INDIVIDUAL TAX UPDATE
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SECTION: 11 USC 542
USING PER DAY METHOD TO ALLOCATE TAX REFUND TO PORTION THAT IS PRE- AND POST-PETITION REASONABLE IN CASE WHERE INCOME AND WITHHOLDING WERE EVEN DURING YEAR

Citation: In Re: Meyers, CA7 No. 09-3478, 8/2/10

The Seventh Circuit accepted the trial court's allocation of a tax refund based on the prorata by days method between pre-petition amounts (that would become part of the bankruptcy estate) and post-petition amounts (that would be available to the debtor). The debtor had argued against the this position, indicating that the court should have only allowed withholdings through the date of the petition in excess of the total tax for the year, a position the debtor argued was supported by a trial court holding from the Western District of Texas in In re Donnell.

The Seventh Circuit disagreed. First, it noted that merely pointing to the conclusion of a trial court in a single case was not sufficient to overcome the prima facia case presented by the trustee. Second, the panel noted that in the Donnell case the income and withholdings did not take place evenly throughout the year, unlike the facts in this case.

While the panel agreed that the prorata by days method would not be applicable in all cases, it held that in this case it seemed to provide a reasonable method to divide the refund between its pre- and post-petition portions.

SECTION: CIRCULAR 230
PROPOSED REVISIONS TO CIRCULAR 230 TO ESTABLISH REGISTERED RETURN PREPARERS, MANDATE FOR OVERSIGHT BY CHIEF TAX PRACTITIONER IN FIRM AND PENALTY FOR FAILING TO ELECTRONIC FILE MANDATED RETURNS

Citation: NPRM REG-138637-7, 8/23/10

The IRS has issued revised proposed regulations under Circular 230 to accomplish a number of goals. First, the regulations revise the proposed return signing standards under §10.34 to bring them into line with revisions to IRC §6694. Second, the changes would broaden Circular 230 to cover the new category of “registered tax return preparer” that is being created under the IRS preparing licensing project and restrict preparation of tax returns for compensation to those covered by Circular 230, which will be expanded to include registered tax return preparers. Third, the IRS puts some teeth into the mandatory electronic filing of §6011(e), defining a failure to electronically file a tax return when required to do so as disreputable conduct under §10.51 for which a

preparer may be disciplined by the Office of Professional Responsibility under Circular 230.

Revised §10.3 contains the definition of a registered return preparer (at §10.3(f)(1)) and limits the practice of those individuals to the preparation of returns and representing taxpayers in an examination if the registered tax return preparer signed the return, interacting with revenue agents, customer service representatives and the like. However such individuals will not be able to represent taxpayers before appeals officers, revenue officers, Counsel or employees with similar duties at the IRS.

Such a person may preparer or assist in preparing all or a substantial portion of a tax return for which the preparer has passed the requisite examination. Initially the IRS proposes to issue two exams, one covering non-business 1040s and the other covering Form 1040 and business returns. A registered return preparer passing the latter exam will be eligible to prepare or assist in preparing all returns, while a registered return preparer passing only the first exam will be limited to preparing such non-business 1040 returns.

Proposed §10.4(c) provides the requirements to be designated as a registered return preparer.

Under Proposed §10.6(e)(3) registered tax return preparers will be required to obtain 15 hours of continuing professional education, including 2 hours of ethics, 3 hours of federal tax law updates and 10 hours of other federal tax topics. Standards that such continuing education courses must meet are also defined in §10.6.

Proposed §10.8 clarifies that the preparation of a tax return is practice before the IRS, subject to the requirements of Circular 230 and can only be done for compensation by someone who is authorized under Circular 230 (generally a CPA, EA, attorney or registered tax return preparer).

Proposed §10.30 prohibits registered tax return preparers from using the word “certified” or using a designation that suggests they are in an employee/employer relationship with the IRS. The IRS suggests an acceptable description that a registered tax return preparer may use is “designated as a registered tax return preparer with the Internal Revenue Service.”

Proposed §10.34 is revised to come more closely into compliance with the standards found in IRC §6694. A practitioner may not sign a return that the practitioner knows, or reasonably should know, contains a position that lacks a reasonable basis, is a willful attempt to understate the tax liability of the taxpayer or is treated as an unreasonable position under §6694(a)(2). The latter category would expand the coverage to include positions lacking substantial authority which are not disclosed and positions related to

tax shelters for which it is not reasonable to assume the position would more likely than not be sustained on its merits. Similar standards apply to advice the preparer may give a taxpayer.

For purposes of this rule the practitioner must be shown to have acted willfully, recklessly or through gross incompetence. The preamble to the regulations notes that this will apply less often than the penalty under §6694 would, since the IRC penalty does not require a showing that the preparer acted willfully, recklessly or through gross incompetence for the penalty to apply.

Proposed §10.36 which previously dealt only with procedures in the firm to assure compliance with the covered opinion rules of §10.35 is greatly expanded in scope. The new provision requires practitioners with principal authority for overseeing a firm's tax practice to insure the firm has in place adequate procedures to insure the all employees comply with the requirements of Circular 230. Such practitioners will be subject to OPR discipline if either he/she does not take reasonable steps to insure compliance and one or more members of the firm violates Circular 230 or the individual, upon becoming aware that an individual in the firm is violating Circular 230 does not take prompt action to correct the noncompliance. The latter category will include violations which the practitioner with principal authority should have known took place, even if the IRS can't show actual knowledge of the violation.

Proposed §10.51 will expand the list of items that are deemed to be disreputable conduct in practice to include willfully failing to file a return electronically that is required to be filed electronically unless the failure is due to reasonable cause. Some had noted that the new electronic filing requirement of §6011 for 2011 did not have a penalty clause—the IRS, noting the same, has now decided to use Circular 230 to provide the “big stick” to insure preparers electronically file returns as mandated by law.

As well, anyone preparing a return who does not possess a valid PTIN will also be deemed to have violated Circular 230.

As many of these regulations are necessary for the IRS to implement the preparer licensing program, we can expect final regulations before we begin filing 2010 tax returns.

SECTION: CIRCULAR 230
CPA DISBARRED FOR FAILING TO FILE RETURNS, INADEQUATE DUE DILIGENCE ON CLIENT INFORMATION

Citation: IR 2010-82, OPR v. Kaskey, OPR Complaint No. 2009-26, 7/6/10

A CPA was disbarred by the Office of Professional Responsibility, and the disbarment imposed by the Administrative Law Judge was sustained on appeal, the IRS announced in a news release this week.

While the news release concentrates on preparer's lack of due diligence in relying on the representations of his client, the actual decision of the ALJ noted most prominently that the CPA had failed to file his personal returns for five consecutive years, an offense which happens to the one that the OPR most often takes action against. But this CPA had also prepared tax returns for a client where there was significant evidence that the CPA did not perform adequate due diligence on the information provided.

The appeals report noted that the officer compensation reported on the corporate return did not agree with the amounts reported on the individual returns, the corporate books clearly identified personal expenses of the owners that had been paid by the corporation that were not reported as either loans or income by the individual taxpayers and it should have been obvious the taxpayers could not maintain their lifestyle based solely on the reported income.

The CPA also did not help his case by ignoring the original complaint filed by the OPR and the later Motion by the OPR to the administrative law judge for a default finding against the CPA.

As preparers we are clearly allowed to accept the representations of our clients unless we have reason to believe those representations are either false or in error. In that case we cannot turn a blind eye towards things we are aware of (such as the officers' salary reported on the corporate return we also prepared) or the implications of other information we become aware of (such as clearly personal expenses reported in a ledger analysis we may prepare in doing accounting work for the taxpayer's business).

The IRS definitely “spun” this case in the press release to emphasize the client information issues, even if the actual decisions seemed to treat those as secondary issues. The IRS uses such press releases to influence the actions of tax preparers and their clients, and this press release may be read as notice that the IRS believes preparers have been taking too many liberties with the law and information they are aware of.

SECTION: FBAR REPORTING
TAXPAYER NOT FOUND TO HAVE WILLFULLY FAILED TO FILE TDF 90-22.1 WHERE TAXPAYER WAS AWARE IRS KNEW OF ACCOUNT

Citation: United States v. Williams, USDC Eastern District Virginia, 9/1/10

In a case decided under prior law, a District Court denied the Treasury's attempt to impose a penalty for failing to disclose a foreign bank account on Form TDF 90-22.1 pursuant to 31 U.S.C. § 5314. The taxpayer in question had a bank account in Switzerland during 2000. The taxpayer answered no to the question on Schedule B asking if he had signature authority over a foreign account and he did not file the required Form TDF 90-22.1.

At the time a penalty applied for a willful failure to disclose the account. The Court found that at the time the individual failed to file the return he was aware the U.S. Government knew of the account. The account had been frozen by Swiss authorities at the request of the U.S. Government in November of 2000 and the taxpayer was aware of that fact. The court found that it did not make sense that the taxpayer was willfully trying to conceal the existence of the account at June 30, 2001, the date when the form in question was due. His actions after that date were consistent with the view that he was not continuing to conceal the account, suggesting that there was no reason for him to willfully fail to file the form.

While the case is a taxpayer victory, we should remember that in 2004 the law was changed to remove the willfulness requirement for the penalty to apply. Thus a taxpayer in the same situation today would have to show that he/she had reasonable cause for the failure to file the form.

SECTION: FBAR REPORTING
IRS EXTENDS RELIEF FOR SOME INDIVIDUALS FOR FBAR FILING TO JUNE 30, 2011

Citation: Notice 2010-23, 2/26/10

The IRS has extended the relief for filing of the foreign bank account reporting form, Form TD F 90-22.1, for individuals in two classes. Individuals who have only signature authority but no financial interest in a foreign bank or financial account for which an FBAR would have been due on June 30, 2010 will now have until June 30, 2011 to report those foreign accounts.

Individuals that with a financial interest or signature authority over a “foreign comingled fund” that is a mutual fund will be required to file an FBAR unless another exception applies. However, for 2009 and prior years the IRS will not interpret comingled funds to

include any funds other than mutual funds. Specifically this exception includes a foreign hedge fund or private equity fund.

If a taxpayer has no other reportable accounts and is covered by this relief, the question on Schedule B regarding interests in foreign accounts should be answered no on the 2009 return.

SECTION: FBAR REPORTING
REQUIREMENT TO FILE FBAR REPORTS NOT TO BE APPLIED TO PERSONS WHO ARE NOT UNITED STATES CITIZENS, UNITED STATES RESIDENTS OR DOMESTIC ENTITIES

Citation: Announcement 2010-16, 2/26/10

The IRS will not require persons who are not United States citizens, residents or domestic entities file Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR), for 2009 and earlier calendar years. This extends the relief originally granted in Announcement 2009-51 that relieved such individuals and entities from having to file the FBAR form in 2009.

The definition of a "United States Person" from the July 2000 version of FBAR can continue to be applied by all persons for determining the need to file a report by June 30, 2010. All other requirements of the 2008 version of the FBAR form and instructions are still required to be followed—only the changed definition that impacted who had to file the form is being suspended by this Announcement.

SECTION: TAX FORMS
IRS TO STOP MAILING PAPER TAX PACKAGES TO TAXPAYERS

Citation: IRS e-News for Tax Professionals 2010-40, 9/25/10

One of the standard events that mark each new year will be no more. The IRS announced in e-News for Tax Professionals issue 2010-40 that the IRS will cease mailing tax packages to either individuals or businesses. In early October the IRS will send a postcard to individuals that filed a paper return for 2009 and to businesses that normally receive tax packages to inform them that the forms will no longer be mailed to them.

The postcard will explain how taxpayers may obtain such paper forms and the instructions for such forms in the future. The IRS cited the growth of electronic filing as the reason why the IRS is taking this step at this time. It would appear the IRS believes by making it a bit of a nuisance to obtain paper forms that it's likely a number of individuals still filing returns on paper will instead use electronic filing.

SECTION: 23
IRS DEFINES SAFE HARBOR FOR TREATING FOREIGN ADOPTIONS COVERED BY HAGUE CONVENTION

Citation: Revenue Procedure 2010-31, 9/29/10

The United States is a party to the Hague Convention on Protection of Children and Co-operation in Respect of Intercountry Adoption, effective on April 1, 2008. The IRS has released safe harbor guidance for adoptions under that convention for the determination of when the adoption is final. The guidance supercedes Rev. Proc. 2005-31 for these adoptions, however the older ruling continues to apply to foreign adoptions not covered by this convention.

For adoptions after April 1, 2008 covered by the convention, the IRS will not challenge an adoption finalized in another country if 1) the sending country enters a final decree of adoption and 2) the U.S. Secretary of State issues a certificate under §301(a) of the Intercountry Adoption Act of 2000. Similarly, the IRS will not challenge a taxpayers's treatment of the adoption as final for a child that has entered the United States for the purpose of adoption subject to §301(c) of the Intercountry Adoption Act as being final in the taxable year that a state court enters a final decree of adoption.

This ruling applies only to adoptions covered by this convention, meaning it is not effective prior to April 1, 2008. However it is effective for adoptions finalized after that date. It's possible that taxpayers may need to amend prior returns to claim a refund for tax year 2008 or 2009, and the ruling specifically allows such claims so long as they are filed before the statute of limitations for claims for refunds.

SECTION: 36
GETTING MARRIED COST COUPLE TWO HOMEBUYER CREDITS

Citation: INFO 2010-0117, 6/25/10

The IRS often gets asked by the offices of various members of Congress to write explanatory letters which they can then forward to their constituents asking about various issues. Amusingly, most often the letters are simply explaining why the bad result exists primarily due to how the law is written (meaning very often what their elected representative voted for). A recent letter in response to a Congressman's inquiry points out a quirk in the homebuyer credit.

In this case one spouse had owned and lived in a residence from December 2001 to July 2007. In May 2008 this person married an individual who had never previously owned a home. In December of 2009 they bought a new home.

The first spouse, if not married, would have qualified for the long time homebuyer credit on the purchase of the home. The second spouse, again if not married, would have qualified for the first time homebuyer credit.

The ruling notes that, however, since they married the fact that the first spouse owned a home used as a principal residence in the prior three years eliminates any eligibility for the first time homebuyer credit. And, similarly, the fact that the second spouse did not own a home prior to 2009 blocked any ability for the married couple to claim the long time homebuyer credit.

SECTION: 36C
IRS PROVIDES GUIDANCE ON PATIENT PROTECTION AND AFFORDABLE CARE ACT REVISIONS TO ADOPTION CREDIT

Citation: Notice 2010-66, 9/29/10

Interim guidance has been issued by the IRS on the modifications made by the Patient Protection and Affordable Care Act to the Adoption Credit. Such changes included making the credit refundable and redesignating the applicable code section from §23 to §36C. These changes are effective for tax year beginning after December 31, 2009.

The guidance notes that if a taxpayer has a credit that is being carried forward from a prior year to 2010, that credit carryforward will become a refundable credit in 2010. As well, that part of the credit is not subject to an income limitation based on 2010 income.

The guidance also explains the substantiation requirements. For a domestic or foreign adoption that has been finalized, the taxpayer must attach a copy of an adoption order or decree. If the adoption is a foreign adoption subject to the Hague Convention and finalized in another country, the taxpayer must attach 1) a Hague Adoption Certificate (Immigrating Child), an IH-3 visa or a foreign adoption decree translated into English. If the country is not subject to the Hague Convention then a taxpayer must attach either a foreign adoption decree translated into English or an IR-2 or IR-3 visa.

For domestic adoptions that are not final, the taxpayer must attach one of the following: 1) an adoption taxpayer identification number, obtained by the taxpayer for the child, included on the taxpayer's income tax return, 2) a home study completed by an authorized placement agency, 3) a placement agreement with an authorized placement agency, 4) a document signed by a hospital official authorizing the release of a newborn child from the hospital to the taxpayer for legal adoption, 5) a court document ordering or approving the placement of a child with the taxpayer for legal adoption, or 6) an original affidavit or notarized statement signed under penalties of perjury from an adoption attorney, government official, or other person, stating that the signor: A. placed

or is placing a child with the taxpayer for legal adoption, or B. is facilitating the adoption process for the taxpayer in an official capacity, summarizing the facilitation.

If the adoption is of a special needs child, the taxpayer must attach a copy of the state determination of special needs to the taxpayer's income tax return for the taxable year that the taxpayer claims the adoption credit for a child with special needs. While the notice authorizes the taxpayer to initially redact what may be sensitive personal information from the information supplied, the notice cautions that the IRS may nevertheless determine that it must receive an unredacted version of the documents in order to make a determination that the taxpayer is qualified for the credit in this case.

SECTION: 59
TAX TREATY DID NOT ELIMINATE LIABILITY FOR ALTERNATIVE MINIMUM TAX

Citation: Jamieson v. Commissioner, CA DC, No. 08-1253, 10/16/09

The Court of Appeals for the DC Circuit ruled that the US Canada tax treaty that prohibits the double taxation of income by the two countries does not require that a 100% foreign tax credit be allowed taxpayers with income taxed by both the United States and Canada. The taxpayers were attempting to distinguish their case from the earlier holding by this circuit in the Kappas case (337 F.3d 1053) by claiming that the treaty should be read as requiring the “double tax” be tested after the 90% foreign tax credit limit was applied.

However, the Circuit Court did not buy their argument. The Court went on to repeat their finding in Kappas that Congress made clear when it retroactively clarified the Tax Reform Act of 1986 to, in the court’s view, make clear that the 90% limit was to supersede any preexisting treaty obligation.

SECTION: 61
CALIFORNIA DOMESTIC PARTNERSHIP COMMUNITY PROPERTY TREATMENT RESPECTED FOR FEDERAL TAX PURPOSES

Citation: PLR 201021048, CCA 201021049, CCA 201022050, 5/28/10

The IRS ruled in PLR 201021048 that California domestic partners are required to report their income on their individual returns using the underlying state law community property rules that apply to their income. The California domestic partner laws were changed effective January 1, 2007 to have the earned income of domestic partners treated as community income for all purposes, removing the prior exception that had earned income not treated as community for state income tax purposes.

The ruling also holds that there is no gift of the community income from the partner that earned it to the other partner, as the income is automatically vested in each partner as it is earned.

In CCA 201021049, the IRS ruled that these community property rules apply for collections as well, so that the IRS can look to the community property of the domestic partner for collection purposes.

In CCA 201021050, the IRS clarified the treatment for domestic partners who had filed their returns under CCA 200608038. That ruling, issued prior to California law changing the treatment of earned income, had the partners each report their own income on their individual return. The new ruling holds that domestic partners may, but are not required, to amend their returns for years beginning before June 1, 2010.

SECTION: 61
LEGAL FEES AWARDED TO TAXPAYER'S COUNSEL NOT TAXABLE TO TAXPAYER WHERE NO OBLIGATION TO PAY COUNSEL EXISTED AND PAYMENT WAS NOT A PORTION OF ORIGINAL AWARD

Citation: PLR 201015016, 4/16/10

Generally if a taxpayer’s attorney is paid with an award of attorney’s fees by the losing party in litigation, the taxpayer has to pick up the payment of such fees as part of the award income. However, the IRS ruled in this particular case that no such inclusion was required, due to some unique facts.

In this case the taxpayer entered into litigation against another party and was represented by a legal aid organization and a law firm. The agreement with the legal aid organization provided that the taxpayer would not be charged a fee in connection with the case, and the law firm also took this on as a pro bono case, with a similar agreement with the taxpayer. However at the end of the lawsuit, the taxpayer had a right, as the prevailing party, for an award of attorney’s fees and the court granted that award which was paid to the legal representatives of the taxpayer.

The taxpayer conceded that the award received was includable in income, but asked the IRS to rule that the award of legal fees was not taxable income. The IRS noted that generally such awarded re taxable income, either under the view that the award satisfied a debt the taxpayer otherwise would have padi personally or is an anticipatory assignment of income.

In this case the taxpayer had no obligation to pay legal counsel, and the legal fees were not paid as part of the award, but rather under a separate action. As such, the amounts were not includable in the taxpayer’s income.

SECTION: 61
TAX COURT RULES NO FORGIVENESS OF DEBT, THEREFORE NO INCOME, ON REPOSSESSION OF TAXPAYER'S CAR

Citation: Martin v. Commissioner, TC Summary Opinion 2009-121, 8/4/09

Steed Martin's 1988 Toyota 4-Runner was repossessed after he stopped making payments and the lender charged off the $6,704.92 of Steed's loan. The lender took back the truck, but then issued a Form 1099-C for the en tire balance of the loan. The IRS went after Steed for the entire $6,704.92 as income, apparently basing their entire case on the Form 1099 standing alone.

The Tax Court was not pleased with the IRS's position. With a recourse loan (as this would be), if the lender could only pursue collection of any amount of the loan in excess of the value of the security taken in exchange for the loan. The 1099 obviously gave no value whatsoever to the truck, and that Tax Court did not find that plausible. Rather the court found more plausible the taxpayer's position that at the time of the repossession the vehicle was worth at least the $6,704.92 balance outstanding. Thus the Court held there was no income on repossession since there was no debt forgiveness.

SECTION: 67
IRS EXTENDS FOR ONE YEAR RELIEF FROM HAVING TO DETERMINE PORTION OF BUNDLED FIDUCIARY FEES SUBJECT TO 2% OF ADJUSTED GROSS INCOME LIMITATION

Citation: Notice 2010-32, 4/1/10

The IRS has extended for one more year, to taxable years beginning before January 1, 2010, the relief for taxpayers from having to determine the portion of a bundled fiduciary fee that is subject to the 2% of adjusted gross income limitation. The extension of time was granted because the IRS has not yet been able to finalize regulations under §1.67-4 to implement the allocation of such expenses.

The regulations are being developed to implement the IRS's victory in the 2008 US Supreme Court Knight decision that held that costs paid to an investment advisor by a nongrantor trust or estate are generally subject to the 2-percent floor for miscellaneous itemized deductions.

SECTION: 71
TAXPAYER HAD NO FINANCIAL INTEREST IN RESIDENCE OF FORMER SPOUSE, THUS ENTIRE MONTHLY MORTGAGE PAYMENT QUALIFIED AS ALIMONY

Citation: Contreras v. Commissioner, TC Summary Opinion 2010-35, 3/29/10

The IRS argued that because the individual in question was a signer on the mortgage on the property now being occupied by his former spouse, only ½ of the mortgage payments he made on that mortgage constituted alimony. Ernesto Contreras was obligated under his divorce decree to pay the mortgage on the residence that his former spouse resided in, and the decree provided that the payments would be treated "as if it were received directly by * * * [Norma], and shall be reportable as income to her and as a deduction for * * * [Mr. Contreras] for federal and state income tax purposes…"

However, the IRS noted that Ernesto was a signer on the mortgage, and thus contended that ½ of his payment represented a benefit to him in reducing the debt he was obligated upon. The IRS cited the Tax Court's 2000 opinion in the case of Zinsmeister v. Commissioner (TC Memo 2000-364).

However the Court distinguished this case from Zinsmeister, primarily noting that Mr. Contreras had quit claimed the house to his former spouse and retained no financial interest in the house, while Mr. Zinsmeister had sole liability on one of the debts involved and received a lien on the property in the amount of that debt. The Court also, in a footnote, commented that state law in this case (Arizona) provided that there would be no liability to the mortgage holder beyond the surrender of the residence. This combination meant that Mr. Contreras was not receiving a personal benefit from the payment of the mortgage, and the entire amount could qualify as alimony.

