Chapter 2: Individual Taxpayer Issues

Please note. Corrections were made to this workbook through January of 2018. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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Chapter Summary

Crowdfunding campaigns can be donation-, reward-, equity-, or loan-based. When contributions are considered gifts, there often are no tax consequences either for the contributor or recipient. While reward-based campaigns do not have immediate tax consequences for contributors, recipients of contributions can have taxable income, particularly when the activity constitutes a business enterprise. Cash contributions to equity-based campaigns are usually nontaxable transactions. The interest element of loan-based campaigns usually has tax consequences.

The sharing economy includes activities like ridesharing, lessors of lodging (e.g., Airbnb), sale of parking spaces, event ticket resellers, and online sellers. Relevant tax issues include IRS reporting, self-employment, tips, personal/business use allocations, passive activity limitations, and capital gain/ordinary income characterization.

The tax treatment of daily fantasy sports (DFS) depends on whether these activities are considered gambling or games of skill. Professional gambling is considered self-employment. However, achieving this tax treatment for DFS is difficult.

Self-directed IRAs differ from other IRAs because they permit IRA beneficiaries to control investment decisions. This section explores the two most common problems with self-directed IRAs — beneficiaries engaging in prohibited transactions and IRA investments that result in taxation of unrelated business income.

Distributions from a qualified retirement plan or an IRA are excluded from income if they are transferred to another eligible retirement plan within 60 days of the distribution. The IRS can grant a hardship exception to the 60-day rollover requirement for events beyond the reasonable control of the beneficiary. To apply for a hardship exception, the taxpayer must request a letter ruling from the IRS and pay a $10,000 user fee. Alternatively, automatic approval of a waiver to the 60-day requirement is granted when a rollover is not timely because of an error on the part of a financial institution and self-certification procedures are followed. A self-certification is not a waiver by the IRS of the 60-day requirement. During the course of a subsequent examination, the IRS may consider whether the taxpayer meets the requirements for the waiver.

Legal expenses may be deductible as an itemized deduction if incurred for producing or collecting taxable income, determining tax liability, keeping the taxpayer's job, tax advice related to divorce, and collecting taxable alimony.

Legal fees incurred in obtaining taxable payments in connection with claims of "unlawful discrimination" as defined in IRC §62(a) and whistleblower claims are deductible as an adjustment to income instead of as an itemized deduction.

CROWDFUNDING AND THE SHARING ECONOMY

Crowdfunding and the sharing economy arose with the advent of online transactions and the use of technology in commerce. The widespread use of the Internet, smart phones, and apps permits individuals to engage in commercial and noncommercial transactions through peer-to-peer networks or, most commonly, through intermediaries such as Airbnb and Uber.

Crowdfunding, such as Go Fund Me, is the practice of soliciting online contributions by a campaign organizer for a project. Crowdfunding uses social media and other websites to bring campaign organizers and investors (or contributors) together.[1]

The **sharing economy** involves direct transactions between two individuals, in which a supplier makes goods or services available to a consumer.[2] As originally envisioned, the sharing economy permitted individuals to share or rent items (e.g., tools) that would otherwise sit idle. That model of the sharing economy did not become widespread. Over the years, the sharing economy shifted into the model of large commercial intermediaries managing the transactions between suppliers and consumers and withholding a portion of the consideration paid by the consumer to the supplier.[3]

One significant issue with crowdfunding and the sharing economy is the lack of guidance concerning the tax consequences of persons who engage in such transactions. To address this need, the IRS recently created a webpage entitled the Sharing Economy Tax Center.[4] However, it does little other than provide brief descriptions of possible tax responsibilities and links to various pages containing existing IRS forms or publications. It also discusses such topics as self-employment (SE) taxes, filing requirements, etc.

TYPES OF CROWDFUNDING

There are four types of crowdfunding campaigns.[5]

1. Donation-based
2. Reward-based
3. Equity-based
4. Loan-based

Donation-Based

Donation-based campaigns are organized around life events. A campaign could be to help pay medical expenses, help rebuild a home after a disaster, or fund a honeymoon or "bucket list" adventure. Charitable organizations may also use donation-based campaigns to raise money for particular projects or to support their general operating costs. In donation-based campaigns, the contributor receives nothing of value in exchange for the contribution. **It is essentially a gift,** as discussed next.

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1. *Crowdfunding.* Investopedia. [www.investopedia.com/terms/c/crowdfunding.asp] Accessed on Mar. 20, 2017.
2. *Sharing Economy.* Investopedia. [www.investopedia.com/terms/s/sharing-economy.asp] Accessed on Mar. 17, 2017.
3. *The Rise of the Sharing Economy.* Mar. 9, 2013. The Economist. [www.economist.com/news/leaders/21573104-internet-everything-hire-rise-sharing-economy] Accessed on Mar. 17, 2017.
4. *Sharing Economy Tax Center.* Jan. 12, 2017. IRS. [www.irs.gov/businesses/small-businesses-self-employed/sharing-economy-tax-center] Accessed on Jan. 24, 2017.
5. *The 4 Types of Crowdfunding.* Apr. 27, 2014. CrowdFundingLegalHub.com [crowdfundinglegalhub.com/2014/04/27/test-3/] Accessed on Mar. 17, 2017.

Tax Issues. IRC §102 excludes gifts from gross income. The Supreme Court, citing prior cases, described a gift for income tax purposes as proceeding from a "detached and disinterested generosity" and "out of affection, respect, admiration, charity or like impulses."[6] Furthermore, there can be no moral or legal obligation to make the gift or an anticipation of economic benefit. However, if there is an an economic benefit, a gift may still exist to the extent the value of the transfer exceeds the economic benefit received.

Contributions made to donation-based campaigns are gifts for federal tax purposes when donors receive no consideration for their contribution. To avoid gift tax consequences, a donor's annual contribution to a single donee is limited to the current year's gift tax exclusion amount ($14,000 for 2017[7]). Although many taxpayers feel entitled to an income tax deduction for contributions to a "worthy" cause, gifts to individuals are not deductible as charitable contributions, regardless of the reason.

Crowdfunding gifts made to a §501(c)(3) exempt organization may be deductible by the donor subject to the usual substantiation rules. Some crowdfunding sites specifically state on their webpages and on donor receipts that the organization is a charity. If no information on the receipt substantiates the charitable contribution, the donor should contact the organization. The site's receipt may suffice for income tax purposes but not in the event of any single contribution of $250 or more. These require a contemporaneous written acknowledgment from the donee organization.[8] **The donor should contact the organization directly to obtain the acknowledgment.**

As mentioned earlier, money received as a gift is excludable from the gross income of the recipient. A recipient of the gift **may** use it for its intended purpose, such as to help a family who suffered a casualty loss to their home or who had catastrophic medical expenses. However, the recipient cannot simultaneously take an income tax deduction for the same expenses. Deductions for casualty losses and medical expenses **must** be reduced by the amount of **any** reimbursement.[9] In the absence of a statutory exclusion, however, a deduction should be permitted because IRC §265, which disallows deductions attributable to tax-exempt income, does not apply to deductible expenses paid from unrestricted gifts.[10]

Note. For a detailed discussion of the tax rules that apply to gifts, see the 2013 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Advanced Individual Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Reward-Based

Reward-based campaigns are designed for business-to-consumer fund raising. Reward-based campaigns offer donors something in exchange for their contributions. This can be as little as a "thank you," or a T-shirt or hat. However, the "reward" is most often the ability of the donor to obtain a product from the campaign organizer at a discounted price. Reward-based campaigns generally require minimum contributions to obtain rewards and may have tiered rewards depending upon the level of contribution. Occasionally, those who contribute earlier are entitled to priority over later contributors. Although the campaign may advertise a minimum contribution goal, most retain funds received regardless of whether that goal is achieved.

6. *Comm'r v. Duberstein*, 363 U.S. 278 (1960).
7. Rev. Proc. 2016-55, 2016-45 IRB 707.
8. IRS Pub. 1771, *Charitable Contributions.*
9. IRC §§165(a) and 213(a).
10. GCM 34506 (May 26, 1971).

Example 1. Silver Stream Kayak is developing an innovative concept: a kayak that will fold and store easily. In an effort to raise capital, Silver Stream offers 50% off retail pricing for the first 1,000 contributors who give $200 or more.

These initial qualified contributors are potentially receiving a reward for their contribution in the form of a discount.

Tax Issues. By their very nature, reward-based campaigns provide something in exchange for contributions. The question is whether the donor receives value in exchange for the money given. If the donor receives value, then reward-based campaigns are essentially sales of goods. From the donor's perspective, it is the purchase of a product. If nothing was received in exchange for the contribution, it is a gift.

The **organizer** of reward-based campaigns must address the issues of gross income, SE tax, and possibly sales and other tax issues. Are amounts received considered gross income? Most reward-based campaigns claim to offer the product to contributors at a discount from the "retail" price. Because the reward still has significant value, all contributions are includable in gross income.

A question may arise regarding whether a noncharitable organizer has gross income if the value of the reward is substantially less than the contribution amount. Unlike charitable contributions, there is no de minimis rule allowing the value of token gifts in exchange for contributions to be ignored. If the reward-based campaign organizer can prove that the value given is less than the value contributed, then the difference is arguably a gift and excludable from income.

When the reward-based campaign organizer is an individual in the trade or business of selling a product, the income is subject to SE tax. Usually, these campaigns are not isolated sales of a single item; often, they involve selling hundreds or thousands of items.

Note. The same situation exists for a U.S. citizen or resident who regularly sells items on eBay.

The campaign organizer reports the gross income from the reward-based campaign and deducts allowable expenses on a properly filed tax return. If the reward-based campaign launches a first-time product of a newly formed business, expenses for setting up the campaign may be treated as startup expenses under IRC §195. These expenses must be capitalized and amortized.

Equity-Based

Equity-based campaigns raise capital for a business start-up or established business. Investors receive some form of equity interest in the business. These types of campaigns are private placement offerings that are exempt from registration with the Securities and Exchange Commission (SEC), but which can be offered only to **accredited investors.** A formula based on a combination of annual income and net worth is used to determine who qualifies as an accredited investor and their applicable annual investment limits. Because of these requirements and the nature of the campaigns, access by interested businesses is subject to stricter control and review by the fund-raising portal.

Note. See the SEC's website for more information on crowdfunding private placement offerings and accredited investors.[11]

11. *Regulation Crowdfunding: A Small Entity Compliance Guide for Issuers.* May 13, 2016. SEC. [www.sec.gov/info/smallbus/secg/rccomplianceguide-051316.htm] Accessed on Jan. 22, 2017.

Tax Issues. Cash contributed to a corporation in exchange for stock, as occurs in equity-based campaigns, is not taxable to the corporation under IRC §118 or to the stock recipient under IRC §351 if only cash is transferred. Similar rules apply under IRC §721 to cash and property transfers to partnerships in exchange for partnership interests.

Loan-Based

Loan-based campaigns involve lending money to businesses and individuals. Most loan-based campaigns require interest to be paid to the lenders, although a few do not because they involve micro-financing and other low income and third-world financing projects.

Tax Issues. Similar to equity-based campaigns, loan-based campaigns fall within existing tax models. The lender has interest income, and the borrower has interest expense. Deductibility of the expense depends on the borrower's entity type and use of the loan proceeds. If the loan is not repaid, the lender has a short-term capital loss unless the lender can establish that the lending activity rose to the level of a trade or business. In that case, the loss is an ordinary deduction. Interest income is included in net earnings from self-employment.

Loan-based campaigns used for microloans (small, short-term loans) or to otherwise help disadvantaged individuals, in which the lender receives no interest from the borrower, have no tax consequences for either the lender or the borrower except to the extent interest is actually paid. If no interest is paid, it is doubtful that interest would be imputed. Gift loans under IRC §7872 are exempt from imputed interest rules as long as the outstanding balance on any day does not exceed $10,000.[12] Gift loans in excess of $10,000 but less than $100,000 are subject to imputed interest only to the extent of the borrower's net investment income for the year.[13] This situation is unlikely with these types of loans. In addition, if the loan is to a non-U.S. entity or person, the imputed interest rules do not apply.[14]

SHARING ECONOMY

Ridesharing

Ridesharing is a service that allows individuals to arrange one-time individual or shared rides on short notice through smartphone-enabled apps. Well-known ridesharing services include Uber, Lyft, and Sidecar. These organizations do not directly provide the service. Rather, they are transportation network companies (TNCs) through which transactions between service providers (drivers) and customers are arranged and paid.

TNCs offer individuals the ability to make extra money by using their personally owned vehicles to provide paid taxi services. Drivers can work when and as often as they choose. Customers use a smartphone app to request and pay for a ride. The TNC locates and dispatches an available driver and notifies the customer of the driver's details. TNCs rely on GPS to guide the driver to the customer and generally permit the customer to follow the driver's progress.

Drivers may receive tip income. Lyft's app allows the rider to add a tip.[15] In the past, Uber maintained an official no-tipping policy such that the fee for a ride is all that could be paid to the driver. That policy appears to be changing, and drivers are now permitted to have signs or other indicators in their vehicles stating that tips are appreciated.

The TNC charges the driver a commission on each fare as well as other expenses. Drivers can print statements from their accounts showing all their activity as well as a summary statement. Uber, for example, indicates on the summary statement those expenses charged against the driver's account that should be deductible for income tax purposes. The statement also reflects the number of miles the driver drove with passengers in the vehicle.[16] Other mileage, such as trips for fuel and to and from passenger pickups and drop-offs, may also be deductible. A sample Uber statement follows.

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12. IRC §7872(c).
13. IRC §7872(d).
14. Temp. Treas. Reg. §1.7872-5T(b)(10).
15. *How to Tip Your Driver.* Lyft. [help.lyft.com/hc/en-us/articles/213583978-How-to-Tip-Your-Driver] Accessed on Mar. 17, 2017.
16. *UBER Tax Filing Information.* Jan. 25, 2016. I Drive With Uber. [www.idrivewithuber.com/uber-tax-filing-information] Accessed on Feb. 24, 2017.

NOT AN OFFICIAL 1099 FORM

UBER

2016 TAX SUMMARY JOHN DOE

Many of the items below may be deductible; please consult with a tax expert for more guidance.

1099-K breakdown:

Gross fares (Uber fee is included)[1]	$36,000
Sales tax	**500**
Black car fund	**100**
Airport fee	**100**
Split fair fee	**100**
Safe rides fee	**200**
Miscellaneous	**300**
Total	**$37,300**

1099-MISC breakdown:

Incentive payment	$ 400
Referrals	500
Join and support	100
Miscellaneous	200
Total	$ 1,200

Other items:

Device subscription	**$ 40**
Uber fee	**10,800**
Fuel card charges	**200**
On-trip mileage[2]	**30,000 miles**

[1] Gross fares are calculated as a base + time + distance (this includes the Uber fee).

[2] On-trip mileage only. Additional mileage may be deductible. Items in **bold** may be deductible. Check with a tax professional to learn more.

Tax Issues. Rideshare drivers who are paid more than $600 of referral fees, bonuses, and other income not directly attributable to customer rides receive a Form 1099-MISC, *Miscellaneous Income,* for those amounts only. Uber and other TNCs also issue Forms 1099-K, *Payment Card and Third Party Network Transactions,* for customer credit card charges. Uber issues a Form 1099-K regardless of whether a driver reaches the required reporting threshold. Other TNCs do so only when the Form 1099-K transaction threshold is met (discussed later).[17]

TNC drivers are treated as independent contractors. This is a controversial issue and challenges have been raised in a few states, although there is not yet a definitive ruling.[18]

As independent contractors, drivers are required to file Schedule C, *Profit or Loss From Business,* and pay SE tax. They are also entitled to deduct expenses as adjustments to gross income. Many of a driver's expenses are those of any taxpayer using a vehicle in a trade or business, such as standard mileage or actual vehicle costs, repairs, tolls, and parking. Although the driver's statement from the TNC shows total trip miles, this only includes miles from the beginning to end of the fare and does not include mileage to and from the fare, refueling, car washes, and similar travel. Drivers are entitled to deduct expenses charged by the TNC, including the TNC's fee, which can be considerable. Other deductions may include the following.

- Cell phone use (or rent if rented from the TNC)
- Cell phone mounts and chargers
- Candy, water, and other amenities for passengers
- Music apps

17. *Lyft vs. Uber: Lyft Doesn't Actually Report Most Driver Income to the IRS.* Leff, Gary. May 24, 2016. Miles and Points Consulting LLC. [viewfromthewing.boardingarea.com/2016/05/24/lyft-vs-uber-lyft-doesnt-actually-report-driver-income-irs/] Accessed on Mar. 17, 2017.

18. *Sharing is Caring: Are Uber, Lyft Drivers Independent Contractors?* Frazier, Ryan B. Oct. 14, 2016. HR Hero Line. [www.hrhero.com/hl/articles/2016/10/14/sharing-is-caring-are-uber-lyft-drivers-independent-contractors-2] Accessed on Feb. 24, 2017.

- Air freshener
- Allocable share of personal property taxes and car loan interest
- Phone chargers for passengers
- Cost of any required additional insurance

Any personal use of the vehicle or cell phone requires an allocation of some expenses between personal and business use. If vehicle expenses are calculated using actual costs and depreciation, the recordkeeping burden can increase significantly. The luxury automobile limitation must also be addressed.[19] For these reasons, it seems most drivers prefer using the standard mileage rate.

TNCs do not withhold federal income tax for independent-contractor drivers. Therefore, drivers may need to make quarterly estimated tax payments.

> **Observation.** First-time drivers may be shocked when they find out what their tax liability is, especially if they are not familiar with SE tax. Consequently, they may not make sufficient estimated tax payments.

Airbnb

Airbnb, similar to Uber, provides peer-to-peer services — in this case between short-term lessors and lessees of overnight lodging. The original intent was to permit individuals who had extra space in their residences to earn money by renting the space. In exchange for staying in a private residence that lacks hotel amenities, the renters pay less than they would if they stayed at a hotel.

While this model still describes the majority of Airbnb hosts (as lessors are called), some individuals who own overnight-lodging properties use Airbnb as a way to skirt state and local laws governing hotels and to avoid occupancy and other taxes normally imposed on hotel rooms. Airbnb now has agreements in place with many states and localities under which it collects and remits required taxes.[20]

Tax Issues. Most Airbnb hosts rent space in residences as that term is defined in IRC §280A. This limits the taxpayer's ability to deduct expenses for rentals of properties that the taxpayer also uses for personal purposes. The first step in preparing the return for an Airbnb host (or similar provider) is determining which rules apply. The following points help determine whether expenses are deductible.

