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, 2008. 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.

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- 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 (IRC) 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 IRC 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 (TAM). 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"):

- File a petition in the Tax Court without paying the tax.
- 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 the Revenue Reconciliation Act of 1998 (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 website 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 possible (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 website at **www.ustaxcourt.gov.**

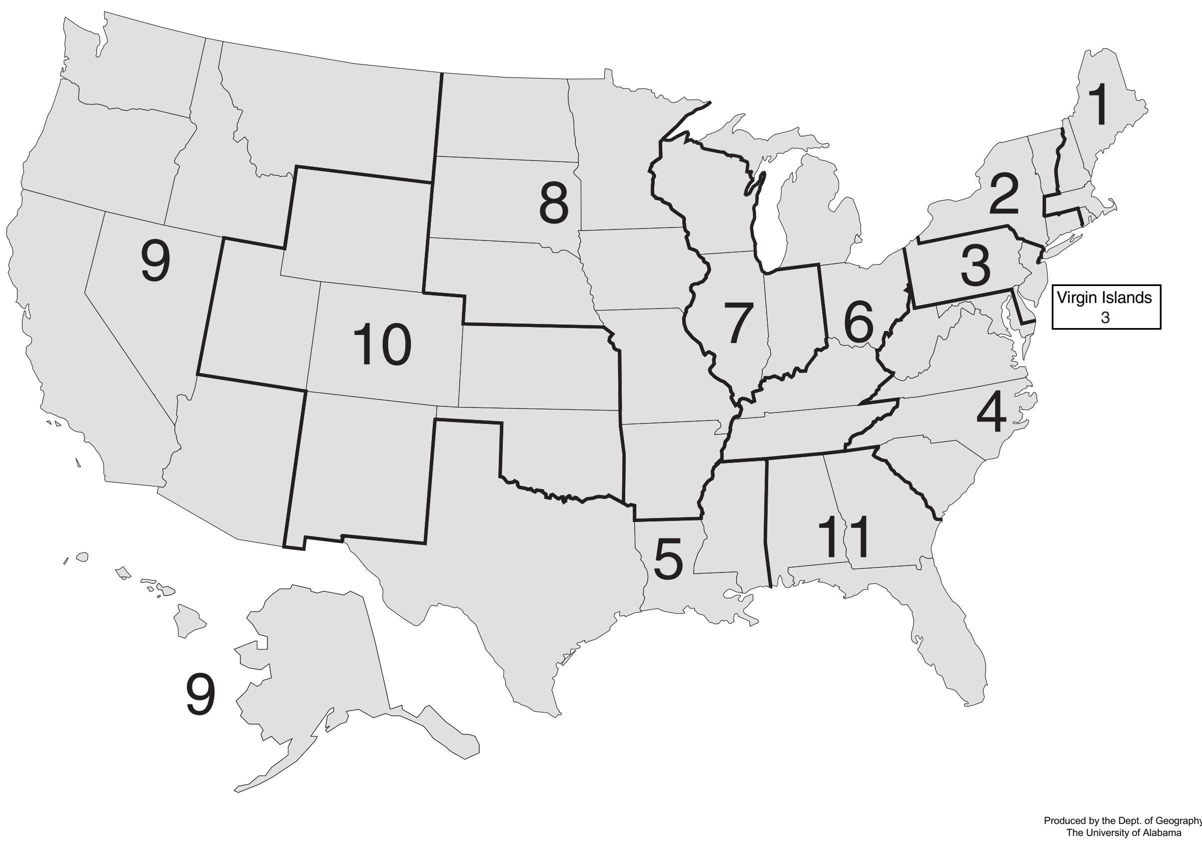
Any decision of the Tax Court can be appealed to the appropriate Circuit Court of Appeals. A final appeal can be made to the Supreme Court, but since its jurisdiction is discretionary, the court hears relatively few tax cases. Many of these court transcripts can be accessed online at **www.uscourts.gov.**

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 District 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

Year of Inclusion of Income

Nelson et. al. v. Comm'r, 130 TC No. 5 (Feb. 28, 2008)
IRC §§451 and 6662

☞ Deferred Reporting of Insurance Proceeds Disallowed

Facts. During the relevant period, the Nelsons operated a farming business in Minnesota through two related family partnerships, both of which used the cash method of accounting. The Nelsons' farming business grew sugar beets and other crops. In 2001, their entire sugar beet crop was destroyed by excess moisture; however, the loss was compensated by $201,919 in federal crop insurance proceeds. In the sugar beet industry, it is generally accepted practice to report 65% of the income from the crop in the year of harvest and the remaining 35% in the following year.

On their 2001 Form 1065, *U.S. Return of Partnership Income,* the Nelsons' partnership did not report any of the insurance proceeds. Upon audit, the IRS asserted a deficiency and an accuracy-related penalty.

Issues. Whether the Nelsons:

- Were entitled to defer their 2001 insurance proceeds to the 2002 tax year
- Are liable for the §6662 accuracy-related penalty

Analysis. A cash-method taxpayer may defer reporting insurance proceeds from destroyed crops to the year following the crop destruction when the proceeds from such crops, if they had not been destroyed, would have been reported in that following year.[1] According to the Regulations, this deferral is permitted only when the income from the crops is normally reported in the following year.[2] However, under Rev. Rul. 74-145, deferral of insurance proceeds to the following year is available when a substantial portion, defined as more than 50%, of the proceeds from the crops would have ordinarily been reported in that following year.

IRC §6662 imposes a penalty for an underpayment of tax when such underpayment is attributable to negligence or disregard of federal income tax requirements. However, no penalty may be imposed when the taxpayer had reasonable cause for the underpayment.

Holding. The court held that the Regulations and Rev. Rul. 74-145 together precluded the Nelsons from deferring the proceeds of the federal crop insurance to 2002 because, under their standard practice, only 35% of the Nelsons' income from their sugar beet crop was reported in the year following the harvest. This percentage did not meet the substantial portion threshold set by Rev. Rul. 74-145 for deferral of crop insurance proceeds (i.e., at least 50%). However, the court further held that, due to the ambiguity of the statute and regulations, the taxpayers had reasonable cause to believe they could defer the insurance proceeds. Therefore, the court declined to sustain the accuracy-related penalty.

1. IRC §451(d)
2. Treas. Reg. §1.451-6

Income Averaging

Treasury Decision 9417 (July 21, 2008)
IRC §§55, 1301 and 7518

☞ Rules for Income Averaging Clarified for Individuals Engaged in Fishing

Purpose. Fishermen were permitted to use income averaging beginning in 2003. This was a provision of the American Jobs Creation Act of 2004. This Treasury Decision clarifies previous uncertainty regarding some aspects of income averaging.

Analysis. Income averaging is available only to those individuals in the business of catching, taking, or harvesting fish, mollusks, crustaceans, or other forms of marine animals. It is **not** available to those individuals who **process fish.**

Some fishermen make deposits to the Merchant Marine Capital Construction Fund. These deposits must reduce the fishing net profit, before determining the amount of income that may be averaged.

Individuals with both farming and fishing income must combine the profits and losses of **both** activities to determine the maximum amount of income available for averaging. Taxpayers who lease vessels used for fishing and receive a percentage of the catch are also allowed to income average. However, as with crop-share farmers, a lease must be entered into before significant fishing activities begin. Landlords receiving a fixed payment for the use of their vessel do not qualify for income averaging.

Crewmembers of a vessel are typically paid a percentage of the catch. Therefore, they are also at risk and subject to the fluctuations of the fishing economy. They are allowed to use income averaging on their fishing income.

Effective Date. The regulations are effective for tax years beginning after July 22, 2008. However, taxpayers may apply the regulations to tax years beginning after December 31, 2003 and ending before July 23, 2008.

> **Note.** Additional information on farm income averaging can be found in the last section of Chapter 14, "Agricultural Issues and Rural Investments."

AMORTIZATION AND DEPRECIATION

IRC §179 Recapture

***Michael R. Birdsill et al. v. Comm'r,* TC Summ. Op. 2008-55 (May 20, 2008)**
IRC §§179, 274(d), 280F(b)(2) and 6001

☞ IRC §179 Recapture Required When Business Use is Unsubstantiated

Facts. Mr. Birdsill was involved in the broadcast industry in California, and had a Schedule C consulting operation that checked on digital radio tower sites during the years in question. In 2002, the taxpayer placed in service a heavy-duty 1998 GMC Suburban utility vehicle and claimed a §179 deduction plus MACRS depreciation on the SUV, totaling $26,396 on his 2002 Schedule C. In 2003, the taxpayer did not list the Suburban as a business vehicle and instead listed a Ford F-250 truck. The IRS audited the 2003 return and recaptured as income the full §179 depreciation claimed in 2002.

At trial, Mr. Birdsill testified that during 2003, the F-150 truck was used 75% for business and the Suburban was used 25% for business. He based his calculation on the fact that at least four of the 35 radio towers he visited in 2003 required an all-wheel drive vehicle (Suburban) to gain access to the site. These four sites were approximately 150 miles away from his home. The other 31 sites were less than 150 miles from his home. Mr. Birdsill indicated he also used the Suburban for other business-related travel such as taking clients to an existing radio station. Mr. Birdsill did not keep any records of business versus personal use of the Suburban.

Issue. Whether the taxpayer is liable for the §179 depreciation recapture

Analysis. Deductions are a matter of legislative grace, and the taxpayer bears the burden of proving that he is entitled to any claimed deduction.[3] Business expenses are deductible provided the taxpayer has adequate records or sufficient evidence to substantiate the deduction.[4] Business expenses include traveling expenses such as meals and lodging while away from home, entertainment, amusement and recreational expenses, gift expenses, or use of listed property (including automobiles). IRC §179 recapture is triggered when business use drops below 50%.[5]

Holding. The court found the taxpayer's testimony that he used the Suburban for business purposes to be credible, but it did not establish that the Suburban was used more than 50% for business. Consequently, the taxpayer did not meet the strict substantiation requirements of §274(d). The court upheld the IRS's decision to require depreciation recapture on the vehicle.

Annual Depreciation Limits

Rev. Proc. 2008-22, IRB 2008-12 (Mar. 4, 2008)
IRC §§168 and 280F

☞ New Depreciation Limits for Business Autos, Light Trucks, and Vans Placed in Service in 2008

Annual depreciation dollar caps for vehicles subject to the luxury-auto limits of IRC §280F and placed in service after December 31, 2007, but before January 1, 2009, are shown as follows:

Annual Depreciation Limitations
(50% additional first-year bonus depreciation does not apply)

Vehicles Subject to Luxury-Auto Limits (Information Taken from Tables 1, 2, and 3)	Annual Depreciation Limitations			
	Year 1	Year 2	Year 3	Year 4
Autos	$2,960	$4,800	$2,850	$1,775
Trucks and vans	3,160	5,100	3,050	1,875

As a result of the Economic Stimulus Act of 2008, an additional 50% first-year bonus depreciation deduction is available for certain **new** property acquired by the taxpayer after December 31, 2007 and before January 1, 2009, as long as no written binding contract for the acquisition of the property existed prior to January 1, 2008.

Annual Depreciation Limitations
(50% additional first-year bonus depreciation applies)

Vehicles Subject to Luxury-Auto Limits (Information Taken from Tables 1, 2, and 3)	Annual Depreciation Limitations			
	Year 1	Year 2	Year 3	Year 4
Autos	$10,960	$4,800	$2,850	$1,775
Trucks and vans	11,160	5,100	3,050	1,875

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3. IRC §6001
4. IRC §274(d)
5. IRC §280F(b)(2)

If the business use of the vehicle is less than 100%, the dollar limits shown in the tables must be reduced accordingly. For example, if a taxpayer buys a new truck in 2008 to which the 50% first-year bonus depreciation applies and uses it 75% for business, the first-year dollar limit is $8,370 ($11,160 × 75%).

Tables are also provided in this Revenue Procedure to compute the amount for inclusion of lessees of passenger autos and trucks/vans.

Note. See Chapter 7, "Depreciation," for more information.

AT RISK

At-Risk Limitations

Hubert Enterprises, Inc. v. Comm'r, TC Memo 2008-46 (Feb. 28, 2008)
IRC §§465 and 761

☞ Recourse Debt Irrelevant in Determining At-Risk Amounts

Facts. Leasing Co., LLC (LCL) was formed in April 1998, and elected to be treated as a partnership for federal income tax purposes. LCL's members were HBW, Inc. (HBW), which owned 99 membership units, and Hubert Holding Co. (HHC), which owned one membership unit. LCL engaged in the business of purchasing and leasing equipment. In 1998, LCL purchased equipment from Capital Resources Group, Inc. (CRG). The purchase was financed by four promissory notes, of which two were partially recourse and two were nonrecourse. LCL again purchased equipment from CRG in 2000; this purchase was financed by two notes which were both partially recourse. Neither HBW nor HHC signed or guaranteed any of these notes.

LCL's initial operating agreement stated that, "[n]o member shall be liable as such for the liabilities of the Company." However, on March 28, 2001, LCL's members amended the operating agreement, stating that such amendment was to be effective as of January 1, 2000. The amended agreement contained a capital account deficit restoration provision (DRO), which stated in relevant part:

> ***Deficit Capital Account Restoration.*** *If any Partner has a deficit Capital Account following the liquidation of his, her or its interest in the partnership, then he, she or it shall restore the amount of such deficit balance to the Partnership by the end of such taxable year or, if later, within 90 days after the date of such liquidation, for payment to creditors or distribution to Partners with positive capital account balances.*

The revised agreement also provided:

> *Nothing express or implied in this Agreement is intended or shall be construed to confer upon or to give any person or entity, other than the parties or their successors-in-interest in accordance with the provision of this Agreement, any rights or remedies hereunder or by reason hereof.*

For its 2000 and 2001 taxable years, HBW took into account its proportionate share of LCL's recourse debt in computing its at-risk amounts under IRC §465(b). Upon audit, the IRS determined that HBW was not entitled to take such debt into account in making this computation, and therefore disallowed HBW's losses claimed in connection with its leasing activities to the extent such losses exceeded its at-risk amounts.

Issues. Whether HBW may take the amount of LCL's recourse debt into account in determining §465 at-risk amounts

Analysis. An amendment to a partnership agreement may only take effect for a taxable year when such amendment is made before the unextended due date of the partnership return.[6] The amount for which a taxpayer is at risk for an activity conducted during a taxable year must be computed as of the end of that year.[7] As a general matter, the amount of tax due for a given tax year is determined with reference to events that take place during that year.

A taxpayer is at risk for the amount of money and/or the adjusted basis of property contributed to a given activity.[8] He is also at risk for amounts borrowed in connection with an activity in which he is "personally liable for repayment of such borrowed amounts" or to the extent that he has pledged property (other than property to be used in connection with that activity) to secure the debt.[9]

Under 6th Circuit law (the law applicable to this case), the test for determining whether or not a taxpayer is at risk for a debt is whether he is the "payor of last resort." That is, a taxpayer is at risk for a debt only when he has a fixed and definite obligation to use personal funds to pay the debt in a worst-case scenario.

Holding. The court held that the March 28, 2001, amendment of LCL's operating agreement had no effect on the 2000 tax year. For the 2001 tax year, the court concluded that HBW was not a "payor of last resort" for LCL's recourse debt because:

- LCL's operating agreement only required HBW to contribute additional capital upon the liquidation of its interest in LCL, and then only to the extent of its negative capital account balance, if any;
- LCL's creditors had no right to force HBW to liquidate its interest;
- Additional capital contributions required by the DRO need not necessarily be paid to creditors; under the agreement, they could instead be distributed to other partners with positive capital account balances.

Therefore, the court held that HBW was not at risk for the recourse debt amounts for purposes of §465 for either 2000 or 2001.

BAD DEBT

Bad Debt Deduction

Bynum v. Comm'r, TC Memo 2008-14 (Jan. 28, 2008)
IRC §§166 and 6651

☞ Couple Not Entitled to Bad Debt Deduction

Facts. Douglas Bynum started an engineering consulting business as a sole proprietorship in 1976. In 1977, he incorporated the business as Starfire Engineering, Inc. When the corporation began to earn sufficient revenues, Bynum used some of these funds to pay startup costs for seven other businesses operated under Starfire. Bynum sold or ceased operations for each of these businesses between 1982 and 1986. Bynum did not demand or receive repayment for any of the startup expenses he incurred on behalf of these businesses. He dissolved Starfire in 1995; and in 2000 and 2001 on their joint return, the Bynums deducted these expenses as business bad debts. The Bynums filed their returns for 2000 and 2001 in April of 2004.

6. IRC §761(c)
7. IRC §465(a)(1)
8. IRC §465(b)(1)(A)
9. IRC §465(b)(2)

Issues. Whether the taxpayers were:

- Entitled to a bad debt deduction for the startup expenses
- Liable for failure-to-file penalty under IRC §6651

Analysis. A taxpayer may deduct bona fide debts that become worthless during the taxable year.[10] Bona fide debts arise from a debtor-creditor relationship and must involve enforceable obligations to pay fixed or determinable amounts of money. Whether or not a bona fide debt exists is "analyzed in terms of its economic reality," and based on the totality of the circumstances. Relevant factors include documents evidencing indebtedness, the inclusion of a fixed maturity date, the source of repayments, the right to enforce payment, the intent of the parties, and the failure of the corporation to repay on the due date. Contributions to capital are not bona fide debts.

A taxpayer is liable for a penalty equal to 5% of the amount that should have been shown on the return, or a maximum of 25%, for failure to timely file a tax return, unless such failure is due to reasonable cause and not willful neglect.[11]

Holding. The court held that Bynum's startup payments were contributions to capital rather than bona fide loans. This was determined based on the fact that:

- There was no valid or enforceable obligation to pay a fixed or determinable amount of money,
- There was no oral or written agreement establishing a debtor-creditor relationship,
- Bynum did not demand or receive any payments for the alleged loans, and
- The advances were not structured as or intended to be loans.

Furthermore, the Bynums presented no evidence that the advances, even if they were deemed to be loans, became worthless in 2000 or 2001.

The court rejected the Bynums' claim that health problems constituted reasonable cause for their failure to timely file their 2000 and 2001 returns. Accordingly, the court held that the Bynums' failure to file was not due to reasonable cause.

BANKRUPTCY AND DISCHARGE OF INDEBTEDNESS

Priority of Tax Liability in Bankruptcy

***In re: Donald Dawes and Phyllis Dawes,* No. 06-11237 United States Bankruptcy Court for the District of Kansas (Feb. 11, 2008)**
IRC §6871

☞ Post-Petition Capital Gains Liability is a General Unsecured Claim

Facts. Debtors Donald and Phyllis Dawes were subject to a judgment for back taxes of approximately $1.5 million plus interest due for the years 1982–1990. In August 2006, the Dawes filed for relief under Chapter 7 of the Bankruptcy Code, which was shortly thereafter converted to a Chapter 12 case (farm bankruptcy). The following October, the IRS obtained an order of stay relief for eight parcels of real estate. The Dawes proposed to pay that portion of their tax liability secured by the real estate by surrendering it to the IRS. The plan further proposed that:

> *[P]ursuant to 11 U.S.C. §1222(a)(2)(A), all claims of the IRS or Kansas Department of Revenue that arise post-petition as a result of the sale, transfer, exchange, or other disposition of the [nine parcels] shall be treated as a general unsecured claim not entitled to priority under §507.*

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10. IRC §166

11. IRC §6651

The IRS objected to this provision. The real estate was thereafter sold for more than $900,000, which gave rise to a new capital gains tax liability. In August 2007, the Dawes filed a motion for the court to characterize the post-petition capital gains liability resulting from the forced sale as a general unsecured claim under §1222(a)(2)(A) of the Bankruptcy Code. The IRS filed a reply claiming that this section does not apply to capital gains arising from post-petition sales.

Issues. Whether the capital gains liability arising from the forced sale of the real estate constitutes a priority claim under §507 of the Bankruptcy Code, and therefore may be treated as a general unsecured claim by operation of §1222(a)(2)(A).

Analysis. Section 1222(a)(2)(A) of the Bankruptcy Code (as amended in 2005) provides that:

> *(a) The plan shall –*
>
> *(2) provide for the full payment, in deferred cash payments, of all claims entitled to priority under §507, unless –*
>
> *(A) A claim owed to a governmental unit that arises as a result of the sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation, in which case the claim shall be treated as an unsecured claim that is not entitled to priority under §507, but the debt shall be treated in such manner only if the debtor receives a discharge.*

Section 507(a)(2) of the Bankruptcy Code provides that administrative expenses, which constitute one of the categories of priority claims, "are generally those that are incurred by the estate after the entry of an order for relief." Specifically, under §503(b)(1), administrative expenses include:

> *(A) the actual, necessary costs and expense of preserving the estate including –*
>
> *(B) any tax –*
>
> *(i) incurred by the estate, whether secured or unsecured, including property taxes for which liability is in rem, in personam, or both, except a tax of a kind specified in §507(a)(8) of this title.*

Relevant caselaw conflicts as to whether capital gains tax liability arising from the post-petition sale of farm assets under Chapter 12 qualifies as an administrative expense of the estate under §503(b)(1)(B). Moreover, according to the legislative history of the 1978 Bankruptcy Code:

> *In general, administrative expenses include taxes which the trustee incurs in administering the debtor's estate, including taxes on capital gains from sales of property by the trustee and taxes on income earned by the estate during the case. Interest on tax liabilities and certain tax penalties incurred by the trustee are also included in this first priority.*

Holding. The court held that §503(b)(1)(B)(i) of the Bankruptcy Code is ambiguous as to whether capital gains tax liability qualifies as an administrative expense "of the estate," as this phrase could apply either to the time at which the liability accrues (i.e., before or after the creation of the bankruptcy estate) or the entity liable for the tax. The court therefore turned to legislative history to determine the meaning of the phrase "of the estate" in §503(b)(1)(B). Following the usage of the term "estate" in the legislative history of the Bankruptcy Code of 1978, the court concluded that, for the purposes of determining administrative expense status, the "estate" refers to the time at which the liability was incurred rather than the entity responsible for the tax. The court therefore rejected the IRS's argument that the Dawes' capital gains tax liability was not an administrative expense "of the estate" because it was the personal liability of the Dawes rather than the liability of the bankruptcy estate.

The court proceeded to observe that the IRS had made arguments which contradict its current interpretation of §503(b)(1)(B)(i) in previous cases where it sought the benefit of administrative expense priority for tax liability in Chapters 7 and 11 cases. It further noted that the construction it adopted is more consistent with the clearly expressed Congressional policy to make reorganization less burdensome for farmers. Because the court held that the Dawes' capital gains tax liability qualifies as an administrative expense under §503(b)(1)(B)(i) and, therefore, as a priority claim under §507(a)(2), the liability may be treated as a general unsecured liability under §1222(a)(2)(A), subject to the condition that the Dawes receive a discharge.

> **Note.** See Chapter 13, "Financial Distress," and Chapter 14, "Agricultural Issues and Rural Investments," for more information on Chapter 12 bankruptcy.

Mortgage Debt Relief

IRS News Release IR-2008-17 (Feb. 8, 2008)
IRC §108

☞ Mortgage Debt Partially or Completely Forgiven

Facts. The IRS announced that homeowners whose mortgage debt was partially or entirely forgiven during 2007, 2008, or 2009 may be eligible for special tax relief by filing a newly revised Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and §1082 Basis Adjustment)* (shown following).

Normally, debt forgiveness is considered taxable income. However, under the Mortgage Forgiveness Debt Relief Act of 2007, taxpayers may exclude debt forgiven on their principal residence if the balance of their loan was less than $2 million. For married taxpayers filing separately, this limit is $1 million. Debt forgiveness related to mortgage restructuring or foreclosure may qualify for this relief. Debt forgiven on second homes, rental property, business property, credit cards or car loans does not qualify for relief.

Borrowers whose debt is forgiven in whole or part receive a Form 1099-C from their lender. The IRS urges taxpayers to carefully check their Forms 1099-C and immediately report any errors to their lender. In particular, taxpayers should check the amount of debt forgiven (box 2) and the value listed for their home (box 7).

> **Note.** See additional information on mortgage debt relief in Chapter 13, "Financial Distress," and in Chapter 11, "New Legislation."

Form **982** (Rev. February 2008) Department of the Treasury Internal Revenue Service

Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

▶ Attach this form to your income tax return.

OMB No. 1545-0046

Attachment Sequence No. **94**

Name shown on return | **Identifying number**

Part I **General Information** (see instructions)

1 Amount excluded is due to (check applicable box(es)):
a Discharge of indebtedness in a title 11 case . . . ☐
b Discharge of indebtedness to the extent insolvent (not in a title 11 case) . . . ☐
c Discharge of qualified farm indebtedness . . . ☐
d Discharge of qualified real property business indebtedness . . . ☐
e Discharge of qualified principal residence indebtedness . . . ☐
2 Total amount of discharged indebtedness excluded from gross income. . . . 2
3 Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property?. . . ☐ Yes ☐ No

Part II **Reduction of Tax Attributes.** You must attach a description of any transactions resulting in the reduction in basis under section 1017. See Regulations section 1.1017-1 for basis reduction ordering rules, and, if applicable, required partnership consent statements. (For additional information, see the instructions for Part II.)

Enter amount excluded from gross income:

4	For a discharge of qualified real property business indebtedness, applied to reduce the basis of depreciable real property . . .	4	
5	That you elect under section 108(b)(5) to apply first to reduce the basis (under section 1017) of depreciable property . . .	5	
6	Applied to reduce any net operating loss that occurred in the tax year of the discharge or carried over to the tax year of the discharge . . .	6	
7	Applied to reduce any general business credit carryover to or from the tax year of the discharge	7	
8	Applied to reduce any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge . . .	8	
9	Applied to reduce any net capital loss for the tax year of the discharge including any capital loss carryovers to the tax year of the discharge . . .	9	
10a	Applied to reduce the basis of nondepreciable and depreciable property if not reduced on line 5. *DO NOT use in the case of discharge of qualified farm indebtedness.* . . .	10a	
b	Applied to reduce the basis of your principal residence. *Enter amount here ONLY if line 1e is checked* . . .	10b	
11	For a discharge of qualified farm indebtedness, applied to reduce the basis of:		
a	Depreciable property used or held for use in a trade or business, or for the production of income, if not reduced on line 5 . . .	11a	
b	Land used or held for use in a trade or business of farming . . .	11b	
c	Other property used or held for use in a trade or business, or for the production of income .	11c	
12	Applied to reduce any passive activity loss and credit carryovers from the tax year of the discharge	12	
13	Applied to reduce any foreign tax credit carryover to or from the tax year of the discharge . .	13	

Part III **Consent of Corporation to Adjustment of Basis of Its Property Under Section 1082(a)(2)**

Under section 1081(b), the corporation named above has excluded $ ______________ from its gross income for the tax year beginning ______________ , and ending ______________ .
Under that section, the corporation consents to have the basis of its property adjusted in accordance with the regulations prescribed under section 1082(a)(2) in effect at the time of filing its income tax return for that year. The corporation is organized under the laws of ______________ .
(State of incorporation)

Note. *You must attach a description of the transactions resulting in the nonrecognition of gain under section 1081.*

For Paperwork Reduction Act Notice, see page 4 of this form. Cat. No. 17066E Form **982** (Rev. 2-2008)

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Mortgage Debt Relief

Publication 4681, *Cancelled Debts, Foreclosures, Repossessions, and Abandonments* (June 8, 2008)

☞ Pub. 4681 Released to Help With Debt Cancellation and Mortgage Situations

The IRS reviews the tax treatments of cancelled debts resulting from foreclosures, repossessions, and abandonments. The publication highlights important changes, including qualified personal residence indebtedness and the end of the exclusion for debt cancelled following Hurricane Katrina.