SECTION: 71
FLORIDA LUMP-SUM ALIMONY IS NOT ALIMONY FOR FEDERAL INCOME TAX PURPOSES

Citation: Banach v. Commissioner, TC Summary Opinion 2010-33, 3/22/10

State law labels aren't controlling when it comes to federal taxation, as Paul Banach discovered to his dismay. Paul paid his former spouse $100,000 in what was clearly labeled "alimony" in his marital settlement agreement. The agreement provided that the payment would be "lump sum alimony" due $80,000 before entry of final judgment and $20,000 within 90 days after entry of that judgment.

However, the problem that arose is that to be deductible alimony under federal tax law, the payment must be one for which there would be no liability after the death of the

recipient. The Court found that under Florida law, an award of lump sum alimony is a fixed and certain obligation that is not subject to change even if the recipient dies before the amount is paid, citing the Florida state law case of Boyd v. Boyd. The fact that it would have been required to be paid even if his former spouse had died before the payment was actually made was fatal to a deduction for alimony.

SECTION: 71
UNALLOCATED PAYMENTS WERE NOT CHILD SUPPORT, HAD TO BE REPORTED AS ALIMONY INCOME

Citation: Smith v. Commissioner, TC Summary Opinion 2010-15, 2/18/10

Kelly Smith claimed that payments she was receiving in 2005 from her former spouse were child support and not alimony. The order initially establishing the payments in August of 2005 and an amendment in March of 2006 both indicated that the payments were considered to be unallocated support and would terminate should Kelly die. However the March 2006 order indicated that $700 of the payment was for support of the child.

Kelly claimed that due to the fact that the level of support was set by the fact that a earlier order indicated payments would be made according to the guidelines. However, the Tax Court found that nothing in the agreement met the requirement of §71(c)(1) that the amount of child support must be fixed by the agreement, as the agreement merely provided for an “unallocated” award of support. The Court found the act of making the amount unallocated indicated it was intended to be alimony.

The Court also noted that the March 2006 could not be applied retroactively into 2005. As well, the Court found that even that order continued to label the payments to be considered as “unallocated” until such time as Kelly was no longer entitled to receive APL/alimony. The Court notes that Kelly has to get the state Court to clearly and unambiguously label these payments as allocable to child support, something the Tax Court will not do for her. Her relief, should it be available, would have to come in front of the state court.

SECTION: 71
TAXPAYER'S PAYMENTS TO SPOUSE OF PORTION OF PENSION BENEFIT DID NOT QUALIFY AS ALIMONY

Citation: Benzin v. Commissioner, TC Summary Opinion 2009-198, 12/28/09

A taxpayer began paying his wife $475 per month shortly after beginning to receive distributions from his USPS pension plan. He claimed a deduction for alimony paid to his former spouse based on these payments. He submitted as part of the evidence to

support his alimony claim a single page (labeled page 2) that contained an order that he pay his former spouse $475 per month as a projected calculation of her interest in his retirement plan.

However, at trial he did not provide any explanation of what this paper represented, nor were the other pages presented. The actual agreement that was part of the divorce proceeding specifically provided that neither party was obligated to pay maintenance to the other, and the taxpayer testified that he did not have to pay alimony. As such the Court held that there was no evidence provided that this payment met the requirements to be deductible as alimony under §71.

The Court suggested that the taxpayer could solve his problem for future years by having a local court issued a Qualified Domestic Relations Order on the plan, the method provided under the IRC to handle a division of plan benefits under §414(p) so as to not run afoul of the anti-alienation provisions of IRC §401(a)(13). Had the taxpayer used a QDRO the entire issue would have been solved, and he would not have had to attempt to meet the specific rules to have a payment treated as alimony under §71.

SECTION: 71
STATE COURT RULING RETROACTIVELY LABELING PAYMENTS TO EX-SPOUSE AS ALIMONY DID NOT CONTROL FEDERAL TAX TREATMENT

Citation: Novak v. Commissioner, TC Summary Opinion 2009-185, 12/7/09

Even though she was able to get a state court to label the amounts she paid her ex-husband as alimony, Lori Novak was denied a deduction for the amounts in question. The Tax Court looked at how the payments had been determined in Lori's divorce case and came to the conclusion that the amounts she was paying were mainly her ½ of the joint debts. The court noted as well that the accounting for the payments gave her ex-husband, who had custody of their children, credit for $100 per month of alimony to Lori, and Lori's payments to him were reduced by that amount.

What about the state court order clarifying that her payments were alimony? That order was issued three years after the fact by a different judge than the one that originally presided. As well, the Tax Court noted, such a state court label doesn't settle the matter for federal tax law purposes—rather, you look to see if the payments meet the requirements of IRC §71.

SECTION: 72
DISTRIBUTION TO TAXPAYER ALREADY OVER 59 1/2 DID NOT INVALIDATE PRIOR PARTIAL ROLLOVER

Citation: PLR 2010138012, 9/24/10

Sometimes a taxpayer is attempting an allowed transaction but needs the cooperation of a third party in reporting the transaction. In the situation that led to this letter ruling the issue was an attempt to make a partial exchange of an annuity contract. Such an exchange is allowed on a tax free basis so long as the requirements of Revenue Procedure 2008-24 are complied with.

One of the requirements that must be met generally Is that either no additional distribution be made during the one year period following the rollover or any such distribution must be made after the occurrence of an event described in Section 72(q)(2)(A), (B), (C), (E), (F) or (G) which has occurred after the date of the rollover. In this case the taxpayer was over age 59 1/2 both when the original rollover took place and when the later distribution took place. The insurance company informed the taxpayer the second distribution had rendered the original transaction no longer eligible to be treated in a tax free manner. The taxpayer sought an IRS ruling that, in fact, he had to simply be over 59 1/2 at the date of the distribution, and he did have to be less than age 59 1/2 at the date of the rollover. The insurance company appeared to believe this exception would only apply if the taxpayer turned 59 1/2 in between the rollover date and the additional distribution.

The IRS held that the taxpayer merely needed to be age 59 1/2 at ten date of the second distribution and did not have to turn 59 1/2 during the period between the rollover date and the second distribution.

SECTION: 72
CHANGE IN ANNUITY AMOUNT FROM IRA DUE TO DIVORCE NOT TREATED AS MODIFICATION TO SUBSTANTIALLY EQUAL PAYMENTS

Citation: PLR 201030038, 7/29/10

A taxpayer had been receiving payments from an IRA prior the attainment of age 59 ½, using the fixed annuitization method described in Rev. Rul. 2002-62. Prior to the end of the required payout period to eliminate the otherwise applicable premature distribution tax under §72 the taxpayer and her spouse were divorced. As part of the divorce settlement, her soon to be ex-husband was to receive a portion of her IRA.

The taxpayer will use the same fixed annuitization method to compute the payments, but using the balance after a portion of the account is distributed to her former spouse.

Thus, she will be receiving less than she would have received under the original schedule.

The IRS ruled that the proposed transfer transaction itself was a nontaxable transfer under §408(d)(6) and that the reduction in the monthly distribution to the IRA owner following the division of the IRA will not be considered a modification to the series of substantially equal payments under §72(t)(4), thus the 10 percent additional tax imposed by §72(t)(1) will not apply.

SECTION: 72
CANCELLATION OF POLICY WHEN POLICY LOAN EXHAUSTED VALUE OF POLICY WAS INCOME UNDER §72 AND NOT CANCELLATION OF DEBT

Citation: McGowen v. Commissioner, TC Memo 2009-285, 12/14/09

The Tax Court rejected a taxpayer's argument that her income from the cancellation of her life insurance policy that took place when her outstanding loans exhausted her cash value in the policy was income from the discharge of indebtedness. Rather the Court held that the tax treatment must be computed using §72(e), treating as a gain on that the difference between their basis in the policy and the amount she was deemed to have received.

While the Court didn't go into details, presumably the taxpayers were insolvent and could have excluded under §108 any discharge of indebtedness. However in this case the taxpayers didn't fail to pay the loan—rather the loan was effectively paid off via the surrender (even if involuntary) of the policy that took care of the outstanding loan against the policy.

SECTION: 72
PROCEEDS FROM SURRENDER OF LIFE INSURANCE POLICY INCLUDES AMOUNT OF LOAN AND GAIN IS ORDINARY INCOME

Citation: Barr v. Commissioner, TC Memo 2009-250, 11/3/09

Yet another case comes at us where a taxpayer has trouble understanding why they have a taxable gain of nearly $136,000 on the surrender of a life insurance policy where the taxpayers received check at surrender of less than $12,000. Mr. Barr paid the premiums on the policy for 8 to 9 years beginning in 1980. At that point, he paid for the premiums by borrowing against the policy. Unfortunately, in 2005 the policy ran out of steam and had insufficient assets to pay the premiums out of its own resources.

The insurance company wrote the taxpayers and warned them that the policy would lapse if they did not forward cash to pay the premiums on their own. Despite being warned by the insurer in a letter that a gain would result if the policy terminated, the taxpayers decided they no longer needed the policy and let it lapse. The taxpayers would end up testifying that, apparently, they never really read the letters as this situation unraveled.

Even though the taxpayer himself did not receive a check for any of the borrowing (they all went to pay premiums as they came due), he nevertheless had taxable gain and that gain was ordinary income. The taxpayers had received the benefit of having insurance coverage for the entire period in question even though they had only directly paid premiums for 8 to 9 years.

SECTION: 104
SETTLEMENT FOR INTENTIONAL INFLICTION OF EMOTIONAL DISTRESS THAT RESULTED IN A HEART ATTACK FOUND PARTIALLY EXCLUDABLE FROM INCOME

Citation: Parkinson v. Commissioner, TC Memo 2010-142, 6/28/10

The Tax Court analyzed a settlement agreement a taxpayer signed with his former employer to determine how much of the settlement was excludable as compensation for physical injuries. The IRS objected that the taxpayer had filed a complaint for, among other things, intentional infliction of emotional distress, which the IRS argued would automatically render the damages includable in income.

The Tax Court found that while a number of claims were pressed, in fact the actual agreement in the end only applied the award to the intentional infliction of emotional distress. But the Tax Court held that alone did not mean the award was not excludable, for in this case the taxpayer had argued in his complaint against the employer that this emotional distress lead to a heart attack. The Court noted a significant portion of the evidence the taxpayer had offered during the claim had related directly to his heart attack.

However the court found that while heart attack was the overriding focus of his court proceeding, and the court believed that physical injuries figured prominently the defendant's payment. But the court found the taxpayer had failed to show the settlement did not include other items and so the court limited the exclusion to only ½ of the overall award.

While the taxpayer picked up a partial victory, a lot of trouble (and perhaps the entire case) could have been avoided had the settlement agreement been more carefully drafted to clearly indicate the significance of the physical injury award.

SECTION: 104
IRS, AFTER HAVING SETTLED IN FAVOR OF TAXPAYER 3 TIMES BEFORE, PREVAILS IN TAX COURT CHALLENGING THAT PAYMENTS WERE NOT NONTAXABLE DISABILITY

Citation: Lukovsky v. Commissioner, TC Memo 2010-117, 5/27/10

The taxpayer in this case had three times before been challenged by the IRS regarding the status of his pension income. The taxpayer was receiving retirement income related to his service as a police officer. However when he had left the police force he had applied for and been denied disability benefits, rather receiving the retirement benefits to which he became eligible to receive. The retirement plan appears to have continued to report these amounts as taxable pension retirement payments rather than as disability payments, and had denied the taxpayer's appeals to obtain disability payments.

In the prior three cases, the IRS had agreed to stipulated decisions that resulted in no deficiency. However, the Tax Court pointed out that because the court had never ruled on the issue of whether his pension was disability income, the IRS was not precluded from carrying that position in this case, despite the taxpayer's protests to the contrary.

The Court, which this time was asked to rule, found that the taxpayer had never received disability payments. Rather, he had asserted he should have received disability, but he never was able to prevail in efforts to get the amounts converted to payments under the disability provisions of the retirement plan. Therefore, the amounts were not excludable from income as payments of a nature similar to workers compensation under §104(a)(1).

SECTION: 104
EMPLOYER'S SETTLEMENT PAYMENT HELD TO BE INTENDED TO COMPENSATE FOR PHYSICAL INJURIES, THUS EXCLUDABLE FROM INCOME

Citation: Domeny v. Commissioner, TC Memo 2010-9, 1/13/10

Julie Domeny suffered from MS. She was working with an organization dealing with autistic students as a professional fundraiser. When a new executive director was hired by the organization, her duties were restricted and her relationship with the director was strained, causing her MS to flare up. She then discovered that the executive director was embezzling funds from accounts being maintained for the students. Although the board told her they would "take care of the matter" they continued to send her out to raise funds while the director remained in place.

At this point her physical symptoms worsened and, was diagnosed by her physician as being unable to return to work for two weeks due to the symptoms. After she informed her employer of this, the executive director called Julie and notified her that her employment was terminated.

Julie hired an attorney who, being informed of her medical condition, negotiated a settlement with her employer on her behalf. The settlement was for $33,308, paid ¼ for compensation due to Julie (and which was reported on her W-2), ¼ sent directly to her attorney with no reporting, and the remaining paid directly to Julie and reported on a Form 1099MISC as nonemployee compensation. Julie reported the W-2 amount as income but did not report the amount shown on the Form 1099MISC, contending it was for physical injuries and thus excludable from income.

The Tax Court agreed with Julie. While it noted the settlement did not restrict the payment to compensation for physical injuries, it found that the division of the settlement made it clear that the payor was aware that there were different components to the settlement. In a case where the settlement agreement itself is ambiguous, the intent of the payor in making the payment is the key factor. Given that Julie asserted an action based on the physical effects of the hostile work environment and the former employer divided up the award, the Court found an appropriate intent to compensate Julie for physical injuries, allowing the payment to be excluded from income under §104(a)(2).

SECTION: 104
EMPLOYMENT RELATED DAMAGES NOT EXCLUDABLE FROM INCOME, BUT TAXPAYER ESCAPES PENALTIES DUE TO RELIANCE ON PROFESSIONAL

Citation: Longoria v. Commissioner, TC Memo 2009-162, 7/2/09

Emblez Longoria received a settlement related to his claim of employment related discrimination. He sought advice from a CPA to whom he provided all information requested. Even though Mr. Longoria informed the CPA that he did not have the settlement agreement with him, the CPA did not request that Mr. Longoria obtain that for him. Rather, after having questioned the taxpayer about whether he had suffered any physical injuries or illness that related to the claim, and being informed by Emblez that he had suffered some such physical effects, the CPA informed Emblez that the amounts could be excluded under §104.

The Tax Court noted that while Mr. Longoria may have suffered physical injuries, there was no evidence either in the settlement agreement or from other sources that his employer intended to have the settlement compensate him for that rather than simply handling the discrimination issue. As such, the amount was taxable. But because he

had acted reasonably in seeking advice, had sought out a professional that appeared to have sufficient background to rule on the taxability of the amount and had provided that CPA with all information that had been requested, the court found that he was not subject to a negligence penalty.

SECTION: 104
LACK OF ALLOCATION OF PORTION OF LAWSUIT SETTLEMENT TO PHYSICAL INJURIES MEANT ALL WAS TAXABLE

Citation: Hellesen v. Commissioner, TC Memo 2009-143, 6/18/09

The exclusion from taxable income for physical injuries for lawsuit awards and settlements under §104 requires not only that there be some physical injury involved and that a settlement cover claims that include such items, but that it be possible to determine what part of the award represents compensation for such claims. While Jon Hellesen cited certain physical ailments he claimed were caused by stress that arose from sexual harassment, the settlement agreement he entered into with his employer covered a laundry list of specific claims along with any other possible claims, and did not allocate any part of the payment directly to physical injuries. As such, the Tax Court ruled that the entire amount of the award was subject to federal income taxation.

SECTION: 105
IRS CLARIFIES APPLICATION OF PPACA PROVISIONS DEALING WITH HEALTH CARE BENEFITS OFFERED TO CHILDREN UNDER AGE 27

Citation: Notice 2010-38, 4/27/10

The IRS issued a clarifying notice dealing with the extension of tax advantaged medical coverage to children of taxpayers under age 27 that was enacted as part of the Patient Protection and Affordable Care Act.

Effective March 10, 2010, employer paid reimbursements of medical expenses that are excludable from income under §105(b) may include payments made to a taxpayer's child under the age of 27, even a child who is not the employee's dependent for the year. The child must not have attained the age of 27 as of the end of the taxable year. The notice points out that for this limit, the residency, support and other tests a child has to clear under §152(c) to be a dependent will not apply to this exclusion.

The notice also announces that the regulations under §106 will be amended to provide that coverage under an employer provided accident or health plan will also be excludable from income if provided for a child meeting the above requirements. The notice gives a number of examples applying these rules. These classes of benefits will also similarly be exempt from FICA and FUTA taxation.

The Notice also indicates that the IRS will be issuing modifications to the regulations under §125 that will allow taxpayers whose children first become eligible to receive benefits from a health care flexible spending arrangement due to these changes to modify their election on the amounts they will defer into the FSA. Employers who wish to offer this benefit under their cafeteria plans will be able to start providing the benefit beginning on any date after the effective date of the law, so long as the plan is formally amended to allow for this no later than December 31, 2010.

SECTION: 108
DEBT DISCHARGED IN YEAR OTHER THAN ONE IN WHICH BANK ISSUED 1099-C

Citation: Gaffney v. Commissioner, TC Summary Opinion 2010-128, 8/30/10

While discharge of indebtedness does, absent the applicability of an exception under §108, result in taxable income, it only does so in the year of the actual debt discharge. That date is not necessarily set by the issuance of a Form 1099-C, an issue the Tax Court pointed out to the IRS.

In this case the taxpayer had been a president of an Arizona S corporation that was building homes in Hawaii. Due to a dispute with the entity's insurer, the taxpayer and wife sold most of their assets, abandoned their personal residence in Hawaii and moved to apartment in Arizona. However, unknown to the taxpayers the lender that held the mortgage on their residence in Hawaii began proceedings to foreclose on the Hawaii residence and the residence was sold at a foreclosure sale with a balance remaining outstanding. The mortgage in question was a recourse debt and, as such, the taxpayers were liable for the balance. This sale took place in 1994.

The mortgage holder intermittently undertook collection activities on the balance due, although the balance was charged off on its books in 1995. However such activities ceased in 2001, aside from creating an asset profile on the taxpayer in 2003. In 2006 the lender finally issued a Form 1099-C reporting the discharge of indebtedness, which it mailed to the taxpayer's former address. The form contained an erroneous name, but had the taxpayer's social security number.

When the IRS contacted the taxpayer about the 1099-C and nonreporting of income, the taxpayer contacted the mortgage holder about why the 1099-C was issued. The lender, in a short letter, simply remarked that it had reviewed the account and the 1099-C was correct.

The taxpayer disputed the 1099-C, noting that if there was debt discharged it took place in a year other than 2006. The Tax Court noted that the taxpayer did not actively dispute the amount of the discharge, so it took the letter as satisfying the IRS's

responsibility under §6201(d) to inquire when the taxpayer disputes the correctness of an information return in a matter before the Tax Court.

However, the Tax Court notes that a debt becomes income at the moment it becomes clear the debt will not be repaid, and most often turns on the subjective intent of the lender as demonstrated by an objectively identifiable event—and 1099-C is not dispositive. Rather the Court noted that in this case the lender ceased all significant collection activity in 2001, and took absolutely no action after 2003 except the issuance of the 1099-C in 2006. As well, a rebuttable presumption exists that an identifiable event has occurred when there is no payment received during a 36 month period.

The Court concluded that while a discharge of indebtedness in the amount listed on the 1099-C had taken place, it also held that this discharge did not take place in 2006. Therefore the taxpayer had not underpaid tax in 2006.

SECTION: 108
TAXPAYER TAXABLE ON CANCELLATION OF INDEBTEDNESS INCOME DESPITE DIVORCE DECREE STATING FORMER SPOUSE WAS LIABLE

Citation: Jensen v. Commissioner, TC Memo 2010-77, 4/15/10

Paul Jensen borrowed funds from Citibank, but in his divorce agreement his former spouse was made specifically liable to repay that debt. When she failed to do so, Citibank issued a 1099-C naming Paul that showed discharge of debt income. Paul claimed that since the divorce agreement clearly stated his former spouse was liable to repay this debt, he did not need to report the income.

The Tax Court did not agree. The Court found Paul was the original borrower, and that while the divorce decree gave Paul a right to seek reimbursement from his former spouse for any amount he had to pay, it did not change the fact that he was obligated to Citibank—and when he did not pay on that obligation, he had discharge of indebtedness income.

SECTION: 121
NEW HOME BUILT ON SITE OF OLD RESIDENCE DID NOT QUALIFY FOR GAIN EXCLUSION ON SALE

Citation: Gates v. Commissioner, 135 TC No. 1, 7/1/10

In a split decision, the Tax Court decided that taxpayers who demolished their residence, built a new residence and then sold the resulting property without ever having moved into the new home could not exclude any of the gain under §121's home sale exclusion. The taxpayers had both owned and lived in the old home for more than

2 years of the five years prior to sale. The taxpayers decided to expand the property, but were informed that building codes had changed, so they demolished the old home and built a brand new one.

The new completed home was not built on the foundation of the old home, and in fact only covered a portion of the area previously occupied by the old building since the building was relocated on the land. The taxpayers argued that §121 should operate to allow for an exclusion of the gain since the property sold included the land they had used, along with the old home, as their principal residence. The IRS argued that without the old home, the property could not qualify for the §121 exclusion.

The Tax Court found the language in §121 to be ambiguous on this issue, so the Court consulted committee reports from the enactment of the law and prior case law under old §1034 (the old replacement of residence deferral provision). The court noted cases under old §1034 that required that the actual property used as a residence had to be sold, not just the land on which the residence resided, in order to qualify for the old deferral. As the same terms are used in current §121 as were used in old §1034, the Court concluded that sale of the actual property used as a residence was required.

The dissenting opinion agreed that you can arrive at the majority's result based on the law as written, but argued it was also possible to arrive at the opposite result. Given that Congress intended to simplify and grant an expanded tax benefit, the dissent argued the proper view should have been to grant the more permissive reading of the ambiguous provision. The dissent also complained that under the majority's logic a taxpayer whose home was destroyed in a disaster and then rebuilt would have the holding period start over at zero, while one whose home was merely damaged wouldn't be so disadvantage. The dissent also complained that the majority position was also going to open up the issue of exactly when a remodeling project would end up creating a new residence (restarting the use period) as opposed to simply modifying the old (which would retain the old use period).

SECTION: 151
DIVORCE DECREE DID NOT SUFFICE TO ALLOW NONCUSTODIAL PARENT TO CLAIM DEPENDENT ON RETURN

Citation: Thomas v. Commissioner, TC Memo 2010-11, 1/19/10

John Thomas's divorce decree provided that, so long as he was current in his child support, he would be allowed to claim his daughter, who lived with his former spouse, as his dependent in even numbered years. Mr. Thomas was current on his child support obligations through 2006, but when he went to electronically file his return, his

CPA told him the return had been rejected because someone else had claimed his daughter as a dependent on an already filed return.