1. If the total number of rental days is less than 15, rents are excluded from gross income and no deductions other than mortgage interest and real estate taxes are permitted.[21]
2. If the rental space is in the same residence in which the host lives and the number of rental days is greater than 14, the residential rental limitations of §280A apply.
   - Taxes and mortgage interest otherwise allowable are deductible.
   - Other expenses are apportioned between rental and nonrental periods of the year and between the portion of the residence rented and the portion used for personal purposes.
   - Ordering rules for expenses require taxes and mortgage interest to be deducted first against rental income, and then other expenses are deducted against any remaining rental income.
   - Deductions cannot exceed income. Any unused deductions carry over to be used against future income but remain subject to the income limitation.

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19. IRC §280F.

20. *In What Areas is Occupancy Tax Collection and Remittance by Airbnb Available?* Airbnb, Inc. [www.airbnb.com/help/article/653/in-what-areas-is-occupancy-tax-collection-and-remittance-by-airbnb-available] Accessed on Feb. 24, 2017.

21. IRC §280A(g).

3. If the rental property is in a different location from the host's residence and the property is not used for personal purposes for more than the lesser of 14 days or 10% of the time it is rented at fair market value,[22] it is not subject to §280A. All expenses are deductible subject to the passive activity loss limitations of IRC §469.

4. The services or amenities the host provides help determine whether rentals should be reported on Schedule E, *Supplemental Income and Loss*, or Schedule C, *Profit or Loss From Business*. This is discussed later under "Significant Services and SE Tax."

Income. It is likely that many Airbnb hosts who have minimal rentals fail to report their income from Airbnb rentals because they receive no information return from Airbnb if their gross receipts are less than the filing threshold for Form 1099-K. They may assume their rentals are not taxable or they intentionally do not report the income.

> **Caution.** Airbnb retains a digital record of all rentals, whether the income is reported on information returns or not. It is possible that the IRS could choose at some point to subpoena rental records and match them against returns.

Airbnb complies with the reporting requirements for Forms 1099-K. Hosts can access their information returns and the underlying details from the transaction history in their accounts.[23]

Airbnb charges a service fee to both the host and the guest on each reservation.[24] These charges vary depending on the specifics of the reservation. If the host does not receive a Form 1099-K, the host's Airbnb gross income is the net remittance the host receives, and the host service fees are not deductible. However, if the rentals are reported on Form 1099-K, the full amount of charges must be reported[25] and the host service fees are deducted separately (the guest service fee does not appear on the Form 1099-K).

If a guest cancels a reservation after a host receives the rental, the full rental amount is reported on Form 1099-K and should be included in the host's income. The host can then deduct any refund.[26]

Deductions. Hosts are entitled to deduct all the ordinary and necessary expenses of the rental property. If there is any personal use of the property beyond the lesser of 14 days or 10% of the number of days it is rented, expenses must be prorated between personal and rental use.[27] In addition, if the host is subject to §280A (discussed earlier), expenses can be deducted only to the extent of income.[28]

> **Note.** See IRS Pub. 527, *Residential Rental Property*, for a detailed description of available deductions, including the §280A limitations. The Airbnb website also has a publication on taxation of rental income prepared for it by Ernst & Young LLP, which can be downloaded.[29]

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22. IRC §280A(d)(1).

23. *Should I Expect to Receive a Tax Form from Airbnb?* Airbnb, Inc. [www.airbnb.com/help/article/414/should-i-expect-to-receive-a-tax-form-from-airbnb] Accessed on Mar. 21, 2017.

24. *What are Host Service Fees?* Airbnb, Inc. [www.airbnb.com/help/article/63/what-are-host-service-fees] Accessed on Mar. 17, 2017.

25. Instructions for Form 1099-K.

26. *Airbnb: General Guidance on the Taxation of Rental Income.* Ernst and Young, LLP. [https://assets.airbnb.com/eyguidance/us.pdf] Accessed on Mar. 9, 2017.

27. IRC §280A(d).

28. IRC §280A(c)(5).

29. *Airbnb: General Guidance on the Taxation of Rental Income.* Ernst and Young, LLP. [https://assets.airbnb.com/eyguidance/us.pdf] Accessed on Mar. 9, 2017.

In allocating expenses between personal and rental use, two methods are available: the IRS method and the Tax Court method. Under the IRS method (as reflected in Worksheet 5-1 of IRS Pub. 527), the total number of rental days is divided by the sum of the rental days and the actual number of days of personal use (rather than the total days in the year). This fraction is then applied to all expenses related to the rental, including mortgage interest and taxes.[30]

The Tax Court method involves creating two fractions, one for allocating mortgage interest and taxes and the other for allocating all other expenses.[31]

1. For mortgage interest and taxes, the allocation percentage is determined by dividing the total number of rental days by the total days in the year.
2. For all other expenses, the allocation percentage is determined by dividing the total number of rental days by the sum of the rental days and the number of days of personal use (rather than the days in the year).

The following example illustrates the difference in results between the two methods.

30. Treas. Reg. §1.280A-3(d).

31. See, e.g., *Bolton v. Comm'r,* 694 F.2d 556 (9th Cir. 1982), *aff'g* 77 TC 104 (1981).

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Example 2. Wade and Chelsea, who file jointly, own a lakeside home they rent at a fair rental price for 75 days during 2017. They use the home for personal purposes on 35 other days during the tax year and rent it to a friend at a discount for 10 days (which they also treat as personal use[32]). Thus, the home is used for some purpose on 120 days during the tax year.

Under the IRS method, the rental allocation fraction for all expenses cannot exceed 62.5% (75 rental days ÷ 120 total days of use).

The following table shows the 2017 income and expenses for the lakeside home and the calculation of allowable expenses using the IRS method.

IRS Method

Gross rental receipts		
75 days at $225 (fair rental) per day	$16,875	
10 days at $100 per day	1,000	
Less: advertising and realtor fees	(2,200)	
Gross rental income	$15,675	$15,675
Mortgage interest and taxes		
Mortgage interest ($15,000 × 62.5%)	$ 9,375	
Real estate taxes ($2,800 × 62.5%)	1,750	
Total allowable interest and taxes	$11,125	(11,125)
Remaining income for other expenses		$ 4,550
Other expenses		
Insurance ($900 × 62.5%)	$ 563	
Utilities ($2,400 × 62.5%)	1,500	
Repairs ($8,000 × 62.5%)	5,000	
Marina charges ($2,600 × 62.5%)	1,625	
Homeowners association fees ($3,000 × 62.5%)	1,875	
Total other expenses	$10,563	$10,563
Allowable other expenses (lesser of $4,550 or $10,563)		(4,550)
Carryover to next year		$ 6,013
Remaining income for depreciation	$ 0	
Depreciation ($2,000 × 62.5%)	1,250	
Allowable depreciation	0	
Total depreciation carryover to next year	$ 1,250	1,250
Total carryover to next year		$ 7,263
Mortgage interest that may be deductible on Schedule A ($15,000 − $9,375)	$ 5,625	
Real estate taxes that may be deductible on Schedule A ($2,800 − $1,750)	1,050	
Total allowable Schedule A deductions	$ 6,675	

32. IRC §280A(d)(2)(C).

Under the Tax Court method, the rental allocation fraction for mortgage interest and taxes is 20.5%, because it uses the total number of days in the year as the denominator (75 rental days ÷ 365 = 20.5%). For the other expenses and depreciation, the IRS allocation fraction (62.5%) is used.

Tax Court Method

Gross rental receipts		
75 days at $225 (fair rental) per day	$16,875	
10 days at $100 per day	1,000	
Less: advertising and realtor fees	(2,200)	
Gross rental income	$15,675	$15,675
Mortgage interest and taxes		
Mortgage interest ($15,000 × 20.5%)	$ 3,075	
Real estate taxes ($2,800 × 20.5%)	574	
Total allowable interest and taxes	$ 3,649	(3,649)
Remaining income for other expenses		$12,026
Other expenses		
Insurance ($900 × 62.5%)	$ 563	
Utilities ($2,400 × 62.5%)	1,500	
Repairs ($8,000 × 62.5%)	5,000	
Marina charges ($2,600 × 62.5%)	1,625	
Homeowners association fees ($3,000 × 62.5%)	1,875	
Total other expenses	$10,563	$10,563
Allowable other expenses (lesser of $12,026 or $10,563)		(10,563)
Carryover to next year		$ 0
Remaining income for depreciation ($12,026 − $10,563)	$ 1,463	
Depreciation ($2,000 × 62.5%)	$ 1,250	
Less: allowable depreciation (lesser of $1,250 or $1,463)	(1,250)	
Total carryover to next year ($1,250 − $1,250)	$ 0	
Mortgage interest that may be deductible on Schedule A ($15,000 − $3,075)	$11,925	
Real estate taxes that may be deductible on Schedule A ($2,800 − $574)	2,226	
Total allowable Schedule A deductions	$14,151	

Which allocation method should be used depends on each taxpayer's circumstances. When a bedroom in a residence is used exclusively for guests and the host uses the residence for personal purposes for the entire year, there is no difference in results between the two methods. This is because the denominator will be the total days in the year for all expenses for both methods. The methods differ only when there are days in the year during which there is neither rental nor personal use.

In deciding which allocation method to use, other factors affecting a taxpayer's return must be considered, such as the following.

- Whether the taxpayer can benefit from itemized deductions
- Whether the taxpayer may reasonably be expected to benefit from disallowed deduction carryovers
- Whether the taxpayer has suspended passive activity losses that could be used against net rental income

Tax Reporting. There seems to be some confusion over whether to report Airbnb rentals on Schedule E or Schedule C. Another item that causes confusion is the 7-day rule for rental activities under the passive activity limitations. In addition, many Airbnb hosts may not understand under what circumstances their income is subject to SE tax.

Schedule E is used to report real estate rental activities. Rental activities are not subject to SE tax when there is a net profit. If the rental activity results in a loss, it is treated as a passive activity. The loss can be deducted in accordance with passive activity limitations. As discussed in the next section, however, Airbnb rentals can become SE income for hosts who provide significant services to their guests.

Significant Services and SE Tax. IRC §1402(a)(1) excludes real estate rental income from net SE earnings. Treas. Reg. §1.1402(a)-4 provides an exception for rentals in which the taxpayer provides significant services to the tenant in addition to furnishing the rental property itself. [33]

> *Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, the collection of trash, and so forth, are not considered as services rendered to the occupant.*

It is common for hosts to provide amenities to guests in addition to a sleeping room. The basic amenities include linens, blankets, towels, and perhaps toiletries, but many hosts go beyond the basics in their efforts to please guests and to earn good reviews.[34] As the level of guest amenities rises, there is a possibility that the host may cross the line between providing services attributable to the property and instead provide services to the guest.

Observation. Some Internet chatrooms indicate that all an Airbnb guest expects is a clean place with the basics, such as soap, towels, sufficient toilet paper, and an overall comfortable place to stay. Other chatrooms encourage competition among hosts to increase rankings and positive reviews. Guest expectations may drive more and more hosts to provide additional amenities beyond those associated with the room itself. This could include such services as local guides; welcome gifts such as wine, fruit baskets, or candy; sleeping masks; toiletries; hairdryers; umbrellas; and breakfast items. One host even provides free airport, bus, or train pickup and drop-off.

Although published authority in this area is sparse, one 1973 case stands out.[35] David Johnson owned and operated a marina and fishing camp as a sole proprietor. He had income from rentals of boat sheds and a net profit from the fishing camp. The following are services Johnson provided to boat owners who rented space in the boat sheds.

- Providing gas and oils
- Selling of sundry items at his store
- Making arrangements for others to repair the boat owners' boats and motors
- Recharging of batteries
- Loaning of boat paddles, cushions, and other gear useful in the operation of boats
- Providing fishing tips
- Checking daily for overdue boats and reporting the overdue boats to the local conservation department

Johnson received payment for gas, oil, fishing tackle, and items sold to boat owners. The other services he provided at no cost. The IRS assessed an SE tax deficiency because it treated Johnson as providing significant services to the boat owners who rented space in his shed.

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33. Treas. Reg. §1.1402(a)-4.

34. *DIY Hosting Tips: Unforgettable Amenities Made Easy.* Aug. 15, 2014. Airbnb, Inc. [blog.airbnb.com/amenities-diy-hosting-tips] Accessed on Mar. 12, 2017.

35. *Johnson v. Comm'r,* 60 TC 829 (1973).

The Tax Court cited social security benefit cases in which rentals that included the provision of significant services to the tenant constituted earned income for purposes of reducing a retiree's benefits. Those cases held that the IRC §1402(a)(1) exception from SE tax for rentals should be narrowly restricted to payments for occupancy only. Any service not clearly required to maintain the property in condition for occupancy should be considered work performed for the tenant. The Tax Court ruled that the same narrow construction should be applied for SE tax purposes so there would be symmetry between the social security eligibility provisions and the corresponding Code provisions regarding SE income.

The court then determined that the gratuitous services provided by Johnson to the boat shed renters were not those usually or customarily provided in connection with the rental of space in a boat shed. Therefore, they constituted significant services and subjected his rental income to SE tax.

In *Bobo v. Comm'r,*[36] the Tax Court again addressed the issue of when services are significant. The Bobos owned a 46-space mobile home park of which most spaces were occupied by owners of their mobile homes and eight spaces were occupied by tenants of mobile homes owned by the Bobos. They provided gas, water, sewer, metered electrical connections, garbage collection, and washers and dryers owned by a third party concessionaire. The washers and dryers were required by state law and the Bobos received a commission from the concessionaire. The mobile home park grounds were paved with concrete and asphalt so that no landscaping maintenance was required.

Mr. Bobo was disabled and received Social Security payments. Mrs. Bobo occasionally visited the park, but overall operation was handled by a resident manager who collected rents, cleaned the laundry facilities, rented mobile homes when tenants moved out, and swept leaves. The manager worked approximately three hours per week. No additional services were provided to the tenants of the eight mobile homes and no recreational facilities or public telephones were provided to the park. The IRS assessed a SE tax deficiency on the basis that the Bobos were providing significant services to the tenants and that the rent therefore constituted net earnings from self-employment.

Citing a non-tax social security case dealing with the issue of whether significant services were provided to tenants,[37] the Tax Court noted there are two factors that must be analyzed.

1. Whether services are **required** for purposes of **maintaining a space in a condition for occupancy**
2. Whether **additional services** are of **such a substantial nature** that the compensation for those services could be said to constitute a **material part** of the tenant's rent payment

The Tax Court found that all of the services other than the washers and dryers constituted services provided solely for purposes of occupancy. Supplying washers and dryers and the cleaning of that space was a service for the tenants, not for occupancy, and the fact that it was operated through a third party concessionaire was irrelevant. The Tax Court concluded, however, that the service was not substantial enough that a material part of the rent payments could be said to be for the washers and dryers rather than occupancy. It was not separately stated, billed, and paid for, but was merely an incidental and minor service to occupants who paid rent primarily for space.

36. *Bobo v. Comm'r,* 70 TC 706 (1978), *acq.* AOD/CC 1983-030 (Sep. 19, 1983).

37. *Delano v. Celebrezze,* 347 F.2d 159 (9th Cir. 1965).

Although the Tax Court used the terms "substantial" and "material," those terms must be interpreted in light of a narrow interpretation applicable to the rental real estate exclusion from the definition of earned income for SE tax purposes. Under that rationale, Airbnb hosts who provide amenities beyond those necessary for occupancy may be providing significant services that subject their rental income to SE tax. There is currently no guidance about which or how many guest amenities create a risk that the income will be considered self-employment. As in Johnson's case, any amenities that go beyond those necessary to provide the rental space itself to a guest create a potential for SE tax liability. In the *Delano* case cited by the Tax Court in *Bobo,* the Ninth Circuit reversed a Social Security Council denial of retirement benefits to Delano because he should have been treated as having Social Security retirement earnings as a result of performing significant services for tenants of apartments. The court said the following about the role of significant services.[38]

> *The Council also erred in holding that non-excluded services were gratuitously performed because the leases did not obligate the owners to perform them. Appellant had no intention of conferring a gratuity. The services were rendered as a part of appellant's total effort to satisfy his tenants and thus assure the profitable operation of the business. They were a portion of the total package of rights and services which was extended to the tenants and for which the tenants were willing to pay, and the record indicates that their availability played a part in maintaining full occupancy of the apartments.*

Passive Activity Limitations. A passive activity is defined in IRC §469(c)(1) as any trade or business in which the taxpayer does not materially participate. IRC §469(c)(2) adds that **any** rental activity is a passive activity. For this reason, rental activities are referred to as "per se" passive activities. This means they are passive activities simply because they are rentals, and material participation is therefore irrelevant in their classification. There are instances under the regulations, however, when rental activities are recharacterized as trades or businesses. By treating the rental activity as a trade or business, a taxpayer can make the activity nonpassive through material participation.

Temp. Treas. Reg. §1.469-1T states that if the average period the property is rented by customers is seven days or less, then for passive activity purposes, the rental is treated as a trade or business and not as a passive activity.[39] This recharacterization rule often leads individuals to think property rented an average of seven days or less must be reported on Schedule C. This is **not** the case. The recharacterization applies **only** for purposes of applying the passive activity rules under §469. In fact, the regulations specifically say the following.[40]

> *Neither the provisions of section 469(a)(1) . . . nor the characterization of items of income or deduction as passive activity gross income . . . or passive activity deductions . . . affects the treatment of any item of income or gain under any provision of the Internal Revenue Code other than section 469.*

Unless a host has a loss from Airbnb rentals, the 7-day rule is not an issue. If the host has a loss and the average period of customer rental is seven days or less, the host must materially participate or the loss becomes a suspended passive activity loss. As such, the loss can be used only against future passive activity income or upon disposition of the entire activity.

Note. If the taxpayer's average period of customer rental is seven days or less and there is a loss from the rentals, the $25,000 special allowance under §469(i) is not applicable because the rental is treated as a trade or business and not as a rental real estate activity.