Generally, forgiven debt is considered income. In certain circumstances, taxpayers can avoid this income recognition with the reduction of "tax attributes." Publication 4681 describes the tax relief available to taxpayers struggling with mortgage debt.

Turnover of Tax Refund

Edwin D. Bailey et ux. v. Andrew W. Suhar, No. 07-8016 U.S. Bankruptcy Appellate Panel of the Sixth Circuit (Jan. 18, 2008)
IRC §6871

☞ Taxpayer gave Attorney Tax Refund to Give to Bankruptcy Court

Facts. The taxpayers voluntarily filed for Chapter 7 bankruptcy protection. At the time of the first bankruptcy hearing, the taxpayers told the bankruptcy trustee they had not yet filed their income tax return. They were advised that if they received a refund they must turn it over to the trustee. They also signed an acknowledgement to this conversation.

After the taxpayers filed their return, they subsequently received a federal refund of $3,430 and a state refund of $620. The taxpayers allege their bankruptcy attorney advised them they were entitled to retain $1,600 of the federal refund, because it was exempt. They then gave the attorney the remainder of the federal refund ($1,830) to forward to the trustee.

The attorney later gave $717 back to the taxpayers and apparently kept another $717 for fees. The trustee filed a motion for turnover of the tax refunds. The attorney responded to the motion and then resigned from the case three days later.

Issue. Are the taxpayers required to give the bankruptcy trustee the $3,430 federal refund even though they no longer have the money in their possession?

Analysis. Federal income tax refunds attributed to the pre-petition portion of the tax year are property of the bankruptcy estate.

Holding. The fact that the taxpayers received erroneous advice from their attorney does not override the turnover requirement. The court analyzed the numbers and determined that the taxpayers did have in their possession at one time all but $717 of the refunds. Even though the taxpayers did not have the $717 from attorney fees in their possession at the time of the turnover motion, they are still required to turn over the entire refund of $3,430.

BUSINESS EXPENSES

Substantiation of Business Expenses

Showler v. Comm'r, TC Summ. Op. 2008-8 (January 29, 2008)
IRC §162

☞ Business Expense Deduction Disallowed

Facts. Peter Showler worked as an independent contractor for National Planning Corp. (NPC). He sold securities and other financial products. He received his compensation in the form of commissions, which were direct deposited into one of his two bank accounts. One of these accounts was Showler's own personal account, the other was a joint account he shared with three business associates. Showler and these business associates each owned a 25% interest in Wise Steward Corp. (Wise).

NPC paid Showler two forms of commissions: "regular" and "override" commissions. Nearly all funds paid to Showler as override commissions were first deposited into Showler's joint account and then were promptly transferred to Wise's business account.

Showler claimed deductions for commissions and fees, travel, meals and entertainment, charitable donations, bonuses, gifts, and memberships. The amount claimed for commissions and fees was equal to the amount NPC paid Showler as override commissions. The IRS disallowed all of Showler's claimed deductions. With the exception of the amount claimed for commissions and fees, Showler provided only incomplete, duplicative and contradictory records in support of his claimed deductions.

Issues. Whether Showler is entitled to:

- A deduction for commissions and fees paid
- Other claimed deductions

Analysis. A taxpayer is generally entitled to a deduction for all ordinary and necessary expenses incurred in carrying on a trade or business.[12] The taxpayer bears the burden of substantiating all deductions with adequate records. Such records must be organized and the taxpayer must clearly demonstrate the relationship between the record and the claimed deduction. Deductions are disallowed for **personal expenses** under §262 and for **illegal payments** under §162(c).

Holding. The court found Showler's records concerning all deductions — except for the deduction claimed for commissions and fees — to be contradictory, unclear, and unreliable. Furthermore, many of the claimed deductions were for nondeductible personal expenses. Accordingly, the court sustained the IRS's disallowance of these deductions.

However, the court determined that Showler's claimed deduction for commissions and fees was adequately substantiated and valid, except for the small amount of the override commissions that was not transferred to Wise's business account. The court rejected the IRS's argument that the payments were either unreasonable or illegal under §162(c).

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12. IRC §162

Professional Gambler

Michael N. and Barbara J. Merkin v. Comm'r, TC Memo 2008-146 (June 5, 2008)
IRC §§162, 165, and 6662

☞ Video Poker Activity Was Not a Trade or Business

Facts. Doctor Merkin was a successful self-employed psychiatrist with offices on Park Avenue in New York City. He explored new ways to augment his income after his retirement. His choice was video poker. He perfected his system, which he was certain could improve his odds of winning video poker jackpots at a Connecticut casino.

In 2003, he was issued a Form W-2G from the casino reflecting his gross winnings for the year. He reported the gambling activity on a Schedule C showing the following income and expenses:

Gross receipts (per Form W-2G)	$691,575
Less: gambling losses	(710,249)
2003 Schedule C net loss	**($ 18,674)**

The IRS determined that Dr. Merkin was not a professional gambler and could not deduct his gambling losses on Schedule C. Instead, the Form W-2G winnings were reportable in arriving at AGI and an equal amount was deductible on Schedule A as other miscellaneous deductions. The IRS assessed additional tax of $21,150 and an accuracy-related penalty of $4,300.

Issues. Whether:

- Dr. Merkin was engaged in a trade or business of gambling during 2003
- The accuracy-related penalty was properly applied

Analysis. The taxpayers argued that Dr. Merkin was in the trade or business of gambling because he pursued the activity in good faith, with regularity, and for the production of income.

Holding. The court relied on the nine subjective factors found in Treas. Reg. §1.183-2(b) and concluded that the video poker activity did not constitute a trade or business. Consequently, the examination determination of the IRS was upheld, including the application of the accuracy-related penalty.

> **Note.** The taxpayers had previously deducted Schedule C gambling losses totaling $105,326 for the tax years 1999 through 2002. Apparently, the IRS did not examine the tax returns for those years.

Unsubstantiated Daycare Expenses

Jonell Marie Broady v. Comm'r, TC Summ. Op. 2008-63 (June 5, 2008)
IRC §162

☞ Expense Deduction not Allowed for Failure to Substantiate

Facts. During 2003, Jonelle M. Broady operated a daycare business out of her rented home in Bowie, Maryland. On her original return filed for 2003, she did not report the income from the daycare business and claimed an earned income tax credit.

The IRS determined a deficiency as a result of limited income reported to support the earned income tax credit claimed. The taxpayer then filed an amended tax return reflecting income and expense on a Schedule C for her daycare business for 2003. The daycare expenses of $12,445 were challenged.

Upon examination, the taxpayer did not provide any documentation to support the following claimed expenses:

- Advertising expenses — $200
- Car and truck expense (mileage, insurance and repairs) — $1,295
- Office supplies (pens and paper) — $6,500
- Utility expense — $1,780
- Repairs and maintenance — $220
- Other supplies (arts and craft supplies) — $630
- Food costs — $1,820

Without any documentation, the IRS disallowed those expenses. The taxpayer offered testimony for her expenses but no written evidence.

Issue. Whether the taxpayer is allowed to deduct any expense for her daycare business.

Analysis. A taxpayer is generally entitled to deduct all ordinary and necessary expenses incurred in carrying on a trade or business.[13] Ms. Broady did not provide any records to support the deduction for daycare expenses. Based on the *Cohan* case,[14] the IRS concluded that it would be inappropriate to estimate such expenses.

Holding. The court agreed with the IRS's disallowance of expenses for the daycare operations.

CAPITAL GAINS AND LOSSES

WorldCom Stock

Mehdi Taghadoss v. Comm'r, TC Summ. Op. 2008-44 (April 29, 2008)
IRC §165

☞ Neither Casualty, Theft, nor Worthless Stock Arguments Help

Facts. Mr. Taghadoss worked for WorldCom for 17 years during which time he received options to purchase stock. He acquired shares of stock through (1) the exercise of stock options on October 31, 2001, (2) purchase on the open market, (3) WorldCom's §401(k) plan, and (4) WorldCom's employee stock purchase plan. WorldCom filed Chapter 11 bankruptcy on July 21, 2002. Fraudulent accounting practices were used by WorldCom executives, resulting in the dramatic decline of the stock value. Mr. Taghadoss claimed a casualty or theft loss totaling $1,344,863 on his 2003 Form 1040 resulting in a $26,853 refund.

In late 2003, WorldCom's plan of reorganization was confirmed by the bankruptcy court; and it finally emerged from bankruptcy on April 20, 2004. The value of his 31,083 shares was then slightly under $700. On May 12, 2004, Mr. Taghadoss's broker issued a notification stating his 31,083 securities were no longer transferable because WorldCom has closed its transfer books.

The IRS disallowed the $1,344,863 claimed casualty or theft loss deduction.

Issue. Whether Mr. Taghadoss is entitled to claim a casualty or theft loss deduction for the loss of value in his WorldCom stock options and stock holdings.

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13. IRC §162

14. *Cohan v. Comm'r,* 39 F 2d 540 (2d Cir 1930)

Analysis. IRC §165(a) allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. In order for the loss to be deductible, the loss must be evidenced by a closed and completed transaction, fixed by an identifiable event, and actually sustained during the taxable year.

Holding. Because Mr. Taghadoss's loss clearly resulted from the misconduct of certain WorldCom officials, bankruptcy filings, and liquidation of securities due to WorldCom's plan of reorganization, a casualty loss was not sustained.

The question then becomes whether the fraudulent acts of the corporate officials constitute a theft. This becomes a question of law in the state where the loss occurred. Mr. Taghadoss alleged that he received several memos in which WorldCom officials said that everything was "fine." However, those documents were not provided during the trial. Mr. Taghadoss did not establish that he relied on the misrepresentations and, thus, the court did not support the claimed theft loss deduction.

In an attempt to provide Mr. Taghadoss some tax relief, the court went one step further and explored the possibility that the losses might be deductible as worthless securities. However, the court concluded, the stock was not worthless.

Noncompete Agreement

Irwin Muskat v. U.S., No. 1:06-cv-00030, U.S. Dist. Ct. for District of New Hampshire (Apr. 2, 2008)
IRC §§1222, 1231, and 7422

☞ Payment Treated as Ordinary Income

Facts. Irwin Muskat (Muskat) was the CEO of a successful meat packing company, Jac Pac Foods, Ltd. (Jac Pac). After lengthy negotiations, Jac Pac was sold to CBFA. The agreement included installment payments totaling $3,955,599 to Muskat, with the first payment of $1 million paid at the time of closing. The agreement required Muskat to work for CBFA. The agreement also prohibited Muskat from soliciting employees to leave the company and diverting business from the company. The agreement was for a 13-year period.

Muskat filed his 1998 income tax return and reported the $1 million payment as ordinary income. He paid income tax and SE tax. In 2002, the Muskats filed an amended return and claimed the $1 million was miscategorized on the original return and was not ordinary income but was instead a payment for personal goodwill. Consequently, it should be taxed at the capital gains rate and be exempt from SE tax. The amended return requested a refund of $203,434. The IRS asserted the payment was properly taxed as ordinary income.

At trial, two issues were raised. One was whether the SE issue could be raised in court because it was not included in the original claim presented to the court. The other issue was whether the $1 million payment was made for a noncompete agreement or for personal capital gain.

Analysis. In the claim for refund, Muskat included the SE tax in the original refund amount. Recategorizing the payment from ordinary income to capital gain income would no longer make the payment subject to SE tax. However, Muskat did not present a challenge that even if the payment was ordinary income, a noncompete agreement does not constitute a trade or business and therefore is exempt from SE tax. The IRS challenged the new claim under the "variance doctrine." This doctrine prohibits a taxpayer from bringing suit to recover a tax refund or a credit "until a claim for refund or credit has been duly filed with the Secretary, according to the provision of law in that regard, and the regulation of the Secretary established in pursuance thereof."[15]

15. IRC §7422(a)

A noncompete agreement results in ordinary income and goodwill results in capital gain income. The court heard testimony from the buyer regarding the negotiation between JacPac and CBFA. The buyer admitted that goodwill was a substantial part of the negotiation process and included $15 million as part of the JacPac's purchase price. However, he said there was never any mention in the negotiations of personal goodwill for Muskat. CBFA requires a noncompete agreement with the principals on any business they purchase and consequently agreed to make a payment directly to Muskat.

Holding. The court agreed with the IRS and ruled the SE issue could not be addressed by the court because the argument was not filed with the original claim. Therefore, no ruling was made on whether a noncompete agreement constitutes a trade or business.

Based on the testimony, the court agreed with the IRS that the entire payment to Muskat was for a noncompete agreement and consequently represented ordinary income. Therefore, the court upheld the IRS's denial of the requested refund.

Insurance Company Demutualization

Fisher, et al. v. U.S., **U.S. Court of Federal Claims, 04-01726T (Aug. 6, 2008)**
IRC §§61 and 1001

☞ Tax Basis Equal to Premiums Paid When Insurance Company Demutalizes

Facts. Mr. Fisher received 3,982 shares of Sun Life Assurance common stock in early 2000 as a result of the demutualization of the life insurance company. Mr. Fisher opted for the "cash election" which permitted Sun Life to sell his shares on the open market for $31,759. Mr. Fisher reported the entire amount of the sale on his 2000 income tax return, and paid $5,729 in federal income taxes.

Fisher then filed a claim for refund with the IRS because he believed that the proceeds from the sale represented a nontaxable policy dividend distribution from the Sun Life insurance company. The IRS denied Fisher's initial claim because the distribution by Sun Life was not a policy dividend.

Issue. Whether:

- A capital gain results from the sale of stock received as a result of a demutualization
- Proceeds of the sale are offset by Fisher's income tax basis in the stock

Analysis. Gross income includes gains derived from dealings with property.[16] Gain from the sale or other disposition of property is the excess of the amount realized over the property's adjusted basis.[17] The adjusted basis of property in this case is generally its cost.[18] When only a portion of the property is transferred, then the basis generally must be apportioned between the portion disposed of and retained.[19]

The IRS maintains the basis of stock received as a result of an insurance demutualization is zero. However, a value of the ownership rights sold by the policyholders of Sun Life was determined to have a basis as a result of an actuarial study by Sun Life. The value of these ownership rights equate to the value of stock received at the time of demutualization. This study specifically stated the stock allocation by Sun Life fairly compensated the policyholders for the loss of control of the company and the right to share in the company's residual value.

16. IRC §61(a)(3)
17. IRC 1001(a)
18. IRC 1011(a)
19. Treas. Reg. §1.61-6(a)

Holding. The court held Fisher's cost basis in the Sun Life insurance policies which were converted into Sun Life common stock upon demutualization was determined by the amount of premiums paid by Fisher. Since the premiums paid exceeded the amount received in demutualization, Fisher did not realize any income on the sale of his stock. As such, Mr. Fisher was entitled to a full refund of taxes paid on the gain of the sale of his Sun Life stock.

The court did not address the holding period for the purpose of long-term capital gain considerations. However, Rev. Rul. 2003-19 discusses variations on the demutualization theme. In essence, the holding period starts when the taxpayer first has an equity interest in the mutual insurance company.

Observation. As of August 2008, a total of 34 life insurance companies have demutualized. Most of these companies converted to a stock company between 1996 and 2002. Policyholders in these companies received cash or stock in exchange for their interest in the mutual insurance company. As a result, many policyholders that received their stock from the demutualization process have sold their stock, and reported the full capital gain with a zero basis on their respective Schedules D. If the stock sale occurred before the 2005 tax year, and the gains reported on the tax return matched the proceeds received, and no protective claim was filed, no relief is available.

However, relief is available for taxpayers who sold the stock they received as a result of a demutualization in 2005 or later years. If the sale was reported in a year for which the statute of limitations remains open (2005–2007), taxpayers can amend their tax returns (in light of the *Fisher* case) to reflect a tax basis for their insurance stock sold. The basis cannot exceed the FMV of the insurance stock at the time of the demutualization. Any appreciation between the date of demutualization and the sale date is taxed as a capital gain.

For those shareholders still holding stock received as a result of demutualization, the cost basis cannot exceed either the premiums paid or the FMV of the stock at the time of demutualization.

Note. Chapter 2, "Ethics" contains more information on protective claims.

CASUALTY LOSS

Presidential Disaster Areas

IRS Website (www.IRS.gov)

IRC §165(i)

☞ Disaster Loss can be Claimed on Prior Year's Return

In 2008, there were a number of storms that resulted in many counties in numerous states being declared a presidentially-declared disaster area. A complete list of the qualifying counties can be found at **www.irs.gov/newsroom/article/0,,id=98936,00.html.** Taxpayers in a declared disaster area may be entitled to an extended tax return filing deadline as announced for flood victims in Illinois, Iowa, Nebraska, West Virginia, and Wisconsin.[20]

IRC §165(i) provides regulations that allow taxpayers who sustain a loss attributable to a disaster in a presidentially-declared disaster area to elect to claim the loss on their tax return filed for the previous year. For example, eligible 2008 taxpayers may claim the loss on an original or amended 2007 return.

The election is made by filing the applicable return and claiming the deduction. The return must be filed before the due date of the return for the year in which the disaster occurred. This is the due date before extensions. Alternatively, the election may be filed for the immediately preceding year by the due date for that return including extensions.

Claiming the deduction on the preceding year's return allows the taxpayer to claim a refund and have access to the funds without waiting until yearend. If the deduction results in a net operating loss, the NOL may be carried back to an earlier year.

20. IRS News Release IR-2008-89 (July 14, 2008)

CLERGY

Rental Allowance

Ltr. Rul. 200803008 (October 18, 2007)
IRC §107

☞ IRS Rules on Exclusion of Rental Allowance for Clergy

Facts. A university founded by a religious denomination requested a ruling regarding the taxability of rental allowances paid to the clergy. The university teaches all subjects from a biblical perspective; and its graduate program prepares students for positions as pastors, missionaries, and other religious posts. Ordained, commissioned, or licensed ministers of the denomination teach and serve in various executive, management, or administrative positions at the university.

Analysis. Gross income does not include the rental value of a home furnished as a part of compensation for a "minister of the gospel."[21] A rental allowance paid as a part of compensation, to the extent the recipient uses the allowance to rent or provide a home, is also excluded as long as the allowance does not exceed the fair rental value of the home. This includes the cost of a garage and the cost of utilities.

To qualify for the exclusion, the home or rental allowance must be provided for services which are ordinarily the duties of a minister of the gospel.

Holding. The IRS found the university was an integral agency of the denomination and under the denomination's authority. The university is required to furnish annual reports, financial statements, and annual audits to the denomination. Therefore, the rental allowances paid to the faculty are excludable from gross income under §107.

CORPORATIONS

Reasonable Compensation

E. J. Harrison & Sons, Inc. v. Comm'r, U.S. Court of Appeals, 9th Circuit; 06-74316 (Mar. 20, 2008)
IRC §§162 and 142

☞ Appellate Court Upholds Determination of Reasonable Compensation

Facts. During the 1995, 1996, and 1997 tax years, taxpayer Mrs. Harrison ("Harrison") served as a member of the board for E. J. Harrison & Sons, Inc. ("Harrison Inc."). At trial, the Tax Court held that a portion of her compensation was unreasonable. The 9th Circuit Court of Appeals reversed, holding that the Tax Court had applied the proper legal standard in determining that some portion of Harrison's compensation was unreasonable but that it improperly ignored evidence that her duties were at least as extensive as those of her sons, who were also members of the board. The appellate court remanded the matter to the Tax Court to determine a reasonable amount that was no lower than the amount paid to her sons. On remand, the Tax Court determined reasonable compensation amounts of $500,000 for 1995 and 1996 and $400,000 for 1997.

Issues. Whether the Tax Court's determination of reasonable compensation for Harrison was clearly erroneous

Analysis. An appellate court may not overturn a trial court's finding of fact unless that finding is "clearly erroneous." The taxpayer bears the burden of establishing the reasonableness of amounts deducted as compensation.[22]

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21. IRC §107

22. IRC §142(a)

Holding. The appellate court held that the Tax Court's determination was not clearly erroneous given the relative lack of evidence regarding the reasonableness of her compensation provided by Harrison. It rejected Harrison's contention that it used the "hypothetical investor" standard, and it denied her request to supplement the record on the grounds that she had already had ample opportunity to introduce relevant evidence.

S Corporation Disproportionate Distributions

Ltr. Rul. 200802002 (September 28, 2007)
IRC §§1361 and 1362

☞ Disproportionate Distribution did not Terminate S Election

Facts. An S corporation made disproportionate distributions to its three shareholders during the tax year. Upon recognition of the error, it made corrective distributions in a subsequent year. When requesting the ruling, the corporation stated that each shareholder had identical rights in liquidation proceeds and distributions. It also said there were no other agreements which contradict these rights. The corporation also stated it had intended to be an S corporation since inception. The corporation requested the letter ruling in order to determine if it had lost its S election.

Analysis. An S corporation is required to have only one class of shareholders. If distributions are not made proportionate to the shareholders' stock holdings, the corporation is deemed to have more than one class of stock.[23]

Holding. The IRS held the disproportionate distributions did not create a second class of stock for purposes of IRC §1361(b)(1)(D).

Constructive Distributions

Alan Beckley and Virginia Johnston Beckley v. Comm'r, 130 TC No.18 (June 30, 2008)
IRC §61

☞ Payments Received by Taxpayer were not Constructive Dividends

Facts. Alan Beckley and Robert Ebert formed a corporation, Computer Tools, Inc. (CT) to develop computer services for graphic designers. Both Alan and Robert were 50% shareholders in the corporation.

CT borrowed at least $106,834 from Alan's wife, Virginia Beckley, during the period from 1988 through 1998 when CT was often short of funds for operations. Part of the funds CT borrowed from Virginia were used to develop a working model of web-based videoconferencing software. CT never repaid any of the funds it borrowed from Virginia before its dissolution in 1998.

In 2000, VirtualDesign.net, Inc. (VDN) was formed as a C corporation in which Alan and Robert were shareholders. VDN was established to carry on CT's business and to continue product development. The working model developed by CT and financed by Virginia was subsequently transferred to VDN. VDN did not execute a written loan assumption agreement for CT's debt to Virginia.

In 2001, VDN paid Virginia $95,434. VDN treated $58,600 of the total as interest and the balance of $36,834 as a nontaxable repayment of loan principal. VDN issued a Form 1099-INT to Virginia in the amount of $58,600. No portion of the $95,434 was reported as a corporate distribution to Alan.

Alan and Virginia reported $58,600 as interest income on their 2001 joint federal income tax return. The couple treated the balance as a nontaxable repayment of loan principal. They did not report any corporate distribution to Alan from VDN with respect to the funds Virginia received from VDN.

23. IRC §1361(b)(1)

In 2002, VDN paid Virginia $70,000, which VDN reported as **nonemployee compensation**. No portion of the $70,000 was reported as a corporate distribution to Alan.

The Beckleys treated the $70,000 Virginia received from VDN in 2002 as a **nontaxable repayment of principal** for federal tax purposes. Again, the couple did not report any corporate distributions to Alan from VDN.

The IRS audited the Beckley's 2001 and 2002 returns. Although the IRS did not dispute the way the couple reported the payments that Virginia received from VDN, they did treat half of the payments Virginia received from VDN ($47,717 in 2001 and $35,000 in 2002) as corporate distributions to Alan, subject to capital gains tax. The position held by the IRS was that VDN's loan payments to Virginia were made on the basis of a personal moral obligation of Alan and Robert to repay Virginia, and not because of any legal obligation to do so.

Issues. Whether a portion of the payments Virginia received represented taxable constructive corporate distributions to her husband, Alan, in addition to being taxable interest income and nontaxable payment of loan principal to Virginia.

Analysis. Shareholders may be treated as having received constructive distributions when the corporation pays personal expenses of the shareholders. Shareholders may be held as having received constructive distributions even though the payments were not made directly to the shareholders, but went, instead, to third parties. An example of this is when a corporation makes lease payments on an automobile used by the corporate owner's wife. The wife has no employee or creditor relationship to the corporation which could explain such lease payments. In this situation, the lease payments are treated as constructive distributions to the shareholder husband.[24]

Although there was no written agreement establishing VDN's obligation to Virginia, VDN's conduct in actually making payments to her reflected the nature of the payments as loan principal and interest. Additionally, VDN's issuance of a Form 1099-INT to Virginia in 2001 showed that the $58,600 represented loan interest. When VDN acquired the working model from CT, which was developed by using funds that Virginia loaned to CT, VDN received the benefit of Virginia's loan and thus would be unjustly enriched if VDN did not repay the loan.

Holding. The payments Virginia received were associated with the creditor relationship that she had with CT, to which VDN succeeded; thus, these funds were held to be interest and principal payments. No portion of these funds was treated as constructive corporate distributions to Alan.

CREDITS

Overlooked Credits

IRS News Release IR-2008-1 (Jan. 2, 2008)
IRC §§55, 32, 24 and 25B

☞ Taxpayers Reminded to Take Advantage of Credits

Purpose. In its first announcement of the year, the IRS reminded taxpayers to review the most overlooked credits. If the taxpayer qualifies for one of the credits, he can reduce his tax liability.

Analysis. The IRS noticed that many taxpayers did not claim credits they were entitled to claim on previous returns. These credits include:

- Alternative minimum tax credit
- Earned income credit
- Child credit
- Retirement savings credit

24. *HJ Builders, Inc. v. Comm'r,* TC Memo 2006-278 (Dec. 28, 2006)

DEDUCTIONS

Theft Loss Deduction

Aben E. Johnson et ux. v. U.S., Nos. 01-428T, 03-2803T, 05-1265T, U.S. Court of Federal Claims, (Jan. 9, 2008)
IRC §§165(a) and (e)

☞ Victims of Fraud Entitled to Partial Theft Loss Deduction

Facts. Mr. and Mrs. Johnson were victims of a fraud perpetrated by John Hansson and his associates in 1997. Their total loss from the fraud was $78,160,409. The Johnsons brought civil actions in multiple jurisdictions against Hansson and his co-conspirators. In response, Mr. Hansson filed various counterclaims and took extensive steps to conceal his assets, including transferring funds to his attorney, his bookkeeper, various trusts, international bank accounts in the Isle of Man and France, and his estranged wife. As of December 31, 1998, the Johnsons believed they had only a reasonable likelihood of recovering $19,919,718 of their loss. As of the date of the present litigation, the Johnsons had actually recovered $39,288,079 from Mr. Hansson and his associates, including $20,346,362 held in Mr. Hansson's French bank account. The most the Johnsons could possibly recover as of the end of 2001 was $39,548,563 (the $20,346,362 in the French bank account plus the $19,202,202 in other ongoing claims).

The taxpayers argued that they should be entitled to a theft loss deduction of $58,240,691 in 1998, or, alternatively, of $57,562,745 in 2001. The IRS argued that, because none of the Johnsons' claims were resolved in 1998 and they were still pursuing some claims for reimbursement in 2001, they could not ascertain with reasonable certainty what amount they would recover in either year. Therefore, the IRS asserted that the Johnsons were not entitled to any theft loss deduction until 2005 at the earliest.

