxpayers are entitled to a $15,000 bad debt deduction on the 1999 Schedule C.

Analysis. Worthless debts arising from **unpaid** wages, salaries, fees, rents, and similar items of taxable income shall not be allowed as a deduction under IRC §166 unless the income has been included in income on a filed return.[11]

Holding. The amount of the alleged bad debt represents commissions which the taxpayer asserts he was owed for services rendered as an independent contractor. However, the commissions in question were never paid to him. **The Treasury Regulations under IRC §166 clearly prohibit the deduction of the alleged $15,000 bad debt.**

> **Note.** At the Tax Court trial, Mr. Lagraff offered that "I did not report the $15,000 as income since I never received it. But, I will declare it if that would fix the problem." The Tax Court noted that if the $15,000 was reported as income on the 1999 Schedule C along with the bad debt deduction, the two items would have cancelled each other and the result would be the same.

11. Treas. Reg. §1.166-1(e)

BANKRUPTCY AND INSOLVENCY

NOLs of Bankruptcy Estate

Oren L. Benton v. Commissioner, **122 TC 353, No. 20, May 12, 2004**
IRC §1398

☞ Taxpayer can Carryback Pre-Bankruptcy NOLs Not Used by Bankruptcy Estate

Facts. Mr. Benton had interests in three entities that were involved in the ownership and operation of the Colorado Rockies baseball team. In February 1995, he (and his related entities) filed a voluntary Chapter 11 reorganization bankruptcy petition. Mr. Benton incurred NOLs in tax years prior to 1995. In addition, his bankruptcy estate incurred tax losses.

An amended bankruptcy plan (the plan) provided that on August 31, 1997, most of the bankruptcy estate's assets would be transferred into a liquidating trust for the benefit of the creditors. **The plan was confirmed by the bankruptcy court judge on August 18, 1997.** The creditors agreed in the plan that all tax attributes would go to Mr. Benton upon confirmation of the plan.

On September 1, 1997, the first day following the effective date of the plan, Mr. Benton was discharged from his debts. He was also relieved of his status as "debtor-in-possession." However, as of December 31, 1997, the bankruptcy court had not entered a formal closing order for the Chapter 11 proceeding.

On his 1997 tax return, Mr. Benton claimed approximately $84 million in NOLs. These NOLs arose **before** his bankruptcy proceeding began and had not been used in his bankruptcy estate. In 1999, Mr. Benton filed Forms 1040X (amended return) for 1995 and 1996 on which he attempted to carryback the $84 million 1997 NOL.

The IRS denied the refunds requested on the amended 1995 and 1996 returns.

Issue. Whether the taxpayer is entitled to carryback the $84 million NOL reported on his 1997 return to his 1995 and 1996 returns.

Analysis. The issue centered on the technical interpretation of IRC §1398.

The Taxpayer's Position. The termination of the Chapter 11 bankruptcy proceeding occurred upon:

- The confirmation of the plan (on August 18, 1997), **and**
- The discharge of debt (on September 1, 1997).

The Position of the IRS. The termination of the bankruptcy proceeding does not terminate until closed by a final order of a bankruptcy court, which occurred in 1998 for the taxpayer's proceeding.

Holding. The Tax Court agreed with the taxpayer's position. Therefore, Mr. Benton could carryback pre-bankruptcy NOLs not used by his bankruptcy estate to the 1995 and 1996 tax years. Those NOLs could be applied for the year of the commencement of the bankruptcy (1995) and later years (1996).

The court observed that in a Chapter 11 bankruptcy reorganization plan, the debtor is generally discharged at the time the plan is confirmed.

> **Note.** Chapter 11 bankruptcy rules differ in many respects from Chapter 7 bankruptcy proceedings.

Cancellation of Indebtedness

***Charles and Marianne T. Anderson v. Commissioner,* TC Summary Opinion 2003-169, December 18, 2003**
IRC §§61 and 108

☞ Cancelled Credit Card Debt is Taxable

Facts. Mr. Anderson allowed a friend, Ms. Feathers, to use his Citibank credit card with the understanding that she would be responsible for any charges she made. Ms. Feathers incurred about $4,600 of credit card charges and did not repay Mr. Anderson. A collection agency contacted Mr. Anderson and offered to settle the credit card debt for approximately 70% of the amount due, or $3,200. He agreed to the offer and later received a Form 1099-C from Citibank for the cancelled debt amount of $1,400.

The $1,400 reported on the Form 1099-C was omitted from the taxpayers' joint 1999 tax return. The IRS assessed additional tax of $420. The case went to Tax Court because Mr. Anderson contended that he did not receive the 1999 Form 1099-C from Citibank.

Issue. Whether the $1,400 cancellation of indebtedness income represents gross income for the 1999 tax year.

Analysis. Gross income includes all income from whatever source derived.[12] Discharge of indebtedness is specifically included as an item of gross income.[13] Under IRC §108, exclusions from gross income apply for certain discharges of indebtedness, including Title 11 bankruptcy and insolvency of the taxpayer.

Holding. Since the taxpayers met none of the exceptions provided in IRC §108, the Tax Court held that the Form 1099-C amount represented taxable income. Mr. Anderson's contention that no Form 1099-C was received, which was disputed by the IRS, was ignored. The court stated: "The nonreceipt of a Form 1099 does not convert a taxable item to a nontaxable item."[14]

BUSINESS EXPENSES

Cell Phone Expense

***George W. Moss and Gwendolyn Arline-Moss v. Commisioner,* TC Summary Opinion 2004-56, May 12, 2004**
IRC §274

☞ Cell Phone Expense Not Allowed to Realtor

Facts. Mrs. Arline-Moss was employed full-time by the state of Michigan. She also worked part-time as a real estate salesperson. Her real estate broker's office had only 12 desks from which the 63 salespersons worked. Due to the difficulty in obtaining work space at her broker's office, she established an office in the basement of her home.

In her home office, she installed a telephone line that was separate from the personal home telephone. The line serviced her business phone number, a fax number, and an Internet line. In addition, she was billed for cell phone service. During 1998, the total amount Mrs. Arline-Moss paid for these services was $4,128. She deducted the entire amount as a business expense on the 1998 Schedule C for her real estate sales activity.

In addition to other exam adjustments to the taxpayers' 1998 tax return, the IRS determined that Mrs. Arline-Moss was not entitled to the telephone deduction on her Schedule C. The position of the IRS was that the strict recordkeeping requirements of IRC §274(d) had not been met.

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12. IRC §61(a)
13. IRC §61(a)(12)
14. *Vaughan v. Commr.*, TC Memo 1992-317 and affirmed by the 9th Circuit Ct. of Appeals, 15 F.3d 1095 (1993)

Issue. Whether the $4,128 deduction for telephone expenses, including cell phone charges, is allowable.

Analysis. For certain business expenses specified in IRC §274(d), stringent substantiation requirements apply. Unless the taxpayer meets the requirements for adequate records, the claimed expenses are not allowable. The strict recordkeeping requirements apply to any travel expenses, including meals and lodging while away from home, gifts, entertainment and "listed property."

The term "listed property" includes cellular phones and other similar telecommunications equipment such as pagers.[15]

The records required by IRC §274(d) include:

1. **Amount of expense,**
2. **Time and place of expense,**
3. **Business purpose of expense, and**
4. **Business relationship to the taxpayer of person(s) involved in the expense.**

Holding. At the trial, the only evidence Mrs. Arline-Moss submitted were monthly bills from the telephone company. The Tax Court judge held that this evidence did not meet the strict recordkeeping requirements for the cell phone expense. Therefore, **the court allowed a telephone deduction of $1,148 which represented the amount paid for services other than for the cell phone**. The balance of $2,980 was properly denied by the IRS.

> **Note.** See Chapter 10, Issue 2, Recordkeeping, for more information on this topic.

Unreimbursed Partnership Expenses

Michael T. Hines v. Commissioner, **TC Summary Opinion 2004-55, May 12, 2004**
IRC §§162 and 6662

☞ Alleged Unreimbursed Partnership Expenses Not Allowed on Partner's Individual Return

Facts. During 2000, Michael Hines was a 50% general partner in an entertainment management partnership. The partnership agreement specifically provided that "the partnership had a non-reimbursement policy when expenses are incurred outside the partnership." The 2000 Form 1065 reported the following:

Total income	$332,973
Total deductions	(233,899)
Ordinary income	$ 99,074

Mr. Hines received a Schedule K-1 showing ordinary income of $49,537 (50% of $99,074). On his Schedule E, Part II, he reported a net amount of only $16,122, calculated as follows:

Schedule K amount of ordinary income	$ 49,537
Less: unreimbursed partnership expenses	(33,415)
Nonpassive income from Schedule K-1	$ 16,122

15. IRC §280F(d)(4)(A)(v)

The IRS determined that the taxpayer was liable for the following additional tax and penalty for the 2000 taxable year:

- $9,500 additional income tax
- 20% accuracy-related negligence penalty of $1,897

Issues.

1. Whether the taxpayer is entitled to reduce the reported Schedule K-1 ordinary income by unreimbursed partnership expenses he allegedly paid.
2. Whether the taxpayer is liable for the accuracy-related negligence penalty under IRC §6662(a).

Analysis for Issue 1. The taxpayer contended that he paid $33,415 of unreimbursed partnership expenses and that he and his partner had a **verbal agreement** that he would not seek reimbursement from the partnership for those expenses.

At trial, the taxpayer offered no evidence, other than his oral testimony, that the verbal agreement existed. In addition, he failed to prove that he was required under the alleged agreement to pay partnership expenses from his own funds.

It is well established that a partner may not directly deduct partnership expenses on his individual return.[16] An **exception** applies when there is an agreement among the partners in a partnership agreement, or in a routine partnership practice tantamount to an agreement, which calls for a partner to pay partnership expenses from his own funds.[17]

Holding for Issue 1. The Tax Court upheld the IRS assessment of $9,500 of additional income tax. The court noted: "Whether or not Mr. Hines ever made any alleged unreimbursed payments, he was not required by the partnership agreement to make them, nor did he prove there was a level of routine partnership practice tantamount to an agreement to do so." Therefore, the court concluded that no deduction of the alleged expenses was allowable.

Analysis for Issue 2. IRC §6662(a) imposes a 20% penalty on the portion of any underpayment of tax attributable to negligence or disregard of rules and regulations.[18] Negligence is any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws.[19] In addition, negligence is the failure to exercise due care or failure to do what a reasonable and prudent person would do under the circumstances.[20]

No penalty is imposed if it is shown that there was reasonable cause and that the taxpayer acted in good faith.[21]

Holding for Issue 2. The court held that the assessed $1,897 accuracy-related negligence penalty was properly applied. The taxpayer's actions were neither prudent nor reasonable.

16. *Cropland Chemical Corp. v. Commr.*, 75 TC 288, November 25, 1980 and affirmed in an unpublished opinion by the 7th Cir. Ct. of Appeals, 665 F. 2d 1050 (1981)
17. *Cropland Chemical Corp. v. Commr.*, *supra* at 295
18. IRC §6662(b)(1)
19. IRC §6662(c)
20. *Ralph and Virginia G. Neely v. Commr.*, 85 TC 934, December 17, 1985
21. IRC §6664(c)

Lack of Substantiation

***Victor Woods v. Commissioner,* TC Memo 2004-114, May 11, 2004**

IRC §§274 and 280A

☞ Schedule C Expenses Denied for Lack of Substantiation

Facts. The taxpayer was a self-employed motivational speaker. His 1999 Schedule C reported the following:

Gross receipts		$16,020
Less expenses:		
Automobile expense	$5,781	
Insurance	984	
Legal services	1,000	
Office expense	250	
Vehicle lease expense	900	
Rent of other business property (home office)	1,524	
Telephone	1,500	
Business supplies	1,500	
Credit card payments	1,200	
Cellular telephone	1,250	
		(15,889)
Schedule C net profit		$ 131

The IRS disallowed all of the Schedule C expenses, resulting in a tax deficiency of $3,438.

Issue. Whether the taxpayer is entitled to deduct his claimed Schedule C expenses for 1999.

Analysis. Deductions are a matter of legislative grace, and a taxpayer bears the burden of proving that he has complied with the specific requirements for a deduction he claims.[22] Under IRC §162, a taxpayer may deduct all ordinary and necessary trade or business expenses paid or incurred, if sufficient records are maintained to substantiate the expenses.[23] However, traveling expenses and expenses pertaining to listed property, which include a passenger automobile, computer or peripheral equipment, and cellular telephones, are deductible only if the taxpayer meets the stringent substantiation requirements of IRC §274(d).

With regard to home office expenses, deductions arising from the use of a dwelling unit that is used by a taxpayer as a residence are generally disallowed.[24] An exception is provided if the taxpayer proves a portion of the dwelling unit was used exclusively and regularly as his principal place of business.[25] Two other exceptions are also provided.[26]

Before the trial, the taxpayer did not cooperate in informal discovery proceedings by providing the IRS with any documentation or written evidence to substantiate his claimed Schedule C expenses. During the trial, the only evidence the taxpayer presented was a July 14, 1999 newspaper article that discussed his background and motivational speeches.

No records were produced at trial regarding business or total mileage or the amount, time, and business purpose for car expenses. Likewise, no records, documents, or other evidence were introduced to substantiate any business use of the computer or cellular phone. The taxpayer admitted that the legal expenses pertained to a custody battle for his daughter.

Holding. The court agreed with the IRS determination that no Schedule C expenses were allowable.

22. *Indopo, Inc. v. Commr.*, 112 Supreme Ct. 1039, 503 U.S. 79 (1992), 92-1USTC ¶50,113, February 26, 1992
23. IRC §§162(a) and 6001
24. IRC §280A(a)
25. IRC §280A(c)(1)(A)
26. IRC §§280A(c)(1)(B) and (C)

Meals and Entertainment Expenses

Revenue Procedure 2004-29, May 3, 2004

IRC §274

☞ IRS Allows Use of Statistical Sampling for Certain Meals and Entertainment Expenses

Purpose. To allow employers to apply an easy-to-use statistical sampling method to establish the amount of substantiated, fully deductible meals and entertainment expenses. These expenses are excepted from the 50% deduction disallowance of IRC §274(n)(1) by reason of IRC §§274(n)(2)(A), (B), (C), (D), or (E) and include:

- Expenses paid or incurred under a reimbursement arrangement in connection with the performance of services
- Meals and entertainment used as compensation
- Recreational perks for rank-and-file employees
- Meal expenses excludable as de minimis fringe benefits
- Tickets to charitable sports events
- Expenses includible in income of persons who are not employees

Prior to the use of the sampling method, a written sampling plan is required. Taxpayers are required to maintain adequate documentation to support the statistical application, sample unit findings, and all aspects of the sample plan and its use. Sampling standards, documentation standards, and technical formulas are provided in appendices of the revenue procedure.

This method is available for use for tax years ending **on or after May 3, 2004 and can apply to open tax years with IRS permission.** The sampling method can be used by employers to recalculate deductions retroactively on the original tax return and file a claim for refund accordingly. The method is also available for use in audits or pending litigation.

> **Note.** The sampling method **cannot** be used to substantiate deductions for meal and entertainment expenses under IRC §274(d) or items subject to the 50% limit described in IRC §274(n)(1).

CAPITAL GAINS AND LOSSES

Investor versus Trader

***Frank Chen v. Commissioner,* TC Memo 2004-132, June 1, 2004**

IRC §§165, 475 and 1211

☞ Software Engineer Was an Investor, not a Trader, for Stock Losses Incurred

Facts. In 1999, Mr. Chen was employed full-time as a software engineer. His 1999 wages were approximately $75,000. He lost $85,000 on 323 stock trades that were completed in 1999. Of these 323 trades, approximately 94% occurred during February, March, and April 1999, with none occurring in six of the other nine months. Mr. Chen held most of the purchased stock for less than one month.

On his 1999 tax return, Mr. Chen deducted his $85,000 of stock trade losses as a business loss rather than reporting the trades on Schedule D. In its exam, the IRS determined that Mr. Chen did not qualify as a "trader" and reclassified him as an "investor." **The IRS limited his 1999 loss on stock trades to the $3,000 maximum allowed by IRC §1211(b).**

There was a dispute between the IRS and Mr. Chen as to whether he made the necessary mark-to-market election under IRC §475(f)(1) for the 1999 tax year. In order to fully deduct his $85,000 of stock trade losses, an election was required by April 15, 1999, the original due date of his tax return for the preceding tax year (1998 return).

Issue. Whether the taxpayer's net loss from stock trades during 1999 is deductible in full or is subject to the $3,000 limitation for net capital losses.

Analysis. In general, a person who buys and sells securities falls into one of three distinct categories: dealer, trader, or investor. A dealer's securities transactions can be exempt from the capital loss limitations imposed by IRC §1211(b). In addition, **a trader can make a mark-to-market** election under IRC §475(f)(1). **If that election is timely made, the gain or loss is treated as ordinary income or loss, and reported in Part II of Form 4797**.[27] Therefore, it is possible for a trader to be exempt from the maximum $3,000 capital loss limitation if the election is properly made.

To qualify as a trader rather than an investor, relevant factors must be considered, including the following:

- The taxpayer's investment intent
- The nature of the income to be derived from the activity
- The frequency, extent, and regularity of the taxpayer's securities transactions.[28]

In order for a taxpayer to qualify as a trader, the taxpayer's trading activity must be "substantial." It must also be "frequent, regular, and continuous."[29] Sporadic trading does not satisfy the "frequent, regular, and continuous" requirement.

Holding. The Tax Court held that Mr. Chen's 1999 stock trading activity, even though "substantial", did not meet the "frequent, regular, and continuous" test. The reasoning of the court was that since the taxpayer did not make any stock trades during six months in 1999, that test was not met. In addition, the fact that Mr. Chen was a full-time employee was not supportive of qualifying as a trader.

Since the court determined that Mr. Chen did not qualify as a trader, the dispute over the mark-to-market election became a moot issue the court did not consider. **The court agreed with the IRS that Mr. Chen's 1999 net stock loss was limited to $3,000.**

> **Note.** For more information on the mark-to-market election for legitimate traders, see Rev. Proc. 99-17 and IRS Letter Ruling 200423015. This case is further evidence that qualifying as a trader rather than an investor is very difficult to do.

RIC and REIT Dividends

IRS Notice 2004-39, May 7, 2004

IRC §1

☞ RIC and REIT Dividends May Qualify for Lower Capital Gain Rates

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Purpose. To explain the reduction in rates of capital gain dividends paid (or accounted for as if paid) by regulated investment companies (RICs) (also known as **Mutual Funds**) and real estate investment trusts (REITs) in taxable years that end **on or after May 6, 2003**.

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27. IRC §475(d)(3)

28. *Joseph A. and Dorothy D. Moller v. United States*, Federal Cir. Ct. of Appeals, 721 F. 2d 810, 83-2 USTC ¶9698, November 18, 1983

29. *Nathan Boatner v. Commr.*, TC Memo 1997-379, affirmed by 9th Cir. Ct. of Appeals, 164 F. 3d 629, 98-2 USTC ¶50,785, September 22, 1998

Background. Prior to enactment of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), long term-capital gains and losses of a noncorporate taxpayer fell into one of three tax-rate groups:

- 20%
- 25%
- 28%

For those falling in the 20% group, certain taxpayers formerly qualified for a 10% rate or an 8% rate if the gain was qualified 5-year gain.

JGTRRA reduced the rates in the 20% group to 15%, 5%, and repealed the 8% rate on qualified 5-year gain, for gains occurring after May 6, 2003.

Notice 2004-39 was issued and revises Notice 97-64, 1997-2 C.B. 323, which was issued to describe regulations for capital gain dividends of RICs and REITs effective for taxable years ending **on or after May 7, 1997**.

Application. If a RIC or REIT designates a dividend as a capital gains dividend, an additional dividend may be designated as a 15% gain distribution subject to limitations provided in Notice 97-64.

The RIC or REIT determines maximum distributable amounts which can be designated in each class of capital gains dividends using a computation required by IRC §1(h). This computation assumes the RIC or REIT is owned by an individual whose ordinary income is subject to a marginal tax rate of at least 28%. The maximum distributable gain in each class of capital gains dividends equals the amount that is multiplied by the rate gain percentage. Modification occurs in the following ways:

- Qualified dividend income does not increase net capital gain
- Deferral adjustment or bifurcation adjustment made
- JGTRRA transition rules taken into account

JGTRRA transitions rules apply at both the RIC/REIT level and shareholder level. Generally, for pass-through entities, the determination of gains and losses are made at the entity level.

> **Example 3.** A RIC pays a capital gain dividend in 2004 which is properly designated as a 20% rate gain distribution. The dividend is received by a fiscal year trust in a year that includes May 6, 2003. It is treated by the trust as gain that is properly taken into account for the portion of the tax year before May 6, 2003.

Conversely, if the same capital gain dividend is received by an individual shareholder, or a trust, whose tax year is the calendar year, the dividend is subject to tax at a rate no higher than 15% because the JGTRRA transition rules apply only to shareholder tax years that include May 6, 2003.

Loss Deductions
IRS Notice 2004-27, March 26, 2004
IRC §165

☞ Decline in Stock Value Due to Corporate Misconduct is Not a Theft Loss

There are many recent incidents of accounting fraud or illegal misconduct by corporate officers or directors. Some taxpayers treated declines in the value of stock caused by fraud or misconduct as a **theft loss** on their tax returns. The IRS disagrees with this position and disallows deductions claimed and may impose penalties under IRC §6662.

IRC §165(a) provides for the deduction of any loss sustained during the taxable year not compensated for by insurance or otherwise. Such loss must be evidenced by a closed and completed transaction, fixed by an identifiable event or events, and actually sustained during the taxable year.[30] **No deduction is allowed solely on account of a decline in the value of stock owned by the taxpayer when the decline is due to a fluctuation in the market price of the stock or similar cause.**[31] The loss is allowed in the year it is actually sustained as the result of sale or exchange or if the stock becomes worthless. In addition, stock held for investment is a capital asset under IRC §1221 and any resulting losses are considered capital losses.

The courts have agreed with the position taken by the IRS. In *Paine,*[32] the taxpayers claimed a theft loss deduction for a decline in value of stock which resulted from corporate official misrepresentations of the financial status. **The court noted that the taxpayers did not purchase the stock from the corporate officers who made the misrepresentations but on the open market.** Other references include:

- *Donald W. Crowell v. Commr.,* TC Memo 1986-314, July 28, 1986
- *Donald A. De Fusco v. Commr.,* TC Memo 1979-230, June 12, 1979
- *Herbert and Gladys Barry v. Commr.,* TC Memo 1978-215, June 8, 1978
- Rev. Rul. 77-17, 1977-1 C.B. 44

Accordingly, such stock losses are allowed as capital losses only when the stock is sold, exchanged, or becomes wholly worthless. Capital losses first offset capital gains and only $3,000 ($1,500 if married filing separately) of an excess loss is deductible against ordinary income each year.

> **Note.** See Chapter 1, Problem 1 for additional information.

CASUALTY LOSS

Flood Damage

***Pamela S. Cooper v. Commissioner,* TC Summary Opinion 2003-168, December 17, 2003**
IRC §165

☞ Washing Machine Malfunction Results in Allowable Casualty Loss

Facts. A hose connecting the sink to Ms. Cooper's washing machine split, resulting in water damage to carpets, furniture, and a water heater. She filed a claim for a $38,000 flood loss with her insurer. The insurer failed to pay the claim. Following a lawsuit filed by Ms. Cooper, the insurance company paid her a $12,500 settlement in 1998.

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30. Treas. Reg. §1.165-1(b)

31. Treas. Reg. §1.165-4(a)

32. *Lester A. Paine v. Commr.,* 63 TC 736, March 31, 1975, aff'd without published opinion, 523 F.2d 1053 (5th Cir. November 1975)

On her 1998 tax return, Ms. Cooper reported a total casualty loss from the flood of $130,851. That loss, reported on Form 4684, is shown below:

	Real Property	Personal Property	Total
Original cost	$100,000	$216,330	$316,330
Fair market value before casualty	142,000	112,059	254,059
Less: Fair market value after casualty	(100,000)	(5,580)	(105,580)
Less: Insurance reimbursement (incorrect)	(10,000)	0	(10,000)
Casualty loss	$ 32,000	$106,479	$138,479
Less: Personal loss floor			(100)
Less: 10% of 1998 AGI			(7,528)
Casualty loss deducted on the 1998 tax return			**$130,851**

In its examination, the IRS disallowed the casualty loss because the taxpayer "did not establish that the failure of the washing machine hose, and subsequent water damage, constitute a casualty with the meaning of IRC §165." As an alternate position, the IRS argued that even if a casualty occurred, the taxpayer's records were inadequate to prove the substantial amount of the loss claimed. The IRS assessed additional 1998 tax of about $13,000 plus a failure to timely file penalty of $3,242.

Issue. Whether Ms. Cooper is entitled to deduct a casualty loss, and if so, the correct amount of the loss.

Analysis. IRC §§165(a) and (c)(3) allows an individual a deduction for loss of personal use property if the loss arises from fire, storm, shipwreck, or **other casualty** if not compensated for by insurance or otherwise. The term **other casualty** was defined by the courts as a loss caused by a "sudden, unexpected, or unusual event, but excluding any loss caused by the progressive deterioration of property through a steadily operating cause or by normal depreciation."[33]

Holding. The Tax Court held that since the washing machine and the hose connection were at least nine years old when the hose split, the failure of the hose was due to progressive deterioration. Therefore, the failure of the hose itself did not qualify as an **other casualty.** But the court reasoned that the consequential water damage resulting from the failure of the hose did qualify as an **other casualty.** The court noted that "the water damage to the taxpayer's house and belongings was the result of an identifiable event which was sudden in nature."

The court also relied on Rev. Rul. 70-91 to distinguish between damage to equipment, which is gradual, and the consequential damage resulting from failure of the equipment.

As to the amount of the allowable casualty loss, the court found that the taxpayer's estimated FMV of the personal property prior to the casualty of $112,059 was unreasonably excessive. The correct figure, according to the court, was only $46,000. In addition, the court allowed no casualty loss to the house itself. **Therefore, the correct amount of the casualty loss was only $20,292 after subtracting the $100 floor, 10% of AGI, and the $12,500 insurance proceeds.**

33. *John A. and Madeline Maher v. Commr.*, 11th Cir. Ct. of Appeals, 680 F. 2d 91, 82-2 USTC ¶9460, July 6, 1982

CORPORATIONS

Unreasonable Compensation

***Metro Leasing and Development Corporation v. Commissioner,* 9th Cir. Ct. of Appeals, No. 02-73933, 2004-2 USTC ¶50,308 (July 23, 2004) [affirming the prior Tax Court decision: TC Memo 2001-119, 81 TCM 1644 (2001)]**
IRC §162

☞ Sole Shareholder and Wife Received Unreasonably High Salaries

Facts. George Valente was the sole shareholder, officer, and director of Metro Leasing & Development Corp., the taxpayer. He was ill in 1995 and his wife Lena temporarily replaced him as president. The only other employee in 1995 was a bookkeeper. The corporation's total 1995 income of $900,000 was 30% higher than the average total income during the preceding three-year period, 1992–1994.

The corporation paid Mr. and Mrs. Valente a total of $240,435 in salaries during 1995, including year-end bonuses of $180,435. Mr. Valente determined his salary and bonus each year based on the profitability of the company. No dividends were paid to Mr. Valente in 1995. However, he did receive dividends ranging from $10,000 to $60,000 during 1988-1993.

The IRS determined that Metro Leasing should be allowed to deduct only $76,800 of the $240,435 total compensation paid in 1995 to the Valentes. The remaining $163,635, according to the IRS, was unreasonable salary and therefore not deductible under IRC §162(a)(1).

