WHAT'S NEW SUPPLEMENT

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Gary J. Hoff and Lanny Lobdell
University of Illinois Extension and
Department of Agricultural and Consumer Economics
University of Illinois at Urbana-Champaign

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CORRECTIONS TO 2004 FEDERAL TAX WORKBOOK

Page Number	Correction To Be Made
581	In Table 2, the Total Line for "Cost of HDHP Insurance with HSA must be changed in all columns. Change $8,640 to $3,468, $9,860 to $4,301, $11,080 to $5,491, $12,300 to $6,069, and $13,620 to $6,732.

NEW LEGISLATION

HEALTH SAVINGS ACCOUNTS

The following is meant to supplement the discussion on Health Savings Accounts, which appears on pages 561 to 588 in the workbook. The following were questions asked by participants of the 2004 schools:

Inquiry 1.

Facts. A husband is over 65 and enrolled in Medicare but his wife is 55. Husband has an HSA in his name.

Question. May the wife establish her own separate HSA?

Answer. Yes.

Question. If so, may she make HSA distributions to pay for her husband's unreimbursed medical expenses, including reimbursing the husband for the Medicare Part B premium deducted from his Social Security check?

Answer. Yes. An HSA account owner can use HSA funds to pay unreimbursed medical expense for the following three individuals:

1. The HSA account owner
2. The spouse of the account owner (regardless of age)
3. Dependents of the account owner

> **Note.** HSAs are a great innovation. If Medicare benefits are dramatically lowered in the future, an HSA with a large balance at age 65 (in this case, the HSA of either the 65-year old husband or the wife when she reaches age 65) is going to represent a very valuable asset.

Inquiry 2.

Facts. An individual's employer offers a group health plan. The employee can opt out of the employer's health plan.

Question. May the employee opt out of the employer's health coverage and establish his HSA with an HDHP?

Answer. Yes, as long as the employee has **no other** health insurance coverage **except** what is permitted in addition to the HDHP. These other types of permitted health-related policies, in addition to the HDHP, include those which cover only:

1. Accidents
2. Vision care
3. Long-term care
4. Specific disease or illness, such as a cancer policy
5. Disability
6. A per diem hospital policy that pays a fixed amount per day for every day the insured is in a hospital.

> **Note.** See pages 490–91 in the *2004 University of Illinois Federal Tax Workbook.*

Inquiry 3.

Facts. I have been covered by a self-only HDHP since February 1, 2004. It has a $2,500 deductible. My wife was covered by a preferred provider health plan of her employer for or during all of 2004.

Question. May I establish an HSA now (in December 2004) and make deductible 2004 HSA contributions to it?

Answer. Yes. Since you were covered under your HDHP for 11 months of 2004, you are entitled to 11 months of 2004 HSA contributions. You weren't covered under your HDHP in January 2004, so you aren't eligible for an HSA contribution for that month. Since your HDHP deductible of $2,500 is **less** than the maximum self-only HSA annual contribution limit of $2,600, your maximum 2004 HSA contribution is 11/12 of $2,500, or $2,292. You may make this maximum 2004 HSA contribution now (in December 2004) or at any time before April 15, 2004.

Question. Even though my wife is not covered under my self-only HDHP, may I use funds in my HSA to pay her unreimbursed medical expenses?

Answer. Yes. You can use distributions from your HSA to pay for your wife's co-payments which are not paid by her employer-provided preferred provider health plan.

Inquiry 4.

Question. May a self-employed husband who has a self-only HDHP establish his own HSA if his wife is employed and covered under her employer's group health plan?

Answer. Yes, provided the husband is not covered by his wife's group plan. This couple has three options in this situation (assuming the husband has not yet established his self-only HDHP in 2004):

1. Add the husband to the wife's plan, if available.
2. Let the husband buy a self-only HDHP paired with his HSA (as suggested in the question).
3. Have the wife drop her employer's group health plan. Then this couple could buy a family-coverage HDHP and establish either one HSA in the name of one of the spouses or establish two separate HSAs.

Inquiry 5.

Facts. My married clients have had a family-coverage HDHP for several years. It has a $5,000 deductible.

Question. If the wife establishes an HSA in her name on Dec. 15, 2004, may she make a 2004 HSA contribution of $5,000 by April 15, 2005 and claim a $5,000 HSA deduction on her 2004 Form 8889?

Answer. Yes. An HSA account owner is eligible to make a monthly HSA contribution for **any month** the account owner is covered by an HDHP on the **first day** of the month. Consequently, the date the HDHP becomes effective is vital. The wife could establish the HSA at any time in 2005 before April 15, 2005 and make the maximum 2004 HSA contribution ($5,000 with the stated facts) as late as April 15, 2005.

SALES TAX DEDUCTION

IRS Pub. 600

IRC §164(b)((5)

☞ **Taxpayers can choose to deduct either state and local income taxes or general sales tax.**

The American Jobs Creation Act of 2004 allows taxpayers to deduct either personal general sales taxes or state and local income taxes. The purpose is to allow a deduction to those taxpayers who live in states that do not have a state income tax. Because the sales tax paid for motor vehicles, boats, aircraft and building materials can be added to the amounts listed in the sales tax tables, some taxpayers in states with income taxes may find it beneficial to claim the sales tax deduction.

The following is taken from Pub. 600, *Optional State Sales Tax Tables,* which may be downloaded at www.IRS.gov.

Purpose

This publication helps taxpayers calculate their deduction for state and local general sales taxes using the Optional State Sales Tax Tables. A general sales tax is a sales tax imposed at one rate for the retail sale of a broad range of classes of items. In addition, certain selective sales taxes (sales taxes imposed at a different rate on certain selected items) are deductible as general sales taxes, as explained below.

Introduction

New for 2004, a taxpayer can elect to deduct state and local general sales taxes instead of state and local income taxes as an itemized deduction on Schedule A (Form 1040). He cannot deduct both. Generally, to calculate the state and local general sales tax deduction, the taxpayer can use either his actual expenses or the Optional State Sales Tax Tables contained in Pub. 600.

Actual expenses. Generally, the actual state and local general sales taxes (including compensating use taxes) paid in 2004 can be deducted only if the tax rate was the same as the general sales tax rate. Sales taxes paid on items used in a trade or business cannot be deducted.

Rate LESS than general rate. Sales taxes on food, clothing, medical supplies, and motor vehicles are deductible as a general sales tax even if the tax rate was less than the general sales tax rate.

Rate MORE than general rate. Sales taxes on motor vehicles also are deductible as a general sales tax if the tax rate was more than the general sales tax rate, but the tax is deductible only up to the amount of tax that would have been imposed at the general sales tax rate. Motor vehicles include:

- Cars,
- Motorcycles,
- Motor homes,
- Recreational vehicles,
- Sport utility vehicles,
- Trucks,
- Vans, and
- Off-road vehicles.

Any state and local general sales taxes paid for a leased motor vehicle are also included.

> **Caution.** Actual receipts showing general sales taxes paid to use this method must be kept.

Optional State Sales Tax Tables. Instead of using actual expenses, a taxpayer can use the Optional State Sales Tax Tables on pages 3 through 5 of Pub. 600 to calculate the state and local general sales tax deduction. The following items may also be added to the table amount.

- Local general sales taxes if the taxpayer's locality imposes a general sales tax.
- State and local general sales taxes paid on certain specified items.

How To Use the Optional State Sales Tax Tables

To determine the state and local general sales tax deduction using the Optional State Sales Tax Tables, follow Steps 1 through 5 and complete the following worksheet.

> **Caution.** If the taxpayer's filing status is married filing separately, both the taxpayer and spouse elect to deduct sales taxes, and the spouse elects to use the Optional State Sales Tax Tables, the taxpayer must also use the tables to calculate the state and local general sales tax deduction.

Step 1. Find the state of residence in 2004 in the Optional State Sales Tax Tables shown on pages 3 through 5 of Pub. 600. But see "What If You Lived in More Than One Place," on page 3 of Pub. 600, if applicable.

Step 2. In the "At least – But less than" columns for the state, find the line that includes the 2004 total available income. Total available income is the amount shown on the taxpayer's Form 1040, line 37, plus any nontaxable items, such as the following.

- Tax-exempt interest.
- Veterans' benefits.
- Nontaxable combat pay.
- Workers' compensation.
- Nontaxable part of social security and railroad retirement benefits.
- Nontaxable part of IRA, pension, or annuity distributions. Do not include rollovers.
- Public assistance payments.

> **Note.** If the taxpayer's filing status is married filing separately, he will use his own total available income. Follow the above instructions, beginning with the amount shown on Form 1040, line 37.

Step 3. Go to the column that includes the total number of exemptions claimed on Form 1040, line 6d. Enter the amount from that column on line 1 of the worksheet below.

Step 4. If the locality imposes a general sales tax, complete lines 2a through 2d of the worksheet below. Otherwise, skip lines 2a through 2c of the worksheet, enter -0- on line 2d, and go to line 3.

Example 1. State A imposes a 6.5% (.065) general sales tax. City B in State A imposes an additional 0.5% (.005) general sales tax. To calculate the local general sales taxes, enter .005 (the local general sales tax rate) on line 2a of the worksheet below. Enter .065 (the state general sales tax rate) on line 2b. Divide the amount on line 2a (.005) by the amount on line 2b (.065) and enter the result (.077) on line 2c. If the amount on line 1 of the worksheet is $1,000, multiply this amount by the amount on line 2c (.077) and enter the result, $77, on line 2d.