Issues. Whether the taxpayers are entitled to a theft loss deduction for 1998, or, alternatively, for 2001

Analysis. A taxpayer is permitted to take "as a deduction any loss sustained during the taxable year and not compensated by insurance or otherwise."[25] Also, "for the purposes of subsection (a), any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss."[26]

A taxpayer is generally entitled to a theft loss deduction during the taxable year in which the taxpayer discovers the loss (not the year in which the loss actually occurs, unless the year of loss and the year of discovery are the same year).[27] However, if in the year of discovery there exists a "reasonable prospect of recovery," no deduction is permitted until it can be "ascertained with reasonable certainty whether or not such reimbursement will be received."[28] A taxpayer may ascertain with reasonable certainty reimbursement, "by a settlement of a claim, by adjudication of the claim, or by an abandonment of the claim."[29]

Holding. In previous litigation, the court held that the Johnsons were not entitled to any theft loss deduction for the fraud in 1997, the year of discovery of the loss, because they still had a "reasonable prospect of recovery." In the present litigation, the court held that, as of December 31, 1998, the Johnsons had not ascertained with reasonable certainty what amount they would recover because they based their prediction of recovery on their lawyers' "conservative estimate… based on their experience in litigation, collection and valuation," and were still initiating new claims against Mr. Hansson's associates.

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25. IRC §165(a)
26. IRC §165(e)
27. Treas. Reg. §1.165-8(a)(2)
28. Treas. Reg. §1.165-1(d)(2)
29. Treas. Reg. §1.165-1(d)(2)(i)

Contrary to the IRS's position, the court held that the Johnsons were entitled to a theft loss deduction for a portion of their loss in 2001 before they had determined exactly how much of their loss they would ultimately recover. Because many of the Johnsons' claims had been settled, adjudicated, or abandoned by the end of 2001, the court held that they were entitled to a deduction for a portion of their losses in that year.

However, because the Johnsons were still pursuing a claim in France (a claim that they were ultimately successful in collecting), they were not entitled to a deduction for the $20,346,362 recovered. The court held that the Johnsons were entitled to a theft loss deduction of $37,216,382 as shown in the following chart:

Total loss	$78,160,409
Less: actual amount recovered as of December 31,2001	(1,395,463)
Less: recovery from French bank account	(20,346,362)
Less: other remaining claims	(19,202,202)
2001 theft loss allowed	**$37,216,382**

Gambling Losses

Gagliardi v. Comm'r, TC Memo 2008-10 (Jan. 24, 2008)
IRC §§6651, 6662 and 165

☞ Individual Substantiates Gambling Losses

Facts. Before 1991, Francis Gagliardi ran a sole proprietorship trucking business. In 1991, Gagliardi won approximately $26.7 million in the California lottery. He elected to receive his winnings in the form of a 20-year annuity, with payments of $1,333,000 each year. In 1994, he and his wife divorced. Pursuant to the terms of the divorce, Mr. Gagliardi and his ex-wife each were entitled to receive $666,500 for the remaining years.

After a trip to a casino with a friend in 1996, Gagliardi developed a serious gambling problem. He gambled heavily in 1997 and 1998. From 1999 through 2001, he spent most of his time gambling (an average of 20 days per month, for 10 hours on each of those days). Over this period, he played slot machines at least four or five times per minute. His average bet was at least $9. Gagliardi's losses for each of the years in question were substantial.

Although Gagliardi did not maintain a contemporaneous "gambling log," (which his accountant and tax preparer did not advise him to do) he retained all his receipts and records relating to his gambling winnings and losses including ATM receipts, copies of checks, bank and credit card statements, and Forms W-2G he received at the casinos. Gagliardi provided all this documentation to his accountant, Mr. Hunner. Hunner never indicated that these records would be insufficient to prepare his return. Hunner believed Gagliardi's gambling losses were even greater than the amount reported, and, to be conservative, he did not include any of Gagliardi's ATM withdrawals made outside the casinos.

Gagliardi timely filed his 1999 return, but did not file his 2000 and 2001 returns until 2003. The IRS disallowed some of Gagliardi's claimed gambling losses, and determined a deficiency for 1999, 2000, and 2001.

Issues. Whether Gagliardi:

- Adequately substantiated his claimed gambling losses
- Is liable for the failure-to-file penalty under IRC §6651
- Is liable for understatement penalties under §6662

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Analysis. Losses from wagering transactions are allowed only to the extent of the gains from such transactions.[30] The trial court is the finder of fact, and it must determine whether the taxpayer's documentation and witnesses are credible.

A taxpayer is liable for a penalty equal to 5% of the amount that should have been shown on the return, or a maximum of 25%, for failure to timely file a tax return, unless such failure is due to reasonable cause and not willful neglect.[31] A taxpayer is also liable for a penalty of 20% on the portion of an underpayment of tax due to negligence or disregard of rules or regulations or a "substantial" understatement of tax.[32] No penalty is imposed if the taxpayer acted with reasonable cause and in good faith.

Holding. The court found Gagliardi's documentation credible. At trial, a clinical psychologist and expert in gambling disorders testified that Gagliardi was, with "an extremely high probability," likely to lose any gambling winnings on future gambling. Another witness, a casino and gaming industry expert with extensive expertise in gaming math and algorithm development, gaming software, and statistical analysis, testified that Gagliardi's claimed losses were within or below the range of losses likely to result from his gambling. The court found both witnesses' testimony credible. Accordingly, the court overruled the IRS's disallowance of Gagliardi's gambling loss deductions.

Because Gagliardi admitted that he did not timely file his 2000 and 2001 tax returns and did not exercise prudence and due care in failing to file, the court held that he was liable for a failure-to-file penalty under §6651. However, because Gagliardi provided supporting documents for his losses and relied in good faith on his accountant, the court held that he was not liable for the substantial-understatement-of-tax penalty under §6662.

Deductions Related to Income-Producing Residence

Mallin et. ux. v. Comm'r, TC Summ. Op. 2008-13 (February 11, 2008)

IRC §§280A and 165

☞ Loss on Sale of Home Deductible and Depreciation Deductions Disallowed

Facts. Brian and Marcie Mallin purchased a principal residence in South Dakota in 1995, which was appraised at $199,000 in 1998 prior to a refinancing. The Mallins subsequently spent $16,179 adding a 352-square foot woodworking workshop in 1999–2000. The workshop was built as an addition to the Mallins' pre-existing 2-car garage, but was separated from the rest of the garage by a wall and had its own garage door. The Mallins used the workshop for their woodworking business.

The Mallins sold the home in 2001 for $203,000 to a company which determined its purchase offer by averaging the amount of two appraisals, one of which was $200,000 and the other $206,000. Those appraisals treated the workshop as a third car garage, and under the two appraisals, valued it at $3,000 and $10,000, respectively. The Mallins reported no gain from this sale under IRC §121 (exclusion of gain from the sale of a primary residence), and reported a loss of $9,731 attributable entirely to the workshop.

The Mallins moved to Wyoming in 2000, where they purchased a home in 2001. In that home, they converted the existing attached garage into a workshop and installed a furnace in the workshop. The Mallins continued carrying on their woodworking business in this workshop until they terminated the business in 2003.

Issues. Whether the taxpayers were entitled to:

- Depreciation deductions for 2001–2003 attributable to the workshop and furnace in their Wyoming residence
- Deduct a loss in 2001, and to what extent, on the sale of their South Dakota residence for the amount of the sale proceeds allocable to the workshop

30. IRC §165(d)
31. IRC §6651
32. IRC §6662

Analysis. Deductions allocable to the business use of a "dwelling unit" used by the taxpayer as a principal residence are generally disallowed.[33] However, if the taxpayer uses the dwelling as his primary place of business, deductions pertaining to that use are permitted to the extent of gross income from such use.[34] A "dwelling unit" includes all structures or property appurtenant to the house.[35]

Holding. The court sustained the IRS's disallowance of depreciation deductions taken on the workshop and the furnace in the Wyoming residence. It held that the workshop and furnace were clearly "appurtenant" to the personal residence, and therefore part of the "dwelling unit" and subject to the deduction limitation of §280A. The court upheld the disallowance of the depreciation taken that exceeded the gross income from the Wyoming workshop.

The court rejected both the Mallins' and the IRS's respective valuations of the workshop in the South Dakota residence. It held that the Mallins' suggested value of $4,000 (the 2001 sale price of $203,000 less the 1998 appraisal value of $199,000) inappropriately assumed that the workshop was entirely responsible for the increase in the home's value between 1998 and 2001. However, it further held that the IRS's allocation based on the workshop's square footage as a percentage of the residence's total square footage inappropriately assumed that the workshop had a value per square foot equal to that of the rest of the residence.

The court held that the purchaser company's valuation, the average of the $3,000 and the $10,000 valuations, was the most accurate estimate the court could make on the record. It believed that value should form the basis of the calculation of loss from the sale.

New Guidance on HSAs

IRS Notice 2008-59, IRB 2008-30

IRC §223

☞ IRS Provides 42 Q&As Regarding HSAs

Notice 2008-59 is an excellent resource for information on a wide range of HSA topics. Practitioners may find it useful in resolving HSA issues of their clients. It can be accessed on the IRS website.

HSA Contribution Rules

IRS Notice 2008-52, IRB 2008-25

IRC §223

☞ New HSA Contribution Rules for 2007 and Later Years

Background. For the tax years 2004 through 2006, the maximum annual HSA contribution was the **lesser** of:

1. The annual deductible under the high-deductible health plan (HDHP), or
2. The statutory maximum under IRC §223(b)(2)(B).

Due to changes included in the Tax Relief Health Care Act of 2006, taxpayers are allowed to fully fund an HSA for 2007 and later tax years.

Analysis. For 2007 and later tax years, an individual's maximum HSA contribution is the indexed maximum annual HSA contribution allowed depending on the type of HDHP coverage. **The amount of the HDHP deductible is no longer a limiting factor beginning with 2007 tax returns.** This rule applies to individuals who are eligible on the first day of the last month of their tax year.

> **Note.** In effect, the new rule treats such individuals as having been eligible for the entire year.

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33. IRC §280A
34. IRC §280A(c)
35. IRC §280A(f)

Example. Tony, age 53, switches his employer-subsidized group PPO health plan to an HDHP with family coverage on December 1, 2008. These are the only two health plans Tony, his wife, and their children were enrolled in during 2008. Tony's employer made no 2008 contributions to his HSA.

Tony is allowed to contribute and deduct a maximum of $5,800 for his 2008 HSA. He must make the $5,800 HSA contribution no later than April 15, 2009 in order to deduct it on his 2008 *Form 8889, Health Savings Accounts.*

Note. This example is not included in Notice 2008-52.

Maximum 2008 HSA contributions. The allowable **maximum** HSA contribution amounts for 2008 and 2009 are:

	2008	2009
Self-only HDHP coverage	$2,900	$3,000
Family HDHP coverage	5,800	5,950
Additional contributions for HSA owners age 55 or older and not enrolled in Medicare	900	1,000

Testing Rule. Use the facts in the above Example, except Tony doesn't like the limitations of his family coverage HDHP that he established on December 1, 2008. Therefore, he switches back to his employer's PPO health plan in October 2009 during open enrollment. **If he made and deducted the maximum 2008 HSA contribution of $5,800 on his 2008 tax return, he must recapture $5,317 of gross income on his 2009 tax return.**

The recapture amount is calculated as follows:

Tony's 2008 HSA deduction	$5,800
Less: allowable 2008 HSA contribution (one month's contribution amount)	(483)
Amount recaptured as gross income for 2009	**$5,317**

Note. Tony is subject to the recapture rule because he was not an eligible individual during the testing period, December 1, 2008 through December 31, 2009. He did not maintain his required HDHP during the testing period.

In addition, Tony will owe a 10% penalty on the recaptured amount.[36] The testing period begins on the first day of the last month of the current taxable year and ends on the last day of the 12th month of the following year. Thus, for 2008 HSA contributions, the testing period begins on December 1, 2008 and ends on December 31, 2009. The 10% penalty is waived for death or disability.

Note. The $5,317 recaptured income and the 10% penalty are reported in Part III of Tony's 2009 Form 8889, *Health Savings Accounts.*

36. IRC §223(b)(8)(B)

Alternative Motor Vehicle Credit

Treasury Inspector General for Tax Administration (TIGTA) Report #2008-30-107 (May 6, 2008)

IRC §30B

☞ Report Indicates IRS Needs to Improve Enforcement of Hybrid Vehicle Credits

Analysis. Following is a synopsis of a review performed by the TIGTA regarding 2006 individual tax returns and/or claims for refund involving the alternative motor vehicle credit:

The complexity of the law provided for the credit has created administrative difficulties for the IRS. The law contains a phase-out provision, which reduces the effect of the credit by calendar quarter after the number of hybrid vehicles sold by the manufacturer reaches 60,000.

Note. There is a slight possibility that Congress will mandate that sellers of qualified hybrid vehicles provide the purchaser and the IRS with an information document, similar to a Form 1099, supporting the proper credit amount.

Based on a sample taken from three states' Department of Motor Vehicles' records of taxpayers leasing hybrid vehicles, 22% of individual taxpayers erroneously claimed the credit.

Note. If a hybrid vehicle is leased, only the lessor may claim the credit. Taxpayers must **purchase** a new hybrid vehicle in order to claim any allowable credit.

Based on a sample of 420 electronically filed 2006 individual returns which claimed a hybrid credit of more than $4,000, 15% of the taxpayers either claimed nonqualifying vehicles or claimed a higher credit amount than allowable.

Note. The Treasury Inspector General's auditors selected the $4,000 amount because it was more than the highest amount allowed for a new hybrid vehicle purchased during 2006. For 2006 returns, the largest amount of hybrid credit allowable was $3,150 for a new Toyota Prius (2005, 2006, or 2007 models).

Nontrade or Business Expenses

Carl H. Jones III et ux v. Comm'r, 131 TC No. 3 (July 28, 2008)
IRC §§274, 212, and 162

☞ Training Course Expenses Not Deductible

Facts. Mr. Jones was a stock investor for over 30 years, before losing his job as an electrical engineer. After he was laid off, he decided to pursue a career as a day trader. In order to enhance his skills, he attended a week long one-on-one day trading course.

Issue. Whether the costs of the course and associated expenses are deductible

Analysis. Costs of attending training seminars and conventions are deductible for taxpayers conducting an active trade or business.[37] The same expenses are not deductible under IRC §212 as trade or business expenses. To be deductible under §212 the expense must be incurred for:

1. The production or collection of income that will be included in income for federal income tax purposes;
2. The management, conservation, or maintenance of property held for the production of income; or
3. In connection with the determination, collection, or refund of any tax.

The expense must also be an ordinary and necessary expense. However, the Regulations specifically exclude the expenses of taking special courses or training.[38]

Holding. The taxpayers admitted they were not conducting an active trade or business. Therefore, the expense was not deductible under §162. The court looked to §274(h)(7) when it made its ruling. This code section states that no deduction is allowed under §212 for expenses applicable to a convention, seminar, or similar meeting.

DEPENDENCY ISSUES

Deductions for Dependents

***Marshall v. Comm'r,* TC Summ. Op. 2008-31 (Mar. 26, 2008)**
IRC §§2(b), 24, 32, 151 and 152

☞ Dependency Deductions and Credits Denied

Facts. From November 2004 to July 2005, Joseph Marshall lived in a house in Baltimore, Maryland with his mother, girlfriend, and his girlfriend's two children. Marshall was not the biological father of his girlfriend's children, and during the relevant period he had not adopted them. Marshall's mother owned the house and did not charge Marshall or his girlfriend rent. Marshall did, however, contribute $250–$300 per month for food and utilities.

Marshall and his girlfriend moved out of Marshall's mother's house and into an apartment in August 2005. Marshall and his girlfriend each paid half the rent in August and September. Marshall paid all the rent from October through December. He also paid for all the utilities.

Marshall earned about $21,000 per year working as a forklift operator. His mother was retired and received social security payments. Marshall's girlfriend worked at a fast-food restaurant until June 2005, after which she worked at a hospital earning $600–$700 per month until she stopped working in September 2005.

On his 2005 federal income tax return, Marshall filed as head of household and claimed dependency exemptions for his girlfriend's children, child tax credits, and an earned income credit. The IRS subsequently denied these tax benefits and determined a deficiency.

37. IRC §162

38. Treas. Reg. §1.212-1(f)

Issues. Whether Marshall:

- Is entitled to a dependency exemption for the two children
- Is entitled to a child tax credit
- Qualifies as a head of household
- Is entitled to an earned income credit

Analysis. A taxpayer may claim a dependency exemption for each of his dependents, but only when the claimed dependent is a qualifying child or a qualifying relative under IRC §152(c). A dependent is a qualifying child when the dependent is either the child of the taxpayer or of a brother, sister, stepbrother, stepsister, or a descendent of any such relative. Legally adopted children and eligible foster children are also treated as "qualifying child[ren]."

A qualifying relative is defined as an individual:[39]

- Who bears a relationship to the taxpayer as described in §152(d)(2);
- Whose gross income for the year is less than the exemption amount defined in §151(d);
- Who receives over half of his support from the taxpayer for the taxable year at issue; and
- Who is not a qualifying child of the taxpayer or of any other taxpayer for the taxable year.

IRC §152(d)(2) requires the existence of a qualifying relationship between the taxpayer and the dependent to meet the "qualifying relative" test. Individuals who are related to the taxpayer by blood, marriage, or are legally adopted by the taxpayer meet this relationship requirement. An individual may also have a qualifying relationship with the taxpayer when such individual:

- Is not the taxpayer's spouse
- Has the same principal place of abode as the taxpayer; and
- Is a member of the taxpayer's household during the taxable year

For an individual to be a member of a taxpayer's household, the taxpayer must "maintain the household" and both the taxpayer and the individual must occupy the household for the taxable year. A taxpayer maintains a household when he pays more than half the household's expenses.

A taxpayer may only claim a child tax credit for a qualifying child. To qualify as a head of household, the taxpayer must maintain as his home a household that is the principal place of residence for more than half the taxable year of an individual who qualifies as the taxpayer's dependent, when a dependent is defined as a qualifying child or qualifying relative. IRC §32(a) provides an earned income credit for a taxpayer with respect to an eligible individual, which is defined in relevant part as a qualifying child.

Holding. Because Marshall's girlfriend's children were not related to him by blood, marriage or were legally adopted by him, the court held that they were not qualifying children under IRC §152. The court further held that because Marshall had not offered sufficient evidence to establish that he had paid more than half of the household's expenses during the 2005 tax year, his girlfriend's children were not qualifying relatives either. Accordingly, the court held that Marshall was not entitled to a dependency exemption deduction, child tax credits, head of household filing status, or an earned income credit.

> **Note.** See Chapter 9, "Individual Taxpayer Problems," "Problem 2: Dependency Exemption Rules for Qualifying Relatives" for more information on requirements for claiming the dependency exemption.

39. IRC §152(d)(1)

Unsigned Divorce Decree

Joseph D. and Rebecca K. Lease v. Comm'r, TC Summ. Op. 2008-73 (June 24, 2008)
IRC §§24 and 151

☞ Noncustodial Father Pays the Price for Unsigned Divorce Decree

Facts. Joseph Lease's marriage to Mary failed and they were divorced in 1995. Mary was awarded custody of their minor child Nora. The divorce decree specified that Joseph could claim the dependency exemption for Nora in odd numbered years provided he was current on child support payments. The decree also ordered Mary to execute and deliver Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents*, by January 31 of even-numbered years.

The presiding judge and the attorneys of record for both Joseph and Mary Lease signed the divorce decree. However, neither Joseph nor Mary signed the decree. After the divorce, Mary refused to deliver Form 8332 to Joseph as specified in the decree. However, Joseph claimed the exemption for his daughter Nora for 1995, 1997, and 1999 and apparently Mary did not for those three years.

When Joseph and Rebecca (his second wife) filed their joint 2005 tax return, they claimed an exemption for Nora and the $1,000 child tax credit on her behalf. **Since Joseph did not receive a Form 8332 from Mary, he attached a copy of the divorce decree to the 2005 return as a substitute for the missing form.**

The IRS denied Nora's dependency exemption and her child tax credit in its examination of Joseph and Rebecca's joint 2005 return.

Issues. Whether the taxpayers were entitled to the dependency exemption for Nora and the child tax credit for her

Analysis. A noncustodial parent may claim the dependency exemption if the custodial parent executes a written declaration releasing his claim to the exemption and the noncustodial parent attaches the declaration to her return.[40] The IRS issued Form 8332 in order to standardize the written declaration requirement. **Any other written declaration not on Form 8332 must conform to the substance of Form 8332, including the signature requirement of IRC §152(e)(2)(A).**

Divorce decree or separation agreement made after 1984. If the divorce decree or separation agreement went into effect after 1984, the noncustodial parent can attach certain pages from the decree or agreement instead of Form 8332. To be able to do this, the decree or agreement must state all three of the following:

1. The noncustodial parent can claim the child as a dependent **without regard to any condition, such as payment of support**. [Bolding added for emphasis]
2. The custodial parent will not claim the child as a dependent for the year.
3. The years that the noncustodial parent, rather than the custodial parent, can claim the child as a dependent.

> **Note.** Beginning with 2009 calendar year returns, a state court order or decree cannot serve as a written declaration used as a substitute for Form 8332. See Treasury Decision 9408 in the Divorce Issues section of this chapter for more information on this topic.

40. IRC §152(e)(2)

Holding. The Tax Court judge, relying on the *Miller* case,[41] held that the unsigned divorce decree was not a valid substitute for Form 8332. As a result, the court upheld the IRS determination which disallowed the dependency exemption for Nora and the related child tax credit.

> **Note.** Even though the issue was not discussed in the court opinion, it appears that even if the divorce decree had been signed by the divorcing parties, the taxpayers technically still would not have been entitled to claim Nora's exemption for 2005. The reason for this conclusion is that the divorce decree placed a condition on Joseph's right to claim Nora's exemption in odd-numbered years. The condition was that he is current in his child support obligations. See the following excerpt from IRS Pub 501, *Exemptions, Standard Deduction, and Filing Information* (For use in preparing 2007 returns):

Form 8332

Michael Artayet v. Comm'r, TC Summ. Op. 2008-34 (Apr. 7, 2008)

IRC §§24, 151 and 152

☞ Court Order Does Not Eliminate Need for Written Declaration

Facts. Mr. Artayet and his wife had two daughters. Things did not go well in the Artayets' marriage and initial divorce proceedings began in 1995. In 1995, Mr. and Mrs. Artayet were each allowed to claim one of the children as a dependent for income tax purposes. The final divorce decree was issued in 1997, superseding the 1995 order, with joint legal custody being given to both Mr. and Mrs. Artayet. The 1997 decree gave Mrs. Artayet physical custody of the girls while Mr. Artayet received visitation rights with both daughters for limited periods. The 1997 decree was silent on who was entitled to claim the children as dependents.

On his timely filed 2004 tax return, Mr. Artayet claimed a dependency exemption and the related $1,000 child tax credit for his 16-year-old daughter. Neither Form 8332 nor its equivalent was attached to Mr. Artayet's tax return. The dependent daughter filed a tax return for 2004 and did not claim a dependency exemption for herself. Her total wages for the year were $2,409.

The IRS denied the dependency exemption and child tax credit reported on Mr. Artayet's return. It determined a deficiency of $1,717.

Mr. Artayet argued that he was entitled to the dependency exemption pursuant to the 1995 order and that the 1997 decree was ambiguous and did not supersede the 1995 order.

Issue. Whether Mr. Artayet is entitled to the dependency exemption and child tax credit for his daughter for 2004

Analysis. Taxpayers are permitted to claim a dependency exemption for a dependent.[42] For divorced parents, special rules apply for claiming the dependency exemption. The noncustodial parent may claim the dependency exemption only with a signed declaration attached to his tax return. This declaration can be either Form 8332 or a written equivalent.[43]

Holding. The court indicated that Mr. Artayet's arguments about whether the 1997 instrument was ambiguous and whether the 1995 order superseded the 1997 order were irrelevant to the proceedings. Because Mr. Artayet was the noncustodial parent and he did not attach the appropriate written declaration to his 2004 tax return, he was not entitled to the dependency exemption and child tax credit for his daughter.

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41. *Miller v. Comm'r*, 114 TC 184, 190 (2000)

42. IRC §151(c)

43. IRC §152(e)(2)

DIVORCE ISSUES

Payments to Former Spouse

Dwight S. Platt et ux. et al. v. Comm'r, TC Memo 2008-17 (Jan. 31, 2008)

IRC §§71, 215, 401, 402, 414(p) and 6662

☞ Pension Distribution Payments Not Includable in Former Spouse's Income

Facts. In 1983, Herbert Bangs and Antonina Platt divorced. During the relevant period, they resided in Maryland. Pursuant to the divorce decree, Bangs was ordered to pay Platt a stipulated percentage of each payment he received from the pension plan offered by his employer, which was the government of Baltimore County, Maryland. The decree was not modified at any point thereafter.

After making payments under the divorce decree to Platt over the course of 2002, Bangs claimed a deduction for the amount of the payments as deductible alimony. Platt did not include the amount of the payments in her reported income on her 2002 return. In January of 2006, the IRS sent a notice of deficiency to both Bangs and Platt. The IRS simultaneously disallowed the deduction to Bangs for the payments and determined that the payments were includable in Platt's income. The IRS further determined that both Bangs and Platt were subject to the accuracy-related penalty under §6662.

Issues.

1. Whether the payments are deductible to Bangs and includable in Platt's income because:
   - They constitute alimony payments under IRC §71
   - Platt owned an interest in Bangs' pension plan
   - The divorce decree was a qualified domestic relations order (QDRO) under §414(p)
2. Whether either party is liable for the accuracy-related penalty under §6662

Analysis. IRC §71 was amended by the Deficit Reduction Act of 1984 (DEFRA). However, the amended §71 applies only to divorce instruments executed after December 31, 1984 and instruments executed before January 1, 1985 but modified on or after that date if the modification expressly provides that amended §71 applies to such modification.

As used in §402(a), the term "distributee" ordinarily means the participant or beneficiary of a plan who is entitled to receive a distribution. The distributee is considered the owner of the plan. Prior to 1986, Maryland law did not authorize state courts to transfer ownership of an interest in a pension plan pursuant to a divorce decree.

A former spouse may be deemed an alternate payee of a pension plan pursuant to a QDRO under §414(p). An alternate payee is treated as a "distributee" for the purposes of §402(a). However, the QDRO provisions under §414(p) do not apply to transfers of marital interests in government pension plans that occurred before December 20, 1989.

Holding. The court held that since the parties executed their divorce decree before December 1984 and did not modify it thereafter, the pre-amendment version of §71 applies. The court rejected Bangs' argument that the parties had stipulated that amended §71 applies, noting that the parties had not in fact done so and that the court is not bound by stipulations of law in any event. Since Bangs conceded that the payments were not alimony under pre-amendment §71, the court held that the payments did not constitute alimony.

The court also held that Bangs was the "distributee" under §402(a) because he was the participant in and the beneficiary of the plan. The court further determined that, because the divorce decree did not provide Platt an interest in the plan and Maryland law at the time forbade state courts from transferring an interest in a plan pursuant to a divorce decree, Platt did not have an interest in the plan. Finally, the court held that the QDRO provisions of §414(p) did not apply to the parties' divorce decree because the alleged transfer of the plan interest was pursuant to an agreement executed before 1989.

The court determined that neither Bangs nor Platt were liable for the accuracy-related penalty under §6662.

Divorced or Separated Parents

TD 9408, Final Regulations for Treas. Reg. §1.152-4 (July 1, 2008)

IRC §152

☞ Final Regulations for Dependent Child of Divorced or Separated Parents

Background. These final regulations contain amendments to the proposed Treasury Regulations which were published in May 2007. They apply to parents who are: 1) divorced; 2) legally separated; or 3) live apart at all times during the last six months of the calendar year regardless of whether or not they were married.

