Chapter 15: Rulings and Cases

EXPLANATION OF CONTENTS

Please Note. This chapter is a collection of selected cases, Revenue Rulings, Revenue Procedures, Treasury Regulations, Announcements, and Letter Rulings that have been issued during the past year, through approximately September 1, 2006. Since they appear in a condensed version, they should not be relied on as a substitute for the full documents. A full citation appears at the end of each item. This is not meant to be a comprehensive coverage of all tax law changes or explanations. It is intended to report the rulings and cases that are likely to be of interest to the average tax professional.

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

Substantial Authority

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

JUDICIAL SYSTEM FOR TAX DISPUTES

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

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

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

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

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

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

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

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

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

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

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

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

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

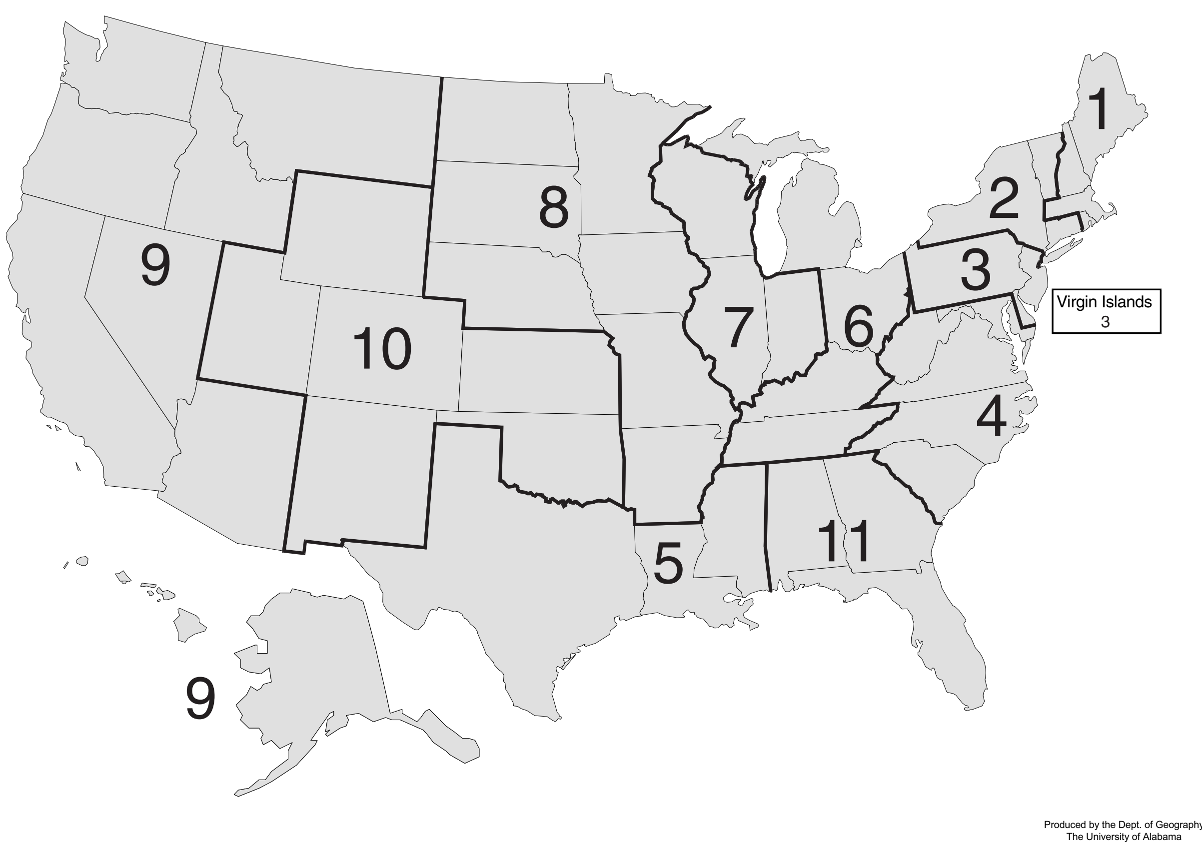
Any decision of the Tax Court can be appealed to the appropriate Circuit Court of Appeals. A final appeal can be made to the Supreme Court, but since its jurisdiction is discretionary, the court hears relatively few tax cases. Many of these court transcripts can be accessed online at **www.uscourts.gov.**

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

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

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

Federal Judicial Circuits and Districts



AGRICULTURAL ISSUES

Constructive receipt

Keith and Janet Scherbart v. Commissioner, 8th Cir. Ct. of Appeals No. 05-1325, July 5, 2006 aff'g TC Memo 2004-143, June 17, 2004
IRC §§451 and 453

☞ Deferral of Value-Added Payment Not Allowed

Facts. Mr. Scherbart, a corn farmer, was a member of the Minnesota Corn Processors (MCP) cooperative during 1994 and 1995. In return for making three deliveries of corn per year to MCP, Mr. Scherbart received units of equity participation in the co-op. MCP then processed the corn and sold it to third parties. MCP's members received contemporaneous payments for their deliveries, as well as "value-added" payments derived by allocating MCP's net proceeds at year end to the owners of units of equity participation.

In both August of 1994 and 1995, Mr. Scherbart was notified that value-added payments would be calculated and paid in mid-November of both years. Equity owners were offered an option to defer these payments for both years until January of the following year. Mr. Scherbart elected the deferral option for both years. The joint tax returns filed by the Scherbarts reported the value-added payments as income for the years in which they were received.

In 1998, the IRS determined that value-added payments could not be deferred since they were earned and payable in the preceding taxable year. The Tax Court agreed with the IRS's position, and the taxpayers appealed to the 8th Circuit.

Issue. Whether the taxpayers are entitled to defer the value-added payments to the years they were actually received.

Analysis. **In the IRS's opinion,** the legal consequences of the relationship between Mr. Scherbart and MCP is vital. MCP was acting as an agent of Mr. Scherbart. The receipt of income by MCP, on which the value-added payments were based, is considered receipt by Mr. Scherbart.

In Mr. Scherbart's opinion, the IRS is required by statute to treat the deliveries of Mr. Scherbart's corn to MCP as an installment sale. Under the installment sale method of reporting, the value-added payments should be recognized as income in the years they were actually received rather than in the previous years when they were calculated.

The taxpayers relied on a previous Tax Court case,[1] which permitted a farmer to defer the reporting of income from "deferred payment contracts" from an elevator. In that case, the Tax Court determined that the "deferred payments contracts" were not sham transactions. As a result, the deferral of income to the year of actual receipt was allowable.

Holding. The 8th Circuit upheld the Tax Court's determination that the deferral of the value-added payments was not permissible. The 8th Circuit emphasized the following in arriving at its decision:

- The deliveries of corn and the value-added payments based on MCP's net proceeds did not constitute an installment agreement.
- MCP was an agent of Mr. Scherbart.
- The deferral election Mr. Scherbart made regarding the value-added payments was voluntary.

Therefore, Mr.Scherbart constructively received the value-added payments in November when they were calculated by the co-op.

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1. *Schniers v. Commr.*, 69 TC 511, 1977

Farmers Audit Techniques Guide (ATG)

☞ IRS Releases New ATG for Farmers

The IRS released its new ATG for farmers. This guide is available on the IRS website at **www.irs.gov/pub/irs-mssp/farmers_072006,pdf.**

Tax preparers will find this guide helpful in understanding current emerging farm issues. Topics contained in this guide include the following:

- Audit flow
- Income
- Basis on farm assets
- Expenses
- Cotton
- Raisin grapes

Tobacco Payments

IRS News Release IR-2006-35, February 23, 2006
IRS Notice 2005-57, July 18, 2005
IRC §61

☞ Information Reporting Clarified

The termination of a tobacco quota is treated as a sale by the quota owner of an interest in land for which owners may receive payments over a period of 10 years. The owner receives a Form 1099-S, *Proceeds from Real Estate Transactions*, for the gross proceeds from the sale (including payments to be received in later years) from the United States Department of Agriculture.

Notice 2005-57 explains the amount reported on Form 1099-S is not necessarily the amount of taxable income to be reported in the year of sale. The owner may report the income utilizing the installment method. Under this method, the owner reports only the income received each year. For example, if in 2006 a quota owner exchanged a quota for 10 annual payments of $10,000 (equal to gross proceeds of $100,000), then the quota owner would receive a Form 1099-S reporting gross proceeds of $100,000. However, under the installment method, the owner reports as income for 2006 only the gain attributable to the $10,000 annual payment received that year.

Technical guidance clarifying Q & A-9 of Notice 2005-57 explaining the interaction of the information reporting rules with the rules governing the quota owner's computation of taxable income will be issued by IRS in the near future.

ALTERNATIVE MINIMUM TAX

ISOs

***Robert J. Merlo v. Commissioner*, 126 TC No. 10, April 25, 2006**
IRC §§55, 56, 1211 and 1212

☞ Capital Loss Limitations Apply for AMT Purposes

Facts. Mr. Merlo exercised incentive stock options (ISOs) in December of 2000 for 46,125 shares of stock in Exodus Communications, Inc. resulting in $1,066,064 of alternative minimum taxable income (AMTI). On Form 6251, *Alternative Minimum Tax — Individuals,* he reported excess AMTI over regular tax income of $452,025. This was calculated based on the FMV of the Exodus shares on April 15, 2001. The total tax liability reported on his return was $251,428, of which $116,973 was AMT tax liability. There was no alternative tax NOL deduction on Form 6251.

In 2001, Exodus filed for bankruptcy. The stock was worthless and resulted in a capital loss for AMT purposes of $1,075,289.

The IRS determined the taxpayer's computation was incorrect. The taxpayers were required to use the FMV at the **date of exercise,** thereby increasing AMTI from $1,001,776 to $1,607,166 resulting in a deficiency of $169,510. The taxpayers filed an amended return reporting a net decrease in tax of $116,973, since his shares of Exodus stock were subject to substantial risk of forfeiture and were not transferable. The IRS did not accept the amended return.

Issue. Whether the capital loss limitations of IRC §§1211 and 1212 apply to the calculation of AMTI and whether capital losses realized in 2001 reduce his AMTI in 2000.

Analysis and Holding. Noncorporate taxpayers are allowed to carry forward unrecognized capital losses to subsequent taxable years, but are not allowed to carry back unrecognized capital losses to prior taxable years.[2]

In an attempt to carry back his AMT capital loss, Mr. Merlo argued that the capital loss limitations do not apply to his AMT capital loss for purposes of calculating his AMTI. Therefore he is entitled to an AMTNOL deduction under IRC §56. Mr. Merlo also asserted "the intent of Congress in imposing an AMT tax on deferral preferences was to accelerate the taxation of economic income without creating an additional tax liability." The only way to comply with congressional intent is to allow him to carry back his AMT capital loss.

The Tax Court concluded the loss limitation rules of IRC §1212(a) apply when computing AMTI. Therefore, Mr. Merlo could not carry back the losses realized in 2001 to offset his AMTI realized in 2000.

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2. IRC §1212(b)

BAD DEBT

Nonbusiness Bad Debt

***William K. and Barbara G. Alt v. Commissioner*, TC Summary Opinion 2006-96, June 27, 2006**
IRC §166

☞ Parents Allowed Bad Debt Deduction on Loan for Son's Failed Business

Facts. In 1995, the taxpayers' son, Michael, convinced his parents to finance the purchase of a pet store business. They did so by lending or advancing Michael the following funds:

- $55,000 for the purchase of the business, which the taxpayers borrowed from a bank by mortgaging their home
- $42,000 for working capital, which came from their savings

On the advice of their attorney, Michael's parents executed an unsecured promissory note for the $55,000. However, no such note was executed by Michael for the $42,000.

Shortly after Michael bought the pet store, a new Wal-Mart opened nearby which competed directly with his business. By 2000, Michael became insolvent and closed the store. He had not made any loan repayments to his parents on the $55,000 promissory note before filing for Chapter 7 bankruptcy.

On their 2000 tax return, the taxpayers claimed a nonbusiness bad debt deduction of $55,000 as a short-term capital loss on Schedule D. The IRS disallowed the maximum $3,000 capital loss deduction and assessed additional tax of $970.

The IRS contended the alleged $55,000 debt did not constitute a valid debt because the note provided no repayment schedule, had no maturity date, and had no default provisions. The IRS concluded that the required debtor/creditor relationship did not exist between the taxpayers and their son Michael.

Issue. Whether the taxpayers are entitled to claim a $55,000 nonbusiness bad debt deduction for the 2000 tax year.

Analysis and Holding. The court rejected the IRS's position and allowed the claimed bad debt. In doing so, the court made the following observations:

- The court found the "candid testimony" of the taxpayers credible when they stated that they never expected repayment of the $42,000 advance to Michael from their savings. However, they explained that they did expect to be fully repaid for the $55,000 loan documented by the promissory note.
- The note executed by Michael was a "valid, enforceable obligation that was due on demand."
- There was a valid debtor/creditor relationship between the taxpayers and Michael.

BANKRUPTCY AND INSOLVENCY

New Procedure

Revenue Procedure 2006-24, May 30, 2006

☞ Prompt Determination Procedure Announced

Background. The trustee (or debtors in possession) representing the bankruptcy estate must follow a new procedure to obtain prompt determination of unpaid tax liabilities of the estate incurred during administration of the case. For bankruptcy cases filed **after October 17, 2005**, if a trustee files a proper determination request, the trustee, estate, debtor, and any successors to the debtor are discharged from any liabilities shown on the a return provided the taxes due are properly paid.

Request for Determination. The trustee must file a written report, in duplicate, with the Centralized Insolvency Operation (PO Box 21126, Philadelphia, PA 19114, **Attn: Request for Prompt Determination**) to request prompt determination of the unpaid tax liability. The request **must** include:

- An exact copy of the valid return(s),
- A statement specifying the return type and tax period for each return,
- The name and office location where each return was filed,
- The name of the debtor,
- The debtor's social security number, taxpayer identification number, or entity identification number,
- The type of bankruptcy estate,
- The bankruptcy case number, and
- The court where the bankruptcy case is pending.

Expectations. After the determination is filed, the request is assigned to a Field Insolvency office. Within 60 days of the request received date, the IRS determines whether the return will be examined. Incomplete requests are returned to the trustee, along with all related documents for completion. The 60-day period for notifying the trustee does not begin until the **complete package** is in the IRS's possession. If selected for exam, the trustee is notified of any tax due within 180 days after the request received date or within additional time permitted by the bankruptcy court.

This document replaces Rev. Proc. 81-17, 1981-1 C.B. 688.

Late Filed Returns

***Gary Wayne Colsen, Appellee v. United States*, 8th Cir. Ct. of Appeals, No. 05-2476, May 4, 2006 affirming decision in United States Bankruptcy Appellate Panel of the 8th Circuit, BAP No. 04-6042 NI, March 25, 2005**
11 U.S.C. §523

☞ Late Filed Returns Still Result in Bankruptcy Discharge

Facts. Mr. Colsen failed to timely file tax returns for 1992 through 1996. The IRS used "substitute for return" procedures to prepare the returns, issued notices of deficiency, and then assessed taxes, interest, and penalties during mid-1999. Later in 1999, Mr. Colsen filed income tax returns for 1992 through 1998 which the IRS examined and authorized partial abatements. In 2003, Mr. Colsen filed a petition for relief under Chapter 7 of the United States Bankruptcy Code and subsequently initiated an adversary proceeding claiming that his federal income tax liabilities for 1992 through 1996 were dischargeable.

The United States moved for summary judgment claiming the Forms 1040 filed by Mr. Colsen were not "returns" because they were filed after the IRS assessment occurred. The bankruptcy court disagreed stating the Forms 1040 qualified as returns, thus making the tax liabilities for 1992 through 1996 dischargeable. Both parties referenced *Beard*[3] to support their position. Both the bankruptcy court, as well as the United States Bankruptcy Appellate Panel (8th Circuit) agreed with the discharge. However, the government appealed the decision to the 8th Circuit Court of Appeals.

Issue. Whether the Forms 1040 filed by Mr. Colsen after the IRS original assessments qualify as returns for dischargeability under 11 U.S.C. §523 (a)(1)(B).

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3. *Beard*, CA-6 86-2 USTC ¶9496, aff'g 82 TC. 766, 1984

Analysis and Holding. The government argued the Forms 1040 filed by Mr. Colsen were **not returns** since they were filed after the IRS assessed the taxes. The bankruptcy court disagreed, finding the Forms 1040 were returns. Therefore, it allowed the discharge of the 1992 through 1996 taxes. The Tax Court found that a document does not qualify as a return unless the:

- Document contains sufficient data to calculate the tax liability,
- Document must purport to be a return,
- Document must be an honest, and genuine attempt at satisfying the requirements of tax law, and
- Taxpayer must execute the return under penalty of perjury.

The government argued that the returns filed after a substitute returns were assessed serves no purpose under the tax law. The 8th Circuit Court of Appeals held that the Forms 1040 qualified as returns within the meaning of the dischargeability exception, affirming the decision of the United States Bankruptcy Appellate Panel, although this approach differed from positions taken by the 4th, 6th, and 7th Circuits. The tax debts for 1992 through 1996 were dischargeable in bankruptcy.

Exempt Property

***Charles Benn, Jr. Debtor v. James. S. Cole, Trustee-Appellee,* United States Bankruptcy Appellate Panel of the 8th Circuit, No. 04-6053EM and 04-6054EM, April 6, 2006**
IRC §6402

☞ Bankruptcy Proceeding Allows Tax Refunds as Exempt Property

Facts. Mr. Benn filed a Chapter 7 bankruptcy petition on December 31, 2003. He claimed an exemption for all possible 2003 tax refunds to which the trustee filed an objection. Prior to entering the order for the claim of exemption, Mr. Benn received a refund of his 2003 income tax withholding from the IRS, and the state totaling $1,538. Mr. Benn's attorney held the checks pending a final judgment. The trustee filed a motion to turn over the refunds, to which Mr. Benn objected.

Based upon prior case law in the district, the bankruptcy judge found that a debtor's anticipated tax refund is not exempt. The bankruptcy judge then ordered it turned over to the trustee. This decision was appealed to the Bankruptcy Appellate Panel.

Issue. Whether the tax refunds are exempt property for purposes of the bankruptcy proceedings.

Analysis and Holding. IRC §6402 provides an exception to the rule that refunds are to be paid by the IRS directly to the taxpayer for certain past due obligations (state income tax debt), but it does not authorize attachment, execution, or garnishment of the federal government.

Mr. Benn argued that state law exempts both his federal and state tax refunds. The court looked at case law for clarification of what is exempt from attachment and execution and concluded that a debtor for which an attachment may be issued must be certain and not contingent. Since the refunds were contingent on the petition dates, they could not be attached by creditors and were considered exempt property under state law.

The Bankruptcy Appellate Panel reversed the bankruptcy court decision holding that tax refunds are exempt property.

Responsible Person for Assessment of Trust Fund Recovery Penalty

***Douglas J. Thatcher v. IRS*, Bankruptcy Court for Middle District of Pennsylvania, 1-04-bk-03689MDF, April 26, 2006**
IRC §6672

☞ Debtor/Restaurant Manager Held to be Responsible Person

Facts. Douglas Thatcher, who previously owed his own restaurant, was hired as manager of "Casey's Clubhouse" on July 1, 2001 by its owner, Mike Casey. As manager, Mr. Thatcher had broad authority, including the following:

- Permission from the owner to sign checks drawn on the restaurant's checking account, including payroll checks
- Permission from the owner to sign Forms 941, *Employer's Quarterly Federal Return*, which were prepared by the restaurant's accountant

Mr. Thatcher signed the Form 941 for the 3rd quarter of 2001. Even though it reported a total tax liability of $6,520, Mr. Thatcher wrote a check to the IRS in the amount of only $66 and remitted it with the return.

The IRS determined that Douglas Thatcher was the "responsible person" and assessed the 100% trust fund recovery penalties against him for unpaid employment taxes. The IRS contended that he was liable for these penalty assessments for the 2nd and 3rd quarters of 2001 and the first three quarters of 2002. In 2004, Mr. Thatcher filed for Chapter 7 bankruptcy protection and petitioned the Bankruptcy Court for discharge of the IRS penalty assessments which totaled $48,000.

Issue. Whether, under IRC §6672(a), Mr. Thatcher is liable for the 100% trust fund recovery penalties for the five quarters in question.

Analysis. The Internal Revenue Code requires employers to withhold from the wages of their employees certain **"trust fund taxes."**[4] IRC §6672(a) provides:

Any person required to collect, truthfully account for, and pay over any tax imposed [by this title] who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.

The court considered the following points in arriving at its conclusion:

- Even though Mr. Thatcher was not an owner of the restaurant business, he clearly exercised significant control over financial aspects of the business.
- After Mr. Thatcher signed the 2001 3rd quarter Form 941, he then signed the $66 check as partial remittance for the $6,520 balance of tax due shown on the return. From that point in time forward, he was aware that trust fund taxes were not being remitted to the IRS as required.
- As of October 31, 2001, Mr. Thatcher either was aware that other business liabilities were paid in preference to withholding taxes, or he recklessly disregarded this fact.

Holding. The Bankruptcy Court determined that Mr. Thatcher was liable for the trust fund recovery penalties for four of the five quarters in dispute. He was liable for the penalty assessments for the 3rd quarter of 2001 and the first three quarters of 2002. Therefore, those debts were not discharged. The court determined that he was not liable for the penalty assessment for the 2nd quarter of 2001 during which he was initially hired. Therefore, the debt for that quarter was discharged.

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4. IRC §§3102, 3402 and 7501

BUSINESS EXPENSES

Personal vs. Business Use

***Charles E. and Sandra A. Anderson v. Commissioner*, TC Memo 2006-33, February 27, 2006**
IRC §280A

☞ Disallowed Deductions for Dual-Use Portions of Inn

Facts. During 2000, Mr. and Mrs. Anderson purchased and began operating Eureka Street Inn (Inn), a California bed and breakfast. Both the Andersons and Mrs. Anderson's parents used part of the Inn as their personal residence. In 2000, $26,476 of rental income resulted from 289 separate room rentals. The Inn has three usable floors with 5,664 total square feet utilized as follows:

- 4,363 square feet used exclusively for Inn operation,
- 695 square feet used exclusively for personal purposes, and
- 606 square feet for both business and personal purposes (dual-use) with 75% for business purposes and 25% for personal (lobby, registration area, office, kitchen, and laundry room).

On their tax return, 4,818 square feet was determined to be business usage [4,363 + (75% × 606)]. The business-use percentage for the entire Inn amounted to 85% (4,818 ÷ 5,664 square feet) with the remaining 15% being personal use. The 85% was applied to the total depreciation and interest expense relating to the Inn. Since the Anderson's treated the Inn as a commercial structure, the exclusive-use limitations of IRC §280A(f)(1)(B) were determined not to apply.

The IRS applied the exclusive-use limitation of IRC §280A(f)(1)(B) and disallowed all deductions for the dual-use portion of the Inn. Allowable depreciation and interest deductions were allowed for the 77% portion exclusively used for business.

Issue. Whether the taxpayers are entitled to deductions for the portion of the Inn which is used for both business and personal purposes.

Analysis and Holding. IRC §280A disallows any business deduction for expenses relating to a dwelling unit used as a personal residence. However, IRC §280A(f)(1)(B) provides when portions of a dwelling unit are used **exclusively** as a hotel, motel, inn, or similar business, the portion that is used exclusively and solely for the business is not considered part of a dwelling unit and a deduction is allowed (the hotel exception). Both the disallowance rule and exclusive-use exception work together in that once personal use exceeds the acceptable limit, the only portion of a bed-and-breakfast excepted from the disallowance rule is the portion used exclusively for business.

At trial, the Andersons used a hypothetical example involving a 500-room hotel where the owner's use of the lobby was de minimis and should not eliminate the lobby as "used exclusively for business." Thus, the general disallowance rule of IRC §280A(a) should **not** apply to the dual-use portion.

The court agreed with the IRS position. It found the exclusive-use exception does not consider the size of the establishment. The court concluded that the dual-use portion of the Inn was not excepted from the disallowance rule because it was not used solely for business purposes.

Gambling Activity

***James Castagnetta v. Commissioner*, TC Summary Opinion 2006-24, February 13, 2006**

IRC §162

☞ Regular Horse Track Gambler Engaged in Trade or Business

Facts. James Castagnetta, who worked three days a week as a truck driver, had 2001 wages of about $18,000. His work days started at 5 a.m. and ended at noon. His passion was handicapping and betting on live and closed circuit simulcast horse races at Yonkers Raceway. In 2001, he spent more than 250 days in this activity.

