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, 2005. Since they appear in a condensed version, they should not be relied on as a substitute for the full documents. A full citation appears at the end of each item. This is not meant to be a comprehensive coverage of all tax law changes or explanations. It is intended to report the rulings and cases that are likely to be of interest to the average tax professional.

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

Substantial Authority

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

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

13

- 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 one, 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.**

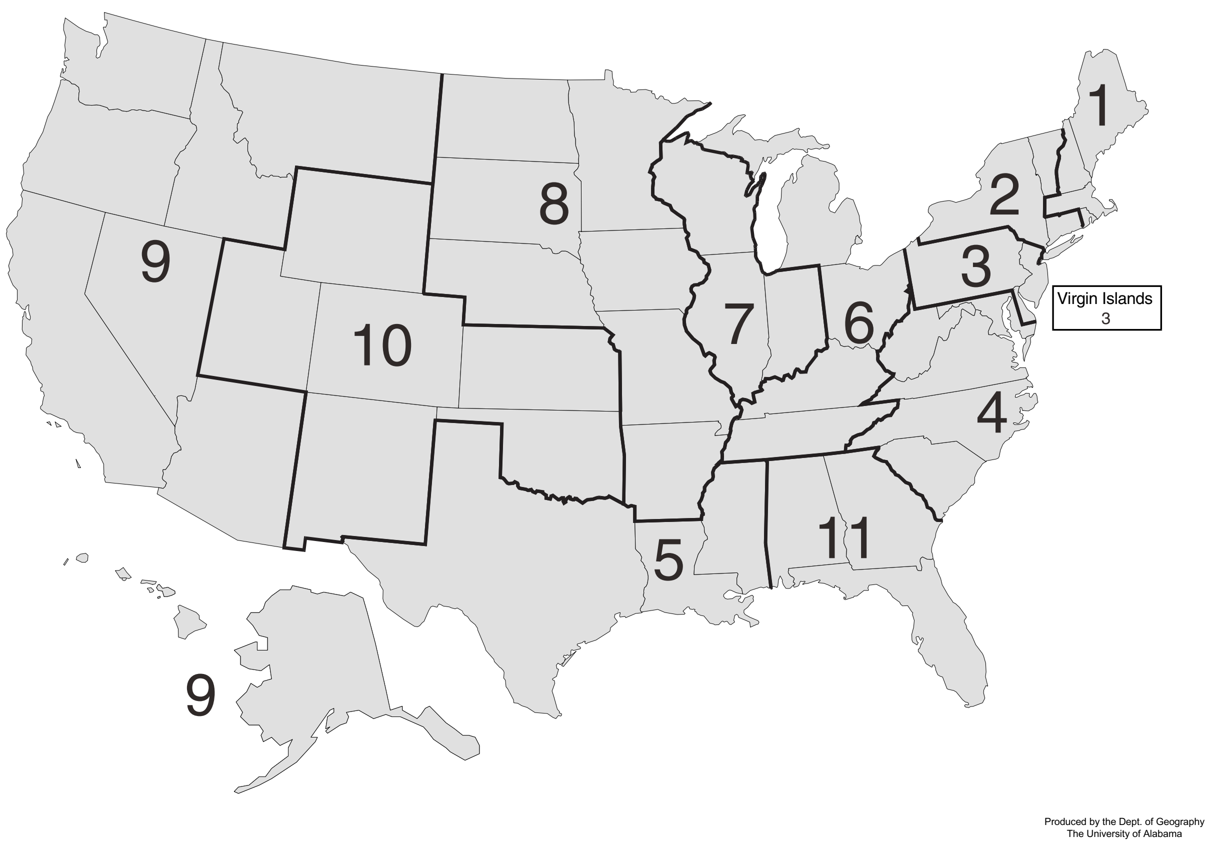
Any decision of the Tax Court can be appealed to the appropriate Circuit Court of Appeals. A final appeal can be made to the Supreme Court, but since its jurisdiction is discretionary, the court hears relatively few tax cases. Many of these court transcripts can be accessed online at **www.uscourts.gov.**

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



AGRICULTURAL ISSUES

CRP Lump-Sum Payment
Chief Counsel Advice 200519048, May 13, 2005
IRC §451

☞ CRP Lump-Sum Payment Includable in Income in Year of Receipt

Purpose. To determine if the taxpayer must include a lump-sum payment received from the sale of a 90% interest in a Conservation Reserve Program (CRP) payment in the year of sale.

Background. Taxpayer entered into three CRP contracts with the USDA with terms and dates as follows:

CRP Contract No.	Contract Period	Payment Due
1	October 1 Year 1 to September 30 Year 11	$X.XX
2	February 1 Year 2 to September 30 Year 12	X.XX
3	October 1 Year 2 to September 30 Year 12	X.XX

The terms of each CRP contract include:

- Not harvesting, selling, or making commercial use of trees/forage/other cover crop on the CRP farmland,
- Certification of crop and land use annually, and
- Control all weeds, insects, pests, and other undesirable species as needed to ensure approved ground cover.

Taxpayer sold to Company A his right to 90% of the remaining nine annual CPR payments for a lump-sum payment in Year 3. Taxpayer agreed to comply with all provisions of the CRP contract, with damage provisions stipulated should taxpayer not comply with these requirements.

If Company A receives more CRP than originally anticipated, Company A is required to pay Taxpayer his proportionate share within 30 days of payment being received.

On the original return filed for Year 3, Taxpayer reported the entire amount received from Company A on Form 4835. On his original Year 4 tax return, the taxpayer included the annual CRP payment on Form 4835, and took a deduction for the part which was previously sold to Company A in Year 3.

When Year 5 was filed, he included the total CRP payment and did not offset the amount he received from Company A.

In Year 5, he filed amended returns to remove the amount reported as income on Form 4835 in Year 3, and to remove the expense deduction in Year 4. Taxpayer rationalized that the lump-sum was not income in Year 3 since he did not have unrestricted claim of right to the funds, and only held them as a conduit.

Analysis. Generally, a lump-sum payment in adequate and full consideration results in ordinary income to the seller in the year of receipt. In this situation, Taxpayer and Company A entered into an arm's-length transaction in which Taxpayer agreed to comply with his CRP contract obligations.

Ruling. The payment was includable in Taxpayer's gross income in Year 3, even though he might have to pay liquidated damages in the event of default. Only the portion of CRP payments not sold to Company A (10%) is includable in Taxpayer's gross income in later years.

Tobacco Farmers

IRS Notice 2005-51, June 22, 2005

IRC §61

☞ Tobacco Quota Buyout Taxed as Capital Gain

Purpose. To provide guidance for federal payments made under the Fair and Equitable Tobacco Reform Act of 2004.

Background. U.S. Department of Agriculture (USDA) will offer to enter into a contract with an eligible tobacco quota holder whereby the holder may receive total payments of $7 per pound of quota which is paid in 10 equal annual payments from FY 2005 through FY 2014 in **exchange** for support.

Note. See Chapter 11, "Agricultural Issues and Rural Investments," Issue 3, for further information.

Income Averaging

Estate of Clifford C. Haugen, Deceased, and Audrey A. Haugen v. Commissioner,
TC Summary Opinion 2004-97, July 26, 2004

IRC §§1301 and 55

☞ NOLs Cannot Create Double Tax Benefits in Income Averaging and Carryback Years

Facts. For nearly 30 years, taxpayers operated a 7,000-acre cattle ranching business in Montana. Mr. Haugen died in 1998, at which time Mrs. Haugen began liquidation of the business by selling the ranch and assets. The 1998 tax was computed utilizing Schedule J, Farm Income Averaging. Two of three base years for income averaging, 1995 and 1996, showed net operating losses (NOLs) which had been fully absorbed in carryback years. The NOL carrybacks resulted in refunds totaling $43,759.

The 1999 return was also computed using Schedule J. The IRS made adjustments to the 1995 and 1996 returns; and the taxpayers agreed with these adjustments based on the Schedules J originally attached to the returns as filed. The IRS disagreed with the use of NOLs in the Schedule J computation and recommended adjustments accordingly. In addition for 1998, the IRS computed additional AMT.

Issues. Whether:

1. Net operating losses previously carried back to earlier years should be added back to the net income for base years due to the tax benefits realized from the NOL carrybacks;
2. The income averaging election for 1999 precludes applicability of AMT or if AMT applies;
3. The regular tax means tax computed without benefit of income averaging.

Analysis. IRC §1301 allows an individual engaged in the trade or business of farming to elect to compute federal income tax by averaging over the prior 3-year period all or a portion of taxable income attributable to farming. The §1301 regulations were not published until January 8, 2002. These regulations prohibit the double benefits realized by carrying back NOLs, receiving a tax refund from such carrybacks, and then using the same NOLs as negative income in income averaging computations in later years. However, the statute and legislative history explicitly suggest that Congress did not intend that taxpayers availing themselves of the benefits of income averaging under §1301 be allowed to include negative income of base years to the extent a refund was received from such an NOL carryback.

IRC §55(a) imposes a tax equal to the excess of:

- The tentative minimum tax for the taxable year, over
- The regular tax for the taxable year. Even though the taxpayer argued that electing the income averaging method is exclusive and trumps the AMT under IRC §55, the court cited the conference committee report to the Taxpayer Relief Act of 1997, as well as the proposed and final regulations both stating "the provision (§1301) does not apply for purposes of the AMT under §55."

Holding. The Tax Court held:

- The income averaging computation does not include negative net income for base years which were used as NOL carrybacks,
- The election to use income averaging does not preclude the applicability of AMT, and
- The "regular tax" means tax computed within the income-averaging provisions.

ALTERNATIVE MINIMUM TAX

Deduction for Home Mortgage Interest

Revenue Ruling 2005-11, April 4, 2005
IRS News Release IR-2005-31, March 17, 2005
IRC §§55 and 56

☞ **Refinanced Home Mortgage Interest May Be Deductible for AMT purposes**

Purpose. To determine if home mortgage interest is deductible as qualified housing interest for purposes of alternative minimum tax (AMT) when the home mortgage has been refinanced more than one time.

Background. In 1990, Taxpayer borrowed $100x to purchase a principal residence. Ten years later (2000), Taxpayer refinanced the $90x mortgage balance. Four years later (2004), Taxpayer again refinanced the mortgage balance ($80x) and also borrowed an additional $30x for a total mortgage of $110x. The additional $30x was not used to improve any principal or qualified residence. At no time did Taxpayer's indebtedness on his qualified principal residence exceed $1 million.

Analysis. IRC §55 provides that AMT is equal to the excess (if any) of the tentative minimum tax over the regular tax for the taxable year. Alternative minimum taxable income (AMTI) is the taxable income determined with adjustments provided in IRC §§56 and 58. IRC §56(b)(1)(C) allows a deduction for qualified residence interest. IRC §56(e)(1) provides that qualified housing interest includes refinancing of indebtedness **only** to the extent the refinanced amount does not exceed the indebtedness immediately before the refinancing.

The 1990 mortgage meets the requirements of qualified residence interest and thus is qualified housing interest for AMT purposes. Since the 2000 refinanced mortgage amount equaled the outstanding principal, and the loan amount was not increased, the interest paid or accrued is deductible as qualified housing interest for AMT purposes.

The 2004 refinance included the remaining mortgage balance ($80x) and an additional $30x which was not used to acquire, construct or, or substantially improve a principal or qualified residence. The same rationale applies for the 2000 mortgage. For AMT purposes, taxpayer may only deduct interest paid or incurred on $80x and **not** the interest attributable to the additional $30x.

Ruling. Interest paid on a home mortgage refinanced more than one time is deductible as qualified housing interest for AMT purposes to the extent the interest is qualified housing interest and the amount of the mortgage indebtedness is not increased.

Form 6251 instructions include a worksheet to assist taxpayers in determining the correct home mortgage interest adjustment.

Offer-in-Compromise (OIC)

***Ronald J. and June M. Speltz v. Commissioner,* 124 TC No. 9, March 23, 2005**

IRC §7122

☞ Rejected OIC was not Result of IRS Discretionary Abuse

Facts. While working as a senior manager for McLeodUSA, the Iowa taxpayer received incentive stock options (ISOs) as part of his compensation package. In 2000, the taxpayer exercised some of the ISOs, resulting in a significant AMT adjustment item of $711,118. The total tax liability reported on the 2000 return amounted to $224,869, of which $206,191 was AMT tax liability. The balance owed was $210,065, a portion of which was paid by the taxpayers.

The value of the McLeodUSA stock declined dramatically. In 2000, the sale prices ranged from $70 - $104, and in 2002, it was less than a dollar per share.

In November of 2001, taxpayers submitted an OIC, based on doubt as to collectibility. The taxpayers offered a cash payment of $4,457 against the upaid 2000 liability which was over $125,000. A statement attached to the OIC explained the "OIC was necessary because of the impact the AMT in 2000 had on their finances and their lifestyle." The $4,457 represented the cash value of life insurance. The OIC was rejected by Appeals and a lien was subsequently filed by the IRS.

Issue. Whether the IRS abused its discretion in refusing an OIC and whether the lien filed by the IRS should remain in place.

Analysis. IRC §7122, which authorized compromise of any civil case arising under Internal Revenue laws, was amended by Congress in 1998. Regulations under §7122 provide three grounds for compromise of a liability:

1. Doubt as to liability
2. Doubt as to collectibility, or
3. Promotion of effective tax administration.

The regulations further state that no compromise may be entered into if such compromise of liability would undermine compliance by the taxpayer with tax laws. While the Tax Court sympathized with the taxpayers, it "cannot conclude that §7122 gives the Court a license to make adjustments to complex tax laws on a case-by-case basis."

The Tax Court does not have the jurisdiction to override the judgment of Congress in passing AMT statutes. Congress is aware of the perceived hardships of AMT but has chosen not to revise or repeal the AMT statutes at this time.

Holding. The IRS did **not** abuse its discretion in declining the OIC offer and allowing the tax lien to remain effective.

BAD DEBT

Business Bad Debt

***Maurice E. John, Jr. and Jan E. John v. Commissioner,* TC Memo 2004-257, November 9, 2004**
IRC §166

☞ Reasonable Steps Must Be Taken To Enforce Bad Debt Collection

Facts. Maurice and Jan John reside in Louisville, Kentucky. Maurice has been an eye surgeon and ophthalmologist providing medical services as a full-time employee of John Eye Clinic, Inc. (Clinic) since 1981.

In 1987, John Evans was hired to serve as Clinic's business manager. While John was Clinic manager, the Clinic became significantly more successful and profitable. The Clinic paid for John to get an MBA degree and also gave him a BMW 740 car as a gift.

Sometime during 1991, Maurice and John became concerned that the ongoing reduction in Medicare reimbursements, which had constituted over 70% of the Clinic's income would decrease the Clinic's revenues. They began exploring possible alternative sources of income. They decided to create three ventures, with both Maurice and John becoming 50% shareholders:

- J.E. Stallion, a management company, to offer management services to other clinics,
- J.E. Stallion-Russia, Inc. (Russia), a company to sell contact lenses, operate sausage factories, and export timber from Russia to Japan, and
- J.E. Stallion International Gallery, Inc. (Gallery), a company to operate an art gallery and to purchase, sell, and exhibit works of art on a national and international basis.

Since John did not have the financial wherewithal to make any capital contributions to the various companies, Maurice advanced approximately $2.5 million from 1992 through 1995 with the expectation that John would repay his 50% of the advances when the companies became profitable. No promissory notes were executed for the advances. Unfortunately, the profitability never occurred. In 1995, Maurice instructed John to cease making certain investments in Russia. When John failed to follow Maurice's instructions, John was fired.

Maurice and the Clinic sued John in 1996 for $1,354,387. A settlement was agreed upon whereby John would pay a total of $250,000, enter into a noncompete agreement, resign as officer of all companies, and give up ownership in all companies.

Maurice and Jan deducted $491,054 as a business bad debt on their joint federal income tax return for 1995 which the IRS subsequently disallowed.

Issue. Whether the taxpayers are entitled to a business bad deduction claimed in connection with a loan to a now-terminated employee.

Analysis. A taxpayer may deduct a debt that becomes wholly worthless during the taxable year pursuant.[1] There is no standard test or formula for determining worthlessness, and the determination depends upon the particular facts and circumstances of the case.

At trial, Maurice presented two arguments:

- Firing John was the "identifiable event" that rendered the loan worthless in 1995.
- The loan was worthless, as a general matter, because John was insolvent.

1. IRC §166

The court determined both arguments to be without merit. Under the first argument, there is nothing to show that repayment was conditioned upon John's continued employment with the Clinic. In addition, no cases were found in which terminating a debtor's employment alone renders a debt worthless.

For the second argument, the court made the following comments:

- Insolvency alone does not render a debt worthless,
- If John's alleged longstanding insolvency rendered the loan worthless, then the loan was worthless before 1995. To write off a loan as worthless, the loan must have value at the beginning of the tax year and became worthless during the year.
- To qualify as worthless, not only must a debt be uncollectible at the time the taxpayer takes the deduction, but the taxpayer has the burden to show it also lacks future value.

Finally the court looked at whether Maurice took reasonable steps to enforce repayment of the debt. No evidence was presented to validate any steps taken on Maurice's behalf.

Holding. After carefully considering all the facts, the Tax Court determined the following:

- Job termination alone did not render John's debt wholly worthless;
- Alleged insolvency alone did not render John's debt worthless; and
- Maurice failed to take reasonable steps to enforce repayment of the debt.

BANKRUPTCY AND INSOLVENCY

> **Note.** See Chapter 12, "New Legislation," beginning on page 447 for more information on the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

IRA

Richard Gerald Rousey et ux v. Jill R. Jacoway, **Supreme Court, No. 03-1407, April 4, 2005**
IRC §§408 and 6871

☞ IRAs Exempted From Bankruptcy Estate

Facts. Richard and Betty Jo Rousey terminated employment with Northrup Grumman Corp. They were required to take distributions from their employer-sponsored pension plan. They deposited these funds into two IRA accounts, one in each of their names.

Several years later, the Rouseys filed a joint Chapter 7 bankruptcy petition. As part of this proceeding, the Rouseys attempted to protect portions of their IRAs from creditors by claiming them as exempt from the bankruptcy estate.

Jill R. Jacoway was appointed as the Chapter 7 trustee by the Bankruptcy Court. Jill objected to the exemption of the IRAs. The Bankruptcy Court agreed with Jill but the taxpayers appealed. Both the Bankruptcy Appellate Panel and the Court of Appeals for the Eighth Circuit agreed with Jill. However, the Supreme Court decided to review this case because several of the circuits reached differing opinions.

Issue. Whether taxpayers can exempt assets in their IRAs from the bankruptcy estate.

Analysis. As a general matter, upon filing a petition for bankruptcy, "all legal or equitable interest of the debtor in property" becomes the property of the bankruptcy estate and is distributed accordingly. However, the bankruptcy code permits the withdrawal of certain interests in property such as car or home up to certain values.

Three requirements **must be met** to be exempted. The right to receive payment:

1. Must be from a bonus, pension, profit-sharing, annuity, or similar plan or contract,
2. Must be on account of illness, disability, death, age, or length of service, and
3. May be exempted only "to the extent" that it is "reasonably necessary to support" the account holder or his dependents.

The dispute in this case is whether the Rouseys meet the first two requirements.

The Court first looked to Test #2. Jacoway argued the Rouseys' right to receive payment from their IRAs is not because of the listed factors. The Rouseys can withdraw funds from their IRAs at any time as long as they are willing to pay the 10% penalty for doing so. The Court disagreed with this interpretation. The Rouseys' right to withdrawals is restricted by the 10% tax penalty applied to withdrawals before the taxpayer reaches age 59½. Since this 10% penalty is removed at age 59½, the Rouseys' right to the balance of their IRAs is a right to payment "on account of age" thus meeting requirement #2.

Next, Test #1 needs to be considered. Do the IRAs fall within the meaning of "similar plan or contract" under IRC §522(d)(10)(E)? Jacoway argued the IRAs are unlike the listed plans and those plans provide "deferred compensation." Rousey argued the IRAs are similar to such plans in that they enable Americans to save for their retirement. The court looked at the definitions of the various terms and determined the common feature of all these plans was they provide income that substitutes for compensation.

Several considerations drove the court to rationalize the IRAs are income that substitute for wages. These factors include:

- Minimum distributions begin at the latest at age 70½,
- Taxation is deferred until year of distribution,
- Withdrawals before age 59½ are subject to penalty, and
- Failure to withdraw minimum distributions at the appropriate age are subject to a 50% tax penalty.

Holding. The Supreme Court held IRAs are exempted from the bankruptcy estate.

Late Filed Returns

***Gary Wayne Colsen v. IRS,* United States Bankruptcy Appellate Panel of the Eight Circuit,**
BAP No. 04-6042 NI, March 25, 2005
IRC §523

☞ Tax Returns Filed After IRS Assessment Constitute Returns for Bankruptcy Purposes

Facts. Gary Colsen failed to timely file tax returns for the years 1992 through 1996. The IRS assessed taxes, interest, and penalty for these years after properly following the substitute-for-return procedures.

In Fall 1999, Mr. Colsen filed returns for 1992 through 1996. The IRS examined these returns and authorized partial abatements of taxes and interest accordingly. Mr. Colsen then filed for Chapter 7 bankruptcy in February 2003.

Mr. Colsen sued in bankruptcy court to determine whether his tax liabilities for 1992 through 1998 should be discharged in bankruptcy. The IRS did not dispute the dischargeability issue for 1997 and 1998. The IRS took the position since Mr. Colsen filed the returns after the IRS assessed the substitute-for-return tax liabilities,and these "filed returns" did not qualify as returns under the Bankruptcy Code. The Bankruptcy Court agreed with Mr. Colsen. Consequently, the IRS appealed the decision.

Issue. Substitute-for-returns are not dischargeable in bankruptcy. However, do the amended returns filed in 1999 by Mr. Colsen qualify as returns for purposes of dischargeabilty under 11 U.S.C. §523(a)(1)(B)(i)?

Analysis. Since neither the Tax Code nor Bankruptcy Code defines "return," the court looked to the definition of "tax return" which was developed by the Tax Court:

- Document must have sufficient data to calculate tax liability,
- Document must claim to be a return,
- There must be an honest and reasonable attempt to satisfy the requirements of the tax law, and
- Return must be executed under the penalties of perjury.

The court analyzed precedent in other circuit courts and **rejected** an absolute rule that a return filed post assessment cannot be an honest and reasonable attempt to satisfy the tax law and therefore cannot be a return. The returns Mr. Colsen filed appeared to be tax returns and the IRS did reduce the assessments based on these documents.

Holding. Tax returns filed after an assessment by the IRS are "returns" for bankruptcy purposes and can be discharged in bankruptcy.

BUSINESS EXPENSES

Clergy

***Johnny J. and Brenda D. Young v. Commissioner,* TC Summary Opinion 2005-76, June 7, 2005**
IRC §§265 and 1401

☞ Allocation Needed Between Exempt and Nonexempt Income

Facts. Johnny and Brenda Young resided in Los Angeles, CA where Johnny was an ordained minister since 1981. From 1992 through 1999, his self-employment (SE) income averaged more than $2,400 per year. For 2000, Johnny was paid $78,000 by the church, classified as parsonage allowance ($42,000) and wages ($36,000). He also received $21,438 of SE income from the ministry in 2000 as well. As part of the 2000 examination, Johnny requested exemption from SE tax by presenting a Form 4361, *Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners.*

Issues.

1. Should expenses be allocated between exempt and nonexempt income?
2. Is Johnny's ministerial income subject to SE tax?

Analysis. Issue 1: IRC §265 provides that no deduction is allowed when expenses are directly or indirectly allocable to nontaxable income. Several court cases have previously been decided around similar issues; they are:

- *McFarland v. Commissioner,* TC Memo 1992-440, August 4, 1992
- *Deason v. Commissioner,* 41 T.C. 465, January 10, 1964
- *Dalan v. Commissioner,* TC Memo 1988-106, March 9, 1988

Facts in this case are very similar to the facts shown in the above cases. The taxpayer earned both nonexempt income as a minister and tax-exempt parsonage income from the church. The IRS determined ministry expenses must be allocated between Schedule A, *Itemized Deductions,* for this ministry employment income and Schedule C for his other ministry income, as well as between tax exempt and nonexempt income.

Issue 2: IRC §1401(a) imposes SE tax on SE income. IRC §1402(e) exempts from SE tax, SE income of certain ministers and others. If a minister chooses to request exemption, an application for exemption must be filed no later than the due date of the return (including extensions) for the second taxable year for which the applicant had net SE earnings of at least $400 from which any part relates to services as a minister. Clearly the Form 4361 presented at the time of examination of the 2000 return did not meet the "second taxable year" since Johnny had SE income from 1992 through 1999.

Holding.

1. The Tax Court agreed with the IRS rationale for allocation of expenses. Since the taxpayer did not provide documentation to determine the proper allocation, the court allocated the expenses on a pro rata basis based on income received.
2. Since Johnny did not timely present his application for exemption from SE tax, his ministry SE income is taxable for the **rest of his life**.

> **Note.** See Chapter 6, "Special Taxpayers," page 219 for more information on reporting clergy expenses.

Capitalization versus Repairs

FedEx Corporation v. Commissioner, **6th Circuit Ct. of Appeals, No. 03-6514, 2001-5 USTC ¶50,186, February 16, 2005, affirming the District Court decision, 291 F.Supp.2d 699, August 27, 2003**

IRC §263

☞ Engine Shop Visits Properly Deducted as Repairs

Facts. FedEx maintains a huge aircraft fleet as part of its shipping business transporting packages and letters worldwide. In order to keep the equipment in running order, engine shop visits (ESVs) are performed on a routine basis (generally every 24 to 60 months) based on

- Engine use since its last shop visit, or
- FAA airworthy requirements.

The ESVs, which are mainly done by third-party vendors at a cost of 1% to 8% of an aircraft's value, involve

- An initial inspection,
- Disassembly of the engine into modules, and
- Replacement of parts with new or serviceable parts, where necessary.

FedEx deducted the costs for ESVs as repairs but the IRS challenged the position saying the costs should have been capitalized. FedEx paid **$70 million in taxes and accrued interest** and decided to take the case to a district court. The district court agreed with the treatment used by FedEx. The government appealed to the Sixth Circuit.

Issue. Whether FedEx is required to capitalize the ESV costs under IRC §263.

Analysis. The District Court questioned whether an ESV adapts engines to a new or different use or prolongs the life of FedEx's aircraft. The IRS asserted the engine values remained relatively flat over time. Therefore, the court concluded the value of an engine after an ESV was not worth more than the value prior to an ESV. If the engine value did not increase, neither did the aircraft value.

Holding. The Sixth Circuit Court of Appeals agreed with the decision of the district court. FedEx properly expensed ESVs as repairs.

Business Aircraft Used for Entertainment

IRS Notice 2005-45, June 13, 2005

IRC §274

☞ Limitations on Deductible Entertainment Expenses Using Business Aircraft

Purpose. To provide guidance on the limitations of deductible business expenses for use of a business aircraft for entertainment incurred **after June 30, 2005.**

Background. No deduction is allowed for an activity considered to be entertainment unless the activity is directly related to or associated with the active conduct of the trade or business.[2] IRC §274(e) provides exceptions to the general disallowance provisions of IRC §274(a). Prior to the enactment of the American Jobs Creation Act of 2004 (AJCA), IRC §247(e)(2) excepted expenses from §274(a) to the extent the expenses are treated by the taxpayer as compensation to the employee/recipient of the entertainment activity. Similarly, IRC §274(e)(9) excepted expenses to the extent the expenses are treated by the taxpayer as income to the persons who are not employees.

2. IRC §274(a)(1)(A)

AJCA amended §§274(e)(2) and (9) exceptions to the disallowance to **apply** in the case of a "specified individual" only to the extent the expenses do not exceed the amount of expenses treated as compensation to the specified individual. Therefore, expenses allocable to entertainment which are not treated as compensation to the specified individual are disallowed.

Application.

Expenses of aircraft subject to disallowance include all expenses of maintaining and operating the aircraft and must be allocated for each taxable year using either **occupied seat hours** or **occupied seat miles flown by the aircraft**. The chosen method must be applied consistently for all usage of the taxable year. The disallowed amount is the sum of the cost of each occupied seat hour (or mile) flown by a specified individual for entertainment purposes less the sum of the amount treated as compensation and the reimbursement received for each specified individual and each flight.

For example, an aircraft is used for three flights during the taxable year. Information is shown as follows:

Aircraft operation expenses	$56,000	
Occupied seat hours	56	
Cost per occupied seat	1,000	$56,000 ÷ 56
Entertainment aircraft usage subject to disallowance	26,000	26 occupied seat hours × $1,000

In situations where both business segments and entertainment segments are present, the costs must be allocated between the two usages. The entertainment cost is the excess of the total cost of the flights over the cost of the flights without the entertainment segment(s).

	Flight 1	Flight 2	Flight 3
Hours for flight	5	5	4
No. of total passengers	4	4	4
No. of passengers who are specified individuals or traveling for entertainment	0	2	4
Expense amount to be disallowed	0	$10,000	$16,000
Amounts treated as compensation	0	(1,200)	(5,200)
Amounts reimbursed	0	(500)	0
Remaining cost allocable to entertainment is DISALLOWED	0	8,300	10,800

Taxpayers who use the Standard Industry Fare Level formula for valuing flights are permitted to use the fair market value rules under Treas. Reg. §1.61-21(b) to value the entertainment use. The IRS and Treasury intend to amend the regulations accordingly. Until such time as the amendment occurs, taxpayers should rely on this notice for guidance.

Note. The principles found in this notice can also be applied to expenses paid or incurred in connection with other entertainment activities. The IRS will not challenge a **reasonable method** of determining disallowed expenses incurred after October 22, 2004 and before July 1, 2005.

Wages Paid to Children

***Cynthia Pamela Aldridge Dumond and Jeffrey Allen Dumond v. Commissioner,* TC Summary Opinion 2005-11, January 31, 2005**

IRC §162

☞ Wages Paid to Children Disallowed Where Taxpayer Retains Control of Monies

Facts. In 1999 and 2000, the taxpayers operated a business in the state of Iowa called State of the Art Vending as a Schedule C business. On filed returns, the taxpayers claimed business deductions of $8,400 in each year for labor paid to their two minor sons (**ages 10 and 5 in 1999**). Each son received $4,200 in a lump-sum payment at the end of December. The checks were not cashed until at least two months later due to poor cash flow in the business. Monies were either reinvested into the business or deposited into the taxpayer's personal account. During examination, the IRS disallowed payments allegedly made to minor children and recommended assertion of accuracy-related penalties for both years.

Issue. Whether the taxpayers are entitled to business expense deductions under IRC §162 for amounts paid to their minor children and whether accuracy-related penalties should be assessed.

Analysis. IRC §162(a)(1) allows a deduction for ordinary and necessary business expenses including a reasonable allowance for salaries or other compensation for personal services actually rendered. Treas. Reg. §1.162-7(a) provides the test of deductibility for compensation payments to be whether the payments are reasonable and whether they are payments purely for services.

At trial, the taxpayer testified the payments to his children were based on what "he believed the law allowed for, so that they (his children) would not have to file taxes." He was not certain how many hours the children worked each week. The children performed the following duties:

- Riding along weekly on the vending routes
- Sorting the totes full of candy
- Putting candy bars into machines
- Breaking down cardboard
- Sorting recyclable products
- Counting money (10-year old child only)

Holding. The Tax Court held:

- The wages paid to the children were disallowed as expenses to the taxpayer since he failed to carry the burden of proof for the deductions taken.
- An accuracy-related penalty was upheld since the taxpayer did not keep adequate books and records or otherwise substantiate the deduction reported on Schedule C.
- Amounts allegedly paid to his children remained in the taxpayer's control.

Unreimbursed Employee Business Expenses

***Lionel D. Jones v. Commissioner,* TC Summary Opinion 2004-76, May 27, 2004**

IRC §§162 and 170

☞ Court uses *Cohan* Rule to Determine Allowable Employee Business Expenses

Facts. During 2001, this Tennessee taxpayer worked in two different occupations, firefighting and law enforcement. For both occupations, he was required to purchase uniforms. Neither uniform was suitable for off-duty use and wearing them off duty was also prohibited. He received an allowance for the cost of three pairs of firefighter pants and one uniform shirt. He attended two different churches and made contributions by check and cash to both churches using offering envelopes. He also contributed to the Salvation Army. On his tax return, he claimed a net deduction for unreimbursed employee expenses of $6,600 and a charitable contribution deduction of $6,045. Both deductions were disallowed during audit due to **lack of substantiation.**

Issue. Whether the taxpayer is entitled to deductions under:

- IRC §162(a) for unreimbursed employee expenses, and
- IRC §170 for charitable contributions.

Analysis. IRC §162 allows a deduction for ordinary and necessary expenses paid or incurred in carrying on a trade or business. IRC §274(d) imposes stringent substantiation requirements; substantiation of the amounts claimed by adequate records or by other sufficient evidence corroborating the claimed expenses.

At trial, the taxpayer **did not** produce canceled checks or credit card receipts. Instead, he produced the following worksheet entitled Fire Fighter and Law Enforcement Deductions.

