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 issued during the past year, through approximately September 1, 2007. They appear in a condensed version, and are not to be relied on as a substitute for the full documents. A full citation appears for each item. This is not a comprehensive coverage of all tax law changes or explanations. It reports the rulings and cases that are likely to be of interest to most tax professionals.

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. Included in this categoty are various legal memoranda (e.g., Internal Legal Memoranda (ILM) and Litigation Guideline Memoranda (LGM)).

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.**

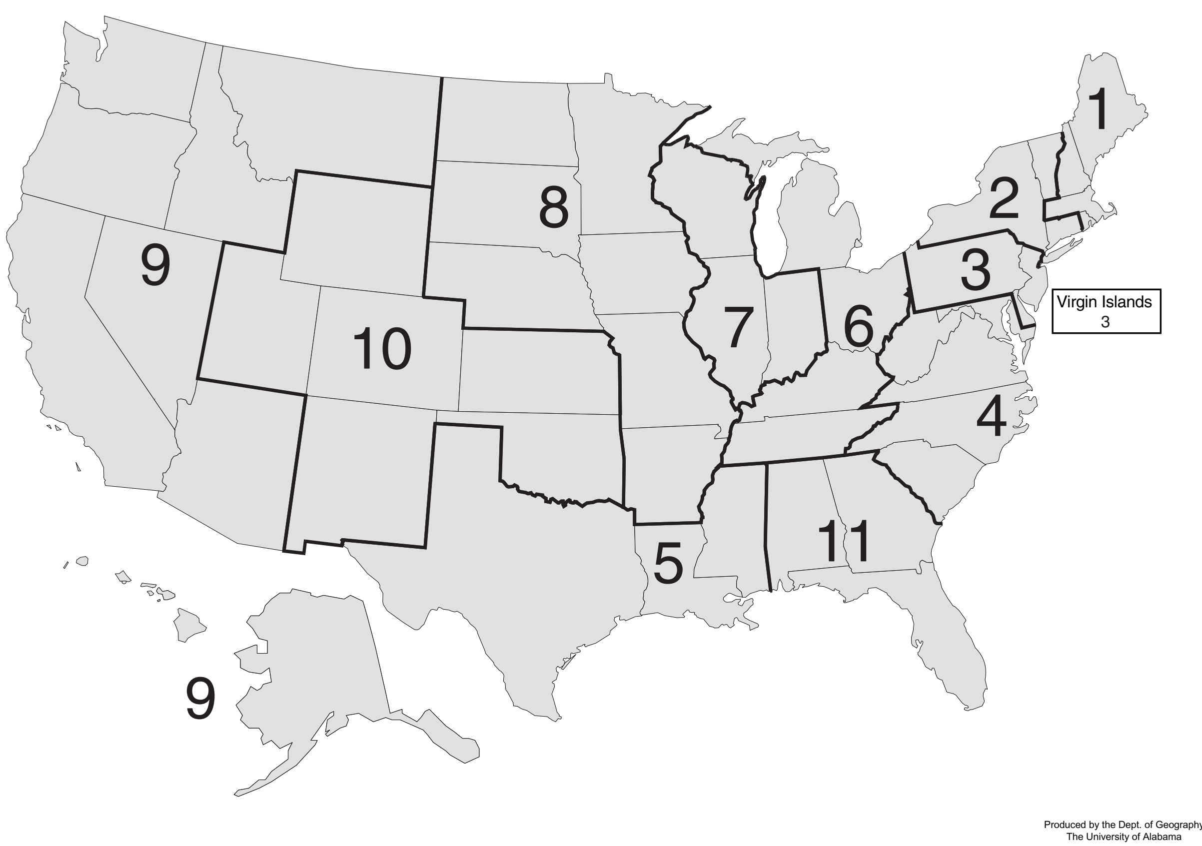
Any decision of the Tax Court can be appealed to the appropriate Circuit Court of Appeals. A final appeal can be made to the Supreme Court, but since its jurisdiction is discretionary, the court hears relatively few tax cases. Many of these court transcripts can be accessed online at **www.uscourts.gov.**

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

Income Averaging

TIGTA Report No. 2006-30-158 (September 22, 2006)
IRC §1301

☞ Over 4,600 Fishers Could Benefit From Income Averaging

Purpose. Prior to the American Jobs Creation Act of 2004 (AJCA), farmers and fishers who chose to income average lost a portion of the benefits due to the alternative minimum tax (AMT). AJCA solved this problem by excluding the income averaging savings from the AMT calculation. In a recent report to the IRS, the Treasury Inspector General For Tax Administration (TIGTA) reported that over 4,600 fishers could have saved an average of $530 by income averaging.

Analysis. The Joint Committee on Taxation estimated this provision could save fishers up to $61 million in taxes over the next decade. TIGTA blames the failure to use income averaging on lack of knowledge by taxpayers and paid tax returns preparers. The 4,600 taxpayers represent 90% of the fishers who could have benefited. Consequently, the IRS plans to publicize the benefits of income averaging in the future.

Conservation Security Program

Revenue Ruling 2006-46, 2006-39 IRB 511
IRC §126

☞ Cost-share Payments May Be Excluded from Gross Income

Purpose. To determine whether cost-share payments received under the conservation security program (CSP) can be excluded from gross income.

Background. IRC §126(a)(9) allows certain conservation payments to be excluded from gross income. The CSP is a conservation program administered by the U.S. Department of Agriculture (USDA). A producer who wishes to participate in the CSP must enter into a long-term conservation security contract with the USDA.

Analysis. The excludible portion of the payment is limited to the portion that:

1. Is determined by the Secretary of Agriculture to be made primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, improving forests, or providing habitat for wildlife;
2. Does not substantially increase the income derived from the property; and
3. Is properly associated with the deductible expense.

Payments in the nature of rent or compensation for services do not qualify for the exclusion.

Conclusion. The IRS accepted the USDA's position that the CSP is a small watershed program. Consequently, cost-share payments received are excluded from gross income to the extent permitted by §126.

Livestock Replacement Period

Notice 2006-91 (September 28, 2006)
IRC §1033

☞ IRS Extends Replacement Period for Livestock Sold Because of Weather

Purpose. If livestock are sold because of extreme weather conditions, the IRS is authorized to extend the replacement period if the weather conditions continue for more than three years. The IRS notice lists counties in 35 states that qualify for the extended replacement period.

Analysis. IRC §1033(a) allows nonrecognition of gains when property is involuntarily converted and replaced with similar property. §1033(e)(1) provides that a sale or exchange of livestock held by the taxpayer for draft, breeding, or dairy purposes in excess of the number that would be sold following the taxpayer's usual business practices is treated as an involuntary conversion if sold solely because of drought, flood, or other weather-related conditions.

Recognition of gain on the livestock sale is only to the extent the amount realized exceeds the cost of replacement property. The normal replacement period is four years after the close of the first year in which the gain from the conversion is realized. The regulations allow the IRS to extend the replacement period on a regional basis for an appropriate amount of time if the area is eligible for assistance by the federal government for more than three years.

Conservation Reserve Program

Notice 2006-108 (December 5, 2006)
IRC §§61, 102 and 1402

☞ All CRP Payments are Subject to Self-Employment Tax

Purpose. In a Chief Counsel Advice (CCA) letter in 2003, the IRS stated that **all** conservation reserve program (CRP) payments were subject to self-employment tax.[1] This letter ruling was directly contrary to a prior letter ruling.[2] The CCA ruling stated all payments under the CRP were subject to self-employment tax. Whether the recipient was a materially participating farmer was of no consequence.

Analysis. Notice 2006-108 is a proposed revenue ruling. It agrees with the position taken by the IRS in the 2003 CCA, but allows interested persons to comment on the proposal. The notice states that CRP payments are not made for the right to use or occupy land. Instead, they are received in exchange for performing tasks "that are intrinsic to the farming trade or business" such as tilling, seeding, fertilizing and weed control.

Comments regarding the proposed revenue ruling were due to the IRS before March 19, 2007.

1. CCA 200325002 (See page 217 in the 2003 *University of Illinois Federal Tax Workbook*)
2. Letter Ruling 8822064 (March 7, 1988)

Depreciation Recovery Periods

***Leo and Evelyn Trentadue v. Comm'r,* 128 TC 91 (2007)**

IRC §167

☞ Six Factors Guide Determination of Improvements to Real Property

Facts. Mr. and Mrs. Trentadue own and operate Trentadue Winery and Vineyards in California, which consists of a winery, vineyard, event center, well, and their personal residence. During 1999 and 2000, their son Victor managed both Trentadue Winery and the vineyard operations. The vineyard consists of 85 planted acres. Of their crop, 75% is used in their own winery and 25% is sold to unrelated wineries. Currently, the taxpayers cultivate 12 different varieties of grape. Each variety is grown by either a trellising or head pruning method in a block. The block installation requires multiple steps including:

- Ripping up the soil and adding nutrients,
- Digging a 2-foot trench and installing PVC pipe for an irrigation system,
- Screwing end posts and anchors, and
- Attaching wires, drip hose, and emitters on the vines.

The taxpayer's Schedule F claimed depreciation deductions for the trellis components, trellis systems, irrigation systems, and well using a 10-year class life. The IRS determined these components had a 20-year class life and recommended adjustments accordingly.

Issues.

- Whether wine grape trellises, irrigation systems, and/or the well should be depreciated as land improvements using a 10-year life as claimed by the taxpayers or a 20-year life as determined by the IRS
- Whether these components are depreciable as permanent land improvements.

Analysis. IRC §167 allows a depreciation deduction for the exhaustion, wear and tear, and obsolescence of property used in a trade or business. Rev. Rul. 87-56 provides the class lives for agriculture components but does not specifically classify trellises, drip irrigation systems, or wells.[3] In essence, the class life categories cover two broad categories — permanent real property improvements, and machinery and equipment.

The court used the six factors found in *Whiteco Indus., Inc, v. Comm'r*[4] to determine whether an asset is an improvement to real property. The six factors include:

1. Is the property capable of being moved?
2. Is the property designed or constructed to remain permanently in place?
3. Do circumstances show the property may or will have to be moved?
4. How substantial and time consuming is removal of the property?
5. How much damage will the property sustain upon its removal?
6. What is the manner of affixation of the property to the land?

3. Rev. Rul. 87-56, 1987-2 CB 674

4. *Whiteco Indus., Inc, v. Comm'r,* 65 TC 664 (1975)

The court analyzed each of the six questions and determined there is no definitive answer to the asset classification. However, because the taxpayers did not use concrete to fix the posts in place, their position is stronger than that found in *Whiteco.* The IRS argued the trellising is intended to last as long as the vines, which have a 25-year life expectancy. In addition, the trellising was dismantled, moved, stored, and/or reused and it is not permanently affixed to the ground. Of the six factors, three were in the taxpayer's favor, one was in favor of the IRS, and two were neutral.

Holding. The Tax Court held the trellising was properly classified as farm machinery or equipment with a 10-year class life. The irrigation systems and well are permanent improvements to the real property classified as land improvements with a 20-year class life.

ALTERNATIVE MINIMUM TAX

ISOs

***Anthony J. Kadillak v. Comm'r,* 127 TC 184, (2006)**
IRC §§55, 56, 83, 1221, and 1341

☞ IRC §83(b) Effects on AMT Losses

Facts. Mr. Kadillak exercised incentive stock options (ISOs) subject to an employment termination restriction in April 2000 for 32,000 shares of stock in Ariba Technologies, Inc. This resulted in $3,260,998 of alternative minimum taxable income (AMTI). He timely filed an IRC §83(b) election in May 2000. His employment terminated in April 2001. At that time, Ariba notified Mr. Kadillak it was exercising repurchase rights for 6,6667 nonvested shares. His 2001 tax return showed no AMT and did not report gain or loss from the forfeiture of the 6,667 nonvested stock shares. On the advice of a tax attorney, he amended both his 2000 and 2001 tax returns along with a Form 8275, *Disclosure Statement.* He asserted the IRC §83(b) election to be invalid and that no AMTI was realized in 2000, and $340,213 of AMTI should have been reported on the 2001 return. Mr. Kadillak filed other amended returns for 2000 and 2001 upon his tax attorney's advice.

The IRS mailed a Notice of Federal Tax Lien Filing for unpaid 2000 and 2001 taxes. Mr. Kadillak requested an administrative hearing, requested the removal of any liens, and requested a temporary reprieve from collection activity. After an adverse decision by the Appeals Office, Mr. Kadillak petitioned the court. The court reviewed the case and returned it to Appeals for consideration of the underlying tax liabilities. After Appeals rejected Mr. Kadillak's arguments, he timely petitioned the court for a review of the lien and levy.

Issues. Whether the:

- Taxpayer's 2000 IRC §83(b) election was valid,
- Taxpayer is entitled to an AMT ordinary loss under IRC §1341,
- Taxpayer may carryback capital losses to reduce his alternative minimum taxable income (AMTI) for 2000, and
- Taxpayer may carryback alternative minimum tax net operating losses (AMTNOL) to reduce his AMTI for 2000.

Analysis. IRC §83(b) allows a taxpayer to elect to include in income in the year of receipt the excess of the stock value subject to a substantial risk of forfeiture over any amount paid for the stock. No dispute exists as to the fact that no income for regular income tax purpose is recognized in 2000 as the result of the ISOs being exercised, and the IRC §83(b) election complied with proper procedural requirements. Mr. Kadillak's argument centers around the fact that the IRC §83(b) election was invalid for the nonvested shares, because these shares were not legally transferred to him. Therefore, he would not have to recognize income until the shares became vested. Upon employment termination, he was required to surrender the nonvested stock for its option price rather than its FMV.

The court analyzed the facts in this case and determined because the condition under which the required return of stock was not permanent (i.e. a lapse restriction), it was not certain whether his services would terminate before the vesting of the stock. The Ariba stock was not transferred on the date of exercise under a condition certain to occur. Accordingly, the stock was properly transferred under IRC §83(b) when the option was exercised.

Holding. The Tax Court concluded:

- The IRC §83(b) election was valid,
- An AMT ordinary loss under IRC §1341 is not allowable, and
- Neither capital loss carryback nor AMTNOL may be carried back to reduce his AMTI for 2000.

Kadillak appealed this case to the 9th Circuit on February 2, 2007, where it is still pending.

Updated AMT Tool

IRS News Release IR-2007-18 (January 26, 2007)
IRC §55

☞ AMT Calculation in 10 Minutes or Less

Alternative Minimum Tax (AMT) Assistant, an Internet-based calculator, is available on **www.irs.gov.** This tool assists practitioners and individual taxpayers in determining if AMT will be due when the return is filed. It is easy to use. To access this tool, enter "AMT Assistant" in the search box on the IRS website.

Practitioners and taxpayers who file paper returns could benefit from the AMT Assistant by completing a draft Form 1040 through line 44 and answering a few simple questions.

AMORTIZATION AND DEPRECIATION

Depreciation

Revenue Procedure 2007-16, 2007-4 IRB 358
IRC §446

☞ Change in Accounting Method Available After Property Disposition

Purpose. To provide an automatic consent procedure which allows a taxpayer to make a change in accounting method under IRC §446(e) for depreciable property after its disposition.

Background. This revenue procedure provides significant changes to Rev. Proc. 2002-9 and 2004-11. It describes procedures to follow when depreciation claimed on disposed property was less than the depreciation that should have been claimed. A taxpayer can request the change on an original return for the year of change by filing Form 3115, *Application for Change in Accounting Method.* In addition, the change can also be made on an amended return for the year of change by filing Form 3115.

Analysis. Rev. Proc. 2002-9 must be followed if the taxpayer used an impermissible method for at least two years preceding the year of the change.

Effective Date. This revenue procedure applies to Form 3115 filed for tax years ending on or after December 26, 2006. Transition rules exist for Forms 3115 filed before December 26, 2006.

Farm Operations

***James M. and Ruth J. Riley v. Comm'r,* T.C. Summary Opinion 2007-26 (February 26, 2007)**

IRC §§162, 167 and 179

☞ IRC §179 Deduction Available Only in Year Placed in Service

Caution. Be aware that beginning with the 2003 tax year through 2009, a §179 election may now be made or revoked on an amended return (which would have changed the result in this case).

Facts. James Riley worked as an extracting metallurgist for the Department of the Interior from 1953 to 1983. Prior to his retirement, he started a cattle feeding operation in Utah. After his retirement, he purchased three farms in Minnesota on which he raised corn, soybeans, and cattle. These farms included various improvements and buildings, some were used in the farming operations. He purchased a 2001 Dodge truck for $35,000 for use in his farming activity. He drove it approximately 7,000 miles per year for transporting grain and for traveling to Montana, Wyoming, and South Dakota to purchase feeder cattle. He also had three other vehicles that he used while conducting both his farming and rental activities.

On the returns for the years at issue, the Rileys reported Schedule E and Schedule F income/loss as follows:

	2001	2002	2003
Schedule E: rental income (loss)	($ 178)	$5,032	$ 5,133
Schedule F: farm income (loss)	(29,350)	6,219	156,492

Schedule F depreciation deductions were claimed for the farm buildings, truck, and field tile installed on one of the farms using the straight-line depreciation method. Mr. Riley estimated the FMV of the farm's buildings rather than allocate the purchase price between the farmland and the improvements. In addition, because he did not claim depreciation for these improvements for 1998 and 1999, he thought he could extend the deprecation deductions for two additional years. Depreciation claimed for these items totaled $14,500, $12,000, and $7,000 for 2001, 2002, and 2003, respectively.

Depreciation claimed for the truck was as follows:

- 2001: $7,000 ($35,000 cost ÷ 5-year useful life)
- 2002: $24,000 IRC §179 deduction plus $1,000 regular depreciation
- 2003: $1,000 regular depreciation

Mr. Riley also claimed travel expenses on both Schedules E and F. He kept some of his receipts but kept no records to substantiate his days away from home or the business purpose of the trips. He **estimated** 15,000 miles of travel each year, which he then multiplied by the standard mileage rate for the year. He computed meals and lodging using 40 days per year multiplied by $90 (low-cost per diem lodging expense rate for the years at issue).

The IRS disallowed all travel expenses and depreciation deductions totaling $19,500, $35,667, and $8,000 for 2001, 2002, and 2003, respectively.

Issues. Whether the Rileys are:

- Entitled to deductions for depreciation of farm buildings and drainage tile claimed on Schedule F,
- Entitled to elect under §179 expenses for a portion of the cost of a truck placed in service in 2001,
- Entitled to deductions for travel expenses claimed on Schedule E and F for 2001, 2002, and 2003, and
- Liable for the accuracy-related penalty under IRC §662(a) for each of the years at issue.

Analysis. IRC §167(a) allows a depreciation deduction for the exhaustion, wear, and tear of property used in a trade or business. At trial, the IRS argued the Rileys were not entitled to the depreciation deductions for the farm buildings because they did not use the buildings in their farming activities, the depreciation periods had expired, and/or they have not established their cost bases in the buildings. The court agreed with the IRS position. The taxpayer's argument that two years of unclaimed depreciation could extend the depreciation period for two additional years was unsuccessful.

Concerning the truck, the IRS agreed the truck was placed in service in 2001 and was used solely for business purposes. **For tax years before 2003,** IRC §179(a) allows a taxpayer to elect to treat the cost of §179 property as a current expense in the year the property is placed in service. In this case, the taxpayers acquired the truck in 2001 and began depreciating it. The 2001 year is the only year in which the §179 deduction is available.

The taxpayer provided substantiation for the following expenses:

	2001	2002	2003
Travel expenses	$ 391.14	$ 940.00	$ 385.01
Lodging expenses	—	689.05	—
Meals and lodging	445.00	240.00	180.00
Truck expenses	7,303.75	7,168.22	7,264.84

Holding. At trial, the court allowed the taxpayers to use IRS per diem rates for meals and incidentals subject to the 50% limitation. Because the taxpayers did not show their underpayments were due to reasonable cause, the court upheld the penalty imposition for all three years.

Depreciation

Revenue Procedure 2007-30, 2007-18 IRB 1104

IRC §§167 and 280F

☞ New Depreciation Limits for Business Autos, Trucks, and Vans Placed in Service in 2007

Purpose. Tables indicating limitations on depreciation deductions for owners of passenger automobiles, including trucks and vans, first placed in service during calendar year 2007 have been issued by the IRS. Also provided are tables indicating the amounts to be included in income for vehicles first leased during calendar year 2007.

Background. For owners of passenger automobiles, §280F(a) imposes dollar limitations on the depreciation deduction for the year that the passenger automobile is placed in service by the taxpayer and each succeeding year. Section 280F(d)(7) requires the amounts allowable as depreciation deductions to be increased by a price inflation adjustment amount for passenger automobiles placed in service after 1988. For leased passenger automobiles, §280F(c) requires a reduction in the deduction allowed to the lessee of the passenger automobile. The reduction must be substantially equivalent to the limitations on the depreciation deductions imposed on owners of passenger automobiles.

Analysis. Annual depreciation dollar limits for vehicles that are subject to the luxury-auto limits of IRC §280F and placed in service after December 31, 2006 but before January 1, 2008 are shown in the following table.

Vehicles Subject to Luxury Auto Limits	Annual Depreciation Limitations			
	Year 1	Year 2	Year 3	Year 4+
Autos	$3,060	$4,900	$2,850	$1,775
Trucks and vans	3,260	5,200	3,050	1,875

In previous years, IRC §280F(a)(1)(C) allowed for higher depreciation deduction limits for certain electric automobiles. Since this applied only for electric automobiles placed in service after December 31, 2001 and before January 1, 2007, the annual depreciation limitations correspond to those listed in the table.

Effective Date. This revenue procedure applies to passenger automobiles (other than leased passenger automobiles) that are first placed in service by the taxpayer during calendar year 2007, and to leased passenger automobiles that are first leased by the taxpayer during calendar year 2007.

BAD DEBT

At Risk

***Hubert Enterprises, Inc. v. Comm'r,* Nos. 05-2616, 05-2617, 05-2619 (6th Cir. April 27, 2007) (affirming in part, vacating and remanding 125 TC 72)**
IRC §§166 and 465

☞ No Bona Fide Debt

Facts. The Hubert Family Trust (HFT) owned Hubert Enterprises, Inc. (HEI), a parent corporation of a group of affiliated companies that filed joint corporate tax returns during 1997–1999. In 1995, Arbor Lake of Sarasota LLC (ALSL) was organized to exploit condominium development opportunities in Sarasota, Florida. Several individuals were owners of both HEI and ALSL. Arbor Lake Development (ALD), a Florida limited partnership, was formed to develop the condominiums with ALSL retaining a 97% interest in ALD as general partner. Since ALD was unable to secure construction financing, HEI provided initial financing of the $2.4 million project. ALSL executed a promissory note. The note had no fixed maturity date, was a demand note, and included interest payable based on the applicable federal rate. HEI took no security interests in the assets of ALSL or its members. Only ALSL members personally guaranteed one payment of slightly less than $44,000. The venture ultimately failed, which resulted in a bad debt deduction on the 1997 HEI tax return. The IRS disallowed the bad debt deduction. The Tax Court agreed with the IRS determination and found the transaction between HEI and ALSL did not create a bona fide debt. The Tax Court determined the sums advanced to ALSL by HEI were constructive dividends paid for the benefit of HEI shareholders.

In August 1999, HEI transferred ownership of its subsidiaries to Hubert Holding Company (HHC) in exchange for 100% of HHC stock. HHC claimed deductions under IRC §465 which the IRS disallowed. The Tax Court ruled in favor of the IRS.

Issues.

- Whether HEI is entitled to a bad debt deduction for sums advanced to ALSL.
- Whether HHC is at risk under IRC §465.

Analysis. IRC §166 allows a deduction for any loss sustained in a profit-seeking activity. IRC §465 provides that the deductions by taxpayers engaged in certain activities, including leasing activities, are limited to the extent they are at risk. HEI challenged the Tax Court determination that certain advances to HEI by another entity constituted a constructive dividend which precluded HEI's deduction of those amounts as either a bad debt or an ordinary business loss. HEI also challenged the determination that amendments to the operating agreement for an LLC of which HHC was a member did not place HHC at risk under IRC §465.

Holding. The Appeals Court ruled the Tax Court did not analyze the worst-case situation in which the taxpayer could be liable under the payor-of-last-resort due to amendments made to the operating agreement of the leasing company, which the taxpayer's subsidiary owned. The decision for HEI's redetermination was denied, and the HHC decision was vacated and remanded for further proceedings.

Nonaccrual-Experience Method

Treasury Decision 9285, 2006-41 IRB 656

IRC §448

☞ Professionals Can Take Advantage of Bad Debt Safe Harbor Provisions

Purpose. This Treasury Decision amends and finalizes the regulations under IRC §448(d)(5).

Background. The final regulations generally follow the rules in the 2003 temporary regulations. The final regulations include the four safe harbor nonaccrual-experience methods provided in the 2003 temporary regulations, but those methods have been modified to provide more flexibility. Unlike the 2003 temporary regulations, the final regulations do not require as a general rule that a taxpayer's nonaccrual-experience method be tested against one of the safe harbor nonaccrual-experience methods. Instead, the final regulations adopt, with modifications, the general rule from the 2003 temporary regulations as a fifth safe harbor. The final regulations also adopt a new general rule that requires a taxpayer's nonaccrual-experience method be tested against actual experience unless the taxpayer has adopted one of the five safe harbor methods.

Analysis. Under final regulations, professionals in the fields of law, accounting, medicine, engineering, architecture, performing arts, and consulting have several ways to determine how much of their billing amount can be deducted as bad debts. These regulations also apply to certain taxpayers with $5 million annual gross receipts for prior years.

The bad-debt deduction can be determined utilizing any nonaccrual-experience method (NAE) which clearly reflects the actual experience rate or a safe harbor method including:

- Revenue-based moving average method,
- Actual experience method,
- Modified Black Motor method, and
- Modified moving average method,

In addition, taxpayers may use a method that reflects their actual experience provided they can substantiate how it is determined. The self-testing requirement, done in the first taxable year, requires a taxpayer to compare its NAE with one of the four safe harbor methods to determine if the method being used clearly reflects experience. If the taxpayer's experience exceeds the NAE deduction, the NAE method for that year cannot be used. The taxpayer must change to another method.

Effective Date. This decision applies to taxable years ending on or after August 31, 2006.

BANKRUPTCY AND INSOLVENCY

Tax Refunds

***Nichols v. Birdsell,* 491 F.3d 987 (9th Cir. 2007)**

IRC §§6402 and 6513

☞ Deposit on Future Tax Liabilities is Asset of Bankruptcy Estate

Facts. The taxpayers overpaid their 27001 federal and state taxes and were entitled to refunds. They decided to leave the refunds on deposit for future tax liabilities. A short while later, they filed for bankruptcy. The bankruptcy trustee demanded the tax deposits be turned over to him. The taxpayer did not turn over the deposits. The taxpayers filed their 2002 tax returns applying the 2001 refunds accordingly. The taxpayers allege that after making the election to carryover the refunds on the 2001 return, they no longer had an interest in these refunds. The bankruptcy court disagreed stating that these refunds are assets of the estate as of the petition date. The taxpayers appealed this decision to the District Court, which denied the appeal. The taxpayers then appealed to the 9th Circuit.

Issue. Whether the debtors' prebankruptcy application of their rights to a tax refund to postbankruptcy obligations constitute an asset that must be turned over to the bankruptcy trustee.