He discovered, not surprisingly, that his former spouse had claimed his daughter as dependent. Following that discovery, his CPA prepared a paper return claiming the daughter and attached a copy of the divorce decree.

Unfortunately, the Tax Court pointed out, the regulations required that either a Form 8332 or a form that conformed to the substance of the Form 8332 had to be attached to the return for the noncustodial parent to claim the exemption. The decree failed on a number of counts. First, the decree only granted the right conditionally, while an 8332 does not impose conditions on its validity. Second, the decree did not contain the date of his former spouse's signature or her social security number, both of which would also have been required.

The judge agreed the result appeared harsh, since clearly Mr. Thomas had fulfilled his obligations under the decree. But the Court made clear that, in this matter, you have to comply with the specific requirements and that attaching the decree failed to accomplish that feat.

SECTION: 152
NONCUSTODIAL PARENT NOT ALLOWED DEPENDENCY DEDUCTION EVEN THOUGH CUSTODIAL PARENT VIOLATED CLEAR STATE COURT ORDER TO EXECUTE FORM 8332

Citation: Himes v. Commissioner, TC Memo 2010-97, 5/4/10

The rules for claiming of an exemption by a noncustodial parent are very rigid and not forgiving, even in cases when it's clear that simple fairness would argue that the rigid rules should not apply. In this case, the divorce decree provided that Leslie Himes would be able to claim the children so long as he remained current on his child support. Under the terms of the decree, his former spouse would deliver a Form 8332 to the clerk of the court, the clerk would verify that all child support had been paid and then release the Form 8332 to Mr. Himes.

However his former spouse decided to leave the state, taking the children with her, and break off all contact with Mr. Himes—except, apparently, to collect the child support which Mr. Himes continued to faithfully pay. Mr. Himes did not know where she had moved to, and eventually lost all contact with his children. As well, his spouse was required under terms of the order to have obtained permission to take the children from the state, but she ignored that requirement as well. His former spouse did not execute a Form 8332, but Mr. Himes continued to claim the exemption that, under the state order, he should have been entitled to.

While sympathetic to his plight, the Tax Court made clear that there is no give in the requirements here—lacking a signed release from his former spouse, Mr. Himes as noncustodial parent was not eligible to claim the dependency exemption for his children.

SECTION: 152
REVISED REGULATIONS IMPOSE MORE STRINGENT REQUIREMENTS FOR NONCUSTODIAL PARENT TO CLAIM CHILD AS DEPENDENT

Citation: TD 9408, Reg. §1.152-4, 7/2/08

Reg. §1.152-4 has been revised by the IRS to impose stricter requirements on when a noncustodial parent to claim a dependency exemption. The new regulations were effective for tax years beginning after July 2, 2008, which means for most taxpayers the 2009 individual return will be the first one where these rules will apply. The regulations make clear that the "custodial parent" is determined by counting the number of nights that a child spends with each parent, with the parent with the largest number of nights being the custodial parent for federal income tax purposes.

The regulations impose strict limits on the documents that will count for a release of an exemption, effectively requiring the use of Form 8332 or a document containing exactly the same information. The final regulations also make clear that divorce decree, court order or separation agreement will not be effective by themselves to transfer the exemption. As well, if a custodial parent has previously signed a release of exemption for future years, the parent can revoke that consent but must that parent must show that he/she actually notified the noncustodial parent of the revocation or made a reasonable attempt to give such notice.

SECTION: 162
GAMBLING WAS TAXPAYER'S TRADE OR BUSINESS DESPITE IRS VIEW THAT HIS METHOD WAS IRRATIONAL AND WASN'T A FULL TIME BUSINESS

Citation: Le v. Commissioner, TC Summary Opinion 2010-94, 7/19/10

The taxpayer in this case based their business plan for their gambling business on religious and cultural beliefs derived from their Vietnamese backgrounds. The taxpayers believed that certain days were "lucky days" and expected to overcome the odds against them with slot machines by gambling on their lucky days. They also attempted to make use of slot machines where they had watched other players lose excessive amounts before giving up, believing playing such machines increased their chances of success.

The IRS argued that the taxpayers were not in the trade or business of gambling, holding that their approach was not businesslike and was irrational. The Tax Court disagreed, holding that the taxpayers clearly believed in the methods they were using and expected them to pay off, noting that the taxpayers had initial success in their gambling that, unfortunately, did not hold up over time. The taxpayers also began pursuing this business after learning his employer was moving operations, and was seeking to replace what he believed would soon be lost income.

The IRS also argued it shouldn't be treated as a trade or business because the taxpayers did not pursue the activity full time. The Tax Court dismissed this claim, noting that there is no requirements that taxpayers must have only a single trade or business, something that would necessarily be true if the IRS's view of a full time requirement were true.

SECTION: 162
TAXPAYER MUST HAVE A TAX HOME TO BE ABLE TO CLAIM TEMPORARY LIVING EXPENSES

Citation: Minick v. Commissioner, TC Memo 2010-12, 1/21/2010

Taxpayers are allowed, in the right circumstances, to claim a deduction for certain living expenses incurred while on temporary assignment away from home under §162(a). However, in order to be able to claim such expenses a taxpayer must be able to show the taxpayer has a tax home to be temporarily away from—and, as the case of Mr. Minick illustrates, a person does not have to have such a home.

The Minicks had long lived in Eure, North Carolina and planned to hold onto their home there even though the local economy was extremely poor and there was no work there. In the year in question neither taxpayer had employment in Eure. Neither taxpayer had any employment in Eure in the year at issue, and there was no reasonable prospect of finding such work there. Rather Mr. Minick worked at various construction sites away from Eure during the year in question.

The Tax Court noted that while the Minicks had personal reasons for being in Eure, there was no business reason shown by Mr. Minick for maintaining the residence in Eure. As a tax home is determined by reference to a person’s principal place of employment and that never was Eure. As such, Mr. Minick could not be allowed a deduction for expenses of being temporarily away from his tax home when he, in fact, had none.

SECTION: 162
EXPENSE OF OBTAINING MBA DEGREE ALLOWED AS BUSINESS DEDUCTION

Citation: Singleton-Clarke v. Commissioner, TC Summary Opinion 2009-182, 12/2/09

Getting a degree does not mean that a taxpayer will not be able to claim a deduction for business related education, though Lori Singleton-Clarke had to go to Tax Court to prevail in her case. Lori had over 20 years of experience, first as an acute bedside clinical nurse and then in nursing management positions. Lori determined that an MBA would be useful in job function, and she paid for and obtained her MBA. She claimed a deduction for the expense, and the IRS disallowed that deduction on exam.

The IRS claimed that pursuing the MBA both enabled Lori to obtain the job she currently holds and that in any event the degree qualified Lori for a new trade or business. The Tax Court found that despite the fact that the job description for Lori's job indicated a need for a degree in health care administration, her outstanding qualifications otherwise lead the Court to believe she would have obtained the job anyway.

The Court also disagreed that the MBA qualified her for a new trade or business. The Court emphasized that an MBA, unlike other degrees, does not qualify an individual for entrance to a profession. Rather the Court examined prior cases regarding MBAs, and noted that if the taxpayer is continuing an existing career an MBA is not generally going to qualify the taxpayer for a new trade or business. Cases where the expense of an MBA degree have not been allowed have been ones where the taxpayer did not have an existing career in which the MBA training would be used.

SECTION: 162
PSYCHOLOGIST NOT ALLOWED TO DEDUCT EDUCATIONAL EXPENSES

Citation: Ortega v. Commissioner, TC Summary Opinion 2009-120, 8/3/09

Corrine Ortega had worked in the mental health filed in Nebraska, and decided she needed to obtain additional education. She attended a doctoral program in psychology at the University of Nebraska. She had previously worked for the Nebraska Department of Corrections as a mental health practitioner. Nebraska did not require, at the time Corrine worked there, for an individual in that position to possess a doctoral degree. One requirement of the doctoral program was that Corrine had to complete a one year internship, and she relocated to New York to meet that requirement .

After obtaining her doctorate, Corrine took a position in New York, a state that did require a doctoral degree as a minimum requirement for the position she took. Corrine

argued that the position she had obtained wasn't significantly different from what she had in Nebraska. However, the Tax Court disagreed. It noted that in Nebraska this was also the minimum requirement to be licensed as a psychologist and, in New York, was simply the minimum to do the work she did. In either case the education qualified her for a new profession and met the minimum requirements of that profession—both of which serve to eliminate any deduction.

SECTION: 162
DESPITE ASSIGNMENT THAT LASTED 13 MONTHS, TAXPAYER ALLOWED AWAY FROM HOME EXPENSES

Citation: Senulis v. Commissioner, TC Summary 2009-97, 6/22/09

Alexander Senulis who lived in Louisiana took a temporary assignment in Houston in January 2002 for a project that was supposed to be completed before the end of 2002. While the exact time for the project couldn't be exactly projected, at the time the assignment was taken on it was projected it would last 9 to 10 months. However, the actual assignment ended up running for 13 months before his services were terminated.

Alexander deducted his meals and incidental expenses, airfare and automobile expenses as ordinary and necessary business expenses for expenses incurred while away from home. The IRS contended that IRC §162(a), which indicates that the taxpayer "shall not be treated as being temporarily away from home during any period of employment if such period exceeds 1 year." However, the Tax Court noted that if employment is expected to last less than one year but later it is discovered it will exceed that period, deductions will still be allowed until such time that the taxpayer's expectations change or the period exceeds one year."

In this case, the Court held that the employment was clearly temporary, and there was not reason to believe the project would exceed one year until it actually did so. So the Court allowed Alexander a deduction for these expenses in 2002.

SECTION: 163
TAXPAYER HAD BENEFICIAL OWNERSHIP OF RESIDENCE HELD IN TRUST, ALLOWED MORTGAGE INTEREST DEDUCTION

Citation: Adams v. Commissioner, TC Memo 2010-72, 4/13/10

The Tax Court considered whether a taxpayer that entered into a nontraditional arrangement to acquire a residence could claim a deduction for mortgage interest and property taxes. Under the concept of equitable ownership, a taxpayer can be found to be the effective owner of a residence even if he/she does not possess formal ownership, and thus be entitled to mortgage interest and property tax deductions.

In this case the property was held in a trust that purchased the property. The taxpayer had a duty to repair or maintain the property while he resided in it, he was responsible for insuring the property, had a duty to pay all property taxes and easements while he lived there, he a right to all income from rents, mortgages or sales, had a right to obtain legal title at any time by pay8ing the balance of the purchase price, was required to make payments to the truest to pay the mortgage payments, and he had some risk of loss since he required to maintain insurance. As well, he could lose the entire amount he had paid into the trust at the end of its five year term if there was no equity in the property or he for whatever reason choose not to exercise the purchase option.

In reality the taxpayer did not exercise that right and let the property go back to the trust, as it had declined in value during the period he resided in it with the trust as owner. That was negative indicator, as was the fact he had to enter into a rental agreement with the trust to occupy the property and he could not make improvements to the property without the approval of the trustee.

On balance, the court found that the factors in favor of finding the taxpayer had beneficial ownership outweighed the facts that suggested the taxpayer did not. Thus, the taxpayer was allowed a deduction for the mortgage interest and property taxes.

SECTION: 163
IRS REVERSES COURSE, DECIDES THAT TAXPAYERS CAN DEDUCT "EXTRA" $100,000 OF ACQUISITION DEBT AS HOME EQUITY DEBT

Citation: ILM 200940030, 10/2/09

It's not often the IRS walks away from a position that they have prevailed on twice in Tax Court, but that is what the IRS did with regard to the proper treatment of original acquisition debt in excess of $1,000,000. In the cases of Pau (TC Memo 1997-43) and Catalano (TC Memo 2000-82) the IRS denied taxpayers deductions for interest on debt they had claimed as home equity debt which represented $100,000 of their original mortgage in excess of the $1,000,000 acquisition debt limit.

The IRS litigating position in those cases, which prevailed in the decisions, was that the proper way to read §163 was that the $1,000,000 was not part of the definition of acquisition debt, but rather a limit on it. That's important because IRC §163 specifically indicates that home equity debt is debt other than acquisition debt. Now the IRS, in this legal memorandum, has decided that those cases are incorrect in their interpretation of the law, and that interest on an additional $100,000 of debt is allowed for regular tax purposes.

Before you decide we have the return of the “kinder, gentler” IRS you should consider one of the reasons the IRS decided that the law should be read differently than the two cases suggest it should. The IRS appears to have discovered that if, in fact, the $1,000,000 is only a cap on acquisition debt rather than part of the definition, there would be no limit on interest deducted on acquisition debt for alternative minimum tax purposes. Therefore taxpayers otherwise subject to the alternative minimum tax who had seven figure mortgages might find themselves able to get out of the alternative minimum tax obligations.

Nevertheless, if you have a taxpayer who followed the Pau and Catalano decisions and did not deduct interest that they could have deducted for regular tax purposes, you should advise them of the option of filing claims for refund using the logic of this memorandum.

SECTION: 165
IRS ANNOUNCES SPECIAL RULES FOR FEDERAL TAX TREATMENT OF REPAIRS RELATED TO CORROSIVE DRYWALL

Citation: Rev. Proc. 2010-36, 9/30/10

The IRS has issued special relief for individuals who have paid to repair the effects of corrosive drywall. The payments include payments to repair damage to an individual’s residence or household appliances that results from corrosive drywall.

Corrosive drywall means drywall identified as problem drywall under the two step identification method outlined by the Consumer Product Safety Commission in their interim guidance published on January 28, 2010. The two step method includes a threshold visual inspection that shows blackening of copper electrical wiring and/or air conditioning evaporator coils and the installation of drywall between 2001 and 2008.

For houses passing this initial test, a set of secondary, more detailed tests must be performed to obtain corroborating evidence of problem drywall. For installations between 2001 and 2004 at least four of these indicia must be presence, while at least two must be present for installations between 2005 and 2008:

(a) Corrosive conditions in the home, demonstrated by the formation of copper sulfide on copper coupons (test strips of metal) placed in the home for a period of 2 weeks to 30 days or confirmation of the presence of sulfur in the blackening of the grounding wires and/or air conditioning coils;

(b) Confirmed markings of Chinese origin for drywall in the home;

(c) Strontium levels in samples of drywall core found in the home (i.e. excluding the exterior paper surfaces) exceeding 1200 parts per million (ppm);

(d) Elemental sulfur levels in samples of drywall core found in the home exceeding 10 ppm;

(e) Elevated levels of hydrogen sulfide, carbonyl sulfide and/or carbon disulfide emitted from samples of drywall from the home when placed in test chambers using ASTM Standard Test Method D5504-08 or similar chamber or headspace testing;

(f) Corrosion of copper metal to form copper sulfide when copper is placed in test chambers with drywall samples taken from the home.

Payments made will be treated as a casualty loss in the year the amount is paid. If no claim for reimbursement is sought, the taxpayer will be able to claim the entire amount of the applicable payment. If a claim is being sought, the taxpayer will be able to deduct 75% of the amount paid in the year of payment. When a settlement is received, a gain or loss will be recorded based on the difference between the 25% costs not yet charged off and the amount received.

Certain limits apply to payments made. First, only amounts paid to return the taxpayer's residence to its pre-loss condition will be allowed as casualty losses—payments that increase the value of the residence above its pre-loss values will not be allowed. Second, if a taxpayer replaces rather than repairs an appliance, the loss will be limited to the lesser of the current cost to replace the appliance or the taxpayer's basis in the appliance.

SECTION: 165
TAX COURT ACCEPTS REDEMPTION OF TOKENS METHOD OF DETERMINING GAMBLING WINS OR LOSSES FOR SLOT MACHINE PLAYER

Citation: Schollenberger v. Commissioner, TC Memo 2009-306, 12/28/09

The Tax Court accepted the methodology that the IRS put forward in Chief Counsel Advice 2008-011 where the taxpayer computed his net wins at the redemption of tokens in the casino is the proper way to determine wins or losses for slot machine players. In this case the taxpayer argued that, instead, he should be able to offset his entire losses for the year above the line against his net losses—a treatment the Court found would effectively render superfluous the provisions limiting casual gamblers to claiming their loss deductions as an itemized deduction.

While the decision doesn't necessarily indicate that the redemption of tokens method advanced in Chief Counsel Advice 2008-011 is the only method that would be allowed, it does indicate that the Tax Court found that methodology to be an effective example of an implementation the Court finds acceptable for session based play. The Court noted earlier decisions that held it wasn't reasonable to demand a "per pull" method of accounting for wins and losses for such gambling activities.

Interestingly, the notice of deficiency issued to the taxpayers used the amount reported on the information return of a $2,000 win on a single pull as the unreported income to be added to adjusted gross income. At trial the IRS reduced that amount to the net winnings for the day—the taxpayers started the day by purchasing $500 of chips, won a $2,000 jackpot and then used up $400 of the winnings in further play during the day (all of which ended up back in the casino's coffers).

SECTION: 166
AMOUNTS ADVANCED TO CONTROLLED CORPORATION WERE CAPITAL CONTRIBUTIONS AND NOT BONA FIDE LOANS

Citation: Javorski v. Commissioner, TC Summary Opinion 2010-136, 9/13/10

The taxpayer's failure to document amounts forwarded to a failing corporation he owned were loans resulted in a disallowance of claim for a bad debt under §166(a), rather being treated as contributions of capital.

The taxpayer had advanced the corporation significant sums of money as it continued to deteriorate financially, but the advances were never documented as loans. The Tax Court paid particular notice to this factor as indicating the amounts were not truly debts.

The taxpayers attempted to cite the court's decisions in Johnson v. Commissioner, TC Memo 1977-436 in rebuttal. The Tax Court agreed the taxpayers in Johnson also did not have a note, but they submitted contemporaneous board meeting minutes that clearly documented the amounts as being loaned to the corporation.

In this case the corporation never recorded the amounts as payables and the taxpayer continued to make advances long after the business had deteriorated to the point that it was no longer reasonable to expect repayment. The Court found it was more reasonable to treat the amounts as capital contributed by the owner rather than actual bona fide loans.

SECTION: 170
APPRAISAL'S RELIANCE ON DISCOUNTS ALLOWED BEFORE IN TAX COURT AS PRIMARY VALUATION METHOD FATAL TO CHARITABLE DEDUCTION

Citation: Scheidelman & Perry v. Commissioner, TC Memo 2010-151, 7/14/10

The issue in this case was the taxpayer's appraisal report in support of a charitable deduction. Because the appraisal failed to meet the standards for a qualified appraisal, the taxpayer lost the entire charitable deduction claimed for a conservation easement

IRC §170 allows for a charitable deduction for, among other things, the contribution of a qualified conservation easement on a property to a charity. However the deduction is limited to the value of the easement and if that value claimed is in excess of $5,000 (which would normally be the case) then a taxpayer is required to obtain a qualified appraisal of the property, attaching a fully completed Form 8283 and maintain the required records to support the contribution.

In this case the taxpayer made such a contribution of an easement on a property she owned in Brooklyn, NY. She engaged the services of an appraiser chosen from a list of appraisers suggested to her by the charity to whom she would make the contribution. The appraiser's report did contain an appraisal of the property without an easement attached, but was short on details on the value of the property once an easement was in place.

The Tax Court concluded that, effectively, the stated justification in the appraisal was that the IRS and Tax Court had generally allowed easements equal to 10-15% of the value of the property, which is in line with what the case law cited held. But the Court pointed out that using prior percentages from court cases was not a valid method of appraising property, and that without some more justification for the exact amount of the appraised value with an easement in place. As Reg. § 1.170A-13(c)(3)(ii)(J) requires that a qualified appraisal contain a description of the method used to value the property, the Court found that this flaw meant no qualified appraisal had been undertaken or attached to the return. As such no deduction was allowed.

The Court also noted that the Form 8283 was not properly completed on the return either. The Form 8283 had omitted the date and method of acquisition of the property contributed, as well as the taxpayer's basis. While this defect does not appear by itself to have doomed the taxpayer's deduction, it did mean the taxpayer now had to show substantial compliance with the regulations, and the Court held that a lack of a qualified appraisal was effectively fatal to any attempt to argue substantial compliance.

On a more minor issue, the taxpayer also was denied a deduction for an amount of cash she was required to pay the charity as part of the transaction. The organization required contributors of easements to make a cash contribution equal to a percentage of the value of the easement for it to be accepted. While the entity was a recognized §501(c)(3) organization, the Court held the taxpayer failed to show she had not received a benefit equal in value to the amount paid and, as such, no deduction was allowed for that amount either.

Note that the principles here are not just applicable to conservation easement valuations. Many practitioners have taken a similar "how much of a discount did the Tax Court allow?" view of valuations in gift tax matters where family limited partnerships and the like are involved. Such "valuations" are likely to face a similarly poor fate if they get before the Tax Court. Tax professionals should critically read valuation reports obtained by the taxpayer to insure the valuation professional did include a clear description of methods used and not just "well, this is what the Court has allowed before" as a method.

SECTION: 170
INDIVIDUAL APPRAISER, AND NOT APPRAISAL FIRM, MUST SIGN PART III OF FORM 8283

Citation: Chief Counsel Email 201022021, 6/4/10

Form 8283 Part III contains a "Declaration of Appraiser" that requires a signature when an appraisal is required by §170 and the regulations to support a noncash contribution made by the taxpayer. In emailed advice, the Chief Counsel's held that the signature must be that of the individual appraiser(s) who performed the appraisal and not by the appraisal firm that was hired for the appraisal.

The email points out that the statutory language specifically requires that the signor of the form be an individual and not a firm, with the reasoning being that the a person is the one held responsible for false or fraudulent overstatements in the appraisal, with a penalty provided for such an individual under §6701. As well, the individuals are subject to sanction under Circular 230 and can be individually sanctioned or disqualified.

SECTION: 170
EXISTENCE OF MORTGAGE HOLDER WITH SUPERIOR RIGHT TO PROCEEDS FROM DISPOSAL VIOLATED RULES FOR CREATING QUALIFIED CONSERVATION EASEMENT, ENTIRE DEDUCTION DISALLOWED

Citation: Kaufman v. Commissioner, 134 TC No. 9, 4/26/10

A specific requirement under Reg. §1.170A-14(g)(6)(ii) for a donation to be a qualified conservation easement is that the charity must be entitled to a portion of any proceeds from a sale, exchange or involuntary conversion that is proportionate to the value of the conservation easement as compared to the total value of the property at the time the easement was created. In the case in question, there was a preexisting mortgage on the property. The lender in that case retained a prior claim to all proceeds of condemnation and all insurance proceeds from any casualty, hazard or accident occurring to or about the property up to the balance remaining due on the mortgage at the date of the event.

The Tax Court held that the existence of the mortgage holder's prior claim to these proceeds caused the donation to fail the requirement that the charity must be entitled to its proportionate share of the proceeds. The Court disagreed with the taxpayers that this was a question of fact, and that should be allowed to show it was exceedingly probable the charity would get its proceeds and therefore obtain the deduction. The Court ruled that it wasn't enough to show the charity might obtain the proceeds—the regulation clearly required that it must receive the proceeds.