Description	Amount
Uniforms	$ 200.00
Dry cleaning/laundry	1,820.00
Association dues	285.00
Professional dues	375.00
Range dues	220.00
Ammunition	104.00
Camera	49.99
Guns	650.00
Telephone (2nd line)	485.00
Telephone (cellular)	650.00
Total	$4,838.99

In addition, the taxpayer incurred $1,761.01 for socks, shoes, belts, short pans, bed linen, and food which were not listed on the worksheet. Total expenses claimed on the worksheet and in oral testimony totaled $6,600. He did not maintain any contemporaneously prepared records to document his employee-related use of the second telephone line or the cellular telephone as required under listed property IRC §280F(d)(4)(A)(v). The taxpayer admitted he was "not the world's best recordkeeper." The court did not allow any deduction for personal items (socks, shoes, belts, short pants, bed linen, and food). However, the court allowed part of his expenses as follows:

Item	Amount
Uniforms	$ 200.00
Dry cleaning/laundry	500.00
Association and professional dues	500.00
Firing range and ammunition costs	100.00
Firearm and camera	200.00
Total	$1,500.00

During the trial, the taxpayer did not provide any canceled checks or credit card receipts for his charitable contributions. However, he provided **letters from the two churches** he attended acknowledging contributions totaling $8,201.

Holding. The Tax Court held the unreimbursed employee expenses and charitable contributions were allowable to the extent of $1,500, and $8,201, respectively.

Professional Gambler

***Pansy V. Panages v. Commissioner,* TC Summary Opinion 2005-3, January 4, 2005**
IRC §§162 and 6662

☞ Gambling Determined Not to be Full-Time Activity

Facts. Before entering the flower business, Pansy completed her freshman year of high school and and had some floral industry training. She decided to open a flower shop in Reno, Nevada called The Flower Bucket Florist. The flower shop was open 12 hours per day Monday through Saturday and a few hours on Sunday.

In 2001, Pansy received compensation of $66,310. She also operated another business, F.B. Wholesale, Inc. This business purchased and sold flowers to retail florists. She received $7,200 from F.B. Wholesale in 2001. She also had additional income from rents.

In 2001, nearing the age of 70, Pansy longed for retirement and began training her two daughters to assume responsibility for the flower shop. In order to supplement her social security income, she began gambling. She was not any ordinary gambler. She had a **talent** for hitting on the slot machines. She gambled almost exclusively at Smith's grocery store on progressive machines. She became well acquainted with the workers at Smith's and tipped them for recommendations of machines which had not "paid out" recently. She spent 20-25 hours per week playing these slot machines after the flower shop closed for the evening.

Pansy was uncertain how to file her tax return for this new profession, so she contacted an IRS agent. The IRS agent told her to file a Schedule C and pay self-employment tax on any profit realized. On her 2001 return, she reported her gambling winnings on Schedule C and claimed Schedule C expenses of $6,000 tips for Smith's grocery employees resulting in a net loss of $13,179. She maintained meticulous records showing exact dates and amounts of her winnings, tips, and ATM charges which she attached to her Schedule C.

During examination, the IRS disallowed the expenses from gambling on Schedule C and assessed an IRC §6662(a) penalty.

Issue. Whether the taxpayer's gambling activity is a "trade or business" allowing her to deduct gambling losses on Schedule C and whether she is liable for a penalty under IRC §6662(a).

Analysis. In *Commissioner v. Groetzinger,*[3] the Supreme Court determined for gambling to reach the level of a trade or business the activity must be "**pursued full time**, in good faith, and with regularity, to the production of income for a livelihood, and not a mere hobby." Pansy did not pursue gambling on a full time basis. Her primary income was from her flower shop.

IRC §6662(d) provides for a reduction of the understatement if the taxpayer supplied relevant facts affecting the tax treatment on the return and if there was reasonable basis for the tax treatment.

Holding. The Tax Court determined Pansy did not qualify as a gambler in the trade or business; therefore her expenses were moved from Schedule C to Schedule A itemized deductions. The penalty was determined not applicable since she attached adequate records to her return and had a reasonable basis for believing she qualified as a professional gambler.

CAPITAL GAINS AND LOSSES

Sale of Family Business

***Richard E. and Mary Ann Hurst v. Commissioner,* 124 TC No. 2, February 3, 2005**
IRC §§302 and 6662(a)

☞ S Corporation Stock Redemption Results in Favorable Tax Treatment

Facts. Richard Hurst was the sole shareholder of an S corporation, Hurst Mechanical Inc. (HMI). In addition, Richard and his wife owned the building in which HMI and another smaller business, RHI, were housed. In 1997, the Hursts began anticipating retirement and decided to sell the business to their three key employees. The sales price was $2.5 million payable with interest over a 15-year period. The details of the transaction included:

- HMI bought 90% of Richard's 1000 shares for a $2 million note
- Son and two other key employees bought remaining 10% of Richard's shares for a $250,000 note
- HMI bought RHI from Hursts for a $250,000 note
- All notes bore interest at the rate of 8% with 60 quarterly installments
- 15-year lease signed between HMI and Hursts giving HMI an option to purchase the building
- HMI gave Mary Hurst a 10-year employment contract
- Entire package provided cross-default provisions in favor of the Hursts

Their 1997 tax return reported stock dispositions for both HMI and RHI as installment sales of long-term capital assets under IRC §302(b)(3) complete redemption.

The IRS disagreed with the treatments used by the Hursts recharacterizing these dispositions as producing over $400,000 in dividends and over $1.8 million in immediately recognized capital gains. The IRS determined health insurance coverage was taxable to Mrs. Hurst since she is considered a 2% shareholder under IRC §318 rules. An accuracy-related penalty was asserted on the entire deficiency.

Issues. Whether:

- Stock sales were properly reported on the 1997 return
- Health insurance coverage was taxable to Mrs. Hurst
- An accuracy-related penalty should apply

3. *Commr. v. Groetzinger,* 480 U.S. 23, 35, February 24, 1987

Analysis. The Tax Court found the methods utilized for the HMI stock sale by the Hursts in structuring the transactions to be consistent with common practice for seller-financed deals. The redemption was complete and the Hursts had no prohibited continuing interest even though:

- Agreements carried extensive cross-default and cross-collateralization provisions
- The Hursts leased a personally-owned building to the corporation
- Mrs. Hurst continued as an employee and received health insurance coverage

Concerning the attribution rules, Mrs. Hursts' relationship to her husband and son caused her to be treated as a 100% shareholder for part of the year and a 51% shareholder for the remainder of the year. Therefore, she is treated as a partner when it comes to determining whether an employee fringe benefit is includable as gross income.

Holding. The Tax Court ruled in favor of the Hursts on all issues except the health insurance issue.

CASUALTY LOSS

Adjusted Basis

***Lee F. McClune and Harriett R. McClune v. Commissioner,* TC Memo 2005-47, March 14, 2005**
IRC §165

☞ Casualty Loss Limited to Adjusted Basis

Facts. Lee and Harriett McClune resided in Knoxville, Iowa. In April of 1978, Lee purchased a remainder interest in 80 acres of Iowa land for $20,000. Lee and his three sons held the property as tenants in common each owning a one-fourth interest in the property ($5,000 adjusted basis for each). Lee's sister held a life estate in the 80 acres from the time of purchase up through at least 1997. The 80 acres was comprised of two 40-acre tracts of land. One of the tracts contained a well-preserved barn, valued at 54% of the total 40 acre price, used for agricultural purposes.

During 1997, a tornado hit the area and destroyed the barn. Approximately $2,000 of salvageable lumber was all that remained.

On their 1997 return, the McClune's claimed a $44,000 casualty loss on Form 4684 ($46,000 value of barn less $2,000 salvageable lumber). No insurance payments were received.

During examination, the IRS reduced the allowable casualty loss to $500, but increased the deduction to $1,350 just before trial.

Issue. Whether the taxpayers are entitled to a casualty loss for the destruction of the barn of $44,000.

Analysis. The amount of a casualty loss deduction is generally computed as the excess of the FMV of the property immediately before the casualty over the FMV of the property immediately after the casualty, **limited by the adjusted basis of the property.**

In this case, Lee took title to the remainder interest in the property with his three sons as tenants in common for a total of $20,000. The IRS argues that one-fourth of the purchase price is attributed to Lee, making his adjusted basis in the 80 acres equal to $5,000. The adjusted basis in the 40-acre tract upon which the barn stood would be $2,500. Because 54% of the value of the 40-acre tract was allocable to the barn, the IRS concluded Lee's adjusted basis in the barn would be no more than $1,350.

Lee argued that, according to statements made by one of the IRS's agents, the general rule under IRC §165 did not apply to remainder interests. Therefore, they should be able to deduct at least Lee's share of the FMV of the barn immediately before the casualty, less the salvageable amount of the remaining lumber ($2,000). Lee claims that, at some point, a deduction of $11,000 was offered to settle his claim.

At trial, the McClunes could not provide any evidence regarding alleged statements for offers made by IRS personnel. However, even if the McClune's could have provided evidence of erroneous statements made by IRS personnel, this would not bind the IRS in the determination of the allowable casualty loss deduction. Offers of settlement are not admissible in the court proceeding and are therefore **irrelevant**.

Holding. The Tax Court determined Lee and Harriett were allowed a casualty loss deduction for the destruction of the barn limited to their adjusted basis in the property. The $1,350 loss was allowed.

Loss on Value of Stock

Ronald C. Singerman v. Commissioner, **TC Summary Opinion 2005-4, January 5, 2005**
IRC §165

☞ Decline in Stock Value Does Not Give Rise to Theft Loss

Facts. A California CPA invested in Ampex, a publicly traded corporation listed on the American Stock Exchange. The Ampex business provided technologies for the acquisition, storage, and processing of visual information. It also developed Internet video programming and technology through its wholly owned subsidiary, iNEXTV. From November 1999 through December 2000, he acquired 60,000 shares of Ampex common stock ranging in price from $6.06 to $.4375 per share. The total cost in the 60,000 shares amounted to $212,987.50.

Ampex stock began to decline from December 1999 through December 2000 when it was trading for $.0375 per share. On his 2000 tax return, the CPA claimed a theft loss of $202,830 which represented the excess of his basis over current $.3750 per share price. Form 8275, *Disclosure Statement,* attached to his return stated that Ampex engaged in a pattern of willful and misleading disclosures and non-disclosures that constitute theft by fraud or false pretenses against its shareholders. In addition, the CPA filed complaints against Ampex with the U.S. Securities and Exchange Commission and the California Department of Corporations in 2001.

Issue. Whether a taxpayer is entitled to a theft loss on an investment in common stock.

Analysis. IRC §165(a) provides a deduction for any loss sustained during the taxpayer's year not compensated for by insurance or otherwise. IRC §165(c)(3) limits the losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. Generally, a taxpayer is not entitled to a loss deduction solely on the account of a decline in the value of stock unless the stock if worthless and has no recognizable value or the stock is sold. State law governs whether the alleged loss constitutes a theft loss.

To support a finding of theft by false pretense, the California Penal Code requires intent on the part of the defender to obtain the victim's property. Such intent implies an element of privity between the perpetrator and victim. Under prior cases involving the California Penal Code, it was established that a taxpayer who purchases corporate stock on the open market cannot support a claim of theft under California law because there is no privity between the alleged corporate defrauder and taxpayer. Since the taxpayer acquired Ampex stock on the open market, there was no privity between Ampex and the taxpayer. Therefore, the taxpayer is not entitled to a theft loss deduction under California law.

The taxpayer still argued he was entitled to a loss based upon a cause of action against Ampex for fraud and negligent misrepresentation under California law citing *Small v. Fritz Cos.*[4] The Tax Court disagreed, finding the tort cause of action for fraudulent or negligent misrepresentation does not give rise to a theft loss deduction, since a theft loss requires a criminal appropriation of another's property.

Holding. The Tax Court held the taxpayer is not entitled to a claimed theft loss deduction for 2000.

4. *Small v. Fritz Cos.,* 65 P.3d 1255, 1257 (Cal. 2003)

13

CORPORATIONS

Double Taxation

Treasury Decision 9180, February 22, 2005

IRC §1374

☞ Duplication of S Corporation Built-in Gain or Loss Prevented

When a C corporation converts to an S corporation, a tax is imposed on net realized built-in gain (NRBIG) attributable to assets held by the C corporation. Also, NRBIG attributable to assets transferred from a C to S corporation in a carryover basis transaction is also subject to tax under IRC §1374.

There are no problems unless a C corporation that elects to be an S corporation holds stock in another C corporation. If the other C corporation transfers assets to the corporation via IRC §§332 or 337 liquidation or 368(a) reorganization, the same built-in gain or loss in the transferred assets may be reflected twice.

The final regulations allow taxpayers to adjust the net unrealized built-in gain (NUBIG) subject to tax in carryover basis transactions.

Several examples are contained in the final regulations that demonstrate the application of the rules to various conversions and transactions. These examples illustrate:

- Computations of NUBIG,
- Adjustments to both NUBIG and net unrealized built-in loss in eliminated C corporation stock, and
- Adjustments to NUBIG in cases of prior gain recognition.

These regulations take effect after February 23, 2005, but S corporations can apply these regulations to transactions occurring on or before February 23, 2005. To obtain relief for earlier tax years, S corporations, along with predecessors or successors and affected shareholders, must file original or amended returns for tax years that are not closed by the statute of limitations.

Constructive Dividend

***Bradley K. Morrison v. Commissioner,* TC Memo 2005-53, March 23, 2005**

IRC §§301 and 316

☞ Monies Advanced by Corporation Determined to be Loans

Facts. The California taxpayer owned 40% of the stock of Caspian Consulting Group, Inc. During 1999, the corporation paid $40,000 and $8,000, respectively, to the IRS and the California Franchise Tax Board to satisfy taxpayer's tax liabilities. In addition, disbursements totaling $232,623 were made to the taxpayer. During 2000, personal items charged to the company credit card were $26,338. The taxpayer reimbursed $14,059 to Caspian in 2000 through payroll deductions.

Issue. Whether the $232,623 and $26,338 corporate payments in 1999 and 2000, respectively, constituted a constructive dividend to the taxpayer or whether they were loans.

Analysis. A loan is defined as an agreement, either express or implied, whereby one person advances money to the other and the other agrees to repay it upon such terms as to time and rate of interest, or without interest, as the parties may agree. Seven factors relevant in determining whether a transaction qualified as a true loan as cited in *Welch v. Commissioner*,[5] include whether:

1. A promise to repay is evidenced by a note or other instrument
2. Interest is charged
3. A fixed schedule for repayments was established
4. Collateral was given to secure payment
5. Repayments were made
6. The borrower had a reasonable prospect of repaying the loan and the lender had sufficient funds to advance the loan
7. Parties conducted themselves as if the transaction were a loan

Holding. The Tax Court held the corporate payments were **not** constructive dividends but were loans for the following reasons:

1. The accountant testified the $14,059 payment made by the taxpayer represented interest on the amounts "borrowed by the taxpayer" during 1999 and 2000 at an interest rate of 6.2%.
2. The corporation had sufficient funds to advance the amounts.
   - The taxpayer had sufficient resources to repay the advanced amounts.
   - The taxpayer testified all monies "borrowed" during 1999 and 2000 have subsequently been repaid.

Schedule M-3
IRS News Release IR-2005-52, April 26, 2005

☞ Help Available Including Instructions and FAQs

Schedule M-3, *Net Income (Loss) Reconciliation for Corporations with Total Assets of $10 Million or More,* is required to be filed by 50,000 large and mid-size corporations along with their Form 1120.

The IRS partnered with stakeholder groups to provide Schedule M-3 FAQ service which is found at **www.irs.gov/businesses/corporations/article/0,,id=136967,00.html.**

The stakeholder groups assisting with this project included:

- American Bar Association,
- Association for Computers and Taxation,
- American Institute of Certified Public Accountants,
- American Taxation Association,
- Manufacturers Alliance, and
- Tax Executives Institute.

13

5. *Welch v. Commissioner,* 204 F.3d 1228, March 1, 2000

S Corporation Audits

IR 2005-76, July 25, 2005

☞ IRS Announces S Corporation Audits

IRS announced the next phase of the National Research Program (NRP) will examine 5,000 randomly selected S corporation returns from tax years 2003 and 2004. The last reporting compliance study of S corporation occurred in 1984.

Since the mid-1980s, the number of S corporations has risen rapidly, growing from 724,749 in 1985 to 3,154,377 in 2002. The growth rate has been even faster for S corporations with over $10 million in assets.

The NRP study is expected to begin later in 2005.

S Corporation Shareholder Salaries

Report to the U.S. Senate

☞ S Corporation Shareholders Receiving Distributions Rather than Salaries

Tax professionals have always considered the exclusion of S corporation earnings from self-employment tax. According to a recent IRS study, the practice of taking a low or no salary has risen to a level that it will become a special project during the upcoming audits of S corporations.

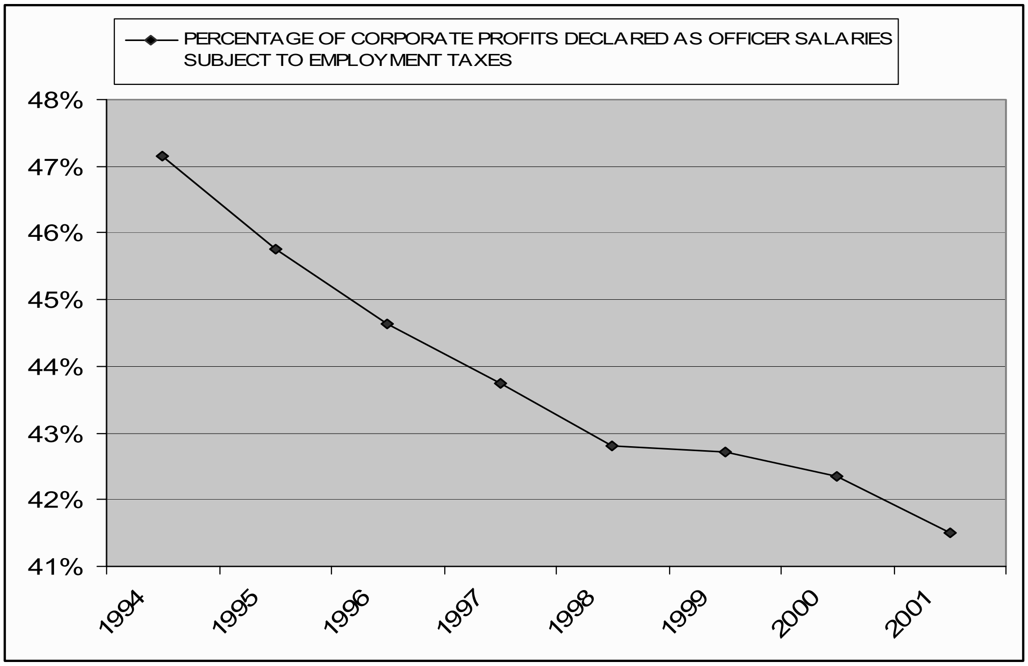
In a report to the Senate Finance Committee, J. Russell George, Treasury Inspector General for Tax Administration, announced the results of a recent study. In Tax Year 2000, the owners of 36,000 single-shareholder S corporations received no salaries from their corporations. However, the operating profits from these same corporations exceeded $100,000. This resulted in no payroll taxes being paid on $13.2 billion in profits.

Mr. George related the 2001 Tax Court case of a veterinarian who was the sole shareholder of his corporation. The corporation produced over $400,000 in total profits over three years, but the owner paid no salary to himself, instead taking the profits as distributions. The court agreed a salary should have been paid and assessed appropriate payroll taxes.[6]

The following chart indicates the decline in officers' salaries since 1994. The downward trend is probably the result of the reduction in audits of S corporations. Consequently, the IRS is increasing the number of audits, but they are hindered by budget constraints.

6. *Veterinary Surgical Consultants, P.C. v. Commr.*, 117 TC 141, October 15, 2001

Officer Salaries Declared by Single-Shareholder S Corporations As a Percentage of Operating Profits (Tax Years 1994 – 2001)



Source: IRS SOI function data.

Some tax analysts expect Congress to consider treating single-owner and family S corporations the same as partnerships regarding self-employment taxes as early as 2006.

CREDITS

Adoption

Revenue Procedure 2005-31, June 15, 2005
IRC §§23 and 137

☞ Clarification of When Foreign Adoptions Become Final

Background. To provide safe harbors for determining the finality of an adoption of a foreign-born child and treatment of re-adoption expenses.

A credit for qualified adoption expenses (QAE) paid or incurred by an individual in connection with the adoption of an eligible child is allowed.[7] An exclusion is allowed from an employee's gross income for QAE paid or incurred by the employer under an adoption assistance program.[8]

7. IRC §23

8. IRC §137

Foreign Adoption. For an adoption of an otherwise eligible child who is not a citizen or resident of the U.S. when the adoption begins (foreign adoption):

- The credit is allowed only if and when the adoption becomes final, and
- QAE paid or incurred before the tax year in which the adoption becomes final are treated as paid or incurred in the year the adoption actually is finalized.

Safe Harbors. This revenue procedure provides some safe harbors for determining the finality of an adoption of a foreign-born child who has received an "immediate relative" (IR) visa from the Department of State. It provides:

1. Adoption for children receiving an IR2, IR3, or IR4 (simple adoption) visa is considered final in the:
   - Taxable year in which a competent authority enters an adoption decree, or
   - Taxable year in which the home state court enters a decree of re-adoption or otherwise recognizes the decree of the foreign-sending county.
2. Adoption for children receiving an IR4 visa (guardianship or legal custody) is considered final in the taxable year the home state court enters an adoption decree.

Otherwise qualified expenses paid or incurred in connection with a re-adoption meet the requirement that expenses be "reasonable and necessary" for QAE determination. This revenue procedure finalizes the revenue procedure proposed in Notice 2003-15, Announcement 2005-45, including modifications and is effective for QAE paid or incurred after June 15, 2005. The IRS will not challenge taxpayers who apply this revenue procedure for QAE paid or incurred on or before June 15, 2005, for taxable years still open under the statute of limitations.

Health Coverage Tax Credit

IRS Notice 2005-50, July 5, 2005
IRC §35

☞ IRS Provides Guidance on Health Coverage Tax Credit (HCTC)

Purpose. To provide guidance on miscellaneous issues related to the HCTC.

Background. IRC §35 allows a 65% tax credit for amounts certain individuals spend on certain kinds of health coverage for themselves and certain family members. HCTC may be claimed for eligible coverage months by eligible individuals. Three categories of individuals include eligible:

1. Trade Adjustment Assistance recipients,
2. Alternative Trade Adjustment Assistance recipients, and
3. Pension Benefit Guaranty Corporation recipients.

In addition, this notice provides answers to many frequently asked questions about the HCTC. A sample question is:

Can an eligible individual claim the HCTC for amounts paid for qualified health coverage of a qualifying family member if the qualified health coverage does not cover the eligible individual?

Alleged Self-Employment Income

***Keisha Sampson v. Commissioner*, TC Summary Opinion 2005-30, March 23, 2005**
IRC §§32 and 61

☞ Taxpayer Failed to Prove Existence of Reported Self-Employment Income for EIC Purposes

Facts. The taxpayer filed her 2002 tax return using head of household filing status. She claimed two dependency exemptions for her children. The only income reported was the net profit from her Schedule C business, the details of which are shown below.

Gross income	$15,935
Less: office expense	(410)
Less: phone expense	(1,200)
Schedule C net profit reported on return	**$14,325**

The Schedule C reported a principal business of "Secretarial/Office Administrative Services." The business address shown was other than the taxpayer's place of abode, which was a leased unit in a public housing complex for low-income individuals.

The taxpayer's 2002 tax return reported the following:

AGI (Schedule C net profit)	$14,325
Less: standard deduction (head of household)	(6,900)
Less: exemptions (3 × $3,000)	(9,000)
Taxable income	($ 1,575)
Income tax	$ 0
Self-employment tax	2,024
Earned income credit (for two qualifying children)	(3,970)
Refund (issued by IRS)	($ 1,946)

In its exam, the IRS determined that the Schedule C was fictitious and ignored it. Therefore, according to the IRS, the taxpayer had no earned income and was entitled to no earned income credit. In addition, the taxpayer had no self-employment tax liability.

Issue. Whether the taxpayer received income from self-employment.

Analysis. At the trial, the taxpayer testified that she had a babysitting business and also mowed yards, cleaned houses, and did several different things to earn a living. However, she failed to provide any documentary evidence to corroborate her testimony.

Holding. The court concluded that the taxpayer did not have any self-employment income for 2002 and ordered the taxpayer to refund the EIC paid to her.

13

Earned Income for EIC Purposes

***DeLinda V. Rogers v. Commissioner*, TC Memo 2004-245, October 27, 2004**

IRC §32

☞ Wages Earned While Incarcerated Do Not Qualify as Earned Income

Facts. While incarcerated in a federal correctional institution, the taxpayer was paid 1998 wages of $1,658 by Unicor-Federal Prison Industries. Her 1998 tax reported zero taxable income and $128 of earned income credit (EIC), which she received. The IRS issued a notice of deficiency for the previously refunded $128 EIC amount.

Issue. Whether an inmate of a penal institution is entitled to earned income credit on wages earned outside a prison.

Analysis. According to IRC §32(c)(2)(B)(iv), wages earned by an individual who is an "inmate at a penal institution" are excluded from the definition of earned income for EIC purposes.

Taxpayer's Argument. The taxpayer contended that the code section cited above did not apply because:

- She performed services at a location outside the prison
- Her work was voluntary rather than compulsory

Holding. "Under the plain and literal language of IRC §32(c)(2)(B)(iv), it makes no difference whether taxpayer performed services at a location outside the penal institution or whether her performance of services was voluntary or compulsory."

Since she was an "inmate at a penal institution" throughout 1998, her wages of $1,658 do not qualify for EIC purposes. Therefore, the court upheld the IRS assessment of additional tax.

DEDUCTIONS

Health Savings Account (HSA)

Revenue Ruling 2005-25, May 2, 2005

IRC §223

☞ Eligible Individual Criteria Clarified

Purpose. To determine if a married individual is eligible to contribute to a Health Savings Account (HSA) if the spouse has non-high deductible health plan (HDHP) family coverage that does not cover the individual and, if eligible, what the maximum contribution limit is.

Analysis. Deductions are allowed for contributions to an HSA for an eligible individual.[9] An eligible individual 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[10]

There are special rules for married couples.[11] Generally, if either spouse has family coverage, both spouses are treated as having such coverage. In addition, if each spouse has family coverage under different health plans, both spouses are treated as having such coverage under the plan with the lowest deductible. However, if a spouse has HDHP family

9. IRC §223(a)
10. IRC §223(c)(1)(A)
11. IRC §223(b)(5)

coverage and the other spouse has non-HDHP self-only coverage, the spouse with the HDHP family coverage is an eligible individual and may contribute to an HSA up to the amount of the annual contribution limit. The spouse covered by the non-HDHP is not an eligible individual and may not contribute to an HSA.

Situation 1. Henry and Willa, both age 35, are married. During 2005, Henry has self-only coverage under a HDHP with an annual deductible of $2,000. Willa has non-HDHP family coverage for both of them plus Willa's two children. Henry is excluded from Willa's coverage. **Henry is an eligible individual and may contribute up to $2,000 to an HSA. Willa has non-HDHP coverage, and is not an eligible individual.**

Situation 2. Same facts as **Situation 1**, except Henry has HDHP family coverage. The family coverage includes Henry and one of their children with a $5,000 annual deductible. Willa has non-HDHP family coverage for herself and their other child. Henry is excluded from Willa's coverage. **Henry is an eligible individual and may contribute up to $5,000 to an HSA. Willa has non-HDHP coverage, and is not an eligible individual.**

Situation 3. Same facts as **Situation 1,** except Henry has HDHP family coverage. The family coverage includes Henry and both of their children with a $5,000 annual deductible. Willa is not covered under Henry's health plan and has no other health plan coverage. **Henry is an eligible individual and may contribute up to $5,000 to an HSA. Willa has no health plan coverage and is not an eligible individual.**

Holding. In the situation where an individual's spouse has non-HDHP family coverage which does not cover the individual, the individual may contribute to an HSA. The maximum the individual may contribute to the HSA is based on whether the individual has self-only or family HDHP coverage.

Health Savings Account (HSA)
U.S. Treasury Website
IRC §223

☞ Website Displays Many Frequently Asked Questions

The U.S. Treasury website provides additional depth and clarity on many questions surrounding the increasingly popular health savings accounts (HSAs). The current website location is: **www.treas.gov/offices/public-affairs/hsa/faq1.shtml**

This website provides useful information such as:

- A married couple's tax filing status doesn't affect a particular spouse's contribution,
- When a spouse has a flexible spending arrangement (FSA) or an HSA through the employer, the taxpayer cannot have an HSA if the spouse's FSA or HSA can pay medical expenses before the HDHP deductible has been met, and
- When both spouses have HDHP coverage but one spouse has other coverage, then contribution limits for spouses vary depending on specific circumstances.

> **Note.** Keep in mind these questions do not have the authority of an IRS ruling or notice.

HSA Contributions

IRS Notice 2005-8, January 24, 2005

IRC §223

☞ Guidance on Partner and Shareholder Contributions to HSA

Purpose. To provide guidance on partnership contributions to a partner's health savings account (HSA) and S corporation contributions to a 2% shareholder-employee's HSA.

Background. Eligible individuals are permitted to establish health savings accounts (HSAs) for taxable years beginning after December 31, 2003.[12] Generally, contributions made to an HSA, by or on behalf of a taxpayer who is an eligible individual, are deductible by a taxpayer.[13] The deduction is an adjustment to gross income under §62(a)(19). If an employer makes a contribution within permissible limits to an HSA on behalf of an employee who is an eligible individual, the contribution is excluded from the employee's gross income and wages.

A partnership may also contribute to a partner's HSA and an S corporation may contribute to the HSA of a 2% shareholder-employee (as defined below).

This notice contains examples to illustrate the tax treatment of partnership and S corporation contributions to employee HSAs.

Health Insurance Deduction for Self-Employed Individuals

Chief Counsel Advice 200524001, June 17, 2005

IRC §162

☞ Self-Employment Earnings Cannot Be Aggregated for Determining Deduction Limit

Purpose. To determine:

1. If a self-employed sole proprietor can deduct medical insurance costs for both the sole proprietor, spouse, and dependents from the earned trade or business income when the health insurance is issued in the individual's name **not** in the business name, and
2. If the profits and losses from two or more businesses may be combined to establish the net income ceiling for claiming insurance cost deductions.

Analysis. An employee is allowed to deduct amounts paid during the taxable year for insurance premiums to provide medical care for the taxpayer, spouse, and dependents.[14] However, no deduction is allowed to the extent that the premium amount exceeds the taxpayer's earned income derived from the trade or business for which the medical care coverage plan is established.[15]

One of the reasons for enacting the IRC §162(1) deduction was that the existing rules relating to the exclusion from gross income for benefits under employer accident or health plans created unfair distinctions between self-employed individuals and corporate owners. Corporate owners could exclude from gross income health benefits provided by the corporation. However, no similar exclusion was available to self-employed individuals. Congress enacted a deduction for self-employed health insurance premiums for taxable years beginning after December 31, 1998 "in order to reduce the disparity of treatment between insurance expenses of self-employed individuals and employer-provided health insurance and to help make health insurance more affordable for self-employed individuals."

12. IRC §223
13. IRC §223(a)
14. IRC §162(1)(1)(A)
15. IRC §162(1)(2)(A)

This statute requires that a plan be established under a trade or business to be qualified for the deduction. Generally, the earned income from only that trade or business can be considered. However, if the self-employed individual establishes a medical plan under business A and a dental plan under business B, the earned income from each business is considered.

Based on IRC §162(1) limitations, a sole proprietor who purchases health insurance in his name, rather than his business' name, has established a plan providing medical care coverage for himself, his spouse, and dependents under IRC §162(1), but only to the extent that the cost does not exceed the earned income from the specific trade or business.

Rulings.

1. A self-employed sole proprietor may deduct medical care insurance costs of the sole proprietor, spouse, and dependents from the earned income of the trade or business when the health insurance policy purchased by the sole proprietor is issued in the individual's name and not in the name of the sole proprietor's trade or business.
2. The health insurance cost deductions must be claimed for a specific plan providing medical care coverage established under a specific trade or business name and the deductions are limited to the earned income of that specific trade or business.[16] However, if a self-employed individual has more than one trade or business, he may deduct the medical care insurance costs of the self-employed individual, spouse, and dependents under **each** specific health insurance plan established under each specific business up to the net earnings of that specific trade or business.

Domestic Production Activities

IRS Notice 2005-14, February 14, 2005
IRC §199

☞ Guidance on Income Attributable to Domestic Production Activities

Purpose. To provide interim guidance about income attributable to domestic production activities to balance the goals of ensuring compliance for IRC §199 and providing clear, administrative rules that minimize the administrative burden on taxpayers and the IRS. This notice applies to all taxable years **beginning after December 31, 2004.**

Background. IRC §199 provides a deduction from gross income for an applicable percentage of qualified production activities income subject to certain limits.

This 39-page document should be used for guidance until the regulations are issued.

> **Note.** See Chapter 15, "Domestic Production Activity Deduction," for further information.