Analysis. At trial, the taxpayers indicated that IRC §§6402(b) and 6513(d) provide for a taxpayer to make an irrevocable election to apply an overpayment of taxes to the subsequent year's tax obligation changing the overpayment to a payment of estimated taxes and leaving no interest for the bankruptcy estate.

Holding. The court disagreed with the taxpayers and determined the refunds are an asset of the bankruptcy estate that is available for creditors to obtain.

Gross Earnings from Services

Notice 2006-83 (September 18, 2006)

IRC §1398

☞ Bankruptcy Estate Required to Report Debtor's Gross Earnings from Postpetition Services

Purpose. Section 1115 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BPACPA) requires the bankruptcy estate, not the debtor, to include the debtor's gross earnings from postpetition services in gross income. The bankruptcy estate also includes the gross income from property acquired by the debtor after the commencement of the case. This applies to Chapter 11 bankruptcies filed on or after October 17, 2005. Prior to BPACPA, this income was taxed to the debtor.

However, the individual debtor must continue to file his own individual tax returns during the bankruptcy proceedings.[5]

Analysis. The debtor in possession or trustee must prepare and file the income tax returns of the bankruptcy estate. After the commencement of a Chapter 11 bankruptcy case, the trustee should notify individuals who prepare Forms 1099 to use the bankruptcy estate's EIN. Postpetition W-2 wages are reported using the social security number of the debtor even though the income is taxed to the bankruptcy estate.

The employer issues a Form W-2 to the debtor. The debtor allocates the proper amounts between the bankruptcy estate and his individual Form 1040. Income tax withholdings are allocated in a similar manner. The debtor must attach a statement to his income tax return stating that he filed a Chapter 11 bankruptcy petition. The statement must reflect the allocations of income and withheld income tax. The bankruptcy trustee attaches a similar statement to the bankruptcy tax return.

5. IRC §6012(a)(1)

While the bankruptcy estate includes any postpetition self-employment earnings in gross income, the debtor must include this income on his individual Schedule SE and pay the self-employment tax.

The IRS notice offers the following suggested attachment:

Notice XXXX-XX
Statement Pending Bankruptcy Case

The taxpayer, ________________, filed a bankruptcy petition under Chapter 11 of the Bankruptcy Code on ______________ in the Bankruptcy Court for the ___________ District of ___________. The bankruptcy court case number is ___________. Gross income, and withheld federal income tax, reported on Form W-2, Forms 1099, K-1, Schedule K-1, and other information returns received under the taxpayer's name and social security number (or other taxpayer identification number) are allocated between the taxpayer and the bankruptcy estate (EIN__-_____) as follows, using [describe allocation method]:

	Year	Taxpayer	Estate
1. Form W-2 from ____________ Co.	_________	$_________	$_________
Withheld income tax shown on Form W-2	_________	$_________	$_________
2. Form 1099-INT from ____________ Bank	_________	$_________	$_________
Withheld income tax (if any)			
3. Form 1099-DIV from ____________ Co.	_________	$_________	$_________
Withheld income tax (if any) shown on Form 1099-DIV	_________	$_________	$_________
4. Form 1099-MISC from ____________ Co.	_________	$_________	$_________
Withheld income tax (if any) shown on Form 1099-MISC	_________	$_________	$_________

Bankruptcy Proceedings

***U.S. v. White,* 466 F.3d 1241 (11th Cir. 2006)**

IRC §§6501, 6672, and 6871

☞ Appellate Court Reverses Decision in Postbankruptcy Trust Fund Recovery Penalty

Facts. Mr. White was the sole shareholder and president of WCC, Inc. On May 3, 1993, he filed a Chapter 11 reorganization. The Bankruptcy Court confirmed this in May of 1994. The IRS made an assessment against Mr. White for a $109,724 trust fund recovery penalty liability under IRC §6672 for unpaid employment taxes. The IRS later sued Mr. White for collection in the Northern District of Georgia. The district court entered a judgment for Mr. White at which time the IRS appealed the decision.

Issue. Whether the trust fund recovery penalty against Mr. White was valid.

Analysis. The district court vacated the IRS assessment because Mr. White enjoyed an automatic stay against the collection of the tax. Once a bankruptcy plan is confirmed, those parties holding nondischargeable debts are allowed to pursue collection unless the plan provides otherwise or the court has so ordered.

Holding. The 11th Circuit Court of Appeals reversed the district court's decision determining the employment taxes were nondischargeable.

BUSINESS EXPENSES

Inventory

***Total Health Center Trust, et al v. Comm'r,* TC Memo 2006-226, October 24, 2006**
IRC §471

☞ Double Inventory Shrinkage Not Allowable

Facts. The taxpayer operated businesses in Texas and Kansas that sold dietary supplements and performed certain diagnostic services. A periodic inventory method was utilized by the businesses. A trial balance and adjusting journal entries were separately prepared for each of the operations. After taking physical inventory, the accountant made an adjusting journal entry debiting inventory and crediting purchases for $48,258 based on shrinkage and spoilage of products.

The Schedule C showed the following cost of goods sold computation:

Beginning inventory	$221,908
Plus: purchases	414,832
	$636,740
Less: ending inventory	(207,516)
Cost of goods sold	$429,224

Examination of the records showed the purchases amount included an increase of $48,258 and the inventory amount included a decrease of $48,258. The IRS determined the taxpayers double-counted the adjustment by including it in the purchases amount as well as reducing ending inventory. Therefore, the IRS proposed an adjustment of $48,258.

Issue. Whether the taxpayers are entitled to adjust cost of goods sold based on inventory shrinkage and reduce ending inventory for a like amount.

Analysis. Treas. Reg. §1.61-3(a) provides that costs of goods sold are subtracted from gross receipts to arrive at the gross income of a business. IRC §471 provides the general rules for computing inventory. The computation of cost of goods sold is made by adding beginning inventory and purchases and subtracting ending inventory.

Holding. The Tax Court determined an adjustment for the product that is no longer saleable in the ending inventory is appropriate. However, the same amount cannot be added to product purchases in calculating cost of goods sold. Otherwise, a double benefit results for the taxpayers.

Cost of Goods Sold

***Carroll Janis and Donna L. Seldin Janis v. Comm'r,* 469 F.3d 256 (2nd Cir. 2006) (affirming TC Memo 2004-117, May 12, 2004)**
IRC §1014

☞ Can Artwork Valuation Differ For Estate and Sales Purposes?

Facts. Sidney Janis owned and operated a well-known art gallery in New York City until he transferred the gallery in 1998 to a trust with his two sons and himself as trustees. Unfortunately, he died a year later. An estate tax return was filed for Sidney Janis's estate using the alternate valuation date (six months from date of death) for the Sidney Janis Gallery artwork. Sotheby's hypothetically appraised the artwork at $25,876,630 based on the individual-by-individual artwork retail values. The executors adjusted the underlying asset value to reflect the actual realizable value in the context of an operating business. A willing buyer would not pay retail value since that would eliminate the profit in the sale of the artwork. In addition, there would be expenses and a waiting period involved in selling the artwork. Discounting Sotheby's appraisal by 52% resulted in the value of $12,403,207 that was used on the estate tax return.

During examination of the estate return, the IRS Art Advisory Panel reviewed 427 of the 464 art pieces. The panel determined the aggregate retail value to be $36,636,630. They also determined a 37% blockage discount that resulted in a total discounted value of $22,955,077. A settlement agreement resulted in a valuation of $14,500,000. Three weeks after the settlement was reached, amended Form 1041 income tax returns for the 1990 through 1992 were filed using an FMV of the artwork of $36,636,630 rather than the agreed upon $14,500,000. Use of this value increased the costs of goods resulting in net operating losses for each year 1990 through 1995. The resulting losses flowed through to the brother's returns.

The IRS examined the brothers' returns based on the losses. It decreased the amounts allowable based on the settlement valuation from the artwork. The Janises appealed the assessment to the Tax Court, which affirmed the deficiencies. The taxpayers appealed the decision. The Janises argued the FMV should be the value attributed by the IRS Art Advisory Panel not the value used in the estate tax valuation.

Issue. Whether the FMV of the artwork also constitutes the cost basis of the property when it was later sold.

Analysis. IRC §1014(a) provides that when inherited property is sold, the income tax due on the sale is assessed on the difference between the sale price and the FMV on the date of death. The taxpayers argued that applying the blockage discount in one situation does not justify using the same FMV when the artwork is sold. The estate tax, which is based on the FMV at the time of death, taxes the unrealized capital gain. Any gain incurred above the FMV at date of death creates a gain upon subsequent resale. In this case, the taxpayers want the lower value for estate tax purposes but a higher value when the artwork was subsequently sold.

Holding. The Court of Appeals agreed with the Tax Court and held the value, as determined by the estate settlement, is properly used to compute gain at the final disposition.

Daycare Expenses

Settimo v. Comm'r, **TC Memo 2006-261, December 7, 2006**

IRC §162

☞ Daycare Expenses Not Directly Related to Corporation Business

Facts. Mr. Settimo owned two S corporations, Professional Window Cleaning, Inc. (PWC) and Algimarso Glass Cleaners, Inc. (AGC). PWC operated during 2001 but terminated in 2002 when AGC was formed. Mrs. Settimo worked for the businesses during 2001 and 2002 as a window washer one or two days per week and as a secretary 10 to 15 hours per week. Mr. Settimo served as the general operations manager during the years in question in addition to washing windows five or six days per week. The Settimos' wages from PWC and AGC for 2001 and 2002 were:

	Mrs. Settimo's Wages	Mr. Settimo's Wages
PWC: 2001	$4,480	$ 0
AGC: 2002	5,000	6,800

During these years, the Settimos' four children, ranging in age from 2 to 11 years old, required supervision by either a neighbor or a daycare service. The neighbor received cash for her services and the daycare service was paid from the corporations' bank account. The corporations did not pay daycare expenses for any of the other employees' children. During 2001 and 2002, PWC and AGC claimed business expenses of $1,288 and $4,800, respectively, for the Settimo children's daycare expenses.

During examination, the IRS disallowed the childcare expenses.

Issue. Whether the taxpayers' two wholly-owned S corporations may deduct daycare expenses for the Settimo children.

Analysis. At trial, the Settimos argued Rev. Rul. 73-348, 1973-2 C.B. 31 permits a corporation's payments to a daycare center to provide care for the preschool children of its employees while they are at work as an IRC §162 "directly related" expense. In this case, the facts presented did **not** show the daycare expenses were directly related to the S corporation business activities.

Holding. The Tax Court determined the daycare expenses were not a deductible business expense.

Start-up Expenses

***Julie A. Toth v. Comm'r,* 128 TC 1 (2007)**

IRC §§195 and 212

☞ IRS Loses in Start-up Expense Case

Facts. Julie Toth worked for Pfizer, Inc. In March 1997, while participating in a stadium jumping clinic, she fell from her horse and suffered a head injury.

In 1998, Julie began operating a horse training and boarding facility on 17 acres of land in (a well-known area within the equestrian community). Although her income started slowly, it steadily increased over time and allowed her to employ additional staff. During 1998 and 2001, she reported the income and expenses on Schedule C. At trial, she conceded that the expenses were not deductible under IRC §162. However, she maintained that they were deductible under IRC §212.

The IRS disallowed the deductions on the basis that these expenses were nondeductible start-up expenses under IRC §195. Penalties under IRC §§6651 and 6654 were also imposed.

Issue. Whether the taxpayer may deduct expenses in connection with her horse training and boarding activities under §212 or whether the taxpayer is required to capitalize them as startup expenditures under §195.

Analysis. IRC §195 provides for capitalization of start-up expenditures. At trial, the IRS argued Ms. Toth anticipated her income-producing activities would become an active trade or business, which required the expenses to be capitalized. The court determined Ms. Toth operated her horse activities for profit in 1998 and continued to engage in these same activities through the trial date.

Holding. The Tax Court determined the expenses were not required to be capitalized as start-up expenditures. Therefore, they were deductible under IRC §212.

Professional Gambler

***George E. and Gloria Tschetschot v. Comm'r,* TC Memo 2007-38, February 20, 2007**

IRC §165

☞ Professional Gambler not Exempt from IRC §165

Facts. Gloria Tschetschot is a database project engineer who became a professional tournament poker player in 2000. George Tschetschot does not fall into the professional gambler category but occasionally plays slots and blackjack while accompanying Gloria on poker tournaments. Tournament play begins with each player "buying in" at the same number of chips. When a player runs out of chips, he is out of the game. Cash prizes are awarded at the end of the tournament to a predetermined number of finishing places. The investment in each tournament is the amount of the buy-in and any re-buys the player may make.

On their 2000 tax return, although Mrs. Tschetschot had winnings in excess of $11,000 from her poker tournament play, she and her husband each filed a Schedule C claiming **losses** of $29,933 and $9,000, respectively.

The IRS disallowed the losses from gambling on Schedule C, stating losses are allowable only to the extent of winnings as a miscellaneous itemized deduction on Schedule A.

Issue. Whether the taxpayers' gambling activity is a "trade or business" allowing them to deduct gambling losses on Schedule C.

Analysis. At trial, the taxpayers agreed Mr. Tschetschot's Schedule C gambling loss should be claimed as a miscellaneous itemized deduction on Schedule A. The IRS conceded that Gloria was a professional gambler and determined that certain expenses related to her professional gambling activity were appropriate Schedule C deductions. However, the real issue is whether Gloria's professional poker playing activity is classified as "entertainment and professional sports" causing IRC §165 restrictions to apply. The taxpayers presented the following arguments:

- Tournament poker is not a wagering activity,
- Tournament poker is conducted in much the same way as other professional sporting tournaments, and
- Professional tournament poker should be treated the same as tournament golf or tennis for tax purposes.

Since Congress made a policy decision to treat businesses involved in wagering activities differently, the court disagreed with all arguments presented by the taxpayers.

Holding. The Tax Court determined the net gambling losses are not exempt from IRC §165 limitations.

Inventory Costs

Load, Inc. v. Comm'r and Coad Inc. v. Comm'r, **TC Memo 2007-51, March 6, 2007**
IRC §§162 and 263A

☞ Miscellaneous Expenses Not §162 Deductions

Facts. Load, Inc. and Coad, Inc. buy and sell manufactured homes in Reno, Nevada. Load and Coad along with 18 other related corporations are either subsidiaries of, or sister corporations to, Associated Dealers, Inc. (ADI). ADI purchases manufactured homes and places the homes on retail lots that ADI leases as sales lots in prominent, high-traffic areas. Independent salespersons, which have contracted with ADI, meet with customers and accompany potential customers through the homes. These salespersons encourage customers to buy a manufactured home selecting a particular floor plan, appliances, and other desired features. The independent salesperson then submits the purchase agreement and bill of sale to ADI. The retail selling prices of these homes range from $30,000 to $115,000 each. ADI then contacts the manufacturer to have the home built. The home is usually shipped within two to three weeks to the customer's home site for installation. If the home site is not ready for installation, the home is delivered to an ADI sales lot where it remains until the home site is ready for the installation to occur.

On occasion, customers buy a manufactured home off the sales lot. In these situations, ADI sells the home to the independent salesperson at the wholesale price. The independent salesperson then sells the home to the customer at an agreed upon retail price. ADI charges each independent salesperson a $300 processing fee for each manufactured home sold. The independent salespersons retain 100% of the retail price markup from the manufacturer's wholesale price.

Load and Coad deducted IRC §162 expenses of $243,350 in sales lot lease payments and $22,387 in miscellaneous expenses (shipping homes to other sales lots, repairs, cleaning, and sheriff seizure fees). During examination, the IRS determined these costs were not ordinary and necessary business expenses but should be considered inventory costs under IRC §263A.

Issue. Whether certain costs relating to manufactured homes owned by the taxpayers and placed on retail sales lots are currently deductible under IRC §162 or should be included in IRC §263A inventory costs.

Analysis. IRC §263A provides that indirect costs allocable to inventory acquired for resale are not currently deductible and are included in inventory. The court looked at whether this situation qualifies as a retail sales facility or an off-site storage facility. Treas. Reg. §1.263A-1(e)(3)(iii)(A) provides an exception which allows marketing, selling, advertising, and distribution costs not to be included in inventory. At trial, the taxpayers argued these costs qualify as marketing, selling, or distribution costs of property held for resale that is excluded from the inventory consideration. The leased sales lots should be treated as on-site storage facilities that are excluded from inventory. Because ADI does not sell homes exclusively to retail customers, the costs do not qualify for §263A exception from inventory for on-site storage costs.

Holding. The Tax Court determined the expenses are not currently deductible as an ordinary and necessary business expense under IRC §162.

This case was appealed to the 9th Circuit on June 19, 2007.

Professional Gambler

***Jose Calvao v. Comm'r,* TC Memo 2007-57, March 8, 2007**

IRC §§162 and 6662

☞ Casino Gambling Plan Does Not Create Trade or Business

Facts. Jose Calvao began Caltex Corporation (Caltex), an S corporation, in 1993. Caltex sells embroidered t-shirts, caps, and other similar products. Mr. Calvao hired his brother, who took over the day-to-day operations of Caltex in 1999. During 2002, Jose worked at Caltex approximately 20-25 hours per week providing consulting services for a salary of $42,000. He also received a $99,790 distribution of income from Caltex in 2002.

Jose enjoyed slot machine gambling. He spent most of his gambling hours at Foxwoods Resort and Casino in Connecticut. He received Forms W-2G for 2002 showing gross winnings of $132,800. His records showed that he gambled on 24 separate occasions winning a total of $132,800, losing $180,300, and incurring travel expenses of $3,150. In addition to his wages, interest, dividends, state tax refund, and income from rental and S corporations, he reported his gambling activity on Schedule C showing a net loss of $50,650.

The IRS determined Jose was not in the trade or business of gambling and disallowed his Schedule C gambling activities. It reclassified his gambling loss as an itemized deduction to the extent of his gambling winnings with appropriate automatic adjustments due to an increase in adjusted gross income. An accuracy-related penalty was asserted.

Issues.

- Whether the taxpayer's gambling activity is a "trade or business" allowing him to deduct gambling losses on Schedule C.
- Whether he is liable for a penalty under IRC §6662(a).

Analysis. At trial, Jose argued he pursued the slot machine gambling activity full-time, in good faith, with regularity, and for the production of income. IRC §162(a) allows deductions for all ordinary and necessary expenses paid or incurred in carrying on a trade or business. IRC §165(d) provides that losses from wagering transactions are allowed only to the extent of gains from such transactions. In *Comm'r v. Groetzinger*,[6] the Supreme Court determined that for gambling to reach the level of a trade or business, the activity must be "pursued full-time, in good faith, and with regularity to the production of income for a livelihood, and not a mere hobby."

6. *Comm'r v. Groetzinger*, 480 U.S. 23, 35 (1987)

Jose argued that he spent a substantial amount of time preparing for his trips to the casino and developed a gambling activity plan utilizing information from the casino hosts on what machines were paying out. He then would determine what slots to play and how much money was needed for the particular day. Once he reached his loss limit or made 20% on his money, he would leave the casino. He also bought a slot machine to study how slot machines worked and read many books on playing slot machines. This, coupled with the amount of time Jose spent gambling were the grounds he used to support his argument that this was a trade or business. Jose stated he maintained daily records that showed he spent 2,206.5 hours during the year gambling at various casinos. He did not provide any documentation of his daily records; however, he provided a schedule of gambling on January 4, 2006. He did not state when the schedule was prepared.

IRC §6664(c) provides the accuracy-related penalty will not be imposed if the taxpayer acted with reasonable cause and in good faith. Treas. Reg. §1.6664-4(c)(1) provides that reasonable cause may be demonstrated by reliance on the advice of a professional. Jose argued he is not liable for a penalty because he relied on the advice of his accountant. However, he did not provide evidence to establish Mr. Beauregard's expertise.

Holding. The Tax Court determined Jose did not qualify as a gambler in the trade or business. Therefore, his expenses were moved from Schedule C to Schedule A itemized deductions. The penalty was sustained.

Medical Marijuana

***Californians Helping to Alleviate Medical Problems, Inc, v. Comm'r,* 128 TC 173 (2007)**
IRC §280E

☞ Controlled Substance Trafficking Results in Disallowed Expenses

Facts. Californians Helping to Alleviate Medical Problems, Inc. (California) was organized as a nonprofit corporation in December 1996 in San Francisco, CA. California served clients with debilitating diseases including acquired immune deficiency syndrome (AIDS), cancer, multiple sclerosis, and other serious diseases. Each member paid a membership fee for the right to receive extensive caregiving services and medical marijuana. The board of directors decided to discontinue all operations on May 6, 2002. A final Form 1120 was filed for 2002 showing a cost of goods sold deduction of $835,312, which included purchases totaling $575,317.

The IRS issued a notice of deficiency disallowing all deductions and cost of goods sold since these items were determined to be expenditures in connection with the illegal sale of drugs pursuant to IRC §280E. Later, the IRS conceded this determination except to the extent that it relates to total deductions of $212,958.

Issues.

- Whether expenses attributable to use of medical marijuana are nondeductible expenses under IRC §280E.
- Whether caregiving services and medical marijuana dispensing are considered separate trade or businesses for purposes of IRC §280E.

Analysis. At trial, the discussion centered on whether the two components, caregiving and providing medical marijuana, are really considered one activity or two. IRC §280E provides that no deduction or credit is allowed in carrying on a trade or business if the activity consists of trafficking in controlled substances which is prohibited by federal law. The California Compassionate Use Act of 1996 gave seriously ill Californians the right to obtain and use marijuana for medical purposes when the medical use is deemed appropriate and is recommended by a physician. Marijuana is a Schedule I controlled substance even when it is recommended by a physician.[7]

15

7. *United States v. Oakland Cannabis Buyers' Coop*, 532 U.S. 483 (2001)

The IRS argued that because Californians trafficked in a controlled substance, Californians is not permitted to deduct any of its expenses. Although legislative history expresses a congressional intent to disallow a deduction attributable to a trade or business of trafficking in controlled substances, they do not expressly intend to deny the deduction of all of a taxpayer's business expenses simply because the taxpayer was involved in trafficking in a controlled substance.

Holding. The court held that IRC §280E does not preclude the taxpayer from deducting expenses attributable to a trade or business other than that of illegal trafficking in controlled substances simply because taxpayer is also involved in the trafficking in a controlled substance. Since trafficking denotes "to engage in commercial activity: buy and sell regularly," the court found that distributing medical marijuana to its members in exchange for membership fees is considered trafficking.

As to the other issue of whether or not to group the two activities — caregiving and providing medical marijuana — the court found them to be substantially different in nature. Based on the extensive activities involved in caregiving, the court determined two separate and distinct businesses existed based on the credible testimony of the taxpayer's executive director. Consequently, those expenses attributable to the caregiving services are allowable deductions. The court determined the expense apportionment partially based on the number of employees who did not work directly with medical marijuana.

Health Savings Accounts

Revenue Procedure 2007-36 (May 11, 2007)

IRC §223

☞ HSA Amounts for 2007 and 2008

Purpose. To provide inflation adjusted items for 2007 and 2008 health savings accounts (HSAs).

Background. The maximum HSA contribution under prior law was the lesser of the deductible of the high deductible health plan (HDHP) or the indexed statutory amount. **For taxable years beginning after December 31, 2006**, the maximum annual HSA contribution is the indexed statutory amount **without** reference to the deductible of the HDHP.

Analysis. For calendar year 2007, the HDHP must have an annual deductible of no less than $1,100 for self-only or $2,200 for family coverage and annual out-of-pocket expenses no greater than $5,500 for self-only or $11,000 for family coverage.

For calendar year 2008, the HDHP must have an annual deductible that is not less than $1,100 for self-only coverage or $2,200 for family coverage and annual out-of-pocket expenses do not exceed $5,600 for self-only coverage or $11,200 for family coverage. The limits for calendar year 2007 and 2008 are as follows:

	2007	2008
Individual with self-only coverage	$2,850	$2,900
Individual with family coverage	5,650	5,800

This revenue procedure modifies and supersedes Section 3.24(1) of Revenue Procedure 2006-53.

Effective Date. This revenue procedure is effective for calendar years 2007 and 2008.

Note. See Chapter 1, "Individual Taxpayer Problems," Issue 2, for additional information on HSAs.

CAPITAL GAINS AND LOSSES

Stock Transfer

***Estate of Frances E. Freedman v. Comm'r,* TC Memo 2007-61, March 19, 2007**
IRC §61

☞ Transfer of Stock to a Joint Account does not Constitute a Gift

Facts. Frances Freedman received 525,000 shares of eConnect, a "penny stock," when she sold her interest in a Costa Rican casino in September 1999. At the time she received the stock, it was worth under 30¢ per share. She opened a joint brokerage account with her 36-year old son in January 2000 and transferred her 525,000 shares to it. Her son never contributed any funds or stock to the joint brokerage account.

When the price of the stock rose dramatically, she sold 257,500 shares in March 2000 and received approximately $3 million in net proceeds. When a CPA prepared the taxpayer's 2000 tax return, he reported the following on Schedule D for the stock sale:

Sales price	$2,974,393
Less: cost basis	(0)
Long-term capital gain	$2,974,393
Date of sale	March 2000
Date stock acquired	September 8, 1998

Prior to her death in June 2003, the IRS commenced an examination of Mrs. Freedman's 2000 return. Based on additional documentation from her estate, the CPA determined that the acquisition date of the 257,500 shares sold in March 2000 was September 1999 rather than September 8, 1998 as he had reported. As a result, the large gain on the 2000 Schedule D was short-term, not long-term.

The CPA proposed the following settlement to the IRS regarding the exam of the decedent's 2000 tax return:

- The $2,974,393 gain was a short-term capital gain.
- Half of the gain should be taxed to Mrs. Freedman, the decedent, and the other half should be taxed to her son since the brokerage account was a joint account (joint tenants with right of survivorship).

The IRS disagreed and held that the entire short-term gain was taxable on Mrs. Freedman's 2000 return. The IRS assessed additional tax of $567,864.

Issue. Whether the taxpayer made a valid gift of half of the shares of eConnect stock to her son when she contributed her stock to the jointly owned brokerage account.

Analysis. The decedent, and not her son, was considered under state (Texas) law to be the owner of all the stock in their joint brokerage account and was, therefore, taxable on the full amount of gain arising from the stock's sale. All of the funding was contributed by the decedent, and the son at no time placed any of his personal assets in the account. The evidence was sufficient to rebut any presumption, arising due to a parent-child relationship, that a gift was intended. Any circumstances cited by the decedent's estate failed to show clear and convincing evidence of an intent to make a gift to the son upon her establishment and funding of the account.

Holding. The Tax Court determined that under state (Texas) law, Mrs. Freedman had not made a valid gift of half of the shares to her son. Therefore, she was liable for tax on the entire short-tem capital gain.

> **Note**. Contentious litigation between the son and his half-sister over the decedent's estate remained unresolved at the time of the Tax Court trial.

CASUALTY AND THEFT LOSS

Gems and Jewelry

***Aben E. and Joan G. Johnson v. U.S.*, 74 Fed.Cl 360 (2006)**
IRC §165

☞ Prospect of Recovery Eliminates Theft Loss Deduction

Facts. In 1997, the taxpayers discovered they had lost approximately $78 million through a series of fraudulent transactions involving gems and jewelry. The taxpayers filed charges against the perpetrator, John Robert Hasson, and finally obtained judgments in 2000 and 2001 against Mr. Hasson and his associates.