Failing to be a qualified conservation easement, the entire amount of the donation was disallowed since it now represented a gift of a partial interest, generally prohibited under §170(f)(3), and was not rescued by the §170(h)(1) qualified conservation easement exception. Effectively, the Court's holding would deny a deduction any time a mortgage existed on property unless the lender agreed to allow its interest to become second to the charity—not something likely to happen on an existing mortgage, especially after the events of the recent past.

SECTION: 183
BASS FISHERMAN'S STRATEGY THAT PUT HIM AT A COMPETITIVE DISADVANTAGE FOUND BY COURT TO INDICATE HE LACKED A PROFIT MOTIVE

Citation: Lowe v. Commissioner, TC Memo 2010-129, 6/14/10

In what the Court conceded was a close case, the Tax Court found that a bass fisherman was not in business to turn a profit, and thus disallowed expenses in excess of income. The Court found the traditional nine factors enumerated at Reg. §1.183-2(b) did not truly resolve the matter, as some factors were in his favor, some against, and others neutral.

While the taxpayer entered tournaments that paid prize money, the Tax Court found that he often entered team competitions set for two competitors where he would enter with his wife (who did not fish and did not compete) as his teammate. To win such a competition, the taxpayer would have had to catch more, by himself, than did his competitors that had two lines in play. As well, his entry fees were effectively doubled under this strategy, since he paid a fee for his wife—a fee that would have been paid by a teammate had he truly entered with a partner.

The Court found that this methodology served to both increase his costs and greatly decrease his likelihood of prevailing, not a reasonable step to be be taken by someone who was trying to turn this into a profitable outing.

SECTION: 183
IRS PUBLISHES AUDIT TECHNIQUE GUIDE ON NOT-FOR-PROFIT ACTIVITIES

Citation: IRS Audit Technique Guide, 6/19/09

The IRS released an Audit Technique Guide on Not-for-Profit Activities to be used by agents examining taxpayers who have activities for which the question of profit motive may be open. The guide is a good review for professionals of the issues that are considered when the matter of whether or not the limitations found in §183 will apply to the activity are potentially open to question. As well, the fact that the IRS has recently revised this guide suggests the IRS has an increased interest in this area that you may find in upcoming audits.

Finally, quite often clients who cannot be convinced by our warnings regarding items that may place them at risk on exam will find an official IRS document to be much more convincing. The document can be used to persuade such clients about the need to pay

attention to factors that may place their activity at risk for a deficiency assessment based on an assertion that the taxpayer lacked the proper profit motive.

SECTION: 183
CHARTER FISHING ACTIVITY NOT CONDUCTED AS A FOR PROFIT ACTIVITY, LOSSES DISALLOWED

Citation: Beasely v. Commissioner, TC Summary 2009-93, 6/10/09

The Tax Court examined the nine factors at Reg. §1.183-2(b) when considering whether the taxpayers had engaged in their charter fishing activity as a for profit activity. On the issue of the manner in which the taxpayer conducted the business, the court found that failure to maintain an adequate set of books was more significant than the fact they maintained a separate bank account and did make some changes to their operation in the last year under consideration. The Court found that they did not have expertise in the business of operating a charter fishing activity. Their time and effort expended was discounted by the Court, since the court found a significant element of personal pleasure was present. The taxpayers had no expectation that the boat would appreciate, so that factor did not favor them. The Court found that the taxpayers' previous experience had no connection with charter fishing. The losses that continued through the years under consideration worked against them, as did the fact that they had substantial other income. Not surprisingly, the Court decided against the taxpayers and disallowed the loss.

However, the Court did not grant the penalties the IRS wished to apply against the deficiency. The Court found the taxpayers had reasonably relied upon their tax professional, providing the professional with all necessary information to make the determination of the proper reporting.

SECTION: 213
TAXPAYER ALLOWED MEDICAL DEDUCTION FOR EXPENSES RELATED TO SEX REASSIGNMENT SURGERY

Citation: O'Donnabhain v. Commissioner, 134 TC No. 4, 2/2/10

The Tax Court, in a split decision, decided that a taxpayer's payments related to sexual reassignment surgery and other treatments related to gender identity disorder (GID) are deductible as medical expenses under §213. The majority found that as gender identity disorder is listed as a mental disorder in DSM-IV-TR, the primary diagnostic tool of American psychiatry, it qualified as an illness.

The Court found the sexual reassignment surgery and hormone therapy were listed as treatments for GID under the Benjamin standards of care and under those standards

were indicated for the patient in this case. Thus, the Court found, the treatments qualified as medical expenses under the standard of §213, holding that a complete consensus of the medical community is not required for a treatment to be deductible.

However, the Court found that the taxpayer's breast augmentation surgery did not meet the requirements of the Benjamin standards in his case, and served primarily to improve the taxpayer's appearance. The Court therefore ruled this surgery was a cosmetic surgery procedure in this case, resulting in a disallowance of the deduction under §213(d)(9)(B).

SECTION: 213
INFANT FORMULA PURCHASED BY DOUBLE MASTECTOMY PATIENT NOT A DEDUCTIBLE MEDICAL EXPENSE

Citation: LTR 200941003, 10/9/09

A woman who had previously undergone a double mastectomy later gave birth to a child and requested a ruling from the IRS. She wanted to know if the amounts paid for infant formula she was going to need to purchase to feed her child would qualify as medical expenses due to her condition.

The IRS ruled the answer was no. IRC §213 defines medical care as amounts paid "or the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body." The problem in this case was that while the condition impacted the mother, the person receiving the treatment was not her but her child. But, of course, as her dependent, if the formula was medical care for the child then all would still be well. But it was not to be the case.

The IRS moved onto Revenue Ruling 55-261 when looking at this from the child's perspective. That ruling hold that cost of food is only deductible if (a) it is prescribed by a physician for alleviation or treatment of a specific illness, (b) are in addition to the patient's normal diet, and (c) in no way are a part of the nutritional needs of the patient. Unfortunately the formula fails all three of those tests as viewed from the infant's perspective.

SECTION: 213
TAX LAWYER'S "MEDICAL" EXPENSES FOR PROSTITUTES AND PORNOGRAPHIC MATERIALS DISALLOWED

Citation: Halby v. Commissioner, TC Memo 2009-204, 9/14/09

William Halby was nothing if not a creative tax attorney. On his 2004 and 2005 returns, he claimed tens of thousands of dollars of deductions on Schedule A for payments

made to prostitutes, along with additional expenses related to the acquisition of pornographic materials. He claimed that these items represented "sex therapy" and should be allowed as a medical deduction on Schedule A. The Tax Court didn't agree. First, Mr. Halby had never discussed the need for or benefits of such sex therapy with his physician. Second, at best Mr. Halby had a claim for "general well being" improvement, which is not sufficient to obtain a medical deduction under §213. Finally, even if the "treatment" otherwise meets the requirements to obtain a deduction under §213, no deduction is allowed for treatments in violation of local law—and prostitution was illegal in New York, the state in which Mr. Halby lived and had obtained the services.

The Tax Court went on to assess a 20% penalty under §6662, holding that Mr. Halby, given his over two decades of experience in tax practice, should have been aware that there was no reasonable support for taking this position on his tax return.

SECTION: 223
HSA LIMITS TO REMAIN UNCHANGED FOR 2011

Citation: Revenue Procedure 2010-22, 5/24/10

The IRS announced that the annual contribution limits for HSAs and minimum annual deductible and maximum out of pocket limits will remain the same for 2011 as they are for 2010.

The annual limitations on deductions for contributions to an HSA for 2011 will remain at $3,050 for any individual with self-only coverage and $6,150 for an individual with family coverage. The minimum deductible for a high deductible health plan for 2011 will remain at $1,200 for an individual with self-only coverage and $2,400 for an individual with family coverage. The maximum amount of annual out-of-pocket expenses under such coverage will remain capped at $5,950 for self-only coverage and $11,900 for family coverage.

SECTION: 274
LACK OF DOCUMENTATION FATAL TO DEDUCTION FOR AUTO EXPENSES AND TAXPAYER INELIGIBLE TO USE PER DIEM AMOUNTS FOR OTHER TRAVEL EXPENSES

Citation: Roddie v. Commissioner, TC Summary 2010-7, 1/21/10

By the time the case got to the Tax Court, the IRS had conceded all issues involving Roddie Evans except for two involving expenses covered by the §274 documentation rules. The IRS denied Mr. Roddie's claimed per diem expenses for travel on the basis

that he was not qualified to use that method, and denied his auto mileage expenses on the basis that he did not maintain adequate records.

The Tax Court agreed with the IRS on both counts. It noted an employee, pursuant to the applicable annual per diem Revenue Procedure, may only use the per diem method of substantiating travel expenses if the employee is paid a per diem by his employer—something Mr. Roddie's employer did not pay. As Mr. Roddie had no documentation on actual travel expenses.

As well, he failed to maintain any records or logs to account for business use of the vehicle, with the only documentation he did possess being certain receipts for trailer park rentals where he parked the trailer he towed. As documentation is a specific requirement for being able to use the mileage method, Mr. Roddie had all of his auto mileage denied.

The result is not surprising—the Tax Court almost without exception denies any deduction to a taxpayer who does not possess records related to their claimed auto expenses. Clients need to understand that they face a choice between maintain some form of contemporaneous record of their auto usage or being unable to claim any deduction for auto expense.

SECTION: 401
STATE COURT ENTITLED TO DETERMINE VALIDITY OF QDRO

Citation: Mack v. Kuckenmeister, CA9 No. 09-15290, 7/22/10

Darren Mack and his wife were involved in a divorce proceeding, and as part of the proceeding Darren had agreed that the Court would name his wife as the alternate payee of his 401(k) plan, instructing her attorney to draft the qualified domestic relations order (QDRO). However before that could be completed, Darren murdered his wife and shot the judge handling the divorce. Her estate asked the Nevada courts to go forward and continue the divorce proceeding, executing the oral orders including the issuance of the QDRO. The courts complied with this request.

Darren challenged the court's action, and the Nevada Supreme Court ruled against him and specifically upheld the issuance of the QDRO. Darren now turned to the federal courts, arguing a QDRO could not be valid if issued after his wife's death.

The Ninth Circuit ruled that the issue of the validity of the QDRO was a matter that was properly decided at the state court level, and that the Nevada Supreme Court ruling should be granted full faith and credit.

SECTION: 401
IRS WAIVES PENALTY ON FAILURE TO TAKE MINIMUM DISTRIBUTION IN CASE WHERE DISTRIBUTION DELAYED BY MURDER CHARGE AGAINST BENEFICIARY

Citation: PLR 201008049, 2/26/10

The case discussed in PLR 201008049 involves problems that occurred when it the primary beneficiary of an IRA was charged with and later convicted of second-degree murder of the original IRA owner. Under applicable Kansas law a person cannot inherit property from a person they murdered. The matter moved slowly through the courts, and during that time period the funds could not be distributed.

Following the final ruling of the Kansas Supreme Court denying the primary beneficiary's appeal of his conviction, the court held that the funds in the IRA passed to the secondary beneficiary—but a number of years had gone by in which no minimum distributions had been taken.

The IRS ruled that while the original beneficiary was the designated beneficiary of the IRA on the testing date, and that distributions had been required for a number of years while the case made its way through the courts, there was reasonable cause for the failure to make minimum distributions and the 50% penalty would be waived for reasonable cause.

Although not at issue here since the funds were withdrawn in total from the IRA shortly after the final transfer, it is of interest to note that the IRS did conclude that since the original beneficiary was the designated beneficiary, distributions would have occurred over that person's life expectancy period rather than that of the person ultimately found to be the true beneficiary.

SECTION: 401
PARTICIPANT WHO HELD CHECK PAYABLE TO NEW PLAN FOR OVER 60 DAYS DID NOT VIOLATE ROLLOVER RULES

Citation: PLR 201005057, 2/5/10

The difference between a direct rollover and a distribution based rollover proved key to the taxpayer who asked the IRS for relief in this case. The taxpayer wanted to transfer funds held in the retirement plan of her former employer to the plan of her new employer. She asked for the funds to be transferred and received a check from her former employer's plan that was made payable to the plan sponsored by her new employer.

For whatever reason, the taxpayer held onto the check for more than 60 days before forwarding the check to the new employer's plan. The issue was whether, having held the check for more than 60 days, the taxpayer had blown the ability to move the funds from one plan to another and rather had a distribution.

The IRS ruled she did not have a taxable distribution and the transfer could take place. Because the check was not payable to the taxpayer, she had no control over the funds and did not receive a distribution subject to the 60 day rollover rule. The result would have been very different, and much less favorable, had the check been payable to the plan participant herself.

SECTION: 408
TAXPAYER'S INTENT TO PLACE FUNDS IN IRA NOT SUFFICIENT TO GRANT LATE ROLLOVER WHERE NO FINANCIAL INSTITUTION ERROR SHOWN

Citation: PLR 201034025, 8/27/10

A taxpayer's intent to roll funds into IRA accounts was not by itself sufficient for the IRS to grant the taxpayer's request to allow a late rollover of IRA funds. In the case in question the taxpayer withdrew funds from his IRA, intending to place them into another IRA with a different financial institution. However, the taxpayer ended up setting up high interest checking account that was not an IRA account.

The error was not noticed until the taxpayer went to prepare his tax return and his tax return preparer notified him that this would be a taxable event. The taxpayer than asked for permission to make a late rollover, claiming "financial error" as the reason why relief should be granted.

The IRS, citing the list of acceptable reasons for granting a late rollover found in Revenue Procedure 2003-16, found that the taxpayer failed to show an error on the part of the financial institution. The taxpayer's application to set up the account did not show he had directed it to be an IRA account, and he provided no documentation to show that the financial institution had been directed to place the funds into an IRA.

Of interest is a paragraph that explains what apparently would have been sufficient to allow the late rollover, noting that the taxpayer had failed to provide either a contemporaneous document to the institution evidencing his intent to have the funds placed in an IRA (such as an application form or letter) or a written statement from the financial institution indicating that it had erred in placing the funds into a non-IRA account.

SECTION: 408
LATE ROLLOVER ALLOWED WHEN ADVISER FAILED TO TELL TAXPAYER OF 60 DAY REQUIREMENT TO COMPLETE ROLLOVER

Citation: PLR 201022027, 6/4/10

The IRS granted an individual a right to make a late rollover of funds received from an IRA due to what an adviser failed to tell her, rather than directly erroneous advice given by the adviser. In this case the taxpayer told the financial adviser she wished to take funds from an investment account and place it into an IRA with her credit union. The adviser advised the taxpayer to be sure and tell the credit union the check for distribution was from an IRA, but neglected to tell the taxpayer about the 60 day rollover requirement, or the possibility of using a trustee-to-trustee transfer rather than utilizing a rollover.

The taxpayer received the check and placed it in a safe deposit box until she returned from a trip to take care of her sister. When she returned she took the check to the credit union, but was informed that the 60 day period had expired.

The IRS found that the failure of the adviser to tell the taxpayer about the 60 day requirement or the availability of a trustee-to-trustee transfer option was an error on behalf of the financial adviser, and thus the IRS granted permission to make a late rollover.

An error by a financial adviser is one of the specific reasons listed in Revenue Procedure 2003-16 that the IRS considers to be a reason in favor of granting relief. The fact that the IRS took a broad view here of what constitutes adviser error suggests that filing for a letter ruling to get permission to make the late rollover may make sense in more cases than many CPAs may initially believe.

SECTION: 408
IGNORANCE OF IRA RULES NOT VALID REASON FOR IRS TO EXTEND 60 DAY ROLLOVER PERIOD

Citation: PLR 201006035, 2/12/10

The IRS did not grant a taxpayer's request to be granted a waiver of the 60 day time period to rollover a distribution from an IRA where the taxpayer indicated he was unaware of the rules. The taxpayer had taken a distribution from his IRA from one financial institution because he wanted to consolidate all of his accounts in another institution. However the account he opened at the second institution was not an IRA account, and he failed to notice this fact until he received a 1099R early in January of the following year, following the expiration of the 60 day period.

The taxpayer claimed that the failure occurred because he was unaware of the specific rules related to IRAs and that he had intended only to consolidate his accounts. However, the IRS declined to allow a late rollover. The IRS looks to the Revenue Procedure 2003-16's list of relevant factors generally in making these determinations, and ignorance of the law is not one of the factors listed.

SECTION: 408A
TAXPAYER THAT FILED RETURN LATE WAS NOT GRANTED RELIEF WHEN LOOKING TO RECHARACTERIZE ROTH IRA CONVERSION DUE TO DROP IN VALUE OF IRA

Citation: PLR 201024071, 6/18/10

A taxpayer emailed his tax adviser early in December 2007 asking whether it was advisable to convert his IRA to a Roth IRA for the year in question. The adviser responded that the taxpayer was eligible to make a conversion without penalty in the year in question, and since his business income was low this would seem to be a good year to convert. The taxpayer converted the IRA early in December. The taxpayer later asked the adviser to file an extensions of time to file his 2007 return, but did not otherwise communicate with the preparer until after the extended due date for filing his 2007 return.

In the interim, the value of the securities in the IRA dropped dramatically, a not terribly unusual occurrence in the late fall of 2008. When the taxpayer finally brought his information in, he was informed that had he filed timely he could have recharacterized the 2007 conversion and unwound the transaction.

The taxpayer asked the IRS for relief, noting that the preparer had not informed him of the October 15, 2008 deadline to recharacterize his IRA. Being unaware of that deadline and facing a number of complex matters in his divorce, he did not take action before that date.

However, the IRS decided he should not be granted relief. The IRS noted that he did not get erroneous advice, and he was eligible to convert for 2007, so relief was not necessary to avoid penalties.

SECTION: 408A
LIMITS ON INCOME FOR ROTH IRA ROLLOVERS GO WAY IN 2010

Citation: IRC §408A(c)(3)

Although it was placed in the law by the 2005 Tax Increase Prevention and Reconciliation Act, we are just now coming up on the effective date of the removal of

the limits based on income for taxpayer s to be able to rollover Roth IRAs. Effective for years beginning after December 31, 2009 there will not any taxable income limit for the conversion of regular IRA accounts to Roth IRAs. As well, for conversions that take place in 2010 there will be an option to delay including the amounts in income, being able to claim ½ in 2011 and ½ in 2012 (not coincidentally after the 2001 rate cuts are scheduled to expire).

However, the income based limits will still be for taxpayers making contributions to a Roth IRA, although it appears taxpayers will be able to later covert any regular IRA contributions to Roth via the rollover mechanism.

This provision presents a planning opportunity for taxpayers who have an interest in extending the payout period from the IRA and using that as an asset to pass on to the next generation, since there are no minimum distributions due from a Roth IRA until it passes to a nonspouse beneficiary.

SECTION: 451
EMPLOYEES WHO VOLUNTARILY WAIVED STATUTORILY DETERMINED SALARY DID NOT HAVE TO INCLUDE WAIVED AMOUNTS IN INCOME

Citation: PLR 201024045, 6/18/10

In the matter that the IRS was being asked to rule upon, employees for a government had statutorily set amounts of salary to be paid to them on a monthly basis. However, the legislature had passed a provision that allowed employees to voluntarily waive a portion of that salary. To do so, the employee had file waivers by a specified date, and those waivers were irrevocable once signed.

The concern was whether the employee, who had a right to receive the set salary per statute, had constructive receipt of the income under Reg. §1.451-2. The IRS found the facts similar to those of an executor who waives statutory fees, which under Revenue Ruling 66-167 were ruled to be not includable in income.

SECTION: 451
FOURTH CIRCUIT AGREES: TAXPAYER HAVE TO LIVE WITH TAX TREATMENT ORIGINALLY CLAIMED FOR SALE OF THEIR E&Y CONSULTING INTERESTS

Citation: United States v. Bergbauer, CA4 No. 08-2054, 4/16/10

The Fourth Circuit has chimed in on the taxation of interests received by Ernst & Young consulting partners when the consulting portion of the firm was transferred to Cap

Gemini, S.A., and yet again the former Ernst & Young partners have lost in an attempt to treat only the shares received in 2000 as taxable in that year.

The facts are basically the same as the other Cap Gemini Ernst & Young, LLC cases. When the consulting partners transferred their interests in Ernst & Young, they received Cap Gemini common stock, but subject to various restrictions. The deal was structured to, it was hoped, have the entire value of the shares taxable to the recipients in the year of the transaction (2000), since the parties involved believed that Cap Gemini shares were going to be much more valuable in the future.

Nevertheless, only 25% of the shares were available to the partners to dispose of immediately following the sale. The rest were held in a restricted brokerage account, and could be forfeited in various circumstances.

As it turns out, the dot com bubble burst and the anticipated growth in Cap Gemini value (whose consulting was in demand by many dot com entities) did not happen. In fact, many of the Ernst & Young partners were terminated as the entity cut back in size in response to a decrease in demand for the entity's services.

A number of the partners filed amended federal income tax returns for 2000, attempting to claim that only the value of the 25% of the shares they had received should be taxable in 2000, with the remaining interests taxable as the restrictions lapsed. The Fourth Circuit agreed with all other courts to rule on this to date that the partners are not entitled to recast the transaction at this point, but did so on slightly different grounds.

The Fourth Circuit analyzed the case as one where a taxpayer attempts to argue substance over form. While the agreement provided that all parties agreed the shares would be immediately taxable and took steps to make sure the parties technically had ownership of the shares, the taxpayers are arguing that this was all an illusion. The Court of Appeals noted immediately that the taxpayers, who were involved in the transaction and accepted its form, have a much higher standard to meet than does the IRS, who was not involved in the design of the transaction.

The Fourth Circuit ruled that to prevail the taxpayer must show either that 1) the intent of the parties was not consistent with the form of the transaction or 2) the economic substance of the transaction is not consistent with the form. The Court found that the taxpayers admitted the form was consistent with the intent at the time of the transaction, so the taxpayers had to show the economic substance was not consistent with the form.

On that level, the court found that the economic substance was consistent with the form of the transaction. Both parties benefitted economically from structuring the transaction in this fashion. Among other items, Cap Gemini was able to claim an immediate tax benefit from the shares transferred, as it could begin to recognize the full value as paid

at that time. And the shareholders benefitted as restricting the disposition of the shares helped prevent the risk of a flood of shares into the market as the new owners sold their shares, thus helping to preserve the value of the stock for the new owners.

The Court also dismissed the taxpayer's view that either §83 or the constructive receipt rules of §451. The court found that the shares were not given as compensation for services, but rather as value for the ownership interests the partners held in Ernst & Young, thus rendering §83, which only applies to items received for services, inapplicable.

The Court held that the constructive receipt argument had to be viewed in the totality of the circumstances. The taxpayer did simply receive shares subject to restriction in the absence of other agreements. Rather, the partners bargained for a complete package of options that, as noted earlier, had various economic benefits to each party. Thus, the restrictions were only part of the larger package and the court held that the taxpayer could not apply §451 to this transaction.

Finally, the Court goes on to point out that these issues did not bother the taxpayer when he thought it would benefit him to argue the opposite conclusion. Only when things didn't turn out as expected did the taxpayer seem to suddenly realize the application of §451 to his situation—and the Court was not going to allow him to now take the opposite position and potentially whipsaw the government on this issue.