16. IRC §162

13

Flexible Spending Accounts
IRS Notice 2005-42, May 31, 2005
IRS Notice 2005-61, September 8, 2005
IRC §125

☞ Grace Period Eased for "Use-It-or-Lose-It" Rule

Purpose. To allow employers to adopt a grace period immediately following the end of each IRC §125 and §129 plan year, allowing unused benefits or contributions remaining to be paid or reimbursed to plan participants for qualified benefit expenses incurred. The grace period allows an additional 2½ months to use up the funds.

The IRS also provides guidance on the Form W-2 reporting requirements resulting when an employer amends a cafeteria plan to allow a grace period for qualified dependent care assistance immediately following the end of a cafeteria plan year.

Background. An IRC §125 cafeteria plan may not include any plan that offers a benefit that defers the receipt of compensation. For example, a plan which allows participants to defer compensation by permitting them to use contributions for one plan year to pay for a benefit provided in a later year is **not** an allowable cafeteria plan. This rule is commonly referred to the "use-it-or-lose-it" rule.

An employee's gross income **excludes** amounts paid by the employer for dependent care assistance when it is provided through a qualified dependent care assistance program.[17]

The IRS now allows an employer to **amend** a cafeteria plan document to provide a grace period immediately following the end of each plan year. The grace period must apply to all participants in the plan and cannot extend beyond 2½ months after the end of the plan year.

In a cash reimbursement arrangement, such as dependent care assistance furnished by an employer under a qualified dependent care assistance program, the amount reported on Form W-2 is the total cash reimbursement furnished to the employee during the calendar year. However, if the employer does not know the actual total amount of cash reimbursement at the time the Form W-2 is prepared, the employer may report a **reasonable estimate of the total amount on Form W-2**. The reasonable estimate is the amount annual employee contribution for dependent care assistance plus any employer-matching contributions.[18]

Employers who amend cafeteria plans to provide a grace period for dependent care assistance should prepare the Form W-2 according to instructions found in Notice 89-111.

Example 1. An employer with a cafeteria plan ending on December 31, 2005 amends the plan document before December 31, 2005, permitting a grace period that extends through March 15, 2006. An employee, who originally elected $1,000 salary reduction for a qualified dependent care assistance plan, has a remaining balance of $200 on December 31, 2005. The same employee elects a $1,500 deferral for the year ending December 31, 2006. From January 1, 2006 through March 15, 2006, the employee incurs $300 of unreimbursed medical expenses. The employee has a balance of $1,400 remaining in the qualified dependent care assistance plan for plan year ending December 31, 2006 after the following are reimbursed:

- $200 (December 31, 2005 remaining balance paid within the grace period)
- $100 (December 31, 2006 plan)

17. IRC §129
18. IRS Notice 89-111, December 4, 1989

Example 2. Use the same facts as in **Example 1,** except the employee incurs $150 of daycare expenses during the grace period. In this case, the $150 would be paid from the December 31, 2005 plan leaving a balance of $50. **This unused balance cannot be cashed-out, converted to any other taxable or nontaxable benefit, or used in any other plan year.** Since the employee did not use it within the extended grace period, the $50 is forfeited. As of March 15, 2005 the employee would have the entire $1,500 balance in his December 31, 2006 qualified dependent care assistance plan.

As outlined in IRS Notice 89-111, the amount reported on the 2005 Form W-2 is the originally elected $1,000 salary reduction since it is assumed the additional amounts will be used up during the grace period. **However, when the employee files the 2005 individual tax return, he will only be able to substantiate $950 of qualified dependent care expense. This results in a $50 taxable Dependent Care Benefit (DCB) which is added to wages on line 7 of the Form 1040.**

Accountable Plans

Revenue Ruling 2005-52, August 3, 2005

IRC §§61 and 62

☞ Nonaccountable Plan Reimbursements Includable in Gross Income

Purpose. To provide guidance about whether tool allowances paid by the employer to employees under an accountable plan are allowed to be excluded from the employees' gross income and are exempt from the withholding and payment of employment taxes.

Facts. An employer operates an automobile repair and maintenance business. The employees are required to provide and maintain various tools. In addition to receiving an hourly wage, the employees receive an established "tool allowance" based on hours worked.

The calculation of the tool allowance is a two-step process.

1. The tool allowance is determined on an annual basis using a combination of national survey average tool expenses and information provided by the employee.
2. The annual rate is converted into an hourly rate based on projected hours to be worked during the year.

At the end of each pay period, the employee reports the hours actually worked that required use of the tools. The employer computes the appropriate tool allowance and pays the employee the corresponding amount.

Each quarter, the employer furnishes a statement to each employee. The statement describes the amount paid to the employee as a tool allowance during the quarter and the tool expenses estimated to be incurred in the quarter (i.e., the hours reported worked requiring the use of tools multiplied by the tool allowance).

Employees are **not required** to provide any substantiation of expenses actually incurred for tools either before or after the quarterly reports are issued. The employer does not require employees to return their excess tool allowance, either before or after the quarterly reports are issued.

Analysis. Gross income is defined as all income from whatever source derived, including compensation for services, fees, commissions, fringe benefits, and similar items.[19]

13

19. IRC §61

An employer can deduct certain business expenses reimbursed to the employee in connection with the performance of services under a reimbursement or other expense allowance arrangement.[20] Such arrangements are not treated as a reimbursement or other expense allowance if the arrangement:

- Does not require the employee to substantiate the expenses covered by the arrangement to the employer, or
- Allows the employee to retain any amount in excess of the substantiated expenses covered under the arrangement.[21]

In order to be considered an accountable plan, a plan must have a business connection, require the employee to substantiate expenses to the employer, and return any reimbursement in excess of expenses.

An arrangement meets the business connection requirement if it provides advances, allowances, or reimbursements only for business expenses that are allowable as deductions and are paid or incurred by the employee in connection with his performance of services as an employee.[22] However, if an employer arranges to pay an amount to an employee, regardless of whether the employee incurs (or is reasonably expected to incur) bona fide employee business expenses, the arrangement does not satisfy the business connection requirements and all amounts paid under the arrangement are treated as paid under a nonaccountable plan.

An arrangement meets the return of excess reimbursement requirement if the arrangement requires the employee to return, within a reasonable period of time, any amount paid under the arrangement in excess of substantiated expenses.[23]

Since this arrangement fails to satisfy the requirements of an accountable plan, the amounts paid to the employees must be reported as wages or other compensation on Form W-2. These amounts are subject to withholding and payment of income and employment taxes.

Holding. The arrangement is a nonaccountable plan and all tool allowance payments must be included as wages on the employees' Form W-2 and are subject to withholding and payment of federal employment and income taxes.

Standard Meal Allowance

U.S. Department of Agriculture

IRC §162

☞ 2005-2006 Standard Meal Allowance Rates for Daycare Providers

The U.S. Department of Agriculture, Child and Adult Care Food Program, determines the standard meal and snack allowance deductions allowable under IRC §162. For the period of July 1, 2005 through June 30, 2006, the rates are:

	Contiguous 48 States	Alaska	Hawaii
Breakfast	$1.06	$1.68	$1.23
Lunch/Dinner	1.96	3.17	2.29
Snack	0.58	0.94	0.68

The rates are equal to the Tier 1 reimbursement rates of the CACFP for meals served in day care homes. They will be adjusted each year and can be found at **www.fns.usda.gov/cga/Federal-Register/2005/071805.pdf.**

20. IRC §62
21. IRC §62(c)
22. Treas. Reg. §1.62-2(d)(1)
23. Treas. Reg. §1.62-2(f)(1)

Clean-Fuel Vehicle

IRS News Release IR-2005-14, February 10, 2005
Tax Tip 2005-57, March 22, 2005
IRS News Release IR-2005-69, June 27, 2005

☞ IRS Certifies Vehicles for Clean-Fuel Vehicle Deduction

Taxpayers who purchase clean-fuel vehicles are allowed up to a $2,000 one-time deduction. The deduction can be taken only by the original owner in the first year of a vehicle's use. Taxpayers do not have to itemize their returns to claim the deduction; it is taken as an adjustment to income by writing in "Clean-Fuel" to the left of line 36 on the 2005 Form 1040.

A vehicle does not have to be used in a trade or business to qualify, but it must meet certain qualifications to be eligible for the adjustment. These qualifications are listed in Chapter 12 of IRS Pub. 535, *Business Expenses.*

The IRS certified that the following vehicles meet the qualifications for the clean-fuel adjustment for the model year(s) indicated:

	2002	2003	2004	2005
Toyota Prius	X	X	X	X
Honda Insight	X	X	X	X
Honda Civic Hybrid		X	X	X
Honda Accord Hybrid				X
Ford Escape Hybrid				X

The clean-fuel deduction sunsets after 2005, but the Working Families Act of 2004 allows a credit up to $500 in tax year 2006 for the purchase of clean-fuel vehicles.

The IRS has certified the following vehicles are qualified for the 2006 clean-fuel credit:

- Lexus RX 400h
- Toyota Highlander Hybrid

Archer MSAs

IRS Announcement 2005-12, February 14, 2005
IRC §220

☞ 2004 is not Archer MSA "Cut-off" Year

Purpose. If the number of Archer medical savings account (Archer MSA) returns filed for 2004 exceed 750,000, then February 1, 2005 is the "cut-off" date for the Archer MSA pilot project.[24] Since the number filed for 2003 and 2004 total less than 140,000, 2004 is not a "cut-off" year.

Background. Effective January 1, 1997, IRC §220 was added to permit eligible individuals to establish Archer MSAs. Originally the "cut-off" year was 2005, however, the "cut-off" year could have been earlier if certain numerical limitations occured.

24. IRC §§220(i) and (j)

If the year is determined to be a "cut-off" year, no individual is eligible for a deduction or exclusion for Archer MSA contributions unless the individual:

- Was an active Archer MSA participant for any taxable year before the "cut-off" year, or
- First become an active Archer MSA participation after the "cut-off" year because of coverage under a high deductible health plan (HDHP) of an Archer MSA participating employer.

The pilot project cut-off limitation is 750,000.[25] IRC §220(j)(2)(B) provides an alternative test for reaching the 750,000 limitation as well.

Depreciation

Revenue Procedure 2005-13, March 21, 2005

IRC §§167 and 280F

☞ IRS Announces New Depreciation Limits for Business Autos, Light Trucks, and Vans Placed in Service in 2005

Annual depreciation dollar caps for vehicles subject to the luxury-auto limits of IRC §280F and placed in service after December 31, 2004 but before January 1, 2006 are shown in the table below.

Vehicles Subject to Luxury-Auto Limits (Information Taken from Tables 1, 2, and 3)	Annual Depreciation Limitations			
	Year 1	Year 2	Year 3	Year 4
Autos	$2,960	$ 4,700	$2,850	$1,675
Trucks and vans	3,260	5,200	3,150	1,875
Electric automobiles (propelled primarily by electricity and built by an original equipment manufacturer)	8,880	14,200	8,450	5,125

If the business use of the vehicle is less than 100%, the dollar limits shown in the above table must be reduced accordingly. For example, if a taxpayer buys a new truck in 2005 and uses it 60% for business, the first year dollar limit is $ 1,956 ($3,260 × 60%).

Tables 4, 5, and 6 are used to compute the amount for inclusion in income of lessees of passenger autos, trucks/vans, and electric automobiles, accordingly.

> **Note.** Tables 4 and 5 can be found in Chapter 9, "Small Business Issues."

[25] IRC §220(j)(2)(A)

Business Ownership

***Bill J. and Sarah J. Malone v. Commissioner*, TC Memo 2005-69, April 4, 2005**

IRC §162

☞ Children As Owners of Business

Facts. Both taxpayers were musically inclined and were determined to make music education an important aspect of their eight home-schooled children's instruction. The two oldest children, who were teenagers at the time, began to give piano, harp, and violin lessons to their friends, neighbors, and classmates in 1996. An unincorporated business, Malone Music, was established for the teaching activity of the two children. The instruction took place in the children's rooms in the family residence.

The taxpayers never gave lessons to the customers of their two teenage children. However, they continued to pay for various music lessons for their children with private teachers and bought numerous musical instruments for their family. From 1996 through 2004, the taxpayers bought:

- 2 Steinway pianos
- An upright piano
- 8 violins
- A viola
- A harp
- A trumpet
- 3 guitars
- 2 banjos

These instruments were used by all eight of the Malone children in their music lessons and practice, as well as by the two oldest children in their capacities as paid instructors for Malone Music.

The taxpayers filed a Schedule C for Malone Music on their joint tax returns for the years 1997-2001. The Schedule Cs reported the following:

Year	Gross Income	Total Expenses	Schedule C Loss Claimed
1997	$ 550	$27,898	($27,348)
1998	1,777	28,074	(26,297)
1999	1,917	8,553	(6,636)
2000	2,559	23,123	(20,564)
2001	5,758	26,060	(20,302)

13

The income reported represented the music lesson income generated and received by the two teenage children. The expenses claimed consisted almost entirely of the amounts the taxpayers paid private instructors for music lessons for their children, and the cost of musical instruments.

In its exam of the taxpayers' 1999 and 2000 tax return, the IRS disallowed the claimed Schedule C losses and assessed additional tax.

Position of the IRS. If Malone Music is a "trade or business" for which "ordinary and necessary expenses" were paid under IRC §162, the business is **not** the taxpayers' trade or business. Rather it is the business of the two teenage children who gave the music lessons for Malone Music and who received payments for the lessons from their customers.

Issue. Whether the taxpayers are entitled to deduct the Schedule C losses.

Analysis. The court, in trying to determine who actually owned the sole proprietorship called Malone Music, focused its attention on ascertaining the following:

- Who owned the assets used in the business?
- Which individuals provided the necessary labor?
- How was Malone Music held out to and perceived by the general public?

Holding. The court agreed with the IRS that Malone Music was not the taxpayers' trade or business. Therefore, neither the Schedule C income nor the expenses are properly includable on the taxpayers' 1999 and 2000 joint tax returns.

It appears that the court gave great weight to the testimony of a music teacher who taught many of the Malone children. She testified that the children she taught referred to Malone Music as the oldest child's business. In addition, a website for Malone Music listed only the two teenage children as the instructors for the business.

DEPENDENCY ISSUES

Signed Divorce Decree

***Brooks E. Omans and Tonya R. Omans Rateau v. Commissioner,* TC Summary Opinion 2005-110, August 1, 2005**
IRC §§24 and 152

☞ Noncustodial Divorced Parent Allowed Children's Exemptions Without Form 8332

Facts. Brooks Omans and Jana Lynn Omans were the parents of two minor children when they were divorced in Greene County, Missouri in February 1993. **Incorporated into the divorce decree was a settlement agreement certified by a notary public.** The agreement, which was signed in three different places by Jana Lynn Omans, contained the following:

- The names of the two minor children
- The name of the wife and mother of the two children, Jana Lynn Omans
- The name of the husband and father of the two children, Brooks E. Omans
- A paragraph stating that Jana Lynn Omans agreed:
  1. To "file separate tax returns for the 1992 tax year and for each year thereafter."
  2. That "Brooks E. Omans shall be allowed to claim the parties' minor children as dependents within the meaning of both state and federal income tax laws so long as [he] is current on his monthly child support obligation."
- A notary's certification statement that read: "JANA LYNN OMANS, of lawful age, being first duly sworn upon oath, states that she is the Petitioner in the above-entitled clause, and that she has executed the forgoing AGREEMENT as her free act and deed."

Brooks Omans and his present wife, Tonya, filed a joint 1998 tax return and claimed the dependency exemptions and the child tax credits for the two children from Mr. Omans' first marriage to Jana. Attached to that joint 1998 tax return was a copy of the 1993 divorce decree and the settlement agreement. These documents were used **in lieu of** a signed Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents,* from Jana, who was the custodial parent.

Due to the duplicate claiming of the two children as dependents, an IRS examination was conducted for the 1998 tax returns of both:

- Brooks (the noncustodial parent) and Tonya Omans, and
- Jana Johnmeyer (the custodial parent) and her second husband.

An IRS Appeals officer concluded that Brook and Tonya Omans were not entitled to claim the two children from Brooks' first marriage as exemption unless they could secure a signed Form 8332 from Jana, the custodial parent.

Jana did eventually sign a Form 8332 for the 1998 tax year; however, it was not executed properly. The IRS Appeals Officer called her and requested that she file an amended 1998 joint return and voluntarily remove the two children as dependents. She wrote the Appeals Officer and declined to amend the 1998 joint return she filed with Mr. Johnmeyer, stating that "she signed the Form 8332 under duress."

Issue. Whether the taxpayers are entitled to claim the dependency exemptions and the child tax credits for the two children of the husband's first marriage.

Analysis and Holding. The Tax Court ruled in favor of the taxpayers, Brooks (the noncustodial parent) and Tanya Omans, and allowed them to claim both the dependency exemptions and the child tax credits for the two children for 1998. The Tax Court reasoned the following in granting the exemptions to the noncustodial parent in spite of the absence of a properly completed Form 8332 from Jana Johnmeyer, the custodial parent:

- The settlement agreement signed by Jana contained all the elements required in a Form 8332 **except:**
  1. The social security numbers of both parents, and
  2. A literal reference to 1998, the tax year in question.

  The court noted that the social security numbers are **not required** by the language of IRC §152(e)(2).[26]

> **Note.** The *Bramante* case analysis is shown on pages 587–588 in the *2003 University of Illinois Federal Tax Workbook.*

- The court placed great reliance on the fact that the settlement agreement portion of the divorce decree was notarized and signed in three places by Jana. The court noted: "The certification of her signature by a notary public imports prima facie truth of its own pertinent recitals."[27]
- The court also noted that in October 2004, as part of the **Working Families Tax Relief Act of 2004,** IRC §152(e)(2) was amended. **Under this revision, the noncustodial parent is entitled to the dependency exemption where:**
  1. The custodial parent signs a written declaration waiving the right to claim it (executing Form 8332), **or**
  2. The dependency exemption is allocated to the noncustodial parent pursuant to a state divorce decree.

13

26. *Bramante v. Commr.,* TC Memo 2002-228, 84 TCM 299, September 12, 2002

27. *Estate of Williams v. Commr.,* TC Memo 1955-321, December 8, 1955

> **Note**. This is a summary opinion of the Tax Court. As such, it cannot be treated as precedent for any other case. The decision in this case represents a rare tax victory for a noncustodial parent who does not have a properly prepared Form 8332 from the custodial parent. The amendment to IRC §152(e)(2) mentioned above should provide more of these favorable tax results to noncustodial divorced parents.

Unsigned Divorce Decree

***Zachary S. and Lisa C. Curello v. Commissioner*, TC Summary Opinion 2005-23, February 24, 2005**

IRC §§24 and 152

☞ Unsigned Divorce Decree Not a Valid Substitute for Form 8332

Facts. Zachary Curello and his former wife were divorced in 1995. The Connecticut divorce decree stated that Zachary was entitled to claim the couple's child as an exemption for federal and state income tax purposes for every year he was current in his child support payments. Mr. Curello's ex-wife had legal and physical custody of their minor child throughout 2001, the year in question.

Even though he asked his ex-wife to sign Form 8332, *Release of Claim to Exemption for Child of Divorced Parents,* she refused to do so. Zachary and his present wife, Lisa, filed their joint 2001 return and claimed the exemption of the minor child of Zachary's previous marriage plus the $600 child tax credit for the child.

The 2001 joint return of the taxpayers contained neither a signed Form 8332 nor a similar statement from the ex-wife. Nor were pertinent portions of the decree attached as a substitute for a signed Form 8332. The IRS disallowed both the exemption and the child tax credit and assessed additional tax.

Issue. Whether the taxpayers are entitled to a dependency exemption and the child tax credit for the taxpayer-husband's minor child from his previous marriage.

Analysis. IRC §152(e)(2) provides an **exception to the general rule** regarding dependency exemption of a child of divorced or separated parents. For that exception, the child is treated as receiving more than half of his support from the noncustodial parent if the:

- Custodial parent signs a written declaration (Form 8332 or similar statement) that the custodial parent will not claim the child as a dependent, and
- Noncustodial parent attaches the written declaration to the noncustodial parent's return.

However, for divorce decrees issued after 1984, pertinent portions of the decree can serve as a substitute for a signed Form 8332 under certain conditions.

Holding. The court upheld the disallowance of the exemption and the child tax credit because the conditions contained in the exception to the general rule were not met. The taxpayers failed to attach a signed Form 8332 or similar statement to their joint 2001 tax return. In addition, portions of the divorce decree could not serve as a valid substitute for a signed Form 8332 for the following reasons:

- The divorce decree was not signed by Mr. Curello's ex-wife.[28]
- Even if it had been signed by the ex-wife, the decree did not **unconditionally** grant the dependency exemption to Mr. Curello due to the "current in child-support payments" requirement.

Note. See page 6 in the *2004 University of Illinois Federal Tax Workbook* for more information on this issue.

DEPRECIATION

Pay Phones

***Edward R. Arevalo v. Commissioner,* 124 TC No. 15, May 18, 2005**
IRC §§44 and 167

☞ Depreciation and Tax Credit Not Allowed on Pay Phone Investment

Facts. In 2001, Edward Arevalo entered into a contract with American Telecommunications Co. (ATC) to purchase "telephone pay phone equipment" for $10,000. The ATC pay phone agreement provided the taxpayer with legal title to the "telephone equipment," however did not identify any pay phone subject to the agreement. In addition to a bill of sale and delivery, the agreement also included many other provisions including a "buy-back election" and a recommended schedule of weekly maintenance work to be performed on the pay phones by the taxpayer.

Mr. Arevalo also entered into an agreement with Alpha Telcom (AT) whereby AT would service and maintain the pay phones for the first three years in exchange for 70% of the monthly adjusted gross revenue from the pay phones. ATC responsibilities included:

- Negotiating the site agreement with the owner/leaseholder of the premises where the pay phones were to be installed
- Installing the pay phones
- Paying the insurance premiums on the pay phones
- Collecting and accounting for the revenues generated by the pay phones
- Paying vendor commissions and fees
- Obtaining all licenses needed to operate the pay phones
- Taking all actions necessary to keep the pay phones in working order

The sales representative for ATC told Mr. Arevalo that the income from the pay phones was taxable, but that it could be offset by depreciation on the pay phones. In addition, the amounts spent also qualified as an IRC §44 tax credit for compliance with the American Disabilities Act of 1990 (ADA) as a result of modifications to make these phones compliant with ADA. Mr. Arevalo was never told the location of his pay phones. The depreciation and credit ($1,894) were claimed on his 2001 tax return.

[28] *Miller v. Commr.*, 114 TC 184, 189, March 24, 2000

Issue. Whether the taxpayer is entitled to claim a deduction for depreciation under IRC §167 and tax credit under IRC §44 for his investment in two public pay phones.

Analysis. A depreciation deduction for a reasonable allowance for the "exhaustion, wear and tear" of property is allowed if the property is:

1. Used in a trade or business, or
2. Held for the production of income.

In instances such as this, some of the factors considered by courts include:

- Whether legal title passes
- How the parties treated the transaction
- Whether an equity was acquired in the property
- Whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments
- Whether the right of possession is vested in the purchaser
- Which party pays the property taxes
- Which party bears the risk of loss or damage to the property
- Which party receives the profits from the operation and sale of the property

Mr. Arevalo contends that he "purchased" the pay phones from ATC and, therefore, held the benefits and burdens of ownership for the pay phones. After considering the relevant factors and weighing the facts and circumstances surrounding the transactions between Mr. Arevalo, ATC, and Alpha Telcom, the Tax Court rejected the contention.

Mr. Arevalo did not receive the benefits and burdens of ownership for the pay phones. Because Mr. Arevalo never received a depreciable interest in the pay phones, he is not entitled to claim a depreciation deduction for them.

In order for an expenditure to qualify as an eligible access expenditure within the meaning given that term by IRC §44(c), it must have been made to enable an eligible small business to comply with the applicable requirements under the ADA. Because Mr. Arevalo's pay phone activities did not obligate him to comply with the requirements set forth in either ADA Title III or Title IV, his $10,000 investment in the pay phones is not an eligible access expenditure.

Holding. The Tax Court held that the taxpayer did not have benefits and burdens of ownership of the phones, thus precluding allowable depreciation deductions. In addition, since his investment was not "an eligible access expenditure," he was not entitled to claim the disabled access credit.

Truck Stop Facilities

***Iowa 80 Group Inc., et al v. IRS,* U.S. Court of Appeals, No. 04-2826 (8th Circuit), May 4, 2005**
IRC §168

☞ Taxpayer Does Not Qualify as Retail Motor Fuels Outlet

Facts. Iowa 80 Group, Inc. (Iowa 80) owns and operates two multi-building truck-stop facilities adjacent to interstate highways in Missouri and Iowa. Each facility contains the following:

- Buildings (restaurant, TV lounge, showers, laundromat, game room, and movie theater)
- Fuel center
- Truck wash
- Service center

The IRS determined these truck stops have a 30-year depreciable life since the facilities qualify as a retail convenience store.

In 1977, Iowa 80 filed an amended return to claim depreciation using a 15-year life on the main buildings in both facilities based on their qualification as retail motor fuel outlets using either the gross-revenue test or floor-space test.[29] Iowa 80 presented arguments that the main buildings were not convenience stores using the gross revenue test. The IRS disallowed Iowa 80's claims, applying the gross revenue test on a facility building-by-building basis.

The case was appealed to the district court, which held that a retail motor fuel outlet could not encompass several buildings. The Eighth Circuit Court affirmed the district court ruling. However, the case was returned to the district court for consideration as to whether the truck stops qualify under the floor-space test. The district court ruled against Iowa 80 regarding the floor-space test and Iowa 80 appealed.

Issue. Whether the facilities qualify for 15-year life based on the floor-space test found in IRC §168(e)(3)(E)(iii).

Analysis. Nonresidential real property is generally depreciated over a 39-year useful life. An exception exists under Rev. Proc. 87-56 which allows 15-year MACRS depreciation if the property qualifies as a **retail motor fuel outlet**. Under a 1995 IRS Coordinated Issue Paper (CIP) on convenience stores, the taxpayer is required to show that 50% of floor space is devoted to petroleum marketing activities. Counter areas for selling gasoline and auto supplies, adjacent carwash buildings, pump islands, and canopies are considered to be devoted to the marketing of petroleum products. This CIP specifically excludes restaurants from a retail motor fuel outlet. The district court excluded space occupied by a TV lounge, laundromat, showers, restaurants, movie theater, and game room from "petroleum marketing activities." The taxpayer argued unsuccessfully that these are used to attract professional truck drivers to fuel at these facilities. The appellate court compared the services offered by the taxpayer to those services offered by traditional service stations.

Holding. The Eighth Circuit held the taxpayer did not meet the floor-space test, thereby it does not qualify as a retail motor fuel outlet.

DIVORCE ISSUES

Alimony

***John R. and Patricia G. Okerson v. Commissioner*, 123 TC 258, No. 14, September 9, 2004**
IRC §71

☞ Alimony Must Completely Terminate Upon the Death of Payee-Spouse

Facts. John and Barbara Okerson were divorced in 1995. According to the original divorce decree and a later supplemental decree, John was ordered to make the following monthly payments:

- 113 monthly payments to Barbara, his ex-wife, totaling $117,000
- 41 monthly payments to Barbara's attorney totaling $33,500 (for her legal fees)

The two decrees stated that the monthly payments would terminate if Barbara died before either the 113 or the 41 monthly payments had been paid in full.

However, if Barbara died before the $117,000 was paid in full, John was required to continue to make substitute monthly payments for future college education expenses of John and Barbara's two children. Similarly, if Barbara died before the $33,500 legal fees were paid, John was obligated to continue making the monthly payments to her attorney until he was fully paid.

29. IRC §168(e)(3)(E)(iii)

In 2000, John paid and deducted $21,600 of alimony payments. In 2003, the IRS disallowed the alimony deduction. In response to the IRS disallowance, John petitioned the state court to modify the two decrees. **The state court issued an order in 2004, which stated:**

- The 113 and 41 required monthly payments have now been paid in full.
- All of the ordered payments were intended by the court to qualify as alimony payments deductible by John and taxable to Barbara.
- The contingency of Barbara's death did not occur and thus this nonevent should not be the basis of confusion as to the court's intent.

Issue. Whether the $21,600 of claimed alimony is deductible.

Analysis. Payments may be deducted as alimony only if all of the following conditions are met:

1. The payments are made in cash.
2. The spouses are not members of the same household at the time the payments are made.
3. The instrument does not designate the payment as not alimony.
4. The payment is not treated as child support.
5. There is no liability to make any payment or a substitute payment after the death of the recipient spouse.[30]

Holding. The court concluded that John was required to make substitute payments after Barbara's death. Therefore, the fifth requirement shown above was not met. As a result, the claimed alimony deduction was properly disallowed. The court also commented that:

- The intent of the parties is immaterial.
- The order of a state court to characterize a payment as alimony has no affect on the determination of the correct application of federal income tax law.
- Whether a taxpayer actually makes post-death substitute payments is not important.

> **Note.** If the two decrees had not tied the potential substitute children's college expenses and the ex-wife's attorney fees to the required monthly payments, the payments would have qualified as alimony. Simply changing the wording and terms of the two decrees would have sufficed.

Property Settlement

***Gerald Barlow v. Commissioner*, TC Summary Opinion 2005-50, April 19, 2005**
IRC §§71 and 215

☞ Division of Husband's Retirement Plan Benefits was a Property Settlement, not Alimony

Facts. Mr. Barlow and his former wife of 37 years were divorced in 1991. The state Circuit Court ordered an equitable distribution of marital assets and awarded alimony to Mr. Barlow's ex-wife. However, none of the alimony payments were made in 2000, the year in question.

30. IRC §71(b)(1)(D)

The divorce decree specifically provided:

1. *Equitable distribution of marital assets shall be as follows:*
   - d. *The Wife is further awarded the following:*
     - 4. *One-half of Husband's retirement plan with City of Lakeland and one-half of retirement/pension plan with State of Florida*
2. *The Husband shall pay to the Wife the alimony awarded to her in this Court's Temporary Order dated February 25, 1991.*

Beginning in December 1992, Mr. Barlow and the City of Lakeland entered into an assignment agreement for his municipal retirement plan and also his supplemental state pension plan. As a result, his former wife began receiving half of both retirement plan benefits from the two plans.

On his 2000 tax return, Mr. Barlow claimed an alimony deduction of $23,378, which represented the one-half portion of his retirement plan benefits paid to his former wife in 2000 by the City of Lakeland. In its exam, the IRS disallowed the claimed alimony deduction and assessed additional tax.

Issue. Whether the retirement plan payments of $23,378 made to the taxpayer's former wife constitute deductible alimony payments by him.

Analysis and Holding. The court agreed with the IRS position that the payments did not represent alimony. The court noted that the divorce decree unambiguously designated the payments from Mr. Barlow's retirement plans as "an equitable distribution of marital assets" in paragraph 1 of the decree. As such, the payments constituted a nondeductible property settlement rather than alimony.

> **Note.** The court did not mention the fact that the taxpayer did not make any of the retirement plan payments to his former wife, which would be another obvious reason for disallowing the claimed alimony deduction.

EMPLOYMENT TAX ISSUES

Worker Classification

***Lisa Beth Levine v. Commissioner,* TC Memo 2005-86, April 14, 2005**

IRC §408

☞ **State Department Worker Determined to be Independent Contractor**

Facts. Lisa Levine was an industrial hygienist who entered into a personal services contract with the State Department to implement the department's occupational health program. Her responsibilities included:

- Managing, coordinating, and implementing the industrial hygienist field technical services program
- Directing evaluation and studies of work environments for health hazards
- Providing specific guidance and assistance to ensure employee protection

13

Her personal services contract ran from July 5, 1998 through July 3, 1999. It entitled her to the same office space, equipment, and supplies as other government employees. Her salary, holiday pay, working hours, annual leave accruals, sick leave accruals, and overtime options mirrored those of other government employees. She received reimbursement for travel expenses, but was not entitled to:

- Coverage under the State Department medical program or the Federal Employees Benefit program,
- Membership in the employee union,
- Park in the employee parking lot,
- Receive subsidies for Metrocheks, or
- Receive performance awards.

Lisa's contract was renewed for a subsequent year. It terminated on November 19, 1999, at which time she was hired as a full-time employee. She was issued a Form W-2 for her earnings as a contractor. Federal and state income taxes, social security, and Medicare were all withheld from her contract earnings.

In March of 2000, Lisa contributed $8,638 to a SEP IRA based on her 1999 contract income. She claimed the SEP IRA deduction on her 1999 return, attaching a statement indicating the Form W-2 issued by the State Department was erroneous since she was a contract employee. She did not pay self-employment tax on her contract earnings.

The IRS disallowed the SEP IRA deduction since Lisa was a common-law employee of the State Department.

Issue. Whether Lisa Levine is an independent contractor, thus being entitled to claim the SEP IRA deduction.

Analysis. The Tax Court reviewed various factors, including:

- Degree of control
- Special skill
- Furnishing of equipment and facilities
- Integral part of the business
- Opportunity for profit or loss
- Termination of relationship
- Permanency of the relationship
- Method of payment
- Social security taxes
- Employee benefits
- Relationship the parties thought they created

The Tax Court cites *Eren,*[31] which involved an architect who worked for the State Department from the late 1970s to at least 1990. Mr. Eren worked at least six years of this time under a personal services contract. The Tax Court determined Mr. Eren was an employee since he was not a specialist hired to solve a problem. The 4th Circuit Court agreed with the Tax Court determination, but noted it was an arguably close case.

