

WHAT'S NEW SUPPLEMENT

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The authors wish to thank Professor John J. Connors, J.D., C.P.A., L.L.M., for his contributions to this supplement.

Corrections to 2005 Federal Tax Workbook

Date Posted	Page	Correction or addition
10/24/05	135	In Example 9 line 2 change "\$11,100" to "\$8,550." In line 4 change "\$10,600" to "\$8,050."
10/28/05	159	The text says there are no clear guidelines to determine whether earnings from an LLC are liable for SE tax. Readers are encouraged to look at Prop. Reg. 1.1402(a)-2(h)(2). These regulations are the third attempt by the IRS to address this issue. These regulations will give some guidance in determining whether the earnings are liable for SE tax for certain members.
10/14/05	198	Example 20. After the workbook was written, the IRS increased the mileage rate from 40½¢ per mile to 48½ ¢ per mile for travel after August 31, 2005. Effective October 1, 2005 the standard meal allowance is \$39 per day. Taxpayers should go to the GSA website at www.gsa.gov/perdiem for the exact rate for their state and locale.
10/17/05	198	Example 20 says "Ginger's total 2004 unreimbursed overnight travel expenses." Change 2004 to 2005.
11/4/05	221	Citation #81 should be TC Summary Opinion 2005-76, not 2005-75.
10/28/05	222	The line in the table which says, "Deductible for self-employment purposes Sch SE NO Sch SE" Change NO to "maybe." The answer depends on whether you are using the Young case as the authority or the pub and MSSP.
10/7/05	244	In Example 9, the accounting and legal expenses are treated as start-up expenses. Since the total start-up expenses exceed \$5,000, amortization is required. It is possible these are actually organization expenses. If that is the case, organization expenses are treated as a separate category and have their own \$5,000 threshold. Consequently, they would be fully deductible.
10/7/05	247	In line 4 of Example 10, replace "a four-year midpoint" with "the same three-year recovery period."
10/7/05	247	In Example 10, replace the amounts of \$22,500, \$67,500, \$52,000, and \$67,500 with \$30,000, \$90,000, \$30,000, and \$90,000.
10/7/05	251	In line 3 of the next to last paragraph, Rev. Proc. 2002-9 should be 2000-19.
10/21/05	305	In the second paragraph, line 2 change "line 10" to "line 11."
10/28/05	358	In the line just prior to the note box, change "\$35,895" to "\$36,255"
10/13/05	385	Delete the last sentence from the note box. Please visit the University of Illinois Tax School website at http://www.ace.uiuc.edu/taxschool/PDF/Like Kind Depreciation Examples.pdf for detailed examples of the issue.
10/17/05	409	Delete the "\$140,000" from line 6.
10/21/05	428	Line 45 should be \$200,000.
10/21/05	431	In step 4 replace \$48,000 with \$24,000.

Date Posted	Page	Correction or addition
11/4/05	443	In the last paragraph. Line 2, remove the word “automatic.” You are also reminded to check the new Form 8901 which may allow the non-custodial parent to claim the exemption, but not the child tax credit.
10/6/05	448	The citation # 10 given to Dr. Neil E. Harl on page 448 also includes the material on pages 449 and 450.
10/28/05	446	The IRS has a draft Form 8901, <i>Information on Qualifying Children Who Are Not Dependents (For Child Tax Credit Only)</i> on their web site in the draft forms section.
11/18/05	446	<p>The workbook does not contain a discussion of Form 8901. However, the instructor may have misinterpreted the use of the form. Apparently the form is limited to the following:</p> <p>The new Form 8901 will probably have very little usage. Only a few taxpayers will be eligible to claim the child tax credit (CTC) but can not claim the child as a dependent.</p> <p>The instructions for Form 8901 will apparently say, “Who Must File: Use Form 8901 if your qualifying child is not your dependent because either of the following applies:</p> <p>You, or your spouse if filing jointly, can be claimed as a dependent on someone else’s 2005 return.</p> <p>Your qualifying child is married and files a joint return for 2005 (other than a joint return filed only as a claim for a refund and no tax liability would exist for either spouse if they had filed separate returns).”</p> <p>An example of the first situation is where Daughter (age 18) lives with Mother and Daughter’s child, which is the Grandchild. Mother may claim Daughter as a dependent. This makes Daughter a dependent ineligible. Because Daughter is a dependent ineligible she may not claim Granddaughter as a dependent. However, Daughter may file Form 8901 and claim the CTC. Apparently, this in turn prevents Grandmother from claiming grandchild as a dependent.</p> <p>An example of the second situation might be where Daughter (age 16) and her husband live with daughter’s Mother. Daughter and husband have a tax liability for the year and file a joint return. While Mother can not claim Daughter as a dependent (Daughter filed a joint return) she may claim the CTC.</p> <p>In situations of divorce and multiple support agreements, the relationship between the child and the taxpayer is significant because the CTC attaches to the dependent exemption, i.e., only the taxpayer entitled to the dependent exemption is entitled to the CTC <i>if</i> the child is a qualifying child.</p>
10/28/05	452	The Energy Act was signed on August 8, 2005. This date applies for those provisions with an effective date on the date of enactment.
10/28/05	455	On page 455 in line 3 change “\$100,000” to “\$105,000”

Date Posted	Page	Correction or addition
10/6/05	494	The daycare provider rates listed are correct. However these rates will not be used in filing 2005 federal income tax returns. The regulations say to file tax returns using the rates in effect on December 31 of the prior year. The rates on page 494 will be used to file 2006 returns.

The 2005 tax return rates are:

Meal	Contiguous 48 States	Alaska	Hawaii
Breakfast	\$1.04	\$1.64	\$1.20
Lunch and supper	1.92	3.11	2.25
Snack	.57	.92	.67

10/6/05	537	In the note box at the top of the page, the word “cooperative” should be replaced with “uncooperative.”
10/28/05	583	The daycare provider meal allowance for July 1, 2004 through June 30, 2005 is incorrect. The correct rates are :

Meal	Contiguous 48 States	Alaska	Hawaii
Breakfast	\$1.04	\$1.64	\$1.20
Lunch and supper	1.92	3.11	2.25
Snack	.57	.92	.67

These rates should be used when filing 2005 tax returns. The bottom table is correct and those rates should be used when filing 2006 tax returns.

10/6/05	607	The seven paragraphs on pages 607 and 608 are taken from <i>Ag Law Digest, by Dr. Neil E.Harl</i> ; February 25, 2005; Vol. 16 No. 4.
11/4/05	Katrina Supp. p. 4	In line 4 of the first paragraph under “Suspension of Contribution Limits” the word “Katrina” should be removed. The deduction is limited to 100% for individuals for contributions made during that period. These contributions are also exempt from the 3% AGI phase-out for high income taxpayers. The deduction is claimed on line 15b of the Sch. A.

This supplement contains a synopsis of the Gulf Opportunity Zone Act of 2005 and various rulings and cases that were issued between the time the 2005 University of Illinois Tax School Workbook was printed and December 15, 2005. This should not be considered a source of all cases and rulings that were decided within that period.

NEW LEGISLATION

GULF OPPORTUNITY ZONE ACT OF 2005 (H.R. 4440), DECEMBER 21, 2005

President George W. Bush signed the Gulf Opportunity (GO) Zone Act of 2005 into law on December 21, 2005, declaring its purpose is "to help the citizens of the Gulf Coast continue to put their lives back together and rebuild their communities in the wake of the devastating hurricanes that hit the region." This is the second act of 2005 to provide tax relief to the coastal region. The projected 10-year cost of this legislation is \$8.6 billion, with the majority of benefits occurring in the first two fiscal years.

Non-Hurricane-Related Provisions

In addition to relief for the Gulf Coast, this bill also contains numerous non-Katrina related technical corrections to prior tax acts, some stretching back ten years. These include:

- Extending the election to treat combat pay as earned income for EITC purposes through 2006
- Clarifying the IRC §199 domestic manufacturing deduction (discussed in more detail in this supplement)
- Placing tougher restrictions on nonqualified deferred compensation
- Treating families as one S corporation shareholder without the requirement to make a formal election
- Treating the estate of a family member as a family member when calculating the number of shareholders in an S corporation
- Applying suspended loss rules between spouses for transfers after December 31, 2004
- Exempting state and local tax itemized deductions from AMT computations

Another major non-Katrina related change in the GO Zone Act clarifies that the five-year personal residence ownership requirement also applies to any property owner who acquires basis in a property from a taxpayer who obtained the property in a like-kind exchange.

The GO Zone Act also retroactively repeals the provision in the Working Families Tax Relief Act of 2004 (WFTRA) that exempted noncustodial parents from the requirement to attach Form 8332, *Release of Exemption*, to their returns. The GO Zone Act again requires the use of Form 8332.

Hurricane-Related Provisions

The type of hurricane tax relief available depends on the disaster area and hurricane zone classification. Zones are determined by location in a designated disaster area. Designated areas for each zone and disaster region are indicated below:

Gulf Opportunity Zone (Katrina GO Zone):

- **Alabama:** Baldwin, Choctaw, Clarke, Greene, Hale, Marengo, Mobile, Pickens, Sumter, Tuscaloosa, and Washington Counties
- **Louisiana:** Acadia, Ascension, Assumption, Calcasieu, Cameron, East Baton Rouge, East Feliciana, Iberia, Iberville, Jefferson, Jefferson Davis, Lafayette, Lafourche, Livingston, Orleans, Pointe Coupee, Plaquemines, St. Bernard, St. Charles, St. Helena, St. James, St. John the Baptist, St. Mary, St. Martin, St. Tammany, Tangipahoa, Terrebonne, Vermilion, Washington, West Baton Rouge and West Feliciana Parishes

- **Mississippi:** Adams, Amite, Attala, Claiborne, Choctaw, Clarke, Copiah, Covington, Forrest, Franklin, George, Greene, Hancock, Harrison, Hinds, Holmes, Humphreys, Jackson, Jasper, Jefferson, Jefferson Davis, Jones, Kemper, Lamar, Lauderdale, Lawrence, Leake, Lincoln, Lowndes, Madison, Marion, Neshoba, Newton, Noxubee, Oktibbeha, Pearl River, Perry, Pike, Rankin, Scott, Simpson, Smith, Stone, Walthall, Warren, Wayne, Wilkinson, Winston and Yazoo Counties

Hurricane Katrina Disaster Area:

- Alabama
- Florida
- Louisiana
- Mississippi

Rita GO Zone:

- **Louisiana:** Acadia, Allen, Ascension, Cameron, Calcasieu, Beauregard, Evangeline, Iberia, Jefferson, Jefferson Davies, Lafayette, Lafourche, Livingston, Plaquemines, Sabine, St. Landry, St. Martin, St. Mary, St. Tammany, Terrebonne, Vermilion, Vernon and West Baton Rouge Parishes
- **Texas:** Angelina, Brazoria, Chambers, Fort Bend, Galveston, Hardin, Harris, Jasper, Jefferson, Liberty, Montgomery, Nacogdoches, Newton, Orange, Polk, Sabine, San Augustine, San Jacinto, Shelby, Trinity, Tyler and Walker Counties

Hurricane Rita Disaster Area:

- Texas
- Louisiana

Wilma GO Zone:

- **Florida:** Brevard, Broward, Collier, Glades, Hendry, Indian River, Lee, Martin, Miami-Dade, Monroe, Okeechobee, Palm Beach and St. Lucie Counties

Hurricane Wilma Disaster Area:

- Florida

The following special tax incentives are intended to provide relief for the Gulf region and are available to most businesses in the designated **GO Zone for Hurricane Katrina**, with the exception of golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, liquor stores or gambling or animal racing property:

- 50% bonus depreciation deductions for qualified Katrina GO Zone property
 - ♦ Qualified property includes IRC §168(k)(2)(A)(i) property (property with a 20-year recovery period) and certain nonresidential real property and residential rental property
 - ♦ Qualifying property must be acquired by the taxpayer on or after August 28, 2005 for use in the Katrina GO Zone
 - ♦ Deduction exempt from AMT
 - ♦ Applies to property placed in service through December 31, 2007 (December 31, 2008 for real property)
 - ♦ Provides a one-year extension of time for taxpayers in hurricane affected areas to place JGTRRA of 2003 bonus property into service

- Increases IRC §179 expensing allowed for qualified Katrina GO Zone property
 - ♦ Doubles the §179 expense allowance to up to \$208,000
 - ♦ Raises phase-out floor from \$400,000 to up to \$1.03 million
 - ♦ Applies to property purchased on or after August 28, 2005 and placed in service on or before December 31, 2007
 - ♦ Requires §179 recapture for property moved out of Katrina GO Zone
 - ♦ Maximum §179 deductions for SUVs remain unchanged at \$25,000
- Expensing of 50% of certain clean up and demolition costs allowed in year paid or incurred
 - ♦ Costs must be paid or incurred between August 28, 2005 and December 31, 2007 for removal of debris or demolition of structures on real property located in the Katrina GO Zone
 - ♦ Included clean-up costs for IRC §1221(a)(1) property (inventory or property held for resale) used in an active trade or business or held for the production of income
 - ♦ Costs must have been otherwise required to be capitalized
- NOL carryback period extended from two years to five years for losses attributed to repairing damages caused by Hurricane Katrina or for costs incurred in moving or providing temporary housing for employees working in areas damaged by Katrina; irrevocable opt out provision available

The above provisions are available to anyone who invests in the affected areas. There is no requirement that taxpayers must have previously owned or operated businesses in the Katrina Go Zone area.

The GO Zone Act also provides these additional tax incentives in the **Katrina GO Zone only**:

- Increased education credits for eligible students attending a school in the Katrina GO Zone in 2005 or 2006:
 - ♦ HOPE credit doubles to \$3,000; Lifetime Learning credit increases to a \$4,000 maximum
 - ♦ Certain room and board expenses qualify for the increased credit
- Allows employees to exclude up to \$600 per month of employer-provided housing expenses
- Increased New Markets credit
- Expanded tax-exempt bond offerings
- Extended environmental remediation expensing; inclusion of petroleum as a qualified hazardous substance

The following incentives affect **Katrina, Rita, and Wilma GO Zones**:

- Expanded employee retention credit
 - ♦ Small employer tax credit created by KETRA expanded to employers with more than 200 employees
 - ♦ KETRA credit extended to employers affected by Hurricanes Wilma and Rita for 40% of first \$6,000 in wages paid to eligible employees while businesses were inoperable as a result of hurricane damage
- Extended low income housing and rehabilitation credits for qualified structures
 - ♦ Non-certified historical structures increased from 10% to 13%
 - ♦ Certified historical structures increased from 20% to 26%
- Increased expensing limits for small timber producers

Individual Gulf Opportunity (GO) Zones have also been created for areas affected by Hurricanes Rita and Wilma to provide motivation to businesses and individuals to rebuild. The GO Zone Act extends the following benefits, similar to the Katrina Emergency Tax Relief Act of 2005 (KETRA), to victims of Hurricanes Rita and Wilma. These include:

- Penalty-free pension plan distributions
- Repayment of qualified hurricane distributions
- Income averaging of qualified hurricane pension distributions
- Timely pension plan repayments not subject to income tax
- Increased charitable contribution limits
- Increased casualty loss limitations
- Earned income and child tax credits based on look-back income
- Extension of filing and penalty relief to February 28, 2006

ADDITIONAL RULINGS AND CASES

ALTERNATIVE MINIMUM TAX

Adjustments

Sandra R. Murray and Khaled M. Abouilnoor v. Commissioner, T.C. Summary Opinion 2005-178, December 5, 2005
IRC §56

+ **Miscellaneous Itemized Deductions Result in AMT for Couple**

Facts. Sandra Murray and Khaled Abouilnoor filed a joint 2002 return claiming zero taxable income and zero tax due. They claimed two exemptions and the following amounts as Schedule A itemized deductions:

Medical and dental (in excess of 7.5% of AGI)	\$ 1,079
State and local taxes	603
Charitable contributions	200
Misc. deductions (in excess of 2% of AGI)	55,302

The taxpayers did not attach Form 6251, *Alternative Minimum Tax — Individuals*, to their return, nor did they compute any alternative minimum tax (AMT). The IRS sent the taxpayers a letter in April of 2003 requesting that they file a Form 6251. The taxpayers responded that they were not liable for AMT. The IRS then issued the taxpayers the refund they requested without assessing any AMT.

The taxpayers' 2002 tax return was subsequently examined and a deficiency of \$2,747 was determined for the couple's AMT liability. The taxpayers argued the IRS should be denied the ability to assess the deficiency, claiming: "The IRS would have never given us a full refund, if our supported items and documentation was not accepted [sic]."

Issues. Are the taxpayers liable for AMT?

Analysis. Married taxpayers with alternative minimum taxable income over \$49,000 may be liable for AMT. To calculate whether any AMT was due, the taxpayers were required to recompute their taxable income by adding back their exemption allowances, miscellaneous itemized deductions, state taxes, and their medical expenses to the extent that they exceeded their AGI by 7.5% but not over 10%. After adjustments, the taxpayers were found liable for \$2,747 of AMT.

Holding. The Court found the taxpayers subject to AMT as a matter of law, no matter how unfair it may seem. Their estoppel claim was rejected based on prior cases establishing that the IRS can issue deficiency notices after it issues refunds since the IRS must often “first pay and then look.”¹

BAD DEBT

Bad Debt Deduction

William A. Egan v. Commissioner, T.C. Memo 2005-234, October 5, 2005

IRC §166 and 6662

+ Taxpayer Failed to Prove Timing and Amount of Bad Debt Deduction

Facts. The taxpayer, William Egan, owned and operated a petroleum distribution company as a sole proprietorship. One of his customers, Brooks Hauser, owned a chain of food stores and was having trouble keeping up with payments on his purchases. Egan placed a limit of \$400,000 on the amount of debt that Hauser could incur before future deliveries were stopped. Hauser offered to give Egan two personal notes for \$100,000 each as security on the amount he owed if Egan would continue delivering fuel. In addition he said he would make Egan the beneficiary of a life insurance policy.

