Chapter 13: Rulings and Cases

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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, 2009. They appear in a condensed version, and are not to be relied on as a substitute for the full documents. A full citation appears for each item. This is not a comprehensive coverage of all tax law changes or explanations. It reports the rulings and cases that are likely to be of interest to most tax professionals.

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

Substantial Authority

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

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

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

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Nature of Analysis. The weight accorded an authority depends on its relevance, 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 memoranda, general counsel memoranda, 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, in descending order of authority:

- 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 category are various legal memoranda (e.g., Internal Legal Memoranda **(ILM)** and Litigation Guideline Memoranda **(LGM)**).

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

Service Center Advice (SCA). These SCAs 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. SSCAs 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 courtroom 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.**

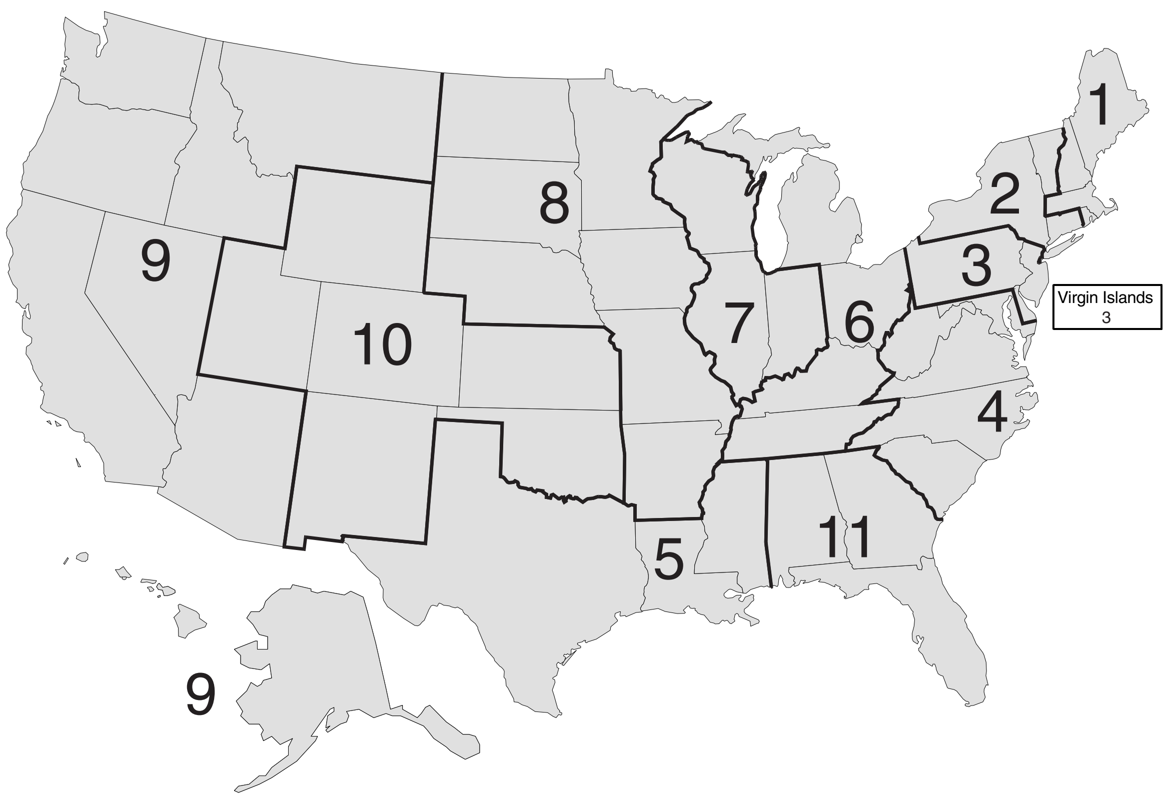
Any decision of the Tax Court can be appealed to the appropriate Circuit Court of Appeals. A final appeal can be made to the Supreme Court, but since its jurisdiction is discretionary, the court hears relatively few tax cases. Many of these court transcripts can be accessed online at **www.uscourts.gov.**

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



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AMORTIZATION AND DEPRECIATION

Bonus Depreciation

Rev. Proc. 2008-65, IRB 2008-44 (Oct. 14, 2008)
IRC §§38, 41, 52, 53, 168, and 6401

☞ Electing Out of Bonus Depreciation to Gain Refundable Credits

Purpose. Rather than claiming 50% additional depreciation on purchases made after March 31, 2008 and before the end of 2009, corporations may elect to increase their limitations on business credits and the AMT credit. The election falls under IRC §168(k)(4).

Analysis. For a corporation's first tax year ending after March 31, 2008, and for any subsequent tax years, a corporation can elect to forgo the Economic Stimulus Act's (ESA) 50% first-year bonus depreciation on eligible qualified property placed in service by the taxpayer (§168(k) election). Instead, the corporation can increase each of the limitations relating to the general business credit described in IRC §38(c) and the AMT credit described in IRC §53(c). Consequently, a corporation can claim unused credits from tax years beginning prior to January 1, 2006 that are allocable to research expenditures or AMT liabilities.

Unless the §168(k) election is made, §38(c)(1) limits the general business credit to the excess of the taxpayer's net income tax less the greater of the tentative minimum tax for the taxable year or 25% of the taxpayer's net regular tax liability that exceeds $25,000. Similarly, §53(c) limits the minimum tax liability to the regular tax liability (less certain credits) less the tentative minimum tax for the taxable year. Making the §168(k) election allows the corporation to increase the §§38(c) and 53(c) credits by the amount of forgone bonus depreciation. The corporation makes an allocation between the credit limitations.

If the corporation makes the §168(k) election, it must use the straight-line method of depreciating the property for all eligible qualified property.

According to the ordering rules for applying elections set forth in §168(k), two elections must be considered:

- The election not to claim the ESA bonus first-year depreciation under §168(k)(2)(D)(iii) for all property in a particular class, and
- The election to apply the provisions of §168(k)(4) to all eligible qualified property (i.e., accelerate the AMT and research credits in lieu of bonus depreciation).

A taxpayer may make both elections; if this is done, the taxpayer applies the provisions of §168(k)(2)(D)(iii) first.

The maximum amount of increase for any taxpayer is the lesser of:

- $30 million, or
- 6% of the total of the business credit increase amount plus the AMT credit increase amount.

The amount of the business credit increase is the portion of the credit allowable under §38 (without regard to §38(c)) for the first tax year ending after March 31, 2008, which is allocable to carryforwards of the business credit to that tax year that are (1) from tax years commencing before January 1, 2006, and (2) properly allocable to the research credit determined under §41(a). However, a business credit carryforward allocable to the research credit from a tax year commencing before January 1, 2006, which expired before the first tax year ending after March 31, 2008, is not taken into account in determining the amount of the business credit increase.

The amount of the AMT credit increase is the portion of the minimum tax credit under §53(b) for the first tax year ending after March 31, 2008, which takes into account only the adjusted minimum tax for tax years commencing before January 1, 2006. Minimum tax credits for this purpose are determined on a first-in, first-out basis.

The IRS advised that fiscal-year taxpayers making the election for a 2007 fiscal year ending after March 31, 2008, should make the election and claim the refundable credit on an amended return, rather than on the original return.

Example 1. Innovation Designs, Inc. (IDI), a calendar-year corporation, makes the §168(k)(4) election for the taxable year ending December 31, 2008. IDI's bonus depreciation amount is $1 million, its business credit increase amount is $100,000 and its AMT credit increase amount is $590,000. IDI's maximum increase amount is $41,400, which is the lesser of $30 million or (.06 × ($100,000 + $590,000)). IDI's bonus depreciation amount that may be used to increase credits is $41,400. IDI can allocate the increased limitation in any manner it chooses as long as the total allocated amount does not exceed $41,400.

The IRS provides the following worksheet[1] to use in calculating the refundable minimum tax credit and research credit amounts. It has been filled in to reflect the amounts in **Example 1.**

Effective Date. October 14, 2008.

Worksheet for Calculating the Refundable Minimum Tax Credit and Research Credit Amounts

1. Enter depreciation (including the special depreciation allowance) that would have been allowed for eligible qualified property placed in service during the tax year if section 168(k)(1) had applied to such property	1.	**1,071,429**
2. Enter depreciation for eligible qualified property placed in service during the tax year figured without regard to section 168(k)(1)	2.	**142,857**
3. Subtract line 2 from line 1	3.	**928,572**
4. Multiply line 3 by 20%	4.	**185,714**
5. Enter any unused research credit carryforward from tax years beginning before 2006	5.	**100,000**
6. Enter any unused minimum tax credit carryforward from tax years beginning before 2006	6.	**590,000**
7. Add line 5 and line 6	7.	**690,000**
8. Multiply line 7 by 6%	8.	**41,400**
9. Enter the smaller of line 8 or $30,000,000	9.	**41,400**
10. Enter any bonus depreciation amounts determined under section 168(k)(4)(C) for all preceding tax years ending after March 31, 2008	10.	**0**
11. Subtract line 10 from line 9. If zero or less, enter -0-	11.	**41,400**
12. Bonus depreciation amount. Enter the smaller of line 4 or line 11	12.	**41,400**

Note. If you do not have a research credit carryforward, or if you choose not to allocate bonus depreciation amounts to research credit carryforwards, skip lines 13 and 14 and enter -0- on line 15.

13. Enter the amount from line 10 allocated to the research credit carryforward shown on line 5	13.	**0**
14. Maximum bonus depreciation amount allocable to the research credit. Subtract line 13 from line 5	14.	**100,000**
15. Refundable research credit. Enter the smaller of line 14 or the amount on line 12 that you choose to allocate to the research credit. If you have a minimum tax credit, continue to line 16. All others, enter this amount on your 2007 Form 1120X, line 5g	15.	**25,000**
16. Subtract line 15 from line 12	16.	**16,400**
17. Enter the amount from line 10 allocated to the minimum tax credit carryforward shown on line 6	17.	**0**
18. Maximum special depreciation allowance amount allocable to the minimum tax credit. Subtract line 17 from 6	18.	**590,000**
19. Refundable minimum tax credit. Enter the smaller of line 18 or line 16	19.	**16,400**
20. Add lines 15 and 19. Enter this amount on your 2007 Form 1120X, line 5g	20.	**41,400**

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[1] [www.irs.gov/pub/irs-utl/amtresearchworksheet.pdf] Accessed on August 14, 2009.

BANKRUPTCY AND DISCHARGE OF INDEBTEDNESS

Interest Charges on Federal Tax Claim

***In re: Alta Marie Broadus,* No. 02-15358, U.S. Bankruptcy Court for the Southern District of Alabama (Jan. 29, 2009)**
IRC §6871

☞ Unpaid Interest on Tax Debt Survives Bankruptcy Discharge

Facts. Alta Marie Broadus filed a Chapter 13 bankruptcy petition in September 2002. The IRS filed a proof of claim for $63,897 of secured debt, after which Broadus amended her plan to cover the total debt listed in the IRS proof of claim.

An order regarding the IRS's objection to Broadus' original plan was signed on May 28, 2002. One of the issues covered in the order stated that Broadus was to fully pay the allowed claim, with interest at the Title 26 rate, in equal monthly payments over the remaining life of the plan.

The bankruptcy plan was confirmed in June 2003. Throughout the plan term, the bankruptcy trustee paid the IRS $63,897, the amount listed in its proofs of claim. On October 10, 2008, a discharge order for Broadus was entered. The IRS then filed a motion to reconsider discharge on October 16, 2008, requesting that it be granted relief from the discharge order because Broadus failed to pay the interest due on the tax claim. The IRS maintains that Broadus agreed, and was ordered by the court, to pay the tax claim with statutory interest in equal monthly payments over the life of the plan. However, interest was not paid; only the amount listed on the IRS's proof of claim was paid.

Broadus and the trustee argued that the IRS did not amend its claim to reflect the interest to be paid through the plan. The trustee disburses plan payments based on filed proofs of claims and relied on the IRS claim to determine the amount due the IRS. According to Broadus, the IRS waived its right to collect interest on the claim because it had notice of plan amendments, received payments in the amount of its filed claim for five years, and the case had been discharged.

Issues. Whether the debtor owes the IRS unpaid interest on its secured claim.

Analysis. The Bankruptcy Court stated that the interest rate or amount does not have to be detailed in the proof of claim in order for the debtor to be liable for it. The standard proof of claim form directs the creditor to list the amount of its claim "at time case filed," which is what the IRS did.

The Court stated that the interest liability on the IRS claim does survive bankruptcy discharge. Broadus and the IRS entered into an agreement that she was to pay the allowed secured tax claim in full, with interest at the Title 26 rate. In the agreement entered into on May 28, 2002, Broadus was ordered to pay the secured claim with interest at the designated nonbankruptcy rate.

Holding. The court concluded that the interest liability owed to the IRS must be paid. In its ruling, the court stated that, in future cases, it expects that the United States will take action to specify the interest owed in a proof of claim; otherwise, the court will deem the interest owed intentionally waived and discharged when the case is completed, unless the United States pleads appropriate grounds for relief.

Insolvency

IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments* (Apr. 7, 2009)
IRC §108

☞ IRS Pub. 4681 Updated

The IRS updated this publication, which highlights the recent changes for individuals in the tax treatment of debt cancellation from foreclosures, repossessions, and abandonments. The latest changes include:

- **Qualified principal residence indebtedness extension.** The exclusion from gross income for the discharge of qualified principal residence indebtedness was extended for an additional three years. The exclusion applies to debt discharged after 2006 and before 2013.
- **Qualified Midwestern disaster area indebtedness.** Qualified individuals are allowed to exclude from gross income discharges of certain indebtedness because of Midwestern disasters.
- **Reacquisition of business debt.** Certain businesses may elect to defer and include ratably over five tax years any income from the cancellation of business debt arising from the reacquisition of certain types of business debt repurchased in 2009 or 2010.

An insolvency worksheet is included in the publication to help taxpayers calculate whether and to what extent they were insolvent immediately before the cancellation of any debt. The results obtained from the worksheet can be used to determine the amount of canceled debt that is excludable from income.

The publication provides a number of detailed examples with filled-in forms.

> **Note.** See Chapter 5, Calculating Basis, for more information on basis for cancellation of indebtedness.

Cancellation of Debt Income

***David Isaac Plotinsky v. Comm'r,* TC Memo 2008-244 (Oct. 29, 2008)**
IRC §§61(a)(12) and 102

☞ Forgiven Student Loans Not Excludable as Gift

Facts. David Plotinsky financed a portion of his college education with federal student loans during 1993 through 1997. He then financed a portion of his law school education with several additional federal student loans during 1997 through 2000.

Key Bank USA/American Education Services (AES) offered student loan consolidation as part of its business services. To induce persons with student loans to consolidate them, AES offered a payment incentive program. Under the incentive program, if an individual consolidated his student loans by taking out a loan from AES and subsequently made 36 consecutive on-time monthly payments on the loan, it would discharge a portion of the loan.

After graduating from law school, Plotinsky consolidated his federal student loans through AES in August 2001. The promissory note that Plotinsky signed did not mention any incentive program for the loan repayment.

Three years after graduation, his employer, the U.S. House of Representatives, paid $6,288 on his consolidated student loan during 2004. Plotinsky did not make any additional loan payments during that year. In 2004, AES discharged $3,043 of the loan after 36 consecutive timely payments were made on the consolidated student loan. AES issued a Form 1099-C, *Cancellation of Debt,* to Plotinsky for 2004, which showed $3,043 of canceled debt.

Plotinsky filed his 2004 Form 1040, reporting $76,917 of gross income which did not include the $3,043 of cancellation of debt income. Instead, he attached a note to his return indicating that he had received the cancellation of debt but was not reporting this amount as income because he interpreted IRS Pub. 525 to state that the cancellation constituted a gift rather than income.

In 2006, the IRS issued a notice of deficiency to Plotinsky for the taxable year 2004 taxing the omitted $3,043 of discharged student loan income.

Issues. Whether Plotinsky is entitled to exclude $3,043 of cancellation of debt income from his gross income for 2004.

Analysis. Cancellation of debt income is generally includable in gross income, although there are certain exceptions to this rule. The exception that Plotinsky relied on pertains to the value of property acquired by gift. Under IRC §102(a), the debtor has no income resulting from a discharge of a loan if such discharge constitutes a gift from the creditor to the debtor. For the exception to apply, it must be found that there was "a release of something to the debtor for nothing."[2]

The Tax Court held that AES offered its incentive program in order to induce individuals to consolidate their student loans with AES. Pursuant to this incentive program, AES discharged $3,043 of Plotinsky's consolidated student loan because 36 consecutive timely payments had been made on the loan. The Tax Court stated that AES did not intend to discharge the $3,043 out of "detached and disinterested generosity" or "out of affection, respect, admiration, charity or like impulses." Thus, Plotinsky failed to prove the discharge of debt was intended as a gift from AES.

Holding. The court ruled that Plotinsky must include the $3,043 in his gross income for the taxable year 2004.

Turnover of Tax Refund

***In Re: James W. Graves and Kathryn P. Graves,* No. CO-08-038 United States Bankruptcy Appellate Panel of the 10th Circuit (Oct. 22, 2008)**

IRC §1398

☞ Denial of Motion for Turnover of Tax Refund Affirmed

Facts. James and Kathryn Graves (Debtors) filed their 2006 federal income tax return, which showed they were entitled to a $3,000 refund for overpayment of taxes. On September 20, 2008, the couple filed a voluntary Chapter 7 bankruptcy petition. In January 2008, Jeffrey Weinman, the trustee, filed a motion for turnover of the couples' tax refund for 2006; and this matter was considered at a hearing held in March 2008. The Bankruptcy Court denied the trustee's motion, and the trustee then filed a notice of appeal in April 2008.

Issues. Whether a tax refund that the Debtors elected to apply in prepayment of a subsequent year's tax liability is subject to turnover.

Analysis. Bankruptcy trustees are given certain powers by the Bankruptcy Code, which include the authority to compel turnover of estate property from anyone who has the property in their "possession, custody, or control, during the case." The trustee's contention in this case is that the Debtors' 2006 tax overpayment is property of the estate and, thus, subject to turnover. The Debtors responded that they were never in possession, custody, or control of the refund because of their election to apply the overpayment to a subsequent tax year.

Section 542 of the Bankruptcy Code limits turnover to "property that the trustee may use, sell, or lease," and which is in the debtors' possession or control during the bankruptcy case.

Holding. The Appellate Panel affirmed the Bankruptcy Court's decision that the funds sought by the trustee were not within the Debtors' possession, custody, or control; thus, turnover of the prepaid taxes was properly refused.

2. *Helvering v. Am. Dental Co.,* 318 U.S. 322, 331 (1943).

BUSINESS EXPENSES

Substantiation of Claimed Losses

***Patrick and Leanne Furey v. Comm'r,* TC Memo 2009-35 (Feb. 12, 2009)**
IRC §§179, 465, 469, 475, 704, and 1221

☞ Failure to Produce Credible Evidence Leads to Denial of Claimed Losses

Facts. Patrick and Leanne Furey filed joint income tax returns for 2002, 2003, and 2004, which claimed tax overpayments for those respective years in the amounts of $18,226, $18,067, and $31,558. The IRS processed these returns and refunded the claimed overpayments.

In an IRS audit of the Fureys' 2002–2004 returns, Patrick Furey provided the IRS agent with what appeared to be partially amended returns for the years in question. These amended returns were not signed by the Fureys, were not dated, and had not been filed with the IRS. Among the items amended was the occupation of Patrick: on the original return, it had been reported as "corporate executive," while on the amended return it was listed as "trader in securities."

The Fureys' 2002 and 2003 income tax returns reported ordinary losses of $173,260 and $158,303, respectively, from Patrick's interest in the Harmony Malting (HM) partnership. According to Patrick Furey, Robert Saterdalen was his partner in HM; in 2003, Saterdalen disappeared and HM went out of business. Patrick said that if Saterdalen is not located, Patrick might be liable for HM debts of approximately $510,000. It appears that the losses relating to HM were based on this alleged speculative liability.

The Fureys' tax return preparer claimed that he had prepared 2002 and 2003 Forms 1065, *U.S. Return of Partnership Income*, for HM. The preparer said that these partnership returns were never filed with the IRS because the IRS did not ask him to do so. The identification numbers listed on the alleged Forms 1065 submitted to the IRS agent during the course of the audit were either nonexistent or were assigned to other taxpayers.

On their returns for 2002-2004, the Fureys reported income, IRC §179 expenses, and nonpassive ordinary losses relating to Patrick's alleged interest in Becker Sunset Farms (BSF). The IRS did not find any credible evidence to substantiate that BSF existed in the years in question.

Additionally, Patrick invested frequently in the stock market for his own account. On the couples' 2002, 2003, and 2004 filed tax returns, Patrick's securities trading activity was treated as an investment, nonbusiness activity. Patrick reported a capital loss from this activity of $214,608 for 2002, and capital gains for 2003 and 2004 of $23,780 and $28,345, respectively. Patrick did not conduct securities trades for others and never made an election under IRC §475(f) to use the mark-to-market accounting method.

On the amended 2002, 2003, and 2004 returns, Patrick reported different amounts for his securities trading gains and losses and changed the character thereof from capital to ordinary.

Issues. Whether the Fureys:

- Substantiated the claimed partnership income, losses, and expenses; and
- Have securities trading losses which may be treated as ordinary losses.

Analysis. IRS determinations are generally presumed correct, and petitioners bear the burden of proving that the adjustments set forth in the IRS's notice of deficiency are erroneous. In this case, the Fureys made no claim that any shift in the burden of proof should occur. They did not answer IRS interrogatories and did not file a pretrial memorandum.

In order to deduct partnership losses, a partner must establish his basis in the partnership. Partnership losses may be deducted only to the extent the partner has basis at risk.

Dealers in securities may recognize ordinary income or loss on their securities trading activity. Apart from dealers, however, only securities traders whose trading activity rises to the level of a trade or business and who make a valid election under §475(f) are entitled to treat gains and losses from the sale of securities as ordinary.[3]

The court stated that the Fureys offered implausible explanations and evidence relating to the losses and expenses in question. They did not adequately establish the existence of HM and BSF for the years in issue and what losses, if any, they were entitled to relating to these entities.

Patrick had not established that his security trading activity was anything other than a nonbusiness investment activity for which he realized only capital gains and losses.

Holding. The court sustained the IRS adjustments relating to HM and BSF and the securities trading activity. Accordingly, the deficiencies determined by the IRS for 2002, 2003, and 2004 in the amounts of $14,310, $7,089, and $31,872, respectively, were upheld.

Professional Gambling

Office of Chief Counsel IRS Memorandum AM2008-013 (Dec. 10, 2008)
IRC §§162, 165, and 172

☞ Professional Gambler's Losses and Business Expenses

Facts. IRS counsel issued advice about a recurring litigation issue as to whether expenses incurred by a professional gambler engaged in the business of gambling are subject to the limitation on deducting "losses from wagering transactions" in IRC §165(d).

Analysis. The terms "gains" and "losses" are not defined in the Code. Courts have differed in interpreting these terms. In IRC §165, a "loss" is the result of a transaction or event which caused the taxpayer to lose cash or investment in property. The term "loss" is also used in the broader sense to mean an excess of expenditures over receipts.

IRC §165(d) states that "losses from wagering transactions shall be allowed only to the extent of the gains from such transactions." This usage conforms with the common understanding of the phrase "losses from wagering transactions" to mean the amount of the wager lost. If the return from a wager is less than the amount of the wager, the wagering loss equals the wager minus the amount of the return.

Wagering losses are distinguished from business expenses under §162(a) and business NOLs under §172 which may be carried forward or back to offset gain in other tax years.

Professional gamblers may use wagering losses to offset wagering gains only in that same tax year and may not carry over wagering losses in excess of wagering gains to offset income in another year.

> **Example 2.** Franklin is a professional gambler engaged in the business of playing poker. Gambling is Franklin's sole occupation; he has no other source of income. During 2008, Franklin traveled to various casinos to participate in poker tournaments. At the end of 2008, he had total wagering gains of $75,000, total wagering losses of $100,000, and total business expenses of $15,000 for transportation, meals, and lodging.
>
> Franklin must report the $75,000 of wagering gains as gross receipts. He can deduct wagering losses to the extent of wagering gains under §165(d). Thus, Franklin can subtract only $75,000 of his $100,000 of wagering losses, to completely offset his $75,000 of gross receipts. He cannot carry over the excess $25,000 of wagering losses to offset wagering gains or other income in another taxable year. However, under §162(a)(2), Franklin is allowed to deduct the $15,000 of business expenses without regard to §165(d), resulting in an NOL of $15,000. He may carry that $15,000 NOL forward or back to another year under §172(b).

3. See *U.S. v. Diamond*, 788 F.2d 1025, 1028-1030 (4th Cir. 1986); *Vines v. Comm'r*, 126 TC 279, 288 (2006).

Conclusion. IRC §165(d) applies only to wagering losses and does not limit §162(a) deductions for business expenses of professional gamblers.