---

31. *Eren v. Commr.,* 180 F.3d 594, 597, 4th Cir. 1999, June 14, 1999

Lisa's personal services contract materially differs from the relationship Mr. Eren had with the State Department. She was hired to **evaluate and solve a problem.** The State Department accepted her work without significant change and had little control over the means and manner of her work accomplishments. She was responsible for planning and carrying out the projects. She submitted her evaluations and recommendations in a comprehensive written report when the project was completed and was not required to maintain or submit daily/monthly logs. Her work relationship with the State Department was more transitory than that of Mr. Eren. He worked for many years while her contract lasted a little over a year.

Holding. The Tax Court evaluated the factors and determined Lisa was an independent contractor and allowed the SEP IRA contribution accordingly.

Redesigned Employment Tax Returns

IRS News Release IR-2005-18, February 23, 2005

☞ Redesign of Form 941, *Employer's Quarterly Federal Tax Return*

Shading, bigger boxes, and improved instructions on the newly designed Form 941 are intended to reduce the burden associated with completing and filing this form, as well as eliminate common errors encountered by businesses, tax practitioners, and payroll companies.

Form 941 is shown on the following two pages.

Form **941 for 2005: Employer's Quarterly Federal Tax Return** 9901

(Rev. January 2005) Department of the Treasury — Internal Revenue Service OMB No. 1545-0029

Employer identification number ☐☐ – ☐☐☐☐☐☐☐

Name *(not your trade name)*

Trade name *(if any)*

Address

Number Street Suite or room number

City State ZIP code

Report for this Quarter ...
(Check one.)

☐ **1:** January, February, March
☐ **2:** April, May, June
☐ **3:** July, August, September
☐ **4:** October, November, December

Read the separate instructions before you fill out this form. Please type or print within the boxes.

Part 1: Answer these questions for this quarter.

1	**Number of employees who received wages, tips, or other compensation for the pay period including:** ***Mar. 12*** **(Quarter 1),** ***June 12*** **(Quarter 2),** ***Sept. 12*** **(Quarter 3),** ***Dec. 12*** **(Quarter 4)**	1	
2	**Wages, tips, and other compensation**	2	.
3	**Total income tax withheld from wages, tips, and other compensation**	3	.
4	**If no wages, tips, and other compensation are subject to social security or Medicare tax**		☐ Check and go to line 6.

5 Taxable social security and Medicare wages and tips:

	Column 1		Column 2
5a Taxable social security wages	.	× .124 =	.
5b Taxable social security tips	.	× .124 =	.
5c Taxable Medicare wages & tips	.	× .029 =	.

5d	**Total social security and Medicare taxes** (*Column 2,* lines 5a + 5b + 5c = line 5d)	5d	.
6	**Total taxes before adjustments** (lines 3 + 5d = line 6)	6	.

7 Tax adjustments (If your answer is a negative number, write it in brackets.):

7a	**Current quarter's fractions of cents**	.
7b	**Current quarter's sick pay**	.
7c	**Current quarter's adjustments for tips and group-term life insurance**	.
7d	**Current year's income tax withholding** (Attach Form 941c)	.
7e	**Prior quarters' social security and Medicare taxes** (Attach Form 941c)	.
7f	**Special additions to federal income tax** (reserved use)	.
7g	**Special additions to social security and Medicare** (reserved use)	.

7h	**Total adjustments** (Combine all amounts: lines 7a through 7g.)	7h	.
8	**Total taxes after adjustments** (Combine lines 6 and 7h.)	8	.
9	**Advance earned income credit (EIC) payments made to employees**	9	.
10	**Total taxes after adjustment for advance EIC** (lines 8 – 9 = line 10)	10	.
11	**Total deposits for this quarter, including overpayment applied from a prior quarter**	11	.
12	**Balance due** (lines 10 – 11 = line 12) Make checks payable to the *United States Treasury*	12	.

13 Overpayment (If line 11 is more than line 10, write the difference here.) . Check one ☐ Apply to next return. ☐ Send a refund.

Next ➔

For Privacy Act and Paperwork Reduction Act Notice, see the back of the Payment Voucher. Cat. No. 17001Z Form **941** (Rev. 1-2005)

9902

Name *(not your trade name)*	Employer identification number

Part 2: Tell us about your deposit schedule for this quarter.

If you are unsure about whether you are a monthly schedule depositor or a semiweekly schedule depositor, see *Pub. 15 (Circular E),* section 11.

14 ☐☐ **Write the state abbreviation for the state where you made your deposits** OR **write "MU" if you made your deposits in *multiple* states.**

15 Check one: ☐ **Line 10 is less than $2,500.** Go to Part 3.

☐ **You were a monthly schedule depositor for the entire quarter. Fill out your tax liability for each month.** Then go to Part 3.

Tax liability:	
Month 1	.
Month 2	.
Month 3	.
Total	. **Total must equal line 10.**

☐ **You were a semiweekly schedule depositor for any part of this quarter.** Fill out *Schedule B (Form 941): Report of Tax Liability for Semiweekly Schedule Depositors,* and attach it to this form.

Part 3: Tell us about your business. If a question does NOT apply to your business, leave it blank.

16 If your business has closed and you do not have to file returns in the future . . . . ☐ Check here, and enter the final date you paid wages / / .

17 If you are a seasonal employer and you do not have to file a return for every quarter of the year . . ☐ Check here.

Part 4: May we contact your third-party designee?

Do you want to allow an employee, a paid tax preparer, or another person to discuss this return with the IRS? See the instructions for details.

☐ Yes. Designee's name

Phone ( ) –   Personal Identification Number (PIN) ☐☐☐☐☐

☐ No.

Part 5: Sign here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

✗ Sign your name here

Print name and title

Date / /   Phone ( ) –

Part 6: For paid preparers only *(optional)*

Preparer's signature

Firm's name

Address   EIN

  ZIP code

Date / /   Phone ( ) –   SSN/PTIN

☐ Check if you are self-employed.

Page **2**   Form **941** (Rev. 1-2005)

13

Penalties

***Donald's Electric and Refrigeration Service, Inc.*, DC Va, 2005-1 USTC 50,224, March 2, 2005**

IRC §§6651 and 6656

☞ Reasonable Cause Not Found in Delinquent Employment Tax Case

Facts. Donald's Electric and Refrigeration Service, Inc. specializes in the repair of refrigeration equipment in the mid-Atlantic and southeastern states. Steven Donald handles the repair activities while Mrs. Donald performs duties as the office manager. Mrs. Donald began suffering from depression in 1998. The condition worsened in 2000 with the death of her father and drove her to compulsive spending and attempted suicide in 2002. During the time of Mrs. Donald's depression, the corporation was consistently late in filing, paying, and depositing employment taxes.

The IRS first visited with Mr. Donald in 1998 and continued contacts with Mr. Donald through March 2002. Mr. Donald initially believed his wife would handle the corporate matters and as the result of the continued delinquencies, he ultimately removed her from her job. Mr. Donald paid all taxes, penalties, and interest before filing abatement requests seeking refunds of the penalty amounts assessed.

Issue. Whether penalties should be abated based on an employee's mental illness.

Analysis. A penalty is excused if the taxpayer can prove that the failure to timely file was not due to willful neglect, and, at the same time, prove the failure was due to a reasonable cause. A corporation is not disabled from complying with tax deadlines if it retains control over the agent responsible for tax liabilities. The corporation admits Mr. Donald received several notices of noncompliance from the IRS but Mr. Donald still left the matters in the hands of his troubled wife. The Court found that reliance on the employee to file, pay, and deposit employment taxes did not relieve the corporation from the obligation to meet its deadlines.

Holding. The corporation was not entitled to abatement of penalties paid.

ESTATE AND GIFT

Family Limited Partnership

***Estate of Virginia A. Bigelow v. Commissioner*, TC Memo 2005-65, March 30, 2005**

IRC §2036

☞ Real Estate Transferred to FLP Included in Transferor's Estate

Facts. In 1991, the decedent set up a revocable trust and transferred her personal residence into the trust. At the time of transfer, she owned 98.2857% interest in the residence which was valued at approximately $1.75 million. The remaining interest in the residence had previously been gifted equally to each of her three children. The decedent suffered a stroke and began residing in an assisted-living facility in 1992. Subsequently in 1993, the trust exchanged the California residence for other real property receiving $125,000 and a property worth $1.2 million. The property was then leased back to the transferor for a term of 12 months at $3,500 per month. A $350,000 loan and a $100,000 line of credit loan were secured by the new property. A family limited partnership (FLP) was formed in December of 1994. The FLP was established to reduce federal estate tax as well as facilitate gift giving. The trust transferred the real property via fee simple interest (FMV of $1.45 million) but **not** the debt secured by the property. After the transfer, the decedent was unable to afford both her living expenses and the liability for the indebtedness. The FLP made $2,000 monthly loan payments on behalf of the decedent as well as provided additional funds for her support.

Issue. Whether the real property transferred to the FLP is includable in the decedent's gross estate under IRC §2036(a)(1).

Analysis. IRC §2036 allows the value of an interest in property to be included in a decedent's gross estate if:

1. The decedent made an inter vivos transfer of the property,
2. The transfer was for less than adequate and full consideration, and
3. The decedent retained the possession or enjoyment of, or the right to the income from, the transferred property.

However, a decedent's gross estate does not include property transferred within a bona fide sale for adequate and full consideration.

The estate contended the property is not includable in the estate because:

- The decedent did not retain enjoyment of, or the right to the income from, the property, and
- Transfer of the property was a bona fide sale for adequate and full consideration.

Holding. The Tax Court held the real property was includable in the decedent's gross estate for the following reasons:

- There was an implied agreement between the decedent and her children that she would retain the right to the income from the property.
- There was an implied agreement for the decedent to retain enjoyment of the property via present economic benefits.
- The fee simple interest transfer was not made in good faith.
- The transfer of the property had adverse financial effect on the decedent.
- The failure to respect partnership formalities shows the transaction was not entered into in good faith.
- The transfer had no potential to provide any nontax benefit to decedent.

Family Limited Partnership
***Albert Strangi, Deceased, Rosalie Gulig, Independent Executrix, v. Commissioner,* 5th Circuit Court of Appeals, No. 03-60992, July 15, 2005, affirming prior decision of Tax Court: *Estate of Strangi v. Commissioner,* TC Memo 2003-145, 85 TCM 1331, May 20, 2003**
IRC §2036

☞ 5th Circuit Upholds Full Inclusion in Gross Estate of Assets Transferred to FLP

Facts. In a culmination of litigation that originally began in 2000 in the Tax Court, the 5th Circuit upheld the previous Tax Court decision which applied a strict interpretation of IRC §2036(a). Albert Strangi transferred 98% of his assets, valued at about $10 million, to a family limited partnership (FLP) **two months prior** to his death in October 1994. Included in the transferred property was approximately $7.5 million of cash and securities.

FMV of decedent's assets transferred to FLP in August 1994	$ 9.93 million
FMV of decedent's transferred assets in the FLP at date of death	10.95 million
Reported estate tax return value of transferred assets after discounts of 33%	6.56 million

Position of the IRS and facts to support its position.

- The FLP should be ignored because it lacked economic substance and a valid business purpose.
- Mr. Strangi retained only minimal liquid assets after transferring his assets to the FLP, consisting of two bank accounts with funds that totaled only $762.

> **Note.** Mr. Strangi received a monthly pension of $1,438 plus social security benefits of $1,559 during the two months he lived after transferring his assets to the FLP. However, his monthly living expenses during these two months were in excess of $9,000.

- Mr. Strangi retained beneficial control and enjoyment of his transferred assets. This was evidenced by two payments totaling $14,000 made by the FLP for his needs and personal expenses during the two months between the formation of the FLP and his death.
- In addition, he continued to reside in one of two houses he had transferred to the FLP. Even though the accrued house rent was recorded in the FLP's books, it was not actually paid until January 1997, more than two years after Mr. Strangi's death.
- In addition to the $14,000 paid to Mr. Strangi before he died, the FLP paid the following expenses after his death in October 1994:
    1. $40,000 to pay for funeral expenses, estate administration, and various personal debts of Mr. Strangi in 1994.
    2. $65,000 to pay estate expenses and specific bequest made by Mr. Strangi in 1995 and 1996.
    3. $3,187,800 to pay federal estate and state inheritance taxes in 1995.
- The transfer of Mr. Strangi's assets to the FLP two months prior to his death did not meet the "bona fide sale" exception of IRC §2036(a).

The IRS included the full FMV of the assets transferred to the FLP in the decedent's gross estate. The result was an additional estate tax assessment of $2.55 million.

Issue. Whether the transferred assets were properly included in the gross estate.

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,
- Retained the right to income from the transferred property, or
- Retained the right to designate the person(s) who shall possess or enjoy the property or the income from it for the decedent's life.[32]

There are **two exceptions** to the general rule:

1. The transfer is a **bona fide sale** for a full and adequate consideration.[33]
2. The decedent did **not** retain the
    a. Possession, enjoyment, or rights to the transferred property, or
    b. Right to designate the persons who would possess or enjoy the transferred property.[34]

---

32. IRC §2036(a)
33. Treas. Reg. §20.2036-1(a)
34. *Estate of Eugene Stone III v. Commr.*, TC Memo 2003-309, 86 TCM 551, November 7, 2003

Holding. The 5th Circuit held that:

- **The "full and adequate consideration" requirement was met** because the "formalities of the family limited partnership were respected." This was because Mr. Stangi received a 99% limited partnership interest in the FLP in exchange for his transferred assets. The IRS conceded this issue.
- However, **the "bona fide sale" requirement was not met** because the Tax Court heard uncontested evidence that "no active business was conducted by the FLP following its formation." **Therefore, Mr. Strangi's transfer of his assets to the FLP lacked a "substantial business or other nontax purpose."**[35]
- Accordingly, the transferred assets were properly included in the taxable estate.

> **Note.** See pages 366–372 in the *2003 University of Illinois Federal Tax Workbook* for more information on the use of family limited partnerships for estate tax planning purposes. See also pages 504–505 in the *2004 University of Illinois Federal Tax Workbook* for an analysis of the *Estate of Ida Abraham*[36] Tax Court decision. The Tax Court's holding in this case, which has similar facts and the identical result, was upheld by the 1st Circuit Court of Appeals in May 2005.

Minority and Marketability Discounts

Letter Ruling 200448006, November 26, 2004
IRC §2032A

☞ Special Valuations for Inherited Farm Businesses

Purpose. To determine if two discounts can be considered simultaneously in valuing farm real estate, as well as an interest in the underlying farming business, for purposes of decedent's estate valuation.

Background. Decedent died leaving three children as survivors. Decedent's estate included both general and limited partnership interests. Assets of the partnership included farmland, among other assets. The Form 706 elected to value qualifying farm property in the partnership at its special use value under IRC §2032A.

In computing the value of both the general and limited partnership interests, both discounts for lack of marketability and minority interests were applied. Application of these discounts resulted in a favorable $770,000 maximum reduction in valuation under §2032A.

Analysis. In *Estate of Hoover,*[37] a 30% discount for minority interest and lack of marketability was applied. The discounts for minority interest and lack of marketability are applied before the §2032A valuation is considered. The IRS acquiesced on this decision.

Conversely, in *Estate of Maddox*[38]*,* the §2032A valuation occurred first, while the minority discount was applied later. The court would not allow the §2032A to occur first.

Holding. The IRS determined that a discount for minority interest or lack of marketability is permitted in determining the FMV of a property interest that is specially valued under §2032A for estate tax purposes.

13

---

35. *Estate of Ruth A. Kimbell v. United States,* 5th Circuit Ct. of Appeals, No. 03-10529, 2004-1 USTC ¶60,486, May 20, 2004
36. *Estate of Ida Abraham v. Commr.,* TC Memo 2004-39, February 18, 2004
37. *Estate of Hoover v. Commr.,* 95-2 USTC ¶60, 217, November 1, 1995
38. *Estate of Maddox, v. Commr.,* 93 TC 228, August 10, 1989

Estate Tax Lien

***First American Title Insurance Co. v. U.S.* No. C04-429JLR 2005 WL 1126929 (W.D.Wash.), 95 A.F.T.R.2d 2005-2460, May 12, 2005**

IRC §6324

☞ Estate Taxes Properly Sought from Home Buyers

Facts. First American Title Insurance Company and Chicago Title Insurance Company sued the United States to recover federal estate taxes alleged to have been "erroneously or illegally assessed or collected" under 28 U.S.C. §1346(a). Roberta C. Smith died leaving an estate primarily consisting of three houses and stock in Frisko Freeze, a drive-in restaurant in Tacoma, Washington. After her death, the Pierce County Superior Court entered an order admitting Roberta's will to probate and appointing her daughter, Penny Jensen, as the estate's personal representative with non-intervention powers. The court order gave Penny the "power to transfer any and all real and personal property of decedent without further order of this court."

Penny deeded the three houses in the estate to herself and her husband. In addition, she filed and paid the federal estate tax due for her mother's estate. Penny later sold the houses to purchasers who obtained title insurance policies issued by the title companies. During this same period, the IRS examined the Smith estate and increased the value of the Frisko Freeze stock by almost $150,000 more than shown on the estate tax return. When the Smith estate failed to make installment payments on the estate taxes owed, the IRS sent letters to the three new homeowners threatening to seize and sell the houses unless remaining estate tax was paid by the new homeowners. The homeowners contacted the title companies who paid $189,371.99 in taxes under protest. The title companies filed claims with the IRS seeking a refund of the amount paid. The IRS denied the claims and the title companies filed suit.

Issue. Did the IRS use the proper authority to assess a special estate tax lien.

Analysis. IRC §6324 creates a special estate tax lien that attaches to the gross estate of a decedent for ten years from the date of death. Probate property, such as the property at issue here, retains the special estate tax lien upon transfer to a purchaser unless the IRS discharges the personal representative of the lien under IRC §2204. The gross estate is divested of the special estate tax lien to the extent that the gross estate is "used for the payment of charges against the estate and expenses of its administration, allowed by any court having jurisdiction thereof."

The title companies contend that the proceeds from the sale of the three homes were used to pay charges against the estate and expenses of its administration, thereby divesting the lien under IRC §6324(a)(1). To prove that divestment occurred under IRC §5324(a)(1), the title companies must establish that:

- The sale proceeds satisfied "charges against the estate or expenses of its administration," and
- A court with proper jurisdiction allowed the satisfaction.

The title companies contend that they used the proceeds from the house sales to pay encumbrances, taxes, title insurance premiums, and real estate commissions and that these payments qualify as "charges against the estate or expenses of its administration."

It is undisputed that Penny did not petition the probate court to allow any of the sale proceeds from the three properties to satisfy "charges against the estate and expenses against its administration."

Holding. The court acknowledged the arguments raised but agreed with the IRS position. The court granted summary judgment in favor of the IRS based on the title companies' inability to establish that the second element of divestment, court "allowance," existed.

Future Lottery Payments

***Estate of John R. Donovan, Jr. v. United States,* U.S. District Court (Mass.), Civil Action No. 04-10594-DPW, April 26, 2005**

IRC §§2031 and 7520

☞ Future Lottery Payments Valued Using Annuity Tables

Facts. The taxpayer won the Massachusetts lottery on January 4, 1999, and received the first of twenty annual $100,000 checks. The lottery interest was not assignable under Massachusetts law. He died on July 23, 1999. An estate tax return was filed in 2000 showing an asset valued at $367,482 for the remaining nineteen payments due, with no resulting estate tax being owed.

An IRS examination determined the value assigned to the asset by the appraiser to be incorrect and recommended a value of $1,091,553.28 based on statutory annuity tables under IRC §7520. The resulting estate tax of $173,610.99 plus interest was paid by the estate. The estate then filed a claim for refund and subsequently executed a Waiver of Statutory Notice of Claim Disallowance before bringing this suit about.

Issue. Whether the future lottery installment payments are considered to be an annuity and if determined to be an annuity, how the value is determined.

Analysis. The taxpayer argued on two different points. The first argument was that the lottery prize did not constitute an annuity. Several court cases determined these types of payments do constitute an annuity within the meaning of IRC §7520. *Cook*, *Shackleford*, and *Gribauskas* all support the annuity finding.[39]

The second argument was against valuing the payments using the IRC §7520 tables. The tables must be used unless it is shown that the result using the tables is so unrealistic and unreasonable that some modification in the prescribed method should be made and a more reasonable and realistic means of determining value is available. The taxpayer did not demonstrate use of the annuity tables produced an unreasonable result.

Holding. The Court held the payments fall within the definition of annuity and determined the value based on the annuity tables provided.

> **Note.** Circuit courts of appeal are split on valuing future payments of lottery winnings using the IRC §7520 annuity tables. The Fifth Circuit ruled the annuity tables must be used while the Second and Ninth Circuits took the opposite position and allowed special discounts. If this case is appealed, the First Circuit would get a chance to determine its position.

---

39. *Cook*, 349 F.3d at 855, *Shackleford v. United States,* 262 F3d 1028, 1031 (9th Cir. 2001), and *Gribauskas v. Commr.,* 116 TC 142, 154 (2001)

EXCISE TAX

Flat-Rate (Cents-per-Minute) Long-Distance Phone calls

***American Bankers Insurance Group v. United States*, 11th Circuit Court of Appeals, No. 04-10720, May 12, 2005, reversing prior decision of United States District Court for the Southern District of Florida**
IRC §§4251 and 4252

☞ IRS Continues to Lose on the 3% Excise Tax on Long-Distance Phone Service

Facts. Between October 1, 1998 and March 31, 2002, the taxpayer purchased interstate, international, and intrastate long distance service for five states from AT&T. The taxpayer paid a **uniform toll rate** for:

- All interstate long-distance calls made within the United States, and
- All intrastate long-distance calls made to the five selected states.

In addition, the taxpayer paid AT&T a uniform rate for all international calls. However, this uniform international rate varied depending on which country was being called.

The taxpayer remitted about $362,000 of telephone excise taxes, levied at a 3% rate, to AT&T during this period. The collected excise taxes were in turn remitted to the IRS on behalf of the taxpayer.

The taxpayer filed two refund claims with a Florida U.S. district court for the federal excise taxes it had paid to AT&T during the period. These claims were denied by the district court. The taxpayer then appealed to the 11th Circuit Court of Appeals.

Issue. Whether the 3% federal excise tax levied under IRC §4251 should be applied to a telephone toll charge that is based on length of the call, but not distance.

Analysis and Holding. After thoroughly analyzing the definitions contained in IRC §4252(b)(1), the 11th Circuit ruled in favor of the taxpayer and held that the refunds claims, if properly calculated, should be paid by the IRS. The Excise Tax Reduction Act of 1965 clearly defined taxable toll telephone service as calls that set rates that varied by both (1) elapsed transmission time **and** (2) distance. Since the telephone service the taxpayer purchased from AT&T was based solely on time and not distance, the excise tax is not applicable.

> **Note.** The IRS has now lost six cases on this issue, including one at the Court of Federal Claims. It appears that the IRS will be forced to accept similar claims and pay refunds on telephone excise taxes levied and remitted to it by phone companies where the toll charges were not based on distance. Any claims for refund should be made on Form 8849, *Claim for Refund of Excise Taxes.* A blank Form 8849 can be found in the Excise Tax Exemption section of the Military section of Chapter 6, "Special Taxpayer Issues," of this workbook.

Truck Body Excise Tax

Revenue Procedure 2005-19, April 4, 2005
IRS News Release IR-2005-29, March 15, 2005
IRC §4051

☞ IRS Issues Guidance on Truck Bodies Subject to Federal Excise Tax

Background. IRC §4051 imposes an excise tax on the first sale of certain truck chassis and bodies. This tax does not apply to truck:

- Bodies and chassis suitable for use with vehicles having gross vehicle weight of 33,000 pounds or less, or
- Trailer and semi-trailer bodies and chassis suitable for use with vehicles having gross vehicle weight of 26,000 pounds or less.

Retailers have often been challenged to determine whether or not excise tax is due since they are **not** aware of the gross vehicle weight of the vehicle on which the body will be mounted.

This issue, worked under the Industry Issues Resolution (IIR) program, resulted in the establishment of four classifications of truck body types. These meet the "suitable for use" standard and are **excluded** from the retail excise tax.

1. Platform truck bodies 21 feet or less in length
2. Dry freight and refrigerated truck van bodies 24 feet or less in length
3. Dump-truck bodies with load capacities of eight cubic yards or less
4. Refuse-packer truck bodies with load capacities of 20 cubic yards or less

If a body type described above does not fall into the classifications listed, the body type may still satisfy the "suitable for use" standard if the seller can establish that the truck body has practical and commercial fitness for use with a vehicle having a gross vehicle weight of 33,000 pounds or less under IRC §145.4051-1(a)(4).

These classifications are effective for sales **on or after April 4, 2005.**

GROSS INCOME

Fringe Benefits

Revenue Procedure 2005-48, August 8, 2005
IRC §61

☞ 2005 Maximum Fair Market Values for Employer-Provided Vehicles

Background. To provide the 2005 valuation for fringe benefit purposes using:

- Maximum fair market values (FMVs) for personal use of employer-provided vehicles using 40.5¢ per mile,[40] and
- Maximum fleet-average FMVs for vehicles using the annual lease value (ALV) valuation method the special valuation rules.[41]

13

40. Treas. Reg. §1.61-21(e)
41. Treas. Reg. §1.61-21(d)

Maximum FMVs for Personal Use of Employer-Provided Vehicles. Personal use of an employer-provided vehicle by an employee is a **fringe benefit**. The value of the personal use can be determined utilizing the mileage allowance rate (40.5¢ per mile for 2005) provided the FMV of the vehicle does not exceed:

- Vehicles in use before 2005: $12,000
- Vehicles first made available in 2005
  - $14,800 (auto)
  - $16,300 (truck or van)

Maximum FMVs for Fleet-Average Value. Under the ALV method, the fringe benefit value of the personal use can be determined utilizing the fleet-average valuation rule[42] for employers with fleets of 20 or more autos provided the FMV of the vehicle first made available in 2005 does not exceed:

- $19,600 (auto) or
- $21,300 (truck or van)

Under either of these methods, if the FMV exceeds these amounts, the employer may determine the value of the personal use under:

- General valuation rules[43]
- Special valuation rules (Automobile lease valuation)[44]
- Commuting valuation[45]

This revenue procedure applies to employer-provided passenger automobiles, trucks or vans first made available to employees for personal use in calendar year 2005.

> **Note.** See Chapter 9, "Small Business Issues," for further information.

New York State Income Tax

Thomas L. Huckaby v. New York State Division of Tax Appeals, **No.8, March 290, 2005**

☞ State of New York Fully Taxes Tennessee Resident

> **Note.** Although this court case is a state income tax decision, it does have implications for employees who work from their home office and who occasionally also work in the state of New York for a New York employer.

Facts. Thomas, a resident of Tennessee, was employed by the National Organization of Industrial Trade Unions (NOITU) located in Jamaica, New York. His duties included supporting software programs, assisting the Information System Department's manager in selecting new technology, and instructing computer-use classes at company headquarters to NOITU's New York personnel.

42. Treas. Reg. §1.61-21(d)(5)(v)
43. Treas. Reg. §1.61-21(b)
44. Treas. Reg. §1.61-21(d)
45. Treas. Reg. §1.61-21(f)

During 1994 and 1995, Thomas worked 75% of his workdays in his Tennessee home office. The other 25% of his workdays during those two years were spent in the Jamaica, NY headquarters of his employer. Based on that allocation, he reported only 25% of his 1994 and 1995 wages on his New York income tax returns (state and city) as subject to New York income tax.

The New York State Department of Taxation allocated 100% of his wages to New York state and New York City and assessed additional taxes. **The Department of Taxation held that because Mr. Huckaby worked from his Tennessee home office for his convenience rather than for the convenience of NOITU, and all of his wages were subject to New York state and city income taxes.**

Issue. Whether 25% or 100% of his 1994 and 1995 wages were subject to New York state and city income taxes.

Analysis and Holding. In a 4-3 decision, the New York Court of Appeals **ruled in favor of the state of New York** by upholding the assessment of additional state and city income tax. The Appeals Court rejected the taxpayer's contentions that:

- The "convenience of the employer" rule violated his constitutional rights under due process
- His constitutional rights were violated by taxing him out of all proportion to the benefits that he received from New York

The majority opinion stated: "He is one who chose to accept employment from a New York employer (with the advantages of a New York salary and fringe benefits) while maintaining his residence in Tennessee."

Discharge of Indebtedness

Gerald A. Bunker v. Commissioner, **TC Summary Opinion 2005-35, March 30, 2005**
IRC §61

☞ Credit Card Insurance Payment Considered Discharge of Indebtedness

Facts. Gerald Bunker was employed in a civilian position at Kelly Air Force Base (AFB) in San Antonio, Texas during which time he decided to purchase credit card insurance from two different companies. He wanted to ensure his ability to pay his bills in case of disability, unemployment, or death.

Unfortunately Kelly AFB closed and Gerald lost his job on November 6, 2000. He remained unemployed throughout most of 2001. He requested payment from both credit card insurance policies. The two companies paid in excess of $15,000 (combined) on his behalf. The companies issued Forms 1099-MISC and 1099-C to Gerald, but he did not include these amounts on his tax return for 2001.

The IRS issued a notice of deficiency including the payments as gross income received.

Issue. Are the payments made by the credit card insurance company includable as gross income?

Analysis. Gross income includes all income from whatever source derived unless otherwise provided.[46] Gross income includes income from discharge of indebtedness.[47]

At trial, the taxpayer argued that his situation mirrors that in which an insured automobile is damaged in an accident. The insurance company insuring the vehicle pays the body shop for the cost of repairs, while the payments do not constitute gross income to the vehicle owner.

46. IRC §61

47. IRC §61(a)(12)

The court looked back to the general rule where taxability of recovery payments depends upon the nature of the claim. If the recovery represents damages for lost profits, the payment is considered income. If the recovery represents replacement of capital destroyed or damaged, the recovery is not considered income unless it exceeds the basis of damaged or destroyed property.

Holding. Since the taxpayer had no basis in his credit card liability, the court determined the payments to be gross income not a recovery or restoration of capital.

Income in Respect of a Decedent

Revenue Ruling 2005-30, May 16, 2005

IRC §§72, 691, and 1014

☞ Proceeds in Excess of Investment Result is Income

Purpose. To clarify that a death benefit paid under a deferred annuity contract, whose owner dies before the starting date, is taxable to the beneficiary as income in respect of a decedent (IRD) to the extent the amount received exceeds the owner's investment.

Facts. Individual Q purchased a deferred annuity contract providing for annuity payments to Q beginning as of a specific date. The contract provides that if Q dies before the annuity starting date, Beneficiary B will receive a death benefit equal to the account value as determined by the formula provided under the contract. At B's election, the death benefit can be paid either as a lump sum or as periodic payments.[48]

Q dies before the annuity starting date and B receives the death benefit under the contract. The death benefit exceeds Q's investment in the contract.

Analysis. Gross income includes any amount received as an annuity.[49] IRC §§72(b) through (d) provide rules for determining what portion of an annuity payment represents a nontaxable return of investment. IRC §72(e) identifies rules for amounts received under an annuity contract, but not received as an annuity (and therefore not described in §72(b) through (d)). Specifically, amounts received before the annuity start date are generally includable in gross income to the extent they are allocable to income on the annuity contract. IRC §72(s) describes rules regarding the period in which an interest in an annuity contract must be distributed after the holder's death in order for the contract to qualify as an annuity contract within the meaning of §72.

Rev. Rul. 79-335 describes a situation in which the owner-annuitant purchases a deferred variable annuity contract. The contracts specifies that if the owner dies prior to the annuity start date, the named beneficiary may elect to receive the present accumulated value of the contract either in the form of an annuity or as a lump-sum payment. For purposes of IRC §1014, the contract is an annuity described in §72 (as then in effect), and therefore receives no basis adjustment by reason of the owner's death because it is governed by the annuity exception of IRC §1014(b)(9)(A). If the beneficiary elects a lump-sum payment, the excess of the amount received over the amount of consideration paid by the decedent is includable in the beneficiary's gross income.

IRC §691 provides guidance for IRD. The basis of property in the hand of the person acquiring it from a decedent generally is the FMV at the date of death.[50]

48. IRC §72(s)

49. IRC §72(a)

50. IRC §1014(a)(1)

Holding. If the owner-annuitant of a deferred annuity contract dies before the annuity start date, and the beneficiary receives a death benefit under the annuity contract, the amount received by the beneficiary in a lump sum in excess of the owner-annuitant's investment in the contract is includable in the beneficiary's gross income as IRD within the meaning of IRC §691. If the death benefit is instead received in the form of a series of periodic payments in accordance with §72(s), the amounts received are likewise includable in the beneficiary's gross income (in an amount determined under §72) as IRD within the meaning of IRC §691.

Note. This ruling supersedes Rev. Rul. 79-335 for deferred annuity contracts purchased after October 20, 1979.