Hauser died in 1994 still owing Egan. Egan found Hauser had not named him as a beneficiary on his life insurance policy and in 1995 attempted to collect from Hauser’s widow. Mrs. Hauser’s attorney sent Egan a letter saying she had no interest in her late husband’s business and was not liable for the debt. She later filed personal bankruptcy and received a discharge in 1998.

Egan claimed a bad debt deduction of \$158,381 on his 1998 income tax return. The IRS disallowed the deduction claiming doubt as to the amount of the liability and asserting the deduction was claimed in the wrong year.

Egan could not produce any records showing the exact amount Hauser owed, claiming he destroyed all of his old records after the IRS audited his 1994 and prior tax returns and approved the gross income reported. He could not show how the deduction of \$158,381 was determined. During the trial Egan testified attorneys told him he could claim the deduction, but he could not tell the court the name of the attorneys. His accountant, Mr. Rabonowitz, testified the amount of \$158,381 was correct, but he did not have any workpapers showing how he arrived at this amount.

Issues.

1. Did Egan substantiate his claim for the bad debt?
2. If the bad debt existed, did it become worthless in 1998?
3. Should the accuracy-related penalty for understatement of tax apply?

¹ *Warner v. Commr.*, 526 F.2d 1 (9th Cir. 1975)

Analysis.

1. The burden of proving the deduction for the bad debt fell on Egan. Egan claimed to have destroyed all of his records following an audit, but the court did not find the lack of substantiation excusable since the audit related to gross receipts and did not relate to amounts purchased or owed. The court was skeptical that Egan, “an astute businessman,” would destroy records relating to outstanding accounts receivable.

The court found Egan’s reliance on a footnote in a Senate report² to be misplaced. The report indicates the burden of proof may shift in the event records are destroyed through no fault of the taxpayer. Since Egan destroyed the records himself, this exception does not apply.

The court also declined to apply the *Cohan*³ rule, which would have allowed Egan to estimate the amount of the deduction from his records. Although Egan introduced proof the debt existed, the court found “evidence of debt is not sufficient to substantiate the deduction of a different amount.” The court concluded there was no basis for a reasonable estimate and any deduction allowed “would amount to unguided largesse.”

2. A bad debt must become worthless during the taxable year to be deductible. The taxpayer must prove the debt had value at the beginning of the year but was worthless by the close of the tax year in which the deduction was claimed. The objective determination of whether a debt is worthless or not is fixed by identifiable events. The taxpayer must establish reasonable grounds for abandoning any hope of recovery of the debt before it can be deemed worthless.

Egan failed to prove the debt he was owed had value at the beginning of 1998. Evidence showed Egan knew the debt was uncollectible prior to 1998 since Hauser died in 1994 and his stock was taken over by shareholders and secured creditors. He also knew the debt was uncollectible from Mrs. Hauser since her attorney informed him in 1995 the debt was unlikely to be repaid. Mrs. Hauser’s 1998 bankruptcy discharge was of no consequence to Egan since Mrs. Hauser was not liable for repayment of her late husband’s debt.

3. The accuracy-related penalty for substantial understatement of tax⁴ was upheld. Egan had no reasonable cause for his position since he lacked proof of a bona fide debt (a valid, enforceable obligation to pay a fixed and determinable amount)⁵ and there was no proof of the debt on his books (e.g., interest charged, payments applied, balance due, etc.).

Egan also failed to establish that he relied in good faith on the opinion of a competent tax advisor. He failed to identify the attorneys who advised him on his position, although he did identify his accountant, Mr. Rabinowitz, who Egan knew had been convicted of tax fraud for filing a false return. But the court could not even find evidence that Egan supplied his shady accountant with all of the relevant facts to determine whether a bad debt existed.

Holding. Although the court acknowledged Egan was probably “duped” by Mr. Hauser, it disallowed Egan’s unsubstantiated claim for a bad debt deduction in 1998 and upheld the accuracy-related penalty for substantial understatement of tax.

² Senate Report 105-174, 46 n.27 (1998), 1998-3 C.B. 537, 582

³ *Cohan v. Commr.*, 39 F.2d 540 (2d Cir. 1930)

⁴ IRC §6662: substantial understatement is the greater of 10% of the required tax or \$5,000

⁵ Treas. Reg. §1.166-1(c)

BUSINESS EXPENSES

Alimony, Business Expenses, Not-for-profit activity

Dennis E. & Paula W. Lofstrom v. Commissioner, 125 TC --, November 22, 2005

IRC §§ 71, 183, 280A

+ Court Determines Personal Use of Home Exceeds Use as Bed and Breakfast

The taxpayers, Dr. Dennis Lofstrom and his second wife, Paula, were assessed deficiencies for 1997 and 1998. The IRS disallowed a 1997 alimony deduction and 1997 expenses for the operation of a bed and breakfast (B&B) out of their personal residence. The IRS also disallowed expenses Dr. Lofstrom claimed on his 1997 and 1998 Schedule Cs for writing activities.

Alimony

Facts. Dr. Lofstrom was ordered to pay alimony to Dorothy, his first wife and mother of his 11 children, in the amount of \$1,500 per month. Dr. Lofstrom discontinued making payments in 1995 and a year later asked a Minnesota court for a reduction of payments following his retirement from medical practice. The court reduced his alimony to \$1,000 per month, but found the doctor in arrears for \$18,000.

The former Mrs. Lofstrom later agreed to surrender her claims for past and future alimony payments in exchange for \$4,000 cash and the future interest in a \$29,000 contract for deed with a 7.5% interest rate. The Lofstroms initially claimed only the \$4,000 cash as an alimony payment, but later amended their 1997 return to include the \$29,000 value of the transfer of the contract for deed as an additional alimony payment.

Issue. Can Dr. Lofstrom claim an alimony deduction for the \$29,000 value of the contract for deed he transferred to his former wife?

Analysis. IRC §71(b)(1) requires alimony payments to be made in cash or the equivalent of cash, such as a check or money order. As a third-party debt instrument, a contract for deed is not considered a cash equivalent. Alimony payments also must terminate upon the death of the recipient spouse.⁶ Since Dorothy Lofstrom's interest in the contract for deed would terminate on the completion of the contract and could conceivably continue after her death, the value of the transfer does not qualify as alimony.

Holding. The court ruled in favor of the IRS and held the transfer of a contract for deed does not constitute an alimony payment under IRC §71.

Bed & Breakfast

Facts. The Lofstroms claimed \$19,158 in expenses for the operation of a B&B on the first floor of their personal residence in 1997, \$12,622 of which was for depreciation. They claimed income of \$649 for this period.

One of Dr. Lofstrom's daughters and her family stayed rent-free at the B&B on a "single occasion"⁷ for an indeterminate period in 1997. The taxpayers produced no records of rent collected, guest rates, or the number of guests who stayed at the B&B.

Issue. Can the Lofstroms deduct expenses for the operation of a B&B in their home if the B&B was used by a relative for an indeterminate amount of time?

⁶ IRC §71(b)(1)(D); see case footnotes 6 and 8

⁷ Quote from taxpayer in case footnote 11

Analysis. No deduction is allowed for the business use of a home unless the personal use of the business portion is less than 14 days or 10% of the number of days the unit is rented at fair market value.⁸ “Personal use” includes use by lineal descendants, unless fair market rent is received.⁹ Expenses are also disallowed for portions of a personal residence not used exclusively for business purposes.¹⁰

The Lofstroms produced no records to substantiate the number of days their home was rented during 1997. Because they could not substantiate that Dr. Lofstrom’s daughter’s family stayed at the B&B less than 14 days, they failed to prove their business deductions were allowable. They also failed to prove they used the first floor exclusively for business purposes.

Holding. The Court held the expenses were not deductible since the taxpayers failed to meet their burden of proof to substantiate their expenses.

Writing Expenses:

Facts. Dr. Lofstrom claimed expenses he incurred in 1997 and 1998 for travel costs and writing supplies associated with composing a science fiction novel and a book on health and fitness. Neither book was published, although he did distribute 100 copies of something he had written for free. Dr. Lofstrom did not report any income from his writing activities, although he had reported losses since 1994.

Although Dr. and Mrs. Lofstrom responded to the IRS’s interrogatives, they did not appear in court to testify on their own behalf and were unavailable to cross-witness. They did produce a “deluge of miscellaneous handwritten notes, correspondence with publishers, a typewritten ‘novel,’ and hundreds of hand-written notes on health, fitness, and dieting.”¹¹

Issue. Can Dr. Lofstrom deduct expenses he incurred in writing novels and manuscripts?

Analysis. Although there are nine factors to consider when determining whether an activity is engaged in for profit or not, the *Lofstrom* Court applied only four because the Lofstroms failed to produce enough evidence to consider the other factors.

The Court considered the amount of time and effort Dr. Lofstrom expended on writing, the manner in which he carried on the activity, the history of income or loss associated with his writings, and the amount of profit he earned from writing. The Court cited Dr. Lofstrom’s lack of adequate records regarding his time spent writing, his failure to have anything published, and his string of losses with no reported income in their decision that Dr. Lofstrom lacked a bona fide profit motive.

Holding. Dr. Lofstrom may not deduct expenses associated with writing since he failed to prove he engaged in writing for profit.



⁸ IRC §280A(a), (d)(1)

⁹ IRC §267(c)(4)

¹⁰ IRC §280A(c)(1), (f)(1)(B)

¹¹ Case footnote 15

Education Expense

Daniel R. Allemier, Jr. v. Commissioner, TC Memo 2005-207, August 31, 2005

IRC §§162, 274, and 6664

+ Taxpayer Allowed to Deduct Cost of Obtaining MBA

Facts. The taxpayer became a part-time employee of Selane Products in 1996. When he graduated from college with his bachelor degree in 1997, he was employed full time. He was very successful in his job and began moving up the corporate ladder.

The CEO of the company met with the taxpayer and told him that obtaining an MBA would speed up his advancement process in the company. However, the company did not have a program that would pay the cost of the MBA. In 1998 the taxpayer made a decision to pursue an MBA at his own expense. He finished the degree in 2001.

In 2001, the taxpayer filed Form 2106-EZ, *Unreimbursed Employee Business Expenses*, and reported a tuition expense of \$17,500 and \$231 of parking fees. He also claimed deductions for some vehicle and travel expense related to his employment.

After enrolling in the MBA program, but before obtaining the degree, the taxpayer was promoted to several new positions in the company. The courses he took were all related to duties he was performing for the employer.

Issue. Is the tuition expense deductible? Are the business related expenses deductible?

Analysis. Education expenses are not deductible if they prepare a taxpayer for a new occupation or are necessary to meet the minimum education requirement of the employer, even if the taxpayer does not intend to enter a new trade or business or his duties do not significantly change after obtaining the degree.

In this case, Selane did not require an MBA degree for the duties the taxpayer performed. In fact, he was assigned the duties prior to obtaining the degree. The IRS was unable to show that the taxpayer's advancement was contingent on obtaining the degree.

Unfortunately, the taxpayer could not document the parking or business-related expenses. While he had calendars that indicated his travel dates, he did not show the IRS documents or provide witnesses to verify the amounts of the deductions.

Holding. The court allowed the tuition fee deduction, but disallowed the parking expense and the business expense deductions due to lack of records.

Shareholder Deduction of S Corporation Expenses

Ronnie O. and June Craft v. Commissioner, TC Memo 2005-197, August 15, 2005

IRC §§62, 162, and 274

+ Taxpayer Allowed Deduction for S Corporation Expenses

Facts. The taxpayer was a 50% shareholder of an S corporation in which he was an officer. In 2001, he filed a Schedule C claiming expenses, some of which were attributable to S corporation activities. No income was reported on his Schedule C. The taxpayer reported his wages as an officer of the S corporation on line 1 of his Form 1040 and the K-1 income on Schedule E. He reported the following expenses:

Vehicle expenses	\$ 2,246
Depreciation	8,847
Legal and professional	4,650
Office supplies	449
Dues and subscriptions	1,162
Post office box rental	250
Total	<u>\$17,604</u>

The taxpayer explained the vehicle expenses were for the use of his pickup truck in conjunction with his job as a corporate officer. The depreciation expense was on office equipment and the pick-up. The legal and professional expenses included tax return preparation, legal fees applicable to the settlement of a stock transfer, a property tax abatement issue, and reviewing legal documents.

The office supplies, dues, and subscriptions were related to the S corporation. The taxpayer was involved with two other entities who shared the postal box with the S corporation.

The S corporation previously adopted a resolution stating that the president and vice president of the company were responsible for supplying office space and their own vehicles and would not be reimbursed for these expenses.

Issue. Is the taxpayer entitled to a deduction for the expenses attributable to the S corporation? Where should the expenses be deducted if allowable?

Analysis. The court first looked at the issue of deductibility of the expenses. A corporation is treated as a separate entity from its shareholders. The voluntary payment of corporate expenses by officers, employees, or shareholders may not be deducted on the taxpayer's individual return. These payments are treated as capital contributions or loans to the corporation and are only deductible by the corporation. However, because the corporation resolution specified these are the expenses, they are deductible by the payee.

The next issue is determining whether the expenses were incurred as an employee or as a shareholder of the corporation. If the shareholder incurred the expenses to protect his investment in the corporation, they are not deductible but must be capitalized. However, an employee of the corporation can deduct ordinary and necessary expenses related to the performance of his job. IRC §62 specifies that unreimbursed employee business expenses are subject to the 2% limitation imposed by IRC §67.

The court determined the car and truck expenses, office supplies, dues, and subscriptions were employee business expenses. However, depreciation was disallowed because the taxpayer did not produce documentation to substantiate the deduction.

Caution. The taxpayer did attach documentation with his pretrial memorandum. However, he lost the deduction for not supplying the same documents in court.

Because the post office box was used by three different businesses, the court only allowed a deduction for one-third of the expense. The court found the legal fees did not apply to the S corporation and disallowed them as employee business expenses. However, some of the legal fees were allowed as a miscellaneous deduction subject to the 2% limitation.

Holding. The court allowed the taxpayer to claim the applicable employee business expenses as a part of the itemized deduction subject to the 2% limitation.



CAPITAL GAINS AND LOSSES

Basis Computation

Robin A. & Susan D. Bettencourt v. Commissioner, T.C. Summary Opinion 2005-175, November 29, 2005

IRC §§61 and 1016

+ Court Requires Documentation to Substantiate Basis

The IRS assessed a deficiency of \$10,289 on Robin and Susan Bettencourt's 1999 tax return, challenging the taxpayers' basis computation for the sale of Mrs. Bettencourt's one-third interest in her father's former residence. Mr. Bettencourt, a CPA with 30 years of experience, prepared the couples' 1999 return.

Mrs. Bettencourt and her two sisters inherited the home upon their father's death in 1981. They allowed their step-mother, Mrs. Hatch, to occupy the home under a living probate homestead agreement until she either moved from the residence or died. Mrs. Hatch moved in with her son in 1993 and rented out the home, contrary to the terms of her homestead agreement. Mrs. Bettencourt and her sisters did not receive any rent from this arrangement and incurred legal fees to evict the tenants and perfect title prior to selling the home.

The home was sold for \$400,000 in 1999, with each sister reporting a gross sales price of \$133,333. The Bettencourt's Schedule D reflected a basis of \$101,485 for Mrs. B's one-third interest in the property, including the following:

FMV of inheritance in 1981	\$ 45,000
Closing costs	6,133
Legal and other misc. expenses	5,400
Travel costs for annual inspection	10,450
Improvements	23,442
(Not stipulated)	11,060
Total adjusted basis	\$101,485

The IRS asserted the home's basis was only \$51,041, the \$45,000 inherited basis increased by recomputed closing costs of \$6,041.

The Bettencourts claimed improvements made to the home by Mrs. Hatch, including a new deck, front door, roof, and windows as well as remodeling, landscape improvements, and earthquake damage repairs, were capital improvements "gifted" by Mrs. Hatch to her step-daughters. Although the Bettencourts were unable to establish the exact amounts spent or the dates for the improvements, they appealed to the Court to apply the *Cohan* rule to estimate allowable expenses.

Although Mr. Bettencourt explained he failed to maintain a record of the improvements because the expenditures "were 'arm's length' transactions between siblings," the Court expected better documentation from an experienced CPA and disallowed all unsubstantiated costs of improvements. The Court cited the *Cohan* court itself in declining to apply the doctrine to improvements made by Mrs. Hatch, emphasizing, "the Court bears heavily against the taxpayer whose inexactitude is of his or her own making."¹² It also disagreed with the taxpayers' claim that the improvements were "gifts" to the property owners by Mrs. Hatch.

The taxpayers did provide documentation to support expenses for legal fees and some travel costs associated with maintaining the property. The Court found these expenses necessary and allowed \$5,000 for reasonable expenses under the *Cohan* rule.

¹² *Cohan v. Commr.*, 39 F. 2d 540 (2d Cir. 1930)

Lottery Winnings: Capital gain v. Ordinary Income

Shirley B. Prebola n.k.a. Shirley D. Begy v. Commissioner, TC Memo. 2005-261, November 8, 2005

IRC §1221

+ Sale of Rights to Receive Lottery Winnings Is Ordinary Income

Facts. Shirley Prebola, now Begy, won \$17.5 million in the New York State Lottery in 1997. She was scheduled to receive 26 annual payments, but after receiving and reporting her annual payments as ordinary income for 1997 through 1999, she sold her remaining rights to Settlement Funding in 2000 for a lump-sum payment of \$7.1 million.

Settlement Funding issued Prebola-Begy a 2000 Form 1099-B, *Proceeds from Broker and Barter Exchange Transactions*. She reported this amount on her 2000 Schedule D, *Capital Gains and Losses*, as a long-term capital gain of \$7.1 million. The IRS issued her a deficiency notice for over \$1.3 million, recharacterizing the settlement amount as ordinary income.

Issue. Was the amount received for the assignment of the right to receive future lottery payments a capital asset within the meaning of IRC §1221?

Analysis. The Court cited numerous precedential cases where the assignment of the right to receive future lottery payments has been determined to be ordinary income.¹³ Prebola-Begy failed to distinguish her case from any of the previous cases.