Generally, a **noncustodial parent** may claim a dependency exemption for a qualifying child (or qualifying relative) **if the custodial parent releases the claim to the exemption**. The child is a qualifying child of the noncustodial parent as long as the parents provide over 50% of the child's support for the calendar year. In addition, the child must be in the custody of one or both parents for more than half of the year.

Entitlement to a dependency exemption also brings with it other tax benefits. The parent who may claim the child as a dependent may also claim the child tax credit on behalf of the child, as well as any allowable Hope or lifetime learning education credits for the child.

Effective Date. The final regulations are effective for taxable years that begin after July 2, 2008.

> **Note.** For calendar-year taxpayers, the final regulations discussed below will apply to **2009 and later** tax years. See page 37 in the 2006 *University of Illinois Federal Tax Workbook* for the rules that will apply for 2008 and earlier tax years. It describes when portions of a decree of divorce or separate maintenance can be used as a substitute for Form 8332, *Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent.* See the **Example 1** for Yugo and Zelda on the following page.

Analysis. The most important portions of the final regulations include:

1. **Definition of custodial parent.** The custodial parent is the parent with whom the child resides for the greater number of nights during the calendar year **(the counting nights rule)**. For these purposes, a child resides for a night with a parent if the child sleeps:

   - At the parent's residence (whether or not the parent is present), or
   - In the company of the parent when the child does not sleep at a parent's residence (for example, if the parent and child are on vacation).

   Under this rule, the time that a child goes to sleep is irrelevant. A night that extends over two taxable years is allocated to the taxable year when the night begins. Thus, the night that begins on December 31, 2008, is counted for the 2008 tax year.

2. **Release of right to claim child's exemption by custodial parent.** The best way for the custodial parent to release the exemption is by properly completing Form 8332. A written declaration not on Form 8332 must conform to the substance of that form and must be executed for the sole purpose of releasing the claim. **A state court order or decree cannot serve as a written declaration used as a substitute for Form 8332.**

> **Note.** See the *Lease* Tax Court Summary Opinion case in the Dependency Issues section of this chapter for more information on this topic.

3. **Revocation of release of exemption granted for future tax years.** A custodial parent can unilaterally revoke a prior release of right to claim the child's exemption. The revocation can be made on Form 8332 or a substitute document. Treasury Decision 9408 specifies that the parent revoking a written declaration must provide written notice of the revocation to the other parent. Such revocation is effective no earlier than the taxable year that begins in the first calendar year after the calendar year in which the parent provides the written notice of revocation.The custodial parent must attach either the original or a copy of the revocation to his tax return for any year the taxpayer claims the child's exemption as a result of the revocation.

Example 1. Yugo and Zelda are the divorced parents of Natsia. In 2003, Yugo and Zelda enter into a separation agreement, which was incorporated into their divorce decree. The agreement specifies that Yugo, the custodial parent, releases his right to claim Natsia as a dependent for all future years. At the time separation agreement was created, it satisfied the requirements for the form of a written declaration in effect at the time. Zelda attached a copy of the agreement to her 2003 through 2009 returns.

Example 2. Use the same facts as **Example 1,** except Zelda remarries in 2008 which distresses Yugo to no end. In 2009, Yugo no longer wishes to release his right to claim the dependency exemption for Natsia. As the custodial parent, he completes Form 8332 and revokes the release of Natsia's dependency exemption. Yugo provides written notice of the revocation to Zelda on December 31, 2009, the last day he can do so to make the revocation effective for the 2010 taxable year. He attaches this form to his 2010 return. Zelda can no longer claim Natsia's dependency exemption, regardless of what is included in the divorce decree.

EMPLOYMENT TAX ISSUES

Self-Employment Tax

David and Gail Vigil v. Comm'r, TC Summ. Op. 2008-6 (January 9, 2008)
IRC §§1401, 1402, 6651, 6662, 162, and 274(d)

☞ Minister and Wife Liable for Unpaid Self-Employment (SE) Tax

Facts. Mr. Vigil worked part-time as a minister for the Independent Pentecostal Church in 1979 and full-time from 1980 onward. Beginning in 1987, Mr. Vigil claimed exemption from SE taxes under IRC §1402(e). During an examination of the Vigils' 1994 joint return, Mr. Vigil wrote a letter to the IRS claiming that he had filed a Form 4361, *Application for Exemption from Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners,* in 1987. Mr. Vigil claimed that an approved copy of the Form 4361 had been returned to him, and he requested another copy of the approved form from the IRS. Neither the IRS nor the Social Security Administration could find any record that Mr. Vigil's Form 4361 had been approved or that he had filed a request for exemption before 1996. The IRS notified the Vigils of the results of its search, and in 1997 proposed an adjustment to their 1994 return, along with a negligence penalty. However, the IRS subsequently informed the Vigils that the examination of their 1994 return resulted in no change to the tax owed.

On February 27, 2004, the Vigils filed their 2001 return along with a request for an extension of time to file that same 2001 return. The IRS disallowed several claimed business deductions, including travel and meal expenses and automobile expenses, and determined a deficiency in the Vigils' 2001 income tax. It also determined that Mr. Vigil was not exempt from SE tax under §1402(e). Further, the IRS assessed a failure-to-file penalty under §6651(a)(1) and an accuracy-related penalty under §6662. The Vigils appealed.

> **Observation.** The taxpayers erroneously sought to extend their 2001 tax return almost two years late. This late filed extension request had no merit or benefit.

Issues. Whether the taxpayers are:

- Liable for SE tax on income Mr. Vigil earned as a minister in 2001
- Entitled to certain claimed deductions attributable to a trade or business
- Liable for the failure-to-file penalty under IRC §6651(a)(1)
- Liable for the accuracy-related penalty under §6662

Analysis. The taxpayer generally bears the burden of showing that an IRS determination is incorrect. The IRS bears the burden of production of sufficient evidence to show that the imposition of a penalty is appropriate. Once the IRS meets this burden, the taxpayer must introduce persuasive evidence that the penalty is inappropriate.

IRC §1401 imposes a tax on the "net earnings from self-employment" derived by a self-employed individual in a given tax year. Net earnings equal gross income from any trade or business less deductions attributable to that trade or business. However, ministers are exempt from this tax when certain specific requirements are met. Among other things, the presumed minister must file for the exemption on or before the later of:

- The due date of the return (including any extensions) for the second taxable year for which the taxpayer has net earnings from self employment of $400 or more, any part of which was derived from the performance of services as a minister, or
- The due date of the return (including any extensions) for his second taxable year ending after 1967.

The taxpayer bears the burden of proving eligibility for the exemption and that his Form 4361 was timely filed.

Under §6001, a taxpayer must maintain records sufficient to substantiate each deduction pursuant to §162. When a taxpayer adequately establishes that he incurred some deductible expense but cannot establish the exact amount, the court may estimate, bearing heavily against the taxpayer, the amount of the allowed deduction as long as there is a rational basis on which to form an estimate. However, IRC §274(d) forbids the court from making such an estimate in the case of certain expenses. This prohibition applies to traveling expenses (including meals), and expenses associated with listed property (including computers and passenger automobiles). A taxpayer must substantiate these expenses with adequate records, unless such records have been destroyed by forces beyond his control.

A taxpayer may avoid a penalty for failure to file when the failure was "due to reasonable cause and not willful neglect." Reliance on a tax preparer is not sufficient to establish reasonable cause. A taxpayer is also liable for a 20% penalty (imposed on the amount of any tax understatement) for any understatement of tax that is attributable to neglect or disregard, or that is "substantial." An understatement is substantial if it exceeds the greater of 10% of the tax due or $5,000. A taxpayer may avoid this penalty if he can establish that there was "reasonable cause" and that he acted in good faith.

Holding. Because the taxpayers failed to carry the burden of proof that they filed the proper form, the court held that the IRS properly denied the exemption from SE tax. Because a mistake of law in one year does not estop the IRS from correcting that error in a subsequent year, the court rejected the Vigils' claim that the IRS was somehow "estopped" from later denying the minister exemption after it allowed it in 1994. With respect to the claimed business deductions, the court held that the Vigils failed to satisfy the strict substantiation requirements under IRC §274(d).

The court rejected the Vigils' argument that they should not be assessed a failure-to-file penalty, holding that reliance on a tax preparer does not establish "reasonable cause" as a matter of law. Similarly, with respect to the accuracy-related penalty, the court held that reliance on a tax preparer is not sufficient to establish a "reasonable cause" and "good faith" defense. The court therefore sustained both penalties.

Insurance Commissions

Harold D. and Joan A. Edwards v. Comm'r, TC Memo 2008-24 (Feb. 7, 2008)

IRC §§1401 and 1402

☞ Semi-Retired Insurance Agent Liable for SE Tax

Facts. Harold Edwards established the Edwards Agency in 1963 to sell insurance policies for the Farmers Insurance Group. The business was later organized under Washington state law as a single-owner LLC which elected to be taxed as a sole proprietorship. Sometime before 2003, Mr. Edwards retired from the day-to-day operation of the business. In 2003, he spent less than two hours per day in his office and performed the following duties:

- Signed all payroll checks
- Examined books and records
- Paid bills

The agency, which had three full-time employees, earned a 2003 net profit of $62,483. The income was reported on a Schedule C which showed Mrs. Edwards, not Mr. Edwards, as the sole proprietor. However, she was not involved in the business and did not hold a required Washington state insurance license. Under Washington law, Mrs. Edwards could not own an insurance agency.

No SE tax was reported on the 2003 joint return. The IRS determined that the Schedule C income constituted self employment of Mr. Edwards and assessed SE tax of $7,729. The taxpayers' position was that since Mr. Edwards had retired from the agency, he did not have a sufficient nexus with the agency's income to actually be carrying on a trade or business.

Issue. Whether the income Mr. Edwards received from the agency treated as a sole proprietorship was subject to SE tax under IRC §§1401 and 1402

Analysis. It is well established that renewal commissions received by a retired insurance agent are subject to SE tax as a form of deferred compensation.[44] A single-owner LLC is disregarded as an entity separate from its owner for federal income tax purposes unless it elects to be classified as an association.

Holding. It is immaterial that the day-to-day operations of a business are conducted by the owner's employees. A trade or business can be "carried on" by the individual owner either personally or through his agents or employees.[45] Accordingly, the Tax Court upheld the IRS determination that Mr. Edwards owed SE tax on the agency's 2003 net income.

44. *Norman D. Erickson v. Comm'r*, TC Memo 1992-585 (Sept. 30, 1992) (affirmed by 1st Cir. Ct. of Appeals on Aug. 2, 1993 in an unpublished opinion)

45. *Newberry v. Comm'r*, 76 TC 441 (1981)

Liability for Failure to Pay Payroll Tax

Jack Horovitz v. U.S., No. 2:06-cv-00279; United States District Court for Western District of Pennsylvania (Feb. 11, 2008)
IRC §6672

☞ Executives Jointly Liable for Failure to Pay Employment Taxes

Facts. In 1981 Jack Constantino founded a trucking company called CDS Lines, Inc. Constantino owned an 80% share in CDS and served as CEO, president, and treasurer for the company. He earned an annual salary of $232,000 during the period September 30, 1998 to March 31, 1999. Jack Horovitz served as CFO, vice president, and secretary for CDS, earning an annual salary of $180,000 over the same period. Horovitz also owned the remaining 20% share in the company.

Constantino had unlimited hiring and firing authority for the entire company. Horovitz ran the accounting department and had the authority to hire and fire employees within that department. Both had full signature authority for CDS's corporate bank accounts. Horovitz signed CDS's Form 941 payroll tax returns during the relevant period.

Both Constantino and Horovitz were aware that CDS had failed to pay its payroll tax obligations from 1995–1997. Horovitz informed Constantino that CDS was again failing to pay its payroll taxes in 1998, and an IRS agent informed Constantino of the failure to pay in 1999.

Issues. Whether, under IRC §6672, Horovitz and/or Constantino are personally liable for CDS's failure to pay payroll taxes.

Analysis. Any person required to withhold, truthfully account for, and pay tax, but who willfully fails to do so, is personally liable for the amount of the unpaid tax.[46] "Responsible person" status is determined on the basis of an employee's status, duty, and authority. Exclusive control over the company's finances is not necessary. The factors used in making the responsible person determination are:

- Contents of the corporate bylaws
- Ability to sign checks on the company's bank account
- Signature on the employer's federal quarterly and other tax returns
- Payment of other creditors in lieu of the United States
- Identity of officers, directors, and principal stockholders in the firm
- Identity of individuals in charge of hiring and discharging employees
- Identity of individuals in charge of the firm's financial affairs

An employee may not avoid responsible person status merely by showing that a superior had instructed him not to withhold taxes. The burden of proof and production rests with the taxpayer to show that he is not a responsible person.

For the purposes of IRC §6672, a responsible person acts "willfully" when he knowingly pays other creditors before the IRS, fails to investigate and correct a failure to pay tax, or otherwise shows "reckless disregard" for the existence of the tax liability. A responsible person may not avoid liability simply by delegating responsibility to a subordinate.

Holding. The court held that Horovitz was a responsible person because he:

- Maintained significant control over the disbursement of CDS's funds,
- Had the authority to hire and fire employees,
- Had full signature authority with CDS's corporate bank accounts and Form 941 returns, and
- Was a high-ranking corporate officer and 20% shareholder.

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46. IRC §6672

The court rejected Horovitz's argument that he had been phased out of his position of control within the company and therefore was not a responsible person during the relevant period. The court further held that Horovitz's failure to pay tax was "willful" because he had paid numerous other creditors before the IRS after having knowledge of the unpaid tax liability and that his contention that Constantino had directed him to do so was irrelevant.

Similarly, the court held that Constantino was a responsible person because he:

- Was the CEO of CDS,
- Had unlimited hiring, firing, and check-writing authority, and
- Was an 80% shareholder.

The court also held that Constantino's failure to pay tax was "willful" because he had been aware of the payroll tax liability problem since 1995, and he failed to investigate or correct the problem. The court rejected Constantino's argument that he had not acted willfully because he had delegated full responsibility for CDS's financial affairs to Horovitz. Therefore, the court held that both Horovitz and Constantino were jointly liable for the amount of the unpaid tax plus interest and penalties.

Responsible Person Status

Saraleigh Looney v. U.S., No. 4:06-cv-01166; United States District Court for the Southern District of Texas (Feb. 26, 2008)
IRC §§6672 and 7433

☞ CPA Failed to Disprove Responsible Person Status

Facts. Taxpayer Looney, a certified public accountant, served as controller of NexTec Operating Corporation ("NexTec") between May 2000 and October 2003. According to the testimony of the company's president, Looney was responsible for ensuring that NexTec paid employment withholding taxes during this period, which it had failed to do for the last two quarters of 2002.

Upon audit in 2004, the IRS determined that Looney was responsible for NexTec's failure to pay its employment withholding taxes and proposed to assess her for the amount of NexTec's outstanding liability. On August 30, 2004, the IRS entered into a repayment installment agreement with NexTec. The IRS denied Looney's appeal for the proposed assessment in March 2005. Looney filed for Chapter 13 bankruptcy protection on April 8, 2005.

On May 16, 2005, the IRS assessed Looney for the amount of NexTec's outstanding tax liability ($85,207 for the third quarter and $158,500 for the fourth quarter of 2002). Since then, NexTec had paid its outstanding tax liability for the third quarter of 2002, but at the time of this opinion, its fourth quarter liability remained outstanding. The IRS withheld Looney's $2,607 tax refund for the 2004 tax year.

Looney filed a Claim for Refund and Request for Abatement, which was subsequently denied. Looney then sued, claiming that the IRS had wrongfully assessed her for NexTec's unpaid tax liability and withheld her 2004 refund. In addition, she sought costs, attorney's fees, and damages of $1 million. The IRS responded with a counterclaim for $158,500, plus interest and statutory additions.

Issues. Whether:

- Looney was a "responsible person" for ensuring that NexTec paid its tax liability
- Looney had acted willfully in failing to ensure that NexTec paid its tax liability
- The IRS had wrongfully assessed Looney for NexTec's tax liability

Analysis. IRC §6672 imposes personal liability on any person "responsible for collecting, paying, or truthfully accounting for federal withholding taxes who willfully fails to do so or attempts to evade or defeat the payment of such taxes." Responsible person status is determined by reference to several nonexclusive, nondispositive factors. These factors include whether the taxpayer:

- Is an officer or member of the board of directors
- Owns a substantial portion of the company's stock
- Manages the day-to-day operations of the business
- Has the authority to hire or fire employees
- Makes decisions regarding the disbursement of funds and payment of creditors
- Has authority to sign company checks

The "critical question is 'whether the person had the 'effective power' to pay the taxes — that is, whether he [or she] had the actual authority or ability, in view of his [or her] status within the corporation, to pay the taxes owed.'"

A responsible person **acts willfully** when she "recklessly disregards the risk that the taxes may not be remitted to the government." Willfulness is determined at the time she was responsible for collecting or paying the withholding taxes.

A responsible person's liability is independent of the corporation's duty to pay its tax liability. Accordingly, the IRS is not required to seek payment from the corporation before assessing a responsible person. Similarly, the IRS is not required to allocate a corporation's payment on its outstanding tax liability towards the deficiency for which a responsible person is assessed.

"An assessment for any tax" is exempt from the "automatic stay" required by §362 of the Bankruptcy Code. Because IRC §6672 is nonpunitive in nature and is merely designed to ensure that tax due is actually paid, it is treated as a tax assessment rather than a penalty for the purposes of §362.

The IRS's assessments are presumed to be correct, and the taxpayer bears the burden of establishing that the assessment is erroneous.

Holding. The court held that Looney had not offered sufficient evidence either to establish that she was not a responsible person under IRC §6672 or that she had not acted willfully when she failed to ensure that NexTec paid the tax it owed. The court further held that the IRS had no responsibility to seek repayment from NexTec before it assessed Looney, nor to allocate NexTec's payments towards the unpaid tax liability for which Looney had been assessed. Finally, the court held that the IRS had not violated the "automatic stay" because it sought taxes due, and therefore that Looney had failed to state a claim for wrongful assessment of taxes or violation of §362 of the Bankruptcy Code.

SE Taxes Due From Foreign Activities

Robert Rusten et. ux. v. Comm'r, TC Summ. Op. 2008-16 (February 19, 2008)
IRC §§901, 911, 1401 and 1402

☞ Taxpayer Liable for SE Tax on Activities Conducted in Canada

Facts. Over the relevant period, Robert Rusten was a citizen and resident of the United States. However, he performed work in Canada as a railroad industry consultant. He conducted this work as an independent contractor for a company called CLN Industries International. Although Rusten was taxed as an independent contractor in the United States, he was taxed as an employee of CLN in Canada. CLN withheld and paid approximately $21,000 in tax to the Canada Revenue Agency.

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In 1998, the IRS audited Rusten's federal income tax return, after which it increased Rusten's taxable SE income by $12,385 (subject to an agreement) and, subsequently, by an additional $68,638. Rusten's regular income tax liability was offset by the foreign tax credit but his SE tax liability was not. The IRS also reduced the cost of goods sold in 1998 to $5,818 and determined that Rusten was liable for the penalty under IRC §6662.

Issues. Whether:

- Rusten's 1998 SE income is taxable in the United States
- Rusten's cost of goods sold was greater than the amount allowed by the IRS
- Rusten is liable for a penalty under §6662

Analysis. IRC §1401 imposes a tax on SE income, including income earned by U.S. citizens working abroad. IRC §911, which excludes foreign earned income from gross income under some circumstances, does not apply to SE income. However, when there is a treaty in effect between the United States and another country under §233 of the Social Security Act, income subject to tax under a foreign country's social security system is exempt from U.S. SE tax.[47] Because such a treaty is in effect between the United States and Canada, the United States may not tax SE income properly subject to Canadian tax. Under Article V of the treaty, when a worker is considered an independent contractor in the United States, but an employee in Canada, the worker is treated as self-employed.

IRC §6001 and the pursuant regulations require that taxpayers maintain adequate books and records. When the taxpayer fails to do this, the IRS must estimate the taxpayer's income and expenses through reasonably reliable indirect methods.

A taxpayer is liable for a penalty equal to 20% of the underpayment of tax due to negligence or due to a substantial understatement of tax. An understatement of tax is substantial when it exceeds the greater of 10% of the tax required to be shown on the return or $5,000.[48] However, the amount of a tax understatement may be reduced by any portion that is attributable to a tax item for which there was substantial authority.[49]

Holding. The court held that, even though Rusten paid taxes on his SE income to the Canada Revenue Agency, Canada did not have the right to tax such income under the treaty. Therefore, such income is still subject to U.S. SE tax.

The court determined that Rusten had proven $17,680 of the additional costs of goods for equipment and materials, but no additional costs were adequately substantiated. Finally, the court held that due to the exceptional facts of the case, Rusten's understatement of tax was due to reasonable cause. Consequently, the §6662 penalty did not apply.

47. IRC §1401(c)

48. IRC §6662(a)

49. IRC §6662(d)(2)(B)(i)

ESTATE AND GIFT

Disclaimed Funds

Charles Offner v. U.S., No. 2:07-cv-00343; United States District Court for the Western District of Pennsylvania (Feb. 11, 2008)
IRC §2051

☞ **Disclaimed Funds Included in Gross Estate**

Facts. Mrs. Deanie Offner passed away in November 2002. She had prepared a Last Will and Testament in 1999 and Codicil in 2001. Prior to executing the will and codicil, Mrs. Offner created the Offner Family Grandchildren Trust. This was an irrevocable trust for her grandchildren's maintenance, support, health, and education. The Grandchildren Trust was to be funded by the proceeds from a residuary clause in her will.

The will bequeathed $1 million to her three children: 45% to her son Charles, 45% to her son Dean, and 10% to her daughter Linda. It further instructed that, "should any of my children predecease me, then his/her issue shall receive and share equally in his/her respective share of such property." Within nine months of Mrs. Offner's death, Charles and Dean Offner both disclaimed $125,000 of the $450,000 due to each of them.

Issues. Whether Mrs. Offner's estate may take a deduction in the amount of $250,000 for the value of the funds disclaimed by Charles and Dean Offner.

Analysis. When a beneficiary of a bequest executes a valid disclaimer, the beneficiary is treated as if he predeceased the decedent.

Holding. The court held that Charles and Dean Offners' disclaimers were valid. However, it further held that the disclaimers did not trigger the will's residuary clause (which would have directed the disclaimed funds to the Grandchildren Trust) because the will expressly provided that the share due to any children who predecease Mrs. Offner would be distributed to such child's "issue" in equal shares, and a valid disclaimer has the same effect as if a child were to predecease the decedent. Therefore, the disclaimed funds passed automatically to the grandchildren instead of to the Grandchildren Trust, and the amount must be included in the value of Mrs. Offner's estate.

Transfers With Retained Life Estate

Estate of Anna Mirowski et al v. Comm'r, TC Memo 2008-74 (Mar. 26, 2008)
IRC §§2035, 2036, and 2038

☞ **Formation of Family LLC 12 Days Before Death Was for Nontax Purposes**

> **Note.** The facts in this case are complicated. They include the formation of a family LLC with transfers of property worth over $62 million. The formation of the LLC and the transfers by Anna Mirowski occurred within 12 days prior to her death. The estate paid over $24 million of estate and gift tax. Ms. Mirowski retained approximately $7.6 million of personal assets in her own name following her substantial transfers of property to the newly formed family LLC.

Facts. The decedent married Dr. Mirowski, the inventor of the implantable cardioverter defibrillator (ICD). He died in 1990, and Mrs. Mirowski inherited his interest in the ICD patent's license agreement. In the two weeks before her death on September 11, 2001, her attorney persuaded her to form a family LLC and transfer most of her property to it, including her 51% interest under the patents license agreement. She also transferred about $62 million of cash and securities to the LLC shortly before her death.

In exchange for the transfers, Mrs. Mirowski received a 100% interest in the LLC. She immediately gifted a 16% interest in the LLC to **each** of her three daughters' trusts, resulting in her remaining interest in the LLC of 52%. A 2001 Form 709, *Gift Tax Return*, was timely filed by her estate in July 2002. The value of these three gifts was valued at $17.1 million ($5.7 million each) and gift tax of $9.7 million was voluntarily paid.

The decedent's Form 706, *Estate (and Generation-Skipping Transfer) Tax Return*, was timely filed in June 2002. The reported gross estate was $27.8 million and $14.1 million of estate tax was voluntarily paid. **However, the IRS objected to the valuation of the assets transferred to the family LLC.** The IRS proposed to increase the gross estate by $43.4 million (from the reported $27.8 million to $71.2 million). As a result, the IRS assessed additional estate tax of $14.2 million.

> **Note.** Both the $9.7 million gift tax and the $14.2 million estate tax liabilities were paid with funds that the family LLC distributed to the estate.

The IRS insisted that under IRC §2036(a), the total date-of-death FMVs of all the assets that Mrs. Mirowski transferred to the LLC were includable in her gross estate.

Issue. Whether the assets transferred to the family LLC shortly before death are includable in the gross estate of Mrs. Mirowski under §2036(a) [Transfers with retained life estate]

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

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

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

1. The transfer is a **bona fide sale** for full and adequate consideration,[50] and
2. The decedent did **not** retain the:
   - Possession, enjoyment, or rights to the transferred property, or
   - Right to designate the person(s) who would possess or enjoy the transferred property.[51]

The Tax Court reasoned that although Mrs. Mirowski understood that certain tax benefits could result from forming the family LLC, the potential tax benefits were not the most significant factor in her decision to form it. To the contrary, she had the following legitimate and significant nontax purposes for forming and then transferring a sizeable portion of her assets to it:

1. She desired joint management of the family's assets by her three daughters and eventually her grandchildren.
2. She wanted to maintain the bulk of the family's assets in a single pool of assets in order to allow for investment opportunities that would not be available if she was to make a separate gift of a portion of her assets to each of her daughters or to each of her daughters' trusts.
3. She wanted to provide for each of her daughters and eventually each of her grandchildren on an equal basis.

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50. Treas. Reg. §20.2036-1(a)

51. *Estate of Eugene Stone III v. Comm'r*, TC Memo 2003-309 (Nov. 7, 2003)

The IRS maintained that the decedent retained the right to the possession or the enjoyment of, or the right to the income from, the 16% interests in the family LLC that she gifted to each of her daughters' trusts. The IRS insisted that the LLC's operating agreement gave her the authority as general manager to decide the timing and amounts of distributions.

Holding. After a lengthy analysis, the Tax Court held that §2036(a) did not apply. Therefore, the estate did not owe the $14.2 million deficiency assessed by the IRS.

> **Note.** See pages 590–591 in the 2006 *University of Illinois Federal Tax Workbook* for more information about the insistence by both the IRS and the Tax Court on a strict interpretation of IRC §2036(a) requirements.

Partial Disclaimer

Estate of Helen Christiansen v. Comm'r, 130 TC No. 1 (Jan. 24, 2008)
IRC §2518

☞ Partial Disclaimer Fatal to Estate's Deduction for Property Passing to Charitable Trust

> **Note.** This case involves unusual language in the decedent's will. The technical issue raised by the IRS would have been moot if the will had simply divided her estate among her only child, an existing foundation, and a trust. That thought is expressed in the Tax Court's Findings of Fact.

Facts. The decedent's will left everything to her only child, Christine. The will anticipated that Christine would disclaim a part of her inheritance. It further directed that any disclaimed portion of the estate would go to two entities. A charitable trust was to receive 75% of the disclaimed portion and a charitable foundation the decedent had previously established would receive the remaining 25%.

The charitable trust was to last for 20 years, and would make an annual (annuity) payment of 7% of the corpus's net FMV at the time of death to the foundation. At the end of the 20 years, if Christine was still alive, the property left in the trust would transfer to her.