In the prior 2001 Tax Court trial, the court determined that an additional $12,950 should be added to the $76,800 reasonable salary determined by the IRS. Thus, **the Tax Court allowed Metro Leasing to deduct a total of $89,750 as reasonable compensation paid to Mr. and Mrs. Valente for 1995.**

Issue. Whether the Tax Court properly determined the amount of reasonable officer's salary that may be deducted in 1995.

Analysis. The reasonableness of an officer's compensation is a factual determination to be made in light of all the evidence. The 9th Circuit had previously established a five-factor analysis to determine the issue.[34]

These five factors are:

1. The officer's role in the corporation;
2. The salaries paid by similar companies for like services;
3. The character and condition of the corporation;
4. Any conflicts of interest in which the corporation may be disguising nondeductible shareholder dividends as salary; and
5. The internal consistency of the compensation plan

Holding. The 9th Circuit upheld the Tax Court's reasonable officer compensation figure of $89,750. The 9th Circuit noted that it could not reverse the Tax Court unless there was a clear error.

34. *Elliots, Inc. v. Commr.*, 9th Cir. Ct. of Appeals, 716 F.2d 1241, 83-2 USTC ¶9610, September 26, 1983

Note. Another issue in this case was the correct computation of the $55,396 accumulated earnings tax which the IRS assessed for 1995. The 9th Circuit determined that it was correctly computed by the IRS and the Tax Court. The accumulated earnings tax is a penalty imposed on a corporation for accumulating earnings and profits in excess of its reasonable business needs. This is a seldom-raised IRS exam issue. **With dividends now taxed at 15%, there may be an incentive for cash-rich closely-held corporations to begin to pay dividends to officer/shareholders.**

Yacht Expenses

***Mediaworks, Inc. v. Commissioner,* TC Memo 2004-177, July 28, 2004**

IRC §§162 and 274

☞ Corporation's Yacht Expenses Not Deductible

Facts. Mediaworks, Inc., a C corporation engaged in producing films, was solely owned by William Roach. He was also president and a director of the corporation. Mr. Roach was an avid sailor and a member of the exclusive California Yacht Club. In 1997, the corporation bought a 42-foot Centurion sailboat for $155,000. The board of directors passed the following resolution:

"It is in the best interest of the Corporation to purchase a 1985 Centurion boat to be used for general business office, staff and client meetings, and corporate entertainment for $155,000."

Mr. Roach used the boat to enter numerous sailboat races from California to Mexico in 1998 and 1999. Neither the corporation nor Mr. Roach maintained a guest log for the boat for 1998 or 1999. The corporation deducted the following depreciation, interest, slip charges, and repairs for the yacht:

Fiscal Year Ending	Total Yacht Expenses Deducted on Form 1120
August 31, 1998	$159,134
August 31, 1999	135,834

The IRS disallowed the expenses and assessed additional corporate income tax of $120,000 for the two tax years.

Issue. Whether the corporation is entitled to deduct the yacht expenses.

Analysis. IRC §162(a) allows the deduction of "all ordinary and necessary trade or business expenses." However, even if those requirements are met, the expenses are not allowed for a "facility" when it is used in connection with an activity which is generally considered to constitute:

- Entertainment,
- Amusement, or
- Recreation.[35]

Position of the IRS. The yacht expenses do not meet the "ordinary and necessary" requirement of IRC §162(a). And even if they did, the yacht is a "recreation facility" used by the shareholder for his personal pleasure and enjoyment. As such, the yacht expenses are automatically disallowed by IRC §274.

35. IRC §274(a)(1)(B)

Position of the Taxpayer. The yacht was used 100% for business as a conference/meeting room for corporation employees and customers.

Holding. The Tax Court agreed with the IRS and upheld the disallowance of all of the yacht expenses. The court gave the following reasons for reaching its decision:

- Mr. Roach signed property tax statements for the Los Angeles County Assessor for 1998 and 1999 in which he stated that the boat was used for "recreation" and "pleasure."
- Based on the evidence presented at trial, the court did not find Mr. Roach's testimony credible.
- The slightest use of the "facility" (the yacht) for "entertainment, amusement, or recreation" triggers the automatic disallowance of expenses.[36]
- The facts were indisputable that Mr. Roach used the yacht for his personal sailing enjoyment, which is a "recreation" activity.

> **Note.** It is unclear if the IRS characterized the disallowed corporate yacht expenses as constructive dividends to Mr. Roach. However, that is a logical assumption.

Constructive Dividend

***Stephen M. and Rebecca A. Kerns v. Commissioner,* TC Memo 2004-63, March 11, 2004**
IRC §§301 and 316

☞ Permanent Seat License Payment to Houston Texans was a Constructive Dividend

Facts. The taxpayers owned 100% of the stock of InsurMark, Inc., a financial services company. Mr. Kerns was president and chief executive officer. He submitted an application to the Houston Sports Authority in December 1999 for a permanent seat license. It allowed Mr. Kerns to buy six season tickets for all home games of the Houston Texans to be played in the new football stadium (now called Reliant Stadium) which was then under construction.

Mr. Kerns listed his home address and social security number on the application. **The corporation paid $7,800 with the application. However, this payment was not deducted on the 1999 calendar year Form 1120 of InsurMark, Inc.** The corporation made two additional $7,800 installment payments in 2000 and 2001, for a total of $23,400 by the end of 2001.

The IRS determined that the $7,800 corporate payment made in 1999 was a constructive dividend to Mr. Kerns. The IRS assessed additional tax of $3,600 and a 20% accuracy-related penalty of $720 for the taxpayers' 1999 individual tax return.

Issue. Whether the $7,800 corporate payment constituted a constructive dividend to the taxpayers.

Analysis. A shareholder receives a constructive dividend to the extent of the corporation's earning and profits if the corporation pays a personal expense of its shareholder.[37]

36. *Ireland v. Commr.,* 89 TC 978, 981, November 9, 1987 (quoting House Conference Report 95-1800, at 249 (1978))
37. IRC §§301(c) and 316(a)

Holding. The Tax Court held that the $7,800 payment was a constructive dividend for the following reasons:

- Mr. Kerns, not the corporation, had the exclusive right to use the seat license. The license agreement was between the Houston Sports Authority and Mr. Kerns.
- Because Mr. Kerns held title to the seat license until 2003, the corporation did not benefit from the license in 1999.
- The fact that the Houston Texans football team and Reliant Stadium did not exist in 1999 was immaterial.
- The fact that the corporation did not deduct the initial $7,800 installment payment on its 1999 Form 1120 was also immaterial. Since the earnings and profits requirement was met, the payment was a constructive dividend as it conferred an economic benefit on Mr. Kerns without expectation of repayment.[38]

Note. Beginning in 2003, constructive dividends are taxed at a 15% maximum tax rate. This is partial consolation for shareholders of closely-held corporations affected by this often-raised IRS exam issue.

Shareholder Loan Guarantees

Gary and Janet Luiz v. Commissioner, **TC Memo 2004-21, January 29, 2004**
IRC §1366

☞ Loan Guarantees by S Corporation Shareholder Does Not Increase Stock Basis

Facts. Gary Luiz was a shareholder in Green Valley Sawmills, Inc. (Green Valley), an S corporation. He owned 33.3% and 42.03% of the stock of Green Valley in 1996 and 1997 respectively. As of December 31, 1996, the corporation owed over $400,000 to four log suppliers and haulers.

In 1996, Mr. Luiz made **oral loan guarantee agreements** with Green Valley's creditors. He promised to pay Green Valley's debts if the corporation did not. However, **Mr. Luiz made no personal payments to any of Green Valley's creditors in 1996 or 1997**. He did issue a promissory note to one of the creditors in 1988 and began to pay $500 per month on that obligation during 1988.

The taxpayers deducted the following losses from Green Valley on their individual tax returns:

Tax Year	Amount of Green Valley's Losses Deducted on Schedule E
1996	($234,945)
1997	($193,920)

The IRS determined that the husband's basis in Green Valley stock was:

Tax Year	Husband's Basis in Green Valley Stock
1996	$23,965
1997	7,499

Therefore, **the IRS limited the losses deducted on Schedule E from Green Valley to the amount of the stock basis**. As a result, the IRS assessed additional tax of $47,116 and $23,475 for 1996 and 1997 respectively.

38. *United States v. Smith*, 5th Cir. Ct. of Appeals, 418 F. 2d 589, 69-2 USTC ¶9726, November 17, 1969

Issue. Whether Mr. Luiz is entitled to increase his basis in Green Valley stock for 1996 and 1997 by the amount of the loan guarantees.

Analysis. A cash-basis taxpayer generally may not increase the basis of his S corporation stock in the amount of any loan guarantee until an actual economic outlay is made.[39]

A shareholder of an S corporation may deduct his pro rata share of the corporation's losses. However, the shareholder's deduction is limited to the sum of the shareholder's adjusted basis in:

- His S corporation stock, plus
- Any indebtedness of the S corporation to the shareholder.[40]

Holding. The Tax Court agreed with the IRS determination. The court gave two reasons for reaching its decision.

- Mr. Luiz did not personally borrow any funds that he advanced to Green Valley.
- He did not pledge any personal assets as collateral for the personal loan.

Thus the logic of the *Selfe* court case did not apply.[41] Even if it did, the Tax Court had stated previously that it did not agree with the 11th Circuit's reasoning in the *Selfe* decision.

> **Note.** The stock basis issue is one that IRS examiners are instructed to verify and raise in exams of S corporation shareholders. For more information on this important issue, see page 277 in the *2002 University of Illinois Farm Income Tax Workbook.*

Personal Use of Corporate Aircraft

Chief Counsel Advice 200338010, October 31, 2003
IRC §274

☞ Deductibility of Personally Used S Corporation Plane

Purpose. To determine if corporate airplane expenses in excess of the value of flights included in the shareholder's or employee's income should be disallowed as S corporation deductions.

Background. S corporation is made up of shareholders who are all members of the same family. S corporation owned fractional interests in two airplanes. Flight logs revealed 95% personal use by shareholders and two non-family employees. Standard Industry Fare Level (SIFL) was used to value each personal flight which was then included as wages for the shareholders and other employees. Over 75% of the personal-use value was attributable to the S corporation shareholders. The S corporation airplane operating expenses and depreciation, which flowed through to the shareholder returns, amounted to 10 times more than the personal-use value included in income. The S corporation shareholders enjoyed a significant tax deduction despite the inclusion of income.

Analysis. IRC §274 disallows deductions for entertainment unless the expense is directly related the active conduct of a trade or business. However, entertainment expenses that are included in an employee's income are excepted from the IRC §274(a) disallowance. In addition, IRC §274(e)(9) excepts the costs of entertaining the shareholders of an S corporation **if the S corporation reports the value of the benefit to the shareholder** on the S corporation's information return.

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39. *Goatcher v. Commr.*, 10th Cir. Ct. of Appeals, 944 F. 2d 747, 91-2 USTC ¶50,450, September 9, 1991

40. IRC §§1366(d)(A) and (B)

41. *Selfe v. United States*, 11th Cir. Ct. of Appeals, 778 F. 2d 769, 86-1 USTC ¶9115 (December 23, 1985)

In *Sutherland Lumber-Southwest, Inc.,* [42] the IRS contended:

- The IRC §274(e)(2) exception applied **only** to the amount included in employee compensation and wages, and
- IRC §274(a) **disallowed** any deductions for flight expenses in excess of amounts included in employee compensation and wages.

The Tax Court **disagreed** with the IRS position reasoning that Congress:

- Understood that the SIFL valuation could differ from the cost of actually providing the benefit, and
- Chose to permit expenses in excess of income.

In Action on Decision 2002-02 (February 11, 2002), the IRS acquiesced in *Sutherland* thereby allowing a full deduction for the cost of the flights.

Note. See page 462 in the *2001 University of Illinois Farm Income Tax Workbook* for an analysis of this case.

Ruling. S corporation taxpayers will be able to fully deduct operating costs of the airplane provided the SIFL value of personal use is included in employee or shareholder wages.

Entities
Treasury Decision 9139, July 20, 2004
IRC §7701

☞ Entity Classification Elections

Background. Entities may elect to be classified as other than their default classification or to change their classification by filing Form 8832, *Entity Classification Election,* with the appropriate IRS service center.

An entity whose default classification is a partnership may seek to be classified as an S corporation. The entity must file both Form 8832 and Form 2553, *Election by a Small Business Corporation.* When the entity timely files Form 2553 but fails to file Form 8832, the entity must request an extension of time under Section 301.9100 to file a late entity classification election.

New Relief. For eligible entities to be classified as S corporations, they must file two elections. Since the filing of two elections creates a burden not only on the entity itself but the IRS as well, **these temporary regulations are intended to simplify paperwork by eliminating the requirement that the entity elect to be classified as an association.** Rather, an eligible entity making a timely and valid election to be classified as an S corporation will be deemed to have elected to be classified as an association taxable as a corporation. For those entities where the election is **not timely and valid**, the default classification rules apply unless the IRS provides late S corporation election relief or inadvertent invalid election relief.

Effective Date. Temporary and proposed regulations apply to S corporations elections filed **on or after July 20, 2004** as well as those entities who timely filed S corporation elections before July 20, 2004.

42. *Sutherland Lumber-Southwest, Inc. v. Commr.,* 114 TC 197 (2000), aff'd 253 F. 3d 495 (8th Cir. 2001)

CREDITS

Resident Alien Spouse

Mahmud Ahmed v. Commissioner, **TC Summary Opinion 2004-20, March 3, 2004**

IRC §§2 and 32

☞ Head of Household Filing Status and Earned Income Credit (EIC) Denied

Facts. The taxpayer was married to Rehana Akhter, who was not a U.S. citizen. **The taxpayer, his resident alien spouse, and their two daughters resided together during all of 2001**. On his 2001 tax return, the taxpayer:

- Used the head of household filing status,
- Claimed dependency exemption deductions for his two daughters, and
- Claimed $3,870 of EIC with his daughters as qualifying children.

Since he was married throughout 2001, the IRS:

- Switched his filing status to married filing separately, and
- Denied the $3,870 of claimed EIC.

Issues.

1. Whether the taxpayer is entitled to use the head of household filing status for 2001.
2. Whether the taxpayer is entitled to EIC with respect to his two dependent daughters.

Analysis and Holding for Issue 1. An individual is considered a head of household if, and only if, the individual is **not married** at the close of his taxable year.[43] **A taxpayer is considered as not married if at any time during the taxable year his spouse is a nonresident alien.**[44]

An individual is a nonresident alien if he is "neither a citizen of the United States nor a resident of the United States."[45]

The Tax court determined that the taxpayer's spouse was a **resident alien** since she resided with the taxpayer during all of 2001 and the two preceding years. Therefore, she met the **substantial presence test**[46] and qualified as a resident alien. Since she was a resident alien in 2001, the taxpayer was married in 2001 and thus did not qualify for the head of household filing status. **The Tax Court upheld the IRS determination that the taxpayer's correct filing status was married filing separately.**

Analysis and Holding for Issue 2. The earned income credit is eligible to a married individual "only if a joint return is filed for the taxable year."[47] The correct filing status of the taxpayer's 2001 tax return was married filing separately. Therefore, the Tax Court held that the earned income tax credit was properly denied by the IRS.

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43. IRC §2(b)(1)
44. IRC §2(b)(2)(C)
45. IRC §7701(b)(1)(B)
46. IRC §7701(b)(1)(A)(ii)
47. IRC §32(d)

Qualifying Child for EIC

***Mamady B. Cisse v. Commissioner*, TC Summary Opinion 2003-143, October 1, 2003**
IRC §32

☞ EIC Denied for Resident Alien Nephew

Facts. On the taxpayer's 2000 Form 1040, he claimed the earned income tax credit (EIC) for his nephew, Mohamed Toure. The nephew was born in Senegal in 1997 to the taxpayer's sister, Mawa Cisse, and Ibrahima Toure. The nephew was a resident alien in 2000.

The nephew's social security card was stamped "NOT VALID FOR EMPLOYMENT." The IRS determined that the nephew was not the taxpayer's qualifying child for EIC purposes.

Issue. Whether the taxpayer is entitled to claim the EIC even though the alleged qualifying child had a social security card that is stamped "NOT VALID FOR EMPLOYMENT."

Analysis. A "qualifying child" is an individual who satisfies a relationship test, a residency test, an age test, and for whom the taxpayer satisfies an identification requirement.[48] The identification requirement is set forth in IRC §32(c)(3)(D)(i). It provides that a qualifying child "shall not be taken into account unless the taxpayer includes the name, age, and TIN (Taxpayer Identification Number) of the qualifying child on the tax return."

IRC §32(m) defines the term "TIN" as used in IRC §32(c)(3)(D)(i) as: "A social security number (SSN) issued to an individual by the Social Security Administration, **other than a SSN issued under Clause II of Sect. 205(c)(2)(B)(i) of the Social Security Act."**

Holding. Because the nephew's social security card is stamped "NOT VALID FOR EMPLOYMENT" above the SSN, he is covered by Clause II mentioned above. Consequently, the nephew does not meet the TIN requirement. Therefore, the nephew is not a "qualifying child" of the taxpayer for EIC purposes.

> **Note.** In addition to the rampant fraud and abuse in the EIC area, this case shows the monumental technical complexity of IRC §32. Taxpayers and preparers who want to voluntarily comply with the complex EIC rules often must take much time and research to ascertain the facts and correctly interpret the tax law.

Gambling Winnings

***Lillie M. Petty v. Commissioner*, TC Memo 2004-144, June 17, 2004**
IRC §32

☞ Unreported Gambling Winnings Reduce Earned Income Credit (EIC)

Facts. On her 2000 Form 1040, the taxpayer reported only $11,835 of wage income. She claimed head of household filing status, two dependency exemptions for her grandchildren, and the standard deduction. She also claimed the EIC in the amount of $3,888.

Using information from five Forms W-2G, the IRS determined that the taxpayer had omitted $9,180 of gambling winnings from two casinos. As a result, the IRS made the following adjustments to the taxpayer's 2000 tax return:

Corrected AGI ($11,835 reported + $9,180 unreported gambling winnings)	$21,015
Corrected EIC (from EIC tables based on correctly modified AGI of $21,015)	2,133

48. IRC §329(c)(3)

In addition, the IRS allowed the taxpayer to itemize deductions, including $9,180 of gambling losses, an amount equal to her gambling winnings. The additional tax assessed by the IRS was $1,755, the amount of the decrease in the claimed EIC ($3,888 claimed – $2,133 as corrected = $1,755 additional tax).

Issues.

1. Whether the taxpayer had unreported gambling income, and
2. Whether the inclusion of such income reduced the reported EIC amount of $3,888.

Analysis. IRC §32(a)(2) provides that the allowable EIC is phased out if "the modified adjusted gross income (or, if greater, the earned income) of the taxpayer for the taxable year" exceeds a prescribed amount. There is no provision in §32 that excludes gambling winnings from modified AGI or allows the deduction of offsetting gambling losses in arriving at modified AGI.

Holding. The Tax Court agreed with the IRS assessment of $1,755 of additional tax. The court noted that the plain language of §32 left it with no choice but to sustain the determination made by the IRS.

> **Note.** Gambling winnings and losses continue to be a difficult tax issue for preparers to resolve with their clients. For a thorough discussion of this difficult issue, see pages 38–42 in the *2003 University of Illinois Federal Tax Workbook*. This case presents an additional inequity that results from the difference in the proper tax reporting of gambling winnings and losses.

Disabled Access Credit

Chief Counsel Advice 2004411042, March 12, 2004
IRC §44

☞ Expenses to Improve Access to Business Website Not Eligible for Disabled Access Credit

Purpose. To determine if software expenses paid to improve access to a business website are eligible for the disabled access credit.

Background. IRC §44(a) allows a disabled access credit for eligible small businesses equal to 50% of the eligible access expenditures for the tax year that are over $250 but not more than $10,250 up to a maximum of $5,000 (50% of [$10,250 – $250]).

An eligible small business is any business with gross receipts less than or equal to $1 million, or with less than 30 full-time employees during the preceding tax year.

Eligible access expenditures are expenses paid or incurred to comply with the Americans with Disabilities Act (ADA) requirements. Examples of eligible access expenditures include:

- Removing barriers to physical access or communication
- Furnishing qualified interpreters or readers for persons with hearing or visual impairments
- Modifying equipment
- Supplying similar materials or services

Three scenarios are analyzed dealing with software that allows hearing-impaired, speech-impaired, and visually-impaired customers better access to business websites. This software allows disabled individuals to improve communications with a business. Businesses, which conduct all or a substantial amount of their business operations via the Internet, have purchased this software as well as annual subscriptions. Disabled access credits have been claimed on tax returns for these purchases.

Analysis and Conclusion. The Chief Counsel Advice states that this type of software expense does **not** qualify for the disabled access credit. It explains that:

- The taxpayer must be in a trade or business to claim the disabled access credit.
- Businesses already in ADA compliance **cannot claim a credit for upgraded services.**
- Businesses **cannot** claim a credit for services which are not used by disabled customers.
- Businesses **cannot** claim credits for annual program subscriptions.
- Businesses must have a physical structure into which customers enter to satisfy ADA requirements.

DEDUCTIONS

NOL Carryback Waiver

***Harold and Doreen Silk v. Commissioner,* TC Summary Opinion 2004-32, March 18, 2004**
IRC §172

☞ Required Waiver to Carryback NOL Loss Not Made

Facts. The taxpayers filed their joint 1995 tax return in March 1997. The 1995 return contained no election to forgo the net operation loss (NOL) carryback period for the reported 1995 NOL. The taxpayer's 1996 return, which was also filed in an untimely manner in April 2001, reported a $59,032 "NOL loss from 1995" on line 21, other income.

The IRS determined that the taxpayers had not made the required proper election[49] to waive the three-year carryback period for the 1995 NOL. Therefore, the IRS disallowed the $59,032 NOL deduction for the 1996 tax year.

Issue. Whether the taxpayers properly elected to waive the carryback of their 1995 NOL.

Analysis. The election to waive the entire carryback period must be made by a statement attached to the return (or amended return) for the tax return for the year of the NOL. The statement must be attached to a timely filed (including extensions) return. The statement must indicate that the taxpayer is waiving the NOL carryback period.

Holding. The Tax Court analyzed IRC §172 and the regulations. It held that the taxpayers did not satisfy the requirements for making a valid NOL carryback waiver election. Therefore, the $59,032 NOL deduction claimed on the 1996 tax return was properly disallowed.

> **Note.** For NOLs created in a tax year that begins after August 5, 1997, the carryback period is generally two years and the carryforward period is 20 years.[50] For NOLs created in tax years that end in 2001 and 2002, the carryback period was temporarily increased to five years. For excellent instruction on current NOL procedures, see IRS Pub. 536, *NOLs for Individuals.*

49. IRC §172(b)(3)
50. Taxpayer Relief Act of 1997

Personal Expenses

***Richard G. Tuck v. Commissioner*, TC Summary Opinion 2004-10, February 4, 2004**
IRC §262

☞ Expenses for Domestic Partner were Personal, not Business-Related

Facts. Richard Tuck, a self-employed contractor, hired Lisa Brownell in late1992 as an office worker. From that time until April 1997, Mr. Tuck and Ms. Brownell also had a personal relationship. They lived together in a jointly owned home and were the parents of two children. That relationship ended in 1997 when Mr. Tuck moved out of their shared residence.

In 1998, Mr. Tuck and Ms. Brownell reached an agreement in Family Division court regarding paternity, custody, visitation, child support. In that court approved agreement, a division of real property was stipulated as follows:

- Ms. Brownell will quitclaim her interest in the jointly owned home to Mr. Tuck in exchange for $33,000.
- Mr. Tuck will buy and have set up on land he owns a Patriot Victorian double wide ranch style manufactured home. This home will be transferred to Ms. Brownell free and clear of any liens and debt.

Under the court agreement, Mr. Tuck bought the mobile home for $43,000. On his 1998 Schedule C for his business, Mr. Tuck deducted the following:

- $43,000 cost of the mobile home as part of the cost of goods sold
- $6,610 legal costs he incurred for the Family Court proceedings as part of legal and professional services

The IRS determined that both of these expenses were nondeductible personal expenses under IRC §262. As a result, the IRS assessed additional 1998 taxes due of $17,632.

Issue. Whether the mobile home cost and the legal costs for Family Court proceedings are deductible as trade or business expense under IRC §162(a).

Analysis. Personal, living, and family expenses are not deductible.[51] Expenses which are ordinary and necessary in carrying on a trade or business are deductible.[52]

Position of Taxpayer. Mr. Tuck contended that the cost of the mobile home represented "compensation for past services rendered by Ms. Brownell in connection with my business."

Holding. The Tax Court agreed with the IRS position that both claimed expenses were nondeductible personal family-related expenses. The court noted that the taxpayer did not issue a 1998 Form W-2 to Ms. Brownell for the cost of the mobile home. In addition, the fact that he deducted its cost as part of cost of goods sold rather than as wages was inconsistent with his contention.

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51. IRC §262(a)
52. IRC §162(a)

Standard Meal Allowance

U.S. Department of Agriculture

IRC §162

☞ 2004 Standard Meal Allowance Rates for Day Care Providers

U.S. Department of Agriculture, Child and Adult Care Food Program, determines the standard meal and snack allowance deductions allowable under IRC §162. For 2004, the rates are:

	Contiguous 48 States	Alaska	Hawaii
Breakfast	$0.99	$1.57	$1.15
Lunch/dinner	1.83	2.97	2.14
Snack	0.54	0.88	0.63

As rates for future years are determined, check at **www.fns.usda.gov/cnd/care/ProgramBasics/Rates/CurrentRates.htm**

Health Savings Account (HSA)

Revenue Ruling 2004-45, May 11, 2004

IRC §223

☞ Eligibility to Contribute to HSA when Covered by Health FSA or HRA

Purpose. To determine if individuals covered under a high deductible health plan (HDHP) and health flexible spending arrangement (health FSA) or a health reimbursement arrangement (HRA) can contribute to a **Health Savings Account (HSA)**.

Background and Analysis. IRC §223(a) provides that an "eligible individual" may make **deductible contributions** to HSAs subject to certain limitations. An "eligible individual", with respect to any month, is a person covered on the first day of the month by a HDHP and is **not covered** under any health plan which is:

- Not an HDHP, and
- Provides benefit coverage which is covered under the HDHP.

An HDHP, which is defined in IRC §223(c)(2)(A), is a health plan which satisfies certain requirements for minimum annual deductibles and maximum annual out-of-pocket expenses.

Individuals with HDHP coverage can also have "permitted insurance" and "permitted coverage" without losing eligibility to contribute to the HSA.

Permitted insurance includes coverage for liabilities arising under:

- Workers' compensation laws
- Tort liabilities
- Liabilities relating to use or ownership of property
- Insurance for specified disease or illness
- Insurance which pays a fixed amount per day of hospitalization

Permitted coverage includes coverage for:

- Accidents,
- Disability,
- Dental care,
- Vision care, or
- Long-term care.

In the following situations, an individual is considered an eligible individual for contributing to an HSA in the following situations:

- Limited-purpose health FSA or HRA
- Suspended HRA
- Post-deductible Health FSA or HRA
- Retirement HRA

Five situations are explained to illustrate the effect of various participation levels in differing plans.