Holding. The Court held that the sale of a right to future lottery payments results in ordinary income and not a §1221 capital asset.

CORPORATIONS

M-3 Schedule

IR- 2005-141, December 13, 2005

IRC §6011

+ IRS Releases Schedules M-3 for Insurance and S Corporations

The IRS released a draft version and instructions for Schedule M-3 to be used with Forms 1120S, 1120PC, and 1120L starting with tax years ending on or after December 31, 2006. The schedule will be required to be completed by S corporations with assets totaling \$10 million or more and by property & casualty insurance corporations and life insurance companies. The draft version is available on the IRS website.

The new schedule requires affected companies to provide the IRS with more detailed information reconciling financial accounting net income and taxable income. The additional disclosure requirement will enable the IRS to more readily identify returns with compliance risks.

¹³ *U.S. v. Maginnis*, 356 F. 3d 1179 (9th Cir. 2004); *Davis v. Commr.*, 119 T.C. 1 (2002); *Wolman v. Commr.*, T.C. Memo. 2004-262; *Watkins v. Commr.*, T.C. Memo. 2004-244; *Lattera v. Commr.*, T.C. Memo. 2004-216; *Clopton v. Commr.*, T.C. Memo. 2004-95; *Simpson v. Commr.*, T.C. Memo. 2003-155; *Johns v. Commr.*, T.C. Memo. 2003-140; and *Boehme v. Commr.*, T.C. Memo. 2003-81.

S Corporation Passive Income

Letter Ruling 200536004, June 1, 2005

IRC §1362

+ S Corporation Rental Income Not Passive Investment Income

Issue. The taxpayer is seeking a determination of whether the rental income it receives from a particular property is considered passive investment income or income from an active trade or business. If determined to be passive, the S corporation election would be terminated.

Facts. An S corporation owns and rents commercial real estate. The corporation provides the following services:

- Pays real estate taxes
- Reviews property tax assessments
- Maintains general liability insurance
- Reviews and negotiates all insurance policies
- Coordinates all general property maintenance
- Maintains landscaping, parking lots, HVAC systems, roofs, foundations, exterior walls, fire sprinkler systems, exterior lighting, plumbing and electrical systems
- Conducts pest control
- Advertises available space
- Maintains informational brochures and a web site
- Screens all potential tenants
- Negotiates all leases
- Collects all rents
- Establishes and enforces rules for common areas
- Maintains complete records of tenants
- Designs improvements and oversees construction and repairs
- Performs basic repairs and maintenance

Analysis. An S corporation election terminates whenever the corporation has accumulated earnings and profits at the close of three consecutive taxable years and has gross receipts in each year, more than 25% of which are passive investment income. A tax is imposed on the corporation if at the end of the taxable year it has accumulated earnings and profits and gross receipts from passive investment income exceeding 25%.

Passive investment income includes rents, royalties, interest, annuities and sales and exchanges of stock. Rents are defined as amounts received for the right to use or the use of property. However, rents do not include monies derived from an active trade or business.

Determination. The IRS concluded that the taxpayer was conducting an active trade or business because the S corporation provided significant services and incurred substantial costs to provide those services. As such, the rents received did not constitute passive investment income and the S corporation designation remained valid.

Observation. If the taxpayer were a sole proprietorship or partnership, the conduct of an active trade or business would require the payment of self-employment tax on any profits.



Shareholder Loan

Mark O. Kaplan v. Commissioner, TC Memo 2005-218, September 20, 2005

IRC §1366

+ Shareholder Loan Did Not Increase Basis in Stock

Facts. The taxpayer was the sole shareholder in Marc Construction (Marc) and three other S corporations. In 1996, Marc suffered a \$792,752 loss. However, the taxpayer was not able to utilize the loss as he did not have any remaining basis in his Marc stock. The taxpayer attempted to increase his basis in Marc by personally loaning it \$800,000. The following activities track the money transfers the taxpayer used to transact the loan.

1. 12/29/1997 — Taxpayer borrows \$800,000 from bank. He did not furnish any financial statement to the bank and did not have a prior relationship with the bank. The loan matured on 1/30/1998. Taxpayer prepaid \$1,000 in finance charges. As collateral for the loan, the taxpayer used checking accounts from two of his S corporations. The checking accounts did not exist prior to the loan transaction.

Taxpayer transferred the money from his personal checking account to the Marc account.

2. 12/29/1997 — At the same time as the above transaction, Marc issued checks totaling \$800,000 to the two checking accounts used to collateralize the loan.
3. 1/8/1998 — Taxpayer borrowed \$800,000 from the two S corporations holding the proceeds from the loan and depositing the money in his personal checking account.
4. 1/8/1998 — Taxpayer paid off the bank loan of \$800,000 by issuing a check from his personal checking account.
5. 12/15/1998 — Taxpayer merged Marc and the two S corporations used in the loan transfer.

Issue. Does the loan allow the taxpayer to increase his basis in Marc so he can deduct the S corporation losses on his Form 1040?

Analysis. Shareholders may not deduct losses in excess of their basis in S corporation stock. To increase basis, the shareholder must make an actual economic outlay. The taxpayer must show that the transaction was based on “some transaction that when fully consummated left the taxpayer poorer in a material sense.”

Holding. The court agreed with the IRS that the \$800,000 loan caused the taxpayer no actual economic outlay. While the transactions occurred in the form of checks, they were little more than bookkeeping entries. The court ruled in favor of the IRS.

Treating Family as Single Shareholder of S Corporation

Notice 2005-91, November 22, 2005

IRC §1361

+ Election Avoids Limit on Number of Shareholders

Summary. Currently an S corporation is limited to no more than 100 members. Based on this Notice, a family can elect to treat all “family members” as a single taxpayer. A “family member” is defined as the common ancestor, his lineal descendents, and the spouses and former spouses of his lineal descendents. The common ancestor may be no more than six generations removed from the youngest generation of shareholders.

The election must be made for taxable years of the S corporation beginning after December 31, 2004. The election becomes effective the first day of the corporation’s taxable year identified in the election and remains in effect until terminated.

Background. Under C §1361(b)(1)(A), a corporation is not eligible to be an S corporation if it has more than 100 shareholders. In determining whether an S corporation meets this limit, a family may elect for all family members to be treated as just one shareholder.¹⁴ “Family members” include the common ancestor, lineal descendants of the common ancestor, and the spouses (or former spouses) of the lineal descendants or common ancestor. However, an individual will not be considered a “common ancestor” if, as of the later of: 1) the corporation’s first tax year beginning after 2004; or 2) the time the S corporation election is made, the individual is more than six generations removed from the youngest generation of shareholders who would (but for this limit) be family members. For this purpose, a spouse (or former spouse) is treated as being of the same generation as the individual to which such spouse is (or was) married.¹⁵

Making the Election. The election may be made (except as provided in the regulations) by any member of the family.¹⁶ This notice makes it clear that the election does not affect the requirement under IRC §1362(a)(2) that an S corporation election must be consented to by all shareholders, whether or not “members of the family,” who are shareholders at the time of the S corporation election. A member of the family who is, or is treated under IRC §1361 and its regulations as, a shareholder of the S corporation makes the election by notifying the S corporation.

The notification must identify:

1. The name of the family member making the election;
2. The “common ancestor” of the family to which the election applies; and
3. The first tax year of the corporation for which the election is to be effective.

For purposes of identifying the “common ancestor” (who does not have to be alive when the election is made), any current or former spouse of the common ancestor is treated as being in the same generation as the common ancestor, and any current or former spouse of a lineal descendant of the common ancestor is treated as being in the same generation as the lineal descendant to whom that spouse is or was married.

For purposes of the election, the estate of a deceased member of the family is considered to be a member of the family during the period in which the estate, or a trust described in IRC §1361(c)(2)(A)(iii), holds stock in the S corporation. Additionally, for purposes of the election, the members of the family include:

1. Each potential current beneficiary of an electing small business trust (ESBT) who is a member of the family;
2. The income beneficiary of a qualified subchapter S trust (QSST) who makes the QSST election, if that income beneficiary is a member of the family;
3. Each beneficiary of a trust who is a member of the family, if the trust was created primarily to exercise the voting power of stock transferred to it;
4. The member of the family for whose benefit a trust described in IRC §1361(c)(2)(A)(vi) was created;
5. The deemed owner of a trust treated as wholly owned under the grantor trust rules if he is a member of the family; and
6. The owner of an entity disregarded as an entity separate from its owner under Treas. Reg. §301.7701-3, if he is a member of the family.

¹⁴ IRC §1361(c)(1)(A)(ii)

¹⁵ IRC §1361(c)(1)(B)

¹⁶ IRC §1361(c)(1)(D)(i)

Two Elections Relating to Same Family. If a corporation has two or more elections in effect and the members of one family for which the election has been made (i.e., the “inclusive family”) include all the members of another family for which the election was also made (i.e., the “subsumed family”), then the members of the inclusive family are counted as one shareholder as long as the inclusive family’s election is in effect, and the members of the subsumed family are not counted as a separate and additional shareholder.

Election Period. The election is effective as of the first day of the corporation’s tax year designated by the shareholder making the election. Any election will remain in effect until terminated as provided in the regulations.

Effect on Prior Actions. Taxpayers may have already taken certain actions in order to make this election by various forms of notification to the corporation or to the IRS. For the election to be effective for tax years beginning after December 31, 2004, taxpayers must provide the information described in Notice 2005-91 to the corporation to the extent not already provided.

DEPENDENCY ISSUES

Dependency Deduction and Head of Household Filing Status

IRC §§ 2, 32, and 152

+ Taxpayer Could Not Meet Residency Test even though He had a Letter Signed by Child’s Mother

Facts. In 1999, the taxpayer began dating Ms. Laird, who was separated from her husband but not divorced. He lived with Ms. Laird for nearly 3 years, but they did not marry. In 1999, Ms. Laird gave birth to a child, JTMZ. Both the taxpayer and Ms. Laird assumed the taxpayer was the child’s father.

During the period of their relationship, Ms. Laird gave birth to another child, MLB. In 2002, Ms. Laird and the children separated from the taxpayer. Up until that time, they lived continuously with the taxpayer. In 2004, Ms. Laird requested a DNA test to determine the paternity of JTMZ. The test verified the taxpayer was not the father.

The taxpayer claimed JTMZ as his dependent on his 2002 tax return, using the head of household filing status and claiming the earned income tax credit (EIC). In 2003, the IRS notified the taxpayer he was not eligible for the dependency exemption, head of household status, or the EIC.

The taxpayer had a letter typed by Ms. Laird and signed by her, the taxpayer’s minister and the taxpayer’s father stating JTMZ resided with the taxpayer for the entire year. However, this document was never entered into evidence.

Issue. Is the taxpayer eligible to claim the dependency exemption, head of household filing status, and EIC for JTMZ?

Analysis. The court cited the support tests for divorced parents in its ruling. The custodial parent gets the exemption unless:

1. The other parent provides over one-half of the support, and
2. The child is in the custody of one or both parents for more than one-half of the year.

If the custodial parent waives the exemption in writing and this signed document is included with the non-custodial parent’s return, the noncustodial parent may claim the deduction.

Holding. The court ruled the taxpayer was not entitled to the dependency exemption, rendering him ineligible for head of household filing status and the EIC, because he failed to substantiate JTMZ resided with him during the entire taxable year. Although the signed statement by Ms. Laird was not admitted into evidence, the Court ruled it would not have been a valid written declaration under IRC §152(e)(2).

DIVORCE ISSUES

Maintenance Payments

Sandra J. Wolf v. Commissioner, T.C. Summary Opinion 2005-150, October 12, 2005

IRC §71

+ **Maintenance Payments Qualified under IRC §71 Pursuant to State Law**

Facts. Taxpayer Sandra Wolf divorced Wayne Wolf in 1999 in New York State. Sandra was awarded maintenance payments of \$800 per month under a stipulated agreement incorporated into the divorce decree. The instrument stated the payments were to continue “until such time as [Wayne Wolf] is eligible to retire from his employment, approximately 9 years from this date.” The decree was silent regarding termination of payments upon death.

Sandra Wolf received \$9,600 in payments in 2002, which Wayne Wolf deducted as alimony. Sandra did not include the payments as income on her 2002 return. The IRS assessed a deficiency of \$1,391 and an accuracy related penalty of \$278.20 under IRC §6662(a).

Issue. Are maintenance payments taxable income under IRC §71(b) if the instrument is silent regarding termination of payments upon death of the payee spouse?

Analysis. IRC §71(b)(1) defines qualified alimony or separate maintenance payments as cash payments:

- Received by or on behalf of a spouse under a divorce or separation instrument,
- Not designated in the decree as non-qualifying alimony payments,
- Not paid by a member of the same household as the recipient at the time of payment, and
- Not requiring payment after the death of the recipient spouse.

Regulations further specify that payments will not be taxed as alimony if the payor is liable for payments after the death of the recipient spouse.¹⁷

Case law stipulates that state law controls if the instrument is silent regarding an obligation to pay after death.¹⁸ New York Domestic Relations Law provides that court-awarded maintenance “shall terminate upon the death of either party.”¹⁹

Holding. The \$9,600 of maintenance payments Wolf received in 2002 must be included in her gross income under §71(b). The IRS conceded the accuracy-related penalty.



¹⁷ Temporary Treas. Reg. §1.71-1T(b), Q&A-13

¹⁸ *Morgan v. Commr.*, 309 U.S. 78 (1940)

¹⁹ New York Domestic Relations Law §263B(1)(a)

DOMESTIC PRODUCTION DEDUCTION UPDATE

New Developments

Proposed Regulations, October 20, 2005

On October 20, 2005, the Treasury issued proposed regulations for I.R.C. §199. The following is a summary of the major points made by the proposed regulations:

1. For purposes of computing QPAI, if the taxpayer recognizes gross receipts and expenses in different tax years, the taxpayer must take receipts and expenses into account in the tax year the items are recognized under the taxpayer's method of accounting.
2. With respect to pass-through entities, the question of whether less than 5 percent of the entity's total gross receipts are non-DPGR (for purposes of the de minimis test) is made at the entity level. For an owner of a pass-through entity, the de minimis test is determined at the owner level.
3. For purposes of the W-2 wage limitation, payments to independent contractors and self-employment income, including guaranteed payments made to partners, are not included in determining W-2 wages.
4. Hedging gains and losses are taken into account in determining DPGR if the hedge involves:
 - The purchase of supplies used in the business,
 - The sale of stock in trade of the taxpayer or other property of a kind that would be included in inventory if on hand at the close of the tax year, or
 - Property held for sale to customers in the ordinary course of the trade or business.

If the hedge involves the purchase of stock in trade, inventory property or property held for sale, gains and losses are taken into account in determining the cost of goods sold.

5. Gross receipts from mineral royalties and net profits interests (except those derived from operating mineral interests) are not treated as DPGR.
6. A trust or estate may claim the deduction to the extent that QPAI is allocated to the trust or estate, but the deduction applies at the beneficiary level.
7. A cooperative may pass through some, all, or none of the allowable deduction to its patrons. Patronage dividends and per-unit retain allocations received by a patron that are taken into account as part of the cooperative's computation of QPAI may not be taken into account in computing the patron's QPAI from its own activities. In addition, the W-2 wage limitation is to be applied only at the cooperative level whether or not the cooperative chooses to pass through some or all of the deduction. Patrons may claim the deduction without regard to the taxable income limitation.
8. For purposes of determining CGS allocable to DPGR, "CGS" includes the costs that would have been included in ending inventory if the goods sold during the year were on hand at the end of the year. Any reasonable method may be used to allocate indirect costs between DPGR and non-DPGR if the taxpayer's books do not or cannot, without undue burden or expense, identify CGS allocable to DPGR.

The proposed regulations provide three methods for allocating and apportioning deductions:

- a. The "Section 861" method;
- b. The simplified deduction method; and
- c. The small business simplified overall method.

TECHNICAL CORRECTIONS

Section 403 of the Go Zone Act includes significant corrections pertaining to the §199 deduction for domestic production activities. President Bush signed the Act into law December 21, 2005.

1. The Act clarifies the definition of W-2 wages and provides that wages do not include amounts not in a return filed with the Social Security Administration on or before the 60th day after the due date of such return.
2. The Act removes the distinction between direct and indirect expenses and substitutes the term “properly allocable.”
3. The Act adds an active conduct and ordinary course of business requirement for construction, engineering and architecture projects of real property.
4. The Act clarifies that the lease, rental, license, sale or exchange or other disposition of land does not qualify.
5. The Act adds that for purposes of federal government contracts, items manufactured or produced for the federal government under a federal government contract qualify if the federal acquisition regulations provide that the risk of loss is transferred to the federal government before manufacturing or production is completed.
6. The Act provides that a patron of a cooperative who receives certain payments from an agricultural or horticultural cooperative attributable to qualified production activities income is allowed a deduction equal to the portion of the deduction allowed to the cooperative that is attributable to such income.
7. The Act amends the definition of an expanded affiliated group by adopting a “more than 50%” and “at least 80%” test for qualification.
8. The Act provides that the §199 deduction is the same for alternative minimum tax purposes, except that, in the case of a corporation, the taxable income limitation is the corporation’s AMTI.
9. The Act also provides that a §199 deduction is not allowed in determining a taxpayer’s appropriate NOL or NOL carrybacks and carryforwards.
10. The Act also gives the government authority to issue regulations limiting the deduction to one taxpayer with respect to the same economic activity.

ADDITIONAL ISSUES

1. Trade or Business Requirement

Section 199 states that “this section shall be applied by only taking into account items which are attributable to the actual conduct of a trade or business.” As mentioned in the *2005 University of Illinois Tax School Workbook*, the requirement of a “trade or business” raises a question as to the appropriate test for determining when a taxpayer is deemed to be in a “trade or business” for purposes of the deduction.

While only one taxpayer may claim the deduction with respect to an eligible activity, the question has been raised as to whether a crop-share or livestock-share lease where production is split between the landlord and the tenant qualifies both parties for the deduction on their respective shares of income under the lease. In late 2005, the Chief Counsel’s Office of the IRS unofficially took the position that the deduction is tied to ownership of the land. As a result, farm tenants would not be eligible for the deduction.