Interest on Tax-Free Damages

***Chad Anthony Chamberlain v. U.S.,* United States Court of Appeals, 5th Circuit, No. 03-31136, February 18, 2005**
IRC §§61 and 104

☞ Prejudgment Interest Determined Taxable

Facts. Chad Chamberlain was severely injured while swimming. A lawsuit against the State of Louisiana resulted in total damages of just over $9 million with $3.7 million being classified as prejudgment interest. The IRS assessed tax based on the prejudgment interest component of the damages. The Chamberlains paid the tax and filed suit in the district court where the Chamberlains lost their case.

The district court applied a two-part test set forth by the Supreme Court for determining whether the interest should be excluded under IRC §104(a)(2). Under the test, the taxpayer must

- Demonstrate the underlying cause is based on tort type rights, and
- Show the damages were received because of personal injuries or sickness.

The district court found that Chamberlain satisfied the first part of the test, but not the second.

Issue. Is the interest received taxable under IRC §61 or can it be excluded under IRC §104?

Analysis. Both parties agree the interest awarded in a personal injury suit constitutes gross income unless it comes within the §104 exclusion. IRC §104(a)(2) provides that gross income does not include "the amount of any damages received on account of personal injuries or sickness."

The Chamberlains argued that since Louisiana law treats prejudgment interest as part of the compensatory damages intended to make the injured party whole, the interest falls within the exclusion provisions of IRC §104(a)(2).

Although the Supreme Court decided three cases[51] interpreting IRC §104(a) (2), they have not decided whether prejudgment interest is excluded.

In this case, the Chamberlains clearly meet the first test. The underlying cause was personal injuries suffered due to negligence of the State of Louisiana. The First, Third and Tenth Circuits have also addressed similar issues. All three agree prejudgment interest lacks the direct relationship to personal injury necessary to the meet the second test. A closer relationship to the injury itself is required.

Holding. Since the interest compensates for an economic harm rather than for actual physical injury, the interest is taxable.

51. *United States v. Burke,* 504 U.S. 229 (1992), *Commr. v. Schleier,* 515 U.S. 323 (1995), and *United States v. O'Gilvie,* 519 U.S. 79 (1996)

Contingent Attorney Fees

***Commissioner v. Banks,* No. 03-892 (S CT January 24, 2005), *rev'g John W. Banks II v. Commissioner,* 6th Cir. Ct. of Appeals, 345 F.3rd 373, 2003-2 UCTC ¶50,675, September 30, 2003**
IRC §61

☞ Contingent Attorney Fees Includable in Income

Facts. John Banks received a negotiated settlement of $464,000 in 1990 as a result of being fired from his position. He paid $150,000 to his attorney based on a contingent fee arrangement. He did not include any of the $464,000 settlement he received on his 1990 tax return. The IRS included the entire amount in his income.

The original case was heard by both the Tax Court and the Sixth Circuit Court of Appeals. The Sixth Circuit Court of Appeals, reversing the Tax Court decision, held that an individual who settles an employment termination lawsuit does not have to include the fees paid from the settlement directly to an attorney in gross income.

The Supreme Court agreed to hear this case along with a similarly decided case,[52] which also reached the same conclusion for contingent attorney fees on a wrongful discharge suit against a bank.

Issue. Whether paid contingent attorney fees are excludible from gross income.

Analysis. Gross income is defined as all income from whatever source derived.[53]

The Supreme Court determined contingent fee arrangements should be viewed as an anticipatory assignment of a portion of the client's income from any litigation recovery to the attorney. The taxpayers have control over the income-generating asset which is the cause of action derived from the legal injury. Even though the value of a claim may be uncertain at the time a fee agreement is signed, an anticipatory income document is not limited to instances where the precise dollar amounts are known in advance.

A contingent fee arrangement is not a joint venture or business partnership whereby a taxpayer does not retain sole control over underlying claims. This type of relationship mirrors a principal-agent relationship where taxpayers are responsible for making critical decisions, including whether to settle or proceed to trial.

Taxpayers are allowed to deduct attorney fees and court costs paid in connection with any actions involving a claim of unlawful discrimination from adjusted gross income.[54] These deductions are allowable even when AMT applies. **This applies for fees and costs paid after October 22, 2004 for any judgment or settlement occurring after that date.**

Holding. The Supreme Court held the contingent attorney fees paid to their attorneys were includable in income and deductions for fees paid could be claimed on Schedule A or as an adjustment to adjusted gross income.

> **Note.** See pages 513–514 in the *2004 University of Illinois Federal Tax Workbook* for addition information on the *Banks* court case.

---

52. *Banaitis*, CA 9, 92 AFTR 2nd 2003-5834, September 27, 2003

53. IRC §61

54. IRC §62(a)(19), added by American Jobs Creation Act of 2004

Unlawful Employer Discrimination Award

***Marrita Murphy, et al. v. IRS*, District of Columbia U.S. District Court, Civ. 03-02414 (RLC), March 22, 2005**

IRC §104

☞ Compensatory Damages are Taxable

Facts. The taxpayer was awarded $45,000 for mental pain and anguish and $25,000 for damage to her professional reputation in her 2000 discrimination suit against her former employer, the New York National Guard. She reported the $70,000 as taxable income on her 2000 tax return and later filed three amended returns which claimed that the $70,000 was nontaxable income. Her requests for a refund were denied by the IRS and she filed a refund suit with the U.S. District Court.

Issue. Whether the damages were received "on account of physical injuries or physical sickness" under the 1996 amended definition of IRC §104(a)(2).

Analysis. The taxpayer contended that her employer's discrimination caused emotional distress resulting in bruxism (teeth grinding). As a result, she concluded that the entire $70,000 award met the "on account of physical injury" exception of IRC §104(a)(2) and was therefore excludable from gross income.

The House Report concerning the 1996 amendment to §104(a)(2) clearly states:

- "Emotional distress is not considered a physical injury or physical sickness"
- Any damages based on "employment discrimination or injury to reputation accompanied by a claim of emotional distress" do not fall under the revised §104(a)(2) exception

Holding. The court held that the $25,000 award for damage to the taxpayer's professional reputation clearly did not meet the exception and was taxable. In addition, the $45,000 award for mental pain and anguish was also taxable. The court noted that the taxpayer's "mental anguish manifested into a physical problem, bruxism, but this was only a symptom of her emotional distress, not the source of her claim."

Her emotional distress was not "on account of physical injury." Rather, the court added, "it is the other way around." **Therefore, the entire $70,000 award must be included in gross income.**

> **Note.** Under a provision of the American Jobs Creation Act of 2004, the $70,000 award is still taxable. However, if the unlawful discrimination award was received on or after October 23, 2004, any attorney fees paid after October 22, 2004 by the successful litigant would be deductible in arriving at AGI, rather than on Schedule A as a miscellaneous itemized deduction.

Unreported Income

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

IRC §§61, 162, 6651, 6653, and 6662

☞ IRS's Arbitrary Method of Determining Gross Receipts Shot Down in Court

Facts. The Minnesota taxpayer operated a sole proprietorship family law practice during 1987 through 1990. Delinquent returns filed by the taxpayer contained Schedules C showing net profits or (losses) as follows:

Year	Gross Receipts	Expenses	Net Profit (Loss)
1987	$ 75,097	$ 76,198	$ (1,101)
1988	128,896	121,459	7,437
1989	124,463	115,690	8,773
1990	95,730	124,543	(28,813)

13

The IRS examined the returns and proposed additional Schedule C gross receipts as follows:

1987	$ 77,811
1988	117,819
1989	116,483
1990	154,069

These adjustments to gross receipts were based on two personal financial statements, which the taxpayer submitted to American National Bank on December 22, 1987 and August 8, 1989. On the financial statements, the taxpayer listed "Employment Income" of $77,811 and $125,256 for 1987 and 1989, respectively. "Employment Income" represents the taxpayer's estimate of gross income, unreduced by expenses, generated by her law practice as of the date of the financial statement.

In addition, the IRS recommended $59,038 of the 1988 claimed business expenses be disallowed along with **all** the claimed business expenses for 1987, 1989, and 1990 since the taxpayer did not establish the business expenses were paid or incurred during the taxable years. Even though the taxpayer provided expense records, the IRS did not examine the business records except for possibly 1988.

After the IRS issued notices of deficiency, the examiner prepared a bank deposit analyses that resulted in substantially different amounts than shown in the notice of deficiency. The revised amounts were as follows:

1987	$45,767
1988	7,113
1989	47,232
1990	13,785

Issues. Whether the taxpayer

- Failed to report income from her law practice for years 1987–1990
- Is entitled to additional business expense deductions with respect to her law practice for year 1987–1990
- Is entitled to net operating loss deductions
- Is liable for the negligence penalty, accuracy-related penalty, and/or delinquency addition to tax

Analysis. Before trial, the IRS conceded the unreported income adjustments for 1988 and 1990 as well as $11,862 of the proposed adjustment for 1989.

For the 1987 and 1989 bank deposit analysis, the IRS did not adequately analyze the information. The IRS did not

- Analyze retained copies of taxpayer's deposit slips and bank statements
- Obtain missing bank statements or copies of deposited items from financial institutions
- Adjust deposit analysis for all income sources reported on the 1987 return
- Subtract nontaxable items

Before and during the trial, records produced by the taxpayer resulted in allowable Schedule C deductions as follows:

1987	$15,377
1988	42,497
1989	28,507
1990	37,120

The Tax Court looked at each expense deduction claimed in detail. At the end of the exercise, the taxpayer had more deductions than claimed on the original return in 1987 and 1990 ($8,280 in total) and fewer deductions in 1988 and 1989 ($21,310 in total). Interestingly enough, the language in the court case is something IRS needs to keep in mind in future examinations… "respondent's (IRS) determination disallowing her Schedule C expenses for the years at issue was arbitrary and unreasonable. We cannot explain how the audit process malfunctioned so badly, but, it is readily apparent that the malfunction occurred."

Unlike the documentation provided on the Schedule C expenses, the taxpayer failed to provide complete documentation on the net operating losses.

Holding. The Tax Court determined the adjustments to gross receipts as shown in the notices of deficiency were arbitrary and excessive, thereby shifting the burden of proof from the taxpayer to the IRS. However, since the IRS analyses failed to adequately adjust for nontaxable items, failed to analyze all taxpayer's bank accounts, and failed to adjust for all reported taxable income, the court determined there was no credibility in the bank deposit analyses prepared by the IRS.

Schedule C expense deductions were allowed based on the documentation provided to the revenue agent, appeals officer, and Tax Court.

Net operating losses were disallowed since the taxpayer failed to prove she was entitled to any portion of the reported 1980–86 NOL carryforward.

Delinquency penalties were sustained by the Tax Court; however, the IRS did not prevail for either the negligence or accuracy-related penalties.

Gambling Winnings

***Leroy J. Klingaman v. Commissioner,* TC Summary Opinion 2005-36, March 30, 2005**

IRC §§61 and 165

☞ Alleged Shared Gambling Winnings Taxable Entirely to Recipient

Facts. Mr. Klingaman enjoyed playing slot machines while he and his companion traveled throughout the United States. Despite the fact that he received Forms W-2G in 2001 totaling $7,340 in addition to some smaller winnings, his losses exceeded his winnings. However, he did not report any gambling winnings on his 2001 return and claimed the standard deduction.

The IRS issued a notice of deficiency including the $7,340 of unreported gambling winnings in income. This adjustment also resulted in taxable Social Security benefits of $1,002 which were required to be reported. A deduction for gambling losses of $7,340 was allowed as an itemized deduction.

Issue. Whether the taxpayer's gross income should include $7,340 and $1,002 from gambling winnings and Social Security benefits, respectively.

Analysis. IRC §61 provides that gross income includes all income from whatever source derived unless excludable by a specific provision of the Code. IRC §165(d) allows gambling losses as a deduction to the extent of gambling winnings.

At trial, the taxpayers argued that only a portion of the gambling winnings should be taxable to him as he **split** the winnings with his traveling companion. He would not provide her name, but he indicated she had not reported any of the gambling winnings on her return. The Court noted that since the taxpayer likely completed Form 5754, *Statement by Person(s) Receiving Gambling Winnings,* upon winning the slot machine jackpots and Forms W-2G were issued solely in his name, it is likely he did not indicate the winnings were being shared on the Form 5754.

Holding. The Tax Court looked at the arguments presented by the taxpayer and sustained the government's positions due to lack of evidence.

Life Insurance Policy

***Julie J. Revolinski and Kenneth T. White v. Commissioner,* TC Summary Opinion 2005-26, March 14, 2005**

IRC §§61 and 72

☞ Surrender of Life Insurance Policy Results in Gross Income

Facts. In 1987, the taxpayer acquired a universal life insurance policy with Pacific Life. The terms of the policy were such that funds could be withdrawn against the policy's accumulated value or borrowed against the policy to the extent of the loan value available.

From 1987 through 1992, the taxpayer **paid premiums** totaling $14,565. However, between December 1993 and October 1994, the taxpayer received funds for a home down payment from Pacific Life. Each disbursement received from Pacific Life was accompanied by a **loan statement** showing the amount of the loan, interest charged, and outstanding loan balance as follows:

Date Processed	Loan Amount	Interest Charged	Outstanding Loan Balance
12/13/1993	$ 5,159	$159	$ 5,000
2/17/1994	2,044	44	2,000
5/17/1994	1,513	13	1,500
10/3/1994	7,716	316	7,400
Total	$16,432	$532	$15,900

From 1988 through July 2001, the accumulated value of the policy increased from $5,729 to $23,467. In August 2001, the taxpayer surrendered the policy receiving the cash surrender value of $384; values of the policy on the date of surrender were as follows:

- Taxpayer's investment in policy $14,565,
- Accumulated policy value $23,509, and
- Outstanding loans plus accrued interest $23,125.

Pacific Life issued a Form 1099-R showing a gross distribution of $23,509 and a taxable distribution of $8,944 (accumulated value of $23,509 less investment of $14,565). The taxpayers did not include the distribution on the 2001 tax return. The IRS determined the gross income should have been reported and recommended an adjustment accordingly to which the taxpayer disagreed.

Issue. Whether the taxpayer's gross income should include $8,944 from the surrender of a life insurance policy.

Analysis. IRC §61 provides that gross income includes all income from whatever source derived including, but not limited to, life insurance contracts. IRC §72 states the amount received under the surrender of a life insurance contract is included in income to the extent it exceeds the investment in the contract. At trial, the taxpayers presented three different arguments:

- The amount on the Form 1099-R was incorrect since Pacific Union used the policy's accumulated value rather than the cash value in computing the taxable distribution,
- The distributions were withdrawals of investment and not loans even though the taxpayer had never contacted Pacific Union to discuss the erroneous treatment of the "loans", and
- Pacific Life's internal loan classification created a "fictitious tax liability" since the taxpayer received only $15,881, while Pacific Life kept $8,944 to pay fees and charges associated with the policy.

Holding. The Tax Court looked at the arguments presented by the taxpayers and found it remarkable that Pacific Union had never been contacted by the taxpayer to dispute the classification of the distributions as loans. Despite all arguments raised by the taxpayers, the Court found the $8,944 was a taxable distribution and properly includable in gross income.

INNOCENT SPOUSE

Joint and Several Liability Relief

Patricia A. and John J. Hendricks v. Commissioner, **TC Memo 2005-72, April 5, 2005**
IRC §6015

☞ **Innocent Spouse Relief Granted**

Facts. John and Patricia Hendricks are each in their 70s and retired. Prior to their wedding more than 45 years ago, they agreed John would handle the finances and Patricia would run the household. Patricia's only involvement in the family finances was to pay the monthly household expenses from a joint bank account into which John put money. In addition, John had several business bank accounts to which Patricia **did not** have access. John worked as a farm manager, farm and ranch real estate broker, and real estate investor. Patricia relied solely on John for financial, business, and tax decisions. After the joint return was prepared each year, Patricia would sign it based on John and the accountant's recommendations.

In 1980, John began investing a total of $94,002 in Boulder Oil and Gas Associates partnership (BOGA). This investment was solely in John's name and was not made known to Patricia. All mail from BOGA was received by John at his business address. Losses were generated from this investment and claimed on the joint returns on Schedule E for the years 1980 through 1983. Theses losses were combined on Schedule E with at least 11 other properties including condominiums and an office building. Patricia was made aware of this investment when the IRS issued examination reports for the years 1980–1982 showing deficiencies owed from BOGA losses. The IRS assessed taxes, penalties, and interest totaling $387,903 which were subsequently paid by Mr. and Mrs. Hendricks over a period starting in the summer of 1987 through August 1993.

During 1988, the BOGA 1983 partnership was examined under the IRS TEFRA procedures. The 1983 loss claimed on the Hendricks return for this venture amounted to $158,521. The case progressed through the IRS system until the assessment for the 1983 tax year against the Hendricks was finally made. Patricia requested innocent spouse relief for the 1983 year but the IRS denied her request.

Issue. Whether Patricia Hendricks qualifies for innocent spouse relief from joint and several liability under IRC §6015.

Analysis. In order to qualify for innocent spouse relief under §6015, the requesting spouse must establish:

- A joint return was made for the taxable year,
- The joint return resulted in an understatement of tax attributable to erroneous items of one of the spouses, and
- The alleged innocent spouse can show that in signing the joint return, she **did not know and had no reason to know** of the understatement described above.

The Tax Court pointed out various factors which weighed heavily in Mrs. Hendricks favor including:

- BOGA investment was in only in John's name,
- BOGA investment was paid for from his business account,
- BOGA mail went to John's business address (Patricia never saw any mail from this venture),
- Patricia had no work experience or education relating to tax, financial, or accounting matters, and
- Patricia had no reason to doubt the legitimacy of the BOGA deduction.

Holding. The Tax Court determined Patricia Hendricks met all of the requirements entitling her to relief from joint and several tax liability for 1983. In addition, the court noted Patricia had a limited income and would experience financial hardship if relief were denied.

Joint and Several Liability Relief

***Charma Gatlin Cook v. Commissioner,* TC Memo 2005-22, February 10, 2005**
IRC §6015

☞ Innocent Spouse Relief Granted

Facts. Charma Cook and M. Duane Spruill filed a joint return for 1998 showing her salary and his business income as a contract oil well pumper. Since Mr. Spruill did not own a computer or a typewriter, Charma hand wrote his business invoices based on the information he provided to her. At the end of the month, she prepared a summary of invoices which was provided to the accountant. Charma did not see any of the monies collected, nor did she have access to the business bank accounts. Mr. Spruill was physically and emotionally abusive to Charma throughout their marriage which ended in early 2000.

The IRS determined an additional tax liability resulting from $6,907 in unreported income from Thunder Alley Joint Venture. Charma requested innocent spouse relief, which the IRS denied.

Issue. Whether Charma Cook qualifies for innocent spouse relief from joint and several liability under IRC §6015.

Analysis. In order to qualify for innocent spouse relief under IRC §6015, the requesting spouse must establish:

- A joint return was made for the taxable year,
- The joint return resulted in an understatement of tax attributable to erroneous items of one of the spouses, and
- The alleged innocent spouse can show that in signing the joint return, she **did not know and had no reason to know** of the understatement described above.

In order to demonstrate Charma's knowledge, the IRS proposed two findings of fact:

- Charma prepared invoices and the monthly summary of the invoices, and
- Charma had knowledge of the billings corresponding to Thunder Alley.

The Tax Court indicated that when Charma testified at trial, the IRS counsel questioned her but did not inquire as to the details of the invoicing procedures. Mr. Spruill was not called to testify. The IRS did not prove Charma had **actual knowledge** of the Thunder Alley receipts.

Holding. The Tax Court determined Charma Cook met all of the requirements entitling her to relief from joint and several tax liability for 1998.

IRS PROCEDURES: AUDITS

Wages

Revenue Ruling 2005-51, July 12, 2005
IRC §6213

☞ Mathematical or Clerical Error Summary Assessment Clarified

Purpose. To determine if an individual who files an income tax return which reports income in a differing amount than that reported on the Form W-2 attached to the return, falls within the mathematical or clerical error summary assessment procedures of IRC §6213(b).

Facts. In **situation one**, a taxpayer files a 2003 tax return reporting the following:

Wages	$18,000
Standard deduction	4,750
Personal exemption deduction	3,050
Taxable income	10,200
Tax liability	1,184
Federal income tax withheld	2,000
Refund due	816

The Form W-2, which the taxpayer attaches to the return, shows wages of $25,000 and federal tax withheld of $2,000. A statement is attached to the return stating only $18,000 in wages was received, not the $25,000 amount shown on the W-2. If the $25,000 is the correct wage amount, the return would now show a balance due of $234 instead of receiving a refund of $816.

In **situation two**, the same type of facts apply **except** the taxpayer had multiple Forms W-2 and did not attach a statement to the return explaining the discrepancy between the amounts reported on the W-2s ($55,000) and the return as filed ($50,000). One of the Forms W-2 reported $5,000 of wages with $500 of withholding. In this situation, it is not certain if there was a mathematical error or the taxpayer disputed information on the Forms W-2.

Analysis. IRC §6213(a) prohibits the IRS from assessing a deficiency until the period for petitioning the Tax Court expires or a Tax Court decision becomes final when a notice of deficiency is issued based on the information shown on the Form W-2. IRC §6213(b) applies in the case of mathematical or clerical errors appearing on the return. The IRS may assess the additional tax due without a notice of deficiency being issued.

It is clear in **situation one** that a discrepancy exists between what is shown on the return and the Form W-2. In **situation two** it is not clear since nothing is attached to the return to explain the rationale used by the taxpayer. It is not known whether this situation falls under the category of mathematical or clerical error or if the information shown on the Form W-2 is in dispute.

Ruling. Situation one — IRC §6213(b) procedures cannot be used in this situation; a notice of deficiency must be issued under IRC §6212(a).

Situation two — IRC §6213(b) procedures cannot be used in this situation; a notice of deficiency must be issued under IRC §6212(a).

Abusive Tax Avoidance Transactions

IRS News Release IR-2005-17, February 22, 2005
IRS Fact Sheet 2005-11
IRS Announcement 2005-19
IRC §§61, 162, and 6662

☞ IRS Extends Settlement Offer for Executive Stock Option Scheme

Currently, the IRS has identified 42 corporations, many more executives, and more than $700 million of unreported income arising from the **Executive Stock Option Scheme**.

Under this scheme, corporate executives transfer stock options to family controlled partnerships and other related entities. These transfers result in the avoidance of taxes on compensation which is normally taxed to the executive. Once the partnership or other entity receives the options, they exercise the options and sell the stock. The executive contends the tax is not owed until the date of the deferred payment, typically 15 to 30 years later. This tax avoidance resulted in deferred taxes for up to 30 years on the compensation as well as a deferred compensation deduction at the corporate level.

The IRS offered a settlement initiative window through May 23, 2005 for **terms of the settlement offer** via a closing agreement as follows:

1. Executives must:
   - Report 100% of the compensation
   - Pay interest
   - Pay a 10% penalty
2. Corporations and executives must pay appropriate employment taxes
3. Parties are allowed to deduct out of pocket transaction costs (typically promoter and professional fees)
4. Corporations are allowed to deduct compensation expense reported by executive

Announcement 2005-19 provides detailed information surrounding the initiative.

The IRS will pursue taxpayers who have chosen not to come forward and accept the settlement offer, making adjustments and asserting penalties as warranted. Information on these transactions is provided through investor lists obtained in IRS promoter investigations, corporate audits, and successful Department of Justice summons enforcement actions.

Tax Schemes

IRS News Release IR-2005-19, February 28, 2005
IRS News Release IR-2005-27, March 14, 2005
Revenue Rulings 2005-17 through 2005-21, April 2005
IRS Notice 2005-30, "The Truth About Frivolous Tax Arguments," March 14, 2005
IRC §§165, 170, 501, 3102, 6702, and 667

☞ IRS Provides Update on 2005 "Dirty Dozen" Tax Schemes and Other Important Information

The IRS compiled the following information to assist taxpayers in steering away from tax schemes:

- IRS News Release IR-2005-19, February 28, 2005 and IR-2005-17, March 14, 2005
- IRS Notice 2005-30
- Revenue Rulings 2005-17 through 2005-21, April 2005
- "The Truth About Frivolous Tax Arguments"

News Release IR-2005-19. The IRS continues to identify tax schemes which were allegedly promoted as offering 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:

- Trust Misuse
- Frivolous Arguments
- Return Preparer Fraud
- Credit Counseling Agencies
- "Claim of Right" Doctrine

- "No Gain" Deduction
- Corporation Sole
- Identify Theft
- Abuse of Charitable Organizations and Deductions
- Offshore Transactions
- Zero Return
- Employment Tax Evasion

News Release IR-2005-27. The IRS provided guidance describing and rebutting frivolous arguments taxpayers should avoid when filing returns. This guidance is referred to in IRS Notice 2005-30 and five revenue rulings.

IRS Notice 2005-30. Notice 2005-30 describes the 23 most common frivolous arguments taxpayers use when filing returns. They are:

- Filing a return reporting zero income and zero tax liability
- Referring to a separate "straw man" entity created using taxpayer name in ALL CAPITAL LETTERS in government documents
- Wages are not taxable income since labor equals fair market value of wages received thus no gain results
- 16th Amendment is invalid
- "Claim of right" to exclude labor from income
- Only foreign source income is taxable under IRC §861
- Not a "citizen" or "person" within the Internal Revenue Code
- Residents of states are residents of a foreign country and are **not** subject to U.S. income tax
- Tax escaped by putting assets in an offshore bank account
- Elimination of tax by establishing "corporation sole"
- Placing all assets in a trust escapes income taxes even though control over assets is maintained
- Establish home business to deduct amounts paid to maintain household
- The Internal Revenue Code does not impose requirements to file a return
- Filing a tax return is "voluntary"
- Since taxes are voluntary, employers are not required to withhold income or employment taxes from employees
- Taxpayers who disagree with government's use of taxes collected can refuse to pay
- Submit a "set of documents" instead of a tax return
- Submit a return with an attachment that disclaims tax liability
- Submit a return with an altered penalties of perjury statement
- Claim "reparations tax credit"
- Use Disabled Access Credit for inflated purchases to reduce/eliminate tax
- Deduct social security taxes paid or get a refund of those taxes
- Sell (or purchase) the right to claim a qualifying child for EIC purposes

IRS Notice 2005-30 also provides civil and criminal penalties making frivolous arguments which could include:

- IRC §6651 — additions to tax
- IRC §6662 — accuracy-related penalty
- IRC §6663 — penalty for civil fraud
- IRC §6702 — $500 penalty for frivolous income tax return
- IRC §6673 — penalty of up to $25,000 for frivolous arguments made in the U.S. Tax Court

Revenue Rulings 2005-17 through 2005-21 provide further guidance in solidifying the IRS position in combating frivolous tax positions.

- Revenue Ruling 2005-17 emphasizes the frivolous positions taken regarding a refund of social security where right to receive social security benefits has been waived and regarding charitable contribution deductions for social security taxes which taxpayers claim they have "donated" to the government.
- Revenue Ruling 2005-18 emphasizes a return is invalid if it has been changed by striking or otherwise altering the written declaration (the jurat) in a manner that negates or casts doubt on its validity.
- Revenue Ruling 2005-19 emphasizes a taxpayer cannot avoid income tax by making frivolous constitutionally based arguments.
- Revenue Ruling 2005-20 emphasizes liability for federal taxes does not depend on whether the taxpayer agrees with the government programs or policies that are funded with tax receipts.
- Revenue Ruling 2005-21 emphasizes income tax cannot be avoided on the erroneous theory that the government has created a "straw man."

"The Truth About Frivolous Tax Arguments" is a 56-page web-published document addressing 39 frivolous contentions dealing with the legality of not paying taxes or filing returns. The document also includes citations from 13 cases decided by the courts in 2004.[55]

> **Note.** Additional information on tax protestor arguments, including court case citations, can be found in Chapter 3, "Ethics," in this workbook.

Tax Shelters

IRS News Release IR-2005-37, March 24, 2005
Fact Sheet 2205-14, March 2005
IRC §§165, 183, and 701

☞ IRS Settlement Offers for Son of Boss Tax Shelter Net more than $3.2 billion

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.

55. Document found at www.irs.gov/pub/irs-utl/friv_tax.pdf

In 2004, the IRS offered a settlement initiative to over 1,800 taxpayers. Last year, 1,500 taxpayers indicated their intent to take advantage of the settlement offer. As of the publication date of this workbook, 1,200 have participated in the settlement initiative. The typical taxpayer payment was almost $1 million, with 18 taxpayers paying over $20 million each. One taxpayer paid over $100 million as part of the settlement initiative. IRS has collected over $3.7 billion in additional taxes and expects to receive another $4 billion. As a result of this settlement initiative, taxpayers have remitted an additional $23.5 million in state taxes on voluntary amended state returns. As of the publication date of this workbook, information from 1,015 cases were shared with 34 states.

For those taxpayers that did not take advantage of the settlement opportunity, notices of deficiency will soon be issued. The notice of deficiency will show disallowance of all claimed tax losses as well as transaction costs. A 40% penalty will be assessed in addition to statutory interest.

IRS PROCEDURES: ELECTRONIC FILING

TeleFile

IRS Announcement 2005-26, April 25, 2006

☞ TeleFile Discontinued August 17, 2005

Effective August 17, 2005, the IRS discontinued the use of the TeleFile program. TeleFile was used to file Forms 1040EZ, 4868, and 941 via telephone.

Reasons for discontinuing the program include decline in use for most forms, and increasing costs to maintain the system.

In place of TeleFile, the IRS offers a number of electronic filing alternatives. The IRS website provides additional information (**www.irs.gov**).

e-Services

IRS News Release IR-2004-114, September 9, 2004
IRS News Release IR-2005-33, March 21, 2005

☞ IRS Announces New Electronic Tools and Expanded Access

Transcript Delivery System (TDS) is the latest premium addition to the IRS suite of e-services. Premium e-services are "on-line" options available for tax professionals who **e-file any combination of five or more accepted individual and business tax returns in a calendar year.**

Transcript Delivery System is used to request:

- Tax account transcripts,
- Tax return transcripts, and
- Other tax information for business and individual clients.

The requested documents can be sent to the practitioner by:

- A secure online connection **within minutes**, or
- Paper document within days or weeks of the request date.

13

The two other premium e-services are Disclosure Authorization and Electronic Account Resolution which were released in July of 2004. **Disclosure Authorization** allows online submission of Form 2848, *Power of Attorney*, or Form 8821, *Taxpayer Information Authorization.* Tax professionals can also view and modify existing authorization forms and receive acknowledgment of accepted submissions immediately online.

Electronic Account Resolution allows tax professionals to electronically correspond with the IRS on

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

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

Other e-services available to all tax professionals include:

- e-services registration
- Preparer Tax Identification Number (PTIN)
- IRS e-file Application
- Taxpayer Identification Number (TIN) matching

Electronic Filing

IRS News Release IR-2005-8, January 11, 2005

☞ Electronic Filing Mandated for Certain Large Corporations and Tax-Exempt Organizations

For **tax year 2005 returns due in 2006**, corporations filing a Form 1120 or 1120S with total assets of $50 million or more and tax-exempt organizations filing Form 990 with total assets of $100 million or more will be **required** to file electronically.

For **tax year 2006 returns due in 2007**, the following also will be **required** to file electronically:

- Corporations with $10 million or more in total assets
- Tax-exempt organizations with $10 million or more in total assets
- Private foundations and charitable trusts (Form 990-PF) regardless of size

The electronic filing requirements only apply to entities filing at least 250 returns, including income tax, excise tax, information, and employment tax returns during a calendar year.

Electronic Filing

IRS News Release IR-2005-53, April 28, 2005

☞ New Records Set in IRS Electronic Filing

The IRS electronic filing efforts continued to grow during the 2005 filing season, as evidenced by the following numbers:

- 66 million e-file returns were accepted through April 22nd (up almost 11% from the same time last year)
- 5.01 million Free File returns (up 46.2% from last year's 3.43 million returns)
- 16.7 million taxpayers filed from a home computer
- 46 million returns from tax professionals (up more than 10% from same period last year)
- 928,000 taxpayers made payments using a credit card (57% increase from prior period)

IRS PROCEDURES: MISCELLANEOUS

IRS Priorities

IRS News Release IR-2005-80, August 8, 2005
IRS News Release IR-2205-81, August 8, 2005

☞ IRS 2005-2006 Priority Guidance Plan, Strategic Plan, and New IIR Issues

During the next year, the IRS plans on issuing formal legal guidance on 254 tax topics affecting individuals, corporations, charities, international transactions, and employee benefit plans. This key component allows practitioners to understand IRS application of tax law in a timely manner, often before tax returns are required to be filed. Tax topics include:

- Additional legal requirements prompted by stronger reporting standards for tax shelters under American Jobs Creation Act
- Guidance on tax treatment of distributions from Roth IRAs
- Guidance on the impact of providing a 2½ month grace period for flexible spending accounts on health savings accounts
- IRC §529 regulations regarding qualified tuition programs for higher education
- How charities should report car donations they receive
- Legal withholding requirements for prize winners at poker tournaments

In addition, the upcoming IRS Strategic Plan focuses on providing excellent service to taxpayers and enforcing the tax laws in a balanced manner.