In 1998, the taxpayers believed they could recover $20 million of the stolen funds based on Mr. Hasson's financial information. They took a $58 million theft loss on their amended 1998 return. To date, they have recovered slightly less than $20 million in the U.S. and $20 million from a bank account in France. The French recovery occurred in 2005.

The IRS examined the return and determined the taxpayers should not be allowed to claim any loss in 1998 since the net loss was **uncertain**. The taxpayers disagreed with the IRS's position.

Issue. Whether the taxpayers are entitled to a theft loss deduction in 1998.

Analysis. IRC §165(a) provides a deduction for any loss sustained during the tax year not compensated for by insurance or otherwise. IRC §165(e) provides the loss is allowed in the year that the taxpayer discovers the loss. Treas. Reg. §1.165-8(a)(2) states that a loss arising from theft is treated as sustained during the taxable year that the taxpayer discovers the loss.

At trial, the taxpayers argued they discovered that in 1997 they had been the victims of theft. The IRS argued that since the taxpayers were engaged in litigation to recover their loss until at least 2001 with valid claims, the amount of reimbursements were at best a guess.

Holding. The court ruled the taxpayers were not entitled to a theft loss deduction based on an estimate that was claimed before the recovery process was resolved.

Embezzlement

***Bennett Geiger v. Comm'r*, TC Memo 2006-271, December 26, 2006**
IRC §§165 and 6662

☞ Cashed Checks by Employees Does Not Prove Embezzlement

Facts. Mr. Geiger, a Floridian, is the sole shareholder of an S corporation, Big Ben Tree Service, Inc. (BBTS). On its 2000 tax return, BBTS claimed a $1,645,986 theft loss. Theft losses beginning in 1991 and continuing through 1999 were all **first discovered** during 2000. A loss of $155,227 was also deducted on the BBTS Form 4797. Mr. Geiger's 2000 tax return resulted in zero tax liability due to the loss flow-through from BBTS. In addition, Form 1045 was filed resulting in significant refunds for the 1997, 1998, and 1999 tax years.

Mr. Geiger alleged that two former employees embezzled funds from BBTS. One employee was his wife from 1980 until 1990, and the other employee was his girlfriend from 1995 through summer of 1999. The girlfriend was the business' bookkeeper. Both of these two employees provided Mr. Geiger with weekly operating cash by writing a check to Mr. Geiger, endorsing it as Mr. Geiger, and leaving it for him either in the office or delivering it to him. This money was used for business operating expenses. Monies for personal expenses were obtained in the same manner. An investigation of the books and records revealed that all checks written out to Mr. Geiger represented embezzled checks, not operating and/or personal checks. A police report was filed showing theft of personal property but not any cash. Mr. Geiger filed a civil action against both employees seeking damages for the alleged theft loss. A settlement agreement was reached whereby each would pay $12,000. Another suit was filed seeking over $2 million in damages. One of the employees finally admitted to embezzling monies from BBTS although the amount was never determined.

The IRS examined the returns. At that time, Mr. Geiger agreed the theft loss should be reduced by $1,096,713. Affidavits were secured from both employees stating they did not embezzle any monies from BBTS. Mr. Geiger repaid the IRS for the 1997, 1998, and 1999 refunds along with interest. A notice of deficiency was issued by the IRS eliminating the $1,645,986 theft loss deduction for 2000 and the theft loss deduction of $149,641 for 2000. The accuracy-related penalty was asserted on the deficiency.

Issues.

- Whether the taxpayer qualified for and was entitled to a theft loss deduction under IRC §165(c) in excess of $5,586.
- Whether an accuracy-related penalty applied.

Analysis. IRC §165(a) provides a deduction for any loss sustained during the tax year that is not compensated for by insurance or otherwise. IRC §165(e) provides the loss is allowed in the year in which the taxpayer discovers the loss. At trial, Mr. Geiger reduced the amount of the theft loss to $564,711, but did not introduce any credible evidence to support his position. In fact, the IRS provided a full source and applications analysis taking into account both business and personal income. The analysis did not show any missing funds.

Although Mr. Geiger argued that reasonable inferences support the embezzlement conclusion and that the court can estimate the amount of the loss, it disagreed. The evidence presented (i.e. more than one check being written to Mr. Geiger in a day) did not prove a theft occurred.

Holding. The Tax Court held the taxpayer is not entitled to a claimed theft loss deduction and is liable for the accuracy-related penalty.

An appeal of this case to the 11th Circuit was dismissed August 20, 2007.

CORPORATIONS

S Election

Letter Ruling 200721012 (February 7, 2007)
IRC §1362

☞ Reasonable Cause Allows For S Corporation Status

Purpose. To request a ruling allowing a corporation to be treated as an S corporation on the date of its incorporation.

Background. Taxpayer incorporated with the intention of electing S corporation status on the same date. Unfortunately, the election was not timely filed.

Analysis. IRC §1362(a) provides that a small business corporation may elect to be an S corporation. IRC §1362(b) provides rules on when an S election is effective. IRC §1362(b)(5) provides that if no election is made for any taxable year and the IRS determines there was reasonable cause for the failure to timely make the election, then the IRS may treat the election as timely made.

15

Conclusion. Since the taxpayer established reasonable cause for not making a timely S election, relief was granted under IRC §1362(b)(5). The taxpayer was treated as an S corporation effective with the inception of the corporation.

CREDITS

Temporary Absence

***Cynthia L. Rowe v. Comm'r*, 128 TC 13 (2007)**

IRC §32

☞ Incarceration Qualifies as Temporary Absence

Facts. During 2002, Cynthia and her two young children lived together until she was arrested on June 5. She continued to support her children until her incarceration took place on July 2. She was ultimately convicted of murder in 2003 and sentenced to life in prison. On her 2002 tax return, she claimed and received the earned income credit (EIC) of $1,070. The IRS denied the EIC since Cynthia did not have the same place of residence as her children for more than half the year. Cynthia argued the children resided in the same residence for all of 2002.

Issue. Whether the taxpayer is entitled to the EIC because the children lived in the residence for the entire year even though she was incarcerated for more than one-half the year.

Analysis. IRC §32 provides the rules for claiming the EIC. The issue in dispute is whether the taxpayer and children must share the same principal residence for more than half the year in order to claim the EIC. The taxpayer argued her absence was temporary for her incarceration.

Holding. The court agreed with the taxpayer's argument, and held that her temporary absence from home due to jail confinement after her arrest but before her conviction did not disqualify her from eligibility for the EIC. An individual jailed after an arrest but before conviction is necessarily but nonpermanently absent from home, and generally intends to return home. It was reasonable to assume that the taxpayer's absence was temporary, because there was no indication that she intended to choose a new home, she referred to her mother-in-law's home as "my home" in her court documents, and at the end of the tax year, the taxpayer's criminal case was still pending.

Earned Income

***Gertrude M. Jarman v. IRS*, 459 F. Supp. 2d 433 (D.N.C. 2006)**

IRC §32

☞ Aunt Not Qualifying Child

Facts. Ms. Jarman claimed the earned income credit (EIC) on her 1998 tax return for her aunt who required constant and demanding care. The IRS disallowed the credit since the aunt did not meet the relationship test as a qualifying child.

Issue. Whether the taxpayer is entitled to the EIC for her aunt.

Analysis. IRC §32 provides that a qualifying child is required in order to claim the EIC. The child can be a son, daughter, descendent of either, stepchild, or an eligible foster child. Ms. Jarman argued that her aunt was a foster child because the taxpayer cared for her as the taxpayer's own child.

Holding. The court determined the aunt is not a lineal descendant or stepchild and has not been adjudicated as a foster child. Although she cared for her disabled aunt, the credit does not extend to an elder care relationship.

Hybrid Vehicles
IRS News Release IR-2006-183 (November 22, 2006)
IRS News Release IR-2007-08 (January 11, 2007)
IRS News Release IR-2007-22 (January 31, 2007)
IRS News Release IR-2007-28 (February 8, 2007)
IRS News Release IR-2007-29 (February 8, 2007)
IRS News Release IR-2007-64 (March 19, 2007)
IRS News Release IR-2007-95 (May 2, 2007)
IRS News Release IR-2007-96 (May 2, 2007)
IRS News Release IR-2007-108 (May 24, 2007)
IRS News Release IR-2007-133 (July 25, 2007)
IRS News Release IR-2007-156 (September 7, 2007)
IRC §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 related to the vehicle:

- 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 U.S.

Forms to use to claim the credits are:

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

The 2005 and 2006 Honda FCX are unique vehicles that are only capable of operating on hydrogen. They meet the requirements of the alternative motor vehicle credit as a qualified fuel cell vehicle. The credit amount for these vehicles is $12,000 for each one purchased.

Taxpayers may claim the full amount of the allowable credit up to the end of the first calendar quarter after the quarter in which the manufacturer records its sale of 60,000 hybrids or advance lean burn technology.

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 2007 Toyota Prius on October 15, 2007. Her allowable credit will be $0 ($3,150 × 0%).

15

Current IRS acknowledged hybrid vehicles and credit amounts are as follows:

Make	Year	Model	Full 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
	2008	Malibu Hybrid	1,300
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
	2008	Escape 2WD Hybrid	3,000
	2008	Escape 4WD Hybrid	2,200
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	2006	Accord Hybrid AT w/updated calibration and Navi w/updated calibration	1,300[a]
	2006	Civic GX	4,000[a]
	2006	Civic Hybrid CVT	2,100[a]
	2006	Insight CVT	1,450[a]
	2007	Accord Hybrid AT	1,300[a]
	2007	Accord Hybrid Navi AT	1,300[a]
	2007	Civic GX	4,000[a]
	2007	Civic Hybrid CVT	2,100[a]
Lexus	2006	RX400h 2WD and 4WD	2,200[a]
	2007	GS 450h	1,550[a]
	2007	RX 400h 2WD and 4WD	2,200[a]
Mazda	2008	Tribute 2WD Hybrid	3,000
	2008	Tribute 4 WD Hybrid	2,200
Mercury	2006	Mariner 4WD Hybrid	1,950
	2007	Mariner 4WD Hybrid	1,950
	2008	Mariner 2WD Hybrid	3,000
	2008	Mariner 4WD Hybrid	2,200
Nissan	2007	Altima Hybrid	2,350
Saturn	2007	Aura Hybrid	1,300
	2007	Vue Green Line	650
	2008	Aura Hybrid	1,300
Toyota	2006	Highlander 2WD and 4WD Hybrid	2,600[a]
	2006	Prius	3,150[a]
	2007	Camry Hybrid	2,600[a]
	2007	Prius	3,150[a]
	2007	Highlander Hybrid 2WD and 4WD	2,600[a]

[a] Phaseout rules based on date of purchase apply.

DEDUCTIONS

Health Savings Account
Notice 2007-22 (February 15, 2007)
IRC §§105, 106, and 223

☞ Rollover from FSA and HRA to HSA Permitted

Purpose. To provide guidance on rollovers from health flexible spending arrangements (health FSAs) and health reimbursement arrangements (HRAs) to health savings accounts (HSAs). Guidance on special transition relief for rollovers completed before March 15, 2007 is also provided.

Analysis. IRC §223(c)(1) defines eligible individuals who may contribute to an HSA. The Health Opportunity Patient Empowerment Act of 2006 provides for qualified HSA distributions before January 1, 2012.

These new rules provide for certain amounts in a health FSA or HRA to be rolled over into an HSA and for the rollover to receive favorable tax treatment. All of the following conditions must be satisfied to receive favorable tax treatment:

- By end of plan year,
  - Plan must be amended,
  - Employee must elect rollover, and
  - Year-end balance must be frozen
- Employer must transfer funds within two and one-half months after the end of the plan year resulting in a zero balance in the health FSA or HRA

Permanent rules provided under this act include:

- Individuals with a zero balance on the last day of the plan year do not fail to be an eligible individual as of the first day of the immediately following health FSA plan year because of coverage during a health FSA grace period.
- Individuals with a zero balance in a general purpose HRA do not fail to be an eligible individual on the first day of the immediately following HRA plan year provided certain qualifications are met.
- An individual with a balance in a general purpose health FSA with a grace period or a general purpose HRA at the end of a health FSA or HRA plan year is treated as an eligible individual for HSA purposes if certain qualifications are met.

Examples of permanent rules, transition rules, and additional 10% tax are also included.

Effective Date. This notice applies to returns filed on or after December 20, 2006 and before January 1, 2012.

15

Abandonment

Chief Counsel Advice 200637032 (September 15, 2006)

IRC §165

☞ Partnership Interest Not Worthless

Purpose. To determine what year an individual is entitled to claim an IRC §165 loss for the worthlessness or abandonment of a partnership interest.

Background. The taxpayer joined a limited liability partnership as national director. Under the terms of the offer, the taxpayer was expected to provide a contribution to the partnership in the form of a subordinated loan for which a promissory note was executed. The taxpayer did not have any financial responsibility for partnership net losses or liabilities. Awhile later, the taxpayer resigned and requested repayment of the subordinated loan amount according to the partnership agreement provisions. The taxpayer did not receive repayment and continued to pursue repayment in the subsequent two years.

For the year at issue, the taxpayer received a Schedule K-1 that indicated he was a general partner with capital contributions made. The taxpayer filed his return claiming an ordinary loss on Form 4797 which represented the subordinated loan amount plus legal fees and miscellaneous expenses identified as Worthlessness of Partnership Interest.

Analysis. IRC §165(a) allows a deduction for losses sustained during the taxable year and not compensated for by insurance or otherwise. Rev. Rul. 93-80, 1993-2 C.B. 239, provides that a loss incurred on the abandonment or worthlessness of a partnership interest is an ordinary loss if sale or exchange treatment does not apply. IRC §165 requires abandonment of an asset to include both an intention and affirmative act to abandon.

Conclusion. In this situation, the taxpayer did not establish an identifiable event demonstrating the loss was sustained. Therefore, no allowable loss existed at that time.

Alimony

***Leonard Salesky v. Comm'r,* T.C. Summary Opinion 2006-162 (October 5, 2006)**

IRC §§71 and 215

☞ Attorney Fees not Alimony

Facts. Mr. Salesky filed for dissolution of marriage from his wife. In June 2002, the court ordered him to pay $7,500 to a law firm for Ms. Salesky's legal fees, which he promptly did. The order was silent as to the tax treatment of the payment or whether Mr. Salesky's obligation would end upon her death. When he filed his 2002 return using the married filing separate filing status, he claimed an alimony deduction of $25,375.

The IRS disallowed the $7,500 portion of the alimony deduction attributable to the legal fees.

Issue. Whether the taxpayer is entitled to deduct his wife's attorney fees as alimony.

Analysis. IRC §215(a) allows a deduction for the payments made during the year for alimony or separate maintenance. Payments that are deductible must be included in the recipient's gross income for the same year. IRC §71(b)(1) provides four requirements that must be met to consider the payment(s) as alimony or separate maintenance. One of those requirements is that there is no liability to make such payment after the death of the payee spouse. The court order to pay the $7,500 was silent as to whether Mr. Salesky's responsibility to make the payment would terminate in the event of Ms. Salesky's death. As a result, state law must determine the outcome. New Jersey state law clearly indicates that a court order to pay the wife's attorney fees survives the death of an ex-spouse.

Holding. Since the taxpayer would have been liable to pay the attorney fees even in the event of Ms. Salesky's death, the payment is not alimony and cannot be claimed as a deduction.

Health Plan Coverage

Treasury Decision 9298, 2007-6 IRB 434
IRC §9802

☞ Final Regulations Prohibit Health Plan Discrimination

Purpose. Final regulations have been jointly issued by the IRS, the Department of Labor, and the Department of Health and Human Services that prohibit discrimination in health plan coverage. These comprehensive rules apply to

- Group health plans,
- Insurance coverage offered with a group plan, and
- Grandfathered relief for church plans.

Background. The nondiscrimination regulations provide that benefits and restrictions imposed on benefits must be applied uniformly to similarly situated individuals. In other words, restrictions cannot be imposed on participants based on their particular health factors.

Analysis. Employers have the flexibility to offer wellness programs such as membership in a fitness center, diagnostic testing programs, well-baby visits, smoking cessation programs, and monthly health education seminars. The value of the wellness benefits cannot exceed 20% of the health coverage costs.

Employer-paid HRAs are allowed under these regulations as well.

Effective Date. These final regulations apply for plan years beginning on or after July 1, 2007.

HSA Guidance

Letter Ruling 200704010 (January 26, 2007)
IRC §223

☞ Policy Rider May Eliminate HSA Contributions

Purpose. To determine whether employees remain eligible under IRC §223 to contribute to an HSA even though they are covered by other policies, riders, or optional benefits.

Background. The taxpayer offers its eligible employees health and accident benefits including a high deductible heath plan (HDHP). Employees also have the opportunity to purchase various policies, riders, and optional benefits.

Analysis. IRC §223(a) allows a deduction equal to the aggregate amount paid in cash during the taxable year by or on behalf of an individual to an HSA. IRC §223(c)(1) further requires that an eligible individual be covered by an HDHP. Notice 2004-50 provides that an eligible individual may also be covered for any benefit provided by permitted insurance under IRC §223(c)(1)(B)(i).[8] Permitted insurance coverage includes cancer, diabetes, asthma or congestive heart failure as long as the principal health coverage is provided by the HDHP.

Analysis of the various policies revealed some qualified as permitted insurance coverage and others did not.

Conclusion. If an individual is covered by a policy that satisfies the requirements of permitted coverage, permitted insurance, or preventative care but the individual is also covered by a rider or optional benefit that does not satisfy the requirements for permitted coverage, permitted insurance or preventative care, the individual is not eligible to contribute to an HSA. Conversely, if the policy does not meet the requirements for permitted coverage, permitted insurance, or preventative care, then the individual is not an eligible individual for purposes of IRC §223(c)(1) whether or not the individual is covered by riders or optional benefits that satisfy the requirements.

15

8. Notice 2004-50, 2004-2 CB 196

Early Deduction Benefit

Revenue Ruling 2007-12, 2007-11 IRB 685
IRC §461

☞ Payroll Taxes Deduction Allowed Before Deferred Compensation

Purpose. To provide guidance on when a taxpayer using an accrual method of accounting incurs a liability under IRC §461 for payroll taxes on deferred compensation.

Background. A corporation uses an accrual method of accounting and files income tax returns on a calendar year basis. At the end of the year, a fixed liability exists to pay compensation for services provided by corporate employees during the year. All events have occurred to establish the employment tax liabilities under IRC §§3111 and 3301. The corporation properly adopted the recurring item exception under Treas. Reg. §1.461-5 as the method of accounting to be used for payroll taxes. Therefore, the payroll taxes are incurred in the first year even though the deferred compensation is payable and deductible in the subsequent year.

Analysis. IRC §461 provides that the amount of any deduction must be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

Conclusion. If the "all events" test and "recurring item" exception of IRC §461 are otherwise met, an accrual basis taxpayer may treat its payroll tax liability as incurred in the first year even if the deferred compensation is not paid until the subsequent year.

Prepaid Postage

Letter Ruling 200709003 (March 2, 2007)
IRC §§162 and 461

☞ Advance Postal Service Payments Deductible at Time of Payment

Purpose. To determine the proper time for taking a deduction for pre-paid postage expense.

Background. The taxpayer engages in the direct mail advertising business by entering into contracts with clients to print and distribute advertising materials to households and businesses that require substantial postage expenses. To eliminate bulky trips to the local post office, the taxpayer maintains a permit account with the U.S. Postal Service (USPS). Although not required to do so, the taxpayer maintains a balance in the account that depletes as mailings occur. The postage **must** be paid before the mailings are delivered. The taxpayer contributes to the permit account each quarter and generally uses the postage within 3½ months.

Each client enters into either a shared or a solo mailing agreement. Under the shared agreement, the postage cost is included in the contract price. Under the solo agreement, postage is not included in the contract price and is charged as a separate line item.

Analysis. IRC §162 allows a deduction for ordinary and necessary business expenses. IRC §461(h) provides that an accrual basis taxpayer can deduct a liability in the year in which:

- All events have occurred that established the liability,
- The liability amount can be determined with reasonable accuracy, and
- Economic performance has occurred.

Under the "all events" test, a liability must be fixed. Economic performance occurs when services are provided. However, services are treated as provided if the taxpayer reasonably expects to provide the services within 3½ months after the date of payment.

Conclusion. In this situation, the IRS determined that the taxpayer could treat the postage services as provided when the payment is made since the benefit occurs within 3½ months of the payment date.

North American Area
Revenue Ruling 2007-28, 2007-18 IRB 1039
IRC §274

☞ "North American Area" Updated

Purpose. To provide an updated list of all geographical areas currently included in the North American area for purposes of IRC §274(h). This listing allows taxpayers to more easily deduct business expenses for attending seminars, conventions, and other similar meetings in the "North American area."

Background. IRC §274(h) disallows deductions for expenses allocable to an individual's attendance at a convention, seminar, or similar meeting held outside the "North American area" unless the taxpayer demonstrates that the location of the convention satisfies specified standards of reasonableness. IRC §274(h)(3)(A) defines the term "North American area" as the U.S., its possessions, Canada, Mexico, and the territories formerly known as the Trust Territory of the Pacifica Islands. IRC §274(h)(6)(A) defines the term as including any beneficiary country for which there is an effective agreement permitting the exchange of information to execute the U.S. tax laws and the beneficiary country.

Analysis. This revenue ruling provides a complete listing of locations falling within the "North American area."

Conclusion. Three new agreements have been entered into allowing Bahamas, Aruba, and Netherlands Antilles to be part of the "North American area." Saint Lucia is no longer part of the "North American area" because its government has not implemented legislation to enact the agreement. Two other beneficiary countries, Cayman Islands and British Virgin Islands have entered into agreements which do not meet the IRC requirements because of their limited scope. The Cayman Islands and British Virgin Islands are not included in the "North American area."

Amended Regulation
Notice 2007-47 (May 23, 2007)
IRC §262

☞ Lodging Expense Deductibility

Purpose. To provide notice of the amended regulations under IRC §262 relating to the deductibility of lodging expenses.

Analysis. IRC §162(a) allows as a deduction all the ordinary and necessary business expenses paid or incurred during the taxable year in carrying on any trade or business. IRC §162(a)(2) provides that expenses deductible under IRC §162(a) include travel expenses (including lodging expenses that are not lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business. IRC §262 (a) provides that no deduction is allowed for personal, living, or family expenses. Treas. Reg. §1.262-1(b)(5) provides that the costs of a taxpayer's lodging not incurred in traveling away from home are personal expenses and are not deductible unless they qualify as deductible expenses under IRC §217.

The IRS expects to amend Treas. Reg. §1.262-1(b)(5) to include deductibility under **IRC §162** as well as §217. Until the amendment is published, the current regulation will not apply under the following conditions:

- Lodging is on a temporary basis,
- Lodging is needed for participation in a business meeting or function of the employer, and
- Expenses are otherwise deductible by the employee under IRC §162(a).

DEPENDENCY ISSUES

Separated or Divorced Parents

NPRM Reg-149856-03 (May 2, 2007)
IRC §152

☞ Proposed Regulations for Dependency Exemption

Purpose. The IRS recently released Prop. Treas. Reg. §1.152-4 which reflects amendments made under Working Families Tax Relief Act of 2004 and Gulf Opportunity Zone Act of 2005. In situations involving separated or divorced parents, these regulations clarify who is allowed to claim the dependency exemption.

Background. Generally, a noncustodial parent may deduct an exemption amount for a qualifying child, if the custodial parent releases the claim to exemption. A child is considered a qualifying child of the noncustodial parent if the parents:

- Are divorced or legally separated under a decree of divorce or separate maintenance,
- Are separated under a written separation agreement, or
- Live apart at all times during the last six months of the calendar year regardless of whether or not they were married.

Additionally, the child is a qualifying child of the noncustodial parent as long as the parents provide over one-half of the child's support for the calendar year and the child is in the custody of one or both parents for more than one-half of the calendar year.

Entitlement to a dependency exemption also brings with it other tax benefits. The parent who may claim the child as a dependent also may claim the child tax credit on behalf of the child, as well as any Hope or Lifetime Learning credits attributable to education expenditures made for the child, provided the other requirements of those provisions are met. The custodial parent may still use head of household filing status, even if the dependency exemption is waived. The custodial parent may also claim the earned income credit and the dependent care credit, if otherwise eligible.

Analysis. The major changes in the proposed regulations include:

- Defining a custodial parent as the parent with whom the child resides for the greater number of nights during the calendar year. If a child is temporarily absent from a parent's home, the child is viewed as residing with the parent with whom the child usually resides on that night(s). If a child resides with each parent for an equal amount of time during the year, the parent with the higher adjusted gross income for that year is treated as the custodial parent.
- Providing for a custodial parent to release an exemption claim for a child by signing a written declaration that he or she will not claim the child as a dependent. The noncustodial parent must attach the declaration to his or her return to claim the dependency exemption. The declaration may be made on Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents,* or in a written statement that accommodates the substance of Form 8332. The declaration must include an unconditional statement that the custodial parent will not claim the child as a dependent for the specified year(s). An exemption claim can be released for one year, several years or all future years. A declaration that specifies all future years is treated as specifying the first taxable year after the taxable year the release is executed and all subsequent taxable years. A state court order or decree cannot serve as a written declaration and therefore, does not determine the dependency exemption between divorced/separated parents.

- Providing that a custodial parent who released an exemption claim may revoke the release for future tax years by giving written notice of the revocation to the noncustodial parent. The revocation may be made on an IRS-designated form or by a declaration that accommodates the substance of such form. The revoking parent must maintain a copy of the revocation and confirm delivery to the noncustodial parent, and the revoking parent must attach the revocation to his or her return for any tax year the parent claims the exemption.

Conclusion. The proposed regulations will apply to tax years beginning after the date the regulations are final.

Form 8332
Chief Council Advice 200646014 (August 21, 2006)
IRC §152

☞ IRS May Consider Additional Evidence Presented During Examination

Purpose. To determine if the IRS may consider a Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents*, presented during an examination of a noncustodial parent's return if the taxpayer claimed the exemption for a child on his return but did not attach Form 8332.

Background. The previous version of IRC §152(e) presented difficult problems of proof and substantiation of support. To provide more certainty, Congress amended §152(e) to allow the custodial parent the exemption for a child unless an exception applied. The relevant exception permits the custodial parent to waive the exemption and allows the noncustodial parent to claim the exemption. As amended, §152(e) requires that the custodial parent memorialize the waiver in a signed written declaration that the noncustodial parent attaches to the noncustodial parent's return. Congress believed that the new methodology would provide the IRS and the parties with much clearer substantiation of the parties' intent on waiver of the exemption. The increased certainty would reduce the need for the IRS to adjudicate the issue.

Analysis. IRC §152(e) was amended to allow custodial parents to claim the exemption of a child unless an exception applied. It requires the custodial parent to provide a signed written declaration waiving the right to the exemption. This signed written declaration is attached to the noncustodial parents return, and it can be accomplished with either a Form 8332 or a substantially similar statement. Attaching the written declaration to the tax return avoids subsequent disputes.