Note. For a detailed explanation of material participation, limitations on passive activity losses, and the $25,000 special allowance, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Passive Activities. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

38. Ibid.

39. Temp. Treas. Reg. §1.469-1T(e)(3)(ii)(A).

40. Temp. Treas. Reg. §1.469-1T(d)(1).

Renting Parking Spaces

In residential areas surrounding sporting venues, it is common for homeowners to offer parking spaces for rent in their driveways and yards. Mobile apps enable drivers to find private parking spaces for rent, either from commercial parking lots or individuals, nonprofits, or other businesses with surplus parking spaces available. MonkeyParking is an app that was started in San Francisco, which enabled individuals to offer public parking spaces on city streets. The city of San Francisco and other cities enacted ordinances against this practice because the individuals renting out the spaces did not actually "own" them. The app is still available for renting privately owned spaces.[41]

Tax Issues. Renting privately owned parking spaces constitutes real estate rental, and payments are therefore ordinary income. Unless the lessor is providing significant services, such as security or carwashes, the income is not subject to SE tax.

> **Note.** Some municipalities have realized there is a potential for city revenue and now require homeowners to obtain permits or licenses to be able to rent residential parking spaces.[42]

In *Roy v. Comm'r*,[43] the Tax Court ruled that the yard area surrounding a residence is part of the residence for purposes of the residential rental limitations of §280A. IRC §280A (discussed earlier) permits a homeowner who rents parking spaces for fewer than 15 days (e.g., during a college football season) to exclude the income legally.

Event Ticket Resellers

Ticket brokers (or scalpers) may use automated computer programs or other means to obtain many of the best tickets for sporting or entertainment events, intending to sell them at a premium. Ticket brokers are in the business of reselling tickets and are responsible for paying taxes on their net income.

> **Note.** Some ticket purchasing sites often require the completion of a CAPTCHA (Completely Automated Public Turing test to tell Computers and Humans Apart) to prevent or minimize the automated purchase of large ticket quantities.

Tax Issues. Many individuals resell tickets that they cannot use, or resell them with the intention of making a profit. As a practical matter, many of these individuals may not realize they have taxable income, or they simply choose to ignore it.

Sale of Unused Tickets. Tickets purchased for personal use are capital assets under IRC §1221. Tickets sold at a gain generate a capital gain. Usually, the gain is short-term and taxed as ordinary income. Losses on the sale of personal-use assets are not deductible, even as an offset to capital gain.

Sale of Appreciated Tickets. When tickets for an event rapidly appreciate, the ticket owner may decide to sell the tickets to make a profit. If the ticket owner purchased tickets with the intent to use them but later sold the tickets because of the high secondary market price, the result is generally the same as for selling unused tickets.

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41. *Kicked Out of San Francisco, Monkey Parking App Plans a Fresh Start in Santa Monica.* Maddaus, Gene. Sep. 18, 2014. LA Weekly. [www.laweekly.com/news/kicked-out-of-san-francisco-monkeyparking-app-plans-a-fresh-start-in-santa-monica-5080436] Accessed on Mar. 17, 2017.

42. See, e.g., *San Bruno Orders Homeowners to Stop Renting Out Driveway.* Barnard, Cornell. Sep. 30, 2015. ABC, Inc. [http://abc7news.com/traffic/san-bruno-orders-homeowners-to-stop-renting-out-driveway/1011078/] Accessed on Mar. 17, 2017; *How to Make $250 a Month Renting Out Your Driveway or Parking Space.* Pope, Kristen. Jun. 27, 2015. The Penny Hoarder. [www.thepennyhoarder.com/jobs-making-money/side-gigs/rent-your-driveway-parking-apps] Accessed on Mar. 17, 2017; *Parking Space Rental Tax is Now Law!* Fix, David. Mar. 2013. AOA. [www.aoausa.com/magazine/?p=1053] Accessed on Mar. 10, 2017.

43. *Roy v. Comm'r,* TC Memo 1998-125 (Mar. 31, 1998).

Purchased with Intent to Resell. If the purchaser's intent is to resell tickets at a profit, the issue becomes whether the reseller is a ticket dealer. In making this determination, the factors of profit motive, continuity, and regularity are considered. Selling a number of tickets at a profit over a period of months may meet these requirements. Unlike the first two types of resellers described above, a ticket purchaser who intends to resell tickets at a profit and who continues this activity is likely to come under IRS scrutiny.

Many resellers use StubHub or other online facilitators to sell their tickets. These facilitators are payment settlement entities (PSEs). The PSEs issue Forms 1099-K to high-volume resellers who reach the $20,000 or 200 transactions threshold (discussed later), and the IRS matches these information returns with the taxpayer's tax return.

Tax Reporting. Individual resellers of tickets report the gain on Schedule D, *Capital Gains and Losses*. The ticket dealer reports their income and expenses on Schedule C, and their income is subject to SE tax.

Online Selling

For some, eBay may seem like an online garage sale. Even for an occasional disposition of personal property, the seller technically has gross income from which basis is subtracted to arrive at a gain or loss. A gain is either a long- or short-term capital gain. Losses on personal-use assets are not deductible and cannot offset capital gain.

Tax Issues. When an individual goes beyond selling a few personal items and intentionally buys merchandise for resale on eBay, the IRS may determine that the individual is in a trade or business because the Form 1099-K discloses income. In that situation, the goods become inventory and the seller is entitled to a deduction for the cost of goods in determining gain or loss.

INFORMATION REPORTING COMPLIANCE

Form 1099-K

Online contributions to crowdfunding sites, payments to Uber and Lyft drivers, merchant sales on Amazon, and transactions on eBay, Etsy, and other e-commerce websites are made with credit or debit cards. The entities that collect the payment, or the third party handling the credit card charges are PSEs that may be required under IRC §6050W to file Form 1099-K (reproduced below).

☐ CORRECTED (if checked)

FILER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.	FILER'S federal identification no. PAYEE'S taxpayer identification no. 1a Gross amount of payment card/third party network transactions $	OMB No. 1545-2205 2017 Form 1099-K	Payment Card and Third Party Network Transactions
Check to indicate if FILER is a (an): Payment settlement entity (PSE) ☐ Electronic Payment Facilitator (EPF)/Other third party ☐ Check to indicate transactions reported are: Payment card ☐ Third party network ☐	1b Card Not Present transactions $ 3 Number of payment transactions	2 Merchant category code 4 Federal income tax withheld $	Copy B For Payee
PAYEE'S name Street address (including apt. no.) City or town, state or province, country, and ZIP or foreign postal code	5a January $ 5c March $ 5e May $ 5g July $	5b February $ 5d April $ 5f June $ 5h August $	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
PSE'S name and telephone number	5i September $ 5k November $	5j October $ 5l December $	
Account number (see instructions)	6 State	7 State identification no.	8 State income tax withheld $ $

Form **1099-K** (Keep for your records) www.irs.gov/form1099k Department of the Treasury - Internal Revenue Service

For the calendar year, the PSE is required to issue Form 1099-K if **both** of the following are satisfied.[44]

1. The gross amount of total reportable payment transactions exceeds $20,000.
2. The total number of such transactions exceeds 200.

When a Form 1099-K is issued to a taxpayer and that taxpayer fails to report the transactions on their tax return, the IRS issues a CP2000 notice, proposing a deficiency based on the gross proceeds shown on the Form 1099-K.[45] If the transactions involve selling products — such as on eBay, Etsy, or a reward-based crowdfunding campaign — the IRS may assess SE tax in addition to income tax. The burden falls on the individual to respond to the IRS.

Note. Campaign organizers should be careful when establishing a campaign on a crowdfunding website. The campaign should be in the name and tax identification number (TIN) of the individual for whose benefit it is organized. Any Form 1099-K will then be issued to that individual.

Caution. Although the IRS might abate a SE tax deficiency if the individual had only a few casual sales, the IRS may demand that the individual prove their basis in the sold assets. (See "Proving Basis" section later in this chapter.)

Caution. Although amounts reported on a Form 1099-K should not also be reported on a Form 1099-MISC*,* this does occur at times. Taxpayers must reconcile Forms 1099-K and Forms 1099-MISC to gross receipts to avoid double reporting. For example, Uber issues a Form 1099-MISC for certain driver nonfare benefits in addition to issuing a Form 1099-K for all credit card charges. As mentioned earlier, Uber issues Forms 1099-K to all drivers, not just to those who have reached the threshold. Other e-commerce sites issue Forms 1099-K only to drivers who reach the threshold.

Reporting Transactions on Form 1099-K.[46] Form 1099-K reports the amount of credit card transactions processed by a PSE for a participating payee (any person accepting credit card payments). Because the participating payee must provide their TIN to the e-commerce site, multiple accounts with the same TIN are aggregated to determine whether the threshold is reached.[47] Accounts on different sites, such as eBay and Etsy, are not aggregated unless the individual uses the same PSE, such as PayPal, to receive payments from both.

Box 1a of Form 1099-K reports the gross amount of credit card charges. No reduction should be made for fees, refunds, chargebacks, sales taxes, or other costs and refunded amounts. The full amount of the Form 1099-K should be reported on a tax return except that cashback is given to the customer making the charge; therefore, it is not includable in gross receipts and is not deductible as a business expense. Taxpayers must therefore have detailed records to permit reconciliation of their actual business receipts and expenses to the Form 1099-K.

Box 1b reports transactions not actually accomplished via a card terminal. This includes charges made online.

44. IRC §6050W(e).

45. See *Understanding Your CP2000 Notice.* IRS. [www.irs.gov/individuals/understanding-your-cp2000-notice] Accessed on Feb. 10, 2017.

46. Instructions for Form 1099-K.

47. See, e.g., *Does Paypal Combine Business EIN Payments & Personal Account SSN $ to Meet 1099 IRS Threshold?* PayPal Community Help Forum. [www.paypal-community.com/t5/About-Payments-Archive/Does-Paypal-combine-Business-EIN-payments-amp-Personal-account/m-p/1013811]. Accessed on Mar. 10, 2017.

Box 2 is for the payee's merchant category code (MCC). It is important that the MCC correctly describe the payee's business.[48] The IRS uses data accumulated on various industries throughout the years to determine the approximate mix of cash and card transactions those industries typically have. By comparing a business's income tax return with its Forms 1099-K, the IRS can assess whether the business appears to be properly reporting its cash receipts. If the MCC is incorrect, the payee should contact the PSE to request a corrected Form 1099-K.

> **Example 3.** Assume IRS statistics show that convenience store gross receipts should be approximately 60% credit and debit cards and 40% cash. The income tax return of PDQ, a chain of convenience stores, shows a ratio of 75% card transactions and 25% cash. PDQ may be subject to IRS inquiries because the statistics indicate that the business may not be reporting all of its cash receipts.

Box 3 of the Form 1099-K shows the total number of payment transactions processed through the payment card or third party network.

Box 4 shows the federal income tax withheld.

Boxes 5a–5l shows the gross amount paid each month. The total of the monthly amounts should equal the amount reported in box 1a.

Boxes 6–8 provide space for reporting to two different states. Several states require PSEs to file copies of Forms 1099-K with them and may require income tax withholding for permitted payees in their states.

Reconciliation. When reconciling gross receipts to Forms 1099-K, transactions not attributable to the business should be eliminated and documented. Such transactions include the following.

- Transactions from more than one person on a shared terminal
- Transactions made before a purchaser buys a business or after a seller sells a business that are still reported under the purchaser's or seller's TIN
- Changes in business structure not reflected in the records of the PSE
- Cashback to customers
- Using a single card terminal for more than one line of business of the same person

Proving Basis

Some taxpayers could face an unanticipated problem even for nonbusiness sales of items through Internet portals. It is a general rule of tax law that a taxpayer unable to prove their basis in property sold can be required to use a zero basis.[49] It may be difficult for a taxpayer to prove basis in property sold when the property was purchased many years ago and the taxpayer did not retain receipts for the personal assets. However, a taxpayer in that situation may be able to salvage some basis.

For business purposes, the loss of records through casualty or other unavoidable means does not relieve the taxpayer from the requirement to substantiate deductions. Even when the taxpayer's records are lost by the IRS during an audit, the taxpayer still is required to substantiate claimed deductions.[50] When the taxpayer's records are lost or destroyed, the taxpayer may be able to use an alternative method to substantiate the deductions. In rare cases, the sole evidence may be the taxpayer's uncontradicted and credible testimony. This is referred to in general as the **Cohan rule.**

48. MCCs can be found in Rev. Proc. 2004-43, 2004-2 CB 124.

49. See, e.g., *Namyst v. Comm'r,* 435 F.3d 910 (8th Cir. 2006).

50. See, e.g., *Cook v. Comm'r,* TC Memo 1991-590 (Dec 2, 1991).

The Cohan rule comes from a 1930 case.[51] That case established a rule of "indulgence" for deductions, which are otherwise subject to strict rules. Under the Cohan rule, when a taxpayer is unquestionably entitled to a deduction but the amount is not adequately substantiated, the court may make an allowance based on an estimate. The court must be convinced of both of the following.

1. The taxpayer actually incurred the expense.
2. There is some basis upon which to estimate the allowance.

The Cohan rule cannot be used if the taxpayer has access to evidence to support deductions but fails to produce that evidence or if there is no evidence at all to support entitlement to the deductions. In addition, under IRC §274(d), the Cohan rule does not apply to travel, entertainment, gifts, and listed property expenses.

Although the Cohan rule is pro-taxpayer, the taxpayer also bears a heavy burden of proof. In practical terms, a taxpayer trying to establish entitlement to deductions under the Cohan rule is usually allowed to claim estimated expenses that are significantly less than those originally claimed on the return.

The Cohan rule is not only used in court. It can be used in audits and appeals as well, although a taxpayer will probably be less successful with this approach at the audit level, especially given that most audits are correspondence examinations involving CP2000 notices. It may be necessary for a taxpayer to go through the appeals process or even file a petition in Tax Court.

Although the Cohan rule is usually considered in connection with business expenses, courts have applied it in other contexts. This includes estimating asset basis, as shown by *Marcus v. Comm'r*.[52] Following the death of her stepfather in 1980, Maria Marcus inherited a one-third interest in her mother's real estate in Italy. The mother died in 1970 and left the stepfather the equivalent of a life estate in the mother's property. Maria and her two sisters, both of whom lived in Europe, disagreed over the handling of the property. They resolved the matter by entering into an agreement in 1980, under which the other two sisters would give Maria one-third of the proceeds from any liquidation of the real estate. In 1990, Maria received $38,000 from the sale of some of the real estate but did not include it on her 1990 income tax return. The IRS assessed a deficiency based on the inclusion of the entire $38,000 in gross income.

The Tax Court concluded that Maria received the $38,000 with respect to inherited property, the basis of which is its fair market value (FMV) on the mother's date of death in 1970. Maria, however, had no idea of its value on that date or at any subsequent time. Under IRC §102, she claimed an exclusion for the entire $38,000 as an inheritance. She testified that her sister in Italy told her the property had decreased in value between 1970 and 1990. The Tax Court, noting that Maria would have shared in any post-1970 appreciation and depreciation in the property's value, cited the Cohan rule in awarding her $25,000 of basis (a number simply chosen by the judge).

The use of the Cohan rule is very dependent on the facts and circumstances of each individual case. Consequently, no threshold exists that, once satisfied, automatically entitles a taxpayer to estimate deductions under the Cohan rule. To the extent there is a commonality in the cases, it is the taxpayer's **credibility** in the eyes of the court and the efforts of the taxpayer to establish evidence substantiating deductions. Keeping in mind the requirement for credibility, the following is a discussion of some of the means that a taxpayer may use to produce evidence of basis.

- **Testimony of the taxpayer.** If no other documentation is available, the court may accept the taxpayer's credible testimony to substantiate a deduction as it did in Maria Marcus's case. Because this is self-serving testimony, however, the court will closely scrutinize the details of the taxpayer's testimony and the demeanor of the taxpayer on the witness stand. As a witness, the taxpayer must appear open and candid. The more details a taxpayer can provide concerning deductions, the more credible the testimony. Testimony should not be vague or contradictory. Although it is rare for deductions to be allowed solely on the basis of the taxpayer's testimony, credible testimony greatly strengthens a case in which secondary evidence is otherwise weak.

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

52. *Marcus v. Comm'r,* TC Memo 1996-190 (Apr. 22, 1996).

- **Third-party testimony.** Testimony by third parties is subject to the same credibility standard as testimony by the taxpayer. The testimony must make it apparent that the third party was sufficiently involved in a transaction for which the taxpayer claimed a deduction, such that the third party can offer testimony as to specific details of the transaction. Vague, generalized testimony by a third party is not very helpful. Testimony by a related party is subject to a higher standard of credibility because of the obvious lack of arm's-length dealing.

- **Third-party sources.** Third parties can sometimes provide secondary evidence of basis. Taxpayers attempting to use the Cohan rule must make a diligent effort to obtain whatever third-party evidence might be available to corroborate claims of deductions. If there is a reason why those third-party records cannot be produced, the taxpayer should be prepared to show the court that they made the effort and explain why it was not successful. Failure to produce obvious third-party records without a good reason is damaging to a case.

- **Checks and credit card statements.** Canceled checks, bank statements, check registers, and credit card statements when coupled with credible testimony may constitute acceptable secondary evidence of purchase prices of assets.

- **Online accounts.** A taxpayer may be able to retrieve records of purchases through accounts with online vendors.

- **Search engines.** The Internet is a repository of an incredible amount of information, much of which apparently is never deleted. It may be possible to find what a particular item or one similar to it cost when purchased new even if the item was purchased many years ago.

If inherited property was sold, as in Maria Marcus's case, efforts should be made to find evidence of its FMV on the applicable date of death. Gifted property may be more problematic because of carryover basis.

IRC §1015(a) states the general rule that the donee of gifted property takes the same basis the property had in the hands of the donor. It then goes on to say the following.

> *If the facts necessary to determine the basis in the hands of the donor or the last preceding owner are unknown to the donee, the Secretary shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Secretary finds it impossible to obtain such facts, the basis in the hands of such donor or last preceding owner shall be the fair market value of such property as found by the Secretary as of the date or approximate date at which, according to the best information that the Secretary is able to obtain, such property was acquired by such donor or last preceding owner.*

Although there are surprisingly few cases dealing with this provision,[53] the following principles apply to its application.

- Although the taxpayer generally has the burden of proof, the IRS cannot arbitrarily give the taxpayer a zero basis for purposes of determining gain on a disposition of gifted property unless the IRS can show it has no way of determining the property's carryover basis or its FMV.

- In the absence of proof by the taxpayer, courts are likely to sustain the IRS if its determination of FMV is at all reasonable.