> **Note.** Although this gives insight into the IRS's position for this issue, it holds no precedence as a source of authority.
>
> See Problem 4: Losses, in Chapter 4, Individual Taxpayer Problems, for more information on gambling losses.

CAPITAL GAINS AND LOSSES

Subdivided Land

***Bruce A. and Donna M. Rice v. Comm'r,* TC Memo 2009-142 (June 16, 2009)**
IRC §1221

☞ Sale of Excess Lots Qualifies for Capital Gain Treatment

Facts. Bruce and Donna Rice wanted to build their dream home in Austin, Texas. After searching for the perfect location, they bought an undeveloped 14-acre parcel near a preserve for $300,000 in 1998. After constructing their 12,000 square foot residence, they desired to create a certain aesthetic for the home and its surroundings. In essence, they wanted neighbors like them who were wealthy and successful.

The Rices registered a subdivision for a homeowner's association and divided the excess land into 10 smaller lots. They sold a total of seven of the 10 lots during the 9-year period beginning in 2000 and ending in 2008. The lots were sold through word of mouth rather than using conventional advertising methods.

In 2004, one lot was sold for a gain of $89,000. The taxpayers reported the gain as a long-term capital gain on Schedule D. The IRS determined that the lot was held primarily for sale to customers in the ordinary course of business, and the gain should have been reported on Schedule C.

Issue. Whether proceeds from the sale of the excess lot is properly classified as capital or ordinary under IRC §1221(a).

Analysis. The court used the following reasons to reach its conclusion:

1. The taxpayers did not have the option to buy a smaller portion of the original 14-acre parcel.
2. They subdivided the excess land and created a homeowner's association to ensure a certain aesthetic for their neighborhood. In doing so, they wanted to protect their considerable investment in their dream home.
3. The number of lots sold was small, seven in total. The Rices devoted very little time to the sale of excess lots, and both taxpayers were employed full-time in the family business. Their meager advertising efforts were more characteristic of investors than of dealers.
4. The sporadic lot sales accounted for a small percentage of their income.
5. The Rices were not real estate developers, had never developed and subdivided land before, and have not done so since.

Holding. After thoroughly reviewing numerous prior court decisions, the Tax Court held that the reported gain from the sale of the lot qualified for capital gain treatment.

> **Note.** For an excellent analysis of this issue, see the *Biedenharn Realty Co.* 5th Circuit Court case.[4]

4. *Biedenharn Realty Co. v. U.S.*, 526 F.2d 409 (5th Cir. 1976).

Invalid IRC §475(f) Election

***Kazim Z. Acar v. Comm'r*, U.S. Court of Appeals, 9th Circuit, No. 06-16820 (Sep. 23, 2008)**

IRC §§475(f) and 1221

☞ Mark-to-Market Election Cannot be Made Retroactively

Facts. Mr. Acar, a financial planner, traded securities for himself. In 1999, he claimed the maximum $3,000 capital loss deduction based on his Schedule D stock trading loss of $954,041. He made no mark-to-market election for the 1999 tax year until February 2002. With that late election, in which he claimed to be a **trader** rather than an investor, he also provided the IRS with an amended 1999 tax return.

On the amended return for 1999, Mr. Acar treated his net trading loss of $954,041 as an ordinary loss rather than a capital loss. As a result, he claimed a $46,396 overpayment on his 1999 amended return. In September 2002, the IRS examined the amended return and denied his claimed refund. Mr. Acar refused to accept the denial of his requested refund by the IRS appeals office and the U.S. district court.

Issue. Whether the IRS should have approved the retroactive mark-to-market election under IRC §475(f) for the taxpayer's 1999 trading activity.

Analysis. As part of the Taxpayer Relief Act of 1997, Congress added §475(f) to the Code to allow **securities traders** (as opposed to investors) to treat their activity as a trade or business. The result is that taxpayers who make the proper election are allowed to report their gains and losses from trading securities on Part II of Form 4797, *Sales of Business Property*, as ordinary gains and losses. Consequently, the $3,000 maximum capital loss limitation which applies to investors is waived. In addition, all trading-related expenses are fully deductible on Schedule C.

Rules for Making a Mark-to-Market Election. The taxpayer must qualify as a trader rather than an investor. The election must be made by the due date (not including extensions) of the tax return for the year **prior to the year** for which the election becomes effective. The election is made by attaching a statement either to the preceding tax return or to a request for an extension of time to file the preceding return. In addition, the taxpayer must also file Form 3115, *Application of Change in Accounting Method*.[5]

The §475(f) mark-to-market election for the 1999 tax year was not made until February 2002, well after the due date of the taxpayer's 1998 tax return (April 15, 1999), as required by the revenue procedure.[6]

Holding. The 9th Circuit agreed with the IRS that the election was invalid and should be ignored.

The court stated: "In this case, allowing the late election would clearly give Acar some advantage that was not available on the April 15, 1999 due date, namely the knowledge that he would incur trading losses, as opposed to trading gains, in the 1999 tax year. With the benefit of that knowledge, Acar in 2002 sought to make a retroactive section 475(f) election in order to convert what had been capital losses on his original 1999 tax form into ordinary losses and, on that basis, claim a refund. Accordingly, the undisputed evidence shows Acar used **'hindsight'** in filing the late election within the meaning of Treas. Reg. §301.9100-3(b)(3)(iii)."

> **Note.** See pages 81–86 in the 2007 *University of Illinois Federal Tax Workbook* for a thorough analysis of the mark-to-market election available to securities traders. This can be found on the accompanying CD.

5. Rev. Proc. 99-17, 1999-1 CB 503**,** superseded in part by Rev. Proc. 99-49, 1999-2 CB 725.

6. Ibid.

CASUALTY AND THEFT LOSSES

Safe Harbor for Theft Loss from Ponzi Schemes

Rev. Proc. 2009-20 (Apr. 6, 2009)
IRC §165

☞ Safe Harbor for Ponzi Schemes Investors

This revenue procedure provides an optional safe harbor loss calculation for qualified investors that experienced losses in certain investment arrangements discovered to be criminally fraudulent.

Note. See Chapter 4, Individual Taxpayer Problems, for an expanded discussion of Rev. Proc. 2009-20.

Theft Loss from Investment Fraud

Rev. Rul. 2009-9 (Apr. 6, 2009)
IRC §§165 and 172

☞ Guidelines for Fraud Victims

Facts. In Year 1, Amy, in a transaction entered into for profit, opened an investment account with Bernie, and provided Bernie with power of attorney to buy and sell securities on Amy's behalf. Amy instructed Bernie to reinvest any income and gains earned on the investments.

Bernie periodically issued account statements to Amy that reported the securities purchases and sales that Bernie purportedly made in Amy's investment account and the balance of the account. Bernie also issued tax reporting statements to Amy and to the IRS that reflected purported gains and losses on Amy's investment account.

At all times prior to Year 8 and part way through Year 8, Bernie was able to make distributions to investors who requested them.

In Year 8, it was discovered that Bernie's purported investment advisory and brokerage activity was in fact a fraudulent investment arrangement known as a "Ponzi" scheme.

When Bernie's fraud was discovered in Year 8, Bernie had only a small fraction of the funds that he reported on the account statements issued to Amy and other investors.

Amy did not receive any reimbursement or other recovery for the loss in Year 8.

Bernie's actions constituted criminal fraud or embezzlement under the law of the jurisdiction in which the transactions occurred. At no time prior to the discovery did Amy know that Bernie's activities were a fraudulent scheme.

Issue 1 — Theft Loss

Analysis. IRC §165(a) allows a deduction for losses sustained during the taxable year and not compensated by insurance or otherwise. For individuals, §165(c)(2) allows a deduction for losses incurred in a transaction entered into for profit, and §165(c)(3) allows a deduction for certain losses not connected to a transaction entered into for profit, including theft losses.

Under §165(e), a theft loss is sustained in the taxable year the taxpayer discovers the loss. IRC §165(f) permits a deduction for capital losses only to the extent allowed in IRC §§1211 and 1212. In certain circumstances, a theft loss may be taken into account in determining gains and losses under §1231.

The character of an investor's loss related to fraudulent activity depends, in part, on the nature of the investment. For example, a loss that is sustained on the worthlessness or disposition of stock acquired on the open market for investment is a capital loss, even if the decline in the value of the stock is attributable to fraudulent activities of the corporation's officers or directors, because the officers or directors did not have the specific intent to deprive the shareholder of money or property.

Holding. Bernie specifically intended to, and did, deprive Amy of money by criminal acts. Bernie's actions constituted a theft from Amy, as defined in §165. Accordingly, Amy's loss is a theft loss, not a capital loss.

Issue 2 — Deduction Limitations

Analysis. IRC §68 provides an overall limit on itemized deductions based on a percentage of adjusted gross income or total itemized deductions. Under §68(c)(3), losses deductible under §165(c)(2) or (3) are excepted from the amount in excess of 2% of AGI. Accordingly, Amy's theft loss is an itemized deduction that is not subject to the limits on itemized deductions under IRC §§67 and 68.

Holding. In opening an investment account with Bernie, Amy entered into a transaction for profit. Amy's theft loss therefore is deductible under §165(c)(2) and is not subject to the §165(h) limitations.

Issue 3 — Year of Deduction

Analysis. IRC §165(e) provides that any loss arising from theft is treated as sustained during the taxable year in which the taxpayer discovers the loss.

Holding. Amy may deduct the theft loss in Year 8, the year the theft loss is discovered to the extent it is not covered by a claim for reimbursement or other recovery. There must **not** be a reasonable prospect of recovery.

Issue 4 — Amount of Deduction

Analysis. Treas. Reg. §1.165-8(c) provides that the amount deductible in the case of a theft loss is determined consistently with the manner described in Treas. Reg. §1.165-7 for determining the amount of a casualty loss, considering the FMV of the property immediately after the theft to be zero. Under these provisions, the amount of an investment theft loss is the basis of the property (or the amount of money) that was lost, less any reimbursement or other compensation.

The amount of a theft loss resulting from a fraudulent investment arrangement is generally the initial amount invested in the arrangement, plus any additional investments, less amounts withdrawn, if any, reduced by reimbursements or other recoveries and reduced by claims to which there is a reasonable prospect of recovery. If an amount is reported to the investor as income in years prior to the year of discovery of the theft, the investor includes the amount in gross income. If the investor reinvests the amount in the arrangement, the deductible theft loss is increased.

Holding. The amount of Amy's theft loss for purposes of §165 includes her original investment and any additional investments. Amy's loss also includes the amounts that she reported as gross income on her federal income tax returns. Amy's loss is reduced by any amount of money distributed to her. If Amy has a claim for reimbursement for which there is a reasonable prospect of recovery, Amy may not deduct the amount which is covered by the claim.

Issue 5 — Net Operating Loss

Analysis. IRC §172(d)(4)(C) treats any deduction for casualty or theft losses allowable under §165(c)(2) or (3) as a business deduction. A casualty or theft loss an individual sustained after December 31, 2007, is considered a loss from a "sole proprietorship" within the meaning of §172(b)(1)(F)(iii).

Accordingly, an individual may elect either a 3-, 4-, or 5-year NOL carryback for an applicable 2008 NOL, provided the gross-receipts test provided in §172(b)(1)(H)(iv) is satisfied.[7]

7. See Rev. Proc. 2009-19, 2009-14 IRB (Apr. 6, 2009).

Holding. To the extent Amy's theft loss deduction creates or increases a NOL the year it is deducted, she may carry back up to three years and forward up to 20 years the portion of the NOL attributable to the theft loss. If Amy's loss is an applicable 2008 NOL and the gross-receipts test in §172(b)(1)(H)(iv) is met, she may elect either a 3-, 4-, or 5-year NOL carryback for the applicable 2008 NOL.

Note. See Problem 4: Losses, in Chapter 4, Individual Taxpayer Problems, for an expanded discussion and application of Rev. Rul. 2009-9.

CORPORATIONS

Pass-Through Losses

***Marvin and Thelma Kerzner v. Comm'r,* TC Memo 2009-76 (Apr. 6, 2009)**
IRC §1366

☞ No Basis in S Corporation Acquired from Circular Flow of Funds

Facts. In 1986, Marvin and Thelma Kerzner formed the Highland Court Associates partnership (HCA) and Highland Court, Inc. (HCI), an S corporation. Since inception, each of the Kerzners has been a 50% partner in HCA and a 50% shareholder in HCI.

For each year from 1986 to 2001, HCA lent money to the Kerzners, the Kerzners lent money to HCI, and HCI paid rent to HCA. Except for a $14,233 repayment of principal during the 1993 tax year by HCI to the Kerzners, no payments of principal or interest were ever made on any of the notes. After the 1999 year, the loans were combined into a single surplus cash note issued by HCI to the Kerzners.

The Kerzners filed a timely 2001 Form 1040 and a Form 1045, *Application for Tentative Refund*, in which they claimed a pass-through loss from HCI for the year and carried the resulting excess NOL back to the 1996 and 1997 tax years. The IRS sent the Kerzners notices of deficiency for the 1996, 1997, 1998, and 2001 tax years; and the Kerzners filed a petition in response.

The Kerzners disputed the IRS's determination that 2001 losses from HCI should be suspended because of a lack of basis in stock and indebtedness, which resulted in a $130,905 increase in taxable income for 2001. They also disputed the disallowance of a previously-allowed carryback of the NOL to the Kerzners' 1996 and 1997 years and increases in taxable income for 1996 and 1997 in the respective amounts of $105,255 and $15,354.

Issues. Whether the Kerzners made an economic outlay on the yearly loans to HCI.

Analysis. To acquire indebtedness in an S corporation, it is required that:

- The indebtedness run directly from the S corporation to the shareholder, and
- The shareholder make an actual economic outlay that renders him poorer in a material sense.[8]

Transactions involving a circular flow of funds (beginning and ending with the original lender) with the sole purpose of generating basis in an S corporation have no economic substance and are not evidence of the required economic outlay.[9] In the Kerzner's case, there is a circular flow of cash beginning and ending with HCA. Each year, HCA lent money to the Kerzners; the Kerzners lent the proceeds to HCI; and HCI paid rent to HCA to complete the cycle.

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8. *Underwood v. Comm'r*, 63 TC 468 (1975), *aff'd* 535 F.2d 309 (5th Cir. 1976).

9. *Oren v. Comm'r*, TC Memo. 2002172, *aff'd* 357 F.3d 854 (8th Cir. 2004).

NOLs carried back from 2001 previously allowed for the Kerzners' 1996 and 1997 years were disallowed, resulting in increases in taxable income for 1996 and 1997 in the respective amounts of $105,255 and $15,354. Additionally, the determination that losses from HCI should be suspended due to a lack of basis in stock and indebtedness was upheld, resulting in an increase in taxable income for 2001 in the amount of $130,905.

Holding. The court held that the Kerzners did not make an economic outlay on the yearly loans and, accordingly, did not acquire basis in indebtedness.

Reasonable Compensation

***Menard Inc. et al. v. Comm'r,* U.S. Court of Appeals, 7th Circuit; No. 08-2125 (Mar. 10, 2009)**
IRC §162

☞ Tax Court Ruling on Unreasonable Executive Compensation Reversed

Facts. John Menard is the founder, CEO, and majority shareholder of Menard, Inc., a closely-held Wisconsin corporation that operates a chain of retail stores selling hardware, building supplies, and related products under the name "Menards." In 1998, the tax year at issue in this case, Menard, Inc. had 138 stores and was the third largest retail home improvement chain in the U.S., after Home Depot and Lowe's. The evidence shows John Menard working 12 to 16 hours per day, 6 to 7 days per week, rarely taking vacations, and involving himself in every aspect of the firm's operations. Under his leadership, Menard Inc.'s revenues grew from $788 million in 1991 to $3.4 billion in 1998, while the company's taxable income increased from $59 million to $315 million.

In 1998, John Menard received a salary of $157,500, a profit-sharing bonus of $3,017,000, and a "5% bonus" of $17,467,800. The Tax Court ruled that Mr. Menard's compensation was excessive and that the 5% bonus was, in effect, a dividend.

Issue. Whether the compensation paid to John Menard was unreasonable and intended as a dividend, rather than a deductible business expense for the corporation.

Analysis. The IRS occasionally challenges a corporate salary deduction on the grounds that it is really a dividend. Because dividends are not deductible from a corporation's taxable income, a corporation can reduce its income tax liability by treating a dividend as salary. A "reasonable" salary is defined as the amount that "would ordinarily be paid for like-services by like-enterprises under like-circumstances."[10] Of course, this is difficult to put into practice as no two enterprises are alike and no two CEOs are alike.

For the tax year 1998, Menard Inc.'s rate of return on shareholders' equity was 18.8%, higher than that of either Home Depot or Lowe's. There is no indication that any of the company's success was due to windfall factors.

The Tax Court thought that John Menard's compensation was excessive because his entitlement to the 5% bonus was conditioned on his agreement to reimburse the corporation if the IRS or its Wisconsin counterpart disallowed the deduction of the bonus from the corporation's taxable income and because the 5% bonus program "looked" more like a dividend than salary. The Tax Court ruled that the compensation paid to John Menard in 1998 above $7.1 million was excessive by applying a convoluted formula which took into account Home Depot's and Menard Inc.'s return on investment and the compensation of the CEOs of Home Depot and Lowe's.

The court did not think 5% of net corporate income looked like a dividend, because dividends generally are specified dollar amounts per share rather than a percentage of earnings. The reason for varying an executive's compensation with the company's profits is to increase the incentive to work intelligently and hard in order to increase those profits.

10. Treas. Reg. §1.162-7(b)(3).

The appeals court found the formula to determine excess compensation used by the Tax Court to be an "arbitrary as well as dizzying adjustment" as it disregarded differences in the full compensation packages of the executives being compared, differences in the challenges faced by the companies in 1998, and differences in the responsibilities and performance of the three CEOs.

Holding. The appeals court ruled that the Tax Court committed "clear error" in ruling that Mr. Menard's compensation in 1998 was excessive. The decision was reversed, and the compensation paid was upheld as a deductible business expense to the corporation.

Built-in Gain

***MMC Corp. et al. v. Comm'r,* U.S. Court of Appeals for the Tenth Circuit; No. 08-9002 (Jan. 13, 2009)**
IRC §§475, 481, 1361, 1366 and 1374

☞ Adjustments from Change in Accounting Method are Taxable Built-in Gain

Facts. MMC was incorporated as a C corporation under Kansas law. Since inception, it used the accrual method of accounting. Prior to 1997, MMC valued its accounts receivable according to its face value. For the 1997 tax year, MMC adopted mark-to-market accounting wherein assets are valued as though they were sold for FMV on the last day of the tax year. This effectively accelerates loss deductions; consequently, it allows taxpayers using this method to reduce taxable income for the tax year in which the loss deductions are taken.

MMC reported income of $22 million on its 1997 consolidated return. The switch to mark-to-market valuation allowed the company to claim a loss on its customer accounts receivable and a resulting tax deduction of $5.3 million. If the company had not used mark-to-market accounting, it would not have been entitled to deduct these accounts until such time as they actually became worthless.

In 1998, Congress amended the tax code to prohibit the use of mark-to-market valuation of customer paper accounts (i.e., accounts receivable). Because of this change, MMC was required to return to the face-value accounting method it used prior to 1997.

Changes in accounting method often result in the duplication or omission of gross income or deductions. To prevent these duplications and omissions, IRC §481(a) requires taxpayers changing their accounting method to make an adjustment in income during the tax year of the change. When Congress amended the tax code to prohibit mark-to-market accounting for customer paper accounts, it provided that the net amount of any §481 adjustment required by the new amendment should be taken into account ratably over a 4-year period. MMC's 1998 reversion to face-value accounting thus required the company to make a positive §481(a) adjustment to take $5.3 million back into income over a 4-year period.

MMC included the appropriate share of the adjustment in its income for both 1998 and 1999 and paid corporate income tax on these amounts. However, effective January 1, 2000, MMC changed its status from a C corporation to an S corporation. On MMC's 2000 S corporation tax return, MMC noted the §481 adjustment and included the pro-rata amount in its income but did not pay corporate-level entity tax on the sum. MMC took the same position in its 2001 tax return.

The IRS assessed a tax deficiency against MMC for tax years 2000 and 2001 for $357,534 and $468,068, respectively. MMC appealed the Tax Court decision, which upheld the deficiency.

Issues. Whether the §481 adjustments attributable to periods before the company became an S corporation are taxable built-in gain (BIG).

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Analysis. The BIG provisions of IRC §1374 were designed to prevent a taxpayer from using a subchapter S election to avoid corporate tax on gains attributable to periods when the taxpayer was a C corporation and thus subject to entity-level tax. Besides recognizing BIG on the disposition of appreciated assets which were acquired during the time that the S corporation was a C corporation, the BIG tax also reaches certain income that is attributable to that period.

Treas. Reg. §1.1374-4(d) states "Any section 481(a) adjustment taken into account in the recognition period is recognized built-in gain or loss to the extent the adjustment relates to items attributable to periods before the beginning of the recognition period under the principles for determining recognized built-in gain or loss in this section."

The Tax Court relied on this subsection of the regulations to recognize implicitly that MMC's 2000 and 2001 §481 adjustments were taken into account in the recognition period. They concluded that the adjustments related to the $5.3 million income deducted in 1997 and constituted BIG.

On appeal, MMC advanced an alternative analysis, arguing that the §481 adjustments themselves — rather than the 1997 deduction to which the adjustments relate — constitute the pertinent items of income. MMC contended that the amendment to the tax code required the company to make four ratable §481 adjustments from 1998 to 2001; therefore, the 2000 and 2001 adjustments could not have been properly included in gross income by an accrual-method taxpayer before that point in time. According to MMC's reasoning, the adjustments did not represent BIG.

The appeals court disagreed with MMC's position, which ignored Treas. Reg. §1.1374-4(d). The Tax Court properly looked to §1.1374-4(d) and correctly determined that the 2000 and 2001 adjustments relate to the $5.3 million in income that MMC deducted in 1997. The income is attributable to the period before MMC elected S status and was included in gross income prior to January 1, 2000. MMC was an accrual-method taxpayer in 1997 and included the $5.3 million in income before using the mark-to-market valuation method to deduct it.

Holding. The appeals court held the adjustment amounts were BIG.

CREDITS

Earned Income Tax Credit

Treasury Inspector General for Tax Administration (TIGTA) Report #2009-40-024 (Dec. 31, 2008)
IRC §32

☞ TIGTA Releases Review of Earned Income Tax Credit Program

Analysis. TIGTA released a report that states that the IRS made improvements in its oversight and management of the earned income tax credit (EITC) program. However, the IRS still has not developed a reliable method to quantify its progress in meeting its program goals of increasing EITC participation and reducing erroneous payments.

The report said that the IRS has successfully developed a number of processes to identify potentially erroneous EITC payments prior to the time of issuance, but it nonetheless remains unable to stop most of these payments. This is because, starting in tax year 2005, the IRS reallocated its examination resources to focus more on higher income taxpayers, which limits the number of EITC audits the IRS is able to perform each year.

If the IRS does not develop new compliance methods, it will be unable to significantly reduce the amount of erroneous EITC payments, estimated to be between $10–12 billion annually.

One of the report's recommendations was that the IRS conduct a study to identify alternatives that will enhance the agency's ability to identify and adjust EITC claims for which data shows that the taxpayers do not meet the qualifying tests.

IRS management agreed with the recommendations in the TIGTA report.

ITINs/Additional Child Tax Credit

Treasury Inspector General for Tax Administration (TIGTA) Report # 2009-40-057 (Mar. 31, 2009)
IRC §24(d)

☞ Non-U.S. Citizens Use ITINs to Improperly Claim the Additional Child Tax Credit

Background. The Treasury Department conducts investigations of how the IRS carries out the enforcement of the complex laws passed by Congress. This report pertains to the improper use of individual taxpayer identification numbers (ITINs) by resident or nonresident aliens who have no tax liability in order to obtain the additional refundable child tax credit. ITINs are available to individuals who are required to have a taxpayer identification number but do not have and are not eligible to obtain a social security number (SSN). ITINs are given to aliens who lack the authority to legally work in the United States.

Facts Determined by Treasury Department

1. Individuals are assigned multiple ITINs, which result in erroneous refunds.
2. ITINs are improperly used for employment. Employers report wage income under an ITIN. However, the law establishing the ITIN specifically states that it is not an SSN or an account number for an employer to use for wage purposes.
3. Inaccurate information is input into IRS systems from tax returns filed with ITINs. This occurs when a tax return is filed with an ITIN and an attached Form W-2 contains an SSN that does not belong to the individual filing the return. The IRS does not correct these obvious mismatches during return processing.
4. An individual must have an SSN in order to claim the earned income credit.[11] However, a similar legislative limitation is **not** imposed on individuals who use an ITIN for tax filing purposes to claim the additional child tax credit.

> **Note.** For the 2007 tax year, more than 1.2 million (66%) of ITIN filers received additional child tax credits of almost $1.8 billion. Their reported tax liability was zero.