Upon Helen Christiansen's death in 2001, Christine executed the anticipated disclaimer. However, she did not disclaim the contingent remainder interest in the property that passed to the charitable trust. On the estate's tax return (Form 706), it deducted as a charitable contribution the disclaimed property that passed to the foundation and —to the extent of the present value of the annuity interest—the disclaimed property that passed to the charitable trust.

The total value of the gross estate on the estate tax return, following considerable debate and negotiation between the estate and the IRS, was conceded to be $9.6 million. Based on the will's disclaimer language, property worth $2.4 million would pass to the trust and property worth $807,224 would pass to the existing foundation.

The IRS determined that Christine's partial disclaimer did not qualify under IRC §2518.[52] Therefore, the IRS held that the estate was not entitled to any charitable deduction for property passing to **either** the trust or the foundation.

> **Note.** The IRS position in disallowing any charitable deduction for disclaimed property passing to the foundation was clearly incorrect. The IRS acknowledged in the notice of deficiency that "when the other issues are finally resolved, this calculation can be made and a charitable deduction allowed for the proper amount."

52. Treas. Reg. §25.2518-2(e)(3)(b)

At the Tax Court trial, the estate sought charitable deductions for both the $2.4 million and the $807,224 amounts. The IRS continued its position that no charitable deduction was allowable for the $2.4 million disclaimed portion of the estate that passed to the trust.

Issue. Whether the partial disclaimer is a qualified disclaimer under IRC §2518.

Holding for the Disclaimer in Favor of the Charitable Trust. The court upheld the IRS determination that the partial disclaimer was not qualified since Christine retained a remainder interest in the disclaimed property that passed to the trust. **Therefore, the court held that the estate could not claim a charitable deduction for the $2.4 million that passed to the trust.**

Holding for the Disclaimer in Favor of the Foundation. The court held that since the entire value of the disclaimed property passed to the foundation, the disclaimer was qualified. **Consequently, the court allowed the estate a full charitable deduction for the $807,224 value of property that went to the foundation.**

GROSS INCOME

International Income

Clark v. Comm'r, TC Memo 2008-71 (Mar. 19, 2008)
IRC §§6662, 61, 911, 863, 162, and 274(d)

☞ Income Earned in International Waters is Includable in Income

Facts. Over the relevant period, taxpayer Clark, a U.S. citizen, worked intermittently as a second officer aboard two vessels leased by the U.S. military to Maersk Line, Ltd. (Maersk). Clark's work for Maersk took him to Scotland (both ships' home port) and to various ports around the world. Clark also spent a significant amount of time working aboard these vessels in international waters. While at work for Maersk, Clark received meals and lodging free of charge. He did not receive a per diem allowance from Maersk for incidental expenses. During 2002, Clark worked at foreign ports for 117 days and in international waters for 88 days. For 2003, he worked in foreign ports for 89 days and in international waters for 115 days. And during 2004, he worked at foreign ports for 92 days and in international waters for 90.

For the tax years 2002, 2003, and 2004, Clark filed Forms 2555-EZ, *Foreign Earned Income Exclusion*. He claimed that all his income for those years, including wage income from Maersk, military retirement pay, and vacation pay, was foreign earned income excludable under IRC §911. On his 2003 return, Clark failed to report part of his military retirement pay. He also neglected to report small amounts of interest earnings for 2003 and 2004 ($31 and $50, respectively).

Issues. Whether Clark:

- May exclude from gross income wages earned in international waters
- May deduct expenses that he did not pay or incur at federal per diem rates
- Is subject to the accuracy-related penalty under §6662

Analysis. All income from whatever source derived is includable in gross income unless a specific exclusion applies.[53] Subject to certain limitations, a taxpayer may elect to exclude his foreign earned income from gross income.[54] Foreign earned income is defined as "the amount received by such individual from sources within a foreign country or countries which constitute earned income attributable to services performed by such individual."[55] Treas. Reg. §1.911-2(h) defines the term "foreign country," in relevant part as

> *Any territory under the sovereignty of a government other than the United States. It includes the territorial waters of the foreign country (determined in accordance with the laws of the United States), the airspace over the foreign country, and the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the foreign country and over which the foreign country has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources.*

Under international law, international waters are not under the sovereignty of any nation. International waters therefore do not constitute a "foreign country" under §911.

IRC §863 provides special sourcing rules for certain transportation income when such transportation begins or ends in the United States or one of its possessions. It treats income earned in international waters as foreign source income. However, because U.S. citizens are subject to U.S. federal taxation on their worldwide income, such sourcing rules are generally not applicable to U.S. citizens. IRC §863(d) requires that a "United States person," which includes all U.S. citizens, report income earned in international waters as income from "ocean activities" sourced in the United States.

IRC §162 allows a taxpayer to deduct all "ordinary and necessary" business expenses paid or incurred during the taxable year. This includes traveling expenses (including meal, lodging, or other expenses that are not lavish or extravagant). However, in order for a taxpayer to claim a deduction for traveling expenses, he must comply with the strict substantiation requirements under §274(d). The regulations under §274(d) treat the substantiation requirements as met when the taxpayer elects to use federal per diem allowances. However, under recent revenue procedures, a taxpayer's election to use the per diem allowance does not remove the requirement that the expenses for which the taxpayer has claimed a deduction be actually paid or incurred. A taxpayer may be eligible to claim a deduction for incidental expenses at the federal per diem rate for incidental expenses only when the taxpayer's employer provides him with meals.

A taxpayer is liable for a 20% accuracy-related penalty for any substantial underpayment of tax that is attributable to the taxpayer's negligence or disregard of his obligations under the tax laws.[56] An underpayment is substantial when it exceeds the greater of $5,000 or 10% of tax due. The IRS must introduce sufficient evidence indicating the appropriateness of the penalty. Once this burden is met, the taxpayer bears the burden of proving the penalty is inappropriate because of reasonable cause or substantial authority. A taxpayer acts with reasonable cause when he acts in good faith. This determination is made on the basis of all facts and circumstances; however, the most important factor is the extent of the taxpayer's effort to assess his proper tax liability. Reliance on the advice of a tax professional, when such reliance is reasonable and in good faith, may in some circumstances constitute reasonable cause.

Holding. The court held that under the plain terms of §911 and its related regulations, Clark was not entitled to exclude the income earned in international waters. The §863 sourcing rules were not relevant because Clark was a U.S. citizen and none of the voyages began or ended in the United States. IRC §863(d) further requires Clark to report such income. His income attributable to work while docked at international ports, however, was excludable.

53. IRC §61

54. IRC §911

55. IRC §911(b)(1)(A)

56. IRC §6662

The court also held that because Clark did not actually incur meal expenses, he was not entitled to take a deduction at the per diem rate for meal expenses. However, he was entitled to take a deduction for the amount of the per diem rate attributable to incidental expenses.

Finally, the court held that Clark had not established that he had reasonable cause to exclude the income. He did not follow clearly-stated instructions on the relevant forms or seek the advice of a tax professional. Therefore, it sustained the accuracy-related penalty under §6662.

Gambling Losses

Thomas and Christine Dawson v. Comm'r, TC Summ. Op. 2008-17 (February 20, 2008)
IRC §§61, 6662, and 165

☞ Gambling Winnings Included in Adjusted Gross Income (AGI)

Facts. During the 2004 tax year, Thomas and Christine Dawson were employed as a building inspector and a registered nurse, respectively. During this period, they gambled extensively at casinos in Atlantic City, New Jersey, although neither was engaged in the trade or business of professional gambling. Their total winnings for 2004 were $208,420, but their total gambling losses exceeded that amount.

The Dawsons did not report any of their gambling winnings on their 2004 return, because they believed they were not required to do so because their losses exceeded their gains. When the IRS audited their 2004 return, it increased the Dawsons' AGI by $208,420 and allowed an itemized deduction for the same amount. However, by virtue of the increase in AGI, the Dawsons were not entitled to various additional itemized deductions that they had claimed on their return. The IRS also determined that the Dawsons were liable for the IRC §6662 accuracy-related penalty.

Issues. Whether the Dawsons:

- Were correct to omit their gambling winnings in computing their AGI
- Are liable for the §6662 accuracy-related penalty

Analysis. Gross income includes "all income from whatever source derived," including gambling winnings.[57] A taxpayer who is engaged in the trade or business of professional gambling may deduct gambling losses to the extent allowable in computing his AGI. However, a taxpayer who is not a professional gambler may only deduct gambling losses to the extent allowable as an itemized deduction.

IRC §6662 imposes an accuracy-related penalty on taxpayers who are negligent in preparing their returns. Negligence is defined as "any failure to make a reasonable attempt to comply with the provisions" of the tax code.[58]

Holding. The court held that because the Dawsons were not engaged in the trade or business of gambling, the IRS was correct to increase their AGI by the amount of their gambling winnings and to allow a deduction for their gambling losses only to the extent allowable as an itemized deduction. However, the court also held that the Dawsons' mistake was reasonable, and that they had made an honest attempt to comply with their obligations under the tax code. The court, therefore, declined to uphold the IRS's assessment of the §6662 accuracy-related penalty.

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57. IRC §61

58. IRC §6662(c)

Employer Payments

Larsen v. Comm'r, TC Memo 2008-73 (Mar. 26, 2008)

IRC §6662

☞ Employer Payment not a Gift, Accuracy-Related Penalty Upheld

Facts. In July 1999, taxpayer Faith Larsen began working as an executive assistant for Donald Hoiland, the owner of Power Conversion, Inc. (PCI). Her starting salary was $60,000 per year. One year later, Hoiland promoted Larsen to vice president for operations and raised her salary by $30,000. The two were in regular contact and often had lunch together, but their relationship was typically professional in nature and was never intimate.

Larsen was unwilling to agree to employment contracts of longer than one year because she was uncertain how long she would stay in the Seattle area, where PCI was located. In an effort to persuade Larsen to stay on at PCI, Hoiland offered her a $20,000 raise, a Jaguar automobile, a condominium, and a promotion to president. Larsen refused this offer.

Nonetheless, she was promoted to president around December 2000. One month later, she received a $160,000 payment from PCI. Larsen created a bank account to receive the payment which was to be used in connection with her commercial photography business. Dave Skone, PCI's accountant, and Herman Pettegrove, Larsen's attorney, arranged for the payment and receipt of the funds. According to Larsen and Pettegrove, Skone characterized the payment as a gift. However, PCI issued Larsen a Form 1099-MISC, *Miscellaneous Income,* reporting that it had paid her $160,000. Larsen was under the impression that no other PCI employee received a bonus that large.

Shortly thereafter, Hoiland retired from his day-to-day duties at PCI. He traveled extensively during his retirement. While traveling one night, Hoiland called Larsen and threatened to fire her if she did not sleep with him when he returned. As Hoiland was a recovering alcoholic, Larsen attributed the episode to a relapse. Larsen reported the incident to the personnel manager for PCI, who encouraged her to prepare a summary of their conversation. Upon Hoiland's return, he apologized to Larsen and claimed that he had, in fact, been drinking.

The relationship between Larsen and Hoiland deteriorated after this incident. Hoiland fired Larsen in September 2001. In response, Larsen filed an informal claim for damages, and she engaged in mediation with PCI to settle her claim. During these negotiations, Larsen claimed that the $160,000 payment was a bonus.

Larsen did not report the $160,000 payment on her 2001 tax return. Pettegrove assisted her in the preparation of her tax return. He relied on alleged conversations with PCI employees in characterizing the payment as a gift, but he disregarded the Form 1099-MISC that PCI sent and did not make any independent determination as to the proper characterization of the payment.

PCI helped Larsen prepare her state income tax return. On it, it characterized the payment as for "Services and Other Activities." Larsen subsequently paid the state tax due on the $160,000 payment.

PCI did not claim a deduction for the $160,000 payment, and did not withhold taxes on the amount. The IRS determined a deficiency and an accuracy-related penalty under IRC §6662.

Issues. Whether Larsen:

- Should have included the payment from PCI in her taxable income
- Is liable for the 20% accuracy-related penalty

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Analysis. Gross income includes "all income from whatever source derived" unless expressly excluded by another provision of the Code.[59] Gross income includes compensation for services, but under §102(a), it does not include the value of gifts received. Generally, amounts paid from employers to employees are includable in gross income. However, such a payment may be an excludable gift when it is completely unrelated to the employment relationship and reflects no expectation of a business benefit. The transferor's intent is the critical inquiry in making this determination, and such intent must involve "a detached and disinterested generosity…, affection, respect, admiration, charity, or the like." In making this determination, the court need not give weight to the transferor's ex post facto characterization of the payment. Payments may still constitute taxable income even when the transferor and recipient are close friends.

A taxpayer is liable for a 20% accuracy-related penalty when she "substantially" understates her tax liability due to negligence or disregard for the obligations imposed by the tax laws.[60] An underpayment is considered substantial when it exceeds the greater of 10% of tax due or $5,000. A taxpayer is negligent where she fails to make a reasonable effort to comply with the tax laws. A taxpayer shows disregard when she shows carelessness, recklessness, or intentional disregard. A taxpayer is not liable for the penalty, however, when the taxpayer shows that the underpayment was due to reasonable cause and that she acted in good faith. Reliance on the professional judgment of a competent tax adviser, when the taxpayer provides him with all relevant information, may constitute a reasonable effort to comply with the tax laws.

Holding. Based on the fact that Hoiland had offered Larsen a series of escalating financial inducements to remain working at PCI and/or rewards for past job-related performance, the court held that the $160,000 payment was not a gift and therefore was includable in income. The court rejected Larsen's argument that the payment was based on Hoiland's romantic interest on the grounds that she flatly rejected his single, drunken, sexual advance. Furthermore, PCI's issuance of a Form 1099-MISC and inclusion of the payment in Larsen's state income tax return indicate that PCI did not consider the payment a gift.

Larsen only reported $829 in federal income tax due for the tax year in question, while the IRS determined a liability of $65,575. Therefore, the court held that Larsen's underpayment was "substantial." The court also held that Larsen's underpayment was attributable to negligence or disregard, and that she did not establish reasonable cause for the underpayment. The court made this determination on the grounds that she produced no evidence to the effect that PCI had characterized the payment as a gift, nor that Skone was competent to provide tax advice, and furthermore that Skone's issuance of a Form 1099-MISC along with his inclusion of the payment in his calculation of Larsen's state tax liability clearly contradicts Larsen's claim of reliance on PCI's characterization.

The court also declined to give weight to Larsen's claim that she relied on the advice of Pettegrove, because he made no independent determination about the proper characterization of the payment and simply relied on Larsen's characterization without further inquiry. Accordingly, the court held Larsen liable for the 20% accuracy-related penalty.

Characterization of Income

Monk v. Comm'r, TC Memo 2008-64 (Mar. 17, 2008)
IRC §6662

☞ Income Constitutes Rent

Facts. During the relevant period, taxpayer Raymond Monk (Monk) operated a variety of different businesses as sole proprietorships in the Baltimore area. In all but one instance, Monk relied on oral leases in his commercial real estate leasing activities. In 1994, Monk's friend Chuck Maney (Maney) expressed interest in opening a bar. Maney sought

59. IRC §61(a)

60. IRC §6662

Monk's help in providing financing for the venture and, because he was convicted of a felony as a youth, he also needed help obtaining a Maryland state liquor license. Monk agreed and provided $210,000 of the $250,000 required (Maney provided the other $40,000) to purchase the bar, which was named Chuck's Place. Monk applied for and received a Maryland state liquor license and lottery sales agent registration for the bar. He also created a bank account for the business to which he gave Maney full access. After performing these tasks, Monk moved 200 miles away and left the daily operation of the bar to Maney.

As a courtesy to his regular customers, Maney cashed their payroll and personal checks. He expected this would increase the amount of money that the "regulars" would spend at the bar by an amount sufficient to offset the associated risk.

Maney was responsible for the expenses associated with the interior of the bar, and Monk was responsible for expenses associated with the exterior of the bar. The two friends orally agreed that Maney would pay Monk $2,500 per month, offset by any expenses related to the exterior of the bar. Maney's sister and, later, his wife kept the books for the bar. Because Maney did not feel qualified to analyze them himself, he sent the books to Monk. Monk in turn submitted the books to his accountant, Joseph Hahn (Hahn), who was under the impression that Monk owned and operated the bar. Accordingly, Hahn reported the income and expenses from the bar on Monk's Schedule C each year from 1994 until 2002. Subsequently, the IRS audited Monk's 1999 and 2000 returns, during which years he reported net losses from the bar. As the audit was underway, Hahn discovered that Monk had no involvement in the management of the bar and that, in his opinion, Monk's role was more in the nature of a landlord then an owner of the business. Hahn therefore amended Monk's 2000, 2001, and 2002 returns to report Monk's income and expenses (to the extent that they constituted landlord expenses) from the bar on Schedule E instead of on Schedule C.

The IRS did not accept these amendments and determined that Chuck's Place was actually a check-cashing business which had been underreporting its income. Using the accepted "modified-bank-deposits" method for 1999 and the novel "check-cashing-fee" method for 2000, the IRS determined a deficiency for both years.

Issues. Whether Monk was the owner (or co-owner), or the landlord of Chuck's Place.

Analysis. Under applicable caselaw authority, a court can look to all the facts and circumstances to determine the true nature of an economic arrangement. Written documentation that contradicts economic reality does not control. One of the key elements in determining whether a taxpayer is a lessor or a co-owner of a business is whether the taxpayer is exposed to the "risk of loss" from the business. In the case of a labor-intensive business with no employees, there is a presumption that the individual who operates the business is the real owner.

Under Maryland state law, a lease may be oral in nature, and the terms "landlord" and "tenant" are construed very broadly.

A §6662 accuracy-related penalty may not be imposed when the error is reasonable under the circumstances.

Holding. The court looked at a variety of factors when it characterized Monk's relationship with Chuck's Place. The court held that Monk and Maney's oral agreement was sufficient to give rise to a valid lease under the broad provisions of Maryland state law. The court found that because Monk received a fixed $2,500 payment each month (offset by the cost of any exterior-related expenses) regardless of the net income or loss of the bar, Monk was not actually exposed to any "risk of loss" from the business. The court also found that Maney operated a labor-intensive business with no employees, giving rise to the presumption that he was the real owner. Accordingly, the court held that despite the fact that all written documentation indicated otherwise, Monk was actually the landlord for Chuck's Place rather than its owner or co-owner.

The court found that Monk had provided all relevant information to Hahn, and that Hahn's error in reporting the income on Monk's Schedule C was reasonable under the circumstances. The court therefore held that the imposition of a §6662 penalty was inappropriate under these circumstances.

Sexual Harassment Damages

Joyce M. Sanford v. Comm'r, TC Memo 2008-158 (June 23, 2008)

IRC §§61, 104, and 6662

☞ Sexual Harassment Damages are Taxable

Facts. Joyce Sanford was employed by the U.S. Postal Service (USPS) through 2004. She filed complaints with the U.S. Equal Employment Opportunity Commission (EEOC) in 1998 and 1999 alleging unlawful employment discrimination and sexual harassment by a USPS worker. The EEOC determined that she had suffered emotional distress due to the harassment. Her psychologist testified that she had experienced physical symptoms due to the psychiatric problems that the harassment created. The USPS paid the following in addition to past wages lost as ordered by the EEOC:

Year	Harassment Compensation Damages	Direct Attorney Fees	Future Pecuniary Losses
2003	$ 12,000	$16,602 (contingent)	$ 0
2004	103,000	4,686 (contingent)	33,542
Total paid	**$115,000**	**$21,288**	**$33,542**

On her 2003 and 2004 tax returns, Ms. Sanford reported only the past wages paid. She omitted the $115,000, $21,288, and the $33,542 amounts shown above. The IRS determined that the three amounts were includable in her gross income for the two years.

The IRS assessed $15,505 of additional tax and a $3,101 accuracy-related penalty under IRC §6662(a) for 2003. For 2004, the IRS assessed additional tax of $41,012 and an accuracy-related penalty of $8,202.

Issues. Whether the:

- $115,000 and the $33,542 amounts received in the legal action are excludable from gross income under IRC §104(a)(2) as damages received on account of personal physical injury or physical sickness
- $21,288 legal fees paid by the USPS to the taxpayer's attorney are excludable from her gross income
- Taxpayer is liable for the accuracy-related penalty under IRC §6662(a)

Analysis. Damages (other than punitive damages) received on account of personal physical injuries or physical sickness may generally be excluded from gross income. However, emotional distress is not treated as a personal physical injury or physical sickness.[61]

A litigant generally may not exclude the portion of recovery paid to her attorney when the damages received constitute income.[62] This is true even when the attorney's fee was paid on a contingent-fee basis.

Holding. It is evident from the EEOC decision order that none of the award was predicated on personal physical injury or physical sickness as required by IRC §104(a)(2). The EEOC decision stated that the sexual harassment caused the taxpayer's emotional distress. The decision also noted that the emotional distress manifested itself in physical symptoms such as asthma, headaches, and depression. However, these physical symptoms were not the basis of the award received. **The taxpayer sought, and was awarded, relief for sexual harassment and discrimination based on sex.**

The EEOC decision and order compensated the taxpayer for the emotional distress she suffered because of the sexual harassment she experienced at work and her employer's failure to take corrective action. **Damages received on account of emotional distress, even when resultant physical symptoms occur, are not excludable from income.**

The court also upheld the IRS determinations regarding the taxability of contingent attorney fees and the accuracy-related penalties.

61. IRC §104(a)

62. *Comm'r v. Banks*, 543 U.S. 426, Supreme Court (2005)

Tip Income

Mark Monkichi Ito v. Comm'r, TC Summ. Op. 2008-37 (April 16, 2008)
IRC §§61(a), 6001 and 6662

☞ IRS Recalculates the Correct Taxable Income

Facts. Mr. Ito was employed as a bartender during the years 2003 and 2004 in the lobby lounge of the Grand America Hotel in downtown Salt Lake City, Utah. His Forms W-2 for the 2003 and 2004 years were $20,487 and $28,850 respectively for his bartender duties. These amounts included tip income of $419 for 2003 and $7,214 for 2004.

The taxpayer did not keep any records of the amount of tip income that he received.

An employment tax audit by the IRS of the Grand Hotel disclosed tip income to the taxpayer of $21,360 in 2003 and $8,737 in 2004. The IRS relied on documented tip income on credit card sales, used a discount to determine tip income on cash sales, and then calculated an employee per hour tip rate.

The taxpayer acknowledged that he did not keep accurate records. However, he argued that because he worked in the lobby lounge, he received fewer and lower tips than other workers. At trial, he did not produce witnesses to this effect or evidence that supported his argument.

Issues. Whether the taxpayer is liable for:

- Additional tax on unreported tip income
- The accuracy-related penalty

Analysis. Gross income includes "all income from whatever source derived" unless expressly excluded by another provision of the Code.[63] There are no exceptions for tip income. A taxpayer is required to maintain records sufficient to allow the taxpayer to accurately report all income.[64]

IRC §6662 imposes a penalty for an underpayment of tax when such underpayment is attributable to negligence or disregard of federal income tax requirements. However, no penalty may be imposed when the taxpayer has reasonable cause for the underpayment.

Holding. The court agreed with the IRS determination that additional tip income for 2003 and 2004 must be reflected on taxpayer's tax returns. The limited evidence provided by the taxpayer did not eliminate the IRS calculation of the 20% accuracy-related penalty.

Parts Remanufacturer

Jeffrey M. and Cassandra M. Bigler, et al. v. Comm'r, TC Memo 2008-133 (May 19, 2008)
IRC §§446 and 6662

☞ Estimated Core Returns Not Allowed in Computing Income

Facts. Jeffrey Bigler, Bruce Bigler, and Donald Bigler collectively owned BBB Industries, Inc. (BBB). BBB remanufactures automobile parts such as alternators and starters. When each remanufactured part is sold, there are two charges — a unit price and a core price. On the date of sale, the core passes to the customer with BBB having no future rights in the core. The customer, however, does have an unlimited amount of time to return the cores. If BBB is unable to use the core for remanufacturing, they sell the core for scrap. The amount of cores returned to BBB varies from year to year. The cores returned may be greater than or less than the amount sold. As of the end of 2002, BBB did not know how many cores would be returned, which cores would be returned, or when the cores would be returned.

63. IRC §61(a)
64. Treas. Reg. §1.6001-1(a)

At the end of 2002, BBB calculated the amounts it would have to credit customers for anticipated core returns in a subsequent year. BBB credited the "deferred core income" amount for the potential liability based on core invoice prices. Taxable income was reduced by $1,674,499 representing the deferred core income account.

The IRS recomputed income to include total amount billed to customers, eliminated the deduction from income based on estimated return of cores, and asserted the accuracy-related penalty.

Issues. Whether:

- BBB must include the entire amount shown on a customer's invoice as income
- Income amount can be reduced by estimates for the return of customer cores
- Petitioners are liable for the accuracy-related penalty

Analysis. IRC §446(a) provides that taxable income is computed under the method of accounting on the basis of which the taxpayer regularly computes income in keeping its books.

Holding. The court agreed with the IRS position that BBB was required to include the full amount they billed for cores in income. After the sale occurred, the amount of income was fixed thus giving BBB the right to collect the entire amount stated on the invoice. The fact that BBB might have to credit the customer at some point in the future does not mean that income has not accrued thus satisfying the all events test for the entire amount of the invoice.

With respect to the liability for cores, the court determined BBB cannot deduct the amounts for cores that have yet to be returned. The liability is contingent on the return of the core and is not certain to accrue.

The court disagreed with the assertion of the accuracy-related penalty by the IRS. In this case, BBB kept detailed records of its transactions, BBB's bookkeeping was in accordance with generally accepted accounting principles, and BBB followed industry standards. These factors indicate the petitioners acted in good faith. Consequently, the penalty does not apply.

INNOCENT SPOUSE

Relief Revoked

ILM 200802030 (October 12, 2007)
IRC §§6015, 6404, 6501, and 6502

☞ Taxpayer Lie Causes IRS to Revoke Relief

Facts. The IRS gave innocent spouse relief to a wife requesting relief for three years of income tax liability. In order to prevent collection action, the outstanding liability was transferred to the husband's account, reducing her account to zero. During a later investigation, the IRS determined that she had lied about certain facts used to support the relief granted. When the facts came to light, the statute of limitations had passed for reassessing abated taxes.

Analysis. Innocent spouse relief does not constitute an abatement of tax liability. When the IRS reverses innocent spouse relief restoring the tax liability, it is considered a new assessment which is not barred by the statute of limitations. This differs from restoring an abatement of tax liability under §6504 which requires the restoration take place within the statutory period.

Tax abatement occurs because the:

- Original tax assessment was excessive
- Tax was assessed after the statute of limitations had expired
- The assessment was illegal or erroneous

Holding. The IRS can reinstate the erroneous granting of innocent spouse relief after the statute of limitations has expired.

Equitable Relief

Debra E. Bishop v. Comm'r, TC Summ. Op. 2008-33 (March 31, 2008)

IRC §6015

☞ Equitable Relief Granted Despite Ex-Husband's Objection

Facts. In an innocent spouse relief case, the Tax Court granted equitable relief to Debra Bishop and ignored her ex-husband's objections as an intervenor. David and Debra Bishop were married in 1982, separated in 2003, and divorced in 2004. Mr. Bishop, a former IRS revenue agent, plead guilty to bribing a public official in 1994 and was sentenced to 28 months in federal prison. He was released from prison in 1997 and rejoined his wife Debra and their two minor children.

Mr. Bishop began working as an auditor for the Texas Workforce Commission while Debra, a high school graduate, was employed as a claims processor for a health insurance company. Before and after 2000, the Bishop family began living beyond their means and incurred substantial debt. David Bishop was a domineering person who made the family financial decisions and prepared their federal income tax returns.