Step 5. Enter on line 3 of the worksheet below any state and local general sales taxes paid on the following specified items.

- A motor vehicle (including a car, motorcycle, motor home, recreational vehicle, sport utility vehicle, truck, van, and off-road vehicle). Also include any state and local general sales taxes paid for a leased motor vehicle. If the state sales tax rate on these items is higher than the general sales tax rate, only include the amount of tax you would have paid at the general sales tax rate.
- An aircraft, boat, home (including mobile and prefabricated), or home building materials, if the tax rate was the same as the general sales tax rate.

Do not include sales taxes paid on items used in a trade or business.

STATE AND LOCAL GENERAL SALES TAX DEDUCTION WORKSHEET

(Using the Optional State Sales Tax Tables)*(Keep for Your Records)*

1.	State general sales taxes. See *Step 1* through *Step 3* above.	**1.**	______		
2a.	Local general sales tax rate. If zero, skip lines 2a through 2c, enter -0- on line 2d, and go to line 3.	**2a.**	______		
2b.	State general sales tax rate	**2b.**	______		
2c.	Divide line 2a by line 2b. Enter the result as a decimal (rounded to at least three places).	**2c.**	______		
2d.	Local general sales taxes. Multiply line 1 by line 2c.			**2d.**	______
3.	General sales taxes paid on specified items, if any. See *Step 5* above.			**3.**	______
4.	**Deduction for general sales taxes.** Add lines 1, 2d, and 3. Enter the result here and on Schedule A (Form 1040), line 5, and be sure to check box b on that line.			**4.**	______

> **Note.** If the taxpayer elects to deduct general sales taxes, he cannot deduct his state and local income taxes.

What if Taxpayer Lived in More Than One State?

If the taxpayer lived in more than one state during 2004, multiply the table amount for each state he lived in by a fraction. The numerator of the fraction is the number of days he lived in the state and the denominator is the total number of days in the year (366).

Also prorate any local general sales taxes based on the number of days he resided in the locality for which he is determining the local sales tax deduction.

Example 2. Greg lived in State A from January 1 through August 31, 2004 (244 days), and in State B from September 1 through December 31, 2004 (122 days). The table amount for State A is $500. The table amount for State B is $400. Greg would figure his state general sales tax (line 1 of the worksheet on page 2) as follows.

State A:	$500 × (244 ÷ 366) =	$333
State B:	$400 × (122 × 366) =	$133
Total		$466

ADDITIONAL RULINGS AND CASES

The following are rulings and cases that were released after the 2004 workbook was printed, or were omitted because of space limitations. This is not a complete listing.

AGRICULTURAL ISSUES

Built-in Gain

***Garwood Irrigation Company v. Commr.,* TC Memo 2004-195, August 30, 2004**
IRC §1001

☞ **Case details how to value water rights.**

Facts. An S **c**orporation was formed in 1948. It continued as an S corporation until a shareholder's death in 1978. At the time of the death, a trust was not an eligible S corporation shareholder. Consequently, the corporation switched its filing status to a C corporation.

In 1996, trusts became eligible S corporation shareholders. Garwood filed Form 2553 electing S status to be effective on January 1, 1997. At the time of the election, the major asset of the corporation, the right to divert water from the Colorado River (located in Texas) for irrigation was valued at $31.4 million. In 1999, the water rights were actually sold for $90.7 million in two separate reported transactions. On its 1999 Form 1120S, the taxpayer reported built-in gains tax of $9.6 million based on the $31.4 million water rights value on January 1, 1997.

In an exam, the IRS determined that the water rights had a value on January 1, 1997, the date of the S election of $76.6 million. **As a result, the IRS increased the 1999 built-in gains tax by $15.8 million.**

Issue. What is the correct value of the water rights on January 1, 1997, the date of the S election?

Analysis. At the tax court trial, four experts gave their opinions on the value of the water rights. The values submitted ranged from $10.7 million to $76.6 million, the value used by the IRS in its exam.

The actual sales price of the water rights, $90.7 million, was substantially more than the valuation used by the taxpayer. In addition, the time between the January 1, 1997 valuation of $31.4 million and the sale was relatively short. The IRS concluded that the water rights were significantly undervalued for purposes of determining the built-in gains tax for 1999.

In a very thorough analysis, the Tax Court detailed a timeline of events between 1967, when a sale of part of the rights was first discussed, until 1999, when the two sales actually occurred. The court noted that a major factor that must be considered was a change in the political climate of Texas state government regarding sales of water rights. **This change occurred after the valuation date of January 1, 1997.**

Holding. The court determined that the value of the water rights on January 1, 1997 was $22.5 million, which was less than either the taxpayers' value of $31.4 million or the IRS valuation of $76.6 million. As a result, the taxpayer had **overstated** the correct amount of the built-in gains tax on its 1999 Form 1120S. The court stated it would have been impossible for the taxpayer to predict on January 1, 1997 that there would be a change in how Texas state government would approach the sale and transfer of water rights.

> **Note.** This is an excellent case for guidance in valuing water rights.

CAPITAL GAIN AND LOSSES

Lottery Proceeds

***George and Angeline Lattera v. Commr.,* TC Memo 2004-216, September 23, 2004**
IRC §1221

☞ **Income from an assignment of future lottery winnings is not afforded capital gain treatment.**

Facts. The taxpayers purchased the winning ticket for the Pennsylvania lottery in June 1991. They won $9.5 million. State law prohibited a lump sum payment. Therefore, the prize was payable in 26 annual installments of $369,051. In August 1999, the taxpayers received permission from Pennsylvania to sell their remaining 17 installments to Singer Asset Finance Co., LLC (Singer) for $3.4 million.

Singer issued a 1999 Form 1099-B showing the $3.3 million transaction as a sale of stocks or bonds. The taxpayers reported the sale on their 1999 Schedule D as a long-term capital gain with a zero basis.

Issue. Whether the IRS was correct in reclassifying the $3.4 million as ordinary income.

Analysis. The basic question is whether the right to receive future annual lottery payments constitutes a capital asset. The Tax Court relied on the decisions of prior court cases involving the assignment of future lottery winnings. It cited *Davis v. Commr. [Dec, 54,804], 119 T.C. 1(2002)* and various other cases in which the courts ruled against capital gain treatment.

Holding. The taxpayers surrendered the winning lottery ticket to the Pennsylvania lottery commission and claimed their prize of 26 annual payments. They did not sell the lottery ticket to Singer, but rather sold the right to the future payments. Therefore, the $3.4 million they received from Singer represents ordinary income.

Real Estate Developer

***Thomas J. & Deborah A. Phelan v. Commr.,* TC Memo, 2004-206, September 15, 2004**
IRC §1221

☞ **Commercial real estate developer entitled to capital gain on sale of undeveloped residential use land.**

Facts. In 1994, a real estate agent notified Timothy Phelan that a 1,050 acre parcel of land would soon be listed for sale. Mr. Phelan organized an LLC which purchased the parcel for $2.9 million. The intention of the LLC was to hold the property as a long-term investment. Mr. Phelan held a 40% interest in the LLC. None of the LLC members held real estate licenses.

At the time of the purchase, the LLC members knew the land was zoned for residential homes and that infrastructure improvements would be necessary.

The LLC sold 102 acres of the undeveloped land to an unrelated residential development corporation in 1998. The LLC's 1998 Form 1065 reported a $607,000 long-term capital gain for the sale. Mr. Phelan reported his 1998 40% distribution share in a similar fashion. In an exam, the IRS treated the gain as ordinary income arising from Mr. Phelan's occupation as a commercial real estate developer.

Members of the LLC also purchased interests in three other entities which were involved in real estate development.

Issue. Whether the sale of the property by the LLC resulted in ordinary income or capital gain income.

Analysis. While the taxpayer and the other members of the LLC earned their living from commercial real estate development, the 1,050 parcel of land in question was held by the LLC for future long-term appreciation. The IRS challenged the capital gain treatment primarily due to the LLC members' involvement in other real estate development ventures.

Holding. The Tax Court held that the gain did qualify for capital gain treatment under IRC §1221. It based it decision on the following:

- The purpose of the 1994 purchase of the 1,050 acre tract was to hold it for investment.
- The LLC did not provide the development activity to make the 102 acres suitable for sale as residential lots, nor did it advertise the land for sale.
- The sale of the 102 acres in 1998 was unsolicited.

CORPORATIONS

S Corporation

Letter Ruling 200441023, June 3, 2004
§1361

☞ Split-dollar life insurance policy did not create second class of stock

An S corporation, with both voting and non-voting stock purchased split-dollar life insurance on various shareholders. Both classes of stock had identical rights with respect to both operating and non-operating distributions.

The corporation required the recipient to reimburse the corporation for the insurance premium based upon the lowest annual cost of insuring the joint lives. If the recipient fails to make payment, the corporation must make full payment. In the event of death, the payment made by the corporation will be treated as a loan and repaid from the death benefit or the cash surrender value.

Because the shareholder must reimburse the corporation, the insurance policy does not provide an economic benefit to the shareholders whose lives are insured. Therefore, a second class of stock is not created and the insurance does not cause a termination of the S election.