Treasury Department Recommendations

1. The IRS should develop a process to ensure that accurate tax information is input into its systems from both paper and e-filed tax returns filed with an ITIN.
2. The IRS should develop a process to ensure the present residency requirement for the child tax credit and additional child tax credit is met on ITIN returns claiming the two credits.
3. Legislation is needed to clarify whether or not refundable tax credits such as the additional child tax credit may be paid to filers without a valid SSN. Lacking legislation, the IRS should be provided the authority to disallow associated claims for the additional child tax credit.

The IRS's Response to the Recommendations

1. The IRS did **not** agree to ensure that accurate tax information is input into IRS systems from both paper and e-filed tax returns with an ITIN.
2. The IRS did **not** agree to develop a process to ensure the residency requirement is met on ITIN returns claiming the credits. The IRS stated that, without a legislative change, it does not have the legal authority to verify the residency requirement during return processing.
3. The IRS agreed to explore legislative changes with the Treasury Department to address the improper payment of refundable credits to taxpayers who file returns using ITINs.

11. Personal Responsibility and Work Opportunity Reconciliation Act of 1996, P.L. 104-193 Section 401(c).

Alternative Motor Vehicle Credit

IRS News Release IR-2008-113 (Oct. 6, 2008)
IRC §30B

☞ Qualified Lean-Burn Technology Vehicles Certified for Credit

Purpose. The IRS acknowledged that certain lean-burn technology vehicles qualify for the alternative motor vehicle tax credit.

Analysis. Previously, only hybrid, fuel cell, and alternative fuel vehicles were certified for the alternative motor vehicle tax credit. Now, certain advanced lean-burn technology vehicles, which generally run on diesel fuel, are also certified.

To claim the credit, the vehicle must be acquired for use or lease by the taxpayer; and the vehicle's original use must begin with the taxpayer. This credit is phased out beginning at the time a manufacturer sells 60,000 qualified hybrid and advanced lean-burn technology vehicles.

The qualifying vehicles with their respective credit amounts are as follows:

- 2009 Volkswagen Jetta 2.0L TDI Sedan — $1,300
- 2009 Volkswagen Jetta 2.0L TDI SportWagen — $1,300
- Mercedes GL 320 Blue TEC — $1,800
- Mercedes R 320 Blue TEC — $1,550
- Mercedes ML 320 Blue TEC — $900

First-Time Homebuyer Credit

IRS News Release IR-2009-69 (July 29, 2009)
IRC §36

☞ IRS Warns Taxpayers to Beware of First-Time Homebuyer Credit Fraud

Facts. James Otto Price III, a Jacksonville, Florida tax preparer pled guilty to falsely claiming the first-time homebuyer credit on a client's federal tax return. This was the first prosecution of fraud relating to the credit, and the IRS warned taxpayers and tax preparers to beware of any schemes in which the credit is falsely claimed.

As of the date of this news release, the IRS executed seven search warrants and 24 open criminal investigations involving the credit.

> **Note.** More information on the first-time homebuyer credit can be found in Chapter 11, New Legislation.

DEDUCTIONS

Economic Performance

ILM 200834019 (May 7, 2008)

IRC §461

☞ Liability for Cash Rebates Not Incurred on Date of Sale

Facts. The taxpayer is a consumer products' retailer that uses the accrual method of accounting. The taxpayer has a cash-rebate program wherein the customer pays full price for the product at checkout but receives a rebate offer at the time of the purchase. In order to receive the rebate, the customer must comply with all terms of the offer. A third-party administrator is used to process rebates. Often, payment for a rebate is issued several months after a rebate request is submitted.

A field auditor asked whether all events establishing the fact of the taxpayer's liability for the cash rebate have occurred at the time of the product sale which in turn would allow the taxpayer to treat the liability as incurred in the year of issuance.

Analysis. Treas. Reg. §1.461-4(g)(3) states that when the taxpayer's liability is to pay a rebate, refund, or similar payment to another person, economic performance occurs as payment is made to the person to whom the liability is owed.

Treas. Reg. §1.461-5(b)(1) presents a recurring item exception to the rule of economic performance. Under this exception, a liability is treated as incurred for a taxable year if:

1. All events have occurred at the end of the taxable year that establish the fact of the liability and the amount can be determined with reasonable accuracy;
2. Economic performance occurs on or before the earlier of:
   - **a.** The date that the tax return is filed for the taxable year, or
   - **b.** The 15th day of the 9th calendar month after the end of the taxable year;
3. The liability is recurring; and
4. Either the amount of the liability is not material or accrual of the liability results in better matching of the liability against the income to which it relates than would be the case if the accrual of the liability was made in the taxable year during which economic performance takes place.

Conclusion. The IRS stated in this legal memorandum that a retailer cannot treat obligations to pay cash rebates as incurred on the date a product is sold because the liability to pay the rebate is not certain until such time as the customer complies with the requirements of the rebate.

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Restitution Paid

Ltr. Rul. 200834016 (May 20, 2008)
IRC §165

☞ IRS Rules on Deductibility of Restitution Paid as Fraud Settlement

Facts. A physician practicing through an S corporation was indicted for insurance fraud. As part of the settlement, it was agreed that the physician would pay a criminal penalty to New Jersey. He also agreed to provide restitution to the insurance companies to which the fraudulent claims were submitted.

A request for a ruling was submitted on behalf of the physician as to whether the restitution payments he made to insurance companies are deductible as losses incurred in a trade or business under IRC §165(c)(1) or, alternatively, as losses incurred in a transaction entered into for profit under §165(c)(2).

Analysis. Under §165(c)(1), repayment of fraudulently obtained funds is not deductible. Thus, the physician is not entitled to a deduction for the restitution paid to the insurance companies under §165(c)(1).

Under IRC §165(c)(2), taxpayers who repay embezzled funds are ordinarily entitled to a deduction in the year in which the funds are repaid. Rev. Rul. 82-74 holds that a convicted arsonist is entitled to a loss deduction under §165 for restitution paid to an insurance company in the taxable year in which repayment is made to the extent that the proceeds were previously included in income.

Holding. The physician was allowed to deduct the amounts paid in restitution to the insurance companies as a loss on his federal income tax return.

> **Observation.** The restitution paid is reported as a miscellaneous itemized deduction.

> **Note.** Additional information on tax treatment for embezzlers is found in Chapter 6, Small Business Issues, in the workbook.

Timing of Deduction for Medical and Dental Services

TAM 200846021 (July 23, 2008)

IRC §§105, 404, and 461

☞ Employer's Accrual of Deductions for Employees' Medical and Dental Services

Purpose. This technical advice memorandum deals with whether a company that has self-insured medical and dental plans for employees may deduct these payments within the tax year if the service providers are paid for their services more than 2½ months after the end of the tax year.

Background. An accrual-method taxpayer, operating on a 52/53 week taxable year ending in December, maintains self-insured medical and dental plans for its eligible employees. The plans use the calendar year for their plan years.

An eligible employee of the company may receive medical and dental services under the plans by arranging for an appointment with the selected service provider. The service provider then bills a third-party administrator (TPA) for the services provided. Claims are generally filed by the service provider. The TPA reviews the bills and then pays the service providers for covered services. The taxpayer reimburses the TPA from its general assets. There is sometimes a delay by the service provider in billing the TPA; thus, on occasion it is more than 2½ months after the end of the taxable year in which the services were provided before the TPA pays the service provider.

It is the practice of the taxpayer to deduct the expenses in the taxable year during which the services were provided to the employees, even in those cases in which claims are paid more than 2½ months after the end of the taxable year.

Analysis. When payments are made more than 2½ months following the close of the taxpayer's taxable year, the timing of the deduction depends on:

1. When the medical and dental reimbursements paid by the plans would be included in the income of participating employees if these reimbursement amounts were not excludable from the employees' income, and
2. Whether the payments are made by an IRC §419(e) welfare benefit fund.

Regarding the first issue, the provisions of the plan state that eligibility for benefit reimbursement is determined by whether the individual is a participant in the plan on the date services are provided. Thus, eligible employees of the plan are considered to receive reimbursements in the same calendar year in which they receive the medical and dental services.

For the second issue, the taxpayer represents that the plans are not welfare benefit funds under §419(e).

Conclusion. The expenses are deductible by the taxpayer in the taxable year during which the medical and dental services are provided under the plan because that is the time that economic performance occurs according to the provisions of IRC §461.

DIVORCE ISSUES

Divorce Decrees

Chief Counsel Advice 200925041 (June 19, 2009)

IRC §152(e)

☞ Divorce Decrees Must Now Unconditionally Grant Noncustodial Parents a Child's Exemption

Background. The issue raised in this Chief Counsel Advice (CCA) is whether noncustodial parents can use portions of a divorce decree as a substitute for Form 8332, *Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent*. This issue was previously addressed by Treasury Decision 9408 released July 1, 2008. The clarification provided by this CCA ends the confusion regarding this issue.

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> **Note.** See pages 587–588 in the 2008 *University of Illinois Federal Tax Workbook* for a thorough analysis of TD 9408, which are the final regulations under IRC §152. This can be found on the accompanying CD.

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

Note. For calendar-year taxpayers, the final regulations discussed below apply to tax years **beginning after July 2, 2008.** See pages 36–37 in the 2006 *University of Illinois Federal Tax Workbook* for rules that apply for **earlier** tax years. This can be found on the accompanying CD.

Rules for Tax Years Beginning After July 2, 2008 (Usually 2009 and Later Tax Years)

Caution. The information presented below accurately reflects the ruling by the Chief Counsel. However, this ruling does not agree with the information presented in Chapter 2, Dependentcy Exemption Issues. The authors believe calendar-year taxpayers with divorce decrees executed on or before **December 31, 2008** may use **unconditional** divorce decrees in lieu of Form 8832.

This view is based on the position that because the Treasury Regulations are effective for tax years beginning after July 2, 2008, the requirements for a calendar-year taxpayer did not change until the 2009 tax year.

Per the CCA, divorce decrees (or portions thereof) dated on or after July 3, 2008 cannot be used as a substitute for Form 8332 even if the decree unconditionally grants the right to claim a child's exemption to a noncustodial parent. As a result, it is suggested that a noncustodial parent involved in a divorce action insist on a signed Form 8332 from the custodial parent before the decree is finalized. This strategy protects the ability of the noncustodial parent to claim the exemption and potential child tax and education credits.

Note. Instead of using Form 8332, a written declaration can be used (other than the divorce decree). However, the declaration must conform to the substance of Form 8332 and must be executed for the sole purpose of releasing the claim. Using Form 8332, rather than a written declaration, is suggested.

Example 3. Brad and Melinda, the parents of one minor child, Sarah, are granted a divorce. The divorce decree is dated August 12, 2009. It grants Brad, the noncustodial parent, the **unconditional right** to claim Sarah's exemption for 2009 and through the tax year she graduates from high school. Even though the decree requires that Brad make substantial child support payments, the decree is silent regarding the fulfillment of his child support obligations and his right to claim Sarah's exemption.

Tax Result. Brad must secure a signed Form 8332 from Melinda in order to properly claim Sarah's exemption and potential child tax and education credits for her on his 2009 tax return.

Divorce decrees (or portions thereof) dated on or after July 2, 2008 may still be used as a substitute for Form 8332 but only if the decree **unconditionally** grants the right to claim a child's exemption to a noncustodial parent.

Example 4. Stan and Marsha, the parents of one minor child, Ben, were granted a divorce. The divorce decree is dated June 1, 2008. It grants Stan, the noncustodial parent, the **conditional right** to claim Ben's exemption for 2008 and unspecified future years **if** he is current on his required child support payments as of December 31 of each year.

Tax Result. Stan must secure a signed Form 8332 from Marsha in order to properly claim Ben's exemption and potential child tax and education credits for Ben on his tax return for 2008 and later tax years.

Note. These examples are not included in CCA 200925041.

Child Support versus Alimony

***Gregory H. Haubrich v. Comm'r,* TC Memo 2008-299 (Dec. 30, 2008)**

IRC §215

☞ Child Support Arrearage Payments Not Deductible

Facts. Gregory and Betty Haubrich, who were divorced in 2003, had two minor children. The divorce decree provided the following:

- Betty was designated the primary custodial parent and was given physical custody of the children.
- Gregory was ordered to pay $1,000 per month child support starting June 1, 2003 and continuing until each child attained age 21.
- Gregory was ordered to pay a $3,500 child support arrearage at the rate of $250 per month starting July 15, 2003, and continuing each month thereafter until fully paid. The arrearage arose from a Temporary Order of the court entered in January 2002.
- Gregory was ordered to pay Betty total alimony of $72,000 at the rate of $1,000 per month starting July 2003 and continuing each month thereafter until fully paid.
- Gregory was ordered to reimburse Betty 75% of the children's medical insurance premiums and unreimbursed medical expenses that she paid from her own funds.

As of December 31, 2003, Gregory was $5,125 in arrears in his child support obligation. For the tax year 2004, he should have paid the following child support to his ex-wife:

Delinquent child support as of December 31, 2003	$ 5,125
2004 child support obligation ($1,000 per month)	12,000
Reimbursement of 2004 medical insurance premiums and expenses	6,022
Gregory's total 2004 child support obligation	**$23,147**

Gregory paid a total of $17,963 to his ex-wife in 2004 for child support, alimony, and medical reimbursement. He allocated $12,625 to the required alimony obligation and deducted that amount on his 2004 tax return. The IRS determined that he was entitled to **no** alimony deduction and assessed additional tax of $2,245.

Issue. Whether the taxpayer is entitled to a deduction for alimony paid during 2004 and, if so, what amount.

Analysis. The $17,963 total amount Gregory paid to his ex-wife in 2004 was less than his total 2004 child support obligation of $23,147. Therefore, the entire $17,963 is allocated to nondeductible child support.

Holding. The court upheld the IRS determination that no alimony was deductible.

EMPLOYMENT TAX ISSUES

Payroll Taxes

The 2009 Annual Report of the Board of Trustees for the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds (May 12, 2009)

☞ Social Security Wage Base Not Expected to Change

The social security trustees project in their letter to Congress that the wage base for 2010 and 2011 will remain at $106,800. They also predict that there will be no 2010 cost-of-living increase for social security recipients. The trustees indicated the recession was the reason that no increases would be made.

The Social Security Act prohibits an increase in the wage base if there is no cost-of-living adjustment effective for December of the preceding year. The table on the following page is taken from the report.[12]

12. The full report is available online. [www.ssa.gov/OACT/TR/2009/tr09.pdf] Accessed on Aug. 19, 2009.

Table V.C1.—Cost-of-Living Benefit Increases, Average Wage Index, Contribution and Benefit Bases, and Retirement Earnings Test Exempt Amounts, 1975-2018

Calendar year	Cost-of-living benefit increase[a] (percent)	Average wage index (AWI)[b] Amount	Average wage index (AWI)[b] Increase (percent)	Contribution and benefit base[c]	Retirement earnings test exempt amount: Under NRA[d]	Retirement earnings test exempt amount: At NRA[e]
Historical data:						
1975	8.0	$8,630.92	7.5	$14,100	$2,520	$2,520
1976	6.4	9,226.48	6.9	15,300	2,760	2,760
1977	5.9	9,779.44	6.0	16,500	3,000	3,000
1978	6.5	10,556.03	7.9	17,700	3,240	4,000
1979	9.9	11,479.46	8.7	22,900	3,480	4,500
1980	14.3	12,513.46	9.0	25,900	3,720	5,000
1981	11.2	13,773.10	10.1	29,700	4,080	5,500
1982	7.4	14,531.34	5.5	32,400	4,440	6,000
1983	3.5	15,239.24	4.9	35,700	4,920	6,600
1984	3.5	16,135.07	5.9	37,800	5,160	6,960
1985	3.1	16,822.51	4.3	39,600	5,400	7,320
1986	1.3	17,321.82	3.0	42,000	5,760	7,800
1987	4.2	18,426.51	6.4	43,800	6,000	8,160
1988	4.0	19,334.04	4.9	45,000	6,120	8,400
1989	4.7	20,099.55	4.0	48,000	6,480	8,880
1990	5.4	21,027.98	4.6	51,300	6,840	9,360
1991	3.7	21,811.60	3.7	53,400	7,080	9,720
1992	3.0	22,935.42	5.2	55,500	7,440	10,200
1993	2.6	23,132.67	.9	57,600	7,680	10,560
1994	2.8	23,753.53	2.7	60,600	8,040	11,160
1995	2.6	24,705.66	4.0	61,200	8,160	11,280
1996	2.9	25,913.90	4.9	62,700	8,280	12,500
1997	2.1	27,426.00	5.8	65,400	8,640	13,500
1998	1.3	28,861.44	5.2	68,400	9,120	14,500
1999	[f]2.5	30,469.84	5.6	72,600	9,600	15,500
2000	3.5	32,154.82	5.5	76,200	10,080	17,000
2001	2.6	32,921.92	2.4	80,400	10,680	25,000
2002	1.4	33,252.09	1.0	84,900	11,280	30,000
2003	2.1	34,064.95	2.4	87,000	11,520	30,720
2004	2.7	35,648.55	4.6	87,900	11,640	31,080
2005	4.1	36,952.94	3.7	90,000	12,000	31,800
2006	3.3	38,651.41	4.6	94,200	12,480	33,240
2007	2.3	40,405.48	4.5	97,500	12,960	34,440
Intermediate:						
2008	[g]5.8	41,679.58	3.2	[g]102,000	[g]13,560	[g]36,120
2009	.0	42,041.84	.9	[g]106,800	[g]14,160	[g]37,680
2010	.0	43,451.28	3.4	106,800	14,160	37,680
2011	1.4	45,194.92	4.0	106,800	14,160	37,680
2012	2.8	47,013.95	4.0	114,900	15,240	40,560
2013	3.1	48,969.10	4.2	119,400	15,840	42,120
2014	3.0	50,962.45	4.1	124,200	16,440	43,920
2015	2.8	53,085.22	4.2	129,300	17,160	45,720
2016	2.8	55,070.22	3.7	134,700	17,880	47,520
2017	2.8	57,165.32	3.8	140,400	18,600	49,560
2018	2.8	59,362.72	3.8	145,500	19,320	51,360

[a] Effective with benefits payable for June in each year 1975-82, and for December in each year after 1982.
[b] See table VI.F6 for projected dollar amounts of the AWI beyond 2018.
[c] Amounts for 1979-81 were specified by Public Law 95-216. The bases for years after 1989 were increased slightly by changes to the indexing procedure, as required by Public Law 101-239.
[d] Normal retirement age. See table V.C3 for specific values.
[e] In 1955-82, the retirement earnings test did not apply at ages 72 and over; in 1983-99, the test did not apply at ages 70 and over; beginning in 2000, it does not apply beginning with the month of attainment of NRA. In the year of attainment of NRA, the higher exempt amount applies to earnings in the year prior to the month of NRA attainment. Amounts for 1978-82 specified by Public Law 95-216; for 1996-2002, Public Law 104-121.
[f] Originally determined as 2.4 percent, but pursuant to Public Law 106-554, is effectively 2.5 percent.
[g] Actual amount, as determined under automatic-adjustment provisions.

Disregarded Entity

***Medical Practice Solutions LLC et al. v. Comm'r,* 132 TC No. 7 (Mar. 31, 2009)**

IRC §§6320, 6330, 6672 and 7701

☞ Disregarded Entity Owner Liable for Employment Taxes

Facts. Carolyn Britton was the sole member of Medical Practice Solutions, LLC in 2006. She treated the LLC as her sole proprietorship on her 2006 Form 1040 Schedule C, *Profit or Loss from Business.* She did not elect to have the LLC treated as a corporation for federal income tax purposes.

Britton filed Form 941, *Employer's Quarterly Federal Tax Return,* for the quarter that ended March 31, 2006, which reported tax liability in the amount of $16,648 and Form 941 for the period that ended June 30, 2006, which reported tax liability of $18,434. These returns were filed in the name of the LLC, and the liabilities for both periods were not paid.

In December 2006, the IRS sent Britton a Notice of Intent to Levy, which was followed by a Notice of Federal Tax Lien Filing. Britton requested a hearing regarding the collection action in January 2007. This request for hearing also included a penalty abatement request for "reasonable cause." An accompanying letter asserted that the lien notice was filed against the wrong taxpayer because Britton "is not liable for the employment taxes; Medical Practice Solutions, LLC is liable."

Issues. Whether "check-the-box" regulations in effect for the periods at issue allow pursuit of employment tax collection against the sole member of the LLC.

Analysis. Britton's position is that the LLC was the employer liable for the taxes at issue. However, the check-the-box regulations provide that single-owner business entities that are not corporations are "disregarded as an entity separate from its owner."[13] Britton argued that the check-the-box regulations are invalid as they pertain to the collection action against her. The regulations were amended effective January 1, 2009, to treat a disregarded entity as a corporation, and Britton contends that this shows that the prior regulations were unreasonable. However, this contention has consistently been rejected by other courts.[14]

Holding. The validity of the check-the-box regulations was upheld and collection action against Britton is allowed.

SE Tax

***Derrolyn and Terry Steele v. Comm'r,* TC Summ. Op. 2009-45 (Mar. 30, 2009)**

IRC §§61, 1401, and 1402

☞ Grandparents' Income from Childcare Not Subject to SE Tax

Facts. In 2005, Derrolyn and Terry Steele resided in Illinois and cared for their young granddaughter. They received $16,974 from the state of Illinois for providing that care under a state-sponsored childcare program.

The Steeles received Forms 1099 from the state for payments made during 2005, and they included the $16,974 in their gross income for the taxable year.

Issues. Whether the income the Steeles received for childcare is subject to SE tax.

Analysis. IRC §1402(a) states that income from a taxpayer's participation in a "trade or business" is subject to self-employment (SE) tax. "Trade or business" has been interpreted to mean an activity carried on "with continuity and regularity" and with the principal purpose of making income or a profit.[15]

13. Treas. Reg. §301.7701-2(c)(2).

14. See, for example, *Littriello v. U.S.*, 484 F.3d 372 (6th Cir. 2007); *McNamee v. IRS*, 488 F.3d 100 (2d Cir. 2007).

15. *Comm'r v. Groetzinger*, 480 U.S. 23, 35 (1987); *Bot v. Comm'r*, 118 TC 138, 146 (2002).

The Steeles unquestioningly regularly provided care for their granddaughter for which they were compensated. They did this because their daughter was unable to do so. There was no allegation that the couple was running a daycare center, and they did not seek to deduct expenses against the money they received from the state of Illinois.

The Steeles' primary purpose in caring for their granddaughter was not profit such that they were engaged in a "trade or business."

Holding. The court held that the Steeles' were not subject to SE tax on the money they received for childcare from the state of Illinois.

Liability for Failure to Pay Payroll Tax

U. S. v. Joyce A. Rineer and Rose Washington, **No. 3:07-cv-01454, U.S. Dist. Ct. for Northern Dist. Of Texas (Jan. 5, 2009)**
IRC §6672

☞ Company Officers Held Liable for Failure to Pay Trust Fund Taxes

Facts. Joyce Rineer and Rose Washington (Taxpayers), longtime registered nurses, decided to start Specialty Care Inc. (Inc.) in 1988 to place nurses at hospitals. In 1994, they started a second company, Specialty Care Enterprises (Enterprises), to place nurses, social workers, physical therapists, and other personnel in home health care positions.

The Taxpayers were each 50% stockholders in both companies. Washington was the president of Enterprises and the vice-president of Inc., and Rineer was the president of Inc. and the vice-president of Enterprises. They were the only two members of the boards of directors for both companies. They both had the authority to hire and fire employees and were the only two authorized to sign checks.

Inc. encountered difficulty paying payroll taxes starting in 1994, but those taxes were eventually paid. However, beginning in 1997, both Inc. and Enterprises incurred liabilities for payroll taxes which remain outstanding. Subsequently, the Taxpayers were each assessed $582,329, which consisted of unpaid trust fund taxes for Inc. in the amount of $492,981 for the last two quarters of 1997 and all of 1998 and unpaid trust fund taxes for Enterprises totaling $89,348 for the last two quarters of 1997.

Although aware of their companies' unpaid payroll taxes, the Taxpayers each paid themselves a salary in 1997 from Inc. in the amount of $104,000. They both admitted that employees and creditors were paid even though the payroll taxes remained unpaid. Rineer's 1998 income tax return indicated that she received $80,000 in salary from Inc. for that year, although she testified at her deposition that she did not receive any salary in 1998.

Analysis. The Taxpayers did not dispute the material facts in the case. They argued that the United States caused their failure to pay the taxes when they were due because Medicare was slow in reimbursing Inc. and Enterprises for services rendered. They contended that they did not act willfully but that changes Congress made to Medicare reimbursement procedures several years ago were a reasonable cause to excuse their liability for the taxes.

The court in the *Logal* case stated that the "reasonable cause defense to a section 6672 action is exceedingly limited…" and "may not be asserted by a responsible person who knew that the withholding taxes were due, but who made a conscious decision to use corporate funds to pay creditors other than the government."[16]

The Taxpayers were held to be responsible persons of both Specialty Care Inc. and Specialty Care Enterprises for the period in which the payroll taxes were unpaid. They acted willfully in failing to pay the payroll taxes for both companies.