During the years at issue, David advised Debra to decrease her federal income tax withholding by increasing her Form W-4 exemptions. David followed his own advice for his employer's withholding. As a result, the joint returns they filed reflected the following unpaid balances due:

Year	Unpaid Balance Due
2000	$2,532
2001	4,685
2002	6,105

After the couple separated in 2003, Debra corrected her Form W-4 withholding allowances and entered into an installment agreement with the IRS to pay the balance due on her 2003 separate tax return.

Debra's request for **equitable innocent spouse relief** for the unpaid 2000, 2001, and 2002 taxes was denied by the Memphis Appeals Center of the IRS. In 2007, a subsequent review by the Austin Appeals Center of the IRS resulted in a reversal of the denial. This review determined that Debra should be granted full equitable relief under IRC §6015(f) for the 2000, 2001, and 2002 unpaid taxes.

However, David Bishop, now her ex-husband, objected to this action and refused to sign the Austin Appeals Center decision document. A Tax Court trial was necessary to determine the final outcome.

Issue. Whether Debra Bishop is entitled to equitable innocent spouse relief under IRC §6015(f)

Analysis. When the requesting spouse fails to qualify for relief under Rev. Proc. 2003-61, section 4.02, the IRS may nonetheless grant relief under section 4.03 of the same revenue procedure.[65] **There are eight factors that must be considered. After an analysis of these factors, equitable relief may be granted if, taking into account all facts and circumstances, it is inequitable to hold the requesting spouse liable.** The eight factors shown in Rev. Proc. 2003-61, section 4.03(2)(a) are:

1. **Marital status.** Whether the requesting spouse is separated or divorced from the nonrequesting spouse.
2. **Economic hardship.** Whether the requesting spouse would suffer economic hardship if the IRS does not grant relief from the income tax liability.
3. **Knowledge or reason to know.** Regarding underpayment cases, whether the requesting spouse did not know or had no reason to know that the nonrequesting spouse would not pay the income tax liability.

65. Rev. Proc. 2003-61, 2003-2 CB 296

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4. **Nonrequesting spouse's legal obligation.** Whether the nonrequesting spouse has a legal obligation to pay the outstanding income tax liability pursuant to a divorce decree or agreement.

5. **Significant benefit.** Whether the requesting spouse received significant benefit (beyond normal support) from the unpaid income tax liability.

6. **Compliance with income tax laws.** Whether the requesting spouse made a good faith effort to comply with income tax laws in the taxable years following the taxable year(s) to which the request for relief relates.

7. **Abuse.** Whether the nonrequesting spouse abused the requesting spouse.

8. **Mental or physical health.** Whether the requesting spouse was in poor mental or physical health on the date the related tax return or the Form 8857, *Request for Innocent Spouse Relief*, was signed.

Holding. After hearing the testimony of both David and Debra Bishop, the court determined that factors 1 (marital status), 2 (economic hardship), and 7 (mental abuse) shown above favored granting equitable relief. Factor 3 (knowledge or reason to know) weighed against granting relief and the other factors were neutral. Accordingly, the court agreed with the IRS determination that it would be inequitable to hold Debra liable for the underpayments of tax for 2000, 2001, and 2002. Therefore, she was granted equitable innocent spouse relief for the 2000, 2001, and 2002 unpaid taxes.

Equitable Relief

Mary Ellen Lepordo v. Comm'r, TC Summm. Op. 2008-4 (January 7, 2008)
IRC §6015

☞ No Abuse of Discretion by IRS in Denying Equitable Relief

Facts. Mary Lepordo and her husband Joseph filed the following joint returns which reported unpaid balances due:

Year	Unpaid Balance Due
1996	$ 8,598
1998	14,508
2001	18,089
2002	15,484

In April 2003, the IRS issued to Mr. and Mrs. Lepordo a notice of intent to levy with respect to the unpaid 1996 liability. In September 2003, the taxpayers filed an inadequate Offer In Compromise (OIC) for $1,500 which the IRS rejected in February 2004. Shortly after the rejection, Mr. Lepordo died. In May 2005, Mrs. Lepordo filed Form 8857, *Request for Innocent Spouse Relief*, seeking **equitable relief** under IRC §6015(f) for the unpaid taxes for 1996, 1998, 2001, and 2002.

The IRS denied Mrs. Lepordo's innocent spouse request in October 2005 and she petitioned the Tax Court for a redetermination of the denial.

Issue. Whether the IRS abused its discretion in denying equitable innocent spouse relief for the years in question

Analysis and Holding. After a thorough analysis of the eight factors shown in the *Bishop* case described above, the court held that the IRS appeals officer did not act "arbitrarily, capriciously, or without sound basis in fact" in denying innocent spouse relief.

The court found that Mrs. Lepordo did not satisfy the economic hardship factor requirements. In addition, she had knowledge or reason to know at the time she signed the joint returns that the tax reported for each year would not be paid by her husband. Consequently, the denial of innocent spouse relief for the four years in question by the IRS was accepted.

IRS PROCEDURES — MISCELLANEOUS

Hearing Before Levy

Louis A. Cox et ux. v. Comm'r, No. 06-9004; United States Court of Appeals for the Tenth Circuit (Jan. 30, 2008)
IRC §6330

☞ Court Holds Appeals Officer Was Not Impartial

Facts. After the IRS issued taxpayers Louis and Christine Cox a "Notice of Intent to Levy and Notice of Your Right to a Hearing" regarding an unpaid 2000 tax liability, the Coxes requested a collections due process (CDP) hearing to seek a less intrusive collection method. IRS appeals officer Bruce Skidmore was assigned to the Coxes' case. The Coxes requested that their liability be classified as "currently uncollectible" because they had "insufficient income to meet necessary allowable expenses." However, taking into account the fact that the Coxes paid only $1,000 of their $146,460 tax liability for 2001 and 2002 despite earning net income of over $100,000 in the first seven months of 2003, Skidmore concluded that the Coxes had the ability to make payments towards their liability, and decided that he could not recommend an alternative to a levy. Accordingly, the IRS Appeals Office issued a Notice of Determination holding that the levy for the 2000 tax liability was appropriate.

The IRS subsequently sent the Coxes another Notice of Intent to Levy with respect to their unpaid tax liability for 2001 and 2002. The Coxes again requested a CDP hearing, and appeals officer Skidmore was once again assigned to their case. The Coxes requested that Skidmore recuse himself on account of his involvement with their 2000 case, which they believed constituted "prior involvement" with their present case. However, Skidmore and his supervisor believed that because Skidmore had no prior involvement with determining the Coxes' tax liability for 2001 and 2002, his recusal was not "technically required" and "would do nothing but create delay." Skidmore subsequently held the CDP hearing for the Coxes unpaid liability for 2001 and 2002, and again he concluded that he could not recommend an alternative to a levy.

The taxpayers appealed to the Tax Court, which rejected their argument that Skidmore was not an impartial appeals officer with no "prior involvement" in their case. The Coxes then appealed the Tax Court's decision to the Tenth Circuit Court of Appeals.

Issues. Whether the Coxes received a fair CPD hearing for their 2001 and 2002 tax liability by an impartial appeals officer with no "prior involvement" in their case

Analysis. A taxpayer must receive a fair CDP hearing conducted by an impartial appeals officer with no "prior involvement" with respect to the unpaid tax specified in the Notice of Intent to Levy and Notice of Your Right to a Hearing.[66] "Prior involvement" includes participation or involvement in an Appeals hearing that the taxpayer may have had with respect to the tax and tax periods shown on the Notice.[67]

Holding. Citing the plain text of IRC §6330, the court rejected the IRS's argument that the meaning of prior involvement was limited to the meaning of Treas. Reg. §301.6330-1(d)(2), i.e., that the appeals officer previously conducted a hearing for the taxpayer regarding the collection of the same unpaid tax. The court held that the term "involvement" reflected that Congress intended a broad construction to ensure IRS appeals officer impartiality. The court further cited Skidmore's sharply critical remarks about the Coxes during the 2000 hearing as evidence that a broad interpretation of "prior involvement" was appropriate. Finally, the court noted that Skidmore took account of the Coxes' 2001 and 2002 tax liability in making his recommendation regarding the 2000 hearing. The court therefore held that Skidmore did have "prior involvement" with the Coxes' case. However, it granted the IRS's motion to permit the levy pending appeal with respect to 2000.

66. IRC §6330

67. Treas. Reg. §301.6330-1(d)(2)

Taxpayer Damages in Refund Suits

Jimmie and Sandra Cox v. U.S., No. 2:06-cv-00423; United States District Court for the Eastern District of California (Feb. 29, 2008)
IRC §§7422 and 7433

☞ Damage Claim Dismissed Due to Expired Statute of Limitation

Facts. Over the 1992–1997 tax years, the Coxes transferred substantially all their assets into trusts. The IRS audited the Coxes' returns for this period. After the Coxes failed to produce documentation substantiating their deductions and liabilities, the IRS determined the trusts were "sham[s]," ... "established for tax avoidance purposes." In July 2001, the IRS determined that the Coxes owed $459,527, not including penalties or interest. The IRS collected this liability from the Coxes by levying on stock they owned.

In February 2006, the Coxes sued for a refund of $1,040,099 in taxes, penalties, and interest. The Coxes also sought damages for profits and dividends they claimed to have lost as a result of the IRS's levy on their stock. After this suit was filed, the Coxes produced documentation for the 1992–1997 tax years. Based on this new documentation, the IRS determined that the Coxes were entitled to a $357,089 abatement. The Coxes still disputed the remaining $683,010. The IRS also sought a court order requiring the parties to meet on or before April 4, 2008 for at least six hours to discuss a settlement and to subsequently attend a settlement conference.

The IRS filed a motion to dismiss the Coxes' claim for damages, which the Coxes did not oppose.

Issues. Whether the IRS is liable for damages for lost profits and dividends

Analysis. A taxpayer is permitted to recover damages from the government for an IRS employee's intentional, negligent, or reckless disregard for the Internal Revenue Code or the Regulations promulgated thereunder.[68] Except for IRC §7432, which allows a taxpayer to recover damages for the IRS's failure to release a lien, IRC §7433 is the only grounds for allowing a taxpayer to recover damages from the government. An action under §7433 must be brought within two years after the date on which the cause of action arises.

Holding. The court held that the Coxes failed to plead a §7433 claim for damages, and their complaint could not be modified to include such a claim because the statute of limitations expired by that time. Therefore, the court dismissed the Coxes' claim for lack of subject matter jurisdiction. The court also granted the IRS's request for an order requiring a settlement meeting and conference, and encouraged the IRS to refund the $357,089 it conceded it owed the Coxes as soon as possible.

Tax Liens

Moco Investments, LLC v. U. S. et al., No. 02:06-cv-04040; United States District Court for the District of New Jersey (Jan. 31, 2008)
IRC §§6321 and 6323

☞ Court Upholds Tax Lien

Facts. The IRS assessed federal tax liabilities on Chad and Nadine Bacek on May 10, 2003, May 24, 2004, and May 23, 2005, for the 2002, 2003, and 2004 tax years, respectively. These assessments caused tax liens to arise and to attach to the Baceks' real property at the time of each assessment. Taxpayer Moco Investments, LLC (Moco) purchased the Baceks' property on May 31, 2005, and the deed to that property was delivered at that time. The IRS filed notices of the tax liens on December 7, 2005, thereby perfecting such liens. Moco recorded the deed on the property in January 2006.

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68. IRC §7433

Issues. Whether Moco is liable for the tax liens on the property it purchased from the Baceks

Analysis. Federal tax liens arise at the time they are assessed, unless another time is specified by law.[69] Under New Jersey law, the delivery date of a deed makes the deed valid as between the grantor and the grantee, but recordation of the deed is required to protect the grantee against subsequent purchasers. Protection from a federal tax lien requires that the deed be protected from subsequent purchasers.[70]

Holding. The court rejected Moco's argument that the date the deed was delivered (May 31, 2005), and not the date the deed was recorded (January 2006) should control. Since the tax lien was perfected on December 7, 2005 and Moco did not record the deed until January 2006, the deed was not protected from subsequent purchasers at the time the tax liens were perfected under New Jersey law. And because the deed was not protected against subsequent purchasers at the time the tax liens were perfected, Moco was not a "purchaser" of the property under §6323(h)(6) at the time the tax liens were perfected, and was therefore not protected from a federal tax lien. The court held that Moco was liable for the amount of the tax lien.

College Savings Plans

Treas. Reg. §127127-05 (Jan. 17, 2008)
IRC §§529 and 2651

☞ IRS Targets Inconsistencies in Transfer Tax Provisions

Purpose. The IRS is concerned about the possible abuse of §529 college savings plans. They have proposed an anti-abuse rule to prevent taxpayers from using the plans to avoid transfer taxes.

Analysis. The IRS issued proposed regulations relating to §529 college savings plans in 1998. However, these rules leave many unanswered questions which the IRS is attempting to answer with the new proposed regulations. The current law allows the potential for abuse of §529 accounts. Because the §529 plans have been permanently extended, the IRS wants to eliminate the chance for abuse.

Two means of possible abuse have been identified:

1. Taxpayers have the ability to change designated beneficiaries without triggering transfer tax. A taxpayer may create multiple accounts with different designated beneficiaries with the intent to change the beneficiary to a single beneficiary and distribute the entire amount without tax consequences. The present law allows a plan contributor to contribute the current gift maximum of $12,000 to a plan. If he exceeds this amount, he can elect to have the excess treated as if it was contributed over a 5-year period.

Example. Glenna contributes $60,000 to a college savings plan with her grandson Ben as the designated beneficiary. In addition, she established seven other plans for her other grandchildren as the beneficiaries. She later changes the beneficiary designations of the seven other plans to Ben with no tax consequences.

2. Taxpayers may use the §529 plans as retirement accounts with none of the restrictions associated with qualified retirement accounts.

A contribution to the §529 plan is treated as a completed gift to the designated beneficiary. However, the account owner may withdraw the money at his discretion.

69. IRC §6321

70. IRC §6323(h)(6)

The rules expected to be included in the proposed regulations include:

- An anti-abuse rule will prevent the type of abuse described in the **Example.**
- Tax treatment of contributions to and participants in §529 accounts. Gift and generation-skipping tax will apply to a transfer because of a change in the designated beneficiary or a rollover of the account to a new beneficiary. This would not apply if the new designated beneficiary is in the same or a higher generation than the former designated beneficiary or is a member of the family of the former designated beneficiary.
- Rules governing the function and operation of qualified tuition programs.

Effective Date. These are only proposed regulations. An effective date will be announced if they become permanent.

Note. See Chapter 6, "Education Tax Incentives," for more information on §529 plans and new regulations forthcoming from the IRS.

Tax Return Information Disclosure

Treasury Decision 9375 (Jan. 4, 2008, corrected Feb. 12, 2008) and Rev. Proc. 2008-12, IRB 2008-4

IRC §§6713 and 7216

☞ New Consent Requirements

Purpose. The final regulations regarding tax return information disclosure were released in January 2008. These strict requirements limit information a tax practitioner can disclose to others. They also contain the mandatory language for the disclosure statements in Rev. Proc. 2008-12.

Effective Date. For use of tax information after December 31, 2008.

Note. A detailed discussion of all of the recent changes in the disclosure rules is included in Chapter 2, "Ethics."

Filing Time Extensions

Treasury Decision 9407 (July 1, 2008)

IRC §6081

☞ Final and Temporary Regulations for Business and Individual Automatic Extensions

Purpose. The IRS published final and temporary regulations to simplify the procedures for obtaining automatic filing extensions.

Analysis. For individuals, the final regulations adopt without change the earlier temporary regulations which eliminated the 2-step extension process. Individual taxpayers file Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*, and are granted a 6-month extension without the need to provide a signature or explanation.

For corporations, the final regulations do not change the extension rules. However, the appearance and title of Form 7004, *Application for Automatic 6-Month Extension of Time to File Certain Business Income Tax, Information, and Other Returns*, was changed. Additionally, the requirement to list the names and addresses of each member of an affiliated group with the extension request now effectively grants an extension for each member's separate return if the member does not file as part of the consolidated group.

The temporary regulations for pass-through entities (partnerships, estates, and trusts) that generate K-1s and similar statements contain a provision to **reduce** the extension of time for filing returns **from six to five months**. The IRS said that shortening the extension period for pass-through entities gives K-1 recipients more time to prepare and file their returns. **These temporary regulations allow automatic 5-month extensions of time for pass-through entities to file returns due on or after January 1, 2009.** Applications for extensions of time for returns required to be filed before January 1, 2009 are allowed an automatic 6-month extension of time to file the applicable returns.

Effective Date. This decision is effective July 1, 2008.

Refund Anticipation Loans (RALs)

Prop. Treas. Reg. §136596-07

IRC §§7216 and 6713

☞ IRS Attempts to Eliminate RALs

Purpose. In a continuing attempt to limit or eliminate refund anticipation loans (RALs), the IRS released proposed regulations for public discussion. **The IRS expressed two concerns in allowing tax preparers to sell RALs.** First, they are concerned that unscrupulous preparers will inflate the clients refund in an attempt to sell the product because of the financial incentive. Oftentimes, the preparer receives a fee from the RAL provider based on the amount of the refund. The second concern is that the financial benefits of selling a RAL may compromise the compliance with due diligence procedures designed to ensure the accuracy of EITC claims.

The IRS is also concerned about two other products marketed by some tax preparers. One is the refund anticipation check (RAC) and the other is audit insurance.

The proposed regulations create an exception to the disclosure regulations. The exception effectively separates the act of return preparation from the act of marketing or purchasing certain financial products by prohibiting the use of information obtained during the tax preparation process for the nontax administration process of marketing a RAL, RAC, or audit insurance.

> **Note.** Additional information can be found in Chapter 2, "Ethics."

Effective Date. The proposed effective date is that the new rules will apply to returns filed on or after January 1 of the year following the date of publication of the final or temporary regulations in the Federal Register.

Economic Stimulus Payments

IRS Ann. 2008-44, IRB 2008-20 (Apr. 30, 2008)

IRC §6428

☞ ESP Withdrawals from Tax-Favored Accounts Not Subject to Tax or Penalty

Taxpayers who requested direct deposit of their 2007 tax refunds into one account specified on that return will have their economic stimulus payments (ESPs) directly deposited into the same account. The account can be a checking account, savings account or an account that is given favorable tax treatment under the Code such as an IRA, HSA, Archer MSA, Coverdell education savings account or qualified tuition plan.

Taxpayers who have the ESP directed to an IRA or other favored account may remove the payments without incurring any adverse consequences if the payments are withdrawn no later than the due date of the 2008 income tax return plus extensions.

The financial institution who receives the ESP and makes the distribution will report the transactions in the usual manner. Instructions will be provided in the 2008 Form 1040 package explaining how taxpayers should report these distributions so the amounts are not subject to taxes or penalties.

2006 Individual Tax Return Statistics

Internal Revenue Service, Statistics of Income Division (July 2008)

☞ Percentage of Individual Income Tax Paid by High-Income Taxpayers Continues to Rise

Analysis. The most recent statistics show that the top 10% of individual taxpayers (based on AGI) paid 70.79% of the total 2006 individual income taxes. The percentage of 2006 tax paid by the bottom 50% of taxpayers (based on AGI) fell to only 2.99%.

Percentiles Based on 2006 AGI	AGI Threshold	Percentage of Individual Income Tax Paid
Top 1%	$388,806	39.89%
Top 5%	153,542	60.14%
Top 10%	108,904	70.79%
Top 25%	64,702	86.27%
Top 50%	31,987	97.01%
Bottom 50%	Less than $31,987	2.99%

IRS PROCEDURES — PAYMENTS

Breached Offer in Compromise

Michael Poindexter v. Comm'r, TC Memo 2008-99 (Apr. 15, 2008)

IRC §§6320 and 6330

☞ Failure to Meet Future Offer in Compromise Requirements Results in Levy

Facts. Michael Poindexter and his wife, Nancy, habitually filed joint returns which reported balance due amounts. In November 1997, the IRS accepted their offer in compromise (OIC) for the tax years 1990 through 1995. The OIC required them to timely file income tax returns and timely pay any balances due for the **longer** of:

- Five years following acceptance of the OIC, or
- Until the OIC was paid in full.

> **Note.** Michael's filing status for 2000 and 2001 was not married filing jointly.

Michael timely filed his 2000 and 2001 tax returns but failed to pay the reported balances due. In October 2003, the IRS sent a letter which notified him that failure to pay the balances due within 30 days would result in:

- Default on the OIC, and
- **Reinstatement of the original tax liabilities** for the tax years 1990 through 1995.

Michael responded to the IRS with his own letter dated November 2003 in which he requested an additional six months to pay the outstanding balances for his 2000 and 2001 returns. In December 2003, the IRS entered his OIC default in its computer system. In September 2004, the IRS mailed Michael a Notice of Intent to Levy and Your Right to a Hearing regarding 1993, 1994, and 1995. Shortly afterwards, Michael timely filed Form 12153, *Request for a Collection Due Process Hearing* (CDP hearing).

In December 2004, more than one year after the OIC default, Michael paid the outstanding balances for his 2000 and 2001 returns. At the CDP hearing, Michael contended that the OIC should not have been defaulted and that collection action for 1993, 1994, and 1995 was not warranted. In July 2005, the IRS issued a Notice of Determination Concerning Collection Action(s) Under §§6320 and/or 6330 to Michael, it stated that the default of the OIC was procedurally and legally correct and that it was proper to enforce the levy.

Issue. Whether the IRS abused its discretion in sustaining the default of the OIC and determining to proceed with the levy.

Holding. The Tax Court determined that the appeals officer's actions and decisions in the CDP hearing were appropriate.

Note. The Tax Court has noted in several of its reviews of CDP hearings that the hearings were used by taxpayers simply as a delaying tactic. However, that view was not expressed by the Tax Court judge in this case.

IRS PROCEDURES — PENALTIES

Enforcement of Summons

U.S. v. H. Clark Ford III, No. 07-2162; United States Court of Appeals for the 10th Circuit (Jan. 25, 2008)
IRC §7604

☞ Order of Civil Contempt Upheld

Facts. Since at least 2001 or earlier, H. Clark Ford III had not filed tax returns. In response, the IRS issued Ford two summonses in August 2006. Both requested that Ford testify before the IRS and provide documentation related to his income for the years 2001 through 2005 and his assets and liabilities for the period for August 2005 through July 2006. Ford raised various frivolous objections to these summonses and refused to comply.

The IRS then referred the matter to the U.S. Attorney's Office, which sent Ford a letter seeking his compliance. Ford again refused to cooperate. As a result, the government sought an order compelling Ford's compliance from the district court. In April 2007, the district court issued an order requiring Ford to appear before the IRS and supply the requested documentation. Ford responded with a motion for reconsideration of the court's enforcement order, in which he essentially reiterated his previous frivolous objections. The court denied the motion.

On May 2, 2007, Ford appeared before the IRS in compliance with the court's order. However, he produced none of the documents requested and offered no responsive testimony. In response to Ford's noncompliance, the government filed a request with the district court to enforce the IRS summonses and to hold Ford in civil contempt. The government further sought to have Ford placed in federal custody until he agreed to comply with the IRS summonses. During a hearing pursuant to the district court's order to show cause, Ford once again offered a laundry list of frivolous tax protestor arguments. These arguments did not persuade the court, and the court held Ford in civil contempt and placed him into federal custody.

The court further instructed the government to immediately remind Ford that he would be released as soon as he complied with the IRS's requests. The government did so, but Ford still refused to cooperate. He filed a request to be released on his own recognizance, which the court refused. The court did, however, allow Ford to be conditionally released upon the posting of a cash bond. Ford refused to post the bond on the grounds that doing so would be to participate in the illegitimate proceedings against him. Ford filed a request for an expedited appeal to the 10th Circuit Court of Appeals, in which he requested a writ of habeas corpus and appealed both the district court's order of civil contempt and its rejection of his arguments against compliance.

Issues. Whether:

- Ford is entitled to a writ of habeas corpus
- The district court abused its discretion by placing Ford in civil contempt

Analysis. A request for habeas corpus must be made to the appropriate district court.

A district court's civil contempt order is reviewed for abuse of discretion. A district court only abuses its discretion when its determination is based on an error of law or a clearly erroneous finding of fact. The government has the burden of proving, by clear and convincing evidence, that a valid court order existed, that the defendant had knowledge of the order, and that the defendant disobeyed the order. Once the government meets this burden, the burden shifts to the defendant to show that he either complied with the order or could not comply with it.

Holding. The appeals court held that the taxpayer's request for habeas corpus was not properly made, and therefore transferred the request to the district court.

The 10th Circuit held that the district court did not abuse its discretion by issuing a civil contempt order for Ford. The government provided clear and convincing evidence that a valid court order existed, that Ford knew about the order, and that he refused to comply with the order. The court held Ford's tax protestor and due process clause objections to the order were "patently frivolous."

Accuracy-Related Penalty

Larry J. Wadsworth et ux. v. Comm'r, TC Memo 2008-171 (July 21, 2008)
IRC §6662

☞ Taxpayers Should Heed Accountant's Advice

Facts. Wadsworth was a general partner in a medical products and services partnership located in California. The partnership operated a pharmacy and provided services and products to eligible beneficiaries of the California Medical Assistance Program. The California Department of Health Services (DHS) conducted an audit of the partnership and determined the partnership was overpaid for claims and directed the partnership to remit over $2 million within 60 days of receiving the audit report.

The partnership appealed the audit and was represented by its attorney. After the appeal, the attorney requested that the CPA of the partnership file amended partnership returns reporting reduced receipts for the audit years. When the CPA researched the tax code, he determined an amended return was inappropriate because the partnership had not returned any money and was a cash-method taxpayer. The CPA told the attorney and partnership that a deduction could only be claimed in the years the money was remitted to the state. He requested that the attorney provide any contrary legal authority. The CPA never received anything from the attorney.

The partnership decided to hire another accountant and then filed an amended return claiming the invalid deductions. The second accountant's background was in finance rather than in tax. At trial, he testified that he had not researched the issue.

Based on the amended Forms 1065 and Schedule K-1s, the Wadsworths filed amended Form 1040s and claimed refunds created by the reduced partnership income. The IRS paid the refund amounts, but later audited the Wadsworths' individual income tax returns. This resulted in tax deficiencies of over $204,000 and penalties totaling over $40,000.

At the time of the audit, the DHS had ruled on the partnership's appeal and determined the partnership did not owe any money. Unfortunately, before the DHS report was received, the amended returns were filed.

The Wadsworths agreed they received an erroneous refund because of the amended return. However, they insisted they were not liable for an IRC §6662 accuracy-related penalty. They first argued the amended partnership return was due to a contingent liability. They also argued they relied on competent professional advice when filing the amended returns. Because a copy of the amended K-1 was attached to the return, the taxpayers argued the tax position was disclosed on the return which would also negate the penalty.

Analysis. If the partnership uses the cash method of accounting, it is only entitled to deduct the liability in the year in which the liability is paid. An accrual-basis taxpayer generally cannot accrue a deduction for a contested liability unless the conditions of §461(f) are met. Unfortunately, the partnership made no transfer of money within the meaning of §461(f).

To avoid an accuracy-related penalty, disclosure of a position taken on a return must be reported on Form 8275, *Disclosure Statement.* Filing Form 8275 does not abate an accuracy-related penalty if there is no reasonable basis for the position taken.