- If neither the IRS nor the taxpayer can submit reasonable evidence of basis, it is treated as zero.

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53. See the dissent of Judge Bruce in *James E. Caldwell & Company v. Comm'r,* 24 TC 597 (1955), *reversed and remanded*, 234 F.2d 660 (6th Cir. 1956) for a good discussion of this provision. The 6th Circuit reversed the Tax Court based on Judge Bruce's dissenting opinion.

SELF-DIRECTED IRAs

Self-directed IRAs permit IRA beneficiaries to control investment decisions. In many cases, when beneficiaries choose a self-directed IRA, they are simply seeking alternatives to more traditional investments.

The extent to which custodians[54] allow beneficiaries to direct investments varies widely. With most IRA trustees and custodians, even a self-directed IRA is limited to traditional types of investments such as publicly traded equities and bonds and cash accounts. Generally, few self-directed IRA custodians allow the beneficiary to truly self-direct investment decisions by investing in whatever nontraditional assets are not specifically prohibited. However, it is easy to locate custodians on the Internet who permit many forms of nontraditional investments, the most popular of which appears to be real estate. Additionally, in the last decade, self-directed IRAs or 401(k) accounts increasingly have been used as a means for beneficiaries to finance a business without taking a taxable distribution. These accounts are commonly referred to as rollovers as business startups (ROBS).

Little guidance exists regarding the use of self-directed IRAs and nontraditional investments. The IRS expressed concern about ROBS[55] and instituted a means of identifying the use of self-directed IRAs and traditional retirement plans to ascertain whether nontraditional investments are permitted (discussed later).

The two most common problems with self-directed IRAs are beneficiaries engaging in **prohibited transactions** and IRA investments that result in taxation of **unrelated business income.** Both of these issues are discussed in this section.

PROHIBITED TRANSACTIONS

IRC §4975 prohibits certain transactions between plans and disqualified persons. Although §4975 does not specifically include the beneficiary of an IRA as a disqualified person, this apparently was an oversight in drafting the law because the legislative history clearly shows they were intended to be covered. Consequently, the IRS, the Department of Labor (DOL), and the courts consistently apply §4975 to beneficiaries of IRAs.

A **prohibited transaction** is defined in §§4975(c)(1)(A)–(F) as any direct or indirect:

- **A.** Sale, exchange, or lease of any property between a plan and a disqualified person;
- **B.** Lending of money or other extension of credit between a plan and a disqualified person;
- **C.** Furnishing of goods, services, or facilities between a plan and a disqualified person;
- **D.** Transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan;
- **E.** Act by a disqualified person who is a fiduciary whereby the person deals with the income or assets of a plan in the person's own interest or for the person's own account; or
- **F.** Receipt of any consideration for their own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan (referred to in the Internal Revenue Manual as kickbacks[56]).

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54. The term "custodian" in this chapter includes both trustees and custodians.

55. *Guidelines Regarding Rollovers as Business Start-ups.* Julianelle, Michael. Oct. 1, 2008. Department of the Treasury. [www.irs.gov/pub/irs-tege/robs_guidelines.pdf] Accessed on Jan. 28, 2017.

56. IRM 4.72.11.3.6 (Dec. 17, 2015).

Under §4975(d), certain transactions are specifically excluded from the definition of prohibited transactions. The exceptions include loans from a plan to beneficiaries, payment of reasonable compensation to disqualified persons for services rendered to the plan, and reimbursement of expenses incurred in the performance of duties with the plan. Most of these exceptions are intended for qualified plans under IRC §401(a) and do not apply to IRAs.

Disqualified Person

A disqualified person is defined under §§4975(e)(2)(A)–(I) as a person who is one of the following.

A. A fiduciary

B. A person providing services to the plan

C. An employer, any of whose employees are covered by the plan

D. An employee organization, any of whose members are covered by the plan

E. An owner, direct or indirect, of 50% or more of one of the following, which is an employer or employee organization described in C or D

- **i.** The combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation
- **ii.** The capital interest or the profits interest of a partnership
- **iii.** The beneficial interest of a trust or an unincorporated enterprise

F. A member of the family of any individual described in A, B, C, or E

G. A corporation, partnership, or trust or estate, of which, or in which, 50% or more of one of the following is owned directly or indirectly or held by persons described in A–E above

- **i.** The combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation
- **ii.** The capital interest or the profits interest of a partnership
- **iii.** The beneficial interest of such trust or estate

H. An officer, director (or individual having similar responsibilities), a 10% or more shareholder, or a highly compensated employee (earning 10% or more of the yearly wages of an employer) of a person described in C, D, E, or G

I. A 10% or more (in capital or profits) partner or joint venturer of a person described in C, D, E, or G

Family members for the purpose of determining disqualified persons include an individual's spouse, ancestors, lineal descendants, and any spouse of a lineal descendant.[57] Family members **do not include** siblings or spouses of ancestors.

For purposes of ownership in corporations, partnerships, and trusts, certain attribution rules of IRC §267(c) apply.

A **fiduciary** is any person who exercises any discretionary authority or control over the management of a plan or its assets, or has discretionary authority or responsibility in its administration.[58] The **beneficiary of a self-directed IRA** is always considered a fiduciary for purposes of §4975. It is common for courts and the IRS to find that an IRA beneficiary participated in a prohibited transaction by violating their fiduciary duty.

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57. IRC §4975(e)(6).

58. IRC §4975(e)(3).

Consequences of Prohibited Transaction

Under §4975, any disqualified person other than the IRA's beneficiary who engages in a prohibited transaction with an IRA is subject to an excise tax of 15% of the amount involved in the prohibited transaction for each year (or part of a year) that the transaction continues.

In addition, any person on whom the **15%** tax is imposed is subject to an additional tax of **100%** of the amount involved if the prohibited transaction is not corrected by the earlier of:

- The date the IRS mails a notice of deficiency with respect to the 15% tax; or
- The date on which the 15% tax is assessed.

In the case of an IRA, if the beneficiary engages in a prohibited transaction, IRC §408(e)(2)(A) provides that the account **ceases to be an IRA as of the first day of the tax year** in which the prohibited transaction occurs. This applies to the entire account, not just to the amount involved in the prohibited transaction. **If this occurs,** the beneficiary is **not** subject to any of the excise taxes under §4975. Any other disqualified person engaging in a prohibited transaction with the IRA is subject to the excise tax provisions.

This can be an especially harsh treatment. In a 1988 technical advice memorandum (TAM),[59] an individual borrowed $50,000 from a profit-sharing plan of a corporation in which the individual was a one-sixth shareholder and gave the plan a promissory note. The individual also participated in a money purchase plan sponsored by the same employer.

Both plans terminated in 1983. The individual received the following distributions on December 28, 1983.

	Profit Sharing	Money Purchase	Total
Cash	$382,568	$49,112	$431,680
Note balance	41,185	0	41,185
Total	$423,753	$49,112	$472,865

On January 30, 1984, the individual rolled over the cash and note to an IRA and treated it as a tax-free rollover. The IRS ruled that the transfer of the individual's promissory note to the IRA was a prohibited transaction because the continuation of the note in the IRA effectively constituted a loan from the IRA to the individual. Under IRC §408, the IRA ceased being an IRA as of January 1, 1984. This meant the rollover was to an account that was not an IRA, and the transfer was not eligible for rollover treatment. As a result, the entire $472,865 was includable in the gross income of the individual.

Observation. This result is unlikely to happen today because qualified plan administrators usually treat any unpaid plan loan as a distribution if not repaid at the time an individual terminates participation in the plan.

Although there are instances in which the IRS waived the excise tax under §4975, no instances have been found in which the IRS waived the disqualification under §408.

Planning Tip. Only the account in which the prohibited transaction occurred is deemed distributed. When an IRA is invested in different assets, it may be wise to consider establishing a separate IRA for each investment if there is any possibility of a prohibited transaction.

59. TAM 8849001 (Aug. 30, 1988).

Prohibited Transaction Exemptions

Although §4975 is part of the Internal Revenue Code, the DOL has exclusive authority under §4975(c) to grant exemptions from the prohibited transaction rules. The DOL rulings are known as **prohibited transaction exemptions** (PTEs). The DOL issues PTEs upon request for such things as cash sales of stock to beneficiaries to enable a corporation to elect subchapter S and cash sales of real estate from an IRA to the beneficiary. The DOL also issues **advisory opinions** for prospective transactions (similar to private letter rulings) if there is concern that a transaction might be prohibited. Notices of proposed PTEs are frequently published in the Federal Register for a period of public comment before final issuance.[60]

The most common PTEs for IRAs address transfers of property between an IRA and the beneficiary either as a sale or to fund a required minimum distribution (RMD) to the beneficiary. For example, one PTE permitted the beneficiary of an IRA to purchase shares of a closely held corporation that was a disqualified person so the corporation could elect S status.[61]

Examples of Prohibited Transactions

There is a developing body of judicial and administrative guidance illustrating how IRAs are affected by prohibited transactions. The most important lesson is that, although self-directed IRAs are perfectly legitimate, the rules are complicated and the consequences of violations can be severe. Courts are quick to look beyond the form of transactions to the substance in determining whether there is any direct or indirect prohibited transaction.

> **Note.** Individuals contemplating nontraditional investments for their self-directed IRAs should consider seeking guidance from a professional who is knowledgeable about ERISA (Employee Retirement Income Security Act of 1974).

Extending Credit. Shareholders of closely held corporations are frequently required to guarantee loans to their corporation. This is not allowed when a self-directed IRA owns the corporation.

In *Peek, et al. v. Comm'r,*[62] two individuals established traditional IRAs in 2001. They formed FP Company and directed their new IRAs to use rolled-over cash to purchase 100% of FP Company's newly issued stock. They used FP Company to acquire the assets of AFS Corporation. The individuals personally guaranteed loans of FP Company that arose out of the asset purchase. In 2003 and 2004, they rolled over the FP Company stock from their traditional IRAs to Roth IRAs, including the value of the stock in their income. In 2006, after the FP Company stock's value had significantly appreciated, they directed their Roth IRAs to sell all the FP stock. Their personal guaranties on the loans of FP Company continued until the stock sale in 2006.

The IRS challenged their transactions, and the Tax Court held that the taxpayers' personal guaranties of the FP Company loan were prohibited transactions. As a result, the taxpayers' IRAs ceased to be qualified IRAs in 2001 when the original loan guarantees were made. When the Roth IRAs were established in 2003 and 2004, they ceased to be qualified Roth IRAs when funded with FP Company stock because the prohibited transactions continued with those accounts. Consequently, the gains realized in 2006 and 2007 from the sales of FP stock were includable in the taxpayers' income because the accounts holding the stock at that time were not Roth IRAs.

> **Note.** If a taxpayer nonfraudulently omits more than 25% of gross income, IRC §6501(e)(1)(A) provides a 6-year statute of limitations for assessment of a deficiency. The 6-year statute had probably expired in this case.

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60. See *29 CFR 2570 Prohibited Transaction Exemption Procedures Employee Benefit Plans.* Department of Labor. [www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/exemptions/class/pte-procedures] Accessed on Jan. 10, 2017.

61. DOL Authorization 08-09E, Craig E. Pines IRA Application E00598 (Oct. 29, 2008).

62. *Peek, et al. v. Comm'r*, 140 TC 216 (2013).

> **Note.** For more information about the *Peek* case, see the 2013 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 5: Rulings and Cases. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

In a 2016 case,[63] James Thiessen and his wife left their employment, and Mr. Thiessen looked for a metal fabrication business to buy. A broker from a business brokerage firm advised Mr. Thiessen that he could roll over his 401(k) from the former employer into a self-directed IRA and use it to buy a metal fabrication business listed with the brokerage firm. Mr. Thiessen worked with the broker, the CPA of a friend who had recently used his IRA for a ROBS, and a lawyer in structuring the purchase. The broker's firm recommended that the acquisition of an existing business be structured to include a loan from the seller because the seller would have an interest in helping the buyer in the future.

Both Mr. Thiessen and his wife rolled their 401(k)s into self-directed IRAs and used $432,000 to buy the stock of the newly formed corporation. The corporation then purchased the assets of a metal fabrication business using $342,000 of the IRA money, a $60,000 deposit from Mr. Thiessen's personal funds, and a $200,000 promissory note to the seller. The Thiessens personally guaranteed the note.

The IRS challenged the transactions. The Tax Court, citing *Peek,* found the note guarantee to be a prohibited transaction. As a result, the entire $432,000 balance in the IRAs was deemed to be distributed. Unlike *Peek,* the 6-year statute of limitations was applicable because the Thiessens did not disclose income that exceeded 25% of the gross income reported on their return.

> **Note.** For more information about the *Thiessen* case, see the 2016 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 6: Rulings and Cases.

Use of Plan Assets. *Rollins v. Comm'r*[64] involves a prohibited transaction of 401(k) plan assets under §4975(c)(1)(D). The result in this case would have been the same had it been a self-directed IRA because both IRAs and qualified plans are subject to the same prohibited transaction rules.[65]

Joseph Rollins was a CPA and registered investment advisor. He held various certifications in financial planning and investment management. He was a certified employee benefits specialist, a certified financial planner, and a chartered financial consultant.

Mr. Rollins' professional corporation had a 401(k) plan of which he was both trustee and administrator. He was also the sole shareholder and CEO of a separate corporation that offered financial counseling. The professional corporation and the counseling corporation entered into an agreement, which Mr. Rollins signed for both entities. Under the contract, the counseling corporation made all investment decisions on behalf of the professional corporation's 401(k) plan.

The 401(k) plan established various loans to three different corporations in which Mr. Rollins held minority interests. Rollins was an officer in each of those three corporations and signed the promissory notes to the 401(k) plan on behalf of the borrowing corporations. The notes all bore interest rates above market rate, and all the loans were repaid with interest.

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63. *Thiessen v. Comm'r*, 146 TC No. 7 (2016).

64. *Rollins v. Comm'r,* TC Memo 2004-260 (Nov. 15, 2004).

65. See DOL Advisory Opinion 88-18A (Dec. 23, 1988) in which the DOL warned that a loan from a self-directed IRA to a corporation, 48% of the stock of which was owned by the participant who also served as an employee and member of the board of directors, could result in a prohibited transaction. The opinion stated that the participant's interest in the corporation could affect his judgment as a fiduciary and constitute a use of plan assets to benefit a disqualified person or an act of self-dealing.

Because of his use of plan assets, the IRS determined that Mr. Rollins was a disqualified person under §4975(c)(1)(D) and that he breached his fiduciary duty under §4975(c)(1)(E). It assessed an excise tax against him as provided under §4975. (The deemed distribution rule is not applicable to 401(k)s and other qualified plans.)

Mr. Rollins argued that each loan was a sound investment, the plan earned interest above the market rate, the loans were fully secured, and they were repaid. Although he acknowledged that he was a disqualified person, he contended that none of the borrowers were disqualified persons, the loans were not transacted between the plan and him, and that he did not benefit from the loans. However, the Tax Court held that Mr. Rollins had benefited from the use of plan assets in violation of §4975(c)(1)(D).

In reaching its decision, the court extensively reviewed the legislative history of §4975 and concluded that Congress intended to replace what had been an unworkable arm's-length standard with an outright ban on any direct or indirect benefit by a disqualified person from the use of plan assets. It cited an example in the legislative history of a prohibited transaction in which the plan's assets were used to manipulate the price of a security to the advantage of a disqualified person.

The court found that Mr. Rollins **could** have derived a benefit as a significant part owner in each of the borrowing corporations because those corporations secured financing without having to deal with independent lenders. This may have enhanced the value of his ownership in those corporations. It is also possible that he derived no benefit. Because no determination could be made from the evidence in the record, it was Mr. Rollins' burden to prove by a preponderance of the evidence that the loans did not constitute a use of the plan's income or assets for his own benefit. He failed to prove this. Citing prior cases, the court further stated that the prudence of an investment and the fact that the plan benefited is not a defense to a prohibited transaction.

Conflict of Interest. The owner of a self-directed IRA is a disqualified person both as the beneficiary and as a fiduciary. IRC §§4975(c)(1)(E) and (F) apply specifically to fiduciaries. IRC §4975(c)(1)(E) prohibits a disqualified person from dealing with plan income or assets in their own interest or on their own account. IRC §4975(c)(1)(F) prohibits a disqualified person from receiving consideration for their own personal account from a party dealing with income or assets of a plan. Although these Code sections are separate prohibited transactions, the regulations treat them as together barring fiduciaries from engaging in a transaction that creates a conflict of interest between the fiduciary and the IRA. Treas. Reg. §54.4975-6(a)(5)(i) states the following.

> *The prohibitions of sections 4975(c)(1)(E) and (F) supplement the other prohibitions of section 4975(c)(1) by imposing on disqualified persons who are fiduciaries a duty of undivided loyalty to the plans for which they act. These prohibitions are imposed upon fiduciaries to deter them from exercising the authority, control, or responsibility which makes such persons fiduciaries when they have interests which may conflict with the interests of the plans for which they act. In such cases, the fiduciaries have interests in the transactions which may affect the exercise of their best judgment as fiduciaries.*

In a DOL advisory opinion,[66] Mr. Adler wanted to have his IRA purchase a 39.4% interest in a limited partnership in which he held a 6.5% interest and was the general partner. The partnership investments were managed by Bernard L. Madoff Investment Securities, which required a $1 million minimum capital investment for its services. The partnership met the minimum capital requirement, but the IRA by itself had only $500,000 and could not meet the requirement. The DOL ruled that the IRA's purchase would not be a prohibited transaction as a sale or exchange between the IRA and a disqualified person because the combined partnership interests of Mr. Adler and the IRA would be less than 50%.

66. DOL Advisory Opinion 2000-10A (Jul. 27, 2000).

The opinion went on to warn, however, that Mr. Adler was also a fiduciary of his IRA and could not cause the IRA to enter into a transaction that, by its nature, could result in a conflict of interest between the IRA and the fiduciary or a person in which the fiduciary has an interest. If a conflict subsequently develops, the fiduciary must take steps to eliminate it. The opinion further stated that, "[T]he fiduciary must not rely upon and cannot be otherwise dependent upon the participation of the IRA in order for the fiduciary (or persons in which the fiduciary has an interest) to undertake or to continue his or her share of the investment." The DOL stated that these were questions of a factual nature upon which it would not issue an opinion.[67]

Other examples of possible fiduciary conflicts of interest include the following.