Two new issues will be addressed under the Industry Issue Resolution (IIR) program during the upcoming year. They are:

- Member of a family receiving assistance requirements for the Work Opportunity and Welfare to Work Tax Credit, and
- Home construction contracts definition.

TIN Matching
August 2005

☞ New Tool for Form 1099 Payers

Practitioners who report payments on Forms 1099-B, DIV, INT, MISC, OID, or PATR, have a new tool to assist them in matching payee names and taxpayer identification numbers (TIN) against records on file with the IRS before filing these information returns.

To qualify for the TIN matching service, practitioners need have only filed information returns in one of the past two years for any of the Forms 1099 listed above. Practitioners can check up to 25 name/TIN combinations on-line and up to 100,000 name/TIN combinations using a text file submission.

This tool should result in fewer backup withholding and penalty notices.

To use this new service, practitioners must be enrolled in IRS e-services. The IRS website is used to enroll (**www.irs.gov**) or the e-services help desk may be called at 1-866-255-0654.

Summons
***Robert L. Schulz v. Commissioner,* 2nd Cir. Ct. of Appeals, No. 04-0196, 2005-1 USTC ¶50,165, January 25, 2005, (affirming prior U.S. District Court decision)**
IRC §7604

☞ IRS Enforcement Action Required to Quash Summons

Facts. In May and June of 2003, Mr. Schulz was served with a series of administrative summonses by the IRS. Mr. Schulz disagreed with the summons service and filed motions with U.S. District Court for the Northern District of New York to quash them. This court dismissed Mr. Schulz's motion citing that until such time as the IRS attempts to enforce the summons, Mr. Schulz is under no threat for failure to comply. In the event the IRS attempts to compel Mr. Schulz to produce testimony or documents, Mr. Schulz could then contest the request.

Mr. Schulz appealed the decision to the district court which was denied and dismissed. This case appeals the decision of the district court.

Issue. Whether the court can dismiss an IRS summons action which has not yet been **enforced** by IRS.

Analysis. Article III of the Constitution limits jurisdiction of the federal courts to actual cases and controversies. In order for Mr. Schulz to prevail, he must show enforcement action on the part of the IRS which threatens injury to him.

The Supreme Court pointed out in *United States v. Bisceglia*, IRS summonses have no force or effect unless the IRS seeks to enforce them through a §7604 proceeding. [75-1 USTC ¶9247], 420 U.S. 141, 146 (1975), *partially superseded by* 26 U.S.C. §7609, as stated in *In re Does.*[56]

Absent an effort to seek enforcement through a federal court, the IRS summonses apply no force to taxpayers, and no consequence whatever can befall a taxpayer who refuses, ignores, or otherwise does not comply with an IRS summons until that summons is backed by a federal court order. Although this decision is contrary to decisions in *Application of Colton,* and *In re Turner,*[57] this decision completes a task which began forty years ago.

Of course, if the IRS should, at a later time, seek to enforce the summons, then the procedures set forth in IRC §7604(b) will afford Schulz ample opportunity to seek protection from the federal courts.

56. *In re Does,* 82-2 USTC ¶9565, 688 F.2d 144, 148 (2d Cir. 1982)

57. *Application of Colton,* 61-2 USTC ¶9530, 291 F.2d 487, 491 (2d Cir. 1961), and *In re Turner,* 62-2 USTC ¶9764, 309 F.2d 69, 71 (2d Cir. 1962)

Holding. The court held no force was applied to Schulz and his request for action is premature; the decision of the district court dismissing Schulz's motions is affirmed.

> **Note.** In most cases involving uncooperative taxpayers who refuse to obey an IRS summons, the IRS requests a **summons enforcement hearing** before a U.S. District Court judge. It is unknown if the IRS subsequently asked for such a hearing in order to compel the taxpayer to obey the summons.

Closed Examinations

Revenue Procedure 2005-32, June 6, 2005

☞ Reopening of Examinations Clarified

Background. To provide guidance when a case is deemed closed after examination by the IRS, what IRS actions do not constitute examinations, when a closed case may be reopened, and who within the IRS must approve a reopening.

Closed Case Definition. An **agreed case** is closed after examination when the IRS notifies the taxpayer in writing of adjustments to the liability or acceptance of the return without changes. Cases subject to review by the Joint Committee on Taxation are not deemed closed until all review procedures and necessary follow-ups are complete. In cases involving a closing agreement, closing does not occur until the closing agreement is signed by an appropriate IRS official.

Unagreed income, estate, gift, Chapters 41-44 excise tax, worker classification, or plan qualification cases are deemed closed after the period for filing a petition with the U. S. Tax Court or notice of deficiency expires with no petition being filed. Unagreed excise tax cases (not subject to the deficiency procedures of IRC §§6211 through 6215) or employment tax cases expire when the request for appeals hearing expires or no request has been made.

Reopening is defined as an examination of a liability that may result in **unfavorable** results for the same taxable period as the closed case. The IRS's review of books and records on a claim for refund or amended return or Form 843 is not a reopening.

Taxpayer contacts and other actions that are not examinations, inspections, or reopenings. These situations fall into the following four categories:

1. Limited contacts without inspection of books and records
2. Service-administered programs for selective issues resolution such as:
   - Accelerated issue resolution
   - Advance Pricing Agreement program
   - Pre-Filing Agreement program
   - Industry Issue Resolution program
3. Reconsiderations involving positions taken on tax return items or transactions by the same taxpayer in a different taxable period
4. Contacts, compliance checks, examinations, or investigations of a taxpayer or third party for one purpose, tax, or period resulting in obtaining information for the IRS relevant or useful for a different purpose

Reopening Closed Cases. No reopening occurs unless there is:

- Evidence of fraud, malfeasance, collusion, concealment, or misrepresentation of fact,
- A clearly-defined, substantial error based on an established IRS position existing at the time of the examination, or
- A circumstance where failure to reopen would result in serious administrative omission.

Reopening must be approved by an IRS official with delegation authority, as listed in Commissioner Delegation Number 57 (or successor order) for cases under his jurisdiction.

Effective date of this revenue procedure is May 20, 2005.

Form 4868
August 4, 2005

☞ New Form 4868 Provides Six-Month Extension Period

Pending approval of the regulations, the revised draft Form 4868 will allow taxpayers to request a six-month extension for filing their tax returns.

Prior to the availability of this form, if taxpayers needed a six-month extension, they had to file two forms. They filed a Form 4868 prior to the due date of the tax return giving them a four-month extension. Then, they filed Form 2688, which required a description of the reason for an extension of two additional months.

This revised form will save practitioners and taxpayers an estimated nine million hours. Both practitioners and the IRS will benefit from the manpower savings in completing and processing the second form.

Form **4868**
Department of the Treasury
Internal Revenue Service (99)

Application for Automatic Extension of Time To File U.S. Individual Income Tax Return

OMB No. 1545-0188
2005

What's New

- You can now use Form 4868 to obtain an automatic 6-month extension (generally 4 months if you are "out of the country"). You no longer need to file Form 2688 for additional extension of time. See *General Instructions* on page 2.
- If you are "out of the country" and are a U.S. citizen or resident, you must check the box on line 8. See *When To File Form 4868* on page 2 and the instructions for line 8 on page 3.

IRS e-file — It's Convenient, Safe, and Secure

IRS *e-file* is the IRS's electronic filing program. You can get an automatic extension of time to file your tax return by filing Form 4868 electronically. You will receive an electronic acknowledgment once you complete the transaction. Keep it with your records. Do not send in Form 4868 if you file electronically.

Complete Form 4868 to use as a worksheet. If you think you may owe tax when you file your return, you will need to estimate your total tax liability and subtract how much you have already paid (lines 4, 5, and 6 below).

If you think you may owe tax and wish to make a payment, you may pay by electronic funds withdrawal using option 1 or you may pay by credit card using option 2. See *1* and *2* on this page for details.

1 *E-file* Using Your Personal Computer or Through a Tax Professional

Refer to your tax software package or tax preparer for ways to file electronically. Be sure to have a copy of your 2004 tax return—you will be asked to provide information from the return for taxpayer verification. If you wish to make a payment, you can pay by electronic funds withdrawal (see page 4) or send your payment to the address shown in the middle column under *Where To File a Paper Form 4868* on page 4.

2 *E-file* and Pay by Credit Card

You can get an extension if you pay part or all of your estimate of income tax due by using a credit card (American Express® Card, Discover® Card, MasterCard® card, or Visa® card). Your payment must be at least $1. You may pay by phone or over the Internet through one of the service providers listed below.

Each service provider will charge a convenience fee based on the amount of the tax payment you are making. Fees may vary between service providers. You will be told what the fee is during the transaction and will have the option to continue or cancel the transaction. You may also obtain the convenience fee by calling the providers' toll-free automated customer service numbers or visiting their websites. Do not add the convenience fee to your tax payment.

Confirmation number. You will receive a confirmation number when you pay by credit card. Enter the confirmation number below and keep for your records.

Link2Gov Corporation	**Official Payments Corporation**
1-888-PAY-1040sm	1-800-2PAY-TAXsm
(1-888-729-1040)	(1-800-272-9829)
1-888-658-5465 (Customer Service)	1-877-754-4413 (Customer Service)
www.PAY1040.com	*www.officialpayments.com*

Enter confirmation number here ▶ ....

File a Paper Form 4868

If you wish to file on paper instead of electronically, fill in the Form 4868 below and mail it to the address shown on page 4. If you are a fiscal year taxpayer, you must file a paper Form 4868.

▼ DETACH HERE ▼

Form **4868**
Department of the Treasury
Internal Revenue Service

Application for Automatic Extension of Time To File U.S. Individual Income Tax Return

For calendar year 2005, or other tax year beginning , 2005, ending , 200 .

OMB No. 1545-0188
2005

Caution: Incorrect or missing information may cause a delay in processing.

Part I Identification			**Part II** Individual Income Tax	
1 Your name(s) (see instructions)			**4** Estimate of total tax liability for 2005	$
Address (see instructions)			**5** Total 2005 payments	
City, town, or post office	State	ZIP code	**6** **Balance due.** Subtract line 5 from line 4 (see instructions)	
2 Your social security number	**3** Spouse's social security number		**7** Amount you are paying (see instructions) ▶	
			8 Check here if you are "out of the country" and a U.S. citizen or resident ▶ ☐	

For Privacy Act and Paperwork Reduction Act Notice, see page 4. Cat. No. 13141W Form **4868** (2005)

Industry Issue Resolution

IRS News Release IR-2005-73, July 12, 2005
Revenue Procedure 2005-39, July 11, 2005

☞ Facsimile Signatures Allowed on Employment Tax Returns

The National Payroll Consortium submitted an Industry Issue Resolution which resulted in corporate officers or authorized agents now being able to sign employment tax returns by facsimile including alternative signature methods such as mechanical devices or computer software programs.

Revenue Procedure 2005-39 applies to:

- Forms in 940 Series (940, 941, 943, and 945),
- Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons,*
- Form 8027, *Employer's Annual Information Return of Tip Income and Allocated Tips,*
- Form CT-1, *Employer's Annual Railroad Retirement Tax Return,* and
- Any variant of these forms (941c, 941-SS).

This revenue procedure is effective for any of the designated forms filed on or after July 1, 2005.

Circular 230

IRS News Release IR-2004-152, December 17, 2004
IRS News Release IR-2005-59, May 18, 2005

☞ IRS and Treasury Department Amend Circular 230 and Clarify Written Opinion Standards

As part of continuing efforts to curb abusive tax avoidance transactions and improve ethical standards of tax professionals, final regulations amending Treasury Department Circular 230 have been issued. These amendments are intended to ensure that tax professionals do not provide inadequate advice and also require tax professionals to make disclosures if the advice is incomplete.

The IRS intends to monitor attorneys, accountants, and other tax practitioners to ensure they adhere to the professional standards. The IRS has made this to be one of its top four enforcement goals.

In addition, the appointment of Cono Namorato, a former Justice Department prosecutor, as Director of the IRS Office of Professional Responsibility (OPR) has helped with strengthening professional standards.

In News Release IR-2005-59, three of the five revisions expand the definition of "excluded advice," which is not subject to the detailed covered opinion standards of Circular 230. These revisions apply to:

- Advice from in-house tax professionals to their employers,
- Situations in which the advice is provided **after** the client files the relevant tax return, and
- "Negative advice" where the advisor explains the transaction will not provide the purported tax benefit.

Also included in the revised covered opinion standards are:

- Definition of principal purpose of tax avoidance that excludes transactions claiming tax benefits consistent with the statute and Congressional purpose, and
- Specific requirements for format of disclosures required for certain written tax advice rendered **after June 30, 2005.**

> **Note.** More information on Circular 230 can be found in Chapter 3, "Ethics," of this workbook.

IRS Website
IRS News Release IR-2005-51, April 25, 2005

☞ Small Business Assistance Available at IRS Website

A feature is available on the IRS website (**www.irs.gov**) to assist small business and self-employed taxpayers with their tax responsibilities. The small business section of the website provides information on:

- Employment tax requirements,
- Options for making tax payments,
- How to set up and distribute retirement plans,
- Viewing a small business tax workshop through streaming video, and
- How to order free products, such as small business resource guide or tax calendar.

New features are added as they become available, so practitioners are encouraged to check the site often.

EITC Tools
IRS News Release IR-2005-11, January 27, 2005
IRS Fact Sheet 2005-10, January 2005
IRC §32

☞ EITC Assistant Tool Now Available

EITC Assistant, a web-based tool, is now available to assist in determining whether someone is eligible to claim the earned income tax credit (EITC).

This tool is very simple to use. Just answer a few simple questions and provide some basic information to determine

- The taxpayer's correct filing status,
- Whether a child is a qualifying child, and
- An estimate of EITC the taxpayer may receive.

This tool is available in both English and Spanish on **www.irs.gov.**

IRS Fact Sheet 2005-10 and 1040 Central on **www.irs.gov** provide eligibility rules for EITC as well.

Note. A special provision exists for military families to elect to include nontaxable combat pay in earned income for EIC purposes. However, taxpayers should compute their EITC with and without the combat pay to determine the best solution for them. Either all or none of the combat pay must be used in the calculation.

13

Package X
June 2005

☞ Alternatives to Package X Still Available

Package X, a compilation of federal tax forms and instructions, has been eliminated. The IRS will save $1.8 million in printing and mailing as a result of this decision.

Practitioners continue to have access to all the materials formerly contained in the Package X at the IRS website at **www.irs.gov** or IRS Pub. 1726, *IRS Tax Products CD-ROM.* The CD-ROM can be purchased from these sources:

- Superintendent of Documents under Government Printing Office (GPO), or
- National Technical Information System (NTIS) under U.S. Department of Commerce.

In late summer 2005, one final copy of IRS Pub. 1045, *Tax Professionals Guide to Federal Tax Products*, will be mailed to practitioners. This last version will contain order forms for practitioners to use.

Offer In Compromise
IRS News Release IR-2004-129, October 25, 2004

☞ IRS Announces New Form 656, *Offer In Compromise*

The **Form 656** package was redesigned to help tax professionals and taxpayers correctly prepare OIC applications. This redesign effort resulted from recommendations from both external groups and the National Taxpayer Advocate. The new form includes a signature block for the **paid tax professional,** which the IRS hopes will discourage unscrupulous promoters who falsely market offers in compromise to taxpayers with a "pennies-on-the-dollar" approach.

The package also includes:

- Form 656-A, *Income Certification for OIC Application Fee*
- Worksheet for determining if taxpayers meet the exception to the $150 fee
- Checklist to allow taxpayers to determine if they are eligible to file before investing time in the application process
- Step-by-step guide through the OIC process
- Third Party Designee section which allows a third party to discuss additional information needed by IRS for processing OIC
- Summary checklist designed to reduce omission errors

Previous revisions of the OIC should be destroyed.

> **Note.** Additional information on the OIC program and copies of the forms can be found in Chapter 2, "IRS Issues," in this workbook.

Tax Gap

IRS News Release IR-2005-38, March 20, 2005
IRS Fact Sheet 2005-14, March 2005

☞ Tax Gap Exceeds a Quarter Trillion Dollars

The gross tax gap is defined as the difference between what taxpayers **should pay** and what they **actually pay** on a timely basis. Three components included in the tax gap are:

1. Underreporting of income,
2. Underpayment of taxes, and
3. Nonfiling of returns.

The underreporting component represents approximately 80% of the tax gap. The gross tax gap is estimated at more than $300 billion per year. The IRS compliance efforts and late paid tax collections are estimated at $55 billion per year, leaving a net tax gap of approximately $257 billion. These tax gap findings are from the National Research Program (NRP) study, which examined 46,000 individual returns for 2001.

Data has shown a 14.9% increase in the noncompliance rate in 1988 to between 15% and 16.6% currently. The IRS increased enforcement activities by nearly 28%, collecting $43.1 billion in 2004, compared to $33.8 billion in 2001. Examinations for taxpayers earning $100,000 or more doubled from fiscal year 2001 to 2004. Total examinations exceeded 1 million in 2004, representing at 37% increase over 2001 examinations.

Preliminary findings from the NRP study include:

- Underreporting noncompliance accounts for more than 80% of the total tax gap
- Individual income taxes account for two-thirds of the total tax gap
- More than 80% of individual underreporting comes from understated income, not overstated deductions
- Most understated income comes from business activities, not wages or investment income
- Compliance is higher when third-party reporting or withholding is involved

Areas where taxpayer compliance has decreased include:

- Net income reporting from flow-through entities
- Proprietor income and expense reporting
- Various types of deductions

Reporting of farm income is one area where taxpayer compliance has increased.

The IRS received additional funding for continued efforts to aggressively reduce the tax gap. The next steps in the tax gap analysis include using data from the individual taxpayer's study to **build new audit models** and develop **other ways to address noncompliance**.

Withholding Compliance Program

IRS News Release IR-2005-45, April 13, 2005

IRC §§165, 183, and 701

☞ Withholding Compliance Program Strengthened

Effective April 14, 2005, employers are **no longer required** to send copies of potentially questionable Forms W-4, *Employee's Withholding Allowance Certificate,* to the IRS. However, these forms are still subject to review by the IRS. The employer is required to submit copies to the IRS if directed to do so via a written notice. This change is the result of temporary and proposed regulations issued by the Department of Treasury.

The IRS uses information reported on Forms W-2 to more effectively identify workers with withholding compliance problems. In situations where a serious under-withholding problem exits, the employer is notified to withhold additional income tax based on the actual rate needed. This new process also allows the IRS to address situations involving failure to file a federal income tax return.

Resources to assist in determining the proper amount of withholding include the **withholding calculator** and IRS Pub. 919, *How Do I Adjust My Tax Withholding,* both of which can be found at **www.irs.gov.**

Small Business Retirement Plan Resource Guide

IRS News Release IR-2005-50, April 25, 2005

☞ IRS Announces Small Business Retirement Plan Resource Guide

The IRS provides a resource guide compact disc (CD) entitled *Individual Retirement Arrangement (IRA) Resource Guide for Small Business Owners and Individuals.* This product contains information on:

1. Traditional and Roth IRAs
2. IRA-based retirement plans for employers, such as:
    - Simplified employee pensions (SEPs)
    - SIMPLE IRAs
    - Payroll deduction IRA plans

This CD is an easy to use tool which combines various IRA-related print and electronic information from the IRS as well as other federal agencies. It enables business owners to make educated decisions about their own needs as well as those of their employees. The CD also explains rules for keeping plans in compliance with the law. The CD contains videoclips, forms and publications, and interactive resources to assist small business owners with:

- Setting up the best plan,
- Making contributions to the plan,
- Investing funds, and
- Taking distributions.

For a free copy, contact the IRS at 1-800-829-3676 and request IRS Pub. 4395. An online version is also available in the "Retirement Plans" section of the IRS website. Employers are encouraged to subscribe to Retirement News for Employers, a free quarterly newsletter on retirement plan issues.

Refund Assistance
IRS News Release IR-2005-35, March 22, 2005

☞ "Where's My Refund?" Now Available

A feature is available on the IRS website (**www.irs.gov**) to assist taxpayers in locating refund checks and updating flawed mailing addresses when a refund check goes undelivered. Easy to follow instructions allow taxpayers to trace lost checks and change or correct mailing addresses. An online address change updates the IRS database and immediately provides a date when the refund check should be received. This tool can be used when the refund check is not received within 28 days from the original return mailing date.

What information is needed to use the website?

- Social security number,
- Filing status, and
- **Exact** amount of the refund.

For married taxpayers filing joint tax returns, Form 3911, *Taxpayer Statement Regarding Refund,* must be signed by **both** taxpayers and mailed or faxed to the appropriate location.

The information requested on this website should be data that is only known to taxpayers and the IRS, thus reducing the possibility of unauthorized access to the account.

"Where's My Refund" was accessed nearly 24 million times last year and already more than 16 million times in 2005. Taxpayers can reduce the need to access this website by using direct deposit for the refund.

Current website link to directly access the input screen: **https://sa.www4.irs.gov/irfof/lang/en/irfofgetstatus.jsp.**

TAC Closures
IRS News Release IR-2005-63, May 27, 2005

☞ 68 IRS Taxpayer Assistance Centers Scheduled to Close

As part of the IRS effort to foster efficiency, modernize operations, and reduce costs, 68 Taxpayer Assistance Centers (TACs) are scheduled to close Fall 2005. These closures reflect changes in how taxpayers are interacting with the IRS. Many taxpayers are filing returns and accessing tax information through e-filing and **www.irs.gov** website. Currently, the TACs provide walk-in service.

An objective model was used to determine which offices would close by analyzing five components:

- Workload considerations,
- Geographic factors,
- Demographics,
- Employee costs, and
- Facility costs

The gathered statistics indicate a decline in the number of taxpayers visiting TACs from FY 2002 to FY 2004 by 19%. Statistics are as follows:

Service	FY2002	FY2004	% Change
TAC contacts	9,531,000	7,698,000	−19%
Toll-free assistor calls answered	33,202,000	35,536,000	7%
Automated calls answered	46,785,000	33,771,000	−28%*
Online, *Where's My Refund?*	1,050,000	14,866,000	1,316%
www.irs.gov page views	366 million	934 million	155%
www.irs.gov visits	67 million	153 million	128%

*Decline partially due to *Where's My Refund?* visits.

Scheduled TAC closures include

- Arizona (Phoenix, Bullhead City, and Lake Havasu City)
- California (Yuma, San Marcos, Bakersfield, El Centro, Santa Rosa, Santa Barbara, Fresno, and Camarillo)
- Colorado (Colorado Springs)
- Connecticut (Hartford and New Haven)
- Florida (Plantation, St. Petersburg, and Fort Myers)
- Georgia (Atlanta)
- Idaho (Idaho Falls and Pocatello)
- Illinois (Downer's Grove)
- Indiana (Fort Wayne)
- Maine (Augusta and South Portland)
- Maryland (Salisbury, Annapolis, Wheaton, and Frederick)
- Massachusetts (Pittsfield, Fitchburg, Quincy, and Hyannis)
- Minnesota (Minneapolis)
- Missouri (Springfield)
- Montana (Bozeman, Great Falls, and Missoula)
- Nevada (Reno)
- New Hampshire (Keene and Portsmouth)
- New Jersey (Edison, Parsippany, Fairfield, and Paramus)
- New York (New York, Bronx, Hauppauge, Kingston, West Nyack, Albany, and Brooklyn)
- North Carolina (Greensboro and Wilmington)
- Pennsylvania (York and Washington)
- South Carolina (Charleston)
- Texas (Austin and Dallas)

- Utah (Provo)
- Vermont (Brattleboro and Rutland)
- Virginia (Hampton and Bailey's Crossroads)
- Washington (Silverdale)
- Wisconsin (Eau Claire, Madison, and Green Bay)
- Wyoming (Sheridan)

Nationwide, 332 TAC offices will remain open. Check **www.irs.gov** for the office nearest you.

Sanctions

***Lionel D. Kolker v. Commissioner,* TC Memo 2004-288, December 29, 2004**

IRC §§6330 and 6673

☞ Frivolous Arguments Result in Sanctions

Facts. For the 1993 tax year, this California taxpayer filed a joint tax return with his spouse showing a balance due. After assessing the balance due on the return along with interest and penalties, the IRS sent a notice and demand for payment to the taxpayer. Since no payment was received, the IRS then issued a Final Notice—Notice of Intent to Levy and Notice of Your Right to a Hearing.

The taxpayer requested a hearing. As the result of prior court action in which the taxpayer presented a frivolous argument, the appeals officer responded in writing: "The Appeals Office would not offer a face-to-face hearing if the only issues that taxpayer wanted to address were frivolous or groundless." A hearing was held, but the taxpayer pressed the appeals officer to discuss whether he had an "obligation" to file a return and pay tax. He refused to discuss collection alternatives.

A Notice of Determination Concerning Collection Action(s) was issued including a warning that the court was authorized to impose "monetary sanctions of up to $25,000 for taking a position that is frivolous or groundless" and the taxpayer's positions in this case were groundless and without merit. The taxpayer appealed on the following grounds:

- The IRS had not established he was a taxpayer,
- The appeals officer was biased, and
- The law did not create the alleged obligation.

In his petition, the taxpayer stated the proposed levy should not be sustained because

1. The IRS issued "arbitrary legal opinions" in that
   - A timely request for hearing was not made by taxpayer,
   - The IRS could not produce "facts" to support he is a "taxpayer",
   - The IRS did not permit taxpayer to ask what in the Constitution created the obligation to file a return and pay tax, and
   - Lack of evidence of an obligation to file and pay tax created by law
2. The IRS asserted the same arguments to dismiss as filed in other cases
3. Three year delay by the IRS in providing "sham" hearing, and
4. Without facts, an assessment is arbitrary; the arbitrary assessment presents a justifiable controversy.

Issue. Whether the levy action taken by the IRS is proper.

Analysis. IRC §6630 discusses the levy procedure the IRS must follow. The analysis of the process followed by the IRS was well documented and properly handled.

IRC §6673(a)(1) authorizes the court to require a taxpayer to pay to the United States a penalty, not to exceed $25,000, if it appears that the taxpayer has instituted or maintained a proceeding primarily for delay, or that the taxpayer's position is frivolous or groundless. Several court cases have been decided where penalties have been assessed including *Roberts, Eiselstein* and *Yacksyzn*.[58] The court cited another case during which this taxpayer had also wasted time in the federal courts with similar arguments.[59] The Tax Court imposed a $10,000 §6673 penalty. The Ninth Circuit U.S. Court of Appeals imposed an additional §6673 penalty of $1,500.

Holding. Although the taxpayer argued the appeals officers decision to terminate the hearing was an evidence of bias, the court did not agree. The court felt the termination of the hearing demonstrated that there is a limit to the tax system's tolerance for unproductive and frivolous exchanges regarding a taxpayer's obligations to file returns and pay tax. The court sustained the levy action by IRS.

The court also determined the taxpayer deserved an appropriate and **severe** sanction for wasting resources of the federal tax system; a $25,000 §6673(a)(1) penalty was imposed.

Collection Due Process/OIC

***Thomas E. Roberts v. Commissioner,* TC Summary Opinion 2005-31, March 24, 2005**
IRC §6330

☞ IRS Did NOT Abuse Its Discretion in Collection Efforts

Facts. In 1985, Tom Roberts formed a corporation which owned and operated a new car dealership in Texas. In his capacity as president, Tom obtained a loan from First Madisonville for operating capital using various assets of the corporation as security. As time went on, Tom borrowed additional funds for the corporations use including a revolving line of credit. Corporate loans were renewed periodically by Tom both as a corporate officer and in his individual capacity.

The corporation forfeited its corporate charter in June of 1988 and filed for bankruptcy protection in September of 1988. Later in 1990, First Madisonville asked Tom to sign a final note in his individual capacity for the remaining corporate debt (approximately $40,000).

In 1997, Tom encountered severe financial problems and First Madisonville made unsuccessful attempts to collect on the final renewal note. As a result, First Madisonville issued Tom a Form 1099-C, *Cancellation of Debt,* for $51,792. This document was not reported as income on Tom's 1997 tax return.

The IRS issued a notice of deficiency and subsequently assessed additional tax based on the Form 1099-C issued to Tom. In 2001, the IRS mailed a final notice of intent to levy for the 1997 tax liability. Tom requested a Collection Due Process Hearing.

The IRS issued a notice of deficiency and subsequently assessed additional tax based on the Form 1099-C issued to Tom. In 2001, the IRS mailed a final notice of intent to levy for the 1997 tax liability. Tom requested a Collection Due Process Hearing arguing the Form 1099-C income is actually corporation income not his. In 2003, Tom submitted an offer in compromise (OIC), once again stating the loan was a corporate issue not a personal issue. Since he did not provide any supporting documentation, the IRS rejected the OIC via a Notice of Determination under §§6320 and/or 6330.

---

58. *Roberts v. Commr.,* 118 TC 365, 372-373 (2002), affd. 329 F.3d 1224 (11th Cir. 2003); *Eiselstein v. Comm*r., TC Memo 2003-22 January 22, 2003; *Yacksyzn v. Commr.,* TC Memo 2002-99 April 9, 2002

59. *Kolker v. Commr.,* TC Memo 2004-288; December 29, 2004

Issue. Whether the IRS abused its discretion in proceeding with collection efforts.

Analysis. At trial, Tom failed to prove the discharge of indebtedness income resulted exclusively from the cancellation of corporate indebtedness. In addition, the appeals officer did consider the OIC but, like the corporate indebtedness issue, Tom again failed to provide supporting documentation.

Holding. The Tax Court determined the IRS effort to proceed with collection was sustained.

Enforcement

IRS Press Conference, November 18, 2004
IRS News Release IR-2005-30, March 15, 2005

☞ Commissioner Mark Everson Gives Update on IRS Performance

During a press conference, IRS Commissioner Everson provided some critical data on the current IRS strategies and performance measures. In addition to concentration on enforcement efforts, the IRS is also focusing efforts around taxpayer service and business modernization.

Service improvements are experiencing substantial improvement through the delivery of new technology. These include:

- E-filing (16% increase from 2003)
- Web usage (**www.irs.gov**) (33% increase from 2003) (**one million visits per day during filing season**)
- On-line services to tax professionals
- Telephone service (reduced average taxpayer wait time by 20%)
- New computer system for processing tax returns – Customer Account Data Engine (CADE)
- New financial system

Enforcement activities resulted in tax revenue of $43.1 billion during FY 2004, a 15% increase from FY 2003. Results for FY 2004 include:

- High-income taxpayer audits — 40% increase from 2003 (earnings of $100,000 or more)
- Individual taxpayer audits — totalled 1 million for first time since 1999
- Number of levies — totalled 2 million (21% increase from 2003)
- Criminal investigation activity increased nearly 20%

The four enforcement priorities for FY 2005 are:

1. Discourage and deter noncompliance with emphasis on corrosive activity by corporations, high-income individuals, and other contributors to the tax gap
2. Encourage attorneys, accountants, and other tax practitioners to adhere to professional standards and follow the law
3. Detect and deter domestic and off-shore based criminal tax activity and related financial criminal activity
4. Discourage and deter noncompliance within tax-exempt and government entities and misuse of such entities by third parties for tax avoidance purposes

The IRS plans to improve audits of small businesses. Audits of small businesses dropped from 13,680 in FY 2003 to 7,290 in FY 2004. The decline in small business audits is attributable to the diversion of examiners to auditing high-income individuals, labor-intensive abusive schemes, and National Research Programs.

Closing Agreements

Revenue Procedure 2005-12, December 22, 2004

☞ More LMSB Taxpayers Can Use Pre-Filing Agreements

Background. To allow more Large and Mid-Size Business (LMSB) taxpayers to enter into LMSB Pre-Filing Agreements (PFAs). LMSB taxpayers can now obtain PFAs for a limited number of future taxable years including both domestic and international issues.

Eligible taxable years are limited to the four taxable years beyond the current taxable year. Eligible issues are expanded to include domestic and international issues unless the issues conflict with sound tax administration. Examples of issues which are excluded from PFAs include:

- Transfer pricing
- Change in accounting method
- Annual accounting period
- Pending litigation

When requesting a pre-filing agreement, the following information is required:

- Name, address, telephone number, and taxpayer identification number of all interested parties,
- Name, title, address, and telephone number of contact person,
- Annual accounting period and accounting method,
- Location of tax staff and records,
- Description of business operations,
- Taxable year for PFA being requested and date return was filed or will be filed,
- Dollar amount of assets shown on most recently filed return, and
- Specific description of each proposed issue.

If selected to participate in the PFA program, a fee ranging from $1,000 to $10,000 will be assessed depending on the asset size of the taxpayer.

Requests should be submitted to the LMSB Team Manager if a return is currently under examination, or to:

Internal Revenue Service
Attn: LMSB:PFT:PFS
PFA Program Manager
Mint Building
1111 Constitution Ave. NW
Washington, DC 20224

This revenue procedure supersedes Revenue Procedure 2001-22.

IRS PROCEDURES: PAYMENTS

Partial Payment Option
IRC §6159

☞ Another Option for Paying Taxes

The American Jobs Creation Act of 2004 amended IRC §6159 to allow the IRS to enter into installment agreements that result in full or partial payment of a tax liability. The IRS implemented Partial Payment Installment Agreement (PPIA) on January 17, 2005.