SECTION: 451
DESPITE RESTRICTIONS ON ACCESS TO SHARES, TAXPAYER HAD TO RECOGNIZE INCOME WHEN SHARES DEPOSITED IN ESCROW ACCOUNT

Citation: United States v. Nackel, District Court for Central District of California, Docket No. 2:05-cv-06680, 10/20/09

John Nackel was a consulting partner with Ernst & Young when the firm was considering an arrangement to sell its consulting arm to Cap Gemini, a transaction in which John (along with the other consulting partners) received shares of stock in Cap Gemini and gave up their partnership interests in Ernst & Young. The arrangement provided that John and the other consulting partners would receive stock in which they would "immediately vest" in. 25% of that stock was converted to cash to pay taxes, while the remaining 75% was transferred to an escrow account with Merrill Lynch where the shares would be held subject to a series of restrictions under John's employment agreement. The restrictions were to be released gradually over five years.

John would forfeit the shares in the escrow account that had not been relieved of restrictions if he voluntarily quit his job, was fired for cause or went into competition of the new business. John originally reported the stock at 95% of its market price on his

original return. However, the following year John was involuntarily terminated from his position for poor performance, resulting initially in forfeiture of all of his remaining restricted shares. The shares were later returned to him to settle a lawsuit for wrongful termination.

John amended his 2000 return to remove from his income he reported for the shares held in the Merrill Lynch escrow account, claiming that due to the restrictions he should not have had to report the amount in income. The IRS initially issued the refund, but then changed its mind. The Court found that the IRS was correct. The Court held that there was constructive receipt when the shares were transferred. The restrictions were held not to matter because, in the Court's view, Mr. Nackel had matters within his own control to insure he retained the shares.

The Court held that there was not the right of the employer to dismiss at will and retake the shares, since the agreement limited loss only if John was discharged for cause. The Court did not find dismissal for poor performance to be dismissal at will, finding instead it was a subset of termination for cause under the agreement. The Court agreed with the Seventh Circuit's decision in *Fletcher v. Commissioner*.

The Fletcher decision also highlights one additional fact that explains why John wanted to move the income out of 2000 even though he did eventually receive the shares—the price of Cap Gemini shares dropped dramatically after 2000, meaning if John could have the income included in later years he'd recognize far less income.

SECTION: 469
TAXPAYER WAS REAL ESTATE PROFESSIONAL, BUT NEVER MADE ELECTION TO AGGREGATE ACTIVITIES

Citation: Trask v. Commissioner, TC Memo 2010-78, 4/15/10

The taxpayer owned 33 rental properties in Southern California and wanted to deduct his combined losses from the properties under the real estate professional exception to the general treatment of real estate rentals as passive activities under §469(c)(7). The IRS objected on two counts—first, that he had not shown he had performed more than 750 hours in real estate property trades or businesses in the year in question and that he had never made a proper election to aggregate the 33 properties into a single activities.

The IRS complained the taxpayer had not shown specifically that he had spent more than 750 hours in the real estate activities. However the Tax Court disagreed, finding that while it won't accept "ballpark guesstimates" the hours can be established by any reasonable means. In this case the Court noted that the taxpayer had shown he had handled over 80 specific issues for 11 properties and that he performed repairs himself

on larger projects. Thus, the Tax Court found, it was reasonable to conclude he met the 750 hour threshold—and, frankly, it would appear he easily did so.

However the taxpayer didn't fare so well on the other issue—had he ever clearly elected to aggregate activities under §469(c)(7)(A). The regulations require that the taxpayer make a specific, clear election on his/her original return. While the taxpayer contended he had informed the IRS of his intention to treat all rentals as a single activity in prior litigation and that he had always reported the items that way, the Court held neither step would comply with the clear requirements of the regulations. Thus, the taxpayer had failed to aggregate the activities—and that makes it virtually impossible for the taxpayer to meet the standard "activity" tests required to escape passive activity treatment for these numerous activities.

SECTION: 469
REQUIRED DISCLOSURES UNDER §469 FOR GROUPING OF ACTIVITIES OUTLINED BY THE IRS

Citation: Revenue Procedure 2010-13, 1/6/10

The IRS in Revenue Procedure 2010-13 outlined required disclosures to be made when a taxpayer groups activities under Reg. §1.469-4 for purposes of the passive loss rules. The new disclosures will apply to taxable years beginning on or after January 25, 2010—or, for calendar year taxpayers, calendar year 2011.

In the first year a taxpayer groups two or more business activities as one, the taxpayer must attach a statement to the return disclosing the names, addresses and, if applicable, employer identification numbers of the trade or business activities or rental activities that are being grouped as a single activity. As well, the statement must contain a declaration that the grouping constitutes an appropriate economic unit for purposes of measuring gain or loss under §469. The taxpayer must also file a similar statement with the return for any year where a new activity is added to the group.

If the taxpayer regroups activities under Reg. §1.469-4(e)(2) because it is determined the taxpayer's original grouping was clearly inappropriate or a material change has occurred that makes the original grouping clearly inappropriate, the taxpayers makes a disclosure of the same items noted above plus an explanation of why the regrouping was determined to be inappropriate or the nature of the material change that made the grouping inappropriate.

A taxpayer will not need to make a disclosure compliant with this ruling for groupings that existed before the effective date of the ruling unless a change occurs in the grouping.

Partnerships and S corporations don't comply with the above rules, but must comply with the disclosure requirements for reporting activities separately to interest holders via the holders' K-1s.

If a taxpayer fails to report, the taxpayer can make the report with the return for the year the taxpayer discovers the omission. However, if the failure is discovered by the IRS on examination, the taxpayer must show reasonable cause for failure to make the proper disclosure.

SECTION: 469
LLC MEMBERS ARE NOT AUTOMATICALLY TREATED AS PASSIVE UNDER THE LIMITED PARTNER RULE OF §469

Citation: Garnett v. Commissioner, 132 TC No. 19, 6/30/09 and Thompson, Ct. Fd. Clms, 7/20/09

The IRS has lost a series of cases this year attempting to stake out the position that under §469(h)(2), as interpreted by Reg. §1.469-5T(e)(1) and (2), LLC members who hold interests in entities taxed as partnerships that pass out losses must treat those losses as passive regardless of how active they are in the underlying business. The IRS attempted to rely on language in Reg. §1.469-5T(e)(3)(i)(B) that states that a person will be treated as a limited partner if the individual's liability is limited under law to a fixed amount. Additionally, the IRS argued that the "key factor" in being a limited partner is the fact that an individual has limited liability.

The Tax Court disagreed in Garnett. The Tax Court noted that despite that language, the regulation continued on at Reg. §1.469-5T(e)(ii) to override that treatment if the limited partner is also a general partner in the partnership. To the Tax Court, the key issue for purposes of §469 is how active the taxpayer is in the entity, suggesting that historical limits on a limited partners' ability to participate in an activity was the real reason why Congress included the automatic passive treatment for limited partners.

The IRS fared no better in the Court of Claims—in Thompson that court similarly was not persuaded that "LLC member" must be equated with "limited partner" for purposes of §469. Nor did a second try at the Tax Court prove any more fruitful for the IRS. In Precourt v. Commissioner, TC Memo 2010-24 issued on February 16, 2010 the Court found the managing member of a California LLC was not automatically to be treated as a limited partner for purposes of the passive activity rules.

SECTION: 475
DESPITE TAX ADVISERS FAILURE TO ADVISE CLIENT ABOUT §475(F) ELECTION, TAXPAYER DENIED LATE ELECTION RELIEF

Citation: PLR 201014004, 4/9/10

Taxpayers who are traders have the ability to make an election under §475(f) to use the mark to market method of accounting. A significant side effect of that election is that their losses cease to be limited to the $3,000 a year limit on capital losses, which can be important should the taxpayer turn out not to be very good at trading (which, in the author's experience, has been true for the vast majority of taxpayers that venture into this arena).

However that election has an extraordinarily early due date—under Revenue Procedure 99-17 the election must be made by the due date, determined without regard to extensions, for the tax return for the year <u>before</u> the year in which this method will first be used. Thus for individuals the election generally must be made by April 15, attached either to a tax return filed by that date or an extension filed by the taxpayer on or before that date.

The IRS essentially does not grant relief for late elections in this matter, due to the fact that a taxpayer by definition has a huge advantage of knowing the results of trades since the election would have been due—thus giving the taxpayer the benefit of hindsight. In PLR201014004 the IRS held that to be true even when taxpayer's accounting firm had been informed that the taxpayer was engaging in a trading activity prior to April 15 of the year in question, the taxpayer had specifically asked the firm about the tax consequences of such activities and the taxpayer was not informed about the election by the firm.

SECTION: 664
CHARITABLE REMAINDER UNITRUST CORRECTION TO REDUCE PAYOUT PERCENTAGE TO CORRECT DRAFTING ERROR DID NOT DISQUALIFY TRUST, NOR REPRESENT SELF-DEALING

Citation: PLR 201026005, 7/2/10

The taxpayer requested this ruling found that he had a problem—the charitable remainder unitrust he had established ended up with a higher payout percentage than he had believed was going to be part of the trust. The attorney who was responsible for drafting the trust admitted that he had included a higher unitrust payout percentage than was intended to be in the trust. The taxpayer was able to get the local probate court to approve, after notification the charities and the attorney general for the state in question,

a modification of the trust to reduce the payout amount. But now the issue was whether this had negative tax consequences, so he asked for a private letter ruling from the IRS.

The taxpayer agreed to pay back the difference in the payout made per the original trust document along with interest to the trust, and not to claim the increased charitable deduction that would <u>have</u> been available had the proper percentage been included initially. Based on these facts, the IRS found the trust remained a valid charitable remainder unitrust throughout all of the time period involved, and the transfer of "excess" distributions to the income beneficiary followed by a repayment of that amount with interest was not impermissible self-dealing as defined in §4941.

SECTION: 752
COURT FINDS ABSOLUTELY NO CHANCE OF REASONABLE PROFIT FROM SON OF BOSS TRANSACTION AND DISALLOWS TAX BENEFITS CLAIMED

Citation: Stobie Creek Investments v. United States, CA Fed. Cir. No. 2008-5190, 5/11/10

The Federal Circuit sustained the Court of Federal Appeals in its ruling that the transaction in this case lacked economic substance. The taxpayer, who had a large capital gain he was going to incur upon the sale of stock in his business, asked his attorney if he knew of some way to shelter the gain. The attorney referred his client to a law firm that was pushing a Son of BOSS style transaction. The underlying paired set of options had virtually no chance of turning a profit (in fact the Court found that it actually had no chance of turning a profit).

However, making a profit from investing in options wasn't really what the taxpayer was after. Rather the goal was, as the Court pointed out, going through a specific set of steps to get the options into a partnership, along with the stock in the company being sold to be able to use the partnership tax provisions to inflate the basis of that stock.

Under the then existing IRS regulations at the date the transaction was entered into, read literally, the partner would get basis for the purchased option contributed, but did not have to reduce that <u>basis</u> by the outstanding liability to close the position where the option had been sold. Once the options closed out of the money (which is realistically what was most likely to happen and did), the partnership was liquidated with the shares transferred out.

As it was a partnership distributing only a noncash asset, that asset took on the partner's (inflated) basis in his interest. In this case, the taxpayer basis in the stock shot up by $200,000,000 (or at least it did until it faced scrutiny).

The Court found there was absolutely no underlying reason to enter into the transaction other than for tax benefits, causing the Court to invoke the economic substance doctrine to disallow the tax benefits. The Court also found the taxpayer did not act reasonably to by relying on the advice of the attorneys who were involved in promoting the transactions.

The case is a reminder that even if a transaction is designed to clearly fall within the literal letter of the law and regulations, it still must pass muster against the overriding judicial doctrines that are applied to tax cases. Fundamentally, it's important to have a real, nontax reason for a transaction and the way it was structured if you plan to pass these tests.

SECTION: 893
FAILURE OF STATE DEPARTMENT TO CERTIFY FOREIGN GOVERNMENT MEETS §893(A) REQUIREMENTS DOES NOT SERVE TO DENY §839(A) EXCLUSION TO COVERED INDIVIDUALS

Citation: Abel-Fattah v. Commissioner, 134 TC No. 10, 4/27/10

The facts of this case probably aren't relevant to many practitioners, at least unless you represent employees of foreign consulates. But the court's analysis of the underlying law is instructive to all of us that need to, from time to time, attempt to determine the import of provisions in the Internal Revenue Code for which there is not clear supplemental guidance available.

The technical issue in this case is whether an employee of the embassy of the United Arab Emirates can claim an exemption from income taxes for wages paid to him under §893. IRC §893(a) provides for an exclusion from income of compensation paid to an employee of a foreign government if the individual meets the following three tests—the employee is not a U.S. citizen, the services performed are similar to those performed by employees of the U.S. government in foreign countries and the foreign government in question grants a similar exemption to those U.S. employees. The IRS agreed that the taxpayer met all of those requirements.

However, the IRS pointed out that §893(b) indicates that the State Department shall certify to the Treasury the names of foreign countries that meet this qualification. The State Department had adopted a procedure of only issuing certifications if a foreign government asks for one to be issued—and the United Arab Emirates failed to ask for one until the year after the years in question.

The Tax Court noted that the requirement for a foreign government to ask the State Department to issue a certification was nowhere in the statute—rather the statute mandated that the certification be issued. The court also noted that §893(a), as

worded, did not make qualification conditional on any factors other than those listed under it, and §893(b) did not indicate that the benefit could not be conferred until the certification was issued.

Rather, the only thing the statute did was mandate that the State Department prepare certifications for qualifying countries, something the State Department had failed to do. Thus, the taxpayer was entitled to exclude the wages from income even for years prior to the United Arab Emirates eventual application for certification.

SECTION: 1001
TAX COURT RULES AMOUNTS RECEIVED IN TRANSACTION AMOUNTED TO A SALE OF STOCK, NOT A LOAN SECURED BY THE STOCK

Citation: Calloway v. Commissioner, 135 TC No. 3, 7/8/10

The result in the Calloway case was agreed with by all of the judges of the Tax Court, but there was significant disagreement on how that result should be obtained under the law, with the judges writing concurring opinions protesting that the majority's opinion was overly broad and could have significant unintended consequences.

The case involved an attempt by Lizzie and Albert Calloway to get around having to pay a 20% capital gain tax if they sold the highly appreciated IBM stock they owned. The Calloway's financial adviser suggested they use a “90-percent-stock-loan-program” being pushed by Derivium. Mr. Calloway would “borrow” 90% of the value of the IBM stock, while at the same time transferring those shares to Derivium under an agreement where the lender was given the right to, among other things, sell the shares. The loan, entered into in 2001, was a three year term and had a stated interest rate of 10.5%. The loan could not be paid off before the of the three year period. Dividends paid by IBM would be offset against the interest on the loan as it accrued.

At the end of the period, Mr. Calloway had three options. He could pay off the remaining balance of the loan and interest, at which time the IBM shares would be delivered to him. He could opt to enter into a continuation of the loan, though that would incur an additional fee. Or, as the loan was nonrecourse, he could simply surrender the IBM shares and the loan would be paid off. As the IBM shares had dropped in value and were worthing nothing close to the loan balance, he choose to walk away.

Mr. Calloway admitted he entered into the transaction because the 10% fee appeared to be less than the capital gains tax that would have been due on a sale. However, Mr. Calloway did not report the dividends during the three year period as income, nor did he report the sale in 2004 when he surrendered the shares for the balance of the note.

The majority ruled that the transaction was not a loan, analyzing it under an eight factor test based on the 1981 decision in Grodt & McKay Realty, Inc., 77 TC 1221, based on the intent of the parties at the time the transaction was entered into. The Court found that title had passed to the lender, the lender immediately sold the stock (though Mr. Calloway was not aware that had happened), Mr. Calloway could not terminate the contract early to take advantage of any intermediate change in the value of the underlying stock, and he was under no obligation to do anything more. The majority found that, at best, he had an option, excercisable three years later, to acquire IBM stock.

The concurring opinions by Judges Halpern and Holmes agreed with the result, noting that these were horrendously bad facts, but in each case argued that the result should have been arrived in a fashion that did not bring into question a number of nonabusive transactions. Judge Holmes specifically notes that it is very possible to read the majority rationale as calling into question whether any nonrecourse loan should be treated as a sale, something he does not believe is intended or wise.

SECTION: 1012
COURT OF APPEALS AGREES WITH COURT OF FEDERAL CLAIMS ON BASIS OF STOCK RECEIVED IN DEMUTUALIZATION

Citation: Fisher v. United States, CA FC, 2010 TNT 4-15, Case 04-CV-1726, 10/9/09

The Federal Circuit Court of Appeals, ruling against the IRS, upheld the Court of Federal Claims decision in the case of Fisher v. United States. In that case, the Court of Federal Claims held that a taxpayer who received cash rather than stock in a life insurance company demutualization transaction could offset the basis of the policy against that cash under the open transaction doctrine. The IRS had taken the position that any stock the taxpayer received for the voting rights in a policy when a mutual insurance company converted to a stock company had a zero basis, and thus the entire amount of cash received was a gain.

The case did not deal with how to handle the situation where the taxpayer, rather than receiving cash, took the stock and then later sells that stock. But the opinion in the case clearly rejects the IRS's zero basis theory, noting that merely because something may be difficult to value, that does not make it valueless.

SECTION: 1031
IRS OUTLINES SAFE HARBOR METHOD OF REPORTING GAINS OR LOSSES WHEN §1031 EXCHANGE COLLAPSES DUE TO FAILURE OF QUALIFIED INTERMEDIARY

Citation: Revenue Procedure 2010-14, 3/5/10

The IRS released guidance on a safe harbor reporting method that may be used by taxpayers who find their §1031 exchange went awry due to a failure through bankruptcy or receivership of the qualified intermediary the taxpayer was using. The IRS indicates that it is of the view that generally a taxpayer should not be required to report the gain in such a case until the year in which the taxpayer receives a payment attributable to the relinquished property.

To qualify for the treatment in the ruling the taxpayer must have relinquished property in accordance with Reg. §1.1031(k)-1(g)(4), have properly identified replacement property within the 45 identification period (unless the QI default occurs in that period), did not complete the like-kind exchange solely due to a QI's default where the QI became subject to a bankruptcy proceeding or a receivership proceeding and did not have actual or constructive receipt of the proceeds from the property prior to the time the QI entered receivership or bankruptcy.

The taxpayer will not have to recognize gain during the period the taxpayer is unable to enforce its rights or access the proceeds due to the receivership or bankruptcy proceedings. Rather gain will be reported using a gross profit ratio method as the taxpayer receives payments where a payment received is multiplied by a fraction, the numerator of which is the taxpayer's gross profit and the denominator of which is the taxpayer's contract price. Generally the selling price will be the selling price of the relinquished, though if the amount to be paid in full satisfaction of taxpayer's claim is received by the end of the first year that the taxpayer receives payment, the selling price is to be adjusted.

If there existed debt in excess of the basis of the property, the excess over the basis is treated as a payment received in the year in which the debt is satisfied. Recapture income would be recognized in the year in which gain is recognized to the extent gain is recognized in a year until all recapture amounts are included in income.

Adjustments to the gain will generally be taken into account in the last taxable year in which the taxpayer receives a payment attributable to the property. The taxpayer may also be able to claim a loss to the extent the adjusted basis of the property exceeds the sum of payments attributable to the property and debt satisfied not in excess of basis.

The ruling also describes the potential interactions with imputed interest rules under §483 or §1274.

The ruling contains a number of examples outlining the application of the ruling to various fact patterns. The ruling applies to like-kind exchanges that fail due to a QI default on or after January 1, 2009.

SECTION: 1041
RESTRICTED STOCK TRANSFERRED TO SPOUSE IN DIVORCE TAXABLE TO RECEIVING SPOUSE AT EXERCISE, EVEN IF EMPLOYER DOES NOT RETITLE STOCK RIGHTS PRIOR TO VESTING

Citation: PLR 201016031, 4/23/10

In Revenue Ruling 2002-22 the IRS ruled that if, in the context of a divorce, compensation related stock options are transferred from the spouse who received the grant to the other spouse, the transfer does not trigger an immediate recognition of income (being a transfer incident to divorce covered by §1041) and that when the options are exercised, the income triggered is income to the spouse that received the options in the divorce. In a private letter ruling the IRS was asked whether the same result is achieved if the employer does not transfer what in this case was restricted stock to the other spouse, where the shares remain in the name of the employee while the restrictions are in place, but under the divorce decree that employee transfers the shares only after the right to the shares vest and the shares are issued.

The IRS ruled that this situation gets the same treatment as the transaction described in Revenue Ruling 2002-22. That is, the transferring spouse does not recognize the income triggered upon release of the restrictions on the share, but rather the recipient spouse is required to include that amount in his/her income regardless of the reporting on the part of the employer.

SECTION: 1042
TRANSFER OF SHARES CONTAINING DEFERRED ESOP GAIN IN DIVORCE DID NOT TRIGGER IMMEDIATE RECOGNITION OF GAIN

Citation: PLR 201024005, 6/18/10

IRC §1042 allows the deferral of gain from the sale of employer securities to an ESOP if certain conditions are met. Generally, the qualified individual must use the proceeds from redeeming the stock to purchase replacement securities, allowing the conversion of the shares of the closely held stock into a diversified basket of publicly traded securities. However, §1042(e)(1) provides that if the taxpayer disposes of the securities in any manner, regardless of any other exception to recognition that might exist in the

IRC, the gain will be recognized unless §1042 provides an exception, one of which is for transfers by gift.

In the case for which the taxpayer was requesting a ruling, shares that contained the §1042 deferred gain taint were to be transferred to the taxpayer's spouse in a divorce settlement. The taxpayer wished a ruling that a transfer pursuant to §1041 between spouses in a divorce, which holds that such a transfer shall be treated as if acquired by gift, would qualify as a gift for §1042 purposes so that the ESOP deferred gain would not be triggered.

Based on the legislative history of §1041, the IRS found that treating the transfer as a gift was consistent with the legislative history of §1041, even though the section did explicitly make the transfer a gift. Therefore, no gain was triggered under §1042, and the §1042 restrictions would now apply to the recipient spouse.

SECTION: 1471
IRS RELEASES PRELIMINARY GUIDANCE ON NEW 2013 FOREIGN WITHHOLDING AND REPORTING REQUIREMENTS

Citation: IRS Notice 2010-60, 8/30/10

The IRS in Notice 2010-60 has issued guidance regarding reporting involving foreign financial institutions that was contained in the HIRE Act, which becomes effective for payments made after December 31, 2012. The IRS indicates in the notice that they intend to issue proposed regulations that contain the provisions found in this notice, as well as a draft foreign financial institution agreement and draft information reporting and certification forms to be used to implement the HIRE provisions.

The notice contains guidance regarding what will constitute an obligation outstanding on March 18, 2012 which are not subject to withholding. It also outlines certain exemptions from some or all of the obligations under these rules in certain situations.

The IRS is asking for comments on the notice through November 1, 2010.

SECTION: 2033
INDIVIDUAL NOT FOUND TO HOLD OWNERSHIP INTEREST IN FAMILY BUSINESS

Citation: Estate of Fortunato v. Commissioner, TC Memo 2010-105, 5/12/10

The Tax Court held that the IRS was in error in its assertion that Robert Fortunato had an ownership interest in a group of warehouse companies at his death. On that basis the IRS had asserted an estate tax deficiency of $11,662,737 and fraud penalties of $8,649,140 against the estate.