S Corporation

Letter Ruling 200441003, June 8, 2004
§1362

☞ Corporation concerned excess passive income would terminate S election.

A corporation intended to acquire a business which might be considered a rental business. The corporation's concern was that this might be considered passive income and cause termination of the S election.

The facts regarding the new business was that employees would be hired in peak season to maintain cabins, walkways, parking lots, docks, and a central lodge and office. The employees would maintain the grounds and landscape, clean cabins between rentals, plan recreational facilities, and launder linens and towels. They would also assist guests in launching boats.

Based on the job descriptions given, IRS determined this was not a passive activity and would not cause termination of the S election.

S Corporation

Letter Ruling 200441010, June 15, 2004

IRC §1362 (f)

☞ Second class of stock causes inadvertent termination of S election.

Facts. The S corporation transferred shares of its stock to two new shareholders. In its agreement with the new shareholders, the S corporation gave privileges which were not available to other shareholders. When the S corporation discovered that the agreement might have created a second class of stock, an amended agreement was made with the new shareholders. The new agreement would not create the second class of stock.

Conclusion. The IRS acknowledged that a second class of stock was created with the first agreement which would result in an inadvertent termination of the election. However, because of the amended agreement, the IRS did not terminate the election. The IRS applied the rationale of IRC §1362(f) which pertains to an inadvertent termination.

Unreasonable Compensation

***Beiner, Inc. v. Commr.,* TC Memo 2004-219, September 28, 2004**

IRC §§162 and 6662

☞ Unreasonable compensation amount determined by IRS was incorrect.

Facts. Robert Beiner, president, chief executive officer, chief financial officer, secretary and treasurer received salaries and bonuses of $1,087,000 in 1999 and $1,350,000 in 2000. In its exam, the IRS determined reasonable salaries to be $303,020 and $157,982, respectively. After paying all expenses, including salaries and bonuses, the corporation reported net income of $104,545 in 1999 and $382,789 in 2000.

Issues.

1. Whether the compensation was excessive and should be reclassified as a dividend.
2. Whether accuracy-related penalties of $55,165 for 1999 and $81,057 for 2002 were applicable.

Analysis. The taxpayer's expert witness testified in court as to what constituted reasonable compensation for the C corporation's industry, wholesale distribution of motor parts. The expert testified that fixed compensation paid to a chief executive officer typically correlates to the sales of the company. This correlation may be expressed as a mathematical formula to calculate the "average" fixed compensation for the CEO of any size wholesale distributor company.

The court considered five factors, none of which are decisive in and of themselves.

1. Employee's role in the company
2. External comparison
3. Character and condition of the company
4. Conflict of interest
5. Internal comparison

The court determined that Mr. Beiner was the driving force behind the company's success. Without his expertise, the company could not function at its current level. This was confirmed by the fact that sales did not increase during the 60 days he was absent due to a heart attack.

The court compared Mr. Beiner's salary in 1999 and 2000 with the salaries of CEOs from 34 other similar companies. The court concluded that Beiner's compensation was not generally unreasonable. The character and condition of the corporation showed that it could afford Mr. Beiner's compensation. The corporation had experienced rapid growth and an increase in equity during his leadership.

While there could be a conflict of interest in paying compensation rather than a dividend, a hypothetical independent investor would find that the company's earnings on equity remained at a satisfactory level.

Holding. **The court concluded that only $180,260 of Mr. Beiner's 1999 compensation of $1,087,000 was unreasonable.** It also held that the accuracy-related penalties for both years were inappropriately applied.

> **Note.** This case provides excellent information regarding what is necessary to successfully contest an unreasonable compensation issue.

Shareholder Loans

***Jean I. Tedford v. Commr.,* T.C. Summary Opinion 2004-132, September 23, 2004**
IRC §166

☞ **Shareholder loans found to be capital contributions and not eligible for bad debt deduction.**

Facts. J.C. Tedford was the sole shareholder of Border Pre-Cast Concrete, Inc. He maintained complete control of the corporation management until his death in 1995. After his death, the corporation's assets were sold and debts were repaid. However, the sale proceeds were inadequate to repay the $226,188 Tedford had allegedly loaned to keep the corporation in operation.

Mr. Tedford began loaning money to the corporation when the bank refused to extend additional credit. Mr. Tedford was in his mid-seventies at the time and had health problems, but he refused to terminate the corporation.

There were no formal loan documents, but post-it notes attached to copies of checks indicated the amount loaned, dates and interest rates. The attached notes did not indicate any repayment dates. These loans from Mr. Tedford were reflected as liabilities on the corporation balance sheets.

On an amended 1999 Form 1040X, Jean Tedford, Mr. Tedford's widow, claimed a business bad debt deduction of $218,489 for the alleged loans her late husband had made to the defunct company. In its exam, the IRS treated the $218,489 as contributions to capital. As a result, the IRS reclassified that amount as a **capital loss.**

Issue. Whether the loans were legitimate or constituted a contribution of capital. If they were a contribution of capital, they could not be deducted as a bad debt.

Analysis. The court looked at 13 factors in making its determination. Some of the factors considered were:

1. **Names given to the documents.** Mr. Tedford had written "note" on all of the applicable documents.
2. **Presence or absence of fixed maturity date.** The court found that whether Mr. Tedford was repaid would be based on the success of the corporation. This factor indicated an investment rather than a loan. The absence of any maturity dates strengthened the IRS position.
3. **Source of payments.** Even though Mr. Tedford knew the corporation was struggling, he continued to make loans to it. Therefore, it was obvious he would not demand repayment of the loans and jeopardize the future of the company. This factor suggested that the money he advanced to the corporation was capital in nature.
4. **The right to enforce repayment.** Mr. Tedford never demanded repayment of his alleged loans even though the corporation made payments on the bank loans. This factor is more indicative of a capital contribution rather than a legitimate loan.

5. **Source of interest payments.** Mr. Tedford never demanded interest payments and the corporation did not make any interest payments to him. This factor is indicative of a capital contribution.

Holding. Based on the above and other factors, the court held that the alleged loans were actually capital contributions. Thus, the IRS had properly disallowed the 1999 claimed bad debt deduction.

Unreasonable Compensation

***Menard, Inc v. Commr.,* TC Memo 2004-207, September 16, 2004**

IRC §162 and 6662

☞ **CEO's $20 million compensation held to be unreasonably high.**

Facts. The retailer, Menard, Inc (MI). paid John Menard, its CEO and 89% shareholder, over $20 million in total compensation for the fiscal year ending January 31, 1998. In addition, Mr. Menard was the sole shareholder in Team Menard Inc. (TMI), an S corporation which races Indy-style race cars. MI also paid some of TMI's operating expenses. These expenses amounted to $6.5 and $5.7 million in the fiscal years ending January 31, 1998 and the calendar year 1998 respectively. MI did not have a written agreement with TMI regarding the payment and/or reimbursement of the TMI expenses it paid.

Mr. Menard attended the Indy 500 and various other racing events. He met with employees, customers, and vendors. When MI opened a new store, TMI would send a car and driver to the event. MI also used the TMI connection for its promotional items and advertising.

Mr. Menard made regular demand loans of his compensation to MI. In its fiscal year ended January 31, 1998, MI capitalized $639,302 of accrued interest on the shareholder loans it owed to Mr. Menard. MI claimed the full amount as a depreciation deduction.

MI did not record the TMI expenses it paid on its books as sponsorship or advertising expenses. Rather it entered car parts as repairs and fuel as gas and oil expense. In addition, MI owned the racing cars used by TMI and depreciated them on its tax returns.

MI based the bonus to Mr. Menard on a "5% of net income before taxes" formula. During its fiscal year ending January 31, 1998, MI paid Mr. Menard $20.6 million of total compensation. By contrast, the three other principal corporate officers received only $121,307, $55,702, and $172,815. A comparison of Mr. Menard's $20.6 million of compensation to the CEO compensation of similar retailers is shown below.

Company	CEO Compensation
Home Depot	$ 2,841,307
Kohl's	5,110,578
Lowe's	6,054,977
Staples	6,868,747
Target	10,479,528

Comparing Menard's return on equity compared to the other companies showed:

Company	Return on Equity
Menard's	18.8%
Home Depot	16.1%
Kohl's	14.8%
Lowe's	13.7%
Staples	15.3%
Target	16.7%

Issues.

1. Whether Mr. Menard's compensation was excessive and therefore constituted constructive dividends to him.
2. Whether the expenses paid to TMI were ordinary and necessary under IRC §162(a) or were constructive dividends to Mr. Menard.

Analysis. One test the court applied was the **independent investor test**. This common test was formulated in a court case.[1] The test involves whether an independent investor would find the company's return "a far higher return than [he] had any reason to expect." If so, then the compensation paid to the CEO is presumed reasonable. The court agreed the CEO's compensation met the independent investor test, but stated the determination does not end there. It is also necessary to compare the CEO's compensation with similar companies.

Since MI is not a publicly-held company there is no independent board of directors to approve Mr. Menard's salary. It is evident that his salary is not comparable to other officer salaries paid by MI.

Holding for Issue 1. After a very detailed analysis of the opinions of the various expert witnesses, the court decided $7,066,912 represented reasonable compensation during the fiscal year ended January 31, 1998. The balance of approximately $13.6 million was held to be a constructive (disguised) dividend to him.