- **Situation 1.** Individual covered by HDHP with 80/20 coinsurance feature above deductible, health FSA under IRC §125, and HRA where health FSA and HRA pay or reimburse all §213(d) medical expenses not covered by HDHP. **Individual is not eligible to make contributions to HSA.**
- **Situation 2.** Same facts as **Situation 1** except, health FSA and HRA are limited-purpose arrangements where health FSA and HRA pay or reimburse preventive care benefits. **Individual is eligible for making contributions to HSA.**
- **Situation 3.** Same facts as **Situation 1** except, individual is not covered by health FSA. Under employer's HRA, individual elects to forgo payment or reimbursement of medical expenses incurred during coverage period. **Individual is eligible for making contributions until suspension period ends and the individual is again entitled to receive payments or reimbursements from HRA.**
- **Situation 4.** Same facts as **Situation 1** except, the health FSA and HRA are post-deductible arrangements that only pay or reimburse medical expenses after the minimum annual deductible of the HDHP is satisfied. **Individual is eligible for making contributions to HSA.**
- **Situation 5.** Same facts as **Situation 1** except, individual is not covered by a health FSA and employer's HRA is a retirement HRA which only reimburses those medical expenses incurred after the individual retires. **Individual is eligible for making contributions to HSA before retirement.**

Note. If substantially all of the coverage in a health plan (which is intended to be an HDHP) is provided through a health FSA or HRA, the health plan in not an HDHP. See Chapter 14, New Legislation for in depth coverage of HSAs. Rev. Proc. 2004-50 contains useful questions and answers related to HSAs. Some of these are included in Chapter 14.

Education Loan Interest Deduction

Treasury Decision 9125, May 7, 2004

IRC §221

☞ Final Regulations on Education Loan Interest Deductions

The IRS allows any "above-the-line" deduction, limited to a maximum of $2,500, for interest paid on qualified education loans. The deduction is phased out for taxpayers with modified AGI of $50,000 to $65,000 ($100,000 to $130,000 for joint returns). To be considered a "qualified education loan", the school loans must be incurred solely for higher education expenses which are paid within a reasonable period of time before or after the indebtedness is incurred.

Application of Payments. Payments made by taxpayers are **first applied** to unpaid accrued interest and then to principal. For example, interest on Student K's loan accrues while K is in school but K is not required to make any payments until six months after K graduates or leaves school. At that time, the lender capitalizes all accrued but unpaid interest and adds it to the outstanding principal amount of the loan. Thereafter, K is required to make monthly payments of interest and principal on the loan. The interest payable on the loan (including capitalized interest) is original issue discount (OID). K may deduct payments that under the OID rules in Treas. Reg. §1.1275-2(a) are treated as payments of interest, including any principal payments that are treated as payments of capitalized interest.

Third-Party Payments. An education interest deduction is available **only** to the taxpayer on a qualified education loan. In the case of payments made by a third party who is **not** legally obligated to make the payment, the taxpayer is treated as receiving the payment from the third party and, in turn, making the payment.[53]

A taxpayer cannot deduct any education loan interest regardless of modified AGI if either of the following two conditions exist:

1. The taxpayer is claimed as a dependent by another taxpayer.
2. The taxpayer is married and files a separate return.

60-Month Period. Even though the 60-month limitation period was eliminated by the Economic Growth and Tax Relief Reconciliation Act, it continues to apply to interest on qualified education loans due and paid after December 31, 1997 but before January 1, 2002. The limitation applies again after December 31, 2010.

Change in Status of Educational Institution. Should the education institution lose its status as an eligible educational institution after the end of the academic period for which the loan was incurred, the interest paid will still be deductible.

Additional Funds Borrowed. If a taxpayer decides to refinance a qualified education loan and receives additional funds to pay higher education expenses, the interest on the total loan is deductible. However, if the taxpayer refinances and receives funds to be used for purposes **other than** higher education expenses, interest paid on the loan is **not deductible** as qualified education interest.

Effective Date. For interest paid on qualified education loans after December 31, 2001 and before January 1, 2011.

> **Note.** For an excellent discussion of all of the rules relating to the deduction of student loan interest, see IRS Pub. 970, *Tax Benefits for Education.*

53. Treas. Reg. §1.221-1(b)(4)(i)

DEPENDENCY ISSUES

Revised Form 8332

***Jeffrey R. and Sabrina M. King v. Commissioner,* 121 TC 245, No. 12, September 26, 2003**
IRC §152

☞ Unmarried Custodial Parent Can Use Form 8332 to Release Child's Exemption

Facts. Jimmy Lopez and Sabrina King were the biological parents of Monique, who was born in 1986. The parents were never married to each other. The mother, Sabrina, later married Jeffrey King.

In 1988, Sabrina executed a Form 8332 in favor of Jimmy Lopez which released her right as custodial parent to claim the exemption of Monique. Sabrina completed both parts of the Form 8332 which she signed. The details of the Form 8332 Sabrina signed provided that she:

- Released her claim to Monique's exemption for 1987 by completing Part I, and
- Released her claim to Monique's exemption for "future years" by completing Part II.

Jimmy Lopez claimed the dependency exemption for his daughter Monique on his tax returns for the years 1987 through 1999. He attached a copy of the Form 8332 signed by Sabrina to those tax returns.

In 1993, Sabrina married Jeffrey King and they also claimed Monique's exemption on their joint 1993–1999 tax returns. Monique resided with her mother and stepfather at all times during 1998 and 1999, the tax years in question. Sabrina did not inform Jimmy Lopez that she wanted to revoke the release of Monique's exemption which she agreed to by completing and signing the Form 8332 in 1988.

In its exam, the IRS disallowed the exemption of Monique on both the 1998 and 1999 joint tax returns of the Kings and on the 1998 and 1999 tax return of Jimmy Lopez.

Issue. Whether the Kings or Mr. Lopez is entitled to the dependency exemption for Monique for the 1998 and 1999 tax years.

Analysis. A **special support test** of a child of divorced parents is provided by IRC §152(e). The **general rule** is that the custodial parent is entitled to the dependency exemption if:

1. A child receives over half of his support during the calendar year from his parents who are:
   - Divorced or legally separated under a decree of divorce of separate maintenance,
   - Separated under a written separation agreement, or
   - Live apart at all times during the last six months of the calendar year.

In addition, the child must be in the custody of one or both of his parents for more than half of the calendar year.

2. However, an **exception to the general rule** applies where the custodial parent releases his/her claim to the exemption for the year. In that case, the noncustodial parent is treated as having provided over half of the child's support during the calendar year. Consequently, the noncustodial parent is entitled to the dependency exemption.

   In order for this exception to apply, the noncustodial parent must attach the written release declaration (usually Form 8332) to his/her return for the taxable year.

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Arguments of Mr. Lopez. Mr. Lopez contends that he is entitled to the dependency exemption because:

- He and Sabrina King **lived apart at all times** during 1998 and 1999, the tax years in question, and
- Sabrina King signed a Form 8332 in 1988 stating that she would not claim the exemption for 1987 and "future years" which he attached to his 1998 and 1999 tax returns.

Arguments of IRS and Mr. and Mrs. King. The IRS and the Kings contend that the special support test of IRC §152(e) shown above does **not** apply to parents who have never married each other. Because the facts clearly show that the Kings provided over half of Monique's support during 1998 and 1999, they would be entitled to the dependency exemptions if §152(e) does not apply to parents who have never married each other.

Holding. "This case presents an issue that has not been squarely addressed by the Tax Court. Additionally, it appears that the Commissioner (IRS) has at times taken inconsistent positions of this matter." **After a careful analysis of IRC §152(e), the Tax Court found that Jimmy Lopez was entitled to the dependency exemptions for Monique for 1998 and 1999.** The court stated: "The Form 8332 itself clearly demonstrates that Sabrina King intended to release her claim to the exemptions for 1987 and all subsequent years, and we reject the respondent's (IRS's) new argument that the omission of the word "all" renders the release ineffective."

Note. See Problem 2 in the Individual Problems chapter for more information on this topic. Form 8332 (Revised December 2003) reflects the decision reached by the Tax Court in the *King* case. The IRS agrees that a custodial parent who was never married to the noncustodial parent is entitled to release a child's exemption by using the revised Form 8332.

Caution. It is suggested that tax preparers should advise custodial parent clients to release exemption(s) on a yearly basis only in Part I of Form 8332. This strategy prevents adverse tax results as shown in the *King* case.

Standard Deduction of Dependent

Allyson C. Briggs v. Commissioner, **TC Summary Opinion 2004-22, March 5, 2004**
IRC §63(c)(5)(B)

☞ "Earned Income" Defined for Computation of a Dependent's Standard Deduction

Facts. Allyson Briggs was claimed as a dependent on her parents' 1999 joint return. She filed her 1999 tax return as a single individual. It reported the following:

Wages	$4,275
Interest income	7,922
Schedule C lawn mowing/cleaning business net loss	(3,703)
Capital loss	(2,858)
Adjusted gross income	$5,636
Less: exemption	N/A (claimed by parents)
Less: Standard deduction [greater of $700 or ($250 + earned income)] consisting of her W-2 wage income of $4,275, but limited to $4,300	**(4,300)**
Taxable income	$1,336

The IRS recalculated the standard deduction, arriving at the corrected amount of $822. The IRS used the same formula as shown for Allyson's standard deduction. **However, according to the IRS, her earned income included both her wages of $4,275 less her Schedule C business net loss of $3,703**. Therefore, the IRS computation of the allowable standard deduction was only $822, rather than the taxpayer's figure of $4,300. The IRS corrected amount for her standard deduction of $822 is shown in the following computation:

Greater of either $700, or	$250
Plus: earned income consisting of wages of $4,275 – Sch. C loss of $3,703	572
Allowable standard deduction determined by the IRS	**$822**

Issue. Whether the correct amount of the standard deduction is $4,300 as calculated by the taxpayer, or $822 as corrected by the IRS.

Analysis and Holding. Following a detailed analysis of the legislative history of IRC §63, which pertains in part to the standard deduction, the Tax Court agreed with the taxpayer. Therefore, the correct amount of her 1999 standard deduction was the maximum $4,300 amount. **The court accepted the taxpayer's theory that earned income for purposes of a dependent's standard deduction consists solely of positive figures from wages, tips, professional fees, and other personal service compensation.** The court rejected the IRS position that earned income under IRC §63 should be calculated in the same manner as earned income under IRC §32 for purposes of calculating the earned income credit.

Note. For 2004, the standard deduction for dependents is the **greater of** (i) $800 (a $50 increase from 2003) or (ii) $250 plus the dependent's earned income, but limited to $4,850 (if the dependent is under age 65 and not blind).

DIVORCE ISSUES

Requested Refund Denied

L. Thorne McCarty and Mary Lynne Robertson v. United States, **New Jersey U.S. District Court, No. 01-4942 (SRC), January 29, 2004**
IRC §7433

☞ Ignorance of Tax Law is no Grounds to Ignore Marriage of Two-Earner Couple

Facts. During the time that Mr. McCarty and Ms. Robertson had a relationship, Mr. McCarty was "philosophically opposed to marriage" while Ms. Robertson favored a "traditional marriage." In order to reach a compromise, they agreed to a "symbolic wedding ceremony" in June 1997 while vacationing in Fiji.

In August 1998 when they filed their joint 1997 tax return, Mr. McCarty was shocked when he discovered that the "marriage penalty" cost them almost $5,000 extra tax dollars.

In order to rectify this result, Mr. McCarty devised a plan. He sent a letter to the Fijian Registrar General with an affidavit attached. The letter concluded that his marriage to Ms. Robertson "was, is, and always will be null and void." The affidavit explained that he certainly would never have consented to the Fiji wedding if he had known the tax cost to him. The affidavit concluded: "This **mistake** as to the nature and consequences of the wedding ceremony in Fiji went to the essence of the agreement between the parties, and vitiated their consent to the marriage."

At about the same time Mr. McCarty sent the letter to the Fijian authorities, he and his wife filed amended 1997 tax returns with the IRS requesting a refund of $4,635. This requested refund amount is explained below.

Total tax on original 1997 joint return filed by McCarty and Robertson		$38,822
Total tax on the amended 1997 single return of McCarty	$25,226	
Total tax on the amended 1997 head of household return of Robertson	8,961	
		(34,187)
Requested refunded by the taxpayers via the amended 1997 returns		**$ 4,635**

Neither the Fiji Registrar General nor the IRS was impressed with Mr. McCarty's reasoning. The Fijian authorities refused to honor Mr. McCarty's letter and affidavit, explaining that the June 1997 wedding was legal until terminated by a divorce. After the IRS rejected the couple's $4,635 refund request, they sued for refund in the New Jersey U.S. District Court.

Issue. Whether the taxpayers were entitled to a refund on their original 1997 joint tax return.

Analysis. At the district court trial, Mr. McCarty insisted that the Fiji marriage was not valid. His alternative position was that if the marriage was valid, the resulting "marriage penalty" was unconstitutional.

Holding. The district court agreed with the IRS and denied the refund claim. The court noted that the validity of a marriage for federal tax purposes is determined by state law. Under Fijian law, the "symbolic wedding ceremony" performed in 1997 was valid. In addition, there was no New Jersey statute or case which would support the contention that the marriage was null and void**. The judge noted that the couple "simply failed to research the economic consequences of their marriage and came to regret it later."**

Alimony

***Charles W. and Nancy T. Smith v. Commissioner*, TC Summary Opinion 2003-167, December 17, 2003**

IRC §§71 and 215

☞ Alimony Must Terminate Upon the Death of Payee-Spouse

Facts. Charles and Sheila Smith were divorced by a Florida state court in 2000. Two clauses in the divorce decree are shown below.

> **PENSION/RETIREMENT.** Both parties agree that the Husband shall pay to the Wife one-half of The Husband's current 401(k) plan which has a balance of $150,000 as of October 1, 1999. Accordingly, the Wife shall receive $75,000, plus an additional $32,000 representing lump-sum alimony, for a total amount due the Wife from the Husband's 401(k) of $107,000.
>
> **ALIMONY.** The Husband agrees to pay the Wife as lump-sum alimony, the amount of $32,000, payable from his 401(k).

Mr. Smith paid the $32,000 to his ex-wife during 2000 and he and his new wife claimed an alimony deduction for it on their joint 2000 Form 1040. The IRS determined that the $32,000 did not qualify as alimony. The resulting disallowance created a $7,146 tax deficiency in 2000.

Issue. Whether the $32,000 lump-sum payment qualifies as deductible alimony.

Analysis. For tax purposed, the term "alimony" is defined in IRC §71(b)(1) as any cash payment the meets the following four requirements:

1. Such payment is received by a spouse under a divorce or separation instrument.
2. The divorce or separation instrument does not designate such a payment as one which is not includible in gross income and not allowable as a deduction under IRC §215.

3. In the case of an individual legally separated from his spouse under a decree of divorce or of separate maintenance, the payee spouse and the payor spouse are not members of the same household at the time such payment is made.

4. There is no liability to make such payment for any period after the death of the payee spouse.

Holding. The Tax Court held that the fourth criterion was not met for two reasons:

- The divorce decree was silent regarding whether Mr. Smith's obligation to pay the $32,000 would cease if his former spouse died before the payment was made.
- Under Florida law, Mr. Smith's obligation to make the $32,000 payment would have continued if his former spouse died prior to the payment of it.

Therefore, the court agreed with the IRS in upholding the disallowance of the $32,000 as deductible alimony. The fact that the payment was described in the decree as "alimony" is not controlling for federal income tax purposes.[54]

> **Note.** This case demonstrates the importance of correct language and clauses in divorce decrees. Mr. Smith's attorney could have inserted a clause that specifically required that his obligation to pay the $32,000 would terminate in the event of his former spouse's death. The failure to do so cost Mr. Smith $7,146 of extra tax for the 2000 tax year.

EMPLOYMENT TAX ISSUES

Worker Classification

***Specialty Transport & Delivery Services, Inc. v. Commissioner,* 3rd Circuit Ct. of Appeals, 03-2732, 2004-1 USTC ¶50,203, March 12, 2004, affirming the prior Tax Court decision: TC Memo 2003-51, 85 TCM 920, (2003)**
IRC §§3121 and 3401

☞ Corporate Officer is a Statutory Employee of S Corporation-Section 530 Relief Denied

Facts. John Ludlow was the President, Vice President, Secretary, Treasurer and the sole director of the taxpayer, an S corporation. Other than occasional assistance from his wife, Mr. Ludlow was the only person who performed services for the S corporation.

During the three-year period 1996 through 1998, the S corporation made no regular salary payments to Mr. Ludlow. Rather, checks from the taxpayer to Mr. Ludlow were written as he needed funds. His services to the taxpayer constituted Mr. Ludlow's only business activity and sole source of income.

For the three years in question, no Forms 941, 940 (FUTA) or W-2 were filed. No Forms 1099-MISC were issued to Mr. Ludlow for the years 1996 and 1997. However, a 1998 Form 1099-MISC was issued to him for "non-employee compensation" in the amount of $15,000.

For the three years in question, the Forms 1120S reported the following:

Tax Year	1120S Ordinary Income
1996	$15,605
1997	27,362
1998	38,487

54. *Douglas D. Benedict v. Commr.*, 82 TC 573 , April 4, 1984

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John Ludlow and his wife, Sharon, reported the 1120S ordinary income amounts shown above as nonpassive income from Schedule K-1 in Part II of Schedule E on their joint Forms 1040 for 1996, 1997, and 1998. No self-employment tax was paid on the nonpassive income amounts.

The IRS determined that John Ludlow was an employee of the corporation for years 1996, 1997, and 1998. Consequently, delinquent FICA and FUTA taxes were assessed against the corporation. The IRS also determined that the S corporation was not entitled to the safe harbor protection under Section 530 of the Revenue Act of 1978.

Issue. Whether Mr. Ludlow was an employee of the taxpayer for federal employment tax purposes for 1996 through 1998, and, if so, whether relief under Section 530 of the Revenue Act of 1978 is warranted.

Analysis. IRC §3121(d) states that **the term "employee" means**:

1. "Any officer of a corporation; or
2. Any individual, who under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee."

Generally, an officer of a corporation is an employee. However, an officer who does not perform any services or performs only minor services and who receives no remunerations is considered not to be an employee of the corporation.[55]

Holding. The 3rd Circuit agreed with the Tax Court and the IRS that Mr. Ludlow was a statutory employee of the taxpayer. His services were not minor and he was paid for them. Therefore, the distribution of the S corporation ordinary income to him represented wages subject to both FICA and FUTA. **The 3rd Circuit also upheld the Tax Court in denying Section 530 relief as the taxpayer provided no "reasonable basis" for not treating Mr. Ludlow as an employee.**

Worker Classification

***Frederick C. Kumpel v. Commissioner,* TC Memo 2003-265, 86 TCM 358, September 10, 2003**
IRC §3121(d)(2)

☞ Workers Who Performed Secretarial Services for Attorney Were Employees

Facts. The taxpayer, a self-employed personal injury attorney, utilized the secretarial services of two women in his law practice. Prior to opening his law practice, he contacted a CPA who suggested that Mr. Kumpel obtain an employer identification number (EIN). However, Mr. Kumpel ignored that advice.

During the years 1993-1997, the two workers performed the following secretarial services for the taxpayer, subject to his control and direction:

- Used Mr. Kumpel's photocopier, stationery, computer, and printer to perform tasks assigned by him
- Typed, answered the telephone, did bookkeeping, helped track expenses, paid bills, ran errands, filed court papers, and filed office records

Mr. Kumpel paid the two workers at the rate of $10 per hour. They were required to keep track of the hours they worked as they occasionally worked at their homes. There was no written employment contract. Mr. Kumpel paid membership dues to the local Legal Secretaries Association on behalf of the workers.

55. Treas. Reg. §31.3121(d)-1(b)

During the five years in question, Mr. Kumpel failed to do the following:

- File any Forms 941
- Issue any Forms 1099-MISC to the two workers for the work they performed

Instead of deducting the amounts paid to the two workers as a Schedule C expense, Mr. Kumpel reported the labor payments as "negative gross receipts." As a result, Mr. Kumpel was able to conceal a possible employment tax issue from the IRS.

An IRS exam reclassified the workers as common-law employees and delinquent employment taxes were assessed for the five-year period.

Issue. Whether the workers were common law employees under IRC §3121(d)(2) whose remuneration was subject to federal employment taxes.

Analysis. Treas. Reg. §31.3121(d)-1(c)2) defines the common law employer-employee relationship as follows:

"Generally such relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done."

Holding. After a careful analysis of the various common law factors, the court held that:

- The workers were employees.
- Mr. Kumpel was liable for delinquent federal employment taxes.

The court noted that Mr. Kumpel and his two secretaries intended to avoid rules applicable to employees. In addition, the court agreed with the IRS that Mr. Kumpel was liable for the failure to timely file and the failure to deposit penalties imposed by IRC §§6651 and 6656.

Employment Taxes
IRS News Release IR-2004-47, April 5, 2004
IRC §§1402, 3121(d)(1), 3401 and 3501

☞ Business Owner Alert on Employment Tax Practices

The IRS continues to challenge business owners who do not withhold or pay employment taxes. Employment taxes include taxes withheld from employee wages (such as federal income tax, social security tax, and Medicare tax), unemployment taxes, and state withholding taxes. Reasons business owners do not withhold or pay employment taxes include:

- Borrowing of withheld employment taxes for paying other creditors rather than the IRS
- Retaining of withheld employment taxes due to financial difficulties
- Philosophical differences with tax law (which have been consistently rejected by the courts)

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Employers are currently utilizing many schemes to avoid the proper withholding and payment of employment taxes. The IRS has been successful in combating these schemes as evidenced by recent convictions and court rulings involving such schemes. The eight most common types of employment tax noncompliance include:

1. Pyramiding
   - Business uses withheld taxes to pay creditors other than IRS
   - Employment tax liabilities continue to accumulate or "pyramid"
   - Business likely to shut down or file for bankruptcy
   - Business owner starts a new business with a new employer identification number thus the pyramiding is likely to occur again
2. Unreliable third party payers
   - Include payroll services providers and professional employer organizations
   - Business owners need to ensure both company types properly handle employment tax responsibilities
   - Use of Electronic Federal Tax Payment System (EFTPS) by third party payer allows payment verification by the business owner
3. Frivolous arguments
   - Incorrect interpretations of "§861" which have been refuted in court
   - Use of 941c, Supporting Statement to Correct Information on Form 941, to obtain refund of previously paid employment taxes
4. Offshore employee leasing
   - Individuals are "leased" to the business
   - Funds are sent offshore as "deferred" compensation
   - "Deferred" compensation paid to leased employee treated as "loan" or put into an account under employee control
   - Neither employment taxes nor income taxes are owed on the "deferred" compensation
5. Misclassifying worker status
   - Employee is incorrectly classified as an independent contractor
6. Paying employees in cash
   - Business owners required to withhold employment taxes but likely do not
7. Filing false payroll tax returns or failing to file payroll tax returns
   - Business owners intentionally understate the correct amount of wages
8. S-corporation officer compensation treated as corporate distributions
   - Officer compensation received for services is subject to employment taxes

The IRS encourages employees to report employers who fail to properly withhold and pay employment taxes by contacting 1-800-829-1040 or report suspected tax fraud by calling 1-800-829-0433.

Levy of Limited Liability Company (LLC) Members
Revenue Ruling 2004-41, May 3, 2004
IRC §6331

☞ No Levy on LLC Members for LLC Employment Tax Liability

Purpose. To determine if multi-member domestic LLC members can be held personally liable for federal employment tax liabilities incurred by the LLC and, as such, be subject to IRS levy on members' property and rights to property.

Background. In states where LLCs are permitted to be formed, state law generally provides LLC members are not liable for the debts of the LLC except in limited exceptions. However, since an LLC is an entity classified as a partnership for federal tax purposes, can the IRS collect federal employment tax liabilities from the LLC members as if they were general partners of a partnership and thus be subject to levy?

Analysis. Although state law generally provides that general partners are jointly and severally liable for the partnership's debts, an LLC member is generally not liable under state law for LLC's debts.

Ruling. When state law holds that LLC members are not liable for debts of the LLC, the IRS cannot collect LLC employment tax liability from members, including by levy on property and right to property of the members.

Note. LLC members may be held liable for the trust fund recovery penalty under IRC §6672. The 100% penalty assessment could apply to an LLC member who is the "responsible person" for assuring that withheld employment taxes are paid to the IRS.

FICA Student Exception
IRS Notice 2004-12, February 24, 2004
IRC §3401 (Proposed Regulations)

☞ IRS Proposes to Narrow FICA Student Exception

Purpose. To explain the proposed regulations regarding the FICA exception which apply to students employed by a higher education institution for **services performed after February 24, 2004.**

Background. Services performed in the employ of a school, college, or university (SCU) whether or not the organization is tax-exempt, or an IRC §509(a)(3) affiliated organization are **excepted from employment for FICA purposes if performed by a student** who is enrolled and regularly attending classes at the institution.[56] The student FICA exception applies only if both the SCU and student status are met. **Rev. Proc. 98-16** provided the student FICA exception did **not** apply to services performed by:

- "Career employee"
- Post doctorate students
- Post doctorate fellows
- Medical residents
- Medical interns

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56. IRC §3121(b)(10)

The FICA exception issue as it applies to medical residents and interns has been litigated twice in the last six years. The IRS lost both of these court decisions.

Application. The IRS has determined a need to narrow the FICA student exception through the issuance of Notice 2004-12. **Therefore, effective February 25, 2004, Rev. Proc. 98-16 is suspended.** The changes proposed by Notice 2004-12 are that the FICA exception **would not apply to:**

1. Certain institutions (hospitals or museums) whose primary function is other than conducting educational activities
2. Employees who regularly work 40 hours or more per week
3. Career employees

The notice also expands the definition of **"career employee"** to be an employee who meets any of the four following tests:

1. Regularly performs services 40 hours or more per week
2. Is a professional employee whose primary work:
   - Requires knowledge of an advanced type
   - Requires consistent exercise of discretion and judgment
   - Is predominantly intellectual and varied in character
   - Is of such character that the work results cannot be standardized
3. Is licensed under state and local law to work in the field
4. Is eligible for benefits such as:
   - Vacation, sick leave, or paid holiday benefits
   - Retirement plan or arrangement
   - Reduced tuition because of the individual's employment relationship with the institution
   - Life insurance
   - Qualified educational assistance
   - Dependent care assistance programs
   - Adoption assistance

Rules for Undergraduate and Graduate Students. In the case of undergraduate and graduate students, an individual who is a **half-time student and who is not a career employee** would qualify for the student FICA exception for services performed at or for the **institution of higher education** in which enrolled. **Services performed by the student for any other employer would not qualify for the exception.**

Effective Date. For services performed on or after February 25, 2004.

FTD Penalty

IRS News Release IR-2004-70, May 24, 2004

IRC §6656

☞ One-Time Failure to Deposit Penalty Refund Offer is Available

Business taxpayers have the opportunity to receive an automatic **one-time penalty abatement** if they have ever been assessed a failure to deposit (FTD) penalty on a Form 941, *Employer's Quarterly Federal Tax Return.* In order to qualify the employer must:

- Not be required to use Electronic Federal Tax Payment System (EFTPS),
- Use EFTPS for one year (four consecutive quarters),
- Timely make all Form 941 payments, and
- Have **fully paid** the failure to deposit penalty which was previously assessed.

Beginning in 2005, the IRS will automatically determine which employers have met the four quarters of EFTPS compliance and will abate and refund the most recent fully-paid FTD penalty. (The look back period will be the four quarters prior to the four-quarter compliance period.) Penalties paid prior to the look back period are **not eligible** for the automatic offer. A refund will be sent if no outstanding taxes are owed by the employer.

The EFTPS system allows businesses, individuals, and tax professionals to make payments electronically online, by phone, or with batch provider software. EFTPS allows payments to be made 24 hours a day, seven days a week from home or office. Business payments can be scheduled up to 120 days in advance while individual payments can be scheduled 365 days in advance. Other features of EFTPS include access to the last 16 months of tax payment information and an immediate acknowledgement number issued for each EFTPS transaction.

To enroll in the program, practitioners can visit www.EFTPS.gov or contact a EFTPS Customer Service at 1-800-555-4477 to request an enrollment form by mail. For additional information on the special refund offer, see IRS Pub. 4048, *Special IRS Penalty Refund Offer*. For questions regarding the refund offer, call the number listed above.