Conclusion. Only one parent is entitled to the dependency exemption for a child. If the need arises to evaluate the noncustodial parent's claim for the dependency exemption during an audit, the IRS must address the situation by considering all relevant evidence including a Form 8332 not filed with the original return.

Noncustodial Parent

***Michael Scott Snelgrove, Sr. v. Comm'r,* T.C. Summary Opinion 2007-44 (March 20, 2007)**
IRC §151

☞ Court Order Does Not Replace Form 8332

Facts. Mr. Snelgrove was married from 1989 through 2002. During that time, he and his wife had three children. On his 2003 tax return, he claimed dependency exemptions and a child tax credit for all three children. He also claimed head of household filing status. Two of the children resided with their mother during 2003 and one child resided with Mr. Snelgrove.

The IRS issued a notice of deficiency changing his filing status to single and disallowing the dependency exemptions and child tax credit for all three children. At trial, the IRS conceded Mr. Snelgrove was entitled to head of household filing status and a dependency exemption for the child who resided with him during 2003.

Issue. Whether the taxpayer is entitled to dependency exemptions and child tax credit for two of his children who resided with their mother.

Analysis. IRC §152(e)(2) provides when a custodial parent signs a "written declaration" (Form 8332) releasing the dependency exemption from the custodial parent to the noncustodial parent, the noncustodial parent is entitled to the dependency exemption deduction for that year.

A Form 8332 was not executed by Mr. Snelgrove's ex-wife. He attached a copy of the court order to his tax return allowing him to claim the dependency exemptions. The court, relying on *Miller v. Comm'r*,[9] held that attaching a copy of the court order to the income tax return does not satisfy the requirement in the absence of a signature by the custodial parent releasing the dependency exemption.

Holding. The Tax Court determined Mr. Snelgrove did not satisfy the requisite requirements to claim dependency exemptions for his two noncustodial children.

DIVORCE ISSUES

Stock Option Redemption

Letter Ruling 200646003 (November 17, 2006)
IRC §83

☞ Income and Withholding Results on Exercise of Options

Purpose. To determine the treatment of nonstatutory stock options transferred as part of a property settlement incident to a divorce.

Background. As part of a divorce settlement, the taxpayer's spouse received vested nonstatutory stock options originally received by the taxpayer as part of the employment package. The taxpayer was to retain possession of the options until written instructions were provided to exercise the options. A request to exercise the options was provided at which time the taxpayer exercised the options. The stock was sold and the net proceeds were forwarded to the former spouse. Form W-2 for the year was issued to the taxpayer including applicable federal income tax withholding.

---

9. *Miller v. Comm'r*, 114 T.C. 184 (2000)

Analysis. IRC §83(a) provides that if property is transferred to any person in connection with the performance of services, the excess of the FMV of the property over the amount paid for the property is included in the gross income of the person performing the services in the first taxable year. Rev. Rul. 2004-60 involved an employee-spouse who received FICA wages when the nonemployee spouse exercised stock options. The employer was required to withhold income tax and FICA taxes on the proceeds and both amounts were deducted from the amount paid to the nonemployee spouse.

Conclusion. After reviewing all facts and rulings, the IRS concluded the income is includible in gross income along with a credit for withholding for the taxpayer's spouse. No credit is available for the FICA tax withheld.

EMPLOYMENT TAX ISSUES

Worker Classification

Colorado Mufflers Unlimited, Inc. v. Comm'r, **TC Memo 2007-222, August 13, 2007**

IRC §§530, 3111, 3301, and 6673

☞ Frivolous Arguments Lead to Court Imposed Penalty

Facts. Colorado Mufflers Unlimited, Inc. (Colorado) operated a muffler shop. Prior to 2000, Forms 941 and 940 were filed and Forms W-2 were issued to employees of the business. In 2000, Colorado decided the corporation had no employees and filed for refunds of 1997 and 1998 employment taxes originally reported on Forms 940 and 941. The IRS refunded the monies, but later determined erroneous refunds were made. The IRS audited Colorado's employment tax returns.

The IRS agent had difficulty in gathering records in this case. No payroll records existed and large checks were periodically written to cash. The revenue agent calculated wages paid and corresponding payroll taxes owed for nine employees for 2000 and 2001 based on the 1999 wage information. The revenue agent also recommended against granting relief under IRC §530.

Issues.

- Whether the nine workers were employees during 2000 and 2001.
- Whether relief is available under §530.
- Whether the IRC §6673 penalty applies.

Analysis. 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 §6673 imposes a maximum $25,000 penalty when the taxpayer's position is frivolous or groundless.

The Tax Court looked to the following seven factors to determine if the workers **were in an employment relationship:**

- Degree of control
- Investment in facilities
- Opportunity for profit or loss
- Right to discharge
- Colorado's regular business
- Permanency of the relationship, and
- Relationship the parties believed they were creating.

Holding. After determining that workers were employees, the Tax Court imposed an IRC §6673 penalty of $3,000. This was because Colorado, representing themselves pro se, on at least two separate occasions raised frivolous arguments such as:

- Forms 940, 941, and W-2 are invalid because they lack on Office of Management and Budget (OMB) number, and
- Forms 940, 941, and W-2 violated the Paperwork Reduction Act (PRA).

Employees versus Independent Contractors

Peno Trucking, Incorporated v. Comm'r, **TC Memo 2007-66, March 21, 2007**
IRC §3401

☞ Drivers are Employees Despite Contracts Stating They were Independent Contractors

Facts. The taxpayer, an S corporation, owned and leased approximately 15 tractor-trailers (trucks) to another trucking company. Under the lease, Peno Trucking was "required to provide drivers to operate its trucks and to be responsible for all work performed by the drivers." The day-to-day procedures between Peno Trucking and its drivers included the following:

- Peno Trucking owned the trucks and paid for all operating costs including fuel and repairs.
- Peno Trucking determined the days the drivers could work and controlled which loads the drivers would haul.
- The drivers could choose the routes to take to the specified destinations.
- The drivers were paid between 23% to 27% of the amount Peno Trucking received from the lessee trucking company for each load hauled.

Peno directed, supervised, paid, disciplined, and discharged its drivers in addition to setting the work days/hours, routes traveled, and order of pick up/delivery of shipments. Peno entered into written agreements with each driver that stated the drivers were independent contractors, not employees. Each driver had the right to refuse to transport a load, work on any particular day, or any particular schedule. Drivers were paid on a weekly basis anywhere from 23% to 27% of the 75% Peno received. Forms 1099-MISC were issued to the drivers at the end of the year. Two drivers had attempted to file workers' compensation claims as **employees** of Peno. Both claims were denied initially and on appeal because the drivers were truly independent contractors.

For 1997, 1998, and 1999, the IRS reclassified 29, 24, and 21 drivers, respectively from independent contractors to employee status. During examination, the IRS reclassified the drivers as employees of Peno and denied IRC §530 relief.

The taxpayer required each driver to sign a contract which stated in part: "Peno Trucking Inc. and Operator agree and understand that Operator is not an employee or agent of Peno Trucking Inc. The Operator is an independent contractor and Peno Trucking Inc. shall not direct in any manner the means or method by which Operator shall perform his occupation."

Issues.

- Whether the drivers were employees for federal employment tax purposes.
- Whether the taxpayer is entitled to relief under section 530 of the Revenue Act of 1978.

Analysis. Determining whether an individual is a common law employee depends primarily on the degree of control test. Other factors considered include:

- Investment in facilities,
- Opportunity for profit or loss,
- Right to discharge,
- Integral part of business,
- Permanency of the relationship, and
- Relationship parties believed they created

Holding. The Tax Court ignored the contracts and held that the drivers were common law employees. Therefore, the payments to them constituted wages subject to employment taxes. In addition, §530 relief was denied because Peno Trucking had **no reasonable basis** for treating the drivers as independent contractors as opposed to employees. This was in spite of the fact that Peno Trucking never treated its drivers as employees and consistently issued them Forms 1099-MISC.

This case was appealed to the 6th Circuit July 3, 2007.

Single Member LLC (SMLLC)

***Sean P. McNamee. v. U.S.,* 488 F.3d 100 (2nd Cir. 2007)**
IRC §§3101, 3102, 3111, 3301, 3402, and 7701

☞ Owner Liable for Payroll Taxes of Single Member Limited Liability Company (SMLLC)

Facts. Mr. McNamee was the sole owner of an unincorporated accounting firm, W.F. McNamee & Company, LLC (WF). WF employed an average of six persons before ceasing operations in March 2002. For the third and fourth quarters of 2000 and all four quarters in 2001, WF did not pay any employment taxes. Because Mr. McNamee failed to exercise the option of having his LLC treated as a corporation, WF was treated as a sole proprietorship. Therefore, Mr. McNamee became personally liable for WF's employment tax liabilities. The unpaid payroll taxes of $64,736 were assessed against Mr. McNamee and a lien was placed on his property.

Mr. McNamee disagreed with the assessment. He claimed that under Connecticut law members of an LLC are not personally liable for the LLC debts. He also claimed the IRS check-the-box regulation was in direct conflict with LLC member rights. An appeals conference was held and the IRS determination was sustained. Mr. McNamee sought review of the IRS administrative determination in the district court where he presented the same arguments. He then moved for summary judgment. The district court agreed with the IRS's position. An appeal followed.

Issues. Whether WF is treated as a separate tax entity (LLC) for employment tax purposes or whether Mr. McNamee is liable for employment tax liabilities of WF.

Analysis. IRC §7701(a) defines various types of business entities. LLCs are not expressly mentioned or defined in the code. Connecticut law allows single-member LLCs. The code is unclear as to where this type of entity falls. Mr. McNamee argued the regulations were invalid because they contravene federal statutory scheme and state law. He argued that since the IRS proposed new regulations making an LLC's single owner not liable for the LLC's unpaid payroll taxes this means that the current regulations are "wrong." He also argued that the check-the-box regulations contradict the IRC statutory provisions. Treas. Reg. §301.7701-1 provides that certain organizations that have a single owner can choose to be recognized or disregarded as entities separate from their owners.

Holding. The court determined there is no basis for finding the existing regulations unreasonable. Although the state law may affect the federal tax provision applications, it does not control them. The Circuit Court affirmed the District Court decision.

> **Note**. See the following similar cases: *Littriello v. U.S.*, 484 F.3d 372 (6th Cir. 2007); *Stearn & Co. LLC v. U.S.*, No. 2:06-cv-14923 (E.D.Mich. 2007). *Littriello* is discussed fully in Chapter 11, "Entity Issues."

Student Exception

***Albany Medical Center v. U.S.*, No. 1:04-CV-1399, (N.D.N.Y. January 10, 2007)**

IRC §3121

☞ Medical Residents Subject to FICA Tax

Facts. Albany Medical Center (Albany) had residency educational programs in 40 medical specialties for which the residents received remuneration and benefits ranging from $32,000 to $35,000 annually. Albany withheld and paid FICA taxes on this remuneration from 1995 to 1999. In February 2002, Albany filed Form 843 seeking a refund of the FICA taxes plus applicable interest. The IRS disallowed the claim. Albany filed a refund suit seeking $7,321,279.

Issue. Whether medical students meet the "student exception" under IRC §3121 and, as such, whether the remuneration is not subject to FICA taxes.

Analysis. IRC §3121(b)(10) provides that services rendered by a student enrolled and regularly attending classes at the school, college, or university are not considered employment and are consequently not subject to FICA taxes. The IRS argued medical residents are not included as part of the student exception based on the legislative history and related IRC provisions. Albany argued the legislative history shows that **medical residents qualify** for the student exception. There are two components to consider in the medical resident situation — the educational component and the hospital setting.

Holding. After considering the legislative history review, the court determined medical residents do not qualify for the student exception.

Form Redesign

IRS News Release IR-2007-017 (January 26, 2007)

☞ Improvements for Form 940

The IRS redesigned Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return.* This redesign effort incorporates the advantages of Form 940-EZ into a simplified form for all filers and includes the following improvements:

- Logical sequence from the taxpayer's point of view,
- Eight separate parts which allow the tasks to be broken into smaller steps,
- New Schedule A for multi-state employers or credit reduction situations, and
- Check boxes instead of "A, B, C" questions

Management Guidance

Memorandum from SB/SE Chief, Employment Tax Operations (March 22, 2007)

IRC §§530, 3509, and 7436

☞ Employment Tax Operations Chief Issues Guidance

A memorandum providing guidance and clarification on officer compensation and §530 relief was recently issued by the IRS Small Business/Self-Employed Employment Tax Operations Chief.

If the IRS determines a person should be classified as an employee during an employment tax audit, it will not assess the proposed tax until a Notice of Determination of Worker Classification is issued, and the taxpayer either exhausts or fails to pursue Tax Court remedies. IRC §7436 only applies if the determination of a worker's classification involves an actual controversy. For example, if the employer treated the individual as a nonemployee, there would be a controversy. This also applies in the case of a corporate officer who was treated as a nonemployee.

Two other important areas covered in this memorandum include:

- Reduced rates for income and employment tax withholding under IRC §3509 are available when employers failed to deduct withholding because the individuals were treated as nonemployees, unless the taxpayer intentionally disregarded the employment tax requirements.
- IRC §530 must be considered when there is controversy involving classification of individuals as employees.

ESTATE AND GIFT

Expenses

***Estate of Sarah M. Davenport v. Comm'r,* TC Memo 2006-215, October 5, 2006**

IRC §§2033, 2039, 2053, and 7520

☞ Annuities Included in Decedent's Estate and Funeral Luncheon Not Deductible

Facts. Sarah M. Davenport was born with major life threatening complications. She received a lawsuit settlement comprised of a lump-sum payment of $2,775,000 plus $2,500 per month for the remainder of her life. Sarah died on October 31, 2000 at the age of 12.

Her estate tax return reported mutual funds and U.S. Treasury bills. Annuities from Allstate and Safeco listed on Schedule I showed $0 FMV at the date of death. Funeral luncheon expenses of $3,639 were claimed on Schedule J.

The IRS examined the estate tax return. The examiner discovered an inventory prepared for the Wayne County Probate Court that showed annuities valued at $1,118,000. The IRS proposed to include the value of the annuities ($1,514,572) in the gross estate and to disallow $3,639 for the funeral luncheon. The estate disagreed with both proposed adjustments.

Issues.

- Whether the two annuities are includable in the gross estate under IRC §§2033 or 2039.
- Whether the annuities were properly valued under IRC §7520.
- Whether the estate is entitled to a deduction for a funeral luncheon under IRC §2053.

Analysis. IRC §2033 includes all property in the gross estate value. IRC §2039 includes the value of annuities in the gross estate. At trial, arguments were raised alleging the annuities were compensation to the parents for pain and suffering and should not be included in the estate value.

The value of two annuities payable pursuant to the malpractice settlement was determined under IRC §7520. In §7520, the annuities were valued using the actuarial tables provided in Treas. Reg. §20.2031-7. The estate's contention that the annuities should be valued using Treas. Reg. §20.2031-8 was rejected because the right under the settlement agreement was to periodic payments from the medical malpractice defendant, not from a commercial annuity provider.

IRC §2053(a)(1)(B) allows an estate tax deduction for funeral expenses. The estate argued that the funeral reception (luncheon) expense was an expense intimately tied to her funeral arrangements. Sarah had unique medical circumstances requiring enormous support, care, and assistance during her short lifetime. This funeral luncheon was a tribute to Sarah and a way of thanking everyone who touched Sarah throughout her lifetime.

Holding. The court clearly disagreed and included the annuities in the gross estate. Moreover, the estate offered no evidence regarding the valuation of comparable commercial annuities. Consequently, the government's valuation of $1,514,572 for the two annuities was upheld. Finally, although the court applauded the spirit of gratitude and generosity behind the funeral luncheon, there was no detail of the $3,639 total expense. Therefore, the entire amount was disallowed.

Private Annuity Proposed Regulations

IRS News Release IR 2006-161, October 17, 2006

IRC §§72 and 1001

☞ Appreciated Property Cannot be Exchanged for a Private Annuity

Background. In the past, the IRS allowed exchanges of appreciated property for a private annuity. This is inconsistent with the tax treatment of exchanges for commercial annuities and other kinds of property. The IRS allowed the exchanges because taxpayers could not determine the value of the private annuity for federal income tax purposes. Prior to the proposed regulations, the IRS relied on Rev. Rul. 69-74 in which the transferor recognized gain over his life expectancy.

Analysis and Holding. Both the Treasury Department and the IRS were concerned that current law was used inappropriately in transactions designed to avoid U.S. income tax. The proposed regulations[10] do not affect charitable gift annuities or installment sales.

The proposed regulations would treat the transferor as having sold the appreciated property for cash and then using the proceeds to purchase an annuity contract. If an annuity contract is received in exchange for property **other than money:**

- The amount realized attributable to the annuity contract is the FMV of the contract at the time of the exchange.
- The entire gain or loss is recognized at the time of the exchange, regardless of the taxpayer's method of accounting.
- The aggregate amount of premiums or other consideration paid for the annuity equals the amount realized attributable to the annuity for purposes of determining the initial investment in the contract.

If the proposed regulations are adopted, they would be effective October 18, 2006 for any transactions that have not been completed. However, for legitimate estate planning transactions currently in progress, the effective date is postponed for six months until April 18, 2007. The postponement is for transactions that pose the least likelihood of abuse. These include transactions in which:

- The issuer of the annuity contract is an individual.
- The obligations under the contract are not secured, either directly or indirectly.
- The property transferred in the exchange is not subsequently sold or otherwise disposed of by the transferor during the 2-year period beginning on the date of the exchange.

10. Prop. Treas. Regs. §§1.72-6 and 1.1001-1

Investment Advice

***William L. Rudkin Testamentary Trust v. Comm'r*, 467 F.3d 149 (2nd Cir. 2006)**
IRC §67

☞ Investment Advice Not Fully Deductible In Calculating AGI

Facts. The trust was originally funded from the proceeds of the sale of Pepperidge Farm. In the year at issue, the trust reported total income of $624,816 and claimed a full deduction for investment management fees of $22,241. The IRS held that only those fees in excess of 20% of the trust's AGI were deductible.

Issue. Whether the investment advice fees are fully deductible.

Analysis. The trust contended that the trustee's fiduciary duty required investment advisory services for the proper administration of the trust's sizable stock portfolio; therefore, the investment advice fees were fully deductible. The court held that the AGI of the trust should be computed in the same manner as in the case of an individual, with one exception. That exception was that the deduction for costs paid in connection with the administration of the trust, which would not have been incurred if the property were not held in trust, are fully deductible in calculating AGI.[11]

The court analyzed how AGI was calculated for an individual. It concluded that the AGI of a trust should be computed in a similar manner. The court noted that there was a split between the circuit courts on this issue. Some circuits applied the 20% of AGI limitation and others ignored it.

Holding. The Second Circuit held that the investment advice fees were subject to the 2% of AGI limitation.

Real Property Transfers

***Estate of Margot Stewart v. Comm'r*, TC Memo 2006-225, October 24, 2006**
IRC §§2036 and 2053

☞ A Gift is a Gift Even if Deed is Not Timely Filed

Facts. Margot Stewart owned real property in New York City in which she and her son Brandon resided. Three additional floors of the New York City property were leased to Financial Solutions, Ltd. for $9,000 per month. In May 2000, Margot transferred a 49% ownership in the New York City property to Brandon creating tenants in common ownership. Margot continued to receive all the rental payments and pay all expenses despite the ownership transfer.

The attorney took the deed to the abstract company to have it recorded. Unfortunately, the deed was misplaced and was not recorded until April 4, 2001. Margot died on November 27, 2000. In August 2001, a Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*, was filed for the New York City property transfer. The decedent's federal estate tax return was filed in February, 2002.

The IRS determined the New York City property transfer was not completed until April 4, 2001 when the deed was recorded. As a result, the IRS proposed adjustments on both the gift and estate tax returns.

Issues.

- Whether the decedent made a completed gift of a 49% interest in real property.
- Whether the value of that property should be included in the decedent's estate.
- Whether the decedent's estate is entitled to deductions relating to property taxes and claims against the estate.

11. IRC §67(e)(1)

Analysis. IRC §2036(a)(1) provides a decedent's gross estate includes the value of all property interests transferred by a decedent during her life where she has retained for life the possession or enjoyment of the property, or the right to the income from the property.

Mr. Stewart and the IRS differed on how much of the value of the New York City property should be included in Margot's estate tax return. The IRS's position relied heavily on the fact that Margot Stewart retained the $9,000 monthly income from the rental. Mr. Stewart argued that he and his mother verbally agreed to split income and expenses based on their respective ownership interests. Mr. Stewart alleged they verbally agreed to reconcile income and expenses at the end of 2000, although Mr. Stewart's accountant was not informed of the intention to do such a reconciliation. Consequently, the full value of the New York City property was included in Margot Stewart's estate with no deduction being allowed for the reconciliation amount allegedly owned to Mr. Stewart.

Holding. The court determined the gift of the New York City property did not hinge on when the recording of the deed occurred. The gift took place in May of 2000 as intended by Margot Stewart.

IRC §2053(c)(1)(B) provides that property taxes are not deductible by an estate unless the taxes are an enforceable obligation of the decedent at the time of death. In this case, Margot did not have an outstanding property tax obligation at the time of her death. Therefore, no deduction was allowed.

FRINGE BENEFITS

Transit Passes

Revenue Ruling 2006-57, 2006-47 IRB 911
IRC §132

☞ Qualified Transportation Fringe Benefits Excluded From Income

Purpose. To provide guidance as to how employers can use smartcards and debit cards to provide their employees with qualified transportation benefits.

Background. IRC §132 provides that employees may exclude from income qualified transportation fringe benefits up to a specified dollar amount including:

- Transportation in a commuter highway vehicle for travel between the employee's residence and place of employment;
- Transit passes for use on a mass transit facility; and
- Qualified parking at or near the employer's business premises.

Dollar limits for the following fringe benefits that can be excluded:

	2006	2007
Combined value of excludable transit passes and vanpools (per month)	$105	$110
Qualified parking (per month)	205	215

Three of four situations discussed in this revenue ruling illustrate examples that are **free of income, payroll, and withholding tax.** In **Situation 1**, Transit System X uses plastic smart cards that store fares. The employer makes monthly payments to Transit System X who then allocates funds to each participating employee's smart card. The funds can only be used for fare media. The employer does not require its employees to substantiate their use of the smartcard.

In **Situation 2,** Provider P provides terminal-restricted debit cards. The employer makes monthly payments to Provider P who then allocates funds to each participating employee debit card. Terminal-restricted debit cards can only be used at terminals where fare media for the transit system is sold. The employer does not require its employees to substantiate their use of the debit card.

Situation 3 involves Provider Q providing debit cards for use at merchants who are assigned a merchant category code (MCC). This MCC indicates the merchant sells fare media as well as other items. The first monthly fare media amount is paid by the employee. At the end of the first month, the employee substantiates the fare media expense usage to the employer. The employer then pays Provider Q the amount of substantiated fare media. This substantiated fare media is electronically allocated to the employee debit card for the upcoming month. These same procedures are followed each subsequent month.

Situation 4 has the same facts as **Situation 3** except an employer provided a MCC-restricted debit card to an employee as soon as he began his employment. The employee certifies the card will be used solely to purchase transit passes. The employee is **never** required to provide substantiation of the used fare media expenses.

Analysis. IRC §61 provides gross income means all income from whatever source derived. IRC §132 provides that any fringe benefit that is a qualified transportation fringe is **excluded** from income.

In **Situation 1**, because the fare media stored on the smartcards is only usable for Transit System X, this qualifies as a transit system voucher under Treas. Reg. §1.132-9(b) and is excluded from gross income. **Situation 2** has the same result as **Situation 1** because the terminal-restricted debit cards also qualifies under Treas. Reg. §1.132-9(b).

Situation 3 debit card does not qualify as a transit system voucher because this debit card can be used to purchase other nontransit items. However, because the reimbursements are provided under a bona fide reimbursement arrangement, they qualify as an exclusion from gross income. Conversely, in **Situation 4**, the arrangement is not a bona fide reimbursement arrangement because it provides advances rather than reimbursements and relies solely on employee certifications provided before the expense is incurred. The amounts provided to the employees are not excluded from gross income and are wages for employment tax purposes.

Effective Date. Although this ruling is effective January 1, 2008, employers may rely on its guidance for transactions occurring before that date.

Note. See Chapter 9, "Small Business Issues," Issue 1, "Fringe Benefits" for more information on employee fringe benefits.

FSA and HRA

Notice 2007-2 (December 14, 2006)

IRC §105

☞ Expanded Options for FSA and HRA Debit Cards

Purpose. To provide guidance for the use of debit cards for medical expense reimbursements at merchants with nonhealthcare related merchant category codes and the use of debit cards for medical expense reimbursements at drug stores and pharmacies.

Background. Rev. Rul. 2003-43 allowed employees who were given debit cards to withdraw funds from their health FSA or HRA to exclude the funds from gross income. These funds could be used to pay medical co-payments and other medical-related items not covered by insurance. The debit card usage was limited to merchants with specific category codes related to healthcare.

There are many merchants that do not have a merchant category code related to healthcare. Therefore, **until December 31, 2007**, a temporary treatment allows supermarkets, grocery stores, discount stores, and wholesale clubs that do not have a merchant category code to be considered an "other medical care provider." **After December 31, 2007**, these merchants must have inventory approval systems in place.

After December 31, 2008, FSA or HRA debit cards may not be used at stores with the drug stores and pharmacies merchant category code unless:

- The store participates in inventory approval system, or
- On a store-by-store location basis, 90% of the store's gross receipts during the prior tax year consisted of item which qualify as expenses under IRC §213(d).

Company Vehicle

Revenue Procedure 2007-11, 2007-2 IRB 261
IRC §61

☞ Maximum Values Released for Fringe Benefit Computation

Purpose. To provide the maximum value of employer-provided vehicles first made available to employees for personal use in 2007 using either the vehicle cents-per-mile valuation method or fleet-average valuation methods.

Analysis. The taxable fringe benefit for personal use of the company vehicle is calculated by taking the standard mileage rate multiplied by the number of miles driven as long as the FMV of the vehicle is limited to $15,100 for a car and $16,100 for a truck or van. For those vehicles having a greater FMV, the benefit must be calculated using either the auto-lease or actual valuation method.

Those employers who have a fleet of 20 or more vehicles may use the average value of the vehicles to determine a fleet-average value and then apply this amount to the table of annual lease values. Vehicle FMVs are limited to $20,100 for a car and $21,200 for a truck or van. When the vehicle value exceeds the maximum limitation, the employer must use the table to determine the annual lease value.

Effective Date. This revenue procedure applies to employer-provided passenger vehicles first made available to employees for personal use in calendar year 2007.

GROSS INCOME

Age Restriction Damages

***Douglas A. Gibson v. Comm'r,* TC Memo 2007-224, August 13, 2007**
IRC §§104 and 6662

☞ Lack of Ailment Corroborating Evidence Results in Taxable Income Determination

Facts. In 1991, the Gibson family moved into a home in Sun City, California that Mrs. Gibson had inherited. The residence was located in an area that was zoned as a "Senior Citizen Development" by Riverside County. This zoning requirement placed age restrictions on the residences of the area, which the Gibson's did not meet. County code enforcement authorities contacted the Gibsons on various occasions. It ultimately issued a notice to appear in court and alleged a criminal violation of the ordinance that imposed the restriction. The county later dropped the charges.