Holding for Issue 2. The court determined that MI was entitled to deduct only $3.9 million of the expenses it paid to TMI during its fiscal year ended January 31, 1998. The balance of approximately $1.6 million was held to be a disguised dividend to Mr. Menard.

Abandon Stock

***DeVault v. Commr.*, T.C. Summary Opinion 2004-122, September 7, 2004**

IRC §§1366 and 6662

☞ **Non participation in S corporation does not relieve tax liability of passthrough items.**

Facts. Taxpayer formed an S corporation in 1995 and became a 49% shareholder. He worked for the new corporation for a time until he began having marital problems which were affecting his job performance. The marital problems eventually resulted in divorce and the taxpayer borrowing $22,000 from the corporation.

Near the end of 1998, the other shareholder offered to forgive the taxpayers debt and pay him $10,000 for his ownership interest. The taxpayer refused this offer, but never returned to work.

In 1999, the taxpayer filed for bankruptcy. His bankruptcy petition disclosed his ownership interest in the S corporation, but did not attach a value to it. The bankruptcy court did discharge the $22,000 debt to the corporation.

1. *Exacto Spring Corp v. Commr., 99-2 USTC, 196 F.3d 833 (7th Cir. 1999)*

The December 1999 corporation annual meeting minutes indicated the taxpayer was reelected as vice president and member of the board of directors. The taxpayer was not present at this meeting. The same thing occurred at the December 2000 annual meeting.

The taxpayer had no contact with the corporation from the time he left except for receiving a Schedule K-1 showing his share of the passthrough items.

Issue. Whether the taxpayer was a shareholder in the corporation.

Analysis and Holding. A shareholder remains a shareholder until he is validly divested of his shares despite any announcement of resignation or abandonment of that status. Even though the shareholder testified he abandoned his shares, all evidence indicated he still owned them. Consequently, the court agreed with the IRS that the passthrough item should be reported on the taxpayer's return.

S Corporation Expenses

***Sundby v. Commr.,* T C Summary Opinion 2004-104, July 28, 2004**
IRC §§162 and 6001

☞ **S corporation expenses not deductible on Schedule C Form 1040.**

The taxpayer formed a corporation and filed for S corporation status which was granted. However, when the taxpayer filed his tax return, he claimed all of the expenses, $89,069, on his Schedule C. No income was reported by either the taxpayer or the corporation. The taxpayer claimed the corporation was for "name only" purposes.

The court ruled the expenses were not deductible for four reasons:

1. The activity did not constitute a bona fide business entered into for profit.
2. It was not established the expenditures were paid by the taxpayer during the year for ordinary and necessary business expenses.
3. The expenses were start-up expenses.
4. The expenses were not the taxpayer's but were the corporation's.

It did not help the taxpayer's case that he admitted the expenses were estimates and he could not prove supporting documents were used to arrive at the amounts.

DEDUCTIONS

Job Hunting Expense

***Franklin v. Commr.,* T.C. Summary Opinion 2004-126, September 10, 2004**
IRC §§274 and 6651

☞ **Job hunting expenses nondeductible due to lack of documentation.**

Facts. The taxpayer was employed at the time of the job hunting trips. His wife had been unemployed for four years. The taxpayers decided they would look for jobs in a different city where they had a better chance of finding jobs in their fields. They testified in court that they did not set up appointments in the destination cities nor were they clear as to the job positions they were seeking.

The couple made four job hunting trips and reported expenses of $14,971.38. However, they could not produce any documentation for the expenses. At the time of trial they were still at their original jobs.

The taxpayers also failed to file their federal tax return on time. The couple testified they mailed the return in October 1999, but the IRS contends it was mailed on April 4, 2000.

Issues. Whether the couple is entitled to a job hunting deduction and whether they are liable for failure to file penalties.

Holding and Analysis. In order for job hunting expenses to be deductible, the taxpayer must be employed and looking for a job in his field of employment. Due to the fact the wife was unemployed for four years, she was not considered to be in a trade or business and her expenses are not deductible. While the court was not sure if the husband was looking for a job in his field of employment, it gave him the benefit of the doubt.

Nearly all of the expenses were travel expenses which have strict substantiation requirements. The couple testified they kept accurate records, but that the records were destroyed by water damage. They did provide an expense log based upon their recollection of the expenses and travel dates, but no receipts were used in its preparation.

The court did not accept the travel log since it was prepared two months before trial and about six years after the expenses occurred. Consequently, the husband's job hunting expenses were also denied.

The IRS produced both a date stamp on the filed return showing an April receipt date and the return envelope postmark showing an April postmark. The taxpayers could supply no proof of timely filing other than their recollection. Therefore they were liable for the failure to file penalty.

Section 179 Deduction

***Shirley v. Commr.*, TC Memo 2004-188, August 24, 2004**
IRC §§50 and 179

☞ **Taxpayer allowed to claim IRC §179 deduction on motor homes.**

Facts. Taxpayer owns a motor home sales and rental business. He purchased a motor home (known as MH #22) and claimed a §179 deduction on the allowable part of the purchase price. The IRS challenged the deduction on the grounds the motor home is used for lodging and therefore ineligible for the deduction.

The taxpayer argues the motor home is used for transportation and hence eligible.

Both the taxpayer and the IRS agree that transportation assets are eligible if used in a trade or business while lodging assets are not.

The business owns 27 motor homes which it rents on a daily or weekly basis. The rental fee includes 100 miles per day with a $.25/mile fee charged for additional miles driven. Most of the customers use the motor homes less than 100 miles per day.

Issue. Does the motor home qualify for the §179 deduction?

Holding and Analysis. The court agrees that if the predominant use of the motor home is for lodging, the deduction should be denied. However, if the primary use is transportation, the deduction should be allowed. However, the question is what happens if the asset is used for both lodging and transportation?

In order to make a decision, the court had to decide if it should look at MH #22 alone or at the entire business. The court decided the taxpayer looked at MH #22 as just another asset of the business and managed the business accordingly.

Because most customers rent the motor homes for less than 30 days, the court ruled they were used primarily for transportation and allowed the §179 deduction.

30% Bonus Depreciation Election

Letter Ruling 200442002, June 29, 2004

IRC §168

☞ **Taxpayer allowed to amend election not to claim 30% bonus depreciation.**

Facts. The taxpayer, an S corporation, elected to not claim the 30% bonus depreciation on its tax return. The election was made because it appeared the taxpayer would have a loss. Consequently the return was filed without the 30% bonus. Upon review by another tax preparer, it was discovered that both the book loss and the tax loss were deducted when the return was originally filed. Therefore, claiming the 30% bonus depreciation would be advisable.

The S corporation requested an IRS ruling allowing it to amend the return, revoke the election, and claim the 30% bonus depreciation. Regulations allow a taxpayer to revoke the election only with permission from the Internal Revenue Service.

Conclusion. The taxpayer was allowed 60 days from the date of the ruling to amend the return and revoke the election. It was determined that revoking the election would not prejudice the interests of the government.

DEPENDENCY ISSUES

Dependency Exemption

***Jean G. Joseph v. Commr.,* T.C. Summary Opinion 2004-137, October 8, 2004**

IRC §§32 and 152

☞ **Father not allowed to claim dependency exemption or EIC.**

Facts. Taxpayer lived with his girlfriend and two children, one of whom was his daughter (Dina). Both taxpayer and his girlfriend were employed and filed tax returns. Both claimed Dina for purposes of the dependency exemption, and the earned income credit (EIC). Taxpayer is a self-employed taxi driver who reported $7,589 of taxable income for 2001.

Issue. Whether taxpayer furnished over one-half of Dina's support.

Analysis. Taxpayer claimed he paid approximately $600 per month for food, clothing, etc. and $500 per month for housing for the support of his girlfriend and two children, totaling $1,100 per month. He had no records to support these amounts. The court noted that this total of $13,200 was approximately $5,000 more than his reported 2001 taxable income amount. The Tax Court judge determined that Mr. Joseph was either overstating his support expenses or understating his Schedule C income. Since his girlfriend reported 2001 taxable income of $18,855, she was allowed the dependency exemption, the child tax credit, and the EIC for Dina.

> **Note.** The judge stated: "We have seen an increasing number of these cases where there has been no substance other than an inept attempt to take advantage of tax deductions and credits. Often this results from advice given by return preparers who know better."

DIVORCE ISSUES

Alimony

***John R. and Patricia G. Okerson v. Commr.*, TC-,No. 14, September 9, 2004**
IRC §§71 and 122

☞ **Even with court change to the divorce decree, an alimony deduction was denied.**

Facts. In a 1995 divorce decree, the divorce court ordered John Okerson to make 113 monthly alimony payments totaling $113,000 to his former spouse, Barbara. **In the event of her death before all payments were made, Mr. Okerson was obligated to make payments to Barbara's attorney to fund an education fund for their two children.**

In 1997, the court ordered Mr. Okerson to make an additional 42 monthly payments totaling $33,500. In its order, the court stated that this additional alimony "is deductible by the Plaintiff, Mr. Okerson, and taxable to the Defendant, Barbara, the ex-wife."

In 2004, after John Okerson began his challenge of the IRS's denial of his alimony deductions, the divorce court modified the final divorce decree. The modification included a clause that stated that all required alimony payments had been made and that Barbara was still living. Therefore, the court made it clear that its intention was to allow John Okerson a tax deduction for his alimony payments.