However, recently the Chief Counsel’s Office of the IRS revised that unofficial position. The current indication is that the person or entity that produces the crop would qualify for the deduction. This is more in line with other types of businesses. Therefore crop produced on cash rent land would qualify. Whether a crop share landlord qualifies would be based on a facts and circumstances basis.

2. W-2 Wages

The statute specifies that “W-2 wages” are amounts required to be included on statements under the Code.²⁰ This includes wages, and elective deferrals, as the term wages is further defined in the Code,²¹ but excludes “agricultural labor”²² unless the remuneration paid is wages as further defined.²³ However this excludes remuneration paid in any medium other than cash²⁴ (e.g., payment-in-kind).

In addition, the Code defines employment for “purposes of this chapter” to exclude services performed by a child under the age of 18 in the employ of his father or mother.²⁵ The bottom line is that neither agricultural labor paid in kind nor wages paid to the taxpayer’s children under age 18 count as eligible W-2 wages.

3. Government Farm Program Payments

A question has arisen as to whether federal farm program payments count as eligible income for purposes of the deduction. I.R.S. Notice 2005-14 provides that “payments in lieu of production” count as eligible for the deduction. That seems to indicate that farm program payments give rise to DPGR if the payments are related to an actual crop of the taxpayer. But, if the payment is not related to an actual crop, the payments are not “in lieu of production” and do not give rise to DPGR.

Note. The IRS has not released a list of qualifying payments.

ESTATE AND GIFT

Gift to Social Club

PLR 102100-05, May 9, 2005

IRC 501

+ Gift to Social Club Subject to \$11,000 Limit

A taxpayer requested a ruling regarding gifts to be made to a social club (Club). Club qualifies for a tax exemption under IRC §501(c)(7). The Club does not issue stock to its members. Club operates dining rooms, a bar, banquet facilities, thirteen private meeting rooms, a library, a game room, and ten overnight guest rooms. Club sponsors dinners, dances, lecture series, special guest speakers, and cultural and athletic events.

The taxpayer intends to make a cash contribution to Club to enable it to upgrade its facilities. All gifts will be subject to the immediate control of the board of directors. The taxpayer wanted to be sure Club would be treated as a single entity and qualify for the gift tax annual exclusion under IRC §2503(b) as long as the gift does not exceed the annual exclusion amount.

Transfers to a corporation generally represent a gift to the shareholders of the corporation. However, there is an exception for gifts made to a charitable, public, political, or similar organizations. Therefore, a gift to Club will be treated as a gift to a single entity.

²⁰ IRC §6051(a)(3),(8)

²¹ IRC §3401(a)

²² IRC §3401(a)(2)

²³ IRC §3121(a)

²⁴ IRC §3121(a)(8)(A)

²⁵ IRC §3121(b)

Minority and Marketability Discount

Estate of Webster E. Kelley v. Commissioner, TC Memo 2005-235, October 11, 2005

IRC §2031

+ Court Allows Combined Marketability and Minority Discount of 35 Percent

Facts. The decedent owned a one-third interest in an LLC at the time of death. The LLC owned a 1% general partnership interest in a family limited partnership (FLP) and a 94.83% limited partnership interest in the same FLP. The FLP was primarily an investment partnership.

The value of the FLP interest was established by a professional appraiser using the net asset value approach. The appraiser then applied a 53.5% valuation discount. While the appraiser for the estate justified his discount, the expert witness for the IRS determined the appropriate discount to be 25.2%.

Issue. What discount should be applied if a partner has both a general and limited partnership interest in an FLP?

Analysis. When comparing the estate's appraisal and the IRS expert witness' appraisal, the court decided neither discount was appropriate and used its own formula. The court agreed that it was appropriate to claim both a minority and marketability discount. This finding provides an excellent source of information for taxpayers who wish to justify the amount of discount they wish to claim.

Holding. The court ruled a combined discount of 35% was appropriate.

Self-Prepared Will

Estate of Tony R. Sowder, Deceased v. United States of America, U.S. District Court for the Eastern District of Washington; No. CV-02-0136-WFN, November 10, 2005

IRC §2056

+ Language in Self-Prepared Will Confuses IRS

Facts. The taxpayer prepared his own Last Will and Testament. At his death the will bequeathed \$200,000 to each of his three children and the remainder of his estate to his spouse. The will provided:

"All the rest, residue and remainder of my estate, both real and personal, of every nature and wherever situate, of which I may die seized or possessed, I give, devise and bequeath unto my wife, Marie L. Sowder, if she survives me, and if she does not survive me, or dies before my estate is distributed to her, to my issue me surviving, in equal shares per stirpes."

After the death of Mr. Sowder, Mrs. Sowder filed a federal estate tax return claiming no tax was due based on the marital deduction. Upon audit, the IRS assessed over \$800,000 in estate taxes and \$134,000 in interest, which Mrs. Sowder paid. She later filed a claim for refund, which the IRS denied.

Issue. Was the estate entitled to the marital deduction?

Analysis. The marital deduction allows a person to leave their property to their surviving spouse exempt of the federal estate tax. However, the terminal interest rule provides an exception to the unlimited marital deduction.

Based on the notes and papers that the deceased kept in his files, the judge was convinced the deceased was attempting to comply with the unlimited marital deduction rules. Unfortunately, his wording was not as clear regarding the deduction.

Holding. The court ruled in favor of the estate, since the intent of the testator was demonstrated.

Termination of Trust

***Estate of Mildred S. Jackson v. U.S.*, U.S. District Court for the Northern District of West Virginia, No. 2:04CV34, November 23, 2005**

IRC §2055

+ **Split-Interest Trust Allowed Charitable Deduction on Termination; IRC §2055(e) Ruled Inapplicable**

Facts. The decedent, Mildred Jackson, established a revocable inter vivos trust in April 1994 naming Floyd Estridge, Jr. and Davis Trust Company as co-trustees. Upon Jackson's death on November 28, 1999, the trust became irrevocable.

In accordance with the terms of the trust, Jackson's nephew and three nieces each received \$150,000 with the balance of assets remaining in trust. First United Methodist Church of Elkins (First UMC) was named as remainder beneficiary, entitled to receive one-fourth of the trust corpus upon the death of each beneficiary.

Investment decisions were made by a trust committee. Two members of the trust committee were also members of First UMC, where they served on the church's board of trustees and building committee. James L. Schoonover, acting representative for co-trustee Davis Trust Company, was also a member of First UMC.

Schoonover became concerned about possible conflicts of interest after Jackson's death. Among other things, co-trustee Estridge was married to one of the beneficiaries and the family was dissatisfied with the trust's performance. Schoonover suggested terminating the trust to prevent any conflict. The trustees, beneficiaries, and First UMC signed a trust termination agreement on June 9, 2000. Income was distributed to each family beneficiary based on fair market value and the IRS life expectancy tables. The church received the remainder.

A charitable contribution deduction was claimed for the distribution to First UMC on Jackson's Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, filed on August 28, 2000. The IRS denied the deduction. The estate paid the additional tax and interest assessed by the IRS, but appealed the assessment. The IRS denied the appeal, so the estate filed suit in district court.

Issue. Does the distribution to First UMC qualify Jackson's estate for a split-interest exception under IRC §2055(e)(2), allowing the estate to take the charitable contribution deduction on Form 706?

Analysis. IRC §2055 was intended to encourage gifts to charity by allowing estates to deduct the value of charitable contributions. However, prior to the 1969 enactment of §2055(e), estates with irrevocable charitable remainders were allowed to reduce estate taxes by the actuarial value of the remainder interest. This often resulted in a deduction that exceeded the value the charity eventually received.

Section 2055(e) was enacted to ensure that charitable deductions and charitable contributions would match more closely. This subsection disallows charitable deductions for estates with split-interest charitable remainders, unless the property is held in an annuity trust, a unitrust, or a pooled income fund.²⁶ An unqualified split-interest trust can convert to a qualified trust with a timely change to an allowable arrangement.²⁷

²⁶ IRC §2055(e)(2)

²⁷ IRC §2055(e)(3)

Case law has held that the §2055(e) disallowance does not apply when intervening events destroy the split-interest remainder and cause a direct transfer to a charitable organization.²⁸ Four factors are used by the Court to determine whether a deduction is allowable:²⁹

- Did the property transfer directly to the charity?
- Did any noncharitable beneficiaries retain an interest in the property?
- Does the deduction sought correspond to the amount received by the charity?
- Is the contribution motivated solely by a desire to circumvent §2055(e)?

The Court applied these factors to *Jackson* and determined that the contribution passed directly to First UMC in the same amount as the deduction claimed on the estate return. The Jackson family beneficiaries did not retain any rights over the contribution and the motivation for the termination of the estate was to avoid a potential conflict of interest and not to receive any benefit derived by the contribution.

Holding. The contribution qualified as a §2055(e)(2) exception because the trust was terminated in good faith for the valid reason of avoiding any potential conflict of interest and not to gain a tax benefit by circumventing §2055. The estate was entitled to the charitable contribution deduction to First UMC.



FRINGE BENEFITS

Fringe Benefits

Notice 2005-86, November 22, 2005

+ Employers Given Two Options to Handle HSA Eligibility During 2½-Month Cafeteria Plan Grace Period

FSA Background: Under the “use it or lose it” rule,³⁰ cafeteria plan benefits generally cannot be carried over from one plan year to the next. However, the IRS recently concluded in Notice 2005-42 that an IRC §125 plan may provide for a 2½-month “grace period” after the end of a plan year during which a participant may use up benefits left in his FSA at the end of the preceding plan year.

HSA Background: An otherwise eligible individual (i.e., one who has high-deductible insurance) is not permitted to contribute to an HSA if he is covered under a “general purpose” health FSA (i.e., an FSA that provides reimbursements for medical and dental expenses on a first-dollar basis) since this type of FSA is considered to provide impermissible “other coverage.”³¹ A 2½-month FSA grace period extension of an individual’s FSA coverage would in many cases be treated as disqualifying “other coverage” for HSA purposes. As a result, an employee could not contribute to an HSA during the portion of the HSA plan year that includes the extended FSA coverage (i.e., the testing would be done on the 1st day of January, February, and March of the following tax year during the 2½-month grace period).

²⁸ *Flanagan v. U.S.*, 810 F.2d 930 (10th Cir. 1987); *First Nat’l Bank of Fayetteville v. U.S.*, 727 F.2d 741 (8th Cir. 1984); *Oetting v. U.S.*, 712 F.2d 358 (8th Cir. 1983); *Estate of Strock v. U.S.*, 655 F. Supp. 1334 (W.D. Penn. 1987)

²⁹ *Burdick v. Commr.*, 979 F.3d 1369 (9th Cir. 1992); *Flanagan* at 934-35; *First Nat’l Bank* at 746-48; *Strock* at 1340

³⁰ Set out in Prop. Reg. §1.125-1, Q&A 7 and Prop. Reg. §1.125-2, Q&A 5

³¹ §223(c)(1)(A)(ii) and Rev. Rul. 2004-45

Observation. As discussed below in Option #2, “preventive care” items can still be covered under an employer HSA or medical reimbursement plan, or an employee FSA, without violating the rules for HSAs.

Notice 2005-86 Summary. A participant in a health flexible spending arrangement (health FSA) is generally not allowed to contribute to an HSA during the 2½-month cafeteria grace period, even if the participant’s health FSA has no unused benefits at the end of the prior cafeteria plan year. In this notice, the IRS provides two approaches to address this dilemma:

- An employer can continue to maintain a general purpose health FSA and a participant in it can contribute to an HSA on the first day of the first month following the end of the grace period, or
- An employer can amend the cafeteria plan document to allow a health FSA participant to become HSA eligible during the grace period.

Option #1: If the first option is chosen, an individual who participated in the health FSA (or a spouse whose medical expenses are eligible for reimbursement under the health FSA) for the immediately preceding cafeteria plan year, and who is covered during the grace period, may only begin contributing to an HSA on the first day of the first month following the end of the grace period (i.e., April 1).

Example. A health FSA covering the 2005 calendar year has a 2½-month grace period that ends March 15, 2006. An individual who did not elect coverage by a general health FSA or other disqualifying coverage for 2006 is HSA eligible on April 1, 2006, and can contribute 9/12’s of the 2006 HSA contribution limit. The result is the same even if a participant’s health FSA has a zero balance remaining at the end of the immediately preceding cafeteria plan year.

Option #2: If the employer amends its general purpose health FSA by converting it to an “HSA compatible FSA” (i.e., a limited-purpose or post-deductible FSA, or combined limited-purpose and post-deductible health FSA) during the grace period, then participants may make HSA contributions during the grace period if they are otherwise eligible to do so. A “limited-purpose health FSA” is one which pays or reimburses expenses only for preventive care and “permitted coverage” (e.g., dental care and vision care).

A “post-deductible health FSA” pays or reimburses preventive care and for other qualified medical expenses only if incurred after the minimum annual deductible for the high-deductible health plan (HDHP) under IRC §223(c)(2)(A) is satisfied. This means that qualified medical expenses incurred before the HDHP deductible is satisfied cannot be reimbursed by a post-deductible HDHP even after the HDHP deductible had been satisfied.

Furthermore, if the second option is chosen, individual participants cannot be permitted to choose between an HSA-compatible FSA or an FSA that isn’t HSA-compatible. The amendment must apply to the entire grace period and to all participants in the health FSA who are covered during the grace period. It must also satisfy all other requirements of Notice 2005-42. However, coverage of these participants by the HSA-compatible FSA during the grace period does not disqualify participants who are otherwise eligible individuals from contributing to an HSA during the grace period.

Transitional Relief: For cafeteria plan years ending before June 5, 2006, an individual participating in a “general purpose health FSA” that provides coverage during a grace period may contribute to an HSA during the grace period provided that:

- If not for the coverage under a general purpose health FSA, the individual would be an “eligible individual” as defined in §223(c)(1)(A) during the grace period, is covered under an HDHP and is not, while covered under an HDHP, covered under any impermissible other health coverage; and
- Either the individual’s general purpose health FSA has no unused contributions or benefits remaining at the end of the immediately preceding cafeteria plan year, or the employer amends the cafeteria plan document to provide that the grace period does not provide coverage to an individual who elects HDHP coverage.

GROSS INCOME

Disability Payments

John M and Nancy L Jerose v. Commissioner, T.C. Summary Opinion 2005-132, September 6, 2005

IRC §105

+ **Disability Payments from Employer's Group Plan Were Not Excludible**

Facts. The taxpayer was a former nursing assistant who received disability payments from her employer's group long-term disability policy. She was employed from 1991 through September 2000. One of the employee benefits was a long-term disability contract administered by Fortis Benefits Insurance Company.

The plan called for disability benefits of 60% of the employee's monthly pay subject to certain deductions. Employees disabled before age 65 could receive benefits for 36 months following the qualifying period.

As a result of degenerative disk disease of the spine and permanent nerve damage, the taxpayer ceased working for her employer in September 1999. The illness prevented her from engaging in gainful employment after 1999. During 2000, she received disability benefits of \$9,481 from Fortis. She also received a W-2 form at the end of the year reporting the payments as wages. The taxpayer did not report the wages as gross income on her 2000 tax return, but instead reported them on a Form 8275, *Disclosure Statement*. She indicated Fortis miscoded the payments on the W-2 and that the payments were not subject to income tax. She said she was in contact with Fortis to correct the statement.

The taxpayer said she paid \$3.50 per week for the disability coverage, but she could not supply evidence of this fact.

Issue. Should the payments be included in the taxpayer's gross income?

Analysis. Normally, gross income does not include amounts received through accident and health insurance for personal injuries or sickness. However, amounts received which are attributable to contributions by the employer, which were not included in gross income of the employee or paid by the employer, are included. If the amounts are not covered by any exceptions they are includible as gross income under IRC §105(a).

Four conditions must be met for §105(a) to apply:

1. Payments must be received through accident or health insurance.
2. Payments must be for personal injuries or sickness.
3. Payments must be attributable to contributions made by the employer.
4. The employer's contributions must not have been includable in the employee's gross income.

Payments may be excluded from gross income under IRC §§105(c)(1) and (2) if both exceptions are met. Section 105(c)(1) requires the payments to be made for the permanent loss, loss of use of a member or function of the body, or the permanent disfigurement of the taxpayer. Section 105(c)(2) requires the payment to be computed with reference to the nature of the injury, without regard to the period the employee is absent from work.

In this case, the taxpayer could not meet the requirement of IRC §105(c)(2) so the court did not rule on §105(c)(1).

Holding. The court ruled the payment should be included in gross income. The court also said it would be unusual if the employee made payments based on the type of policy under which she was covered.

Gambling Losses

Traci A. and Ronald R. Tomko v. Commissioner, T.C. Summary Opinion 2005-139, September 27, 2005

IRC §6001

+ Court Allows Gambling Losses under *Cohan* Rule

Facts. Casinos reported gambling winnings of \$44,464 to the IRS for the taxpayers in 2001, but the taxpayers reported only \$21,100 of gambling winnings on their 2001 income tax return. The taxpayers also deducted \$21,100 of gambling losses on their 2001 Schedule A, *Itemized Deductions*. The IRS determined the correct amount of winnings to be \$44,464 and disallowed the taxpayers' losses due to a lack of adequate records.

The taxpayers reconstructed their gambling losses for 2001, presenting credit card and bank statements showing \$46,542 of advances and withdrawals transacted at casinos during that year. The taxpayers claim that they never left a casino with any of the cash they withdrew unless they hit a payout of more than \$1,200.

Issue. Can the taxpayers rely on the *Cohan* rule to estimate their gambling losses?

Analysis. The taxpayers conceded the amount of their 2001 winnings were \$44,464 as reported by the casinos, but maintained their losses exceeded \$46,000. Although the Court expressed doubt that the taxpayers always left the casino broke unless they hit a jackpot, the Court did find it reasonable to assume that the taxpayers sustained losses based on their history of bank and credit card withdrawals while at the casinos and their testimony regarding their general knowledge of gambling.