In May 1994, the Gibsons and other residents initiated a class action lawsuit against the county setting forth 14 claims. The District Court entered a consent decree awarding the Gibson family $350,000; Mr. Gibson's share amounted to $175,000. The consent decree also established a fund for making distributions to unnamed plaintiffs who later submitted qualified claims. Mr. Gibson met with an experienced tax attorney who determined $12,500 of his $175,000 should be reported as "damages" on the other income line of his 2002 Form 1040.

The IRS disagreed with Mr. Gibson's income amount and determined all $175,000 should be included as gross income. An accuracy-related penalty was recommended as well.

Issues.

- Whether the $175,000 lawsuit settlement is excludable from gross income under IRC §104(a)(2).
- Whether the IRC §6662 accuracy-related penalty applies.

Analysis. IRC §104(a)(2) provides that gross income does not include "the amount of any damages received … on account of personal physical injuries or physical sickness."

The court looked to the written terms of the settlement agreement to determine the origin and allocation of the settlement proceeds. In this case, the settlement agreement lacked express language stating what the settlement amount represented, so the court then turned to the **intent** of the payor to decide this issue. Mr. Gibson argued that the first amended complaint included a cause of action and remedy for bodily injury and physical distress causing him headaches, stomachaches, and breathing problems. However, he did not provide any evidence to corroborate these ailments. Mr. Gibson also argued that the consent decree entered for unnamed claimants provided payments for physical injuries and physical sickness. The court also rejected this argument.

Holding. The court determined the entire $175,000 was includible in gross income. However, because Mr. Gibson consulted with a tax attorney, the accuracy-related penalty did not apply.

Local Tax Relief

Letter Ruling 200721017 (May 25, 2007)
IRC §§61 and 164

☞ Taxation of Property Tax Rebate Depends on Year of Receipt

Purpose. To determine the proper federal income tax treatment of payments made to residents under a property rebate program.

Background. Statute provides for local tax relief on primary residences if it is a one, two or three family residence, a farm dwelling, or residential property held in a condominium or cooperative form of ownership. It must also serve as the primary residence of one of the property owners. Property owners must not have any arrearages in order to qualify for the rebate. Some rebate payments were received in 2006 while others will be made in 2007.

Analysis. In general, a taxpayer who receives a rebate of state taxes previously deducted on a prior year's federal income tax return must include the rebate in gross income in the year received to the extent of any federal income tax benefit. A taxpayer who receives a rebate of state taxes that were not previously deducted on a prior year's federal income tax return is not required to include the rebate in gross income in the year received. In either case, however, a taxpayer must include the rebate of state taxes in gross income to the extent that it exceeds property taxes actually paid by the taxpayer.

Conclusion. The taxpayer who receives property tax rebate in the same year the property taxes are paid is not required to include the rebate as gross income unless the rebate exceeds the property tax paid. The amount of the rebate reduces the itemized deduction for taxes. However, rebates received in the year following the year the taxes are paid must be included in gross income in the year received to the extent of any federal income tax benefit.

Stock Options

***U.S. v. James H. Tuff,* 469 F.3d 1249 (9th Cir. 2006)**

IRC §83

☞ Imposition of Blackout Period Was Immaterial

Facts. Mr. Tuff, an employee of RealNetworks, Inc., could sell shares only during open trading windows approved by the company. He received stock options that he exercised twice in 1999. The shares he purchased had a difference between market and exercise price of $453,956. He used money borrowed from Morgan Stanley (MS) to purchase the shares pledging the stock as collateral. Under the terms of the agreement, MS had the right to liquidate the shares when necessary to maintain sufficient funds in his margin account. MS sold 2,200 shares of the pledged stock in 1999.

The 1999 tax return originally reported the gain from the stock option exercise spread but an amended return was later filed claiming no income arose when the options were exercised. A refund check was issued to the Tuffs, but the IRS later changed its mind and sought to recover the refund.

Issue. Whether the taxpayers realized income from the exercise of stock options.

Analysis. IRC §83(b) allows a taxpayer to elect to include in income in the year of receipt the excess of the value of the stock subject to a substantial risk of forfeiture over any amount paid for the stock. The court determined Mr. Tuff held legal title to the stock and was entitled to receive dividends. There were no restrictions imposed by the corporation and he had the right to vote the shares, sell the shares during open trading windows, and pledge the shares as collateral. Mr. Tuff argued the imposition of a blackout period by the employer should be treated as an exception.

Holding. The court disagreed with Mr. Tuff's argument and ruled for the IRS.

High-Cost Foreign Cities

Notice 2006-87 (October 6, 2006)

IRC §911

☞ Foreign City Housing Exclusion Adjusted

Purpose. To provide adjustments to the limitation on housing expenses for specific locations based on geographic differences in housing costs as compared with U.S. housing costs.

Analysis. IRC §911 allows a qualified individual to elect to exclude from U.S. gross income foreign earned income and housing costs.

TIPRA amended IRC §911(c)(1) to define the housing cost amount as the excess of maximum housing expenses over 16% of the exclusion amount ($67.73 per day for 2006 or $82,400 for the full year) multiplied by the appropriate number of days.

The new IRC §911(c)(2)(A) limits excludable housing expenses to 30% of the applicable number of days. Thus, for 2006, a qualified individual whose entire taxable year is within the applicable period is limited to maximum housing expenses of $24,720 ($82,400 × .30). Accordingly, the maximum housing cost amount that a qualified individual may exclude from income in 2006 is $11,536 ($24,720 – $13,184).

In addition, IRC §911(d)(7) limits the total amount excluded or deducted to the individual's foreign earned income for such year. IRC §911(b)(1)(B) excludes certain amounts from the definition of foreign earned income, including amounts paid by the United States or an agency thereof to an employee of the United States or an agency thereof. Consequently, the exclusion of the housing cost amount is not available to an individual whose earned income consists solely of amounts paid by the United States or an agency thereof.

This notice provides a listing of over 150 high-cost foreign cities for both the full year and daily amounts.

Effective Date. This notice applies to taxable years beginning on or after January 1, 2006.

Demutualization

***Eugene A. Fisher, Trustee, Seymour P. Nagan Irrevocable Trust v. U.S.,* No. 04-1726T (Fed. Cl. November 15, 2006) (unpublished opinion related to 69 Fed.Cl 193) (2006)**
IRC §72

☞ Demutualization May Result in Cost Basis for Stock

Facts. A life insurance policy was purchased by the Nagan trust in 1990 from Sun Life. The policy allowed the holder to receive dividends declared out of surplus, receive distributions in the event of liquidation, and vote in the election of company directors. In 1999, the policyholders voted to convert Sun Life into a stock company. A demutualization occurred with Sun Life distributing shares of the stock company to the policyholders in exchange for their voting rights in Sun Life. The Nagan trust received 3,892 shares from this demutualization that were subsequently sold for $31,579 on the open market. The sale, unreduced by a basis adjustment, was reported on the 2000 tax return resulting in tax of $5,725. A claim for a refund of $5,725 was filed in February 2004, which the IRS denied.

Issue. Whether the proceeds from the demutualization should be offset by a basis to properly compute the taxable gain.

Analysis. IRC §72 provides that gross income includes any amount received as an annuity.

At trial, the trust representative argued that the stock sale proceeds were actually a distribution of a policy dividend which is excludible from gross income under the IRC §72 annuity rules. The court disagreed with this argument, stating the distribution was an unrelated sale of stock received in the demutualization.

The trust representative then argued that no capital gain should be realized on the stock sale since the proceeds should be offset by the trust's basis in the stock. A portion of the paid premiums should be allocated to voting and liquidation rights that were exchanged for stock. The IRS argued that the voting and liquidation rights were worthless.

Review of other case decisions indicated that voting and liquidation rights exchanged for stock may have value. This could apply in this instance because Sun Life had a surplus of over $5.7 billion as of June 30, 1999.

Holding. The Court of Federal Claims held that a trial should take place to determine the proper value of the surrendered voting and liquidation rights.

> **Note.** Many taxpayers who sold stock in 2004 which they received from a demutualized insurance company reported a zero basis in the stock. These taxpayers were following the position of the IRS that their surrendered voting and liquidation rights had no value. These taxpayers may want to file a "Protective Claim" on Form 1040-X for the 2004 tax year to preserve their right to claim a basis in the stock if the pending trial decision is taxpayer-friendly.

Form 1099-MISC

***Roosevelt Wallace v. Comm'r,* 128 TC 132, (2007)**
IRC §61

☞ Compensated Work Therapy Program Payments Are Excludable

Facts. In 2000, Mr. Wallace participated in a Department of Veterans Affairs (VA) compensated work therapy (CWT) program as directed by his doctor. The VA issued a Form 1099-MISC to him for the $16,393 he received for participating in the program. When he filed his 2000 tax return, he did not report the payments as taxable income.

The IRS determined the payments should be included in Mr. Wallace's gross income and issued a statutory notice of deficiency.

Issue. Whether payments received in connection with the work therapy program are includible in gross income.

Analysis. IRC §61 provides that gross income includes income derived from all sources unless otherwise provided.

At trial, Mr. Wallace argued that the payments he received constituted payment of a tax-exempt veterans' benefit. In a very similar situation,[12] the IRS ruled that payments of benefits under any law administered by the VA are excludable from the recipient's gross income. The IRS insisted that CWT payments are not similar to social welfare benefit programs that are excludable from gross income.

Holding. The court analyzed the veterans' benefit statutes and concluded that the payments constituted "payment of benefit" as defined by Title 38 of the U.S. Code, Section 5301(a), and are therefore not includible in gross income.

Stock Options

Walter and Susan Moore v. Comm'r, **TC Memo 2007-123, May 17, 2007**
IRC §§83, 422, and 6662

☞ Recognition of Stock Option Income

Facts. Mrs. Moore began working as a compensation consultant for Cell Therapeutics, Inc. (CTI) in January 1993. She received a series of promotions within the company and eventually became an executive vice president who served on the strategic management team and reported directly to the chief executive officer (CEO). As part of her compensation package, she received options to purchase CTI common stock through four different option agreements. At the end of 2000, Mrs. Moore approached the CEO indicating the need to terminate her employment. The CEO convinced her to work as a consultant for a year to establish a transition plan. As of the date of termination, Mrs. Moore held 112,788 vested options and 35,000 unvested options to purchase CTI stock. A consulting agreement was entered into between CTI and Mrs. Moore, which included a provision shortening the vesting period of her stock options.

On March 5, 2002, Mrs. Moore exercised her CTI stock options paying $316,382 to purchase the stock valued at over $2 million as well as $616,487 to cover the income tax, social security, and Medicare taxes associated with the exercises. In early 2003, CTI provided Mrs. Moore a Form 1099 reporting $21,787 and a Form W-2 showing wages of $2,156,436 that included the spread between the strike prices and the FMV of stock at the date the options were exercised.

The Moore's 2002 tax return reported a small fraction of the wages ($29,404) with a taxable income of $54,073 and tax of $7,889. Based on their withholding of $582,148, a $574,259 overpayment resulted.

A Substitute Form W-2, Form 4852 calculation, and Form 8275 Disclosure Statement were all attached to the return indicating the Form W-2 issued by CTI was erroneous and needed to be changed.

The IRS determined the taxpayer's position was incorrect and made adjustments based on the original documents provided by CTI.

Issues.

- Whether the income from stock options exercised is includible in gross income.
- Whether an accuracy-related penalty should be assessed.

Analysis. IRC §83 provides for the taxation of restricted property transferred in connection with services. In such cases, the excess of the property's FMV as of the time it becomes substantially vested, over any amounts paid for it, is included in the recipient's gross income in the year when the property is vested.

---

12. Rev. Rul. 72-605, 1972-2 CB 35

Holding. The court rejected the arguments presented by the taxpayers. Because the six requirements found in IRC §422 were not met, the transactions did not qualify as ISOs. The options are not entitled to ISO treatment because Mrs. Moore was not an employee of CTI at all times during the period beginning on the date of the option granting and ending on the day three months before the date she exercised her options pursuant to IRC §422(a)(2). The taxpayers argued that no transfer occurred on the exercise date of because the options were paid using nonrecourse debt. The court disagreed.

Because the taxpayers acted reasonably and in good faith by relying on their tax adviser to prepare their 2002 tax return accurately, the penalty was eliminated.

Unlawful Discrimination

***Marrita Murphy and Daniel J. Leveille v. IRS* and U.S., No. 05-5139, (D.C. Cir., July 3, 2007)**
IRC §§61, 104 and 7402

☞ Constitutionality Raised as Issue

Facts. Marrita Leveille Murphy was unlawfully discriminated against by the New York Air National Guard (NYANG). This discrimination caused her to suffer mental and physical injuries. She received $70,000, of which $45,000 was for "past and future emotional distress" and $25,000 for "injury to vocational reputation." Marrita included the entire $70,000 as gross income and paid $20,665 in taxes.

Based on IRC §104, Marrita later filed an amended return excluding the $70,000 from income. The IRS subsequently denied her request for a refund. The District Court rejected all of Marrita's claims and granted summary judgment for the IRS concluding the exclusion under IRC §104(a)(2) was applicable only to personal injury damages awarded because of personal injuries. Marrita appealed this decision.

Issue. Whether the payment received under an unlawful discrimination suit was includible in gross income.

Analysis. IRC §104(a) provides that gross income does not include the amount of any damages received because of personal physical injuries or physical sickness. On appeal, Marrita argued IRC §104 was unconstitutional since it failed to exclude amounts that were not income within the meaning of the Sixteenth Amendment.

Holding. The court concluded:

- Marrita's compensatory award was not related to personal physical injuries and is therefore not tax-exempt under IRC §104(a)(2),
- The award is part of her "gross income" under IRC §61, and
- The tax upon the award is an excise tax and not a direct tax subject to the apportionment requirement of Article I, Section 9 of the Constitution.

INNOCENT SPOUSE

Denial of Relief

Charles Roy Schwendeman and Cindy L. Butler v. Comm'r, **TC Memo 2007-227, August 14, 2007**
IRC §§170 and 6015

☞ Relief Denied Based on Full Knowledge

Facts. Roy Schwendeman and Cindy Butler filed a joint tax return for 2002. In 2003, they divorced. They jointly went to H&R Block to have the 2002 return prepared. During Cindy's review of the return, she noted $13,590 of charitable contributions claimed on the return. She asked Charles about the claimed contributions, because she knew she had not **contributed charitably** during the year. Charles responded that the amount claimed was "within Internal Revenue Service guidelines." Although she doubted he had made the contributions, she decided to sign the return as prepared and not inquire further.

The IRS examined the return disallowing all claimed charitable contributions. The taxpayers petitioned the Tax Court. In addition, Cindy filed Form 8857, *Request for Innocent Spouse Relief*, which was also denied by the IRS.

Issues.

- Whether all charitable contributions claimed on the 2002 tax return should be disallowed, and
- Whether Cindy Butler is entitled to innocent spouse relief under IRC §6015(b), (c), or (f).

Analysis. Taxpayers are required to document any deduction taken on a federal tax return. This includes charitable deductions. Generally, taxpayers are jointly and severally liable for federal income tax. However, it is possible for one taxpayer to be relieved of the joint liability if certain circumstances exist.

To obtain relief, the spouse must establish that:

1. There are erroneous items on the tax return which create an additional tax liability.
2. The innocent spouse did not know of the erroneous item on the tax return which created the additional tax liability.
3. Based on all of the facts and circumstances, it would be inequitable for the IRS to hold the spouse liable for the tax liability.

Holding. The charitable contribution deduction was denied by the Tax Court because both taxpayers testified neither of them had made any charitable contributions during 2002.

The Tax Court denied innocent spouse relief because Cindy was aware at the time she signed the return that no charitable contributions claimed on the return had actually been made. She did question her husband regarding the contributions but chose to sign the return knowing he had not made any contributions. She also did not qualify for equitable relief under IRC §6015(f).

Form 8857

IRS News Release IR-2007-125 (July 5, 2007)

☞ Request for Innocent Spouse Relief Form Redesigned

When a taxpayer files a joint return, each spouse is jointly and individually responsible for the tax. Innocent spouse relief is available when circumstances arise for one spouse to be relieved from the joint debt. If a taxpayer believes that only the current or former spouse is responsible for the tax, the taxpayer can request relief from the tax liability by using Form 8857.

A redesigned Form 8857, *Request for Innocent Spouse Relief,* is now available. This new design results from an IRS process improvement team led by the Office of Taxpayer Burden Reduction. The form requests more information and results in it being processed more rapidly.

Equitable Relief

***Robby Goodale Gilbert v. Comm'r,* TC Summary Opinion 2007-16, January 30, 2007**

IRC §6015

☞ Equitable Relief Granted to Husband Due to Wife's Deception

Facts. Mr. Gilbert and his former spouse Juliette filed joint returns for 2000 and 2001. The returns showed the following balances due:

Year	Unpaid Tax Due
2000	$19,869
2001	5,850

Robby and Juliette separated in June 2001 and were divorced in January 2002. Juliette handled the couple's financial affairs and prepared their joint 2000 return. They agreed that the $19,869 balance due on their 2000 joint return would be paid from funds in a joint money market account. However, Robby was unaware that Juliette had transferred all of the money market funds (approximately $40,000) to a checking account in her name shortly before the 2000 return was filed.

Even though the divorce became final in January 2002, Robby agreed to file a joint 2001 return with Juliette. The divorce decree required the following:

- Robby was ordered to pay a $21,500 property settlement to Juliette, which he did.
- Juliette was ordered to pay $7,508 of the unpaid 2000 tax liability from the property settlement.
- Juliette was ordered to pay $1,463, or one-fourth, of the unpaid 2001 tax liability from the property settlement.

Instead of remitting the decree-mandated amounts to the IRS, Juliette kept the $21,500, kidnapped the couple's minor son and fled to New Zealand.

Mr. Gilbert filed Form 8857, *Request for Innocent Spouse Relief,* in June 2002, requesting relief from the joint tax liabilities for 2000 and 2001. The IRS denied his request because the unpaid taxes stemmed from his Schedule C income.

Issue. Whether the IRS denial of equitable innocent spouse relief under IRC §6015(f) was an abuse of discretion.

Analysis. Taxpayers are generally jointly and severally liable for the accuracy and any income tax reported on a jointly filed tax return. IRC §6015(f) allows a taxpayer relief from unpaid federal income tax if the taxpayer can show that it would be inequitable to hold him liable for the unpaid tax.

If the IRS denies the equitable relief for an unpaid tax liability, the taxpayer may petition the court for further review of the request.

Holding. The Tax Court determined that the IRS abused its discretion and granted equitable relief to Mr. Gilbert for the following reasons:

- He did not know or have reason to know that Juliette would deceptively refuse to pay the unpaid 2000 tax liability by transferring the joint money market funds to an account in her name only.
- Even though he was the sole proprietor of his Schedule C business, Juliette performed work for and helped administer the affairs of the business.
- Through prior installment agreements, he had already paid what he was legally obligated to pay under the divorce decree for his share of the unpaid tax liabilities.

> **Note.** As of the date of the Tax Court trial, Juliette had been extradited to the USA and incarcerated. The minor son was returned to the custody of Mr. Gilbert.

IRS PROCEDURES — AUDITS

Upcoming Study

IRS News Release IR-2007-113 (June 6, 2007)

☞ National Research Program Update

A new National Research Program (NRP) for individual taxpayers provides more accurate audit selection tools and support efforts to reduce the highly publicized tax gap. This study starts in October 2007. It will include 13,000 randomly selected 2006 individual tax returns. The study will be part of an innovative multi-year rolling methodology with similar sample sizes used in subsequent tax years. This NRP methodology combines results over a rolling 3-year period. This will allow annual updates to compliance estimates and development of more efficient annual workload plans.

For those individuals selected to participate in this program, the majority will only have specific lines of their returns verified through in-person examinations. If the IRS can obtain matching and third party data that confirms accuracy of the return, no contact will be made by the IRS. Under prior NRP programs, **all** lines of the tax return were checked.

The IRS is currently concluding the S corporation NRP study that encompasses 5,000 tax returns for 2003 and 2004.

IRS PROCEDURES — ELECTRONIC FILING

Signature Requirement

Treasury Decision 9300, 2007-2 IRB 246

☞ Final Regulations on Electronic Filing

Purpose. This revenue procedure informs authorized IRS *e-file* providers of their obligations to the IRS, taxpayers, and other participants in the IRS *e-file* program. It also combines the rules governing IRS *e-file*. The final regulations are designed to eliminate regulatory impediments to the electronic filing of certain income tax returns and other forms.

Analysis. Highlights include:

- Corporations may elect to treat charitable contributions as made in the current year even if the contributions are made in the subsequent year without attaching a signed declaration and a copy of the board resolutions.
- An unsigned Form 972, *Consent of Shareholders to Include Specific Amount in Gross Income,* may be submitted with the tax return if the original is maintained by the corporation.
- S corporation provisions include:
  - Treating a tax year as if it consisted of two separate tax years
  - Certain elections relating to the source of distributions
  - Determining the treatment of distributions in the even of certain ownership changes, and
  - Signature requirements for some consolidated group elections are eliminated.

Effective Date. The effective date of these regulations is December 8, 2006.

Personal Identification Number

IRS News Release IR-2007-130 (July 16, 2007)
Revenue Procedure 2007-40 2007-26 IRB 1488

☞ 2008 Brings Electronic PIN Signature Requirement

Purpose. Beginning with the 2008 filing season, e-filing is available **only** if returns are signed electronically using either the self-select personal identification number (PIN) or a practitioner PIN. This change will result in **substantially less paperwork** for tax practitioners.

Analysis. Taxpayers can select a 5-digit PIN that allows them to sign their return electronically. A practitioner PIN is used by an electronic return originator (ERO) to sign electronically on behalf of the taxpayers. Practitioner PINs require Form 8879, *IRS e-file Signature Authorization,* to be used and retained by the ERO.

A **new Form 8453**, which will be released before the 2008 filing season, will be used to transmit supporting paper documents required to be submitted with e-filed returns.

Rev. Proc. 2007-40 explains obligations that authorized e-file providers have to the IRS, taxpayers, and other participants in the program. It also includes rules governing IRS e-file such as:

- Acceptance in the IRS e-file program,
- Responsibilities of an authorized e-file provider,
- Penalties,
- Monitoring and sanctioning an authorized e-file provider, and
- Administrative review process.

Effective Date. This revenue procedure supersedes Rev. Proc. 2005-60, 2005-2 C.B. 449 and is effective June 25, 2007.

Form 2290

IRS News Release IR-2007-128 (July 12, 2007)

☞ Electronic Filing Moves to Excise Tax Returns

An electronic version of the new Form 2290, *Heavy Highway Vehicle Use Tax Return,* is expected to be available late summer 2007. This will become the first excise tax return which can be e-filed. Form 720, *Quarterly Federal Excise Tax Return,* and Form 8849, *Claim for Refund of Excise Taxes,* will also be available for e-filing later this year.

IRS PROCEDURES — MISCELLANEOUS

Delinquent Payroll Taxes

***Fifty Below Sales & Marketing, Inc. v. U.S.*, No. 06-3255/3245, (8th Cir., August 14, 2007)**

IRC §6330

☞ The IRS Did Not Abuse Discretion in Levy of Property

Facts. Fifty Below is a Minnesota corporation that provides Internet marketing services and designs web pages. Since beginning operations in 1997, Fifty Below has continually been behind in paying employment taxes. The IRS originally levied on Fifty Below's property rather than allowing Fifty Below to enter into installment agreements to satisfy tax liabilities. An appeal was made to the District Court, which agreed with the original IRS determination. A further appeal was made to the Court of Appeals.

Issue. Whether the IRS abused its discretion when it did not allow an installment agreement to satisfy delinquently payroll tax obligations.

Analysis. In the original case,[13] the taxpayer had incurred a substantial unpaid employment tax liability. Fifty Below asked for an installment agreement in order to pay its tax liability. The IRS agreed to the terms of the installment agreement. Fifty Below defaulted on the payment terms and the IRS issued a second *Final Notice of Intent to Levy* letter. Fifty Below again asked and received an installment agreement. They also defaulted on this agreement and incurred additional employment taxes. After reviewing an Offer in Compromise request, the IRS issued a third *Final Notice of Intent to Levy* letter. After further notices and requests, the IRS filed for a Temporary Restraining Order (TRO) against Fifty Below to prevent additional employment taxes from being incurred. The court granted the TRO.

Holding. The Court of Appeals reviewed the documentation submitted by the IRS appeals officer. The attachment to the Notice of Determination Concerning Collection Action under IRC §6330 clearly stated the views of the appeals officer. Fifty Below filed its first employment tax return in 1997 and has been in collection status ever since (except for 2000 and 2001). In addition, the IRS gave alternatives to Fifty Below including an offer in compromise and installment agreements, all of which were defaulted. Based on the history in this case, an installment agreement was not an appropriate solution. The court agreed with the IRS determination allowing the notice of levy to remain.

13. *Fifty Below Sales and Marketing, Inc. v. U.S.,* No. 05-1380, (D. Minn. May 5, 2006)

Interim Report

IRS News Release IR-2007-132 (July 19, 2007)

☞ Community Benefit Must Be Provided to Retain Tax-Exempt Status

An interim report was released that summarized responses from almost 500 tax-exempt hospitals. It described how hospitals provide and report benefits to the community. Hospitals seeking and retaining tax-exempt status as charities **must provide community benefit.**

Although approximately 97% of the responses say they have a written uncompensated care policy, there is no uniform definition. The IRS project team is likely to recommend the development of a separate Form 990 schedule for hospitals to address uniformity in definitions and reporting. A new Schedule H, *Hospitals,* is part of the recently released discussion draft form.

Interest Abatement

John F. Hinck, Et Ux. v. U.S.**,127 S.Ct. 2011 (May 21, 2007)**

IRC §6404

☞ Supreme Court Rules in Interest Abatement Case

Facts. The Hincks filed a tax return for 1986 claiming a loss from a limited partnership interest in Agri-Cal Venture Associates (ACVA). ACVA was examined, with substantial adjustments resulting. In May 1996, the Hincks made an advance remittance to the IRS of $93,890. A settlement was reached resulting in tax of $16,409 and interest of $21,669. A $55,812 refund was sent to the Hincks.

The Hincks filed a claim requesting the IRS abate interest from March 21, 1989 to April 1, 1993. The claim was denied by the IRS, the Court of Federal Claims, and the U.S. Court of Appeals. At trial, the Hincks argued against exclusive Tax Court jurisdiction in this matter.

Issue. Whether the Tax Court provides the exclusive forum for judicial review of a refusal to abate interest case.

Analysis. IRC §6601(a) permits interest to be charged on unpaid taxes for the period from the date the taxes were due until paid. However, IRC §6404 allows the Secretary of Treasury to abate the interest in certain cases. One circumstance is when an officer or IRS employee is responsible for the delay. If the IRS refuses to abate the interest, the decision is subject to judicial review.

Holding. The Supreme Court disagreed with the Hincks' argument. Chief Justice Roberts said, "Bad things happen if you fail to pay federal income taxes when due. One of them is that interest accrues on the unpaid amount. Sometimes it takes a while for the IRS to determine that taxes should have been paid that were not." The judgment of the U.S. Court of Appeals was affirmed.