Issue. Whether the alimony payments are deductible since they do not terminate upon the death of the former spouse, Barbara.

Analysis. The Tax Court went to great lengths explaining that state divorce law does not control federal taxation. Unless the taxpayer meets the exact terms specified in the Internal Revenue Code in respect to deductible alimony, the deduction will not be allowed.

Holding. The court upheld the IRS determination that the payments **did not qualify as alimony due to the post death payment requirement.**

EMPLOYMENT TAX ISSUES

Gift Certificate

TAM 200437030, April 30, 2004

☞ **$35 grocery gift certificate is not de minimus fringe benefit.**

An employer provided $35 holiday gift coupons to employees which could be used at several local grocery stores. The IRS ruled this was not a benefit that qualified as a de minimus fringe under IRC §132(a)(4).

In prior years, the employer had given ham, turkey or gift baskets as employee holiday gifts. Because of employee religious convictions and dietary issues it was decided that a grocery coupon would provide a gift of equal value, but allow the recipient to chose what to purchase. The coupon had a restriction that it could not be used for alcohol, tobacco or pharmacy goods.

The regulations allow de minimus holiday gifts of tangible personal property having a low fair market value.[2] However, this does not apply to cash or cash equivalents. The IRS determined that a $35 gift coupon had a value of $35.

2. Treas. Reg. §1.132-6(e)(1)

Cancellation Payment

Rev. Rul. 2004-110, November 23, 2004
IRC §§61 and 3401

☞ **Employment cancellation payments subject to payroll taxes.**

Facts. Employee and employer agree to terminate employment agreement prior to end of contract. Employer will pay employee money to terminate the contract even though this is not a part of the employment contract.

Issue. Whether the payment is subject to FICA, FUTA and withholding.

Holding and Analysis. For payments made after January 11, 2005, payroll taxes are applied

Estate and Gift

Family Limited Partnership

Estate of Thompson v. Commr., **3rd. Cir Ct. of Appeals, 03-3173, September 1, 2004, Affirming the prior Tax Court Decision: T.C. Memo 2002-246 (2002)**
IRC §2036

☞ **3rd Circuit agrees assets transferred to FLPs must be included in gross estate.**

Facts. Theodore Thompson transferred most of his assets to two family limited partnerships (FLPs) in 1993. When he died in 1995, the value of the assets in the FLPs was not included in his gross estate. In an exam of the estate tax return, the IRS relied on IRC §2036(a) and included the value of the assets in the decedent's gross estate.

Issue. Whether the Tax Court was correct in its prior decision which upheld the inclusion of the FLP assets in the gross estate.

Holding. The appeals court agreed with the Tax Court's decision. This important case represents another affirmation that the requirements of IRC §2036(a) should be strictly interpreted.

> **Note.** This case is thoroughly analyzed on pages 593–4 in the *2003 University of Illinois Tax School Workbook.* See also pages 366–372 in the same book for more information on the use of FLPs as an estate tax savings strategy.

GROSS INCOME

FEMA Payments

Letter Ruling 200431012, June 29, 2004
IRC §61

☞ **The IRS rules FEMA payment taxable**

Facts. The Federal Emergency Management Agency (FEMA) distributes Flood Mitigation Assistance (FMA) Program funds to states which set mitigation priorities and administer the programs. The purpose of the FMA programs is to aid taxpayers in elevating or relocating flood-prone homes to mitigate the adverse effects of future disasters. These payments must be made to the states which distributes them to either contractors who provide flood mitigation services or directly to owners of flood-prone homes who pay the contractors.

The payments are made under these three programs:

1. The Flood Mitigation Assistance Program (FMA)
2. The Pre-Disaster Mitigation Program (PDM)
3. The Hazard Mitigation Grant Program (HMGP)

The questions regarding the payments for elevating the foundation of a property are:

- Are the benefits received by the property owner taxable?
- Do the benefits received by the property owner qualify for the deferral of recognition of income as an involuntary conversion?
- What amount received by a property owner is included in income?
- Are state and local governments required to file information returns for the payments made to homeowners?
- Are state and local governments required to file information returns for the payments made to contractors?

Analysis. The Stafford Act provides for a general welfare exclusion of certain payments from income. However, Congress did not statutorily provide that payments made under the FMA, PDM, and HMGP programs were tax exempt. The IRS believes payments or benefits received under these programs increase the value of the property and therefore increase the wealth of the recipient.

Conclusion. These payments must be included in the recipient's income. The amount to include in income is the amount of direct compensation paid to the homeowner and/or the amount paid to contractors who perform services. Any property value increase is not included in income.

Payments made by state or local governments to either property owners or contractors must be reported on Form 1099-MISC if they exceed $600. Information reported is not required if the payee contractor is a corporation.

Parking Reimbursement

Rev. Rul. 2004-98, October 18, 2004
IRC §132

☞ **Employer-provided parking reimbursement is not excludable from employees' income.**

Facts. Some employers reduce employee's salaries in exchange for employer-provided parking followed by reimbursement to the employees of an alleged "tax-free fringe benefit." As a result, employees' net compensation was the same but part of it escaped taxation.

Conclusion. The reimbursements are taxable and are subject to federal income, FICA, and FUTA withholdings. This decision is based of the fact the employees did not actually incur reimbursable expenses as the employer incurred the parking expenses.

Assignment of Income

Letter Ruling 200445002, July 20, 2004

IRC §61

☞ **Ruling allows assignment of potential court award.**

The taxpayer requested approval that a potential court award could be assigned to a charitable organization and excluded from the taxpayer's gross income.

Facts. The taxpayer, a corporation, brought suit against another party. After the trial, but prior to an award, it sought the advice of the IRS regarding whether it could assign 50% of the award to a charitable organization and exclude that portion of the award from its gross income.

Conclusion. Generally, a taxpayer cannot escape the taxation of income by assigning it to a third party. However, since there was no certainty that the taxpayer would be successful in the lawsuit, the IRS agreed that the income could be assigned and excluded. The letter ruling cites four previous court cases.

INNOCENT SPOUSE

Psychological Disorder

***Nancy A. Sjodin v. Commr.*, TC Memo 2004-205, September 14, 2004**

IRC §6015

☞ **Taxpayer had reason to know of unpaid tax liability which precludes the granting of innocent spouse relief.**

Facts. Nancy Sjodin filed a joint return with her husband Kenneth for 1987, 1988, 1990 and 1992. She and her husband remain married and have never been separated. During the years in question, Nancy worked as a retail clerk and tax was withheld from her wages. Her husband, Kenneth, was a self-employed realtor. They filed joint returns for the four years in question which showed large unpaid balances due. The unpaid liabilities were primarily due to Mr. Sjodin's reality business profit.

Nancy signed the returns in question. However, she began filing separate returns when she learned of an IRS tax lien on their home.

Kenneth Sojdin was a Korean War veteran who suffered from a combat-related psychological disorder which caused him to be secretive and uncommunicative. While he did not physically harm his wife, he did not provide information to her relating to his business. He did provide financial support to Nancy and their four children.

Issue. Whether Nancy is eligible for innocent spouse relief for the years 1987, 1988, 1990, and 1992.

Analysis. The IRS agreed that forcing Nancy to pay the taxes would cause her economic hardship. She currently was earning only $2,000 per month and her husband, Kenneth is now retired and drawing social security. The unpaid tax amount exceeds $275,000.

Nancy Sojdin had not been physically abused by her husband. However, she contends his secrecy is a form of mental abuse.

Holding. The Tax Court concluded that Mrs. Sjodin was not entitled to innocent spouse relief and that the IRS did not abuse its discretion in denying it to her. The main factors in reaching its conclusion were:

- She had reason to know that the reported tax balances shown on the returns would not be paid. This is an extremely strong factor weighing against relief.[3]
- The alleged mental abuse by her husband was not sufficient to weigh as a factor in her favor.

3. Rev. Proc. 2000-15

IRS PROCEDURES — AUDITS

Reconstruction of Income

***Ragnhild A. Westby v. Commr.*, TC Memo 2004-179, August 3, 2004**

IRC §§446, 162, 6001 and 6651

☞ **Tax Court holds that the IRS reconstruction of income was not correct.**

Facts. The taxpayer's law firm gross income was substantially increased by the IRS in its exam. The IRS used the bank deposits method to reconstruct the Schedule C gross income. In addition, the IRS disallowed all of the claimed Schedule C deductions without examining the expense records furnished by the taxpayer.

Issue. Whether the IRS's reconstruction of the Schedule C net profits was correct.

Analysis. The reconstruction of income by the IRS produced completely erroneous results. The agent added $77,811 and $125,256 to the reported income reported Schedule C net profit reported on the taxpayer's 1987 and 1988 tax returns. These amounts were based on a financial statement which the taxpayer furnished to a bank. Both the taxpayer and the bank acknowledged that the amounts on the financial statements represented gross business income rather than net business income. Therefore, these additional amounts were already included in the gross income reported on the two Schedule Cs.

In addition, the revenue agent disallowed all Schedule C business expenses. While the taxpayer did not have formal journals and ledgers, she did have cancelled checks, invoices and other documentation which was sorted by category. In addition, the accountant who prepared the return had worksheets which summarized her business records. According to the testimony, the revenue agent refused to look at these records and worksheets.