Holding. The district court held the Taxpayers were each indebted to the United States for the deficiency plus interest and all statutory additions provided by law.

16. *Logal v. U.S.*, 195 F.3d 229, 233 (5th Cir. 1999).

FICA Wages

***Mayo Foundation for Medical Education and Research v. U.S.*, U.S. Court of Appeals, 8th Circuit, No. 07-3242 (June 12, 2009)**

IRC §3121

☞ IRS Wins Important 8th Circuit Case Involving FICA Taxes on Medical Residents

> **Note.** Two medical school employers, Mayo Foundation for Medical Education and Research and the University of Minnesota, brought suit in the 8th Circuit seeking a refund of previously paid FICA taxes. The medical schools had prevailed at the district court level. However, the 8th Circuit reversed the prior district court decisions in this recent case.

Facts. In a legal battle dating back to 1998, the IRS convinced the 8th Circuit that the amended Treasury Regulations under IRC §3121 (finalized in late 2004) were reasonable. The Mayo Foundation had sued for a refund of $1.7 million of FICA taxes it had paid or withheld on stipends paid to medical residents during the second quarter of 2005.

Issue. Whether the amended Treasury Regulations[17] written by the IRS are a valid interpretation of the **student exception** to Federal Insurance Contributions Act (FICA) taxes imposed on employers and employees.

Analysis. The amended regulation[18] states: "The services of a full-time employee are not incident to and for the purpose of pursuing a course of study… Regardless of the employer's classification of the employee, an employee whose normal work schedule is 40 hours or more per week is considered a full-time employee… The determination of an employee's normal work schedule is not affected by the fact that the services performed by the employee may have an educational, instructional, or training aspect."

Holding. The 8th Circuit concluded that the amended Treasury Regulations that denied the student exception to FICA taxes for "full-time employees" (40 hours or more per week) was a permissible interpretation of the FICA statutes.

> **Note.** This is the first appeals court decision involving the 2004 amended Treasury Regulation quoted above. The final amended regulations to IRC §3121 became effective April 1, 2005.[19]

17. Treas. Regs. §§31.3121(b)(10)-2(b)–(d) (2004).

18. Treas. Reg. §31.3121(b)(10)-2(d)(3)(iii).

19. TD 9167, 2005-1 CB 261.

Common-Law Employee

***Walter N. Maimon v. Comm'r,* TC Summ. Op. 2009-53 (Apr. 20, 2009)**

IRC §3121(d)

☞ Physician Who Received a Form W-2 was an Employee

Facts. Dr. Maimon, a surgeon, was employed by Dayton Head and Neck Surgeons, Inc. (DHN). He joined DHN as a shareholder/employee in 1999. In 2001, he signed an employment contract with DHN that expressly identified him as an "employee."

DHN paid Dr. Maimon's hospital staff dues and provided his medical office facilities and medical equipment. During 2004, Dr. Maimon received the following from DHN:

- Base salary plus bonus of $409,300, which was reported as wages on his 2004 Form W-2
- Reimbursement of professional expenses
- Paid vacations
- Employee benefits
- Participation in DHN's retirement plan

When Dr. Maimon filed his 2004 tax return, he left line 7 of Form 1040 (Wages) blank. He attached Schedule C, *Profit or Loss From Business,* and reported gross receipts of $409,300, the amount of wages shown on his Form W-2. He incorrectly checked the box on Schedule C indicating that the "statutory employee" box on his Form W-2 was checked.

During 2004, Dr. Maimon paid legal fees of $22,155 for defending a medical malpractice lawsuit against him. That same year, he settled the lawsuit for $1.4 million of which his insurer agreed to pay $400,000. Dr. Maimon agreed to pay the remaining $1 million and did so in 2005.

On his 2004 Schedule C, Dr. Maimon deducted the $22,155 of legal fees paid. The IRS determined that the taxpayer was a common-law employee of DHN. As such, the legal fees he paid were deductible only as an employee business expense on Schedule A, subject to the 2% of AGI limitation. Consequently, the IRS assessed additional tax of approximately $12,000.

Issue. Whether the taxpayer was a common-law employee or an independent contractor during 2004.

Analysis and Holding. The facts clearly did not support the taxpayer's contention that he was an independent contractor. The court determined that the taxpayer was a common-law employee of DHN. After application of the 2% of AGI limitation, none of the legal fees paid were deductible and the IRS deficiency was upheld.

Note. Although the case involved only the 2004 tax year, it is likely that the IRS challenged the taxpayer's similar 2005 Schedule C deduction of the $1 million lawsuit settlement he paid. If so, the $1 million would also represent an employee business expense deductible only on Schedule A, with the potential to create 2005 AMT liability.

ESTATE AND GIFT TAXES

Estate and Gift Taxes

IRS Pub. 950, *Introduction to Estate and Gift Taxes*
IRC §§2001 and 2511

This publication gives a general explanation of estate and gift taxes and clarifies how much money or property can be gifted during one's lifetime or transferred to heirs at death before tax is owed. Important changes include the following:

- The top marginal tax rate for estates and gifts decreased from 46% in 2006 to 45% in 2007. It will remain at 45% through 2009.
- For 2010, the estate tax has been repealed, and the highest gift tax rate will be decreased to 35%.
- These provisions are currently set to expire after December 31, 2010.

The publication also clarifies when a gift or estate tax return must be filed; explains the unified credit and generation-skipping transfer tax; and gives a list of resources to consult if more information is needed.

Power of Attorney

***Estate of Willis R. Barnett v. U.S.*, No. 07-cv-844, Western Dist. of PA (May 27, 2009)**
IRC §2038

☞ Gift Checks Issued by Son Includable in Gross Estate

Facts. Willis Barnett, the decedent, executed a power of attorney (POA) in favor of his son, Elton. However, the POA failed to include a provision that authorized gifts. Shortly before the decedent died, his son issued a series of 17 checks to various family members. The total amount of the 17 gift checks was $148,227. When the estate tax return was filed, the $148,227 amount was excluded from the gross estate.

The IRS determined that the amount represented by the 17 gift checks must be included in the gross estate. The IRS made other adjustments to the estate tax return and assessed additional estate tax of $245,000. The estate paid the additional estate tax and sued for refund in a Pennsylvania U.S. District Court.

Issue. Whether the amount of the gift checks should be included in the taxable estate.

Analysis. The IRS argued that the POA granted to the son did not authorize him to make gifts. Therefore, none of the 17 checks effected a transfer out of the estate and the monies from those checks should be included in the decedent's gross estate.

The estate argued that the decedent and his son, Elton, had discussed the making of gifts; and the decedent agreed to the arrangement.

It is indisputable that Pennsylvania state law governs the proper authority of a POA. Under Pennsylvania law, generally, a principal may empower an agent to make a gift in a POA only if a clause is included that permits limited and/or unlimited gifts by the agent.

Holding. The district court ruled in favor of the IRS position.

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> **Note.** This tax dispute could have been avoided if the necessary language had been included in the POA executed by the decedent. The laws of most states pertaining to POAs are similar to the Pennsylvania statute.

GROSS INCOME

Damage Awards

***Luis and Margarita Carranza v. Comm'r*, TC Summm. Op. 2009-28 (Feb. 26, 2009)**
IRC §§86, 104, and 6662

☞ Settlement of Wrongful Termination Suit Taxable

Facts. Luis Carranza worked for Spears Manufacturing Co. in California. The company manufactures fittings used for plumbing. Carranza worked 25 years for the company and was in charge of Spears' production operation. He worked 10-hour days, six days per week. The stress of his job led to anxiety and hypertension, which, in turn, may have caused a central arterial occlusion and loss of sight in Carranza's left eye in 1999.

Carranza developed a hematoma in his leg which affected nerves and muscles and made it difficult for him to walk. His leg atrophied, and he lost the ability to control it. He became unable to function effectively in his supervisory position at Spears. Upon the advice of a doctor, he was assigned lighter responsibilities at Spears in November 2001.

The owner of the company, Wayne Spears, made demands on Carranza that were beyond his lessened physical capabilities. In April 2002, he was dismissed from his position at Spears. Carranza's anxiety became severe after his dismissal, and he was unable to find another job because of his mental and physical condition.

After Carranza's dismissal, he commenced an action against Spears for violations of the California Fair Employment and Housing Act, including disability discrimination, age discrimination, wrongful termination, and breach of implied contract.

The suit against Spears was settled for $162,500 in 2003. Of that amount, $97,500 was paid directly to Carranza "for personal injury in the form of emotional distress damages resulting from the conduct that is the subject of tort or tort-like claims;" the remaining $65,000 was paid directly to Carranza's attorney for legal fees. A Form 1099-MISC was issued to Carranza in the amount of $97,500, and a Form 1099-MISC was issued to the attorney for $65,000.

The Carranzas' 2003 joint income tax return was prepared by an accountant who had been preparing their income tax returns for several years. The couple provided the Form 1099-MISC and other information about the lawsuit to the preparer. The preparer concluded that the $97,500 settlement amount was not includable in income, and the Carranzas relied upon his judgment about that decision. They also provided their preparer with information about social security payments they had received in 2003, but no part of those payments was reported on their tax return.

The IRS assessed an income tax deficiency for the Carranzas' 2003 income tax return for $35,217, for failure to report social security benefits and settlement proceeds as income. The IRS also assessed an accuracy-related penalty of $7,043.

Issues. Whether the proceeds of the wrongful termination action are includable in the Carranzas' gross income and whether they are liable for an accuracy-related penalty.

Analysis. IRC §104(a)(2) excludes damages received "on account of personal physical injuries or physical sickness" from income. The Code specifically states that emotional distress is not treated as a physical injury or physical sickness. In Carranza's suit against Spears, he sought damages for emotional distress and mental suffering. It was on this basis that the settlement was made.

As to the portion of the settlement that is includable in income, there had been differing treatment by courts as to whether the attorney's fees portion of damage settlements and other litigation should be included in the taxpayer's income. The Supreme Court resolved those differences in 2005 when they held that the portion of the settlement paid to attorneys was income to the taxpayer.[20] Accordingly, Carranza was entitled to the entire $162,500 and that the $65,000 paid directly to his attorney was money to which Carranza was entitled under the settlement.

[20] *Comm'r v. Banks*, 543 U.S. 426 (2005).

An accuracy-related penalty is not imposed on any portion of the understatement when the taxpayer acts with reasonable cause and in good faith. The Carranzas used and relied upon a professional preparer who they had used for prior years' returns. The court heard the preparer's testimony and concluded that he was a competent professional with sufficient expertise to prepare tax returns. Under the circumstances of the case, it was reasonable for the Carranzas to rely on the judgment of their preparer.

Holding. The court found that the Carranzas were liable for the determined income tax deficiency on the entire amount of the settlement. However, the Carranzas were not held liable for the accuracy-related penalty.

Life Insurance Policy

***Reid and Irene Burnham Chambers v. Comm'r,* TC Summ. Op. 2009-63 (May 4, 2009)**
IRC §72

☞ Deemed Distribution from Life Insurance Policy Results in Gross Income

Facts. In 1981, Irene Burnham Chambers obtained whole life insurance from Nationwide Life Insurance Co. through its agent, Michael Travis. She elected the automatic premium loan (APL) provision in her application. The policy was issued on April 27, 1981, and the monthly premiums were paid through an automatic debit to Ms. Chambers' checking account.

Ms. Chambers moved to Philadelphia in early 1986 and moved her checking account to a different bank. After her former bank declined the next scheduled automatic debit payment for the life insurance, Nationwide wrote to Ms. Chambers regarding the unpaid premium. She then informed Nationwide of her change of address and switch to a new bank, requested a change to a quarterly payment schedule, and issued a check for the missed premium payment.

On March 28, 1986, Ms. Chambers made the next quarterly payment. After that, she received a benefits package from her employer and no longer needed the life insurance from Nationwide. Accordingly, she orally instructed Mr. Travis to cancel the policy. He told her the policy was being canceled and did not indicate that she needed to take further action to cancel the policy.

Ms. Chambers believed that her policy had been canceled and ceased making payments. However, Nationwide had not canceled her policy. As a result, the nonpayment of premiums triggered the APL provision of her policy. Beginning in September 1986, Nationwide automatically granted her policy loans to cover the unpaid premiums.

Over the next several years, Nationwide sent numerous letters and billing statements to Ms. Chambers. According to her statements, she did not receive some of the correspondence because she moved several times during the period; and she disregarded most of the correspondence she did receive, believing that it had been sent in error.

Nationwide ceased granting policy loans to Ms. Chambers under the APL provision in June 2003 because the next policy loan would have caused the total indebtedness to exceed the cash value of the policy. Instead, Ms. Chambers' coverage was converted from whole life insurance to extended term insurance for a period based on the net cash value of the policy.

In November 2005, Nationwide notified Ms. Chambers that the term insurance would expire without value on December 7, 2005. A few days later, Nationwide informed her that she had gross income of $8,753 as a result of the expiration of her policy. In March 2006, Nationwide sent her a corrected Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.,* which reported a gross distribution of $8,753 and income of $3,006. Ms. Chambers and her husband did not include these amounts on their 2005 joint income tax return.

Issues. Whether Ms. Chambers received a deemed distribution under her life insurance contract which resulted in gross income.

Analysis. When Ms. Chambers' policy terminated, Nationwide applied the policy's cash value to the outstanding balance on the policy loans. That resulted in a constructive distribution which is gross income to Ms. Chambers to the extent it exceeds the sum of the premiums paid by her.[21]

Ms. Chambers argued that she canceled her insurance contract with Nationwide before any policy loan had been granted; thus, there would have been no deemed distribution to satisfy nonexistent debt. However, she did not comply with the requirements for termination. In order to terminate the contract, she was required to give written notice and surrender the policy. She never did this, and the contract did not provide her the right to terminate by giving oral notice to Mr. Travis.

Holding. Ms. Chambers had gross income from satisfaction of the policy loans granted under her life insurance contract.

Damage Award

***Ronald Colquitt v. Comm'r,* TC Summ. Op. 2009-27 (Feb. 26, 2009)**
IRC §§61 and 104

☞ Wrongful Termination Award Taxable

Facts. While residing in California, Ronald Colquitt experienced a physical injury or sickness during the time that he was working as a private investigator. His manager instructed him to keep working after he developed the physical injury or sickness. Mr. Colquitt declined the request and was then terminated from his job.

Following the termination, Mr. Colquitt sued his former employer and received $14,000 from the lawsuit in 2005. He filed a 2005 Form 1040 which did not include the lawsuit proceeds as income even though he received a Form 1099 from his former employer for the $14,000.

Issues. Whether the $14,000 wrongful termination award must be reported as income.

Analysis. IRC §104(a)(2) excludes "amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness…" from gross income. The damages received (other than worker's compensation) must have been the result of prosecution of a legal suit or action based upon tort or through a settlement agreement.[22]

State law determines whether the claim is based upon tort. Under California law, at-will employees who can show that their discharges violated public policy may recover tort damages from employers.

California labor law prohibits employers from requiring employees to work in any place that is not safe or healthful and from discharging employees who refuse to work in unsafe areas.

Mr. Colquitt did have a tort claim against his former employer. There are two avenues of recovery in this situation: (a) the employer's insistence that the employee continue working in unhealthful conditions could support a claim of negligence, or (b) through a claim for wrongful termination.

Although Mr. Colquitt's termination was wrongful, he did not demonstrate that he received payment because of his physical injury or sickness. The record indicates that the recovery was "additional pay and benefits." To exclude from taxation those damages that substitute for lost wages which would have been taxed had the victim earned them would make the compensated taxpayer better off from a tax standpoint than had the personal injury not taken place.[23]

Holding. The payment to Colquitt was determined not to be damages received for personal physical injury or sickness and is therefore not excludable from gross income under §104(a)(2).

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21. See *Atwood v. Comm'r,* TC Memo 1999-61; *Dean v. Comm'r,* TC Memo 1993-226.

22. Treas. Reg. §1.104-1(c).

23. *O'Gilvie v. U.S.*, 519 U.S. 79, 86 (1996).

Erroneous Refund Suit

Michael and Cynthia Fletcher v. U.S., **U.S. Court of Appeals, 7th Circuit; No. 08-2173 (Apr. 10, 2009)**

IRC §§451 and 7405

☞ Government Entitled to Recover Erroneous Refund

Facts. In 2000, Ernst & Young spun off its information-technology consulting group. This business was bought by Cap Gemini, S.A., a French corporation; thereafter, it became known as Cap Gemini Ernst & Young. Today, the company is known as Capgemini.

The consulting partners of Ernst & Young exchanged their partnership interests in Ernst & Young for shares in Capgemini. The Ernst & Young partners wanted all the income recognized in 2000, so that the expected appreciation of the shares in the new business would be taxed as capital gains. Cap Gemini, S.A., on the other hand, wanted to ensure the partners' loyalty to the new business. Transferring the shares in installments might help ensure that the partners would stay with the company but would make the transfers look like ordinary income. Ernst & Young and Cap Gemini, S.A., decided that a transfer of all the shares in 2000, in an escrow-type arrangement, would serve the business objectives as well as preserve the tax benefits to the partners. Accordingly, the shares received in the transaction were restricted for five years. If a partner left the company, some or all of the shares could be forfeited.

All parties agreed by contract that they would report the transaction as a partnership-for-shares swap in 2000 and that it would be fully taxable in that year. Approximately 25% of the shares were sold in 2000 to generate cash that the partners used to pay their taxes. The rest of the shares were held by Merrill Lynch until the restrictions lapsed.

Cynthia Fletcher, one of Ernst & Young's consulting partners, voted to accept the terms of the transaction, signed the contract, moved to Capgemini, and received 16,500 shares in that business as payment for her partnership interest. The market value of these shares on the day the sale closed was about $2.5 million. Only 12,375 shares were deposited in her restricted account; the rest were sold for $653,756, which was distributed to Fletcher to cover taxes. In February 2001, Capgemini sent Fletcher a Form 1099-B reflecting that she had received $2,478,655 in stock, most of which was taxable at ordinary-income rates, from the sale of her partnership interest. She and her husband, Michael, reported this income as received in 2000 on their joint return, as her contract with Capgemini required. The couple's gross income for 2000 was reported as $3.7 million on which they paid $972,121 in income tax.

Instead of the anticipated stock appreciation, however, the price of the stock declined from €300 early in 2001 to below €50 in 2003. In retrospect, this made the deal a bad one. The partners would have been better off if the distribution of the stock had been deferred.

Fletcher quit in 2003, which was earlier than the five years required by the contract. However, Capgemini waived its rights and directed Merrill Lynch to lift all restrictions on the stock in her account. Fletcher then filed an amended tax return for 2000, taking the position that only the $653,756 distributed from the account in 2000 was income for that year. According to her revised stance on the transaction, the rest of the income was not received until 2003 and that amount was greatly reduced because of the lower market price of the shares at that time. The IRS paid Fletcher a refund of about $387,000 plus interest. The United States then filed suit to get the money back, contending that this refund was a mistake.

Analysis. Cap Gemini, S.A., deposited all of the shares into individual accounts in 2000; from its perspective, the consideration had been paid in full, although the accounts were restricted. The IRS contends that the ex-partners became the beneficial owners of the stock from the time the transaction occurred in 2000 and, thus, bore the economic risk. If the stock rose in the market, the ex-partners stood to reap the whole gain; and, if the stock fell, the ex-partners would bear the whole loss. For her part, Fletcher stresses the restrictions placed on the stock and maintains that until she could do with it as she pleased — in other words, sell it, not just watch as it rose or fell — it did not count as income.

The appeals court said that three aspects of the contract Fletcher signed are important in this case. First, Fletcher and the other ex-partners stood to receive the entire market gain and to bear all loss from the time that the transaction closed in 2000. That shows constructive possession in 2000. Second, Fletcher agreed to postpone her unrestricted access to the stock. Third, Fletcher agreed to the amount of the discount — the restrictions were treated as reducing the value of the stock to 95% of its market price on the closing date.

Holding. The appeals court held that Fletcher's shares are taxable in 2000 at their value on the date of deposit to the Merrill Lynch accounts. Income was constructively received at that time. Fletcher was ordered to repay the refund.

Unreported Income

***Darlene Martinez v. Comm'r,* TC Summm. Op. 2009-54 (Apr. 21, 2009)**

IRC §61

☞ Unreported Income Found Through Analysis of Bank Deposits

Facts. Darlene Martinez was employed full-time as a housekeeper in 2005 and was paid wages of $11,940, which she reported on her 2005 federal tax return. During 2005, Martinez also performed janitorial services as an independent contractor. She reported $12,955 of gross income and $5,118 of net income from her sole proprietorship on her 2005 return. Martinez reported no other income on her 2005 return.

The IRS determined that Martinez did not have "adequate records" for her sole proprietorship. Therefore, it obtained her bank records and prepared a bank deposits analysis. On the basis of this analysis, the IRS calculated that Martinez had $20,248 of unexplained deposits, which the IRS claimed was unreported income.

During 2005, Martinez was the leader of a cundina. Cundinas are informal savings plans in which various participants in the plan entrust the leader with their money for later return to the participants without addition or subtraction. Approximately 10 people entrusted their money to Martinez at various times during 2005. Each participant generally transferred $100 to Martinez on an irregular basis, usually by depositing $100 into her bank account. Martinez allowed each participant to use other participants' money without paying interest. She allowed one participant during each week to borrow funds from the cundina corpus in increments of $100 up to a maximum of $1,000. Each borrower paid back his or her borrowing over a maximum of 10 weeks through transfers of $100 to Martinez. At the end of 2005, Martinez returned to each participant the full amount of money that the participant had transferred to her.

Issues. Whether the $20,248 which the IRS determined was unexplained deposits was income to Martinez.

Analysis. Martinez claimed that the $20,248 is attributable to the cundina in which she was the leader and is not income to her. The IRS argued that no correlation existed between the deposits into and withdrawals out of Martinez' bank account that would support her claim.

Martinez and a witness testified credibly and without contradiction as to events occurring in 2005. The witness testified that she participated at least twice in the cundina and that each time Martinez returned the same amount of money that the witness had transferred to her. The witness explained that she transferred money to Martinez so that the funds would not be easily accessible for the witness to spend. The witness also identified other participants in the cundina.

Martinez' bank statements for 2005 show 80 deposits totaling $15,000, each in multiples of $100. The bank statements also show 96 withdrawals totaling just over $15,000.

Holding. The court held that $15,000 of the $20,248 of deposits that the IRS determined to be unreported income was attributable to Martinez' receipts and disbursements of other people's money. Thus, $15,000 of the $20,248 is not unreported income. Martinez failed to prove any of the remaining $5,248 was attributable to a nontaxable source. Thus, the court ruled that Martinez failed to report income of $5,248.

Self-Employment Income or Gift

***Jue-Ya Yang v. Comm'r,* TC Summ. Op. 2008-156 (Dec. 15, 2008)**

IRC §§61 and 6662(a)

☞ California Live-In Girlfriend Convinces Tax Court With Sincere Testimony

Facts. During 2005, Ms. Yang and Howard Shih, an artist and calligrapher, cohabited in his home. Ms. Yang did some housekeeping and cooking for Mr. Shih, but she had no skills or experience relating to Mr. Shih's business activities. He paid Ms. Yang $10,500 in 2005 by check and issued a Form 1099-MISC to her, reporting the $10,500 as nonemployee compensation.

Ms. Yang did not report the $10,500 as gross income on her 2005 tax return. She also omitted nonemployee compensation of $40,000, reported on a separate and legitimate Form 1099-MISC. The information document matching program of the IRS detected the omissions of income. The IRS assessed additional 2005 income tax and SE tax of $9,423, plus an accuracy-related penalty of $1,183.

Ms. Yang conceded that the omitted $40,000 amount represented unreported income. However, she insisted that the $10,500 amount from Mr. Shih was a nontaxable gift.

Issue. Whether the $10,500 reported on the Form 1099-MISC was SE income or a nontaxable gift.

Analysis. The Supreme Court previously defined a gift in the statutory sense in the following manner: A gift proceeds from a "detached and disinterested generosity… out of affection, respect, admiration, charity or like impulses."[24]

Upon hearing the testimony of both Ms. Yang and Mr. Shih, the court found the latter's testimony to be "evasive and untrue." On the other hand, the court found Ms. Yang's testimony to be forthright, as she answered all questions regardless of whether they favored her position.

Holding. The court held that the $10,500 amount paid by Mr. Shih was a gift based on his affection for Ms. Yang at the time of payment.

The accuracy-related penalty was upheld regarding Ms. Yang's omission of the legitimate $40,000 amount reported on Form 1099-MISC.

Income Tax Deficiency

***Ilya Roytburd v. Comm'r,* TC Memo 2008-198 (Aug. 26, 2008)**

IRC §6673

☞ Taxes and Penalty Assessed on Unexplained Bank Deposits

Facts. The IRS assessed deficiencies in Mr. Ilya Roytburd's 2002 and 2003 tax returns of over $41,000, plus penalties, based on unexplained deposits to Roytburd's bank account. At a hearing, the IRS stated that Roytburd had conceded all adjustments to his income except for an increase to his 2002 taxable income of $38,767, which was deposited in his account at Sovereign Bank.

