

**SUPPLEMENTAL TAX UPDATES
OCTOBER 1, 2010 TO OCTOBER 15, 2010**

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SECTION: 163

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

Citation: Revenue Ruling 2010-25, 10/14/10

Just over a year after making waves with an legal memorandum that indicated the IRS had “buyers remorse” over two cases in which it prevailed on the question on what is truly the definition of acquisition indebtedness (ILM 200940030) the IRS has formalized that guidance in a Revenue Ruling.

In the 1997 case of *Pau v. Commissioner* and the 2000 case of *Catalano v. Commissioner* the IRS won victories when it limited taxpayers to deducting interest on only \$1,000,000 of debt for acquiring the home mortgage, blocking the taxpayers from treating the first \$100,000 in excess of that amount as home equity debt. In those cases, the Tax Court agreed with the IRS’s view that the \$1,000,000 was not part of the definition of what is acquisition indebtedness, but rather just a limitation imposed how much of such debt could generated deductible interest.

That holding was important because §163(h)(3)(C) defines home equity indebtedness as any debt secured by the residence other than acquisition indebtedness. Thus the debt in excess of \$1,000,000 was still acquisition indebtedness and could not be treated as deductible home equity indebtednesses up to \$100,000 in debt.

The IRS has announced that it will no longer follow the results in the *Pau* and *Catalano* cases. What the ruling does not state, but the ILM did, is that if you follow the logic of the *Pau* and *Catalano* cases when looking at §56 and the alternative minimum tax, you would conclude that there is no limit on acquisition indebtedness for alternative minimum tax purposes, since §56 never references any limit on the amount of debt, but relies on the definition of “qualified residence interest” under §163(h). Thus the ruling may not be quite as generous as it may appear at first glance.

However there may be clients who are not subject to the alternative minimum tax may have refund claims that should be filed for open years to claim additional interest deductions if their interest had previously been reported using the caps provided in the *Pau* and *Catalano* decisions.

SECTION: 183

TAXPAYERS LOSSES FROM HORSE BREEDING ALLOWED, AS COURT FOUND A TRUE PROFIT MOTIVE

Citation: Dennis v. Commissioner, TC Memo 2010-216, 10/5/10

Horse breeding activities are notorious for often failing the test of whether the activity was conducted with a profit motive. However a key factor most often is that a) the person conducting the activities appears to mainly just wish to be around horses for personal reasons and b) the taxpayers have sufficient other income to allow them to continue to absorb the losses for an effectively limitless period of time.

In this case the taxpayer had entered into the breeding activity when he had lost his prior job due to the bankruptcy of his employer. While his spouse had reasonable income, the reality was that the losses incurred were large enough to create real financial hardship, causing the taxpayers to borrow funds from a relative and pledge their land as collateral for the note. The operation was plagued by bad luck, including drought conditions that raised the cost of feed dramatically, and even though the taxpayers tried various means to change their operations they eventually decided to shut the operation down.

Even though some of the nine tests found in Reg. §1.183-2(b) indicated a potential lack of a profit motive, the Tax Court made clear that the test is not merely a simplistic scorecard. In reality, the fact that the taxpayers could not afford the losses, took steps to attempt to change their fortunes and eventually shut down the operation when they could not turn it around were the truly crucial items in the eyes of the Tax Court.

SECTION: 197

DESIGNATION OF VINEYARD AS AN AMERICAN VITICULTURAL AREA CAN GIVE RISE TO A §197 INTANGIBLE

Citation: Chief Counsel Memorandum 201040004, 10/8/10

The taxpayer in the matter in question purchased a vineyard in two “American viticultural areas” as designated by the Alcohol and Tobacco Tax and Trade Bureau of the United States Treasury. The taxpayer argued that it should be able to allocate a portion of the purchase price of the land to the right to use the “AVA” designation and treat it as a Section 197 intangible which may be amortized. The Chief Counsel’s office was consulted on whether such a treatment was appropriate.

The memorandum looks at the details of how an area is designated as an AVA and the right to use that designation for wines that come from the regions in question. The memorandum concludes that the right to use the AVA designation is not a right that attaches to a particular piece of land and therefore not an interest in land under §197(e)(2), but rather a right granted by a governmental unit governed by §197.