ESTATE AND GIFT

Family-Owned Business Interests

Letter Ruling 200430030, March 24, 2004

IRC §2057

☞ Election to Deduct Value of Qualified Family-Owned Business Interests is Invalid

Facts. When Decedent died, his estate included two tracts of farmland, Properties 1 and 2, and a checking account. Property 2 was devised to a daughter. However, she sold it during the administration of the estate to an unrelated third party.

The executor timely filed the Form 706 for the estate. **On Schedule T, the estate elected the §2057 deduction for Property 1 and the checking account. Property 2, the farmland sold by the daughter, was not listed as a §2057 asset.** Based on the information contained on the Form 706, the adjusted (reduced) value of Property 1 and the checking account exceeded 50% of Decedent's adjusted gross estate. Therefore, the estate appeared to qualify for the §2057 deduction.

The IRS, in its exam of the estate, determined that the estate failed to include the amount of Decedent's gifts made within three years of his death in the gross estate. When the unreported gifts were included, the adjusted value of Property 1 and the checking account no longer exceeded 50% of Decedent's adjusted gross estate. **When the IRS informed the estate that it did not qualify for the §2057 deduction, the estate argued that Property 2, the tract sold by the daughter, should be included in the §2057 computation.**

Issue. Whether the §2057 election made by the estate to deduct the value of Decedent's qualified family-owned business interests is valid.

Analysis. In order for the §2057 deduction to apply, several requirements must be satisfied. One of those requirements is the **10-year recapture agreement** that must be made for qualified family-owned farm or trade or business property. **Without the required recapture agreement of all qualified heirs, the §2057 election is not valid.**

Conclusion. The IRS agreed that when the value of Property 2 was considered, the adjusted value of Decedent's qualified family-owned business interests exceeded 50% of the adjusted gross estate. However, the estate did not list Property 2 as a qualified family-owned business interest on Schedule T of Form 706. Therefore, the qualified heirs did not agree to the recapture provisions of §2057(f) for Property 2. As a result, **the §2057 election to deduct Decedent's qualified family-owned business interests is invalid. No §2057 deduction may be claimed by the estate.**

Family Limited Partnerships

***Estate of Ida Abraham v. Commissioner,* TC Memo 2004-39, February 18, 2004**
IRC §2036

☞ Full FMV of Family Limited Partnership Includable in Gross Estate

Facts. Ida Abraham inherited substantial estate assets from her deceased husband on his death in 1991, including ice and roller skating rinks and a lumber yard. Mrs. Abraham's health failed and she was placed under a guardianship by her three children in 1993. In 1994, the children and their legal advisers designed an estate tax plan involving three family limited partnerships (FLPs).

Various properties owned by Mrs. Abraham, including the skating rinks and the lumber yard, were transferred to three FLPs. The FMV of the transferred properties was approximately $2.5 million. In return, she received both a general and limited partnership interest. Her children were limited partners. When **the FLPs were created in 1995, the three children provided the following consideration to their mother in exchange for their limited partner interests in the FLPS**:

1. Richard Abraham paid no cash consideration to his mother. Instead, he received his limited partnership interest in exchange for the settlement of his claims against the future estate of Ida Abraham.
2. Two daughters paid $160,000 each to Ida Abraham in exchange for their limited partnership interests.

According to the state court approved decree which authorized the creation of the FLPs, Ida Abraham's financial needs were to be considered **first** from FLP-generated income. Only after her personal expenses were met did her children/limited partners have a right to partnership income.

Ida Abraham died in June 1997. **At the date of death, the FMV of the real property she had previously transferred to the three FLPs was approximately $3 million.** However, according to the FLP agreements, the decedent owned minority interests in each of the three FLPs at death**. Her minority interests in the three FLPs were valued at approximately $720,000 on her estate tax return.** In valuing the FLPs for estate tax purposes**, a total discount of 35% was applied** for minority and lack of marketability reasons.

In its exam of the estate, the IRS determined that the full FMV of the FLPs was includable in her gross estate. The IRS contended that Mrs. Abraham did not receive adequate and full consideration for the FLP interests which were transferred to her children in 1995. As a result, the exception from inclusion in her gross estate provided by IRC §2036(a) did not apply. The IRS assessed additional estate tax of $1.1 million.

Issue. Whether the full date of death value of the three FLPs is includable in the taxable estate under IRC §2036.

Analysis. The general purpose of §2036 is to "include in a decedent's gross estate transfers that are essentially testamentary, i.e., transfers which leave the transferor a significant interest in or control over the property transferred during his lifetime."[57] "Thus, an asset transferred by a decedent while he was alive cannot be excluded from his gross estate unless he absolutely, unequivocally, irrevocably, and without possible reservations, parts with all of his title and all of his possession and all of his enjoyment of the transferred property."[58]

Holding. The Tax Court upheld the additional estate tax deficiency as determined by the IRS. The court stated: "The record demonstrates that the structure that the decedent employed through her legal representatives and family was merely a testamentary vehicle employed to shift her assets to future generations while maintaining her continued right to benefit from the FLP interests she transferred. This is precisely the type of situation for which §2036 was created."

The court also agreed with the IRS position that the decedent did not receive adequate and full consideration for the FLP interests she transferred to her children.

> **Note.** The strict interpretation of IRC §2036 by the IRS is evidenced by numerous estate tax decisions of various courts during the last several years. For another case with similar facts and the identical result, see *Estate of Hillgren v. Commr.*, TC Memo 2004-26, March 3, 2004.

Family Limited Partnerships

***Estate of Ruth A. Kimbell v. United States,* 5th Circuit Ct. of Appeals, No. 03-10529, 2004-1 USTC ¶60,486, May 20, 2004, reversing the prior Northern Texas U.S. District Court decision: No. 7:01-CV-0218-R, 2003-1 USTC ¶60,455, January 14, 2003**

IRC §2036

☞ 5th Circuit Sanctions Validity of FLP Formed Two Months Before Death

Facts. Ruth Kimbell died on March 25, 1998 at age 96. In a series of estate tax planning transactions beginning in 1991 and ending two months before her death, Ruth had transferred the bulk of her assets to the three entities listed below.

Name of Entity	Type of Entity	Date Created	Decedent's Ownership %
1) R.A. Kimbell Living Trust	Revocable trust	1991	100%
2) R.A. Kimbell Management Co.	LLC	01/07/1998	50% via trust
3) R.A. Kimbell Property Co.	Family Ltd. Partnership	01/29/1998	99.5% via trust and LLC

When the FLP was created less than two months before Ruth's death, her trust contributed $2.5 million in cash, oil and gas working interests, securities, and other assets to the FLP. In exchange, Ruth received a 99% pro-rata **limited** partnership interest. The LLC contributed $25,000 in cash to the FLP and in exchange received a 1% pro-rata **general partner** interest. The FLP had a term of 40 years.

57. *United States v. Estate of Grace*, Supreme Ct., 395 U.S. 316, 69-1 USTC ¶12,609, June 2, 1969

58. *Estate of Thompson v. Commr.*, TC Memo 2002-246, September 26, 2002

Under the stated terms of the FLP agreement, the purposes in forming were to:

- Increase the family wealth
- Prevent transfer of a family member's interest in the FLP as a result of a failed marriage
- Provide flexibility and continuity in business planning for the family not available through trusts, corporations, or other business entities
- Promote the family's knowledge of and communication about family assets
- Preserve family harmony and avoid the expense and problems of litigation
- Facilitate the administration and reduce the cost associated with probate of the estate of family members

The estate filed its federal estate tax return in December 1998. At the time of Ruth's death, the market value of the FLP's assets, of which she owed 99%, was $2.4 million. **The estate claimed a 49% discount on the FLP assets due to the decedent's (1) lack of control (Ruth was only a limited partner) and (2) lack of marketability.** As a result, the estate valued Ruth's 99% interest in the FLP on her death at only $1.2 million.

Ruth Kimbell retained over $450,000 of personal assets outside the LLC and the FLP to pay for her personal living expenses until she died (which was shortly after the two entities were formed).

The IRS audited the estate and determined that the full value of the assets Ruth transferred to the FLP, rather than her 99% interest in the FLP, should have been included in the gross estate. The IRS relied on IRC §2036(a) as its authority. Consequently, the estate owed additional tax of $837,000. The executor paid that amount and sued for refund in U.S. District Court.

The Northern Texas U.S. District court agreed with the IRS in 2003. The estate appealed that decision to the 5th Circuit Court of Appeals.

Issue. Whether the IRS overvalued the decedent's interest in the family limited partnership on the estate tax return.

> **Note.** The Analysis and Holding omits the issue of the value of the decedent's interest in the LLC as that was a minor valuation issue compared to the valuation of the FLP.

Analysis. Under §2036(a), a decedent's gross estate must include the value of property transferred during his lifetime if he:

- Retained the possession or enjoyment of the transferred property, or
- Retained the right to income from the transferred property, or
- Retained the right to designate the persons who shall possess or enjoy the property or the income from it for the decedent's life.[59]

There are two exceptions to the general rule:

1. The transfer is a bona fide sale for full and adequate consideration.[60]
2. The decedent did not retain the (1) possession, enjoyment or rights to the transferred property, or (2) the right to designate the persons who would possess or enjoy the transferred property.[61]

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59. IRC §2036(a)

60. Treas. Reg. §20.2036-1(a)

61. *Estate of Eugene Stone III v. Commr.*, TC Memo 2003-309, 86 TCM 551, November 7, 2003

Holding. After an exhaustive review of previous court decisions and an analysis of the Internal Revenue Code and Regulations, the 5th Circuit sided with the estate and against the IRS and the Texas U.S. District Court. The 5th Circuit held that the first exception to the general rule of §2036(a) applied. It held that Ruth Kimbell's transfer of the bulk of her personal assets to the FLP was a bona fide sale for full and adequate consideration. Therefore, the estate was entitled to an $837,000 refund.

> **Note.** See pages 366–372 and 593–94 in the *2003 University of Illinois Federal Tax Workbook* for more information on using family limited partnerships as an estate tax saving vehicle. Some tax reference sources have predicted that the IRS will continue to insist on a strict interpretation of §2036(a) outside the 5th Circuit.

Future Lottery Installment Payments

Estate of Paul C. Gribauskas v. Commissioner, **2nd Circuit Ct. of Appeals, No. 01-4189, 2003-2 USTC ¶60,466, August 26, 2003, reversing the prior Tax Court decision: 116 TC 142 (2001)**
IRC §§2031, 2033 and 7520

☞ 2nd Circuit joins 9th Circuit in Allowing an Estate Discount for Future Lottery Payments

Facts. The decedent and his wife won a $15.8 million Connecticut Lotto prize in 1992, to be paid in 20 annual installments of $790,000. Following the receipt of the first installment, the decedent and his wife divorced. Thereafter, each was entitled to receive $395,000 for 19 remaining years. Paul Gribauskas died intestate on June 4, 1994 with 18 installments remaining to be paid. The total of the 18 remaining payments to his estate was $7.1 million.

Connecticut law forbids the option of a lump-sum payout for winnings in excess of $1 million. In addition, lottery winners were forbidden from assigning or transferring their right to future installments to third parties. Nevertheless, there was a market for such "unassignable winnings," although at a sizable discount. The IRS did not dispute this fact.

Considering the lack of liquidity and marketability restrictions imposed by state law, the estate valued the remaining $7.1 million lottery payments at $2.6 million. The estate treated the future payments as an unsecured debt obligation and applied a 15% discount.

IRS determined that the remaining payments constituted an annuity and valued them at $3.5 million using the actuarial tables under IRC §7520. As a result, the IRS assessed additional estate tax of $403,000. The Tax Court agreed with the IRS position and the estate appealed to the 2nd Circuit Court of Appeals.

Issue. Whether future lottery installment payments must be valued using the actuarial tables for annuities under §7520.

Analysis and Holding. The 2nd Circuit reversed the Tax Court and accepted the estate value of $2.6 million for the future lottery payments. The 2nd Circuit used the prior *Shackleford* 9th Circuit Ct. of Appeals decision[62] as a strong precedent to hold that the use of the actuarial tables under §7520 was improper. The 2nd Circuit judges quoted the following from the *Shackleford* opinion: "The right to transfer is one of the most essential sticks in the bundle of rights that are commonly characterized as property."

Therefore, according the 2nd Circuit, the assignment restrictions imposed by state law must be considered in properly valuing the future lottery payments. The court accepted the 15% discount factor used by the estate.

62. *Estate of Rosa Shackleford v. United States*, 9th Cir. Ct. of Appeals, 262 F. 3rd 1028, 2001-2 USTC ¶60,417, August 28, 2001

Notes.

See page 400 in the *2001 University of Illinois Farm Income Tax Workbook* for an analysis of the prior Tax Court decision in this case.

See page 574 in the *1999 University of Illinois Farm Income Tax Workbook* for an analysis of a California U.S. District Court decision in the *Estate of Shackleford*. The IRS appealed this decision and lost again in the 9th Circuit in 2001.

The 5th Circuit Court of Appeals reached an opposite decision to that of the 9th and 2nd Circuits in the *Estate of Cook*.[63] The 5th Circuit, in agreeing with the IRS and a prior Tax Court decision, ruled that future lottery payments qualify as a private annuity. As such, the annuity tables under §7520 is the proper way to value the payments for estate tax purposes. The *Estate of Cook* 5th Circuit decision is not included for full analysis in this chapter.

With the split in the Circuit Courts of Appeal, there is a reasonable chance that the Supreme Court will eventually decide this issue in the future.

Charitable Deductions

Revenue Ruling 2003-123, December 15, 2003

IRC §§170, 641, 642 and 661

☞ No Charitable Deduction or Distribution Deduction for Trusts

Purpose. To determine if a trust is allowed a charitable deduction under IRC §642(c) or a distribution deduction under IRC §661(a)(2) for a charitable "qualified conservation contribution" under IRC §170(h).

Background. A complex trust owns two adjacent parcels of real property. The parcels include 20 acres of undeveloped land and 50 acres with improvements. The trust is authorized to make charitable contributions and, therefore, **conveys a perpetual conservation easement "qualified conservation contribution"** to State Agency. The value of the easement is \$10x while the gross income of the trust is \$20x. **The contribution of the conservation easement is from the principal of the trust.**

Analysis. Trusts are allowed a deduction for any amount of **gross income** paid as a charitable deduction.[64] However, amounts paid to a charity from a trust's corpus do **not** qualify for either the charitable deduction or the distribution deduction.[65]

Ruling. A trust may not take either a charitable deduction or a distribution deduction when it conveys a perpetual conservation easement from trust **principal**.

63. *Estate of Gladys J. Cook v. Commr.*, 5th Circuit Ct. of Appeals, No. 02-61011, 2003-2 USTC ¶60,471, November 13, 2003

64. IRC §642(c)(1)

65. IRC §663(a)(2) and Rev. Rul. 68-667

Income Tax Reimbursement

Revenue Ruling 2004-64, July 6, 2004
IRC §§671, 2036, 2501 and 2512

☞ Intentional Defective Grantor Trusts Receive Favorable Treatment

Issues. (1) What is the gift tax consequence when the grantor of a trust pays the income tax attributable to the inclusion of the trust's income in the grantor's taxable income? (2) What is the estate tax consequence if the grantor may or must be reimbursed by the trust for that income tax?

Facts. In Year 1, Taxpayer A creates and funds an irrevocable inter vivos trust for the benefit of A's descendents. Trust receives taxable income in Year 1 which is reported on A's personal income tax return. This additional income increases A's individual income tax liability by $2.5x. A dies later in Year 3 at which time the FMV of the trust assets are $150x.

Situation 1. Neither state law nor the trust governing instrument require or permit the trustee to distribute amounts to A to satisfy the income tax liability resulting from inclusion of trust income in A's taxable income. Therefore, A pays the income tax from A's own funds.

Holding. A's payment of the $2.5x income tax liability does not constitute a gift by A to the beneficiaries of the trust because A, not the trust, is liable for the taxes.

Situation 2. The Trust's governing instrument provides that if A is treated as the owner of any portion of the Trust, the trustee will distribute income or principal to cover the additional tax liability. The trustee distributes $2.5x to cover the additional income tax liability occurring.

Holding. A's payment of $2.5x income tax liability does not constitute a gift by A, because A is liable for the tax. The trustee's distribution as reimbursement for income tax is not a gift by the trust beneficiaries to A because the distribution from the trust is mandated by the terms of the trust agreement. However, the full value of the trust assets, $150x, must be included in A's gross estate on his death in Year 3 under IRC §2036(a)(1).

Situation 3. The trust's governing instrument provides that if A is treated as the owner of any portion of the trust, **the trustee may, in the trustee's discretion,** distribute income or principal to cover all or part of A's additional income tax liability. The trustee distributes $2.5x to reimburse A for A's additional income tax liability.

Holding. A's payment of $2.5x income tax liability does not constitute a gift by A because A is liable for the tax. Since the reimbursement resulted from the exercise of the trustee's discretion, the payment is not considered a gift by the trust beneficiaries to A. Trustee discretion in combination with other facts may cause inclusion of trust assets in A's gross estate for federal estate tax purposes.

Prospective Application. The IRS will not adversely apply the estate tax holding in Situation 2 to grantor's estate for any trust created before October 4, 2004.

> **Note.** Estate tax attorneys and planners are extremely pleased with this favorable ruling. The result is that the grantor's payment of individual income tax does not constitute a gift to the beneficiaries of the trust. The result is the grantor can make more gifts to beneficiaries that qualify for the $11,000 annual gift tax exclusion.

GROSS INCOME

Resident Alien Taxation

***Sudheshna Purushotham v. Commissioner,* TC Summary Opinion 2003-164, December 2, 2003**
IRC §1

☞ Resident Alien's Gross Income Computed in Same Manner as a U.S. Citizen

Facts. The taxpayer, a citizen of India, was a lawful permanent resident of the United States during 2000. She received the following gross income during 2000:

Wages reported on Form W-2	$13,512
Nonemployee compensation reported on Form 1099-MISC	14,164
Interest income reported on Form 1099-INT	190
Dividend income reported on Form 1099-DIV	22

When she prepared her 2000 tax return, she reported only the Form W-2 wages and income tax withheld and omitted the other income. Her 2000 return showed a refund due of approximately $1,000. The IRS Service Center, in the information document matching program, detected the unreported income. As a result, the IRS determined that the taxpayer was liable for the following:

- Additional income and self-employment tax of approximately $4,000 on the unreported income
- A $600 failure to pay penalty since she filed her 2000 return after April 15, 2001 with no extension

Taxpayer's Position. As a resident alien, she was unconstitutionally subject to "taxation without representation" because no members of Congress are resident aliens.

Holding. The Tax Court dismissed the constitutional issue and noted that the Constitution requires that members of Congress must be citizens of the United States.

> **Note.** The brief one-page court transcript suggests that this may have been the **shortest trial** in the long history of the Tax Court. Naturally, the taxpayer represented herself.

Qui Tam Payment

***Emmanuel L. Roco v. Commissioner,* 121 TC 160, No. 10, September 11, 2003**
IRC §§61 and 6662

☞ Qui Tam Reward Payment from U.S. Government is Taxable

Facts. The taxpayer, an accountant, worked for the New York University Medical Center (NYUMC) from 1974 to 1992. He was fired after he told his manager that he believed NYUMC had substantially overcharged the United States for costs associated with federally sponsored research grants, Medicaid, and Medicare.

He, acting as "relator," filed a "qui tam" action lawsuit against NYUMC in the New York U.S. District Court in 1993. The taxpayer researched the law concerning "qui tam" actions suits, drafted the complaint, and appeared pro se in the "qui tam" proceeding.

> **Note.** Congress enacted the False Claims Act (FCA) in 1863 to discourage price gouging by suppliers to the War Department during the Civil War. Under the FCA, either the United States or a private person (the relator) may bring suit, known as a "qui tam" action, against any person who knowingly submits a false or fraudulent claim for payment to the United States.

The U.S. Attorney intervened in the lawsuit. NYUMC quickly settled by agreeing to reimburse the United States $15.5 million which was paid in May 1997. The United States then paid the taxpayer $1,568,087 in 1987 for which a 1997 Form 1099-MISC was issued.

The taxpayer, who had always filed jointly with his wife, discussed the tax implications of the payment with her. His wife was a New York state income tax auditor. They jointly decided that the $1.57 million reward payment was not taxable. However, the wife refused to file a joint 1997 federal tax return with the taxpayer. She feared that she might lose her job if her employer discovered she owed additional federal income tax for failing to report the payment.

The taxpayer filed his 1997 separate return and neither reported nor disclosed the $1.57 million reward payment. The IRS Service Center, in the information document matching program, determined that the payment represented unreported income. As a result, the IRS assessed:

- $610,000 of additional tax, and a
- $122,000 substantial understatement of tax penalty.

Issues.

1. Whether the $1,568,087 "qui tam" payment represents gross income.
2. Whether the taxpayer is liable for the accuracy-related substantial understatement of tax penalty under IRC §6662(a).

Analysis and Holding for Issue 1

Position of the Taxpayer. If "qui tam" payments are taxable, taxpayers will be discouraged from bringing recovery suits which might benefit the United States.

Position of the IRS. Rewards are generally taxable.[66]

The Tax Court agreed with the IRS, holding that the reward was taxable.

Holding for Issue 2. The court also upheld the imposition of the 20% accuracy-related penalty. The court concluded that the taxpayers actions failed to demonstrate good faith and reasonable cause. The taxpayer testified that "since I received a Form 1099-MISC, I expected the IRS would audit my 1997 return." **The court noted: "Triggering an audit by omitting income reported on a Form 1099 is not a good faith attempt to comply with the tax laws."**

> **Note.** The penalty might have been avoided if (1) there was a **reasonable basis** to hold that the payment was excludable (very doubtful), and (2) **adequate disclosure** of the position was made by attaching Form 8275 to the return.

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66. Treas. Reg. §1.61-2(a)

Embezzlement Income

***Howard H. Thompson, Jr. v. Commissioner,* TC Memo 2004-2, January 5, 2004**

IRC §61

☞ Embezzled Funds Reported on Form 1099-MISC are Taxable

Facts. Following the death of his father in 1994, the taxpayer temporarily served as president, secretary, treasurer, and chairman of the board of directors of Weavewood, Inc. (Weavewood). It was a family owned closely-held corporation engaged in the manufacture of wood products. The taxpayer's tenure with Weavewood began in August 1995 and ended in July 1996.

The taxpayer was dismissed by Weavewood from his management duties for the following reasons:

- The business suffered financially.
- Bills were not being paid.
- Taxes were not being paid.
- Corporate-owned stock held for decades was being sold.
- Corporate funds were being used by the taxpayer for non-business purposes.

Following a thorough audit of company finances, it was determined that the taxpayer had improperly converted $122,391 of Weavewood's funds to his personal use in 1996. A 1996 Form 1099-MISC was issued to the taxpayer for that amount. **Weavewood contended that the $122,391 represented embezzlement income.**

Mr. Thompson did not file a 1996 individual tax return. The IRS determined, in addition to the embezzlement income, he had $4,000 of wages, $2,200 of unemployment compensation, and substantial rental income. Based on these facts, the IRS assessed additional tax of $89,500 for 1996. The IRS also assessed a failure to file penalty of $22,300.

Issues.

1. Whether the taxpayer had unreported income in 1996.
2. Whether the failure to file penalty under IRC §6651(a)(1) was properly assessed.

Analysis and Holding. The Tax Court, after evaluating voluminous evidence pertaining to the alleged embezzlement income, agreed with the IRS on both issues. The IRS assessment of additional tax and the failure to pay penalty was upheld. **Gross income includes illegal income.**

Note. Illegal income, such as stolen or embezzled funds, represent taxable income and should be included as "Other income" on line 21, Form 1040, or on Schedule C if from a self-employment activity.[67]

67. IRS Pub. 525, *Taxable and Nontaxable Income* (For Use in Preparing 2003 Returns), page 28

Contingent Attorney Fees

***John W. Banks II v. Commissioner,* 6th Cir. Ct. of Appeals, 345 F. 3rd 373, 2003-2 USTC ¶50,675, September 30, 2003, reversing in part the prior Tax Court decision: TC Memo 2001-48, 81 TCM 1219, February 28,2001**
IRC §61

☞ Sixth Circuit Continues to Allow Exclusion for Contingent Fee Portion of an Award

Facts. Mr. Banks worked for the California Department of Education (CDOE) from 1972 to 1986, when he was terminated. He sued the CDOE, alleging employment discrimination under Title VII of the Civil Rights Act of 1964. His attorney negotiated a $464,000 settlement from the CDOE in 1990. The settlement agreement stated:

"The CDOE agrees to pay John W. Banks II the sum of $464,000 in full and complete satisfaction of his claims. Mr. Banks characterizes the $464,000 as payment for personal injury damages suffered after his discharge on July 14, 1986."

Mr. Banks paid to his attorney $150,000 of the settlement amount based on a contingent fee arrangement between them. On his 1990 tax return, Mr. Banks reported none of the $464,000 settlement proceeds. He contended that it was excludable under IRC §104(a) as "damages received on account of personal physical injury."

The IRS disagreed with that position and so did the Tax Court. Both the IRS and Tax Court held that the $464,000 was **not** attributable to any "personal injury," even though the settlement agreement signed by the parties mentioned "personal injury damages."

Issues.

1. Whether the entire $464,000 was excludable under IRC §104(a) as "damages received on account of personal physical injury."
2. Whether the $150,000 contingent attorney fee can be excluded from income even if the $464,000 settlement amount is not "damages received on account of personal physical injury."

Analysis for Issue 1. IRC §61 states that "gross income means all income from whatever source derived." However, various exclusions from income are provided, including the one found in IRC §104(a). The Supreme Court held that a §104(a) exclusion is warranted only where a two-prong test is satisfied:[68]

1. The taxpayer must have received the damages amount through the litigation of an action (or a settlement thereof) based on tort or tort-type rights.
2. The amount must be paid "on account of personal physical injuries or physical sickness."

Holding for Issue 1. The 6th Circuit held that $464,000 settlement amount was not attributable to "damages received on account of personal physical injuries" under IRC §104(a). **Therefore, the $464,000 was not excludable from gross income.**

Analysis for Issue 2. Even though there is split on the issue of whether contingent fees must be included in gross income, the 6th Circuit previously ruled that they can be excluded.[69] Based on that prior decision, the 6th Circuit reasoned that the assignment of income theory should not be applied to contingent attorney fees for the following reasons:

- A contingent fee, as part of a litigation claim, is not already earned, vested or even relatively certain to be paid to the litigant/assignor.
- The fee is merely an "intangible, contingent expectancy," dependent upon the attorney's skills to realize any value from it.

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68. *Commr. v. Erich E. and Helen B. Schleier*, 515 U.S. 323, 327-28, 95-1 USTC ¶50,309, June 14, 1995

69. *Estate of Arthur L. Clarks v. United States*, 6th Cir. Ct. of Appeals, 202 F. 3rd 854, 2000-1 USTC ¶50,158, January 13, 2000

- A contingent fee arrangement is similar to a partnership between the litigant/assignor and the attorney.
- No tax avoidance purpose motivates a contingent fee arrangement. To the contrary, a business purpose, namely a division of property, motivates its creation.
- If the fee is included in income, double taxation results.

Holding for Issue 2. The 6th Circuit reversed the Tax Court's holding that the $150,000 contingent fee must be included in income. **Therefore, Mr. Banks was required to include in his 1990 gross income only $314,000 ($464,000 settlement amount – $150,000 contingent fee).**

> **Note.** See Chapter 1, Individual Taxpayer Problems, Problem 5 for a thorough discussion of the contentious contingent attorney fee issue. The 6th Circuit includes Kentucky, Michigan, Ohio, and Tennessee.