Robert had a “colorful” life, in his youth being charged with crimes to which he pled guilty and spent 6 years in Sing Sing. He later became a co-owner of a warehouse and export business. The business became one of the largest exporting companies in the country, but size did not translate into financial success—the enterprise hit severe financial problems, leaving Bobby with a trust fund penalty liability to the IRS of $490,000 and hundreds of thousands of dollars of debt due to other creditors.

His brother, Anthony, was bit more stable and eventually started a warehouse operation. Bobby initially consulted with Anthony on the business, and eventually Anthony brought Bobby in, and Bobby assumed leadership of the Company. Nevertheless, Anthony organized and managed the physical operation and provided the financial backing. Bobby, out of fear of creditors finding him, potential issues with licensing due to his background and out of a severe dislike for paying taxes, did not ever obtain ownership in the enterprise, did not sign any documents or maintain bank accounts and his salaries were paid by writing checks payable to a nonexistent person, with the checks cashed and Bobby having access to the cash.

Bobby set up operations for the enterprise in other states and moved to West Coast to run the operation there. When Anthony decided at one point to attempt to sell the business, Bobby was involved in the negotiations—the buyer insisted that Bobby remain and work with the business. Bobby wasn’t thrilled about that, and at one point asked, “What would I do with the money?” if a sale went through. That statement, as you might expect, is one the IRS believed made clear Bobby really was an owner.

However, the Tax Court didn’t buy it. The Court pointed out that while Bobby was clearly influential, he was compensated very well in salary and benefits for the services he provided. He had little reason to want an equity ownership, as the only beneficiary of his will was his brother Tony—so he wasn’t looking to pass on value to his heirs.

Rather, the Court accepted the view that Tony was the owner both in form and in substance, and that he simply had a very well paid general manager type who was also his brother. Bobby’s statements regarding the money he would receive on a sale to the court simply reflected his belief that due to family ties Tony would provide for him, as he did for other relatives—not a belief that he was legally entitled to a share as an owner. Thus the Court found that there was no estate tax deficiency.

SECTION: 2033
PROPERTY HAD BEEN HELD AS TENANCY BY ENTIRETIES AT DEATH OF DECEDENT'S SPOUSE, ENTIRE VALUE INCLUDED IN ESTATE

Citation: Estate of Goldberg v. Commissioner, TC Memo 2010-26, 2/16/10

Not taking care of the details by the decedent and his spouse ended costing an estate over $384,432.96. In this case the taxpayer transferred two parcels of property via a quitclaim deed that had been his to himself and his wife. However, the deed only mentioned the land was now held by "Oscar Goldberg and Judith Goldberg, as wife" and didn't indicate if the land was held as a tenant by the entirety or a tenant in common. As Judith predeceased Oscar, the issue was whether what was part of Oscar's estate at his death was the entire interest in the property (which would be the case had it been held in a tenancy by the entirety at Judith's passing) or only one half (the case if the property were held as tenant in common).

The Tax Court turned to New York law which indicated that when spouses receive property as husband and wife, the property is treated as held as a tenancy by the entirety absent an express declaration of the property as being held otherwise. Because the deed was silent on the topic, the Court found that New York law would not allow consideration of other evidence of intent, since the law requires an express intent either at the time the property is received as husband and wife or an express action to convert the property later—neither of which occurred in this case.

SECTION: 2036
TRANSFER TO PARTNERSHIP FOUND TO BE BONA FIDE SALE FOR FULL AND ADEQUATE CONSIDERATION, PARTNERSHIP ASSETS NOT REQUIRED TO BE INCLUDED IN DECEDENT'S ESTATE

Citation: Shurtz v. Commissioner, TC Memo 2010-21, 2/3/10

The Tax Court again visited the issue of whether, in forming a family limited partnership, there was a "bona fide sale for full and adequate consideration" that would serve to insulate the partnership from further analysis under §2036(a) to determine if there was a retained life estate. In this case, the decedent had transferred assets to a family limited partnership and then at her death left the remainder of her estate to a bypass trust and marital trusts, so her estate showed no amount taxable. However, if the partnership assets could be returned to the estate under §2036(a) there would be a taxable estate—and the estate would owe federal estate tax of over $4.7 million.

In this case the Court, in analyzing if there was a bona fide sale, determined there existed valid reasons apart from estate tax savings for forming the partnership. The

Court found there was a legitimate concern about preserving the family business, as the alternative of having multiple undivided ownership interests impeded the management of the timberland. Even though only a portion of the assets contributed required such a level of active management, that was found to be sufficient.

The Court also found that the contributors received interests in the partnership proportionate to the ownership interest each contributed. The partnership properly accounted for each partner's interest, and it was found to be "carried out in the way that ordinary parties to a business transaction would do business with each other."

SECTION: 2053
DEBT NOT NECESSARY TO PAY ESTATE TAXES, THEREFORE INTEREST ON DEBT NOT DEDUCTIBLE FOR ESTATE TAX PURPOSES

Citation: Estate of Stick v. Commissioner, TC Memo 2010-192, 9/1/10

An estate was denied a deduction for estate tax purposes for interest incurred on a loan taken out to pay estate taxes. The Tax Court agreed with the IRS that the estate failed to show the borrowing was truly necessary for the estate, arguing it had sufficient liquidity to pay the federal and state tax due. Thus, the expenses were not ones necessarily incurred in the administration of the estate as required by Reg. §20.2053-3(a).

The Tax Court noted that the assets of the estate that were reasonably liquid were more than sufficient to cover the federal and state tax due, finding the estate had liquid assets of over $229,000 more than needed to pay taxes due. Thus the Court found the borrowing was not necessary for the administration of the estate, leading to the conclusion that interest incurred on that debt was not a necessary administration expense.

The Tax Court did reject the IRS's alternative theory that because the estate had claimed the interest on the estate's Form 1041 income tax return as a deduction it should be denied the deduction for estate tax purposes. The Court noted that §642(g) impacts the income tax deduction, not the estate tax deduction. Under that section no income tax deduction is allowed on the estate's fiduciary income tax return unless the estate waives its right to a deduction for the expense on the estate tax return. Thus claiming the expense on the Form 1041 did not preclude the deduction on the Form 706—rather, if this had been a valid expense of administration for estate tax purposes, the IRS would only have the right to disallow the deduction on the Form 1041.

SECTION: 2055
ESTATE NOT ALLOWED A CHARITABLE DEDUCTION FOR AMOUNT PAID TO CHARITY IN SETTLEMENT OF DISPUTE OVER RESIDUAL OF ESTATE

Citation: TAM 201004022, 1/29/10

In a ruling that depends on the application of the specific state law to a situation, the IRS ruled that an estate could not claim an estate tax charitable contribution deduction under §2055(a) for amounts paid to a Charitable Trust in settlement of a dispute about the proper disposition of the residuary of the decedent's estate. The decedent's will generally provided that various amounts would placed in trust for various relatives of the decedent (including the decedent's son), providing them income for life and, at their death, transfer the remaining property in the various trusts to the Charitable Trust. The Will also provided that if any heir contested the will, they will have been deemed to have predeceased the decedent and their share would go to the charitable trust. However, the will lacked any provision providing for what happened to the residuary estate after these bequests were taken care of.

Son, as the decedent's sole intestate heir, claimed that the lack of a residuary clause meant that he should receive the residuary estate. The Charitable Trust claimed that it was entity that should receive the residuary and the lack of a residuary clause was scrivener's error—a claim backed by the attorney that drafted the various documents. The attorney testified that the decedent intended the residuary to pass to the charity and the decedent had a history of making a large number of lifetime charitable transfers. Eventually the parties settled the dispute with the son agreeing to take a certain amount to settle his claim and the rest going to charity. The estate then claimed a charitable contribution deduction. On examination, the matter was referred to the National Office for technical advice.

In the TAM, the IRS National Office ruled that to be considered deductible, the parties had to show the Charitable Trust's right had to pass under state law, correctly interpreted—and that a settlement of the parties to the dispute did not necessarily reflect that fact. The office relied on the Supreme Court decision in Commissioner v. Estate of Bosch and the Ninth Circuit's decision in Ahmanson Foundation v. United States. The National Office found that the state law in question generally would follow the written terms of the will in this case, and would not allow extrinsic evidence to insert a residuary clause where none existed.

SECTION: 2057
INTERESTS FOR PURPOSES OF QUALIFIED FAMILY OWNED BUSINESS DEDUCTION LIMITED TO EQUITY INTERESTS ONLY

Citation: Estate of Mary Roppolo Artall v. Commissioner, CA5, No. 09-60092, 1/29/10

Absent Congressional action before December 31, 2010, the qualified family owned business exclusion of §2057 would return to the Internal Revenue Code at the same time as the estate tax. Thus the Fifth Circuit's decision regarding whether debt can constitute an interest for purposes of determining the existence of a "Qualified Family Owned Business Interest" (QFOBI) may again become relevant.

The estate in the case of Estate of Mary Roppolo Artall had unsuccessfully argued before the Tax Court that Mary's loan receivable from the Artall's family farm should be counted as an "interests" for purposes of the 50% liquidity test. The Fifth Circuit agreed with the Tax Court that only equity interests, and not debt interests, are included under the statute as "interests" for purposes of qualifying for this deduction.

The Court stated that it found its finding consistent with the policy behind §2057 to avoid the necessity of selling a family business to pay the estate tax—the opinion noted "disposing of debt interests does not affect the ownership of a business." While it recognized that the debt may not be marketable, the Court noted that the business had made the choice when structuring its financing to use debt rather than equity from Mary, and the estate had to live with the consequences of that choice.

SECTION: 2207B
POD ACCOUNT BENEFICIARY UNDER WISCONSIN LAW NOT REQUIRED TO CONTRIBUTE TOWARD ESTATE TAX IMPOSED ON HER SHARE

Citation: Estate of Sheppard v. Schleis, Wisconsin Supreme Court 2009AP1021, 5/4/10

We've all had clients, through use of various titling options and changing, accidentally unwind carefully crafted estate plans, largely due to the distinction between probate and nonprobate items, as well as the fact that each class of nonprobate items tends to work under its own rules. However, the estate tax does not limit its application to probate items—but, in some states, only the probate estate is held liable for paying the tax absent clear instructions from the decedent.

A recent Wisconsin Supreme Court decision reminds us of the some of the pitfalls that await those who aren't careful in this area. The decendent died intestate with a taxable estate worth approximately $12 million. $3.8 million of that was contained in two

accounts that were titled as payable on death to his goddaughter, Jessica, who was age 17 at the date of the decedent's passing. Counsel for the estate asked Jessica's parents to sign an agreement that 50% of the balance would be left in the account to pay for "required estate taxes."

After a guardian ad litem was appointed for Jessica, the guardian advised the Estate's attorney that she had advised the family that, under Wisconsin law, Jessica had no liability to contribute toward any of the estate tax imposed on the estate, and all funds were withdrawn.

The Wisconsin Supreme Court agreed that the P.O.D. accounts did not bear any of the estate tax, the liability falling on the probate estate. The Court ruled that the estate was in error in claiming that §2207B imposed a right of recovery, noting that the provision was limited to items taxable under §2036, ruling that the P.O.D. was not a transfer during the decedent's life in which he retained an interest. Under Wisconsin law, no rights existed for Jessica in the P.O.D. account until the instant that the decedent died—he could have removed her entirely from the account, and was not required to inform her she was on the account.

The Court also found that Wisconsin law generally required the probate estate to bear the estate tax unless the decedent directed otherwise—and this decedent had failed to leave a will. As well, the agreement to retain 50% to pay "required estate taxes" was held to create no liability, as no "required estate taxes" existed on that balance, no guardian had been appointed at the time Jessica's parents signed the document and the court found that a guardian would not have been allowed to make a "gift" of the amount of the tax without petitioning the court.

SECTION: 2503
FAMILY PARTNERSHIP OPERATING AGREEMENT RIGHT OF FIRST REFUSAL SERVED TO ELIMINATE PRESENT INTEREST ELEMENT OF GIFT, THUS NO EXCLUSION ALLOWED

Citation: Fisher v. United States, USDC Southern District of Indiana, No. 1:08-cv-00908, 3/11/10

Another taxpayer finds that the restrictions placed on the interests of their children by their family limited partnership's operating agreement causes the interest to be treated as other than a present interest in a gift in the Fisher case from Indiana. Thus the Court's opinion, citing heavily from the Tax Court's Hackl decision, held the gift was not eligible for the annual exclusion under §2503.

In this case the operating agreement gave the partnership a right of first refusal for any sale of a partner's interest, with that interest that could be sold being specifically limited to the partner's share of the profits and losses of the company and any distributions. If the partnership exercised that right it could set the date of closing up to ninety days after it received notice of the proposed sale, and would pay the transferor a non-negotiable promissory note payable over a period of up to fifteen years, with the first payment due one year after closing.

The Court held that the limitations served to eliminate any effective present interest related to the recipient's right to transfer the asset. As well, distributions to a partner would be made solely at the discretion of the General Manager, making the right to receive distributions not a present economic interest. Finally the partnership attempted to argue the interests gave the recipients the right to possess, use and enjoy the partnership's primary asset, which was Lake Michigan beachfront property. However the Court found nothing in the operating agreement that granted the beneficiaries that right based on the transfer of an interest to them and, in any even, the Court found the right to possess, use and enjoy property alone does not create a right to a substantial economic benefit.

SECTION: 2503
GIFTS OF PARTNERSHIP INTERESTS WERE NOT PRESENT INTERESTS

Citation: Price v. Commissioner, TC Memo 2010-2, 1/4/10

A taxpayer who made a gift of partnership interests to his children was deemed not to have made a gift of a present interest, and thus was not eligible to apply the annual gift tax exclusion to the interests transferred. In the case at hand the partnership agreement provided the following:

Members had no right to unilaterally withdraw their capital accounts

Members had no right to sell, assign or transfer their partnership interests to third parties or encumber their interests without the consent of all partners

The Court noted that since the agreement also provided that a transfer to anyone not currently a partner granted that person only an assignee interests, in fact the children were not even partners, but rather assignees under the explicit terms of the partnership agreement.

The Court also noted that although this partnership, unlike the one in Hackl, was expected to generate income, any distribution of that income was solely at the discretion of the general partner and that, in fact, in two of the prior six years there had not been distributions—thus, there was also no reasonable expectation of access to income.

The case expands on the position the Tax Court outlined in its 2002 decision in Hackl v. Commissioner, 118 TC 279, making clear that the decision there was not limited to the unique facts of the Hackl partnership's lack of income—rather, some of the very restrictions on rights that give rise to higher valuation discounts put the existence of a present interest in question.

SECTION: 2503
FRESH FROM AFFIRMATION IN CHRISTIANSEN, TAX COURT RULES USE OF FORMULA CLAUSE FOR GIFT SPLIT BETWEEN CHARITIES AND OTHERS DID NOT VIOLATE PUBLIC POLICY

Citation: Estate of Petter v. Commissioner, TC Memo 2009-280, 12/7/09

Within a month of the Eighth Circuit affirming its holding in Christiansen that formula clauses in estate planning documents do not violate public policy, the Tax Court ruled again that a formula clause in a gift split between a charity and others that served to insure that any subsequent adjustment to the value of the assets transferred would not generate a gift tax was not a violation of public policy. The Court upheld the validity of the clause, as well as a full deduction for the value of the interests eventually treated as going to the charity as of the date of the gift for income tax purposes.

The formula clause provided that, effectively, the charities would receive the portion of the donated interests in the family LLC that would be in excess of what could pass gift tax free to the other donees. When the original value was challenged on exam, the amount that would go to charity was increased, something the IRS argued frustrated public policy giving no incentive to properly value the assets.

The Tax Court disagreed, noting in this case that the charities had an obligation, if they wished to maintain their tax exempt status, not to act "in cahoots with a tax-dodging donor." As well, the state's attorney general is given the right under state law with enforcing the charity's rights—so there were checks in place to prevent abuse, so that the threat of a gift tax was not needed to insure the items were properly valued.

SECTION: 2511
IRS CLARIFIES THAT NEW SECTION 2511(C) SERVES SOLELY TO EXPAND, NOT LIMIT, APPLICATION OF GIFT TAX IN 2010

Citation: Notice 2010-19, 2/2/10

The IRS issued guidance to clarify that §2511(c), which became effective on January 1, 2010, expands rather than limits the types of transfers that are subject to the gift tax. IRC §2511(c) provides, in the IRS's wording in the notice, that "certain transfers in trust are treated as transfers of property by gift even though such transfers would have been

regarded as incomplete gifts, or would not have been treated as transfers under the gift tax provisions in effect prior to 2010." That provision attacks transfers to trusts that had been treated as incomplete gifts for gift tax purposes, but which served to transfer the income to a taxpayer in a lower tax bracket. Under the current law where there exists a gift tax but not an estate tax, such a transfer would allow significant income tax planning while avoiding transfer tax liability.

The notice indicates the IRS became aware that some practitioners were taking the position that the language of the provision served to make transfers to a trust that qualified as wholly owned by the grantor for income tax purposes not be subject to the gift tax. The IRS announced that it will issue guidance to clarify that transfers that were subject to gift tax under the law prior to 2010 will remain subject to the gift tax.

SECTION: 2512
TAXPAYER'S CLAIMED GIFT OF PARTIAL INTEREST AND SALE OF REMAINING INTEREST IN LLC HELD TO BE SINGLE BARGAIN SALE UNDER STEP TRANSACTION RULES

Citation: Pierre v. Commissioner, TC Memo 2010-106, 5/13/10

Suzanne Pierre had previously fared well in the first decision the Tax Court issued on her dispute with the IRS. In Pierre I (133 TC No. 2) the Tax Court ruled that the existence of an LLC was to be respected for transfer tax purposes even if, prior to the transfer, the entity had been a single member LLC taxed as a disregarded entity for income tax purposes under the "check the box" regulations.

However issues remained to be decided in the case, resulting in a second Pierre decision. Suzanne transferred securities to the LLCs, and then 12 days later managed to transfer her entire interest in the LLCs to trusts for her son and granddaughter.

The appraiser that Suzanne had hired informed her that she could transfer a 9.5% interest in each trust without triggering gift taxes, so she treated that amount as gifted and had the trusts sign installment notes to purchase the remaining interests. Income distributions from the partnership were used by the trust to pay the interest on the notes and no principal had been paid over the eight years the notes were outstanding at the time of trial.

The IRS contended that rather than a gift of an interest followed by the purchase of an interest, this was a bargain sale of a 50% interest to each trust under the step transaction doctrine. The Tax Court found Suzanne did not give any nontax reason for structuring the transaction in this fashion and held for the IRS that under the step transaction doctrine this amounted to a single transaction.

The Court also found that, since the interests should be valued as 50% interest, the minority interest discount was reduced from 10% to 8%, even though the IRS did not produce its own expert, relying on the concession from the taxpayer's expert that a 50% interest, due to the ability to block the appointment of a new manager, would receive less of a discount than a less than 50% interest.

However, the Court did not reduce the lack of marketability discount from the amount the taxpayer claimed on the gift tax return, noting that the IRS had not provided any contrary evidence. The IRS had, instead of getting a valuation prepared, relied entirely on the theory that the LLC itself could be ignored.

SECTION: 2512
CHECK THE BOX RULES DO NOT APPLY TO VALUATION OF INTEREST IN SINGLE MEMBER LLC

Citation: Pierre v. Commissioner, 133 TC No. 2, 8/24/09

A divided Tax Court held, in a reported decision, that the check the box rules for a single member LLC treated as a disregarded entity do not require that the entity be disregarded for purposes of valuing interests that are gifted by the taxpayer to other parties. Rather, marketability and minority interest discounts are properly applied to the LLC interests themselves.

Suzanne Pierre received $10 million and placed it into a single member LLC. She then created trusts for her son and granddaughter, and gave the trusts each a 9.5 percent interest and sold 40.5 of her interest to each of the trusts for a note, claiming discounts in both cases. The IRS disallowed the discounts, claiming that check the box required the entity be disregarded.

However, the majority of the Tax Court held that, based on the history of the gift tax and Supreme Court precedent, state law property rights must be used for valuation purposes, which required respecting the LLC as an entity for valuation purposes. The Court held the check the box regulations do not alter this result. Needless to say, dissenting Tax Court judges did not agree.

SECTION: 2518
EIGHTH CIRCUIT RULES A FRACTIONAL DISCLAIMER DOES NOT VIOLATE PUBLIC POLICY

Citation: Estate of Christiansen, CA8, No. 08-3844, 11/13/09

The Eighth Circuit held in the Estate of Christiansen that a fractional disclaimer of an inheritance above a set amount did not violate public policy, and allowed the

recalculation of the amount of the disclaimer, also holding that the IRS examination was not an “act or precedent event” that would trigger Reg. §20.2055-2(b)(1). On the public policy issue, the Eighth Circuit held that merely because such a fractional disclaimer would create a situation where the IRS would not be able to collect any additional tax if it challenged the value of the asset, that did not violate any public policy.

The Court noted that the IRS was charged with enforcing the tax laws, and not with collecting the maximum amount of tax. The Court found no indication that Congress had, as a matter of policy, wanted to give the IRS the incentive to collect the maximum tax and thus a fractional disclaimer that would have the effect of eliminating any possible tax did not violate any public policy. The Court also pointed out that, in this particular case, due to other issues that 25% of the increase in value would create a tax liability.

The Eighth Circuit’s willingness to address and reject the public policy argument is a matter of interest, since such fractional formulas that serve to insure that any change in value simply increases the transfer to a entity for which a full deduction would be allowed is a technique that is sometimes used in estate planning documents.

SECTION: 3121
INDIVIDUAL HELD TO BE EMPLOYEE OF HIS CONTROLLED CORPORATION, PERSONAL DEDUCTIONS DENIED

Citation: Martin v. Commissioner, TC Memo 2009-234, 10/13/09

David Martin was advised by his tax adviser that he should form a corporation and stop reporting his income as a real estate salesman on Schedule C—and, in a twist, he was advised to have the corporation taxed as a C corporation and pay corporate tax on the income. While Mr. Martin did not take a salary, the corporation paid his personal and business expenses and he did not report that amount as income. His adviser’s position was that since RE/MAX did not treat Mr. Martin as an employee, Mr. Martin’s corporation isn’t required to do so either.

The IRS disagreed, assessing Mr. Martin individual income taxes on wages and going after the corporation for the payroll taxes. The Tax Court ruled that the payment of both personal and business expenses were wage income to Mr. Martin—the latter due to the fact that the corporation lacked an accountable plan that complied with IRC §62(c). As well, since the payroll tax matter was still in dispute for the year in question, the Tax Court did not allow the corporation a deduction for payroll taxes in that year.

SECTION: 4975
SALARY PAID TO IRA OWNER (EVEN IF VIA LLC OWNED BY IRA) DEEMED TO BE PROHIBITED TRANSACTION

Citation: CCA Email 200952049, 12/24/09

In an emailed advice (CCA Email 200952049), a member of the IRS Chief Counsel's office opined that an IRA owner that is paid a salary for services rendered to the IRA, even if paid via an LLC owned by the IRA, has participated in a prohibited transaction under §4975(c), even though §4975(d)(10) has a reasonable compensation and reimbursement provision. The email reasons that §4975(d)(10) does not apply to acts covered by §4975(c)(1)(E) (for fiduciaries dealing with assets for their own interest or account) or §4975(c)(1)(F) (a fiduciary receiving fees for their own personal account). The email concludes that the IRA owner has a conflict of interest when he is able to determine how much compensation to pay himself.