Holding. The Court allowed the taxpayers to reconstruct their gambling losses under *Cohan* using bank and credit card statements of withdrawals, but limited their loss to a reasonable estimate of \$40,000.



Loan v. Income

Karns Prime & Fancy Food, Ltd. V. Commissioner, T.C. Memo 2005-233, October 5, 2005

IRC §61

+ Money Received from Principal Supplier was Income

Facts. The taxpayer owned and operated several grocery stores. In 1999, the principal supplier provided financial assistance to the taxpayer to make capital improvements to the stores. The amount of the assistance totaled \$1.5 million. While the supplier did not normally loan money to its customers, it did make 10 to 15 loans to various customers each year. The financial assistance was given only if the supplier thought it would increase the profitability of the customer, resulting in more sales for the supplier. The supplier required the customer to:

- Enter into a written supply agreement requiring the customer to purchase an annual minimum amount of products and that contemplated the supplier would pay an advance price rebate at the inception of the agreement, and
- Execute a promissory note payable to the supplier for the amount of the advance rebate.

The supplier anticipated the customer could meet the minimum purchase requirement, but used the note as protection in case the minimum purchase was not met or the customer breached the agreement. The taxpayer had a current loan with its bank which allowed the bank to maintain a first security position.

In 2000 and 2001, the first two years after the payment was received, the taxpayer met the minimum purchase requirement and \$250,000 of the advance rebate was forgiven for each year. The taxpayer included the \$250,000 advance rebate as income in both 2000 and 2001.

Issue. Was the supplier payment to the taxpayer a loan or is it required to be included in gross income as a rebate in the year received?

Analysis. To be considered a loan, there must be an unconditional obligation for the funds to be repaid at the time of receipt. The repayment agreement in this case was conditioned on an annual purchase agreement between the taxpayer and the supplier.

Holding. The Court determined the obligation to repay did not arise until the taxpayer breached the minimum purchase agreement in its third year, therefore the advancement could not be considered a loan. The full \$1.5 million advancement is taxable to the taxpayer in 2000, the year the taxpayer received the funds.

Note. Were the taxpayer successful in its argument, it would have included in gross income \$250,000 each year as the terms of the agreement were met. However, the court's findings resulted in the taxpayer including the entire \$1.5 million in gross income in the year the funds were received. Hence the taxpayer had a \$486,355 tax deficiency in 1999.



Loan v. Constructive Dividend

Nariman Teymourian v. Commissioner, T.C. Memo 2005-232, October 5, 2005

IRC §§61 and 6662

+ Employee Advances Were Not Constructive Dividends

Facts. During an audit of a corporation in which the taxpayer was one of two shareholders, the auditor discovered that checks were written to the taxpayer and categorized as employee advances. At the end of the year, these amounts were reclassified as notes. The amount classified as a note during 1999 was \$643,034 and an additional \$927,300 was added in 2000. The auditor determined these amounts were really constructive dividends.

The corporation auditor examined the taxpayer's return and found these amounts were not reported as gross income. The auditor also determined the taxpayer failed to report \$16,200 of rent in both 1999 and 2000. Based on these findings the auditor assessed an accuracy related penalty.

The corporation reported the shareholder-employee paid \$48,345 of interest on December 29, 2000. The taxpayer could not remember if the interest rate was 6.2% or 1% over prime. At the same time he repaid \$400,000 of principle.

Issue. Were the corporate payments loans or dividends to the taxpayer? Did the taxpayer actually receive the purported rental income? Did the taxpayer have reasonable cause for not reporting this income?

Analysis. When a corporation makes a payment to a shareholder-employee the determination of loan or constructive dividend depends on whether the employee intends to repay the amounts and whether the corporation intends repayment to be made. Because an employee-shareholder says he will repay the amounts does not make the transaction a loan. However, the formality of a note is not necessary if there are reliable indicia of debt. Factors ruling in favor of debt include a promise to repay, evidenced by a note or other instrument on which;

1. Interest was charged;
2. A fixed schedule for repayments was established;
3. Collateral was given to secure payment;
4. Repayments were made;
5. The borrower had a reasonable prospect of repaying the loan,
6. The lender had sufficient funds to advance the loan; and
7. The parties conducted themselves as if the transaction were a loan.

Although the taxpayer in this case failed on three factors, the factors he supported outweighed those he failed to support.

Based on the income of the taxpayer and his spouse, there was reasonable prospect the amounts could be repaid in full. The repayment in 2000 gave credibility that the amounts were actually loans and were intended to be repaid.

During the years in question, the taxpayer was arranging for a residential loan. On the loan application the taxpayer reported a net loss on one rental of \$948 and a gain of \$1,350 on another. The IRS auditor testified her sole reason for determining there was \$16,200 of unreported rent in each year was due to a statement the taxpayer made on his loan application that the rental income was \$16,200 each year.

The taxpayer testified the loan application was completed by the loan officer and he thought the loan officer wanted to know the fair market rental value of the homes. He testified his parents lived in one property rent free.

Whether an accuracy related penalty is imposed depends on the amount of unreported tax and whether the taxpayer has reasonable cause for failing to report the income. The IRS has the burden of proof with respect to penalties.

Holding. The court determined the employee advances were actually loans, even though there was no formal note. The facts of the case show that both the borrower and the lender intended repayment.

The court also found the taxpayer's testimony regarding the absence of rental income to be credible. The taxpayer's reliance on the advice of a CPA gave the court justification for abating the accuracy penalty.

Stock Options

Gamiel C Gran and Gail K Gran v. United States of America, U.S. Dist. Court, No. Dist. Calif.; 04-4605-SC,

August 26, 2005

IRC §83

+ Taxpayer Wants to Revoke Stock Option Election

Facts. The taxpayer received a grant of 163,755 unvested incentive stock options in consideration for employment. The taxpayer made an irrevocable election under IRC §83(b) to include the value of the stock in gross income. The taxpayer received a second grant of 68,750 shares and also made the §83(b) election. The taxpayer stated the amount paid for the shares was \$1.333 per share and the fair market value was \$4.00 per share.

Two years later, the taxpayer requested and received a refund of the tax paid on the shares. The taxpayer requested the refund because the stock had become worthless. Two years after payment of the refund, the IRS determined the refund was sent in error and assessed a deficiency of \$214,675, which included the applicable penalties. The taxpayer paid the deficiency and filed suit for refund.

Issue. Should the IRS allow the taxpayer to revoke the §83(b) election and refund the previously paid taxes?

Analysis. The general rule is that the difference between fair market value and the amount paid for a nonqualified stock option is included in gross income in the year the stock is no longer subject to substantial risk of forfeiture. The difference is taxed as ordinary income. However, §83(b) allows an election to include the difference in gross income in the year the option is granted. Any difference between the value on the date of the election and the date of the ultimate sale of the stock then becomes a capital gain or loss.

Holding. The court held the taxpayer made a valid irrevocable §83(b) election and declined the taxpayer's request to revalue the shares.

Workers Compensation

Gary E. and Rebecca L. Hurley v. Commissioner, T.C. Summary Opinion 2005-125, August 16, 2005

IRC §104

+ **Employee Wages Not Excludible from Gross Income**

Facts. The taxpayer was employed as a correctional officer. While at work he injured his back when he moved a coffee urn. It was determined he had a 30% permanent disability and received a lump-sum disability check.

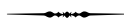
The taxpayer later returned to work for the same employer. He performed the same services for the same compensation as prior to the disability. He thought that 30% of the wages were eligible for exclusion because of the 30% disability determination.

Issue. Are 30% of the wages excludible from gross income?

Analysis. The taxpayer said he was told by his tax preparer and several other law enforcement officers that since he was 30% disabled he was only able to do 70% of his normal job. Therefore, since he was receiving 100% of his normal pay, 30% was attributable to worker's compensation.

Holding. The court disagreed with the taxpayer. While a taxpayer can exclude workers' compensation from income, the taxpayer agreed that he was no longer receiving workers' compensation when he returned to work and his wages were not reduced by 30%. The court pointed out that exclusions from income must be based upon an explicit statute and may not be inferred.

The court agreed that the taxpayer did rely on tax professionals for advice on the exclusion and did not assess the accuracy-related penalty.



INNOCENT SPOUSE

Equitable Relief Granted

Ann Marie Bright v. Commissioner, T.C. Summary Opinion 2005-145, October 4, 2005

IRC §6015

+ **Taxpayer Obtained Innocent Spouse Treatment**

Facts. The taxpayer was an office manager receiving wages from which federal income taxes were withheld. Her spouse was a self-employed construction contractor who made no quarterly estimated tax payments. The taxpayer maintained a joint checking account with her spouse, but did not pay any of the household bills or have access to the checkbook without her spouse's knowledge. Her spouse maintained a separate checking account for his business and she had no access to that account.

The taxpayer filed joint tax returns with her spouse. The spouse was responsible for the return preparation. The returns normally showed a balance due and the spouse set up installment agreements to make the payments. When the tax return was filed, the taxpayer knew that not all of the tax liability was paid.

The spouse abused alcohol and drugs and was abusive to the taxpayer. At times the taxpayer feared for her safety. Eventually, the taxpayer filed for divorce and moved from the house. The divorce decree required the spouse to pay child support and the outstanding tax liability. Since the divorce, the spouse was delinquent on the child support and did not pay the outstanding tax liability.

The taxpayer has been current on her tax obligations since the divorce.

Issue. Does the taxpayer qualify for innocent spouse treatment under §§4.02 or 4.03 of Rev. Proc. 2000-15.?

Analysis. IRC §6013(a) allows a husband and wife to elect to file a joint tax return. If a joint return is filed, each spouse should have knowledge of the information reported on the return and each spouse has joint and several liability for the entire tax due for the year.

The law allows an individual who files a joint return to seek relief from the joint and several liability. IRC §6015(f) provides relief only if “it is inequitable to hold the individual liable for any unpaid tax or deficiency.” Only the Commissioner can grant relief.

Section 4.02 of Rev. Proc. 2000-15 states the Commissioner will ordinarily grant relief if all of the following elements are satisfied:

1. The requesting spouse is divorced or legally separated from the former spouse at the time the request is made,
2. The requesting spouse did not reasonably expect that the tax would not be paid when signing the tax return, and
3. The requesting spouse will suffer economic hardship if relief is not granted.

The IRS was unable to grant relief under this section because the taxpayer knew there was an outstanding tax liability when she signed the return.

If the taxpayer does not qualify for relief under §4.02, then §4.03 may apply. This section lists six factors weighing in favor of granting relief:

1. The requesting spouse is separated or divorced from the nonrequesting spouse,
2. The requesting spouse will suffer economic hardship if the request is denied,
3. The requesting spouse was abused by the nonrequesting spouse,
4. The requesting spouse did not know or have reason to know that the tax liability would not be paid,
5. The nonrequesting spouse has a legal obligation pursuant to a divorce decree to pay the unpaid tax, and
6. The unpaid liability is attributable to the nonrequesting spouse.

Section 4.03 also lists six factors weighing against granting relief:

1. The unpaid liability is attributed to the requesting spouse,
2. The requesting spouse knew or had reason to know at the time the return was signed the tax liability would not be paid,
3. The requesting spouse significantly benefited from the unpaid liability,
4. The requesting spouse will not suffer economic hardship from paying the unpaid tax,
5. The requesting spouse has not made a good-faith effort to comply with the tax laws in subsequent years, and
6. The requesting spouse has a legal obligation because of the divorce decree to pay the tax.

Holding. Although the taxpayer did not meet the tests of §4.02, she met all but the hardship test of §4.03. The court ruled that the failure to meet the hardship test did not outweigh the other five tests of §4.03 and granted the requesting spouse relief from the unpaid tax liability.



IRS PROCEDURES — AUDITS

Increased Criminal Activity

Speech by Nancy Jardini, Chief of IRS Criminal Investigation Division

+ IRS Says Criminal Investigations Reach Five-Year High

In a speech to the American Bar Association, the Chief of the IRS Criminal Investigation Division (CI) announced a five-year high in criminal investigations in fiscal year 2005. Internal Revenue Code violations accounted for 60% of the increase and the remaining 40% was from abusive tax schemes. Cases involving tax preparers increased 20%.

The IRS is currently training 60 examiners in spotting cases to refer to CI. It was also noted that the courts are giving longer sentences for many criminal convictions.

IRS PROCEDURES — ELECTRONIC FILING

Direct Deposit Dates for E-filed Returns

I.R.S. Publication 2043

+ IRS Lists Dates for Direct Deposit and Mailing Refunds of Electronically Filed Tax Returns.

Transmitted and Accepted (by Noon) Between	Direct Deposit Sent*	Paper Check Mailed*	Transmitted and Accepted (by Noon) Between	Direct Deposit Sent*	Paper Check Mailed*
Jan 13 and Jan 19 2006	Jan 27, 2006	Feb 3, 2006	Jun 1 and Jun 8 2006	Jun 16, 2006	Jun 23, 2006
Jan 19 and Jan 26 2006	Feb 3, 2006	Feb 10, 2006	Jun 8 and Jun 15 2006	Jun 23, 2006	Jun 30, 2006
Jan 26 and Feb 2 2006	Feb 10, 2006	Feb 17, 2006	Jun 15 and Jun 22 2006	Jun 30, 2006	Jul 7, 2006
Feb 2 and Feb 9 2006	Feb 17, 2006	Feb 24, 2006	Jun 22 and Jun 29 2006	Jul 7, 2006	Jul 14, 2006
Feb 9 and Feb 16 2006	Feb 24, 2006	Mar 3, 2006	Jun 29 and Jul 6 2006	Jul 14, 2006	Jul 21, 2006
Feb 16 and Feb 23 2006	Mar 3, 2006	Mar 10, 2006	Jul 6 and Jul 13 2006	Jul 21, 2006	Jul 28, 2006
Feb 23 and Mar 2 2006	Mar 10, 2006	Mar 17, 2006	Jul 13 and Jul 20 2006	Jul 28, 2006	Aug 4, 2006
Mar 2 and Mar 9 2006	Mar 17, 2006	Mar 24, 2006	Jul 20 and Jul 27 2006	Aug 4, 2006	Aug 11, 2006
Mar 9 and Mar 16 2006	Mar 24, 2006	Mar 31, 2006	Jul 27 and Aug 3 2006	Aug 11, 2006	Aug 18, 2006
Mar 16 and Mar 23 2006	Mar 31, 2006	Apr 7, 2006	Aug 3 and Aug 10 2006	Aug 18, 2006	Aug 25, 2006
Mar 23 and Mar 30 2006	Apr 7, 2006	Apr 14, 2006	Aug 10 and Aug 17 2006	Aug 25, 2006	Sep 1, 2006
Mar 30 and Apr 6 2006	Apr 14, 2006	Apr 21, 2006	Aug 17 and Aug 24 2006	Sep 1, 2006	Sep 8, 2006
Apr 6 and Apr 13 2006	Apr 21, 2006	Apr 28, 2006	Aug 24 and Aug 31 2006	Sep 8, 2006	Sep 15, 2006
Apr 13 and Apr 20 2006	Apr 28, 2006	May 5, 2006	Aug 31 and Sep 7 2006	Sep 15, 2006	Sep 22, 2006
Apr 20 and Apr 27 2006	May 5, 2006	May 12, 2006	Sep 7 and Sep 14 2006	Sep 22, 2006	Sep 29, 2006
Apr 27 and May 4 2006	May 12, 2006	May 19, 2006	Sep 14 and Sep 21 2006	Sep 29, 2006	Oct 6, 2006
May 4 and May 11 2006	May 19, 2006	May 26, 2006	Sep 21 and Sep 28 2006	Oct 6, 2006	Oct 13, 2006
May 11 and May 18 2006	May 26, 2006	Jun 2, 2006	Sep 28 and Oct 5 2006	Oct 13, 2006	Oct 20, 2006
May 18 and May 25 2006	Jun 2, 2006	Jun 9, 2006	Oct 5 and Oct 12 2006	Oct 20, 2006	Oct 27, 2006
May 25 and Jun 1 2006	Jun 9, 2006	Jun 16, 2006	Oct 12 and Oct 19 2006	Oct 27, 2006	Nov 3, 2006

* The IRS does not guarantee a specific date that a refund will be mailed or deposited into a taxpayer's financial institution account.

IRS PROCEDURES — MISCELLANEOUS

Additional Circular 230 Regulations

Speech by Steven Whitlock to Members of AICPA on October 31, 2005

+ **Contingent Fees Included in Amended Regulations**

The IRS plans to release amendments to the Circular 230 regulations soon. These amendments will affect contingent fees, the investigation process, and include greater disclosure and transparency regulations.

Applicable Federal Rates

Revenue Rules 2005-66, 71, and 77

IRC §§382, 642, 1274, and 1288

+ **IRS Announces Rates for October through December 2005**

		Annual	Semiannual	Quarterly	Monthly
Oct-05	Short-term	3.89%	3.85%	3.83%	3.82%
	Mid-term	4.08%	4.04%	4.02%	4.01%
	Long-term	4.40%	4.35%	4.33%	4.31%
Nov-05	Short-term	4.04%	4.00%	3.98%	3.97%
	Mid-term	4.23%	4.19%	4.17%	4.15%
	Long-term	4.57%	4.52%	4.49%	4.48%
Dec-05	Short-term	4.34%	4.29%	4.27%	4.25%
	Mid-term	4.52%	4.47%	4.45%	4.43%
	Long-term	4.79%	4.73%	4.70%	4.68%

Erroneous Form 1099-INT

INFO 2005-0123

IRC §7434

+ **Disgruntled Car Dealer Barred from Issuing Customer a Form 1099-INT**

In this instance, a taxpayer bought a new car from a local dealer after being told that he qualified for 0% financing. However, the dealer later informed him “there had been a mistake” and the taxpayer would have to sign a new contract with a higher interest rate. When the taxpayer refused, the dealer threatened to void the registration and repossess the car.