Holding. Regarding the issue of competent professional advice, the court ruled that neither the attorney nor the accountant that prepared the amended returns constituted competent professional advice. The court noted that the original preparer of the returns had researched the issues and informed the client and attorney that an amended return was not appropriate. They also stated that Mr. Wadsworth was a successful business person who operated a multimillion-dollar business. It is reasonable to assume that such a person would investigate the basis for amending his returns when his long-time accountant advised against the position taken on those returns.

Finally, the court ruled that attaching the K-1 was not sufficient disclosure.

The court ruled in favor of the IRS and confirmed the accuracy-related penalty applied.

Change in Penalties

IRS Notice 2008-13, IRB 2008-3

IRC §§ 6695, 6694, and 6696

☞ Enhanced Standard of Conduct for Tax Preparers

Purpose. The IRS announced guidelines which raise the standards tax preparers must uphold to avoid the expanded preparer penalties.

The following notices were also released:

- Notice 2008-11; Clarification of transitional relief of Notice 2007-54
- Notice 2008-12; Tax preparer signature requirements

> **Note** A detailed discussion of all of the recent changes in preparer penalties is included in Chapter 2, "Ethics."

Effective Date. As of January 1, 2008 for most returns.

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ITEMIZED DEDUCTIONS

Nonfiler

David Jahn vs. Comm'r, TC Memo 2008-141 (May 21, 2008)
IRC §§63(e), 6651, and 6654

☞ Nonfiler Forfeits Right to Itemize

Facts. David Jahn, who was married, refused to file federal tax returns for several years, including 2004, even though he had significant wages and income tax withheld. Using the substitute for return procedure, the IRS Service Center calculated his 2004 tax liability as follows:

Form W-2 wages	$96,990
Rental income from employer per Form 1099-MISC	2,281
AGI	$99,271
Less: standard deduction (MFS)	(4,850)
Less: personal exemption	(3,100)
Taxable income	$91,321
Tax (MFS)	$20,647
Less: federal income tax withheld (per Form W-2)	(14,407)
Deficiency	$ 6,240
Plus: failure-to-file penalty	1,404
Plus: failure to timely pay penalty	562
Plus: failure to pay estimated tax	133
Amount due per Service Center (not including interest)	**$ 8,339**

The taxpayer represented himself at the Tax Court trial and contended that he was entitled to itemize deductions for 2004.

Issues. Whether the nonfiling taxpayer was:

1. Entitled to itemized deductions as a substitute for the $4,850 standard deduction amount used by the IRS
2. Liable for the failure to file, failure to timely pay, and failure to pay estimated tax penalties

Holding. The court held that a taxpayer must file a return in order to **elect** to itemize deductions.[71] Therefore, the standard deduction allowed by the IRS was proper. In addition, the court upheld the three penalty amounts.

71. IRC §63(e)(2)

Education Expense Deduction

Veronica L. Foster v. Comm'r, TC Summ. Op. 2008-22 (February 28, 2008)
IRC §§162, 262, 263 and 6662

☞ Education Expense Deductions Disallowed

Facts. Veronica Foster moved to the United States from New Zealand in the fall of 2001 to obtain an MBA from Harvard Business School (HBS). Her undergraduate degree, which she earned from the University of Canterbury in New Zealand, was in chemical engineering and did not involve the study of business or management. Foster worked as an engineering consultant for International Food and Beverage Services immediately before moving to the United States, and at no time before moving did she hold a position in marketing or management.

Foster was specifically required to take several courses in finance and accounting before she matriculated at HBS. She did not have a specific job arranged after graduation. As part of her MBA practical curriculum training, Foster worked as a corporate strategy consultant at Snapple Beverages Corp. In the spring of 2003, upon graduation from HBS, she accepted the position of vice president of marketing at Refreshment Brands, Inc.

On Foster's 2002 Form 1040NR, *U.S. Nonresident Alien Income Tax Return*, which was prepared by a tax return preparer, she stated her occupation as "management" and claimed itemized deductions for her fees and tuition attributable to her MBA degree. As part of its petition for an H-1B Visa for Foster, Refreshment Brands stated that:

> *The position of Vice President of Marketing requires theoretical and practical application of highly specialized knowledge and attainment of a Bachelor's Degree in Business Administration or equivalent. The position requires at least a Bachelor's degree in a field related to the specialty occupation.*

The IRS audited Foster's return, disallowed the education expenses, determined a deficiency, and assessed a penalty under §6662.

Issues. Whether Foster:

- May deduct the expenses of obtaining her MBA
- Is liable for the §6662 accuracy-related penalty

Analysis. IRC §162(a) allows a deduction for all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Educational expenses are deductible under this section when such education improves or maintains the taxpayer's skills required by his employment or other trade or business. In order to claim such a deduction, the taxpayer must show a direct and proximate relationship between the education and the skills required in his employment. However, educational expenses incurred to meet minimum educational requirements for a taxpayer's trade or business or which qualify the taxpayer for a new trade or business are deemed personal or capital in nature[72] and are not deductible under §162.

IRC §6662 imposes a 20% accuracy-related penalty for a substantial underpayment of tax when the underpayment is attributable to negligence or disregard for the requirements of the tax laws. However, §6664 provides a defense when the taxpayer establishes that he acted with reasonable cause and in good faith. The extent of a taxpayer's efforts to determine and comply with his tax obligations is generally the most important factor in making this determination. Reliance on a tax preparer alone is not sufficient; such reliance must be reasonable under the circumstances.

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72. Treas. Reg. §1.162-5(b)(1)-(3)

Holding. Relying on Refreshment Brands' H-1B petition and the fact Foster had no prior education in business or marketing, the court found that Foster's MBA was necessary to fulfill the minimum requirements of her position as vice president of marketing. The court also held that her MBA degree qualified her for a new trade or business, and therefore her expenses were not deductible. This determination was based on the fact that HBS required Foster to take accounting and finance courses prior to matriculation, that she studied marketing extensively while at HBS, and that Foster's MBA qualified her to perform significantly different tasks and activities.

Because Foster did not supply all the relevant information to her tax return preparer when she simply listed her occupation as "management," or establish that she made any effort to try to determine her proper tax liability, the court sustained the IRS's imposition of the §6662 penalty.

> **Note.** See Chapter 6, "Education Tax Incentives," for more information on the deductibility of higher education expenses.

Recordkeeping

Akin Falodun v. Comm'r, TC Summ. Op. 2008-5 (January 7, 2008)

IRC §§162, 274, and 6001

☞ Tax Court Has Little Sympathy for Taxpayer's Lack of Records

Facts. The taxpayer was a full-time employee of Hughes Network Systems and did some tutoring on evenings and weekends for Consolidated Education Resources. The table below shows the 2003 income-reporting forms he received and where he reported them on his 2003 tax return.

Type of Income	Form Received	Amount of Income	Where Reported on Return
Wages from employer	W-2	$43,563	Form 1040, line 7
Tutoring	1099-MISC	6,215	Schedule C-EZ

The Schedule C-EZ for the tutoring activity reported no expenses. However, the taxpayer completed Form 2106, *Employee Business Expenses*, which reported the following tutoring-related expense:

Business miles driven in 2003	28,744
Business auto expense [28,744 × $0.36 (standard mileage rate)]	$10,348

The taxpayer itemized his deductions. On his 2003 Schedule A, he reported the following charitable contributions:

Gifts by cash or check	$ 4,356
Other than by cash or check	8,565
Total charitable contributions	$12,921

A Form 8283, *Noncash Charitable Contributions*, was completed. It reported that clothes, toys, appliances, a shoe rack, a TV, a VCR, five leather cases, and 1,000 cups were given to the Salvation Army and the National Children's Center.

The IRS determined that due to lack of substantiation, the taxpayer was not entitled to claim any employee business expenses or charitable contributions.

Issue. Whether the taxpayer was entitled to deduct charitable contributions of $12,921 and unreimbursed employee business expenses (before the application of the 2% of AGI floor) of $10,348.

Analysis. Deductions are a matter of legislative grace, and the taxpayer bears the burden of proving that he is entitled to any deduction claimed.[73] Taxpayers are required to maintain records sufficient to permit verification of income and expenses.[74]

In addition, no deduction is allowable for expenses incurred in respect of listed property such as a passenger automobile on the basis of any approximation or the unsupported testimony of the taxpayer.[75] These stringent substantiation requirements are designed to encourage taxpayers to maintain records, as well as documentary evidence to substantiate each element of the claimed expense.[76]

Holding. Because the taxpayer's records were practically nonexistent, the court allowed only the following deductions:

- $250 for church contributions
- $250 for gifts of property (noncash charitable contributions)
- Nothing for business auto expense claimed on Form 2106 (due to failure to satisfy the strict recordkeeping requirements for listed property)

LIKE-KIND EXCHANGES

Qualified Intermediary

Ltr. Rul. 200803003 (October 17, 2007)
IRC §1031

☞ Proposed QI is not a Disqualified Person

Facts. A Firm provides financial services to its clients either directly or indirectly. One of its wholly-owned subsidiaries, Sub B, provides investment advice, brokerage, and financial planning services. Sub B owns Sub B1, whose business is advising on insurance matters and selling insurance and annuity products. Firm's other wholly-owned subsidiary, Sub C, owns Banks 1 and 2. Bank 2 is the proposed qualified intermediary (QI). Firm wants to begin offering like-kind exchange services and use Bank 2 as its intermediary. Bank 2's customers will include current clients of the Firm's subsidiaries.

Analysis. No gain or loss is recognized on a qualified like-kind exchange.[77] However, if the taxpayer actually or constructively receives money or other unlike property before receiving the like-kind replacement property, gain is recognized on the exchange. In order to facilitate exchanges, the IRS published safe harbor rules which allow an intermediary to receive the property. However, the QI cannot be a disqualified person.

A QI is considered a disqualified person if it acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent within two years of the date the relinquished property is transferred. This rule does not apply to a bank or bank affiliate solely because the bank is a member of the same controlled group of a person who has provided investment banking or brokerage services.

Holding. Bank 2 is not a disqualified person for purposes of the exchange.

73. Tax Court Rule #142(a)
74. IRC §6001 and Treas. Reg. §1.6001-1(a)
75. IRC §274(d) and *Golden v. Comm'r*, TC Memo 1993-602 (Dec. 20, 1993)
76. Temp. Treas. Reg. §1.274-5T(c)(1)
77. IRC §1031

Development Rights

Ltr. Rul. 200805012 (October 30, 2007)
IRC §1031

☞ Development Rights Like-Kind to Real Property

Facts. The taxpayer, a corporation, owns two properties and intends to transfer one property to a QI who will sell the relinquished property to a third-party purchaser. The QI will use the proceeds to purchase development rights from a third-party seller. The development rights will then be attached to the other property, allowing the corporation to develop the property with greater floor space than would have been otherwise permitted.

Analysis. A tax-deferred like-kind exchange of real property is allowed.[78] Both the relinquished and replacement properties must be used in an active trade or business or held for investment. "Like-kind" refers to the nature or character of the property and not to its grade or quality. The definition of real or personal property is generally determined under state or local law. In this case the development rights are considered real property.

Holding. A §1031 exchange is permitted.

Multi-Party Exchanges

Ltr. Rul. 200810016 (December 6, 2007)
IRC §1031

☞ 2-Year Holding Period Required for Nonrecognition of Gain for Exchanges Between Related Parties

Facts. Two LLCs, taxed as partnerships, are owned by related persons. AB LLC (AB) owns Blackacre and CD LLC (CD) owns Greenacre. AB agreed to transfer Blackacre to an unrelated buyer. AB intends to exchange Blackacre for replacement property as part of a like-kind exchange. CD also intends to sell Greenacre and use the proceeds to acquire like-kind property.

AB and CD want to facilitate their exchanges with the help of a QI. The QI will be treated as the seller of Blackacre to the unrelated buyer. The QI will be treated as acquiring Greenacre from CD and transferring it to AB in exchange for Blackacre. The QI will be treated as acquiring CD's replacement property to replace Greenacre and transferring it to CD in exchange for Greenacre. CD's replacement property will be acquired through the QI from the unrelated seller.

Once all transactions are completed, the unrelated buyer will own Blackacre, AB will own Greenacre and CD will own its replacement property. AB will not dispose of Greenacre for the requisite two years.

Analysis. No gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment, if the property exchanged is like-kind to the relinquished property.[79] There are special rules for related persons. If a taxpayer exchanges property with a related person, there is no recognition of loss or gain if the relinquished or replacement property is held for two years.[80] This rule does not apply in certain circumstances such as:

- The death of the taxpayer or related person,
- In situations of involuntary conversion, or
- If the IRS determines the exchange had as one of its principal purposes to avoid federal income tax.[81]

Holding. Provided the LLCs with related owners hold the exchanged property for two years, there is no recognition of gain or loss on the exchange.

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78. IRC §1031
79. IRC §1031(a)(1)
80. IRC §1031(f)(1)
81. IRC §1031(f)(2)

Like-Kind Exchanges

Rev. Proc. 2008-16, IRB 2008-10 (Feb. 15, 2008)

IRC §§1031 and 280A

☞ Safe Harbor for Exchanges of Dwellings Occasionally Used for Personal Purposes

Purpose. The IRS provided a safe harbor under which it will not challenge whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment for purposes under §1031.

Analysis. No gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment (**relinquished property)** if the property is exchanged solely for property of like-kind that is to be held for productive use in a trade or business or for investment (**replacement property**).[82] The provisions of §1031 do not apply to property used solely as a principal residence. However, the IRS has recognized that many taxpayers hold dwelling units primarily for the production of current rental income, although the taxpayers may occasionally use the properties for personal purposes. Rev. Proc. 2008-16 provides taxpayers with a safe harbor under which a dwelling unit will qualify as property held for productive use in a trade or business or for investment under §1031 even though the taxpayer occasionally uses the dwelling unit for personal purposes.

The IRS will not challenge whether a dwelling unit qualifies under §1031 if the qualifying use standards are met. Under these standards, a dwelling unit that the taxpayer intends to be **relinquished property** in a §1031 exchange qualifies as property held for productive use in a trade or business or for investment if:

- The relinquished property is owned by the taxpayer for a minimum of 24 months immediately **before** the exchange (the qualifying use period);
- Within the qualifying-use period, in each of the two 12-month periods immediately **preceding** the exchange, the taxpayer rents the dwelling unit to another person or persons at a fair rent for 14 days or more; and
- The taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10% of the number of days in the 12-month period that the dwelling unit is rented at a fair rental value.

A dwelling unit that a taxpayer intends to be **replacement property** in a §1031 exchange qualifies as property held for productive use in a trade or business or for investment if:

- The dwelling unit is owned by the taxpayer for a minimum of 24 months immediately **after** the exchange (the qualifying use period);
- Within the qualifying-use period, in each of the two 12-month periods immediately **after** the exchange, the taxpayer rents the dwelling unit to another person or persons at a fair rent for 14 days or more; and
- The taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10% of the number of days in the 12-month period that the dwelling unit is rented at a fair rental value.

Effective Date. This revenue procedure is effective for exchanges of dwelling units occurring on or after March 10, 2008.

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82. IRC §1031(a)

NOT FOR PROFIT

Not-for-Profit Activities

Benson v. Comm'r, TC Summ. Op. 2008-29 (March 13, 2008)
IRC §§162, 183, 212, and 6502

☞ Expense Deductions Disallowed for Activity Not Engaged in for Profit

Facts. Ms. Benson won the Colorado lottery in 2000. She received proceeds of $2.72 million and used these funds to create the Lila Osborne Memorial (Memorial), a Christian counseling center. During this time, Benson continued working as a nurse.

Benson acquired a building for use in connection with Memorial in 2000. Her sister helped run the building and her nephew helped maintain it. The building had nine offices, a waiting room, and a bathroom. Benson's brothers used one office for playing video games and using the computers. One office room was used for prayer by a volunteer missionary who provided free counseling services, and another was used as a reading room for religious books and a computer version of the Bible. Benson used the other offices to provide mortgage broker (for which she had previously attended a class) and reflexology services. She allegedly used these services to provide income to offset the Memorial's expenses. She earned a total of $445 performing these activities in 2002 and 2003. Her expenses attributable to the Memorial during this period totaled $55,301.

Benson filed Schedules C, *Profit or Loss from Business*, in both 2002 and 2003 which reported income only from her reflexology services. Upon audit, the IRS denied Benson's claimed deductions for her Memorial-related expenses to the extent they exceeded her Memorial-related gross income for the 2002 and 2003 tax years.

Issues. Whether Benson operated the Memorial building or offered mortgage broker and reflexology services for profit

Analysis. A deduction is allowed only for ordinary and necessary expenses incurred in a trade or business.[83] A deduction is allowed only for expenses incurred in connection with the production of income.[84] Both IRC §§162 and 212 allow a deduction only when a taxpayer engages in an activity with an actual and honest profit expectation, though that expectation need not be reasonable. The profit expected must be economic in nature, and must be independent of tax consequences. Expense deductions are expressly denied for activities not engaged in for profit to the extent that such expenses exceed gross income from such activities.[85]

In determining whether an activity is engaged in for profit, objective factors are weighed more heavily than a taxpayer's own statements of intent, and the taxpayer bears the burden of establishing that he had the requisite profit expectation on the basis of all the facts and circumstances.

Under Treas. Reg. §1.183-2(b), nine nonexclusive factors are used to determine whether an activity is engaged in for profit.

> **Note.** The nine factors are discussed in detail in Chapter 10, "Small Business Issues."

No single factor is controlling, and each question must be resolved on the basis of all relevant facts and circumstances.

83. IRC §162
84. IRC §212
85. IRC §183

Holding. The court held that Benson did not operate the Memorial building with an expectation of profit. This was based on the fact that Benson:

1. Did not maintain accurate records or books for Memorial,
2. Did not have a budget or business plan for any of its activities,
3. Historically had only losses for her Memorial-related activities,
4. Did not charge for admission or counseling services, and
5. Did not charge her brothers rent for the use of a room.

The court also determined that Benson had not engaged in mortgage broker services for profit, because she provided no evidence that she was a licensed or registered broker, did not understand the distinction between a mortgage lender and a mortgage broker, and had not actually done any business as a broker. The court further noted that, even if she had a profit expectation with respect to her mortgage broker services, her expense attributable to this activity was for a mortgage broker class, and such an expense constitutes an investigative or startup cost rather than an expense incurred in the active conduct of a trade or business.

Finally, the court concluded that because she only earned $445 from her reflexology services over the 2002 and 2003 tax years, and because she provided no evidence sufficient to rebut the IRS's determination, she also had not engaged in the reflexology services for profit.

> **Note.** See Chapter 10, "Small Business Issues," "Issue 2: Not-For-Profit Activities," for more information on deductions of hobby losses.

Not-for-Profit Activities

Robert A. Eder v. Comm'r, TC Summ. Op. 2008-12 (February 6, 2008)
IRC §183

☞ Losses from Network Marketing Activities Disallowed

Facts. Robert Eder earned a substantial income as a full-time engineer in 2002. Beginning in 1997, he became an independent distributor for Reliv International, selling healthcare products using network marketing methods. Eder had no prior experience in marketing, sales, or distribution. Under Reliv's compensation scheme, distributors typically earn incidental income from direct sales, but derive most of their earnings from sponsoring new Reliv distributors. Distributors receive a discount on Reliv merchandise.

Eder engaged in a number of promotional and marketing activities on behalf of Reliv. He advertised in a newspaper, distributed flyers, and attended bi-weekly meetings. He called women whose names he found in an Internet database to set up face-to-face meetings with them. Over the course of Eder's activities for Reliv, he made direct sales only to family members and sponsored only his brother and his son as new distributors.

Eder prepared a purported budget for his Reliv activities in 1998, which he reused in each subsequent year. He did not prepare a business plan until trial, did not keep organized records or profit projections, and did not calculate a break-even point for how much profit he would need to recoup his past losses. For the 2002 tax year, he reported $1,124 of gross income and $12,895 of expenses on his Reliv Schedule C, *Profit or Loss From Business*. The IRS disallowed the claimed net loss of $11,771.

Issues. Did Eder engage in his marketing and promotional efforts on behalf of Reliv for profit?

Analysis. Deductions for not-for-profit activities are allowable only to the extent of gross income derived from those activities.[86] To show that an activity is engaged in for profit, a taxpayer must show a "good faith expectation of profit." The expectation, if sincere, need not be reasonable.

Under Treas. Reg. §1.183-2(b), nine nonexclusive factors are used to determine whether an activity is engaged in for profit.

> **Note.** The nine factors are discussed in detail in Chapter 10, "Small Business Issues."

No single factor is controlling, and each question must be resolved on the basis of all relevant facts and circumstances.

Holding. The court analyzed Eder's Reliv activities according to the nine factors listed under Treas. Reg. §1.183-2(b). The court held that Eder's lack of a business plan, organized records, profit projections, or a calculated break-even point weighed against him. The court supported this conclusion by referencing Eder's stipulation at trial that he "will not stop his Reliv activities until he runs out of money to finance the activity."

The court held that Eder's activities were not engaged in for profit and he was entitled to losses only to the extent of his gross income from the activities. It based its decision on Eder's:

- Lack of experience in sales, marketing, or distribution;
- Relatively small amount of time devoted to his Reliv activities;
- Lack of income or profits from such activities;
- Substantial income from working full-time; and
- Extensive use of family members and product discounts.

The court held that the other relevant factors were neutral.

> **Note.** See Chapter 10, "Small Business Issues," "Issue 2: Not-For-Profit Activities," for more information on deductions of hobby losses.

86. IRC §183(b)(2)

PARTNERSHIPS

Simplified Reporting
Tax Talk Today (Jan. 8, 2008)

☞ Simplified Reporting for Married Couple Partnerships

During the January 8, 2008, Tax Talk Today program, IRS officials discussed new partnership procedure relief for qualified joint ventures (QJV). A QJV is a business owned **only** by a married couple operating as a partnership. A QJV can benefit from legislation which allows simplified reporting of their partnership income. The couple can choose to file two Schedules C with their Form 1040 reflecting each partner's actual participation in the partnership. This eliminates the need to file Form 1065, *U.S. Return of Partnership Income.*

There is no need to file any type of election or notice. Taxpayers simply file the Schedule Cs with the Form 1040. This filing method is available to both existing and newly-formed partnerships. This change was a part of the Small Business and Work Opportunity Act of 2007 and is effective for returns filed after December 31, 2006.

> **Note.** The QJV election is discussed in detail in Chapter 14, "Agricultural Issues and Rural Investments."

Manner of Electing Optional Adjustment to Basis
Ltr. Rul. 200806001 (November 5, 2007)
IRC §754

☞ LLC Allowed Extension of Time to Make a §754 Election

Facts. Two members purchased interests in an LLC. It was intended that a §754 election to make an optional adjustment to the basis of partnership property be filed with the partnership return for the year in which the two members purchased their interest. However, the tax return for the taxable year of the purchase was filed by the applicable due date, but the §754 election was inadvertently omitted.

Analysis. An election under §754 to adjust the basis of partnership property with respect to a distribution of property to a partner or a transfer of partnership interest is required to be made in a written statement filed with the partnership return for the taxable year in which the distribution or transfer occurs.[87] This election will apply to all distributions of property by the partnership and to all transfers of interests in the partnership during the taxable year for which the election was made and in all subsequent years. In order for the election to be valid, the return must be timely filed by the due date, including extensions, for that taxable year.

The Commissioner may grant an extension of time to make a regulatory or statutory election if the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith, and that such relief does not prejudice the interests of the government.

Holding. The taxpayers were granted a 60-day extension from the date of the ruling to file an amended return which included the §754 election statement for the taxable year.

87. Treas. Reg. §1.754-1(b)

Limited Liability Companies

Pub. 3402, *Tax Issues for Limited Liability Companies*

The IRS provides basic information for single-member and multi-member LLCs in the following areas:

- Tax forms on which the LLC's income and expense is reported
- Employment taxes
- Self-employment tax
- Employer identification numbers
- Common pitfalls

The publication also provides a list of resources from which additional information regarding LLCs may be obtained.

PASSIVE ACTIVITIES

Passive Activity Losses

Ltr. Rul. 200826010 (March 12, 2008)
IRC §469

☞ Filing Extension Granted to Elect to Treat all Rental Real Estate Interests as Single Activity

Facts. A married couple in the rental property business qualified to make an election to treat all their interests in rental real estate as a single rental real estate activity.[88] The couple's tax professional failed to advise them of the availability and benefits of filing an election under §469(c)(7), and the couple consequently filed their joint return without the election.

Analysis. A taxpayer who meets the following requirements will not have his rental real estate activity considered presumptively passive:

- More than half of the personal services performed in trades or businesses by the taxpayer during the taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and
- The taxpayer performs more than 750 hours of services during the taxable year in real property businesses in which the taxpayer materially participates.

The tests specified above are applied as if each interest of the taxpayer in rental real estate is a separate activity unless the taxpayer files a statement with his original income tax return for the taxable year electing to treat all interests in rental real estate as a single activity. By making this election, the taxpayer can meet the tests specified above in the aggregate for all properties. If the election is not made, a determination on material participation must be made separately for each rental property.

The Commissioner may grant an extension of time to make an election if the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith, and such relief does not prejudice the interests of the government. In this case, the IRS found the taxpayers acted reasonably and in good faith since they reasonably relied on a tax professional; and the tax professional failed to advise the taxpayers to make the election.

Holding. The taxpayers were granted a 60-day extension of time from the date of the ruling to file an amended return which included the election statement to treat all their interests in rental real estate as a single activity.

88. IRS §469(c)(7)

RESIDENCES

Deductible Qualified Residence Interest Expense

IRS Notice 2008-15, IRB 2008-4 (Jan. 8, 2008)

IRC §§163 and 6050H

☞ Guidance Provided on Allocating and Reporting Prepaid Qualified Mortgage Insurance Premiums

Prior to the enactment of the Tax Relief and Health Care Act of 2007, taxpayers could not deduct premiums paid for mortgage insurance as qualified residence interest. Beginning in 2008,[89] taxpayers can treat qualified mortgage insurance premiums that are paid or accrued in 2007 for qualified mortgage insurance contracts issued in 2007 as deductible qualified residence interest. The deduction is limited to the amount allocable to 2007.

The qualified mortgage insurance is reported to the taxpayer in box 4 of Form 1098. Generally, this premium is allocated to the shorter period of 84 months or the stated term of the mortgage to determine the amount treated as deductible qualified mortgage interest. The deduction is claimed on the 2008 Form 1040, Schedule A, line 13.

With the enactment of the Mortgage Forgiveness Debt Relief Act of 2007, this deduction is extended for tax years 2008 through 2010 for mortgage insurance contracts issued between January 1, 2007 and December 31, 2010.

RETIREMENT

Early IRA Distributions

Jay A. Reindl v. Comm'r, TC Summ. Op. 2008-30 (March 13, 2008)

IRC §72(t)

☞ 10% Early IRA Distribution Penalty Upheld

Facts. In 2004, Mr. Reindl received a $37,200 distribution from his IRA. This was his only income for that year. He had not reached age 59½ at that time. Federal income tax of $7,440 was withheld from the distribution. On his 2004 return, he reported the IRA distribution and a tax liability of $4,056. However, he omitted the §72(t) 10% early withdrawal penalty.

Upon audit, the IRS determined that Reindl owed the 10% penalty.

Issues. Whether Reindl may be exempt from the 10% penalty by virtue of his financial hardship and/or ignorance of the tax laws.

Analysis. An IRA distribution taken before a taxpayer reaches age 59½ is subject to a 10% early-withdrawal penalty unless a specific statutory exception applies. Such exceptions are narrowly construed under the uniform rules for distributions under §72(t)(2).