At the November 2007 trial, the IRS conceded that the $38,767 adjustment was overstated by $7,000 and that Roytburd was not liable for SE tax. The IRS presented bank records showing that two wire transfers totaling $28,000 were deposited into Roytburd's saving account in 2002 from First Clearing Corp. There was also a deposit from Travelers Indemnity Co. of $2,441 and another deposit from an unidentified source for $1,326. Roytburd testified that he received checks for an insurance claim and for unemployment compensation. He stated that the wire transfers were money that he moved from other accounts but offered no further explanation for the deposits.

Issues. Whether the assessment of tax deficiency based on unexplained bank deposits of $31,767 into Roytburd's account during 2002 is valid.

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24. *Comm'r v. Duberstein*, 363 U.S. 278, 287-289 (1960).

Analysis. At the conclusion of the trial, the court requested that briefs be submitted. As Roytburd was appearing pro se, he was cautioned about adhering to Rule 151, which sets forth the requirements for the form and content of briefs. The brief submitted by the IRS complied with Rule 151 and contained proposed findings of fact and legal argument. Roytburd answered this brief with a document that neither proposed any findings of fact nor objected to the IRS's proposed findings of fact. Instead, Roytburd's argument, essentially, was that he was not a U.S. citizen or taxpayer. He claimed to be domiciled in the sovereign Republic of Pennsylvania and that he was a state citizen. Roytburd went on to argue that the case against him should be dismissed unless he could be proved a "U.S. citizen" during the period at issue.

Roytburd's brief did not contain any argument concerning the bank deposits. Further, at trial, his only explanation about the deposits was that they were primarily from other bank accounts, which he did not identify. Roytburd did not offer any type of evidence to corroborate his claim that he was redepositing already taxed or nontaxable funds, although the court had previously advised Roytburd that unexplained bank deposits were prima facie evidence of income.

Holding. The court found that Roytburd failed to prove that the bank deposits of $31,767 were from a nontaxable source. Therefore, the determination of a deficiency in tax for 2002 was sustained.

Roytburd was assessed a penalty of $5,000 under IRC §6673(a)(1) because he persisted in advancing frivolous, groundless arguments for the purpose of delaying the collection of federal income tax.

INFORMATION REPORTING

Rental Real-Estate Activity

GAO Report GAO-08-956 (Aug. 2008)
IRC §§162 and 167

☞ GAO Recommendations for Improved Real-Estate Reporting Compliance

In a report entitled "Actions That Could Improve Real Estate Reporting Compliance," the GAO estimates that at least 53% of individuals with rental real estate misreported their rental real estate activities for the 2001 tax year. This resulted in an estimated $12.4 billion of net misreported income.

The most common error was inaccurately reporting rental real estate expenses. An estimated 43% of taxpayers with rental real-estate activity fell into this category. This includes 2.1 million taxpayers who failed to substantiate their reported expenses which resulted in $5.2 billion of lost tax revenue.

Of the taxpayers misreporting their rental real estate activity, an estimated 75% underreported their net rental income with approximately one-third of these taxpayers underreporting their income by less than $1,000. For the 25% of taxpayers misreporting their rental real estate activity who overreported their rental income, the median overstatement was $518.

The GAO recommends rental real estate activities be subjected to improved information reporting, although the agency acknowledged that a requirement for increased information reporting would place a substantial burden on taxpayers and return preparers.

The report noted existing law makes it difficult to determine whether taxpayers' rental real estate activity should be treated as a trade or business. Consequently, the GAO recommends the tax code be amended to subject all taxpayers with rental activity to the trade or business reporting requirements.

In order to motivate paid tax return preparers to question their clients more carefully to obtain more accurate income and expense information, the GAO recommends the IRS begin requiring additional detail on tax returns. Eighty percent of individual taxpayers reporting rental real estate activity use a paid tax return preparer.

Note. The complete GAO report can be found at **www.gao.gov/new.items/d08956.pdf.**

INNOCENT SPOUSE

Innocent Spouse Relief

***Alina Karp et al. v. Comm'r,* TC Memo 2009-40 (Feb. 18, 2009)**
IRC §6015

☞ No Refund from Community Property to Provide Innocent Spouse Relief

Facts. Alina and Orrin Karp were married in March 1993 and resided in California. Orrin worked in the commercial real-estate business during their marriage. Alina worked as a legal secretary until June 1994 and did not work outside the home for the rest of their marriage. Alina and Orrin were divorced in March 2007.

During their marriage, the couple lived in a home that Orrin had originally purchased as separate property. He used his separate funds as a down payment for the purchase and to make improvements. In December 1993, Orrin quitclaimed his separate property interest to Alina and himself as community property.

The Karps did not file tax returns for 1995 through 2002 until the IRS contacted them. The Karps then filed delinquent tax returns for 1995 through 2001. Approximately one year after filing those returns, the Karps met with an IRS collection officer. They subsequently hired an accountant to prepare amended returns for 1995 through 2001. These returns were audited by the IRS after they were filed. Subsequently, the IRS sent notices of deficiency to the Karps in October 2005 for their 2000 and 2001 returns.

The Karps timely filed their 2003 joint income tax return; however, the IRS disallowed certain expenses claimed on Schedule C, *Profit or Loss from Business,* and sent the Karps a notice of deficiency regarding this return.

As of July 2006, the IRS assessed the following amounts as tax, penalties, and interest: $152,884 for 2000 (including an understatement resulting from a math error), $6,286 for 2001, and $130,804 for 2003. These amounts were paid from the proceeds of the sale of the Karp's family home.

Alina filed Form 8857, *Request for Innocent Spouse Relief,* in August 2005, requesting relief for 2000, 2001, and 2003. The results of her request are as follows:

- 2000 underpayment: IRC §6015(f) relief denied on September 22, 2006
- 2000 understatement: partial §6015(c) relief awarded and §6015(b) relief denied on September 22, 2006. The IRS's award of partial §6015(c) relief was for the portion of the understatement not due to math error.
- 2001 understatement: full §6015(c) relief awarded and §6015(b) relief denied on September 25, 2006.
- 2003 understatement: full §6015(c) relief awarded and §6015(b) relief denied on September 25, 2006.

In December 2006, Alina petitioned the Tax Court to review the IRS's determination regarding the innocent spouse relief for 2000, 2001, and 2003. Since the tax liabilities for those years were satisfied from the proceeds from the sale of community property (the Karps' former residence), Alina sought a refund of her share of the community property proceeds used to satisfy the joint tax liabilities.

Issues. Whether Alina is entitled to a refund of her share of the community property proceeds used to satisfy joint income tax liabilities for 2000, 2001, and 2003.

Analysis. IRC §6015(g)(3) precludes a refund in the case of §6015(c) relief. Even if Alina is entitled to §§6015(b) or (f) relief, she could not be refunded the amounts paid from community property.[25] The court in *Ordlock* stated that "The nature of a marital community in California is to generally allow the individual debts of the spouses to be collected out of community assets."

Holding. Alina could not be refunded the amounts paid from community property. Accordingly, the court was unable to grant her relief under §§6015(b), (c), or (f).

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[25] *Ordlock v. Comm'r,* 126 TC 47 (2006), *aff'd* 533 F.3d 1136 (2008).

Equitable Relief

***Mary Ann and Thomas O'Meara v. Comm'r,* TC Memo 2009-71 (Mar. 30, 2009)**

IRC §6015(f)

☞ Equitable Relief Denied to Chronic Late Filers/Nonpayers

Facts. Mary Ann (age 80) and Thomas O'Meara have a long history of filing their joint returns late and of refusing to pay any estimated taxes or balances due. The following chart shows the unpaid balance due for the tax years at issue:

Year	Total Tax Assessed	Total Tax Paid	Filing Date
1991	$ 26,819	$0	05/07/1998
1992	88,223	0	05/07/1998
1993	37,899	0	05/07/1998
1995	36,232	0	05/07/1998
1999	22,571	0	10/11/2001
2000	21,870	0	10/17/2001
2001	1,138	0	10/16/2002
Total	$234,752		

Although the couple was married, Mrs. O'Meara separately filed her 2003 tax return late and reported total tax due of $4,733, which remains unpaid.

In 2005, the IRS mailed the taxpayers a notice of intent to levy relating to the unpaid tax liabilities shown above. In 2006, Mrs. O'Meara filed a request for equitable innocent spouse tax relief with the IRS for the years in issue.

The following assets were listed on Mrs. O'Meara's Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals:*

Assets	Value
Cash	$ 25,848
Boats	7,000
Snowmobiles	5,000
Automobiles	0
Real estate:	
Home	161,000
Cabin	85,721
Rental properties	Unknown
Total reported value	$284,569

After determining the value of the rental properties, the IRS appeals office determined that the taxpayers' reasonable collection potential was $521,600. In 2007, the IRS mailed a notice of determination to the taxpayers that sustained the original notice of intent to levy issued in 2005. At the same time, the IRS mailed a notice of determination denying Mrs. O'Meara's request for equitable innocent spouse relief. The taxpayers petitioned the Tax Court to pursue their objection to the adverse IRS determination on the request for innocent spouse relief.

Issue. Whether Mrs. O'Meara is entitled to equitable innocent spouse relief under IRC §6015(f).

Analysis. There are eight factors that must be considered. After an analysis of the factors and all the facts and circumstances, equitable relief may be granted when it is inequitable to hold the requesting spouse liable.[26]

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 reason to know that the nonrequesting spouse would not pay the income tax liability.
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 the 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 Form 8857, *Request for Innocent Spouse Relief*, was signed.

The court considered five of the eight factors. The conclusion for each of the five factors is shown below:

Factor	Conclusion of Court
Marital status	Neutral since the taxpayers were married
Economic hardship	Neutral —highly-valued assets offset by Mrs. O'Meara's age (80)
Knowledge or reason to know	Factor weighs against relief
Significant benefit	Neutral since record is not sufficient to prove or disprove
Compliance with tax laws	Factor weighs against relief because of Mrs. O'Meara's balance due on her 2003 tax return

Holding. Three factors were neutral and two factors weighed against Mrs. O'Meara. As a result, the court upheld the prior IRS determination which denied equitable innocent spouse relief.

> **Note.** See pages 607–608 in the 2008 *University of Illinois Federal Tax Workbook* for more information regarding equitable innocent spouse relief. This can be found on the accompanying CD.

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26. Rev. Proc. 2003-61, sect. 4.03(2)(a), 2003-32 CB 298.

Equitable Relief

***Rose Marie Sunleaf v. Comm'r,* TC Memo 2009-52 (Mar. 11, 2009)**

IRC §6015

☞ Widow Granted Innocent Spouse Relief

Facts. Rose Marie Sunleaf was 70 years old at the time of trial in February 2008. She learned shortly after her husband's death in 2003 of their financial difficulties.

She and Mr. Sunleaf were married in 1965 and lived in Montezuma, Iowa for approximately 40 years. Mrs. Sunleaf graduated from nursing school but was forced to stop working as a nurse in 1966 because of a back injury.

The Sunleafs had a joint checking account, but Mrs. Sunleaf never saw the bank statements for the account. Mr. Sunleaf managed the joint account and primarily used it to pay for the expenses he handled.

Mr. Sunleaf prepared the couple's 2000 income tax return and presented it to Mrs. Sunleaf for her signature shortly before the post office closed on the day the return was due. This prevented Mrs. Sunleaf from reviewing the tax return because she was rushed and pressured into signing it.

At the time Mrs. Sunleaf signed the 2000 income tax return, she was unaware of any financial problems the couple had. Mr. Sunleaf did not speak to her about money and finances. When the subject of taxes came up, Mr. Sunleaf told his wife that he would "handle it."

There were unopened envelopes in Mr. Sunleaf's office from creditors, banks, and the IRS. Prior to his death, Mr. Sunleaf picked up all the couple's mail at the post office in Montezuma and brought home only magazines and personal letters. Mrs. Sunleaf discovered their 2000 joint federal income tax liability of $9,500 had not been paid.

Mrs. Sunleaf requested innocent spouse relief in April 2004 by submitting Form 8857, *Request for Innocent Spouse Relief*, Form 12510, *Questionnaire for Requesting Spouse*, and a letter explaining her circumstances. The IRS denied her innocent spouse relief for the tax year 2000 in October 2004 because her claim was not timely filed. The first collection activity for the tax year 2000 liability was made in July 2001, and Mrs. Sunleaf's request for innocent spouse relief was made more than two years after that. After Mrs. Sunleaf filed a statement of disagreement in November 2004, the IRS sent Mrs. Sunleaf a letter informing her that her request for relief was being reconsidered. In a final determination dated April 2005, the IRS denied Mrs. Sunleaf's request for relief because she did not have reason to believe at the time the 2000 return was filed that the tax would be paid by Mr. Sunleaf.

Issue. Whether the IRS abused its discretion by denying Mrs. Sunleaf innocent spouse relief for 2000.

Analysis. Rev. Proc. 2003-61 has a safe harbor wherein innocent spouse relief is granted to a requesting spouse if three conditions are met:

1. **The requesting spouse is divorced or legally separated from, or has not been a member of the same household as the nonrequesting spouse at any time during the 12-month period ending on the date of the request for relief.**

   Mrs. Sunleaf was widowed when she made her request for relief. The court determined her status as a widow is "tantamount to her being separated or divorced."

2. **On the date the requesting spouse signed the joint return, the requesting spouse had no knowledge or reason to know that the nonrequesting spouse would not pay the income tax liability.**

   Mrs. Sunleaf credibly testified that she did not learn about the tax liability and was not aware of any tax problems or other financial matters until after Mr. Sunleaf's death in 2003. Mr. Sunleaf had handled the couple's finances and taxes for approximately 38 years; thus, Mrs. Sunleaf's belief that her husband would pay the 2000 tax liability was reasonable.

3. **The requesting spouse will suffer economic hardship if the IRS does not grant relief.**

   Mrs. Sunleaf is 70 years old and suffers from a disability. She has made significant lifestyle changes but still has monthly expenses that exceed her monthly income. Collection of the tax liability will cause Mrs. Sunleaf to be unable to pay reasonable basic living expenses.

Holding. The court ruled that Mrs. Sunleaf satisfied the safe-harbor conditions and was granted innocent spouse relief.

IRS PROCEDURES — AUDITS

Work Product Privilege

***U.S. v. Textron Inc. et al.*, U.S. Court of Appeals, 1st Circuit; No. 07-2631 (Jan. 21, 2009)**
IRC §§7525, 7602, and 7604

☞ Corporation's Tax-Accrual Workpapers are Protected Work Product

Facts. Textron Inc. prepares tax-accrual workpapers that list the questionable positions Textron reported on its tax returns. The workpapers also estimate the chances that these positions might not withstand IRS scrutiny, and calculate the amount of additional tax liability that would result from revision of those positions. Textron prepares its workpaper estimates so that it can maintain an adequate reserve fund, properly report its assets and liabilities, and obtain independent certification of its financial statements from the company's auditor, Ernst & Young.

The IRS noticed what appeared to be potential tax-shelter transactions on Textron's tax return and issued an administrative summons to the company to obtain tax-accrual workpapers for Textron's 2001 tax returns. Textron refused to comply, asserting a number of defenses; and the IRS sued to enforce the subpoena. The district court ruled for Textron on its work-product protection claim but rejected other defenses. The IRS appealed.

Issues. Whether a corporation's tax accrual workpapers are protected by the work-product privilege and whether any such work-product protection was waived through disclosure to the auditors.

Analysis. The IRS audits every Textron return in multi-year cycles. When Textron and the IRS dispute tax liability, their disputes can be resolved through conferences with the audit team, by presentation of arguments to the IRS's Office of Appeals, or through federal court litigation.

The district court held a hearing on the types of documents included in the definition of "tax-accrual workpapers" and the basis for Textron's claim of work-product privilege. An IRS expert witness, testified that public companies prepare tax-accrual workpapers every year to comply with securities law. But Textron legal counsel testified that their workpapers were prepared under the assumption that issues identified would be challenged by the IRS and would have to be defended.

IRS agents stated that access to the workpapers would help them navigate their way through Textron's 4,000-page tax return which was accompanied by "Nine 4-drawer file cabinets" of paper. An agent testified that in 2006 the IRS adopted the practice of seeking tax-accrual workpapers when the audit team became aware of potentially abusive tax-shelter transactions.

Regarding the work-product protection claim, Textron's legal counsel, testified that its ultimate purpose in preparing the tax-accrual workpapers was to ensure that it was "adequately reserved with respect to any potential disputes or litigation that would happen in the future." The appeals court noted the circuit court's "because of" test which recognizes that there is no protection for "documents that are prepared in the ordinary course of business or that would have been created in essentially similar form irrespective of the litigation."[27] The district court reasoned that while the papers were used to obtain a favorable opinion letter from Ernst & Young regarding Textron's reserves, there would have been no need for such reserves if Textron had not anticipated a dispute with the IRS that was likely to result in litigation.

The IRS testified that companies create these tax-accrual workpapers knowing they will be shared with auditors. However, the auditor's code of ethics requires information to be kept confidential unless required to be produced in response to a legal obligation. The IRS said that auditors owed an allegiance to the investing public and have obligations of disclosure in some situations.

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27. *Maine v. U.S. Dept. of the Interior*, 298 F.3d 60, 70 (1st Cir. 2002).

The district court concluded that disclosure of Textron's tax accrual workpapers to Ernst & Young did not constitute a waiver of the work-product protection since disclosure "did not substantially increase the IRS's opportunity to obtain the information contained in them." The district court based its decision on Ernst & Young's professional confidentiality obligations and the fact that Ernst & Young declared that it had not actually disclosed the information.

The circuit court stated that in the case of tax-accrual workpapers, the dual purposes of financial reporting and anticipating litigation are necessarily intertwined; the function of preparing adequate financial reports requires Textron to anticipate and analyze litigation. The work-product doctrine protects documents prepared in anticipation of litigation. The court concluded that Textron's need to consider the possibility of litigation for each disputed position fulfills the requirement for work-product protection.

Though Textron's tax-accrual workpapers are protected, case law suggests that Ernst & Young's workpapers may be discoverable.

Holding. The circuit court remanded to the district court the question of whether disclosure of Ernst & Young's workpapers would reveal the information contained in Textron's own workpapers. On remand, the district court is also to assess the discoverability of Ernst & Young's workpapers by determining whether Textron has the legal right or ability to obtain the documents.

> **Note.** In August, the First Circuit vacated the January decision in this case, stating that "the Textron work papers were independently required by statutory and audit requirements and that the **work product privilege does not apply**" (emphasis added).
>
> A *Wall Street Journal* article[28] quotes Frederick Krebs, president of the Association of Corporate Counsel, as saying the ruling "eviscerates the work-product doctrine." Krebs says the ruling could influence other courts outside the First Circuit (Northeast) and will embolden the IRS to seek more such documents from public companies.

Accuracy-Related Penalty

***Valero Energy Corp., in its own right and as successor to Ultramar Diamond Shamrock Corp., v. U.S.,* U.S. Court of Appeals, 7th Circuit, No. 08-3473 (June 17, 2009)**

IRC §6662(d)(2)(C)(ii)

☞ Accountant-Client Privilege

Facts. Valero Energy Corporation sought information from its accountant when it was considering the acquisition of Ultramar Diamond Shamrock Corporation (UDS), an oil company with Canadian subsidiaries. Shortly after the acquisition, Valero realized $105 million in tax-deductible foreign currency losses. The large loss caused the IRS to examine Valero's federal income tax return.

In order to determine if the loss was deductible, the IRS issued a summons to the accounting firm for all documents related to the transaction.

Issue. Whether the summons was excessive and whether many of the documents were protected work-product under the tax practitioner-client privilege.

28. Efrati, Amir. (2009, Aug. 20). Ruling in Tax-Auditing Case Puts Corporations on Edge. *Wall Street Journal.* [http://online.wsj.com/article/SB125072397055744533.html] Accessed on Aug. 20, 2009.

Analysis. IRC §7525(a)(1) states that tax advice between a taxpayer and any federally-authorized tax practitioner has the same common-law protections of confidentiality which apply to communications between a taxpayer and an attorney. This applies to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney. However, the privilege between the tax professional and the client only applies to providing federal income tax advice.

The IRS insisted that IRC §7525(b) took precedence because the communication fell under the category of a tax shelter. Tax-shelter communication is not protected by §7525.

Holding. The court held the documents fell within the tax-shelter exception. They ruled the communications were made in connection with the promotion of the corporation's participation in a tax shelter.

> **Note.** See Chapter 3, IRS Update, for more information on accountant-client privilege.

IRS PROCEDURES — MISCELLANEOUS

Tax Collection

Treasury Inspector General for Tax Administration (TIGTA) Report #2009-30-023 (Feb. 5, 2009)

☞ IRS Inefficiencies May have Resulted in Failure to Collect Over $200 million

TIGTA released its report on the evaluation of whether large-dollar cases are worked effectively by the IRS's automated collection system (ACS) function. A large-dollar case is defined as one in which the taxpayer's aggregate delinquent tax owed is between $100,000 and $1 million. The report estimated that work might have been prematurely discontinued on over 1,000 taxpayer accounts with a potential dollar impact of up to $209 million.

TIGTA determined that ACS management effectively assigned the workload and managed the inventory of large-dollar cases. However, some large-dollar cases were systematically moved from the ACS workload to the queue before ACS employees could complete their work. When cases are moved to the queue, delinquent taxes are less likely to be collected.

TIGTA reviewed a sample of 62 closed cases from fiscal year 2007 in the ACS large-dollar unit that had an aggregate balance due of $11.4 million. Nine of these cases were systemically moved to the queue prior to the stated expiration dates defined in the IRS's general criteria for working such cases. After these cases were moved to the queue, very few or no actions were taken.

In eight of the remaining sampled cases, ACS employees did not work the cases to their appropriate conclusion, follow all case requirements, or resolve the cases properly. Although managers reviewed five of the eight cases, they did not always take steps to ensure that employees followed proper procedures. TIGTA said that when employees make decisions on cases without following procedural requirements and taking required actions, revenue can be lost.

TIGTA made a number of recommendations in the report, which included conducting training for employees in the required actions for handling large-dollar cases and reminding managers of the importance of reviewing the actions taken in working cases.

Compliance Statistics

Treasury Inspector General for Tax Administration (TIGTA) Report #2009-30-082 (June 10, 2009)

☞ Fiscal Year 2008 IRS Compliance Activities

Background. The Treasury Department issues an annual report which summarizes the compliance activities of the IRS. This report covers the period October 1, 2007, through September 30, 2008.

Statistical Information

1. IRS gross collections increased almost 41% since fiscal year (FY) 2003 and reached a new record high of $2.75 trillion in FY 2008.

2. During FY 2008, IRS enforcement revenue collected decreased by 5% to $56.4 billion. However, this amount (not adjusted for inflation) is still 71% higher than the FY 1999 enforcement revenue amount.

3. During FY 2008, slightly more than 82% of all examinations were conducted via correspondence from the various IRS service centers. Only one of every 545 individual income tax returns received a face-to-face examination, while one of every 121 received a correspondence exam.

4. In September 2006, the IRS started assigning balance-due cases to private collection agencies. Otherwise, these cases probably would not have been processed. Through FY 2008, the IRS received a total of $57.8 million after expected commissions on cases assigned to collection agencies. However, the IRS recently announced that contracts with the private collection agencies would not be renewed.

Note. The Treasury report noted that there had been substantial opposition to the use of private collection agencies from some members of Congress, the Taxpayer Advocate Service, and the National Treasury Employees Union.

5. The IRS Oversight Board's study of taxpayer attitudes showed that a smaller percentage of taxpayers believed that it was acceptable to cheat on their income taxes in 2008 (9%) than did in 2007 (13%).

6. In 2007, 54% of taxpayers surveyed cited fear of examination as a factor that influenced their voluntary compliance. This percentage increased to 59% in 2008.

7. According to a tax gap strategy document,[29] the tax gap for the 2001 tax year was $345 billion, representing a compliance rate of about 84%. The purpose of the strategy document was to provide a broad base on which to build future efforts to address the tax gap.

8. One proposal of the IRS to combat the tax gap is to add information-reporting requirements, which is a statistically-proven method for increasing compliance. Sixty-three percent of taxpayers surveyed cited information reporting as a factor for reporting and paying taxes honestly.[30]

29. *A Comprehensive Strategy for Reducing the Tax Gap* (Department of the Treasury, Office of Tax Policy) (Sep. 26, 2006).

30. *IRS Oversight Board 2008 Taxpayer Attitude Survey* (Feb. 2009).

Unemployment Issues

IRS Pub. 4128, *Tax Impact of Job Loss*

IRC §§67, 72(t), 85, 217, 401, 408, and 1401

This publication explains tax issues associated with job loss such as unemployment compensation, severance pay, IRAs, pension plans, job search expenses, and possible moving costs. Additionally, it discusses self-employment issues for the newly unemployed.

> **Note.** See Chapter 3, IRS Update, for more information about the "What Ifs of an Economic Downturn."