- A taxpayer's purchase of stock through his IRA from an employee stock ownership plan (ESOP) was determined to be a prohibited transaction. It appeared that the transaction was not in the best interest of the IRA but was instead to provide money for the ESOP to pay off a loan and for the taxpayer to gain a larger interest in a bank's stock.[68]
- Corporation B owned 35% of the shares of Corporation A. The taxpayer was president of Corporation B and a director of Corporation A. The IRS ruled that a purchase of 5% of Corporation A stock by the taxpayer's IRA would not be a prohibited sale or exchange between disqualified persons because the combined ownership of the taxpayer and the IRA in Corporation A was less than 50%. There would be a prohibited transaction in his capacity as a fiduciary, however, if he benefited directly or indirectly from the purchase. This could occur if the IRA's stock acquisition ensured his reelection as a director of Corporation A or benefited him in his position as president of Corporation B.[69]

INVESTING

Except for statutory restrictions against collectibles[70] and life insurance contracts,[71] no assets are prohibited IRA investments. However, there may be indirect limits such as an IRA's general ineligibility to be an S corporation shareholder.[72] Consequently, investments held in a self-directed IRA can be invested in real estate, foreign property, limited partnerships, closely held C corporations, and just about anything else. The only limitation is whether a custodian is willing to accept a particular asset as an IRA investment. An investment choice can also be influenced by whether it is subject to income tax on **unrelated business taxable income** (UBTI).

An IRA can invest in any type of real estate or instrument associated with real estate such as unimproved, rental, and commercial property; trust deeds; limited partnerships, LLCs, and corporations holding real estate; tax liens; and real estate investment trusts.

Rollovers as Business Startups (ROBS)

Under the court's ruling in *Swanson v. Comm'r,*[73] **self-directed IRAs are permitted to fund ROBS.** In January 1985, Mr. Swanson, the sole shareholder of an S corporation, Tool Company, organized a domestic international sales corporation (DISC). He also created a self-directed IRA (IRA #1) for his benefit. Mr. Swanson was director and president of the DISC. On the same day that IRA #1 was established, it received 2,500 shares of the DISC's stock and became the DISC's sole shareholder.

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67. For the same reason, the IRS will not issue a ruling. See Ltr. Rul. 8009091 (Dec. 7, 1979).
68. CCA 200945040 (Sep. 24, 2008).
69. Ltr. Rul. 8009091 (Dec. 7, 1979).
70. IRC §408(m).
71. IRC §408(a)(3).
72. *Taproot Administrative Services, Inc. v. Comm'r,* 679 F.3d 1109 (9th Cir. 2012); Rev. Rul. 92-73, 1992-2 CB 224.
73. *Swanson v. Comm'r,* 106 TC 76 (1996).

For the years 1985 to 1988, Tool Company paid commissions to the DISC on Tool Company's sale of export property. During those years, Mr. Swanson, as president of the DISC, directed the DISC to pay dividends to IRA #1. The dividends totaled $593,602 during those four years. Tool Company stopped paying commissions to the DISC after December 31, 1988, because Swanson no longer considered such payments advantageous from a tax planning perspective.

In 1989, Mr. Swanson directed the trustee of his IRA to transfer $5,000 to a new self-directed IRA (IRA #2). At the same time, he created a foreign sales corporation (FSC). IRA #2 received 2,500 shares and became the sole shareholder of the FSC. In 1990, the FSC paid a $28,000 dividend to IRA #2.

The IRS issued notices of deficiency to Mr. Swanson and his wife alleging that prohibited transactions occurred within each IRA and, because of those transactions, each IRA ceased to be an IRA under §408(e)(2)(A). The alleged prohibited transactions included the following.

1. The sale of stock by the DISC and the FSC to the respective IRAs
2. The payment of dividends by these companies to their IRA shareholders

The IRS ultimately conceded the case at the administrative level and Swanson and his wife sued for attorney fees. The Tax Court, in awarding litigation costs to the taxpayers under IRC §7430, held that the IRS's position regarding prohibited transactions was not substantially justified.

The court concluded that when the initial issuance of DISC (and FSC) stock to the IRA occurred, the issuing company was not yet a disqualified person because the newly issued stock was not owned by anyone at the time of the sale. Thus, the sale of stock to the IRA was not a sale or exchange of property between a plan (the IRA) and a disqualified person within the meaning of §4975(c)(1)(A).

The payment of dividends by the DISC (or FSC) to the IRA was further held not to be the use of IRA assets for the benefit of a disqualified person within the meaning of §4975(c)(1)(D) because the dividends did not become IRA assets until they were paid.

Finally, the court ruled that the actions of arranging for IRA ownership of DISC (and FSC) stock and for the subsequent payment of dividends by the DISC (and FSC) to the IRA, considered together, did not constitute an act whereby a fiduciary directly or indirectly deals with income or assets of a plan in their own interest or for their own account within the meaning of §4975(c)(1)(E). The court noted that the IRS had not alleged that the taxpayer ever dealt with the corpus of the IRA for his own benefit, saying that the only benefit Mr. Swanson received related solely to his status as a participant in the IRAs. This benefit is one to which a disqualified person is specifically entitled under §4975(d)(9).

Ellis v. Comm'r[74] provides guidance on how a ROBS **should not be structured.** In 2005, Terry Ellis rolled his qualified plan into a self-directed IRA. He then formed CST LLC (which elected C corporation status), in which the IRA owned 98% of the membership interests and an unrelated party (not identified) owned the remaining 2%. The IRA paid a total of $319,500 to CST in exchange for its membership interest.

CST's business was used car sales. Under CST's operating agreement, Mr. Ellis was general manager and entitled to guaranteed payments for services as such. CST paid Mr. Ellis a salary of $29,000 in 2006.

Also in 2005, Mr. Ellis formed CDJ LLC, a partnership consisting of Mr. Ellis, his wife, and their children. CDJ purchased real estate. Beginning January 1, 2006, CST rented the real estate and paid CDJ a total of $21,800 during 2006.

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74. *Ellis v. Comm'r*, TC Memo 2013-245 (Oct. 29, 2013), *aff'd* 787 F.3d 1213 (8th Cir. 2015).

The IRS assessed deficiencies for both 2005 and 2006, alleging the following were prohibited transactions in one of those two years.

1. Formation of CST LLC in 2005 using IRA funds
2. Payment of compensation to Mr. Ellis by CST
3. Mr. Ellis's causing CST to enter into the lease with CDJ

The Tax Court found that forming CST did not constitute a prohibited transaction under *Swanson*. The court concluded, however, that payment of compensation to Mr. Ellis in 2005 constituted a prohibited transaction under §4975(c)(1)(E). As a fiduciary of his IRA and as general manager of CST, he indirectly dealt with the IRA assets in his own interest because he controlled both sides of the transaction. In addition, he transferred IRA assets to himself indirectly because nearly all the capital of CST consisted of IRA plan contributions that were used to fund his compensation. The Tax Court affirmed a deficiency of nearly $136,000 plus $27,000 in accuracy-related penalties for the 2005 tax year.

Because the court found one prohibited transaction, it was not necessary for it to address the lease with CDJ. Had the court done so, it is likely the lease would have constituted a prohibited transaction under §4975(c)(1)(A) because CDJ was a disqualified person under §4975(e)(2)(G).

Note. Interestingly, Mr. Ellis argued that §4975(d)(10) exempted his compensation from being classified as a prohibited transaction. Under that Code section, the payment of reasonable compensation by a plan to a disqualified person is allowed for services rendered to the plan. The court noted that Mr. Ellis provided services to CST, not to the plan, and therefore did not qualify for the exception.

Custodians who permit self-directed IRAs to form ROBS generally advise individuals that they must pay themselves salaries from the business profits. If the IRA purchases an **existing business,** there may be immediate business profits from which to pay salaries. Often, however, ROBS are used to form new businesses.

Observation. Sales of franchises as ROBS are heavily promoted on the Internet. It is unlikely that a brand-new business will generate enough immediate profit to pay a salary. The danger is that the beneficiary may be tempted to use IRA money contributed to the corporation as capital to fund a salary.

Roth IRAs and ROBS. Most custodians of self-directed IRAs do not permit the use of Roth IRAs for ROBS. Because of the abusive use of Roth IRAs, IRS Notice 2004-8 identified as "listed transactions" certain arrangements that involve holding business interests.[75] The IRS notice applies only to transactions that are substantially similar to those described in it.

These listed transactions typically involve an individual who creates a Roth IRA and minimally funds it with a contribution sufficient to enable the Roth IRA to become the sole shareholder of a newly formed C corporation. The Roth corporation then enters into some form of management contract with an existing business or businesses owned by the beneficiary. The Roth corporation receives management fees and, in turn, distributes significant dividends to the Roth IRA.

The IRS identified these as tax avoidance transactions intended to circumvent the annual contribution limitation applicable to Roth IRAs. Taxpayers must indicate their participation in listed transactions on their income tax returns or they may be subject to large penalties. The IRS notice does not completely prohibit the use of Roth IRAs for ROBS.

75. IRS Notice 2004-8, 2004-1 CB 333.

Real Estate

Real estate is a common investment for self-directed IRAs. Real estate investments include rental houses, "flip" properties, rehabs, farms, and derivatives of real estate, such as property tax certificates and loans.

> **Observation.** Many questions posted on self-directed IRA chat boards deal with investing in rehab properties through a self-directed IRA. These investments are permitted. There are, however, potentially serious limitations from a practical perspective because of how some IRA beneficiaries want to structure these transactions.

Furnishing services is a prohibited transaction under §4975(c)(1)(C). When a self-directed IRA invests in real estate that is going to be rehabbed, neither the IRA beneficiary nor any other disqualified person should perform any services in rehabbing the property. For example, if the beneficiary owns 50% or more of a construction company (including ownership attribution from related parties), the company cannot rehab the property. No authority exists to indicate that providing services is a prohibited transaction only when the disqualified person is compensated for the services. Therefore, custodians typically indicate that a beneficiary cannot perform services, even without compensation.

> **Observation.** Although some websites indicate the rehab services may be performed as long as the disqualified person receives absolutely no compensation, this is only a supposition derived indirectly from several PTE exemptions issued by the DOL regarding unrelated issues.

When an IRA makes successive investments in rehab properties, is it in the trade or business of rehabbing properties? If the activity rises to the level of a trade or business, then income from the business is subject to the tax on UBTI. Being subject to UBTI defeats the whole purpose of using the self-directed IRA because income is subject to taxation when earned by the IRA and then a second time upon distribution.

A similar income tax on unrelated debt-financed income can arise if the IRA borrows money to finance real estate. If a rehab encounters unexpected problems that increase the cost of rehabbing beyond the financial resources of the IRA, such as asbestos or lead-based paint elimination, the IRA may experience serious losses unless the beneficiary can make additional contributions from another IRA or retirement plan, or contribute within their annual limit to cover the loss.

> **Note.** See the section on "Unrelated Business Taxable Income" later in this chapter for more information about the impact of self-directed IRAs investing in real estate.

Because neither the beneficiary nor any disqualified person is generally permitted to have personal possession of any IRA assets, all expenses relating to the rehab must be handled directly by the custodian or possibly by an unrelated third party, such as an accountant, who agrees to do so for a fee. It is not clear, however, how such a third-party arrangement might work, because neither the IRS nor the DOL has issued a ruling on this.

Partnering. It is common to find self-directed IRA custodians or chat boards on the Internet recommending that a beneficiary partner with their IRA as a means of acquiring real estate investments.[76] This can be accomplished through co-ownership as tenants in common or as members of an LLC. As mentioned earlier, a fiduciary engages in a prohibited transaction if they depend upon the IRA's participation in order for the fiduciary or persons in whom the fiduciary has an interest to undertake or to continue their share of an investment. Both the DOL and the IRS have said they will not issue rulings in this area due to its factual nature.

If a beneficiary and their self-directed IRA partner to acquire real estate as tenants in common, the following problems might arise.

- The IRS could treat the partnering as a prohibited transaction that enabled the beneficiary as fiduciary to undertake the investment. According to the Tax Court in the *Rollins* case (discussed earlier), the burden of disproving a prohibited transaction is on the beneficiary. This might require, for example, that the beneficiary prove that both they and the IRA had sufficient individual assets to purchase the entire property.
- If outside financing is required, it must be nonrecourse to both parties. If it is nonrecourse only to the IRA and not the beneficiary, this would amount to an indirect extension of credit to the IRA, which is a prohibited transaction.
- If each party borrows funds, they must either have separate loans or a single loan carefully structured to limit each party's liability under the loan to their proportionate interest in the real estate. Otherwise, there may be an extension of credit between them.
- A lender will want a lien on the property to secure borrowings. The extent of the lien must be limited to a party's proportionate interest as a tenant in common so that in the event of default only that party's interest would be foreclosed. A lien on the entire property for the individual debt of either party would be an extension of credit.
- In a tenancy in common, each party is entitled to the benefit and use of the entire property but only to the extent of their share of the property's value. Each is also liable for payment of their share of expenses. If either party is unable to pay their share of expenses, the other party cannot do so for them because this would constitute a prohibited transaction.
- Commingling is not allowed. Each party's share of income and expenses must be credited to and paid from their separate accounts.
- If the separate interest of either party is foreclosed, it will likely be acquired by the lender because of the difficulty of selling an undivided fractional interest in real estate. However, the lender then becomes a tenant in common with the remaining party and can sue to have the property partitioned. In most cases, this means the property will be sold at public auction and the proceeds divided between the lender and the remaining owner in proportion to their interests. This may result in the higher value for partition of the whole property versus the lower value of a fractional interest being treated as an indirect extension of credit between the parties.

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76. See, e.g., *Partnering with Your Own Self Directed IRA to Purchase Land.* Bigger Pockets. [www.biggerpockets.com/forums/50/topics/349964-partnering-with-your-own-self-directed-ira-to-purchase-land] Accessed on Feb. 22, 2017; *5 Ways to Partner Your Self-Directed IRA.* The Entrust Group. [www.theentrustgroup.com/blog/5-ways-to-partner-your-self-directed-ira] Accessed on Feb. 22, 2017.

If the parties are instead members of an LLC that will acquire the property, the following problems may arise.

- Based on the *Swanson* case (discussed earlier), the parties would have to make simultaneous transfers of assets in exchange for their initial membership interests to avoid having a sale or exchange between disqualified persons (the members and the LLC) that would be a prohibited transaction.
- The IRS could treat the partnering as a prohibited transaction in which the LLC enabled the fiduciary to undertake the investment.
- Neither member can guarantee any debt incurred by the LLC.
- No authority exists on whether subsequent capital contributions can be made to the LLC once it becomes a disqualified person. If any contributions are made, they must be in proportion to the members' interests. Disproportionate contributions might be viewed as an indirect extension of credit by the member making them.
- Interim distributions of LLC profits to the members should be permitted, although there is no authority addressing this.
- The redemption of a member's interest by the LLC would be a sale or exchange. Therefore, the redemption is a prohibited transaction.
- No authority exists on whether distributions in liquidation of the members' interests would be treated as an exchange between disqualified persons that constitutes a prohibited transaction. *Swanson* (discussed earlier) emphasized that the entity came into being with the issuance of shares to the IRA and was therefore not a disqualified person until after that occurred. It is possible that a similar rationale might be applied to a distribution terminating the disqualified person's existence.
- In-kind distributions of nonfungible assets should be in proportion to the members' interests and as tenants in common, if necessary.
- The beneficiary-fiduciary controls all aspects of the LLC, creating the potential for conflict of interest and a prohibited transaction.

Problems with these arrangements can also affect bankruptcy filings. Generally, an individual who files bankruptcy can claim as exempt property up to $1 million of an IRA. A bankruptcy court[77] ruled that an individual's self-directed IRA was not exempt because the taxpayer had partnered with his IRA in forming an LLC to buy unimproved land for development. The court found that he had violated §§4975(c)(1)(D) or 4975(c)(1)(E) because acquisition and development of the property significantly enhanced the value of adjoining property already owned by the individual.

Caution. Even when a transaction is likely permissible under the prohibited transaction rules, caution should be exercised. In one advisory opinion,[78] the DOL opined that a loan from a self-directed IRA to a corporation, where 48% of the stock was owned by the participant who also served as an employee and member of the board of directors, could result in a prohibited transaction. According to the DOL, the participant's interest in the corporation could affect his judgment as a fiduciary and constitute a use of plan assets to benefit a disqualified person or an act of self-dealing under the prohibited transaction rules. This is true even though there might not be any current violation.

77. *In Re Kellerman*, 531 BR 219 (E.D. Ark. 2015).

78. DOL Advisory Opinion 88-18A (Dec. 23, 1988).

Required Minimum Distribution Issues. RMDs must begin by April 1 of the year after the beneficiary reaches age 70½. The RMD is a fractional portion of the IRA's value determined as of December 31 of the previous year. With traditional IRA investments, this is generally not an issue. The assets are valued using an objective standard that is easily divisible for purposes of making an in-kind distribution if desired.

An IRA holding real estate faces issues related to RMDs. The first issue concerns how to determine the fair market value (FMV) as of the previous year. This may necessitate an appraisal of the property. A question arises about how often to reappraise the property, and the requirement varies among custodians.

Another issue is that real estate is not easily divisible like shares of stock. It is possible to transfer a fractional ownership interest in real estate by using a tenancy in common, which permits different owners to have unequal fractional interests in property. The problem with this arrangement concerns how to ensure that the proper RMD is distributed. Typically, lack of marketability valuation discounts apply to fractional real estate interests, which can expose the beneficiary to the 50% excise tax for failure to take sufficient distributions.

> **Example 4.** An IRA contains real estate with a $100,000 FMV. The RMD is based on the owner's actuarial life expectancy of 20 years and is therefore $5,000 ($100,000 ÷ 20). A distribution to the IRA beneficiary of an undivided one-twentieth interest as a tenant in common in the property appears to accomplish the $5,000 distribution. However, if an appropriate marketability discount is 20%, the value of the one-twentieth interest is only $4,000, not $5,000. In this situation, the RMD amount is less than required.[79]

Unfortunately, there is no definitive means to determine the appropriate lack-of-marketability discount for any particular situation. Because of the complexities of making fractional distributions of real estate under the RMD rules, custodians may require the beneficiary to take a single distribution of the entire property or require the IRA to sell the property in order to fund distributions (if there are insufficient liquid assets for distributions). If the property itself is distributed in a single transaction, this results in the beneficiary having "phantom" income because the full FMV of the property is includable in the beneficiary's gross income as ordinary income with no cash distributed. The beneficiary then has a basis in the property equal to its FMV. If the IRA is a Roth IRA and the distribution is qualified, there is no phantom income.