After the taxpayer filed a complaint with the state Department of Motor Vehicles, he received a Form 1099-INT from the dealer reporting interest income of \$2,997. Since the contract called for 0% interest, the IRS concluded the dealer had no basis for issuing Form 1099-INT. Furthermore, under IRC §7434 a civil action can be filed against a person who willfully files a false information return reporting payments purportedly made to that person.

Form Instructions Update

+ **New Schedule D Instructions**

The IRS released new Schedule D instructions. The previously issued instructions required a taxpayer with more than five stock sales to use Schedule D-1 to report any additional sales. A statement of “see attached schedule” and taxpayer-provided documents would not be accepted.

The new instructions allow taxpayer-provided schedules as long they are formatted and contain the same information required on Schedule D-1.

Fourth Quarter Interest Rates

Revenue Ruling 2005-62

IRC §6621

+ **Interest Rates for Both Overpayments and Underpayments Increase for Fourth Quarter of 2005**

For the calendar quarter beginning October 1, 2005 the following interest rates are in effect:

Overpayments other than for corporations	7 percent
Overpayments for corporations	6 percent
Corporate overpayments exceeding \$10,000	5.5 percent
Underpayments	7 percent
Underpayments for large corporations	9 percent

2006 Inflation Adjustments

Rev. Proc. 2005-70, October 31, 2005

IRC §§ 24, 25A, 32, 63, 68, 151, 179, 221, and 223

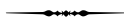
+ **IRS Announces 2006 Inflation Adjustments**

The following are just a few of the 2006 inflation adjustments:

- **Child Tax Credit** — The value used in determining the potentially refundable amount of child tax credit is \$11,300.
- **Education Credits** — 100% of qualified tuition and related expenses not in excess of \$1,100 and 50% of the excess expenses, up to \$1,100, when determining the Hope Scholarship Credit. This increases the maximum credit from \$1,500 to \$1,650. Reductions in the credit are taken into account when the AGI exceeds \$45,000 for a single filer and \$90,000 for joint filers for both the Hope and Lifetime Learning credits. (See the New Legislation section for changes applicable to students in the Hurricane Katrina GO Zone.)
- **Earned Income Credit** — The earned income limit to receive maximum EIC has increased to \$8,080 for a qualifying individual with one child, \$11,340 for a taxpayer with two or more qualifying children, and \$5,380 for taxpayers with no children. If investment income exceeds \$2,800, all EIC is denied. (See GO Zone Act for special provisions.)
- **Standard Deduction** — \$10,300 for surviving spouses and taxpayers filing joint returns, \$7,550 for heads of households and, \$5,150 for single individuals and taxpayers married filing separately.

- **Itemized Deductions** — The phase-out of itemized deductions begins at \$150,500 (\$75,250 for taxpayers married filing separately).
- **Personal Exemption** — \$3,300 for each personal deduction.
- **Depreciable Assets** — \$108,000 for the maximum IRC §179 deduction. The reduction of the §179 deduction begins at \$430,000. (See Go Zone Act for special provisions.)
- **Education Interest** — The \$2,500 maximum deduction for education interest is reduced when MAGI exceeds \$50,000 (\$105,000 for joint filers). The deduction is eliminated when MAGI reaches \$65,000/\$135,000.
- **Medical Savings Accounts** — the monthly limit on the HSA deduction for high-deductible health plans (HDHP) is the lesser of:
 1. The actual monthly contribution, or
 2. One-twelfth of the annual deductible ($\frac{1}{12} \times \$2,700 = \225 for self-only coverage; $\frac{1}{12} \times \$5,450 = \454 for family coverage).

An HDHP plan has an annual deductible of not less than \$1,050 for self-only coverage and \$2,100 for family coverage. Out-of-pocket expenses may not exceed \$5,250 for self-only coverage and \$10,500 for family coverage.



Information Confidentiality
Notice 2005-93, December 8, 2005

+ **Regulations Proposed to Safeguard Taxpayer Information**

Notice 2005-93 provides guidance on proposed regulations requiring tax return preparers to obtain informed, voluntary consent from taxpayers before using or disclosing their tax return information.

The proposed regulations broaden the definitions of a tax preparer and tax return information, modify the procedure and form for obtaining consent, and include a requirement for preparers to obtain the consent of clients before sending tax information offshore.

Note. Preparers will need to obtain their client's consent before sending their tax information to nonfirm out-of-state colleagues for assistance with foreign state returns.



Late Filing Penalty

James H. Jordan v. Commissioner, TC Memo 2005-266, November 17, 2005

IRC §6651

+ Drug Addiction No Excuse to Abate Late Filing Penalty

Facts. The taxpayer failed to file tax returns from 1997 to 2002. When he finally filed the returns he owed almost \$360,000 in back taxes and over \$104,000 in penalties and interest.

The taxpayer was a life insurance salesman. He claimed that his drug addiction, memory loss, and other medical problems were reasonable cause to abate the failure to file penalties. The taxpayer underwent three weeks of rehabilitation in 1999.

The drug addiction was the result of taking the pain medication, OxyContin, for severe headaches. The taxpayer was aware of his increasing dependency on OxyContin and ceased taking the drug in January 1999. He suffered a grand mal seizure shortly thereafter and was admitted to a rehabilitation center. The taxpayer was able to continue his life insurance business throughout the six-year period.

Issue. Is drug addiction a reasonable cause for failure to file?

Analysis. A taxpayer may have reasonable cause for failure to file when he or a member of his family experiences an illness or incapacity that prevents them from filing. However, the same illness or incapacity would probably cause the taxpayer to cease his business.

Holding. Because the taxpayer continued to function in his insurance business, the Court ruled the addiction was not reasonable cause to abate the failure to file penalties.

Mailing Addresses

Draft Instructions for Form 1040

+ IRS Changes Mailing Addresses for Some States

The IRS has again changed the mailing addresses for some states. Tax practitioners should check form instructions for correct mailing addresses. The draft instructions for Form 1040 indicate changes for residents of Colorado, Delaware, Kansas, Maryland, Mississippi, Nebraska, New Mexico, Ohio, South Dakota, Virginia, West Virginia, and the District of Columbia.

Penalty for failure to pay tax

Devery W. Hennard v. Commissioner, TC Memo. 2005-275, November 28, 2005

IRC §§6020, 6651, 6654, and 6673

+ Taxpayer penalized for failure to file and failure to pay

Facts. The taxpayer, Devery Hennard, worked for a roofing contractor in Texas from 1998 to 2001. The contractor paid Hennard in excess of \$88,000 in each of the four years, yet Hennard did not file tax returns for any of the years in question. The IRS prepared substitute returns for Hennard after he failed to respond to requests to file and assessed tax and penalties for failure to file a tax return,³² failure to pay the amount of tax shown on a return,³³ and failure to pay estimated tax payments³⁴ for each of the four years.

³² IRC §6651(a)(1)

³³ IRC §6651(a)(2)

³⁴ IRC §6654

Hennard thanked the Secretary for the correspondence, but declined to accept the “unsolicited, and bad, legal and accounting advice” he received from the IRS and asked to be put on the “no call list.” He then petitioned the Tax Court with a variety of arguments against the imposition of tax and penalties against him. Hennard did not appear when his case was called to trial on a Motion for Summary Judgment.

Issue. Is Hennard liable for penalties for failure to pay the tax shown on his returns if he never filed returns?

Analysis. IRC §6651(a)(2) imposes a penalty for failure to pay the amount of tax shown on a return, but applies only when there is tax shown on a return.³⁵ However, the Secretary is authorized to prepare a return for a taxpayer³⁶ that will be treated as if filed by the taxpayer for the purpose of imposing a §6651(a)(2) penalty.³⁷

Holding. The Tax Court granted the IRS summary judgment and found Hennard liable for penalties for failure to file, failure to pay, and failure to file estimated tax payments. Although the Court noted Hennard’s petition was “nonsensical” and “frivolous” it did not apply an IRC §6673(a)(1) penalty for frivolous proceedings. However, the Court warned Hennard the penalty would apply if he tried similar arguments in the future.

Return Extensions

Treasury Decision 9229, November 9, 2005

IRC §6081

+ New Automatic Six Month Extension for Most Returns

The IRS recently released a draft of Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*. No instructions were released with the form. However, the “What’s New” section at the top of the draft form states that Form 4868 may now be used to obtain an automatic six-month extension of time to file Form 1040 starting with returns filed for the 2005 tax year. In addition, the IRS recently released IRS Pub. 509, *Tax Calendars*, which states that individuals can now use Form 4868 to receive an automatic six-month extension of time.

Observation. Previously, Form 4868 granted taxpayers an automatic four-month extension. As a result of this change, the IRS is making Form 2868, *Application for Additional Extension of Time to File U.S. Individual Income Tax Return*, obsolete beginning with 2005 returns. The IRS has issued temporary and proposed regulations granting the six-month automatic extension,³⁸ stating that the new extension is meant “to reduce the complexity of the pre-existing extension process, and to provide cost savings and other benefits to taxpayers and IRS.”

Observation. A calendar year individual whose 2005 return is due on April 17, 2006 and who files Form 4868 would have until October 16th to file under the extended six-month extension. Furthermore, there is no need to sign the request or explain why an extension is being sought. Taxpayers still must make a proper estimate of any tax due; failure to pay any tax by the original due date of the return may subject the taxpayer to penalties and interest.³⁹

³⁵ *Cabirac v. Commr.*, 120 T.C. 163 (2003)

³⁶ IRC §6020(b)

³⁷ IRC §6651(g)(2)

³⁸ Cf. T.D. 9229

³⁹ Treas. Reg. § 1.6081-4T

Corporate Taxpayers: These regulations do **not** affect the existing rules on filing extensions for corporate income tax returns. Currently, corporations may obtain an automatic six-month extension of time to file their income tax returns by submitting Form 7004, *Application for Automatic Extension of Time to File Corporation Income Tax Return*. Corporations do not have to sign the extension request or give a reason for the request. Form 7004 does **not** extend the time for payment of any and all taxes otherwise due.

Observation. While the regulations do not change the rules regarding filing extensions for corporations, they do change the title and appearance of Form 7004. Taxpayers filing certain other types of returns will also use Form 7004 to request an automatic six-month extension of time to file. The new Form 7004 will be titled “Application for Automatic 6-Month Extension of Time to File Certain Business Income Tax, Information, and Other Returns” and will apply to a larger number of returns.⁴⁰

Form 2758 Eliminated: Under the old rules, Form 2758, *Application for Extension of Time To File Certain Excise, Income, Information, and Other Returns*, was used to request a 90-day extension of time to file certain excise, income, information, and other returns. In order to obtain a 90-day extension, these taxpayers had to sign the form and provide an explanation of the need for the extension. To obtain additional time beyond the 90-day period, they then had to file Form 2758 a **second** time, providing an explanation of why the initial extension was not sufficient. Under the new regulations, these taxpayers may request an automatic six-month extension of time to file by filing the new Form 7004.⁴¹

Partnerships, REMICs, and Certain Trusts: Under the old regulations, partnerships, real estate mortgage investment conduits (REMICs), and certain trusts would request three-month automatic extensions of time to file by submitting Form 8736, *Application for Automatic Extension of Time to File U.S. Return for a Partnership, REMIC, or for Certain Trusts*. They could then file a second request for an additional three-month extension of time to file on Form 8800, *Application for Additional Extension of Time to File U.S. Return for a Partnership, REMIC, or for Certain Trusts*. Under the new regulations, these taxpayers may request an automatic six-month extension of time to file by filing the new Form 7004.⁴² As a result, Forms 8736 and 8800 have been made obsolete.

Observation. The new regulations could effectively increase the filing burdens for partners since partnerships and individuals can qualify for a six-month automatic extension until October 15 and corporations can qualify for an automatic extension until September 15. Now, an individual or corporate partner might not even receive a K-1 information return from the partnership before the individual’s or corporation’s extended due date. As a result, the partner may have to file using estimates of income and then file an amended return after receiving the K-1. Even though this could have happened under the pre-existing rules, it may occur more frequently now.

Effective Date and Transition Rule: The regulations are effective for automatic extensions filed after 2005.⁴³ As a result, they apply to applications for extension of time to file tax year 2005 returns and to tax year 2004 fiscal-year returns due after 2005. Affected fiscal year taxpayers should continue to use the tax year 2004 extension forms but will be granted a six-month extension.

⁴⁰ Reg. §1.6081-2T, Reg. §1.6081-3T, and Reg. §1.6081-6T

⁴¹ Reg. §1.6081-6T, Reg. §1.6081-10T, and Reg. §26.6081-1T

⁴² Reg. §1.6081-2T (i.e., partners), Reg. §1.6081-6T (i.e., trusts), Reg. §1.6081-7T (i.e., REMICs)

⁴³ Reg. §1.6081-2T(h) and Reg. §1.6081-4T(f)

Employee Plan Returns: The regulations also allow administrators and sponsors of employee benefit plans subject to Employee Retirement Income Security Act of 1974 (ERISA) to report information concerning the plans and direct filing entities to use a new version of Form 5558, *Application for Extension of Time To File Certain Employee Plan Returns*, for an automatic 2½-month extension of time to file.⁴⁴ Under the regulations, Form 5558 no longer requires taxpayers to sign or provide an explanation of the need for the extension of time to file.

Gift Tax Returns: Under IRC §6075(b)(2), an individual who makes a gift and who also requests an automatic extension of time to file his income tax return is deemed to have an extension of time to file the return required by IRC §6019. The regulations also allow donors who do not request an extension of time to file an income tax return to request an automatic six-month extension of time to file Form 709 by filing a **new** version of Form 8892, *Payment of Gift/GST Tax and/or Application for Extension of Time to File Form 709*.⁴⁵

Under the regulations, Form 8892 no longer requires a signature or an explanation of the need for the extension of time to file.

S Corporation Tax Preparer

Letter Ruling 200542034, July 14, 2005

IRC §§6695 and 7701

+ Does a Tax Preparer Penalty go to the Employee or the Employer?

Facts. An S corporation with one shareholder and at least one employee was in the tax preparation business. Neither the shareholder nor the employee (a niece of the shareholder) received compensation from the corporation. During an audit of the S corporation, the Revenue Agent asked to see a list of all of the tax returns prepared by the corporation. When told that no list existed, he requested copies of the bills given to the clients.

The shareholder produced approximately 400 bills, however, IRS records indicated over 1,500 returns were prepared with either the name of the S corporation or one of the two employees as the return preparer.

Due to the failure to produce the requested list, the IRS assessed penalties for the remaining 1,100 returns.

Issue. Should the penalties be assessed on the S corporation or the shareholder?

Analysis. Under IRC §6107(b), a tax preparer is required to:

1. Retain a copy of each completed return or a list of the names and identification numbers for each return prepared for a period of three years, and
2. Make a copy of the returns or the list available to the IRS upon request.

Failure to maintain these records and produce them for the IRS upon request subjects the preparer to a \$25 penalty per return up to a maximum penalty of \$25,000.

When determining who to assess the penalty against, the court looked at the definition of a tax preparer. A preparer is defined as any person who prepares returns for compensation, or employs more than one person to prepare returns. In this case the court determined the S corporation was the return preparer.

Holding. A penalty could be assessed against the S corporation. However, the court noted that if the shareholder established enough facts to prove that the failure to provide the requested information was due to reasonable cause and not due to willful neglect, the penalty could be abated.

⁴⁴ Reg. §1.6081-11T

⁴⁵ Reg. §25.6081-1T

Signature Requirements

Notice 2004-54 (Clarification), August 16, 2004

+ **IRS Clarifies Signature Requirements for Preparers**

The IRS has issued a clarification regarding non-manual signatures (e.g., rubber stamp, mechanical or computer generated signatures) on original or amended returns or requests for filing extensions. Non-manual signatures are allowed only when signing as a preparer, and not when signing on behalf of the taxpayer.

This policy change stipulates that forms requiring only one signature must be signed manually, including Form 2758, *Application for Extension of Time to File Certain Excise, Income, Information, and Other Returns*, and Form 8800, *Application for Additional Extension of Time to File U.S. Return for a Partnership, REMIC, or for Certain Trusts*.



Top 20 Tax Professional Errors for Form 1040 Paper Submissions
www.irs.gov/taxpros/article/0,,id=99032,00.html, September 23, 2005

+ **IRS Web Site Publishes List of Tax Professional Errors.**



Top Errors for Paid Preparers on Paper Return Submissions

Top 20 Errors for Paid Preparers through September 23, 2005

Note: Rate Reduction Credit errors are for tax year 2001 returns that are now being corrected in the Error Resolution System.

	Paper Return 1040 (Paper Only)	Error Count
1.	Dependent's last name didn't match SSA or our records. We didn't allow the exemption.	159,107
2.	EIC was figured or entered incorrectly.	48,218
3.	Failed to subtract the advanced child tax credit payment from total credit amount.	45,495
4.	Tax was refigured using computation from schedule D tax worksheet or qualified dividends and capital gain tax worksheet	44,462
5.	Child's SSN and/or name didn't match SSA or our records. EIC was changed	37,855
6.	Didn't include SSN or itin for dependents. We didn't allow the exemptions.	34,780
7.	Child(ren)'s age exceeded the limit. All or part of child tax credit and/or additional child tax credit was disallowed.	31,834
8.	Child tax credit was figured incorrectly based on the number of boxes checked and/or on adjusted gross income.	30,499
9.	Taxable amount of social security benefits on page 1 of return was figured incorrectly.	26,485
10.	Based on information reported, we refigured the tax using the filing status for a single person.	25,735
11.	Additional child tax credit from Form 8812 was incorrectly computed or transferred to the return.	23,966
12.	EIC was not allowed. Didn't file form 8862.	20,380
13.	Tax amount wasn't the correct amount based on taxable income and filing status.	18,655
14.	Spouse's SSN or ITIN and/or name didn't match SSA or our records. Spouse's personal exemption wasn't allowed.	18,100
15.	Refund amount or the amount owed was figured incorrectly.	17,698
16.	SE tax from Schedule SE was incorrectly computed or transferred to Form 1040.	16,129
17.	EIC was not allowed. You or your spouse must be at least 25, but less than 65, years old within the tax year	12,355
18.	Taxpayer's SSN or ITIN and/or name didn't match SSA or our records. Personal exemption wasn't allowed.	11,650
19.	Taxpayer notice was sent for miscellaneous errors.	10,513
20.	Net profit or loss from business was incorrectly computed or transferred to Form 1040.	9,905

The IRS notes that many of these errors could have been prevented if the preparers had electronically filed these tax returns. Tax preparers can access error information for Forms 1040 A and 1040 EZ at the same address.