He kept meticulous records of his gambling activity, including:

- Amount of daily wagers
- Amount of daily winnings
- "Speed figures" on all horses updated in chronological order (maintained on his personally designed computer spreadsheets)
- Racing forms and programs
- Losing betting tickets

He generally bet 2.5% of his "bankroll" on each race. During 2001, he won on average of $1.04 for every dollar bet he placed. According to the racetrack, Yonkers Raceway pays about 83¢ for each dollar bet placed.

He reported his 2001 racetrack betting activity on Schedule C. It showed the following:

Gross receipts (winnings)	$52,501
Less: total wagered	(50,725)
Gross income	$ 1,776
Less: expenses (supplies & racing forms and programs)	(1,542)
Net profit	$ 234

The IRS determined that the activity did not constitute a trade or business. The $52,501 winnings were recharacterized as "Other income" (page 1 of Form 1040) and the losses of $50,725 were allowed as a miscellaneous itemized deduction in lieu of the standard deduction. The IRS assessed an additional tax of $863.

Issue. Whether the gambling activity constituted a trade or business for purposes of IRC §162 business deductions.

Analysis and Holding. The court ruled that the "gambling activity was conducted with the requisite continuity and regularity to allow for treatment as a trade or business." The court was convinced that the taxpayer's primary purpose for engaging in the activity was to realize a profit. The Schedule C figures were accepted and the IRS deficiency was ruled invalid.

> **Note.** This Summary Opinion of the Tax Court cannot be cited as authority. The court warned that "our holding in this case does no more than resolve the year (2001) in issue." The court also noted that "maintaining a 'bankroll' used exclusively for gambling purposes strongly suggests that his (Mr. Castagnetta's) gambling activity does **not** constitute a trade or business."

Capital versus Ordinary

Letter Ruling 200607003, February 17, 2006

IRC §§162 and 263

☞ Mold Remediation Project Determined Ordinary Expense

Purpose. To determine if costs incurred in a mold remediation project are deductible under IRC §162 as ordinary and necessary business expenses.

Background. Taxpayer purchased a building with several wings to operate a skilled nursing facility. At the time of purchase, there was no sign of mold in the building. A few years later, taxpayer stopped operating the skilled nursing facility and began renting it for use as a skilled nursing facility. Subsequently, a severe mold problem was found in one of the wings as a result of roof leaks and condensation problems.

An extensive and costly mold remediation project was undertaken to keep the building in efficient operating condition. Part of the cost was paid by insurance proceeds with the remaining cost incurred by the taxpayer. This project did not substantially prolong the useful life of the building, add to its value, or adapt it to new use.

Analysis. IRC §162 allows a deduction for ordinary and necessary expense paid or incurred in carrying on a trade or business. IRC §263(a) provides that no deduction is allowed for any amount paid for permanent improvements to increase the value of the property, prolong the useful life, or adapt if for a different use.

Holding. Since the mold remediation project did not structurally alter the building, adapt the building to a new or different use, prolong its useful life, or increase the value of the building, the mold remediation project expenses are deductible as ordinary and necessary business expenses.

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

Facts. 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 stepmother, 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.

Analysis. 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. 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."[5]

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.

Conclusion. The court disallowed all costs for unsubstantiated improvements. It also disagreed with the taxpayers' claim that the improvements were "gifts" to the property owners by Mrs. Hatch.

CORPORATIONS

Qualified Personal Service Corporation (QPSC)

***Ron Lykins, Inc. v. Commissioner,* TC Memo 2006-35, March 2, 2006**
IRC §448

☞ Split Avoids QPSC Determination

Facts. Ronald Lykins, a CPA with an MBA and PhD, began preparing tax returns in 1969 and providing accounting services. He also expanded into financial and investment advice. He incorporated as Ron Lykins, Inc. (C corporation) in 1980. Due to the immense amount of time required for the financial and investment services, he formed Lykins Financial Group, LLC under Ohio law in 2000 to handle this portion of the business. Lykins, Inc. continued to offer tax services.

Segregating the income for each business was easy; segregating the expenses was more of a challenge since both businesses shared the same office space, phone number, copy machine, fax, employee manual, and coffee machine. Some employees worked separately for the distinct businesses, while others performed services for both operations. To further complicate matters, Lykins, Inc. provided overhead services such as reception and payroll to Lykins Financial. The expenses were allocated between the two companies based on Mr. Lykins testimony of the actual number of hours worked. Each entity filed a separate corporate tax return.

The IRS examined Lykins, Inc. for 1999 and 2000 and determined it was a "qualified personal services corporation" (QPSC) for the 2000 year.

Issue. Whether Ron Lykins, Inc. is a QPSC for the 2000 tax year.

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

Analysis. IRC §448(a)(2) defines QPSCs as corporations in which substantially all activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial sciences, performing arts, or consulting, and in which substantially all stock is held by employees performing services for such corporation.

The Court looked at two tests to make the decision: **ownership and function**.

The **ownership** test is clearly determined since Mr. Lykins is the sole shareholder. He therefore meets the equal to or greater than 95% ownership test.

The **function** test deals with substantially all or one of the enumerated services found in the statute. The "substantially all" test is satisfied when employees spend at least 95% or more of their time performing services in a qualifying field.

Holding. The breakdown for Ron Lykins, Inc. showed 80.53% of the employee hours in 2000 were spent on accounting services, not the 95% which is required for consideration as a QPSC. The court agreed with the taxpayer.

Debt versus Equity

***Indmar Products Co., Inc. v. Commissioner,* 6th Cir. Ct. of Appeals, No. 03-15428, April 14, 2006**
IRC §163

☞ Interest Deductions Allowed Based on Shareholder Advances

Facts. Indmar Products Co., Inc. (Indmar) was a successful manufacturer of marine engines. It did not declare or pay formal dividends during any years at issue. From the 1970s until present time, the shareholders advanced funds to Indmar with a guaranteed 10% annual return paid out on the advanced funds. The 10% return was treated as interest expense on the corporate return and as interest income on the individual returns. Prior to 1993, no documents were executed for these transactions. Beginning in 1993, demand loan notes were executed to cover all the advanced funds.

On the 1998–2000 tax returns, Indmar claimed deductions for interest paid on the shareholder advances. The IRS disallowed the payments and the taxpayer petitioned the Tax Court. The Tax Court ruled the advances were not genuine debt and disallowed the interest expense deductions. Indmar appealed.

Issue. Whether the shareholder advances to a closely-held corporation were loans, not equity, thus allowing an interest expense for monies paid on the advances.

Analysis. Initially, the Tax Court concluded the advances were equity contributions. However, the 6th Circuit determined the Tax Court erred by not addressing evidence such as:

- Fixed rate of interest and interest payments clearly indicate the advances were bona fide debt
- Subsequent history of executed notes
- Advances documented by demand notes with a fixed rate of interest and regular interest payments
- Additional debt from outside source
- Advances clearly used for working capital
- Lack of a sinking fund not significant in light of Indmar's sound capitalization

Holding. The Tax Court decision was reversed. The advances truly were loans giving rise to interest deductions on the corporate returns.

Net Operating Loss

***Garber Industries, Inc. v. Commissioner,* 5th Cir. Ct. of Appeals, No. 05-60142, January 9, 2006**
IRC §§318 and 382

☞ Brothers Are Not Family Members For NOL Carryforward Purposes

Facts. Garber Industries (Garber) incorporated in 1982 under the 94% ownership of two brothers (Kenneth and Charles). In July 1996, Garber undertook a reorganization in which the two brothers' ownership shifted from 68% and 26% to 19% and 65% respectively. Subsequently, in April 1998, Kenneth and his wife sold all of their shares to Charles at which time Charles' interest increased from 19% to 84%.

Garber incurred net operating losses (NOLs) from 1983 to 1989 and then again in 1992. At the end of 1997, the balance of NOL carryforwards was over $20 million.

The 1998 tax return for Garber claimed an NOL carryforward deduction in excess of $800,000. The IRS examination for 1997 and 1998 determined the NOL deduction was limited to $121,258, due to the ownership change under IRC §382. A notice of deficiency was issued and challenged in Tax Court. The Tax Court ruled in favor of the IRS. It held that the sale between the brothers constituted an ownership change, thus limiting deductibility of the NOL carryforward. Garber appealed the decision.

Issue. Whether an ownership change occurred which triggered a limitation in the deduction of NOL carryforwards by Garber under IRC §382 provisions.

Analysis. IRC §382 provides limitations on NOL carryforwards following ownership change. IRC §318(a)(1) defines the members of a family as the individual stockholder and the stockholder's spouse, parents, children, and grandchildren. The code clearly defines family members and such definition does not include brothers. Garber argued that the brothers should be treated as family members since they have common parents and grandparents and, as such, would be members of the same family.

Holding. The 5th Circuit Court of Appeals concluded "family membership" rules should be applied from the perspective of individuals who are shareholders. Based on the literal reading of IRC §318, the brothers are not members of the same families. Therefore, the limitation in the deduction of NOL carryforwards was not limited by IRC §382. The Tax Court decision was upheld.

CREDITS

Hybrid Tax Credit

IRS News Release IR-2006-28 (February 8, 2006)
IRS News Release IR-2006-56 (April 7, 2006)
IRS News Release IR-2006-57 (April 7, 2006)
IRS News Release IR-2006-67 (April 25, 2006)
IRS News Release IR-2006-86 (June 1, 2006)
IRS News Release IR-2006-98 (June 21, 2006)
Notice 2006-9 (January 13, 2006)
IRS News Release IR-2006-108 (July 11, 2006)
IRS News Release IR-2006-110 (July 11, 2006)
IRS News Release IR-2006-122 (August 9, 2006)
IRS News Release IR-2006-125 (August 14, 2006)
IRS News Release IR-2006-126 (August 14, 2006)
IRC §179A and 30B

☞ Qualified Hybrid Vehicles Qualify for Credit

The Energy Policy Act of 2005 authorizes a credit for acquiring certain energy efficient vehicles. The manufacturer must certify the specific make, model, and year of the vehicle as well as the credit amount.

To qualify for the credit, the taxpayer must meet the following requirements with respect to the vehicle:

- The vehicle must be placed in service **after December 31, 2005** and **purchased on or before December 31, 2010,**
- **Original use** must begin with taxpayer,
- Acquired for use or lease by taxpayer claiming credit,
- Used predominantly within the US.

Forms used to claim the credits are:

- **Form 8910**, *Alternative Motor Vehicle Credit* (personal use)
- **Form 3800,** *General Business Credit* (business use)

Current IRS acknowledged hybrid vehicles and credit amounts are:

Make	Year	Model	Credit Amount
Chevrolet	2006	Silverado 2WD Hybrid Pickup Truck	$ 250
	2006	Silverado 4WD Hybrid Pickup Truck	650
	2007	Silverado 2WD Hybrid Pickup Truck	250
	2007	Silverado 4WD Hybrid Pickup Truck	650
Ford	2006	Escape Hybrid 2WD Front Wheel Drive	2,600
	2006	Escape Hybrid 4WD	1,950
	2007	Escape Hybrid 2WD	2,600
	2007	Escape Hybrid 4WD	1,950
GMC	2006	Sierra 2WD Hybrid Pickup Truck	250
	2006	Sierra 4WD Hybrid Pickup Truck	650
	2007	Sierra 2WD Hybrid Pickup Truck	250
	2007	Sierra 4WD Hybrid Pickup Truck	650
Honda	2005	Accord Hybrid AT and Navi AT	650
	2005	Civic Hybrid CVT and MT	1,700
	2005	Insight CVT	1,450
	2006	Accord Hybrid AT w/updated calibration and Navi w/updated calibration	1,300
	2006	Civic Hybrid CVT	2,100
	2006	Insight CVT	1,450
Lexus	2006	RX400h 2WD and 4WD	2,200
	2007	GS450h	1,550
Mercury	2006	Mariner 4WD Hybrid	1,950
	2007	Mariner 4WD Hybrid	1,950
Saturn	2007	Vue Green Line	650
Toyota	2005	Prius	3,150
	2006	Highlander 2WD and 4WD Hybrid	2,600
	2006	Prius	3,150
	2007	Camry Hybrid	2,600

Notice 2006-9 provides procedures for manufacturers to certify which vehicles qualify for the credit and the credit amount. As of July 12, 2006, the IRS acknowledged the following quarterly reports:

Manufacturer	Quarter Ended	Number of Vehicles Sold to Dealers
Ford	June 30, 2006	5,663
GM	June 30, 2006	1,388
Honda	June 30, 2006	9,424
Toyota (including Lexus)	June 30, 2006	>60,000

Currently, the new qualified hybrid motor vehicle credit begins to phase out in the second calendar quarter after the calendar quarter in which at **least 60,000** of the manufacturer's qualifying passenger automobiles and light trucks have been sold.

The 60,000 vehicle threshold was met for Toyota and Lexus vehicles during the second quarter of 2006. Therefore, the phaseout reduction of the credits for these vehicles will begin for those purchased after October 1, 2006. The applicable reduced credit percentages for Toyota and Lexus models are shown below:

Purchase Date of Vehicle	Allowable Credit %
October 1, 2006–March 31, 2007	50%
April 1, 2007–September 30, 2007	25%
On or after October 1, 2007	0%

Example 1. Ella purchased a new 2006 Toyota Prius on October 15, 2006. Her allowable credit will be $1,575 ($3,150 × 50%).

Earned Income Credit

Richard A. Mullen v. Commissioner, **TC Summary Opinion 2006-91, May 30, 2006**

IRC §§2 and 32

☞ Separation Agreement Deciding Factor

Facts. Mr. Mullen and his wife, Lisa, separated in the late 1990's. They have two children. In September 2000, Lisa filed for divorce. It was agreed that she would have physical custody of the children, although legal custody was still in dispute between them. Mr. Mullen leased a large house in June of 2002 which he apparently shared with his landlord. The lease agreement stated that the children would stay at the house at least 50% of the year.

The Mullens entered into a separation agreement in November 2003, in which they agreed to share legal custody of the children, and the children would reside primarily with Lisa. In addition, the separation agreement gave Mr. Mullen the right to have the children for a total of 182 days during the year as determined by a specific schedule. The "schedule" was not adhered to by either party. However, Mr. Mullen kept a record of the days the children stayed with him.

Mr. Mullen filed his 2003 return utilizing the head of household filing status and claiming an earned income credit of $1,509 based on his two qualifying children. The IRS determined Mr. Mullen's filing status should be single, and it also disallowed the earned income credit.

Issue. Whether the taxpayer qualifies as head of household and is entitled to earned income credit

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Analysis and Holding. At trial, the IRS argued Mr. Mullen did not qualify for head of household status since neither of his children lived with him for more than half the year. In addition, the related earned income credit was denied. Mr. Mullen stated both of his children lived with him for more than half the year. Lisa testified in direct opposition to Mr. Mullen. Mr. Mullen cross examined Lisa regarding her proof of the amount of time the children lived with her to which she responded, "Well, I guess it's my word against yours."

The court determined the children resided with each of the parents for at least 50% of the year with such a close proximity to being equal. In the separation agreement, they expressly agreed that "the children shall reside primarily" with her. Based on the agreement, Mr. Mullen's residence was not the principal abode of either children for more than half of 2003. The court concluded Mr. Mullen did not qualify as head of household and was not entitled to the earned income credit.

Lifetime Learning Credit

***Jayesh B. and Devsmita J. Patel v. Commissioner,* TC Summary Opinion 2006-40, March 16, 2006**
IRC §25A

☞ Prepaid Tuition Generates Credit in Year of Payment

Facts. Mr. and Mrs. Patel paid $3,611 to York College in 2001 for qualified prepaid tuition expense for their dependent niece Ami since they were going to be out of the country when the tuition became due in January/February of 2002. Ami was a full-time student during the 2002 tax year. On their 2002 tax return, the Patels claimed a Lifetime Learning Credit for Ami via Form 8863, *Education Credits (Hope and Lifetime Learning Credits)*. The credit was computed by adding the prepayment made in 2001, plus the other qualified education expenses paid in 2002. This totaled $7,600, resulting in a $1,000 education credit.

The IRS disallowed $250 of the credit for 2002 since the payment was made in 2001 and could have been claimed on the 2001 tax return. The taxpayers disagreed with the IRS decision.

Issue. Whether prepayment of $3,611 tuition in 2001 for the spring 2002 semester entitles them to a Lifetime Learning Credit under §25A in tax year 2002.

Analysis. IRC §25A(c)(1) provides the Lifetime Learning Credit is an amount equal to 20% of the qualified tuition and related expenses paid during the taxable year for education furnished during any academic period beginning in such taxable year which does not exceed $10,000. IRC §25A(g)(4) provides that if qualified tuition and related expenses are paid by the taxpayer during a taxable year for an academic period which begins the first three months following such taxable year, such academic period is treated as beginning during such taxable year.

In this case, the prepaid qualified tuition payment of $3,611 was made in 2001 for the 2002 spring semester, an academic period which begins during the first three months following taxable year 2001.

Holding. The court upheld the IRS determination that the prepayment is an expense for 2001 and should have been claimed on their 2001 tax return.

Caution. A **prepayment** for academic periods falling outside the three-month window would **not** support a credit for any tax year.

DEDUCTIONS

Unlawful Discrimination

Letter Ruling 200550004, December 16, 2005
IRC §62

☞ Retirement Plan Settlement Results in Deductible Attorney Fees

Purpose. To determine if attorney fees and court costs paid to obtain pension benefits are deductible under IRC §62.

Background. The taxpayer was employed by Company A and then was employed by Company B until retirement. While employed by Company B, changes where made to the pension plan which increased benefits for employees other than the taxpayer and those similarly situated. The taxpayer retired and received a lump-sum payout of retirement benefits. He inquired if the lump-sum payment was correct after taking into consideration changes to the pension plan. Even though the pension consultant admitted the taxpayer's employment with Company A **was not considered** in the lump-sum payout computation, Company B advised that the final pension benefits were "calculated appropriately."

The taxpayer took the case to court, which resulted in adverse summary judgments to both parties. A settlement agreement was entered into between both parties with monies being paid to the taxpayer and his attorney for services rendered. The entire amount received (taxpayer and taxpayer's attorney receipt) was includible in the taxpayer's gross income.

Analysis and Conclusion. IRC §62(a)(19)[20], enacted by AJCA of 2004, provides that adjusted gross income means gross income minus any deduction allowable under Chapter 1 for attorney fees and court costs paid by or on behalf of taxpayer in connection with any action involving a claim for **unlawful discrimination**. **Under the definition of IRC §62(e)(18)(ii), this settlement qualifies as a claim of unlawful discrimination.** The attorney fees and courts costs paid directly to the attorney are deductible in arriving at AGI.

> **Note.** See Example 16 in Chapter 2, "Individual Taxpayer Problems," for more information on how to report the receipt of unlawful discrimination lawsuit settlements.

DEPENDENCY ISSUES

Custodial Parent

Form 8332 Instructions
IRC §152

☞ New Definition for Custodial Parent In Form 8332 Instructions

Updated Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents*, is now available on **www.irs.gov.** The form contains definition changes as the result of GO Zone Act of 2005 which are **retroactive to January 1, 2005**.

New definitions include:

- **Custodial parent** — parent who has custody of a child for the greater part of the year. Custody means child lives in the parent's main home.
- **Noncustodial parent** — parent who is not the custodial parent. If a noncustodial parent claims an exemption for a child, the custodial parent must sign Form 8332 (or similar statement) with the form being **attached** to the noncustodial parent's return.

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DIVORCE

Alimony

***Carol A. Johanson and Alfred F. Melzig, Jr. v. Commissioner,* TC Memo 2006-105, May 15, 2006**
IRC §71

☞ Interpretation of State Law Results in Taxable Alimony to Ex-Wife

Facts. The taxpayer, Carol Johanson, and her ex-husband were divorced in California in 1996. The "Marital Settlement Agreement" was approved and incorporated into the divorce decree by the state court. The agreement specifically and unambiguously stated that:

- Carol's ex-husband will pay "spousal support" to her in the amount of $5,250 per month.
- The "spousal support" shall continue at the $5,250 monthly amount through October 31, 2010, at which time Carol's right to collect it will permanently terminate.

However, the divorce was silent regarding whether the spousal support payments would end if Carol died prior to October 31, 2010. The 2002 joint tax return filed by Carol and her present husband, Alfred, omitted the $63,000 total spousal support payments Carol received. The IRS determined the $63,000 represented taxable alimony and assessed additional 2002 tax of $20,475.

Issue. Whether the spousal support payments constitute alimony under IRC §71.

Analysis. IRC §71(b) defines the terms alimony or separate maintenance payments which are taxable to the recipient. One of the requirements is that "there is no liability to make any such payment for any period after the death of the payee spouse."[6] California state law clearly provides that "except as otherwise agreed by the parties in writing," spousal support payments "terminate upon the death of either party."[7]

Holding. The court held that the $63,000 constituted taxable alimony to Carol for 2002.

> **Note.** In most states, including Illinois, the state statutes are identical to the California provision. For example, if an Illinois divorce decree is silent regarding the issue, the obligation of the payor-spouse to make the spousal support payments **terminates** upon the death of either spouse.[8] Therefore, the tax result would be identical to the decision reached in this Tax Court case.

6. IRC §71(b)(D)
7. California Family Law Code §4337
8. Illinois Revised Statutes §510(c)

EMPLOYMENT TAX ISSUES

Worker Classification

***Western Management, Inc. v. Commissioner,* 9th Cir. Ct. of Appeals, No. 04-70795, April 12, 2006**

IRC §§3111, 3301, 6656, 6662, and 7436

☞ Sole Shareholder Deemed Statutory Employee

Facts. Mr. Robert Kovacevich was the president, secretary-treasurer, and sole shareholder of Western Management, Inc. (WM). In 1981 Mr. Kovacevich received an annual salary of $28,000. Eventually his salary grew to $60,000. Mr. Kovacevich performed all services for WM to generate gross receipts including:

- Signing checks, and paying bills
- Hiring employees, and determining employee compensation
- Renewing malpractice insurance
- Signing federal tax returns

In addition, Mr. Kovacevich also received funds as needed, and was not compensated for services at predetermined intervals. During 1994 and part of 1995, MW issued checks to Mr. Kovacevich, his wife, and their creditors to the extent of $132,000 and $33,250 respectively. Mr. Kovacevich considered these payments to be draws which were classified as loans on the corporate return. Forms 1099-MISC were not issued for the payments made on behalf of Mr. Kovacevich. In addition, WM sponsored a defined benefit plan for Mr. Kovacevich from 1982 through 1992.

The MW corporate income tax returns for 1994 and 1995 claimed officers' compensation expenses of $132,000 and $133,000, respectively. This compensation was not given at predetermined intervals but, rather as Mr. Kovacevich needed the money.

The IRS determined Mr. Kovacevich to be an employee of WM for purposes of federal employment taxes and that WM was not entitled to IRC §530 relief. Total tax and penalties for 1994 and 1995 amounted to over $75,000. The Tax Court agreed with the IRS determination and WM appealed to the 9th Circuit.

Issues. Whether

1. Robert E. Kovacevich was an employee for federal employment tax purposes,
2. Relief is available under IRC §530,
3. Employment taxes under IRC §§3111 and 3301 were owed, and
4. Penalties were owed under IRC §§6656 and 6662(a).

Analysis and Holding. IRC §§3111 and 3301 impose taxes on employers under FICA and FUTA, respectively, based on wages paid to employees. IRC §530 provides relief from employment tax liability, notwithstanding the actual relationship between the taxpayer and the individual performing services. IRC §§6656 and 6662(a) impose underpayment in tax penalties for failure to deposit and negligence, respectively.

WM treated Kovacevich as an employee by paying him a $60,000 salary in 1991, and issuing him a Form W-2. WM also filed an amended Form 941, *Employer's Quarterly Federal Tax Return*, in 1991, and in his capacity as president, Kovacevich included the following statement:

The amount of earnings of Employee Robert E. Kovacevich was not clear, hence was left off. The Employee paid all Income Tax due, hence the withholding is unnecessary. However the Social Security Tax is due. A completed W-2(c) form is included.