There is, however, a DOL PTE[80] approving distribution of real estate owned by an IRA to the IRA's beneficiary in satisfaction of the RMD. An undivided half interest was distributed on the last banking day of the year and the remaining undivided half interest distributed on the first banking day of the following year. The short span of time between the distributions presented minimal opportunity for a conflict of interest between the beneficiary (a disqualified person) and the IRA. Two separate appraisals were obtained from qualified appraisers. Both appraisals determined the same FMV, although one was discounted due to lack of marketability.

The DOL approved the PTE on the following basis.

- The transaction was necessary to satisfy the RMD requirements.
- The conflict of interest risk was minimal.
- The terms and conditions were at least as favorable to the IRA as they would have been in an arm's-length transaction between unrelated parties.
- The property's FMV was determined by independent qualified appraisers.
- The IRA would not pay costs associated with the transaction.

The DOL also required the property's FMV to be determined without the lack-of-marketability discount.

79. IRC §4974.

80. DOL PTE 2005-17 (Dec. 28, 2005).

Checkbook IRAs

Custodian fees and the custodians' delay in processing payment for assets the beneficiary wants the IRA to purchase is a common complaint of self-directed IRA beneficiaries. In response, several websites promote **checkbook IRAs.** These arrangements provide an IRA beneficiary with indirect access to IRA money. The IRA forms an LLC of which it is the sole member. The beneficiary is appointed manager of the LLC under the operating agreement and establishes a checking account over which the beneficiary-manager has signature authority and which is funded by money from the IRA. The beneficiary-manager can then write checks directly to pay expenses or acquire assets for the LLC.

> **Observation.** Neither the IRS nor the DOL has addressed checkbook IRAs. This absence of guidance may seem to legitimize checkbook IRAs. More conservative commentators and custodians view checkbook IRAs as problematic. While the assets of an entity owned by a self-directed IRA are generally considered separate from the outside interest owned by the IRA (stock or membership interest), it is apparent from *Ellis* and developing case law that courts do not hesitate to pierce the veil of entity ownership to find indirect use of IRA assets by a beneficiary. What beneficiaries cannot do directly, they also cannot do indirectly.

Borrowing

Although some banks may make loans to self-directed IRAs, this is uncommon and can cause difficulty. In order for an IRA to borrow money, the debt must be nonrecourse. Only property that serves as collateral is available to satisfy the debt if the IRA defaults. The lender cannot go after other assets of the IRA. Lenders may require a high equity-to-loan ratio to protect them. The IRA beneficiary or any disqualified person cannot personally guarantee or in any other manner back the loan.

Banks that sell their loan portfolios are unlikely to make a loan to an IRA because the loan is not marketable. Beneficiaries may need to use a smaller bank that holds its own loan portfolios and is familiar enough with the beneficiary to enter into a nonrecourse loan with the IRA.

> **Observation.** In perusing applicable Internet chat boards, this inability to find a willing lender appears to be a serious handicap to leveraged IRA investments.

IRS Scrutiny

It appears that the proliferation of self-directed IRA investment schemes has attracted the interest of the IRS. An increasing number of taxpayers are going to court to settle disputes with the IRS about IRAs and prohibited transactions. Changes made by the IRS in response to self-directed IRA investment schemes include the following.

- Form 1065, Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.,* includes a question (part II, question I2) about whether the partner is an IRA or other retirement plan.
- Form 5498, *IRA Contribution Information,* (boxes 15a and 15b) asks specifically for the FMV of nontraded business and other IRA assets that do not have a readily available FMV.

Additionally, a 2015 Government Accounting Office (GAO) report[81] focused on the use of IRAs for nontraditional investments and their potential for enabling taxpayers to accumulate large amounts in their IRAs through investments in closely held businesses. The GAO expressed concern about the increasing potential for self-directed IRAs to be involved in prohibited transactions and noted the inability of the IRS to easily identify situations where that might occur. The GAO noted the additional information required on Form 5498 and urged the IRS to digitize that information to help it identify situations requiring attention. The GAO also questioned whether the existing 3-year statute of limitations gives the IRS enough time to find prohibited transaction violations and whether Congress should be asked to enact a longer limitations period.

81. *2015 Annual Report: Additional Opportunities to Reduce Fragmentation, Overlap, and Duplication and Achieve Other Financial Benefits.* April 2015. Government Accounting Office. [www.gao.gov/assets/670/669613.pdf] Accessed on Feb. 9, 2017.

UNRELATED BUSINESS TAXABLE INCOME

Although earnings in an IRA or a qualified plan generally are exempt from current taxation, under IRC §§511–514, an income tax is imposed on **unrelated business taxable income** (UBTI). UBTI includes income from a trade or business regularly carried on by an IRA that is not substantially related to the IRA's tax-exempt purpose. The fact that an IRA is intended to produce profits or appreciation in assets in order to fund a beneficiary's retirement benefit is expressly **excluded** under §513(a) as being substantially related to its tax-exempt purpose. In general, the UBTI rules apply to both qualified plans and IRAs in the same manner.

Because the taxes imposed by §511 are those imposed by Chapter 1 of the Internal Revenue Code, all the provisions of Chapter 1 are applicable to the assessment and collection of the UBTI. Tax-exempt organizations are therefore also required to pay estimated taxes according to the provisions of IRC §6654 and are subject to the same penalties as nonexempt entities.

The term "trade or business" has the same meaning as it has in IRC §162(a), relating to trade or business expenses.[82] Unfortunately, it is not always easy to determine whether an activity is a trade or business, especially for self-directed IRAs investing in real estate.

Trade or Business

The standard by which an activity is deemed to be a trade or business originated in a court case on gambling. In *Comm'r v. Groetzinger,*[83] Mr. Groetzinger devoted 60 to 80 hours per week to pari-mutuel wagering on dog races with the hope of earning a living from the activity. He had no other employment and gambled solely for his own account. In 1978, he had gross winnings of $70,000 on wagers of $72,082, for a $2,082 net gambling loss. His other income during the year was $6,500 from interest, dividends, capital gains, and salary earned before his job was terminated in February 1978.

On his 1978 income tax return, Mr. Groetzinger reported as income only the $6,500 received from nongambling sources. He did not report any gambling winnings or deduct any gambling losses. The IRS assessed a deficiency against him for minimum tax purposes because, under the income tax law in effect in 1978, gambling losses were a tax preference and were not deductible for minimum tax purposes.

Mr. Groetzinger successfully asserted in the Tax Court that he was in the trade or business of gambling so that the gambling losses should be deductible in determining adjusted gross income for both regular and minimum tax purposes. The IRS appealed to the Supreme Court.

The IRS contended that Mr. Groetzinger could not be in a trade or business, because he made wagers only for his own account and did not have any customers or goods or services that he sold to others. The Court rejected this argument. They ruled that although sporadic activities, hobbies, or amusement diversions do not qualify as a business, if a taxpayer's gambling activity occurs full-time, in good faith, and with regularity for the production of income for a livelihood, it is a trade or business. In this case, given the time and effort expended by Mr. Groetzinger and his clear intent to derive profits, the Court concluded he was in a trade or business.

Application of the *Groetzinger* standard is inherently factual. There is no bright-line test. Generally, a single venture into a for-profit activity for a limited period does not rise to the level of a trade or business. In *Batok v. Comm'r,*[84] a retired automobile mechanic stained and engraved glass as a hobby. He was hired for one month to help install office windows. He received $4,000, and it was reported on a Form 1099-MISC, *Miscellaneous Income.* The taxpayer did not include this amount on his tax return, and the IRS assessed income and self-employment (SE) tax deficiencies. The Tax Court held that the activity was not a trade or business. Although it was engaged in for profit, it was neither continuous nor regular. The taxpayer had never installed windows prior to or after that time.

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82. Treas. Reg. §1.513-1(b).

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

84. *Batok v. Comm'r,* TC Memo 1992-727 (Dec. 28, 1992).

IRA as Real Estate Dealer

As discussed later in the section on unrelated debt-financed income (UDFI), rental real estate income earned by a self-directed IRA is not subject to the tax on UBTI except to the extent it is debt-financed. Some individuals, however, use their self-directed IRAs to buy and rehab properties, sell them, then purchase new properties. Others may perform only minimal repairs before "flipping" the properties. The issue in such instances is whether the IRA is in the trade or business of dealing in real estate and therefore liable for tax on UBTI derived from the trade or business.

Generally, rental real estate is a trade or business for income tax purposes. Like other trades or businesses, dispositions are reported on Form 4797, *Sales of Business Property,* and not on Schedule D, *Capital Gains and Losses.* Rental real estate income is not generally subject to SE tax because it is excluded from the definition of net earnings from self-employment under IRC §1402(a)(1) unless:

- The lessor provides significant services,[85]
- The lessor is a dealer in real estate,[86] or
- The rent is derived from a material participation crop share arrangement.[87]

IRAs are not subject to SE tax. The proper analysis for whether an IRA is in a real estate trade or business for UBTI purposes is therefore based on whether a sale of property by the IRA should be treated as the sale of a capital asset or as one used by the IRA in its nonrental trade or business.

IRC §1221(a) defines a capital asset as "property held by the taxpayer (whether or not connected with his trade or business)."[88] However, IRC §1221(a)(1) specifically excludes from the definition "stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." The Supreme Court held that the word "primarily" as used in §1221(a)(1) means "of first importance" or "principally."[89] In doing so, it rejected a lower court interpretation that a purpose was primary if it was "substantial." In another case, the Court held that the term "capital asset" is to be interpreted narrowly in keeping with congressional intent that it apply to cases of realization of appreciation in value accrued over a substantial period.[90]

In connection with **real estate dealers,** the issue is whether property was held for sale to customers in the taxpayer's trade or business. This requires two separate factual analyses: whether property was held **primarily** for sale and whether the sale was in the taxpayer's **trade or business.**[91] The second factor distinguishes the sale of investment property from sale of property as a trade or business.[92]

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85. Treas. Reg. §1.1402(a)-4(c).
86. Treas. Reg. §1.1402(a)-4(a).
87. Treas. Reg. §1.1402(a)-4(b).
88. IRC §1221(a).
89. *Malat v. Riddell,* 383 U.S. 569 (1966).
90. *Comm'r v. Gillette Motor Transport, Inc.,* 364 U.S. 130 (1960).
91. *Buono, et al. v. Comm'r,* 74 TC 187 (1980), *acq.* 1981-2 CB 1.
92. *Malat v. Riddell,* 383 U.S. 569 (1966).

Generally, courts consider the following factors when determining whether a taxpayer is a dealer in real estate.[93]

- **The nature and purpose of buying the property —** A taxpayer's original purpose for acquiring property is important, but the alleged purpose must be supported by credible facts. Although even investment property may be acquired with the intent to sell it, investment property is generally held for long-term market appreciation. Shorter holding periods, frequent sales, and efforts by a taxpayer to increase the value of property are facts that may rebut a claim of acquiring property for investment purposes.

- **The length of time the taxpayer owned the property —** Short-term holding periods do not support acquisition for investment purposes. "Short-term" and "long-term" are subjective terms based on the facts of each case and have no relationship to short- or long-term capital gain holding periods. Although an isolated short-term holding period may be disregarded if due to unusual facts, evidence of a pattern of short-term holding periods weighs against investment purposes.

- **The continuity of sales activity over a period of time —** A trade or business is viewed as an activity continuing over a period of time. This is in keeping with the "regularity" requirement in the *Groetzinger* definition of trade or business (discussed earlier). Although important, the overriding intent of the taxpayer or circumstances can overcome this factor. For example, in *Estate of Simpson,*[94] taxpayers inherited 400 acres of Kentucky farmland in 1930 but were unable to sell it as a single parcel for an acceptable price. Therefore, from 1936 through 1955, they periodically subdivided parts of the farm, laid out lots, installed sewers and streets, made water and utilities available, and appointed one of the heirs as full-time agent in handling the property. The Tax Court held they were not in a trade or business because all activities were conducted solely for purposes of liquidating an estate.

- **The number and frequency of sales —** This is generally considered one of the most important factors, as it is characteristic of a trade or business and is inconsistent with holding property for long-term appreciation in value.

- **The extent to which the taxpayer developed the property, solicited customers, and advertised —** Investment property increases in value by virtue of overall appreciation in the marketplace. When value is derived, instead, from efforts by the taxpayer to improve the property's marketability, it may be indicative of a trade or business but does not by itself establish that fact. Other factors, such as number and frequency of sales are also relevant. Courts tend to ignore such things as platting property with no physical improvements.[95] As demonstrated by *Estate of Simpson,*[96] even substantial development is disregarded when necessity dictates development as the only feasible means of selling investment property. Solicitation and advertising, while mentioned in many cases, is subject to too many variables to be significant. It may not be necessary in a seller's market, or investment property may require widespread advertising and the use of brokers to obtain the best price.

- **The ratio of sales to other sources of income —** The greater the proportion of a taxpayer's income from sales of real estate is to other sources of income, the greater the likelihood real estate will be treated as a trade or business. This is especially true when combined with other factors, such as continuity and frequency. Even when real estate sales constituted 100% of a partnership's income, however, the Tax Court found that two sales in four years of undeveloped properties were of insufficient frequency to be from a trade or business.[97]

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93. *McCullen v. Comm'r,* TC Memo 1997-280 (Jun. 19, 1997).

94. *Estate of Simpson, et al. v Comm'r,* TC Memo 1962-71 (Mar. 30, 1962).

95. *Buono, et al. v. Comm'r,* 74 TC 187 (1980), *acq.* 1981-2 CB 1.

96. *Estate of Simpson, et al. v Comm'r,* TC Memo 1962-71 (Mar. 30, 1962).

97. *Phelan v. Comm'r,* TC Memo 2004-206 (Sep. 15, 2004).

No authority exists to address whether a self-directed IRA or qualified plan has UBTI from real estate dealings. The IRS's current interest in self-directed IRAs with nontraditional investments calls for speculation as to how the preceding factors may apply to an IRA rehabbing or flipping real estate. The following is a **theoretical discussion** of how these factors might be applied to a self-directed IRA.

- **Purpose in acquiring** — The facts probably make it evident whether the IRA's real estate was acquired as rental or investment property or instead as rehab or flip property, especially if the real estate activity was engaged in over a period of time. If the property is being rehabbed or flipped, the beneficiary engages in efforts to improve the property for sale when the improvements are completed or engages in active marketing efforts soon after acquisition.

- **Length of ownership** — This is a significant factor because the most important characteristic of investment property is that it is held for market appreciation. Although this is a subjective facts-and-circumstances determination, it is likely that evidence of attempts to sell property — especially if the IRA improved it — within a few years of acquisition does not favor the determination that the IRA held the property for investment in the absence of special circumstances justifying a shorter holding period.

- **Continuity** — The *Groetzinger* definition of trade or business requires regularity in the carrying on of an activity. Sporadic activities do not come within its scope. To determine whether an activity is undertaken with continuity and regularity, the question must be asked: Can a pattern of ongoing sales activity be detected over a period of time? The fact that a self-directed IRA may be selling rehabbed or flipped properties on an irregular basis is a matter of timing, not pattern. Furthermore, rehabbing and marketing efforts — not just the sales — are part of the activity being evaluated. In this sense, the use of the word "sporadic" in *Groetzinger* is misleading. In *Levinson v. Comm'r,*[98] for example, Mr. Levinson was the proprietor of a retail store selling electronic goods and collectibles but also created and patented inventions in his spare time. One of his patents was for a microwave cookware container. He later received an award against a company for patent infringement. The award included a license agreement for use of the patent, under which he received significant sums over a period of time. The IRS assessed a deficiency for SE tax. The Tax Court held that Mr. Levinson was not in a trade or business because he did not develop or design inventions on a continuous or regular basis. It accepted his testimony that his inventions were a result of sudden inspirations that were unpredictable and irregular. Therefore, according to the court, his activities were sporadic.

- **Number and frequency of sales** — Unless a self-directed IRA has the resources to engage simultaneously in multiple real estate activities, this is likely to be a relatively insignificant factor.

- **Development and marketing** — Rehabbing involves development by the IRA, and both rehabbing and flipping generally require active marketing efforts. These activities are inconsistent with holding property for investment.

- **Sources of income** — This is a significant factor, because it is likely that the IRA's income is derived entirely from its real estate activity. Although it is true that a self-directed IRA could have rental or investment properties in addition to properties acquired for rehabbing or flipping, this does not appear to be common. If a beneficiary has more than one IRA, the IRAs cannot be aggregated for purposes of determining sources of income because each IRA is a separate taxpayer for purposes of filing Form 990-T, *Exempt Organization Business Income Tax Return*.

98. *Levinson v. Comm'r,* TC Memo 1999-212 (Jun. 29, 1999).

IRA is Partner in a Partnership

If an IRA is a partner in a partnership and the partnership is engaged in a trade or business, the IRA's UBTI must include its share of the partnership's gross income, regardless of whether the income is distributed. There is no distinction between limited and general partners. The same rule applies to LLCs classified as partnerships.

In seeking higher returns on IRA investments, brokers of IRA custodians may recommend a master limited partnership (MLP) as an investment for self-directed IRAs. The consequences of this investment may not be beneficial. Distributive shares of income from MLPs are UBTI. When the MLP's Form 1065, Schedule K-1, is properly prepared, UBTI is shown in box 20 ("other information") with a "V" code indicating UBTI. Even when box 20 contains no entry, if box 1 ("ordinary business income (loss)") has a positive entry, this amount constitutes unrelated business income or loss.

Caution. Although the partnership Schedule K-1 should be sent to the IRA custodian, it is common for the IRA beneficiary to receive it and not be aware of the reporting requirements. Tax return preparers who are aware of a client with a self-directed IRA invested in an MLP or nontraditional investment should advise the client to file returns for the IRA if required. This applies even when there are losses, such as from oil and gas publicly traded partnerships (PTPs). It is important to track suspended loss carryovers.

If income taxes are from a client's IRA containing an MLP investment, it is important to ascertain whether the custodian filed a Form 990-T and obtain a copy. The tax preparer should make sure the IRA properly took into account any loss carryovers that may have arisen in prior years.