Holding. The court held that neither financial hardship nor ignorance of the tax laws excused Reindl from the 10% penalty, because no statutory or caselaw authority authorizes either proposed exception.

89. IRC §§163(h)(3) and 163(h)(4)

IRA Rollover

Ltr. Rul. 200804024 (October 29, 2007)
IRC §408

☞ IRS Waives IRA Distribution Rule Requirements

Fact. The taxpayer's spouse requested a distribution from her husband's IRA. She deposited the money in her personal checking account. When the distribution was discovered, the taxpayer requested a waiver of the 60-day rollover rules.

Analysis. The 81-year-old taxpayer said his wife, who was age 80, did not have authority to request or receive the distribution. At the time of the transfer, the taxpayer, suffering from physical and mental incapacitates, was confined to a nursing home. A conservator was appointed to handle his affairs. Following the transfer, the court determined his spouse suffered from severe mental incapacity, which impaired her ability to understand the consequences of her actions. Consequently, the court appointed a conservator for her.

Holding. Based on the facts and circumstances, the IRS approved the waiver and allowed the taxpayers to transfer the money to another IRA.

IRA Distributions

Ltr. Rul. 200806012 (November 14, 2007)
IRC §408(d)(3)

☞ Taxpayer can Ignore 60-day IRA Rollover Provision When Financial Institution Made Error

Facts. A 49-year-old taxpayer received an IRA distribution with the intention of rolling it into another IRA. The taxpayer sent a check to his financial institution for deposit into a new IRA. Contrary to his instructions, the financial institution deposited the check into a non-IRA account. When he received his Form 1099-R indicating an early distribution, the taxpayer ignored it thinking it was completed in error. The taxpayer completed his tax return as if the distribution had been timely rolled into another IRA, as he had instructed his financial institution to do. When the taxpayer received a notice from the IRS indicating he owed additional tax due to his early withdrawal from an IRA, his financial institution acknowledged the error and offered to reimburse the taxpayer for his losses and damages.

Analysis. Any amount paid or distributed out of an IRA is included in gross income.[90] Amounts paid or distributed from one IRA into another IRA (rollover) within 60 days for the benefit of the same individual are not taxable.[91] Unless a taxpayer is granted a waiver of time to rollover an IRA distribution within a 60-day period, the IRA is not only taxable but also could be subject to applicable penalties.[92] The IRS may waive the 60-day requirement when the failure to provide the waiver would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual subject to the requirement.[93] This waiver can only be granted for IRA distributions made after December 31, 2001.

Holding. Because the failure to accomplish a rollover within the 60-day period was due to an error on the part of the financial institution, the taxpayer was granted the waiver. The IRS considered errors made by the financial institution to be beyond the reasonable control of the taxpayer.

90. IRC §408(d)(1)
91. IRC §408(d)(3)
92. IRC §72(t)(2)
93. IRC §408(d)(3)(I)

Economic Hardship Distribution

Shawn Timothy Hynes v. Comm'r, TC Summ. Op. 2008-1 (Jan. 2, 2008)
IRC §§72(t) and 6662

☞ 10% Penalty Upheld Despite Misunderstanding of Tax Law

Facts. Mr. Hynes worked as a paralegal and participated in the firm's qualified pension plan under IRC §401(k). He left the position to attend law school. In April 2003, as he was preparing to graduate from law school and sit for the bar exam, he withdrew $16,263 from his qualified pension plan at his previous paralegal job and deposited the net check for $13,011 into his checking account. The $13,011 net distribution was comprised of gross distribution ($16,263) minus income tax withheld ($3,252). In the summer of 2003, Mr. Hynes moved from New York to California to take a new job in a law firm.

Mr. Hynes filed his 2003 tax return including only $51,304 of wages, salaries, and tips from the job he started in September 2003 after finishing law school. The IRS received third-party information as follows:

- $16 total interest income on two bank accounts
- $16,263 pension and annuity income
- $3,025 student loan interest payments made to two institutions

The IRS issued a notice of deficiency to Mr. Hynes showing $6,564 of additional tax due as a result of the changes to interest income, pension and annuity income, and student loan interest payments as well as a 10% early-withdrawal penalty. An accuracy-related penalty was also assessed.

Mr. Hynes argued his distribution should not be subject to the 10% penalty for early withdrawal because he suffered economic hardship after graduating from law school. He had expenses related to studying for the bar exam, school loans, credit card bills and day-to-day living expenses during the summer of 2003. In his research regarding the 10% penalty, Mr. Hynes looked no further than IRC §401(k)(2)(B)(i).

Mr. Hynes argued that he should not be liable for the accuracy-related penalty because:

- The distribution amount was not reported on his 2003 return because he did not receive a Form 1099-MISC reporting the distribution, which was due to his move from New York to California; and
- His failure to remember to report the distribution was not deliberate, but due to the extraordinary demands of his job as an attorney.

Issues. Whether Mr. Hynes is liable for:

- The 10% additional tax under IRC §72(t) for an early withdrawal from a qualified pension plan
- An accuracy-related penalty pursuant to IRC §6662(a)

Analysis. A qualified pension plan distribution prior to attaining age 59½ is subject to a 10% additional tax unless one of several exceptions applies.[94] There is no hardship exception to the 10% penalty, and the exemption from the penalty when the distribution is used for qualified higher education expenses applies to distributions from IRAs, not 401(k) plans.

IRC §6662 imposes a penalty for an underpayment of tax when such underpayment is attributable to negligence or disregard of federal income tax requirements. However, no penalty may be imposed when the taxpayer had reasonable cause for the underpayment.

94. IRC §72(t)

Holding. The court supported the IRS's argument that there was no exception to the 10% penalty for the early distribution from Mr. Hynes 401(k) plan. The IRS argued that Mr. Hynes' failure to report approximately 35% of his adjusted gross income for 2003 showed lack of reasonable cause and good faith. The court determined the non-receipt of the proper third-party information return is not required to remind a taxpayer of income that must be reported. It held the 20% accuracy-related penalty applied.

Roth IRA Conversions

Treasury Decision 9418 (July 28, 2008)
IRC §408A

☞ Valuation When Converting non-Roth IRA Annuity to a Roth IRA

Purpose. The IRS has finalized the proposed valuation rules used when converting a non-Roth IRA annuity to a Roth IRA.

Analysis. When the conversion is made, the amount treated as a distribution is the fair market value (FMV) of the annuity on the date of conversion. In order to determine the FMV of the contract, the taxpayer should see if the company that sold the annuity is selling comparable annuities. If so, the taxpayer should look at the cost of the comparable contract. For example, assume the taxpayer is 60-years old and purchased an annuity at an earlier age that will pay $500 per month for life beginning at age 70. The FMV of the annuity is the cost of an annuity purchased at age 60 that will pay $500 per month beginning at age 70.

Effective Date. The regulations are effective for annuity contracts distributed from a traditional IRA to a Roth IRA on or after August 19, 2005. However, taxpayers may rely on the temporary regulations for conversions on or before December 31, 2008.

Note. See Chapter 12, "Retirement," for more details on Roth conversions.

Required Minimum Distribution

Ltr. Rul. 200811028 (December 21, 2007)
IRC §§401 and 4974(a)

☞ Late RMD Results in 50% Excise Tax

Purpose. To request a ruling as to whether the:

- Required minimum distributions from IRA X and IRA Y for 2003 and beyond may be calculated based on the life expectancy of the taxpayer pursuant to Treas. Reg. §1.401(a)(9)-9;
- Failure to timely take requirement minimum distributions for 2003 and 2004 affects the calculation of minimum required distributions in subsequent years; and
- Failure to timely distribute required minimum distributions for 2003 and 2004 resulted in the imposition of the 50% excise tax under IRC §4974(a).

Background. The decedent died in 2002 leaving IRA X and IRA Y to the taxpayer. The terms of both IRAs provide distributions must start by December 31 of the year following the year of the decedent's death and be taken over his life expectancy, or distributions may be elected in accordance with the 5-year rule. The taxpayer's 2003, 2004, and 2005 required minimum distributions were taken in aggregate in 2005 based on taxpayer's life expectancy. In 2007, taxpayer paid the additional tax pursuant to IRC §4974(a) for failure to timely receive required minimum distributions for 2003 and 2004. The taxpayer did not elect the 5-year distribution rule.

Analysis. IRC §401(a)(9) provides rules that apply to the entire interest of an individual for whose benefit the IRA is maintained including when distributions are required to be taken. IRC §4974(a) imposes a tax equal to 50% of the amount by which the minimum required distribution exceeds the actual distribution unless "good cause" exists.

Conclusion. **Since the taxpayer did not elect the 5-year distribution rule**, the required minimum distributions are determined by the taxpayer's life expectancy. Even though the required minimum distributions were not taken on a timely basis, this does not affect the calculation of the minimum required distributions in subsequent years. The 50% excise tax under IRC §4974(a) was properly imposed.

S CORPORATION

Passive Income

Ltr. Rul. 200801037 (September 14, 2007)
IRC §1362

☞ Taxpayer Assured Rental Income Received by S Corporation was Not Passive

Facts. An S corporation can lose its S status if it has accumulated earnings and profits at the close of each of three consecutive taxable years and more than 25% of its gross receipts are passive investment income. This taxpayer was concerned that it might fall into this category.

Analysis. The S corporation (Company 1) has accumulated earnings and profits and is in the business of owning and leasing residential and commercial properties. Company 1 hires Company 2 to manage the properties and provide various services such as:

- Tenant billings and collections
- Compliance with lease terms
- Collection issues with delinquent clients
- Paying all expenses
- Coordinating maintenance and repairs
- Many other services

Holding. Based on the facts given, the IRS determined that the gross rents did not constitute passive investment income.

Passive Income

Ltr. Rul. 200804008 (October 16, 2007)
IRC §1362

☞ Rental Income Not Passive

Facts. The S corporation owns a rental property, which is managed by a related property manager. The property manager provides services including monitoring all exterior and interior maintenance of the property, maintenance and repair of the structural components, maintenance of an alleyway, and supervision of tenant improvements. In addition, the manager markets the property, negotiates leases, and collects rent. The taxpayer requested a ruling to determine if the rental property was considered passive income.

Analysis. A corporation will lose its S election if it has accumulated earnings and profits at the close of each of the three consecutive taxable years and has gross receipts for each of these years of more than 25% passive investment income. "Passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities. However, "rents" do not include rents derived in the trade or business of renting property. The determination is made based on all facts and circumstances relating to the corporations activities. Typically, "net leases" do not provide that the corporation will provide significant services.

Holding. Based on the facts given, the IRS determined the property rent was not passive investment income.

TAX FRAUD

Telephone Excise Tax

Department of Justice News Release (Jan. 17, 2008)
IRC §§7206 and 7207

☞ $460,000 of Fraudulent TET Refunds Claimed

Facts. A federal jury convicted a Georgia tax preparer of willfully filing false personal income tax returns. Tony Govereh filed 107 returns in January and February. On those returns he claimed over $460,000 of telephone excise tax refunds even though the correct limit ranged between $30 and $60. Govereh charged between $500 and $800 for each return and forced the clients to split the fraudulent refunds paid by the IRS.

Erroneous Fuel Tax Credits

Department of Justice News Release (Jan. 23, 2008)
IRC §7207

☞ Tax Preparer Claims More Than $1.2 Million in Fraudulent Fuel Tax Credits

Fact. According to the Justice Department, the U.S. government sued Farai Chihota seeking to bar him and his business from preparing tax returns for others. The IRS identified tax returns claiming more than $1.2 million in fraudulent fuel tax credits.

The IRS identified a return in which the client, a janitor, claimed that he bought 53,454 gallons of gasoline for business-related purposes. This would require the janitor to have spent more than five times his total income on gasoline.

The IRS stated the fuel credit scheme is a serious enforcement problem.

861 Argument
Department of Justice News Release (Feb. 1, 2008)
IRC §6651

☞ Snipes Escapes Fraud Charges

Facts. In 2006, actor Wesley Snipes was charged with eight counts of conspiracy to defraud the IRS and presenting a fraudulent claim for refund. He was also charged with six counts of failing to file income tax returns. According to the IRS, Snipes filed amended tax returns requesting refunds of almost $12 million. In addition, he failed to file tax returns for the years 1999 through 2004. Snipes contended he was not liable for income tax, using the so-called "861 argument" asserting U.S. citizens and residents can be taxed only on income derived from certain foreign-based activities and not on wages and other income earned within the United States.

Analysis. Tax protesters often use the "861 argument," which claims that Temp. Treas. Reg. §1.861-8T(d)(2)(iii) defines taxable activities. They argue, because the domestic activities of residents of the United States are not shown to be taxable, the domestic income arising from these activities does not become taxable "gross income." The courts have consistently ruled that the "861 argument" is without legal merit.

Holding. The jury found Snipes guilty on three misdemeanor charges for failing to file income tax returns. He was acquitted on felony charges of conspiracy to defraud and presenting a fraudulent claim for payments. However the tax scheme promoter and the accountant were found guilty of conspiracy.

Snipes Sentenced
U.S. v. Wesley Trent Snipes, No. 5:06-cr-22, U.S. Dist. Ct. for the Middle District of Florida (Apr. 23, 2008)
IRC §7203

Holding. The court sentenced Snipes to three years imprisonment, one year for each charge of failing to file income tax returns. At the time of sentencing, Snipes gave the court $5 million as a partial payment of the unpaid taxes.

Fraudulent Police Detective
Department of Justice Press Release #08-437 (May 19, 2008)
IRC §7201

☞ D.C. Police Detective Faces Up to 15 Years in Federal Prison

Facts. Michael Irving, a homicide detective for the Metropolitan Police Department (MPD) of the District of Columbia, was convicted of two counts of felony tax evasion by a U.S. District Court. His tax evasion scheme included:

- Arranging for the MPD to stop withholding income taxes from his paychecks
- Filing a false W-4 withholding form with the MPD which stated he was "exempt" from withholding because he supposedly owed no taxes for the prior or current years
- Filing a 2002 tax return in which he claimed he made zero wages
- Failing to file federal tax returns for 2003, 2004, and 2005

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His MPD wages for the three years he failed to file returns are shown in the table below:

Year	Wages Per Form W-2
2003	$152,153
2004	136,962
2005	181,913

According to the Justice Department announcement, Mr. Irving "spent money on, among other things, custom-tailored suits, jewelry for his wife, Redskins tickets, renovations on his $805,000 home, and apartment building investments."

Eileen Mayer, Chief, IRS Criminal Investigation was quoted in the announcement. She stated: "It's deeply disappointing when anyone asked to enforce the law doesn't personally follow it. Filing accurate tax returns is a legal requirement. Regardless of where you work or what you do, there is a heavy price to pay for ignoring your tax responsibilities."

> **Note.** This conviction is the result of a comprehensive initiative of the Tax Division of the Justice Department called the National Tax Defier Initiative. See **www.usdoj.gov/tax/taxpress2007.htm** for information on this initiative.

Announcements of Disciplinary Sanctions

IRS Ann. 2008-50, IRB 2008-2, 1024 (May 27, 2008)
IRC §6428

☞ Disciplinary Sanctions Announcements List Specific Violations of Circular 230

The IRS Office of Professional Responsibility will publish announcements of disciplinary sanctions in a new format with specific violations of Treasury Department Circular 230. The relevant section number of Circular 230 and a brief description of the misconduct will be presented in a redesigned "Disciplinary Sanction" column. The listing will continue to state whether each sanctioned individual is an attorney, CPA, enrolled agent, enrolled actuary, enrolled retirement plan agent, or appraiser. The list will be presented in alphabetical order, first by the names of the sanctioned individuals' state of residence, and then by the last names of the individuals.

Previously, disciplinary sanction announcements were published on a quarterly basis, and each announcement was published in five consecutive issues of the Internal Revenue Bulletin. In the future, announcements will be published more frequently. Also, each announcement will be published in one issue of the Internal Revenue Bulletin and again in the Cumulative Bulletin.

Warning About Bad Tax Preparers

FS 2008-10 (Jan. 2, 2008)
IRC §§6060 and 6011

☞ IRS Warns Taxpayers to Beware of Bad Tax Preparers

Facts. In its continuing attempt to curb tax abuse, the IRS issued a fact sheet in January warning taxpayers about bad tax preparers. In the fact sheet, they listed the names of a number of tax practitioners who have recently been convicted of tax abuse.

The fact sheet gives several hints when choosing a tax preparer:

- Be careful if the preparer claims he can obtain larger refunds than other preparers.
- Avoid preparers who base their fee on a percentage of the refund.
- Only use a preparer who signs the tax return and provides a copy.
- Consider whether the preparer will be around to answer questions later.
- Review the return before signing and question entries which are not understandable.
- Never sign a blank return.

Attempt to Evade Taxes

U.S. v. Richard Hatch No. 06-1902 U.S. Court of Appeals for the First Circuit (Feb. 1, 2008)
IRC §§7201 and 7206

☞ First Survivor Winner Does Not Survive Tax Fraud Appeal

Facts. In 2005, Richard Hatch, the first winner on the television show *Survivor* was indicted on three counts of filing false tax returns and sentenced to 51 months of incarceration. He appealed the decision and made four arguments on appeal.

Hatch was convicted of filing false tax returns for the years 2000 and 2001. He failed to report the $1 million prize from the *Survivor* show, even though he received a Form 1099 reporting the amount. He also failed to report $18,000 of rental income and $25,000 of charitable donations he diverted to his own use.

In 2001, he failed to report $320,000 from hosting a radio show, the $27,000 value of a car he won on *Survivor*, and another $11,500 of contributions he diverted to his own use.

Hatch's appeal was based on:

1. The court violated his Sixth Amendment rights by curtailing some of his explanation on why he believed the taxes were already paid on the $1 million prize.
2. The court improperly limited his right to cross-examine.
3. The court allowed the government to use "unqualified experts."
4. His sentence was unreasonable.

Analysis. The court opinion discusses each of Hatch's arguments in detail. It discusses the fact Hatch failed to disclose information to his accountant even though she told him the winnings were taxable and included them on a tax return which he failed to file. He then asked her to prepare a return so he could see the actual tax cost of the prize. She agreed to prepare a spreadsheet, but he insisted on an actual return which she reluctantly prepared. She made Hatch sign a document stating the return was only for evaluation purposes and would not be filed. Hatch immediately filed the return with the IRS.

Hatch formed an S corporation called Horizon Bound whose purpose was to take disadvantaged teens on camping trips to raise their self-esteem. He was able to obtain donations to the cause, but diverted the money to his own personal accounts.

Holding. The court ruled against Hatch on all accounts and upheld the 51-month prison sentence.

TRAVEL AND TRANSPORTATION EXPENSE

Business and Travel Expenses

Jozsef Balla et ux. v. Comm'r, TC Memo 2008-18 (Jan. 31, 2008)
IRC §§162 and 274(d)

☞ Deduction Allowed for Travel and Incidental Expenses, Disallowed for Meals

Facts. Jozsef Balla lived in Sarasota, Florida and worked as a merchant sailor during the relevant period. Balla's employer, Hornbeck, did not provide him a per diem allowance for his work-related meals or incidental expenses. However, while Balla was on duty, Hornbeck did provide him with meals and lodging free of charge.

Although Hornbeck did not require or provide reimbursement for him to do so, Balla attended a firefighting school in Fort Lauderdale, Florida in April 2002. Balla's union paid for his tuition. Balla drove his own automobile to and from the firefighting school (a distance of about 209 miles each way). He kept records of the dates, location, and purpose of the trip on his personal calendar.

Balla claimed deductions for travel expenses, incidental expenses, and other job-related and miscellaneous expenses.

Issues. Whether Balla may deduct:

- Meal expenses he did not pay for at the federal per diem rates
- Incidental expenses at the federal per diem rates for 2003
- Mileage expenses for travel to and from firefighting school in 2002
- Other job-related and miscellaneous expenses in 2002 and 2003

Analysis. A taxpayer is generally entitled to a deduction for all ordinary and necessary expenses incurred in carrying on a trade or business.[95] Deductible expenses include travel expenses (including meals and lodging), which are not lavish or extravagant, and which are incurred while away from home and in pursuit of a trade or business.[96] However, such deductions are disallowed unless they comply with the strict substantiation requirements provided under §274(d).

Under the Regulations pursuant to §274(d), taxpayers may, instead of substantiating actual expenses, elect to compute deductible expenses under certain authorized alternative methods. Under one such method, the IRS will deem certain expenses substantiated if they are computed using a stipulated per diem rate for ordinary and necessary expenses incurred when traveling away from home.

Rev. Proc. 2002-63 and Rev. Proc. 2003-80 both expressly provide that taxpayers who receive meals free of charge from their employer may, instead of substantiating actual incidental expenses, compute the amount of such expenses using an established per diem rate of $2 or $3, depending on which Rev. Proc. applies to the date of travel. Rev. Proc. 2001-47, which also provides rules for using the per diem substantiation method, does not include a similar provision. However, under Tax Court caselaw precedent, the incidental expenses portion of the meals and incidental expenses per diem rate may be used to substantiate incidental expenses when meals are provided by the employer. Each of the cited revenue procedures provides that the meals and incidental expenses per diem rate should be applied, with certain stated exceptions, in the same manner as the federal travel regulations in effect at that time.

All travel expenses and away from home expenses must be substantiated by adequate records or sufficient corroborating evidence which establish the amount, business purpose, time, and place of each expense incurred.[97]

95. IRC §162
96. IRC §162(a)(2)
97. IRC §274(d)

Holding. The court rejected Balla's argument that the revenue procedure and federal travel regulations in effect at the time allowed him to deduct the full meals and incidental expenses per diem rate despite the fact that his employer provided him with meals free of charge during this period. In doing so, the court noted that the federal travel regulations applied only to common carriers and complimentary meals received at a motel or hotel, and Balla neither worked on a common carrier nor stayed at a motel or hotel during the relevant period. The court further noted that the federal travel regulations require that a federal employee's per diem rate be adjusted by deducting the appropriate amount for meals provided by the government. Accordingly, the court held that Balla was not entitled to the full meals and incidental expenses per diem rate in computing his deductions. However, the court also held that Balla was entitled to a deduction computed using the per diem rate in force at the time for incidental expenses only.

The court rejected the IRS's argument that Balla's firefighting course was not an ordinary or necessary business expense simply because Hornbeck did not reimburse Balla for tuition for the program. The court noted that Balla's union had, in fact, paid for the tuition and that firefighting is sufficiently related to Balla's work as a merchant sailor. The court further held that Balla's records adequately substantiated the time, place, and amount of travel for which he claimed this deduction. Finally, the court denied Balla's claimed deductions for certain other job-related and miscellaneous expenses either because they were not ordinary or necessary business expenses or because they lacked adequate substantiation.

Substantiation of Business Travel Expenses

Estate of David B. Lease et. al. v. Comm'r, TC Summ. Op. 2008-11 (January 30, 2008)
IRC §§162, 262, and 274(d)

☞ Disallowed Travel Expense Deductions Overruled in Part, Upheld in Part

Facts. Taxpayer David Lease worked as a millwright. During the relevant period, he resided in West Virginia and worked out of a union hall in nearby Cumberland, Maryland. Each week, Lease signed up for work in the union hall "workbook," and a union representative contacted him when a job was available. In 2002, when local jobs became scarce, he began to work jobs as far as 250 miles away.

When Lease took a job, he was usually assigned to complete a particular task, after which he was laid off and awaited a new assignment from the union. He rarely worked for the same employer twice. Lease worked 112 days during the year and commuted almost 100 miles per workday. He received nine different Forms W-2 for 2002.

His 2002 joint return claimed deductions for:

- $3,934 for business miles driven to temporary job sites using the standard mileage rate of $0.365 per mile, and
- $5,503 for away-from-home expenses which were largely for meals.

The IRS disallowed both deductions.

Issues. Whether Lease is entitled to a deduction for:

- Business mileage expense
- Away-from-home expenses

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Analysis. A taxpayer is generally entitled to deduct all ordinary and necessary expenses incurred in carrying on a trade or business.[98] Conversely, personal expenses are disallowed.[99] The cost of commuting from home to work is generally considered a personal expense. However, when a taxpayer is away from home on a temporary basis, his travel and living expenses may be deductible. For these purposes, a taxpayer's "home" is considered the vicinity of his principal place of business rather than the location of his principal residence.

Meals and lodging expenses may be deducted only when the expenses are reasonable and necessary, were incurred away from home, and were incurred in the pursuit of a trade or business.[100] All travel expenses and away-from-home expenses must be substantiated by adequate records or sufficient corroborating evidence.[101]

Holding. The court held that each of Lease's work assignments located outside of the vicinity of his normal place of employment were temporary. The court further held that Lease met the substantiation requirements of §274 with respect to his travel expenses. However, for Lease's claimed deduction for meals, the court held that his records did not meet these requirements. Therefore, the court allowed the deduction for travel expenses and disallowed the deduction for meals.

Temporary versus Indefinite Work Assignment

Joseph Cornelius v. Comm'r, TC Summ. Op. 2008-42 (April 23, 2008)

IRC §§162 and 6651(a)(1)

☞ No Deduction for Travel Expenses for an Indefinite Assignment that Exceeded One Year

Facts. Cornelius lived and worked in the Austin, Texas area from 1984 through March of 2002. He worked as a computer system administrator until his employer closed the Austin, Texas office at the close of 2001.

In February 2002, Cornelius accepted employment on an as-needed basis with Princeton Information Systems in Boulder, Colorado. The Colorado assignment started in early March 2002, and continued through April 2003. Cornelius rented living quarters in Colorado and gave up his Austin apartment in June of 2002. When the Colorado assignment ended in April of 2003, Cornelius took a New Jersey assignment from April 2003 through July 2005.

Cornelius did not file his 2002 and 2003 individual income tax returns until the early part of 2006. His tax returns included a Form 1040, Schedule A that reported employee business expenses for meals and lodging while in Colorado and New Jersey and for travel back and forth to Austin, Texas to visit family and friends. He explained that his reason for not filing his returns in 2002 and 2003 was that once he is overdue on something, he has a bad habit of avoiding it.

The IRS issued a notice of deficiency for his 2002 return in the amount of $16,445 plus $140 for penalties, and for the 2003 return, they assessed a deficiency of $19,420 plus $1,446 for penalties.

Issue. Whether the taxpayer is:

- Entitled to a deduction for travel expenses while away from home
- Is subject to penalties for filing his tax returns late

98. IRC §162

99. IRC §262

100. IRC §162(a)(2)

101. IRC §274

Analysis. A deduction is permitted for business travel expenses that are:

1. Reasonable and necessary,
2. Incurred while traveling "away from home," and
3. Directly related to the conduct of a taxpayer's trade or business.[102]

Generally, a taxpayer's tax home is determined by the location of the taxpayer's regular or principal place of business regardless of where the taxpayer's residence is located.[103] Job assignments that exceed one year or more are not considered temporary.[104]

A taxpayer is liable for a penalty equal to 5% of the amount that should have been shown on the return, or a maximum of 25%, for failure to timely file a tax return, unless such failure is due to reasonable cause and not willful neglect.[105]

Holding. The court held that the IRS was correct in its determination that the job assignments were indefinite and not temporary. No business expenses are allowed because the taxpayer's tax home is the location of the taxpayer's place of business. Further, travel between his job sites and Austin, Texas were personal expenses and not deductible. The taxpayer did not provide reasons for his late filed tax returns to prevent the assessed late filing penalties in each year. Therefore, the taxpayer was subject to the penalty for failure to timely file.

102. IRC 162(a)(2)

103. Treas. Reg. §1.911(b)

104. IRC §162(a)

105. IRC §6651