Class Action Attorney Fee Award

Letter Ruling 200344022, October 31, 2003
IRC §§61, 3405, and 6041

☞ Attorney Fees are Excludable from Gross Income

Purpose. To determine if:

- Attorney's fees paid from a class action settlement are includible in gross income of the class members,
- Federal income tax is required to be withheld from the payments received by the class members for the attorneys' fees paid, and
- Information returns are required to be issued and filed to the class members for the attorneys' fees.

Facts. Plaintiff filed a class action lawsuit against B, alleging B has miscalculated lump sum distributions to participants in violation of the Employee Retirement Income Security Act of 1974. Recovery of additional pension benefits from B payable to a class of plaintiffs comprised of all participants who had received lump sum distributions from B at any time after a specified date was sought. Class members automatically became a class member entitled to the settlement benefits.

No individual class member personally entered into a fee agreement with the class counsel. The court granted final approval of the settlement agreement and awarded fees to the class counsel from the settlement fund for attorneys' fees, administrative expenses, and costs. B paid attorneys' fees directly to the class counsel.

The settlement agreement provided guidelines as to who would be considered a Class Member for purposes of the settlement agreement and further allowed claims to be submitted by the 90th day following the date of final judgment. Thus, as of the date of final judgment, the identity of the Class Members and the amount of their claims were unknown. A settlement fund was created with each class member receiving a base payment plus a proportional share of the "**net settlement fund**". "Net settlement fund" is the settlement fund less:

- Total base payments, and
- Amount awarded for attorneys fees, administrative expenses, and costs

Analysis. IRC §61 defines gross income as all income received from whatever source derived. In Situation 3 of Rev. Rul. 80-364, a portion of the settlement was designated for attorneys' fees and was not includible in the gross income of the individual union members.

Class actions are used by the judicial system to consolidate a group of common claims into one large claim against the same defendant. Class members obtain the benefits of the settlement by merely coming within the definition of the class. **Since the class members do not have any express contractual relationship with class counsel** and were not necessarily even identified until after final judgment of the case, **the attorneys' fees awarded are not includible in the gross income of the class members** and are not subject to mandatory withholding under IRC § 3405(c)(1)(B). In addition, no person is subject to the reporting requirements of IRC §6041 for the attorneys' fees portion of the payment.

Ruling. Class counsel attorneys' fees payments are not includible in class members' gross income and are not subject to withholding and reporting requirements.

Contract Dispute Payment

***Paul S. Lindsey, Jr. and Kristen L. Lindsey v. Commissioner,* TC Memo 2004-113, May 11, 2004**

IRC §§61,104(a)(2), 6651(a)(1) and 6662(a)

☞ Contract Dispute Settlement isTaxable

Facts. Paul Lindsey was the majority stockholder, CEO, and chairman of the board of Empire Gas Corp. In 1994, an investment banker introduced Mr. Lindsey to representatives from Northwest Public Service Company (NPSC). In an effort to expand the market for Empire Gas Corp., a contract was signed by the two companies.

In 1996, a contract termination agreement was reached between the two companies to settle a contentious dispute and the resulting lawsuit. The termination agreement provided that NPSC would pay Empire Gas Corp. and/or Paul Lindsey a total of $20 million.

Paul Lindsey, as CEO and chairman of the board of Empire Gas, proposed that $2 million of the $20 million contract be paid directly to him by NPSC. A clause in the contract termination agreement provided the following:

"NPSC and Paul Lindsey, Jr. hereby agree that, in exchange for the written general release from Mr. Lindsey, $2,000,000 of the payment amount ($20 million) shall be allocated to Mr. Lindsey, in settlement of his claims for tortuous interference with contracts, for personal injury including injury to Mr. Lindsey's personal and professional reputation and emotional distress, humiliation and embarrassment resulting from the contract termination."

Mr. Lindsey received the $2 million check from NPSC in December 1996. However, NPSC did not issue a 1996 Form 1099-MISC to Mr. Lindsey for the $2 million payment.

The Lindseys filed their joint 1996 tax return in January 1998 even though their automatic 4-month extension expired on August 15, 1997. **The $2 million payment was omitted from their 1996 tax return which reported a zero tax liability.**

An IRS examination of their joint 1996 tax return determined that the $2 million payment was taxable under IRC §61. As a result, the IRS assessed the following:

- Additional tax of $725,255
- Failure to time file penalty of $171,000
- 20% accuracy-related substantial understatement of tax penalty of $145,000

Issues.

1. Whether the $2 million payment was excludable from gross income under IRC §104(a)(2) as a payment received "on account of personal physical injury or physical sickness."
2. Whether the taxpayers were liable for the failure to timely file penalty under IRC §6651(a)(1).
3. Whether the taxpayers were liable for the 20% accuracy-related substantial understatement of tax penalty under IRC §6662(a).

Analysis for Issue 1. Gross income includes "all income from whatever source derived" unless otherwise provided.[70] IRC §104(a)(2) provides otherwise. **However, the unambiguous language of IRC §104(a)(2) clearly explains that "emotional distress shall not be treated as a physical injury or physical sickness."** As a result, only reimbursements for actual medical care for such injuries are now excludable. **These provisions apply to "amounts received on or after August 21, 1996 in taxable years ending after such date."**[71]

The position of the taxpayers is that the amendments made to IRC §104(a)(2) by the SBJPA are not effective until 1997 because that is the tax year ending after the enactment of the SBJPA. Alternately, the taxpayers' argued that Mr. Lindsey suffered physical injury due to the stressful and contentious contract dispute for which he was paid $2 million to settle.

Holding for Issue 1. The $2 million payment was received on December 17, 1996, which is after the date of enactment of the Small Business Job Protection Act (SBJPA) of 1996. The taxpayers' 1996 taxable year ended on December 31, 1996, which is also after the date of enactment of the SBJPA. **Clearly, the $2 million payment was received "on or after August 21, 1996" in the taxpayers' 1996 taxable year, which "ended after such date."**

Regarding the alternate position of the taxpayers, the court noted that the testimony of Mr. Lindsey's physician showed that Mr. Lindsey's physical exam in June of 1996 disclosed that he complained of easy fatigue, occasional indigestion, difficulty sleeping, and stress. **The court held that those symptoms are the type of injuries or sickness that Congress intended to be identified within the definition of emotional distress.**[72]

The Tax Court concluded that the $2 million payment was not received "on account of personal physical injuries or physical sickness" and therefore was taxable.

Holding for Issues 2 and 3. The court held that the taxpayers were liable for both penalties as they **failed to meet** either the reasonable cause or good faith exceptions.

INNOCENT SPOUSE

Equitable Relief

***Verna Doyel v. Commissioner,* TC Memo 2004-35, February 10, 2004**
IRC §6015

☞ Innocent Spouse Relief Denied Because Wife Knew of Tax Shelter Investment

Facts. Verna Doyel married Christopher Doyel in 1973. In 1984, the taxpayer and her husband invested in a cattle breeding tax shelter partnership. As a result of large partnership losses, Mr. and Mr. Doyel reported negligible total tax on their 1984, 1985, and 1986 joint tax returns.

Following an extensive exam of the tax shelter partnership by the IRS, additional tax was assessed to Mr. and Mrs. Doyel. The additional tax and interest was never fully paid. In 2001, Verna Doyel requested innocent spouse relief which was denied by the IRS Cincinnati Service Center. That decision was litigated in the Tax Court.

Issue. Whether the taxpayer qualifies for innocent spouse relief from joint and several liability under (1) IRC §6015(b)(1) (general relief) or (2) equitable relief under IRC §6015(f).

Analysis and Holding of General Innocent Spouse Relief under IRC §6015(b). In order to qualify for this type of relief, the requesting spouse must establish:

70. IRC §61(a)

71. The effective date as provided by the Small Business Jobs Protection Act of 1996 (SBJPA), which was enacted August 20, 1996

72. House Conf. Report 104-737, at 301

1. A joint return was made for a taxable year;
2. On that return there is an understatement of tax attributable to erroneous items of one of the spouses; and
3. The other spouse (the alleged innocent spouse) shows that in signing the joint return, **she did not know, and had no reason to know,** that there was an understatement as described in 2.[73]

The Tax Court determined that Mrs. Doyel did "have reason to know" that investing in a tax shelter partnership could and probably would lead to an understatement of tax. Therefore, the court upheld the innocent spouse relief denial by the IRS.

Analysis and Holding of Equitable Relief under IRC §6015(f). After considering the six factors outlined in Rev. Proc. 2000-15 regarding equitable relief, the Tax Court held that Mrs. Doyel did **not** qualify for it. The court stated that none of the six factors weighing in favor of granting relief were present including the following:

1. Verna Doyel was not divorced from her husband.
2. She would not suffer economic hardship if relief was denied.
3. She was not abused by her husband.
4. She did have "reason to know" that potential tax understatements existed due to her investment in the tax shelter partnership.

> **Note.** Perhaps the Tax Court judge was reluctant to grant innocent spouse relief because the Doyels owned two residences, numerous investments, and 401(k) plans valued in excess of $500,000. See pages 637–38 in the *2000 University of Illinois Farm Income Tax Workbook* for a thorough analysis of the six factors of Rev. Proc. 2000-15 that must be considered in determining whether equitable relief should be granted by the IRS.

Equitable Relief
***Gwendolyn A. Ewing v. Commissioner,* 122 TC 32, No. 2, January 28, 2004**
IRC §6015

☞ Tax Court Grants Equitable Relief to Innocent Spouse

Facts. Gwendolyn Ewing, a laboratory scientist, married Richard Wiwi in 1995. At the time of the Tax Court trial, Mr. Wiwi was an unsuccessful self-employed insurance and securities salesman. He concealed from Gwendolyn that he had prior financial obligations, including unpaid federal income tax for 1993 and 1994.

Gwendlolyn and Mr. Wiwi filed a joint 1995 tax return. Some of the information regarding their joint 1995 tax return is:

Gwendolyn's wages from Red Cross	$65,000	(rounded)
Federal income tax withheld from her wages	10,862	
Additional tax due	6,220	
Amount of balance due paid by Gwendolyn	1,069	
Amount of balance due paid by Mr. Wiwi	551	

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[73] IRC §§6015(b)(1)(A)(B) and (C)

Gwendolyn contended that the $1,069 she paid with the return was equal to the tax she owed on her 1995 income. The $551 which Mr. Wiwi paid was less than the tax due on his 1995 income. **Mr. Wiwi told the his wife that he would pay the unpaid $4,600 on 1995 tax as provided in a proposed installment agreement submitted with the 1995 return. However, he failed to make the installment payments.** In 1999, Mr. Wiwi filed an offer in compromise in which he contended he could not pay the remaining 1995 tax liability.

When Mr. Wiwi filed his offer in compromise in early 1999, Gwendolyn filed Form 8857, *Request for Innocent Spouse Relief.* She requested equitable relief from joint liability under IRC §6015(f). The IRS denied her request.

Issue. Whether Gwendolyn is entitled to innocent spouse equitable relief for 1995.

Analysis. Rev. Proc. 2000-15 lists various factors that the IRS must consider in determining whether to grant equitable relief. The Tax Court thoroughly considered each factor.

Position of the IRS. When Gwendolyn signed the joint 1995 return, she **knew or had reason to know** that her husband would not pay the $4,600 of unpaid tax. It was not reasonable for her to believe that her husband would pay the $4,600.

Position of the Taxpayer. Gwendolyn reasonably believed that her husband would pay the $4,600 according to the installment agreement attached to the 1995 return. She contended that her husband concealed from her until 1998 that he had made no installment payments.

Holding. After considering the factors, the Tax Court held that the taxpayer was entitled to equitable relief from joint liability. One factor that impressed the court was the fact that Gwendolyn filed subsequent tax returns and paid with those returns an amount equal to the tax on her income. Therefore, she had complied with tax laws in years following 1995.

She paid $4,453 with the 1997 joint return. The IRS believed that Gwendolyn demonstrated she was not compliant since federal income tax was underwithheld from her 1997 wages.

> **Note.** The Tax Court struggled with the technical legal issue of whether to allow the taxpayer to introduce additional evidence at the trial that was not included in the IRS's administrative record. Eleven of the judges decided that it was proper and three objected.

IRS PROCEDURES — AUDITS

Tax Schemes

IRS Fact Sheet FS-2004-12, March 2004
IRS News Release IR-2004-26, March 1, 2004
Revenue Rulings 2004-27 through 2004-34, March 2004
IRS Notices 2004-13 and 2004-22, March 2004
IRC §§165, 183, 501, and 701

☞ IRS Provides Update on 2004 "Dirty Dozen" Tax Schemes and Other Important Information

The IRS has compiled a variety of information to assist taxpayers in steering away from tax schemes.

Fact Sheet FS-2004-12. Guidance was issued to assist taxpayers in avoiding tax schemes and errors. This guidance includes:

- Eight revenue ruling identifying frivolous positions
- Two notices warning taxpayers about specific errors to avoid
- A news release identifying the 2004 "Dirty Dozen" most frequently used tax schemes

Check **www.irs.gov** for valuable information at the following sites:

1. "The Newsroom"
   - "What's Hot"
   - "Scams/Consumer Alerts"
2. "Tax Pro News"
3. "Topics for Individuals"

News Release IR-2004-26. The IRS continues to identify tax schemes that are promoted to offer alleged substantial tax benefits. Promoters and many of their clients are being pursued and successfully prosecuted for fraud and tax evasion.

The "Dirty Dozen" currently includes the following types of schemes:

- Misuse of Trusts
- "Claim of Right" Doctrine (Rev. Rul. 2004-29)
- Corporation Sole (Rev. Rul. 2004-27)
- Offshore Transactions
- Employment Tax Evasion (Rev. Rul. 2004-30)
- Return Preparer Fraud
- Americans with Disabilities Act
- African-Americans Get a Special Tax Refund (Rev. Rul. 2004-33)
- Improper Home-Based Business (Rev. Rul. 2004-32)
- Frivolous Arguments (Rev. Rul. 2004-28, 31, and 34)
- Identity Theft
- Share/Borrow EIC Dependents

IRS Notice 2004-13. This notice warns taxpayers about common math errors which are discovered during return processing and mistakes which are discovered after the return processing. Refund delays and follow-up letters can be avoided by filing accurate returns.

IRS Notice 2004-22. This notice provides a list of frivolous positions taken on taxpayer returns including the 16th Amendment being invalid. Those taxpayers asserting frivolous positions may likely be surprised to see the assertion of a **$500 penalty**. Those taxpayers who pursue these arguments at the Tax Court could face a **penalty of up to $25,000.**

Tax Schemes

Revenue Ruling 2004-32, March 1, 2004

IRC §§262, 6662, 6663, 6702 and 6673

☞ IRS Cautions Taxpayers About Tax Schemes Involving Home-based Businesses

Promoters are marketing Home-based Business Schemes (sometimes referred to as a "Tax Toolbox" or a "Tax Toolkit") containing video or audio tapes, workbooks, and recordkeeping aids. Promoters claim **that taxpayers can legally take tax deductions for personal, living, or family expenses** under the guise of conducting a home-based business. Claims made by the promoters include:

- Reducing federal income taxes by establishing a business, regardless of whether or not it is a bona fide business
- Operating a business will allow personal expenses to be deducted as legitimate business expenses
- Placing a calendar, desk, file cabinet, telephone, or other office-type item in each room of the home will allow most of the personal residence operating expenses to be deducted
- Using materials provided by promoters guarantees substantial reduction in federal income tax liability

The IRS is aware of this scheme and cautions taxpayers and their representatives that the alleged tax benefits are not allowable. The IRS intends to challenge Home-based Business Schemes **made for tax avoidance purposes** and take vigorous enforcement action against taxpayers, promoters and tax preparers as warranted. Courts have also enjoined promoters who market frivolous tax avoidance schemes utilizing frivolous arguments.

Tax Shelters

IRS News Release IR-2004-87, July 1, 2004

IRC §§165, 183 and 701

☞ 1,500 Taxpayers Decide to Participate in IRS Settlement Offer for Son of Boss Tax Shelter

In the late 1990s and 2000, the **Son of Boss** tax shelter was marketed to wealthy taxpayers with the promise of huge tax savings. Many taxpayers had transactions generating tax losses of **between $10 million and $50 million** while a few taxpayers claimed tax losses **in excess of $500 million**. In August 2000, the IRS issued Notice 2000-44 declaring the Son of Boss transactions abusive and requiring promoters to maintain a list of investors.

The IRS announced a settlement initiative window from May 5, 2004 through June 21, 2004 for Son of Boss tax shelter. More than 1,500 taxpayers have indicated their desire to take advantage of the settlement offer. **Terms of the settlement offer include:**

- Concession by the taxpayers of all claimed losses
- Full payment of interest
- Assertion and full payment of penalties (10 or 20% depending whether they had been involved in other abusive shelters) **unless they previously disclosed their participation in the transaction**
- Long-term capital loss will be allowed for out-of-pocket costs and fees, such as promoter or professional fees

For those taxpayers who have **chosen not** to accept the Son of Boss settlement offer, the IRS will issue a statutory notice of deficiency disallowing all losses and out-of-pocket costs and asserting maximum penalties up to 40%.

Stock Options

IRS Notice 2004-28, March 26, 2004

IRC §§56 and 83

☞ Taxpayers Warned about Frivolous Positions Regarding Stock Options

Stock options of a company, which are granted in exchange for services, can be either:

- Nonstatutory (compensatory stock option)
- Statutory (incentive stock option)

In either case, income tax consequences arise when the stock option is exercised. In the case of a **nonstatutory option,** IRC §83 and long standing judicial authority require the employee's gross income (compensation) include the excess of the FMV of the stock over the option exercise price. When a **statutory option** is exercised, IRC §56 requires that the employee's gross income, for purposes of computing **alternative minimum tax,** include the excess of the FMV of the stock over the option exercise price (the spread amount).

Generally, on the date of the grant, **statutory stock options** are **not** subject to regular tax. **Nonstatutory stock options** are subject to tax on the grant date **only** if an option is actively traded on an established securities market on that date or, if not so traded, it has a readily ascertainable FMV.

Four different positions are currently being utilized by taxpayers to achieve greater tax benefits thereby circumventing the appropriate tax treatment of stock option reporting. They are:

- FMV of stock purchased under option is reduced by restrictions placed on stock which prohibits employee from selling stock for a specified time.

> **Note.** See Letter Ruling 200338010 in the AMT section of this chapter for more information on this incorrect position regarding incentive stock options.

- Stock purchased under a nonstatutory option and subsequently sold due to a margin call results in an ordinary loss when the stock is pledged as security for a loan to fund the exercise price.
- Stock purchased with borrowed funds is not a purchase since employee does not have ability to repay the loan.
- Options are viewed as the economic equivalent of the underlying stock. Therefore the spread amount is not subject to AMT taxation on the exercise date.

The IRS is aware of these frivolous claims and cautions taxpayers and their representatives to properly report stock option transactions on the original and amended returns.

IRS Tax Exempt Compensation Initiative

IRS News Release IR-2004-81, June 22, 2004

IRC §§4941 and 4945

☞ IRS Targets "Seemingly High Compensation" of Tax-Exempt and Charitable Organization Leaders

Commissioner Mark Everson testified before the U.S. Senate Committee on Finance during a hearing on abuses at tax-exempt organizations. One of the issues that warrant scrutiny is excessive compensation paid to leaders of tax exempt groups. Commissioner Everson stated, "Neither a public charity nor a private foundation can provide more than reasonable compensation."

A comprehensive enforcement project, **IRS Tax-Exempt Compensation Initiative,** is being launched during the summer of 2004 to explore the reasonable compensation issues. This program will include contacts with hundreds of organizations using both traditional examinations as well as correspondence compliance checks. The first stage of the project will involve public charities and private foundations. Information requested from the organizations will include:

- Detailed information and supporting documentation on compensation practices and procedures
- Practices of setting and reporting compensation for specific executives
- Documentation on governing body which approved compensation
- Details and responsibilities of managers within the organization

Subsequent stages will include review of insider transaction (loans or sales to executives and officers) and organizations which failed to complete compensation information on Form 990.

The IRS hopes to use the information it receives to enhance compliance by:

- Learning what practices organizations use to set compensation;
- Learning how organizations report compensation to the IRS and the public; and
- Encouraging organizations to be realistic in compensation matters.

IRS PROCEDURES — ELECTRONIC FILING

E-Services

IRS News Release IR-2004-89, July 6, 2004
IRC §6103

☞ IRS Announces New Electronic Tools

Disclosure Authorization and Electronic Account Resolution are the two latest premium additions to the IRS suite of e-services. Premium e-services are available online options for tax professionals who successfully e-file 100 or more individual tax returns and are registered to use e-services.

Disclosure Authorization allows eligible tax practitioners to submit Power of Attorney (Form 2848) or Taxpayer Information Authorization (Form 8821) online. In addition, tax professionals can also view and modify existing authorization forms, as well as receive acknowledgement of accepted submissions **immediately** online. Each submission is acknowledged within seconds and allows tax professionals to represent clients immediately.

Electronic Account Resolution, which eliminates telephone and written response times, allows tax professionals to electronically correspond with IRS on:

- Individual or business account problems,
- Refunds,
- Installment agreements, and
- Notices or missing payments.

After verification of the tax professionals' authority, the IRS provides answers within **three business days** to an electronic secure mailbox and notifies the tax professional via email.

Transcript Delivery System (TDS) is the third premium e-service is TDS is used to request:

- Tax return transcripts,
- Account transcripts,
- Account records for individual taxpayers, and
- Account records for business taxpayers.

Other services previously delivered through the IRS Business Modernization program include:

- Registration,
- Preparer Tax Identification Number (PTIN) Application,
- Online *e-file* Application, and
- Taxpayer Identification Number (TIN) Matching.

E-Filing Fraud

IRS Criminal Investigation Comments, July 2004

☞ Increase in Rate of Fraudulent E-Filing

As the increase in e-filing has taken place, fraudulent e-filing has increased to approximately one out of every 1,200 returns e-filed. Four years ago, the rate of fraudulent e-filing was one in every 5,000 returns e-filed. The increase represents more than a 1,400% increase in fraudulent e-filed returns.

For 2004, 23% of e-filed returns were attached to refund anticipation loans (RAL) or similar products. In addition, approximately 80% of fraudulent e-filed returns are associated with some type of refund product. Through June 2004, the IRS has seen false claims of more than $200 million from more than 50,000 fraudulent e-filed returns during 2004 compared with $185 million a year earlier.

The IRS has boosted staffing in fraud detection centers by nearly 40% to help curb the e-filing fraud epidemic. Criminal Investigation has been using data mining to "resequence" returns, which involves delaying a return's refund cycle to give investigators time to determine a claim's legitimacy.

To assist the IRS with elimination of e-filing fraud, return preparers should question information provided to them and look for suspicious patterns in returns which might suggest fraud.

> **Note.** Gary Bell, Director of Refund Crimes Unit (Criminal Investigation) at Atlantic City, NJ Tax Forum is the source of this information.

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IRS PROCEDURES — MISCELLANEOUS

IRS Strategic Plan

IRS News Release IR-2004-95, July 16, 2004

☞ IRS Announces 2005-2009 Enforcement Goals

The IRS's Strategic Plan for 2005-2009 includes these enforcement goals:

1. Discourage and deter noncompliance by corporations and high-income individuals. Noncompliance includes failure to file and underreporting.
2. Continue policy of pursuing attorneys, accountants, and other tax practitioners who engage in abusive practices. These individuals can expect:
   - Preparer penalties
   - Disciplinary action under Circular 230
   - Suspended electronic filing privileges
   - Injunctions and actions by the IRS's Criminal Investigation Division
3. Detect and deter domestic and off-shore based tax and financial criminal activity.
4. Discourage and deter noncompliance within tax-exempt entities and misuse of such entities by third parties for tax avoidance.

Collection Due Process

***James M. Robinette v. Commissioner,* 123 TC No. 5, July 20, 2004**

IRC §6330

☞ IRS Abused Its Discretion in Ignoring Offer in Compromise

Facts. In 1995, the IRS accepted the taxpayer's offer-in-compromise (OIC) proposal on the basis of doubt as to collectibility. The taxpayer agreed to pay $100,000 to settle approximately $1 million of unpaid individual income taxes for 1983–1991. When the OIC was accepted by the IRS, the taxpayer agreed to the following terms:

- "I agree to file my tax returns for five years from the date the IRS accepts the OIC."
- "If I fail to meet any of the terms and conditions of the OIC, the offer is in default, and the IRS may levy to collect the original amount of tax liability, without further notice of any kind."

The taxpayer complied with all OIC conditions for his 1995, 1996, 1997, 1999, and 2000 individual tax returns by timely filing them and paying any balance due amounts. However, due to an apparent Postal Service error, the IRS did not receive taxpayer's 1998 return by the October 15, 1999 extended due date.

In July 2000, an IRS Revenue Officer declared the OIC in default because of nonreceipt of the taxpayer's 1998 return. A Final Notice—Notice of Intent to Levy and Your Right to a Hearing was issued in September 2000. In response, the taxpayer, through his accountant, requested a Collection Due Process (CDP) hearing with an IRS Appeals Officer.

In August 2001, an IRS Appeals Officer determined that:

- The OIC was in default, and
- The IRS could collect the original amount of unpaid tax liability for the 1983–1991 tax years.

Issue. Whether the IRS abused its discretion in determining to proceed with collection.

Analysis and Holding. The Tax Court concluded that the IRS did abuse its discretion under IRC §6330 for the following reasons:

1. The taxpayer established a clear pattern of timely filing on October 15 for his 1995–1997 and 1999–2000 individual tax returns.
2. The 1998 return, which reported a refund of $3,300, was evidently placed in the mail by taxpayer's accountant at 11 p.m. on October 15, 1999, along with two of his other clients' 1998 returns.
3. The IRS Appeals Officer refused to consider any evidence from the taxpayer's accountant regarding the:
   - Preparation of the 1998 return prior to October 15, 1999, and
   - The mailing of the 1998 return as indicated by a private postage meter log.

> **Note.** This case demonstrates poor judgment on the part of several IRS employees. The IRS would not consider the substantial evidence that indicated the 1998 refund return was timely filed and lost by either the Postal Service or the IRS. The Tax Court stated that both the taxpayer's and the accountant's testimony was "honest, forthright, and credible."

Collection Due Process

Nield and Linda Montgomery v. Commissioner, **122 TC 1, No. 1, January 22, 2004**
IRC §6330

☞ Tax Court Split in Expanding Scope of Collection Due Process Hearings

Facts. The taxpayers timely filed their joint 2000 tax return and reported the following:

- Total tax of $2,831,360
- Total payments of $2,636,723
- Balance due of $194,637
- Estimated tax penalty of $1,369

The IRS accepted and processed the 2000 tax return. Since the taxpayers failed to pay the $194,637 balance due, the IRS issued a Final Notice-Notice of Intent to Levy and Notice of Your Right to a Hearing in March 2002. In April 2002, the taxpayers submitted to the IRS a Form 12153, *Request for a Collection Due Process (CDP) Hearing.*

The taxpayers' Form 12153 included the following explanation:

"We have a good track record of paying our taxes timely, as evidenced by the 1997-1999 tax returns. However, in tax year 2000, we had an extraordinary tax liability due to an exercise of several incentive and nonqualified stock options and the application of the AMT rates.

We were able to pay $2,636,723 of the tax liability, but, unfortunately, the value of the stock received plummeted before year-end 2000 and is now essentially worthless. Thus, the remaining tax liability is currently thousands of times higher than the value of the stock received. We are working diligently and in good faith with various professional advisors to evaluate the situation and remedy the outstanding tax liability."

The CDP hearing request also stated that:

1. The taxpayers intended to prepare and submit an amended 2000 tax return which would show that they were actually entitled to a refund rather than owing a balance due.
2. The parties should explore alternatives to the proposed levy including an installment agreement, an offer in compromise, or posting a bond.