The Tax Court determined Mr. Kovacevich, the sole shareholder and president of WM, was also an employee of the corporation. The corporation was liable for FICA and FUTA taxes and income tax withholding on amounts paid to Mr. Kovacevich. Since the employee paid income tax on the compensation, the employer was not liable for withholding tax, although it could still be liable for penalties for its failure to withhold. The Tax Court also found that the corporation was not entitled to relief under Section 530 of the Revenue Act of 1978. To be entitled to relief, the corporation must not have treated the individual as an employee, must have filed returns in a consistent manner, and must have had a reasonable basis for not treating the worker as an employee.

Holding. The 9th Circuit found that Mr. Kovacevich exercised sole authority over major corporate decisions, such as paying creditors, signing checks, signing tax returns and drawing money from corporate accounts. Amounts paid to him clearly were compensation for services. The corporation deducted the payments as "officer compensation" and Mr. Kovacevich used the funds to pay personal expenses of his wife and himself. The only reversal to not hold WM liable for income tax withholding to the extent that Mr. and Mrs. Kovacevich paid personal income tax withholding for the WM wages.

Tips

IRS News Release IR-2006-118, July 28, 2006
Revenue Procedure 2006-30, July 28, 2006
IRC §6053

☞ Attributed Tip Income Program Begins January 1, 2007

The new tip reporting procedure, **Attributed Tip Income Program (ATIP),** expands existing IRS tip reporting and education programs by offering food and beverage employers an additional tip reporting program. This program reduces industry recordkeeping burdens, has simple enrollment requirements, and promotes tip reporting on tax returns. This is a 3-year pilot program which begins on January 1, 2007.

General requirements for participating restaurants include:

- Annual election to participate by checking ATIP participation box,
- Use of prescribed methodology for reporting tips by filing Form 8027, *Transmittal of Employer's Annual Information Return of Tip Income and Allocated Tips*,
- Establishment must have at least 20% charged gross receipts reflecting a charged tip,
- At least 75% of tipped employees must agree to participate, and
- Attributed tips are reported on Forms W-2 and taxes are paid using the formula tip rate (charged tip rate – 2%).

Benefits to employers participating in ATIP include:

- No employer-only examination under IRC §3121 will be initiated by the IRS,
- Simplified tip reporting,
- Meeting not required with the IRS to determine tip rates or eligibility,
- No requirement to sign agreement with the IRS, and
- Simple enrollment by checking box on Form 8027, *Employer's Annual Information Return of Tip Income and Allocated Tips.*

Benefits to employees participating in ATIP include:

- No requirement to keep daily tip log or other tip records,
- No tip examination during participation period, and
- Improved employee loan qualification.

Embezzlement

***Pediatric Affiliates v. United States,* United States District Court, D. New Jersey, No. 05-3108, February 23, 2006**
IRC §6331

☞ Tale of Woes For Professional Corporation

Facts. Pediatric Affiliates, P.A. (Pediatric) is a professional corporation providing pediatric medical services. Pediatric hired PAL Data (PAL) in 1994 to service Pediatrics payroll accounting needs. Pediatric retained responsibility for remitting quarterly payroll taxes to the IRS. Pediatric alleges in 1998 the IRS began requiring businesses to electronically transfer tax payments to a depository service, or independent payroll tax service, which in turn remitted the payments to the IRS. Pediatric began using PAL to pay its payroll taxes.

Unbeknownst to Pediatric, PAL's founder, Hirsch, embezzled tax payments paid by Pediatric as well as other clients. The scheme was simple. Hirsch requested payment of the actual tax liability from Pediatric. However, a tax form with an understated tax liability was sent to the IRS along with the understated amount. Hirsch invested the difference in a personal hedge fund.

The IRS contacted Pediatric in 2002 about underpayment of payroll taxes for 1999 and 2000. Pediatric reviewed the withdrawal records compared to tax liabilities and determined the IRS had probably made an error since the amounts matched exactly. Second and third notices were then sent by the IRS, and Pediatric again found no discrepancies. The IRS finally provided Pediatric with documents reflecting differing information than that provided by PAL. Upon contacting PAL, Pediatric discovered Hirsch had misappropriated some of the funds which should have been turned over to the IRS.

Hirsch pled guilty in U.S. District Court for converting over $2,314,000 from over 50 client funds, and filing over 160 false and fraudulent tax returns. Hirsch was assessed monetary penalties and sentenced to serve thirty-seven months in prison.

The IRS sent a notice to levy Pediatrics' assets in March of 2003 for taxes still owed from 1999 and 2000 due to Hirsch's underpayment. Pediatric requested a collection due process (CDP) hearing to which the appeals office determined the levy notice was proper. Pediatric requested redetermination of the collection action resulting from the CDP hearing.

Issue. Whether the IRS may proceed with collection of payroll tax liabilities for 1999 and 2000.

Analysis. IRC §6331(a) authorizes the IRS to levy upon all property, and rights to property of a taxpayer where there exists a failure to pay any tax liability within 10 days after demand for payment. IRC §6330(c) addresses the matters to be considered at the hearing.

At court, the IRS argued the complaint should be dismissed because Pediatric is liable to pay:

- Taxes owed as a matter of law, and
- Interest, since the tax deficiency is not attributable to an IRS error or delay.

Pediatric argued that the responsibility no longer rested with them since:

- Pediatric paid the taxes owed to PAL,
- Pediatric is not responsible for the embezzlement by Hirsch, and
- The U.S. is judicially estopped from recovering payroll taxes from Pediatric.

The court determined reliance on a bookkeeper, controller, or outside payroll service does not qualify as reasonable cause to excuse the failure to pay taxes. The payroll service is a third-party agent of the company. The form the taxpayer must execute to authorize an agent to make tax payments on its behalf contains an agreement that states: "I understand that this agreement does not relieve me, as the taxpayer, of the responsibility to ensure that all tax returns are filed and that all deposits and payments are made."

In addition, reliance on an agent does not constitute reasonable cause even when the agent embezzles a company's tax payments. Several court cases have addressed this problem with the same end result … the betrayal is unfortunate but the company is responsible for overseeing the acts of their agents.

Holding. The IRS prevailed for collection of employment taxes due for 1999 and 2000.

> **Caution.** Cases involving embezzlements continue to arise. Taxpayers need to take extra steps to feel secure about the service providers with whom they entrust funds to pay tax liabilities.

Abuse of Discretion

Emiel Kandi v. United States, **United States District Court (W.D. Washington), No. C05-0840C, January 11, 2006**
IRC §7701

☞ Retroactive Application of Regulations Denied; No Abuse of Discretion

Facts. Mr. Kandi, along with an associate, formed Lounge Lizards, LLC. (Lounge) in March 1999. In January 2001, Mr. Kandi became the sole member. In September 2001, he sold his entire interest to another individual. Lounge incurred employment tax liabilities in excess of $225,000 for the first two quarters of 2001.

The IRS attempted to collect the unpaid employment taxes from Mr. Kandi personally since Mr. Kandi had never filed an election to have Lounge taxed as a corporation. A collection due process hearing took place before the IRS determined collection action again Mr. Kandi was correct. Mr. Kandi sought judicial review of the IRS decision in the district court.

During the time the case was pending in court, the IRS issued proposed regulations whereby the owner of a single-member LLC is not personally liable for the LLC's employment tax liability. At the time the proposed regulations were released, the IRS announced that the final regulations would be applied prospectively. Accordingly, the Court allowed additional briefing regarding the parties' positions on applicability to or other impact of the proposed regulations.

Issue. Whether the collection actions taken by the IRS related to Mr. Kandi were proper and whether the proposed regulations could be applied retroactively.

Analysis and Holding. At trial, the taxpayer argued that the IRS's decision not to apply the more favorable regulations retroactively to his situation was an abuse of discretion.

The district court upheld the IRS determination not to apply regulations retroactively and protect a small business owner from personal responsibility for unpaid federal employment taxes. Proposed check-the-box regulations, which were released while the case was pending, would have placed the employment tax liability squarely on the taxpayer's LLC. However, the IRS applied the regulations prospectively only, and its decision was not an abuse of discretion.

Personal Expenses

Marc Jordan v. Commissioner, **United States District Court (D. Minnesota), No. Civ. 04-3800(JNE/RLE), March 23, 2006**
IRC §§3101 and 3402

☞ Travel Expenses Subject to FICA and Wage Withholding

Facts. Mr. Jordan, a pilot employed by Atlas, had been assigned to the Anchorage, Alaska base since 2001. As part of the collective bargaining agreement, Atlas provided Mr. Jordan with transportation at the beginning and end of the work week from his residence in Bemidji, Minnesota to Anchorage as well as lodging, per diem, and incidental expenses while in Alaska. These expenses were referred to as "gateway expenses."

In June 2003, Atlas began withholding income and FICA taxes on the gateway expenses. Mr. Jordan disagreed that the gateway expense money should be subject to employment taxes, so he filed a Form 843, *Claim for Refund and Request for Abatement*. He claimed a refund of $110.42 for FICA taxes withheld. When the IRS failed to respond to his refund claim, Mr. Jordan filed suit in district court.

Issue. Whether payments for expenses were subject to the FICA and withholding requirements.

Analysis. The answer to the question lies in whether the employee could have deducted these costs as business expenses. The government argued that Mr. Jordan cannot consider these business expenses for two reasons.

- Mr. Jordan's work home was Anchorage, Alaska so he did not incur gateway expenses while away from home.
- The gateway expenses were incurred for Jordan's personal convenience, not in pursuit of a trade or business.

Mr. Jordan argued that his employer would find it difficult, if not impossible, to staff its operations if transportation, lodging, and incidental expenses were not paid by Atlas. He argued these expenses should be considered ordinary and necessary business expenses.

Holding. The court found the travel between Minnesota and Alaska to be for personal convenience, not a business necessity, and as such, the expenses were subject to both FICA and income tax withholding. Therefore Mr. Jordan's claim for refund was denied.

Withholding

IRS News Release IR-2006-112, July 13, 2006

IRC §§3111 and 3301

☞ Cash Incentives Are Taxable Compensation

Efforts by employers to subsidize employees for the purchase of environmentally-friendly hybrid cars in the form of a cash incentive or rebate is taxable compensation. The cash incentive amount is subject to income tax withholding and employment taxes. The incentive amount should also be reported on Form W-2 at year end.

An exclusion from income for employee discounts exists **only if the employer produces the product** and certain other requirements are met.

Early Retirement Incentive Payments

***Donald F. Appolini, Sr. et al v. U.S.*, 6th Cir. Ct. of Appeals, No. 04-1049, 2006-1 USTC ¶50,347, June 7, 2006 [affirming prior U.S. District Court of Western Michigan decision: No. 5:02-CV-176, July 21, 2004, 2004-2 USTC ¶50,333]**

IRC §3121

☞ Public School Teachers' Early Retirement Payments are FICA Wages

Facts. This decision involved two prior U.S. District Court class action cases that were consolidated on appeal to the 6th Circuit Court of Appeals. The facts in both prior cases were similar. The facts which follow apply to Donald Appolini, one of the Michigan public school teacher class action members.

During the 2000–2001 school year, Donald Appolini was offered an early "employee severance plan." Mr. Appolini accepted the offer and resigned his teaching position on June 30, 2001. He signed a waiver in which he agreed to "waive all claims arising out of employment with the school district, including claims … under the Michigan Teacher's Act," which was the basis for his tenured status. The school district paid him the equivalent of his 1999–2000 salary in 60 monthly payments in return for his acceptance of the "employee severance plan."

The school district withheld FICA taxes from the installment payments. Mr. Appolini filed a claim for refund of the FICA taxes, which the IRS denied. He then filed suit in U.S. District Court which upheld the prior determination of the IRS that he was not entitled to a refund of withheld FICA taxes.

Issue. Whether payments made by school districts to public school teachers in exchange for relinquishing their tenure rights are considered "wages" subject to FICA under IRC §3121(a).

Position of Taxpayer. The taxpayer relied on two sources of authority to support his contention that the severance payments did not constitute "wages" subject to FICA:

- An 8th Circuit Court of Appeals decision in 2001 in which early retirement payments made to tenured university professors were not "wages" for FICA purposes.[9]
- Rev. Rul. 58-301 which was relied on by the 8th Circuit in its 2001 decision involving tenured university professors.[10]

Position of the IRS. The IRS relied on the conclusion reached in Rev. Rul. 75-44.[11] It held that lump-sum payments to railroad employees in exchange for relinquishing employment rights constituted "wages" under the Railroad Retirement Act (the counterpart of FICA for railroad employees).

Holding. The 6th Circuit Court found the severance payments fell within the definition of FICA wages as **"all remuneration for employment"** under IRC §3121(a).

> **Note.** The IRS is following the rationale reached by the 8th Circuit in the *North Dakota State University* case only in the seven states in that circuit: Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota. It will continue to deny claims for refunds of withheld FICA and Medicare taxes in similar cases from taxpayers in the other 43 states.

Litigation Costs

***Images in Motion of El Paso, Inc., v. Commissioner,* TC Memo 2006-19, February 7, 2006**

IRC §7430

☞ IRS Loses In Worker Classification Case

Facts. Images in Motion of El Paso, Inc. (Images) is a dance studio located in El Paso, Texas that offers classes in dance, gymnastics, martial arts, and other fitness-related activities. Images was acquired as a sole proprietorship in 1997 under the name "Champion Studio" and incorporated in 1998 under the Images name. However, it continued to conduct business as Champion Studio. As the result of informant information provided to the IRS, an examination was conducted in 2001 for the years 2000 and 2001 to determine if dance instructors were really employees rather than independent contractors. Information provided indicated these instructors were issued "employee manuals," were required to follow the directives in the manuals, and could be **fired** for failing to attend work.

The IRS employment tax specialist conducted a thorough investigation and determined an employer-employee relationship was in existence whereby Images did not qualify for IRC §530 relief. A 30-day letter was issued in October 2002 showing taxes due in excess of $33,000 with an appeal timely requested. The case was **never** forwarded to the Appeals division, but instead resulted in the issuance of a Notice of Determination in February 2003. Again

9. *North Dakota State University v. U.S.*, 8th Cir. Ct. of Appeals, 255 F.3d 599, 2001-2 USTC ¶50,485, 2001

10. Rev. Rul. 58-301, 1958-1 CB 23

11. Rev. Rul. 75-44, 1975-1 CB 15

the determination was challenged and this time, the case was assigned to an Appeals officer. The Appeals officer determined Images would likely prevail on the worker classification issue thereby conceding the case. After the stipulated decision was entered in November, 2003, a motion for reasonable litigation costs proceeded.

Issue. Whether Images is entitled to an award of reasonable litigation costs.

Analysis and Holding. IRC §7430(a) provides that the prevailing party may be awarded reasonable litigation costs in connection with any court proceeding brought by or against the United States for the determination of any tax. In addition to being the prevailing party, to be eligible for litigation costs, a taxpayer must have:

- Exhausted all administrative remedies, and
- Not unreasonably protracted the underlying proceeding.

Although the IRS conceded the employment tax issue, this concession did not automatically mean the prior IRS position was unreasonable thus entitling Images to litigation costs. The court looked at several of the following factors in making its determination:

- Whether Images exhausted the available administrative remedies,
- Whether the IRS litigating position was substantially justified, and
- Did Images unreasonably protract the proceedings?

The court considered whether the IRS's position was substantially justified, and whether the taxpayer presented all relevant information under its control and relevant legal arguments supporting its position to the appropriate IRS personnel. Based on the actual attorney time spent, Images was awarded $16,087.50 and $265.40 for court cost, duplication costs, and paralegal fees.

Insurance Renewal Commissions

Gregg R. and Teresa M. Gilbert v. Commissioner, **TC Summary Opinion 2005-176, December 1, 2005**
IRC §1402

☞ Insurance Renewal Commissions are Subject to Self-Employment Tax

Facts. Gregg Gilbert became a self-employed insurance agent for Capital American Life Insurance Company, now Conseco, in 1985. His relationship with the company was established by a "Marketing Agreement" which contained a "Commission Schedule and Vesting Provisions." The standard rate for renewal commissions under the Commission Schedule was 15%.

Due to a serious accident, Mr. Gilbert retired on Social Security disability. He was effectively terminated by Conseco in January 1999. However, he continued to receive renewal commissions based on the Marketing Agreement. He received the following renewal commissions:

Year	Commissions per Renewal Form 1099-MISC	Where Reported on Return 1040 (Other Income)
2000	$17,067	Line 21
2001	16,001	Line 21

The taxpayer did not report self-employment tax liability on either return. The IRS determined that self-employment tax was due on the renewal commissions in the amount of $2,411 for 2000 and $2,512 for 2001.

Issue. Whether the insurance renewal commissions received in 2000 and 2001 are subject to self-employment tax under IRC §1402.

Analysis. The term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions attributable to such trade or business.[12] The Tax Court had previously held that, for income to be taxable as self-employment income, "there must be a **nexus** between the income received and a trade or business that is, or was, actually carried on."[13] In addition, income may be subject to self-employment tax even when it is attributable in whole or part to services rendered in a prior taxable year.[14]

In response to the *Jackson* Tax Court case,[15] Congress amended IRC §1402 related to "termination payments" made after December 31, 1997 to former "insurance salesmen."[16] In general, IRC §1402(k) provides that "termination payments" are **not** subject to self-employment tax if certain requirements are met, including the following:

- The payment "depends primarily on policies sold by such individual during the **last year** of such agreement."[17]
- The payment "does not depend to any extent on length of service or overall earnings from services performed for such company (without regard to whether eligibility for payment depends on length of service)."[18]

The taxpayer argued that IRC §1402(k) applies, resulting in the renewal commissions not being subject to self-employment tax.

Holding. The court held that because the renewal commissions from Conseco were "tied to the quantity and quality of the taxpayer's prior labor," they were subject to self-employment tax. The court also noted that the commissions were disbursed per the "Marketing Agreement" rather than per a "termination agreement" as was true in the *Jackson* case. In addition, the commissions were not paid primarily for policies sold during Mr. Gilbert's last year of service for Conseco.

> **Note.** The *Jackson* case involved a retiring self-employed State Farm agent. The payments made to Mr. Jackson by State Farm Insurance Co. were "termination payments" made for a two-year period based on a fixed percentage of his final-year's compensation without regard to the length of service.

Form 944

IRS News Release IR-2006-002, January 3, 2006

☞ Reduction of Tax Filing Burden for Small Business Owners

Effective January 1, 2006, the new Form 944, *Employer's Annual Federal Tax Return*, is available for use by small employers whose estimated annual employment tax liability is $1,000 or less. Instead filing quarterly Forms 941, only one return is required and employment taxes are paid at the time the form is filed. Form 944 and employment taxes are due on January 31 of the year after the tax year for which the return is filed. However, if the employer pays all accumulated employment taxes by that date, the employer has **10 extra calendar days to file the form**.

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12. IRC §1402(a)
13. *Newberry v. Commissioner*, 76 TC 441, 1981
14. Treas. Reg. §1.1402(a)-1(c)
15. *Jackson v. Commissioner*, 108 TC 130, 1997
16. IRC §1402(k)
17. IRC §1402(k)(4)(A)
18. IRC §1402(k)(4)(B)

This new opportunity applies to those who filed Forms 941 in prior years, and to new employers. If a new employer pays $4,000 or less in annual wages, the employer likely qualifies to use the Form 944. New employers should estimate their tax amount and include it when applying for their Employer Identification Number on Form SS-4, line 13.

Employers can still choose to file Form 941 in lieu of Form 944 if either the employer:

- Prefers to electronically file Forms 941 on a quarterly basis, or
- Anticipates annual employment tax liability in excess of $1,000.

Form 944 completely replaces Form 941 for program participants. However, taxpayers filing Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees,* and Form 1040, Schedule H, *Household Employment Taxes*, are **not** eligible to file Form 944.

Question. What happens if the final year end liability exceeds the $1,000 anticipated liability?

Answer. Form 944 must be filed for the year. When the forms reports a larger liability than $1,000, the IRS sends the employer a written notification that the employer's filing requirements have changed. The employers will be required to file Forms 941 in future years.

Proposed regulations were released to **allow** many more Form 941 small employers, who are still required to file quarterly, **an expanded safe-harbor from making monthly or semi-weekly deposits**. Relief is given from unexpected deposit liabilities by allowing payments with a quarterly return if taxes due in the prior quarter or current quarter are less than $2,500.

Form **944 for 2006: Employer's ANNUAL Federal Tax Return** 790106

Department of the Treasury — Internal Revenue Service

OMB No. 1545-2007

Employer identification number (EIN) ☐☐ – ☐☐☐☐☐☐☐

Name *(not your trade name)*

Trade name *(if any)*

Address

Number Street Suite or room number

City State ZIP code

Who Must File Form 944

You must file annual Form 944 instead of filing quarterly Forms 941 **only if the IRS notified you in writing.**

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

Part 1: Answer these questions for 2006.

1 **Wages, tips, and other compensation** 1

2 **Total income tax withheld from wages, tips, and other compensation** 2

3 **If no wages, tips, and other compensation are subject to social security or Medicare tax** . 3 ☐ Check and go to line 5.

4 **Taxable social security and Medicare wages and tips:**

	Column 1		Column 2
4a **Taxable social security wages**	.	× .124 =	.
4b **Taxable social security tips**	.	× .124 =	.
4c **Taxable Medicare wages & tips**	.	× .029 =	.

4d **Total social security and Medicare taxes** (*Column 2,* lines 4a + 4b + 4c = line 4d) . . . 4d

5 **Total taxes before adjustments** (lines 2 + 4d = line 5) 5

6 **TAX ADJUSTMENTS** (Read the instructions for line 6 before completing lines 6a through 6f.):

6a **Current year's adjustments** (See instructions) 6a

6b **Prior years' income tax withholding adjustments** (See instructions. Attach Form 941c.) 6b

6c **Prior years' social security and Medicare tax adjustments** (See instructions. Attach Form 941c.) 6c

6d **Special additions to federal income tax** (reserved use). Attach Form 941c 6d

6e **Special additions to social security and Medicare taxes** (reserved use). Attach Form 941c 6e

6f **TOTAL ADJUSTMENTS** (Combine all amounts: lines 6a through 6e.) 6f

7 **Total taxes after adjustments** (Combine lines 5 and 6f.) 7

8 **Advance earned income credit (EIC) payments made to employees** 8

9 **Total taxes after adjustment for advance EIC** (line 7 – line 8 = line 9) 9

10 **Total deposits for this year, including overpayment applied from a prior year** 10

11 **Balance due** (If line 9 is more than line 10, write the difference here.) Make your check payable to the *United States Treasury* and write your EIN, *Form 944,* and *2006* on the check 11

12 **Overpayment** (If line 10 is more than line 9, write the difference here.) 12 Check one ☐ Apply to next return. ☐ Send a refund.

▶ **You MUST fill out both pages of this form and SIGN it.**

Next ➔

For Privacy Act and Paperwork Reduction Act Notice, see the back of the Payment Voucher. Cat. No. 39316N Form **944** (2006)

ESTATE AND GIFT

Stock Valuation
***Michael W. and Caroline P. Huber v. Commissioner,* TC Memo 2006-96, May 9, 2006**
IRC §2501

☞ Discount Claimed for Gifted Shares was Appropriate

Facts. Huber Corp. (Huber), founded in the late 1880s and headquartered in Edison, New Jersey, is a privately-held corporation with annual sales in excess of $500 million. During the years at issue, it had 250 shareholders and 3,000–5,000 employees. Huber's board of directors is comprised mainly of non-Huber family members.

Huber shares are not publicly traded. Since 1993, Ernst & Young (E&Y) appraised the shares on an annual basis. Huber shares are currently held by family members, the Huber Foundation, and various independent nonprofit organizations, including universities. Although there is no formal stock buy-back program in place, redemption of stock from shareholders is authorized in the bylaws at E&Y's value less 5%. In addition, the bylaws also provide Huber the right of first refusal to purchase shares offered outside the Huber family at a specified price. From 1994 to 2000 there were approximately 90 sales transactions of Huber shares between shareholders in which the sales price was based on the E&Y valuation method.

Taxpayers timely filed Forms 709, *United States Gift (and Generation-Skipping Transfer) Tax Return,* for 1997 through 2000 reflecting gifts of Huber shares to their lineal descendants. The IRS challenged the gift tax values and issued notices of deficiency. The IRS disagreed with the lack of marketability discount percentage used to calculate the reported gift tax value of the gifted shares. While E&Y had always applied a 50% discount, an IRS expert witness applied a 30% discount for 1997, a 25% discount for 1998, a 45% discount for 1999, and a 30% discount for 2000. The discrepancies in valuation of the gifted shares are as follows:

Year	Taxpayer's Stock Value per Share	IRS Stock Value per Share
1997	$45.75	$64.05
1998	51.50	77.25
1999	47.50	52.25
2000	58.00	81.20

Issue. Whether the gift tax value of Huber stock was correctly calculated.