However the memorandum cautions that valuing this right could prove to be a problem, since it will be difficult in many cases to find comparable land that does not have the right to the designation that would be necessary to determine the incremental value of that right. As well, the memo notes that the taxpayer would need to show a clear premium, such as a marketable and recognizable tradename to a taxpayer's vineyard, to be able to recognize the intangible asset.

SECTION: 351

TAXPAYERS DID NOT TRANSFER FARMING ACTIVITY TO NEW CORPORATION, INCOME TAXABLE TO SHAREHOLDERS DIRECTLY

Citation: *Slota v. Commissioner*, TC Summary Opinion 2010-152, 10/12/10

Taxpayers at times aren't the best at following all the formalities when establishing a corporation or transferring their business to the corporation. In this case the taxpayer's inability to show that the underlying assets were transferred to the corporation resulted in the court finding that the deposit of proceeds from the taxpayer's crop in the corporate checking account was an impermissible assignment of income to the corporation.

The taxpayer owned and operated a farm as a sole proprietor. In 2005 he organized a corporation under Iowa law. However they executed no documents transferring title of any assets, including the farm land or crops, to the corporation, transferring only \$10,000 of cash from their checking account. However when the money came in from the USDA for \$61,416 or \$195,938 for the crops, the amounts were deposited in the corporation and reported there.

The Court found that merely depositing the cash wasn't enough to treat the income as corporate income—rather, the amounts were truly taxable to the individuals.

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: Abdel-Fattah v. Commissioner, 134 TC No. 10, 4/27/10, AOD 2010-04, 10/13/10

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.

Now the IRS has officially given up its position in this case, acquiescing in the holding of this case in AOD 2010-04, so the issuance of State Department certification will no longer be a requirement before the exemption can be claimed where the foreign country simply had not yet requested the certification.

SECTION: 1235
PAYMENTS TO INDIVIDUAL WERE FOR SERVICES AND NOT RELATED TO PATENT, REPRESENTED ORDINARY INCOME

Citation: Farris v. Commissioner, TC Memo 2010-222, 10/12/10

The taxpayer developed a method and apparatus for transferring fluid from a vial to a syringe without using a needle, allowing filling a syringe without exposing the liquid to potential airborne contaminants. The taxpayer sold the rights to this invention to a pharmaceutical and manufacturing business for \$1 and “other valuable consideration.”

Three months later the taxpayer entered into a representative sales agreement with the same entity, requiring him to devote 40 hours per week for two years serving as an independent contractor to the entity. The taxpayer claimed that these payments were truly for the patent and, as such, should be taxed as capital gains.

The Tax Court did not agree. The Court noted that the agreement did not hold that the services being provided were in relation to the patent, as the activities related primarily to generating sales and not offering technical advice related to the patent. As such the payments represented ordinary income and not capital gain income.

SECTION: 6015
TAXPAYER'S FAILURE TO REVIEW RETURN NOT FATAL TO CLAIM FOR INNOCENT SPOUSE RELIEF

Citation: Harper v. Commissioner, TC Summary Opinion 2010-153, 10/14/10

Even though the taxpayer requesting innocent spouse equitable relief from liability under §6015(f) did not review the returns for accuracy before filing them, the Tax Court found she still qualified for relief. The taxpayer had divorced her husband following the years in question, and the ex-husband had died in the interim. Her ex-husband ran a substance abuse facility, and she had met him while a resident at the facility.

The IRS contended that the failure to review the returns meant she could not have known there was a balance due or that her husband would not pay the tax due. However the taxpayer did not have her own personal bank account (the couple's only account was in the name of and maintained by the husband), and all financial details of their marriage were handled by her husband. As such, the court concluded that even if she had reviewed the return and notice a balance due, she could not have known her husband would be unable to pay the balance of the tax due.

The Tax Court also disagreed with the IRS that the taxpayer had not shown she would suffer financial hardship if relief were not granted. The Court found her testimony credible regarding her resources, found that she had no assets following the divorce and her income was, at best, equal to the expenses allowed under the IRS national standards.