Outreach Efforts

IRS News Release IR-2007-137 (August 2, 2007)

☞ IRS Addresses the Tax Gap

The IRS released a report titled, "Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance," which details methods to close the tax gap. The report is based on the components of the 2006 Treasury Department report, *Comprehensive Strategy for Reducing the Tax Gap.* It contains detailed information on objectives and initiatives including targeted completion dates. It incorporates an outreach approach to noncompliant taxpayers and recognizes taxpayers' rights. Additionally, the report acknowledges the need to minimize the burden on compliant taxpayers.

Because of the overwhelming publicity around the large tax gap, the IRS has implemented strategies to help reduce it. The tax gap is the difference between the amount of tax that taxpayers should pay and the amount that is paid voluntarily on time.

Several resources are available at **www.irs.gov** for use in understanding how the practitioner's efforts can help reduce the tax gap.

- Monthly fact sheet series
    - Reporting Farm Income and Expenses (June 2007)
    - Reporting Capital Gains (May 2007)
    - Business or Hobby? Answer Has Implications for Deductions (April 2007)
    - Deducting "Other" Business Expenses (March 2007)
    - Deducting Rent and Lease Expenses (February 2007)
    - Deducting Travel, Entertainment and Gift Expenses (January 2007)
    - Deducting Business Supply Expenses (December 2006)
    - Depreciation Reminders (November 2006)
    - Car and Truck Expense Deduction Reminders (October 2006)
    - Home Office Deduction Reminders (September 2006)
    - Third-Party Reporting Reminders (August 2006)
    - Cost of Goods Sold and the Tax Gap (July 2006)
    - Business Income and the Tax Gap (June 2006)
- IRS Commissioner Statement FY2008 Budget
- A Comprehensive Strategy for Reducing the Tax Gap (September 2006)
- IRS Updates Tax Gap Estimates (February 2006)
- Tax Year 2001 Federal Tax Gap (graphic)
- New IRS Study Provides Preliminary Tax Gap Estimate (March 2005)
- Tax Gap Facts and Figures (March 2005)
- Understanding the Tax Gap (March 2005)

Hurricane Victims Relief

IRS News Release IR-2007-134 (July 31, 2007)

IRC §121

☞ Victims of 2005 Hurricanes Have Additional Year to Sell Vacant Land

The IRS granted the victims of Hurricanes Katrina, Rita and Wilma an additional year to utilize the IRC §121 primary residence gain exclusion when they sell vacant land which was the site of their principal residence. Victims of these hurricanes now have three years from the date of the destruction of their principal residence to sell the vacant land and exclude the gain.

Fifth Amendment

***Bedell & Company, CPAs et al v. U.S.*, 98 A.F.T.R.2d (RIA) 2006-7939 (E.D.N.Y. October 30, 2006)**

IRC §7602

☞ No Option to Invoke Fifth Amendment

Facts. During an IRS investigation, an administrative summons was issued to the taxpayers directing the records custodian of several defunct entities to appear, give testimony, and produce documents as described in the summons. The custodian objected to the summons under the Fifth Amendment privilege.

Issue. Whether the Fifth Amendment privilege applies to allow noncompliance with IRS summonses by an individual who is the custodian of records for the defunct entities.

Analysis. IRC §7602 provides the authority for the IRS to summons information. At trial, the custodian argued he had an "act of production" privilege as records custodian.

Holding. The court agreed with the IRS in finding the collective entity rule could not be extended from former employees of an existing company to former principals or partners of defunct entities. Applying the exception would prevent documents from a defunct entity from ever being accessed by a subpoena or summons.

Information Reporting Requirements

Notice 2006-93 (October 4, 2006)

IRC §6049

☞ Transitional Relief for Tax-Exempt Bond Interest

Purpose. This notice provides guidance on the new information reporting requirements of IRC §6049 for payments of interest on state or local tax-exempt bonds. It also provides transition relief from various information reporting rules for tax-exempt interest paid during 2006 and from backup withholding for interest paid through March 31, 2007.

Analysis. IRC §6049 requires payors to annually report all interest payments aggregating $10 or more during the calendar year. TIPRA added tax-exempt interest paid after December 31, 2005 to this requirement. The IRS allows tax-exempt interest payors relief from penalties for not complying with IRC §6049 information reporting requirements if a payor provides both the IRS and the payee with a substitute statement including:

- Payor's name, address, telephone number, and employer identification number,
- Payees' name, address, taxpayer identification number, and account number,
- Amount of tax-exempt interest,
- Amount of tax-exempt AMT interest, and
- Amount of federal income tax withheld.

Effective Date. The effective date of this notice is October 30, 2006.

IRS Advice

***Aaron L. Katz and Judith L. Miller v. U.S.*, No. 04-1790T, (Fed. Cl. July 25, 2006)**

IRC §6511

☞ Reliance on IRS Toll-Free Advice

Facts. Taxpayers filed their 1999 tax return on October 30, 2000. Their tax liability was paid using their withholdings, estimated tax credit for an earlier period, and money paid with the extension request. The taxpayers called the IRS toll-free number in July 2003. They were told they could still file an amended return through December 18, 2003. An amended return was filed on October 17, 2003 claiming a net operating loss deduction omitted from a prior return. The claim was denied by IRS since the 1999 taxes had been paid more than three years (including the extension date) earlier than the date the claim was filed. The taxpayers filed suit.

Issue. Whether the claim for refund was timely filed.

Analysis. A claim for credit or refund must be filed within three years from the time the return was filed or two years from the time the tax was paid, whichever expires later. IRC §6511(b)(2)(A) limits the amount of any refund to the taxes paid within the period immediately preceding the filing of the claim. This period is three years plus the period of any extension.

Holding. At trial, the taxpayers argued that because an IRS employee provided erroneous information, the government should be estopped from denying their refund. The Claims Court rejected the argument citing *U.S. v. Brockamp*[14] which referenced equitable tolling. The taxpayers attempted to distinguish equitable tolling from equitable estoppel but were not successful. The court denied the refund since the payments were made more than three years after the refund claim was filed.

Mark Everson

November, 2006

www.irs.gov/newsroom/article/0,,id=164435,00.html

☞ FY2006 Enforcement and Service Results

Former Commissioner Mark Everson provided information on improvements in services for taxpayers and in key enforcement activities. Enforcement revenues rose from $47.3 billion in FY05 to $48.7 billion in FY06. These efforts collectively resulted from increased enforcement staffing, improved case analysis, improved workload identification, and successful targeted tax compliance efforts.

FY06 individual enforcement information:

- Revenue increased over 6% from FY05 to $1,293,681
- Field audits increased by 23% in FY06
- Targeted enforcement efforts for high-income taxpayers (earnings of $100,000 and more) increased nearly 33% in one year

FY06 business enforcement information:

- Increased efforts in review of S corporation (34%) and partnership (15%) returns
- Small business corporate audits remained steady (17,871)
- Larger corporation audits decreased by 2.2% to 10,591

14. *U.S. v. Brockamp*, 117 S.Ct. 849 (1997)

FY06 exempt organization information:

- Audits increased 43% from prior year, with highest level of audits since 2000
- Completed over 5,200 new compliance contacts

Other important information:

- Collection levies increased by 36% to 3,742,276
- Collection liens increased by 20% to 629,813
- Individual e-filing increased 6% for a total of 54% e-filed individual returns
- Customer satisfaction with the toll-free number remains at 94%
- Tax law accuracy provided through toll-free number at 91%
- Visits to **www.irs.gov** increased by 10% to more than 193 million visits
- Where's My Refund visits increased by 12% to 24.7 million status checks

Information Reporting
Revenue Procedure 2007-12, 2007-4 IRB 354
IRC §6045

☞ Sale of Residence Reporting Clarified

Purpose. Because of changes made under the American Jobs Creation Act of 2004 and the Gulf Opportunity Zone Act of 2005, this revenue procedure amends the assurances on proper certification paperwork that home buyers need from their sellers to exempt them from direct information reporting to the IRS on the home sale.

Analysis. IRC §6045(e) and the related regulations require a real estate reporting person to file an information return regarding a real estate transaction and to furnish a payee statement (Form 1099-S) to the seller regarding that transaction. The Form 1099-S must include:

- Seller's name and address,
- Seller's taxpayer identification number, and
- Gross proceeds of the real estate transaction.

In order to avoid the reporting requirements, the real estate reporting agent must obtain the following information via a written certification signed by the seller under penalties of perjury:

- The seller owned and used the residence as his personal residence for at least two of the last five years,
- The seller has not sold or exchanged another principal residence during the past 2-year period,
- The residence has not been used for business or rental purposes after May 6, 1997,
- One of three statements apply:
    1. The sale or exchange of entire residence is $250,000 or less,
    2. If seller is married, the sale or exchange of the entire residence is $500,000 or less, and the resulting gain is $250,000 or less, or
    3. If seller is married, the sale or exchange of the entire residence is $500,000 or less, the spouse also used residence for at least two of the past five years, the spouse has not sold another residence during past years, and the couple will file a joint return.

- During the past 5-year period, the seller did not acquire the residence in an IRC §1031 exchange, and
- When the seller's basis results from a previous IRC §1031, the exchange occurred more than five years prior to the sale or exchange of the residence.

The appendix of the revenue procedure provides a sample certification for real estate agents to use in obtaining the appropriate assurances from the seller.

Effective Date. This revenue procedure is effective for sales or exchanges of a principal residence occurring **after January 22, 2007.**

Collection Due Process
***Joseph E. Lewis v. Comm'r,* 128 TC 48 (2007)**
IRC §6330

☞ CDP Hearing Precludes Discussion of Previously Upheld Argument

Facts. Mr. Lewis was a plumber in Lancaster, California. He filed a 2002 joint tax return with his wife in January, 2004 remitting the balance due of $11,636. The IRS assessed late filing and late payment penalties. Mr. Lewis requested the IRS abate the additional assessments since his accountant was hospitalized with stomach cancer at the time the return was due. The case was reviewed and sustained by an appeals officer. After the IRS issued the Final Notice and Notice of Intent to Levy, Mr. Lewis submitted Form 12153, *Request for a Collection Due Process Hearing*, in which he again requested abatement of the penalties based on reasonable cause. A Notice of Determination Concerning Collection Action under IRC §6320 and/or 6330 was issued upholding the IRS determination. Mr. Lewis appealed to the Tax Court.

Issue. Whether the penalties for late filing and payment can be abated as part of IRC §6330 collection review proceeding.

Analysis. IRC §6330 provides that the IRS cannot proceed with the collection of a person's taxes by levy until the person has been given notice and the opportunity for an administrative review of the matter. IRC §6330(c)(4) provides a person is prohibited from raising an issue that was raised and considered at a previous administrative or judicial proceeding in a collection review proceeding. At trial, the IRS argued Mr. Lewis had the opportunity for a conference with an appeals officer and thus cannot raise this matter either in a collection review hearing or on appeal to the Tax Court.

Holding. The Tax Court agreed with the IRS.

Collection Due Process
***Anthony and Lena C. Andre v. Comm'r,* 127 TC 68 (August 28, 2006)**
IRC §6330

☞ Premature Request for CDP Hearing Won't Be Considered

Facts. The taxpayers received a notice of **federal tax lien** for tax years **1996–2000** for unpaid taxes. A collection due process (CDP) hearing for an **IRS levy** was requested by the taxpayers for the years **1990–2000**. The IRS contacted the taxpayers telling them their request for CDP hearing was wrong and included another blank CDP form. This time the taxpayers indicated it was for a **tax lien** but again listed 1990-2000 as the taxable periods. Subsequently, the IRS issued a notice of intent to levy for the 1990-1994 tax years, and issued a notice of determination. The taxpayers petitioned the Tax Court.

Issue. Whether a CDP request can be made for tax years for which the IRS has not yet issued a notice of intent to levy.

Analysis. IRC §6330(a)(2) states a notice of intent to levy must be mailed not less than 30 days before the date of the first levy with respect to the amount of the unpaid tax for the taxable period. Under IRC §6330(a)(3), a taxpayer has the right to request a hearing **during** the 30-day period before the day of the first levy for a particular tax period.

Holding. The court determined the IRS's argument that allowed a taxpayer to disrupt the normal sequence with a premature CDP request would likely cause prejudice and cause confusion in calculating the statute of limitations that a suspended collection activity triggers. The court concluded that premature requests for a CDP hearing are not allowable.

New Program

Announcement 2006-74 (October 2, 2006)

☞ IVES Program Launches

The income verification express service (IVES) program began on October 2, 2006. This program offers electronic delivery of IRS transcripts and available records upon submission of Form 4506-T, *Request for Transcript of Tax Return.*

The system is user-friendly and easy to navigate. The IVES site on **www.irs.gov** provides the following information:

- How to apply for IVES
- How to register with e-Services
- How to pay
- Getting started with the program
- IVES system tutorials, and
- Frequently asked questions.

Agent Appointment

IRS News Release IR-2007-121 (June 20, 2007)

☞ New Form 2678 Now Available

The IRS will only accept the May 2007 version of Form 2678, *Employer/Payer Appointment of Agent.* This form authorizes an agent to handle employment tax responsibilities including filing tax returns and depositing/paying payroll taxes. The form should be submitted 60 days before the appointment is effective. Those with approved appointments currently on file need not take any actions unless they wish to revoke an existing appointment. Employers retain responsibility for filing Form 940 and depositing/paying FUTA tax.

Enhancements to the new Form 2678, which make it more user-friendly and clearer, include:

- Plain language instructions,
- Signature lines for employer/payer and agent to request agent's authority,
- Only one signature required to revoke authority,
- Check boxes which clearly establish which forms the agent is authorized to file,
- Check box to indicate if the employer is a disabled individual or other welfare recipient receiving home-care services through a local or state program, and
- Disclosure language authorizing the IRS to provide information to the agent.

2007 Report to Congress
IRS News Release IR-2007-131 (July 19, 2007)

☞ National Taxpayer Advocate Identifies Upcoming Priorities

In the 2007 Report to Congress, the IRS National Taxpayer Advocate identified the priorities her office will address in the upcoming fiscal year. They are:

- Improving taxpayer services,
- Ensuring protection of taxpayer rights in the IRS's private debt collection initiative, and
- Making the offer in compromise program more accessible for those taxpayers who cannot full pay their tax debts.

Each state, District of Columbia, and Puerto Rico has at least one local taxpayer advocate who reports directly to the national taxpayer advocate but remains independent of the local IRS office. From fiscal year 2004 through 2006, taxpayer advocate service (TAS) experienced a 43% increase in workload and a decline in staffing of 8%. TAS assists both individual and business taxpayers who:

- Are experiencing economic harm,
- Are seeking help resolving tax problems which cannot be resolved through normal IRS processing channels, or
- Believe an IRS system is not working as it should be.

The TAS toll-free number is 1-877-777-4778. The local TAS office address and phone number is found in the local telephone directory.

Tax-Exempt Organization
***CRSO v. Comm'r,* 128 TC 153 (2007)**
IRC §§501(c)(3), 502, and 7428

☞ Commercial Real Estate Rental Income Considered Trade or Business for the Purpose of IRC §502

Facts. Two commercial real estate parcels were acquired by Hudson and Cynthia Staffield in 1997 for $2,297,000. CRSO, a Washington nonprofit corporation, was incorporated in December of 2000 with the Staffields giving the two real estate parcels to CRSO subject to an outstanding mortgage of approximately $1.4 million. The Staffields remained personally liable on the mortgage after the transfer. CRSO's only two activities consisted of renting out the two parcels of commercial real estate and distributing the profits to Chi Rho Corp., an IRC §501(c)(3) organization. CRSO applied for IRC §501(c)(3) tax exemption in October 2001. The IRS sent a final adverse determination in 2003 to the **wrong** address. The letter was finally received after being sent to their counsel in 2005. CRSO filed a petition within 90 days of actually receiving the final adverse determination letter disputing the decision as to their tax exemption.

Issues. Whether CRSO's petition was timely filed, and if CRSO qualifies as a tax-exempt organization under IRC §501(c)(3).

Analysis. IRC §7428 requires a petition to be filed within 90 days of the IRS sending a notice of determination to the organization either by certified or registered mail. Since the IRS mailed the notice to a wrong address, the 90-day period did not begin. Once the notice of determination was mailed to the taxpayer's counsel, CRSO timely filed a petition. The court agreed the petition was timely filed.

IRC §501(a) provides that an organization which is organized and operated exclusively for charitable purposes under IRC §501(c)(3) is exempt from federal income tax unless exemption is denied under IRC §§502 or 503. IRC §502 provides that an organization operated for the primary purpose of **carrying on a trade or business** for profit shall be exempt from taxation under IRC §501 because all of its profits are payable to one or more organizations exempt from taxation under IRC §501. IRC §502 specifically mentions rents. The rental activity would not be considered a trade or business if the rents would be excluded from unrelated business taxable income (UBTI). In this case, the IRS argued CRSO had only two activities, renting commercial property and distributing profits, and that such activities cause CRSO to be a feeder organization not an IRC §501(c)(3) organization. CRSO argued that its rental activity operated using triple net leases were investment vehicles, not business activities.

Holding. The court determined the rental activity constitutes a trade or business. Therefore, CRSO is not operated exclusively for tax-exempt purposes. The request for IRC §501(c)(3) status was denied.

This case was appealed to the 9th Circuit on June 25, 2007.

Statute of Limitations

***Vincent Allen v. Comm'r,* 128 TC 37 (2007)**

IRC §6501

☞ Statute of Limitations Suspended Due to Preparer Fraud

Facts. During 1999 and 2000, Mr. Goosby prepared and filed Mr. Allen's tax returns. These tax returns claimed fraudulent deductions on Schedule A, including charitable contributions, meals and entertainment, and pager/computer expenses. The IRS Criminal Investigation Division visited Mr. Allen before Mr. Goosby was indicted, tried, and convicted on 30 violations of fraudulent income tax return preparation.

The normal statute of limitations for the 1999 and 2000 tax returns expired on April 15, 2003 and April 15, 2004, respectively. However, in March 2005, the IRS issued a deficiency notice disallowing numerous Schedule A deductions claimed on both the 1999 and 2000 tax returns with no fraud penalties being asserted.

Issue. Whether the statute of limitations for assessing income tax pursuant to IRC §6501(c)(1) is extended due to the **fraudulent intent of the income tax return preparer.**

Analysis. IRC §6501(a) provides the IRS must generally make an assessment of income taxes within a 3-year period after the taxpayer files the return. When a false or fraudulent return is filed, the assessment may be made at any time.[15] At issue is whether the preparer's fraudulent intent is sufficient to keep the statute of limitations periods open. The taxpayer argued the intent applies only to the taxpayer and not the preparer. The IRS disagreed.

At trial, the taxpayers cited various cases whereby the fraud penalty was asserted against the taxpayer and the statute of limitations period was extended. These cases all refer to acts by the **taxpayer not the preparer** who committed fraud. The taxpayers also argued that extending the statute of limitations for fraud committed by the preparer would require the taxpayer to keep records indefinitely.

Holding. The court disagreed with the taxpayers' interpretation of the court cases and their argument related to keeping records indefinitely. Taxpayers have the obligation to file a correct tax return **after** they review the return.

The Tax Court determined the statute of limitations is extended indefinitely since the return was fraudulently prepared.

15

15. IRC §6501(c)

Information Reporting Requirements

IRS Notice 2006-72 (September 5, 2006)

IRC §6050S

☞ Form 1098-T Answers Provided

Purpose. To provide guidance on the information reporting requirements for qualified tuition and related expenses under IRC §6050S.

Background. IRC §6050S requires any eligible educational institution to file information returns and to furnish information statements to assist taxpayers in determining the amount of qualified tuition and related expenses for an education tax credit.

Institutions are required to include on Form 1098-T the following information:

- Institutions name, address, and taxpayer identification number (TIN),
- Students name, address, and TIN,
- Payments received (box 1) or amount billed (box 2) for qualified expenses during the calendar year,
- Whether an institution has changed its method of reporting (box 3),
- Amount of reimbursements, refunds, or reductions in charges of qualified expenses (box 4)
- Amount of scholarships or grants administered and processed by the institution (box 5),
- Amount of scholarship or grant reductions reported for prior calendar year (box 6),
- Indication of whether amounts billed or payments received apply to an academic period that begins during the first three months of the following calendar year (box 7),
- Indication of whether the student was enrolled at least half-time for at least one academic period (box 8), and
- Indication if student was enrolled in a graduate-level degree program (box 9).

This notice answers some common questions surrounding the preparation of Form 1098-T including:

- Reporting must be made for high school students attending even though they have not graduated from high school
- Adjustments for subsequent year when course load shifts from one period to another.
- Reporting for nonresident aliens
- What constitutes a formal billing arrangement and who is considered to be a payor under such an agreement
- Amounts to be reported by the institution in box 5 as scholarships or grants
- How to handle scholarships or grants that are received in the year following the billing of qualified expenses
- Definition of the graduate-level indicator and when to check box 9
- Institution telephone number to be included

Mandatory Bond

***Estate of Edward P. Roski, Sr. v. Comm'r*, 128 TC 113 (2007)**
IRC §§6165 and 6166

☞ IRS Discretion to Require a Special Bond or Lien

Facts. The executor of Edward P. Roski's estate timely filed a Form 706 with a balance due in excess of $32 million along with a notice of election under IRC §6166 to pay the tax in installments. A short time later, an amended Form 706 and an amended IRC §6166 election were filed reducing the liability to slightly less than $29 million. The IRS requested the estate either secure a bond equivalent to twice the deferred tax or provide a special lien pursuant to IRC §6324A. The estate disagreed with the request asking the IRS to exercise discretion and find it unnecessary because of the minimal financial risk. The IRS responded with a notice of determination denying the estate's election. The estate petitioned the court seeking relief under IRC §7479 asking for a redetermination of the IRS's denial of the election and that the IRS erred in requiring a bond or special lien in order to qualify for the election.

Issues. Whether:

- The court has jurisdiction to review the determination made by the IRS, and
- The IRS has the authority to require a bond or special lien in every case.

Analysis. IRC §6166(a)(1) provides a qualifying estate may elect to pay the estate tax in installments over an extended period. IRC §6165 provides a bond may be required when the time to pay tax or deficiency has been extended. Over the last 15 years, the IRS has changed its position on this issue **four** times. Since the law in this area is not absolute, the court recommended that the IRS take a conservative approach and establish standards for determining whether a bond should be a condition for granting the extension.

The IRS argued IRC §7479 limits judicial review to substantive requirements of IRC §6166. Even if the court had jurisdiction to review the IRS's exercise of discretion to require a bond, IRC §6165 provides no standard for the application of the IRS's discretion. Therefore, no criterion exists for the court to judge whether the IRS exceeded its authority.

Holding. The court determined it had jurisdiction under IRC §7479 to review the determination. In addition, even the strictest construction of IRC §6166 does not give the IRS the authority to impose a mandatory bond requirement without exercising any discretion. The IRS arbitrarily failed to exercise discretion and may not impose a bright-line bond requirement. The IRS has no authority to require a bond or special lien in every case.

IRS PROCEDURES — PAYMENTS

Options

IRS Fact Sheet FS-2007-11 (January 2007)

☞ 2007 Electronic Payment Options Available

There are several options available for both individual and business taxpayers to use when paying federal taxes. These options can be used to pay income, corporate, and fiduciary taxes.

The options available include:

- Electronic funds withdrawal
- Credit card payments
- Electronic federal tax payment system (EFTPS)

Electronic funds withdrawal is fast and free to use. Taxpayers simply schedule the tax payment to be withdrawn from their back account.

Credit card payments can be used on either an electronically or paper filed return, over the telephone, or online. The IRS does not charge a fee for credit card payments. However, a convenience fee is charged by the company processing the payment. Two companies are currently authorized to accept credit card payments: Official Payments Corporation and Link2Gov Corporation.

EFTPS is a free payment system provided by U.S. Department of Treasury enabling taxpayers to pay federal taxes online or by telephone 24 hours per day 7 days per week. Taxpayers can enroll on the IRS website or by calling 1-800-555-4477 to request an enrollment form. All federal tax payments (income, employment, estimated, and excise) can be made using EFTPS. **Individuals can schedule payments up to one year in advance. Businesses can schedule payments up to 120 days in advance.**

Payment Agreement

IRS News Release IR-2006-196 (December 28, 2006)
IRS News Release IR-2007-112 (June 5, 2007)

☞ Reduced User Fee Installment Agreement Now Available

Effective January 1, 2007, user fees increased to **$105** for nondirect debit agreements, **$52** for direct debit agreements, and **$45** for reinstatements.

Form 13844, *Application for Reduced User Fee for Installment Agreements*, is used by an **individual** to request a reduced fee for entering into an installment agreement for federal taxes owed. For individuals whose income is at or below certain established levels (based on Department of Health and Human Services poverty guidelines), they can apply to pay a reduced user fee of $43 for new agreements or have payments directly deducted from a bank account. This form must be submitted to the IRS within 30 days from the date of the installment agreement acceptance letter.

Form 13844 does not prevent the current year tax refund from being applied to prior taxes. This includes taxes being paid in installments or to taxes the IRS has deemed not collectible.

Form **13844**
(January 2007)

Department of the Treasury — Internal Revenue Service

Application For Reduced User Fee For Installment Agreements

The user fee for entering into an installment agreement after January 1, 2007 may be reduced to $43 for individuals whose income fall below 250% of the dollar criteria established by the poverty guidelines updated annually by the U.S. Department of Health and Human Services. The reduced user fee for individuals with incomes below these levels does not apply to corporations or partnerships. Use this form to apply for the reduced user fee. If your application is granted, the amount of any user fee collected in excess of $43 will be applied against your Internal Revenue Code liabilities and thereby reduce the amount of interest and penalties that may otherwise accrue. Use this form for the reduced user fee and mail it to: IRS, P.O. Box 219236, Stop 5050, Kansas City, MO 64121-9236

If you are an individual, follow the steps below to determine if you qualify for a reduced installment agreement user fee.

1. **Family Unit Size** _______. Enter the total number of dependents (including yourself and your spouse) claimed on your current income tax return (Form 1040, Line 6d).
2. **Total Income** ____________. Enter the amount of total income reported on your current income tax return (Form 1040, Line 22).
3. Compare the information you entered in items 1 and 2, above, to the Reduced User Fee Income Guidelines table below. Find the "Size of Family Unit" equal to the number you entered in item 1. Next, find the column which represents where you reside (48 Contiguous States and DC …, Alaska or Hawaii). Compare the Total Income you entered in item 2 to the number in the row and column that corresponds to your family unit size and residence. For example, if you reside in one of the 48 contiguous states, and your family unit size from item 1 above is 4, and your Total Income from item 2 above is $45,000, then you are qualified for a reduction of the installment agreement user fee because your income is less than the $50,000 guideline amount.
4. If the total income you entered in item 2 is more than the amount shown for your family unit size and residence in the Reduced User Fee Income Guidelines table below, you do not qualify for a reduction of the installment agreement user fee.
5. If the total income you entered in item 2 is equal to or less than the amount shown for your family unit size and residence in the Reduced User Fee Income Guidelines table below, you may qualify for a reduction of the installment agreement user fee. If you qualify for a reduction of the user fee based on your income level, you must sign and date the certification portion of this form and submit it to the IRS within 30 days from the date of the Installment Agreement acceptance letter that you received. **Applications submitted after the due date will not be considered for qualification.**

Reduced User Fee Income Guidelines

Size of Family Unit	48 Contiguous States and D.C.	Alaska	Hawaii
1	$24,500	$30,625	$28,175
2	$33,000	$41,250	$37,950
3	$41,500	$51,875	$47,725
4	$50,000	$62,500	$57,500
5	$58,500	$73,125	$67,275
6	$67,000	$83,750	$77,050
7	$75,500	$94,375	$86,825
8	$84,000	$105,000	$96,600
For each additional person, add	$8,500	$10,625	$9,775

Source: Based on 2006 US Dept of Health & Human Services Poverty Guidelines, Federal Register, Vol. 71, No. 15, January 24, 2006, pp. 3848-3849

Your Name *(Last, First, Middle Initial) (Please Print)*	Social security number (SSN) or Taxpayer identification number (TIN)
Spouse's Name *(Last, First, Middle Initial) (Please Print)*	Social security number (SSN) or Taxpayer identification number (TIN)

Certification: I certify under penalty of perjury that I am eligible for a reduction of the installment agreement user fee based on my family unit size and income.