Analysis and Holding. IRC §2501 imposes a tax on the transfer of property by gift during the taxable year.

The real issue was whether there were arm's length sales of Huber shares that could be used to determine the values of the gifts made by taxpayers. The IRS's contention that Huber takes itself public to sell its shares at fair price was rejected as the courts have long recognized the right of shareholders in closely-held companies to remain private.

At trial, several transactions were cited as representative of the 90 sales between shareholders. The Tax Court determined that these representative sales of stock qualified as arm's length transactions. Based on that fact, **the court determined that the 50% lack of marketability discount used to value the gifted shares was appropriate**.

Family Limited Partnership

***Estate of Lillie Rosen v. Commissioner,* TC Memo 2006-115, June 1, 2006**

IRC §2036

☞ Implied Agreement Results in Gross Estate Inclusion of Transferred Property

Facts. Lillie Rosen, a widow with a large portfolio of stocks, bonds, and cash, formed a revocable trust in 1974 and acted as its trustee. Most of her assets were transferred to the trust. In 1994 she was diagnosed with dementia. Her son-in-law had attended a seminar on family limited partnerships (FLPs) and was intrigued with the apparent estate tax savings aspect of FLPs.

In 1996, the son-in-law contacted Lillie's attorney who advised him that simply transferring the assets of the trust to a FLP would generate significant tax savings. The Lillie Rosen FLP was then formed and $2.4 million of trust assets were transferred to it. In exchange, Lillie's trust received a 99% limited FLP interest. Her two children were named general partners and each received a 0.5% interest in the FLP.

Later in 1996, Lillie's daughter, acting under a power of attorney, gave herself and her brother a 16.5% interest in the FLP. **This was done before they had contributed any funds to the FLP for consideration.** A few weeks later, Lillie's two children each contributed $12,145 in cash to the FLP in consideration for their initial 0.5% general FLP interest.

Following the formation of the FLP, Lillie's retained assets were insufficient to pay for the following:

- Her living expenses including those relating to her Alzheimer's disease, and
- Funding her annual $10,000 gifts to eight grandchildren.

As a result, about $259,000 of withdrawals were made from the FLP from its formation in 1996 until Lillie's death in 2000 to pay for these expenditures. All the withdrawals were characterized as loans from the FLP to Lillie. However, there was no expectation that these alleged loans would ever be repaid by Lillie even though two demand notes were prepared. The second demand note was prepared after Lillie's death.

When Lillie died in 2000, the assets of the FLP were worth $3.2 million. Due to additional gifting of FLP interests to grandchildren from 1996 through 2000, her revocable trust owned only a 35% limited interest in the FLP on her date of death. Lillie's estate tax return reported a value of $743,263 for her date of death FLP interest.

The IRS determined that the trust assets transferred to the FLP in 1996 were includible in Lillie's gross estate and assessed additional estate tax of $1.1 million.

Issue. Whether the decedent retained the possession or enjoyment of property[19] transferred to the FLP resulting in the transferred property's inclusion in her gross estate.

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

1. Retained the possession, or enjoyment of the transferred property,
2. Retained the right to income from the transferred property, or
3. Retained the right to designate the person(s) who shall possess or enjoy the property or the income from it for the decedent's life.[20]

19. IRC §2036(a)(1)

20. IRC §§2036(a)(1) and (2)

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

1. The transfer is a **bona fide sale** for a full and adequate consideration.[21]
2. The decedent did **not** retain the
   a. Possession, enjoyment, or rights to the transferred property, or
   b. Right to designate the person(s) who would possess or enjoy the transferred property.[22]

Holding. The court held that the transfer of Lillie's revocable trust assets to the FLP did not meet either of the two exceptions. According to the court:

- The decedent did retain until her death the possession or enjoyment of, or the right to income from, the transferred assets.
- In addition, the assets were transferred from the trust to the FLP in other than a bona fide sale for full and adequate consideration.
- The court noted that the "credible evidence" supports the conclusion that the FLP was formed solely to avoid federal estate and gift taxes. Accordingly, the imposition of the additional estate tax by the IRS was correct.

Note. This is another case which indicates that both the IRS and the Tax Court will insist on a strict interpretation of the IRC §2036(a) requirements for FLPs. The case also shows the importance of ensuring the decendent retains sufficient personal assets outside the FLP to pay for all personal living expenses until death. If FLP withdrawals are necessary for these expenses, it seems likely that the Tax Court will side with the IRS. The opinion in the court transcript is informative for estate tax attorneys and others who advise clients regarding the formation of FLPS.

Stock-Purchase Agreement

Estate of George C. Blount v. Commissioner, **11th Cir. Ct. of Appeals, No. 04-15013, October 31, 2005**
IRC §2031

☞ Modified Agreement Not Valid for Determining Fair Market Value

Facts. Blount Construction Company (BCC) was a closely-held Georgia corporation owned by two shareholders. In 1981, the two shareholders and BCC entered into a stock-purchase agreement **requiring** BCC to purchase the stock upon the death of a shareholder. To ensure business continuation should one or both of the shareholders die, BCC purchased insurance policies in the early 1990s to provide roughly $3 million per shareholder. One of the shareholders died in January 1996. BCC used a little less than $3 million to purchase the shareholder's outstanding shares from the estate based on the previous year's book value.

In 1996, Mr. Blount, the remaining major shareholder, executed an amendment to the 1981 agreement for $4 million for shares owned at death. At the time of his death in 1997, Mr. Blount owned 43,080 shares, or roughly 83% of BCC. His estate tax return showed the value of his BCC stock to be $4 million, based on the amended agreement executed in 1996. The IRS determined the correct value to be $7,921,975.

The Tax Court held the modified agreement was to be disregarded for the purpose of determining the value of the shares. The court also held that the amount of tax should have been calculated by adding the insurance proceeds to the other assets of BCC in order to arrive at the FMV of BCC totaling $1.36 million in additional taxes. The estate appealed the Tax Court decision.

21. IRC §2036(a)(1) and Treas. Reg. §20.2036-1(a)
22. Ibid

Issues. Whether the modified stock-purchase agreement should have been used to compute stock value and whether proceeds of an insurance policy on a shareholder's life should be considered in computing FMV.

Analysis. IRC §2031(a) provides the value of the taxable estate generally is the FMV of the decedent's property at the date of death. The regulations contain an exception for property subject to a valid stock-purchase agreement. Three requirements must be met:

1. The offering price must be fixed and determinable,
2. An agreement must be binding on the parties both during life and after death, and
3. A restrictive agreement must have been entered into for a bona fide business reason, not a substitute for a testamentary disposition.

Holding. The Court of Appeals, agreeing with the Tax Court, held the stock-purchase agreement did not meet requirements for general valuation at fair market value. However, the Tax Court erred when it ignored the amended agreement's creation of a contractual liability for BCC, which the insurance proceeds were committed to satisfy. The insurance proceeds should not have been included in the computation of BCC's fair market value.

Gift Tax

Letter Ruling 200602002, January 13, 2006
IRC §§2503 and 2611

☞ Prepaid Tuition Payments Excluded from Gift and Generations-Skipping Transfer Tax

Purpose. To determine the gift and generations-skipping transfer (GST) tax consequences of a proposed transaction.

Background. The taxpayer has three children and six grandchildren. The taxpayer proposed to prepay tuition expenses for each grandchild for the current year and multiple years thereafter, up through the year of graduation. A separate written agreement for each child was entered into with the school. Under the agreement the taxpayer agrees:

- To pay any balance due after the application of prepayment based on any tuition increases,
- The payments are nonrefundable,
- Once paid, the payments become the sole property of the school, and
- Prepayment does not allow additional privileges for the students.

The taxpayer requested the prepaid tuition be considered a qualified transfer which is excluded from gift tax under IRC §2503(e) as well as an exclusion from generation-skipping transfer under IRC §2611(b)(1).

Analysis. IRC §2503(e)(1) provides that any "qualified transfer" is not treated as a transfer of property by gift. Under IRC §2503(e)(2)(A), a qualified transfer includes tuition to an educational organization. Treas. Reg. §25.2503-6(b)(2) further clarifies that the tuition expenses can be for full or part-time students paid directly to the educational organization as direct tuition costs. IRC §2611(b)(1) provides that "generation-skipping transfer" does not include any transfer, which if made inter vivos by an individual, is not treated as a taxable gift by reason of IRC §2503(e).

Holding. Since the payments are made directly to the educational organization for exclusive use of tuition costs for designated individuals, the payments are excluded from gift tax under IRC §2503(e) and the prepayments do not constitute generation-skipping transfers.

Statute of Limitations

***Roger C. Malm v. U.S.,* United States District Court, D. North Dakota, No. CIV.A2-05-48, November 30, 2005**
IRC §§1311, 1312, and 1313

☞ Statute of Limitations and Mitigation Provisions Found in Favor of IRS

Facts. Harry Malm died August 5, 1998. The estate included shares of Medtronic valued at an amount that the IRS believed was understated. Before the dispute was resolved, shares of stock were sold and gain was computed utilizing the basis determined by the estate on a tax return filed November 14, 1999. In July 2003, the court agreed with the IRS valuation of the Medtronic stock. In February 2004, the estate requested a refund based on the overstated gain on sale of stock which the IRS denied stating the claim was barred by the expired statute of limitations.

Issue. Whether the claim for refund was barred by statute of limitations or relief was available under the statutory mitigation provisions.

Analysis. Under IRC §6511(a), a claim for a refund of a tax overpayment generally must be filed by the taxpayer within three years of the date the return containing the overpayment was filed. Since the estate did not file a refund claim until February 12, 2004, the claim was barred by IRC §6511.

In order to qualify for the mitigating provisions, the following four provisions of IRC §§1311 – 1313 must be met:

1. The error must have occurred in a closed tax year that cannot otherwise be corrected by operation of law,
2. There must be a determination under IRC §1313(a),
3. The determination must be a specified circumstance of adjustment, and
4. The party against whom the mitigation provisions are being invoked has maintained a position inconsistent with the challenged inclusion of income.

Holding. In this case, the described error was the erroneous gain recognition and the subsequent erroneous gross income inclusion of the Medtronic stock sale. However, the Medtronic stock sale was not the transaction which determined the stock basis. The basis-determining transaction was Harry Malm's death, which triggered the transfer of the stock to his estate. Since this is not the transaction in which the erroneous gain recognition occurred, the taxpayer may not use the mitigation provisions to avoid the statute of limitations.

Estate Tax Discounts

***Estate of Doris F. Kahn v. Commissioner,* 125 TC 227, No. 11, November 17, 2005**
IRC §2031

☞ IRAs Cannot be Discounted for Estate Tax Valuation

Facts. When Doris Kahn died in 2000, she owned two IRAs that had increased significantly in value due to appreciation of securities. The date of death values of the IRAs were $1.4 million and $1.2 million. The executor determined that the following discounts should be applied in arriving at the correct date of death values for estate tax purposes:

IRA Account	Date of Death FMV	Discount Taken	IRA Value Shown on Form 706
Harris Bank	$1.4 million	21.0%	$1.1 million
Rothchild	1.2 million	22.5%	1 million

The IRS determined the discounts were not allowable and assessed additional estate tax of $843,892.

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Issue. Whether the discounts taken to reduce the gross estate are allowable.

Analysis. An IRA owned by a decedent at death is considered part of the gross estate for federal estate tax purposes.[23] In addition, beneficiaries of inherited IRAs must pay income tax when the IRAs are distributed to them.[24] To partially compensate for this potential double taxation, the recipient of an item of income in respect of a decedent (IRD), such as an inherited IRA, is entitled to an income tax deduction equal to the amount of federal estate tax attributable to the item of IRD.[25]

It was the position of the estate that the discounts were properly taken because of the expected federal income tax liability that the heirs would pay when the IRA assets were distributed to them. The application of the **"willing buyer-willing seller test"** mandates a discount in the FMV of the IRAs to reflect the anticipated future tax liability of the beneficiaries when they receive IRA distributions.

Holding. The court rejected the estate's logic because an IRA cannot be legally sold; instead, only the underlying assets held by the IRA may be sold. Therefore, there is no "willing buyer" to satisfy the "willing buyer-willing seller test." **The estate tax values of the IRAs were properly determined by the IRS because the discounts are not allowable.**

Split-Interest Trust

***Edmond C. Galloway v. U.S.*, U.S. District Court (Pennsylvania), No. 1:05-cv-00050-SJM, May 9, 2006**
IRC §2055

☞ No Estate Tax Deduction for a Split-Interest Revocable Living Trust

Facts. The decedent, James Galloway, created the James Galloway Revocable Living Trust in 1991. When he died in 1998, the trust provided that the residue would pass in four equal shares to:

- Two individuals (his son, Edmund, and a granddaughter), and
- Two charities.

The trust provided for distributions to each of the four beneficiaries on two separate dates. Each of the residual beneficiaries would receive 50% of their one-quarter share in 2006. The remaining corpus of the trust would be paid in four equal one-quarter shares in 2016. At that point, the trust would cease to exist.

The trust also provided that if an individual beneficiary was deceased at the time of the final distribution in 2016, his or her share would be distributed to the three remaining beneficiaries. If both individual beneficiaries were deceased in 2016, the entire corpus would go to the two charities.

On its estate tax return, the trust claimed a $399,079 deduction under IRC §2055(a) for the portion of the corpus it calculated would ultimately be distributed to the two charities. The IRS disallowed the deduction as it determined that the trust was a "classic split-interest trust" that divided the same property between charitable and non-charitable entities. The additional estate tax assessed by the IRS was $160,394.

Issue. Whether, under IRC §2055(a), the estate is allowed a deduction for "all bequests, legacies, devices, or transfers to or for the use of a qualifying charitable entity."

23. IRC §2039(a)

24. IRC §§408(d)(1) and 691(a)(1)(B)

25. IRC §691(c)

Analysis. The general rule[26] allows an estate tax deduction for charitable bequests. However, the general rule does **not** apply if the trust creates a **"split-interest"** by bequeathing interests in the **same property** to both charitable and noncharitable beneficiaries.[27]

Holding. The court upheld the disallowance by the IRS of the estate's $399,079 charitable bequest for the following reasons:

- The trust terms were unambiguous. The decedent's attorney created only one trust which split the trust principal and income between four beneficiaries, two charities and two individuals.
- The trust was created from a single document and one set of property.

> **Note.** The District Court applied a strict interpretation of IRC §2055(e)(2), the disallowance exception to the general rule. The estate tax deduction for the charitable bequest could have been achieved if two separate trusts had been created in 1991, one for the benefit of the two charities and another for the two individual beneficiaries.

Gift of Real Property

Letter Ruling 200540008, December 22, 2005

IRC §§61, 1001, 1015, and 2501

☞ Gift of Real Property Treated as Sale

Purpose. To determine the proper tax treatment of the transfer of a tenancy-in-common interest in real property to a child. Questions to consider:

- Is this considered a sale, for capital gain tax purposes, to the extent that a portion of the loan balance is being assumed, with the excess value treated as a gift to the child?
- Is the taxpayer's remaining basis in the 50% ownership after transfer equal to one half of the property's adjusted basis immediately before the transfer?
- Does the transfer result in any income from discharge of indebtedness to the taxpayers?
- What is the child's basis in the 50% interest?

Background. Taxpayers acquired community property interest in residential rental property from an inter vivos trust. Subsequent to the property acquisition, a recourse loan was secured against the property. The taxpayers want to give their child a one-half undivided interest in the property. The child will be responsible for repaying one-half of the loan's principal balance as determined at the time of transfer. Subsequent to the gift, the parents and the child each own the property as tenants-in-common of residential rental property, with the property eventually becoming the child's principal residence.

Analysis. Gross income includes income from discharge of indebtedness.[28] IRC §1001(a) provides that the gain from the sale of property is the excess of the amount realized over the adjusted basis for determining loss as defined by IRC §1011. The amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged.[29] IRC §2501 imposes a tax on the transfer of property by gift by an individual, resident, or nonresident.

26. IRC §2055(a)
27. IRC §2055(e)(2)
28. IRC §61(a)(12)
29. Treas. Reg. §1.1001-2(a)(1)

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In *Crane*,[30] if a taxpayer sells property subject to a mortgage that is equal to or less than the value of the property, the amount of the mortgage is properly included in the amount realized on the sale. However, since the property transferred to the child has an FMV in excess of the portion of the loan principal which the child will agree to pay, no assets offset by the obligation of the loan will be made available to the taxpayers by their child's agreement to repay a portion of the loan.

Holding. Since the child is now responsible for repaying one half of the loan's principal balance, the taxpayers are discharged from that liability. The transfer is treated as a sale, for capital gain tax purposes, to the extent of the assumed loan amount. This transfer does not result in any income from discharge of indebtedness. The taxpayers' combined basis in their 50% interest in the property immediately after the transfer is equal to one half of the property's adjusted basis immediately before the transfer.

The transfer by the taxpayers of a 50% undivided tenancy-in-common interest to their child in this situation is treated as a gift to the extent it is not treated as a sale or exchange.[31] The child's basis in her 50% interest in the property is the greater of the amount of consideration paid by the child for the property, or the same as the taxpayers' adjusted basis. The amount of increase in basis, if any, is authorized by IRC §1015(d) for gift tax paid.

GROSS INCOME

Percentage of Completion

TAM 200552012, December 30, 2005

IRC §460

☞ Land Developer Is Not a Home Builder

Purpose. To determine if land sale contracts between two parties are considered home construction contracts under IRC §460.

Background. Taxpayer, a land development corporation, developed six extensive planned communities during 2000, 2001, and 2002 through corporation and partnership subsidiaries. In six separate contracts, Taxpayer contracted to sell residential building lots and agreed to provide paved roads, curbs, gutters, and utilities as part of the deal. In addition, in three of the contracts, Taxpayer also agreed to provide common amenities and recreational facilities. Taxpayer uses completed contract method (CCM) to report the income on the premise that its construction contracts qualify for the "home construction contract" exception under IRC §460(e)(6)(A). The IRS examination division insists the percentage of completion method (PCM) be used.

Analysis. The plain intent of the statute is to provide the more favorable CCM to taxpayers who **actually build homes**, i.e., houses used as consumer dwellings. The IRS first issued Notice 89-15, 1989-1 C.B. 634, to interpret home construction contracts. Then the regulations were issued indicating that only the party building or producing the house has a home construction contract.

Holding. In this situation, Taxpayer is not performing construction contract activities for dwelling units, and therefore is not eligible to use the CCM method of accounting.

30. *Crane v. Commissioner,* 331 U.S. 1, 8 (l947) decided, April 14, 1947

31. IRC §1001

Domestic Partners

Chief Counsel Advice 200608038, February 24, 2006

IRC §61

☞ Gross Income Computation for Domestic Partners

Purpose. To determine if a registered domestic partner under the California Domestic Partner Rights and Responsibilities Act of 2003, is required to include in gross income all his earned income for 2005 or half of the combined income earned by the individual and his partner.

Background. Married couples who reside in California, one of nine community property states, who file as married filing separately must include half of the combined earned income of both spouses in gross income. Since 1999, those domestic partners who register with the California Secretary of State are afforded certain rights of married couples. The enactment of the California Domestic Partner Rights and Responsibilities Act of 2003, which became effective on January 1, 2005, throws a wrench into these rights by requiring registered domestic partners to file **separate** income tax returns for state tax purposes with individual income only (not half of the combined earned income for the individual and his partner) being reported on the return.

Analysis. IRC §61(a)(1) provides that gross income means all income from whatever source derived including compensation for services such as fees, commissions, fringe benefits, and similar items.

The Chief Counsel analyzed several court cases and looked to the Supreme Court decision of *Poe v. Seaborn*, 282 U.S. 101, which dealt with Washington's community property law as applied to a husband/wife situation. Since the relationship between registered domestic partners is **not marriage** under California law, the Supreme Court's decision in *Poe v. Seaborn* does **not** extend to registered domestic partners. Consequently, an individual who is a registered domestic partner in California must report all income earned from the performance of his personal services.

> **Caution**. This could be a controversial position, and may give rise to additional rulings/decisions in the future.

401(k) Distributions

***Richard Bradley v. Commissioner,* TC Summary Opinion 2006-11, January 26, 2006**

IRC §§72, 402, and 408

☞ IRS Return Preparation Errors Not Considered Economic Hardship

Facts. Mr. Bradley was employed by Circle International Group, Inc. (CIG) as a building manager and engineer in 2000 and 2001, where he participated in an employer-sponsored 401(k) plan. In July of 2000, Mr. Bradley borrowed $9,000 against his 401(k) plan. He made subsequent repayments of $3,420.42 during 2000. CIG was then acquired by Eagle Global Logistics (Eagle) in 2001, where Mr. Bradley remained as an employee.

Mr. Bradley received two distributions in 2001 from retirement plans. He received a Form 1099-R showing a distribution of $7,089.95 with "L" as the distribution code, indicating his **outstanding loan balance** was treated as a distribution subject to the 10% tax.

He also received two Forms 1099-R with distribution codes of "1," signifying an early distribution subject to the 10% additional tax as follows:

- $15,322.60 from the CIG-sponsored retirement plan
- $7,000.00 from the Eagle retirement plan

Mr. Bradley suffered a cerebral brain hemorrhage in December 2001 resulting in partial memory loss. Mr. Bradley was under the age of 59½ at the time the distributions occurred. The IRS assisted Mr. Bradley in his 2001 return preparation. Somehow, the $7,000 distribution was omitted from the return as filed, as well as part of the taxable distributions. The IRS issued a notice of deficiency based on the unreported amounts and Mr. Bradley petitioned the Tax Court.

Issues. Whether:

1. Gross income should be increased by $22,322.69 for retirement plan receipts,
2. The loan from the retirement plan is taxable to the extent of $7,089.95, and
3. The early distributions are subject to the 10% additional tax under IRC §72(t).

Analysis and Holding. At trial, Mr. Bradley argued that the IRS's failure to include distributions in income increased his tax liability and created an economic hardship. He argued that the doctrine of equitable estoppel should apply against the IRS. He also asserted he did not recall receiving a $7,000 distribution and that the loan balance reported to the IRS on his 401(k) plan was incorrect. Mr. Bradley did not provide evidence to support these statements.

Even if the IRS made a mistake of law by not including the proper distributions as income, equitable estoppel does not prevent the IRS from correcting a mistake of law unless Mr. Bradley would suffer an unconscionable injury. Regarding the 10% additional tax under IRC §72(t), Mr. Bradley did not provide evidence that "economic hardship" falls under the exceptions for waiver of the penalty.

Employee Relocation Costs

Revenue Ruling 2005-74, November 30, 2005

IRC §§61, 82, and 1001

☞ Tax Consequences Identified on Home Sale through Relocation Service

Purpose.

1. To clarify the treatment of a home sale by an employee to an employer through the employer's agent (relocation management company), followed by a separate sale of the home to a third party
2. To clarify the sale of a home from an employee to a third party utilizing the assistance of the employer's relocation management company. Three common relocation scenarios are reviewed.

Scenario 1. Individual A works for Company X. Company X contracts with a relocation management company (RMC) who purchases the employee homes at fair market value and sells the home to a third party. A transfers home to RMC for an agreed upon price and executes a deed without a name on it. RMC can either insert its own name or the name of the third party buyer. RMC does not record the deed. RMC lists the home, sells the home, inserts the name of the buyer in the title, and then conveys title to the seller. The second sale results in a $10,000 loss plus other selling expenses. These transactions are treated as two sales for federal tax purposes. Any loss payments made or selling expenses realized by the employer on the second sale will not be taxable gain to the employee.

Scenario 2. Same facts in **Scenario 1** except an amended value option allows the listing of the home with a qualified real estate broker (from the RMC listing) by the employee. Any potential offers are referred by the broker to RMC who then evaluates the offer and matches the offer. A then accepts the offer from RMC and executes a blank deed to RMC. RMC then enters into a new listing agreement with a broker to market the home to a third party buyer. RMC sells the home to the buyer, inserts the name into the blank deed and records the deed. The second sale results in a $20,000 gain in excess of the first sale.

Scenario 3. Same facts as **Scenario 2** except an amended value option with different options contracted through a **different** RMC. Any potential offers are referred by the broker to RMC who then evaluates the offer but is not required to match the offer. A retains the right to approve or reject any offer made between RMC and a third-party buyer. The sale proceeds resulting from a higher sale are distributed to A only if and when the sale to third party buyer closes.