At the trial, the IRS attorney, recognizing errors in the government's income used the bank deposits reconciliation method in an effort to properly to reconstruct income. However, the IRS attorney did not have all of the bank statements or all of the bank accounts. Consequently, he included in income bank loans and transfers between bank accounts.

Holding. The court prepared voluminous summaries to prove that the claimed Schedule C expenses were accurate. In addition, the court rejected the unreliable bank deposits method employed by the IRS attorney to reconstruct Schedule C income. As a result, the court accepted the 1987 and 1989 Schedule Cs of the taxpayer. However, the court did agree with the IRS that NOL carryforward deductions were properly disallowed.

IRS PROCEDURES — MISCELLANEOUS

Taxpayer Representation

CCA 200431013, April 29, 2004

IRC §7453

☞ **An Illinois CPA must hold a valid public accountant (PA) license to represent taxpayers before the IRS.**

A ruling was requested regarding whether an individual who held an Illinois CPA certificate, but not a license, could practice before the Internal Revenue Service. The IRS ruled that the individual must not only hold a CPA certificate, they must be a licensed public accountant. In Illinois, this is a two-step process. The first is passing the CPA examination and the second is obtaining an Illinois license. Obtaining the license requires one year of practice and not committing disreputable conduct. Only licensed accountants are monitored by Illinois.

Assuming the individual does not hold a valid Illinois CPA license, the following four questions are raised:

Question 1. Can the individual sign a Form 2848 as a CPA.

Answer 1. No, they must hold a valid Illinois license.

Question 2. If the individual is not a licensed accountant, and they sign a Form 2848, are they providing false information or in violation of any Federal criminal statute?

Answer 2. If the individual subsequently applies to the Office of Professional Responsibility (OPR) for enrollment to practice before the IRS, OPR should take the prior act into consideration.

Question 3. Since an individual cannot be a licensed accountant without being a CPA, may IRS employees accept Form 2848s from individuals who sign as CPAs but only hold themselves out to be PAs?

Answer 3. Yes, because in Illinois the individual must be a CPA to be licensed as a PA.

Question 4. Is a PA whose license has been suspended or revoked for cause subject to an expedited proceeding under Circular 230?

Answer 4. Yes, even though Circular 230 only mentions a CPA.

Offer In Compromise

IRS News Release IR-2004-130, October 25, 2004
IRC §7122

☞ **The IRS is concerned about dubious offer in compromise schemes.**

The IRS expressed concern regarding OIC schemes where taxpayers are advised they can settle their tax liabilities for "pennies on the dollar." Some promoters are charging taxpayers excessive fees when there is no chance the offer will be accepted by the IRS because the taxpayer does not qualify for the OIC.

The IRS is warning taxpayers to be aware of these schemes.

Combat Zone

Letter Ruling 200447035, August 16, 2004
IRC §§692 and 7508

☞ **The IRS discusses statute of limitation when a soldier is killed in combat zone.**

The letter ruling addresses two issues:

1. That a taxpayer who is killed in a combat zone is not subject to tax for any year starting with the first year that he served in a combat zone.[4]
2. The statute of limitations, for purposes of filing a claim for refund, is extended until 180 days following the date of death of a taxpayer killed in a combat zone.[5]

IRC §692 provides that income tax will not be imposed on an individual who dies while in active service as a member of the U.S. Armed Forces serving in a combat zone **for the taxable year of the date of death, as well as any prior taxable year ending on or after the first day the individual served in a combat zone (emphasis added)**. If any income tax was assessed against, and collected from the individual during the period for which income tax is not imposed, the prior taxes will be abated and refunded.

4. IRC §692
5. IRC §7508(a)(1)(E)

Because §692 provides that the period of non taxation begins with the "first day the individual served in **a** combat zone," as opposed to "the first day the individual served in **the** combat zone," if an individual qualifying under §692 served in more than one combat zone before his or her death, tax will not be imposed for the years preceding the death, beginning with the tax year that the individual first served in a combat zone.

Although many years may elapse between an individual's first service in a combat zone and the individual's service in the combat zone where he or she died, claims for refund based on §692 must be filed within the statute of limitations on filing a claim for refund under §6511(a).[6]

IRC §6511(a) generally provides that claims for refund must be filed within three years from the date the return was filed or two years from the date the tax was paid, whichever period expires later. In addition, under §7508(a)(1)(E), the period for filing a claim for refund will be extended for the period that an individual served as a member of the U.S. Armed Forces in a combat zone, and for the next 180 days thereafter.

> **Example 3.** Corporal Smith generally has three years from April 15, 2001, to file a claim for refund against her timely filed 2000 tax return. This means that her claim normally must be filed by April 15, 2004. However, if she served in a combat zone from November 1, 2003, through March 23, 2004, and was not injured, her deadline for filing that claim is extended 347 days (180 plus 167) **after** she leaves the combat zone. Therefore, her deadline is extended to March 5, 2005. The 167 additional days are the number of days in the three-year period for filing the refund claim that were left when she entered the combat zone on November 1 (November 1, 2003 – April 15, 2004).

It is much more difficult to calculate the time for filing for a claim refund if the taxpayer has been in and out of a combat zone numerous times. Consider the following example .

> **Example 4.** The taxpayer has served in the Armed Forces for over 12 years. During that time, he has served both in and out of combat zones. The following table illustrates when the normal statute of limitations expires for the various years of his service career. It is assumed that a tax return was filed on April 15 of each year.

		Combat Zone Period				
Year #	Year	From	To	Combat Days	Normal Due Date	Normal 3-Yr Statute
1	1992	01/01/92	07/31/92	212	04/15/93	04/15/96
2	1993	09/01/93	12/31/93	121	04/15/94	04/15/97
3	1994	03/01/94	05/31/94	91	04/17/95	04/15/98
4	1994	08/01/94	12/31/94	152	04/17/95	04/15/98
4	1995	01/01/95	01/31/95	30	04/15/96	04/15/99
5	1996			0	04/15/97	04/17/00
6	1997			0	04/15/98	04/16/01
7	1998	02/01/98	02/28/98	27	04/15/99	04/15/02
8	1999			0	04/17/00	04/15/03
9	2000			0	04/16/01	04/15/04
10	2001	08/01/01	11/30/01	121	04/16/02	04/15/05
11	2002	07/01/02	10/31/02	122	04/16/03	04/17/06
12	2003	01/01/03	03/23/03	81	04/15/04	04/16/07
13	2004			0	04/15/05	04/15/08

6. See Rev. Rul. 69-301, 1969-1 C.B. 183.

Taxpayer's 1999 return was filed or deemed filed on April 15, 2000. The normal statute of limitations under §6511(a) for a claim for refund for Taxpayer's 1999 tax year expired on April 15, 2003. Under §7508(a)(1)(E), however, the three-year statute of limitations under §6511(a) for filing a claim for refund ("statute of limitations") for Taxpayer's 1999 tax year was suspended from August 1, 2001 through November 30, 2001 (time spent in a combat zone). On August 1, 2001, Taxpayer had one year and 258 days left on his statute of limitations for the 1999 tax year. After Taxpayer returned from the combat zone, the statute of limitations was further suspended from December 1, 2001 through May 29, 2002 (180 days from the date he left the combat zone). The statute of limitations started running again from May 30, 2002 through June 30, 2002. On July 1, 2002, there was one year and 226 days left on Taxpayer's statute of limitations for the 1999 tax year. On July 1, 2002, Taxpayer entered another combat zone and stayed in the combat zone until October 31, 2002. He then re-entered the combat zone on January 1, 2003, and he stayed there until his death on March 23, 2003. Because there are less than 180 days between November 1, 2002 and December 31, 2002, Taxpayer's statute of limitations was suspended from July 1, 2002 through March 23, 2003, and for the next 180 days. Thus, Taxpayer's statute of limitations was suspended through September 19, 2003. At that point, Taxpayer's statute of limitations started to run again, and there was still one year and 226 days left on the statute of limitations. **Accordingly, Taxpayer's statute of limitations for the 1999 tax year will expire on May 3, 2005, more than two years beyond the normal statute.**

Rev. Proc. 2004-71, December 31, 2004

IRC §§2032A, 2503, 2523, 6601, and 7430

☞ The IRS releases 2005 inflation adjusted amounts.

The IRS released the following inflation adjusted amounts for **2005**:

IRC §	Item	Amount
1(g)(4)(A)(ii)(1)	Kiddie Tax amount	$800
25A(d)(2)(A)(ii)	Modified AGI thresholds for Hope and Lifetime learning credit reduction	Single $43,000 MFJ $87,000
23(a)(3)	Maximum adoption credit Modified AGI phaseout range	$10,630 $159,450 to $199,450
63(c)(2)	Standard Deduction	MFJ $10,000 HH $7,300 Single $5,000 MFS $5,000
63(c)(5)	Standard deduction for individual claimed as a dependent	May not exceed greater of $800 or $250 plus earned income
63(f)	Additional standard deduction for blind and aged	$1,000 each $1,250 if unmarried and not surviving spouse
68(b)	Itemized deduction AGI phaseout range	$145,950 or $72,975 for MFS individual
151(d)	Personal exemption	$3,200
1(a) 1(b) 1(c) 1(d)	Personal exemption AGI phaseout range	MFJ $218,950 to $341,450 HH $182,450 to $304,950 Single $145,950 to $268,450 MFS $109,475 to $170,725
179(b)(1)	Section 179 deduction	$105,000
179(b)(2)	Section 179 property limit	$420,000
223(b)(2)(A)	HSA self-only coverage contribution limit HSA family coverage contribution limit	$2,650 $5,250
2032A	Maximum special use valuation reduction allowed for qualified farm land	$870,000

Timely Filing

***Sorrentino v. IRS,* United States Court of Appeals Tenth Circuit. Nos. 02-1114&02-1137**

IRC §§7422, 7430, and 7502

☞ **Appeals court reverses district court on mailbox rule.**

Determining whether something was timely mailed to the IRS has always presented challenges to the tax courts. Within the Tenth Circuit, a physical postmark, or certified or registered or electronic receipts was not the only way for a taxpayer to establish the presumption of delivery outside of the §7502 exceptions.

