2016/2017 Bonus CPE: Federal Tax Review

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2016/2017 BONUS CPE: FEDERAL TAX REVIEW

Course objectives: This material provides additional information pertaining to the review and analysis of important issues in federal and California tax law and regulations that have affected taxpayers during the last year. Topics discussed include: workers' compensation, charitable contributions, the ***Cohan*** rule, health savings accounts, bankruptcy and self-employment tax, hobby loss rules, IRC §754 election, recourse and nonrecourse debt, S corporation elections, qualified subchapter S trusts (QSSTs), electing small business trusts (ESBTs), IRA rollovers, IRC §1035 exchanges, qualified terminable interest property trusts (QTIPs), worker classification, disgorgement, the Tax Court, and much more.

After completing this course, you will be able to:

- Recall the rules for excluding workers' compensation from gross income
- Recall how and to whom qualifying distributions from a health savings account may be applied
- Determine if a profit motive exists as it relates to hobby loss rules
- Recall how self-rental rules apply to S corporations
- Recall how recourse debt is allocated in partnerships
- Identify which entities qualify to succeed to the ownership of S corporation stock after the death of a shareholder
- Choose which trusts qualify for the electing small business trust election
- Determine when nonrecognition treatment applies in an IRC §1035 exchange
- Recall the common law factors used to determine evidence of worker classification status
- Identify the circumstances under which disgorgement applies

Category: Taxes

Recommended CPE Hours: CPAs— 8 Tax
EAs/CRTPs — 8 Federal Tax

Level: Basic

Prerequisite: Completion of 2016/17 Federal and California Taxes seminar, webinar, on-demand webinar, or self-study is required.

Advanced Preparation: None

Expiration Date: November 2017

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INDIVIDUAL ISSUES

INCOME

NO FRIVOLOUS-RETURN PENALTY WHERE TAXPAYER PLEADS THE FIFTH

A taxpayer who redacted some information on his Schedule B regarding certain interest and dividends was found not liable for a frivolous-return penalty. (***Youssefzadeh v. Comm.*** (November 6, 2015) USTC Order, Docket No. 14868-14 L) The taxpayer argued that the penalty should not apply because he was avoiding self-incrimination by redacting information that could have triggered a duty to file an FBAR. The court agreed, noting that the taxpayer had provided plenty of information on the return, including the total amount of interest (he had blacked out the sources of the interest). The taxpayer was able to prove that he had reasonable cause to fear that answering a question on his return could lead to criminal prosecution.

TAXPAYERS ENTITLED TO DAMAGES FOR EMOTIONAL DISTRESS

Married taxpayers were entitled to damages for emotional distress caused by the IRS sending multiple levy notices while an automatic stay was in effect for the taxpayers' bankruptcy case. (***In re: Hunsaker*** (January 13, 2016) United States Bankruptcy Court, District of Oregon, Case No. 12-64782-fra13) Specifically, the notices caused migraine headaches and added to the tension of an already very complicated bankruptcy case. The IRS admitted that the notices were sent in violation of the stay, but that it was immune from damage claims for emotional distress under 11 U.S.C. §106. However, §106 only excludes punitive damages and no other type of damages.

TAXPAYERS CANNOT CHOOSE TIMING OF INCOME AND DEDUCTIONS

A cash basis taxpayer must report gross income in the year received and expenses in the year paid and cannot fix errors in one year with equal and offsetting errors in another year. (***Udeobong v. Comm.***, TCM 2016-109)

Facts

The taxpayer owned a cash basis medical supply business. He received payments from a customer in Year 1, which he reported as income. In Year 2, he refunded the payments but failed to take a deduction. Litigation followed, and in Year 3, the customer was forced to pay the amount back to the taxpayer. The taxpayer did not include the repayment in his gross income in Year 3 because he didn't take a deduction in Year 2.