Prior to the enactment of this legislation, taxpayers could only enter into an installment agreement with the IRS for full payment of a liability.

In order to qualify for a PPIA, taxpayers must provide complete and accurate financial information which is reviewed and verified by the IRS. Equity in taxpayer assets is also reviewed to determine how much can be used to reduce or pay in full the outstanding liabilities.

Those taxpayers who are granted PPIAs are subject to financial review every two years. If the taxpayer's financial situation improves, installment payments could increase or the agreement could be terminated.

Note. For more information on PPIAs, see page 67 in Chapter 2, "IRS Issues."

Laundered Funds
***William J. McCorkle v. Commissioner,* 124 TC No. 5, February 24, 2005**
IRC §§6320 and 6330

☞ $2 Million Laundered Funds Not Used to Satisfy Tax Liability

Facts. William McCorkle did not file a tax return for 1996 although he requested an extension of time to file. Subsequently, in May 1997, the taxpayer made a $2 million dollar remittance for the 1996 tax year shortly after federal agents seized his property and documents.

Mr. McCorkle, along with several others, were defendants in a multicount criminal case involving fraud and money laundering. The indictment included a forfeiture count whereby any proceeds obtained from fraud and money laundering activities were forfeitable to the United States. Mr. McCorkle and his wife deposited $7 million of laundered monies into the Royal Bank of Canada Trust Company in the Cayman Islands. Part of the $7 million was disbursed as follows:

- $2 million to the IRS
- $2 million to a legal trust fund to pay legal fees to criminal defense attorneys, including F. Lee Bailey

In November of 1998, a jury convicted Mr. McCorkle and others of executing a telemarketing scheme and laundering the monies. The jury also determined the $2 million remittance to the IRS and the $2 million to the legal trust fund were subject to forfeiture since the funds were traceable to the taxpayer's criminal acts. The district court entered a forfeiture order in December 1998, with funds transferred to the Marshal Service in February 1999.

The IRS determined a tax liability for Mr. McCorkle in excess of $900,000 and issued a Notice of Deficiency accordingly. The total amount due to the IRS in 2000 exceeded $1.8 million. A federal tax lien was subsequently filed to which the taxpayer appealed stating he had already made a $2 million remittance, which more than covered his liability. Since the taxpayer was in prison at the time, an appeal was handled via correspondence.

Issue. Whether funds remitted to the IRS should be used to satisfy the 1996 tax liability and additions to tax.

Analysis. The essence of McCorkle's argument is that he satisfied the 1996 tax liability with the $2 million remittance before he forfeited to the United States his ownership rights in the laundered funds. The court analyzed the sequence of events which took place prior to the IRS turning the funds over to the Marshall Service. Since Mr. McCorkle failed to petition the court after the forfeiture order was entered, Mr. McCorkle must obey the order as entered and now has no right to challenge it. McCorkle argued to no avail that the IRS should have petitioned the court about the forfeiture order since there was no tax return filed to show a deficiency owed at that time.

Holding. The Tax Court determined the IRS acted appropriately in the release of forfeiture funds to the Marshall Service and McCorkle is responsible for paying the tax, interest, and penalties determined by the IRS.

Collection Due Process/OIC

***Sal Alaniz and Ruth Alaniz v. Commissioner,* TC Memo 2005-4, January 11, 2005**

IRC §6330

☞ IRS Did Not Abuse Its Discretion in Collection Efforts

Facts. Sal is a 73-year-old insurance salesman suffering from severe vision impairment and high blood pressure. Ruth assists Sal in the insurance business but is not otherwise employed outside the home. For the tax years 1994, 1996, and 1997, total liabilities, including penalties and interest, amounted to $221,372. In 2000, the taxpayers offered $4,650 to settle the liabilities. Shortly after submitting the offer, the taxpayers bought two new automobiles and a life insurance policy which increased their money expenses by $1,000. Taxpayers also transferred a 1964 Ford Thunderbird to a son-in-law for less than market value. The IRS rejected the offer in 2001 and issued a Final Notice of Intent to Levy in March of 2002.

In August of 2002, the taxpayers submitted an offer in compromise (OIC) offering $2,000 to settle their outstanding liabilities. This OIC showed monthly living expenses in excess of income to the extent of $1,170. Monthly expenses included claimed housing expense and insurance expense of $2,895 and $500, respectively. The appeals officer recalculated the collection potential using national standard expenses. The resulting net monthly income was computed at $712 with a present value of net income over a 48 month timeframe totaling $34,176. Based on the IRS recomputed collection potential of $46,000 ($34,176 plus $11,008 from the Thunderbird sale), the $2,000 OIC was rejected by the IRS in 2003.

The taxpayers disagreed with the IRS determination claiming the figure was too high and that Sal's income will decline in future years based on his advanced age and deteriorating health. Despite efforts to work out an acceptable agreement, the taxpayers counsel declined an offer to suspend collection activities for one year to allow taxpayers time to adjust their finances and change their spending habits to reduce expenses. The taxpayers argued the OIC rejection was unreasonable and an abuse of discretion.

Issue. Whether the IRS abused its discretion in rejected the OIC submitted by the taxpayers.

Analysis. At trial, the taxpayers submitted additional documentation which had not been submitted to the appeals officer as follows:

- Schedule C for 2002 showing $2,605 monthly income,
- A junkyard's appraisal of the Ford Thunderbird, and
- Documentation of Sal's medical condition.

The IRS cannot be held to have committed an abuse of discretion when information that might have supported taxpayers' position was not forthcoming at the time of the administrative hearing.

Holding. The Tax Court determined the IRS did not abuse it discretion in rejecting the OIC submitted by the taxpayers.

Collection Due Process/OIC

***Kenneth Hawkins v. Commissioner,* TC Memo 2005-88, April 19, 2005**

IRC §6330

☞ IRS Did Not Abuse Its Discretion in Collection Efforts

Facts. Kenneth Hawkins resided in Pompano Beach, Florida and operated "Professional Investigations and Consulting, Inc." during 1993, 1995, and 1996. He did not timely file tax returns for any of the years under consideration. Deficiencies were due for all years under consideration.

In 1997, Kenneth married. He purchased a residence as tenants-by-the-entirety with his spouse. He contributed $50,000 (one-half the down payment) to the purchase.

Subsequently, in December 1977, Kenneth filed a Form 656, *Offer-in-Compromise (OIC),* based on doubt as to collectibility, offering to pay $16,209 of the total unpaid tax liability of $26,266. The IRS rejected his offer since the amount due appeared to be collectible based on the information submitted. A second OIC was submitted in 2001 for $2,200. This OIC showed Kenneth as now having a 25% interest in his home, living expenses in excess of income by $834 per month, and a wife who is unemployable. After further review by the IRS, the second OIC was also rejected since circumstances had not changed from the first OIC submission and the second OIC was not materially different from the first offer. A Notice of Federal Tax Lien was then filed on Kenneth's property and sustained by appeals.

Issue. Whether the IRS abused its discretion by sustaining the filing of a federal tax lien.

Analysis. The court reviewed the actions taken by the IRS in determining Kenneth monthly expenses through the use of national or local averages. Kenneth had every opportunity to refute the methodology but did not. In addition, the proration of the expenses between Kenneth and his wife was appropriate since she received passive income. The taxpayer's second OIC fell short of a reasonable offer since the value of his home exceeded both the offer and the full amount of the tax liability, even at 25% ownership.

Kenneth argued that the IRS's haste in filing the notices of lien shows that the IRS was predisposed to reject the second OIC. This rationale was rejected by the court.

One argument did have some potential for success; he was suffering from economic hardship when the second OIC was submitted. The two factors he relied on to support his position were:

- Long-term illness, medical condition, or disability which renders taxpayer incapable of earning a living, and
- Unable to borrow against equity in assets.

At trial, both arguments were based solely on self-serving testimony and disregarded by the court.

Holding. The Tax Court determined the IRS did not abuse discretion and correctly determined to proceed with collection.

Form 2290 Filers

IRS News Release IR-2005-68, June 23, 2005

13

☞ Form 2290 Installment Payment Option Eliminated

The installment option is no longer available for Form 2290, *Heavy Highway Vehicle Use Tax Return.* For the tax year beginning on July 1, 2005 and ending on June 30, 2006. The balance due must be paid via check, money order, or Electronic Federal Tax Payments System (EFTPS) by August 31, 2005 in most cases. This change was included in the American Jobs Creation Action of 2004 (AJCA).

This is a change for many taxpayers. Last year, 148,000 taxpayers chose to pay their Form 2290 tax liability in four equal installments, which were due on the last day of August, December, March, and June.

Other changes included as part of AJCA are:

- Eliminated reduced tax rates for vehicles registered in Canada or Mexico
- Electronic filing is mandatory for taxpayers filing highway use tax returns for 25 or more vehicles

The availability of electronic filing for Forms 2290 is pending. Taxpayer should continue filing paper returns until electronic filing is made available.

Form 2290 and instructions have been revised to incorporate changes made by AJCA.

LIKE-KIND EXCHANGE

Real Properties

***Teruya Brothers, Ltd. & Subsidiaries v. Commissioner,* 124 TC No. 4, February 9, 2005**

IRC §§267 and 1031

☞ Related Party Rules Still Apply

Facts. In 1995, Teruya Brothers, Ltd. transferred Hawaiian real properties to a qualified intermediary in a series of planned transactions. The qualified intermediary then sold the real properties to unrelated third parties. The sale proceeds, along with additional funds, where used to purchase like-kind replacement properties from Times Super Market Ltd (Times). Teruya owned 62.5% of Times so the two were considered to be related parties under IRC §267(b).

Teruya realized large capital gains on the real property sales. Times realized both gains and losses on the properties sold to the qualified intermediary but did not recognize the loss due to the related-party loss restrictions. Teruya considered the exchanges to fall within the like-kind exchange rules. The IRS disagreed with the treatment of the like-kind exchange and requested Teruya pay an additional $4 million.

Issue. Whether the taxpayer is entitled to defer gains realized on certain like-kind exchanges under IRC §1031(a) or must recognize gains under §1031(f).

Analysis. Generally, no gain or loss is recognized on the exchange of like-kind properties held for productive use in a trade or business or for investment.[60] Under certain conditions, a taxpayer's nonsimultaneous transfer and receipt of like-kind properties may qualify for §1031 treatment, provided the taxpayer identifies the new property within 45 days and receives it within 180 days of transferring the old property. To facilitate such a deferred exchange, the taxpayer may use a qualified intermediary.

Generally, if a taxpayer and a related person exchange like-kind property, and within two years either one disposes of the exchanged property, the nonrecognition provisions of §1031(a) do not apply.[61] Instead, any gain or loss must be taken into account as of the date of the disposition.

Congressional intent was reviewed with the taxpayer suggesting that Congress intended §1031(f) to apply only insofar as the taxpayer fails to "continue its investment" in property that it receives in a related-person deferred exchange. The taxpayer seems to suggest that what happens to the relinquished property is of no consequence. The Tax Court rejected any such suggestion as contrary to §1031(f) which applies with equal force to post-exchange dispositions by either the taxpayer or the related person.

60. IRC §1031(a)(1)

61. IRC §1031(f)(1)

Holding. The Tax Court held that the taxpayer was required to recognize gains under the statute that provides special rules governing like-kind exchanges between related persons.

> **Note.** See Chapter 10, "Like-Kind Exchanges," for additional information on related party rules.

PARTNERSHIP

Death of Partner

Letter Ruling 200523017, June 10, 2005
IRC §§754 and 9100

☞ Extension of Time Granted to Make §754 Election

Purpose. To determine if an extension of time can be granted to make an election under IRC §754.

Background. The taxpayer is a limited liability partnership. A partner of the partnership died during Year 1 but the partnership failed to make a §754 election on its partnership return.

Analysis. If a partnership files a §754 election, the basis of partnership property is adjusted under IRC §743. An §754 election is made in a written statement filed with the partnership return for the taxable year during which the distribution or transfer occurs.[62] In order for the election to be valid, the return must be filed no later than the time for filing the return for the taxable year, including extensions.

The IRS may grant a reasonable extension of time to make a regulatory election, or a statutory election.[63] Treas. Reg. §301.9100-3 provides extensions of time for making elections that do not meet the requirements of Treas. Reg. §301.9100-2. Requests for relief under Treas. Reg. §301.9100-3 are granted when the taxpayer provides evidence to establish that it acted reasonably and in good faith, and that granting relief did not prejudice the interests of the government.

Since the requirements of Treas. Regs. §§301.9100-1 and 301.9100-3 were satisfied, the partnership was granted an extension of 60 days to make a §754 election effective Year 1. The election should be made in a written statement filed with the applicable service center for the partnership's tax return.

13

62. Treas. Reg. §1.754-1(b)
63. Treas. Reg. §301.9100-1(c)

Schedule K-1

IRS News Release IR-2005-34, March 22, 2005

☞ Tips for Accuracy

To avoid errors when preparing Schedule K-1:

- Ensure codes on page 2 are used to identify items on lines 10 through 17 (Form 1120-S) and lines 11 through 20 (Form 1065)
- Ensure correct taxpayer identification numbers are used, particularly those issued to owners of entities disregarded for federal tax purposes, such as single member limited liability companies
- Identify "amended" information by checking the appropriate box

For recipients of Schedules K-1:

- Report income in the proper location on individual returns based on Schedule K-1 instructions
- Avoid netting or combining income from separately stated losses or expenses
- Report deductible "at risk" or basis limitation losses carried forward from prior years on a separate line from current year transactions
- Identify "estimated" K-1 income on Form 8082, *Notice of Inconsistent Treatment or Administrative Adjustment Request*.

Form 8893

☞ New Form 8893

2004 Form 1065, Schedule B, Question 4 refers to Form 8893, *Election of Partnership Level Tax Treatment.* Form 8893 is used only by small partnerships electing the unified audit and litigation procedures as set forth in §6231(a)(1)(B)(ii). A "small partnership" is defined as any partnership having 10 or fewer partners, each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner. For this purpose, a husband and wife (and their estates) are treated as one partner.

This form must be attached to the partnership return for the tax year shown and must be filed by the due date of the return (including extensions). If the partnership files Form 1065 on time, the election can be made on an amended return filed no later than 6 months after the due date (excluding extensions) of the original return. Write "FILED PURSUANT TO SECTION 301.9100-2" in the top margin of the amended return and file it at the same address the original return was filed.

The election will be effective for the partnership tax year to which the return relates and all subsequent tax years unless revoked with IRS consent. A revocation of the election can be requested by filing Form 8894, *Request to Revoke Partnership Level Tax Treatment Election.*

Each partner who was a partner in the partnership during the tax year for which the election is filed must sign the form. This includes all partners during the year, not just those who are partners at the end of the year.

> **Note.** Question 4 of the 2004 Form 1065, Schedule B has been reworded since 2003. If a small partnership (fewer than 10 partners) has a partner that is an estate, domestic individual, or a C corporation, it is not subject to the consolidated audit procedures. The new Form 8893, or a statement to elect the consolidated audit procedure can be used. If a small partnership has partners that are also partnerships, it cannot file Form 8893 or an election statement because it is automatically subject to the consolidated audit procedures.

Form **8893**
(December 2004)
Department of the Treasury
Internal Revenue Service

Election of Partnership Level Tax Treatment

For tax year beginning ...., 20...... and ending ...., 20......

OMB No. 1545-1912

Partnership's name, address, and ZIP code	**Employer identification number**

Election

We, the partners of the above named partnership, elect to have the provisions of subchapter C of chapter 63 of the Internal Revenue Code apply with respect to this partnership. This election will subject the partnership to the unified audit and litigation procedures of sections 6221 through 6234. We understand that this election is revocable only with IRS consent. All partners, who were members of the partnership at any time during the tax year shown above, have signed this form.

Partners' Signatures

All partners, who were partners at any time during the tax year shown above, must sign below.

Under penalties of perjury, I declare that I was a partner during the taxable year as stated above and my signature confirms my agreement with the request for election. I have examined this consent statement, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature	Date

For Paperwork Reduction Act Notice, see page 2. Cat. No. 37701Y Form **8893** (12-2004)

13

PASSIVE ACTIVITIES

Real Property Leasing

***Assaf F. Al Assaf and Rehab Assaf v. Commissioner,* TC Memo 2005-14, January 31, 2005**
IRC §469

☞ Extraordinary Personal Services Result in Nonpassive Activity Status

Facts. Assaf Al, a medical doctor, and Rehab Assaf, a law firm partner, worked in Oklahoma City, Oklahoma. Each of their respective practices where conducted in an office building owned by AGI Consulting, LLC (AGI). AGI leased office space in the office building to attorneys. These attorneys choose to rent space here in order to take advantage of the legal support services offered by AGI. Assaf and Rehab were each 50% shareholders in AGI.

To support the attorneys who leased space, AGI provided the following services:

1. A clerical support staff of at least three employees, who performed the following duties:
   - Client intake
   - Answering phones
   - Filing documents at courthouse and state capitol
   - Process serving
   - Conducting legal research
   - Typing briefs and legal memoranda
   - Managing a file room
   - Maintaining updated law library and conference facilities
2. Leased office space
3. Consulting services
4. Other services
   - Security service
   - Trash removal
   - Janitorial services
   - Coffee service
   - General utilities

In addition, Rehab **exclusively** managed AGI's leasing activities and legal support services during 1999 and 2000. Her duties consisted of:

- Supervising AGI's office staff
- Procuring supplies
- Performing/overseeing repairs and maintenance of office building and equipment
- Paying bills and payroll
- Filing employment tax returns
- Remaining on call seven days per week with the security service
- Overseeing tenants moving in and out of the office building on weekends

Both the leasing activities and the legal support services resulted in losses and were classified as **nonpassive.** These losses were netted with the consulting activity income on the partnership returns. For 1999 and 2000, AGI had net losses of $34,090 and $34,207, respectively. Schedule K-1 was issued to both Assaf and Rehab for 50% of the loss. Rehab's losses from AGI reduced her self-employment income earned from her law practice.

The IRS determined the losses generated by AGI were passive, and therefore were limited by the passive activity rules.

Issue. Whether AGI's leasing activities constituted passive activity losses.

Analysis. Passive activities include "trade or business" activities in which the taxpayer does not "materially participate." Generally, rental activities are passive without regard to whether the taxpayer materially participates in them. One exception is the extraordinary personal services exception. To qualify for this exception, taxpayers must prove the activity was not a "rental activity" and that material participation was involved.

The court referenced *Welch,*[64] which involved personal service contracts in addition to leasing tools and equipment. The **primary motivation** in this case was for **services** not leasing. Similarly AGI's attorney-tenants leased from AGI primarily to obtain legal support services and not to lease the office space.

Regarding material participation, the taxpayer must show the involvement in the activity to be regular, continuous, and substantial with participation in excess of 500 hours during the year. At trial, Rehab established she provided regular and substantial services to AGI tenants of approximately 1,340 hours per year. The IRS disputed the "1,340 hours" estimate as being neither reasonable nor reliable. She argued that even though written documentation did not exist, she continues to do the same duties at the current time so this estimate is not based on distant memories. The court determined the testimony by Rehab along with other objective evidence and witness testimony to be credible.

Holding. The Tax Court determined the payments made by the attorney-tenants were mainly for use of **extraordinary personal services** with property leasing being incidental to the services offered by AGI. The taxpayers materially participated in the AGI leasing activities. Therefore, the losses were not passive activities for purposes of the passive loss rules thereby allowing the losses to offset other income.

Short-Term Rental Exception

***Robert P. Sweet and Dawnielle K. Lawson v. Commissioner*, TC Summary Opinion 2004-125, September 9, 2004**
IRC §469

☞ Significant Personal Services Requirement Not Met

Facts. During 2000, the taxpayers owned two Florida beachfront condos which were rented for an average of not more than 30 days. The rental loss of $16,703 was deducted and Form 8582, *Passive Activity Loss Limitations,* was omitted. The IRS disallowed the rental loss under the passive loss rules since the taxpayers' 2000 AGI exceeded the phaseout ceiling for the $25,000 special rental loss allowance.

Issue. Whether the rental loss claimed on Schedule E is allowable.

Analysis. Rental activities are by definition passive activities.[65] However, Treasury regulations provide an exception to the general rule for rentals of tangible property which meet two tests:

13

1. The average period of customer use is 30 days or less.
2. **"Significant personal services"** are provided by or on behalf of the owner of the property in connection with making it available for customer use.[66]

---

64. *Welch v. Commr.,* TC Memo 1998-310, August 24,1998
65. IRC §469(c)(2)
66. Temp. Treas. Reg. §1.469-1T(e)(3)(ii)(B)

In determining whether personal services are significant, all relevant facts are taken into account, including the frequency, the type and amount of labor required to perform the services, and the value of the services relative to the amount charged for the use of the property.[67]

Holding. After a careful analysis of the taxpayers' estimates of hours and types of services they performed, **the court concluded that the "significant personal services" test was not met**. As a result, the exception to the general rule for passive activity losses did not apply and the rental loss was not allowable.

The court noted that the following services are **excluded** by Treasury regulations from the "significant personal services" definition:

- Responding to telephone and Internet inquiries regarding rental of the units was held to constitute marketing activities that were not provided for "customer use."
- Travel from the taxpayers' Indiana home to the Florida rental properties was held to be an inherently personal and nondeductible commuting expense.
- Repair and cleaning of the units was held to be insignificant as the amount paid for maid and linen services was less than 10% of gross rentals.[68]
- Banking and bookkeeping was held to be related more to ownership duties than making the units available for "customer use."

Self Rental Rule

***Tony R. and Judith D. Carlos v. Commissioner*, 123 TC 275, No. 16, September 20, 2004**
IRC §469

☞ Rental Profit from Commercial Building was Recharacterized as Nonpassive

Facts. Mr. and Mrs. Carlos owned two commercial buildings which were rented to their two wholly-owned S corporations in 1999 and 2000. One S corporation was a steel supply business and the other was a restaurant. The steel supply S corporation was profitable and the restaurant S corporation was not.

The two lease agreements between the taxpayers and their S corporations provided for the following annual rental payments:

- $120,000 by the steel supply corporation
- $60,000 by the restaurant corporation

The profitable steel supply corporation made the required rental payments to the taxpayers during 1999 and 2000. However, due to cash flow problems, the restaurant corporation failed to pay any rent to the taxpayers in 1999 and 2000.

The taxpayers made a proper election to "group" their two rental properties as a single activity for "measurement of gain or loss purposes of §469."[69]

---

67. Temp. Treas. Reg. §1.469-1T(e)(3)(iv)
68. Temp. Treas. Reg. §1.469-1T(e)(3)(viii)-Example 4
69. Treas. Reg. §1.469-4(c)(1)

The Schedules E of the taxpayers reported the following for 1999 and 2000:

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

Mr. and Mrs. Carlos reported the net rental profit amounts as nonpassive income and omitted Form 8582, *Passive Activity Loss Limitations,* for both years. The IRS disallowed the rental losses from the restaurant building as passive activity losses under IRC §469(a). At the Tax Court trial, both parties conceded that:

- The grouping of the two rental properties as a single activity was proper.
- Both Mr. and Mrs. Carlos "materially participated" in the conduct of both the S corporations during 1999 and 2000.
- The self-rental recharacterization rule is valid.[70]

Issue. Whether the proper grouping of two rental properties as a single activity precludes application of the self-rental recharacterization rule for the property that produced a rental profit (the steel supply building).

Analysis and Holding. After a thorough analysis of the self-rental rule,[71] the court agreed with the IRS that it applied even though the multiple rental properties were grouped as a single passive activity. The tax result of the decision was that:

- The rental profits generated by the steel supply building were taxable since they were recharacterized as nonpassive income under the self-rental rule.
- The rental losses generated by the restaurant building were nondeductible passive losses under the general rule of IRC §469(a).

The court listed the following reason for its holding:

- The self-rental rule explicitly recharacterizes net rental activity income from an "item of property" rather than net income from the entire rental activity.

An opposite holding would:

- Undermine the congressional purpose for enacting IRS §469 and authorizing the self-rental rule, and

Allow a taxpayer to convert nonpassive income into passive income. Therefore, passive losses could be offset by manipulating the payment of rent from a property owned by the taxpayer and rented to a controlled business.

13

70. Treas. Reg. §1.469-2(f)(6)

71. Ibid

PROFIT MOTIVE

Inflated Values

***Donald L. Walford v. Commissioner,* 10th Circuit Court of Appeals, 04-9004, 2005-1 USTC ¶50,206, February 24, 2005, affirming the prior Tax Court decision; TC Memo 2003-296, 86 TCM 479, October 23, 2003**
IRC §183

☞ Partnership Losses Fall Within §183 Guidelines

Facts. Donald Walford invested in Sav-Fuel Associates, a Connecticut limited partnership. Sav-Fuel was formed to acquire an energy management system (EMS) to be installed in a California manufacturing plant called Gould. The EMS components were designed to provide a technologically sophisticated method of energy management.

Consumer Energy Funding (CEF), David Systems, Inc. (DSI), and promoter Richard Gangel were also heavily involved in the Sav-Fuel partnership structuring. In 1980, CEF sold the EMS to DSI for $337,500. Later in 1980, DSI sold the EMS to Sav-Fuel for $10.35 million with $9 million to be paid by a nonrecourse note payable solely from 80% of the gross income actually received by Sav-Fuel from the use of EMS. DSI was controlled by promoter Richard Gangel. Unfortunately there was no evidence to show the EMS was ever installed at Gould or ever generated any actual energy savings.

On his tax returns for 1980 and 1981, Donald claimed losses from his partnership investment that were subsequently disallowed by the IRS since the partnership did not demonstrate a requisite profit motive. The Tax Court agreed with the IRS determination of the loss disallowance, as well as penalties and increased interest. Donald appealed the Tax Court decision of the Sav-Fuel partnership losses.

Issue. Whether Sav-Fuel was intended to be a profit-making venture.

Analysis. The Tax Court originally based its determination on five objective factors:

- Grossly inflated sales price paid by Sav-Fuel for the EMS,
- Large amount of nonrecourse note with payment of the note limited to a very speculative income source,
- Lack of expertise in the energy management field of Sav-Fuel's general partner and promoters,
- Application of the factors described in Treas. Reg. §1.1.83-2(b), and
- Calculation of a negative net present value for Sav-Fuel.

In addition, the Tax Court also looked to the nine factors provided by §183 of the Regulations which are common threads in all cases of this nature. Analysis of these factors further supported the conclusion that Sav-Fuel was not intended to earn an economic profit.

On appeal, Donald argued the 25-year useful life used for the present-value analysis was too short of time to use. His expert believed the EMS equipment would last at least 30 years. However, the Tax Court refused to give any weight to the expert's opinion since no factual data or support was ever presented as corroborating evidence.

Holding. After an extensive review of the previous court decision and analysis of arguments presented by Mr. Walford, the 10th Circuit sided with the IRS and affirmed the original decision of the Tax Court that losses from the Sav-Fuel partnership are not allowed.

Profit Motive

***Jane Freed v. Commissioner*, TC Memo 2004-215, September 23, 2004**

IRC §183

☞ Thoroughbred Horse Breeding and Racing Activity Lacked Profit Motive

Facts. Jane Freed had $1.1 million in overall losses from 1982 through 1996 in her thoroughbred horse activities. She is the beneficiary of three trusts with total assets of approximately $6 million. On her 1996 tax return, she reported over $200,000 of trust-related dividend and interest income.

The IRS disallowed her horse activity loss for 1996 and assessed $64,000 of additional tax.

Issue. Whether the taxpayer operated her horse breeding and racing activity for profit in 1996.

Analysis. The court thoroughly analyzed nine subjective factors[72] and found the taxpayer failed on seven of the nine.

Factor 1: The manner in which the taxpayer carried on the activity. The court found that Jane did **not meet** this factor primarily because "she failed to make meaningful changes in her method of operation despite a 14-year history of significant losses."[73] This result was surprising considering that the taxpayer had the following competent advisers:

- She employed a professional breeding manager, McMahon Farms of Saratoga, NY, who cared for her horses and maintained breeding records. Joseph McMahon had approximately 90 thoroughbred horse breeding clients. His farm produced Funny Cide, the winner of the 2003 Kentucky Derby and Preakness Stakes.
- She employed a professional trainer in 1996 for her eight racing horses.
- She employed a CPA who specialized in horse-owner clients to keep accurate and separate horse activity records. He also provided other financial services. However, he did not prepare balance sheets, budgets, or future financial projections for the taxpayer.

Factor 2: The expertise of the taxpayer or her advisers. Jane **prevailed** on this factor.

Factor 3: The time and effort expended by the taxpayer in carrying on the activity. The court concluded Jane **lost on this factor** since she failed to corroborate her testimony regarding the estimated number of hours she spent each week on the activity.

Factor 4: The expectation that assets used in the activity may appreciate in value. The taxpayer **lost on this factor** as she never had her horses appraised.

Factor 5: The success of the taxpayer in carrying on similar or dissimilar activities. The taxpayer **lost on this factor** because "she never transformed an unprofitable enterprise into a profitable one."

> **Note.** The taxpayer's representative tried to convince the judge to ignore this factor based on a professional journal article. The judge declined.

Factor 6: The history of income or loss with respect to the activity. The taxpayer **lost on this factor** as she incurred losses of more than $1.1 million on her horse-related activities from 1982 through 1996, the year at issue.

Factor 7: The amount of occasional profits, if any. The taxpayer **lost on this factor**. The court ignored the small profits from the activity reported on the taxpayer's 2001, 2002, and 2003 tax returns. The court noted that the 2001 profit was primarily due to capitalizing $70,000 of boarding costs that had been expensed in prior years. If these costs had been treated the same as in previous years, the 2001 return would have also shown a loss. The court also concluded that no evidence was produced to justify the small 2002 and 2003 profits.

72. Treas. Reg. §1.183-2(b)

73. *Ballich v. Commr.*, TC Memo 1978-497, December 13, 1978

Factor 8: The financial status of the taxpayer. The taxpayer **lost on this factor** because her considerable trust income provided with her over $3.2 million of income during the period 1985 through 1996. The court concluded the taxpayer enjoyed a significant tax benefit from her horse activity.

Factor 9: Whether elements of personal pleasure or recreation are involved. The taxpayer **prevailed on this factor** since she never rode the horses and had limited contact with them.

Holding. The court concluded the taxpayer failed to prove that she engaged in the activity with an actual and honest intent to earn a profit.

RESIDENCES

Adjustment to Basis

Letter Ruling 200513011, April 1, 2005

IRC §§61 and 1016

☞ **Damages for Faulty Construction Reduce Basis in Home**

Purpose. To determine the proper tax treatment of damages received in settlement of a lawsuit for faulty construction of his residence.

Background. Taxpayer hired a contractor to build a home in accordance with plans prepared by his architect. A year after he moved into the house, the house sustained water damage resulting from faulty construction. The taxpayer sued both the contractor and architect for breach of contract, breach of implied warranty for fitness, negligence, and faulty construction. In the subsequent year, the taxpayer completed partial repairs on the house for which he did not claim any losses on his tax return. The taxpayer was awarded damages as well as legal fees and costs for the faulty construction.

Analysis. Gross income includes all income from whatever source derived unless such payment is considered to be a return of basis.[74] Adjustments to cost basis based on expenditures, losses, or other items are allowed to be made.[75]

In Rev. Rul. 81-277, a set price was agreed to by both parties in the construction of a nuclear power plant. During the construction period, stricter environmental requirements were required creating a dispute as to who was actually responsible for the additional costs. The taxpayer received monies from the contractor to be released from the stricter standards. Since the taxpayer received no economic gain as a result of the estimated cost payment and was merely made whole under the contract, the payment was a return of capital, reducing the taxpayer's basis in the plant.

In Rev. Rul. 81-152, a homeowner's association instituted an action against the builder of a condominium development for damages arising from construction defects. The ruling holds that the settlement funds were not income to the unit owners but instead represented a return of capital to each unit owner to the extent the recovery did not exceed the owner's basis in his property interest.

Conclusion. Keeping in line with cited authority, the damages (excluding both the legal fees and costs) were determined to be a recovery of the taxpayer's basis.

74. IRC §61

75. IRC §1016(a)

Gain on Sale of Residence

Letter Ruling 200504012, January 28, 2005
IRC §121

☞ Liberal Unforeseen Circumstances Test

Purpose. To determine whether part of the gain on the sale of a residence is eligible to be excluded under IRC §121(c).

Facts. Taxpayer and spouse signed a contract to purchase a townhouse and moved into the townhouse approximately 13 months later. The taxpayer is a police officer who applied and tested for a position in the K-9 unit of the police force. Shortly after the taxpayers moved into the townhouse, taxpayer was notified he had been selected to be a K-9 officer. The K-9 officer is **required** to care for a dog and maintain a six by nine foot kennel at the officer's residence. Consequently, the taxpayers sold the townhouse before it was owned and used for two years.

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 out of the preceding five years. For those people who do not meet the ownership and use tests, a reduced maximum exclusion is available under IRC §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 submitted, the IRS concluded the sale of the house would be considered an "unforeseen circumstance" and, as such, part of the gain on sale of the residence would be excludible up to the reduced maximum exclusion amount.