Following the CDP hearing in July 2002, the IRS concluded that the proposed levy should be allowed to proceed. The reason for that conclusion was that no amended 2000 return had been received "in a reasonable time."

In October 11, 2002, the taxpayers did file an amended 2000 return which reported a refund due of about $500,000. Two weeks later, the taxpayers petitioned the Tax Court for a review of the CDP hearing which recommended that the levy proceed.

Issue. Whether the taxpayers have a right to challenge the amount of their reported 2000 tax liability of $2,831,360 during the CDP hearing.

Analysis. The taxpayer may challenge the "existence or amount of the underlying tax liability" if the taxpayer did not either:

- Receive any statutory notice of deficiency for such tax liability, or
- Have an opportunity to dispute such tax liability.[74]

Holding. The Tax Court, in what appears to be a major expansion of taxpayer rights in CDP hearings, held that the Montgomerys could challenge their self-assessed tax liability as reported on their original 2000 tax return.

Notes.

1. The Tax Court was split on the decision, with 12 judges agreeing and four dissenting. The main reason for the disagreement was the court's interpretation of the term "underlying tax liability." The CDP hearing process was created by Congress to govern collection matters. The four dissenting judges questioned why a taxpayer should be allowed to challenge a return assessment that has never been paid.
2. Many observers expect that the IRS will appeal this decision and, in the meantime, might ignore it. Other tax professionals insist that the facts of this case are unusual. Therefore, the ability of taxpayers to challenge a previously assessed tax liability in CDP hearings will be limited.

74. IRC §6330(c)(2)(B)

Joint Returns

IRS Publication 17 – Your Federal Income Tax

IRC §6013

☞ Legally Married Same-Sex Couples Prohibited from Filing Joint Returns

Many states have been addressing the concept of legal same-sex marriages. In May, 2004, the Massachusetts Supreme Court case recognized same-sex couple marriages. The Massachusetts Department of Revenue has provided draft technical information which states such couples must file their state income tax returns either as married filing joint or married filing separately.

"The Defense of Marriage Act"[75] defines marriage for purposes of administering federal law as the "legal union between one man and one woman as husband and wife." It further defines "spouse" as "a person of the opposite sex who is a husband or wife." **Based on the legal definition, the IRS prohibits legally married same-sex couples from filing a joint return.**

Technical Guidance

IRS News Release IR-2004-105, August 4, 2004

☞ IRS Announces Technical Guidance Available via E-mail

The IRS is launching a new service which allows technical guidance via e-mail to tax professionals when documents are issued.

Practitioners wishing to subscribe to this service should:

1. Log onto www.irs.gov
2. Click on "The Newsroom"
3. Click on "e-News Subscriptions"
4. Select "IRS GuideWire"

The IRS also has the following e-mail services currently available through "e-News Subscriptions":

- Weekly summary of IRS technical guidance and other important news – subscribe to Digital Dispatch
- News releases through IRS Newswire
- IRS Tax Tips

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75. Sec. 3, P.L. 104-199, September 21, 1996

Tips

IRS News Release IR-2003-145, December 23, 2003

IRC §§3402 and 6053

☞ Tip Compliance Agreement Expands to the Gaming Industry

The IRS has expanded its voluntary agreement program to the gaming industry. The voluntary agreement program, known as the Tip Compliance Agreement, provides benefits to both employers and employees who participate. The agreement is renewable every three years.

Benefits to employers include:

- Reduced recordkeeping and reporting burden
- IRS audit protection for employment taxes on tip income of participating employees while agreement is in effect

Benefits to employees include:

- Potentially eligible for higher social security or other pension, Medicare, unemployment, and workers' compensation benefits
- Assistance in qualifying for loans and other financial arrangements
- IRS audit protection if tips are reported at or above established tip rate

Steps to the process include:

- Employer and IRS enter into a Gaming Industry Tip Compliance Agreement, which states a minimum level of employee participation as well as a tip rate specific to the establishment. The tip rate is determined objectively by the IRS, employer, and employees.
- Employer requests voluntary participation by employees.
- Participating employees report tip income to employer at or above the established tip rates, unless tip logs can substantiate a lesser amount.
- Employer withholds income tax based on tip rates or substantiated lesser amount.
- Employer reports income on employees' Form W-2.

> **Note.** Further details on the compliance agreement can be obtained from Rev. Proc. 2003-35, "Gaming Industry Tip Compliance Agreement Program," at www.irs.gov/pub/irs-drop/rp-03-35.pdf.

2001 Individual Income Tax Information

TD News Release JS-1287, April 1, 2004

IRC §1

☞ Who Pays the Most Individual Income Taxes?

The Treasury Department recently released information from 2001 (latest year of available data) which shows the following information:

- Top 1% of taxpayers paid nearly 34% of all individual income taxes
- Top 5% of taxpayers paid more than 53% of all individual income taxes
- Top 50% of taxpayers paid **over 96%** of total individual income taxes
- Tax cut provisions which are fully in effect in 2004 will cause higher-income taxpayers tax share to **increase**

Information on the individual share of income taxes paid from 1990–2001 are shown in the table below:

Share of Individual Income Taxes 1990–2001

Year	Top 1%	Top 5%	Top 10%	Top 25%	Top 50%	Bottom 50%
2001	33.9	53.3	64.9	82.9	96.0	4.0
2000	37.4	56.5	67.3	84.0	96.1	3.9
1995	30.3	48.9	60.8	80.4	95.4	5.6
1990	25.1	43.6	55.4	77.0	94.2	5.8

Projected individual income taxes for 2004 both with and without tax cuts are shown in the table below:

Projected Share of Individual Income Taxes in 2004

Year	Top 1%	Top 5%	Top 10%	Top 25%	Top 50%	Bottom 50%
With the tax cuts	32.3	52.8	64.8	83.0	96.4	3.6
Without the tax cuts	30.5	50.2	62.6	81.8	95.9	4.1

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IRS PROCEDURES — PAYMENTS

Collection Due Process

***Harris Rabinovich v. Commissioner,* TC Summary Opinion 2004-15, February 11, 2004**
IRC §§6330 and 6511

☞ Later of 2-Year or 3-Year Lookback Period Rule for Prior Overpayments Applied

Facts. The taxpayer habitually filed his tax return late as shown in the following chart:

Year	Date Return Filed	Balance Due	Overpayment
1994	May 14, 1997		$11,187
1995	August 14, 2001		12,750
1996	March 26, 2002		4,422
1997	October 3, 2001	$5,713	

The IRS issued a Final Notice — Notice of Intent to Levy to collect the $5,713 unpaid balance due on the taxpayer's delinquent 1997 return. The Final Notice was issued in April 2002. In response, the taxpayer submitted Form 12153, *Request for a Collection Due Process Hearing.* At the hearing with the IRS Appeals Officer, the taxpayer insisted that the $5,713 unpaid 1997 balance due be offset with the two following payments:

- A **$5,000** payment he made on April 8, 1986 with the extension request Form 4868 for his **1985 tax return**
- A **$10,000** estimated tax payment he made for his **1994 tax return** on February 23, 1995

The Appeals Officer determined that the statute of limitations under IRC §6511 barred application of these two payments to the taxpayer's balance due on his 1997 return. In addition, any unrefunded overpayments associated with the delinquent 1994 return were similarly barred.

Issue. Whether the IRS abused its discretion in determining that the two payments and any alleged overpayment for the 1994 return are not available to offset the taxpayer's unpaid balance due on his 1997 return.

Analysis. A refund of an overpayment of any tax must be filed by the taxpayer within the later of:

- Two years from the time the tax was paid, or
- Three years from the time the return was filed.[76]

Holding. The Tax Court held that the IRS did **not** abuse its discretion by issuing the Notice of Intent to Levy for the unpaid balance due on the 1997 return. IRC §6511 barred application of the two payments, the $5,000 made in 1986 and the $10,000 made in 1995, as well as any unrefunded overpayment due on the 1994 return.

76. IRC §6511(a)

Installment Agreement

***Gunter R. and Jay R. Wall v. Commissioner,* TC Summary Opinion 2003-165, December 11, 2003**

IRC §6159

☞ IRS Properly Rejected Taxpayers' Unrealistic Installment Agreement Proposal

Facts. Mr. Wall was a college instructor. During the tax years 1989 through 2001, the taxpayers' joint tax returns reflected a balance due. However, no remittance was ever paid to the IRS for any of the 13 tax returns. The 2001 tax return reported the following:

Husband's wages	$44,591
Taxable social security benefits	13,269
Total tax	5,021
Income tax withheld from wages	1,896
Balance due on the joint 2001 tax return	3,125

Despite prior recommendations from the IRS, the taxpayers declined to increase the federal income tax withholding from wages or make quarterly estimated tax payments. As a result, the total taxes, interest, and penalties owed the IRS for the years 1989 through 2001 exceeded $50,000.

In response to collection attempts, the taxpayers submitted to the IRS a proposed installment agreement of **$50 a month** to satisfy their total outstanding tax liability. The IRS rejected that proposal and sent the taxpayers a Final Notice — Notice of Intent to Levy and Notice of Your Right to a Hearing. In response to the Final Notice, the taxpayers requested a Collection Due Process Hearing.

After conducting two telephone hearings with the taxpayers, **the IRS Appeals officer determined that the taxpayers should pay $898 per month.** The Notice of Determination Concerning Collection Actions issued by the Appeals officer stated:

"You would like to pay $50 monthly. As explained to you, based on your current average monthly income of $5,222 vs. allowable expenses totaling $4,324, you have the ability to pay $898 monthly. We (the IRS) cannot enter into an installment agreement for $50 monthly considering the total amount owed, $898 disposable monthly income, and that you continue to owe each year. We (the IRS) suggested that you decrease the number of dependents claimed on your W-4 Form (so you won't owe each year), however, your response was that you refuse to do this."

Issue. Whether the IRS was required to accept the taxpayers' installment agreement proposal to pay $50 per month.

Analysis. Before a levy may be made on any property, a taxpayer is entitled to a notice of intent to levy and notice of the right to a fair hearing before any impartial office of the Appeals office.[77] An installment agreement generally requires the payment of a tax liability in full.[78]

Holding. The Tax Court held that the IRS's rejection of the taxpayers' proposed $50 per month installment agreement was not an abuse of power. The court noted that a $50 per month payment would have been far from adequate to satisfy the total tax liability within the collection periods of limitation. The court added: "The fact that the taxpayers have consistently underpaid their taxes since 1989, yet have refused to adjust withholding or to begin making estimated tax payments, is relevant to the determination of the adequacy of their offer."

77. IRC §§6330(a) and (b), and 6331(d)

78. IRC §6159(a)

IRS PROCEDURES — PENALTIES

Substantial Understatement of Tax Penalty

Jerry L. and Valerie J. Hill v. Commissioner, **TC Memo 2004-156, June 30, 2004**

IRC §6662(a)

☞ Abusive Trust Adjustments Warrant Substantial Understatement of Tax Penalty

Facts. Mr. Hill, a real estate broker, attended seminars promoting the use of family trusts to shelter income tax liability. As a result, he and his wife formed Re-Cap Trust and transferred most of their personal assets to the trust.

The taxpayers' individual joint 1999 tax return reported the following:

AGI (mainly compensation received by husband from the trust)	$ 19,504
Total tax	1,024

The 1999 Form 1041 for Re-Cap Trust reported the following:

Total income (mainly commission income earned by husband)	$332,530
Deductions (including many of the taxpayers' personal expenses)	(330,818)

In its exam of the 1999 Form 1040, the IRS assessed additional tax of $130,000 and an accuracy-related substantial understatement of tax penalty of $26,000. Before the case went to trial, the taxpayers conceded that the trust should be disregarded for income tax purposes. Therefore, the only disputed issue was the substantial understatement of tax penalty.

Issue. Whether the taxpayers are liable for the accuracy-related penalty under IRC §6662(a).

Analysis. An understatement of income tax is substantial if it exceeds the greater of:

1. 10% of the correct tax, or
2. $5,000.[79]

The taxpayer may establish that part or all of the accuracy-related penalty is inapplicable because the taxpayer acted with reasonable cause and in good faith.[80] In determining whether a taxpayer meets that standard, the taxpayer's effort to assess his correct tax liability is a critical consideration.

Taxpayers' Position. The taxpayers contended they relied reasonably upon their tax preparer to correctly prepare their joint 1999 tax return.

Holding. The court concluded that the taxpayers could not use reliance on their preparer to shield them from the penalty. Neither taxpayer consulted a competent professional regarding the potential income tax consequences of forming the abusive family trust.

79. IRC §6662(d)(1)(A)

80. IRC §6664(c)(1)

Failure to Pay Penalty

***Pacific Wallboard & Plaster Co. v. United States*, Oregon U.S. District Court, CV 03-1562-PA, April 13, 2004**
IRC §6651

☞ Refund of Failure to Pay Penalty Denied

Facts. The taxpayer failed to meet its employment tax obligations for 12 consecutive quarters in 1998, 1999, and 2000. No employment tax deposits were made for 150 consecutive weeks. The IRS assessed failure to pay penalties under IRC §6651 of $129,000.

The taxpayer contended it was unable to make the required deposits because its long-time controller was secretly embezzling about $750,000 from the company over a five-year period. This embezzlement scheme was not detected until 2001. Following this discovery, the corporation requested the IRS to abate and refund the penalties. The IRS declined and the taxpayer sued for refund in Oregon U.S. District Court.

During 1998, 1999, and 2000, the corporation deducted money from the paychecks of its employees, but did not remit that money to the IRS each week as required. The company's highest financial officers made a conscious decision not to pay the IRS, choosing to use the withheld amounts for other purposes they considered more pressing.

Issue. Whether the previously paid failure to pay penalties should be refunded with interest.

Analysis. When a tax is paid late, a penalty is imposed "unless it is shown that such failure is due to reasonable cause and not due to willful neglect."[81] "Willful neglect means a conscious, intentional failure or reckless indifference."[82]

Holding. The District Court judge granted a summary motion by the IRS to dismiss the case, refusing to let a jury hear it. The judge stated:

"On a number of occasions, the taxpayer had sufficient funds to pay the taxes owing for a given payroll period, and to make the required tax deposits for that week. The taxpayer chose to use the money for other purposes.

During the relevant time period, the taxpayer loaned over $1 million to other companies controlled by its President. That money could have been used to pay at least some the taxes that came due. This seriously undermines the taxpayer's contention that it was doing everything reasonable possible to meet its obligations to the IRS.

So far as I can tell from the record, the IRS was last in line to be paid. The taxpayer's case focuses almost entirely on the fact of the embezzlement, and a general assertion that it was chronically short of money as a result. That isn't enough to sustain the taxpayer's burden of proof."

The judge, showing no sympathy to the taxpayer, concluded with these remarks: "Paying your taxes, and remitting employee trust funds to the IRS, is not intended to be optional."

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81. IRC §6651(a)(2)

82. *United States v. Robert W. Boyle*, Supreme Ct., 469 U.S. 241, 245, 85-1 USTC ¶13,602, January 9, 1985

ITEMIZED DEDUCTIONS

State Tax on Real Estate Sales

***Kurt S. and Juanita F. Urban v. Commissioner,* TC Summary Opinion 2004-100, July 27, 2004**
IRC §164

☞ State Taxes Imposed on Sales of Real Estate Are Not Deductible on Schedule A

Facts. The state of Washington imposes a tax of 1.28% of the selling price on the sale of real estate. When the taxpayers sold their home in 1998, their settlement sheet showed on the "Government Recording and Transfer Charges" excise tax of $12,068.

The taxpayers deducted the $12,068 Washington state excise tax on line 8 (other taxes) on their 1998 Schedule A. The IRS disallowed it.

Issue. Whether the Washington state tax imposed on the selling price of real estate is deductible.

Analysis and Holding. The Tax Court held the excise tax was not deductible on Schedule A for the following reasons:

1. The tax is imposed on the privilege of selling real property.
2. It is an excise tax and not a property tax because it is a tax on the transaction rather than on ownership.
3. The tax is not one "imposed on **interests** in real property and levied for the general public welfare."[83] Therefore, it is not deductible under IRC §164(a).

> **Note.** Other states, including Pennsylvania and Maryland, have charged similar taxes on real property transactions.

Continuing Care Medical Expenses

***Delbert L. and Margaret Baker v. Commissioner,* 122 TC 143, No. 8, February 19, 2004**
IRC §213

☞ Actuarial Method Not Required to Compute Medical Portion of Continuing Care Fees

Facts. The taxpayers entered an exclusive lifetime retirement community in 1989. They chose an independent living unit (ILU). In exchange for their $130,000 entrance fee plus monthly service fees, they were entitled to lifetime care. The facility used the percentage method of total costs per resident to compute the portion of ILU monthly service fees allocable to medical care. That method yielded the figures shown below.

Year	Total Medical Care per ILU (Regardless of Number of Residents Living in Unit)
1997	$4,488
1998	4,992

83. Treas. Reg. §1.164-3(b)

The facility informed each resident of the total yearly medical expense amounts shown above. However, an ad hoc committee of residents disputed the facility's figures and calculated its own amounts that were considered allocable to medical care. The committee's conclusions are shown below.

Year	Total Medical Care per ILU (Regardless of Number of Residents Living in Unit)
1997	$6,557
1998	9,891

The taxpayers used the committee's numbers in determining unreimbursed medical expenses on Schedule A for 1997 and 1998.

In addition, they claimed a separate medical expense for use of the facility's pool, spa, and exercise equipment. This additional medical expense amounted to $3,461 and $3,596 for the years 1997 and 1998 respectively. This separate expense was based on a doctor's letter stating that "it is imperative that Mr. Baker continue his exercise program, including the exercise room, pool, and whirlpool at least three times a week." The letter stated this exercise program "will help alleviate the symptoms of his chronic illnesses," including arthritis and hypertension.

The IRS originally determined that the correct amounts for medical care were the figures determined by the facility (first chart above) rather than by the ad hoc committee (second chart above). However, in the Tax Court trial, the IRS relied on an actuary's exhaustive data to show that the correct medical care portion was slightly higher than that determined by the facility. In addition, the IRS **completely disallowed** the separate deductions for the exercise program.

Issues.

1. What portions of monthly service fees paid for lifetime residence are allocable to medical care under IRC §213.
2. Whether the taxpayers are entitled to deduct additional amounts for use of the pool, spa, and exercise facilities.

Analysis and Holding for Issue 1. The percentage method used by the facility to arrive at allocable medical care per unit has been sanctioned by three Revenue Rulings:

1. Rev. Rul. 67-185
2. Rev. Rul. 75-302
3. Rev. Rul. 76-481

The court held that the percentage method, rather than the actuarial method, was appropriate based on the revenue rulings. **The court used its own calculations and determined that $7,766 and $8,476 was the correct medical care portion of monthly service fees paid in 1997 and 1998 respectively.**

Holding for Issue 2. The court held that none of additional medical expenses claimed for the exercise program were allowable.

Charitable Contributions

Goodwill Industries International Website

IRC §170

☞ No Standard Valuation for Used Clothing

Goodwill Industries International, Inc. has website which discusses donations for used items. Goodwill does not maintain national estimates for donated items. Donated item market values are based on the condition of the item and may well vary from one region to another.

To assess "fair market value" of donations:

1. Consult a local tax advisor who should be familiar with regional market values.
2. Contact a Goodwill store and price similar items, or ask if they have a local valuation guide. Additionally, U.S. residents may call (800) 664-6577 and enter their five-digit ZIP code to contact the Goodwill serving your area.
3. Review the following tax guides available from the IRS
   - **IRS Pub. 561 — *Determining the Fair Value of Property*.** Defines "fair market value" and helps donors and appraisers determine the value of property given to qualified organizations.
   - **IRS Pub. 526 — *Charitable Contributions.*** Explains which organizations are qualified to receive deductible charitable contributions, the types of contributions you can deduct, how much you can deduct, what records to keep, and how to report charitable contributions.
   - **Form 8283 — *Noncash Charitable Contributions.*** Applies to deduction claims totaling more than $500 for all contributed items.

Medical expense

U.S. Food and Drug Administration (FDA)

IRC §213

☞ Deduction for Medicine and Drugs Includes Only Items Legally Procured

A medical expense deduction is permitted for prescribed drugs or insulin.[84] A prescribed drug is defined as a drug or biological that requires a prescription of a physician and must be filled by a pharmacist.[85] A medical deduction is allowed only for items that are legally procured. For example, even though state law may allow the purchase and use of marijuana for medical purposes, or small amounts of drugs sold abroad and imported for a patient's treatment is allowable, it still violates federal law.

Recent guidance issued by the FDA states the "virtually all drugs imported to the United States from Canada by or for individual consumers violate the Food and Drug Act and thus federal law. Consequently these expenses are not tax deductible through itemized deductions or health care reimbursement through an IRC §105 or IRC §125 plan."

> **Note.** The source of this ruling is the FDA, not the IRS. It appears that, from a discussion with an employee of the IRS National Office, the IRS is reluctant to issue a formal ruling on this subject. It also appears that compliance with this FDA ruling will be minimal.

84. IRC §213(b)

85. IRC §213(d)(3)

Home Exercise Equipment

IRS Information Letter 2003-0202, April 8, 2003

IRC §213

☞ Home Exercise Equipment Deductible In Certain Circumstances

For an individual who is diagnosed and treated by a physician for a specific medical condition such as obesity, the cost of home exercise equipment as a part of the treatment is a deductible medical expense. This deduction is allowable only to the extent the total unreimbursed medical expenses exceed 7.5% of the individual's adjusted gross income.

> **Note.** An itemized deduction is **not allowed** for those individuals who purchase home exercise equipment to maintain general good health.

Charitable Donations for Cars

IRS News Release IR-2004-84, June 29, 2004

IRC §170

☞ IRS Issues Two New Publications for Car Donations

In recent years, car donation programs have increased dramatically. In an effort to assist both charities and taxpayers in avoiding potential pitfalls, the IRS released two publications:

- **IRS Pub. 4302,** ***A Charity's Guide to Car Donations***
- **IRS Pub. 4303,** ***A Donor's Guide to Car Donations***

IRS Pub. 4302. This new publication discusses the ramifications that can result when a charity "operates a car donation program in a manner that confers improper benefits on private parties." In some cases the charity's exemption may be adversely affected. If the charity loses its exemption, its income is subject to tax and it must file the appropriate federal income tax return.

Four common types of car donation programs (and the tax consequences for a charity and its contributors) are:

1. **Charity uses or distributes cars.** Charity uses donated cars in its program, or gives them to the needy.
   - There is no adverse impact on charity's tax-exempt status.
   - Contributions are deductible by the donor.
2. **Charity sells donated cars.** Charity sells cars and uses the proceeds to fund its charitable programs.
   - There is no adverse impact on charity's tax-exempt status.
   - Contributions are deductible by the donor.
3. **Charity hires agent to operate car donation program.** Charity hires private, for-profit entity as agent to operate car donation program.
   - Charity/entity must establish agency relationship valid under applicable state law.
   - Charity must actively monitor program operations.
   - Charity must have right to review and approve all documents.
   - There is no adverse impact on charity's tax-exempt status.
   - Contributions are deductible by the donor.

4. **For profit entity receives and sells cars using charity's name.** Charity allows for-profit entity the right to use charity's name to solicit used car donations.
   - Charity receives flat fee or a percentage of car sales proceeds.
   - Charity has no control over the for-profit activities.
   - This activity could result in adverse impact on charity's tax-exempt status.
   - Contributions are **not deductible** by the donor.

IRS Pub. 4303. This new publication provides general guidelines for individuals who donate their cars. In order to be tax deductible, the donation must be made to a qualified organization. To ensure that an organization is qualified, taxpayers should:

- Review **IRS Pub. 78, *Cumulative List of Organizations*** (available at www.irs.gov), or
- Contact the IRS Customer Account Service division for Tax Exempt and Government Entities at (877) 829-5500 (tollfree).

The value of the donated car should be the **FMV**. Although a used car guide is a good starting point for determining value, many times this value is substantially higher than the FMV. **IRS Pub. 561**, *Determining the Value of Donated Property*, should be consulted for additional information.

Example 4. A taxpayer donates a car to the local high school for use by students studying car repair. His credit union representative told him that the "blue book" value of the car is $1,600. However, the car needs extensive repairs, and after some checking, the taxpayer finds that he could sell his car for only $750. The taxpayer's charitable contribution deduction may not exceed $750, the FMV of the car.

If the charitable donation exceeds $500, Section A of Form 8283, *Noncash Charitable Contributions,* must be completed. For charitable donations greater than $5,000, a written appraisal is required and Section B of Form 8283 must be completed.

Note. Practitioners may want to obtain these two new publications. The Donor's Guide contains a thorough explanation of how to properly value the donated vehicle. With increased IRS scrutiny, a proper valuation is vital.

Form **8283** (Rev. October 1998)
Department of the Treasury Internal Revenue Service

Noncash Charitable Contributions

▶ Attach to your tax return if you claimed a total deduction of over $500 for all contributed property.
▶ See separate instructions.

OMB No. 1545-0908
Attachment Sequence No. **55**

Name(s) shown on your income tax return | **Identifying number**

Note: *Figure the amount of your contribution deduction before completing this form. See your tax return instructions.*

Section A—List in this section **only** items (or groups of similar items) for which you claimed a deduction of $5,000 or less. Also, list certain publicly traded securities even if the deduction is over $5,000 (see instructions).

Part I **Information on Donated Property**—If you need more space, attach a statement.

1	(a) Name and address of the donee organization	(b) Description of donated property
A		
B		
C		
D		
E		

Note: *If the amount you claimed as a deduction for an item is $500 or less, you do not have to complete columns (d), (e), and (f).*

	(c) Date of the contribution	(d) Date acquired by donor (mo., yr.)	(e) How acquired by donor	(f) Donor's cost or adjusted basis	(g) Fair market value	(h) Method used to determine the fair market value
A						
B						
C						
D						
E						

Part II **Other Information**—Complete line 2 if you gave less than an entire interest in property listed in Part I. Complete line 3 if conditions were attached to a contribution listed in Part I.

2 If, during the year, you contributed less than the entire interest in the property, complete lines a–e.

a Enter the letter from Part I that identifies the property ▶ ________. If Part II applies to more than one property, attach a separate statement.

b Total amount claimed as a deduction for the property listed in Part I: **(1)** For this tax year ▶ ________________.
(2) For any prior tax years ▶ ________________.

c Name and address of each organization to which any such contribution was made in a prior year (complete only if different from the donee organization above):

Name of charitable organization (donee)

Address (number, street, and room or suite no.)

City or town, state, and ZIP code

d For tangible property, enter the place where the property is located or kept ▶ ________________

e Name of any person, other than the donee organization, having actual possession of the property ▶ ________________

3 If conditions were attached to any contribution listed in Part I, answer questions a – c and attach the required statement (see instructions).

		Yes	No
a	Is there a restriction, either temporary or permanent, on the donee's right to use or dispose of the donated property?		
b	Did you give to anyone (other than the donee organization or another organization participating with the donee organization in cooperative fundraising) the right to the income from the donated property or to the possession of the property, including the right to vote donated securities, to acquire the property by purchase or otherwise, or to designate the person having such income, possession, or right to acquire?		
c	Is there a restriction limiting the donated property for a particular use?		

For Paperwork Reduction Act Notice, see page 4 of separate instructions. Cat. No. 62299J Form **8283** (Rev. 10-98)

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Form 8283 (Rev. 10-98) Page **2**

Name(s) shown on your income tax return	**Identifying number**

Section B—Appraisal Summary—List in this section only items (or groups of similar items) for which you claimed a deduction of more than $5,000 per item or group. **Exception.** Report contributions of certain publicly traded securities only in Section A.