Analysis. IRC §61(a) provides that gross income includes gains derived from dealings in property. IRC §82 provides gross income (as compensation for services) includes any amount received or accrued by an individual as payment for or reimbursement of expenses of moving from one residence to another which is attributable to employment. IRC §1001(a) provides that the gain or loss from the sale or other disposition of property shall be the excess of the amount realized over the adjusted basis for determining gain, and the excess of the adjusted basis over the amount realized for determining loss.

The real question here is whether each of the scenarios involve two separate home sales (from the employee to employer then to third-party buyer) or one sale (from employee to third-party buyer). For federal tax purposes, the sale actually occurs upon the transfer of the benefits and burdens of ownership. The passage of legal title is a significant, but not determinative factor.

The court considers the following factors, using an analysis of benefits and burdens of ownership transferred:

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

Applying a benefits and burdens analysis to both **Scenario 1 and 2,** it is apparent two separate sales exist. **Scenario 3,** on the other hand, yields a different result whereby there is only one sale resulting. Any expenses paid by the company related to the home, such as maintenance costs, taxes, or insurance, would be considered paid by the employer and would constitute taxable compensation to A.

Holding. The sales in both **Scenario 1 and 2** constitute sales from an employee to an employer via the employer's agent followed by a separate sale to a third party buyer. However, the **Scenario 3** sale is one by an employee to a third-party buyer that was facilitated by the employer through the RMC.

Discharge of Indebtedness Income

***George W. Earnshaw v. Commissioner*, 10th Cir. Ct. of Appeals, No. 02-9015, 2005-2 USTC ¶50,566, September 22, 2005 [affirming prior Tax Court decision: TC Memo 2002-191, August 5, 2002]**
IRC §61

☞ Form 1099-C from Credit Card Issuer Results in Cancellation of Indebtedness Income

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Facts. George Earnshaw, a Kansas attorney, had a MasterCard account with MBNA. Following a dispute regarding late fee charges, MBNA offered to settle the $32,567 balance of his account for a payment of $12,700. He agreed to this proposal and sent MBNA his check for $12,700 in January 1998.

In January 1999, MBNA sent Mr. Earnshaw a 1998 Form 1099-C, *Cancellation of Debt*, in the amount of $19,867. In response, Mr. Earnshaw returned the Form 1099-C to MBNA with a cover letter in which he stated:

"The debt was never 'forgiveness' of anything, but as you know, a compromise of many issues of a vague, doubtful and disputed claim…After considerable negotiations, a settlement was effected of $12,700. This was to save us a lawsuit and legal expense, as well as an equitable conclusion to your improper handling of my account."

Mr. Earnshaw attached the following statement to his 1998 tax return:

"No amounts pursuant to the attached Form 1099-C have been included in income. The cancellation [of debt] should be characterized as a compromise of a doubtful and disputed claim."

The IRS service center later sent Mr. Earnshaw a notice of deficiency in the amount of $3,514 for failure to report the $19,687 Form 1099-C cancellation of debt income. The Tax Court determined that $3,729 of finance charges and late payment fees did not create a liquidated debt.

According to the Tax Court, the amount of actual debt that was cancelled after receipt of the $12,700 settlement payment was $13,100. That amount constituted unreported income for the 1998 tax year since Mr. Earnshaw was neither bankrupt nor insolvent when the debt was forgiven.

Mr. Earnshaw then appealed the decision of the Tax Court to the 10th Circuit Court of Appeals.

Issue. Whether the taxpayer realized discharge of indebtedness income under IRC §61.

Analysis. Gross income includes "income from discharge of indebtedness" unless the exclusions of IRC §108 apply.[32] In general, IRC §108 provides exclusions for discharge of indebtedness income when:

- The taxpayer is bankrupt or insolvent,
- The discharged debt is qualified farm debt, or
- The discharged debt is qualified real property business indebtedness.[33]

Holding. The 10th Circuit upheld the prior Tax Court decision. **It rejected the taxpayer's contention that the credit card debt was a compromise of a disputed liability.** Therefore, the "contested liability/disputed debt" exception to recognition of discharge of indebtedness income did not apply.[34]

> **Note.** Another case in this area is *Millard J. and Jacquie M. Scott v. Commissioner,* TC Summary Opinion 2006-16, January 30, 2006

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32. IRC §61(a)(12)

33. IRC §108 (a)(1)

34. *Layne E. and Sue F. Preslar v. Commissioner*, 10th Cir. Ct. of Appeals, 167 F3d 1323, 99-1 USTC ¶50,258, February 16, 1999, reversing prior Tax Court decision: TC Memo 1996-543

Gift or Income

***Milton D. and Linda M. Peebles v. Commissioner,* TC Summary Opinion 2006-61, April 19, 2006**
IRC §61

☞ Payment Received by Husband of Wife's Lover was not a Gift

Facts. The taxpayers lived in small Arkansas town. In 1999, Milton Peebles, a town police officer, became aware that his wife, Linda, was having an affair with her physician. Mr. Peebles, armed with recorded phone conversations between his wife and the doctor, confronted the doctor with the evidence.

Mr. Peebles threatened the doctor with a $150,000 lawsuit. Several days later, the doctor agreed to pay $25,000 to Mr. Peebles. The two men met in a bank parking lot where the doctor gave Milton Peebles $25,000 in cash. Some of the conversation, which was taped by Mr. Peebles, is shown below.

- The doctor said he was sorry about the affair and stated that this was "free money," but it could be considered income.
- Mr. Peebles commented that if he and his wife divorced, he would not file on the grounds of adultery or name the doctor in the divorce proceedings.

One of the taxpayers' daughters contacted the Arkansas State Medical Board and reported the affair between the doctor and her mother.

In February 2000, a few days after the state medical board ethical hearing, the doctor's accountant prepared a 1999 Form 1099-MISC in the amount of $25,000 and sent it to Mr. Peebles. The $25,000 was reported in the "Other income" box of the form. When Mr. and Mrs. Peebles, filed their joint 1999 tax return, they did not report the $25,000. In its information document matching program, the IRS sent the taxpayers a deficiency notice for the unreported $25,000 income.

Issue. Whether the $25,000 represented a nontaxable gift or gross income under IRC §61.

Position of Taxpayers. Mr. and Mrs. Peebles contended that the $25,000 was a gift because it was the doctor's idea to pay it, and Mr. Peebles did not force him to pay it. They also contended they never received the 1999 Form 1099-MISC.

Holding. The court concluded that the $25,000 represented taxable income for the following reasons:

- It was not the result of "detached and disinterested generosity or paid out of affection, respect, admiration, or charity."
- It was paid to avoid a lawsuit and to avoid public and professional embarrassment.
- Nonreceipt of a Form 1099 does not make a taxable income item nontaxable.[35]

Medical Benefits of Spouse

***Peter F. and Maureen L. Speltz,* TC Summary Opinion 2006-25, February 14, 2006**
IRC §§105, 162, and 7491

☞ Sole Proprietor Allowed to Deduct Medical Benefit Expenses for Spouse

Facts. Maureen Speltz operated a daycare business in her home. She cared for up to 16 children daily during 2000 and 2001. After meeting with a tax advisor in 2000, she established an employer-provided health plan for her husband-employee, Peter Speltz. This tax planning device is commonly referred to as an IRC §105(b) plan.

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35. *Bond v. Commissioner*, TC Memo 2005-251, October 31, 2005 and *Vaughn v. Commissioner*, TC Memo 1992-317, affirmed 1993

Three documents were executed in establishing this plan:

1. **An employment contract** describing the job duties of Mr. Speltz (e.g., childcare, lawn care, chopping firewood, and repairing toys). Mr. Speltz signed the contract.
2. **An employee salary redirection agreement** providing that $542 per month would be directed to a flexible spending account (FSA) on Mr. Speltz's behalf to pay for his insured and uninsured healthcare costs. The agreement was signed by Mr. Speltz as an "employee" and by Mrs. Speltz as his "employer."
3. **A client data sheet** requiring Mr. Speltz to work a minimum of 12.5 hours a week and a minimum of seven months a year. It also stated that Mr. Speltz's medical reimbursement was limited to $6,500 per year.

Mrs. Speltz deducted the following as "employee benefit program" expenses on her 2000 and 2001 Schedule Cs:

- $3,279, including $707 for health insurance premiums (2000)
- $4,539, including $968 for health insurance premiums (2001)

The IRS disallowed the claimed expenses.

Issues.

1. Whether the married taxpayers had an employer-employee relationship.
2. Whether Mr. Speltz may exclude from gross income the medical benefits paid by his employer-spouse under IRC §105(b).
3. Whether Mrs. Speltz may deduct the employee benefit program expenses as business expenses under IRC §162(a).

Analysis. The taxpayers contended that Maureen Speltz had properly established a §105(b) plan for her bona fide employee-spouse, Peter. The IRS contended that Mr. Speltz was not a bona fide employee and that he did not work the required 12.5 hours per week for **every week** of the two years.

Holding. The Tax Court held that Maureen and Peter Speltz had a valid employer-employee relationship. Therefore, the medical benefits were excludable by Peter and deductible by Maureen on her Schedule Cs. The court noted that the total medical benefits he received equated to $13 an hour, an amount Mrs. Speltz testified that she would have had to pay an unrelated worker.

> **Note.** This case also involved the issue of whether the **burden of proof** shifted to the IRS at the Tax Court under the rules of IRC §7491(a). The court ruled that it did because the taxpayers reasonably complied with requests from the IRS for information, documents, and meetings.

Unlawful Employer Discrimination Award

***Marrita Murphy, et al. v. Internal Revenue Service,* District of Columbia Circuit Court of Appeals, No. 05-5139, August 22, 2006 [reversing prior U.S. District Court for the District of Columbia decision: No. 03cv02414, March 22, 2005]**
IRC §104

☞ IRC §104(a)(2) Ruled Unconstitutional

Facts. Marrita Murphy sued her former employer, the New York National Guard (NYNG), after she was fired for filing a complaint regarding environmental hazards at an airbase. She was awarded a total of $70,000, consisting of:

- $45,000 for mental pain and anguish, and
- $25,000 for "injury to professional reputation" from having been blacklisted by the NYNG.

She originally reported the $70,000 on her 2000 return and later filed three amended returns to try to convince the IRS that it should be excluded. She contended that the entire award was excludable because her mental pain and distress resulted in a severe case of bruxism (teeth grinding), which qualifies as a "physical sickness."

Her repeated requests for a refund of taxes paid on the $70,000 were denied by the IRS. She filed a refund suit with the U.S. District Court which held that the entire award was taxable.

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

Analysis and Holding. In an extremely unusual and surprising decision, the Appeals Court held that:

- The $70,000 was **not** received "on account of physical injuries or physical sickness" and statutorily was **not excludable** from gross income.
- However, IRC §104(a)(2) is **unconstitutional** under the Sixteenth Amendment **since the entire award was unrelated to lost wages or earnings.**
- As a result, the entire $70,000 is excludable from gross income.

Note. The IRS will likely appeal this decision to the Supreme Court. This decision will undoubtedly result in:

1. Many protective refund claims from taxpayers who have already included similar past awards in gross income, and
2. Numerous similar constitutional challenges to the definition of gross income as defined by the Internal Revenue Code.

See page 523 in the 2005 *University of Illinois Federal Tax Workbook* for an analysis of the prior U.S. District Court decision.

INNOCENT SPOUSE

Equitable Relief

***Marc S. Feldman v. Commissioner*, 9th Cir. Ct. of Appeals, No. 03-74792, October 28, 2005 [affirming prior Tax Court decision: TC Memo 2003-201, July 10, 2003]**
IRC §6015

☞ Highly Paid Attorney Denied Innocent Spouse Relief

Facts. Marc Feldman, a partner in a Los Angeles law firm, was married to Lauren Trevino. Due to the many hours he worked each week, Lauren was responsible for the family finances. Generally, Marc signed his law firm paychecks and gave them to Lauren who would then pay the family's bills and make investments.

In 1997, the law firm was experiencing cash flow problems. Marc, as managing partner, engaged a bank to provide a line of credit to the law firm, pledging his personal bank accounts as collateral for the loan. It was then that Marc determined that his bank accounts had been closed or had minimal balances due mainly to Lauren's prolific spending. Marc and Lauren separated in September 1997 and were divorced in 1999.

The following information relating to the joint 1996 and 1997 tax returns filed by Marc and Lauren was reported on their two joint returns:

Year	AGI	Taxable Income	Total Tax	Estimated Tax Paid	Balance Due
1996	$762,751	$573,117	$228,143	$153,500	$ 74,643
1997	454,227	280,876	119,595	None	126,038*

*The $126,038 balance due for 1997 includes an estimated tax penalty of $6,443.

In 1998, Marc filed Form 8857, *Request for Innocent Spouse Relief*, seeking innocent spouse relief under the equitable relief provisions of IRC §6015(f), for the 1996 and 1997 tax liabilities. The requested relief was denied in chronological order by:

- The IRS's Cincinnati Service Center
- The Appeals Office of IRS
- The Tax Court in its prior TC Memo 2003-201 decision

Issue. Whether, under IRC §6015(f), the taxpayer was entitled to equitable relief from tax liability as an innocent spouse for 1996 and 1997.

Analysis. Rev. Proc. 2003-61 provides six negative and six positive factors to be considered when determining whether to grant equitable innocent spouse relief.

Holding. The Appeals Court held that the decision of the Tax Court to deny the equitable innocent spouse relief was proper because the negative factors outweighed the positive factors. The Tax Court had found that the three following negative factors were the most important in deciding to deny relief to Mr. Feldman:

- He knew or should have known that the 1996 and 1997 taxes were unpaid when he signed the two tax returns.
- All of the tax liability 1996 and 1997 was attributable to his income since his wife had no income of her own.
- Because he was a highly paid attorney, he would suffer no economic hardship if he was denied innocent spouse relief.

The Tax Court had decided that the only positive factor in favor of granting relief was that Mr. Feldman was divorced.

IRS Denial of Innocent Spouse Relief

***Gwendolyn A. Ewing v. Commissioner*, 9th Cir. Ct. of Appeals, Nos. 04-73237 & 04-73699, February 28, 2006 [reversing two prior Tax Court decisions: 118 TC 494 and 122 TC 32, No. 2]**
IRC §6015(e)

☞ Lack of Assessed Tax Deficiency Dooms Innocent Spouse Relief Request

Facts. Gwendolyn Ewing married Richard Wiwi in 1995. He was an unsuccessful self-employed insurance and securities salesman. He concealed from Gwendolyn that he had prior financial problems, including unpaid federal income tax for 1993 and 1994.

Gwendolyn and Richard filed a joint 1995 tax return. The 1995 return reported the following:

Balance due	$6,220
Amount of balance due paid with the return by Gwendolyn	1,069
Amount of balance due paid with the return by Richard	551
Unpaid balance due	**$4,600**

After the IRS made numerous attempts to collect the unpaid balance, Richard Wiwi filed an offer in compromise in 1999. He contended that he was unable to pay the entire outstanding 1995 tax liability. At the same time, Gwendolyn filed Form 8857, *Request for Innocent Spouse Relief*. **She requested equitable relief from joint liability under IRC §6015(f).**

The IRS denied her request and Gwendolyn Ewing petitioned the Tax Court. In 1994, the Tax Court held that Gwendolyn was entitled to equitable relief from joint tax liability. **This decision by the Tax Court was in spite of the fact that the IRS had never assessed a tax deficiency against the tax liability originally reported on the couple's 1995 joint tax return.** The IRS then appealed the 1994 Tax Court decision to the 9th Circuit.

Issue. Whether the Tax Court has jurisdiction under IRC §6015(e) to review an IRS denial of innocent spouse relief when no tax deficiency was asserted by the IRS.

Analysis. IRC §6015(e) provides a review by the Tax Court for innocent spouse relief requests that are initially denied by the IRS.

Holding. The 9th Circuit held that because no deficiency was assessed by the IRS against Mrs. Ewing for the 1995 joint tax return, the Tax Court did **not** have jurisdiction to review the denial of her innocent spouse relief request.

> **Observation.** The 9th Circuit made it clear that the review by the Tax Court of IRS denials of innocent spouse relief is limited to situations in which a tax deficiency was assessed and the taxpayer is seeking relief under either:
>
> 1. **IRC §6015(b).** Understatement of tax due to "erroneous items" of the other spouse or former spouse of which the innocent spouse was unaware, or
> 2. **IRC §6015(c).** Separation of liability for an understatement of tax, if the taxpayers are divorced, separated, or living apart.

The Tax Court review is **not** available to situations in which the innocent spouse has requested **equitable relief** under IRC §6015(f) as Mrs. Ewing did.

> **Note.** See pages 517-18 in the *2004 University of Illinois Federal Tax Workbook* for an analysis of the 2004 Tax Court decision in which innocent spouse relief was granted to Mrs. Ewing.

IRS PROCEDURES — AUDITS

Examination

Chief Counsel Advice 200612015, March 24, 2006

IRC §7605

☞ Voluntary Contact Does Not Constitute Examination Opening

Purpose. To determine if an informal meeting with the IRS and a response to a questionnaire is considered an examination.

Background. The IRS is using a new software system to identify returns that are likely to have a high probability of error. A list of returns was generated and the IRS examined a specific number of returns showing the highest probability of error. For the remaining returns, the IRS implemented an optional contact approach by sending letters asking taxpayers to voluntarily answer a questionnaire and informally meet with an IRS examiner. The questionnaire asks a number of general questions, as well as specific questions tied to the taxpayer's return. The cover letter clearly states the IRS is not conducting an examination, does not want to examine taxpayer's books and records, and will follow the proper protocol for opening an examination if one is warranted.

IRC §7605(b) provides that a taxpayer may not be subjected to unnecessary examinations or investigations and that the IRS may inspect a taxpayer's books and records only once the IRS notifies the taxpayer that an additional inspection is necessary.

Analysis and Conclusion. The Chief Counsel relied heavily on the voluntary aspect of both the answering of questions, as well as the meeting with an IRS representative in determining the letter and questionnaire do not constitute an examination pursuant to IRC §7605(b).

IRS PROCEDURES — ELECTRONIC ISSUES

www.irs.gov
IRS News Release IR-2005-134, November 21, 2005

☞ New and Improved IRS Website

The IRS website (**www.irs.gov**) is continuously improved to allow ease of navigation and obtaining information. Most recently, a new color scheme and banner logo were added to the website. A new row of navigation buttons for Individuals, Businesses, Nonprofits and Charities, Tax Professionals, and other areas were also added. These "shortcut" buttons take you directly to key pages. An improved search function now allows for searches by keyword or search term.

Other highlights include:

- **Most requested forms and publications** — highlights the top five most requested forms and publications
- **Online tools** — features several of the most frequently used online tools such as filing electronically and determining refund status
- **Featured content** — reserved for information currently important to many users such as news headlines
- **Information about** — provides six links to general information accessed by many users
- **I need to … —** drop-down menu that gives users quick access to frequently accessed information within a particular content area
- **Image** — contains main image for www.irs.gov homepage
- **Promotional advertisements** — allows IRS to bring new programs, information, and features on web site to users' attention.

e-File

IRS News Release IR-2006-1, January 3, 2006
IRS News Release IR-2006-10, January 12, 2006
IRS News Release IR-2006-39, March 7, 2006
IRS News Release IR-2006-53, April 6, 2006
IRS News Release IR-2006-64, April 14, 2006
IRS News Release IR-2006-68, April 26, 2006
IRS Fact Sheet FS-2006-4, January 2006

☞ e-File Marks its 20th Year

IRS e-File celebrates its 20th anniversary in 2006. The IRS e-file pilot project was launched in 1986 involving three cities: Cincinnati, Phoenix, and Raleigh-Durham. During the pilot, 25,000 tax returns were filed electronically. Expansion of the e-file program went nationwide in 1990 with 4.2 million returns filed electronically.

More than 70 million tax returns were filed during the 2006 filing season. This figure included 20 millions returns filed from a home computer and **50 million returns from tax professionals.**

ElectronicIRS

IRS News Release IR-2006-10, January 12, 2006

☞ Debut of electronicIRS

As part of its e-File 20th anniversary celebration, the IRS launched electronicIRS, a centralized source for all IRS electronic options.

Some of the options included in electroinicIRS are:

- Individual Taxpayers
- Where's My Refund? tool
- Calculate Form W-4 withholding
- Get copies of tax returns
- Compute EITC eligibility
- Determine 2004 Earned Income – Online option for Hurricane Victims
- Use the Alternative Minimum Tax (AMT) assistant
- Large Business Taxpayers
- Small Business Taxpayers
- Obtain an Employer Identification Number (EIN) online
- Visit the Small Business/Self-Employed online classroom
- Subscribe to retirement news for employers
- Tax Professionals
- Find out about electronic payment options
- Find e-file information designed for tax professionals

- Participate in Tax Talk Today
- Apply to be an Authorized e-file Provider
- Review materials in the IRS Electronic Reading Room
- Utilize e-help services to access phone representatives
- Subscribe to electronic alerts and newsletters
- Submit information returns utilizing the FIRE program
- Tax-exempt organizations
- Discover e-file options for charities and non-profits
- Determine if **required** to electronically file
- Check if an organization is eligible to receive deductible charitable contributions
- Electronic filing options
- Pay electronically using EFTPS, Electronic Funds Withdrawal, or credit card
- Find an authorized e-file provider
- File W-2s electronically
- Register for e-services
- Download forms and publications

Phishing

IRS News Release IR-2006-49, March 27, 2006

☞ IRS Email Address Created to Report Fraudulent Emails

An electronic mailbox was established by the IRS to allow taxpayers to send copies of potentially fraudulent emails allegedly sent from the IRS involving misuse of the IRS name or IRS logo. The email address is phishing@irs.gov. These e-mails are intended to trick recipients into disclosing personal and financial information that could be used to steal the recipients' identity and financial assets. Emails submitted to the IRS will not be acknowledged due to the anticipated volume.

Currently, the Treasury Inspector General for Tax Administration (TIGTA) identified more than two dozen IRS-related **phishing scams** with scam web sites located in at least 20 different countries. Current scams claim to originate from the IRS and indicate a refund is due. The email directs the taxpayer to a web site that appears to be a genuine IRS site.

The IRS does not send out unsolicited e-mails, ask for detailed personal information such as PIN numbers, passwords, or similar secret access information for their credit card, bank, or other financial accounts.

Email addresses that are heavily targeted are those from the education community with email addresses ending in ".edu."

A sample phishing email that might be received follows:

From: Internal Revenue Service [mailto:admin@irs.gov]
Sent: Wednesday, March 01, 2006 12:45 PM
To: john.doe@jdoe.com
Subject: IRS Notification - Please Read This.

After the last annual calculations of your fiscal activity we have determined that you are eligible to receive a tax refund of **$63.80.** Please submit the tax refund request and allow us 6-9 days in order to process it.

A refund can be delayed for a variety of reasons. For example submitting invalid records or applying after the deadline. To access the form for your tax refund, please **click here**

Regards,
Internal Revenue Service

When looking at a potential website, make sure that the address in the browser bar begins with **http://www.irs.gov/** to ensure you are at the IRS web page.

IRS PROCEDURES — MISCELLANEOUS

Tax Gap
IRS News Release IR-2006-28, February 14, 2006

☞ 2001 Tax Gap $345 Billion Dollars

The gross tax gap is defined as the difference between what taxpayers **should pay** and what they **actually pay** on a timely basis. Three components included in the tax gap are:

1. Underreporting of income,
2. Underpayment of taxes, and
3. Nonfiling of returns.

The tax gap findings resulted from the three-year National Research Program (NRP) study which examined 46,000 individual returns for 2001. In 2005, the gross tax gap was estimated at more than $300 billion, with an offset from IRS compliance efforts and late paid taxes estimated at $55 billion. This results in a net tax gap of approximately $257 billion.

The IRS determined the tax gap for 2001 was actually $345 billion. After the $55 billion recovery from IRS compliance efforts and late paid taxes, a net tax gap of $290 billion remains. More than 80% of the tax gap comes from underreported taxes; the remaining 20% comes from underpayment of tax and nonfiling.

The IRS increased enforcement activities by nearly 40%, from $33.8 billion in 2001 to $47.3 billion in 2005. Examinations for taxpayers earning $100,000 or more topped 221,000 in fiscal year 2005, the highest number in the past 10 years. Total examinations exceeded 1.2 million in 2005, representing at 20% increase from 2004.