Information Security

Treasury Inspector General for Tax Administration (TIGTA) Report #2008-20-176 (Sep. 17, 2008)

☞ IRS Needs to Address Computer System Weaknesses

Purpose. TIGTA conducted a review to determine whether the IRS's Office of Research, Analysis, and Statistics (RAS) maintained effective security controls over its information systems.

Analysis. The RAS organization is the main provider of statistics about the tax system and contains a significant amount of sensitive taxpayer data. It provides IRS officials with research tools and analyses to support management decisions.

Several weaknesses over the management of access to the computer systems were identified during TIGTA's review. These include the following:

- Controls to prevent unauthorized users from accessing the computer systems were not properly utilized,
- Unencrypted sensitive data was transferred between computers,
- Controls to detect inappropriate security events were not effective and virus protection software was not current,
- Offsite storage was not used for backup files, and
- Database security was not adequate.

TIGTA made the following recommendations after conducting its review:

- Designate a security officer to monitor compliance with IRS security requirements,
- Require system administrators and managers to ensure all system access controls are followed,
- Implement secure processes for transferring sensitive data between computers,
- Implement and monitor a process to validate that system access is limited,
- Ensure audit and accountability controls are sufficient,
- Require the use of offsite storage for system and data backup files, and
- Verify intrusion detection systems are installed and virus protection software is current.

Following TIGTA's review, the Director of RAS agreed with the recommendations and stated that many of the corrective actions were already implemented.

IRS PROCEDURES — PAYMENTS

IRS Levy

***DT Floormasters, Inc. v. U.S.*, No. 4:07-cv-0112-DFH-WGH, U.S. Dist. Ct. for Southern Dist. Of Indiana (July 10, 2008)**
IRC §7426

☞ Funds Transferred to Payroll Service Company Subject to IRS Levy

Facts. DT Floormasters, Inc. (Floormasters) sells and installs commercial flooring in California. They had a contract with Innovative Personnel Solutions, Inc. (IPS), under which IPS, an Indiana company, provided standard payroll services, including paying employees' wages, all federal, state and local payroll taxes, worker's compensation and medical insurance, and benefits. Each week, Floormasters sent funds via wire transfer to IPS's bank account at 1st Independence Bank. IPS then sent the payroll checks to Floormasters, who distributed the checks to employees.

Floormasters transferred $105,233 to the bank account of IPS for payroll checks on July 21, 2005. The next day, the IRS levied IPS's account at 1st Independence Bank for taxes IPS owed the IRS and seized funds which included those Floormasters had just transferred to cover its payroll. After the seizure, Floormasters paid another payroll service company to issue checks to the employees who were unpaid because of the levy on IPS's account.

Floormasters subsequently filed suit, claiming that the IRS improperly levied funds belonging to Floormasters. They contended the funds held by IPS were in trust for Floormasters. The IRS's position was that the funds became 1st Independence Bank's property when the money was wired to the bank account.

Issues. Whether the funds seized from IPS's bank account were the property of Floormasters or 1st Independence Bank.

Analysis. Federal courts "look to state law for delineation of the taxpayer's rights or interest."[31] The parties in this case agreed that whether the funds in IPS's account in an Indiana bank were held in trust for Floormasters was governed by Indiana law. Federal law determines whether the taxpayer's rights or interests constitute property under a federal revenue act.

According to Ind. Code Sect. 30-4-1-1(a), "a trust is a fiduciary relationship between a person who, as trustee, holds title to property and another person for whom, as beneficiary, the title is held." The contract between Floormasters and IPS did not contain any language expressly creating a trust or transforming the traditional debtor-creditor relationship into a fiduciary relationship.

However, the Seventh Circuit said "the words used in a document are not always conclusive evidence of a trust. The principal consideration is intent."[32] The service agreement between Floormasters and IPS did not show sufficient intent to create an express trust. Instead, the contract indicated an intention to create an equal relationship between the parties: "IPS shall be an independent contractor of Customer and shall not be its principal, director, agent, master, servant, employer or employee." Further, IPS could have used a separate agreement to designate the account as a trust since the choice of creating a trust was available on the Bank's signature card form for the account. The signature card for the IPS bank account identified it as a for-profit corporate account belonging to IPS, rather than as a trust.

Holding. The court ruled that the funds in the bank account of IPS were not held in trust for Floormasters. When the IRS served its notice of levy, the funds belonged to the bank, were owed to IPS, and were thus subject to levy to pay IPS's tax obligations.

31. *Drye v. U.S.*, 528 U.S. 49, 52 (84 AFTR 2d 99-7160) (1999).

32. *Judd v. First Federal Savings and Loan Ass'n of Indianapolis,* 710 F.2d 1237, 1241 (7th Cir. 1983).

IRS PROCEDURES — PENALTIES

Information Reporting

IRS Program Manager Technical Assistance PMTA-2009-02014 (Oct. 17, 2008)
IRC §§6050I, 6501, 6721, and 6722

☞ Form 8300 Penalties and Limitations Period

Facts. A business timely filed a Form 8300, *Report of Cash Payments Over $10,000 Received in a Trade or Business,* with the IRS in 2003 that omitted the taxpayer identification number (TIN) of a customer who paid cash to the business. Additionally, the business did not provide a payee statement notifying each customer whose name was identified on Form 8300. During a Form 8300 examination, an IRS agent asserted penalties for the failure to file a correct Form 8300 under IRC §6721 and for the failure to furnish a payee statement under IRC §6722. On review, the case was returned to the field on the determination that the period of limitations had run on both penalties.

Issues.

- Whether there is a period of limitations on the assessment of a penalty imposed by §6722 for failure to furnish a payee statement.
- Whether the failure to report identifying information on Form 8300 of the person from whom cash was received, is sufficiently egregious to be subject to the §6721 penalty.

Analysis. Any person engaged in a trade or business that received cash in excess of $10,000 in one transaction, or two or more related transactions, must file Form 8300 with the IRS within 15 days of receipt of the cash payment.[33] Form 8300 must include:

- The customer's name, TIN, and address;
- The amount of cash received;
- The date and nature of the transaction; and
- Other information.

Any business required to file Form 8300 must also furnish a written statement to each person identified on the form by January 31 of the succeeding calendar year.

For purposes of the statute of limitations on assessment of taxes imposed under IRC §6501, tax must be assessed within three years after the return was filed, whether or not such return was timely filed. The term "return" in this context means the return required to be filed by the taxpayer.[34]

IRC §6501 does not impose a limitation period on the assessment of penalties that are not dependent on the filing of a return. Penalties under §6722 are imposed on businesses that do not provide timely and complete statements to customers that should have been identified in Forms 8300. These penalties are not dependent on the filing of a return. There is no other statute that imposes a period of limitations on the assessment of §6722 penalties.

A penalty is imposed under §6721 for any failure to file an information return with the IRS by the required filing date and for any failure to include all the required information on the return. However, these penalties are not assessed for inconsequential errors or omissions. Errors or omissions are **never considered inconsequential** if they concern a TIN, a surname of a payee, or any monetary amount.[35]

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33. IRC §6050I(a); Treas. Reg. §1.6050I-1(e).
34. IRC §6501(a).
35. Treas. Reg. §301.6721-1(c)(2).

Conclusion. There is no period of limitations that applies to the assessment of penalties under §6722. This penalty may be assessed at any time.

The §6721 penalty may be assessed on Form 8300 errors or omissions that relate to the TIN, the surname of a person from whom cash was received, and the amount of cash received.

ITEMIZED DEDUCTIONS

Charitable Contributions

Sherrel and Leslie Stephen Jones v. Comm'r, **U.S. Court of Appeals, 10th Circuit; No. 08-9001 (Mar. 27, 2009)**
IRC §§170, 1221, and 1222

☞ Attorney Denied Charitable Contribution Deduction for Discovery Materials

Facts. During the Oklahoma City bombing trial, Leslie Stephen Jones served as lead defense counsel for Timothy McVeigh. In this capacity, the government provided Jones with voluminous amounts of discovery material relevant to McVeigh's prosecution. This same discovery material was also furnished to the Oklahoma State Bureau of Investigation, the Oklahoma County District Attorney's Office, and counsel for McVeigh's co-defendant, Terry Nichols. Jones withdrew as lead defense counsel after McVeigh was convicted in August 1997. In December 1997, Jones donated the discovery material to the Center for American History at the University of Texas.

Jones had the discovery material appraised by an expert at $294,877 prior to the donation. He claimed a charitable contribution deduction for the material on the 1997 joint income tax return. The unused amount of the 1997 charitable deduction was carried over to subsequent tax years.

In 2004, the IRS sent Jones a notice for income tax deficiencies of $3,675 for 2000 and $11,110 for 2001. The IRS stated that Jones did not "own" the donated material and, therefore, could not claim a charitable contribution deduction on it. Further, the IRS said that because the material was either ordinary income or short-term capital income, the amount of the deduction was limited to Jones' basis in the donated property. According to the IRS, Jones' basis in the discovery material was zero; thus, the amount he could claim as a charitable contribution was zero.

Jones filed a Tax Court petition seeking a redetermination of the deficiencies. The court ruled that Jones did not own the donated material under Oklahoma law. It held that primary ownership in an attorney's case file lies with the client and not the attorney.

The Tax Court also ruled, in the alternative, that **if** Jones owned the discovery material, it was not a capital asset and, thus, the amount Jones could claim as a deduction was equal to his basis in the donated material. Because Jones' basis was zero, he could not claim a charitable contribution deduction.

Issues. Whether Jones is entitled to a charitable contribution deduction for the donated discovery material.

Analysis. The appeals court noted that property described as a "letter, memorandum, or similar property" that is "prepared or produced" for a taxpayer is excluded from the Code's definition of capital asset.[36] Thus, the sale of such property provides ordinary income; and the allowable income tax deduction for donating the item is limited to the taxpayer's basis in the property.

Holding. The appeals court affirmed the Tax Court's ruling that the discovery material donated by Jones was excluded from the Code's definition of capital asset.

> **Note.** The IRS was barred by the statute of limitations from disallowing the claimed charitable contributions on the taxpayers' 1997–1999 tax returns.

36. IRC §1221(a)(3)(B).

Elizabeth Bruzewicz and Howard Prossnitz v. U.S., **No. 1:07-cv-04074; United States District Court for the Northern District of Illinois (Mar. 25, 2009)**
IRC §§170 and 7422

☞ Preservation Easement Contribution Not Properly Substantiated

Facts. Elizabeth Bruzewicz and her husband, Howard Prossnitz, (taxpayers) own a residence in Oak Park, Illinois, which is located in the Frank Lloyd Wright-Prairie School of Architecture Historic District. The area contains 26 structures designed by Wright and over 60 buildings designed by members of the Prairie School.

In November 2002, LTV Real Estate Services, Ltd., was contacted to conduct an appraisal of a preservation easement that the taxpayers considered donating to the Landmarks Preservation Council of Illinois (Landmarks). The appraisal was completed on November 25, 2002 and the proposed easement was valued at $216,000. The taxpayers executed the easement on December 3, 2002 and recorded it on December 16. The easement prevents the taxpayers from demolishing or removing their home, or changing the front and two side facades or making repairs or reconstruction after a casualty loss without permission of Landmarks. The home's value prior to the easement was $1.2 million and the after-easement value was appraised as $984,000.

The couple deducted $216,000 on their 2002 income tax return as a charitable contribution. They also claimed a $21,600 deduction for a cash payment made to Landmarks during 2002.

Because of deductibility limits, the deductions were spread over the years 2002–2004. In 2005, the IRS audited the couple's returns and disallowed both the claimed deduction for the $216,000 easement and the $21,600 cash donation. The IRS next issued a statutory notice of deficiency to the taxpayers in the amount of $74,521 in taxes for the years 2002–2004 and $14,904 in penalties. The taxpayers paid the taxes, penalties, and interest and subsequently filed a claim for refund of the amounts paid. They received a small portion of that claim and then filed suit seeking a refund of the remainder.

Issues. Whether the couple is entitled to the claimed charitable contributions.

Analysis. Charitable contributions are generally permitted as a deduction only when properly substantiated. Contributions of $250 or more require substantiation in the form of "contemporaneous written acknowledgment of the contribution by the donee organization."[37]

The IRS contends that the $216,000 charitable contribution deduction for the preservation easement was properly disallowed because the taxpayers' appraisal attached to the 2002 return failed to comply with several substantiation requirements. The appraisal did not contain the signatures of the appraisers, did not include the cost basis of the property affected by the easement, and did not use the correct definition of market value. The couple admitted that they did not comply with some of the regulations but believe that they were nevertheless entitled to the deduction because of their substantial compliance with the regulations.

The court stated that the view expressed in *Prussner* guides the determination of the impact that the taxpayers' compliance — or lack thereof — has on their charitable contribution deduction. The court in that case concluded: "The common law doctrine of substantial compliance should not be allowed to spread beyond cases in which the taxpayer had a good excuse (though not a legal justification) for failing to comply with either an unimportant requirement or one unclearly or confusingly stated in the regulations or the statute."[38]

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37. IRC §170(f)(8)(A).

38. *Prussner v. U.S.*, 896 F.2d 218, 224 (7th Cir. 1990).

The first issue reviewed under the substantial compliance doctrine is whether the taxpayers properly obtained a contemporaneous written acknowledgment from Landmarks. The taxpayers produced a letter from Landmarks' President that stated "The following is a list of your contributions from January–December 2002" and then listed two cash contributions made by the couple to Landmarks (one for $500, the other for $21,600), the respective check numbers of those contributions and, in a column entitled "Type of Donation" the word "Easement."

The court stated that the letter's identification of cash contributions of $500 and $21,600 could not be stretched to encompass preservation easements valued at $216,000. There is no description of any claimed easement or its terms in the letter from Landmarks.

The statutes clearly spell out what must be included in the written acknowledgment for a contribution of $250 or more. The failure of the taxpayers to comply with the statutory requirement for written acknowledgment is fatal to their claimed deduction of the preservation easement in and of itself.

Although the failure of the couple to comply with the written acknowledgment requirement was sufficient for a ruling on this case, the court went on to consider their instances of noncompliance of other substantiation requirements on which an easement deduction is conditioned. This was done to reveal that the added deficiencies confirmed the failure of the taxpayers to meet even a generous application of the substantial compliance doctrine.

Holding. The court granted the IRS's motion to disallow the $216,000 preservation easement. The court granted the taxpayers' cross-motion to validate their $21,600 cash donation and ordered the IRS to refund the portion of taxes and penalty attributable to that $21,600 cash payment.

Charitable Contributions

***Kiva Dunes Conservation LLC, et al. v. Comm'r,* TC Memo 2009-145 (June 22, 2009)**

IRC §§170 and 6662

☞ Tax Court Determines Value of Donated Conservation Easement[39]

Facts. The taxpayer purchased 251 acres in Alabama on the Gulf of Mexico for $1.05 million in the early 1990s. About 18 months later, the taxpayer conveyed his interest in the property to an LLC that he had created a few weeks earlier (D&E Investments, LLC). The LLC then developed the property into a gated, residential subdivision (a resort) known as Kiva Dunes and a 141-acre golf course. The golf course was then conveyed to another LLC that the taxpayer had formed — Kiva Dunes LLC.

In 2002, this LLC placed a perpetual conservation easement on the golf course and donated the easement to the North American Land Trust, a qualified land trust. The property subject to the easement could be used either as a golf course, park, or some type of agricultural enterprise. The LLC (which was taxed as a partnership) took a $30.6 million charitable contribution deduction for the easement on its 2002 Form 1065. The IRS audited and, while conceding that the taxpayer was entitled to a charitable contribution, disallowed a large portion of the deduction by valuing the easement at $10 million. The IRS also assessed an accuracy-related penalty.

Issues. Two issues faced the Tax Court:

1. The proper value of the donated easement; and

2. Whether the taxpayer was subject to an accuracy-related penalty.

39. McEowen, R., *Iowa State University Center for Agricultural Law and Taxation Newsletter.* [www.calt.iastate.edu/briefs/CALT%20Legal%20Brief%20-%20Tax%20Court%20Determines%20Value%20of%20Donated%20Easement.pdf]. Accessed on Aug. 4, 2009.

Analysis. The key to valuation is to determine the property's FMV at the time the charitable contribution is made. The Tax Court said arriving at the proper value involved not only examining the current use of the property, but also determining its highest and best use. On that point, the experts for the IRS and the taxpayer's expert agreed that the highest and best use of the easement would have been as a residential subdivision. However, data for comparable easement sales was lacking. The Tax Court used the fall-back test of the regulations — the before and after approach.[40] In assessing the value of the donated property before the easement restriction was placed on the property, the Tax Court focused on three key variables on which the experts' assumptions varied:

1. The number of lots available for sale on the easement area in the hypothetical residential subdivision
2. The average sales price of the lots
3. The rate at which the lots would sell

Due to the differences in assumptions behind these three points, the experts' "before donation" valuation differed dramatically. The taxpayer's expert valued the property before the easement restriction was placed on the property at $31.9 million, and the expert for the IRS valued the property before the easement restriction at $10 million. The Tax Court first noted that another golf course in the area had been sold for $17.8 million for development as a residential community. However, that course was 15 miles from the Kiva Dunes golf course and was six miles inland. The Kiva Dunes course, the Tax Court noted, was on "one of the most beautiful stretches of coastline in the United States." As such, a willing buyer would pay a premium for the property. Accordingly, the "before" valuation of the IRS expert was too low.

The Tax Court examined the experts' assumptions and noted that the IRS expert incorrectly interpreted a local zoning regulation to conclude that only 300 lots could be developed. The taxpayer's expert determined that 370 lots could be developed, and the IRS expert later conceded that point. This added to the value of the property before the easement restriction was imposed.

On the second assumption (average selling price of each lot), the taxpayer's expert did a market analysis that supported an average of $170,000 per lot based on quality of the lots, market demand, and comparable sales. The IRS expert, on the other hand, didn't rely on comparable lot characteristics when determining an $85,000 value.

On the third assumption (absorption rate), the taxpayer's expert assumed the 370 lots would all be sold in 10 years based on absorption data from other nearby developments. The IRS expert projected a 15-year absorption rate for 300 lots. The Tax Court believed the taxpayer's expert's assumptions were reasonable and that his testimony was credible. Based on a discounted cash-flow analysis, the taxpayer's expert determined the property before the easement restriction was valued at $31.9 million.

On the post-donation valuation of the property (the value of the property after the easement restriction), the experts again used different valuation methods. The taxpayer's expert used comparable sales (market approach) to determine value. The IRS's expert used the capitalization of income approach which focused on the projected earnings of the golf course. Unfortunately for the IRS, their expert lacked experience in Alabama and made serious errors in the application of his valuation methodology, not the least of which was that he capitalized the wrong income stream. Consequently, the Tax Court placed no weight on his testimony on post-restriction value testimony.

Alternatively, the taxpayer's expert presented five comparable sales of similar pieces of property in Alabama. He then made adjustments to each comparable sale based on seven variables, including market conditions, location, and size.

Holding. The Tax Court found the taxpayer's expert valuation to be more persuasive. However, the Tax Court increased the property's post-easement value related to improvements that were made to the golf course. After accounting for those adjustments and an additional value enhancement on the taxpayer's property that was not subject to the easement, the Tax Court concluded the post-easement value of the property equaled $3.3 million. Subtracting that amount from the property's pre-restriction value resulted in a charitable deduction for the donated easement valued at $28.6 million.

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40. Treas. Reg. §1.170A-14(h)(3)(i).

Mortgage Interest

ILM 200911007 (Nov. 24, 2008)

IRC §§121 and 163(h)(3)

☞ Deductible Mortgage Interest Limited to Acquisition Indebtedness of $1 million

Facts. The taxpayer owned a principal residence with a mortgage in excess of $1 million. He paid the mortgage interest for the first two years of the mortgage himself. In the second year, the taxpayer added another individual as co-owner and obligor on the mortgage. During the third year of the mortgage, the taxpayer and the co-owner each paid a portion of the mortgage interest.

Issue. Whether the $1 million aggregate acquisition indebtedness under IRC §163(h)(3)(B)(ii) applies when the taxpayer is a partial owner of a residence for which total mortgage debt exceeds $1 million.

Analysis. Under §163(h)(3)(B)(ii), the aggregate amount treated as acquisition indebtedness for any year is limited to $1 million for purposes of the qualified residence interest deduction. The taxpayer argued that the $1 million limit should be interpreted on a per person basis; thus, the taxpayer and the co-owner of the residence could each deduct interest for up to $1 million of acquisition indebtedness for the same residence.

Acquisition indebtedness under §163(h)(3)(B)(ii) is defined as indebtedness incurred in acquiring a qualified residence of the taxpayer rather than indebtedness incurred in acquiring taxpayer's **portion** of a qualified residence. Acquisition indebtedness for purposes of the qualified residence interest deduction is limited to $1 million of aggregate acquisition indebtedness. This is apparent from the parenthetical in §163(h)(3)(B)(ii) which limits the aggregate acquisition indebtedness to $500,000 for a married taxpayer filing a separate return.

Conclusion. The IRS disagreed with the taxpayer.

Mortgage Interest and Business Expenses

***Ndile Njenge and Ekinde Rachel v. Comm'r,* TC Summ. Op. 2008-84 (July 15, 2008)**

IRC §§162, 163, and 164

☞ Mortgage Interest Deductible by Equitable and Beneficial Owners

Facts. On their 2003 income tax return, the taxpayers claimed deductions for home mortgage interest of $3,522 and real estate taxes of $3,194 on property claimed as their residence. In 2003, title to the residence property and the mortgage on the property was in the name of the taxpayers' son. The couple resided at the property for all of 2003. The taxpayers' son obtained a mortgage and took title to the house in 2001 because the taxpayers were unable to secure a loan due to financial difficulties. From 2001 through 2005, mortgage payments were made through Camrock General Engineering Co. (Camrock), a family business entity.

Issues. Whether the taxpayers are entitled to claim Schedule A deductions for the mortgage interest and real estate taxes they paid on the residence owned by their son.

Analysis. IRC §163(h)(3)(A) defines qualified residence interest as interest paid or accrued on acquisition indebtedness or home equity indebtedness for any qualified residence of the taxpayer. When the taxpayers are equitable and beneficial owners of the property, payments of interest are deductible. Thus, the first issue centers on whether petitioners are the equitable and beneficial owners of the residence property.

The IRS contends that because the taxpayers had no legal obligation to make mortgage payments and did not hold legal title to the residence property they were not entitled to deduct mortgage interest. The IRS also argued the taxpayers did not make any mortgage payments on the residence property because all payments were made by Camrock.

The taxpayers asserted that they owned Camrock and had assumed payment of the mortgage liability through the company from its outset. The mortgage payments were made from a bank account registered to Camrock of which the taxpayers were signatories. The company suspended business in October 2003, but the taxpayers continued to use the Camrock bank account to pay personal bills.

The taxpayers paid all maintenance and taxes on the property. They occupied the residence from the outset of its acquisition and used their son's name solely to acquire a mortgage loan. The son did not reside at the residence.

Holding. The court held that the taxpayers were the equitable and beneficial owners of the residence property. As such, they are entitled to the claimed Schedule A deductions for the mortgage interest and real estate taxes on the residence property.

LIKE-KIND EXCHANGES

Like-Kind Exchanges

ILM 200911006 (Feb. 12, 2009)
IRC §1031

☞ Certain Intangibles Qualify for Like-Kind Exchange

Facts. In January 2006, the Chief Counsel's Office issued technical advice stating that registered trademarks and trade names of a business entity could not be considered like kind to the trademarks and trade names of another business entity because they were "closely related to (if not a part of) the goodwill or going concern value of a business."[41] As a result, exchanged intangibles were not of a like kind; and, thus, the gain from the exchange was not eligible for deferral under IRC §1031.

Issue. Whether certain intangibles can be separated from goodwill for purposes of like-kind exchanges.

Analysis. In further consideration of this issue, the IRS looked at the *Newark Morning Ledger*[42] case in which the court upheld the petitioner's position that part of the purchase price of a newspaper company was properly allocated to a base of "paid subscribers," as it was separate and distinct from goodwill and could be amortized over its useful life.

Holding. The IRS determined that intangibles such as trademarks, trade names, mastheads, and other intangibles that can be separately valued apart from goodwill qualify as like-kind property under §1031 as long as the property satisfies all other requirements of §1031.

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41. TAM 200602034 (Jan. 13, 2006).

42. *Newark Morning Ledger Co. v. U.S.*, 507 U.S. 546 (1993).

Related-Party Exchanges
***Ocmulgee Fields, Inc. v. Comm'r*, 132 TC No. 6 (Mar. 31, 2009)**
IRC §1031

☞ Avoidance of Tax Was a Principal Purpose for Exchange of Properties by Related Taxpayers

Facts. Ocmulgee Fields, Inc. (OFI), a C corporation, developed, owned, and managed commercial real estate in the Macon, Georgia area. OFI's real-estate holdings included shopping centers and office buildings. OFI owned Wesleyan Station Shopping Center (Wesleyan Station) and a portion of Rivergate Shopping Center (Rivergate).