Given that the consequences of violation of the prohibited transaction rules for an IRA account is the immediate deemed distribution of the entire account balance to the owner, attention has to be paid to any situation where the IRS asserts the transaction would be such a prohibited transaction. Clients who may have gone down the path of using IRA funds to invest in a closely held business should be aware that this memo, while not officially binding, certainly suggests there is a risk of an IRS attack on any compensation or other amounts paid directly or indirectly to the owner.

SECTION: 4975
PLEDGING IRA OWNER'S NON-IRA ASSETS HELD BY BROKER TO SECURE DEBTS OF THE IRA ACCOUNT A PROHIBITED TRANSACTION

Citation: Department of Labor Advisory Opinion 2009-03, 10/27/09

The Department of Labor ruled that an IRA owner who grants to the brokerage firm holding his IRA account a security interest in the non-IRA accounts of the owner held in the same brokerage firm would engage in a prohibited transaction under §4975. In the case of an IRA, engaging in a prohibited transaction results in the entire IRA balance being deemed to be distributed to the owner in a taxable transaction.

The DOL found that the transaction violated four separate provisions of §4975, the one way the requestor was concerned the transaction was in violation and two other ways that had not been mentioned in the original request. The transfer violated §4975(c)(1)(B)'s prohibition of an extension of credit from the IRA owner to the IRA.

However, the DOL went on to determine that it would violate three broader prohibition sections found in §4975(c)(1)(B), (D) and (E) because the language of the proposed

agreement with brokerage appeared to pledge all assets to cover all debts. In the Department's view, the granting of a security interest in the IRA's assets for the non-IRA accounts would also amount to an extension of credit by the IRA to the IRA owner (violating §4975(c)(1)(B)), a transfer or use of the IRA assets for the benefit of the owner (violating §4975(c)(1)(D)) and would amount to the IRA owner dealing with the income or asset of the IRA for his own benefit (violating §4975(c)(1)(E)).

SECTION: 6011
PAID PREPARERS OF MORE THAN 10 INDIVIDUAL AND FIDUCIARY RETURNS REQUIRED TO EFILE BEGINNING IN 2011

Citation: Worker, Homeowner, and Business Assistance Act of 2009, Act Sec. 17, 11/6/09

In the Worker, Homeownership, and Business Assistance Act of 2009 Congress mandated that paid preparers who reasonably expects to file more than 10 individual and/or fiduciary returns shall file the returns electronically for returns filed after December 31, 2010. While there have been mandates imposed in certain states, generally those mandates have had to allow for certain returns that could not be electronically filed.

As written, IRC §6011(e)(3) does not seem to allow for any exceptions to the electronic filing, even though under the current IRS system certain returns simply will not be accepted electronically (such as a return properly claiming a dependency exemption for an individual that was improperly claimed on another return). Professionals will need to keep an eye out for how the IRS decides to handle such matters for the filing season beginning 2010, but prudence suggests beginning to educate clients who are not electronically filing that there will likely be no option next year.

The IRS has indicated on their website that they are going to provide some temporary relief for preparers that file less than 100 returns. Only those that anticipate filing 100 or more federal individual or trust returns during the year will be required to efile the returns of their clients beginning January 1, 2011. Those that anticipate filing less than 100 but more than 10 returns will not be required to use efiling for their clients until January 1, 2012, giving that group one additional year to get ready (from http://www.irs.gov/taxpros/providers/article/0,,id=223832,00.html as revised on June 11, 2010).

SECTION: 6015
IRS REVISES GUIDANCE TO ITS ATTORNEYS FOLLOWING VICTORY IN §6015(F) TWO YEAR RULE CASE

Citation: Chief Counsel Notice CC-2010-011, 6/18/10

Less than two weeks after the Seventh Circuit in Lantz v. Commissioner rÍeversed the Tax Court's holding that the requirement that equitable innocent spouse relief under §6015(f) must be requested within two years of first contact was an invalid regulation, the IRS Chief Counsel's office has issued revised guidance to its attorneys on how to proceed on such cases. The guidance notes that the IRS has appeals pending in the Second and Third Circuit Courts of Appeal, and is considering filing appeals in other circuits. This guidance supersedes Chief Counsel Notice CC-2010-005 issued in March of 2010 prior to the IRS victory at the Seventh Circuit.

The guidance indicates that the IRS will object to an attempt to have a case with this issue move forward as a Small Tax Court case, as the results of such cases cannot be appealed. The IRS attorneys are directed to move to remove these cases from the Small Tax Court case designation. Should the Tax Court turn down that request, in Circuits where an appeal is pending, the attorney should request that the case be held in abeyance pending the resolution of that appeal.

Attorneys are also directed that they should raise the two year deadline rule in every case and that the Chief Counsel will not settle or concede the two year issue in any docketed case.

The guidance notes that nearly half the cases where this matter is at issue are Small Tax Court cases. A number of such cases were already decided as Small Tax Court cases prior to the Seventh Circuit's decisions in Lantz and clearly the IRS now wants to take steps to insure that such cases are not decided in that venue before either the IRS can get a ruling in its favor from the applicable Court of Appeal or the Tax Court reverses its position in the light of appellate court rulings.

SECTION: 6015
TAXPAYER'S KNOWLEDGE THAT TAX WAS UNLIKELY TO BE PAID WHEN SIGNING JOINT RETURN NOT SUFFICIENT, BY ITSELF, TO ELIMINATE AVAILABILITY OF §6015(F) RELIEF

Citation: Withers v. Commissioner, TC Summary Opinion 2010-73, 6/10/10

The fact that a taxpayer was aware, at the time she filed a joint return with her ex-husband, that the tax was not likely to be paid was not sufficient, standing alone, to deny the taxpayer innocent spouse relief under §6015(f). The IRS had denied the

taxpayer innocent spouse relief based primarily on the fact that when she signed the tax returns with her husband, she knew that her husband had a significant gambling problem, had reduced his withholdings dramatically and that the couple's financial condition was such that they would be unable to pay the tax. She was the major contributor to the household's finances and was aware her husband was reckless with regard to finances.

However, the Tax Court noted that in Revenue Procedure 2003-61 the IRS downgraded this factor from a heavily weighted factor to simply one of many equally weighted factors. In this case, the Court found the taxpayer was no longer married to her ex-husband, her husband was charged by the state family court to pay ½ of the tax liability, she gained no significant benefit from the unpaid taxes and she had been compliant with federal tax laws since the year in question, having increased her withholdings to insure she had sufficient tax paid even in light of tight financial circumstances. Thus, the Tax Court found, she qualified for relief from her ex-husband's share of the joint tax liability.

SECTION: 6015
TWO YEAR LIMIT ON FILING FOR EQUITABLE INNOCENT SPOUSE RELIEF A VALID INTERPRETATION OF THE LAW, TAX COURT DECISION REVERSED

Citation: Lantz v. Commissioner, CA7, No. 09-3345, 6/8/10

The Seventh Circuit Court of Appeals overturned the Tax Court's prior invalidation (132 TC No. 8) of IRS Regulation §1.6015-5(b)(1). That regulation requires that an individual seeking equitable relief under §6015(f) must file for such relief within two years of the IRS's first action to collect the tax in question. The Tax Court held that since Congress explicitly put a two year statute in §6015(b) and (c) relief filings but included no such limit in §6015(f), the IRS went against the clear “audible silence” of Congress that meant §6015(f) to provide a relief option when none other was available.

Judge Posner wrote that it is reasonable of the IRS to impose a time limit of some sort for filing for relief under this provision, and that a two year term is reasonable regardless of whether the IRS was or was not looking to apply the term found in §6015(b) and (c). As well, the Court found that allowing an indefinite period for a taxpayer to file under §6015(f) would undermine the other two provisions, since §6015(f) could effectively be used to extend the statutes on those two provisions, even though Congress clearly limited the time period to file for those types of relief—Judge Posner notes that a taxpayer that satisfies the criteria for §6015(b) would always satisfy the criteria for §6015(f), thus making the deadline for filing for §6015(b) relief superfluous.

This is a significant victory for the IRS, which has continued to assert the 2 year rule in Tax Court in cases following Lantz. As the Lantz case is a reported Tax Court decision, for now it would appear to continue to apply outside the Seventh Circuit. But it seems likely the IRS will attempt to secure a reversal in other Circuits should the Tax Court continue to hold to its position in cases outside the Seventh Circuit.

SECTION: 6045
PROPOSED REGULATIONS OUTLINE BROKER BASIS REPORTING RULES TO BE EFFECTIVE IN 2011

Citation: REG-101896-09, 12/16/09

Proposed regulations have been issued by the IRS to govern the expanded reporting of adjusted cost basis for securities sold that will be required on Form 1099B. This rule will apply to any sale on or after January 1, 2011 for most corporate stock and any sale on or after January 1, 2012 for shares in a mutual fund or held in a dividend reinvestment plan. The proposed regulations, with run 141 pages, go into detail about various special issues in computing adjusting basis, including treatments of items such as wash sales.

The regulations also govern the required information to be reported when such covered securities are transferred to another reporting entity (such as when the taxpayer changes brokerage firms). The rules deal, as well, with basis adjustments to be taken into account and notations required to be made if the shares are gifted or inherited.

The IRS also issued a draft of the new Form 1099-B that will be used to report these cost basis figures.

The Energy Improvement and Extension Act of 2008 added these basis reporting rules.

SECTION: 6061
TAXPAYER'S IMPLIED CONSENT ENOUGH FOR PREPARER TO EFILE RETURN SUFFICIENT TO TREAT THE RETURN AS THE TAXPAYER'S RETURN

Citation: Ballantype v. Commissioner, TC Memo 2010-125, 6/10/10

In this case, the taxpayer was seeking to avoid an IRS assessment for an assessment of taxes against the taxpayer's 2007 income tax return, a return that the taxpayer agrees contained overstated deductions. The hitch was that the taxpayer had not seen the return prior to filing, instead the return being electronically filed by the tax preparer to whom the taxpayer had given his information for 2007, just as he had for three years previously.

The taxpayer, beginning with his 2004 return, used this preparer to prepare his returns. In the past he had used commercial services to electronically file the return, and in those cases he had reviewed the return prior to filing. However, he no longer did that with his new preparer. And, in fact, rather than having refunds deposited in the taxpayer's account, the refunds were actually deposited in the preparer's account. Each year the preparer gave the taxpayer an amount he claimed was the taxpayer's refund, though in fact the amount given was far less than the amounts received—the preparer keeping the "extra" refunds generated by false deductions he claimed.

In 2007 the taxpayer gave the preparer his W-2. He called the preparer to check the status of the return when it was taking longer than he expected, and on April 3 the preparer electronically filed the taxpayer's return. As in prior years, the taxpayer did not review the return. However, the IRS was onto the preparer and a portion of the refund was held back.

In June of 2008 the taxpayer discovered from a Department of Justice press release his preparer was being sued for filing fraudulent returns, at which time the taxpayer notified the IRS that the preparer may have prepared fraudulent returns for him. When the IRS assesed the taxpayer for tax after removing the overstated deductions, the taxpayer's defense was that the preparer had no authority to file the returns.

The Tax Court disagreed. While the taxpayer had not signed the returns in question, or apparently signed anything else to authorize the filing, the Court found that by his actions he had authorized the preparer to file and was stuck with the results. He followed the same procedures he had in prior years and, significantly, had not independently filed a return for that year. At trial he conceded that he expected the preparer to file his return as he had in prior years.

SECTION: 6081
PENALTIES FOR LATE FILING OF ESTATE TAX RETURN REFUNDED WHERE IRS FAILED TO CONSIDER GOOD AND SUFFICIENT CAUSE FOR LATE EXTENSION REQUEST

Citation: Estate of Proske v. United States, US District Court for the District of New Jersey, No. 2:09-00670, 5/25/10

An estate was granted a refund of late filing penalties by a United States District Court, the Court finding that the IRS had abused its discretion in denying the estate's request for an extension of time to file the return, even though that request was filed after the due date for the return in question.

Normally an estate would request an extension of time to file a tax return under the automatic provisions of Reg. §20.6081-1(b). That requires filing a Form 4768 on or

before the original due date for filing the Form 706. The estate in this case did not do so. However, Reg. §20.6081-1(c) the IRS may, upon a showing of good and sufficient cause, grant an extension of time to file the estate tax return.

In this case, the estate claimed it was unable to timely file an extension for a number of reasons. Just over a month after the unextended due date had passed, the estate did file a request for extension along with a payment of $1.8 million in estimated taxes, along with a detailed explanation of why it believed the estate should qualify for an extension under Reg. §20.6018-1(c).

The IRS originally denied the extension, simply noting that it was filed after the due date for the return. The IRS was unable to produce any evidence to indicate why the IRS examiner that handled the extension request had deemed there not to be good and sufficient cause for the late extension request, or even that he had considered anything except the date the request was filed. Thus the Court found the IRS had abused its discretion (or, effectively, simply ignored Reg. §20.6081-1(c)'s existence).

But the estate still needed to actually have good and sufficient cause, so the Court turned to the estate's reasons. The Court found that the taxpayer was required to both estimate the tax due and must have a sufficient basis for the amounts it includes on the form, seeming to find the latter largely from testimony of the IRS examining agent that if an extension was filed without sufficient knowledge of the truth of the information in the request, it could result in prosecution for perjury. Thus, the Court found, given the facts of this case, the estate had good and sufficient cause to delay requesting the extension until such time as it could meet the second prong of that test, something it was unable to do at the due date due to disputes among the heirs.

Note that it is likely another court would be less apt to have found the taxpayer was unable to estimate a proper tax under these facts—the IRS examiner's musing on possible perjury charges was likely a major factor here in the taxpayer's success in this case.

But the existence of the "second chance" option for estate tax returns in Reg. §20.6081-1(c) (an option not available for most other extensions under §6081) must be remembered if a practitioner is faced with estate that has failed to timely file for an extension for the estate tax return.

SECTION: 6109
IRS ISSUES FINAL REGULATIONS ON PREPARER REGISTRATION, NO CPA FIRM PARAPROFESSIONAL OR CANDIDATE EXCEPTION

Citation: Reg §1.6109-2, TD 9501, 9/28/10

The IRS final regulations to implement the preparer registration and regulation provisions were adopted in a virtually unchanged form from that found in the proposed regulations. Specifically, the IRS chose not to exempt from the registration provisions individuals working under the supervision of a signing registered preparer. That will include paraprofessionals and CPA candidates working in CPA firms. While noting that the IRS had received a number of comments asking for such an exemption, the IRS concluded that exempting this large class of non-signing preparers would not be consistent with the IRS's goal of having a record of those preparing returns for compensation and assuring that all such individuals had undergone a background check and demonstrated at least a minimum level of competence.

The immediate effect of this change is that all such non-CPA, non-EA members of firms will need to register with the IRS prior to December 31, 2010 to obtain a PTIN and pass the basic tax compliance background checks conducted prior to the issuance of a number. In the future such individuals will also need to pass the IRS exam to demonstrate competence.

SECTION: 6109
IRS OPENS UP REGISTRATION WEBSITE FOR RENEWAL OF AND APPLYING FOR NEW PTINS

Citation: IRS News Release IR-2010-099, 9/28/10

The IRS has begun taking registrations for 2011 PTINs on the IRS's new PTIN site. Everyone who will be preparing returns next year is required to visit the site to either obtain a PTIN or renew their current PTIN, and this step must be completed before January 1. After January 1, a PTIN registered under the new system will be required before any individual can prepare a 2011 income tax return.

The application requires a practitioner to set up a new account with the IRS—the older eServices accounts will not work with this step. Once an account is setup online, an individual is sent a temporary password to log into the site, being required to immediately select a permanent password.

For online registration a preparer will need to have access to his/her tax return for the prior year, as well as information on the individual's licensing with the appropriate entity. The IRS indicates that once a person has completed the process the new (or renewed) PTIN will be immediately available.

If an individual doesn't wish to apply online, a Form W-12 can be filed with the IRS. The IRS notes that a paper application will take 4-6 weeks to process.

The fee for a PTIN, payable at the time of the application, will be $64.25 for the upcoming filing season beginning in January 2011. Annual renewal of the PTIN, along with payment of the fee, will be required.

SECTION: 6109
FEES FOR PAID PREPARERS TO RENEW PTIN WILL BE $64.25 FOR 2011

Citation: IRS News Release IR-2010-091, 8/19/10

In a news release, the IRS announced that the user fee that will be charged to paid preparers for 2011 to renew their PTIN will be $64.25.

The IRS also announced that the prior PTIN application page would cease accepting applications on August 22, 2010, with its successor registration system to become active once the proposed regulations on preparer registration become final regulations.

SECTION: 6109
IRS PROPOSES LICENSING, TESTING AND CONTINUING EDUCATION FOR RETURN PREPARERS NOT CURRENTLY SUBJECT TO CIRCULAR 230

Citation: IRS Return Preparer Review Report, 1/4/10

The IRS completed and published its study of the tax return preparation industry, along with its proposed actions to regulate the conduct of preparers. In general the IRS's recommendations primarily will impact individuals who are preparers and who are not currently CPAs, EAs or attorneys.

The IRS proposes to take the following steps by issuing regulations under §6109, though the IRS makes clear these requirements will not be in place for the upcoming 2010 filing season:

All preparers will be required to obtain a PTIN and subjected to a tax compliance check to determine if the preparers have filed required federal income, employment and business tax returns

1. Competency testing will be required of all preparers who are not currently CPAs, EAs or attorneys in active practice and in good standing with their respective licensing entity
2. Continuing education will be required for preparers other than CPAs, EAs and attorneys

Expanding the definition of practice before the IRS to include the preparation of income tax returns, bringing all preparers under Circular 230

The IRS also announced in news release IR-2010-1 an initiative to send out letters to 10,000 preparers as an initial step in this process. The release also indicated that the IRS would follow up this letter with a personal visit to “thousands” of the letter recipients.

The report also identified areas where the IRS has determined it will need to seek more data before deciding on whether additional regulations make sense. The areas identified for further study are:

Tax preparation software

Refund anticipation loans

The IRS posted a set of frequently asked questions on its website to clarify issues about its new preparer registration program. While CPAs will not be required to take the competency testing, CPAs will have to register and pay a fee under the new program. CPAs will also not have to comply with the preparer continuing education requirements, even if the CPA is licensed in a state that does not require continuing professional education. However, the IRS indicated they would consider implementing requirements in that area should there be shown to be a need.

The IRS also published details about the status of “registered” or “licensed public accountants,” a class of accountants that exist in certain states. The IRS specifically found that LPAs in the following states have the same rights and privileges as a CPA, and thus will not need to pass the exam or satisfy CPE requirements: Alabama, Alaska, Arkansas, California, Colorado, Connecticut, Hawaii, Idaho, Maine, Montana, New Hampshire, New Jersey, New York, North Dakota, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Dakota, Tennessee, Vermont, and West Virginia. However, LPAs in the following states were determined not to have the same rights and privileges as CPAs, and thus will need pass the exam and meet the IRS continuing education requirements: Delaware, Illinois, Iowa, Kansas, Michigan, Oregon, and South Carolina. The IRS, in the FAQ, specifically did not rule on the status of Minnesota Registered Public Accountants.

SECTION: 6321
PROPERTY TRANSFERRED IN DIVORCE TO SPOUSE BY UNRECORDED

QUIT CLAIM DEED STILL AVAILABLE FOR IRS LIEN AGAINST POST DIVORCE TAX LIABILITIES OF THE NOW NONOWNER SPOUSE

Citation: CCM 201024039, 6/18/10

In response to an inquiry from the Taxpayer Advocate's Office, the Chief Counsel's office in a memorandum responded that in spite of contrary case law in three Circuits, the IRS holds to the view that a federal tax lien can be attached to property awarded to the non-delinquent spouse in a divorce where the quit claim deed the other spouse was ordered to execute was not recorded. This is true even though the tax debts all arose subsequent the divorce.

The memo relies upon the 1965 Fifth Circuit ruling in United States v. Creamer Industries that held that if the applicable state statute requires recording of a document for the transfer of title to be effective against creditors, the IRS retains the right to lien against the property for debts of the former owner until that recording takes place.

The memo notes that the First, Eighth and Tenth Circuits ruled against the IRS on the same issue, holding that the taxpayer had no property rights on which to impose the lien. All three cases were decided after the Creamer case. Nevertheless, the Chief Counsel's office reasoned that those decisions were flawed and thus the IRS had acted appropriately, in the case the Taxpayers Advocate's office was inquiring about, in determining the property is subject to collection.

SECTION: 6501
ONLY WAY TO START STATUTE RUNNING ON INADEQUATE DISCLOSURE ON FORM 709 IS TO FILE AN AMENDED GIFT TAX RETURN

Citation: CC Email 201030029, 7/30/10

In a twice removed request, a Congressman wrote a letter for a constituent who was worried about a gift tax return filed by a relative. The constituent was worried that the disclosures related to the gift included on the gift tax return were not adequate under Reg. §301.6501(c)-1(f)(2). The constituent wanted the IRS to enter into a Closing Agreement to resolve the uncertainty.

The IRS email concludes that since the return has been filed and is not under exam, the proper way to begin to resolve the matter is for the taxpayer to file an amended gift tax return containing the additional disclosures. The IRS would then be able to decide whether to examine the gift tax return.

SECTION: 6501
IRS REGULATIONS APPLYING SIX YEAR STATUTE TO LARGE OVERSTATEMENT OF BASIS HELD INVALID BY TAX COURT

Citation: Intermountain Insurance Service of Vail, LLC v. Commissioner, 134 TC No. 11, 5/6/10

The majority of the Tax Court went out of its way to strike down an IRS Temporary Regulation when the IRS asked to grant a motion to vacate the Court's original decision and rule on the matter under temporary regulations issued after the original decision. The question involved whether a taxpayer's overstatement of basis by a taxpayer created a omission from gross income that, if large enough, triggers the six year statute of limitations under §6229(c)(2).

Previously the Tax Court, citing its prior decision in Bakersfield Energy Partners, LP, 128 TC 207, affirmed on appeal by the Ninth Circuit, held that a basis overstatement did not amount to an omission from income and therefore ruled for the taxpayer in this case that IRS was time barred from assessing the tax. Less than a month after that decision, the IRS published Temporary Regulations §§ 301.6229(c)(2)-1T and 301.6501(e)-1T that held that an overstatement of basis is an omission from income, with an effective date for any taxable years for which the period for assessing tax had not expired by the date the regulations were published. In the IRS's view, since the regulations, if applied, would have meant the statute was open, the Tax Court no longer could rule assessment of the tax was time barred.

The majority of the Tax Court first ruled that the language of the regulation itself made the regulation inapplicable—the statute was closed already when the regulation was issued, and under its terms the issuance of the regulation itself could not extend the statute under the plain meaning of the effective date the IRS itself had placed on the regulation. That, in of itself, would have been enough to end the case.