Note. Rate Reduction Credit errors are for tax year 2001 returns that are now being corrected in the Error Resolution System.



User Fees

IR 2005-144, December 19, 2005

+ IRS Issues New User Fee Schedule

IRC §§367, 401, 403, 408, 408A, 412, 446, 482, 501, 503, 507, 509, 511, 521, 528, 4871, 4945, 4975, 6039G, 7121 and 7871 and Statement of Procedural Rules §601.201

The Office of Management and Budget requires that federal agencies charge user fees reflecting the full cost of providing services if the benefit to the recipient exceeds the benefit to the general public. The IRS has increased these user fees recently for Employee Plans (EP) and Exempt Organizations (EO).

Effective February 1, 2006:

- EP rulings, which currently range from \$95–\$5,415, will increase to \$200–\$14,500
- EO letter rulings, which currently range from \$155–\$2,570, will increase to \$275–\$8,700

Effective July 1, 2006:

- Opinions issued under the revised and centralized EP determination letter program for Forms 5300, 5307, and 5310 letters, currently ranging from \$125–\$6,500, will increase to \$200–\$15,000
- EO fees for determination letters and group exemption letters, currently ranging from \$150–\$500, will increase to \$300–\$900

IRS PROCEDURES — PAYMENTS

Erroneous refund

United States of America v. Angus N. MacPhail, US-DIST-CT, 2005-2 USTC ¶150,563, September 27, 2004

IRC §7405

+ Taxpayer Required to Repay Refund from IRS Error

Facts. Taxpayer and spouse filed a joint extension prior to their divorce with a payment for \$490,000. When the return was filed, their tax liability was \$190,464. The taxpayer elected to apply the overpayment to the next year's return. By the time that return was filed, the taxpayers were divorced. Mr. MacPhail did not ask to apply the refund amount to his subsequent return, but the IRS applied the overpayment to his return and sent him a refund check for \$299,536.

When his former spouse requested that the overpayment be applied to her subsequent return, she was informed the overpayment was refunded to her ex-spouse. She then filed claim for the refund. The entire \$490,000 for the extension was supplied by an LLC of which she was the sole owner. The IRS finally agreed that she was entitled to the credit for the overpayment and then filed for a return of the erroneous refund from MacPhail.

Issue. Is Mr. MacPhail required to return the money to the IRS?

Analysis. MacPhail argued since the IRS made a voluntary payment to him and twice affirmed that decision, it cannot claim the refund was erroneous. MacPhail also contends that there are issues with regard to equitable considerations applicable in an erroneous refund action. The IRS argued that when they found the refund belonged to the ex-spouse, MacPhail's refund became erroneous.

Holding. Unfortunately for MacPhail, his argument was based on a case which predates the present erroneous refund statute. The court ruled in favor of the IRS.

Joint Estimated Tax Payments

Treasury Decision 9224, September 2, 2005

IRC §6654

+ Taxpayers May Make a Joint Estimate Even if Living Apart

New regulation §1.6654-2(e)(5)(i) clarifies that married taxpayers may make a joint estimated tax payment even if living separately. Joint payments are **not allowed if**:

1. There is a decree of divorce or separate maintenance;
2. The married taxpayers have different tax years; or
3. The taxpayer's spouse is a nonresident alien, unless an election under IRC §6013(g) or (h) is in effect.

If the taxpayers decide to file separate income tax returns, they may allocate the estimated payments in any manner on which they agree.

Abuse of Discretion

Jerome J. Norris v. Commissioner, TC Memo 2005-237, October 11, 2005

IRC §§ 6330 and 7491

+ IRS Levies on 48-Cent Underpayment

Facts. The taxpayer, an attorney, reported a balance due of \$51,349 when he filed his 2002 income tax return. He paid \$26,305 with the return leaving a balance due of \$25,044. He then entered into a payment arrangement with the IRS agreeing to make two payments of \$13,348.24, which included penalties and interest.

The taxpayer timely made these payments but rounded each payment to \$13,348. Six months later the IRS sent the taxpayer a notice reflecting a balance due of \$0.48 plus penalties of \$175.44 and interest due of \$264.08. The taxpayer then filed Form 12153, *Request for a Collection Due Process Hearing*, and explained that a “colossal blunder” had been made by the IRS. Five months after filing the Form 12153, the taxpayer discussed the matter with an Appeals officer.

The Appeals officer then sent a notice to the taxpayer explaining that under IRC §§6320 and 6330, installment payments that are not paid in full continue to be charged a late payment penalty and interest on the unpaid balance until they are paid in full. The IRS then informed the taxpayer of a notice to levy.

Issue. Does the taxpayer owe the balance due plus the penalty and interest assessed?

Analysis. The court noted this contention involved a de minimus amount, since the amount levied represented less than 1% of the original balance. While the IRS was relying on an abbreviated statement of the tax account, it contends it should be allowed to pursue collection. The taxpayer contends he paid the entire balance due and does not owe any money.

The taxpayer argued that rounding the amount of the payment met the IRS guidelines and the additional penalty and interest should not be assessed.

Holding. The court held for the taxpayer. The IRS was unable to show how the penalty and interest were calculated. The court also agreed that rounding was an acceptable procedure.

ITEMIZED DEDUCTIONS

Salary Overpayments

INFO 2005-0146

IRC §§61 and 6513

+ IRS Rules Salary Overpayments Taxable in Original Year of Receipt

Under the “claim of right” doctrine, salary overpayments are taxable in the year of receipt. If an employee repays the excess in the same year, the employer reports only the net salary on the employee’s Form W-2. However, if the repayment is made in a later year, the total salary payment is included on the employee’s first year’s W-2 for the year the overpayment was made and the employee gets an itemized deduction in the year of repayment.

Note. Special rules apply under the claim of right doctrine when the overpayment is more than \$3,000. See IRS Pub. 525, *Taxable and Nontaxable Income*, for additional information.

Value of Charitable Contribution

Roger and Sharon Wortmann v. Commissioner, T.C. Memo 2005-227, September 29, 2005

IRC §170

+ Fair Market Value of Donated Real Estate

Facts. The taxpayers, three couples and an individual studying to be a Catholic deacon, formed Tintern Retreat Center, LLC (TRC), to purchase a former monastery. The property was purchased from a nonprofit organization titled Monks of Tintern, Inc. (Monks). Father Clifford Stevens, a Catholic priest, was founder and president of Monks.

Father Stevens reluctantly placed the monastery for sale after experiencing financial difficulty operating the property. Father Stevens testified he priced the property to pay Monks remaining debts and to “provide a little seed money for future endeavors.” However, he placed a stipulation on the contract that the property could be used only for religious purposes and that gave Monks the first right to repurchase the property if the purchaser wished to sell it.

Monks sold 210 acres of the 240-acre parcel for \$63,000 in 1996. It then sold the remaining 30 acres, which included the monastery, chapel, and two-story dormitory, to TRC for \$75,000 in 1997. TRC leased the property for \$1 a year to Tintern Retreat & Resource Center, Inc. (TRRC), a 501(c)(3) charitable organization that operated the property as a retreat center.

After 17 months of operation, TRC donated the property to TRRC and claimed a charitable contribution of \$475,000. Each of TRC’s owners claimed a respective 25% share of the appraised value of the contribution on their individual tax returns in 1998. Because the value of their contributions exceeded the statutory contribution limit of 30% of AGI, their charitable deductions carried over into 1999 and 2000.

In 2003, the IRS issued deficiency notices to each owner for tax years 1999 and 2000. The IRS asserted the fair market value of the donated property was only \$76,200, and not \$475,000 as the taxpayers claimed.

Issue. What was the fair market value of the donated property on the date of the contribution?

Analysis. Normally, the burden of proof falls on the taxpayer to prove that an IRS deficiency was made in error. However, if a taxpayer produces credible evidence and establishes that he substantiated items, maintained required records, and fully cooperated with the IRS’s requests, the burden may shift to the IRS. In this case, since both the IRS and the taxpayers presented evidence and introduced expert witnesses to substantiate their wildly disparate valuations, the Court decided to base its decision on a preponderance of evidence without regard to burden of proof.

The Court was presented with four appraisals for the property: the original TRC purchase price, the county assessor's valuation, and appraisals provided by both the taxpayers' and IRS's expert witnesses. Two of the appraisals, the IRS's expert's appraisal and the assessor's, were reasonably close to the TRC purchase price of \$75,000. The taxpayers' expert witness appraised the property \$400,000 higher than the other fair market value assessments.

The Court considered the actual sales price of the property 17 months prior to the donation, the county assessor's valuation, and the valuation methods used by both appraisers as evidence of the property's actual fair market value. The Court found the IRS's appraiser's valuation methodology and conclusions were more credible than those employed by the taxpayers' appraiser.

The Court did not find the taxpayers' argument that Father Steven's sold the property below market value to be valid since there was no evidence of a forced sale (e.g. collection or foreclosure proceedings). The Court also did not find the conditions of the contract (Monk's right of first refusal and the stipulation that the property be used solely for religious purposes) significantly diminished the value of the property.

Holding. The Court determined the prior sale was made at fair market value between a willing buyer and a willing seller and that the value changed only slightly due to improvements to the property between sales. Therefore, the Court determined the value of the contribution was \$76,200, as the IRS contended.



Vehicle Donations

IR 2005-145, December 20, 2005

IRC §§6701 and 6720

+ **IRS Warns of Questionable Deductions for Donated Vehicles.**

Taxpayers may claim an itemized deduction for the fair market value (FMV) of a vehicle donated to a qualified charity. If the vehicle is sold at auction, the sales price is considered to be the FMV. However, the IRS has found situations where charities are valuing the FMV above the sales price by claiming the vehicle was sold to a needy person or family and is excepted from the FMV rule.

The IRS has announced it will only accept the auction sales price as the FMV. Taxpayers are reminded to attach Form 1098-C, provided by the charity for vehicle donations in excess of \$500, to their returns.



PARTNERSHIP

Partnership Allocation Rules

NPRM REG-144620-04; November 18, 2005

IRC §704

+ **Partnership Allocations to Look-through Partners Clarified**

IRC §704(a) instructs taxpayers to allocate income, gain, loss, deduction, or credits based on the terms of the partnership agreement. IRC §704(b) requires allocation to be based on the partner's interest percentage if the partnership agreement is silent or the allocation method has no substantial economic effect. When the partner is a look-through entity, such as an S corporation, the proposed regulations provide that the interaction of the allocation must be taken into account when testing the substantiality of the allocation.

In addition, the after-tax economic consequences to a partner resulting from an allocation must be compared to the after-tax economic consequences to that partner if the allocation was made in accordance with the partner's interest in the partnership. The proposed regulations provide rules for testing the substantiality of an allocation where the partners are look-through entities.

Section §704(b) significantly limits the flexibility of §704(a) by requiring the allocation to be based on partnership interest unless the allocation has substantial economic effect. The analysis of substantial economic effect is a two-part analysis. First, the allocation must have economic effect and second, the economic effect must be substantial.

To have economic effect, the allocation must be consistent with the underlying economic arrangement of the partners. This means if there is a benefit or burden that corresponds to the allocation, the partner receiving the allocation must receive the economic effect of the benefit or burden. Therefore, an allocation has economic effect only if the partnership agreement provides for:

1. The determination and maintenance of the partner's capital accounts;
2. Liquidating distributions to the partners to be made in accordance with the positive capital account balances of the partners; and
3. Each partner to have an unconditional obligation to restore the deficit in their capital accounts following the liquidation of the partner's partnership interest.

These proposed regulations are not effective until they are published as final.

Sale of Partnership Interest

Joseph D. Doll and Charlotte J. Doll v. Commissioner, T.C. Memo 2005-269, November 21, 2005

IRC §§741 and 1001

+ Taxpayer Could Not Prove Basis in Partnership Interest

Fact. The taxpayer is the president and majority shareholder in two corporations. One of the corporations is the general partner in a limited partnership. Effectively, the taxpayer owns 80% of the entities.

Creditors were attempting to force one of the corporations into involuntary bankruptcy. In an attempt to prevent the bankruptcy, the taxpayer sold part of his partnership interest to third parties and lent the sale proceeds to the corporation. He agreed to place the sale proceeds directly into the corporate bank account. He sold the partnership interest for \$199,375 and deposited the money as agreed. The deposit was reported as a loan and the corporation later repaid \$15,000 of the loan.

When the taxpayer filed his individual tax return, he reported the sale on Schedule D and did not show any basis in the partnership interest. However, he failed to report the gain on the front of Form 1040. This resulted in the IRS sending a correction notice. Upon receiving the correction notice, he filed an amended return showing the same sale price on Schedule D but reporting a basis of \$184,375. This resulted in a \$15,000 gain which he reported on Form 1040.

The taxpayer later filed a second amended return. On this return he reported a sale of \$15,000 instead of \$199,375, but did not show any basis. The second amended return did not result in any additional tax liability.

Issue. Does the partnership interest have a basis? Must the taxpayer report the entire sale proceeds even though he only had the use of \$15,000?

Analysis. The taxpayer's argument was that he was not allowed to personally take the sale proceeds. He testified the Securities Act prohibited him from depositing the purchaser's check into his personal account and using the money for private purposes. He further argues that only the corporation could sell the partnership interest.

Holding. The taxpayer agreed with the IRS that the partnership interest did not have any basis. The court noted that while the partnership interest might be covered under the Securities Act, the interest was sold by the taxpayer not the corporation. Because it was the taxpayer's decision to sell the partnership interest, it was all taxable to him in the year of sale.

Observation. Taxpayers should be aware that some transactions result in taxable income even when the taxpayer does not receive any cash.

PASSIVE ACTIVITIES

Combining Passive Activities

Richard B. and Jane M. May v. Commissioner, T.C. Summary Opinion 2005-146, October 11, 2005

IRC §469

+ IRS Disallows Aggregating Multiple Passive

Facts. Mrs. May was a full time teacher and Mr. May worked 28–30 hours per week as a court advocate. The Mays owned 18 units consisting of 36 rentals. Mr. May personally managed the rental units and spent 40–45 hours per week on rental management activities. He did hire independent contractors to do any necessary major repairs. The taxpayers agree that without aggregating the rental properties, they would not meet the material participation requirements to be classified as a real estate professional.

The Mays aggregated all of the rental units on their income tax return as if they were a single unit. However, they never attached an election to treat the rentals as a single activity.

Issue. Can taxpayers make a “deemed” election to aggregate their rental activities by treating all properties as a single unit?

Analysis. Generally, IRC §469 disallows a deduction for passive activity losses incurred by individual taxpayers. Rental activities are presumed to be passive activities without regard to the taxpayer's material participation in the activity. However, the presumption does not apply to a real estate professional. Classification as a real estate professional requires the taxpayer to:

1. Perform more than one-half of his personal services in real estate activities in which he materially participates, and
2. Perform more than 750 hours of services during the year in those real estate activities.

Holding. The court could find no evidence that the required election to aggregate rental activities was ever made. They disregarded the Mays “deemed election” argument and ruled each rental was a separate activity.

Passive Activity Audit Technique Guide

IRC §469

+ **IRS Releases New Audit Guide**

The IRS has released its new Audit Technique Guide for Passive Activities. This guide is available on the IRS web site at <http://www.irs.gov/businesses/small/article/0,,id=146318,00.html>.

Tax preparers will find the guide helpful in understanding current emerging issues, Form 8582, and loss limitations. The guide provides specific guidance on potential audit issues and highlights common errors. It also includes various checklists and decision trees.

RETIREMENT

2006 COLA Adjustments to Retirement Plans

Notice 2005-75, November 7, 2005

IRC §§ 415, 402, 401, 409, 414, 404, 408, 457 and, 416

+ **IRS Announces Increase in Retirement Plan Contributions**

Effective January 1, 2006, taxpayers may increase the maximum contribution to their retirement plans.

IRC §	Type of Plan	Old Limit	New Limit
415(b)(1)(A)	Defined benefit plan	\$170,000	\$175,000
415(c)(1)(A)	Defined contribution plan	42,000	44,000
402(g)(3)	401(k) plans	14,000	15,000
409(o)(1)(c)(ii)	ESOP maximum balance	850,000	885,000
409(o)(1)(c)(ii)	ESOP lengthen 5-year distribution	170,000	175,000
414(q)(1)(B)	Definition of highly compensated	95,000	100,000
401(a)(17), 404(l), 408(k)(3)(C), 408(k)(6)(D)(ii)	Compensation limit	210,000	220,000
408(k)(2)(C)	SEP compensation	450	450
408(p)(2)(E)	SIMPLE	10,000	10,000
457(e)(15)	State and local government plans	14,000	15,000
416(i)(1)(A)(i)	Key employee definition	135,000	140,000
414(v)(2)(B)(i)	Catch-up contributions	4,000	5,000
414(v)(2)(B)(ii)	Catch-up contributions	2,000	2,500

Early Distribution Penalty: IRA

Jeffrey Thomas Olup & Louise Marie Olup, T.C. Summary Opinion 2005-183, December 13, 2005

+ **Distribution Not for First Time Home Purchase**

Facts. Mr. Olup bought a townhouse in April of 1995, which he used as his personal residence until April of 2003. His wife moved into the townhouse with him after their marriage in June of 2001. Prior to that time, Mrs. Olup lived at home with her parents.

In June of 2002, the Olups purchased a lot so they could build a home. Mr. Olup withdrew \$20,617 from his IRA in 2002 and used the proceeds on the new home, which they moved into in June of 2003. The taxpayers reported this distribution as income on their 2002 return, but claimed a first-time home-buyer exception from the additional 10% penalty on Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*, on \$10,000 of the early distribution.