Three parcels of real property in Rivergate were referred to as the "Barnes and Noble Corner." OFI had owned the property before selling it in 1996 to Treaty Fields, LLC (the LLC), a **related party** to OFI. At the time of that sale in 1996, the Barnes and Noble property was undeveloped real property. OFI sold it so the LLC would benefit by its development.

During early 2003, an unrelated party approached the president of OFI and offered to buy Wesleyan Station for \$7.25 million. The closing was scheduled to take place no later than October 10, 2003. After consultation with its experienced CPA, OFI decided to engage in a like-kind exchange of Wesleyan Station rather than an outright sale of it to the unrelated party.

Following is a timeline analysis of transactions entered into by OFI, the related LLC, and the qualified intermediary:

Date of Transaction	Description of Transaction
October 9, 2003	OFI engaged a Macon bank as a qualified intermediary (QI) and transferred its right to sell Wesleyan Station for \$7.25 million to the QI. OFI's basis in the property was \$716,164.
October 10, 2003	The QI sold Wesleyan Station to the unrelated party for \$7.25 million.
October 15, 2003	OFI executed a purchase contract with the related LLC for the Barnes and Noble Corner. The contract was transferred to the QI. The QI bought the property from the related LLC for \$6.74 million. The LLC's basis in the property was \$2.55 million.
November 4, 2003	The QI transferred the Barnes and Noble Corner to OFI as the replacement property for Wesleyan Station. The tax-deferred exchange was now completed.

The LLC realized a gain of \$4.19 million on its sale of the Barnes and Noble Corner to the QI. This gain was reported by the LLC on its 2003 partnership return.

OFI's realized gain on the exchange of Wesleyan Station was \$6.1 million. On OFI's 2004 Form 1120, the \$6.1 million gain was reported on Form 8824, *Like-Kind Exchanges*. The Form 8824 identified the replacement property as the Barnes and Noble Corner. In the "Related Party Exchange Information" on Form 8824, the LLC was identified as a related party.

The IRS determined that OFI's alleged tax-deferred exchange gain did not meet the nonrecognition provisions of IRC §1031. As a result, the IRS assessed additional tax of about \$2 million for OFI's Form 1120 for the fiscal year that ended May 31, 2004.

Issue. Whether the nonrecognition like-kind exchange provisions of §1031 apply regarding the exchange of the Wesleyan Station property for the Barnes and Noble Corner previously owned by the related LLC.

Analysis. Generally, the nonrecognition provisions do **not** apply to exchanges between related parties.[43] Specifically, the nonrecognition provisions do **not** apply to "any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes" of the general related-party rules.[44]

However, the related party disallowance rule can be negated if a taxpayer can "establish to the satisfaction of the Secretary [the IRS] that neither the exchange nor such disposition had as one of its principal purposes the avoidance of federal income tax."[45]

1. If the exchange with the QI was ignored, OFI in effect exchanged the Wesleyan Station property with the related LLC for the Barnes and Noble Corner. In this hypothetical scenario, the court assumed that the LLC then sold Wesleyan Station to the unrelated party for $7.25 million. The tax result would be a $1.8 million reduction in the LLC's recognized gain on the sale. The $1.8 million reduction in gain is computed in the chart below.

LLC's basis in Barnes and Noble Corner which transfers to Wesleyan Station	$2,000,000
Less: OFI's basis in Wesleyan Station	(700,000)
Reduction in the LLC's recognized gain	**$1,800,000**

   In addition, the LLC's members would pay only a 15% tax rate on the reduced gain.

   If OFI had sold the Wesleyan Station directly to the unrelated party, OFI's larger gain would have been taxed at the 34% C corporation rate. As a result, the court reasoned that avoidance of income tax was a principal purpose of the tax-deferred like-kind exchange strategy with the related LLC. Therefore, the exception provided by IRC §1031(f)(2)(C) does not apply.

2. The court noted that the facts were very similar to the transactions in a previous Tax Court decision.[46]

Holding. In a well-written and thoroughly researched opinion, the Tax Court upheld the IRS assessment of additional tax.

Note. See pages 554–555 in the 2005 *University of Illinois Federal Tax Workbook* for an analysis of the previous Tax Court decision with similar facts and an identical holding. This can be found on the accompanying CD.

Note. For additional information on like-kind exchanges between related parties, see Chapter 8, Related Parties.

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43. IRC §1031(f).

44. IRC §1031(f)(4).

45. IRC §1031(f)(2)(C).

46. *Teruya Bros., Ltd. & Subs. v. Comm'r*, 124 TC 45 (2005).

PARTNERSHIPS

S Corporation Elections

Rev. Rul. 2009-15, 2009-21 IRB 1 (May 7, 2009)
IRC §§1361, 1362, and 7701

☞ No Intervening Short Taxable Year for Partnership Converting to S Corporation

Facts. In the first situation, a calendar-year taxpayer is organized on January 1, 2009, as an unincorporated entity classified as a partnership for federal tax purposes. The entity elects to be treated as an association for federal tax purposes, effective January 1, 2010. On February 1, 2010, the entity files an election under IRC §1362(a) to be taxed as an S corporation effective January 1, 2010. The second situation mirrors the first, except that the entity converts into a corporation under a state law formless conversion statute, effective January 1, 2010.

Issue. Whether an unincorporated entity taxed as a partnership becomes a corporation for federal tax purposes in order to address the issue of whether the corporation is eligible to elect to be taxed as an S corporation effective for its first taxable year.

Analysis. Rev. Rul. 2004-59 states that the conversion of a partnership into a state law corporation under a state law formless conversion statute is treated in the same way as if the entity had made an election to be treated as an association under Treas. Reg. §301.7701-3(c)(1)(i). As in the first situation, the partnership will not be deemed to own stock of the corporation during any portion of the corporation's first taxable year beginning January 1, 2010.

When an entity classified as a partnership elects to be classified as an association for federal tax purposes under Treas. Reg. §301.7701-3(c)(1)(i), the following steps are deemed to occur:

- The entity contributes all of its assets and liabilities to the association in exchange for stock in the association, and
- Immediately thereafter, the entity liquidates by distributing the stock of the association to its partners.

These deemed steps are treated as occurring immediately before the close of the day before the election is effective. Therefore, the taxable year of the partnership ends on December 31, 2009, and the first taxable year of the association begins on January 1, 2010. Because the partnership's taxable year ends immediately before the close of the day on December 31, 2009, and the association's first taxable year begins on January 1, 2010, the deemed steps will not cause the entity to have an intervening short taxable year in which it was a C corporation.

Holding. The entity is eligible to elect S corporation status effective January 1, 2010, and the deemed steps will not cause the entity to have an intervening short taxable year as a C corporation.

Partnership Level Treatment

***Charles Bassing III v. U.S.,* U.S. Court of Appeals for the Federal Circuit; No. 2008-5107 (Apr. 16, 2009)**
IRC §§108, 6221, 6231, and 7422

☞ Partner's Refund Claim Based on Discharge of Debt Denied

Facts. The 1110 Bonifant Limited Partnership was organized under Maryland law in 1985 for the purpose of developing an office building. Richard Cohen and Charles Bassing III were the two general partners and were also limited partners. Several other individuals and entities were also limited partners. The partnership maintained a capital account balance for each partner reflecting each partner's contributions to the partnership, allocation of the partnership's income, and share of the partnership's expenditures and losses. The partnership agreement provided that in the event of the liquidation of the partnership, any partner with a negative capital account was obligated to restore the amount of the deficiency to the partnership.

The partnership became unable to satisfy its obligations in the late 1980s. It subsequently entered into a settlement agreement with its principal creditor in February 1991 and was liquidated as of that date. At that time, Bassing had a negative capital account balance of $882,871, which he was obligated to restore to the partnership. However, Bassing was insolvent. Consequently, when the partners entered into a settlement agreement with the partnership's creditor, they also entered into a separate agreement which released Bassing from his partnership obligations.

When Bassing filed his income tax return for 1991, he treated the release from his deficit restoration obligation as a deemed sale of his partnership interests and reported a long-term capital gain of $882,871 from the transaction. He reported tax due of $68,695 on the return but did not pay any of that amount at the time of filing.

Bassing's tax obligation for the 1991 tax year grew to $152,539 by 2002, which he paid in April 2002. Later that year, he filed an amended return for 1991 in which he claimed that the release of his deficit restoration obligation should have been characterized as income from the cancellation of a debt rather than a deemed sale. Therefore, because he was insolvent, most of the gain from the transaction should have been excluded from his 1991 gross income. The IRS denied his claim.

Bassing filed suit in the Court of Federal Claims seeking a refund of his 2002 payment. The government responded that his action was barred by 26 USC §7422(h), which prohibits refund actions attributable to "partnership items," except in limited circumstances not present in this case. Bassing replied that the release was not a partnership item but, rather, an item that should be treated at the partner level, in which case, the bar of §7422(h) did not apply. The Court of Federal Claims agreed with the IRS that the release was a partnership item and concluded that it is "difficult to imagine an item more appropriate for treatment at the partnership level than the release of one of the partner's financial obligations to the partnership." It therefore granted the IRS's motion for summary judgment.

Issue. Whether the release of Bassing's obligation to restore a capital account deficit is a "partnership item."

Analysis. Bassing admitted that his negative capital account balance was a partnership item. However, he contended that his negative account balance should be treated for tax purposes as an item determined at the partner level, and therefore, he is free to recharacterize that obligation as a personal debt. The IRS argued that treating these items as though they were on the partner level is contrary to the legislative framework for partnership taxation established by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). TEFRA was enacted "in order that one proceeding would determine how partnership items would be reported on all partners' individual returns." TEFRA ensures each item is treated consistently by all partners affected by it. A decision about whether an item should be characterized as debt cancellation or a deemed sale can have tax implications for all the partners in a partnership; thus, it is "more appropriately determined at the partnership level than at the partner level."[47]

Under Treas. Reg. §301.6231(a)(3)-1(a)(4), in order for Bassing to prevail on his claim that the release should be treated as a cancellation of debt rather than as a deemed sale of his partnership interest, he would have to show that the item should have been treated as a debt cancellation at the partnership level. An attempt to justify such treatment in this action is barred by 26 USC §7422(h).

Holding. Bassing's refund action was properly dismissed by the Court of Federal Claims.

[47] 26 USC Sect. 6231(a)(3).

PASSIVE ACTIVITIES

Passive Activity Losses

Carlos A. and Maria Senra v. Comm'r, **TC Memo 2009-79 (Apr. 15, 2009)**
IRC §469

☞ LLC's Rental Losses Can't Offset Wages From C Corporation

Facts. Carlos Senra was president and majority shareholder of Keys Granite, Inc., a C corporation engaged in the retail sale of granite and marble. Mr. Senra and his wife, Maria, received the following wages from the corporation in 2001 and 2002:

Year	Wages Received
2001	$581,462
2002	394,612

Mr. Senra was also a single-member owner of a limited liability company (LLC) that owned a warehouse. The LLC rented the warehouse to Keys Granite, Inc. during 2001 and 2002. The LLC's income and expenses were reported on a Schedule C of the Senras' individual tax returns as shown in the following table:

Year	Rental Income	Rental Expenses	Net Rental Loss
2001	$324,000	$410,701	($ 86,701)
2002	432,000	544,328	(112,328)

The IRS disallowed the Schedule C rental losses for 2001 and 2002 under the passive loss limitation rules of IRC §469 and rejected the taxpayers' contention that the C corporation's activities and the LLC's activities were related and could be treated as a single activity for passive activity loss purposes.

Note. The taxpayers had no passive activity income in 2001 and 2002. Their only passive activity for those two years was the rental activity of the single-member LLC.

Issue. Whether the taxpayers are permitted to group the activities of the C corporation and the LLC as a single "appropriate economic unit" for purposes of the passive loss rules.[48]

Analysis. The regulations[49] allow the grouping of a C corporation's activities with another activity of the taxpayer, **but only** for determining if a taxpayer materially or significantly participated in the LLC activities.

48. Treas. Reg. §1.469-4(d)(5)(ii).

49. Ibid.

Holding. The Tax Court agreed with the IRS position that the rental losses of the LLC were passive losses which could **not** be used to offset the nonpassive wage income from the C corporation. The taxpayers were **not** allowed to group the activities of the C corporation and the LLC as a single economic unit. The court rejected the "what if" argument of the taxpayers which reasoned that the C corporation **could have** owned the warehouse rather than the LLC.

> **Observations.** This unpleasant tax result could have been alleviated if the C corporation had paid more rental income to the LLC and made up the difference by paying a smaller salary to Mr. Senra.
>
> If Mr. Senra qualified as a real estate professional in his capacity of single-member LLC owner, his material participation in the LLC would have resulted in the rental losses being considered nonpassive instead of passive. However, Mr. Senra failed to raise this argument at the Tax Court trial. It is doubtful that he could have met the real estate professional definition even if the argument had been raised.

> **Note.** See pages 627–628 in the 2006 *University of Illinois Federal Tax Workbook* for an analysis of the *May* Tax Court Summary Opinion case, which deals with the issue of qualifying for real estate professional status. This can be found on the accompanying CD.

Interests in LLCs and LLPs

Paul D. and Alicia Garnett v. Comm'r, **132 TC No. 19 (June 30, 2009)**
IRC §469

☞ **Interests in LLCs and LLPs are not Automatically Treated as Passive**

Facts. Paul and Alicia Garnett owned interests in seven limited liability partnerships (LLPs) and two limited liability companies (LLCs) during 2000–2002. The LLPs and LLCs were engaged in agribusiness operations, primarily the production of poultry, eggs, and hogs. The taxpayers' interests in the seven LLPs and two LLCs were owned indirectly through one of five separate LLCs (the holding LLCs).

On Schedule K-1, *Partner's Share of Income, Credits, Deductions, etc.*, each of the seven LLPs identified the relevant holding LLC or Mr. Garnett as a **"limited partner."** For the tax years 2000–2002, the taxpayers reported all of the various Schedule K-1 income and losses as ordinary business income and losses rather than treating the losses as passive activity losses. The IRS objected and held that the Schedule K-1 losses were passive losses because Mr. Garnett failed to meet the material-participation requirements of IRC §469 for the various business entities.

The IRS assessed a total of $361,468 of additional tax for the three tax years in question plus $41,294 of accuracy-related penalties under IRC §6662(a). The taxpayers requested a summary judgment from the Tax Court.

Issue. Whether the LLP and LLC interests in the business entities are subject to the limitation of IRC §469(h)(2), which treats losses from an "interest in a limited partnership as a limited partner" as **presumptively** passive.

> **Note.** The IRS was confident that the answer to the issue shown above would be "yes" due to §469(h)(2) which provides: "**Interests in limited partnerships.** Except as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates." This IRC rule has been consistently applied by the IRS in exam situations since 1986 when §469 was added to the Code (effective for tax years beginning after 1986).

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Analysis. The regulations provide an exception to the general rule of §469(h)(2). If a limited partner is also a general partner in a limited partnership, the partnership interest of the LLC or LLP member is not treated as a limited partnership interest.[50]

Holding. To the surprise of many in the tax preparation community, the Tax Court determined that §469(h)(2) was too narrow and literal. In regard to that Code section, the court stated:

> *"We do not believe that this rationale properly extends to interests in LLPs and LLCs. As previously discussed, members of LLPs and LLCs, unlike limited partners in State law limited partnerships, are not barred by State law from materially participating in the entities' business. Accordingly, it cannot be presumed that they do not materially participate. Rather, it is necessary to examine the facts and circumstances to ascertain the nature and extent of their participation.*
>
> *We conclude and hold that petitioners' [the taxpayers] ownership interests in the LLPs and the LLCs are excepted from classification as "limited partnership interests" under the temporary regulations[51] by the operation of the general partner exception.[52]*
>
> *Accordingly, petitioners' ownership interests in the LLPs and the LLCs are not subject to the special rule of section 469(h)(2). In reaching this result, we emphasize that we do not invalidate the temporary regulations in any respect but simply decline to fill any gap therein to reflect respondent's [the IRS] litigating position in this case."*

The court held that even though Mr. Garnett was characterized as a limited partner, he held his interests in the LLCs and LLPs **as a general partner.** Therefore, his interests were excepted from the general rule shown in the **notebox** in the Issue section of this case description.

Observation. This is an extremely important case. It is expected that the IRS will appeal this decision to the 8th Circuit Court of Appeals. However, Tax Court decisions apply to all taxpayers in all circuits. As a result, this important case presents myriad tax planning and **amended return opportunities** for tax preparers and their clients.

The rationale of this decision allows **active members** in LLCs and LLPs to properly deduct their losses against ordinary income including wages and investment income reported on Schedules B and D. It is assumed that an active LLC or LLP member is one who can meet one of the seven material participation tests.[53]

Prior to this decision, these losses were treated by the Code and the IRS as passive losses. In many cases, these losses became nondeductible suspended passive losses which would benefit taxpayers **only in future years** when the LLC or LLP business activity became profitable or was sold.

Note. See also the *Thompson* Court of Federal Claims decision for a similar conclusion regarding the identical issue decided in the *Garnett* Tax Court case.[54]

50. Temp. Treas. Reg. § 1.469-5T(e)(3)(ii).

51. Temp. Treas. Reg. §1.469-5T(e)(3)(i).

52. Temp. Treas. Reg. §1.469-5T(e)(3)(ii).

53. Temp. Treas. Reg. §1.469-5T(a).

54. *James R. Thompson v. U.S.,* Ct. of Fed. Cl., No. 06-211 T (July 20, 2009).

IRA Distributions

***Gregory and Kim Benz v. Comm'r,* 132 TC No. 15, Docket No. 15867-07 (May 11, 2009)**
IRC §72(t)

☞ No Additional Tax Liability for IRA Distribution

Facts. Kim Benz maintained an IRA while employed by Proctor & Gamble. After separating from her employment, she made an election in January 2002, to receive distributions from her IRA in a series of substantially-equal periodic payments. Based on her life expectancy, she was to receive a distribution of $102,311 on January 15 each year.

On January 15, 2004, Ms. Benz received her annual distribution from the IRA. During 2004, she also received two additional IRA distributions totaling $22,500. Ms. Benz had not attained age 59½ when she received these distributions. She used the $22,500 distributions for her son's qualified higher-education expenses, which totaled $35,221 in 2004.

The taxpayers timely filed Form 1040 for 2004, reporting the $124,811 in distributions from Ms. Benz's IRA during the year. The couple did not report the 10% additional tax for early withdrawal from an IRA for any portion of the distributions.

In June 2007, the IRS issued a notice of deficiency to the taxpayers for $8,959. The IRS had determined that $89,590 of the $124,811 distributed from Ms. Benz's IRA was subject to the 10% additional tax imposed by IRC §72(t)(1) on early distributions. The IRS noted that the exception for qualified higher-education expenses applied to the remaining $35,221.

Issue. Whether a distribution for qualified higher-education expenses is an impermissible modification to a series of substantially-equal periodic payments.

Analysis. An exception is provided under IRC §72(t)(2)(A)(iv) from the 10% additional tax for distributions that are "part of a series of substantially-equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of such employee and his designated beneficiary." If the series of substantially-equal periodic payments is modified within five years of the date of the first distribution for any reason other than by death or disability, then the 10% additional tax is imposed retroactively on prior distributions made before the taxpayer attains age 59½ (referred to as the recapture tax), plus interest.[55] The recapture tax also applies when a modification occurs after the initial 5-year period but before the employee has attained age 59½.[56]

Independent from the exception for a series of substantially-equal payments, IRC §72(t)(2)(E) provides an exception from the 10% additional tax for distributions for qualified higher-education expenses. Such expenses serve one of the several purposes Congress identified as deserving special treatment.

Ms. Benz's distributions for qualified higher-education expenses were made within five years of the first annual periodic payment and before she had reached age 59½. The IRS's contention is that the additional distributions represent an impermissible alteration to the periodic payment election. The IRS position is that the substantially-equal periodic payment exception is no longer effective for the 2004 distribution but that $35,221 of the total 2004 distributions satisfied the qualified higher-education expense exception.

55. IRC §72(t)(4)(A)(ii)(I).

56. IRC §72(t)(4)(A)(ii)(II).

The IRS argued that a person who elects a series of substantially-equal periodic payments is not allowed any additional distributions within the first five years of the election whether or not the distribution would qualify for another statutory exception to the §72(t) tax unless the employee dies or becomes disabled. The taxpayers countered that a distribution used for a purpose that qualifies for a statutory exception is not an impermissible modification of a series of substantially-equal periodic payments that triggers the recapture tax under §72(t)(4).

The court stated that Congress enacted the recapture tax to apply to prior distributions received under a series of equal periodic payments in which the individual fails to hold to the elected payment schedule for at least five years. There is no indication that Congress intended to disallow **all** additional distributions within five years of the election to receive periodic payments.

Holding. The court rejected the IRS's position and held that a distribution that satisfied the statutory exception for higher-education expenses **does not** modify a series of substantially-equal payments. Consequently, the 5-year rule prohibiting modifications except in the case of death or disability is not violated.

IRA Distributions

Nancy Garza-Martinez v. Comm'r, **TC Summ. Op. 2009-38 (Mar. 23, 2009)**
IRC §72(t)

☞ Penalty Imposed on Early Distributions from IRA

Facts. Nancy Garza-Martinez rolled her Southwestern Bell retirement plan into an IRA in 2000 before she took early retirement from Southwestern Bell in 2001 at age 48. She elected to receive monthly payment distributions from her IRA beginning in February 2001.

In 2004, when Garza-Martinez was 52 years old, she received $4,050 of distributions in addition to her monthly payment distributions of $1,200. The $4,050 was purportedly used to pay her son's higher-education expenses. However, she did not know specifically how her son spent the money she gave him but believed that he used most of the money for college books and supplies.

Issue. Whether some or all of the distributions that Garza-Martinez received in 2004 are subject to the IRC §72(t)(1) additional tax of 10%.

Analysis. One of the exceptions to the 10% additional tax on early distributions from qualified retirement plans provided in IRC §72(t)(2) is for "Distributions which are part of a series of substantially-equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of such employee and his designated beneficiary…"[57]

The exception noted above is not applicable if the series of substantially-equal periodic payments is subsequently modified, other than by reason of death or disability, before the employee attains age 59½.

Garza-Martinez' distributions of $1,200 per month that she received from her IRA plan were set up to qualify as substantially-equal periodic payments. However, she admitted that she received distributions in 2004 in addition to the monthly payments. Garza-Martinez maintains that she should not be subject to the 10% penalty because she received those additional distributions in order to pay her son's higher-education expenses, although she produced no documentation to substantiate her claim.

Holding. Because Garza-Martinez failed to present documentation to corroborate the alleged higher-education expenses, the court held that she was not entitled to the claimed exception to the 10% additional tax. Because the series of substantially-equal payments Garza-Martinez was entitled to receive was modified before she reached age 59½, the 10% additional tax is imposed on the full distribution for the year. Accordingly, the 10% additional tax applies to the entire $18,450 distributed to Garza-Martinez from her IRA in 2004.

57. IRC §72(t)(2)(A)(iv).

IRA Deduction

***Ted T. and Sophie M. Starnes v. Comm'r,* TC Summ. Op. 2008-148 (Nov. 24, 2008)**
IRC §219

☞ Active Participant Status Results in IRA Deduction Denial

Facts. Ted Starnes retired from the New Mexico State Aging Department (NMSAD) in 1999. During 2005, he received a $36,574 pension from the state employee retirement plan. When he was reemployed by NMSAD in 2005, he was given two choices:

- Suspend his pension payments, or
- Make contributions to the state pension plan without receiving service credit for the mandatory contributions

Mr. Starnes elected the latter. Accordingly, pension plan contributions of $5,284 were withheld from his 2005 salary. His 2005 Form W-2 from NMSAD showed an "X" in the pension plan box indicating that he was an active participant.

For 2005, each spouse made the maximum $4,500 IRA contribution allowed for individuals age 50 and older. When the taxpayers filed their joint 2005 tax return, they ignored the IRA deduction phaseout rules even though their modified AGI was $177,982. Their combined $9,000 IRA deduction was completely disallowed by the IRS in its correspondence examination.

Issue. Whether the taxpayers' $9,000 IRA deduction for 2005 is allowable under IRC §219(g).

Analysis. For 2005, the IRA deduction phaseout ranges were:

- $70,000–$80,000 on a joint return for an active participant spouse
- $150,000– $160,000 on a joint return for a spouse who was not an active participant but was married to an active participant

Position of the Taxpayers. They argued that Mr. Starnes was not an active participant in 2005 because he received no service credit for his mandatory pension plan contributions. Their alternative position was that the entire 2005 IRA deduction should be allowed because a similar deduction was claimed and allowed on their 2004 joint return.

Position of the IRS. Mr. Starnes was an active participant in 2005 as indicated by the "X" in the pension plan box on his Form W-2. The fact that he received no service credit for his pension plan contributions does not negate his active participant status.