Updated findings from the NRP study include estimates of the Net Misreporting Percentage (NMP) for each major line item on individual income tax returns. Even though the NMP varies by category of income, compliance is highest where third-party reporting or withholding occurs.

The National Taxpayer Advocate, as well as the Government Accountability Office (GAO), both voiced opinions on the tax gap situation. Measures to narrow the gap might include:

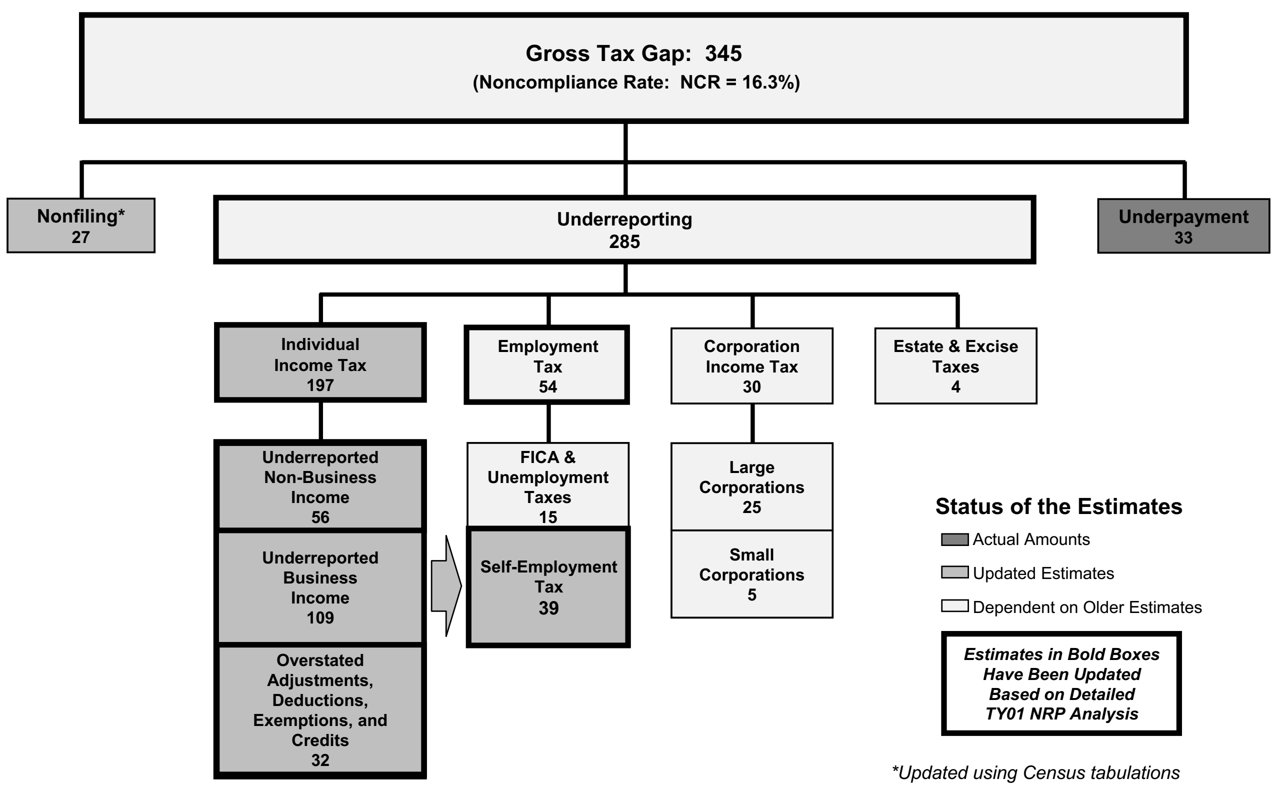
- Simplifying the Internal Revenue Code,
- Increasing tax withholding for income currently not subject to withholding,
- Improving information reporting,
- Leveraging technology to improve the IRS's ability to receive and process tax returns, and
- Requiring brokers to report their customers' cost basis for stock and mutual fund sales.

Five legislative changes to reduce the tax gap are contained in the fiscal year 2007 President's budget proposal. They include:

1. Expansion of third-party information reporting to include certain government payments for property and services,
2. Expansion of third-party information reporting on debt and credit card reimbursements to certain merchants,
3. Clarification of employment tax liability for employee leasing companies and their clients,
4. Expansion of the requirement that paid return preparers **sign returns beyond income taxes** and imposition of a penalty when they fail to do so, and
5. Authorization of the IRS to issue levies in order to collect employment tax debts prior to collection due process proceedings.

Tax Year 2001 FEDERAL TAX GAP

(in Billions of Dollars)



User Fees

IRS News Release IR-2005-144, December 19, 2005
Revenue Procedure 2006-1, January 3, 2006
Revenue Procedure 2006-2, January 3, 2006
Revenue Procedure 2006-3, January 3, 2006
Revenue Procedure 2006-4, January 3, 2006
Revenue Procedure 2006-5, January 3, 2006
Revenue Procedure 2006-6, January 3, 2006
Revenue Procedure 2006-7, January 3, 2006
Revenue Procedure 2006-8, January 3, 2006
Revenue Procedure 2006-9, January 9, 2006
IRC §§367, 401, 403, 408A, 412, 446, 482, 501, 503, 507, 509, 511, 521, 528, 4871, 4945, 4975, 6039G, 7121, and 7871

☞ IRS Provides Updated User Fee Schedules

Effective February 1, 2006, user fees increased to reflect the costs of processing various applications, ruling requests, and opinion letters.

The nine revenue procedures listed (2006-1 through 2006-9) provide additional information on fees charged, instructions for making requests, what types of information can be requested, and other items important to practitioners.

	Current Fee	Increased Fee
Effective February 1, 2006		
Private letter rulings	$7,500	$10,000
Changes in accounting methods	$1,500	$2,500
Pre-filing agreement (corporate taxpayers)	Max of $10,000	Flat fee of $50,000
Advance pricing agreements	$5,000–$25,000	$22,500–$50,000
Employee plans, fees for opinion letters on prototype IRAs, SEPs, SIMPLE IRAs and Roth IRAs	$125–$2,570	$200–$4,500
Exempt organization rulings	$155–$2,570	$275–$8,700
Effective July 1, 2006		
Exempt organization applications and request for group exemption letters	$150–$500	$300–$900
Opinions issued under revised and centralized EP determination letter program for Forms 5300, 5307, and 5310	$125–$6,500	$200–$15,000

Special Provisions

IRS Fact Sheet FS-2006-12, January 2006
IRS Fact Sheet FS-2006-13, January 2006
IRS News Release IR-2006-18, January 24, 2006
IRS News Release IR-2006-27, February 10, 2006

☞ Changes Resulting From Katrina, Rita, and Wilma

IRS Pub. 4492, *Information for Taxpayers Affected by Hurricanes Katrina*, *Rita*, and Wilma, is currently available at **www.irs.gov.**

Highlights of **current changes** include:

- Tax-favored early distributions and loans from retirement accounts
- Elimination of limitations on claiming of losses
- Regarding earned income credit (EIC) and refundable child tax credit: taxpayers can choose either the 2004 or 2005 earned income figures to compute their 2005 EIC and 2005 refundable child tax credit
- Exclusion of certain cancellation of debt from income
- Extends replacement period for converted properties from two to five years
- Expansion of Hope and lifetime learning credits for students enrolled and paying tuition at institutions in the GO Zone for tax years beginning in 2005 or 2006
- Removal of $100 and 10% limitations for losses on personal-use property; allowing the entire unreimbursed loss to be deductible

To encourage charity, the law:

- Suspends limits on certain charitable contributions,
- Creates an exemption for those housing Hurricane Katrina displaced individuals,
- Increases standard mileage rate for charitable use of vehicles, and
- Excludes from gross income certain mileage reimbursements to charitable volunteers.

Business related provisions include:

- Increased expensing for small businesses
- Special bonus depreciation
- Deduction for demolition and clean-up costs
- Net operating loss carryback
- Work opportunity tax credit for Hurricane Katrina employees
- Income exclusion and employer credit for housing employees in the region affected by Hurricane Katrina.

Current law also allows:

- Disaster-related losses claimed on prior year tax return until October 16, 2006,
- Automatic extensions in many areas hardest hit by Hurricane Katrina through August 28, 2006,

Adequate disclosure

***Eric B. Benson, et al v. Commissioner,* TC Memo 2006-55, March 27, 2006 supplementing opinion in *Benson v. Commissioner,* TC Memo 2004-272, November 29, 2004**
IRC §6501

☞ Amended Returns Irrelevant

Facts. In *Benson v. Commissioner,*[36] the court found that the Bensons received constructive dividends in 1989, 1990, 1993, and 1994. Several entities including an S corporation and C corporation were included in the group. The taxpayers then filed a motion for reconsideration alleging the prior opinion did not provide a basis to resolve if understatements of gross income were disclosed on the returns as filed. The court agreed to the reconsideration.

The 1989, 1990, 1993, and 1994 tax returns showed unreported income totaling $629,177, $456,500, $3,831,923, and $469,713, respectively. The normal 3-year statute of limitations period pursuant to IRC §6501(a) would bar these assessments unless IRC §6501(e) applies. The IRS believed the 6-year statute should apply and the taxpayer disagreed.

Issue. Whether the 6-year statute of limitations under IRC §6501(e) is applicable, thus allowing assessment of the deficiencies.

Analysis. IRC §6501(a) generally bars the assessment of a deficiency after three years from the date the return was filed. IRC §6501(e) provides for a 6-year period of limitations if more than 25% of the gross income stated on the return is omitted. IRC §6501(e)(1)(A)(ii) provides that any amount disclosed in a return or in an attached statement, is not considered omitted gross income, as long as it is disclosed in a manner adequate to apprise the IRS as to the nature and amount of the items.

In this case, the court applied a **rigorous standard** to determine what constitutes adequate disclosure when greater than 25% unreported gross income exists. Amended returns filed that **decrease** the underreporting to less than 25% do not weigh in the taxpayers favor for shortening the 6-year assessment period. Clear disclosures on income must be made or misleading items are considered omitted items.

In this case, the court found that the S corporation did not disclose royalties received from a related C corporation even though the taxpayer acted on behalf of both entities. The same rationale was raised for certain engineering services. This also applied to rents as well as constructive dividends.

Holding. The court determined more than 25% of gross income was omitted. Therefore, the 6-year statute of limitations applies.

Personal Wealth

***New Dynamics Foundation v. United States,* United States Court of Federal Claims, No. 99-197T, April 24, 2006**
IRC §501(c)(3)

☞ Donor Advised Fund Denied Exempt Status

Facts. In May 1996, New Dynamics Foundation (NDF) initially filed with the IRS seeking tax-exempt status. The initial charitable purpose included support for prison ministries, alcohol and drug abuse education, and wildlife conservation. Donors had the choice of either directing gifts for a specific purpose or board determined projects. NDF provided a copy of the organization's operation manual which explained listed examples of charitable uses and how the funds were to be used, including the ability to also benefit the donor or donor's family. In addition, NDF used administrative expenses to pay the donor or donor family member to research an investment or attend a meeting. After

15

[36] *Benson v. Commissioner,* TC Memo 2004-272, November 29, 2004

review of additional information and NDF protest, the IRS issued a final ruling denying the application because NDF failed to establish:

- It was operated exclusively for IRC §501(c)(3) purposes,
- Net earnings would not insure the benefit of private individuals, and
- More than an insubstantial part of its activities would further private purposes.

NDF then filed suit challenging the IRS determination.

Issue. Whether NDF qualifies as a tax-exempt organization under IRC §501(c)(3).

Analysis and Holding. A tax-exempt organization is required to be organized for at least one exempt purpose. Although NDF was organized for exempt purposes, it was **not operated for exempt purposes**. Donors were reimbursed for trips, retreats, meals, and lodging. Major expenditures were approved such as a $150,000 motor home used only incidentally to provide charitable services. NDF promotional materials stated that donors could use donor funds to "warehouse wealth for long-range planning and wealth accumulations" thus avoiding capital gains and eliminating estate taxes.

The court upheld the IRS's denial of IRC §501(c)(3) status since the organization was in reality a conduit through which donors could increase personal wealth tax-free and use the accumulated wealth to pay for personal expenditures.

> **Note.** See Chapter 8, "Special Taxpayers," for a discussion of tax-exempt organizations.

2006 Report to Congress

IRS News Release IR-2006-111, July 13, 2006

☞ National Taxpayer Advocate Identifies Priority Issues

In the 2006 Report to Congress, the IRS National Taxpayer Advocate identified the priorities her office will address in the upcoming fiscal year. They are:

- Rules governing the use, or disclosure of tax return information by return preparers,
- New partial payment requirement with submissions of offers in compromise,
- Guidance on non-hardship effective tax administration offers, and
- Private debt collection initiative.

To contact the Taxpayer Advocate Service call toll-free at 1-877-777-4778 or write/call your local advocate at the address or phone number listed in the local telephone directory.

Delinquent Tax Collection Effort

IRS News Release IR-2006-42, March 9, 2006

IRS Fact Sheet FS-2006-18, March, 2006

☞ Private Debt Collection Initiative

The 2004 American Jobs Creation Act authorized the IRS to hire private firms to collect federal tax debts. Three firms, who were awarded contracts to participate in the first phase of the private debt collection initiative, are:

- The CBE Group, Inc.
- Linebarger Goggan Blaire & Sampson, LLP
- Pioneer Credit Recovery, Inc.

These firms are subject to the same stringent taxpayer collection and privacy rules under which IRS employees work. These firms are authorized to contact taxpayers to make payment arrangements. FS-2006-18 provides a listing of Taxpayer Disclosure and Safeguards designed to protect taxpayers as part of this private debt collection initiative. Private firms **cannot**:

- Subcontract the debt collection work,
- Perform enforcement actions such as liens, levies, or seizures, or
- Work on technical issues such as offers in compromise, bankruptcies, litigation, or hardship issues.

The second phase is scheduled for 2008 and will contract with an estimated 10 firms. Over the course of 10 years, an additional $1.4 billion in outstanding taxes will be collected with the help of private firms.

IRS Chief Counsel Comments

Bank Secrecy Act

IRS News Release IR-2006-70, April 27, 2006

☞ Money Laundering Agreements Will Enhance Compliance

Bank Secrecy Act (BSA) information is shared between the IRS and 33 states, as well as Puerto Rico, to allow leveraging of resources. This ensures that money services businesses (MSBs) are in compliance to report cash transactions and suspicious activities. Examples of MSBs include currency exchangers, check cashers, issuers of traveler's checks or stored value cards, and money transmitters.

The IRS and participating states share only BSA examination information, not tax information. This helps both the states and the IRS present a united compliance front to MSBs and their representatives.

States signing partnership agreements include: Alabama, Alaska, Arizona, Arkansas, California, Connecticut, Georgia, Idaho, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Nebraska, New Jersey, New York, North Carolina, Ohio, Oregon, Pennsylvania, South Dakota, Tennessee, Texas, Utah, Vermont, Washington, West Virginia, Wisconsin and Wyoming.

The following states cannot enter into these agreements either because they do not regulate the industry or it is prohibited by state law: Colorado, Hawaii, Montana, New Hampshire, New Mexico and Montana.

Additional information is available on **www.irs.gov** and the Financial Crimes Enforcement Network (FinCEN) at **www.fincen.gov.**

Credit Counseling Agencies

IRS News Release IR-2006-80, May 15, 2006
Chief Counsel Advice 200620001, May 9, 2006
IRC §501(c)(3)

☞ Crackdown on Abuses by Credit Counseling Agencies

Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), anyone who files for bankruptcy must first visit a credit counseling agency. There are more than 800 tax-exempt credit counseling agencies which provide counseling and education services.

> **Note.** More information regarding BAPCPA can be found in Chapter 8, "Special Taxpayers," and Chapter 12, "Agricultural Issues and Rural Investments."

IRS Commissioner Mark Everson stated, "Over a period of years, tax-exempt credit counseling became a big business dominated by bad actors. Our examinations substantiated that these organizations have not been operating for the public good and don't deserve tax-exempt status."

Over the past two years, this $1 billion industry has undergone audits. The IRS audited 63 credit counseling agencies. These 63 agencies represent more than half of the revenue in the industry. Of the 41 audits that are complete, **all** of the audits resulted in **revocation, proposed revocation, or other termination of tax-exempt status.** Most of these actions were a result of failure to provide the level of public benefit required to qualify for tax exemption.

As a result, the IRS is

- Tightening up its review of new applications by credit counseling firms for tax-exempt status,
- Issuing expanded guidance, including legal standards for exemption and factors considered by the IRS in its audits, and
- Sending compliance inquiries to each of the remaining 740 known tax-exempt credit counseling agencies.

Questionable Refund Program

IRS News Release IR-2006-24, February 6, 2006

☞ Improvement Made to Questionable Refund Program (QRP)

The QRP, which started in 1977, identifies fraudulent refund claims. Its primary focus is on individual returns. Many cases involve bogus W-2s and EITC abuse, costing the federal government up to $500 million in fraudulent refund claims. The IRS freezes less than 1% of all refunds as part of this program.

As the result of questions raised by Congress and the IRS National Taxpayer Advocate, the IRS is taking serious steps to improve the Questionable Refund Program (QRP).

Improvements include:

- Notifying taxpayers when their refunds are frozen
- Expediting review of returns, resulting in an earlier release of refunds
- Refining accuracy filters to reduce the initial number of valid refund claims held by the IRS

Implementation of these improvements is currently underway at the IRS.

IRS PROCEDURES — PAYMENTS

CDP

***Thomas Butti v. Commissioner,* TC Memo 2006-66, April 5, 2006**
IRC §6330

☞ Prison Inmate Wins Opportunity For CDP Hearing

Facts. Mr. Butti, a pro se taxpayer, was a licensed chiropractor practicing in Yonkers, New York. In August of 1994, he pled guilty and was incarcerated for the following charges:

- Grand larceny in the second degree,
- Attempted grand larceny in the third degree,
- Offering a false instrument for filing in the first degree, and
- Insurance fraud in the second degree.

The IRS sent a notice of deficiency for tax years 1989 and 1990 which was received at Gowanda Correctional Facility on January 4, 1999. Unfortunately, Mr. Butti did not arrive at this facility until January 21, 1999 when he signed for two pieces of certified mail. The log at the prison did not indicate whether other certified mail had also been delivered.

A notice of intent to levy was issued on November 8, 2000, when Mr. Butti owed in excess of $380,000 for 1989, 1990 and 1999. Mr. Butti timely responded with a request for collection due process (CDP) hearing. He attached an explanation that he had not received the notice of deficiency and was not liable for the amounts as stated in the notice.

The Appeals officer scheduled a hearing for Mr. Butti in the IRS New York office. Mr. Butti responded by a letter to the appeals officer notifying him of his incarceration and lack of funds to hire a representative. The Appeals officer did not reschedule the hearing at Mr. Butti's request, although he indicated he would in his correspondence. A Notice of Determination Concerning Collection Action Under IRC §§6320 and/or 6330 was issued, upholding the appeals officer's determination. Mr. Butti then appealed to the Tax Court.

Issue. Whether the IRS may proceed with collection of income tax liabilities for 1989, 1990, and 1999.

Analysis and Holding. At trial, Mr. Butti argued that he had a right to a hearing and had not received a notice of deficiency. The Tax Court agreed with Mr. Butti. Since the appeals officer had not rescheduled the hearing, Mr. Butti was denied the opportunity for a hearing under IRC §6330(b). The case was returned to the IRS for a CDP hearing as required by IRC §6330(b).

Collection Due Process (CDP)

***James M. Robinette v. Commissioner,* United States Court of Appeals, (8th Circuit), No. 04-3600, March 8, 2006 reversing the Tax Court decision, 123 TC 5, July 20, 2004**
IRC §6330§ and 6331

☞ CDP Hearing Limited to Administrative Record

Facts. Mr. Robinette failed to pay his federal income taxes between 1983 and 1991. He also neglected to pay his trust fund taxes from 1988–1990. His tax liabilities were over $1 million. In 1994, he submitted an offer in compromise for $100,000 along with a collateral agreement for an additional percentage of any income over $100,000 for 1996–2000 timely filed tax returns.

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A problem arose when the 1998 tax return was not timely filed despite repeated letters from the IRS. Finally, in July 2000, the IRS sent Mr. Robinette a letter notifying him that since he had violated the terms of the agreement, his offer was being defaulted.

A notice of levy was sent and the taxpayer disputed the amounts owed and requested a collection due process hearing. During the appeals conference, the accountant/attorney insisted the 1998 return was mailed just before midnight on October 16, 1999 along with several other clients' returns. The return was processed by the IRS on February 16, 2001. The appeals officer sustained the levy imposition since Mr. Robinette had not responded to the requests to file the return before the offer was defaulted.

Mr. Robinette appealed to the Tax Court which ultimately agreed with Mr. Robinette. The Tax Court reasoned the offer should not have been defaulted and the decision to proceed with collection was an **abuse of IRS discretion** based on additional documentation provided in the Tax Court proceedings. The IRS appealed the Tax Court decision.

Issue. Whether the IRS may proceed with collection of the tax liabilities based on the defaulted offer in compromise.

Analysis. IRC §6331(a) authorizes the IRS to levy upon all property and rights to property of a taxpayer where there exists a failure to pay any tax liability within 10 days after demand for payment. IRC §6330(c) addresses the matters to be considered at the hearing:

The Appeals Court disagreed with two Tax Court rulings:

- The appeals officer did not have an open mind to Mr. Robinette's arguments, and that he should have independently analyzed whether the offer in compromise had been materially breached, and
- The appeals officer abused his discretion by not properly weighing the alternatives to collection, and failing to have an open mind regarding reinstatement.

Holding. The Appeals Court determined the Tax Court should have limited its review solely to the administrative record and should not have examined additional evidence outside the administrative record. Reversing the Tax Court decision, the Appeals Court determined the IRS did not abuse its discretion in upholding the levy against the taxpayer.

> **Caution.** In many cases, the Tax Court's decision is based on evidence presented during the trial itself. This ruling could be a setback if taxpayers are limited to evidence based on the administrative record. This limitation could likely be tested in other circuits.

Offer in Compromise
IRS Fact Sheet FS-2006-22, July 11, 2006
IRS Notice 2006-68, July 11, 2006
IRC §7122

☞ Newly Revamped Offer in Compromise (OIC) Program

Section 509 of The Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) made major changes to the offer in compromise (OIC) program, which apply to all offers received by the IRS **on or after July 16, 2006.** The offer postmark date is irrelevant.

The major changes include:

- Addition of IRC §7122(c) "Rules for Submission of Offers-in-Compromise",
- A 20% nonrefundable, up front payment must accompany lump-sum offers (five or fewer installments),

- A nonrefundable, up-front payment plus any other proposed payments during the IRS offer evaluation period, must accompany a periodic-payment OIC (six or more installments),
- Low-income taxpayers, or offers based on doubt as to liability qualify for waiver of new partial payment requirements, and
- If the IRS fails to act upon the OIC application within **two** years, it is deemed accepted.

Failure to pay either the 20% payment or installment payment with the offer results in an unprocessable offer which is returned to the taxpayer. However, if a lump-sum offer is submitted with a payment less than the required 20%, the taxpayer is asked to submit the additional money. If the additional money is not received, the offer is returned to the taxpayer and the $150 application fee is retained by the IRS. Both payments are considered payments on tax and are not refundable deposits.

Additionally, an offer is treated as a withdrawal when a taxpayer fails to make installment payments on periodic-payment offers after providing the initial payment. The offer application is returned to the taxpayer.

In addition to OIC, other payment solutions continue to be available to taxpayers owing monies to the IRS such as:

- Extension of time to pay
- Installment agreement
- Delaying collection

Jeopardy Levy

Michael A. and Gina A. Zapara v. Commissioner, **126 TC No. 11, April 25, 2006**
IRC §6335

☞ Request to Sell Levied Stock Must Be Honored by IRS

Facts. Mr. and Mrs. Zapara owed tax liabilities of $500,000 for years 1993-1998 at the time the IRS made a jeopardy levy related to certain nominee stock accounts. The taxpayers requested an appeals hearing. While they were awaiting the appeals process, the taxpayers became concerned about a possible decline in the stock and requested permission to sell. The appeals officer considered the request but never officially approved the permission to sell that stock.

In May 2002, a Notice of Determination Concerning Collection Action Under IRC §§6320 and/or 6330 was issued to the taxpayers. This notice determined the taxpayers were precluded from challenging their underlying tax liabilities and that the jeopardy levy would not be withdrawn. The request to sell the stock was not addressed.