If you donated art, you may have to attach the complete appraisal. See the **Note** in Part I below.

Part I **Information on Donated Property—**To be completed by the taxpayer and/or appraiser.

4 Check type of property:

- ☐ Art* (contribution of $20,000 or more)
- ☐ Art* (contribution of less than $20,000)
- ☐ Real Estate
- ☐ Coin Collections
- ☐ Gems/Jewelry
- ☐ Books
- ☐ Stamp Collections
- ☐ Other

*Art includes paintings, sculptures, watercolors, prints, drawings, ceramics, antique furniture, decorative arts, textiles, carpets, silver, rare manuscripts, historical memorabilia, and other similar objects.

Note: *If your total art contribution deduction was $20,000 or more, you must attach a complete copy of the signed appraisal. See instructions.*

5	**(a)** Description of donated property (if you need more space, attach a separate statement)	**(b)** If tangible property was donated, give a brief summary of the overall physical condition at the time of the gift	**(c)** Appraised fair market value
A			
B			
C			
D			

	(d) Date acquired by donor (mo., yr.)	**(e)** How acquired by donor	**(f)** Donor's cost or adjusted basis	**(g)** For bargain sales, enter amount received	See instructions: **(h)** Amount claimed as a deduction	See instructions: **(i)** Average trading price of securities
A						
B						
C						
D						

Part II **Taxpayer (Donor) Statement—**List each item included in Part I above that the appraisal identifies as having a value of $500 or less. See instructions.

I declare that the following item(s) included in Part I above has to the best of my knowledge and belief an appraised value of not more than $500 (per item). Enter identifying letter from Part I and describe the specific item. See instructions. ▶ ____________

Signature of taxpayer (donor) ▶ Date ▶

Part III **Declaration of Appraiser**

I declare that I am not the donor, the donee, a party to the transaction in which the donor acquired the property, employed by, or related to any of the foregoing persons, or married to any person who is related to any of the foregoing persons. And, if regularly used by the donor, donee, or party to the transaction, I performed the majority of my appraisals during my tax year for other persons.

Also, I declare that I hold myself out to the public as an appraiser or perform appraisals on a regular basis; and that because of my qualifications as described in the appraisal, I am qualified to make appraisals of the type of property being valued. I certify that the appraisal fees were not based on a percentage of the appraised property value. Furthermore, I understand that a false or fraudulent overstatement of the property value as described in the qualified appraisal or this appraisal summary may subject me to the penalty under section 6701(a) (aiding and abetting the understatement of tax liability). I affirm that I have not been barred from presenting evidence or testimony by the Director of Practice.

Sign Here Signature ▶ Title ▶ Date of appraisal ▶

Business address (including room or suite no.)	**Identifying number**
City or town, state, and ZIP code	

Part IV **Donee Acknowledgment—**To be completed by the charitable organization.

This charitable organization acknowledges that it is a qualified organization under section 170(c) and that it received the donated property as described in Section B, Part I, above on ▶ ____________ (Date)

Furthermore, this organization affirms that in the event it sells, exchanges, or otherwise disposes of the property described in Section B, Part I (or any portion thereof) within 2 years after the date of receipt, it will file **Form 8282,** Donee Information Return, with the IRS and give the donor a copy of that form. This acknowledgment does not represent agreement with the claimed fair market value.

Does the organization intend to use the property for an unrelated use? . . . . ▶ ☐ Yes ☐ No

Name of charitable organization (donee)	**Employer identification number**	
Address (number, street, and room or suite no.)	City or town, state, and ZIP code	
Authorized signature	Title	Date

Pending legislation in the House and Senate may affect these types of donations. The House bill requires a qualified appraisal of the donated property (vehicles, boats, or aircraft) if it is valued at $250 or more. The effective date is for donations made after June 3, 2004.

The Senate bill would restrict the amount of any deduction for donated property (vehicles, boats, or aircraft) valued at over $500. The restriction would limit the deduction to the sales price received by the charity for the donated property. The effective date is for donation made after June 30, 2004.

Note. See Chapter 6, Charitable Contributions for more information regarding contributions of automobiles.

LIKE-KIND EXCHANGES

Like Kind Exchange

Treasury Decision 9151, August 13, 2004

IRC §1031

☞ **Final regulations Replacing SIC Codes with NAICS Codes**

In 1997 the Department of Commerce stopped using the Service Industry Code (SIC) system for classifying businesses and began using the North American Industry Classification System (NAICS). The IRS used the SIC codes to identify if property was of a similar kind to qualify for a like-kind exchange (LKE). Until August 13, 2004, the IRS has continued to allowed taxpayers to use the SIC codes for LKE purposes.

The SIC codes were four digit codes. By looking at the codes it was easy to determine if the property qualified for a LKE. The NAICS uses a six digit code to classify. Therefore, taxpayers have been interested in how the IRS would implement the use of the NAICS codes.

Under the new regulations, Temp. Treas. Reg. §1.1031(a)-2T and amendments to Treas. Reg. §1.031(a)-2, the IRS will only use the codes for the manufacturing sector. This includes all of the codes between 311111 and 339999, which covers most tangible personal property. Typically, property which fell into the same four digit SIC code will fall into the same six digit NAICS code. For example, farm equipment, 333111, has over 60 different items listed, yet all qualify for a LKE. Code 333111 includes everything from bale throwers to weeding machines. NAICS codes ending in 9 are not considered to be in a product class. This is no different than SIC codes ending in 9.

The code for construction property is 333120. It contains over fifty items from aggregate spreaders to concrete vibrators.

These regulations are effective for a like-kind exchange made after August 13, 2004, but taxpayers may use them for LKEs occurring on or after January 1, 1997. Taxpayers should have no difficulty complying with these regulations.

Note. A list of the NAICs codes can be found at www.census.gov/epcd/naics02/naicdo02.html.

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Reverse Like-Kind Exchange

Revenue Procedure 2004-51, July 20, 2004
IRC §1031

☞ Property Already Owned by Taxpayer Will Not Qualify as Replacement Property

Background. Rev. Proc. 2000-37 provided a safe-harbor procedure that, if followed, **allowed the acquisition of replacement property prior to the sale of relinquished property.** If the procedures are followed, Rev. Proc. 2000-37 sanctioned a reverse like-kind exchange as a tax-deferred transaction according to IRC §1031.

> **Note.** For a thorough analysis of Rev. Proc. 2000-37, see pages 335–38 and 441–42 in the *2001 University of Illinois Farm Income Tax Workbook*.

Purpose. Rev. Proc. 2004-51 was issued to modify and clarify portions of the previously issued Rev. Proc. 2000-37. The IRS was aware that some taxpayers have interpreted Rev. Proc. 2000-37 to permit them to treat as a like-kind exchange transaction situations when:

- The taxpayer transfers property to an Exchange Accommodation Titleholder (EAT) and receives that **same property** as replacement property in an alleged exchange for other property owned by the taxpayer

Clarification provided by Rev. Proc. 2004-51. Property already owned by the taxpayer or a related party cannot qualify as replacement property in a reverse like-kind exchange.

> **Note.** The IRS is aware of abuse in "parking transactions" in reverse exchanges. For example, some taxpayers "park" sales proceeds from their real estate sales with an EAT to fund construction of a building on other land that they already own. These taxpayers claim that they qualify for a reverse like-kind exchange. The IRS issued Rev. Proc. 2004-51 to prevent that incorrect interpretation of Rev. Proc. 2000-37.

Effective Date. For transfers on or after July 20, 2004.

NOT FOR PROFIT

$25,000 Special Allowance

Edward D. and Yolonda B. Hamilton v. Commissioner, **TC Memo 2004-161, July 12, 2004**
IRC §469

☞ $25,000 Rental Real Estate Loss Phased Out Due to Reported Lottery Winnings

Facts. The taxpayers reported the following on their joint 2000 tax return:

Wages	$118,053
Interest	4,731
State tax refund	872
Rental real estate loss	(22,300)
California state lottery winnings	136,041
Adjusted gross income	**$237,397**

The IRS determined that the phaseout rules[86] preclude the taxpayers from currently deducting any of their $22,300 rental real estate loss. As a result, the IRS assessed additional tax $8,793 for 2000.

86. IRC §469(i)(3)

Positions of the Taxpayer.

1. The reported lottery winnings should not be included in gross income because they are not professional gamblers.
2. The lottery winnings are excludable in calculating the phaseout of the $25,000 special allowance for rental real estate losses.
3. If positions #1 and #2 are wrong, the court should recognize that they are in a tight financial bind and apply equity to allow them to deduct at least half of their rental real estate loss.

Analysis and Holding. The Tax Court, in a very short trial, sustained the IRS additional tax assessment for 2000. The court declined to consider the taxpayer's third position, stating: "This court is not authorized to ignore such a clear expression of Congress' intent as applies here."

Profit Motive

Albert R. Matthews v. Commissioner, **TC Summary Opinion 2004-89, July 1, 2004**
IRC §§183, 6651 and 6662

☞ Attorney's Horse Activity Losses Not Allowable

Facts. The taxpayer, a personal injury attorney, lived on a ranch where he raised and trained rodeo horses. The taxpayer reported the following gross receipts, expenses, and net losses on Schedule F as shown in the chart below.

Year	Gross Receipts	Expenses	Net Schedule F Loss
1991	$17,763	$92,116	($74,353)
1992		Data not available	
1993	6,264	66,211	(59,947)
1994	3,130	58,983	(55,853)
1995	15,195	53,622	(38,427)
1996	4,625	45,736	(41,111)
1997	1,016	60,837	(59,821)
1998	8,212	52,477	(44,265)
1999	4,616	47,377	(42,761)
Total	**$60,821**	**$477,359**	**($416,538)**

The IRS determined that the taxpayer did not have a profit motive and disallowed the net losses for the 1997, 1998, and 1999 tax years. In addition, the failure to timely file penalty[87] and the 20% accuracy-related substantial understatement of tax penalty[88] were assessed. The total additional tax and penalties assessed was $88,000.

Issue. Whether the taxpayer engaged in his horse activity during 1997–1999 with the objective of making a profit within the meaning of IRC §183.

Analysis. Instead of introducing objective evidence at the Tax Court trial, the taxpayer stated: "I chose to come and tell my story of what I have done for the past 45 years." Despite his training and experience as an attorney, he chose not to include his books and records as stipulated evidence. The taxpayer's main reasoning was that most ranchers lose money but recoup their losses when they sell their land. He estimated that the value of his land had increased from $150 per acre to about $1,200 per acre.

87. IRC §6651(a)
88. IRC §6662

The court considered the nine subjective factors under the regulations.[89]

Holding. The court agreed with the IRS that the horse activity did not have an actual and honest objective of making a profit. Some of the reasons for the decision were:

1. The complete lack of books and records (which the court might have analyzed)
2. No separate checking account maintained for the activity
3. The lack of a budget or informal business plan
4. A clear record of a history of losses
5. The lack of a horse inventory
6. The personal pleasure and enjoyment the taxpayer experienced from his horse activity
7. The magnitude of the horse activity losses and the substantial tax benefit received by offsetting the substantial income from his law practice

The court also sustained the imposition of the penalties. The failure to timely file penalty was properly assessed because the taxpayer habitually filed his tax returns after the August 15 automatic extension due date.

Profit Motive

***George R. and Barbara H. Burrus v. Commissioner,* TC Memo 2003-285, October 3, 2003**
IRC §183

☞ Physician's Cattle Raising Activity Had Profit Motive

Facts. Dr. Burrus had a lucrative medical practice during 1990-1995. He also was engaged in raising purebred Hereford cattle on 840 acres which he called the Maple Hill Hereford Ranch. **The taxpayers reported Schedule F losses during the six-year period (1990–1995) from the ranch of $1.1 million.** In its exam of the taxpayers' returns for 1990–1995, the IRS determined that the required profit motive was lacking, disallowed the claimed losses, and assessed $355,000 of additional taxes.

At the Tax Court trial, Dr. Burrus testified that he anticipated that the cattle operation would begin to show a profit "once his herd reached 100 productive cows." He anticipated selling two-year old purebred bulls for approximately $2,000 each, as well as a small number of culled heifers, while retaining the others to build his cow herd. The inventory records supported his contention that he was building up his herd size as shown in the chart below.

Year	Heifers Born	Bulls Born	Total
1990	13	6	19
1991	10	7	17
1992	15	15	30
1993	17	20	37
1994	27	24	51
1995	30	23	53

89. Treas. Reg. §1.183-2(b)

The IRS did not dispute the fact that the land purchased for the cattle operation had significantly increased in value. However, the IRS insisted on the application of a Treasury regulation which states:

"Where land is purchased or held primarily with the intent to profit from increase in its value, and the taxpayer also engages in farming on such land, the farming and holding of the land will ordinarily be considered a single activity only if the farming activity reduces the net cost of carrying the land for its appreciation in value."[90]

The court agreed that, according to the regulation, the taxpayers had two separate activities:

1. Holding land for appreciation, and
2. Cattle raising operation

The separate cattle raising activity still reported huge losses after excluding income and expenses directly attributable to the holding of the farmland.

Issue. Whether the cattle raising activity was not engaged in for profit according to IRC §183.

Analysis. At the trial, Dr. Burrus stated: "If I was going to make a profit related to the ranch, it was because of the land rather than the herd, the cattle." **The IRS assumed that if the court agreed that the regulation shown above should apply, the separately computed Schedule F loss attributable solely to cattle income and expenses would probably be disallowed.** At the trial, the IRS conceded that the large separately computed portion of the Schedule F losses attributable solely to income and expenses related to the holding of the land would be deductible.

However, the court meticulously applied the nine subjective factors[91] in determining whether the remaining separate cattle operation was an activity engaged in for profit.

Holding. In the court's opinion, the taxpayers prevailed in seven of the nine factors. The two factors which definitely were unfavorable to the taxpayers, (1) the amount of occasional profits in relation to losses, and (2) substantial income from other sources were determined to be neutral.

In addition, the court noted that even though substantial losses were reported during all six years in question, "we are persuaded that these years constituted a reasonable startup period." **Therefore, the disallowance of the Schedule F losses for the six-year period was not sustained.**

Mary Kay Cosmetics Business

Ralph D. and Brenda Konchar v. Commissioner, **TC Summary Opinion 2004-59, May 13, 2004**
IRC §183

☞ Wife's Cosmetics Activity Did Not Meet Profit Motive Test

Facts. Brenda Konchar resided in Indiana with her husband and four children. She became a Mary Kay Cosmetics (Mary Kay) "independent beauty consultant" in 1996 when she agreed to take over 12 of her sister's Mary Kay customers. When she began this activity, her sister had 12 customers consisting of family members and friends. Three of Brenda's customers lived in Pennsylvania, two lived in Florida, and seven lived in Texas. In addition, all of her extended family resided in those three states, including her parents, who lived in San Antonio, Texas.

During 1996, the initial year of her Mary Kay activity, she made several trips to Pennsylvania, Dallas and San Antonio, Texas, and Florida. Her children and husband accompanied her on the majority of the trips. The mileage for all of the trips was claimed as business mileage on Brenda's 1996 Mary Kay activity Schedule C.

90. Treas. Reg. §1.183-1(d)(1)

91. Treas. Reg. §1.183-2(b)

In 1996, 1997, and 1998, Brenda's Schedule Cs for those three years reported a gross profit only once, amounting to $438 in 1998. For those three years, she reported the following net Schedule C losses:

Year	Schedule C Net Loss Deducted
1996	($19,300)
1997	(21,308)
1998	(9,132)

Included in business deductions were automobile and travel expenses of over $10,000 for 1996 and 1997 and over $7,000 for 1998. In its exam, the IRS disallowed the losses and assessed additional taxes of approximately $5,400, $6,000 and $2,500 for 1996, 1997, and for 1998 respectively.

Issue. Whether Brenda's Mary Kay distribution activity was conducted with the intent to earn a profit under IRC §183(a).

Analysis. If an activity is not entered into for profit, no deduction attributable to the activity is allowed.[92] Whether the required profit objective exists is to be determined based on the facts and circumstances of each case. The Treasury Regulations list nine nonexclusive factors to consider in making this determination.[93] No single factor is controlling, and the determination is not reached merely by counting the factors that support each party's position.

Holding. After reviewing all of the relevant facts, **the Tax Court determined that Brenda's Mary Kay activity was not operated with an actual and honest profit motive.** The court found the following factors relevant in arriving at its decision:

1. According to her Schedule Cs, she reported a gross profit in only one of the three years in question. "When questioned at trial about this fact, she could not explain it. She did not seem to understand that it suggests that she was selling her products at or near cost."
2. Her Mary Kay activity provided her with significant personal pleasure. She traveled, often with her children and husband, to distant states to conduct the activity. As a result, she and her family were able to see her parents, her sister, and other family and friends.
3. She provided no evidence to prove that she consulted with someone who could have provided an objective opinion on the advantages and disadvantages of conducting a Mary Kay distributorship.
4. A very important factor, according to the court, was that there was no indication that she had a chance to recover the substantial Schedule C losses she claimed and deducted.
5. The taxpayers have substantial income from other sources. The Mary Kay losses sheltered her husband's significant salary income to a large degree.

Note. For a recent case involving an Amway distributor, see *Randall B. Ollett,* TC Summary Opinion 2004-103. The facts and decision reached are similar to the *Konchar* case.

92. IRC §183(a)

93. Treas. Reg. §1.183-2(b)

PASSIVE ACTIVITIES

Rental Real Estate Election

Letter Ruling 200404036, January 23, 2004

IRC §§469 and 9100

☞ Extension Granted to Make Election to Treat all Rental Real Estate Interests as a Single Activity

Issue. Whether taxpayers who fail to make a timely election to treat all rental real estate interests as a single activity may be granted an extension of time to make the required election required under IRC §469(c)(7)(A).

Facts. A married couple **inadvertently** failed to make a timely election to treat all of their interests in rental real estate as a single real estate activity. They were required to attach a statement to their original joint return for the first year the election was to be effective.[94]

Analysis. Some elections qualify for automatic extensions.[95] For those taxpayers who don't qualify automatically, **Treas. Reg. §301.9100-3(a) allows the IRS to grant requests for relief when it can be established the taxpayer acted reasonably and in good faith, and that such relief will not prejudice the interests of the government.**

Conclusion. Since the taxpayers acted reasonably and in good faith, they are granted 60 days from the date of the ruling to make the election. They may do this by filing an amended return for the first taxable year and attaching to it the required election statement.

> **Note.** A letter ruling request is apparently necessary in order for the IRS to grant taxpayers permission to make this late election.

Real Estate Professional

***Alfredo A. and Jane R. Galagar v. Commissioner,* TC Summary Opinion 2004-39, March 25, 2004**

IRC §469

☞ Husband Failed to Prove He Qualified as a Real Estate Professional

Facts. Alfredo and Jane Galagar owned and rented a single family home in 1998. The taxpayer's 1998 Schedule E reported the following for this rental activity:

Rental income	$14,748
Total expenses including depreciation	(36,001)
Schedule E rental loss deducted	**($21,253)**

On their joint 1998 return, Mr. Galagar listed his occupation as "real estate professional." However, Mr. and Mrs. Galagar reported combined wages of $148,514 on their 1998 return. The IRS disallowed $20,721 of the claimed $21,253 Schedule E loss. The IRS determined that Mr. Galagar did not have the required records to prove that he qualified as a real estate professional. Therefore, the $25,000 special allowance for rental real estate with active participation was subject to the AGI phase out rules. The additional tax for 1998 as a result of the IRS exam was approximately $6,000.

94. Treas. Reg. §1.469-9(g)(3)

95. Treas. Reg. §301.9100-2

At the Tax Court trial, Mr. Galagar admitted that he estimated that he spent more than the required 750 hours on the single rental real estate activity during 1998. However, no appointment book, calendar, or narrative summaries were submitted to the court. He stated that the rental property was "run down" and that he was forced to "supervise" the repair work performed on the roof, pool, and landscape. Mr. Galagar also stated that he paid a rental management company to collect all of the rent from the tenants. In addition, the management company arranged and paid for the normal recurring repairs to the property.

Issues.

1. Whether Mr. Galagar qualified as a real estate professional under IRC §469(c)(7).
2. Whether the claimed rental loss is subject to the phase out provision for rental real estate activities with active participation under IRC §469(i) (the special $25,000 allowance).

Analysis. A "real estate professional" must meet the following two tests:[96]

- **More than one-half** of the personal services performed in trades or businesses by the taxpayer during the taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and
- The taxpayer performs **more than 750 hours** of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.

A contemporaneous daily log is not required to establish the hours spent on real estate activities if established by "other reasonable means."[97] Reasonable means includes "identification of services performed over a period of time and the approximate number of hours spent performing such services, based on appointment books, calendars, or narrative summaries."[98]

Holding. "We have only Mr. Galagar's own oral testimony that he spent the requisite number of hours on his real estate activities. **He failed to establish by any reasonable means that he spent more than 750 hours on his real estate activities**. Thus, we must conclude that he was **not** a real estate professional under IRC §469(c)(7)(B) during taxable year 1998."

The court also upheld the IRS's calculation of the phase out of the $25,000 special allowance under IRC §469(i)(3)(A). Since the taxpayers' 1998 AGI was $148,937, they were entitled to deduct only $532 of the claimed $21,253 Schedule E rental loss. The disallowed portion of $20,721 was a suspended passive loss.

> **Note.** See Chapter 11, Special Taxpayers for additional information on Real Estate Professionals.

Cattle Breeding Activity

***Thomas E. and Susan L. Truskowsky v. Commissioner,* TC Summary Opinion 2003-130, September 15, 2003**
IRC §469

☞ Cattle Breeding Activity of Full-Time Employed Couple was a Passive Activity

Facts. Thomas and Susan Truskowsky were full-time employees of Oracle Corp., a large computer software company. Both had management jobs which required significant travel. They became interested in Limousin cattle, a French beef breed, in 1994 when they bought their first cows. **However, they did not own any farm property during 1996 and 1997, the years in question.**

96. IRC §469(c)(7)(B)
97. Temp. Treas. Reg. §1.469-5T(f)(4)
98. Temp. Treas. Reg. §1.469-5T(f)(4)

They chose K-C Delight Farm (K-C), located 100 miles from their home, as the place to shelter and care for their growing herd of cattle. The owner of K-C spent about 1½ hours a day feeding and caring for the taxpayers' cattle, which averaged 15 to 20 head in 1996 and 1997. For his labor, K-C's owner charged the taxpayers $1 per day per head.

The taxpayers reported their cattle operation on Schedule C for 1996 and 1997. The reported Schedule C net losses were:

- ($45,833) for 1996, and
- ($51,972) for 1997

The IRS disallowed the losses under the passive activity loss rules of IRC §469.

Issue. Whether the cattle breeding activity constituted passive activity losses.

Analysis. Passive activities include "trade or business" activities in which the taxpayer does not "materially participate."[99] The "material participation" test is generally met only if the taxpayer is involved in the business activity on a "regular, continuous, and substantial" basis.[100]

"Material participation" is further explained in Treasury Regulations.[101] These regulations provide a **7-test method** to determine if a taxpayer meets the required "material participation" standard for a trade or business activity. A taxpayer must meet at least one of the following seven tests:

1. The taxpayer participated in the activity for **more than 500 hours** during the tax year.
2. The taxpayer's participation in the activity during the tax year constitutes **substantially all** of the participation in the activity of all individuals during that year.
3. The taxpayer participated in the activity for **more than 100 hours** during the tax year, and that participation is **not less** than any other individual's participation for that year.
4. The trade or business constitutes a "significant participation" activity, and the taxpayer devotes more than 500 hours during the tax year to it.
5. The taxpayer materially participated in the activity for any five tax years (whether or not consecutive) during the 10 tax years immediately preceding the tax year.
6. The activity is a personal service activity which the taxpayer materially participated in for any three tax years preceding the tax year.
7. Based on all the **facts and circumstances**, the taxpayer participated in the activity during the tax year on a regular, continuous, and substantial basis.

Position of the taxpayer. Even though no log of (1) hours worked and (2) duties performed was kept for 1996 and 1997, the taxpayers reconstructed one. It showed that the taxpayers worked the following hours:

- 777 hours in 1996, and
- 831 hours in 1997.

Therefore, they met both Test "1 (the 500 hour test) and Test #3 (the 100 hour test) shown above.

99. IRC §469(c)(1)

100. IRC §469(h)(1)

101. Temp. Treas. Reg. §1.469-5T(a)

Position of the IRS. The taxpayers met none of the seven "material participation" tests shown above for the following reasons:

- The 777 and 831 hours shown in their reconstructed log included significant "commuting" hours between their home and K-C Farm, a round-trip distance of 200 miles. The "commuting" hours must be subtracted. In addition, the remaining hours were inflated and unrealistic. **The result was that Test 1 (the 500 hour test) shown above was not met.**
- Even though the taxpayers legitimately devoted over 100 hours during each of 1996 and 1997 to their cattle breeding activity, the owner of K-C Farm spent more time each year caring for their cattle heard. **The result was that Test 3 (the 100 hour test) shown above was not met.**

Holding. The Tax Court agreed with IRS and held that the activity was properly determined to be a passive activity. **As a result, the large Schedule C losses were unallowable suspended passive losses**. The court explored the possibility that Test 7, the facts and circumstances test, might have been met. **However, the fact that the taxpayers lived 100 miles from K-C Farm was detrimental to showing that their participation met the "regular, continuous, and substantial" requirement.**

RESIDENCES

Vacation Home

***Sharon M. and Richard C. Rivera v. Commissioner,* TC Summary Opinion 2004-81, June 23, 2004**
IRC §§183 and 280A

☞ Vacation Home Rental Losses Result in Split Decision

Facts. The taxpayers bought a condominium near Lake Tahoe in 1989 for $80,000. When purchased, they realistically expected it to appreciate. Their expectation was realized since it was worth $160,000 at the time of the Tax Court trial in 2004.

The taxpayers were avid skiers and resided in their condo an average of 8–12 days a year. During the early 1990s, they utilized a management company to rent their unit for the balance of the ski season. However, they abandoned this practice due to damages caused by the short-term renters. The taxpayers eventually decided that they "were going to rent to people that we knew," including co-workers and other friends.

The personal use and rental activity information for 1999 and 2000 is shown in the chart below.

Year	Rental Income	Schedule E Loss Deducted	# of Days Rented	# of Personal Use Days
1999	$1,400	($19,322)	25½	8
2000	1,500	(19,336)	23	8

The IRS disallowed the rental losses under IRC §183 because the taxpayers did not have an actual and honest profit motive in their rental endeavors. This conclusion was apparently reached because the taxpayers usually rented the unit for less than the daily fair rental figure of $65. Although not entirely clear, **it appears that the IRS allowed a deduction of 100% of the interest and taxes on Schedule A.**

Issue. Whether the Schedule E losses were properly disallowed under IRC §183.

Tax Court Analysis and Holding. The Tax Court, in a split decision, reached different conclusions for the two tax years. The fact that both parties stipulated that $65 was the daily fair rental figure was important in reaching the split decision.

Analysis and Holding for 1999. The taxpayers' daily average rental rate of $54.90 ($1,400 ÷ 25½ days rented) was **less** than the daily fair rental figure of $65 per day. Since it was, the 25½ days of rental use are deemed to be used by the taxpayers for "personal purposes."[102] Therefore, the personal use days during 1999 were 33½, not eight.[103]

Because the 1999 rental income of $1,400 was less than the mortgage interest and property taxes, the 1999 Schedule E expenses other than interest and taxes must be carried over to 2000.[104]

> **Note.** The Tax Court ignored the "not for profit" reasoning of the IRS and instead relied on the rules of IRC §280A to determine the amount of taxes and interest allocable to Schedules A and E.