But the Tax Court continued on to rule that the Temporary Regulations are in violation of the clear language of the statute, as interpreted by the 1958 U.S. Supreme Court in the Colony, Inc. case. Since, in the Tax Court's view, the Supreme Court had ruled the plain meaning of the statute required that some item of gross income be omitted from the return, the IRS could not by regulation overturn the law. Thus, the case holds that the IRS's temporary regulation is invalid, so the IRS would fail even if they had not fouled up the effective date.

There were a number of concurring opinions that, while agreeing with the result in this case (the IRS does not deserve to have the matter reopened), disagreed with how the majority arrived at that decision, complaining that the majority had written an

unnecessarily broad decision when other, case specific grounds, would have sufficed to arrive at the result.

However, at this point the IRS faces a reported Tax Court decision holding that the temporary regulations issued in September of 2009 are invalid, and that the holding of the Bakersfield case continues to apply.

SECTION: 6502
HUSBAND'S FAILURE TO CLAIM SIGNATURE ON STATUTE WAIVER WAS FORGED UNTIL AFTER STATUTE HAD OTHERWISE EXPIRED AMOUNTED TO ACCEPTANCE OF WAIVER

Citation: Jordan v. Commissioner, 134 TC No. 1, 1/11/10

The taxpayers argued that while the wife had signed the waiver of the statute of limitations on collection when entering into an installment agreement, the husband’s signature was not his. Based on that, they argued, the IRS did not have a valid waiver for either of them and therefore could no longer collect the remaining tax due.

The Tax Court first determined that the party asserting the statute had expired had the burden of proof in the case, citing the *Adler* case (85 TC 535). While *Adler* had been regarding the application of the three year statute on assessments, the court found the same reasoning applied to the ten year statute on collections. The court also found that even if the husband had not signed the waiver, the waiver would still be valid as to the wife who, it was conceded, had signed the form. However, to be enforceable against the husband, he must have signed the form or otherwise was pre-empted from repudiating it.

However, the court found that the taxpayers had not carried their burden of showing the husband had not signed the return. A key factor in the court’s decision was the fact that the wife was not called to testify on the issue of whether her husband had signed the return, and the court presumed that was because her testimony would not have been favorable.

But even if the court had determined the husband had not signed the return, he had ratified that signature when he made payments pursuant to the installment agreement, not raising the forgery issue until after the statute had otherwise expired. He accepted the benefit of the IRS not pursuing other collection actions against him while the statute was open, and could not disadvantage the IRS by only bringing up the issue after they could no longer pursue those other options.

SECTION: 6511
STANDARDS FOR TREATING A NEW CLAIM FOR REFUND AS

AMENDMENT TO ORIGINAL CLAIM DETAILED BY CHIEF COUNSEL EMAIL

Citation: Chief Counsel Email 201024051, 6/18/10

In Chief Counsel email 201024051, we find a discussion of the factors the IRS should consider to determine if a revised supplemental claim filed after the original claim would be considered timely. The issue arose because while the original claim was filed just prior to the expiration of the statute of limitations for claiming a refund, the revised claim was filed after the expiration of the statute. So if the claim was considered as part of the original claim, it would be timely, but if not it would be considered time barred.

The email held that a claim would not be considered an amendment to the origin claim if it would require investigation of matters *that* would not have been disclosed *by* investigating the original claim. As well, if the IRS had taken final action on the original claim, either accepting or rejecting it in whole or in part, the claim would not be a valid amendment of the first claim. But if the amendment was filed before the IRS took final action on the first claim and involves matters that would have been disclosed in the investigation of the original claim, then the item is a valid amendment and would not be time barred.

SECTION: 6651
FAILURE TO FILE PENALTY APPLIES TO TAX DUE ON 5329 IF NOT FILED WITH 1040 WHEN REQUIRED

Citation: Chief Counsel Email 201034024, 8/27/10

An email from the Chief Counsel's office pointed out that if a taxpayer is required to file Form 5329 with his/her 1040 to report a retirement account related tax and fails to do so, the failure to file penalty applies independently to the tax due on the Form 5329, even though that tax would have been reported on the timely filed Form 1040.

The email refers the recipient who raised the question to 4.4.4.14.2.8 of the Internal Revenue Manual for a discussion of the applicability of the failure to file penalty in this situation. The IRM notes that the IRS is supposed to manually compute the failure to file penalty on the tax that should have been shown on the Form 5329, and that if the delinquency penalty applies then the negligence penalty would not apply to that portion of the tax.

SECTION: 6651
LACK OF ACCESS TO RECORDS, OTHER FACTORS, NOT REASONABLE CAUSE FOR FAILURE TO TIMELY FILE TAX RETURN

Citation: Kalinoski v. Commissioner, TC Summary Opinion 2010-30, 3/15/10

Dennis Kalinoski had lots of reasons he felt gave him reasonable cause for not timely filing his federal income tax return for 2002. He had faced charges for not conducting mandated buyer identification procedures in his firearms business and then with knowingly possessing stolen firearms, charges that were dismissed in 2002. But this hardly ended Dennis's problems--during 2002 he became addicted to crack cocaine.

In March 2003, after purchasing software to prepare his 2002 return, he had encountered back pains that kept him bedridden. His physician told him he needed surgery, but Dennis had another set of problems. He had women living with him who had opened the home to their friends, friends that would take drugs or steal Dennis's property while he was bedridden and he felt he could not leave the home or, presumably, things would get worse. He also felt that calling the police to solve his problem due to the little problem of the illegal drugs in his home.

In May 2003, though, the police showed up anyway with a warrant and, after seizing various items, including Dennis' records, charged Dennis with a number of felonies. He was then incarcerated and convicted of crimes. Following this Dennis's family came to his home to clean it up, boxing up the papers they found strewn about the home, and boxed up the documents in no particular order.

Dennis argued that these events should serve as reasonable cause for failing to timely file his return, since he could not access his records and was also otherwise disposed. However the Tax Court disagreed. It noted that Dennis had his records on the due date of his 2002 return, and that his problems did not prevent him from conducting other activities, including participating in his own defense, during the period his return went unfiled.

The Court also noted that a lack of access to records is not a valid reason for a late filing, noting the case law makes it clear that a taxpayer can file a return based on the best available information and then file an amended return later. Finding no valid reasonable cause for Dennis' late filing of his 2002 return, the Court ruled that the failure to file penalty applied in this case.

SECTION: 6654
JOINT FORM 4868 REMITTANCE PAID ENTIRELY FROM ONE SPOUSE'S FUNDS STILL SUBJECT TO BEING SPLIT BETWEEN THE SPOUSES IF SEPARATE RETURNS FILED

Citation: Chief Counsel Email 201035023, 9/3/10

If a husband and wife file a Form 4868 to extend the time to file their return jointly and submit a payment with it, how should that payment be divided if the taxpayers later file separate returns. In the case in question the couple ended up in divorce proceedings between the time the Form 4868 was filed and their returns for the year in question ended up being prepared.

The husband's CPA discovered the IRS had allocated the payment as an estimated tax payment under Reg. §1.6654-2, dividing it between his client and his client's spouse. The CPA informed the IRS that the payment had come from the husband's own funds and that all of the payment should be allocated to him. His wife, upon learning of the new allocation (which the IRS initially went along with), demanded that the IRS return the funds to her account under Reg. §1.6654-2's provisions when spouses do no agree upon a division of estimated tax payments.

IRS Counsel was asked to give advice to the IRS on this matter. Counsel determined that the payment was properly treated as a payment of estimated tax and had to be handled under those rules. The email distinguishes this case from the cases the CPA cited in his claim for the husband. In both cases the item in question was found to be an overpayment rather than a payment of estimated taxes.

In one case the funds in question did not come with a Form 4868, so the email concludes that case is clearly not in line with the facts in the current situation. The email notes that the second case, which did involve a Form 4868, while sustained by the Sixth Circuit in result was not sustained for the reasons given the by trial court—and those reasons were what the CPA was relying upon in this case.

SECTION: 6654
EMOTIONAL PROBLEMS EXCUSED LATE FILING FOR ONE YEAR BUT NOT THE FOLLOWING YEAR

Citation: Humes v. Commissioner, TC Memo 2009-100, 7/6/09

A physician who had severe emotional problems and was hospitalized in August 2004 related to those issues. She did not file her tax returns for either 2003 or 2004, and the IRS assessed penalties for underpayment of estimated taxes, failure to file and failure to pay taxes. Dr. Humed argued that her emotional problems were so overwhelming that

"all she could do" was to meet her work obligations in 2004, and that led to her hospitalization and eventually to her having to quit working entirely.

The court noted that the IRS failed to show if Dr. Hume had filed a return for 2002 and, if so, the amount of tax shown on that return. Given that IRC §6654(d)(1)(B) limits the amount due to 100% of the tax shown on the prior year return, the Tax Court found it did not have sufficient evidence to compute what penalty may have been due for underpayment of estimated taxes in that year.

The Tax Court found that her problems in 2004 amounted to reasonable cause for her late filing of the 2003 return and waived the late filing penalties. However the Court noted that she did not present any evidence why she was unable to file her 2004 return timely, that one being due in 2005 after she had ceased working. The Court held for the IRS that for 2004 the penalties did apply.

SECTION: 6662
IRS OUTLINES ADEQUATE DISCLOSURE FOR PURPOSES OF §6662 AND §6694

Citation: Revenue Procedure 2010-15, 1/27/10

After not issuing its normally annual revenue procedure regarding disclosures on tax returns in 2009, the IRS returned to issuing the annual document in 2010, applicable for 2009 income tax returns. The document outlines disclosures made on the return that will be deemed to be adequate to escape the penalty for substantial understatement of tax without having to file a Form 8275 or 8275-R for positions that have, at a minimum, a reasonable basis. The requirements are listed generally by form and information type, and describe what items will and will not constitute adequate disclosure.

This year's version of the revenue procedure added description of new schedules required to be filed by Forms 1120 and 1065 filers filing Schedule M-3.

The document outlines what the IRS expects of taxpayers when filling out tax returns forms to properly disclose items and should be reviewed by all individuals who are involved in the preparation of tax returns.

SECTION: 6707A
IRS CLARIFIES EXTENT OF JUDICIAL REVIEW IN §6707A REPORTABLE TRANSACTIONS

Citation: Chief Counsel Email 201020020, 5/21/10

In an email, the Chief Counsel's office pointed out an important distinction on the amount of judicial review of penalties under §6707A. The email notes that while the

statutory language precludes a court from reviewing the IRS's determination on whether to rescind the penalty upon failure to disclose a reportable transaction that is not a listed transaction, the taxpayer could challenge whether all elements existed for the penalty to apply at all.

This same distinction should apply to the penalty for failing to disclose a listed transaction, which is not subject to rescission by the IRS at all. The mere fact the IRS asserts this penalty applies does not mean it does apply—but our defense has to be that the penalty did not apply in this case.

SECTION: 6707A
TRANSACTION SUBSTANTIALLY SIMILAR TO LISTED TRANSACTION, STATUTE OF LIMITATIONS REMAINED OPEN DUE TO NONDISCLOSURE

Citation: BLAK Investments v. Commissioner, 133 TC No. 19, 12/23/09

The Tax Court ruled that the incorporation in §6501(c)(10) of the definition of a listed transaction found at §6707A did not mean that §6501(c)(10) did not operate to extend the statute of limitations for returns due before the effective date of §6707A but whose own statute of limitations had not expired before the effective date of §6501(c)(10). IRC §6707A, as added by American Jobs Creation Act of 2004, created the penalty for failure to disclose a reportable transaction, while §6501(c)(10) kept the statute of limitations open for one year beyond the date when the disclosure is filed on a listed transaction.

The taxpayers participated in a listed transaction for which returns were required to be filed, and were filed, prior to October 24, 2004. The Court found that the purposes of the two sections were different, and it was Congress's intent to have transactions that were not subject to the penalty under §6707A but for which the statute remained open under §6501(c)(10).

The Court also found that even though the transaction the taxpayer entered into involved the sale of securities and not options, that did not amount to enough of a difference to make the transaction not "substantially similar" to the Son-of-BOSS transaction described in Notice 2000-44. A listed transaction includes transactions that are substantially similar to those described specifically as listed transactions by the IRS.

Thus the Court found that the statute of limitations remained open for assessments on the transaction that the taxpayers had not disclosed.

SECTION: 6901
IRS CAN COLLECT UNPAID ESTATE TAX FROM HEIRS WHO SETTLED LAWSUIT AGAINST ESTATE DUE TO TRANSFEREE LIABILITY

Citation: Upchurch v. Commissioner, TC Memo 2010-169, 8/2/10

Judith Upchurch's will provided that most of her estate would go to her three children, but the interest in her residence would be divided equally among her three children and the two children of her former spouse, who had passed away earlier. However, just prior to Judith's death she divided the parcel on which her home stood in half and transferred the property by quitclaim deed to two of her children.

As you might expect, the children of her former husband weren't happy about that and litigation ensued. The children that were left out named the other children that received the property and the estate as defendants in the suit to recover the value of the property. The matter was settled by the estate paying each of the plaintiffs $53,500 after the plaintiffs filed a claim against the estate. The plaintiffs' attorney withheld his fee from the award and then transmitted the remainder to his clients.

The IRS later examined the estate and determined that the estate's claimed deduction for the amount paid in settlement was not a legitimate deduction for estate tax purposes. As such, an estate tax deficiency was assessed and agreed to by the executor. The IRS now sought to collect by going after the amounts awarded to the plaintiff children, arguing that since they had received assets from the estate, they could be held liable for the unpaid estate tax up to the amount they had received under transferee liability principles.

The plaintiffs argued first that they hadn't received estate property, as children of Judith were named in the suit. The Tax Court rejected this, noting the estate was a named defendant and that, in fact, the settlement stipulated the amount would be treated as a claim against the estate—thus they had received estate property.

As well, the IRS could pursue them for unpaid taxes up to $53,500 each, despite the fact that the amount they had actually received was less than that due to the payment of attorney fees. Citing the Supreme Court's decision in the Banks case (543 US 426, 2005), the Tax Court found that the children retained dominion over the asset throughout litigation and the mere fact that a portion had been used to pay their attorney was not relevant.

SECTION: 6901
TRANSFEREE LIABILITY APPLIED TO SON WHO RECEIVED CONDOMINIUM FROM DAD, EVEN THOUGH PROPERTY COVERED BY FLORIDA HOMESTEAD EXEMPTION

Citation: Rubenstein v. Commissioner, 134 TC No. 13, 6/7/10

Scott Rubenstein moved to Florida to live with and care for his ailing father. In 2002 his father purchased a condominium in which both father and son lived. However, Dad had a number of outstanding debts, including over $100,000 in unpaid federal taxes. In 2003 Dad transferred the condominium to Scott for $10, at which time all parties agree that Dad was insolvent and Scott was aware of this fact. The condominium would generally have been protected from the claims of creditors by Florida's homestead exemption.

The IRS argued that the transfer was a fraudulent conveyance under Florida's Uniform Fraudulent Transfer Act, the relevant provision of which is identical to that found in the standard version of the Uniform Fraudulent Transfer Act. The taxpayer argued that the same act exempts from fraudulent transfer assets that are “generally exempt under nonbankruptcy law.” The Tax Court, after noting that it found no prior cases that clearly addressed the issue, found that because the IRS, under federal law, could have forced a sale of the property, the proper way to read that provision is whether the asset was exempt with regard to the particular creditor—and, in this case, the condominium was not beyond the reach of the IRS when Dad owned it.

The Court also found that the IRS was not blocked from pursuing the condominium even though it had previously evaluated the home's net realizable equity was zero when rejecting Dad's offer in compromise earlier. The Court indicated that it is not clear the Eleventh Circuit would allow an equitable estoppel claim against the government, but even if that was deemed allowable Scott would need to show that he had relied upon the government's statement, the government acted with willfulness or negligence in the matter, and that there was affirmative misconduct on behalf of the government—and he had shown none of these factors to be present.

The Court also rejected Scott's final claim that the condominium was compensation for the care he had provided. The Court noted Scott testified he provided the care out of love, and the he never felt there was a debt. As well, Florida law provides a presumption that no debt is created in a situation of this sort absent an express written document or implied promise, neither of which was shown.

Thus, §6901 transferee liability rules apply and the IRS could go after Scott for taxes his Dad owed.

SECTION: 7216
CLIENT CONSENT NOT NEEDED TO PROVIDE INFORMATION TO MALPRACTICE CARRIERS

Citation: Revenue Ruling 2010-5, 12/30/09

The IRS clarified that tax preparers can disclose, for the limited purpose of obtaining professional liability insurance, information to potential liability insurance carriers who are located in the United States without having a client's consent to disclose the data. The IRS ruled that such insurance is an auxiliary service provided in connection with the preparation of tax returns under the regulations issued under §7216. The items disclosed must be limited to that data needed to obtain or maintain insurance, and the insurance carriers are prohibited from further use or disclosure of this information.

As well, the preparer may disclose tax return information to the carrier for the purpose of investigating claims without obtaining the client's consent to this disclosure. Similarly, if the insurer selects an attorney that will represent the preparer in the potential claim, tax return information necessary for the legal representation may be disclosed without taxpayer consent.

SECTION: 7216
IRS CLARIFIES WHEN NO CONSENT WILL BE REQUIRED FOR ACTIONS LEADING TO CONTACT WITH CURRENT AND FORMER CLIENTS

Citation: Revenue Ruling 2010-4, 12/30/09

The IRS in Revenue Ruling 2010-4 has given five examples of situations in which tax preparers can make use of information without taxpayer consent. The issue relates to compliance with IRC §7216 and related regulations that restrict the use or disclosure of taxpayer information without the taxpayer's consent. The first two deal with issues of contacting current and former clients regarding changes in the tax law that may impact the taxpayer, while the final three deal with outsourcing newsletter type operations to a third party service provider.

In the first example, the IRS ruled that a preparer who, in response to a change in the tax law, uses information obtained from the tax returns he/she had prepared to compile a list to be used to contact taxpayers that may be impacted by the change does not need to obtain the client's permission for this use of tax return information. In the second fact pattern, the IRS ruled that even though the preparer did not prepare the taxpayer's most recent return he/she may still use the information from the returns he did file to contact these former clients and inform them of the impact of the change in the law.

The final set of three examples deal with disclosing taxpayer's names and addresses (both email and postal) to third parties who are going to provide the taxpayers with newsletters on tax related matters, as well as solicitations for tax return preparation services by the preparers. In the first case, the outside entity publishes its own electronic and print newsletters that it sends to the list of clients provided by the preparer. In the second case, a preparer that had previously published a newsletter in house now goes to the outside entity to handle all aspects of the newsletter. In the third case, the preparer creates and publishes the newsletters herself, but then delivers them to the outside entity solely to handle the mailing using the addresses and names she provides.

In all three cases the IRS rules that the outside entity is providing services auxiliary to tax return preparation. No taxpayer consent will be required for this disclosure if:

> The outside entity is located in the United States;
>
> The outside entity provides no substantive determinations or advice affecting the reported tax liability of the taxpayers *and*
>
> The preparer has determined, via use of its own procedures to maintain the confidentiality of taxpayer information, that the outside entity has sufficient data confidentiality procedures in place to keep the tax information confidential.

SECTION: 7216
IRS ISSUES TEMPORARY REGULATIONS ON CERTAIN PERMITTED USES AND DISCLOSURES OF TAX RETURN INFORMATION WITHOUT CLIENT CONSENT

Citation: TD 9478, 12/29/09

The IRS issued temporary regulations modifying the final regulations issued under §7216 that went into affect on January 1, 2009. The IRS looked to modify provisions in Regulation §301.7216-2(n), (o) and (p).

The revisions to §301.7216-2(n) deal with the use of tax return information for the solicitation of tax return business without explicit taxpayer consent. The revised temporary regulation expands the type of information that may be compiled and maintained in a list for solicitation to include individual status and tax return type (such as Form 1040 or Form 1120 clients). The regulations allow the IRS to identify future information that may be included in such a list by publishing guidance in the Internal Revenue Bulletin rather than having to modify the regulation itself.

The regulation expands the definition of tax information that can be provided to taxpayers to specifically include general business or economic information for educational purposes—and that is indicated to specifically cover information explaining current developments in the tax law. As well, the regulations clarify that disclosure of this limited amount of information in conjunction with the sale of the preparer's business includes disclosure in the due diligence phase of a potential acquisition.

The rules allowing disclosures of compilation of taxpayer information for limited purposes under Reg. §301.7216-2(o) are also expanded. Disclosure of such anonymous compilations is allowed in conjunction with bona fide research or public policy discussions concerning taxation. However, the revised regulations specifically prohibit, for marketing or advertising, the disclosure of dollar amounts or percentages of refunds, credit or deductions based on such compilations.

Finally, regulation §301.7216-2(p) is modified to allow the use and disclosure of tax return information to comply with conflict of interest reviews required by governmental agencies or professional association ethics committees, but only to the extent necessary to accomplish the review.

The regulations apply to disclosures or uses of tax return information occurring on or after January 4, 2010. The temporary regulations will expire on or before December 28, 2012.

SECTION: 7701
IRS ISSUES GUIDANCE ON ECONOMIC SUBSTANCE CODIFICATION

Citation: Notice 2010-62, 9/13/10

The IRS has issued guidance on the application of provisions regarding economic substance found in the Patient Protection and Affordable Care Act passed in 2010.

The IRS first explains its interpretation of the conjunctive test under §7701(o)(1). Under that test, applicable to transaction entered into on or after March 31, 2010, a transaction or series of transactions will be deemed to lack economic substance unless a taxpayer can show both 1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position and 2) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into the transaction. While these terms are applied using tests as applied in the common law doctrine previously developed, the IRS announced that due to the new legislation it will challenge any taxpayer that attempts to argue, based on prior case law, that they only need to satisfy one of the two prongs of this test. Rather, the IRS holds that a taxpayer must demonstrate both factors in order to avoid a finding that the transaction lacked economic substance.

The IRS also announced that since the provision references the existing economic substance doctrine as developed under case law and is to be applied as if the section had not been enacted, the IRS expects to continue to develop the doctrine. For this reason, the IRS will not issue general guidance as to the types of transactions to which the economic substance doctrine does or does not apply.

In computing the net present value of the reasonably expected pretax profit under this provision, the IRS announced that it will apply existing case law and other published guidance.

Under §7701(o)(2)(B) the IRS is granted the authority to issue regulations requiring foreign taxes to be treated as pre-tax profit in appropriate cases. While the IRS has not yet issued regulations in this area, the notice indicates the IRS plans to do and, in the interim, takes the position that courts can continue the appropriate treatment of such taxes until the regulations are issued.

Under new §6662(i) the negligence penalty for transactions lacking economic substance will increase to 40% from 20% if the transactions was not adequately disclosed. In the notice the IRS holds that a transaction will be adequately disclosed if disclosed in a manner that would comply with the disclosure requirements for the substantial understatement penalty under §6662(d)(2)(B) (ignoring the inapplicability to tax shelter provisions of §6662(d)(2)(C)) and is done so either on the original return or a qualified amended return (as the latter is defined under Reg. §1.6664-2(c)(3)).

Generally such disclosure must be made on a Form 8275, 8275R or via other mechanisms otherwise described in forms, publications or other IRS guidance.

The IRS also announced that it will not issue a private letter ruling to a taxpayer regarding whether or not a transaction complies with §7701(o).

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