The Tenth Circuit Court of Appeals has now reversed a district court. The ruling requires the mailing evidence be in the form of a registered or certified receipt. The ruling places the burden of proof on the taxpayer. Formerly, the burden of proof was on the IRS to contradict a taxpayers' sworn statement that a return was timely mailed from a U.S. Post office.

IRS PROCEDURES — PAYMENTS

Reliance on Private Letter Ruling

CCA 200441029, April 7, 2004

IRC §§117 and 3121

☞ **Chief Counsel discusses effect of a private letter ruling**

The taxpayer (college) requested and received a private letter ruling regarding the withholding of FICA on a non-National Research Service Award. In 2000, the college who made the award requested a ruling regarding whether such awards were liable for FICA tax. They received a response that these awards were non-compensatory and did not qualify as FICA wages. In this letter ruling Chief Counsel proceeds to explain to the college the standards upon which a letter ruling can be relied.

Counsel based his letter on Rev. Proc. 2004-1 which provided that a taxpayer may ordinarily rely upon a letter ruling received from the Office of Chief Counsel subject to certain conditions and limitations. When the recipient's tax return is examined, the examiner must ascertain whether:

1. The conclusions stated in the letter ruling are accurately reflected in the return;
2. The representations upon which the letter ruling was based reflected an accurate statement of controlling facts;
3. The transaction was carried out substantially as proposed; and

There had been any change in the law that applies to the period during which the transaction or continuing series of transactions were consummated.

If the examiner finds that a letter ruling should be revoked or modified, the findings and recommendations are forwarded to the appropriate Associate office for consideration and further advice. Otherwise the letter ruling is applied in determining the taxpayer's liability.

Interest on Overpayments

CCA 200441002, May 11, 2004
IRC §§6611 and 7502

☞ **IRS determines when the 45-day interest-free date begins and ends.**

The IRS is required to pay interest on overpayments if they are not made within 45 days from the time the return is due and the date the overpayment is refunded. Two different questions are addressed in this ruling.

1. Does the 45-day period begin when the return is postmarked or when it is received by the IRS?
2. Does the 45-day period end when the IRS requests the refund from Financial Management Services (FMS)?

In this case, the return was postmarked on the due date, but it was not received by the IRS until two days later. Chief Counsel ruled the 45-day period begins the date the return is due or postmarked, whichever is later.

The IRS requested payment from FMS 44 days after the postmark date, but the check was not dated until 48 days after the postmark date. Counsel ruled the ending date on the 45-day period is the date printed on the check.

IRS PROCEDURES — PENALTIES

Tax Preparer Sanction

***United States v. Hubacek,* Nevada U.S. District Court, Civ. CV-S-03-1523-JCM-RJJ, June 24, 2004**
IRC §§ 7402 and 7407

☞ **Tax preparer ordered to give the IRS his entire list of clients and is banned permanently from preparing future returns.**

Facts. Jeffrey Hubace prepared tax returns since the 1990s. He prepared for a fee 40-50 fraudulent zero-income Forms 1040X and at least as many fraudulent zero-income Forms 1040.

He based the zero-income return on the Irwin Schiff "corporate profit" theory that rests on the premise that no section of the Internal Revenue Code establishes an income tax liability on wages. On June 16, 2003, the court issued an order that the "corporate profits" theory and its resulting zero-income returns are fraudulent and frivolous.

An IRS examination of 28 amended and original returns indicated the preparer was responsible for at least $393,000 in customer tax understatements.

Issue. What penalties should be imposed on the tax practitioner?

Holdings. The district court ordered Mr. Hubacek to:

1. Provide a list of persons for which he prepared federal income tax returns from January 2000 through the present within 11 days.
2. Contact all persons for which he prepared returns and inform them of the court's finding concerning the:
   - Falsity of his representations,
   - Falsity of the tax returns prepared on their behalf,
   - Possibility of a frivolous filing penalty against them,
   - Possibility that the U.S. may seek to collect any additional income taxes, penalties, and interest they might owe, and
   - Existence of district court's permanent injunction which banned him from preparing future tax returns.

ITEMIZED DEDUCTIONS

Contribution of Conservation Easement

Notice 2004-41, June 30, 2004
IRC §170

☞ **IRS looking at charitable contributions of conservation easements.**

The IRS warned taxpayers that it may not allow deductions for charitable donations of conservation easements or the donation of money to a charity which is connected with the purchase of property. To be deductible, the easement value must be substantiated. The contribution must be of a qualified real property interest to a qualified organization exclusively for certain conservation purposes.

The IRS is aware that some taxpayers are purchasing real property from a charitable organization at less than fair market prices. Then they make a charitable contribution to the same organization. The total of the purchase and the contribution reimburses the organization for the full value of the property.

LIKE-KIND EXCHANGES

Related Party Exchange

Letter Ruling 200440002, June 14, 2004
IRC §1031

☞ **IRS sanctions related party tax deferred exchange.**

Two related partnerships, Alpha and Beta requested a ruling on a proposed transaction. Alpha owns building 1 and Beta owns building 2. Alpha agrees to transfer 1 to a buyer (Buyer). Alpha wants to defer the gain recognition on building 1 and will acquire building 2 from Beta. Beta will acquire replacement property in the exchange of building 2.

Alpha and Beta will use the services of a qualified intermediary (QI). QI will be treated as the seller of building 1 to Buyer. QI will acquire building 2 from Beta and transfer it to Alpha in exchange for building 1. QI will purchase replacement property from a party not related to Beta to exchange for building 2.

The final result is Alpha will own building 2, Beta will own its own replacement property and Buyer will own building 1.

The partnerships' concern was that property received in a like-kind exchange from a **related party** will trigger gain recognition **if sold within two years** from the date of the exchange. Since building 1 becomes the property of Buyer, the concern is that it could be in violation of the Code and be required to recognize gain.

The IRS ruled that since nether Alpha or Beta received cash in the exchanges, they qualify as like-kind exchanges under IRC §1031.

NAICS Codes

T. D. 9151, September 20, 2004
IRC §1031

☞ **IRS switches from SIC code to NAICS codes in determining like-kind property.**

The IRS released temporary and final regulations replacing the SIC codes with the North American Industry Classification System (NAICS) codes for determining whether personal properties are like-kind for purposes of §1031 exchanges.

The temporary regulations discontinue the use of the SIC codes, which are four digit codes. The new NAICS codes are six digit codes, but basically leave properties grouped the same as the SIC codes.

The NAICS codes can be searched at http://www.naics.com/search.htm.

NOT FOR PROFIT

Hobby Loss

***Jane Freed v. Commr.,* TC Memo 2004-215 September 23, 2004**
IRC §183

☞ **Lack of personal enjoyment does not negate hobby loss.**

Facts. Mrs. Freed carried on a thoroughbred horse breeding and racing operation from 1982 through 1996, the year in question. During this time, she never reported a profit and her cumulative tax losses exceeded $1.1 million. She is beneficiary of three trusts with total assets of approximately $6 million. Her income from the trusts in1996 was over $200,000.

Mrs. Freed acquired her first horse in 1949, after her first marriage. Prior to her second marriage, she acquired a steeplechase horse for showing. Her first experience with thoroughbred horses began in the 60s when she took over her husband's unprofitable thoroughbred activities. She began active breeding operations in 1982 and racing activities in 1984.

Her breeding herd is stabled at a professional breeding farm, Saratoga Thoroughbreds Farm. This breeding farm produced Funny Cide, the winner of the 2003 Kentucky Derby and Preakness Stakes. Her thoroughbreds are kept at various stables in the southern states. None of the horses are stabled in New Jersey where the taxpayer resides. In fact, the taxpayer only sees her horses three or four times each year.

Issue. Whether the horse operation was conducted for profit.

Analysis. The court analyzed the nine nonexclusive factors in the Treasury Regulations that pertain to hobby losses. The taxpayer urged the Tax Court judge to place the greatest reliance on the first three factors. The judge noted that he was not bound to follow that advice.

1. **The manner in which the taxpayer carried on the activity.** To determine whether the operation was carried on in a business-like manner, one consideration is whether accurate books were kept and whether the operation was carried on in a manner substantially similar to other for-profit horse-related businesses. The court concluded the operation was not operated in a business-like manner. Even though the taxpayer kept adequate records and employed a CPA, she failed to make meaningful changes in the operation despite a 14-year history of large losses.

2. **The expertise of the taxpayer or their advisors.** The court agreed that Mrs. Freed was using very competent advisors.