Result

The Tax Court held that the taxpayer understated his income in Year 3. Taxpayers cannot simply "fix" errors in one year with offsetting errors in another year. To allow taxpayers to do so would be to allow taxpayers to choose the timing of their income and deductions. While tedious, a taxpayer in Mr. Udeobong's situation must amend his Year 2 income tax return to claim the missed deduction.

COMPENSATION FOR INJURY OR SICKNESS

Settlement for emotional distress not excludable

The Tax Court determined that damages received by a taxpayer could not be excluded under IRC §104 because the damages were for emotional distress caused by her employer's discriminatory conduct. (***Barbato v. Comm.***, TCM 2016-23) IRC §104(a)(2) excludes damages received for personal physical injury or sickness. Because emotional distress is not considered a physical injury or physical sickness, taxpayers may not exclude damages they receive for emotional distress unless the damages are specifically paid for medical care attributable to the emotional distress. (Treas. Regs. §1.104-1(c))

Workers' compensation settlement denied income exclusion

Settlement payments made to a taxpayer were not made "under" California's Workers' Compensation Act and therefore could not be excluded from her income under IRC §104. (***Simpson v. Comm.*** (August 10, 2016) United States Court of Appeals, Ninth Circuit, Case No. 14-72372) Upon reaching a settlement that included only general terms that did not specifically mention the Workers' Compensation Act as a reason for the settlement, and because the taxpayer failed to seek approval of the settlement from the California Workers' Compensation Appeals Board, the settlement did not follow the procedures required for the agreement to be valid under California's workers' compensation scheme.

Come see the stressful side of Sears

The taxpayer was a thirty-year employee of Sears. She suffered injuries to her shoulder, knee, and neck and was diagnosed with clinical depression, irritable bowel syndrome, and fibromyalgia, which she reported to Sears' district human resources manager as work-related injuries.

Five months later, the taxpayer's employment was terminated, and she sued Sears for employment discrimination under California's Fair Employment and Housing Act (FEHA). Failing in her FEHA suit on most counts, the taxpayer abandoned that suit and filed a workers' compensation claim.

The taxpayer ultimately came to a settlement with Sears where she released Sears from "each and every claim" she might have against it, "including, but not limited to, claims asserted in" the FEHA suit. Further, the settlement was silent regarding her workers' compensation claims. The Tax Court agreed with the taxpayer that some portion of the settlement was for her workers' compensation but assigned only 10% of the settlement as compensation for physical injuries and sickness, which was therefore excludible from income under IRC §104. The Ninth Circuit affirmed.

Background — IRC §104

Under IRC §104, gross income does not include amounts received under workers' compensation acts as compensation for personal injuries or sickness unless the compensation offsets amounts deducted as medical expenses under IRC §213. (IRC §104(a)(1))

To be excluded, the payments must:

- Be received under a workers' compensation act or under a statute in the nature of a workers' compensation act;
- Be compensation for personal injuries or sickness;
- Not be related to the employee's age or length of service; and
- Be incurred in the course of employment.
  (Treas. Regs. §1.104-1(b))

California conformity

California conforms to the exclusion from income under IRC §104. (R&TC §17131)

When settlement agreement silent, look to underlying claim

Where damages are received pursuant to a settlement agreement, the nature of the claim that was the actual basis for settlement controls whether those damages are excludable under IRC §104(a)(2). (***U.S. v. Burke*** (1992) 504 U.S. 229) The determination of the nature of the claim is usually made by reference to the settlement agreement. (See ***Knuckles v. Comm.*** (1965) 349 F.2d 610, aff'g TCM 1964-33; ***Robinson v. Comm.*** (1994) 102 TC 116) IRC §104(a)(2) states that gross income does not include the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness.

A married couple both worked for the same employer and filed their own separate lawsuits against the employer. (***Dulanto v. Comm.***, TCM 2016-34) The couple and their employer settled the lawsuit, but the settlement agreement between the couple and their employer did not allocate payments to a claim of personal physical injuries or physical sickness. The court noted that many of the couple's causes of action against their employer dealt with discrimination, the failure to pay wages, and a hostile work environment rather than physical injuries and physical sickness.