Issue. Whether the taxpayers' timely requested sale of stock and the value of such stock should be offset against the outstanding liability.

Analysis. IRC §6335(f) allows the owner of any property seized by levy the right to request its sale within 60 days. The taxpayers contended they timely requested to sell stock when the stock had sufficient value to pay the full balance due the IRS. The IRS argued the requests were not sufficient to sell the stock.

Holding. The Tax Court held that the IRS must grant credit to the taxpayers for the levied stock value on the date of the request to sell it. The court further found there was an abuse of discretion on the part of the IRS by requiring the taxpayers to provide further information about the FMV of the stock before selling it.

IRS PROCEDURES — PENALTIES

Unreported Property Sale

Robert K. & Dawn E. Lowry v. Commissioner, **9th Cir. Ct. of Appeals, No. 04-71950, February 22, 2006**
IRC §§1231 and 6662

☞ Reliance on Accountant Does Not Eliminate Penalty

Facts. Mr. Lowry had a 50% partnership interest in Lowry Wells Investment (Lowry). Lowry owned the Fitch Property, which was encumbered by a Deed of Trust and Security Agreement reflecting a $3.5 million loan made by the Aid Association for Lutherans (AAL) to the partnership. The loan was signed and personally guaranteed by both partners. As of June 29, 1993, the loan was in default and foreclosure proceedings were started by AAL. A negotiated settlement agreement was reached whereby the Fitch Property would be transferred to AAL in full settlement of the outstanding debt. In December, 1993, escrow instructions were issued to the title company and a Grant Deed was executed. From December until May 1994, work continued on the transaction so that the title company could remove exceptions raised by the title report and provide title insurance as required. The Grant Deed was recorded on May 27, 1994.

AAL issued a 1993 Form 1099-A to Lowry showing:

- $3,218,046 of outstanding debt secured by Fitch Property,
- December 15, 1993 date of acquisition or abandonment, and
- $1,915,000 appraised value for Fitch Property.

The 1993 Form 1065, *U.S. Return of Partnership Income*, was filed for Lowy in October 1994 contained a statement that the Form 1099-A, *Acquisition or Abandonment of Secured Property*, was wholly **inaccurate** since the title transfer did not occur until May, 1994 and such transaction would be properly reported on the 1994 return. Mr. and Mrs. Lowry did not report the IRC §1231 gain of $774,982 on their 1994 return (nor the 1993 return). The IRS determined deficiencies for 1994 and 1995 of $30,096 and $179,066, respectively along with application of IRC §6662(a) penalties.

Issues. Whether an IRC §1231 gain of $774,982 was realized and whether it should be recognized in 1993 or 1994, and whether penalties under IRC §6662(a) apply for the 1994 and 1995 tax years.

Analysis and Holding. IRC §1231 provides for the recognition of gain on the sale or exchange of property used in a trade or business.

At issue is whether the cancellation of indebtedness occurred in 1993 or 1994. The taxpayers believed it was 1993 because:

- Grant Deed and Covenant Not to Sue agreement were dated December 15, 1993 and
- AAL issued a 1993 Form 1099-A with a date of December 15, 1993.

The court determined title to the property that all of the documents executed in 1993 are actually documents essential to a closing of title when all conditions precedent thereto have been satisfied and the escrow could be closed. Several pieces of correspondence clearly state the intended closing to be in 1994. Although taxpayers presented arguments to the contrary, **the court determined title to the property passed in 1994 and the income is properly reported on the 1994 tax return.**

IRC §6662(b) imposes an accuracy-related penalty in the amount of 20% of any underpayment. The taxpayers argued the penalty should not be assessed since they relied on professional CPA advice for the preparation of the 1994 and 1996 returns, and the test for adequate disclosure should be applied to the Lowry partnership return not to their individual return. All facts lead to the conclusion the Fitch property transaction was not reported on either the 1993 or 1994 tax return. The court concluded that the taxpayers failed to prove they acted with reasonable cause and in good faith. **Therefore, the court upheld the assertion of the accuracy-related penalties.**

Failure to File and Estimated Tax Penalties

***Ruth Ann Gillings v. Commissioner,* TC Memo 2006-65, April 4, 2006**

IRC §§6651 and 6654

☞ Disowning By Parents Not Reasonable Cause

Facts. Ruth Ann Gillings, a pro se taxpayer, was employed at Washoe Health Systems, Inc. as a respiratory therapist. During 2003, she earned in excess of $54,000 from this job, but did not file a tax return or pay estimated tax payments as required. The IRS issued a notice of deficiency for tax as well as penalties. Ms. Gillings paid the tax liability but not the applicable penalties. Instead, she filed a petition with the court.

Issue. Whether the taxpayer is liable for penalties under IRC §§6651(a)(1) and 6654(a) for 2003.

Analysis and Holding. IRC §6651(a)(1) imposes an addition to tax for failure to timely file a return unless it is shown that failure is due to reasonable cause. At trial, Ms. Gillings admitted not filing her return or paying estimated taxes. She argued that the penalties should not be asserted since her parents raised her to believe that **IRS was an illegal organization** and instructed her not to file or pay taxes. If she did file or pay taxes she believed her parents would disown her. The court determined Ms. Gillings' fear did not excuse her failure to file. Since Ms. Gillings' failure was not due to reasonable cause, the court upheld the penalties recommended by the IRS.

ITEMIZED DEDUCTIONS

Charitable Contribution

***James D. and Beverly H. Turner v. Commissioner,* 126 TC No. 16, May 16, 2006**

IRC §§170 and 6662

☞ Former Land Owned by George Washington Fails to Qualify as Conservation Easement

Facts. James Turner embarked on a plan to acquire several contiguous parcels of land located in Virginia close to Mount Vernon. This land was once owned by President George Washington. A total of 29.3 acres (once owned by President George Washington) was eventually acquired and conglomerated at the Grist Mill Woods subdivision through a limited liability company in which Mr. Turner held a 60% ownership interest. Slightly more than half the property was situated in a designated 100-year floodplain and was not available for residential development. Mr. Turner initially stated over 60 dwellings or residences could be built in Grist Mill. In reality, due to the current county zoning requirements, only 30 dwellings could have been built there.

Grist Mill was sold in December 1999 at which time a **conservation easement** deed was executed to the county. The deed contained language indicating the Fairfax County Board of Supervisors wished them to limit construction on the property to 30 single-family residential lots.

Mr. Turner claimed a $1,248,000 charitable deduction on his 1999 tax return which was reduced to $342,781 as the result of an AGI limitation. The $1,248,000 represented his share of the total $3,120,000 appraised easement. Unfortunately, the appraisal was made on the erroneous assumption that the entire Grist Mill property could have been fully developed.

Form 8283, *Noncash Charitable Contributions,* which was attached to the Turner's tax return, did not contain a properly signed donee acknowledgement from Fairfax County Board of Supervisors. Consequently, the IRS disallowed the charitable contribution and asserted a 20% accuracy-related penalty.

Issues. Whether the taxpayers

- Are entitled to a charitable contribution under IRC §170 of a qualified conservation easement (and if qualified, the value of the easement) and
- Are liable for the accuracy-related penalty under §6662.

Analysis. IRC §170 allows a deduction for a charitable contribution made during the taxable year. A contribution of real property may constitute a qualified conservation contribution if

- Real property is a "qualified real property interest,"
- Donee is a "qualified organization," and
- Contribution is "exclusively for conservation purposes".

The major disputes are whether there was a qualified real property interest in addition to whether the contribution is exclusively for conservation purposes. The taxpayers raised several arguments with which the court did not agree.

Did the taxpayers satisfy the historic prevention requirement of IRC §170(h)? There was no "historic structure" on the Grist Mill property that taxpayer could have preserved. There was no historical structure on the Grist Mill property to preserve and the easement's limitation on development on land near the Grist Mill does not preserve the historical structures on those properties. In addition, the taxpayers' claim that the Grist Mill property is independently significant, like a Civil War battlefield, is invalid since there is no evidence that anything on the property was historically unique. There is nothing to support a finding that any public benefit would be furthered by the conservation easement.

In support of the application of the penalty, the IRS looked at the failure by the taxpayers to obtain a signature on Form 8283, as well as an incorrect statement supplied by the taxpayers in the letter to the appraiser.

Holding. The Tax Court held the taxpayers did not make a contribution of qualified conservation easement. The deed did not satisfy the "open space" requirement nor did it preserve any "historically important land area". To make matters worse, the penalty was also sustained.

Investment Income

Letter Ruling 200620018, February 8, 2006

IRC §§163 and 9100

☞ Late Election Allowed

Purpose. To determine if a late election to treat qualified dividend income is investment income.

Facts. Taxpayer filed Form 1040 which included Form 4952, *Investment Interest Expense Deduction.* The software program that the taxpayer used allowed him to elect to include all the qualified dividend income as investment income. Unfortunately, the software does not compute the **optimal amount** of qualified dividend income which should be included in investment income. Taxpayer is required to manually calculate the amount and enter it into the software program. In this instance, the taxpayer did not realize a computation was needed and merely elected to include all qualified income as investment income.

Analysis and Conclusion. IRC §§163(d)-1(b) provides the election for qualified dividend income must be made on or before the due date of the tax return for which the qualified dividend income is received. Treas. Reg. §§301.9100-1 through 3 provides the standards used to determine whether an extension of time to make a regulatory election should be granted.

In this case, the taxpayer acted reasonably and in good faith, and would not have an aggregate lower tax liability had the election been made timely. Accordingly, taxpayer is granted an extension of time for making the election.

Form 1098-C, Instructions for Form 1098-C, March 2006
IRC §170

☞ Form 1098-C Revised for Vehicle Donations Valued at More Than $500

The 2006 Form 1098-C, *Contributions of Motor Vehicles, Boats, and Airplanes,* was revised. A charity **must** use this form to report qualified vehicle donations to the IRS. These new stringent rules were added by AJCA of 2004 and modified by the GO Zone Act of 2005.

A separate Form 1098-C must be filed by the charity for each qualified vehicle contribution having a value of more than $500. The charity must also provide a contemporaneous written acknowledgment to the taxpayer providing the same information as shown on the Form 1098-C. Form 1098-C copy B may be used as this contemporaneous written acknowledgment.

The GO Zone Act clarified that the donee acknowledgment for **contributions exceeding $500** must contain:

- Donor's name,
- Taxpayer identification number,
- Vehicle identification number,
- Date of contribution,
- Whether donee organization provided any goods or services in consideration of the vehicle, and
- Description and good faith estimate of the value of any such goods or services, or if goods or services consists solely of intangible religious benefits, a statement to that effect.

Revised Form 1098-C has the following new boxes as the result of GO Zone Act:

- Box 6a: Were goods and services provided in exchange for the vehicle?
- Box 6b: Value of goods and services provided in exchange for vehicle
- Box 6c: Description of the goods and services, if any, that were provided
- Box 7: If this box is checked, a donor may not claim a deduction of more than $500 for this vehicle.

The revised Form 1090-C is shown on the following page.

7878 ☐ CORRECTED

DONEE'S name, street address, city, state, ZIP code, and telephone no.	1 Date of contribution	OMB No. 1545-1959 2006 Form 1098-C
	2 Make, model, and year of vehicle	
DONEE'S federal identification number / DONOR'S identification number	3 Vehicle or other identification number	
DONOR'S name	4a ☐ Donee certifies that vehicle was sold in arm's length transaction to unrelated party	
Street address (including apt. no.)	4b Date of sale	
City, state, and ZIP code	4c Gross proceeds from sale (see instructions) $	

Contributions of Motor Vehicles, Boats, and Airplanes

5a ☐ Donee certifies that vehicle will not be transferred for money, other property, or services before completion of material improvements or significant intervening use

5b ☐ Donee certifies that vehicle is to be transferred to a needy individual for significantly below fair market value in furtherance of donee's charitable purpose

5c Donee certifies the following detailed description of material improvements or significant intervening use and duration of use

6a Did you provide goods or services in exchange for the vehicle? . . . . ▶ **Yes** ☐ **No** ☐

6b Value of goods and services provided in exchange for the vehicle

$

6c Describe the goods and services, if any, that were provided. If this box is checked, donee certifies that the goods and services consisted solely of intangible religious benefits . . . . ▶ ☐

7 Under the law, the donor may not claim a deduction of more than $500 for this vehicle if this box is checked . . . . ▶ ☐

Copy A

For Internal Revenue Service Center

File with Form 1096.

For Privacy Act and Paperwork Reduction Act Notice, see the **2006 General Instructions for Forms 1099, 1098, 5498, and W-2G.**

Form **1098-C** Cat. No. 39732R Department of the Treasury - Internal Revenue Service

Charitable Contributions

***Michael and Marla Sklar v. Commissioner,* 125 TC No. 14, December 21, 2005**

IRC §§170 and 6662

☞ Religious School Tuition is Nondeductible Charitable Contribution

Facts. During 1995, Mr. and Mrs. Sklar had five school age children which they educated at private Orthodox Jewish day schools in the Los Angeles, California area. These schools were chosen based on the religious component of the children's education as well as the secular education. Both day schools were exempt from tax under IRC §501(c)(3) and qualified as IRC §170(b)(1)(A)(ii) educational organizations. Both schools required payment of tuition, registration, and certain other fees in order for their children to attend classes. A total of $27,283 was paid to the schools in 1995, $15,000 of which was deducted as a charitable contribution based on letters provided by the schools which estimated 55% of the total cost was for religious purposes.

At the time the 1995 return was filed, amended 1991, 1992, and 1993 returns had also claimed similar charitable contribution deductions which were allowed by the IRS. The IRS erroneously believed the 1991 contributions were payments to the Church of Scientology. In addition, the 1994 return was under examination for similar charitable contributions. The amounts deducted on the 1994 returns mirrored the percentages claimed on the 1995 returns. The 1994 charitable contributions were later disallowed by the IRS and upheld by the Tax Court as well as the U.S. Court of Appeals.

The IRS disallowed the $15,000 charitable contribution and applied an accuracy-related penalty.

Issues. Whether the taxpayers are entitled to a $15,000 charitable contribution for tuition and fees paid to Orthodox Jewish day schools for the secular and religious education of their five children, including $175 paid to one of the schools for Mishna classes and whether the accuracy-related penalty should apply.

Analysis. At trial, the Sklar's argued the religious education the schools provided their children is an "intangible religious benefit" defined in IRC §§170(f)(8) and 6115 and the disallowance violates the Establishment Clause of the First Amendment to the U.S. Constitution because the IRS allows members of the Church of Scientology to deduct "auditing" and "training" payments as charitable contributions.

The court took into consideration Rev. Rul. 67-246,[37] as well as numerous court cases ruling that charitable contributions are not permitted if a substantial benefit is received. The court also considered arguments on dual payment theory and tuition paid for secular and religious education and absence of charitable intent.

As to the accuracy-related penalty, at the time the taxpayers filed their 1995 return, the IRS had allowed them to claim the charitable contributions for 1991, 1992, and 1993 with 1994 still under examination by the IRS. Based on previous history with the IRS related to these issues, the court determined the taxpayers had a reasonable basis for claiming the deduction.

Holding. Based on the overwhelming court cases previously decided, the court upheld the IRS determination that none of the payments for tuition, fees, and Mishna classes in 1995 are deductible as charitable contributions. However, the accuracy-related penalty was waived.

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37. 1967-2 C.B. 104

LIKE-KIND EXCHANGES

Intangible Property

TAM 200602034, January 13, 2006
IRC §1031

☞ Trade Names and Trademarks Not Like-Kind

Purpose. To determine if

- Transfers and acquisitions of intangible property qualify as like-kind exchanges
- Transfer of intangible property of a domestic entity and the acquisition of intangible property of a foreign entity qualify as a like-kind exchange
- Exchanges of intangible property complied with identification requirements

Background. Taxpayer entered into four transactions involving the transfer and acquisition of tangible and intangible business assets properly claiming like-kind exchange treatment on the tax return. Taxpayer also claimed deferral of taxable gain based on the exchange of two categories of intangible property — trademarks/trade names and trade secrets/know-how.

Analysis and Conclusion. IRC §1031 provides generally that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

A two-prong analysis was used for **tangible personal properties** which requires the matching of the nature of the rights involved and nature of underlying property to which intangible personal property relates. With respects to **patents**, generally nature of rights under one patent is the same as under a different patent even if the underlying property differs. To satisfy the patent requirements, a patent must exist on both sides of the exchange as well as by General Asset Class and Product Class. For trademarks and trade names, these items are not alike and are not considered like-kind under any circumstance.

Transfers and acquisitions of intangible property qualify as like-kind exchanges with gain or loss deferred to extent of like-kind exchange property. Intangible property exchanges between a domestic entity and foreign entity do not qualify as like-kind exchanges when property is used within and outside the United States.

Once again, the strict approach the IRS takes for like-kind exchanges of intangible personal property is reinforced. These exchanges require specificity and analysis of item-by-item exchanges rather than a global basis as prescribed when the IRS rejected like-kind exchanges of patents, trademarks, and other intangible property.

PARTNERSHIP

Partnership Allocation Rules

Notice of Proposed Rule Making 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.

PASSIVE ACTIVITIES

Single Activity Election for Rental Real Estate

***Richard B. and Jane M. May v. Commissioner,* TC Summary Opinion 2005-146, October 11, 2005**
IRC §469

☞ Failure to Make Election Results in Denial of Real Estate Professional Status

Facts. During 1996 and 1997, Jane May was employed as a full-time teacher. Her husband, Richard, was employed on a part-time basis for about 30 hours per week. In addition, he spent approximately 40-45 hours per week managing the couple's 16 rental duplexes. The following was reported on the taxpayers' 1996 and 1997 Schedules E regarding the rental real estate activity:

Year	Rental Income	Total Expenses Including Depreciation	Net Rental Loss
1996	$94,050	$167,397	($73,347)
1997	87,030	154,324	(67,294)

The 1996 and 1997 Schedules E did not identify each of the 16 rental duplexes. Instead, "Res Rental, Buffalo, NY" was shown on of Schedule E, line 1, which states: "List the type and location of each rental real estate property." The full net rental loss for each year was deducted on Form 1040. However, the taxpayers never made a specific election under IRC §469(c)(7)(A) to treat the 16 rental duplexes as a single activity.

The IRS determined that, since Mr. May did not qualify as a "real estate professional," only $25,000 of the net rental losses were allowable. Consequently, the IRS assessed additional tax of $10,385 and $6,878 respectively for 1996 and 1997.

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Issue. Whether the taxpayers made the election to treat their various rental real estate activities as a single activity for 1996 and 1997.

Analysis. The general rule is that rental activities are presumed to be passive, without regard to whether the taxpayer materially participates in the activity.[38] However, the presumptive general rule does not apply to the rental real estate activities of taxpayers engaged in a real property business.[39] This exception to the general disallowance rule for passive losses is referred to as the "real estate professional" exception.

Beginning in 1994, a taxpayer who qualifies as a "real estate professional" can deduct current year rental real estate losses in full, regardless of any AGI limitation, if all three of the following tests are met:

- More than half of the taxpayer's personal services performed in all trade or business during the tax year was performed in real property trades or businesses.[40]
- More than 750 hours of services are performed during the tax year in real property trades or business in which the taxpayer materially participates.[41]
- The taxpayer must materially participate in **each** rental real estate activity **unless an election to group all rental real estate activities as a single activity** (for purposes of meeting the material participation test) **was filed**.[42]

Holding. The court could find no evidence that the required election to group the rental properties as a single rental activity had been made. The court rejected the taxpayers' contention that by aggregating the 16 rental duplexes on Schedule E, a "deemed election" had been made. Since Mr. May did not spend 750 hours managing **each property** in 1996 and 1997, the assessment of additional tax by the IRS was upheld.

> **Note.** See pages 39 and 397–408 in the *2004 University of Illinois Federal Tax Workbook* for complete information regarding this important election under IRC §469(c)(7)(A).

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 **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, *Passive Activity Loss Limitations,* and loss limitations. The guide provides specific guidance on potential audit issues and highlights common errors. It also includes various checklists and decision trees.

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38. IRC §469(c)(2)
39. IRC §469(c)(7)(B)
40. IRC §469(c)(7)(B)(i)
41. IRC §469(c)(7)(B)(ii)
42. IRC §469(c)(7)(A)

PROFIT MOTIVE

Appreciated Value

***Elizabeth Giles v. Commissioner,* TC Memo 2006-15, January 31, 2006**

IRC §§183 and 6662(a)

☞ Horse Lady Not For Profit

Facts. Ms. Giles, a California dentist, purchased real property for use in her horse operation. The two properties are described as follows:

	Falling Water Way	Gavilan Hills
Year of purchase	1983	1990
Purchase price	$135,000	$70,000
Number of acres	1.48	11.53
Square footage of house	2,252	NA
Horse facilities	Four-stall barn with tack room, feed rooms, hay storage, arena, and paddocks	NA
FMV June 2004 (total)	$530,000	$306,000
FMV June 2004 (horse facilities and property)	$375,000	$306,000

Ms. Giles was raised around horses for most of her life. Her first horse was purchased in 1984. She purchased additional horses beginning in 1988 when she started her Arabian horse activity. She was involved with breeding, training, working, worming, and vaccinating her horses. She also maintained a library of horse reference materials, spending six to eight hours per month reading trade journals. She also spent between four and a half to six hours per day with the horses; feeding, watering, administering medications, exercising and training the horses, as well as cleaning the stalls. Personal use of the horses was nonexistent.

Ms. Giles' horses produced several offspring, and she eventually sold some of them. An annual one-page business plan was prepared for the years 1989 through 1994 showing long-term goals which included selling horses, and potentially selling Falling Water Way to move the operations to Gavilan Hills. A general one-page business plan was also prepared each year.

Schedules C for 1988 through 2003 reflected the following information:

Year	Gross Receipts	Total Expenses	Profit/(Loss)
1988	$ 95	$27,782	($27,687)
1989	3,508	32,244	(28,736)
1990	244	38,197	(37,953)
1991	0	28,136	(28,136)
1992	3,000	32,545	(29,545)
1993	3,200	46,622	(43,422)
1994	4,080	38,152	(34,072)
1995	2,500	40,703	(38,203)
1996	3,024	40,337	(37,313)
1997	260	24,475	(24,215)
1998	500	21,568	(21,068)
1999	900	23,677	(22,777)
2000	1,000	18,649	(17,649)
2001	20,000	19,791	209
2002	0	27,072	(27,072)
2003	200	23,621	(23,421)

The IRS determined the activity was not engaged in for profit, and it disallowed the losses for 1999 and 2000, and the expenses for 2001. It also asserted the accuracy-related penalty for all three years.

Issues. Whether the horse activity was engaged in for profit during the years at issue, and whether the accuracy-related penalties should be applied for 1999 and 2000.

Analysis and Holding. After a review of the nine factors which determine business versus hobby income,[43] the court found that all factors with the exception of the appreciation of land, weighed against the taxpayer. The court sustained the IRS's determination. Conversely, since the taxpayer acted with reasonable cause and in good faith in taking deductions, the accuracy-related penalty was not warranted.

Profit Motive

Austin L. and Rebecca A. Mitchell v. Commissioner, **TC Memo 2006-145, July 6, 2006**

IRC §§183 and 6662

☞ Taxpayers Lose for the Third Time Regarding Claimed Farming Losses

Facts. Austin Mitchell, a Missouri licensed CPA and attorney, also had a farming business consisting of 38 acres of tillable bottom land, 35 to 40 acres of pasture, a 20-acres timber stand, and the taxpayers' home. On his joint return, Mr. and Mrs. Mitchell reported the following for the farming business:

Year	Gross Receipts	Expenses	Net Profit (Loss)
1998	0	$2,352	($2,352)
1999	$11,655 (including $7,500 of timber sales reported on Sch. D)	6,295	5,360
2000	1,690	6,369	(4,679)

43. Treas. Reg. §1.183-2(b)

The IRS determined that the taxpayers failed to establish a profit motive for the farming activities for 1998-2000. As a result, the IRS disallowed the claimed Schedule F losses and assessed additional taxes for all three years, plus the 20% accuracy-related penalties due to negligence.

Issues.

1. Whether, under IRC §183, the taxpayers conducted their farming activity for profit.
2. Whether, under IRC §6662(a), the taxpayers are liable for the accuracy-related penalty attributable to negligence or disregard of rules or regulations.