3. **The time and effort expended by the taxpayer in carrying on the activity.** The taxpayer claimed to spend 10 to 20 hours per week on bookkeeping duties and reading industry articles. The IRS contended she overstated the estimated hours. The court determined that the taxpayer failed to prove her testimony. Thus, this factor was decided against her.

4. **The expectation that the assets used in the operation may appreciate in value.** Since the taxpayer did not have the horses appraised, she did not have any proof regarding any increase in value. Therefore, this factor was not in her favor.

5. **The success of the taxpayer in carrying on other similar or dissimilar activities.** The taxpayer could not show a record of success in any business venture.

6. **The taxpayer's history of income or loss related to the activity.** The court found no history of anything but losses and no effort to try to make the operation profitable.

7. **The amount of occasional profits, if any, which are earned.** The taxpayer did show a profit in 2001, 2002 and 2003. However, the 2001 profit was primarily due to capitalizing $70,000 of boarding costs. If they had been expensed, as they were in prior years, the reported 2001 profit would have evaporated. In addition, the taxpayer produced no evidence to substantiate the alleged profits in 2002 and 2003.

8. **The financial status of the taxpayer.** Since the taxpayer must not rely on income from the venture to fund her living expenses, this weighs against the taxpayer.

9. **Whether elements of personal pleasure or recreation are involved.** The court found little to indicate personal pleasure from the horse operation. She did not live on the farm in a trophy house, ride the horses, or have anything but limited contact with the horses. This factor weighs in favor of the taxpayer.

Holding. Based on an analysis of the nine factors, the court determined the losses to be nondeductible under the law and regulations.

PARTNERSHIPS

Extension to Make §754 Election

Letter Rulings 200445005, 200445006, 200445007, 200443026, 200442028, and 200442030
IRC §754

☞ **IRS grants extensions of time to file the IRC §754 election for the optional adjustment to the basis of partnership property.**

All six of these letter rulings are based of similar facts. The accountants for the six partnerships failed to make a §754 election when there was a change in partnership ownership. The six partnerships relied on their accountants who failed to recognize the significance of the §754 election.

In all six letter rulings, the IRS allowed an extension of time to file the §754 election.

PASSIVE ACTIVITIES

Self-rentals

***Tony R. and Judith D. Carlos v. Commr.,* 123 TC- No. 16, September 20, 2004**
IRC §469

☞ **Taxpayers were not allowed to combine two self-rental properties for passive loss limitation purposes.**

Facts. The taxpayers owned two commercial real estate properties which they rented to two separate S corporations which they owned. Therefore, the self-rental rule applied. One of the buildings was rented to the taxpayer's steel supply company. The company paid rent to the taxpayers as required by the lease. The other building was leased to their wholly-owned restaurant business. The restaurant failed to pay the required rent for 1999 and 2000.

The 1999 and 2000 Schedule E of the taxpayers is summarized in the following chart.

Year	Loss on Restaurant Building	Profit on Steel Supply Building	Net Rental Profit
1999	($41,706)	$120,646	$60,940
2000	(40,169)	102,045	61,876

The taxpayers reported the net rental profit on their 1999 and 2000 Forms 1040.

Issue. Whether the two rental real estate activities can be combined as a "single" activity for passive activity loss limitation purposes.

Analysis. IRC §469(a) disallows the passive activity loss of an individual taxpayer. "Passive activity" is defined by the Code as an activity involving the conduct of a trade or business in which the taxpayer does not materially participate. "Passive activity" generally includes any rental activity, regardless of material participation.

The IRS agreed the grouping of the two rental real estate buildings as an economic unit was appropriate. However, under the self-rental property rule, the net rental income from self-rented property is treated as nonpassive income. If net rental losses result from self-rented properties, those losses are passive losses subject to the passive loss limitations.

Holding. The Tax Court upheld the IRS determination. The tax result was that the net rental profits from the steel supply building represented nonpassive taxable income for 1999 and 2000. However, the net rental losses from the restaurant building were nonpassive and nondeductible for both years.

Rental Income

Letter Ruling 200448011, August 3, 2004

IRC §1362

☞ **Rental income received by S corporation is not passive income.**

Facts. The S corporation owns, develops, leases, and manages commercial real estate. The corporation was concerned its rental income might cause it to lose its S election.

The company maintains the exterior portion of the property it rents. It also maintains common areas, repairs structural components and systems, maintains water and sewer lines, landscaping and various other aspects of the property.

Conclusion. The IRS held that the corporation was participating in a trade or business and the rental income was not passive income.

RETIREMENT

2005 COLAs

IRS News Release IR-2004-127, October 21, 2004

IRC §61

☞ **2005 COLA adjustments released.**

The following is the result of cost of living adjustments. The new amounts are effective January 1, 2005.

Item	IRC	Old Amount	New Amount
Annual benefit limit for defined benefit plans	415(b)(1)(A)	$165,000	$170,000
Annual benefit limit for defined contribution plans	415(c)(1)(A)	41,000	42,000
Elective deferrals to 401(k) plans and the government's Thrift Savings Plan	402(g)(1)	13,000	14,000
Maximum account balance in ESOP subject to five-year distribution period	409(o)(1)(C)(ii)	830,000	850,000
Dollar amount used to determine the lengthening of five-year distribution period	409(o)(1)(C)(ii)	165,000	170,000
Annual compensation limit	401(a)(17), 404(i), 408(k)(3)(C), and 408(k)(6)(D)(ii)	205,000	210,000
Annual compensation limit	401(a)(17)	305,000	315,000
Compensation amount for SEPs	408(k)(2)(C)	450	450
Limitation regarding SIMPLE IRAs	408(p)(2)(E)	9,000	10,000
Deferral limit on state and local government and tax exempt organizations	457(e)(15)	13,000	14,000
Definition of "control employee" for fringe benefit valuations	Reg. §1.61-21(f)(5)(i)	80,000	85,000
Compensation amount	Reg. §1.61-21(f)(5)(iii)	165,000	170,000
Definition of key-employee in top-heavy plans	416(i)(1)(A)(i)	130,000	135,000
Catch-up contributions other than 401(k) and 408(p) plans for age 50 and over	414(v)(2)(B)(i)	3,000	4,000
Catch-up contributions in 401(k) and 408(p) plans for age 50 and over	414(v)(2)(B)(ii)	1,500	2,000

SECA Limit

Notice 2004-73, November 15, 2004

IRC §§1401, 3510, and 6041

☞ SSA announces 2005 social security base and threshold amounts.

The maximum income subject to FICA or self-employment tax for 2005 is $90,000. The new domestic employee coverage threshold is $1,400, the minimum amount a domestic worker must earn before the workers' earnings are covered under FICA or Medicare.

COLAs

Social Security Web Site

☞ Social Security Administration announces 2005 amounts.

The following table contains cost of living adjusted amounts for 2005. These amounts can be found on the Social Security web site.

	2004	2005
Maximum earnings taxable	$87,900	$90,000
Medicare	No limit	No limit
Quarter of coverage	900	920
Retirement Earnings Test Exempt Amounts		
Under full retirement age	11,640/yr.	12,000/yr.
Year individual reaches full retirement age	31,080/yr.	31,800/yr.
Monthly Medicare Part B Payment	66.60	78.20/mo.

Full Retirement Age

Year of Birth	Full Retirement Age
1937 or earlier	65
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943-1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67

TAX FRAUD

Abusive Tax Shelter

***Long Term Capital Holdings v. United States,* Conn. U.S., August 27, 2004**

IRC §§351, 358, 721 and 6226

☞ **A hedge fund formed by two Nobel Prize winning economists ruled to have no economic substance and capital losses were properly disallowed by the IRS.**

Facts. Through a series of transactions, both in the U.S. and foreign countries, the developers of this shelter funded a foreign corporation with assets worth $4 million and claimed a basis of $400 million when it transferred its preferred stock in exchange for a partnership interest. The partnership then sold the stock and claimed a deduction for the loss.

Issue. Whether the claimed capital losses were valid and deductible.

Holding. The court upheld the IRS determination which held the transactions lacked economic substance and that the losses were not deductible.

> **Note.** This case is too detailed to explain in this text. However, tax practitioners might want to read the case to see the amount of effort put into creating a tax shelter and how the IRS successfully attacked it.

TRAVEL AND TRANSPORTATION EXPENSES

New Per Diem Rates

Rev. Proc. 2004-60, October 4, 2004

IRC §§62, 162, and 274

☞ **IRS announces per diem rates that are effective beginning for October 1, 2004.**

The updated per diem allowances paid for travel on or after October 1, 2004 have been announced. The rate for high-cost locales dropped from $207 to $199 while the low locale rate increased from $126 to $127. The incidental expense rate remains constant at $3 per day.

The new rated may be used on or after October 1, 2004, however taxpayers may continue to use the old 2003 rates for the last three months of 2004. Under the transition rules, they may not switch methods prior to January 1, 2005. As a result, taxpayers cannot switch from the high-low method to the GSA per diem method or actual expenses for the remainder of 2004.

2005 Standard Mileage Rates

Rev. Proc. 2004-64, November 17, 2004

IRC §§61, 62, 162, 170, 213, 217, 274, and 1016

☞ **IRS releases 2005 standard mileage rates.**

The mileage rates for 2005 are:

Business	40.5¢ per mile
Charitable	14¢ per mile
Medical and moving	15¢ per mile