If a settlement agreement lacks express statements of the claims that payment was to settle, the intent of the payor is determined by taking into consideration all of the facts and circumstances, including but not limited to, the amount paid, the circumstances that led to the settlement agreement, and the original complaint filed by the injured party. (***Green v. Comm.*** (2007) 507 F.3d 857, aff'g TCM 2005-250; ***Knuckles v. Comm.***, supra; ***Robinson v. Comm.***, supra; ***Ahmed v. Comm.***, TCM 2011-295; ***Longoria v. Comm.***, TCM 2009-162)

The court held that because the basis of the claims in the couple's lawsuit related to their employer's failure to pay wages and overtime, failure to provide itemized wages statements, and failure to provide meal and rest periods, that the damages paid by the employer in its settlement to the couple were not excluded from income under §104(a)(2).

EXEMPTIONS AND DEDUCTIONS

LOVE AND MARRIAGE

Ex-wife violates divorce decree, husband pays the tax

Facts

The taxpayer was the father of three children: Child A, Child B, and Child C. Children A and B were born to the taxpayer's first ex-wife, and Child C was born to the taxpayer's second wife, with whom he was in divorce proceedings at the time he litigated this issue. (***Chappel v. Comm.***, TCM 2016-150)

In 2002 a Florida family court entered a child support order in the divorce case between the taxpayer and his first ex-wife. The court ordered that the taxpayer "will receive the child dependency exemption for Children A and B each and every year beginning in 2001 but "only if he remains current from this point forward in his child support." The taxpayer credibly testified that he had been current in his child support payments at all relevant times.

The taxpayer timely filed his 2011 income tax return and claimed all three children as dependents. Notwithstanding the Florida court's 2002 order, the taxpayer's first ex-wife likewise claimed Children A and B as dependents for 2011. The taxpayer's soon-to-be second ex-wife claimed Child C as dependent.

None of the children resided with the taxpayer during 2011, and the taxpayer did not know where Children A or B resided. The taxpayer did not obtain from either of his ex-wives executed Forms 8332, Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent.

Law

IRC §151 provides as a deduction an exemption from taxable income for each "dependent" as defined in IRC §152. IRC §152(a) defines a dependent as either a "qualifying child" or a "qualifying relative" of the taxpayer.

A "qualifying child" is defined as an individual:

- Who is a child or descendent of a child of the taxpayer or is a brother, sister, stepbrother, or stepsister of the taxpayer or a descendant of such relative;
- Who has the same principal place of abode as the taxpayer for more than one-half of such taxable year;
- Who is younger than the taxpayer claiming the exemption and has neither attained the age of 19 as of the close of the calendar year in which the taxable year of the taxpayer begins or is a student who has not attained the age of 24 as of the close of such calendar year;
- Who has not provided over one-half of such individual's own support for the calendar year in which the taxable year of the taxpayer begins; and
- Who has not filed a joint return (other than only for a claim of refund) with the individual's spouse under IRC §6013 for the taxable year beginning in the calendar year in which the taxable year of the taxpayer begins.
  (IRC §152(c))

Special rules apply for noncustodial parents to become entitled to a dependency exemption for minor children. When parents are legally separated or divorced, IRC §152(e)(1) generally awards the dependency exemption to the custodial parent, that is, the parent having custody of the child for the greater portion of the year. (IRC §152(e)(4)) There is an exception to this rule if two conditions are met:

- The custodial parent "signs a written declaration" releasing his or her claim to the exemption; and
- The noncustodial parent "attaches such written declaration to the noncustodial parent's return for the taxable year."
  (IRC §152(e)(2)(A) and (B))

The written declaration by the custodial parents must be made on Form 8332 or in a signed document substantially similar to Form 8332. (***Armstrong v. Comm.*** (2012) 139 TC 468)

Result

Despite the fact that the taxpayer's first ex-wife violated the Florida court's divorce decree, the Tax Court held that the taxpayer failed to carry his burden of proving his entitlement to a dependency exemption for Children A and B. The court noted the unfairness of the result but that the Internal Revenue Code is very clear on the issue.