SECTION: 6045
IRS GRANTS RELIEF TO BROKERS TRANSFERRING SHARES FROM
BASIS REPORTING TO RECEIVING BROKER IN 2011

Citation: Notice 2010-67, 10/12/10

The IRS, while finalizing the regulations related to the reporting of cost basis by brokers on Forms 1099B beginning in 2011, provided a one year relief from penalties under §6045A for transferring brokers and other persons who are not able to supply basis information to the receiving broker. The IRS will not impose the penalty found in §6722 on any such failure that takes place in 2011. As well, a receiving broker who finds the information is provided by the transferor in 2011 is allowed to treat that security as a noncovered security for which basis information will not need to be reported.

The IRS is taking this step, per the Notice, to “promote industry readiness to comply with the reporting requirements for the sale of covered securities under section 6045(g) beginning in 2011.” The idea is that the industry will concentrate first on building the systems to handle the basis reporting under §6045(g), and only after that is complete turn their attention to the §6045A requirements.

The Notice did not provide any relief to issuers under §6045B to report to the IRS and any shareholder basis information affects related to any organizational action such as a stock split, merger, or acquisition that affects basis.

SECTION: 6051

IRS WILL NOT PENALIZE EMPLOYERS FOR FAILING TO REPORT COST OF EMPLOYER PAID HEALTH CARE ON 2011 FORMS W-2

Citation: Notice 2010-69, 10/12/10

The IRS has announced relief from the requirement for employers to report premiums paid on behalf of employees as an information line on 2011 Forms W-2. The IRS indicated that the relief was being granted to give employers time to modify their information reporting systems to be able to obtain the necessary information for payment of medical premiums for each employee.

The guidance technically doesn't repeal the requirement, but merely notes that the IRS will not impose any penalties on employers that fail to report the amounts paid as required by §6051(a)(14) paid for employer provided coverage for each employee.

The notice goes on to note that the IRS expects to issue guidance on the reporting requirements under this provision by the end of 2010.

SECTION: 6213

OFFSET OF REFUND AGAINST PROPOSED DEFICIENCY DURING 90 DAY PERIOD TO FILE TAX COURT PETITION ALLOWED

Citation: Perry v. Commissioner, TC Memo 2010-219, 10/7/10

The taxpayer was upset that the IRS offset his refund from his 2007 return against a deficiency the IRS claimed existed on his 2002 return. The IRS made this assessment during the 90 day period during which the taxpayer could file a petition in Tax Court regarding the 2002 deficiency, and the taxpayer claimed that was in violation of the prohibition on levy under §6213(a) during the period when the taxpayer can file the petition.

The Tax Court noted that §6402(a) expressly allows the IRS to credit an overpayment against any liability. However the taxpayer argued that while §6213(a) did not explicitly address offsets, offsetting an overpayment against the proposed liability went against the "underlying fundamental principle" of the statute. However the Tax Court did not agree, finding the offset was a mere bookkeeping entry and was not either a levy nor an action in court, the two items prohibited by §6213(a).

SECTION: 7502

TAXPAYER ALLOWED TO INTRODUCE EVIDENCE FOR TIMELY MAILING FOR ENVELOPE DESTROYED BY USPS

Citation: Van Brunt v. Commissioner, TC Memo 2010-220, 10/7/10

The envelope the taxpayer mailed their Tax Court petition in was severely damaged by the US Postal Service. In fact, the only part of the envelope that was still attached and legible was the return address—the mailing label to the Tax Court was gone entirely, as was the original postmark. The USPS returned the envelope to the taxpayer for “a better address”—or, perhaps more properly, a useable address of any sort.

Unfortunately the taxpayer’s attorney had left the original document with a UPS store on the final day for filing the petition. When the document was returned the taxpayer’s representative mailed the petition in a new envelope along with the damaged envelope and an appropriate explanation. The IRS claimed that the petition was filed late and therefore the Tax Court had no jurisdiction.

The Tax Court found that the taxpayer was allowed to introduce evidence of timely filing. The Court found the testimony of the taxpayer’s attorney to be credible that he had placed the envelope with the UPS store on the day in question with the envelope properly address. In addition, the Court found the testimony of the employee of the UPS store that the envelope was entered in the log and taken to the post office on the day in question to also be credible.

Thus, the Tax Court found the envelope was postmarked on the final day for filing the petition and thus, under §7502, is treated as having been timely filed.