Holding. The court sided with the IRS and upheld the disallowance of the $9,000 IRA deduction. The court noted that Congress enacted the IRA deduction phaseout limitations due to concerns that taxpayers could receive duplicate tax benefits from participating in both an employer retirement plan and an IRA.

Early Distributions

***Bernard W. and Deborah L. Evers v. Comm'r*, TC Summ. Op. 2008-140 (Nov. 3, 2008)**
IRC §§72(t) and 213

☞ No Exception Allowed for Early Distribution Used to Pay Medical Expense Loan

Facts. Bernard and Deborah Evers borrowed $15,000 in 2003 to pay expenses incurred in the treatment of infertility. They used part of the loan proceeds to pay medical expenses of $12,010 for in vitro fertilization procedures.

Mr. and Mrs. Evers withdrew $16,250 from their qualified retirement account(s) in 2004. They used $13,000 of this withdrawal in partial repayment of the loan.

The couple timely filed their Form 1040 for 2004 on which they reported total income of $104,713. They reported the $16,250 distribution but omitted the additional 10% additional tax under IRC §72(t).

In November 2006, the IRS sent the taxpayers a notice of deficiency which assessed a 10% additional tax of $1,625. They contended they were eligible for an exception to the 10% additional tax because the distribution from their qualified retirement account was used to cover medical expenses.

Issues. Whether the taxpayers are eligible for an exception to the 10% additional tax under §72(t)(2)(B) for the $16,250 early withdrawal from their qualified retirement account(s).

Analysis. An exception is allowed under §72(t)(2)(B) "… to the extent such distributions do not exceed the amount allowable as a deduction under §213 to the employee for amounts paid during the taxable year for medical care (determined without regard to whether the employee itemizes deductions for such taxable year)." The §213 medical expense deduction is allowable only for expenses actually paid during the taxable year.

The §72(t)(2)(B) exception is limited to deductible medical expenses paid during the taxable year of the distribution.

Holding. The Tax Court held that this exception does not apply to the medical expenses that the Evers paid in 2003 with the borrowed funds because the taxable year of the early distribution was 2004.

TAX FRAUD

Failure to File

***Thomas and Iris Tilley v. Comm'r,* TC Memo 2009-83 (Apr. 27, 2009)**
IRC §§6020, 6651, 6654, 7454, and 7491

☞ Court Upholds Deficiencies Charged Against Tax Protesters

Facts. Thomas and Iris Tilley did not file federal income tax returns for several years, including 2000 and 2001. The Tilleys did not produce books and records and refused to cooperate in the determination of their taxable income. As a result, the IRS examiner had summonses served on banks where the Tilleys did business. After obtaining bank records and third-party reports of specific income items, the examiner reconstructed the Tilleys' income using the source and application of funds method.

The known sources of funds received by Thomas (and Iris) totaled $12,457 ($6,033 for Iris) in 2000 and $14,117 ($6,491 for Iris) in 2001. Additional unreported income was determined from loan payments applied to loans showing Thomas (and Iris) as a joint borrower totaling $820,505 ($797,390 for Iris) in 2000 and $3.9 million ($3.8 million for Iris) in 2001. Additional applications of funds were determined on the basis of personal living expenses shown in the bank records.

Included in the records obtained as a result of the summonses were financial statements signed by the Tilleys which reported that they owned a mobile home park and other real estate and that they received substantial income from their properties. The statement showed a net worth for the Tilleys of $7,772,683.

The IRS served requests for admission on the Tilleys, setting out conclusions that had been reached by the examiner on the basis of the records obtained as a result of the summonses. The Tilleys responded to the requests for admission with a document entitled "Affidavit of Truth." Among the statements included in this document was an allegation that the Tilleys were not required to file a tax return because they had no taxable income and that "wages are not income as defined in the IRS law." Shortly before their trial, the Tilleys sent a package of documents which contained various accusations against the IRS, previously refuted tax protester theories, and other unintelligible and irrelevant arguments to the court.

The Tilleys failed to appear at trial. The IRS presented evidence that the Tilleys had not filed returns for 2000 and 2001 and that substitute returns had been filed for those years and for subsequent years.

The 2000 income tax deficiency and penalties charged against Thomas (and Iris) was $686,600 ($663,294 for Iris), and the 2001 deficiency and penalties was $3,239,778 ($3,217,017 for Iris).

The IRS also presented evidence supporting the penalty for fraudulent failure to file income tax returns. The IRS examiner and counsel both acknowledged that there was duplication of income items in the separate notices of deficiency but stated that the records did not support allocation and that the separate determinations were necessary to prevent "whipsaw" in case either Thomas or Iris later claimed that the income belonged to the other.

Issues. Whether the IRS can base income tax deficiencies and penalties on allocation that duplicates income.

Analysis. If the Tilleys had cooperated and explained the sources of loan payments, the income would have been allocated between them and the duplication eliminated. Without their cooperation, there is no reasonable method for income allocation.

The IRS presented evidence of unreported income. To refute this, the Tilleys are required to come forward with evidence to support any claimed defenses; however, they failed to do so.

Holding. The court concluded that there was no basis for reducing the income tax deficiencies, which were reasonably determined by the examining agent. The deficiencies were sustained because of the Tilleys' failure to appear for trial, failure to comply with the court's orders, and failure to properly prosecute the case.

All penalties were sustained, except for a failure to file estimated tax penalty for 2000 in the amount of $18,080 for Thomas and $17,466 for Iris.

Fraudulent Returns

U.S. v. Gregory Louis Clarke, **U. S. Court of Appeals for the 11th Circuit; No. 08-10038 (Mar. 20, 2009)**
IRC §7206

☞ Minister Convicted of Tax Fraud

Facts. Gregory Louis Clarke has been pastor of New Hope Baptist Church and superintendent of New Hope Christian School in Birmingham, Alabama, since 1986. In 2001, he also served as interim manager of the New Hope Federal Credit Union. Clarke received separate compensation for the services he performed in each of these positions; all compensation was paid by the church. Additionally, he received an annual nontaxable minister's housing allowance of $36,000, which was deposited into an account held by the church at Colonial Bank.

In January 2004, the IRS Criminal Investigation Division began an investigation of Clarke after receiving an anonymous letter. During the investigation, the IRS identified payments made by the church and school to various sources for Clarke's benefit and determined that Clarke failed to report income of $11,206, $28,715, and $70,450 on his 2000, 2001, and 2002 tax returns, respectively. As a result of the investigation, Clarke was charged with willfully filing false tax returns for tax years 2000, 2001, and 2002.

At trial, the three individuals who prepared Clarke's 2000, 2001, and 2002 returns testified that the returns were based solely on the Forms W-2 and 1099 from Clarke and that he identified no additional income sources.

The IRS testified that the school paid Clarke's disability insurance premiums in 2000 and also made monthly payments on a loan Clarke had taken out to purchase a vehicle for his daughter. Other witnesses testified that in 2000 they had paid Clarke fees for speaking engagements, "bird-dog" fees for referring customers to a car dealership, referral fees for sending loans to a mortgage company, and a "finder's fee" for bringing in investors to fund a real-estate development project. None of this income was reported on Clarke's 2000 tax return.

The IRS testified that the church paid Clarke's life insurance premiums for 2001, which totaled over $6,000, and that the school continued paying Clarke's disability insurance premiums and monthly payments on Clarke's daughter's car loan. Additionally, the church paid Clarke a salary of $15,000 for serving as interim manager of the credit union. The church's CFO testified that these salary checks were deposited directly into Clarke's housing-allowance account and thus were not routed through the payroll system.

The IRS further testified that the school continued to pay Clarke's disability premiums and car loan payments and made various other miscellaneous payments in 2002. Clarke received a total of $10,308 in unreported income from the school in 2002.

The biggest item of unreported income for 2002 was $60,000 from the church for Clarke's work at its South Avondale location. This $60,000 was designated for "pastor's housing expenses" and listed under the heading "salaries" in the church's 2002 budget. The CFO testified that the church did not give this money directly to Clarke but deposited it into the church's savings account at the credit union. Clarke then brought his personal bills to the CFO, and he paid them at Clarke's direction until the amounts disbursed totaled $60,000.

Clarke presented several witnesses who testified that the $60,000 payment from the church was a gift, rather than compensation for services. However, these witnesses did not produce any evidence to back up their contention that the payment was a gift.

A pre-sentence investigation report (PSI) determined that there was a tax loss of $35,684 to the government. At sentencing, Clarke objected to the tax loss amount, arguing that it should be calculated as though he had amended his tax return to reflect a married filing jointly status. He also contended that his was a "routine tax case" and thus the "sophisticated means" enhancement was inappropriate. The district court overruled Clarke's objections, adopted the PSI, and sentenced Clarke to 21 months' imprisonment. Clarke appealed his convictions and sentence.

Issue. Whether the district court erred in calculating the tax loss amount and in applying the "sophisticated means" enhancement.

Analysis. The sentencing guidelines provide that when the offense involves the filing of a fraudulent tax return, "the tax loss is the total amount of loss that was the object of the offense (i.e., the loss that would have resulted had the offense been successfully completed)."[58] Unclaimed deductions or any other reduction in tax liability unrelated to the offense at issue may not be used to offset the tax loss amount.

58. USSG section 2T1.1(c)(1).

The tax loss is the amount of loss the defendant intends to create when he files a false tax return; it must therefore be calculated based upon the fraudulent return. In Clarke's case, that his tax liability may have been lower had he filed with a married filing jointly status is irrelevant to the determination of the amount of loss to the government when he underreported his income.

The sentencing guidelines allow the district court to enhance a defendant's base offense if the offense involves "sophisticated means."[59] Sophisticated means is described as an "especially complex or especially intricate offense conduct pertaining to the execution or concealment of an offense."[60] Clarke concealed the true extent of his income by: (1) depositing his salary into accounts not registered in his own name; (2) instructing the church to make payments out of these accounts to his personal creditors; and (3) directing the school and church to pay his life and disability insurance premiums to the insurance companies.

Holding. The district court's convictions and sentences for Clarke were affirmed.

Economic Substance Doctrine

Reginald Jarret et al. v. Comm'r, **TC Summ. Op. 2008-94 (July 31, 2008)**
IRC §§1401, 1402, 6662, 6651, 162, and 274

☞ Increase in Self-Employment Tax Imposed Due to Lack of Economic Substance

Facts. Between 1975 and 1998, Thomas Jarrett was the sole proprietor of a tax return preparation business known as TJ's Enterprises. In March 1998, he formed a North Carolina corporation named Trecom, Inc. (Trecom) for the tax return preparation business. Thomas and his son, Reginald, were each 50% shareholders in Trecom; and Thomas and his wife, Juda, were officers of Trecom.

After Trecom was formed, Thomas continued to operate his tax return preparation business as before. Clients of the business continued to pay for services by writing checks to Thomas personally or to TJ's Enterprises, not to Trecom. No bank account was opened in the name of Trecom. In 1999, Thomas had two bank accounts — one in his name and one in the name of TJ's Enterprises.

Thomas received payments from tax preparation clients totaling approximately $7,000 in 1999. Some of these funds were deposited in TJ's Enterprises' bank account; other funds were spent by Thomas for personal purposes without first being deposited into a bank account.

Thomas prepared and filed a joint return with Juda for 1999. The return included a Schedule C for TJ's Enterprises that reported $17,444 in gross income (including the $7,000 Thomas received for tax return preparation fees). The Schedule C listed $16,420 in expenses, which included $7,000 that Thomas allegedly paid to Trecom for professional services purportedly rendered by Trecom to TJ's Enterprises. Taxable income of $1,024 was reported, on which Thomas paid SE tax of $145. Thomas' return also included a Schedule E, in which he reported $7,000 as pass-through income from Trecom, the amount listed on his Schedule C as paid to Trecom for professional services.

Reginald operated a cabinet installation business as a sole proprietorship in 1999. He performed no services for Trecom and did not receive a salary from Trecom.

Thomas prepared Reginald's 1999 federal tax return. It included a Schedule C for Reginald's cabinet installation business, which reported $20,149 in gross income. Expenses of $19,363 were claimed, which included $7,200 that Reginald allegedly paid to Trecom for professional services. The Schedule C showed $786 in taxable income, on which Reginald calculated SE tax of $111. Reginald included a Schedule E with his return, which reported $7,200 as pass-through income from Trecom, the amount listed on his Schedule C as paid to Trecom for professional services.

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59. USSG section 2T1.1(b)(2).

60. USSG section 2T1.1(b).

Thomas also prepared and filed Trecom's 1999 Form 1120S. Trecom's reported income was $14,200, which consisted solely of the $7,000 and $7,200 allegedly paid to Trecom by Thomas and Reginald, respectively.

Issues. Whether Thomas and Reginald owe SE tax on income from their sole proprietorships that they passed through an S corporation.

Analysis. SE tax is due on income derived from the self employment of an individual, less allowable expenses. Income from a trade or business operated as a sole proprietorship generally is subject to SE taxes.[61]

Income from a trade or business operated as an S corporation and passed through to shareholders is generally not considered SE income and therefore is not subject to SE tax.[62]

The IRS conducted an audit of Thomas and Juda's 1999 return. The $7,000 in Schedule C expenses for payments allegedly made to Trecom was disallowed, and the pass-through income of $7,000 from Trecom was removed as a result of the audit. Because of these adjustments, Thomas's SE tax liability increased from $145 to $1,134, although Thomas was allowed a deduction for half of the recalculated SE tax.

Reginald's 1999 return was also audited. The audit disallowed $8,078 in expenses Reginald reported, which included the $7,200 that Reginald claimed he had paid to Trecom, along with vehicle and storage expenses. The audit also removed the $7,200 of passthrough income that Reginald reported from Trecom. These adjustments caused Reginald's 1999 SE tax to increase from $111 to $1,252. Reginald was also allowed a deduction for half of the recomputed SE tax.

It was established that Thomas and Reginald operated their businesses as sole proprietors; thus, the income in question is properly treated as earned by Thomas and Reginald individually, rather than by Trecom.

Holding. The court held that the alleged $14,200 reported as paid by Thomas and Reginald to Trecom, and then reported as income from Trecom to Thomas and Reginald lacked economic substance and should be disregarded. These offsetting payments had no business purpose and produced only SE tax avoidance for Thomas and Reginald. Thus, the $7,000 and $7,200 were held to be includable in Thomas and Reginald's gross income, respectively, and are subject to SE tax.

Additionally, a 20% penalty under IRC §6662(a) was imposed due to negligence or disregard of federal income tax rule.

61. IRC §§1402(a) and (b).

62. Rev. Rul. 59-221 (Jan. 1, 1959).

Identity Theft

IRS Pub. 4535, *Identity Theft Prevention and Victim Assistance*

This publication answers the following questions:

- What is identity theft?
- How can you minimize becoming a victim?
- What if you are a victim of identity theft?
- How could identity theft impact your tax records?
- How can you protect your tax records?
- What should you do if your tax records are affected by identity theft?
- What if you receive an email claiming to be from the IRS?

> **Note.** Additional information regarding identity theft is found beginning on page 61 of the 2008 *University of Illinois Federal Tax Workbook*. This can be found on the accompanying CD.

TRAVEL AND TRANSPORTATION EXPENSE

Unreimbursed Employee Business Expenses

***Laura and Scott Burley v. Comm'r,* TC Summ. Op. 2009-65 (May 7, 2009)**
IRC §§162 and 262

☞ Business Travel Expenses Disallowed Due to Length of Assignment

Facts. Laura and Scott Burley resided in Apple Valley, Minnesota and were both employed as airline mechanics for Northwest Airlines, Inc. Northwest reduced its workforce in 2003, and Mr. Burley was "bumped" from his job in Minneapolis by a mechanic with more seniority. In order to keep his job and his seniority, Mr. Burley took a position with Northwest in Milwaukee, Wisconsin. Mrs. Burley kept her job with Northwest as a mechanic in Minnesota while Mr. Burley commuted between his job in Wisconsin and the couple's residence in Minnesota. Mr. Burley was under the impression that the Milwaukee position would last less than a year. Fourteen months later, Mr. Burley returned to his position in Minneapolis.

On their 2003 and 2004 income tax returns, the Burleys deducted unreimbursed employee business expenses attributable to the costs Mr. Burley incurred while living in Milwaukee and traveling between that city and Minneapolis.

Issues. Whether the Burleys are entitled to deduct unreimbursed business travel expenses for 2003 and 2004 for expenses Mr. Burley incurred while working in Milwaukee.

Analysis. Properly substantiated traveling expenses incurred by a taxpayer while traveling away from home in the pursuit of a trade or business are deductible. To qualify for the deduction under IRC §162(a)(2), the traveling expense must be:

- Reasonable and necessary,
- Incurred while the taxpayer was temporarily "away from home," and
- Directly related to the conduct of the taxpayer's trade or business.[63]

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[63] *Comm'r v. Flowers,* 326 U.S. 465, 470 (1946).

Part of the Burleys' claimed deductions for the years at issue include amounts spent for meals, lodging, travel, and Internet access while Mr. Burley was working in Milwaukee. According to the IRS, however, Mr. Burley was not "away from home" while working in Milwaukee.

A taxpayer's tax home is generally determined by the location of the taxpayer's regular or principal place of business, regardless of where the taxpayer's residence is located. Usually, if the taxpayer's regular place of business changes, the taxpayer's tax home also changes, unless the period of employment at the new location is, or is reasonably expected to be, temporary.[64] IRC §162(a) states that a "taxpayer shall **not** be treated as being temporarily away from home during any period of employment if such period **exceeds 1 year."**

The Burleys argued that Milwaukee should not be treated as Mr. Burley's tax home for the years in issue because his assignment there was temporary. However, the fact that it turned out to be temporary is not as important as the assignment's **actual** duration, which was 14 months.

Holding. Because Mr. Burley's position with Northwest in Milwaukee lasted for **more than one year,** that location is considered his tax home for the period he worked there. Since he was not "away from home" for business reasons, the expenses Mr. Burley incurred while living in Milwaukee and traveling back and forth between the Minneapolis metro area and Milwaukee were incurred for personal purposes, and the Burleys are not entitled to a deduction for those expenses.

Unreimbursed Meal Expense

***Hatem Elsayed v. Comm'r,* TC Summ. Op. 2009-81 (May 26, 2009)**

IRC §§162, 274, and 6013

☞ Truck Driver Allowed Additional Meal Expense Deduction

Facts. Hatem Elsayed, a resident of Texas, was employed as a long-haul truck driver by two related trucking firms in 2004. He drove trucks owned by his employers and received Forms W-2 from them. He was reimbursed for certain expenses including motels, tolls, scales, showers, truck washes, lumpers (people he paid to help unload the truck), and truck repairs. However, he was not reimbursed for any meals consumed while he was traveling.

On his 2004 tax return, $17,667 was deducted for unreimbursed employee business expenses. When the 2004 return was examined, Mr. Elsayed could not reconcile the $17,667 deduction. However, a significant component was for meals he had purchased while away from his home terminal.

The IRS accepted Mr. Elsayed's driver logs which showed that he was away from home 268 days during 2004. The IRS examiner allowed the following for unreimbursed meals (before the 2% of AGI reduction) on the examination report:

268 days away from home × $31 per diem rate	$8,308
Allowance rate under IRC §274(n)	× .50
Amount of meals expense allowed by IRS examiner	**$4,154**

During the exam, Mr. Elsayed raised the issue that he was entitled to use married filing jointly rather than single status for 2004 because of the common-law marriage arrangement between himself and Irma Cueto. He married Ms. Cueto in March 2005.

64. *Kroll v. Comm'r,* 49 TC 557, 561-562 (1968); *Mitchell v. Comm'r,* TC Memo 1999-283.

Issues:

1. Whether the meals expense allowed by the IRS in its examination is correct.
2. Whether the taxpayer is entitled to file a 2004 joint return with his common-law wife.

Analysis and Holding for Issue 1. The court determined that the $31 per diem rate used by the IRS examiner was incorrect. Instead, the correct per diem rate for meals and incidental expenses while the taxpayer was on the road in the continental United States (CONUS) during 2004 was $41. This is the higher allowable per diem rate for transportation industry employees. Additionally, the normal 50% allowance for meals[65] is superseded by a more generous 70% allowance for transportation industry employees for 2004.[66]

The correct meals expense determined by the court was $7,692 as shown in the following table:

268 days away from home × $41 per diem rate	$10,988
Allowance rate under IRC §274(n)(3)(B) for 2004	× .70
Amount of meals expense allowed by Tax Court	**$ 7,692**

> **Note.** For the first nine months of 2009, employed and self-employed transportation industry workers can claim the CONUS rate of $52 per day for reimbursed meals and incidental expenses. This rate may change October 1, 2009. The 2009 allowance rate for these workers is 80% instead of the normal 50% for transportation workers subject to the Department of Transportation hours of service limitation.

Analysis and Holding for Issue 2. State law determines a person's marital status for federal income tax purposes.[67] The state of Texas recognizes common-law marriages if three conditions are met:

1. The parties must agree to marry.
2. They must live together in Texas as husband and wife.
3. They must represent to others that a marriage exists.

The court determined that Mr. Elsayed was **not** entitled to a filing status of married filing jointly for 2004 because the third condition was not satisfied. The couple did **not** represent to others that a marriage existed in 2004 as evidenced by the following factors:

- When the taxpayer purchased a home in 2004 which became the couple's principal residence, the title and the mortgage showed only his name and omitted Ms. Cueto's name.
- The taxpayer did not add Ms. Cueto's name to the utility bills or his checking account.
- Ms. Cueto did not change her driver's license to her married name until after the wedding in 2005.
- The taxpayer had the opportunity to alert the IRS that he believed he was married when he filed his 2004 tax return using the single filing status. However, he chose not to do so. He raised the common-law marriage issue only after the IRS conducted an examination of his return.

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65. IRC § 274(n).

66. IRC § 274(n)(3)(B).

67. Rev. Rul. 58-66, 1958-1 CB 60. The Defense of Marriage Act does not allow married same-sex couples to file a joint federal income tax return.

Temporary vs. Indefinite Assignment

***Alexander D. Senulis, Jr. v. Comm'r,* TC Summm. Op. 2009-97 (June 22, 2009)**

IRC §162

☞ Job Assignment was Temporary for First 12 Months

Facts. Alex Senulis had a long history of self employment as an insurance claims consultant in and around Destrehan, Louisiana. When his consulting income evaporated in late 2001, he contacted Managed Healthcare, Inc. (MHI), a medical insurance administration company in Houston, Texas. He began a month-to-month independent contractor assignment with MHI in January 2002. His project with MHI involved the merging of various computer systems.

At the time he signed the contract, the project completion date was unknown. However, Mr. Senulis estimated that the project would take at most 10 months to complete. It was understood that his services would end when the project was completed.

Mr. Senulis was paid $2,000 per month by MHI and was furnished a cubicle in which he set up his own computer equipment and supplies. He received no reimbursement for any of his expenses. While working on the project, he lived with his mother in a Houston suburb in order to minimize expenses. He had only a bedroom at his mother's residence and did not maintain any of his computer equipment or business records there.

During the time he was working on the MHI project, he continued to maintain a rented townhouse in Destrehan. The distance from the Louisiana townhouse to his mother's house in Texas was 320 miles. The project at MHI was abruptly terminated in January 2003 after Mr. Senulis had worked on it for 13 months. During that time, he made five round trips to Destrehan to research new software technology and to search for clients that might need work similar to the MHI project.

On his 2002 tax return, Mr. Senulis claimed the following MHI-related Schedule C expenses:

- $14,053 of meals and incidental expenses while living at his mother's house (331 full or partial days at applicable per diem rate).
- $14,053 × 50% = $7,027 of claimed deductible meals and incidental expenses on Schedule C.
- $1,197 of automobile expenses for five round trips from his mother's home in Texas to his office in Louisiana.

The IRS determined that none of the claimed Schedule C expenses were deductible because the MHI project in Houston was indefinite, not temporary.

Issue. Whether the taxpayer was temporarily away from his Louisiana home during 2002 and thus entitled to deduct the business expenses shown above.

Analysis. If employment is initially expected to last one year or less and at some later point it is expected to exceed one year, then the employment is treated as temporary until the **earlier** of:

- When the taxpayer's reasonable expectations change, or
- One year.[68]

[68] Rev. Rul. 93-86, 1993-2 CB 71

The taxpayer's tax home in 2002 was in Louisiana and the claimed Schedule C expenses were allowable. The following factors were considered:

1. The taxpayer maintained a personal residence in Louisiana for at least 20 years and had a lengthy history of self employment in Louisiana.
2. He was initially contracted on a month-to-month basis by MHI on a project that was estimated to last less than one year.
3. The project ultimately lasted 13 months due to unexpected technological delays.
4. He had no prospects for continued employment with MHI in Houston following either the completion or termination of the project.

Holding. The Tax Court determined that the MHI project in Houston was a temporary assignment for all of 2002. Consequently, the taxpayer's 2002 expenses were deductible. The court further held that the assignment ceased being temporary as of January 1, 2003.

> **Note.** The court ignored the issue of whether the taxpayer actually paid his mother for the meals consumed in her home. Since he was self employed, he was entitled to the per diem rate for meals and incidental expenses.