The charitable Mr. Depp

In early August 2016, actors Johnny Depp and Amber Heard reached a settlement in their divorce. The settlement reportedly requires Mr. Depp to pay $7 million to Ms. Heard, which she pledged to donate to charity. According to Ms. Heard's representatives, Mr. Depp decided to donate the money directly to charity in his ex-wife's name, rather than give the money to her and then allow her to make the payments.

The question is whether Mr. Depp received tax benefits from making the direct payments to charity, which Ms. Heard's representatives allege is a violation of the terms of their settlement agreement. Ms. Heard's representatives claim that Mr. Depp should be required to donate $14 million so that after he receives tax benefits of $7 million as alleged by Ms. Heard, he will have paid a net $7 million. Whether Mr. Depp received a significant tax break depends on multiple factors, including:

- The specific provisions of the settlement agreement;
- Whether Depp complied with IRS rules; and
- Depp's taxable income received and his other itemized deductions for the year.

One issue is whether the donations Depp made to charity on Heard's behalf are from a "detached and disinterested generosity," which is required for a payment to a qualifying charity to be deductible under IRC §102. If Depp made the payments to charity because of his divorce settlement, a strong argument can be made that they are not deductible to him.

Further, Temp. Treas. Regs. §1.1041-1T(c), Q&A 9 addresses this very issue. The regulation treats a payment made by a former husband to a qualifying charity as a charitable contribution made by the former wife, if:

- The former husband made the charitable contribution on behalf of the former wife pursuant to the marital settlement agreement;
- The former husband made the charitable contribution on behalf of the former wife pursuant to the written request of the former wife; or
- The former wife provides to the former husband her written consent to, or ratification of, the charitable contribution made by the former husband on behalf of the former wife.

If any one of the above tests are met, the payment by Depp directly to the charity will be treated as a constructive, nontaxable transfer between spouses incident to divorce pursuant to IRC §1041, and immediately thereafter, a contribution of the amount by Heard to the charities, so she gets the tax deduction and not him.

EDUCATION

Young taxpayer says timing of deductions "just seems kind of wrong"

Facts

A cash basis taxpayer who reported on a calendar-year basis was a student at Arizona State University (ASU) and graduated in 2012. The taxpayer paid his tuition for the 2012 spring semester in December 2011. The 2012 spring semester was the taxpayer's last semester before graduating. The taxpayer claimed an American Opportunity Tax Credit (AOTC) of $2,500 on his 2012 income tax return. The IRS audited the taxpayer and disallowed the 2012 credit because he paid his tuition in 2011. (***McCarville v. Comm.***, TCS 2016-14)

Law

IRC §25A authorizes an AOTC equal to:

- 100% of so much of the qualified tuition and related expenses paid by the taxpayer during the taxable year for education furnished during any academic period beginning in such taxable year as does not exceed $2,000; plus
- 25% of such expenses so paid as exceeds $2,000 but does not exceed $4,000. (IRC §25A(i)(1))

Thus, the maximum amount of the credit is $2,500 (2,000 + 0.25 x ($4,000-$2,000)).

In general, an AOTC is allowed "only for payments of qualified tuition and related expenses for an academic period beginning in the same taxable year as the year the payment is made." (Treas. Regs. §1.25A-5(e)(1)) For a taxpayer who uses the cash, rather than the accrual, method of accounting, such qualified tuition and related expenses are treated as paid in the year in which the expenses are actually paid.