IRA Receives Rent from Realty and Personal Property

When computing UBTI, rents from real property and from certain personal property leased with real property (and the deductions pertaining to them) are excluded. However, rents attributable to the personal property must be incidental to the total amount of rents received or accrued under the lease (determined when the personal property is first placed in service by the lessee). It is generally not "incidental" when rents attributable to personal property exceed 10% of the total rents from all property leased. In general, rents from personal property are UBTI.[99]

Both the rent from the real property and the personal property are taxable if determining the amount of the rents depends on the income or profits derived by any person from the leased property (other than an amount based on a fixed percentage of gross receipts or sales).[100] The point of this rule appears to be that the sharing of **net profit** is the equivalent of a business partnership in which the real property is the tax exempt entity's contribution to the business operation (analogous to a material participation crop share arrangement).

IRA Invests in Farmland

In some parts of the country, farmland is an increasingly popular self-directed IRA investment. If the IRA actively farms the land, even through an agent, the activity is an unrelated trade or business. Therefore, the farmland must be rented while it is held in the IRA to avoid UBTI. If there is no unrelated debt-financed income (UDFI, discussed later), the rental income is not UBTI.

Cash leases of farmland alone are not a problem for UBTI purposes. However, farmland is commonly rented on a crop share basis. Crop share arrangements can be complicated for income tax purposes. When they are structured in one way, the income derived is rent; when they are structured in another way, it is trade or business income. The distinction between the two is not clear.

99. IRC §512(b)(3).

100. IRC §512(b)(3)(B)(ii).

Several court cases and private letter rulings address the issue of whether a crop share arrangement is excluded from UBTI as rental income. Three prominent cases are included in the following discussion.[101] The analysis focuses on whether the arrangement amounts to sharing net profit from the crop production. If the arrangement does so, it is a trade or business.

All three cases contain similar facts. Charitable trusts owned farmland they rented under written crop share leases. They all referred to the transaction as a lease, and the parties were referred to as landlord and tenant.

In each case, the landlord furnished the land and the tenant furnished machinery, equipment, and labor. The landlord generally maintained the property. The tenant farmed the land in a businesslike manner. Crops were divided 50-50 between the parties and each paid half the cost of seed, herbicides, insecticides, and fertilizers. In some of the cases, the parties also shared the costs of soil tests, limestone, and electricity for drying crops. In all three cases, the charitable trusts were represented on the farms by third-party farm managers with whom the tenants were required to confer concerning such things as planting, crop rotation, cultivation, participation in farm programs, and harvesting.

These leasing activities might constitute a material participation crop share for SE tax purposes under §1402(a)(1), depending on the actual degree of the farm managers' involvement.

It appears as though the IRS used SE cases in support of its position that the rent was UBTI. The circuit court expressly rejected such arguments, saying that the issue for unrelated business tax purposes is whether the arrangement between the landlord and the tenant is that they shared net profit acting as a partnership, or that the arrangement is a lease in which they shared gross profit. The trusts have UBTI only when sharing **net profit.**

In all three cases, the courts concluded that the landlord and tenant **shared gross profit.** In support of their conclusions, the courts cited the following factors.

- The parties' written leases were consistent with their creation of a landlord-tenant relationship.
- The details of the leases reflected arrangements commonly accepted as being leases in the local area and under state law.
- None of the farm managers participated sufficiently in the day-to-day activities of the operations to rise to the level of creating a partnership.
- In the event of a loss, the landlord was not required to make contributions to cover it as would be the case in a partnership, and no losses were carried over from one year to another.
- It is common for nonfarm commercial leases to contain some form of cost sharing.
- In the Tax Court case, it was important that the lease contained a provision making the tenant liable for all accidents attributable to its farming the land (in a joint venture, both parties are liable).

Deductions

In computing the unrelated business income tax of an exempt organization, deductions are allowed for expenses, depreciation, and similar items that are deductible by a commercial enterprise in computing its income tax. The deductions must have a proximate and primary relationship to carrying on the unrelated business. When expenses relate to both the exempt functions and the conduct of an unrelated business, an allocation is required between the two activities.

101. *U.S. v. Myra Foundation,* 382 F.2d 107 (8th Cir. 1967); *Harlan E. Moore Charitable Trust v. U.S.,* 9 F.3d 623 (7th Cir. 1993); *Emily Oblinger Trust v. Comm'r,* 100 TC 114 (1993).

Exclusions

The following income items and any deductions directly connected with them are excluded from UBTI.[102]

- Dividends
- Interest
- Annuities
- Royalties
- Rents from real property, including personal property leased with the real property unless the determination of the amount of rent depends on the income or profits derived by any person from the leased property (other than an amount based on a fixed percentage of gross receipts or sales)
- Gains and losses from the sale or other disposition of property other than stock in trade inventory

Unrelated Debt-Financed Income

When a self-directed IRA borrows funds to purchase real estate, it is subject to the rules for UDFI. A percentage of the IRA's (or other tax-exempt entity's) UDFI is taxed as UBTI.

IRC §514 covers UDFI. It defines **debt-financed property** as any income- or gain-producing property (other than exempt types) on which there is acquisition indebtedness at any time during the tax year or during the preceding 12 months, if the property is disposed of during the year. It does not include debt-financed property used for certain purposes, such as in the entity's exempt function or unrelated business. It also does not include income taxable as UBTI.[103]

The percentage of gross income from the debt-financed property included in UBTI is the same percentage (but not more than 100%) as the **average acquisition indebtedness** for the tax year is of the **average amount of the adjusted basis** of the property during the period it is held in the tax year.[104] UDFI is represented by the following formula.

$$\textbf{UDFI} = \frac{\textbf{Average acquisition indebtedness}}{\textbf{Average adjusted basis}} \times \textbf{Gross income}$$

The **average adjusted basis** is the average of the adjusted basis of the property on the first and last days of the tax year. The fact that the entity is tax-exempt does not eliminate the requirement that, for purposes of determining average adjusted basis, depreciation adjustments must be made for prior years.[105]

Example 5. Warren's self-directed IRA owns an office building that is debt-financed property. The building produced \$10,000 of gross rental income in 2016. The average adjusted basis of the building during 2016 was \$100,000, and the average acquisition indebtedness for the building was \$50,000. Accordingly, the debt/basis percentage was 50% (\$50,000 ÷ \$100,000). Therefore, the UDFI for the building was \$5,000 (50% × \$10,000).[106]

102. IRC §512(b).

103. IRC §514(b)(1).

104. Treas. Reg. §1.514(a)-1(a)(1).

105. Treas. Reg. §1.514(a)-1(a)(2).

106. This example is adapted from IRS Pub. 598, *Tax on Unrelated Business Income of Exempt Organizations*.

Acquisition indebtedness is the unpaid amount of any indebtedness:[107]

- Incurred in acquiring or improving the property;
- Incurred before the acquisition or improvement, provided the indebtedness would not have been incurred but for the acquisition or improvement; or
- Incurred after the acquisition or improvement, provided:
  - The indebtedness would not have been incurred but for the acquisition or improvement, and
  - The incurring of indebtedness was reasonably foreseeable at the time of acquisition or improvement.

Extension, renewal, or refinancing of a pre-existing indebtedness is not treated as the creation of a new indebtedness.

The same percentage used in computing UDFI is used to determine the percentage of deductions allowed on the property. The percentage is not used, however, for a capital loss deduction resulting from the carryover of unused losses in prior tax years.

Debt incurred by **qualified retirement plans** (but not IRAs) to finance real estate investments, with certain exceptions, is not included in the definition of acquisition indebtedness. Thus, income or gain received from such investments in real property is not debt-financed income and is not subject to the tax on UBTI.[108]

Compliance and Reporting

If an IRA has UBTI, this can create difficulties, such as the following.

- The custodian must file a Form 990-T for the IRA. If the custodian refuses to prepare the Form 990-T, the beneficiary must do so.
- Any amounts owed on the Form 990-T **must** be paid with IRA funds and not by the beneficiary.[109]
- If the IRA invests in an MLP, Forms 990-T must be filed for early years even though MLPs typically have deductions in those years that offset income or create losses. This is necessary to track loss carryforwards in order to offset future income or gain from disposition of the MLP interest.
- Late-filed Forms 990-T with a balance due incur normal late filing and payment penalties and interest.

Any IRA or qualified plan subject to tax on UBTI is taxed as a trust. UBTI should be reported on Form 990-T if an organization's gross income from unrelated business is $1,000 or more.

The first $1,000 of UBTI is known as the **specific deduction** and is not subject to tax. The $1,000 deduction is not allowed in calculating the net operating loss (NOL) for purposes both of the NOL deduction and of UBTI. **Each separate IRA** is treated as a separate taxpayer for purposes of the tax on UBTI and is therefore entitled to its own $1,000 specific deduction.[110]

> **Planning Tip.** Individuals wanting to invest self-directed IRAs in MLPs or other UBTI-generating activities should evaluate the potential trade-off of avoiding taxation on UBTI against the increased administrative costs from creating separate IRAs for each investment in order to leverage specific deductions.

107. IRC §514(c)(1).

108. IRC §514(c)(9).

109. Ltr. Rul. 8830061 (May 4, 1988).

110. Instructions for Form 990-T.

Generally, Form 990-T is filed by the 15th day of the fifth month after the end of the tax year. However, an IRA or an employees' trust must file Form 990-T by the 15th day of the **fourth** month following the end of its tax year. An exempt corporation may file for an automatic 6-month extension. Extensions are requested by filing Form 8868, *Application for Automatic Extension of Time To File an Exempt Organization Return.*[111]

> Note. At the time this workbook went to press, Form 990-T was not eligible for electronic filing.

Any tax-exempt organization that expects its tax on UBTI to be $500 or more is required to make estimated tax payments, due by the 15th day of the 4th, 6th, 9th, and 12th months of the organization's tax year. Form 990-W (Worksheet), *Estimated Tax on Unrelated Business Taxable Income for Tax-Exempt Organizations*, is used to calculate the estimated tax payments.[112]

SUMMARY

The following is a summary of important points in this section.

- Practitioners may not be aware a client has a self-directed IRA invested in a ROBS.
- Both the IRS and the DOL have jurisdiction over prohibited transactions but only the DOL can issue PTEs.
- Sales of franchises as ROBS are heavily promoted on the Internet but they can lead to individuals unknowingly engaging in prohibited transactions.
- The IRS and courts look at the substance of transactions involving self-directed IRAs and are not hesitant to find direct or indirect prohibited transactions.
- Lack of guidance from the IRS does not mean that arrangements presently permitted by some self-directed IRA custodians, such as checkbook IRAs, do not constitute prohibited transactions.
- The burden of proof is generally on the taxpayer to establish that a prohibited transaction did not occur.
- The IRS has information available through Schedules K-1 and Forms 5498 enabling them to identify taxpayers who may have ROBS. There is no guarantee the IRS will not launch an examination program focusing on self-directed IRAs and ROBS.
- Self-directed IRAs engaging in a trade or business are taxed on their UBTI in the same manner as trusts.
- The definition of trade or business is the same as for other purposes of the Code and include an IRA's distributive share of trade or business income from a partnership.
- UBTI from a partnership is required to be shown on line 20 of the partnership K-1 with a "V" code. However, if there is no entry there, any partnership trade or business income reported on line 1 should be treated as UBTI.
- If an IRA investment is financed through borrowing, such as stock purchased on margin, income or gain from the investment that is treated as UDFI is taxed in the same manner as UBTI.
- The IRA custodian is responsible for filing Form 990-T and paying any tax due from the IRA's funds. However, the beneficiary assumes this responsibility if the custodian fails to perform these duties.
- IRAs and qualified plans with UBTI are required to file Form 990-T by the 15th day of the fourth month following the end of the tax year, unlike Form 990-T for exempt organizations, which is not due until the 15th day of the fifth month.

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111. Ibid.

112. Ibid.

WAIVER OF 60-DAY ROLLOVER PERIOD[113]

A rollover is a nontaxable distribution from one retirement account to another. Any amount distributed from a qualified retirement plan or an IRA is excluded from income if it is transferred to an eligible plan within 60 days of the date that the taxpayer received the distribution.[114] If the taxpayer receives a distribution and does not roll it over, it is generally taxable. In addition, the taxpayer may also be subject to an additional 10% tax unless they qualify for an exception.[115]

The following chart shows which rollover transactions are allowed between one type of retirement account and another.[116]

ROLLOVER CHART

Roll From \ Roll To	Roth IRA	Traditional IRA	SIMPLE IRA	SEP-IRA	Governmental 457(b)	Qualified Plan[1] (pre-tax)	403(b) (pre-tax)	Designated Roth Account (401(k), 403(b) or 457(b))
Roth IRA	Yes[2]	No	No	No	No	No	No	No
Traditional IRA	Yes[3]	Yes[2]	Yes[2, 7], after two years	Yes[2]	Yes[4]	Yes	Yes	No
SIMPLE IRA	Yes[3], after two years	Yes[2], after two years	Yes[2]	Yes[2], after two years	Yes[4], after two years	Yes, after two years	Yes, after two years	No
SEP-IRA	Yes[3]	Yes[2]	Yes[2, 7], after two years	Yes[2]	Yes[4]	Yes	Yes	No
Governmental 457(b)	Yes[3]	Yes	Yes[7], after two years	Yes	Yes	Yes	Yes	Yes[3,5]
Qualified Plan[1] (pre-tax)	Yes[3]	Yes	Yes[7], after two years`	Yes	Yes[4]	Yes	Yes	Yes[3,5]
403(b) (pre-tax)	Yes[3]	Yes	Yes[7], after two years	Yes	Yes[4]	Yes	Yes	Yes[3,5]
Designated Roth Account (401(k), 403(b) or 457(b))	Yes	No	No	No	No	No	No	Yes[6]

[1]Qualified plans include, for example, profit-sharing, 401(k), money purchase, and defined benefit plans.
[2] Only one rollover in any 12-month period.
[3]Must include in income.
[4]Must have separate accounts.
[5]Must be an in-plan rollover.
[6]Any nontaxable amounts distributed must be rolled over by direct trustee-to-trustee transfer.
[7]Applies to rollover contributions after December 18, 2015. For more information regarding retirement plans and rollovers, visit Tax Information for Retirement Plans.

113. Rev. Proc. 2016-47, 2016-37 IRB 346.

114. IRC §§402(c)(3) and 408(d)(3).

115. IRC §72(t); *Retirement Topics—Exceptions to Tax on Early Distributions.* Jan. 30, 2017. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-tax-on-early-distributions] Accessed on May 8, 2017.

116. *Rollover Chart.* IRS. [www.irs.gov/pub/irs-tege/rollover_chart.pdf] Accessed on May 8, 2017.

WAIVER

The IRS can grant a **hardship exception** to the 60-day rollover requirement when the failure to waive the requirement would be "against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement."[117] To apply for a hardship exception, the taxpayer must request a letter ruling following the procedures established in Rev. Proc. 2003-16. A $10,000 user fee must accompany every request for a letter ruling to waive the 60-day rollover requirement.[118]

Rev. Proc. 2003-16 also provides for automatic approval of a waiver to the 60-day requirement in certain circumstances in which a rollover is not timely because of an error on the part of a financial institution. No letter ruling request to the IRS is required in this case. Instead, the self-certification procedures described in the next section can be used.

SELF-CERTIFICATION PROCEDURES

Under Rev. Proc. 2016-47, effective August 24, 2016, taxpayers can make a written self-certification to a plan administrator or an IRA trustee if they meet the following conditions.

1. The rollover contribution meets all the other requirements for a valid rollover except the 60-day requirement.[119]
2. The distribution came from an IRA established by the taxpayer or from a retirement plan the taxpayer participated in.[120]
3. The IRS did not previously deny the taxpayer's waiver request regarding a rollover of all or part of the distribution to which a contribution relates.
4. The taxpayer was unable to complete a rollover before the 60-day deadline because of one or more of the following reasons.
    - The financial institution receiving the contribution or making the distribution to which the contribution relates committed an error.
    - The distribution was made by check, and the taxpayer misplaced or never cashed the check.
    - The taxpayer deposited the distribution into an account that the taxpayer mistakenly thought was an eligible retirement plan and the distribution remained in that account.
    - The taxpayer's principal residence was severely damaged.
    - A member of the taxpayer's family died.
    - The taxpayer or a family member was seriously ill.
    - The taxpayer was incarcerated.
    - A foreign country imposed restrictions.
    - A postal error occurred.
    - The distribution was made because of a levy to collect prior taxes under IRC §6331 and the levy proceeds were returned to the taxpayer.
    - The party making the distribution delayed providing information that the receiving plan or IRA required to complete the rollover despite the taxpayer's reasonable efforts to obtain the information.

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117. IRC §§402(c)(3)(B) and 408(d)(3)(I).

118. *Retirement Plans FAQs relating to Waivers of the 60-Day Rollover Requirement.* Mar. 02, 2017. IRS. [www.irs.gov/retirement-plans/retirement-plans-faqs-relating-to-waivers-of-the-60-day-rollover-requirement] Accessed on May 09, 2017.

119. Ibid.

120. Ibid.

5. The taxpayer makes the contribution to the plan or IRA as soon as practicable after the reason(s) listed above no longer prevent the taxpayer from making the contribution. The requirement is deemed satisfied if the taxpayer makes the contribution within 30 days after the reason no longer prevents the taxpayer from making the contribution.

There is no IRS fee for using the self-certification procedure.[121]

EFFECT OF SELF-CERTIFICATION

A **plan administrator or IRA trustee** can rely on a taxpayer's self-certification in determining whether the taxpayer satisfied the conditions for a waiver of the 60-day rollover requirement. However, the plan administrator or IRA trustee cannot rely on the self-certification for other purposes or if the administrator or trustee has actual knowledge that contradicts the self-certification.[122]

A taxpayer can report the contribution as a valid rollover unless they are later informed otherwise by the IRS. A self-certification is not a waiver by the IRS of the 60-day requirement. During the course of an examination, the IRS may consider whether the taxpayer meets the requirements for a waiver. In this situation, the taxpayer may be subject to additions to income and penalties.[123]

MODEL LETTER

A taxpayer can make the certification by using the following model letter on a word-for-word basis or by using a substantially similar letter. The taxpayer presents the letter to the financial institution receiving the late rollover contribution.[124] The taxpayer should keep a copy of the certification letter and have it available if the IRS requests it.

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121. Ibid.