Analysis and Holding for 2000. The taxpayers' daily average rental rate of $65.21 ($1,500 ÷ 23 days rented) was **more** than the daily fair rental figure of $65. The court ignored both the "not for profit" theory of IRC §183 and the disallowance rules of IRC §280A. Instead, the taxpayers **held the vacation home for dual purposes in 2000:**

- It was held for **"investment purposes"** under IRC § 212 for 11 months during 2000. The taxpayers bought the condo expecting it to appreciate. The condo substantially increased in value while they owned it. **The court noted that the term "income" (**see the Note below) **means not merely income of the taxable year but includes income the taxpayer may realize in the future from selling property.**
- It was held for **both rental and personal use** for one month (31 days of rental and personal use combined) during 2000.

As a result, the court allocated the following deductions for the condominium for 2000:

- The interest and taxes were allowed in full on Schedule A under IRC §§163 and 164(a).
- $^{11}/_{12}$ of homeowners' dues, insurance, and repairs were **investment expenses** under IRC §212.

> **Note.** IRC §212 expenses include those for "management, conservation, or maintenance of property held for production of income." These expenses are deductible as miscellaneous itemized deductions on line 22, Schedule A and are subject to the 2% of AGI limitation.

- The remaining $^{1}/_{12}$ of homeowners' dues, insurance, and repairs plus auto expense, cleaning and maintenance, supplies, utilities, and depreciation were allocated to the **combined rental and personal use activity.** As such, they were **not** deductible.

Gain on Sale of Residence

Letter Ruling 200403049, September 26, 2003

IRC §121

☞ Unforeseen Circumstances Situation Allows Exclusion of Gain

Purpose. To determine whether part of the gain on the sale of a residence is eligible to be excluded under IRC §121(c).

Facts. Taxpayers own a house in which a family member resides. The family member is placed on probation and spends a year at a rehabilitation facility. During the time the family member is in rehabilitation, taxpayers sell their home and move to a different residence. Taxpayers did not plan on the family member returning to live with them in

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102. IRC §280A(d)(2)(C)

103. IRC §§280A(d)(2)(A) and (C)

104. IRC §280A(c)(5)

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the new residence. A month after the taxpayers move in, the court orders the family member to live in the new residence under house arrest and continue receiving rehabilitation counseling. The neighbors are incensed at having the family member in the house and have created stress for the taxpayers by threatening the family member, insisting the family member stay inside the house, and interfering in potential employment opportunities for the family member. The probation officer believes a move to another neighborhood would decrease the house arrest and probation time.

Analysis. IRC §121(a) allows the gain on a sale of a personal residence to be excluded from gross income if the residence has been owned for a period of five years and has been used as a principal residence for two years or more. For those who do not meet the ownership and use tests, a reduced maximum exclusion is available under §121(c) if the primary reason is change in place of employment, health, or unforeseen circumstances. Unforeseen circumstances include an event which is not anticipated at the time the residence is purchased and occupied.

Conclusion. After review of all facts, the IRS concluded the sale of the house is considered an "unforeseen circumstance" and, as such, part of the gain on sale of the residence is excludible.

Sale of Personal Residence

Treasury Decision 9152, August 13, 2004

IRC §121

☞ Clarification on Exclusion of Gain from Sale of Personal Residence

This Treasury Decision contains the final regulations, Treas. Reg. §1.121-5, and amendments to Treas. Reg. §1.121-3 relating to the exclusion of gain from the sale or exchange of a taxpayer's personal residence. Temp. Treas. Reg. §1.121-3T is also removed. The final regulations apply to a taxpayer who has not owned and used the property as his personal residence for two of the preceding five years or who has excluded gain from a sale or exchange within the preceding two years. The final regulations reflect changes to the law by the Taxpayer Relief Act of 1997, as amended by the IRS Restructuring and Reform Act of 1998 and the Military Family Tax Relief Act of 2003.

> **Note.** The *2003 University of Illinois Federal Tax Workbook* contains a detailed discussion regarding Treasury Decisions 9030 and 9031. These two decisions contained the regulations which were finalized under T.D. 9152.

The Military Family Tax Relief Act of 2003 allows military or foreign service employees, serving on qualified official extended duty, to elect to suspend the running of the five year period for a sale or exchange of a personal residence. They can extend the five year period up to ten years, but must still reside in the residence for at least two years.

> **Note.** A full discussion of the Military Act is included in Chapter 14, New Legislation.

The general rule requires residing in the personal residence two out of five years. If the test is met, the entire \$250,000/\$500,000 exclusion is available. Anything less than two years results in loosing the entire exclusion. Because most taxpayers who sell a home in less than two years are doing so because of extenuating circumstances, the IRS found the two-year rule to be too harsh. Therefore, IRC §121(c) allows a reduced maximum exclusion if failure to meet the two year test is because of a change in place of employment, health or unforeseen circumstances.

The reduced exclusion is calculated by dividing the maximum exclusion, \$250,000 or \$500,000, by 730 days and multiplying by the lesser of the number of days of ownership or use. **Since this is a reduced exclusion, rather than a pro-rata recognition of gain, most taxpayers will not recognize any taxable gain from the sale.**

The new regulations provide detailed examples of what qualifies as a change in place of employment, health or unforeseen circumstances.

The effective date for these new regulations is August, 13, 2004. For transactions before this date, but after May 7, 1997, the taxpayer may elect to apply the new regulations retroactively. The changes related to the Military Act also apply to sales or exchanges occurring on or after May 7, 1997.

RETIREMENT

Plan Loans

***James J. Leonard v. Commissioner,* TC Summary Opinion 2004-11, February 4, 2004**
IRC §72

☞ Unpaid Retirement Plan Loan is Taxable

Facts. The taxpayer withdrew $14,500 from his General Electric (GE) 401(k) plan in June 2000. Due to a job and home address change mistake by GE, the taxpayer never received:

1. The quarterly 401(k) account statements for the last two quarters of 2000,
2. The letter dated November 7, 2000 requesting that he remit delinquent loan payments, or
3. The 2000 Form 1099-R which was issued to him.

The taxpayer knew the loan repayments were not being deducted from his paychecks during the last six months of 2000 as required by the loan agreement. He contacted GE's accounting department by e-mail, notifying GE that the loan payments were not being deducted. **However, he failed to make any loan payments by check during 2000.**

The IRS assessed about $4,500 of additional tax and a 10% early distribution penalty of $1,450 for the 2000 tax year.

Issues.

- Whether the failure to make payments on the loan resulted in a taxable distribution, and if so,
- Whether the 10% early distribution penalty[105] is applicable.

Analysis. Distributions from qualified plans generally are included as gross income in the year of distribution.[106] As a general rule, a qualified plan participant who receives a loan from a plan is treated as having received a distribution in the year the loan is received.[107] However, there is an exception to the general rule if "a substantially level amortization of the loan (with payments not less frequently than quarterly) is required over the term of the loan."[108]

Holding. The Tax Court held that the $14,500 loan was taxable and that the 10% penalty was appropriate. The court noted that:

- The taxpayer did not make any voluntary loan repayments in 2000 even though he knew that they were required by the loan agreement he signed.
- No arguments were presented to show that any of the exceptions to the 10% penalty applied.

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105. IRC §72(t)
106. IRC §402(a)
107. IRC §72(p)(1)(A)
108. IRC §72(p)(2)(C)

Early Distribution Penalty

***John and Michele McGovern v. Commissioner,* TC Summary Opinion 2003-137, September 30, 2003**
IRC §72

☞ 10% Penalty Upheld for Early Distribution from Federal Employees Thrift Savings Plan

Facts. John McGovern was a full-time student at Villanova University School of Law during 1999. He received a lump-sum distribution of $27,880 from his federal employees Thrift Savings Plan (TSP). He deposited this amount to his personal checking account. He later rolled over $15,000 to a traditional IRA. The balance of $12,880 was used to pay tuition and fees to Villanova University.

On their joint 1999 tax return, the taxpayers reported the following:

Total pensions and annuities	$27,880
Taxable amount of pension and annuities	12,880

The taxpayers omitted Form 5329 and did not pay the 10% early distribution penalty on the $12,880. Neither John nor Michele had attained the age of 59½ years during 1999.

The IRS Service Center determined that the taxpayers owed the 10% penalty under IRC §72(t)(1).

Issue. Whether the 10% penalty applies to the early distribution from the husband's Federal Employees Thrift Savings Plan.

Analysis. The taxpayers contended that they qualified for the exception for early distributions used to pay qualified higher education expenses.[109] There is no dispute that the $12,880 taxable distribution portion was used to pay "qualified higher education expenses" as mentioned in IRC §72(t)(2)(E). **However, the disputed issue is whether the $12,880 distribution is from "an individual retirement plan" as required.**

Holding. After considering Mr. McGovern's various legal arguments, **the Tax Court agreed with the IRS that the 10% penalty of $1,288 was properly applied. The court held that the term "individual retirement plan" does not include a federal employees TSP.**

The court noted that an early distribution from a traditional IRA to pay "qualified higher education expenses" is eligible for the exception to the 10% penalty. However, the exception does not apply to early distributions from a federal employees TSP.

> **Note.** In another recent Tax Court case,[110] the exception to the 10% penalty was not allowed for a $50,674 early distribution from a 401(k) plan that was used to build a new home. The taxpayer attempted to use the **"qualified first-time homebuyer"** exception under IRC §72(t)(2)(F). However, **that exception applies only to early distributions from IRAs**. It does **not** apply to early distributions from qualified employer plans such as §§401(a) or 401(k) plans.

109. IRC §72(t)(2)(E)

110. *Joseph Jones v. Commr.*, TC Summary Opinion 2003-153, October 20, 2003

Early Distribution Penalty

***Jeanette M. and Tom M. Kimball v. Commissioner,* TC Summary Opinion 2004-2, January 8, 2004**

IRC §72

☞ Timing is Critical in Order to Avoid 10% Early Distribution Penalty

Facts. Jeanette Kimball withdrew $17,223 from her employer's qualified retirement plan in **2000** to pay for large unreimbursed medical expenses. The Kimballs reported the distribution on their joint 2000 tax return but omitted Form 5329 regarding the 10% early distribution penalty. Mrs. Kimball was age 56 when the distribution was received.

The Kimballs did not itemize deductions on their joint 2000 tax return. The IRS Service Center sent the Kimballs a notice of deficiency for $1,722, which represented the 10% penalty on the $17,223 distribution.

The Kimballs did itemize deductions on their joint **2001** tax return. Their **2001** tax return reported the following:

AGI	$100,387
Total unreimbursed medical expenses	16,253
Less: 7.5% of 2001 AGI	(7,529)
Deductible 2001 medical expenses	$ 8,724

Issue. Whether the taxpayers are liable for the IRC §72(t) early distribution penalty from a qualified retirement plan for the taxable year 2000.

Analysis. IRC §72(t)(1) generally imposes a 10% additional tax (penalty) on early distributions from qualified retirement plans and traditional IRAs, unless the distribution satisfies one of several statutory exceptions. The exception that the taxpayers wished to use is the one found in IRC §72(t)(2)(B). This exception provides that the following distributions are not subject to the penalty:

*"**Medical expenses.** Distributions made to the employee to the extent such distributions do not exceed the amount allowable as a deduction under IRC §213 to the employee for amounts paid during the taxable year for medical care (determined without regard to whether the employee itemized deductions for such taxable year)."*

Holding. The Tax Court agreed with the IRS and upheld the assessment of the 10% penalty ($1,722). The court stated: "The unambiguous language of IRC §72(t)(2)(B) limits the scope of the exception to the amount of deductible medical expenses **paid during the taxable year** of the distribution."

The 10% penalty was appropriate because the taxpayers did not have any deductible medical expenses in 2000, the year they received the distribution. The court noted that even if the distribution had been received in 2001 rather than 2000, the taxpayers could not have totally avoided the 10% penalty. They reported 2001 deductible medical expenses of $8,724. That amount would have been exempt from the penalty, but the remainder of $7,529 would have been subject to it.

> **Practice Pointer.** A better funding source for the medical expenses probably would have been a home equity loan, which would have prevented the penalty, preserved future retirement distributions, and created a larger Schedule A interest deduction.

60-day Rollover Waivers
Letter Ruling 200401020, January 2, 2004
Letter Ruling 200401023, January 2, 2004
Letter Ruling 200401024, January 2, 2004
Letter Ruling 200401025, January 2, 2004
Letter Ruling 200402028, January 9, 2004
Letter Ruling 200404053, January 23, 2004
Letter Ruling 200406054, February 6, 2004
IRC §408

☞ IRS Allows Waivers for 60-day Rollover Deadline for IRA Contributions

Background. Rev. Proc. 2003-16 provided guidelines for applying for a waiver of the 60-day deadline for completing a rollover of a distribution received from a traditional IRA.

The revenue procedure provides two types of waivers:

1. Automatic approval, and
2. Hardship waiver via a letter ruling request with payment of the $90 user fee.

An **automatic waiver** applies when the 60-day deadline is not met **due solely to financial institution error.** A **hardship waiver** could be granted after the IRS considers several factors including:

- Errors made by financial institutions other than those described in the automatic approval waiver
- Inability to complete a rollover due to death, disability, hospitalization, incarceration, or postal error
- Time elapsed since the date of the IRA distribution

The IRS will issue a hardship waiver if failure to complete a timely rollover was beyond the reasonable control of the taxpayer and it would be against good conscience or equity not to grant a waiver. The IRS normally grants the taxpayer 60 days from the date of a favorable ruling to complete the rollover transaction.

Note. See pages 630–31 in the *2003 University of Illinois Federal Tax Workbook* for a thorough analysis of Rev. Proc. 2003-16

The IRS granted hardship waivers of the rollover deadlines in the following letter rulings.

Letter Ruling 200401020. Taxpayer was in midst of divorce and needed funds to purchase a residence. He instructed his bank to transfer funds from a brokerage account to his checking account. The bank transferred funds from his IRA account to his checking account. The bank did not provide the taxpayer with any written notification of the withdrawal from the IRA until he received a Form 1099-R indicating a taxable IRA withdrawal.

Letter Ruling 200401023. Taxpayer decided to move her IRA from Bank A to Bank B. She closed her account at Bank A and took the funds to Bank B where she met with a bank officer explaining her desire to deposit the funds in a new IRA account. The bank deposited the funds into a **non-retirement certificate of deposit**. Bank B discovered the error when taxpayer met with her accountant to prepare her 2002 return.

Letter Ruling 200401024. Taxpayer had a history of alcohol abuse and mental illness. He withdrew cash from an IRA account fully intending to redeposit the entire amount within the 60-day period. **Before the end of the 60-day period, taxpayer was involuntarily admitted to a clinic for alcohol abuse treatment and suicidal tendencies.** When taxpayer recovered, the 60-day period had expired. The IRS granted a waiver since the severe mental disability and hospitalization was **beyond the taxpayers control** and prevented him from redepositing the funds in a timely fashion.

Letter Ruling 200401025. Taxpayer made withdrawals from her IRA for purchase of a house while suffering from progressive Alzheimer's disease. During this period of time, she had other funds available to purchase the house. Her daughter requested a medical examination which revealed the taxpayer was incapable of understanding the actions she took regarding the IRA withdrawals. Taxpayer requested that the IRA withdrawals be redeposited but learned the 60-day period had expired. The IRS ruled that the withdrawals were **beyond her reasonable control** due to her Alzheimer's disease.

Letter Ruling 200402028. Taxpayer hired Individual C to manage investments due to the declining stock market. Individual C suggested that taxpayer move an IRA account from one company to another. Taxpayer agreed to the transfer and instructed Individual C to set up a rollover IRA account. Individual C established a regular brokerage account rather than a rollover IRA account resulting in a lump sum distribution. Taxpayer became aware of the error when a Form 1099-R was received. IRS ruled the situation was **beyond the taxpayer's control** and allowed a waiver of the 60-day rollover requirement.

Letter Ruling 200404053. Taxpayers maintained IRA accounts with Bank F. Funds were withdrawn from IRA accounts in Bank F and deposited in Bank C with instructions to deposit the funds in new IRA accounts. When preparing their tax return, the taxpayers realized Bank C had not deposited the funds into IRA accounts because taxable interest was earned on the accounts. The IRS ruled **the taxpayers had provided instructions to Bank C which were not followed** and consequently waived the 60-day rollover requirement.

Letter Ruling 200406054. On December 28, 2002, taxpayer withdrew funds from an IRA account to purchase a condominium. She later changed her mind about the condominium and intended to redeposit the funds into her IRA account. Unfortunately, a major blizzard struck on February 18 which prevented her from reaching the bank. On February 19, the bank would not permit her to complete the rollover transaction since the 60-day period had expired. The IRS allowed a waiver of the 60-day period because the failure to deposit by one day was **beyond the reasonable control** of the taxpayer.

TAX FRAUD

Nonfiler/Protester

***Edward D. Tonitis v. Commissioner,* TC Memo 2004-60, March 10, 2004**
IRC §6651

☞ Nonfiler Was Liable for the Fraudulent Failure to File Penalty

Facts. Edward Tonitis received a degree in finance in 1994. In 1995, he purchased two Unincorporated Business Trusts from Joseph Sweet, an abusive trust promoter. Prior to 1996, he filed his individual federal tax returns which were prepared by a CPA. After working as a loan officer for various companies, he started his own mortgage brokerage business known as Colonial Mortgage Corp. in 1998.

No trust returns were ever filed with the IRS. The taxpayer failed to file Forms 1040 for the years 1996–1999. When contacted by the IRS, he failed to cooperate or to produce requested records. When the IRS issued a summons for the records, he sent letters to the IRS examiner that contained frivolous tax-avoidance arguments.

In the absence of records, the IRS computed Mr. Tonitis' taxable income for the four years 1996–1999 by using the following information:

- Bank deposits
- Information returns
- Third-party contacts

Based on that information, the IRS assessed tax liabilities and penalties as shown in the following chart.

Tax Year	Additional Tax	75% Fraudulent Failure to File Penalty (IRC §6651(f))
1996	$ 9,058	$ 5,845
1997	13,485	10,054
1998	20,731	14,002
1999	5,844	4,288

Issue. Whether the taxpayer's failure to file tax returns was due to fraud.

Analysis. IRC §6651(f) provides a penalty of 75% of the amount required to be shown as tax on unfiled returns if the failure to file the returns is fraudulent.

At the Tax Court trial, the taxpayer denied that he intended to defraud the United States by testifying:

"I relied on the advice of Joseph Sweet, that, you know, as far as not filing was okay. I've seen what they've done, you know, over the last seven, eight years, promoting and telling people not to do this, and they're out there doing it."

Holding. The court held that the taxpayer's failure to file federal tax returns was done with the intent to evade tax. The court noted that the following list of acts clearly demonstrated a fraudulent intention:

1. His use of sham trusts to conceal income.
2. His failure to cooperate in the IRS examination to determine his correct tax liability.
3. His submission of correspondence to the IRS espousing frivolous tax-avoidance arguments.
4. His four-year pattern of failing to file required federal tax returns.

The court noted that "the undisputed facts would constitute clear and convincing evidence of fraud." After hearing the taxpayer's testimony denying fraudulent intent, the court stated: "The thrust of his testimony is that he and others pursued their course of tax protest as long as they could get away with it."

Note. The IRS continues to aggressively pursue tax protest promoters. In June 2004, Irwin Schiff, one of the most visible promoters of nonfiling, appeared in Nevada U.S. District Court. The IRS had assessed over $2 million in additional taxes and penalties on Mr. Schiff for the years 1979–1985. Curiously, Mr. Schiff, who had advised countless citizens that they had no legal obligation to file tax returns, did file his own inaccurate tax returns. The District Court upheld the IRS assessment. In a separate matter, Mr. Schiff is accused of criminal conspiracy. If convicted, he faces imprisonment and over $3 million in fines.

Tax Scams

IRS News Release IR-2004-42, March 29, 2004

IRC §501

☞ IRS Cautions Taxpayers about Tax Scams Involving Corporation Sole Laws

This scam involves the use of Corporation Sole laws.

Corporation Sole laws allow bona-fide churches, religious institutions, and religious leaders (typically bishops or parsons) to incorporate to insure the continuation of ownership of property dedicated to the benefit of a legitimate religious organization. Creditors of a Corporation Sole cannot obtain assets belonging either to the individual holding the office nor the Corporation Sole itself. Sixteen states currently permit Corporation Sole incorporations.

Promoters are marketing Corporation Sole incorporations through seminars with fees up to $1,000 or more per person. Individuals are told the Corporation Sole provides a legal way to escape paying federal income taxes as well as other personal debts by hiding assets in a tax exempt entity. Individuals, who can answer yes or maybe to the following questions, should be skeptical of setting up a Corporation Sole:

- Is the arrangement designed to hide income or assets?
- Is the arrangement designed to evade income taxes?

The IRS is aware of this scam and cautions taxpayers and their representatives that the alleged tax benefits are not allowable. The IRS intends to challenge Corporation Sole incorporations made for tax avoidance purposes. Penalties may be imposed on promoters as well as individuals participating in the scam.

The IRS encourages individuals and representatives to report possible schemes by calling 1-866-775-7474 or sending an email to **irs.tax.shelter.hotline@irs.gov.**

Tax Scams
IRS Notice 2004-30, April 1, 2004
IRC §§170, 6011, 6111 and 6112

☞ Tax-Exempt Organizations Warned about Donations of Nonvoting S Corporation Stock

A tax avoidance transaction is currently being utilized to defer taxation on S corporation income. The IRS determined these types of transactions are "listed transactions." The IRS will disallow tax benefits generated by this type of transaction. Penalties may also be asserted.

A typical transaction operates as follows:

- An S corporation issues nonvoting stock and warrants that are exercisable into nonvoting stock to each of the shareholders on a pro rata basis
- Shareholders then donate nonvoting stock to an **exempt entity** (IRC §§501 (c)(3) or 401(a) entity) which is not subject to tax on unrelated business income (UBIT) under IRC §511 or which has UBIT carryover losses

For example, S corporation with 1,000 shares of voting stock issues nonvoting stock in a ratio of nine shares for every share of voting stock and warrants in a ratio of 10 warrants for every share of nonvoting stock. This would result in 9,000 shares of nonvoting stock and warrants exercisable into 90,000 shares of nonvoting stock in addition to the 1,000 shares of voting stock. The shareholders would, in turn, donate the nonvoting stock to an exempt party. Any taxable income allocated to the nonvoting stock would either not be subject to tax on UBIT or would be offset by UBIT net operating losses.

In this example, 90% of the S corporation's income would be allocated to the exempt organization with the remaining 10% allocated to the original shareholders. In addition, shareholders may also claim charitable deductions under IRC §170 for donations of the nonvoting stock to the exempt entity.

The IRS intends to challenge these transactions based on judicial doctrines as well as a substance over form argument. In addition, IRS may also challenge the S corporation status since the existence of warrants results in a violation of the single class of stock requirement under IRC §1361(b)(1)(D).

Taxpayers and their representatives are encouraged to take appropriate corrective action in situations involving improper tax benefits and ensure the transactions are disclosed properly.

Competency For Trial

***United States v. Roy W. Wooten,* 6th Circuit Ct. of Appeals, No. 02-6534, April 29, 2004**

18 USC §4241(d)

☞ Taxpayer's Erratic Court Behavior Was Due to Mental Disorder

Facts. In 2001, the taxpayer, a professional musician, was indicted by a Tennessee U.S. District Court on four counts of tax evasion. His subsequent conduct caused the District Court to question his competency to stand trial. Mr. Wooten's erratic behavior before the court following his indictment included the actions listed below.

1. He insisted on responding to virtually every question with arcane, pseudo-legal jargon commonly associated with tax protestor literature.
2. He repeatedly proclaimed his beliefs that the federal government is bankrupt, the Dept. of the Navy runs the country under Admiralty Law, and the Internal Revenue Service is really a foreign debt collector based in Puerto Rico.
3. He filed volumes of pleadings with the court, many signed only with his thumb print.

Based on Mr. Wooten's strange behavior, and fearing that he might not be competent to assist in his own defense, the District Court ordered a competency evaluation. The initial evaluation by two psychologists concluded that Mr. Wooten was competent to stand trial. However, that evaluation apparently did not satisfy the District Court judge.

A second evaluation, performed by a neuropsychologist, concluded that the taxpayer suffered from **"persecutory delusional disorder."** Therefore, he was **not competent** to stand trial because "his belief system affected his behavior such that is interfered with his ability to function in a courtroom setting."

Holding. The 6th Circuit Court of Appeals agreed with the Tennessee District Court's decision that the taxpayer was incompetent to stand trial.

TRAVEL & TRANSPORTATION EXPENSES

Per Diem Payments

***Charles A. Boyd et al. v. Commissioner,* 122 TC 305, No. 18, April 27, 2004**

IRC §274

☞ Mileage-Based Per Diem Payments are Subject to 50% Disallowance Rule

Facts. Continental Express, Inc. (Continental) is an S corporation long-haul trucking company of which Mr. Boyd and his ex-wife are shareholders. Continental operates in every state in the continental United States. The average length of their drivers' trips was 1,800 miles. Continental employed approximately 300 drivers during the three tax years in question, 1995 through 1997.

Each semi-tractor owned by Continental had a sleeper cab. Corporate management assumed that drivers slept in the sleeper berths on average six of seven nights on the road. The company assumed that drivers slept in a motel anywhere from two or three times a month to three nights a week.

Instead of paying a typical per diem allowance of $30 a day, Continental paid them a per diem allowance of 9¢ per mile. The main reason Continental paid a mileage-based per diem was that their accounting and payroll system tracked miles driven, not days worked. Therefore, it was nearly impossible to compute the number of days worked. The mileage-based per diem amount paid to truckers typically was in the low $30 range during a 24-hour period. Drivers were not required to submit any records or documentation for their travel expenses.

On its Forms 1120S, Continental deducted 80% of the per diem payments. It arrived at the 80% figure as shown below.

Meal expense (40% of per diem × 50%)	20%
Other per diem	60%
Total deducted per diem	80%

The total amount of the per diem payments for the three S-corporation tax years in question was between $2.2 million and $3.2 million per year.

The IRS determined that according to the applicable per diem revenue procedure,[111] any mileage-based per diem is treated as paid entirely for meals and incidental expenses. As a result, the IRS limited the deduction for the per diem payments to 50% rather than the 80% portion Continental deducted.

Issue. Whether Continental is entitled to deduct 80% or 50% of the *per diem* payments.

Analysis and Holding. The Tax Court agreed with the IRS that only 50% of the per diem payments could be deducted. The court noted that the per diem revenue procedure is elective. Continental made a business decision to elect the revenue procedure rules rather than have their drivers substantiate travel expenses. In doing so, it must follow the terms of the revenue procedure. In reaching its decision, the court cited as precedent a previous Tax Court decision.[112]

> **Note.** See Chapter 11, Special Taxpayers, Transportation Workers for more information on these special taxpayers. See pages 354–55 in the *2002 University of Illinois Farm Income Tax Workbook* for an analysis of a previous Tax Court case with almost identical facts, the *Beech Trucking Co. v. Commr.* case.

2004 Standard Mileage Rates

Revenue Procedure 2003-76, October 15, 2003

IRC §§62 162, 170, 213, 217, 274 and 1016

☞ New 2004 Optional Standard Mileage Rates

Effective January 1, 2004, standard mileage rates increase to

- 37.5¢ per mile for business
- 14¢ per mile for charitable
- 14¢ per mile for medical and moving

Rules are also provided for substantiating ordinary and necessary business expenses incurred by employees for local and away from home travel and transportation where these costs are reimbursed by an employer. Methods of substantiation described in this document are not mandatory. Taxpayers maintaining adequate records may use their actual allowable expenses when deductions are claimed.

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111. Rev. Proc. 2003-80, Section 4.02

112. *Beech Trucking Co. v. Commr.*, 118 TC 428, May 23, 2002