There is a limited exception to the timing rule in the case of certain prepayments of qualified tuition and related expenses. If tuition and related expenses are paid by the taxpayer during a taxable year for an academic period which begins during the first three months following such taxable year, such academic period shall be treated as beginning during such taxable year. (IRC §25A(g)(4))

The regulations further clarify that if qualified tuition and related expenses are paid during one taxable year for an academic period that begins during the first three months of the taxpayer's next taxable year (i.e., January, February, or March of the next taxable year for calendar-year taxpayers), an education tax credit is allowed with respect to the qualified tuition and related expenses *only* in the taxable year in which the expenses are paid. (Treas. Regs. §1.25A-5(e)(2)(i))

Result

Mr. McCarville would only be permitted to claim the AOTC in 2011 because neither IRC §25A nor the regulations thereunder permit a cash basis taxpayer to claim an AOTC for a year other than the taxable year in which the payment was actually made. The court agreed with the young taxpayer's contention that "it just seems kind of wrong" to be denied the credit on his 2012 return "essentially for paying it [tuition] early." However, the court noted that they are bound to apply the law as written.

Must be enrolled at least half-time for AOTC

A taxpayer's AOTC was denied because she was not an "eligible student" based on her course load. (***Pilmer v. Comm.***, TCS 2016-59) During the spring 2012 semester, the taxpayer was enrolled in one five-unit physiology course at Saddleback Community College in Mission Viejo, California. The taxpayer also attended a three-unit contemporary health course on an "informal" basis but was never officially enrolled in the course and ultimately dropped the course after eight weeks. The taxpayer claimed the AOTC on her 2012 income tax return, which the IRS disallowed on audit, arguing that the taxpayer was not an eligible student.

Background

For purposes of the AOTC, an "eligible student" is a student who meets the following criteria:

- The student is enrolled or accepted for enrollment in a degree, certificate, or other program leading to a recognized educational credential at an institution of higher education that is an eligible institution; and
- The student is carrying at least half the normal full-time workload for the course of study the student is pursuing.
  (IRC §25A(b)(3))

The standard for what is half of the normal full-time work load is determined by each eligible educational institution. (Treas. Regs. §1.25A-3(d)(1)(ii))

Result

The IRS conceded that Saddleback Community College was an eligible institution, so the first requirement was met. The taxpayer and the IRS agreed that in 2012, Saddleback Community College defined a full-time workload as 12 academic units and a half-time workload as six academic units. The Tax Court ultimately held that a taxpayer must be formally enrolled in a course before they can count the course's units toward the half-time academic workload requirement. Therefore, the taxpayer in the present case was not enrolled at least half-time and was not an eligible student entitled to claim the AOTC.

"ONE EXAMINATION" RULE DIDN'T APPLY

A taxpayer unsuccessfully claimed that it was not required to supply the IRS its 2009 general ledger, airplane flight logs, and other business travel documents, arguing that the IRS had already examined those records in 2010 during an audit of the 2009 tax year. (***U.S. v. Titan International, Inc.*** (February 1, 2016) U.S. Court of Appeals, Seventh Circuit, Case No. 14-3789) In 2014, the IRS requested the same 2009 records for an audit of the 2010 tax year, and that's when the taxpayer refused, citing IRC §7605(b). Under IRC §7605(b), only one inspection of a taxpayer's books may be made for each taxable year unless the IRS notifies the taxpayer in writing that an additional inspection is necessary. However, this rule does not apply if the IRS requests the records for an audit of a different tax year.

TAX COURT JUDGE INDICTED FOR TAX EVASION

Diane Kroupa, who served on the U.S. Tax Court from June 2003 until she retired in June 2014, was accused of tax evasion and obstruction of an IRS audit. (Department of Justice News Release (April 4, 2016) Available at: www.justice.gov/opa/pr/former-united-states-tax-court-judge-and-husband-indicted-conspiracy-commit-tax-evasion-and) Kroupa and her husband allegedly claimed as business expenses rent and utilities for their second home; renovation expenses of their primary residence; Pilates classes; spa and massage fees; jewelry and personal clothing; wine club fees; Chinese language tutoring; music lessons; personal computers; and expenses for vacations. Also, the couple concealed documents from their tax practitioner and caused misleading documents to be delivered to an IRS employee during an audit.