Analysis. The issue of whether an activity is carried on with an actual and honest objective of making a profit is decided primarily on a careful analysis of nine nonexclusive subjective factors.[44]

Holding

Issue 1. The court reviewed each of the nine factors and concluded:

- Six of the nine factors favored the IRS
- Two of the nine factors were neutral
- One of the nine factors favored the taxpayers

Because the 1999 farming activity reported an overall profit when the timber sales reported on Schedule D were considered, the court determined that the disallowance of the 1999 claimed Schedule F loss of $2,140 was not valid. However, the court agreed that the claimed Schedule F losses for 1998 and 2000 were properly disallowed under §183.

A significant fact that weighed against the taxpayers was the failure to meet the fourth factor in the nine factor analysis: The expectation that the farmland would appreciate and, when sold, would help to offset the previous claimed farming losses.

Austin Mitchell testified that he intended to give the 100-year old family farm to his son, not sell it during his lifetime. Therefore, this factor did not favor the taxpayers.

Issue 2. The 20% accuracy-related penalties were upheld for the years 1998 and 2000. The court noted that the taxpayers "did not act in good faith in claiming Schedule F losses and their underpayments were not due to reasonable cause." The penalty did not apply for 1999 as there was no underpayment of tax.

> **Note.** This case marks the third time that the taxpayers have gone to Tax Court over the lack of a profit motive to support claimed farming activity losses. In the two prior decisions,[45] the Tax Court also found that the taxpayers lacked the necessary profit motive.

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44. Ibid

45. *A.L. Mitchell*, TC Summary Opinion 1998-200, 1998 and TC Memo 2001-269, 82 TCM 732, October 4, 2001

RESIDENCES

Down Payment Assistance

Revenue Ruling 2006-27, May 4, 2006
IRC §§61, 102, and 1012

☞ Low-Income Taxpayer House Payment Assistance Benefit

Purpose. To provide guidance as to whether:

- Home buyers receiving down payment assistance from charitable organization may exclude the amount from gross income and consider the payment as a gift
- Home buyers may increase their cost basis in the home for the down payment assistance amount

Background. Three scenarios are discussed in this revenue ruling. In **Scenario 1**, X is a nonprofit corporation which exclusively provides part of or the entire down payment for qualified low-income individuals to purchase a house. The house must meet X's housing standards. The funds X provides are achieved by conducting a broad-based fundraising program which attracts gifts, grants, and contributions from foundations, businesses, and the general public. A process used by X guards the identity of the applicant and the home seller.

In **Scenario 2,** the facts mirror **Scenario 1**, except the staff knows both the identity of the applicant and the party selling the home. In addition, the Y corporation receives a payment from the home seller. There is a direct correlation between the amount of down payment assistance provided and the amount of the seller's payment to the corporation. The corporation does not conduct broad-based fundraising since most of its support comes from home sellers and real estate businesses.

In **Scenario 3,** Z corporation was formed to combat community deterioration and receives funding from government agencies to build affordable housing units for sale to low and moderate-income families. Z offers down payment assistance to eligible buyers. Z conducts a broad-based fundraising program and attracts gifts, grants, and contributions from foundations, businesses, and the general public.

Analysis and Holding. Under IRC §61, Gross income includes all income from whatever source derived. Generally, the basis of property is its cost to the taxpayer.[46] The value of property acquired by gift is excluded from gross income.[47]

X and Z corporations are 501(c)(3) organizations. Y corporation is not. Down payment assistance payments for home buyers in **Scenarios 1 and 3** are made through detached and disinterested generosity and from charitable or like impulse, rather than to fulfill any moral or legal duty. Consequently, these scenarios qualify the down payments for **exclusion from the home buyers' gross incomes** and are considered "gifts" under IRC §102. **These payments are included when computing the cost basis under §1012.**

In **Scenario 2,** Y receives a payment from the home seller that directly correlates to the amount of the down payment assistance Y provides to the home buyer. In this scenario, the payments received by the home buyers do not qualify for exclusion from gross income as gifts under §102. The down payment assistance received by those home buyers represents a rebate or purchase price reduction. As a rebate or purchase price reduction, the down payment assistance is **not includible** in a home buyer's gross income under §61, and the amount of the down payment assistance is **not included in the home buyer's cost basis** under §1012.

46. IRC §1012

47. IRC §102

Gain on Sale of Residence

Letter Ruling 200601009, January 6. 2006

IRC §121

☞ Troubled Neighborhood Is Unforeseen Circumstances

Purpose. To determine whether gain on the sale of a residence is eligible to be excluded under IRC §121(c).

Facts. Taxpayer and spouse bought a house in another state as a result of her employment. Criminal activities began occurring in their neighborhood and both the taxpayer and son were assaulted. Before the end of two years, the taxpayers sold the house and purchased another residence in a different location.

Analysis. Gain on a sale of a personal residence to be excluded from gross income if the residence has been owned for a period of five years and has been used as a principal residence for two years or more.[48] For those who do not meet the ownership and use tests, a reduced maximum exclusion is available under IRC §121(c) if the primary reason for the sale is a change in place of employment, health, or unforeseen circumstances. Unforeseen circumstances include an event which is not anticipated at the time the residence is purchased and occupied.

Holding. After review of all facts submitted, the IRS concluded the sale of the house was due to an "unforeseen circumstance" and, as such, part of the gain on sale of the residence is excludible up to the reduced maximum exclusion amount.

Gain on Sale of Residence

Letter Ruling 200601022, January 6. 2006

IRC §121

☞ Several Factors Contribute to Unforeseen Circumstances

Purpose. To determine whether gain on the sale of a residence is eligible to be excluded under IRC §121(c).

Background. Taxpayer bought a house and subsequently married a woman with school-age children. In order to continue studies at their same school, they had to provide their own transportation. The oldest child drove the children to school up until her graduation. After graduation, the taxpayers bought a house in the school district while still maintaining the other residence. The intent was to put the original house up for rent until the younger child graduated from school, and then return to the original house. However, after the birth of an additional child, they determined the original house was too small and sold it.

Analysis. Gain on a sale of a personal residence is allowed to be excluded from gross income if the residence has been owned for a period of five years and has been used as a principal residence for two years or more.[49] For those who do not meet the ownership and use tests, a reduced maximum exclusion is available under IRC §121(c) if the primary reason is change in place of employment, health, or unforeseen circumstances. Unforeseen circumstances include an event which is not anticipated at the time the residence is purchased and occupied.

Holding. After review of all facts submitted, the IRS concluded the sale of the house was a result of an "unforeseen circumstance" and, as such, part of the gain on sale of the residence is excludible up to the reduced maximum exclusion amount.

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48. IRC §121(a)

49. Ibid

Gain on Sale of Residence

Letter Ruling 200601023, January 6. 2006

IRC §121

☞ Community Restrictions Are Unforeseen Circumstance

Purpose. To determine whether gain on the sale of a residence is eligible to be excluded under IRC §121(c).

Background. Taxpayers bought a house in another state. After relocating, the taxpayer's daughter lost her job and got a divorce. The change in the daughter's financial situation necessitated that she and her child move in with the taxpayers. Unfortunately there were age restrictions in the taxpayers' living community which prevented them from moving in. The taxpayers sold their home and purchased a new home back in the other state where they are all residing. All these events occurred within less than a 2-year time period.

Analysis. Gain on a sale of a personal residence is allowed to be excluded from gross income if the residence has been owned for a period of five years and has been used as a principal residence for two years or more.[50] For those who do not meet the ownership and use tests, a reduced maximum exclusion is available under IRC §121(c) if the primary reason for the sale is a change in place of employment, health, or unforeseen circumstances. Unforeseen circumstances include an event which is not anticipated at the time the residence is purchased and occupied.

Holding. After review of all facts submitted, the IRS concluded the sale of the house resulted from an "unforeseen circumstance" and, as such, part of the gain on sale of the residence is excludible up to the reduced maximum exclusion amount.

RETIREMENT

Retirement Plan

Letter Ruling 200617037, April 28, 2006

IRC §402

☞ Timely Deposit of Defaulted Loan Results in Nontaxable Event

Purpose. To determine whether a plan loan offset amount is an eligible rollover distribution which can be rolled into an eligible retirement plan under IRC §402 (c)(3).

Background. Taxpayer was employed and participated in a 401(k) plan maintained by his employer. He obtained a loan from his retirement plan to use as a down payment on his first home. He eventually left his employment and subsequently received correspondence from the retirement plan administrator indicating the amount of his outstanding loan balance and the fact that if the loan was not repaid by a certain date, the outstanding balance would be deemed a taxable event.

Taxpayer provided documentation to show two checks, submitted within the applicable 60-day rollover period, and paid to Company B for rolling over into his IRA which included:

- Check issued by his former employer representing the balance in his 401(k) plan, and
- Personal check for the outstanding loan balance on his 401(k) plan.

50. IRC §121(a)

At the end of the year, taxpayer received two Forms 1099-R, *Distributions from Pensions, Annuities, Retirement Profit Sharing Plans, IRAs, Contracts, etc.*, one with distribution code "G" (direct rollover) and the other with distribution code "1" (early distribution). Upon filing the tax return, taxpayer included the early distribution in gross income even though the amount had been properly rolled over into the IRA account within 60 days.

Analysis. IRC §402(c) provides rules governing rollovers from exempt trusts to eligible retirement plans, including IRAs. Treas. Reg. §1.402(c)-2 provides that a distribution of a plan loan offset amount is an eligible rollover if it satisfies the definition of an eligible rollover distribution.

Holding. Since the taxpayer properly deposited the outstanding retirement plan loan amount in an eligible retirement plan, the amount is deemed appropriately rolled over, thus creating a nontaxable event.

Employee Plans Compliance Resolution System

IRS News Release IR-2006-75, May 5, 2006
Revenue Procedure 2006-27, May 5, 2006

☞ Certain Retirement Plan Corrections Can Be Made Without Notifying the IRS

An updated and expanded comprehensive Employee Plans Compliance Resolution System (EPCRS) was issued as **Rev. Proc. 2006-27.** Under expanded EPCRS, plan professionals can correct errors in certain retirement plans without having to notify the IRS. This allows the participants to continue receiving tax-favored retirement benefits and it protects both employee and retiree retirement benefits.

Rev. Proc. 2006-27 incorporates solutions to two emerging issues which caused problems – excluded employees in 401(k) plans and bad loans. In addition, three levels of corrective programs are addressed:

1. Self-Correction Program (SCP)
2. Voluntary Correction Program (VCP)
3. Correction of Audit Program (Audit CAP)

The SCP permits a plan sponsor to correct "insignificant operational failures" in certain simple plans, such as 403(b) plans, SEPs or SIMPLE IRA plans. These corrections can be made **without having to notify the IRS and without paying a fee or penalty**.

The Voluntary Correction Program (VCP) allows a plan sponsor, at any time before an audit, to pay a limited fee and receive the IRS's approval for a correction of a qualified plan, a 403(b) plan, SEP or SIMPLE IRA plan.

The Correction on Audit Program (Audit CAP) allows a sponsor to correct a failure or an error that has been identified on audit and pay a penalty based on the nature, extent and severity of the failure being corrected.

Plan sponsors who fail to take advantage of EPCRS will not receive any available favorable tax treatment if problems are discovered during examinations. The EPCRS is not available in situations which involve abusive tax avoidance transactions.

Retirement Plan Loans

***Stephen Daryl Royal v. Commissioner,* TC Memo 2006-72, April 11, 2006**
IRC §72

☞ Nonrepayment of Loans Creates Additional Taxable Income

Facts. Mr. Royal, a U.S. Postal Service employee, retired due to a disability in 2002. While employed, he made contributions to a retirement account but had two outstanding loans from the plan at the time of his retirement totaling $25,941. The plan contacted Mr. Royal in September 2002 informing him he had until December 3 to repay the loans. The letter plainly stated that if the loans were not repaid, he would receive a taxable distribution to the extent of the unpaid principal and interest in 2002. Mr. Royal did not repay the outstanding loan balances.

At year end, Mr. Royal attached copies to his return, and reported retirement income as follows:

Form No.	Source	Gross	Taxable Amount	Amount Reported on Return
CSA-1099R	OPM Retirement	$ 7,178	UNKNOWN	$7,178
1099R	Federal Thrift Savings Plan (TSP)	25,941	$25,941	0

Based on amounts shown on the return as filed, Mr. Royal also claimed an earned income tax credit.

The IRS issued a notice of deficiency including the $25,941 of unpaid retirement account loans in income, disallowed the earned income tax credit, and asserted the accuracy-related penalty. (The accuracy-related penalty was subsequently agreed to by the taxpayer.)

Issue. Whether the taxpayer was required to include $25,941 in gross income.

Analysis and Holding. Under IRC §72, if a participant receives any amount of a loan from a qualified employer plan, it is usually treated as a distribution from the plan. Since the taxpayer did not repay the loans as directed, the Tax Court found the resulting distributions from the taxpayer's account used to offset the outstanding loan balances resulted in taxable income.

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

Issue. Whether the 10% early distribution penalty is applicable to the 401(k) plan distribution.

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.[51]

51. IRC §72(t)(2)

The Court recognized the similarities between IRA and 401(k) accounts and acknowledged that Mr. Jones would not have been subject to penalty if he had rolled his 401(k) into an IRA account prior to taking his distribution.

Holding. The Court concluded the statutory exception does not extend to distributions from 401(k) plans. Therefore, the taxpayer is liable for the 10% early distribution penalty even though the funds were used for educational and first-time homebuyer expenses.

TAX FRAUD

Collateral Estoppel

Paul McGowan v. Commissioner, **11th Cir. Ct. of Appeals, No. 05-13751, June 28, 2006**
IRC §6663

☞ IRS Fails to Establish Clear Badges of Fraud

Facts. Mr. McGowan was the sole owner of McGowan Construction Company, an 1120-S corporation. From 1991 through 1993, he underreported his income from the 1120-S corporation. He was indicted, tried, and convicted of six tax crimes for which he received a prison sentence and fine. He was also ordered to cooperate with the IRS to determine his civil tax liability. The IRS issued a notice of deficiency with total tax and civil fraud penalties for the three years exceeding $350,000. Mr. McGowan petitioned the tax court claiming the underpayments resulted from confusion between him and his accountant. The accountant told Mr. McGowan the diverted funds were either loan repayments or a return of shareholder equity.

The Tax Court found the IRS failed to meet the burden of establishing McGowan's intent to evade tax by clear and convincing evidence. The court acknowledged McGowan's criminal conviction was a badge of fraud, which estopped him from contesting that he filed false returns and under-reported his taxes for 1991 to 1993. However, the court stated that the IRS could not rely solely on the prior conviction to demonstrate intent to evade tax. The tax court also found the IRS's evidence of intent to evade tax unconvincing, held that McGowan kept adequate and complete records, and held that it was the accountant's fault for not using those records when he compiled the tax returns. The court also found that McGowan did fully comply with the Commissioner's investigation. The IRS appealed the decision.

Issues. Whether the Tax Court (1) erred by not collaterally estopping McGowan from presenting his arguments and (2) concluding that the IRS failed to clearly establish an intent to evade tax.

Analysis. Four elements must be present for collateral estoppel to be invoked:

1. Issue in present as well as previous case must be the same,
2. Issue must have been necessarily decided in prior litigation,
3. Estopped party must have been either a party to the previous litigation or was adequately represented in prior proceeding, and
4. Issue to be precluded must have been litigated in prior proceeding.

The court looked at whether the IRS met its burden of proof for the badges of fraud. Although Mr. McGowan's criminal conviction was a badge of fraud, this in itself is not enough proof to establish Mr. McGowan's intent to evade tax by clear and convincing evidence.

Holding. The court held Mr. McGowan maintained an adequate set of books, and that is was the accountant's fault for not using these records when compiling the tax return. The IRS failed to meet its burden of proof.

IRS Fact Sheet FS-2006-16, February, 2006

☞ Actions Taken to Combat Preparer Fraud

Return preparer fraud involves the preparation and filing of false income tax returns including:

- Inflated personal or business expenses
- False deductions
- Unallowable credits
- Excessive exemptions
- Wrongful tax credits such as earned income tax credit

The IRS Return Preparer Program focuses on **enhanced preparer compliance** by investigating and referring criminal activity to the Department of Justice for potential prosecution and assertion of appropriate civil penalties where these situations have occurred.

Clients should use the following guidelines when selecting a preparer:

- Be wary of those who can obtain larger refunds
- Avoid those whose fee is a percentage of the refund amount
- Make sure the preparer signs the return and provides a copy to the client
- Ask if the preparer will be there if questions arise later
- Determine the preparer's credentials, such as enrolled agent, CPA, or attorney

The following table details Criminal Investigation Statistical Information on return preparer fraud:

	FY 2005	FY 2004	FY 2003
Investigations started	248	206	229
Prosecutions recommended	140	167	169
Indictments/informations	119	121	109
Sentenced	118	90	49
Incarceration rate	85.6%	84.4%	83.7%
Average months to serve	18	19	19

In addition, the courts have issued 132 permanent injunctions against abusive tax scheme promoters and return preparers since 2003, including substantial fines, restitution, and prison terms ranging from 12 to 45 months. Preparers have also been permanently disbarred from preparing tax returns.

Here are examples of the types of situations that occurred:

- On July 22, 2005, in Dallas, Texas, Lacedric Williams was sentenced to 30 months in federal prison, one year of supervised release and ordered to pay restitution of $85,062.84 to the IRS. Williams pled guilty in April 2005 to two counts of a federal indictment charging aiding and assisting in the preparation of a false and fraudulent income tax return. Williams admitted he prepared and caused to be mailed for a taxpayer a tax return reporting $10,500 in false medical and dental expenses and $11,450 in false charitable donations without asking the taxpayer what his true medical and dental expenses were. A second situation with similar facts was created by Williams as well.

- On December 30, 2005, a federal court barred Beverly J. and Darrell J. Hill of Mesa, Arizona, from preparing federal income tax returns for others. According to the court order, the defendants, operating under the names Superior Claims Management and **www.getmytaxesback.com**, recruited customers by promising to recover previously-paid past taxes for a fee of 25% of any refund received.

Tax Schemes

IRS News Release IR-2006-25, February 7, 2006 and IR-2006-45, March 16, 2006
Revenue Ruling 2006-17 through 2006-21, March 2006
IRS Notice 2006-31, March 16, 2006
"The Truth About Frivolous Tax Arguments"
IRC §§165, 170, 501, 3102, 6702, and 667

☞ IRS Provides Update on 2006 "Dirty Dozen" Tax Schemes and Other Important Information

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

News Release IR-2006-25. The IRS continues to identify promoted tax schemes that allegedly offer substantial tax benefits. Promoters and many of their clients are being pursued and successfully prosecuted for fraud and tax evasion.

The "Dirty Dozen" includes two new schemes and several recurring schemes. "Zero wages" and "Form 843 tax abatement" are the two new schemes.

In the "Zero wages" scheme, a taxpayer attaches to the return either a Form 4852 (Substitute Form W-2) or a "corrected" Form 1099 showing zero or little other income. A statement may be included indicating the taxpayer is rebutting information submitted to the IRS by payer(s).

The "Form 843 tax abatement" scheme involves an abatement request of previously assessed tax via Form 843. Many of those using this scheme have not filed tax returns but have had assessments made by the IRS through the Substitute for Return Program.

Other schemes included in the "Dirty Dozen" are:

- Phishing
- Zero Return
- Trust Misuse
- Frivolous Arguments
- Return Preparer Fraud
- Credit Counseling Agencies
- Abuse of Charitable Organizations and Deductions
- Offshore Transactions
- Employment Tax Evasion
- "No Gain" Deduction

Due to the number of court cases against promoters, two of the more noteworthy scams have decreased. These scams are "claim of right" and "corporation sole" and they are no longer part of the 2006 "Dirty Dozen".

News Release IR-2006-45. The IRS provided guidance describing and rebutting frivolous arguments taxpayers should avoid when filing returns. This guidance is referred to in IRS Notice 2006-31 and five revenue rulings.

IRS Notice 2006-31. This notice describes the 26 most common frivolous arguments taxpayers use when filing returns, and also provides civil and criminal penalties for making frivolous arguments.

Rev. Rul. 2006-17 through 2006-21. This notice provides further guidance in solidifying the IRS position in combating frivolous tax positions:

- **Rev. Rul. 2006-17** emphasizes the frivolous positions taken related to insertion of the phrase "nunc pro tunc" has no legal effect and does not validate an invalid return, make a delinquent return timely, invalidate a signature, create a claim for refund of taxes previously paid, or reduce one's federal tax liability.
- **Rev. Rul. 2006-18** emphasizes that all individuals are subject to federal income tax not just federal employees and persons residing in Washington, D.C. or federal territories.
- **Rev. Rul. 2006-19** emphasizes an individual cannot escape taxation by attributing income to a purported trust.
- **Rev. Rul. 2006-20** emphasizes there is no right to exemption from federal income tax for Native Americans under an unspecified "Native American Treaty."
- **Rev. Rul. 2006-21** emphasizes Paperwork Reduction Act of 1980 does not relieve taxpayers of the duty to file income tax returns.

"The Truth About Frivolous Tax Arguments" is a 66-page document addressing frivolous contentions dealing with the legality of not paying taxes or filing returns. The document also includes citations from cases decided by the courts.

TRAVEL AND TRANSPORTATION EXPENSE

Travel Expenses

William D. and Betty J. Boyd v. Commissioner, **TC Summary Opinion 2006-36, March 2, 2006**
IRC §162

☞ Travel Expenses Denied to Taxpayers with No Tax Home

Facts. William Boyd, a licensed Pentecostal minister, conducted religious services and spiritual revival meetings at various churches across the United States. His wife, Betty, accompanied him and served as a singer at each of their services. They traveled the country in a recreational vehicle.

On the 1999 Schedule C for their joint tax return, the taxpayers reported the following:

Gross receipts		$45,153
Less expenses:		
Meals and entertainment	$12,775	
Per diem expense	47,450	
Utilities	744	
Dues	250	
	$61,219	(61,219)
Net loss		**($16,066)**

The IRS disallowed the Schedule C loss, and assessed additional tax of $3,418. The IRS contended that they were not "away from home"[52] when the traveling expenses (meals and per diem) were incurred.

> **Note.** In its notice of deficiency, the IRS chose to disallow the $16,066 net Schedule C loss rather than disallowing the combined $60,225 of meals and entertainment and per diem expense. The court transcript provided no explanation for this examination approach.

Issue. Whether the taxpayers were "away from home" within the meaning of IRC §162(a)(2) during 1999, entitling them to a deduction for traveling expenses.

Analysis. Taxpayers are entitled to a deduction for traveling expenses, including meals and lodging, if the expenses are:

- Ordinary and necessary
- Incurred while "away from home"
- Incurred in pursuit of a trade or business[53]

As a general rule, a taxpayer's principal place of employment is his "tax home."[54] Where the taxpayer has neither a principal place of employment nor a permanent residence, he has no tax home from which he can be away. His home is wherever he happens to be.[55]

The IRC §162(a)(2) deduction is intended to mitigate the burden of a taxpayer who, because of the travel requirements of his trade or business, must maintain **two places of abode** and, therefore, incur **additional living expenses**.[56]

Holding. The Tax Court upheld the disallowance of the net Schedule C loss by the IRS for the following reasons:

- The taxpayers did not own or rent any dwelling in Prentice, Mississippi, which they contended was their "tax home."
- When they made three visits to Prentice, Mississippi in 1999, they stayed either in the local church's parsonage or with their daughter in her home.
- The facts clearly led to a conclusion that the taxpayers had no tax home from which they could be away during 1999.

> **Note.** There are numerous court cases on the issue of whether taxpayers actually had the necessary tax home to be away from. IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses*, provides clear guidance in determining this issue.

52. IRC §162(a)(2)
53. *Bochner v. Commissioner*, 67 TC 824, 1977
54. *Kroll v. Commissioner*, 49 TC 557, 1968
55. *Brandl v.Commissioner*, 6th Cir. Ct. of Appeals, 513 F.2d 697, 1975-1 USTC ¶9414, April 22, 1975, [affirming prior Tax Court decision: TC Memo 1974-160]
56. *Ibid*

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

Background. 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 writeoffs 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.

Analysis and 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–September 30, 2006
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.
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> See GSA Bulletin 06-3 at **http://www.gsa.gov/gsa/cm_attachments/GSA_DOCUMENT/PerDiemBulletin06-3_R2O546_0Z5RDZ-i34K-pR.doc** for more details.