RETIREMENT

Early Distribution Penalty

***Basman Ahmad and Khitam Amerneh v. Commissioner,* TC Summary Opinion 2005-103, July 25, 2005**
IRC §72

☞ 10% Early Distribution Penalty Upheld

Facts. Basman Ahmad is a civil engineer who was employed by the Ohio Department of Transportation from 1990 through 2000. During this time, he accumulated approximately $83,000 in the Ohio Public Employees Retirement System (PERS). Basman divorced his first wife. At that time, the mortgage lender foreclosed on their personal residence. Basman then married Khitam and relocated to California where he gained employment with the California Department of Transportation.

In 2001, Basman took an early distribution of $83,881 from his PERS pension. Federal income tax of $16,776 was withheld, with the remaining funds given to Mr. Sulieman to reimburse him for the loss from the foreclosure on the personal residence. Mr. Sulieman was Basman's brother. He provided the purchase price, and the property was in Mr. Sulieman's name.

The 2001 tax return listed the gross retirement distribution as income, but did not include the 10% penalty tax on the early distribution.

The IRS determined the taxpayers owed the 10% penalty,[76] resulting in a deficiency of $8,388.

76. IRC §72(t)

13

Issue. Whether the 10% penalty applied to the early distribution from Basman's PERS distribution.

Analysis. Mr. Ahmad contends he qualifies for the exception for early distribution based on four reasons:

1. His divorce settlement caused financial and emotional hardship
2. He suffers from fibromyalgia and chronic fatigue syndrome
3. He was enrolled as a student at the University of Toledo in 2001
4. The PERS pension was considered marital property subject to division by the divorce court

The Tax Court carefully reviewed each argument determining none to fall within the exceptions of §72(t) because:

- "Financial and emotional hardship" is not a qualified exception
- Basman worked full time, and therefore was not disabled
- Distributions from an individual retirement plan may be used for higher education, distributions from a qualified retirement plan cannot be used for higher education
- Marital settlement agreements do not qualify as qualified domestic relations orders to meet the penalty exception rule

Holding. The Tax Court looked at the arguments presented by the taxpayers and found them to be without merit. The 10% penalty was upheld.

IRA Contribution

***Gloria Yuen-Mee Ho and Alexander Chi-Shun Tsang v. Commissioner,* T.C. Memo 2005-133, June 2, 2005**
IRC §219

☞ AGI of Both Taxpayers Considered for Purposes of §219 Limitations

Facts. Taxpayers lived in Texas where Alexander was employed with the University of Texas Medical Branch. Alexander was an active participant in a §403(b) employer-sponsored retirement plan. On his 2001 and 2002 tax returns, IRA deductions of $2,000 and $3,000 were claimed respectively. Modified adjusted gross income (AGI) as shown on the filed tax returns was $114,193 and $123,304 for 2001 and 2002, respectively.

The IRS issued notices of deficiency for both 2001 and 2002, disallowing the claimed IRA deductions. The taxpayers agreed to the disallowance for 2002, but disputed the 2001 disallowance.

Issue. Whether the taxpayers are entitled to claim a deduction for Alexander's IRA contributions in 2001.

Analysis. IRC §219(a) provides guidance for deductible IRA contributions. IRC §219(g) describes limitations on deductions where a taxpayer or spouse is an active participant in a qualified §403(b) plan. Limitations reduce the allowable deduction using a formula which results in no allowable deduction when the modified AGI exceeds $63,000.

The taxpayers argued that IRC §219(g)(2)(A)(i) refers to AGI of the taxpayer in the singular form. Therefore, only the AGI of the spouse should be considered in determining whether or not a deductible IRA contribution is allowable. Consequently, the deduction would be allowed since Alexander's AGI was less than $63,000.

The Tax Court disagreed with the interpretation by the taxpayers, and used the combined AGI in the calculation.

Holding. The Tax Court determined the combined AGI should be used to determine the reduction or elimination of the IRA contribution deduction. Since the AGI limits are beyond the maximum, no IRA deduction was allowed for 2001.

QDRO Distribution

***Margaret Louise Kelley v. Commissioner,* TC Summary Opinion 2005-68, June 2, 2005**

IRC §§265 and 1401

☞ Fourth Time Is a Charm?

Facts. Margaret and William Kelley divorced in 1986. Mr. Kelley received retirement benefits from Aerospace Corp., which the California Superior Court determined to be community property. Therefore, it ordered the retirement plan to pay Margaret 50% interest in William's retirement benefits. In 1996, a stipulated Qualified Domestic Relations Order (QDRO) was entered into the Superior Court identifying William as the plan participant and Margaret as the alternate payee. After entry of the QDRO, Margaret began receiving her 50% interest in the benefits via direct deposit to her bank account on the first of the month.

Shortly after the end of the calendar year, Margaret received a Form 1099-R reporting the amount of distribution received. For 2001, the Form 1099-R showed $16,909, which she reported on line 16a of her Form 1040. However, line 16b, the taxable amount, showed "0" and a written note to "see addendum (community property). She attached a copy of the Superior Court's order to the tax return. Each year, she followed the same approach when preparing her tax return.

Issue. Is the distribution received as an alternate payee under a QDRO taxable?

Analysis. The IRS contends the $16,909 is income. Margaret, on the other hand, argues that since she did not receive any property settlement from Mr. Kelley after the divorce, her community property interest in his retirement benefits is essentially a "return of capital" and therefore not taxable. **The IRS also issued "no change" letters on the same issue on three separate occasions after questioning whether or not the benefits were taxable.**

A distribution from a qualified retirement plan is taxable to the distributee.[77] An exception for IRC §402(a) is provided in IRC §402(e)(1)(A) which allows an alternate payee (spouse or former spouse) under a QDRO to be treated as the distributee.

Holding. The Tax Court acknowledged the arguments raised by Margaret related to the lack of property settlement and the IRS acceptance of prior tax returns on the same issue. However, the law is clear. The distribution received as an alternate payee under a QDRO is taxable to Margaret.

ESOPs

IRS News Release IR-2004-155, December 22, 2004

IRC §409

☞ Watch Out for Abuses Involving ESOPs and S Corporations

In December of 2004, the IRS issued letters to 1,700 businesses, and retirement plan sponsors with 10 or fewer participants, advising them of new income and excise taxes which apply to S corporation employee stock ownership plans (ESOPs). The letter also warned of consequences resulting from participating in abusive schemes involving S corporations and ESOPs. It also called attention to other abuses connected with S corporation ESOPs.

IRC §409(p) was enacted to address concerns about ownership structures involving S corporations and ESOPs which concentrate the ESOP benefits in a small number of persons. This code section imposes both income and excise taxes in situations involving abusive arrangements where an S corporation is used to pass corporate income to a tax-exempt ESOP where the only participants in the ESOP are the owner/employees of the business.

IRC §409(p) is effective for plan years beginning after December 31, 2004.

77. IRC §402(a)

Qualified Retirement Plan Limitations

IRS Notice IR-2004-72, November 15, 2004

IRC §415

☞ 2005 Qualified Retirement Plan Limitations Announced

Employer plan limitations increased effective January 1, 2005. The tables shown below reflect the pre-January 1, 2005 limitations as well as the new limitations and should be used for reference.

Cost of Living Limits	Before January 1, 2005	January 1, 2005 and After
Annual benefit under defined benefit plan §415(b)(1)(A)	$165,000	$170,000
Defined contribution plan §415(c)(1)(A)	41,000	42,000
Annual compensation limit under §§401(a)(17), 404(l), 408(k)(3)(C), and 408(k)(6)(D)(ii)	205,000	210,000
Definition of key employer in a top-heavy plan §416(i)(1)(A)(i)	130,000	135,000
Maximum in ESOP subject to 5-year distribution	830,000	850,000
Amount used to determine lengthening of 5-year distribution period	165,000	170,000
Highly compensated employer §414(q)(1)(B)	90,000	95,000
Annual compensation limit in certain governmental plans §401(a)(17)	305,000	315,000
Compensation amount under SEPs §408(k)(2)(C)	450	450
Compensation amount under "control employee" definition for fringe benefits §1.61-21(f)(5)(i)	80,000	85,000
Compensation amount under §1.61-21(f)(5)(iii)	165,000	170,000

Limitations Specified by Statute	Before January 1, 2005	January 1, 2005 and After
Exclusion on elective deferrals §402(g)(1)	$13,000	$14,000
SIMPLE retirement accounts §408(p)(2)(E)	9,000	10,000
§457(e)(15) deferred compensation plans of state and local governments and tax-exempt organizations	13,000	14,000
Catch-up contributions under §414(v)(2)(B)(i) for individuals age 50 and over	3,000	4,000
Catch-up contributions under §414(v)(2)(B)(ii) for individuals age 50 and over	1,500	2,000

Make-up IRA Distribution

Letter Ruling 200503036, January 21, 2005
IRC §§72 and 408

☞ Taxpayer is not Penalized by Error on Part of Brokerage Firm

Purpose. To determine if a make-up IRA distribution payment results in a modification to a series of substantially equal periodic payments and is subject to the additional 10% tax on premature distributions.

Background. The taxpayer began receiving annual distributions from his rollover IRA using the fixed annuitization method of determining substantially equal payments. In the second year, he received part of his required distribution. Towards the end of the same year, he met with his financial advisor to arrange for the remaining amount to be distributed. He completed, signed, and gave the authorization form to the financial advisor. Information on the form included

- IRA account number,
- Withdrawal amount,
- Account number for IRA to be deposited in, and
- Federal tax withholding amount.

Unfortunately, the form was not processed. When the error was discovered the subsequent year, the taxpayer withdrew the remaining distribution for the second year, as well as the current year distribution (third year).

Analysis. Any amount paid or distributed out of an individual retirement plan is included in gross income[78] as provided under IRC §72. IRC §72(t)(1) generally imposes a 10% tax penalty on early distributions from qualified retirement plans and traditional IRAs, unless the distribution satisfies one of several statutory exceptions. IRC §72(t)(2)(A)(iv) provides that §72(t)(1) does not apply to distributions that are part of a series of substantially equal periodic payments made for the life of the employee.

After reviewing all facts as submitted, the IRS concluded that the failure to distribute the entire required annual payment from the IRA for the second year and the subsequent "make-up" distribution for the second year made in the third calendar year are not considered modifications of a series of substantially equal periodic payments under IRC §72(t)(2)(A)(iv). Likewise, the taxpayer is not subject to the 10% penalty on premature distributions.

60-Day Rollover Requirement

Letter Ruling 200504037, January 28, 2005
IRC §§72 and 408

☞ Timing is Critical

Purpose. To determine if the taxpayer qualifies for a waiver of the 60-day rollover requirement, thus waiving the 10% early distribution penalty.

Background. College tuition was due for one of the taxpayer's three children. Despite the daughter's efforts to secure financial aid prior to the tuition's final due date, she was unsuccessful. The taxpayer withdrew funds from his IRA to pay college tuition on the last available date, anticipating the student loan would arrive in plenty of time to replace the funds in the IRA within 60 days of withdrawal. Unfortunately, the loan proceeds did not arrive until two and one half weeks after the 60-day window expired.

78. IRC §408(d)(1)

Analysis. IRC §72(t)(1) generally imposes a 10% penalty on early distributions from qualified retirement plans and traditional IRAs unless the distribution satisfies one of several statutory exceptions. Any amount paid or distributed out of an individual retirement plan is included in gross income[79] as provided under IRC §72. IRC §408(d)(1) does not apply if the entire amount received is paid into an IRA not later than the 60th day after the day on which the individual receives the payment.[80] A waiver of the 60-day requirement is allowed if failure to waive would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual.[81]

The following factors are considered in determining whether to grant a waiver of the 60-day rollover requirement:[82]

- Errors committed by a financial institution
- Inability to complete roll over due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country or postal error
- Use of the amount distributed
- Time elapsed since distribution occurred

After review of all facts as submitted, the IRS concluded that the rollover provisions were enacted to allow portability between eligible retirement plans including IRAs. Use of the distribution as a short-term loan to pay personal expenses negates the original intent.

Holding. The IRS determined the 60-day waiver is **not** allowed since information provided does not demonstrate circumstances which would justify such a waiver.

TAX FRAUD

Real Estate Schemes

IRS Fact Sheet FS-2005-12, February/April, 2005
IRC §6663

☞ Real Estate Fraud Investigations

Common schemes currently being used in real estate fraud investigations conducted by IRS Criminal Investigation include:

- Property flipping
- Two sets of settlement statements
- Fraudulent qualifications

Property flipping involves buying a property at a low price and quickly reselling it for a much higher price with false statements given to the lenders.

In the **two-sets-of-settlement-statements scheme**, one statement is provided showing the correct selling price of the property. A second statement, which shows a highly inflated purported selling price, is given to the lender. The lender loans money based on the inflated value and funds are disbursed among conspirators after the settlement.

79. IRC §408(d)(1)
80. IRC §408(d)(3)(A)
81. IRC §408(d)(3)(I)
82. Rev. Proc. 2003-16, January 27, 2003

Fraudulent qualifications involve real estate agents who assist buyers who cannot qualify for the purchase based on their real information. Employment history and/or credit records are "created" to allow the transaction to occur.

In these types of cases, money laundering is often used to hide the proceeds from these transactions from the government. When the IRS Criminal Investigation Division conducts investigations, the incarceration rate on these types of cases ranges from 71.8% (FY 2001) up to 92.3% (FY 2004). Indictments have also steadily increased from 67 (FY 2001) to 102 (FY 2004). Average jail time has increased from 24 months (FY 2001) to 41 months (FY 2004). Despite limited resources, the IRS continues to investigate real estate fraud.

Disguised In-Kind Payments

Department of Justice News Release, March 7, 2005

IRC §3121

☞ Department of Justice Bars Employment Tax Scheme

Michael Yohe and Michael Thompson were sued as the result of a fraudulent employment tax scheme which affected more than 1,100 farm employees and 50 dairy farms in four western states (Idaho, California, Arizona, and Oregon). This scheme resulted in more than $12 million in employment and income tax losses.

This scheme worked by disguising cash wages paid by the farms to employees as purported in-kind payments of milk thus avoiding employment tax withholding laws. Mr. Yohe and Mr. Thompson allegedly prepared phony commodity statements that state the employees are paid in milk with compensation based on milk production. These documents are distributed to the employees in lieu of traditional Forms W-2. However, the employees are actually compensated in cash based on an hourly wage or number of shifts worked.

The complaint filed against Yohe and Thompson seeks an order barring these men and their companies from promoting and operating the scheme as well as from operating any professional employer organization or payroll services company.

Fraudulent Tax Shelters

IRS News Release IR-2005-83, August 29, 2005

☞ KPMG LLP Admits to Designing and Marketing Fraudulent Tax Shelters and Is Fined

KPMG LLP, the nation's fourth largest accounting firm, spared itself from a federal criminal indictment by admitting to establishing fraudulent tax shelters for its wealthiest clients. The cost to the U.S. Treasury was at least $2.5 billion in evaded taxes. Key points in the August 29, 2005, news conference, which featured U.S. Attorney General Alberto Gonzales and IRS Commissioner Mark Everson, include:

- Eight former employees and tax partners of the firm and one consulting attorney of a prominent New York City law firm were indicted by a federal grand jury on tax fraud charges. The eight indicted former employees included the former deputy chairman of KPMG and the former vice chairman of KPMG in charge of tax. The indicted attorney wrote favorable "opinion letters" on the tax shelters for KPMG that it marketed as impartial legal advice.

> **Note.** The charges contained in the indictment are merely accusations, and the nine defendants are presumed innocent until proven guilty.

- KPMG admitted to guilt in the illegal tax shelter scheme and agreed to pay a $456 million fine.
- According to the Justice Department, the illegal tax shelters were designed to artificially create $10 million to $20 million of tax losses to offset income tax liabilities of wealthy clients. Much of the legitimate tax liabilities were generated by large realized capital gains of wealthy clients during the 1990s.
- The agreement between the Justice Department and KPMG includes permanent restrictions on KPMG's tax practice, including the elimination of the following two services:
  1. "Private client" tax services targeted to wealthy individuals, and
  2. "Compensation and benefits" tax services.

Note. KPMG had already terminated most of its "private client" tax services in 2002.

- U.S. Attorney General Roberto Gonzales made the following statement at the news conference:

  Today's agreement requires KPMG to accept responsibility and make amends for its criminal conduct while protecting innocent workers and others from the consequences of a conviction. The stiff penalty announced today means that the firm is paying for its conduct, while guarantees of cooperation, oversight, and meaningful reform will help to ensure that its future business is conducted with honesty and integrity.

- IRS Commissioner Mark Everson stated:

  Accountants and attorneys should be the pillars of our systems of taxation, not the architects of its circumvention.

Indictments, Arrests, and Convictions

Department of Justice News Releases – February 28, 2005; March 8, 2005; April 22, 2005; April 26, 2005; July 1, 2005

☞ Department of Justice Bars Employment Tax Scheme

Department of Justice (DOJ) continues to indict and prosecute cases. Various actions taken by DOJ are described below.

- **February 28, 2005: Telecommunications Entrepreneur Indicted and Arrested in $200 Million Tax Evasion Case**

  Over a five year period, Walter Anderson personally earned nearly a half billion dollars through investments in business venture via offshore corporations which he set up to appear that he was not personally earning these monies.

- **March 8, 2005: Justice Sues to Halt Allegedly Abusive Tax Scheme Sold to More than 100 Employers Nationwide**

  Mr. Magalhaes and his businesses sold voluntary employee beneficiary association (VEBA) plans to employers. These plans falsely purported to satisfy a provision which would allow employers to make unlimited tax-deductible contributions to certain qualified welfare benefit plans.

- **April 22, 2005: Four Defendants Sentenced in $120 Million International Tax Shelter Case**

  Four Anderson Ark defendants were sentenced to terms of imprisonment ranging from eight to 20 years and were required to pay $120 million in fines. From 1997 through early 2001, the defendants earned tens of millions of dollars in fees from the sale of several fraudulent tax shelter plans via the Internet. These were predominantly called "Look Back" and "Look Forward" programs.

  Each defendant was ordered to pay prosecution costs of $66,288. The court also ordered forfeiture of the seven properties located in Costa Rica, the AAA Administrative Office in Hoodsport, WA and $28 million in laundered funds.

- **April 26, 2005: Two More Defendants Sentenced in Anderson's Ark International Tax Shelter Case**

  Two more Anderson Ark defendants were sentenced to seven years in prison and were required to pay $42 million in fines. Each of the defendants was ordered to pay costs of prosecution of $66,288. The court also ordered forfeiture of $850,863 in earnings from Anderson Ark and Associates, a Colorado home, and a Jeep Cherokee automobile.

- **July 1, 2005: Shelby County, Illinois Insurance Salesman Convicted of Tax Evasion, Wire Fraud, and Money Laundering**

  After 13 days of evidence and over five hours of deliberation, a jury convicted Denny Patridge of tax evasion for wire fraud and money laundering in 1996 and 1997. He operated Patridge Insurance Services, Inc. from an office in his Strasburg home. The evidence presented at trial established that Patridge established "trusts" which he used to conceal his earnings, hide the origin of his income, deceive the IRS, and circumvent personal income taxes.

  Patridge placed funds in bank accounts which bore the names of his "trusts" and claimed on trust tax returns that the funds had been distributed to an offshore trust. However, at all times Patridge retained full control over funds in the trust bank accounts and enjoyed the beneficial use of those funds, which made the income taxable to him personally.

  The trial evidence established that Patridge did not report a substantial amount of his income on returns he filed for 1996 and 1997. In 2000, after the IRS notified Patridge that it had made a formal assessment of the 1996 and 1997 back taxes, Patridge liquidated his investment accounts, set up an offshore account, and placed approximately $200,000 in it. Patridge also evaded approximately $19,523 in taxes for calendar year 1999 on taxable income of approximately $76,796. He evaded those taxes by transferring money he earned to a foreign account, concealing that money from the IRS, using the money to pay personal expenses, and failing to file an individual income tax return.

Badges of Fraud

***Sam F. Ford and Ingrid D. Ford v. Commissioner,* TC Memo 2005-18, February 1, 2005**

IRC §§61, 6653(b)(1), and 6015

☞ Lies, Lies, and More Lies

Facts. Sam and Ingrid Ford met in 1983, married in 1986, and resided in Beverly Hills, CA. Sam had a son, Marc, who lived in Chicago, IL.

In 1968 and 1978, Sam was convicted of securities fraud and mail fraud, respectively. He spent three years in Allenwood Federal Prison and was released in September 1981. While in prison, he was ordered to pay $250,000 to the Securities and Exchange Commission (SEC) by making payments in installments. He moved assets from his name and placed them in both his wife and sons' names. In 1986, he provided many false statements including:

- Gross income of $16,000 in 1985
- A negative net worth of $560,000
- He owned **no** stock or bonds
- He was unemployed

Sam subsequently pled guilty to two felonies in 1990.

The 1986 return filed by the Fords reported a negative taxable income of $275,937, and requested a refund of their entire estimated tax payments of $38,000. Stock trades from Sam's Canadian brokerage account and sales of securities were **not** reported on the return as filed. Many of these transactions were made in his son's name.

Ingrid spent the following amounts in 1986:

- $17,000 — Fur coat
- $114,736 — Rolls-Royce
- $286,000 — Cashier's check
- $346,290 — Cash
- House (down payment)
- $30,400 — Courtyard by Marriott Ltd. Partnership

Issues. Whether the:

- Taxpayers failed to report capital gains and other income totaling $5.1 million
- Taxpayers are liable for fraud penalty
- Ingrid qualifies for innocent spouse relief from joint and several liability under IRC §6015

Analysis. Based on the testimony and documentation provided, gross income from capital gains and other income was determined unreported by the taxpayers.

The badges of fraud were determined based on:

- Sam's acknowledgement under oath of significant unreported income
- His testimony in both his criminal and tax cases
- Ingrid's less than credible testimony of her "lack of knowledge" even though she created the names of a few entities
  - For Door (combination of names Doorn and Ford), and
  - Poor Bear and Bear & Pebbles (named for her dogs)
- Records showing direct control and management of the Canadian accounts by both Sam and Ingrid
- Sham tax return filed by Sam and Ingrid
- Giving implausible or inconsistent explanations of behavior especially in light of the amount of money Ingrid spent
- Concealment of assets or income
- Failure to cooperate with the authorities

In order to qualify for innocent spouse relief under IRC §6015, Ingrid was required to establish:

- A joint return was made for the taxable year,
- That joint return resulted in an understatement of tax attributable to erroneous items of Sam, and
- Ingrid, in signing the joint return, **did not know and had no reason to know** of the understatement.

The Tax Court pointed out various factors which weighed heavily against Ingrid for purposes of innocent spouse relief:

- She knew or had reason to know of the underpayment at the time she signed the return
- She was involved in the convoluted financial transactions which transpired during 1986
- She played a **critical role** in the utilization of nominee corporations and brokerage accounts
- She played a crucial role in the concealment of assets

Holding. The IRS prevailed on all issues in this case.

Summons
***United States v. BDO Seidman, LLP,* United States District Court, N.D. Illinois, No. 02 C 4822, March 30, 2005**
IRC §7525

☞ Tax Practitioner Documents Privileged

Facts. As part of an IRS investigation into BDO Seidman, LLP's (BDO) potential involvement in abusive tax shelters, summonses were served on BDO. BDO and a number of its clients asserted a variety of privilege claims. An Illinois district court allowed previously identified BDO clients to intervene and assert objections to BDO's disclosure of documents. In 2004, the district court agreed that most of the documents could not be disclosed based on attorney-client privilege and the work-product doctrine.

Issue. Whether privilege is available, under the crime-fraud exception, for documents which were part of a pre-packaged product of abusive tax shelters developed, marketed, and implemented by BDO.

Analysis. The government presented arguments that everything done by BDO, third-party law firms, and clients under a legitimate business purpose guise was a cover-up to the unlawful purpose of the tax shelters. These tax shelters were substantially the same as abusive tax shelters previously identified by the IRS.

The court stated that just because the IRS characterizes transactions as abusive does not mean the characterization is a proper conclusion as a matter of law. In addition, the Code and Regulations are full of complexities. Determination by the court of whether there was fraudulent and criminal activity would be premature and would place the "cart before the horse."

The court did an "in-camera" (private) review of the documents using seven potential indicators of fraud to determine if enough evidence existed to support a prima facie showing of fraud. The review indicated:

- Marketing of pre-packaged transactions by BDO,
- BDO and its clients attempted concealment of the true nature of the transactions,
- Vaguely worded consulting agreements, and
- BDO's failure to provide services under the consulting agreement for which payments were received.

Holding. Since the government failed to provide adequate evidence to support their rationale, the court concluded that all of the documents (except for one) were privileged. Thus, the clients did not have to disclose these documents to the IRS.

☞ Website IRS Website Provides Helpful Information

The IRS website provides a wealth of information on **Abusive Tax Shelters and Transactions** for tax professionals. The current website location is: **www.irs.gov/businesses/corporations/article/0,,id=97384,00.html.**

Important information is readily available including:

- The IRS's comprehensive strategy for curtailing abusive tax shelters and transactions
- Tax accrual workpapers
- Current settlement initiative information
- Quick links to
    - Office of Tax Shelter Analysis Hotline
    - Listed Abusive Tax Shelters and Transactions
    - Regulations on Abusive Tax Shelters and Transactions
    - Lead Executives and Technical Contacts
    - Recent Tax Shelter Developments
    - Penalty Policy for Abusive Transactions

The IRS can be contacted to provide information about abusive tax shelters at

- 1-866-775-7474
- 202-283-8406
- irs.tax.shelter.hotline@irs.gov (email)
- IRS, Office of Tax Shelter Analysis, Mint Building M3-336, 1111 Constitution Ave. NW, Washington, DC 20224

TRAVEL AND TRANSPORTATION EXPENSE

Unreimbursed Employee Business Expenses

***Corey L. Wheir v. Commissioner,* TC Summary Opinion 2004-117, August 30, 2004**
IRC §162

☞ IRS Loses on Definition of "Metropolitan Area"

Facts. During the years 1999, 2000, and 2001, the Wisconsin taxpayer worked as a boilermaker through the boilermakers' union. For the three years at issue, the taxpayer worked at 19 different locations throughout Wisconsin. He received no reimbursements for travel expenses. Accordingly, he claimed the expenses as unreimbursed employee business expenses on Schedule A. The claimed expenses included mileage for job assignments outside a 35-mile radius from his home and living expenses at distant locations. Total claimed expenses after the IRC §67(a) adjustment were as follows:

Year	Expenses
1999	$9,845
2000	8,652
2001	5,035

The IRS disallowed all the expenses as "personal commuting expenses."

The taxpayer also worked as a professional bodybuilder during this time period receiving income from posing, seminars, publication of poses, training bodybuilders, and bodybuilding supplements. Income and expenses were reported on Schedule C were as follows:

	1999	2000	2001
Gross income	$ 2,405	$ 8,840	$ 3,975
Total expenses	11,771	14,708	14,539
Net loss	**($ 9,366)**	**($ 5,868)**	**($10,564)**

The IRS disallowed expenses for supplements in each of the three years determining these amounts represented "payments for products that were personal." The term supplements included:

- Bison (buffalo) meat (three pounds per day year round)
- Shakes containing enormous quantities of vitamins and minerals
- Products sprayed on/massaged into skin to enhance appearance

Issue. Whether the taxpayer is entitled to deductions under IRC §162(a) for:

- Unreimbursed transportation and travel expenses, and
- Expenses incurred in his bodybuilding trade or business.

Analysis. A deduction is allowed for ordinary and necessary business expenses, which includes transportation expenses between one's business location and another business location.[83] A deduction is allowed for travel expenses when an employee is required to stay at a business location and the stay requires sleep or rest.[84] No deduction is allowed for personal, living and family expenses.[85]

For transportation and travel expenses, the taxpayer argued the "35-mile radius" constituted the limit of the metropolitan area. The IRS presented arguments that the metropolitan area should be within 80 miles from taxpayer's home at Wisconsin Rapids or the normal work area should be an "economic area" defined by the Bureau of Economic Analysis of the U.S. Department of Commerce. The Tax Court determined the IRS has no authority for defining "metropolitan area" in terms of Census Bureau designations with such a rule leading to **unfair and illogical results**.

The buffalo meat and shakes were determined to be an inherently personal expense that can be used by nonprofessionals interested in their health and physical appearance. However, the products sprayed on/massaged into skin to enhance appearance were allowable business expenses. Although these products can also be used by nonprofessionals, they are marketed directly to bodybuilders and, generally cannot be purchased in regular consumer stores. The "direct-marketing factor" tipped the scale "ever so slightly" in the taxpayers favor.

Holding. The Tax Court held:

- The travel and transportation expenses incurred were allowable deductions for the taxpayer.
- The products sprayed on/massaged into skin to enhance appearance were allowable business expenses for his bodybuilding trade or business; buffalo meat and shakes were personal expenses.

Unreimbursed Travel Expenses

***Wickie B. Whalen v. Commissioner*, TC Summary Opinion 2005-45, April 18, 2005**
IRC §162

☞ Failure to Seek Employer Reimbursement Results in No Deduction

Facts. The taxpayer was a professor at a community college. He made four trips in 2001 for which he deducted employee business travel expenses on his 2001 Form 2106, *Employee Business Expenses.* They consisted of trips to the following locations:

- Istanbul (not required or approved by the employer)
- Italy (approved by the employer — to teach a summer program of the employer)
- Peru (not required or approved by the employer)
- Portland, Oregon (approved by the employer — to attend Community College Humanities Association National Convention)

83. IRC §162(a)
84. IRC §162(a)(2)
85. IRC §262

The taxpayer's employer established a travel reimbursement policy for its employees in 1976. This policy is outlined as follows:

- Employees were required to obtain advance approval from the college president or area head and the human resources office for "out-of-state" travel.
- Requests for "out-of-state" travel were required to be submitted on a form, *Request for Leave of Absence and Reimbursement.*
- Reimbursement was provided only for days that were specifically included in the approved leave days shown on the form.

Although the trip to Italy was approved, the taxpayer purchased his own airfare for over $1,300, ignoring the employer's travel policy.

- All airline tickets must be booked through the employer's Travel Reservation Desk.

Therefore, the taxpayer received only partial reimbursement of $411 for the airfare. Similarly, he purchased his own airfare for the Portland trip and received no reimbursement for it.

The taxpayer claimed a total of $26,189 of unreimbursed employee business expenses on his 2001 Form 2106. The IRS disallowed most of the claimed deductions and assessed additional tax of approximately $7,000.

Issue. Whether the taxpayer is entitled to deductions of unreimbursed employee business expenses greater than those allowed by the IRS.

Analysis. A taxpayer is not entitled to deduct expenses for which he has been or could have been reimbursed.[86] The college had a policy of reimbursing its employees for ordinary and necessary business expenses. Under that policy, the taxpayer received some reimbursements for his trips to Italy and Portland. However, he did not seek reimbursement for his trips to Istanbul and Peru.

Holding. The court agreed with the IRS and upheld the amount of unreimbursed employee business expenses previously determined in the examination. The court stated: "When a taxpayer has the right to obtain reimbursement for his employee business expenses from his employer but fails to seek reimbursement, the taxpayer cannot deduct the expenses because it is not 'necessary' for the taxpayer to remain umreimbursed."

Per Diem Rates

Revenue Procedure 2005-10, January 18, 2005
IRC §§62, 162, and 274

☞ Simplified Per-Diem Rates for Post-2004 Business Travel

Effective for post-2004 travel, the IRS issued revised "high-low" simplified per-diem rates as well as a revised list of high-cost localities.

Under the "high-low" method, there is one uniform per diem rate for all "high-cost" areas within the CONUS (continental U.S.) and another per diem rate for all other areas outside the CONUS. As a result of revised FY 2005 per diem rates issued by GSA effective for travel beginning October 1, 2004, the IRS updated the high-low per diem rates along with its list of high-cost areas.

13

86. IRC §162(a) and *Orvis v. Commr.*, 9th Cir. Ct. of Appeals, 788 F2nd1406 (1986), affirming the prior Tax Court decision: TC Memo 1984-533, October 3, 1984

The pre and post-2004 amounts are as follows:

Optional High-Low Per Diem Rates	October 1–December 31, 2004	Post January 1, 2005
High-cost areas	$199 ($153 lodging; $46 for M&IE)	$204 ($158 lodging; $46 for M&IE)
Other localities	127 (91 lodging; 36 for M&IE)	129 (93 lodging; 36 for M&IE)

In addition, effective January 1, 2005, an updated list of high-cost areas was determined which was slightly different than those listed in Rev. Proc. 2004-60.

Taxpayers are allowed to use the information in Rev. Proc. 2004-60 for the period January 1, 2005 through February 28, 2005 if desired.

Note. This supersedes Rev. Proc. 2004-60, 2004-42, IRB, which carried new high-low per diem rates effective October 1, 2004. Taxpayers should look to see which revenue procedure allows for larger deductions for the period January 2, 1005 through February 28, 2005.

Standard Mileage Rate

IR-2005-99, September 9, 2005

☞ Standard Mileage Rate Increased After September 1, 2005

The optional standard mileage rates are increased to 48.5¢ per mile for business miles, and 22¢ per mile for deductible medical and moving miles. The new rates are effective for travel after September 1, 2005. The rate for charitable mileage was not changed, and remains at 14¢ per mile.