122. Rev. Proc. 2016-47, 2016-37 IRB 346.

123. Ibid.

124. Ibid.

Certification for Late Rollover Contribution

Name
Address
City, State, ZIP Code
Date: ______________________

Plan Administrator/Financial Institution
Address
City, State, ZIP Code

Dear Sir or Madam:

Pursuant to Internal Revenue Service Revenue Procedure 2016-47, I certify that my contribution of $ [ENTER AMOUNT] missed the 60-day rollover deadline for the reason(s) listed below under Reasons for Late Contribution. I am making this contribution as soon as practicable after the reason or reasons listed below no longer prevent me from making the contribution. I understand that this certification concerns only the 60-day requirement for a rollover and that, to complete the rollover, I must comply with all other tax law requirements for a valid rollover and with your rollover procedures.

Pursuant to Revenue Procedure 2016-47, unless you have actual knowledge to the contrary, you may rely on this certification to show that I have satisfied the conditions for a waiver of the 60-day rollover requirement for the amount identified above. You may not rely on this certification in determining whether the contribution satisfies other requirements for a valid rollover.

Reasons for Late Contribution

I intended to make the rollover within 60 days after receiving the distribution but was unable to do so for the following reason(s) (check all that apply):

___ An error was committed by the financial institution making the distribution or receiving the contribution.

___ The distribution was in the form of a check and the check was misplaced and never cashed.

___ The distribution was deposited into and remained in an account that I mistakenly thought was a retirement plan or IRA.

___ My principal residence was severely damaged.

___ One of my family members died.

___ I or one of my family members was seriously ill.

___ I was incarcerated.

___ Restrictions were imposed by a foreign country.

___ A postal error occurred.

___ The distribution was made on account of an IRS levy and the proceeds of the levy have been returned to me.

___ The party making the distribution delayed providing information that the receiving plan or IRA required to complete the rollover despite my reasonable efforts to obtain the information.

Signature

I declare that the representations made in this document are true and that the IRS has not previously denied a request for a waiver of the 60-day rollover requirement with respect to a rollover of all or part of the distribution to which this contribution relates. I understand that in the event I am audited and the IRS does not grant a waiver for this contribution, I may be subject to income and excise taxes, interest, and penalties. If the contribution is made to an IRA, I understand you will be required to report the contribution to the IRS. I also understand that I should retain a copy of this signed certification with my tax records.

Signature: ____

DAILY FANTASY SPORTS

Daily fantasy sports (DFS) played on the Internet are a multi-billion-dollar business in the United States. These activities are contests played over short time periods, such as a single day or week of a season. Contestants who play DFS pay an entry fee that enables them to create virtual teams based on sports figures from actual team rosters. Contestants' virtual teams compete against other virtual teams based on the statistical performance of the actual sports figures during that day's games.[125]

Is it considered gambling to participate in these games? The Unlawful Internet Gambling Enforcement Act of 2006 (UIGEA) prohibits gambling businesses from knowingly accepting payments in connection with the participation of another person in a bet or wager that involves the use of the Internet and that is unlawful under any federal or state law.[126] The law specifically **excludes** fantasy sports that meet certain requirements under which they are allegedly games of skill rather than chance.[127] Some sponsors of DFS games allege that this exception means DFS games are legal. However, that is not universally the case. States have authority to decide whether DFS are legal in their jurisdictions. Some states' attorneys general have declared that DFS games are gambling.[128] However, legislative efforts are increasingly underway to legalize DFS.[129]

Regardless of the legal status, contestants' winnings from DFS are includable in gross income, the same as any other legal or illegal source of income. However, whether the activity is gambling or a game of skill affects how it is treated for income tax purposes. There is no DFS guidance yet from the IRS.

Gambling winnings are reported by the payor to the IRS on Form W-2G, *Certain Gambling Winnings.* Winnings from games of skill are reported on Form 1099-MISC.[130] Gambling (wagering) losses are deductible only to the extent of winnings,[131] but losses from games of skill are not limited. In addition, some states do not allow state income tax deductions for gambling losses even to the extent of winnings.[132]

TREATMENT AS EARNINGS FROM GAMES OF SKILL

DFS sponsors report contestants' winnings in box 3 ("other income") of Form 1099-MISC. For income tax purposes, winnings are reported as "other income" on line 21 of Form 1040, *U.S. Individual Income Tax Return.*[133] Losses are reported as "other expenses" on line 23 of Schedule A, *Itemized Deductions.*[134] Because losses are miscellaneous itemized deductions, they are deductible only to the extent they exceed 2% of adjusted gross income (AGI).[135] Miscellaneous itemized deductions are also an alternative minimum tax (AMT) preference item and, therefore, are not allowable in computing alternative minimum taxable income (AMTI).[136] Finally, unless the taxpayer is in the trade or business of engaging in DFS, expenses are deductible only to the extent of gross income from the activity.[137]

125. *Daily Fantasy Sports Business Gets a Dose of Reality.* Woodward, Curt. Jan. 6, 2017. Boston Globe. [www.bostonglobe.com/business/2017/01/06/daily-fantasy-sports-business-gets-dose-reality/8ShpChIgaD2S8UKguJbdQP/story.html] Accessed on Mar. 17, 2017.

126. *Unlawful Internet Gambling Enforcement Act of 2006 Overview.* FDIC. [www.fdic.gov/news/news/financial/2010/fil10035a.pdf] Accessed on Feb. 10, 2017.

127. 31 USC §5362(1)(E)(ix).

128. *Legislative Tracker: Daily Fantasy Sports, Sports Betting.* Legal Sports Report.com. [www.legalsportsreport.com/dfs-bill-tracker] Accessed on Feb. 23, 2017.

129. Ibid.

130. Ltr. Rul. 200532025 (May 3, 2005); Instructions for Form 1099-MISC.

131. IRC §165(d).

132. *Additions/Subtractions.* Illinois Department of Revenue. [www.revenue.state.il.us/Individuals/Credits/AdditionsSubtractions.htm] Accessed on Feb. 10, 2017.

133. IRS Pub. 525, *Taxable and Nontaxable Income.*

134. Temp. Treas. Reg. §1.67-1T(a)(1)(iv).

135. IRC §67(a).

136. IRC §56(b)(1)(A)(i).

137. See IRC §183(b)(2), if considered an activity not engaged in for profit; IRC §165(d), if considered gambling.

In some cases, the practical result of the deductibility limitations applicable to DFS may be full inclusion of winnings in gross income.

- A taxpayer who does not itemize deductions reports all winnings on line 21 but cannot deduct expenses, which requires a Schedule A.
- A taxpayer who itemizes deductions can deduct DFS expenses on Schedule A. However, if DFS are not treated as gambling, then deductions are only allowed to the extent that all miscellaneous itemized deductions exceed 2% of AGI. Because this is also an AMT preference item, the taxpayer may pay AMT.

TREATMENT AS GAMBLING WINNINGS

Gambling winnings are reported on line 21 of Form 1040 as "other income," but losses from recreational gambling are reported on line 28 of Schedule A as "other miscellaneous deductions." Losses are not subject to the 2%-of-AGI limitation and are not preferences in determining AMTI. However, they are deductible only to the extent of gambling winnings.[138]

Even for professional gamblers, losses are deductible only to the extent of winnings.[139] Because professional gamblers report gambling activities on Schedule C, *Profit or Loss From Business,* **all** expenses (other than wagers) related to the activity are deductible in determining AGI, not just their wagers. This can actually create a loss from the gambling activity because only the wager portion is subject to the winnings limitation.

In determining whether a gambler is a professional engaged in a trade or business, courts hold taxpayers to a much higher standard than is the case for nongambling trades or businesses. The following are some principles derived from cases that have dealt with the issue.

- To rise to the level of professional gambling, the gambling activity should be the taxpayer's full-time occupation. If the taxpayer has another occupation, gambling is generally not seen as being full-time unless the other occupation is part-time and the amount of time devoted to gambling is significantly more than that devoted to the other occupation.[140]
- If the taxpayer has significant income from sources other than gambling, courts view the taxpayer as not earning a livelihood from gambling. Because most gambling cases involve losses in excess of winnings, it is difficult for a taxpayer to win on this point. The courts look to the taxpayer's genuine desire for profit, even if this is unreasonable. Nongambling sources of income should be minimal for the taxpayer to be considered a professional gambler.[141]
- Frequency and regularity of gambling activities are important. Taxpayers who gamble occasionally, even if they do so frequently, are not engaged in the activity with the requisite regularity to be considered professional gamblers.[142]
- Courts often apply hobby loss factors under IRC §183 in determining whether a taxpayer is in the trade or business of gambling. The court's analysis includes such factors as adequacy of recordkeeping, whether the taxpayer has conducted proper research into the gambling activity, whether the taxpayer sought professional advice from others, etc.[143]

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138. IRC §165(d).

139. See, e.g., *Boyd v. U.S.,* 762 F.2d 1369 (9th Cir. 1985).

140. See, e.g*, Moore v. Comm'r,* TC Memo 2011-173 (Jul. 18, 2011).

141. Ibid.

142. See, e.g*, Free-Pacheco v. U.S.,* 117 Fed. Cl. 228 (2014).

143. See Treas. Reg. §1.183-2(b); see also *Merkin v. Comm'r,* TC Memo 2008-146 (Jun. 5, 2008).

Whereas gambling usually occurs at a casino or other physical location, DFS activities exclusively occur online. A commonly cited factor in denying gamblers professional status is their lack of credible evidence supporting the time spent on gambling versus nongambling income-producing activities. Gamblers who play at casinos may have the benefit of a player's card that automatically records time spent gambling. DFS contestants spend more time analyzing players they will pick for their teams than actually interacting with the DFS provider. Unless a player maintains credible contemporaneous documentation of all the time spent on DFS activities, it is unlikely the contestant will succeed in convincing the IRS or Tax Court they have spent enough time to consider the DFS activities a trade or business. Consequently, qualifying as a professional DFS contestant is very difficult to prove.

SUMMARY

Following is a summary of important points in this section.

- All normal tax rules apply to individuals who engage in Internet transactions.
- Receipts from web-based sources are generally includable in gross income unless they are clearly a gift.
- Charitable contributions made through crowdfunding sites that are not §501(c)(3) exempt organizations are subject to the same substantiation requirements as those that are.
- Documentation for contributions of $250 or more must be obtained directly from the charity no later than the date a return is filed. A website receipt is not sufficient for this purpose.
- Charitable contribution deductions are available only for contributions to qualified charitable organizations, not to individuals.
- Crowdfunding receipts in exchange for anything of value are likely to be trade or business income subject to SE tax.
- Regular sales on eBay may also be treated as trade or business income subject to SE tax.
- Airbnb hosts who provide guest amenities not necessary for occupancy of the rented space — such as breakfasts or free guest use of swimming pools, Jacuzzis, or bicycles — may be providing significant services resulting in rent being treated as SE income.
- An IRS CP2000 notice, based on Form 1099-K, may be the first indication that a client is engaged in Internet transactions.
- A person who organizes crowdfunding campaigns on behalf of someone else and who wishes to avoid possible receipt of a Form 1099-K should provide to the PSE the name and taxpayer identification number of the beneficiary of the campaign.

LEGAL FEES

A taxpayer can generally deduct the following types of legal expenses.[144]

- Those that are incurred in attempting to produce or collect taxable income[145]
- Fees paid in connection with the determination, collection, or refund of any tax (This includes expenses paid for tax counsel, tax preparation, or tax proceedings.[146])
- Fees related to either doing or keeping the taxpayer's job (e.g., fees to defend against criminal charges arising out of the taxpayer's trade or business)
- Fees for **tax advice** related to a divorce if the bill specifies how much is for **tax advice** and it is determined in a reasonable manner[147]
- Fees paid to collect taxable alimony[148]

The taxpayer can deduct expenses of resolving tax issues related to business profit or loss (on Schedule C, *Profit or Loss From Business),* rentals or royalties (on Schedule E, *Supplemental Income and Loss),* or farm income and expenses (on Schedule F, *Profit or Loss From Farming).* The taxpayer can deduct expenses of resolving nonbusiness tax issues on Schedule A, *Itemized Deductions,* as a miscellaneous itemized deduction subject to the 2%-of-AGI threshold.[149]

Amounts received from litigation attributable to personal physical injuries or physical sickness are generally nontaxable.[150] Legal fees relating to this nontaxable income are not deductible. Amounts received from lawsuits attributable to claims other than personal physical injuries and physical sickness are taxable income.[151] The attorney fees incurred are generally a miscellaneous itemized deduction. Miscellaneous itemized deductions subject to the 2%-of-AGI threshold are not allowed for purposes of AMT.

UNLAWFUL DISCRIMINATION

A taxpayer may be able to deduct attorney fees and court costs as an adjustment to income, instead of as a miscellaneous itemized deduction. Such treatment applies to actions settled or decided after October 22, 2004, involving the following types of claims, which are specified in IRC §62(a)(20).[152]

- Claims of unlawful discrimination (A detailed listing of what constitutes a "claim of unlawful discrimination" is found in IRC §62(e).)
- Claims against the U.S. government
- Claims made under section 1862(b)(3)(A) of the Social Security Act

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144. IRS Pub. 529, *Miscellaneous Deductions.*

145. Treas. Reg. §1.212-1(a).

146. Treas. Reg. §1.212-1(l).

147. Ibid.

148. Treas. Reg. §1.262-1(b)(7).

149. Treas. Reg. §1.212-1; IRS Pub. 529, *Miscellaneous Deductions*.

150. IRC §104.

151. *Comm'r v. John W. Banks II,* 543 U.S. 426 (2005).

152. IRC §62(a)(20); IRS Pub. 529, *Miscellaneous Deductions.*

The taxpayer includes the amount of such claims on line 36 of Form 1040. On the dotted line next to line 36, the amount of the deduction should be entered and identified as "UDC."[153] The following rules apply.[154]

- The deduction is limited to the amount of the judgment or settlement included in the taxpayer's income for the tax year.
- The attorney fees and court costs must be paid by the taxpayer or on the taxpayer's behalf in connection with the claim.
- The judgment or settlement must occur after October 22, 2004.

The proceeds from the settlement should generally be entered on Form 1040, line 21 ("other income"). However, if the taxpayer receives a settlement in an employment-related lawsuit (e.g., for unlawful discrimination or involuntary termination), the portion of the proceeds that relate to lost wages should be reported on line 7 ("wages, salaries, tips, etc.").[155] This portion of the proceeds is subject to social security and Medicare taxation.[156]

Example 6. Kathleen filed a lawsuit against Shears, Inc., alleging employment discrimination on the basis of her age and gender. In 2016, Kathleen and Shears entered into a settlement agreement under which Shears agreed to pay Kathleen $262,500, of which $12,500 was for lost wages. Kathleen paid a total of $152,000 in attorney's fees and court costs in 2016.[157]

Kathleen reports the settlement of the lawsuit on her Form 1040 as follows.

- The wages of $12,500 is reported on line 7.
- The $250,000 balance of the settlement proceeds is reported on line 21.
- The attorney's fees and court costs of $152,000 are deducted on line 36, with "UDC" entered on the dotted line.

Contingent Fees

The Supreme Court's decision in *Comm'r v. John W. Banks II*[158] settled the issue of whether contingent attorney fees are includable in the gross income of successful litigants. The Supreme Court held that they are.

After full inclusion in AGI, the attorney fees are generally deductible on Schedule A as a miscellaneous itemized deduction subject to the 2%-of-AGI limitation.[159] This rule can result in AMT liability for the recipient in the year any large taxable damage award is received. This is because miscellaneous itemized deductions are not allowed for AMT purposes.[160]

An exception to the general rule was created by a provision of the American Jobs Creation Act of 2004. As mentioned earlier, an adjustment in arriving at AGI is allowed for legal fees paid in connection with claims specified in IRC §62(a)(20).

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153. Instructions to Form 1040.
154. IRC §62(a)(20); IRS Pub. 525, *Taxable and Nontaxable Income.*
155. IRS Pub. 4345, *Settlements—Taxability.*
156. Ibid.
157. Based on *Simpson v. Comm'r,* 141 TC No. 10 (2013); IRC §62(a)(20).
158. *Comm'r v. John W. Banks II*, 543 U.S. 426 (2005).
159. Treas. Reg. §1.212-1; IRS Pub. 529, *Miscellaneous Deductions*.
160. IRC §56(b)(1)(A)(i).

Example 7. Mistie, who is physically handicapped, sued her former employer for unlawful discrimination. Her lawsuit claimed that her dismissal was illegal under a provision of the Americans with Disabilities Act of 1990. The terms of her contingent fee agreement with her attorney provided that she was entitled to keep 70% of any eventual court judgment. Her attorney would retain 30% of the award as payment for his legal services.

The suit began in 2014, and an out-of-court settlement with the former employer was finalized in 2016. Mistie's former employer agreed to pay $200,000 of back wages to settle the lawsuit. A 2016 Form W-2, *Wage and Tax Statement,* was issued to Mistie for the $200,000. Mistie paid no out-of-pocket legal expenses prior to the settlement.

Mistie reported the $200,000 of back wages on line 7 on her 2016 Form 1040. She deducted the contingent attorney fee of $60,000 ($200,000 × 30%) on line 36 of Form 1040 with "UDC" written on the dotted line next to line 36.

Example 8. Use the same facts as **Example 7,** except that Mistie's lawsuit involved alleged securities fraud by her former broker instead of a claim of unlawful discrimination. Any contingent attorney fees she pays for a settlement of that lawsuit are deductible only as a miscellaneous itemized deduction on Schedule A. Mistie may have a 2016 AMT liability due to the AMT adjustment for miscellaneous itemized deductions.

WHISTLEBLOWER CLAIMS

The Tax Relief and Health Care Act of 2006 created IRC §62(a)(21), which provides an above-the-line deduction for attorney fees and court costs associated with suits involving whistleblower claims. The attorney fees or court costs must have been paid in connection with a whistleblower award for providing information regarding violations of tax laws. In addition, the information must have been provided on or after December 20, 2006. As is the case for claims of unlawful discrimination, the deduction is limited to the amount includable in the taxpayer's gross income for the tax year in which the deduction is claimed.[161]

161. IRC §62(a)(21); *Lawsuits, Awards, and Settlements Audit Techniques Guide.* May 2011. IRS. [www.irs.gov/pub/irs-utl/lawsuitesawardssettlements.pdf] Accessed on May 8, 2017.