Your Signature	Date
Spouse's Signature *(if it is a joint liability)*	Date

Catalog Number 49443R www.irs.gov Form **13844** (Rev. 1-2007)

15

Deposit versus Payment

***Joan Huskins, as personal representative of the Estate of Philip Goldstein v. U.S.*, 75 Fed.Cl. 659 (2007)**
IRC §6511

☞ Deposit Must be Refunded by IRS

Facts. On September 22, 1998, Philip Goldstein died. In March 2000, the estate's assets consisted of property in Broward County, Florida, a condominium in Westhampton Beach, New York, and an indirect interest in a mortgage note and mortgage on property located in New York City. The estate accepted an offer to sell the New York condominium but experienced problems because there was no proof of payment of federal and state estate taxes. An agreement was reached whereby the estate would determine the worst case scenario and deposit $165,000 with the IRS in anticipation of any estate taxes due. A check was hand delivered to the IRS on May 5, 2000 with the notation "Estate Tax/Philip Goldstein," the estate's identification number, a cover letter stating this sum was to be applied to the estate tax for Philip Goldstein, and Form 706 was not yet filed. The IRS posted the money as a subsequent payment. A late filed estate tax return showed no federal estate tax liability due. When the $165,000 deposit was requested to be refunded, the IRS replied that no refund was due since the time for making a claim for overpayment was within three years from the date the payment was made.

Issue. Whether the payment made by the estate was considered a deposit.

Analysis. Rev. Proc. 84-58 allows taxpayers to elect to have tax deposits returned to them at any time before the issuance of a revenue agent's report. In addition, any undesignated remittance made before any liability is proposed is treated by the IRS as a deposit.

The estate argued that since no liability was ever assessed against the estate, the remittance in this case was a deposit.

Holding. The court agreed with the estate citing the following factors:

- Estate's remittance was entirely voluntary,
- Remittance was simply an interim arrangement to cover whatever contingencies might arise, and
- The attorney's estimation of "worst-case scenario" was not a good faith estimate of taxes due.

Although the court acknowledged the attorney should have stated the $165,000 was a deposit instead of a payment, the court was persuaded by the letter written by the attorney to the estate, which clearly identified the payment as a deposit against federal estate tax.

IRS PROCEDURES — PENALTIES

Preparer Penalties

IRS Notice 2007-54 (June 11, 2007)
IRS News Release IR-2007-115 (June 11, 2007)
IRC §6694

☞ New Law Results in More Severe Penalties and Return Preparer Transitional Relief

Purpose. To provide guidance and transitional relief for the return preparer penalty provision under IRC §6694 as amended by the Small Business and Work Opportunity Act of 2007, which was effective after May 25, 2007.

Background. IRC §6694(a) was amended to apply the penalty if:

- The tax return preparer knew or should have know of the position,
- There is an unreasonable belief that the position would more likely than not be sustained on its merits, and
- The position was not disclosed[16] or there was no reasonable basis for the position.

16. IRC §6662(d)(2)(B)(ii)

In addition, the penalties amounts increased and apply to all tax return preparers. IRC §6694(a) penalties increase from $250 to the greater of $1,000 or 50% of the income derived by the preparer. IRC §6694(b) penalties increase from $1,000 to the greater of $5,000 or 50% of the income derived by the preparer.

These provisions are effective for all returns, amended returns, refund claims, and extensions filed on or before December 31, 2007, including:

- 2007 estimated tax returns due on or before January 15, 2008, and
- 2007 employment and excise tax returns due on or before January 31, 2008.

Zero Wages

***Donald P. Arnett v. Comm'r,* TC Memo 2006-134, June 27, 2006**

IRC §§1, 6651, 6654, and 6673

☞ Protester Rhetoric Results in Penalty Assertion

Facts. Mr. Arnett filed his 2002 Form 1040 showing zero wages, zero total income, zero adjusted gross income, zero taxable income, and zero total tax along with a statement citing frivolous arguments. The IRS received information from third parties showing payments he received from wages, unemployment compensation, income from self-employment, and IRA distributions totaling $35,873 during 2002. The IRS issued a notice of deficiency based on the unreported amounts and asserted penalties under IRC §§6651, 6654, and 6673. Mr. Arnett disagreed with the findings.

Issues.

- Whether a $4,387 deficiency results based on the corrected income as computed by the IRS.
- Whether the taxpayer is liable for additions to tax under IRC §§6654 and 6651.
- Whether the taxpayer is liable for the IRC §6673 penalty for making frivolous arguments.

Analysis. At trial, Mr. Arnett agreed that he received the income items listed in the notice of deficiency. However, he contended the earnings he received are not income so he is not liable for taxes. In addition, he contended the notice of deficiency must be signed by the Secretary of the Treasury or the Secretary's agent in order to be valid.

Holding. Since Mr. Arnett did not act in good faith and his protester rhetoric was manifestly frivolous and groundless, the court upheld both the tax and all penalties.

ITEMIZED DEDUCTIONS

Entrance Fee

John O., Jr. and Elizabeth Finzer v. U.S., **No. 06 C 2176 (N.D. Ill. March 7, 2007)**
IRC §213

☞ Residency Agreement Results in Partial Medical Expense Deduction

Facts. In 2002, the taxpayers entered into a residency agreement with Classic Residence by Hyatt, a lifetime care facility in Illinois. Under this agreement, they received residential accommodations, assisted living, and skill nursing services if needed. The agreement remains in effect for the taxpayer's lifetimes unless one of the parties terminates the agreement. An entrance fee of $726,300 was paid in addition to $4,665 monthly payments. Monthly fees can be increased or decreased by Hyatt upon 60 days written notice. There is no delineation as to how the entrance fee and monthly fees are allocated between the services Hyatt provides.

Under the Illinois Life Care Facilities Act, an entrance fee is defined as an initial or deferred transfer to a provider of a sum of money or property made or promised to be made by a person entering into a life care contract. Such a fee assures services for the resident. Hyatt sent the taxpayers a letter in February 2003 regarding the potential tax deductibility of their entrance fee. Hyatt stated that 18.9% of the entrance fee may qualify as a medical expense deduction. The taxpayers claimed $136,798 of the entrance fee as part of their medical expense deduction on their 2002 tax return.

Subsequently, the taxpayers received another letter from Hyatt explaining that 2003 tax year actuarial information and statistics were used to calculate the percentage of monthly fees and entrance fees to be 41%. The 2002 information (18.9%) had been calculated using historical operating costs. The taxpayers filed an amended return increasing their itemized deductions by $159,960 to reflect the additional medical deduction. The IRS denied the refund claim. The taxpayer filed suit.

Issue. Whether any portion of the entrance fee is deductible as a medical expense.

Analysis. IRC §213 allows a deduction for medical care to the extent such expenses exceed 7.5% of adjusted gross income. At trial, the IRS argued there was no evidence that any portion of the entrance fee was paid for medical care. Since the entrance fee can be partially refunded under certain circumstances, the entrance fee should not be characterized as a medical expense. The residential agreement also allows for the situation whereby the resident is unable to pay the monthly fee, those charges may be deferred and charged against any potential entrance fee refund.

The taxpayers argue that the IRS issued two revenue rulings (75-302 and 76-481) which support the deductibility of a portion of a fee similar to this one. The IRS distinguishes this case from those rulings by arguing that there is no evidence the life-care fee was paid in consideration for the promise of lifetime care.

Holding. The court disagreed with the IRS. It cited the provision of the lifetime care contract which specifically includes "the right to receive the services described in this Agreement" as well as the Hyatt letters, which calculate the appropriate medical expense percentage.

Charitable Donations

IRS Notice 2006-96 (October 19, 2006)
IRS News Release IR-2006-192 (December 14, 2006)
IRC §§170 and 6695A

☞ Appraisal Requirements, IRA Transfers, and Monetary Contribution Information

IRS Notice 2006-96 provides guidance for the new definitions of qualified appraisal and qualified appraiser. It also explains the new IRC §6695A regarding substantial or gross valuation misstatements as added by §1219 of the Pension Protection Act of 2006 (PPA) for returns filed after August 17, 2006.

Under IRC §170(f)(11)(C), donations of property valued at more than $5,000 require a qualified appraisal that must be attached to the filed tax return. This notice provides transitional guidance until the regulations are issued. It includes who is qualified to do appraisals involving real property and other property. Returns filed after February 16, 2007 must include an additional statement indicating the appraiser understands that a substantial or gross valuation misstatement resulting from the appraisal value may result in a civil penalty under IRC §6695.

IRS News Release IR-2006-192 provides information on several important tax law changes made by the PPA, which affect contributions by both individuals and businesses. Older IRA owners can directly transfer up to $100,000 of an IRA to an eligible charitable organization tax-free during **2006 and 2007 only**. The funds must be contributed directly by the IRA trustee to the eligible charity.

> **Note.** See Chapter 13, "Elder Issues" for more information on charitable contributions using an IRA.

Conservation Easement

***Charles and Susan Glass v. Comm'r*, 471 F.3d 698 (6th Cir. 2006), affirming 124 TC 258**
IRC §170

☞ Conservation Easement Creates Allowable Charitable Contribution

Facts. The taxpayers purchased a 10-acre parcel on the shoreline of Lake Michigan for $283,000 in 1988 as a vacation home. In 1994, it became their part-time primary residence. In 1999-2000, they began using the property as their full-time residence. The three buildings on the property include a home, guest cottage and garage. Little Traverse Conservancy (LTC), a nonprofit organization whose purpose is to protect the natural integrity and scenic beauty of northern Michigan for the enjoyment of future generations, sought conservation easement contributions. The taxpayers made three conservation easements; one each in 1990, 1992, and 1993.

The 1992 and 1993 easements are at issue in this case. Both easements were properly recorded and accompanied by $2,000 cash payments to LTC. The 1992 and 1993 tax returns claimed noncash charitable deductions for the conservation easements of $99,000 and $241,800, respectively. The IRS challenged the contributions stating they did not qualify as "qualified conservation contributions" and if they were allowable, the fair market values were inflated. The taxpayers disagreed and petitioned the Tax Court. The Tax Court ruled in the taxpayers' favor and the IRS appealed.

Issue. Whether the taxpayers are entitled to charitable deductions for conservation easements.

Analysis. At trial, the IRS conceded that two of the three requirements were met for a "qualified conservation contribution." The only question was whether the conservation easements were exclusively for conservation purposes. The court concluded that the conservation easements were qualified conservation contributions because they protect a relatively natural habitat of plants or wildlife, and LTC, or any subsequent holder of the conservation easements, holds or will hold the conservation easements exclusively for conservation purposes as required under IRC §170(h)(5).

Holding. The Appeals Court affirmed the decision of the Tax Court. The third requirement of a qualified conservation easement emphasizes the donee's ability to prevent the donor from uses of the retained interest inconsistent with the conservation purposes of the donation. The Tax Court properly concluded that the easements do not allow taxpayers to use the retained rights in such a way that undermines the easements' conservation purpose.

Imported Prescription Drugs

HR 5441, Department of Homeland Security Appropriations Act (October 4, 2006)

IRC §213

☞ Prescription Drugs Imported from Canada Do Not Qualify as an Itemized Deduction

Purpose. The Department of Homeland Security Appropriation Act prohibits any appropriated funds from being used to prevent an individual from importing an approved prescription drug from Canada.

Analysis. Although Homeland Security cannot spend funds to prevent Canadian drugs from crossing the border into the U.S., the drugs are still considered illegal by the IRS. Illegal drugs are not an allowable itemized deduction.

IRS Publication 561

April 2007

IRC §170

☞ Revised Publication 561 Now Available

As the result of a dramatic overhaul of donations for used clothing and household items by Pension Protection Act of 2006, IRS Pub. 561, *Determining the Value of Donated Property,* was recently revised. Specific changes addressed in this publication include:

- Donations of clothing and household items are allowed only if the item is in good used condition or better,
- Charitable contributions of real property for conservation purposes,
- Appraiser penalties, and
- Revised rules for donating cars and trucks.

Employee Business Expenses

***Oscar R. Contreras v. Comm'r,* TC Memo 2007-63, March 19, 2007**

IRC §§62 and 274

☞ Failure to Seek Approval Eliminates Deduction

Facts. During 2001, Mr. Contreras worked as a worldwide account manager for FedEx. FedEx reimbursed him for reasonable employee business expenses incurred on its behalf. The FedEx policies required original receipts for all travel and entertainment expenses of $10 or more, and authorized operating management to impose stricter limits and guidelines than those imposed in the written company policies.

Due to budgetary concerns, FedEx senior management sent corporate-wide e-mails notifying employees of travel freeze restrictions. Allowable reasonable expenses were generally not reimbursable during this time of restriction **unless** expenses were approved by a vice president. During certain times in 2001, Mr. Contreras incurred expenses for which he did not seek vice presidential authorization or submit reimbursement.

Mr. Contreras claimed $24,373 of unreimbursed employee expenses prior to the 2% adjusted gross income floor adjustment via Form 2106 in 2001 as follows:

Vehicle expense	$2,898
Transportation	1,150
Travel	7,875
Business	9,618
Meals	2,832

Mr. Contreras also attached two Schedules C to his 2001 tax return showing the following information.

	Mexican Restaurant	PDA Consulting
Gross receipts	$ 0	$ 0
Travel expenses	1,700	1,800
Car and truck expenses	0	2,860
Depreciation/§179 expense	0	1,407
Meal and entertainment expense	360	225
Other expenses	0	8,894
Total expenses	$2,060	$15,186
Net loss	($2,060)	($15,186)

The IRS disallowed all the unreimbursed employee business expenses and the net losses for both Schedule C businesses.

Issues. Whether the taxpayer is entitled to deduct:

- Unreimbursed employee expenses,
- Claimed Schedule C net loss for a claimed restaurant business, and
- Claimed Schedule C net loss for a claimed personal digital assistant (PDA) consulting business.

Analysis. IRC §162(a) provides that ordinary and necessary expenses paid or incurred during the taxable year while carrying on a trade or business are deductible. IRC §274 provides additional recordkeeping requirements that must be adhered to for travel, meals, and entertainment.

For the unreimbursed employee expenses, the taxpayer did not submit any requests for reimbursement nor did he seek vice presidential approval authorizing such reimbursements. If he had sought vice presidential approval, he would have received reimbursement from FedEx. Therefore, no deduction would have been taken.

During the trial, Mr. Contreras presented evidence for expenses based on credit card statements, two theater ticket stubs, and his own testimony. The credit card statements did not indicate which expenditures were business related. No additional documentation was provided to establish why the expenses were paid, and the taxpayer's testimony was vague, genera,l and/or conclusory. He argued the 2001 expenses incurred to investigate the acquisition of a restaurant in Dallas, Texas occurred because his uncle was intending to sell him a restaurant in which he worked in 2000. He argued that he had contacted at least four companies in hopes of selling consulting services to PDA companies. The court disagreed stating that an email to the chief executive officer does not necessarily rise to the level of undertaking the activity with continuity and regularity for the primary purpose of carrying on a business for a profit.

Holding. The Tax Court determined the taxpayer is not entitled to deduct unreimbursed employee expenses, deduct a net loss for the restaurant business, or deduct a loss for his PDA consulting business.

15

Charitable Contributions

James Warren v. Comm'r, **T.C. Summary Opinion 2006-142 (September 13, 2006)**

IRC §170

☞ Lack of Contemporaneous Documentation Results in Disallowance

Facts. Mr. Warren had not attended church since 1999. On his 2002 and 2003 tax returns, he claimed cash charitable contributions of $4,500 and $1,000, respectively as well as noncash charitable contributions of $500 each year. These contributions were allegedly given by the taxpayer to his mother who then took the monies to church and deposited them in the collection basket. To support his cash contributions, he provided two computer-generated lists from The Church of Faith in Raleigh, North Carolina. These lists showed weekly contribution amounts beginning at $85 per week in January 2002 and rising steadily during 2002. The 2003 contributions were a flat $20 per week. **These lists were prepared by either Mr. Chester Muhammad, the taxpayer's accountant, or his daughter.** Neither list was signed by a church representative or dated. No documentation was provided for the $500 noncash contributions.

The IRS disallowed the cash and noncash charitable contributions for both years.

Issues. Whether the taxpayer is entitled to deductions for cash contributions of $4,500 and $1,000 in 2002 and 2003, and noncash charitable contributions of $500 in each year.

Analysis. Treas. Reg. §170A-13(a)(1) requires either a canceled check, receipt from the donee, or reliable written records be maintained.

Holding. The court held that since the taxpayer did not provide any contemporaneously prepared records or reliable evidence of his contributions, the charitable contributions were disallowed.

> **Note.** See page 547 of the 2006 *University of Illinois Federal Tax Workbook* for the strict recordkeeping and substantiation requirements for all charitable contributions. These new rules are effective for tax years beginning after August 17, 2006.

Medical Expense

Letter Ruling 200704001 (January 26, 2007)

IRC §213

☞ Special School Tuition Qualifies as Medical Expense

Purpose. To determine if tuition is deductible as a medical expense under IRC §213(a).

Background. The taxpayers' child has several developmental disorders, which cover a wide range of learning, social, and psychiatric difficulties. One of these disorders necessitates an educational environment with greater therapeutic and specialized attention than the child was receiving in the public school special education program. The child enrolled at the beginning of tenth grade in a special school designed to not only overcome disabilities but also assist in the pursuit of higher education. In addition to regular instructors, the special school employs special education teachers, mental health specialists, a speech pathologist, and an occupation therapist.

Analysis. IRC §213(a) provides that expenses paid during the taxable year for medical care of the taxpayer, the taxpayer's spouse, and dependents are deductible to the extent they exceed 7.5% of AGI. IRC §213(d)(1)(A) defines "medical care" to include amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body.

Treas. Reg. §1.213-1(e)(1)(v)(a) provides that ordinary education is not medical care. However, the cost of medical care includes the cost of attending a special school for a mentally or physically handicapped individual, if his condition is such that the resources of the institution for alleviating such mental or physical handicap are a principal reason for his presence there. If this provision applies, the cost of attending such a special school includes the cost of meals and lodging, and the cost of ordinary education furnished which is incidental to the special services furnished by the school. Both Rev. Rul. 70-285, 1970-1 C.B. 52, and Rev. Rul. 78-340, 1978-2 C.B. 124, address special situations involving special schools and the applicable deduction as a medical expense.

Conclusion. Since this school is a "special school" within the meaning of Treas. Reg. §1.213-1(e)(1)(v)(a) and the expenses are incurred for a child diagnosed with a condition that hinders his ability to learn, the tuition is a deductible medical expense.

Online Assistance

IRS News Release IR-2007-19 (January 29, 2007)

IRC §164

☞ State Sales Tax Calculator Available on IRS.gov

Sales tax calculator, an interactive tool on **www.irs.gov,** is available to help ease the burden on taxpayers. It's easy to use. The adjusted gross income, number of exemptions, and zip code is entered to find the base amount of state sales tax deduction. The tool also allows for entry of general sales tax paid on specified items to determine the total general sales tax deduction. If the taxpayer has moved one or more times during the year, this tool still allows the computation to be done based on the place(s) lived during the year.

To locate the tool on www.irs.gov, simply enter "Sales Tax Calculator" in the search box on the web site or access it through the "More Online Tools" section. IRS Pub. 600, *State and Local Sales Taxes*, also contains a worksheet for manually computing the deduction.

Charitable Contributions

IRS Notice 2006-110 (December 1, 2006)

IRC §170

☞ New Rules for Charitable Contributions Paid by Payroll Deduction

Purpose. Recordkeeping requirements of IRC §170(f)(17) took effect on **August 17, 2006**, as the result of the Pension Protection Act of 2006. IRC §170(f)(17) applies to any $250 contribution of cash, check or other monetary gift. These new requirements include maintaining a bank record or written communication from the donee that shows the **donee organization name, contribution date,** and **contribution amount**.

Analysis. How does this effect charitable contributions made by payroll deduction? Written communication from the donee organization must include:

- Pay stub,
- Form W-2, or
- Other employer furnished documents which provide:
  - The amount withheld for payment to donee organization,

15

- A pledge card prepared by or the direction of the donee organization, or
- Statement that the organization does not provide goods or services in whole or partial consideration for any contributions made to the organization by payroll deduction

Until the regulations are revised to incorporate the new IRC §170(f)(17), Notice 2006-110 can be relied upon by practitioners and taxpayers.

Professional Gambler

***Terri L. and Austin W. Hartsock v. Comm'r,* TC Memo 2006-205, September 25, 2006**
IRC §§165 and 6662

☞ Calculated Gambling Loss Does Not Prevail

Facts. The Hartsocks resided in Frederick, Maryland where they worked for The Frederick Painting Company. During 1999 and 2000, they frequented Atlantic City, New Jersey gambling on slot machines at many casinos including Tropicana, Trump Taj Mahal, Resorts Atlantic City, and Harrah's. Unfortunately, the taxpayers did not keep good records to substantiate their losses.

For the 1999 tax year, the casinos gave the taxpayers substitute Form W-2Gs for three days that showed gross daily winnings of $15,500, $35,600, and $51,175 on minimum slot machine bets ranging from $25 to $100. On the same days, they cashed substantial personal checks for gambling funds. The 1999 and 2000 returns showed other income of $230,825 and $293,750 and itemized deductions for gambling losses of $230,825 and $293,022, respectively.

The IRS examined the returns disallowing the Schedule A gambling loss deductions for 1999 and 2000 and asserting the IRC §6662(a) accuracy-related penalty for negligence.

Issues.

- Whether the taxpayers are entitled to deduct gambling losses in excess of the deductions allowed by the IRS.
- Whether the taxpayers are liable for the accuracy-related penalty for negligence under IRC §6662(b)(1).

Analysis. IRC §165 allows taxpayers to deduct losses from wagering transactions to the extent of winning from such transactions. In this case, the taxpayers estimated gambling losses by calculating the number of minutes between gambling winnings at a $100 slot machine or a $25 slot machine per the substitute Forms W-2G on August 13, 14, and September 4, 1999 which were won by playing two coins at a time. Mr. Hartsock computed wagers of $1,200 per minute in the $100 slot machine and $300 per minute in the $25 slot machine. The actual estimated losses were decreased to reflect the time taxpayers spent on lighting up cigarettes, getting drinks, and talking with others. The IRS questioned the reliability of these self-prepared workpapers.

IRC §6662(d) provides for a reduction of the understatement if the taxpayer supplied relevant facts affecting the tax treatment on the return and if there was reasonable basis for the tax treatment. The Hartsocks admit they did not keep records as required.

Holding. At trial, the IRS conceded the Hartsocks incurred gambling losses of $76,314 and $55,750 for 1999 and 2000, respectively. However, the court found the additional evidence submitted to support excess gambling losses unconvincing, and allowed no additional losses. Additionally, the court held that failure to keep adequate records is evidence not only of negligence, but also evidence of intentional disregard of regulations. The penalties remained as originally asserted.

This case was appealed to the 4th Circuit on March 6, 2007.

LIKE-KIND EXCHANGES

Annuity Contract

Revenue Ruling 2007-24, 2007-30 IRB 127 (2007)
IRC §§72 and 1035

☞ Indirect Transfer Does Not Result in Tax-Free Exchange

Purpose. To determine if submission of an endorsed check from a life insurance company under a nonqualified annuity contract to a second life insurance company for an additional annuity contract qualifies as an IRC §1035(a)(3) tax-free exchange.

Background. An individual who owned a nonqualified annuity contract requested the life insurance company issue a check to another life insurance company for payment of a new annuity contract. The individual wanted the transaction to qualify as an IRC §1035(a)(3) **tax-free exchange**. Instead, the originating life insurance company issued the check to the individual who endorsed the check and gave it to the other life insurance company.

Analysis. IRC §1035(a)(3) provides that no gain or loss is recognized on the exchange of an annuity contract for another contract. Both Rev. Rul. 72-358 and Rev. Rul. 2002-75 provide examples of **exchanges** that qualify as tax-free. In the taxpayer's situation there was:

- No exchange of any annuity contract,
- No assignment from the annuity contract from one life insurance company to another, and
- No **direct** transfer from one company to the other for the new contract.

Conclusion. Since the taxpayer received a check and endorsed it for a second annuity contract, this transaction does not qualify as an IRC §1035(a)(3) exchange but rather is taxable to the extent set forth in §72(e).

Vacation Homes

***Barry E. and Deborah E. Moore v. Comm'r,* TC Memo 2007-134, May 30, 2007**
IRC §1031

☞ Vacation Homes Do Not Qualify as Like-Kind Exchange Properties

Facts. The taxpayers owned a vacation home in Georgia using it on most weekends from April through Labor Day. They later changed the location of their personal residence in 1995 or 1996 making it impractical to vacation in Georgia as frequently as previously. They purchased another vacation home nearer to their new residence in 2000 and disposed of their older vacation home using a series of transactions intended to qualify as a like-kind exchange. The IRS challenged the like-kind exchange treatment.

Issue. Whether the exchange of one vacation home for another qualifies as a tax-deferred like-kind exchange under IRC §1031.

Analysis. IRC §1031(a)(1) provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind.

Holding. The Tax Court held that since neither vacation home was held for **investment**, the taxpayers were not entitled to treat the disposal of the first home and acquisition of the second home under the like-kind exchange rules. Both vacation homes were never rented or offered for rent to third parties. Even though the original vacation home was purchased with the expectation of appreciation, that factor is insufficient to convert it from personal use to investment property.

Transfers Between Family Members

Letter Ruling 200706001 (February 9, 2007)

IRC §1031

☞ Timberland Exchange Qualifies as Like-Kind

Purpose. To determine whether an exchange qualifies as a like-kind exchange pursuant to IRC §1031.

Background. The taxpayer's father had three parcels of timberland that was held for income producing and investment purposes. Upon his death, one parcel was transferred to the taxpayer's mother while the other two parcels were transferred to a trust. The trust held the two parcels for benefit of the mother during her lifetime with the taxpayer and her siblings being equal remainder beneficiaries of the trust assets. Taxpayer's mother subsequently gifted her parcel to the taxpayer and her siblings as tenants-in-common.

A decision was made to sell all parcels of timberland. The taxpayer wanted to keep her ownership of real estate so she exchanged her undivided 25% interest in one parcel for a 100% unencumbered fee simple interest in another parcel. The other two parcels were subsequently sold to an unrelated third party.