The IRS disallowed the exception since Mr. Olup was not a first-time homebuyer and asserted a deficiency of \$986 for the early distribution in 2002.

Issue. Are married taxpayers liable for the 10% early distribution penalty under IRC §72(t) for withdrawing funds from an IRA to construct a home when one spouse owned a home in the preceding two years?

Analysis. IRC §72(t)(8)(D)(i)(I) defines a first-time homebuyer as an individual who has not owned a home for two years preceding the acquisition of a principal residence. This subsection further clarifies that a married couple is treated as a unit when applying the prior ownership test. For homeowners who are building, the acquisition date is the date when construction begins.⁴⁶

Although the taxpayers argued that they should qualify as first-time homebuyers because the home they built was the first home they acquired as a marital unit, the Court disagreed. The Court found the language of the statute to be “plain, clear, and unambiguous” and the legislative history explicit that “the spouse of the individual also [must] meet this requirement as of the date the contract is entered into or construction commences.”⁴⁷

Holding. The taxpayers are liable for the 10% penalty. The first-time homebuyer exception does not apply.

Early Distribution Penalty: 401(k)

Keith Lamar Jones v. Commissioner, T.C. Summary Opinion 2005-173, November 29, 2005

IRC §72

+ **Exceptions to 10% Penalty Do Not Apply to Distributions from an Accountant's 401(k) Plan**

Facts. The taxpayer, Keith Lamar Jones, resigned from his position as an accountant at Deloitte & Touche to pursue a Ph.D. degree full-time. He withdrew over \$30,000 from his Deloitte 401(k) plan in 2001 to finance his education and purchase his first home. Jones was under age 59½ at the time he withdrew the funds.

Jones claimed the distribution from his retirement plan as income in 2001, but failed to pay the additional 10% penalty on the early distribution.

Issue. Is Jones liable for the additional tax on the early distribution of funds from his 401(k) plan that were used for education and a first-time home purchase?

⁴⁶ IRC §72(t)(8)(D)(iii)(II)

⁴⁷ S. Rept. 105-33 (1997)

Analysis. Early distributions from retirement plans are subject to income tax plus an additional 10% tax as a penalty to discourage premature withdrawals. Certain distributions are excepted from the penalty, under authorized circumstances. Although exceptions are provided for the qualified purchase of a first home and for education expenses, only distributions from individual retirement accounts (IRAs) are eligible for these exclusions.⁴⁸

The Court recognized the similarities between IRA and 401(k) accounts and acknowledged that Jones would not have been subject to penalty if he had rolled his 401(k) into an IRA account prior to taking his distribution. The Court concluded the statutory exception does not extend to distributions from 401(k) plans.

Holding. Jones is liable for the additional 10% penalty on the early distribution from his 401(k) plan even though the funds were used for educational and first-time homebuyer expenses.

Early Distribution Penalty: IRA

James M & Mary N Gorski v. Commissioner, T.C. Summary Opinion 2005-112, August 4, 2005

IRC §§72 and 529

+ **Student's College Expense Did Not Constitute Qualified Higher Education Expense**

Facts. The taxpayers received an early distribution of \$25,000 from their IRA. The purpose of the distribution was to pay for their daughter's college education. The income was reported on their Form 1040, but they did not pay the 10% early distribution penalty. Upon audit, the taxpayers substantiated that \$7,017 was used to pay for tuition, fees, room and board, and \$2,684 was used to pay for a computer, books, and household expenses. The taxpayer could not substantiate that the remainder of the \$25,000 was related to college expenses.

Issue. Are expenses for a computer, books, housewares, furniture, bedding and appliances qualified education expenses?

Analysis. Unless early IRA distributions are used for qualified higher education expenses, they are subject to a 10% early distribution penalty. Qualified higher education expenses include tuition, fees, books, supplies, and equipment required for enrollment or attendance at an educational institution. Room and board may be qualified higher education expense for students under guaranteed plans, who are at least half-time students. The expenses must be for the taxpayer, taxpayer's spouse, or any child or grandchild of the taxpayer or the taxpayer's spouse.

Holding. The court agreed the \$7,017 was used for qualified expenses. While books are qualified expenses, the taxpayers could not substantiate their expense or show that the books were required for the courses in which the student was enrolled. The taxpayer could not show that the computer was required by the college for enrollment, therefore it did not meet the qualification test. The remainder of the \$2,684 did not meet any of the requirements.

Increase in Social Security Contribution Base

Notice 2005-85, November 14, 2005

IRC §§408, 1401, 1402, 3510, 6017, and 6041

+ **Contribution Base Increased in 2006**

The social security contribution base will increase from \$90,000 in 2005 to \$94,200 in 2006. The threshold for domestic employee coverage increases to \$1,500. The 2006 amount required to earn one quarter of coverage increased from \$920 to \$970 per quarter.

⁴⁸ IRC §72(t)(2)

IRS Levies IRA of Partner

Sidney D Young v. United States Internal Revenue Service, U.S. Dist. Court, East. Dist., N.Y.; 00CV3921 (RJD)(JMA),
August 10, 2005

IRC §7426

+ **IRS Levies Partner's IRA**

Facts. The taxpayer was a partner in Castle Creek Inn & Resort. The IRS assessed tax against the partnership, which was not paid when the partnership dissolved. The IRS sent the taxpayer a Final Notice of Intent to Levy. Later, the notice was served on the broker who was custodian for the taxpayer's IRA.

The taxpayer offered to pay the levy on an installment basis, but the IRS denied the installment payment and levied against the account.

Issue. Was the IRS entitled to levy against the partner for a partnership debt?

Analysis. As a partner in Castle Creek, the taxpayer has joint and several liability for the partnership debts. Therefore, the payment from his IRA was not an overpayment of taxes, but satisfied the debt owed by the partnership for which the taxpayer was liable.

Holding. The court agreed with the IRS. Not only did the IRS take \$214,536 from his IRA account, he is required to include this amount in his gross income. However, the amount is not subject to the 10-percent early withdrawal penalty, even if the taxpayer is not 59 ½ year old.

Roth 401(k)

Economic Growth and Tax Relief Reconciliation Act of 2001

IRC §401

+ **Roth 401(k) Begins in 2006**

The 2001 Tax Act contained over 400 new tax rules. One of these, the Roth 401(k), took effect on January 1, 2006. This new 401(k) plan will allow taxpayers another opportunity to invest for tax-free retirement income. The Roth 401(k) is similar to the Roth IRA in that the contributions are made with after-tax dollars. The advantage of the Roth 401(k) is the 2006 contribution limit is \$20,000 compared to \$5,000 for the Roth IRA. In addition, there are no income limitations on the Roth 401(k).

TAX FRAUD

Tax Preparer Enjoined from Preparing Returns

J.E. Rosamond, DC La., 2005-2 USTC ¶150,639

IRC §§ 6694, 7402, and 7407

+ **Permanent Enjoinment Filed**

Facts. The preparer failed to respond to IRS requests or to appear in court. Based on the result of client audits, the IRS estimated the preparer's clients underpaid their 2002 and 2003 tax liabilities by over \$6.7 million. This amount was determined from 29 audits on tax returns and 22 audits on amended tax returns prepared by the defendant.

The tax preparer charged a fee of 4% of his clients' refunded amounts. He overstated deductions in order to inflate his fee. Upon audit, the average refund was overstated \$4,101. Areas where deductions were fictitious or inflated included:

- Medical expenses,
- Charitable contributions,
- Unreimbursed employee business expenses, and
- Miscellaneous deductions.

Issue. Should the tax preparer be permanently prevented from preparing tax returns?

Analysis. The IRS testified the tax preparer understood income taxes. When a client would question him on what to send IRS, he would tell them to send any documentation they had and tell IRS the balance of the expense was paid in cash.

Holding. The Court found that without a permanent injunction, the tax preparer would probably continue to prepare fraudulent tax returns. The tax preparer was permanently enjoined from preparing tax returns as an individual or in any name.



TAX LIENS

Lien against Marital Home

Janet L. Sei v. United States of America, No. Dist. Ill., East. Div.; 04 C 6446, August 22, 2005

IRC §6321

+ Transfer of Home by Divorce Decree

Facts. Janet and Keith Sei were married in 1984. During that time Keith founded four surgical assistant businesses. In 2001, the Sei's purchased a new home which was deeded as tenants-by-the-entireties. Janet testified she did not know how the property was titled.

In 2001, Janet learned the businesses were having financial problems and that Keith owed \$1,306,145 in back payroll taxes as the responsible person for the businesses. In May 3, 2002, the Sei's signed a \$285,000 mortgage on their home. Later in May and December, the IRS made assessments against Keith for the back payroll taxes. In March 2003, the Sei's divorced. The divorce judgment said the property was jointly owned by the Seis and a quit claim deed would be executed delivering the property to Janet. No quit claim deed was ever executed to convey Keith's interest to Janet.

The property was sold on August 4, 2003, and the escrow agent delivered one-half of the proceeds to Janet and held the other half because of Keith's back taxes. Janet claims that:

1. She purchased Keith's interest in the home when she and Keith took out the \$285,000 mortgage;
2. When she allowed Keith to "withdraw" his half-interest in the property by giving him the proceeds from the \$285,000 mortgage, he lost his right to the remaining value in the property;
3. "Withdrawing his equity in the property" by taking out the mortgage, any interest that Keith may have technically retained in the property was held in trust for Janet;
4. Keith improperly used his influence as Janet's spouse to convince Janet to allow him to "withdraw" money from the property even though he knew that the IRS was on the verge of filing liens; and
5. At the time the liens were created, Keith had no interest in the property under general equitable principles.

Issue. Is the IRS entitled to one-half of the proceeds from the home sale?

Analysis. The IRS is entitled to file a lien against property owned by a taxpayer if the taxpayer fails to pay a tax liability after payment is demanded. At the time the home was sold, both Janet and Keith's names were on the property title. Also, both names were on the \$285,000 mortgage. While the divorce court directed Keith to quit-claim the home to Janet, he never did so. Therefore, regardless of Janet's belief that she purchased Keith's interest in the home when she gave him the loan proceeds, the home remained titled in both names.

No documents exist to show that Janet purchased Keith's interest and no documents were ever recorded showing Janet as the sole owner of the property. Janet claimed that when Keith took the money, any interest he may have had technically retained in the property was held in a resulting or constructive trust for Janet. The court ruled Janet's situation did not create a trust.

Holding. The Court agreed with the IRS and allowed the IRS to keep one-half of the sale proceeds from the house. The Court agreed that morally, Janet had a claim on the entire property, but the court could not dispense moral justice.

TRAVEL AND TRANSPORTATION EXPENSE

Cents-Per-Mile Valuation

Revenue Procedure 2005-48, August 8, 2005

IRC §61

+ **IRS Releases 2005 Vehicle Cents-Per-Mile Valuation**

Purpose. To provide employers with the 2005 maximum vehicle valuation limit for which the cents-per-mile valuation may be used.

Background. If an employer provides an employee with a vehicle that is available for personal use, the value of the personal use must generally be included in the employees' income and wages. The value of the personal use may be determined using the cents-per-mile valuation rule. However, if the vehicle is provided after 1988, the cents-per-mile valuation rule may **not** be used if the value of the vehicle exceeds the annual limitation.

Analysis. For 2005, use of the cents-per-mile valuation rule is limited to passenger automobiles valued at \$14,800 and trucks or vans valued at \$16,300 or less. For employers entitled to use the fleet-average rule, the valuation limit is \$19,600 for passenger automobiles and \$21,300 for trucks or vans. To use the fleet-average rule, the employer must have 20 or more vehicles.

Mileage Substantiation

Brown v. Commissioner, T.C. Summary 2005-155, October 20, 2005

IRC §274

+ **Weekly Activity Sheets Not Sufficient for Substantiation of Mileage Expenses**

The Tax Court upheld the IRS's finding that a taxpayer should not be entitled to employee business expense deductions for mileage expenses related to the use of his two automobiles where his only basis for the write-offs were the weekly activity sheets that he was otherwise required to keep for his business as a sales rep.

Facts. Matthew Brown worked as an outside sales representative. As part of his duties, he frequently drove his automobile to visit existing and potential customers. In 2001, Matthew first used a Honda Accord for both personal and

business transportation and then used a Nissan Maxima for this purpose. Matthew submitted weekly activity reports to his employer. The weekly reports, however, did not reflect the number of miles driven, or any other details as to the business activity. He also kept a day planner for 2001 but that was lost sometime in early 2002. In addition, Matthew discarded his 2002 day planner. On his 2001 federal income tax return, Matthew claimed itemized deductions, the majority of which were for business expenses. On his 2002 federal tax return, he claimed itemized deductions, which also included employee business expenses. The IRS subsequently disallowed the deductions claimed on the returns. At trial, Matthew estimated the use of his automobiles in 2001 as being approximately 20% personal and the remainder business. He also submitted copies of the weekly reports provided to his employer for 15 weeks in 2001 and for the entire 2002 year.

Holding. The Tax Court held that Matthew was not entitled to deduct the claimed mileage expenses for his use of the Honda and the Nissan due to lack of substantiation. The court concluded that Matthew’s records failed the requirements of IRC §274(d), which provides “strict substantiation requirements for travel, meal, or entertainment expense deductions.” In this case, the weekly activity sheets submitted to his employer “were insufficient since they didn’t contain information establishing the amount of the expense, the time and place of each use, and the business purpose of the use of the Honda and the Nissan.” Furthermore, Matthew “lost his day planner for 2001 and disposed of the 2002 planner, and didn’t provide a reconstruction of his mileage expenses to satisfy the substantiation requirements.”

Per Diem Rates

Revenue Procedure 2005-67, October 3, 2005

IRC §§ 62, 162, and 274

+ Simplified Per Diem Rates for Post October 1, 2005 Business Travel

For travel after October 1, 2005, the IRS has 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 continental United States (CONUS) and a different rate for all areas outside the CONUS. The pre- and post-2005 CONUS amounts are as follows:

Optional High-Low Per Diem Rates	October 1–December 31, 2005	January 1, 2006 and After
High-cost areas	\$204 (\$158 lodging); \$46 for M&IE	\$226 (\$168 lodging); \$58 for M&IE
Other localities	\$129 (\$93 lodging); \$36 for M&IE	\$141 (\$96 lodging); \$45 for M&IE

These rates can only be used when an employer is paying an employee a per-diem rate. The rate is not available for self-employed taxpayers or nonreimbursed employees.

If employers have reimbursed under the per diem method for the first nine months of 2005, they may continue to use the pre-October rates for the remainder of 2005. They may also switch to the new rates using the same method.

Rates for individual localities can be found at www.gsa.gov/perdiem. The meal and incidental expense (M&IE) rate for locales in the continental United States (CONUS) not listed in the tables increased to \$39 per day from \$31 per day.

Employees who qualify as **transportation workers** may use \$52 as the M&IE rate for CONUS travel and \$58 for OCONUS travel.

Note. The Government Services Administration (GSA) changed some FY 06 lodging per diem rates in California, Colorado, Florida, Idaho, Missouri, New Jersey, New York, Ohio, Pennsylvania, South Carolina, Tennessee, Texas, Virginia, and Wisconsin. **Also, the GSA made changes to FY 06 M&IE rates for Cook and Lake Counties (Chicago) in Illinois.** The effective date of these changes is November 20, 2005.

See GSA Bulletin 06-3 at http://www.gsa.gov/gsa/cm_attachments/GSA_DOCUMENT/PerDiemBulletin06-3_R20546_0Z5RDZ-i34K-pR.doc for more details.

2006 Standard Mileage Rates

Revenue Procedure 2005-78, December 2, 2005

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

+ 2006 Standard Mileage Rate Lowered

Rev. Proc. 2005-78 sets forth the following standard mileage rates beginning January 1, 2006:

Purpose	Cents per Mile
Business	44.5
Medical/moving	18.0
Charitable (non-Katrina-related)	14.0
Charitable (Katrina-related)	32.0 (deduction) 44.5 (reimbursement)

Note. If employers fail to adjust the 2006 reimbursements from the 2005 rate of 48.5 cents, the excess reimbursement will be taxable income to the recipient.

The Katrina Emergency Relief Act of 2005 increased the charitable mileage rate for charitable travel directly related to the hurricane disaster.

Period	Deduction Rate	Reimbursement Rate
Aug. 25–Aug. 31, 2005	29¢ per mile	40.5¢ per mile
Sep. 1–Dec. 31, 2005	34¢ per mile	48.5¢ per mile
Jan. 1, 2006 and after	32¢ per mile	44.5¢ per mile

Revenue Procedure 2005-78 contains additional information and limitations on the use of the standard mileage rates.

Hybrid Car Deduction

IR 2005-132, November 7, 2005

IRC §§179A and 30B

+ 2006 Ford and Mercury Hybrids Certified for Clean Fuel Deduction

The IRS has certified the eligibility of 2006 model-year Ford Escape and Mercury Mariner hybrids for the IRC §179A clean-burning fuel deduction. Thus far, the only other 2006 model-year vehicles certified by IRS are the Toyota Highlander and Lexus RX 400h.

The following 2005 model-year vehicles also have been certified by the IRS:

- Honda Insight
- Honda Civic Hybrid
- Honda Accord Hybrid
- Ford Escape SUV
- Toyota Prius

Claiming the Deduction: The deduction, which may be taken whether or not the taxpayer itemizes, is available only to buyers of qualifying new clean-fuel vehicles and is taken in the year the vehicle is originally used. The deduction is \$2,000 for vehicles placed in service in 2005. No deduction will be allowed for clean-fuel vehicles placed in service after Dec. 31, 2005. However, qualified vehicles may be eligible for the new IRC §30B alternative motor vehicle credit.

Observation. The new credit amounts for 2006, estimated to be up to \$2,750 for the Toyota Prius, are more valuable than the current \$2,000 deduction. However, purchasers will have to wait to file their 2006 tax returns to claim them. Many potential buyers delayed taking possession of their qualified vehicles until early January of 2006 so they could take advantage of the new credit.

Note. A lessee of a certified vehicle may not claim the clean-fuel deduction; only the lessor is permitted to do so.