Analysis. IRC §1031(a)(1) provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such 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.

Rev. Rul. 73-476, 1973-2 C.B. 300 provides that exchanges of undivided interests in multiple parcels of real estate for 100% ownership of one or more parcels of the same real estate qualify as valid like-kind exchanges. IRC §1031(f)(1) provides an exception to the general like-kind exchange rules involving related parties who have disposed of like-kind exchange property in which nonrecognition of gain or loss occurred.

Conclusion. In this case, the exchange of an undivided interest in one parcel for a fee simple interest in another parcel constitutes a like-kind exchange pursuant to Rev. Rul. 73-476. Neither the exchange nor the subsequent disposition of the first parcel creates recognition of gain pursuant to IRC §1031(f)(1).

Related Parties

Letter Ruling 200712013 (March 23, 2007)

IRC §1031

☞ Multi-Stage Transaction Qualifies for Like-Kind Exchange

Purpose. To determine if nonrecognition treatment under IRC §1031 applies to the transfer of real property in a multi-party exchange involving a related party and a qualified intermediary.

Background. The taxpayer acquired rental property that substantially increased in value over time. A related party wanted to obtain the rental property utilizing IRC §1031 provisions and dispose of it within two years. The taxpayer entered into an agreement with an unrelated third party to acquire like-kind replacement property with a substantially higher FMV than the rental property. The unrelated third property required the closing of the sale of the replacement property prior to the transfer of the rental property to the related property. The taxpayer structured the transaction as a reverse like-kind exchange using a multi-stage transaction involving several entities aimed at eliminating any chance of the transaction being considered a sale rather than an exchange.

Analysis. IRC §1031(a)(1) provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such 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.

Treas. Reg. §1-1031(k)-1(g)(4) allows taxpayers to use a qualified intermediary to facilitate a like-kind exchange. Subsequently, IRC §1031(f)(1) provides special rules for exchanges between related parties.

Conclusion. In this case, the exchange of a property done via a qualified intermediary and subsequent receipt of replacement property from the qualified intermediary is an exchange with the qualified intermediary.

NONPROFIT ACTIVITIES

Two Interrelated Activities

***Tracey L. Topping v. Comm'r,* TC Memo 2007-92, April 17, 2007**
IRC §183

☞ Horse Activity Losses Allowed to Offset Business Net Profits

Facts. In 1998, Ms. Topping was in the middle of bitter divorce. She had two assets, a 16-year old horse and a debt-encumbered condominium in Florida. Ms. Topping had a flair for drafting structural designs freehand and was an experience equestrian. She formulated a **mental** plan utilizing her prominence in the equestrian world to design horse barns and homes for wealthy equestrian families. The plan was discussed with both her CPA and a longtime friend who had successfully started a business. She formed Topping White Design, LLC in 1999 for the interior design business. She hired an administrative person in May to handle the administrative needs.

Ms. Topping competes in the Winter Equestrian Festival at the Jockey Club to make contacts with prospective clients. The Jockey Club is an elite private club where a table for a 7-week session ranges from $5,000 to $25,000. Her riding activity enables her to maintain a reputation as a skilled competitor, which helps her attract potential new clients. She uses no conventional advertising because the Jockey Club members consider it tacky. She meets a perspective client on the weekend and her administrative person arranges for a meeting at the client's design site on the Monday following the horse show. Ms. Topping uses knowledge of a horse's particular injury and temperament to design a barn tailored to meet the horse's needs. Records are maintained on a yearly basis for both her equestrian and interior design activities.

From 1999 through 2001, separate Schedules C were filed for the equestrian and interior design activity. Beginning in 2002, both activities were reported on one Schedule C. Net income/losses for 1998 through 2001 were reported as follows:

Year	Net Income (Loss) of Topping White	Net Income (Loss) of Horse Activity
1998	$200,908	($ 47,123)
1999	157,239	(80,735)
2000	499,908	(206,080)
2001	322,459	(275,169)

Combining the two activities into one business resulted in net incomes ranging from $37,759 to $346,142 over a six year period with one year showing an $8,061 loss. In all years in question, she also received a distribution of less than $20,000 per year from Daniel Topping Trust.

The IRS determined the Schedule C income from horse activity should be considered "other income." All expenses were disallowed and moved to Schedule A expenses since the activity was not engaged in for a profit. The IRS also disallowed some expenses for the interior design activity.

Issues.

- Whether the equestrian and related activities are conducted as part of her design business.
- Whether activities are for profit under IRC §183(a).
- Whether the equestrian expenses are ordinary and necessary pursuant to IRC §162(a) if the equestrian activity is for profit.

Analysis. IRC §183 restricts taxpayers from deducting losses from an activity that is not engaged in for profit. The first issue examined by the court was whether or not the equestrian and design ventures constitute a single activity. Treas. Reg. §1.183-1(d)(1) provides that multiple undertakings of a taxpayer may be treated as one activity if the undertakings are sufficiently interconnected. Analysis of the factors showed these activities are intertwined and are considered one activity.

Holding. After review of the nine factors, the court held that Ms. Topping conducts her equestrian and related activities as part of her design business for a profitable purpose. Therefore, the equestrian-related expenses associated with her activity are ordinary and necessary expenses.

PASSIVE ACTIVITIES

Extension for Making Election

Letter Ruling 200728016 (July 13, 2007)
IRC §469

☞ Late Election to Treat Rental Real Estate Activities as a Single Activity Allowed

Purpose. To determine whether married taxpayers could be granted a 60-day extension to make an election under IRC §469(c)(7) to treat all their interests in rental real estate as single rental real estate activity effective for stated year.

Facts. The taxpayers are married and file their tax returns jointly. In Year 1, they were in a real property business as defined by IRC §469 and were qualified under §469(c)(7)(B) to elect to treat all interests in rental real estate as a single rental real estate activity. However, the taxpayers filed their joint return for Year 1 without the statement required under Treas. Reg. §1.469-9(g)(3).

Issue. Can the taxpayers receive an extension of time under Treas. Reg. §301.9100-3 to file an election under IRC §469(c)(7) to treat all interests in rental real estate as a single rental real estate activity.

Analysis. Under §469(c)(2), passive activity includes any rental activity. IRC §469(c)(7) provides a limited exception to this rule for taxpayers in a real property business. Specifically, §469(c)(7)(A) indicates that if a taxpayer meets the requirements of §469(c)(7)(B), the taxpayer's rental real estate activity is no longer presumptively passive. By its terms, the exception under §469(c)(7)(A) is applied as if each interest of the taxpayer in rental real estate is a separate activity. However, a taxpayer may elect to treat all interests in rental real estate as a single activity. The election is made pursuant to Treas. Reg. §1.469-9(g)(3).

Treas. Reg. §301.9100-1(c) allows the IRS to extend the time to make such an election. Treas. Reg. §§301.9100-1 through 301.9100-3 provide the standards used to determine whether to grant an extension of time to make an election. Treas. Reg. §301.9100-3(a) provides that extensions are possible when the taxpayer provides evidence to establish that the he acted reasonably, in good faith, and the extension will not prejudice the interests of the IRS.

Conclusion. The IRS granted the taxpayers a 60-day extension to make an election under §469(c)(7)(A) to treat all their interests in rental real estate as a single rental real estate activity effective Year 1. The IRS did not opine whether the taxpayers satisfied the requirements under §469(c)(7)(B) or whether taxpayers materially participate in any activity.

Note. See pages 377–378 in Chapter 11, "Entity Issues," for a thorough discussion of this important election.

RESIDENCES

Rebate

Letter Ruling 200721013 (May 25, 2007)
IRC §6041

☞ Broker's Commission Rebate is Treated as Nontaxable Return of Basis

Purpose. To determine if a taxpayer has an information reporting obligation under IRC §6041 for amounts paid to purchasers of real property.

Background. The taxpayer is a real estate broker who agrees to pay the purchaser a percentage of the commission received from the seller in a completed sales transaction by either issuing the purchaser a check after closing or giving the purchaser credit on the closing statement.

Analysis. IRC §61 provides that gross income means all income from whatever source derived. Rev. Rul. 2006-27, 2006-21 IRB 915, held that down payment assistance to a low-income home purchaser represents a rebate and is not included in the purchaser's gross income. Likewise, in Rev. Rul. 76-96, 1976-1 C.B. 23, a rebate to a retail customer who purchased or leased new automobiles represents an adjustment to the purchase price. Consequently, a payment or credit at closing represents an adjustment to purchase price and is not includible in the purchaser's gross income.

IRC §6041 requires all persons engaged in a trade or business to file an information return with the IRS when they exceed $600.

Conclusion. In this case, no information reporting obligation occurs since the payment or credit at closing is treated as an adjustment to the purchase price.

RETIREMENT

> **Note.** See Chapter 7, "Retirement Plans," for information on the following:
>
> 1. **IRS Notice 2007-7,** which provides guidance on several provisions of the Pension Protection Act of 2006;
> 2. **IRS Announcement 2007-63,** which explains that filing Schedule P is no longer necessary; and
> 3. Release of a new **Form W-4P** for withholdings from pension and annuity payments.

Nonqualified Deferred Compensation

Treasury Decision 9321, 2007-19 IRB 1123
Notice 2007-34 (April 10, 2007)
IRC §409A

☞ Nonqualified Deferred Compensation Regulations Become Final

Final regulations were released for IRC §409A nonqualified deferred compensation. These regulations do not extend the transition relief for compliance beyond December 31, 2007. Therefore, plans must comply with the final regulations by January 1, 2008. In addition, due to the complex and varied nature of deferred compensation plans, the IRS chose not to issue model language for plans to use in order to comply.

Final regulations include:

- Clarification and liberalization of the rules for elections, valuations, plan documents, and other areas,
- Clarification of stock options and separation pay,
- Significant changes that should resolve most concerns about the exclusion for stock rights and the treatment of service recipient stock, and
- Exclusion of restricted property under IRC §83, §402(b) trusts, and IRC §457(b) deferrals.

Notice 2007-34 addresses the application of IRC §409A to split-dollar life insurance arrangements.

Effective Date. The effective date of these regulations is April 17, 2007.

> **Note.** See pages 231–233 in the 2006 *University of Illinois Federal Tax Workbook*, along with pages 220–222 in this workbook, for more information on nonqualified deferred compensation plans.

2007 Retirement Plan Limitations

IRS News Release IR 2006-162 (October 18, 2006)

IRC §§61, 401, 402, 404, 408, 409, 414, 415, 416, and 457

☞ IRS Releases COLA Adjustments for 2007 Retirement Plan Contributions

Retirement Plan Limitations	2007	Age 50+ Catch-up
Traditional IRA and Roth IRA contributions	$ 4,000	$1,000
Elective deferrals to SIMPLE IRA and SIMPLE 401(k) plans under IRC §408(p)(2)(E)	10,500	2,500
Elective salary reduction contributions under IRC §402(g) to §401(k), §403(b), §408(k) SARSEPs, and the Thrift Savings Plan	15,500	5,000
Elective deferrals to IRC §457 state or local government plans or IRC §501(c) tax-exempt organization plans	15,500	5,000
The sum of employee elective deferrals and employer contributions to defined contribution plans (IRC §415(c)(1)(A)) and SEP plans (IRC §408(j))	Lesser of: $45,000 or 100% of compensation	
Annual benefit limitation under defined benefit plan allowed by IRC §415(b)(1)(A)	180,000[a]	
Annual compensation caps under IRC §§401(a)(17),[b] 404(l), 408(k)(3)(C), and 408(k)6)(D)(ii)	225,000	
SEP minimum compensation threshold	500	
Dollar limitation under IRC §414(q)(1)(B) used to define a highly-compensated employee	100,000	
Dollar limitation under IRC §416(i)(1)(A)(i) used to define a key employee in a top-heavy plan	145,000	
Maximum account balance in an ESOP subject to 5-year distribution under IRC §409(o)(1)(C)(ii)	915,000	
Dollar limitation used to determine the lengthening of the 5-year distribution period for ESOPs under IRC §409(o)(1)(C)(ii)	180,000	

[a] For participants who separated from service before January 1, 2007, the limitation for defined benefit plans under IRC §415(b)(1)(B) is computed by multiplying the participant's 2006 adjusted compensation limitation by 1.0334.

[b] The 2007 compensation limit is $335,000 for certain governmental plans in effect on July 1, 1993, that allowed for cost-of-living increases.

Educational Distributions

***Roger F. and Mary A. Duronio v. Comm'r,* TC Memo 2007-90, April 17, 2007**
IRC §72

☞ Distribution Must be in Same Year of Payment to Eliminate 10% Penalty

Facts. In December of 2001, the Duronios paid $18,000 to New York University (NYU) for their son's tuition. The son attended NYU as a full-time student residing in a campus dormitory during 2002. In the fall of 2002, the son borrowed $19,263 to finance his educational expenses. However, neither he nor his parents paid any student loan payments or tuition payments during 2002. Mrs. Duronio took a $19,900 early distribution from her IRA in 2002 prior to attaining age 59½. On their 2002 tax return, the taxpayers reported the entire $19,900 early distribution as income but did not compute the IRC §72(t)(1) early distribution penalty.

The IRS determined the 10% early distribution penalty was applicable and recommended an adjustment accordingly.

Issue. Whether the taxpayers qualify for an exception under IRC §72(t)(2)(E) and are therefore not subject to the early distribution penalty.

Analysis. Under IRC §72(t)(1), an IRA distribution prior to attaining age 59½ is subject to a 10% additional tax. IRC §72(t)(2)(E) allows the penalty to be reduced by the amount of a taxpayer's qualified higher educational expenses paid in the year of the distribution.

At trial, the taxpayers argued that their 2001 payment should have been deemed paid in 2002 by the early IRA distribution since money is fungible. In addition, the Duronios argued they guaranteed their son's 2002 student loan. Therefore, the loan guarantee should be treated as a $19,263 payment in 2002. They did not, however, produce **evidence** to show they guaranteed the loan. They also argued they paid other educational expenses in 2002, but did not provide evidence to support their claim.

Holding. In order to qualify for reduction of the early distribution penalty, the qualified higher educational expenses must be paid in the year of the distribution. In this case, they were not. Therefore, the 10% distribution penalty was sustained.

60-day Rollover Period

Letter Ruling 200704042 (January 26, 2007)

IRC §408

☞ Failure to Consult Tax Advisor Is Costly

Purpose. To determine if the taxpayer qualifies for a waiver of the 60-day rollover requirement.

Background. The taxpayer, who suffered from a mental impairment received IRA distributions arranged by his daughter to use for future nursing home care. Unfortunately, the 60-day rollover period had expired before the daughter learned of the tax consequences from the family CPA.

Analysis. IRC §408(d)(1) provides that any amount paid or distributed from an IRA is included in gross income as provided under IRC §72. IRC §408(d)(3)(A) states that IRC §408(d)(1) shall not apply if the entire amount received is paid into an IRA not later than the 60th day after the day on which the individual receives the payment. IRC §408(d)(3)(I) allows waiver of the 60-day requirement if failure to waive would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual.

Rev. Proc. 2003-16, 2003-4 I.R.B 359 explains that the following factors are considered when determining whether to grant a waiver of the 60-day rollover requirement:

- Errors committed by a financial institution,
- Inability to complete rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country or postal error,
- Use of the amount distributed, and
- Time elapsed since distribution occurred.

Conclusion. After reviewing all of the facts, the IRS concluded that neither the taxpayer nor his daughter were prevented from making a timely rollover and denied waiver of the 60-day requirement. The daughter sought to undo the transaction solely based on adverse tax consequences.

Rollover of IRA

Letter Ruling 200639001(July 5, 2006)

IRC §408

☞ Reliance on Confusing Website Results in 60-Day Rollover Waiver

Purpose. To determine whether the 60-day rollover requirement for an IRA distribution can be waived.

Background. The taxpayer had an IRA with Company A. After accessing the Company A website, the taxpayer moved funds from one IRA account to another. Shortly after the 60-day rollover period expired, a Form 1099-R was received indicating a taxable event had taken place. The taxpayer then realized the rollover account was **not an IRA.** The taxpayer immediately sought a waiver from the 60-day rollover requirement period.

Analysis. IRC §408(d)(1) provides any amount paid or distributed from an IRA shall be included in gross income unless an exception under IRC §408(d)(3) exists. IRC §408(d)(3) provides rules governing total or partial IRA rollovers within a 60-day period. IRC §408(d)(3)(1) allows for waiver of the 60-day requirement when the failure to waive would be against equity or good conscience. Further guidance of waiver circumstances is found in Rev. Proc. 2003-16, January 27, 2003.

Conclusion. In this instance, due to the confusing information provided on the website, the 60-day waiver period was granted.

TAX FRAUD

Prosecutions, Indictments, and Sentences

IRS Fact Sheet FS-2007-12 (January 2007)

☞ Efforts Continue to Combat Preparer Fraud

The IRS return preparer program focuses on **enhanced preparer compliance** by investigating and referring criminal activity to the Department of Justice for prosecution and assertion of appropriate civil penalties where appropriate.

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

- Inflated personal or business expenses,
- False deductions,
- Unallowable credits, and
- Excessive exemptions.

Taxpayers should use the following helpful hints when selecting a return preparer:

- Be wary of preparers who claim that they can obtain larger refunds than other preparers,
- Avoid using preparers whose fee is a percentage of the refund amount,
- Avoid using preparers who claim customers can get hundreds back from the telephone tax refund program,
- Paid preparers are required to sign the return and provide a copy to the client,
- Will the preparer be available if questions arise later on, and
- Does the preparer have any credentials such as enrolled agent, CPA, or attorney?

Criminal Investigation Statistical Information on Return Preparer Fraud

	FY 2006	FY 2005	FY 2004
Investigations started	197	248	206
Prosecutions recommended	153	140	167
Indictments/informations	135	119	121
Sentenced	109	118	90
Incarceration rate	89.0%	85.6%	84.4%
Average months to serve	18	18	19

Below are descriptions of some fraudulent situations that occurred:

- On February 13, 2006, in Rockford, Illinois, John H. Bell was sentenced to 56 months in prison and one year of supervised release. Bell, owner of Bell's Income Tax Service and of Real Estate Investors (REI) #2462, Inc, prepared false income tax returns for others by attaching W-2s to the return that falsely stated amounts of income/withholding from REI. He was also charged for filing a false return for himself.
- On October 6, 2006, Susan E. O'Brien of San Diego, CA was sentenced to 10 years and five months in prison and ordered to pay $113,179 in restitution. O'Brien prepared numerous income tax returns that claimed false business deductions. Her co-defendant, Robert Evans, promoted, sold, and managed domestic trusts used by clients to hide their income and assets from the IRS. Evans was sentenced to 78 months in prison.

Tax Schemes
IRS News Release IR-2007-37 (February 20, 2007)
IRS News Release IR-2007-61 (March 15, 2007)
IRS Notice 2007-30 (March 15, 2007)
Revenue Rulings 2007-19 through 2007-22, 2007-14 IRB 843
IRC §§165, 170, 501, 3102, and 6702

☞ 2007 Update on "Dirty Dozen" Tax Schemes

The IRS compiled a variety of information to help taxpayers avoid tax schemes:

- IRS News Release IR-2007-37 (February 20, 2007) and IR-2007-61 (March 15, 2007)
- IRS Notice 2007-30 (March 15, 2007)
- Revenue Rulings 2007-19 through 2007-22 (March 2007)

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

The 2007 "Dirty Dozen" includes **five** new schemes and several recurring schemes. **Fraudulent Refunds for the Telephone Excise Tax Refund** tops the 2007 listing. New additions include the abuses pertaining to zero wages, Form 843 tax abatement, Roth IRAs, the American Indian Employment Credit, domestic shell corporations and structured entity credits.

In the "Zero wages" scheme, a taxpayer attaches either a Form 4852 (Substitute Form W-2) or a "corrected" Form 1099 showing zero or little other income to the return. 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
- Disguised Corporate Ownership
- Return Preparer Fraud
- Trust Misuse
- Abuse of Charitable Organizations and Deductions
- Frivolous Arguments

The IRS has seen substantially less activity related to five of the more noteworthy scams. This is a result of enforcement actions taken against a number of promoters.

IRS Notice 2007-30. This notice describes the 40 most common frivolous arguments taxpayers use when filing returns.

Revenue Rulings dealing with tax schemes include frivolous positions such as:

- 2007-19 (wages are not taxable income)
- 2007-20 (compliance with IRS law is purely voluntary and taxpayer are not legally required to file tax returns)
- 2007-21 (Form 23C must be provided before IRS may collect overdue taxes)
- 2007-22 (Not subject to tax or income is excluded from taxation)

TRAVEL AND TRANSPORTATION EXPENSE

Auto Mileage Allowance

Revenue Procedure 2006-49, 2006-47 IRB 936

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

☞ IRS Announces the 2007 Optional Standard Mileage Rates

Background. The IRS allows taxpayers who use their automobile for business, medical, or charitable purposes to deduct a standard amount per mile rather then requiring detailed expenditure records. For 2006, the standard mileage rate is 44¢ per mile for business miles, 18¢ for medical mileage, and 14¢ for charitable miles.

Analysis. For 2007, the mileage rate is increased to 48.5¢ per mile for business miles, 20¢ for medical miles, and 14¢ for charitable miles. For business automobiles, depreciation is considered to have been allowed at the rate of 16¢ per mile in 2003 and 2004, 17¢ in 2005 and 2006, and 19¢ in 2007.

Per Diem Expense Reimbursements

Revenue Ruling 2006-56, 2006-52 IRB 1169

IRC §§62 and 3401

☞ Employers Need to Track Per Diem Allowances

Purpose. To determine whether, under an expense allowance arrangement, the failure to treat the excess allowances as wages for employment tax purposes causes all payments made under the expense allowance arrangement to be treated as made under a nonaccountable plan.

Background. The taxpayer employs long-haul truck drivers in the transportation industry. The employer compensates the drivers on a mileage basis. The compensation is reported on Form W-2 and the employer pays the applicable employment taxes. The drivers are also reimbursed for meal and incidental expenses (M&IE) paid or incurred while traveling away from home. The drivers are reimbursed through an allowance for each day the driver is away from home. The reimbursement is based on a fixed cents-per-mile driven.

The amount of cents-per-mile driven is based upon the employer's expectation of the amount of daily M&IE that will be paid or incurred and the expectation of the average number of daily miles driven during the pay period. The drivers are required to provide logs to substantiate the time, place, and business purpose of the travel away from home. They are not required to substantiate the actual amount of M&IE. Instead, the taxpayer relies on administrative guidance published by the IRS under which the amount of ordinary and necessary business expenses are deemed substantiated when the employer provides a per diem allowance. For 2006, $52 is deemed substantiated by the IRS.

Analysis. Many of the drivers are paid more than $52 per day, even when computed on a monthly basis. The taxpayer requires the drivers to return any amounts paid to them for days they are not away from home on business travel. He does not require drivers to return the portion of the allowance paid that exceeds $52 for days they were away from home on business travel.

The taxpayer does not have any method of tracking payments in excess of $52 per day. He did not report it on the drivers' Form W-2.

Conclusion. A per diem arrangement is not treated as a reimbursement or other expense allowance arrangement if:

1. The arrangement does not require the employee to substantiate the expenses covered by the arrangement, or
2. The arrangement provides the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement.[17]

If these requirements are not met, the arrangement is treated as a nonaccountable plan and payments must be included in the employee's gross income as wages or other compensation and are subject to withholding and payment of employment taxes. If the arrangement is considered nonaccountable, all amounts paid under the arrangement are subject to income tax and employment tax, not just the excess amounts.

Note. See Chapter 9, "Small Business Issues," Issue 3, for more information on meal and incidental expenses.

Away from Home

***Marc G. Bissonnette and Lillian I. Cone v. Comm'r,* 127 TC 124 (2006)**

IRC §§162 and 274

☞ Ferryboat Captain Required Rest in Off-Peak Season Travel

Facts. Mr. Bissonnette was a ferryboat captain for Clipper Navigation, Inc. in Puget Sound, Washington with his home port in Seattle, Washington. He would work 15 to 17 hour days within a 24 hour period, which included a 1-hour to 6-hour layover at an away from home port during peak-season and off-season voyages respectively. During a 5-hour layover, Clipper Navigation, Inc. provided a second captain to allow Mr. Bissonnette time to rest. On the returns for 2001, 2002, and 2003, Mr. Bissonnette claimed meals and incidental expenses (M&IE) as miscellaneous itemized deductions based on the federal per diem rates provided under Rev. Procs. 2000-39, 2000-2 C.B. 340 and successor revenue procedures.

The IRS denied the deductions since the taxpayer was not "away from home" and his voyages did not require him to obtain rest. In addition, if he was "away from home," the deductions must be prorated based on partial days of travel and 50% reduction under IRC §274.

Issues.

- Whether the taxpayer was "away from home" pursuant to IRC §162.
- Whether he is required to prorate and reduce his allowable M&IE for a partial day of travel.
- Whether a 50% reduction in the deductible expenses are required.

Analysis. IRC §162 allows taxpayers to deduct traveling expenses incurred while away from home in the pursuit or a trade or business. The primary question is whether the taxpayer needed rest while away from home in order to meet the demands of his employment. As a test for meal expense deductibility for business trips completed within one day, if an employee is released from duty for the purpose of eating rather than sleeping, this will not satisfy the "overnight" rule. This test has been evaluated repeatedly in various court cases. If the nature of employment is such that it is reasonable for a taxpayer to **need and obtain** rest to meet the demands of his employment, his expenses would be deductible under §162(a)(2).

The IRS argued the taxpayer is not entitled to a deduction during peak season layovers since the layovers were insufficient in duration (one to five hours) to require rest.

15

[17] Treas. Reg. §1.62-2(c)(1)

For the off-peak travel season, the factors to consider regarding whether the taxpayer needed rest include his age, his physical condition, and the length of his workday and the importance of being alert to carry out his job responsibilities properly without fear of injuries to others. The taxpayer's job was very demanding. It included responsibility for the safety of a crew and up to 1,200 passengers in potentially extreme weather conditions, high sea levels, and many other obstacles. The court determined it was reasonable for the taxpayer to obtain rest during layover periods to meet the demands of his employment. Therefore, deductions for M&IE were allowed during the trips requiring 6-hour layovers.

The next issue was whether the travel expenses should be reduced by the partial day rule. Various revenue procedures authorize various methods for substantiating M&IE while away from home including any method **consistently applied** in accordance with reasonable business practice. In this case, the taxpayer consistently applied the full federal M&IE rate to all off-peak-season voyages requiring him to be away from home for 15 to 17 hours a day.

The last issue dealt with the reduction of M&IE by 50% pursuant to IRC §274(n)(1). At trial, the taxpayer argued that this issue cannot be considered because the IRS did not raise it until the opening brief. Alternatively, if the limitation does apply, he is eligible for an exception because he is a crew member of a commercial vessel on an inland waterway of the United States where food and beverage were required to be provided to crew members if it were operated at sea.

Holding. The court determined the expenses were not deductible, finding that the petitioner was not away from home. As to the partial day rule, the court determined the use of the full federal M&IE rate to be acceptable. Finally, the court disregarded both arguments raised by the taxpayer on the §274(n)(1) issue. Therefore, the 50% limitation applied in this situation.