VEHICLE EXPENSES

A taxpayer was the sole shareholder of an S corporation, whose only other employees were the taxpayer's wife and one other employee. (***Powell v. Comm.***, TCM 2016-111) The taxpayer used his personal vehicle for business and sought to deduct the business mileage on his personal income tax returns. The taxpayer kept logs of his mileage, but the logs did not always keep track of the specific destination, or the mileage appeared to be estimated.

Taxpayers are required to substantiate expenses underlying each claimed deduction by maintaining records sufficient to establish the amount of the deduction and to enable the Commissioner to determine the correct tax liability. (IRC §6001; ***Higbee v. Comm.*** (2000) 116 TC 438, 440-441) Under the ***Cohan*** rule, where a taxpayer is able to demonstrate that he or she has paid or incurred a deductible expense but cannot substantiate the precise amount, the court may estimate the amount of the expense if the taxpayer produces credible evidence providing a basis for the court to do so. (***Cohan v. Comm.*** (1930) 39 F.2d 540) IRC §274(d) supersedes the ***Cohan*** rule, however, imposing strict substantiation requirements for certain expenses such as vehicle expenses. (Treas. Regs. §1.274-5T(a); Temp. Treas. Regs. 50 Fed. Regs. §46014)

To meet the strict substantiation requirements, a taxpayer must substantiate by adequate records or by sufficient evidence corroborating the taxpayer's own statement:

- The amount of the expense;
- The time and place of travel or use; and
- The business purpose of the expense.
  (IRC §274(d))

To substantiate by adequate records, the taxpayer must provide:

- An account book, a log, or a similar record; and
- Documentary evidence, which together are sufficient to establish each element with respect to an expenditure
  (Treas. Regs. §1.274-5T(c)(2)(i); Temp. Treas. Regs. 50 Fed. Regs. §46017)

The court allowed as an auto mileage deduction only those miles that were proven by the taxpayer with daily entries that listed specific mileage and detailed the purpose of the business trip and the location (or for which the location could be reasonably inferred). The other entries appeared to the court to be estimates and/or omitted required information and were disallowed.

"FEE BASED" PUBLIC OFFICIALS GET SPECIAL ABOVE-THE-LINE DEDUCTIONS

Public officials who are compensated in whole or in part on a fee basis qualify for an exception to the unreimbursed employee business expense rules and may take those expenses as above-the-line deductions. (IRC §62(a)(2)(C))

The Tax Court recently addressed this exception when trying to determine whether a Maricopa County, Arizona, Superior Court judge qualified. (***Jones v. Comm***. (February 9, 2016) 146 TC 3)

"Fee basis"

The judge argued that although he was paid a salary subject to withholding, the court itself was funded in part by fees for cases, licenses, etc., and those fees were also used to fund his retirement plan.

The court noted that this was the first time they had addressed this exception, and that neither the Code nor the regulations define what "fee basis" means. However, the court determined that to take the above-the-line deductions, the judge must be able to show that "he received his fees directly from the public in exchange for services that he rendered."

In this case, the judge was paid from the general fund, so he was a salaried employee.

The court did note that their analysis might be different if the judge had received fees directly for services outside of the courtroom as some other county judges do. It was noted that many judges receive direct fees for wedding ceremonies, as they are permitted to do in Maricopa County.

Unfortunately for Judge Jones, he performed all of his wedding ceremonies during the years in question for free, so he never received any fees directly from the public.

Judge Jones' expenses

It is interesting to note that the expenses he claimed appear to be related to his work in the court. There was no question about whether the expenses were legitimate. In fact, the majority of the judge's expenses were incurred because of spending cutbacks in his county. It looks like the judge was just being a good guy.

He purchased a computer for his courtroom himself, as well as gift cards for court employees as incentives because the budget cuts eliminated their bonuses. He even paid for some basic necessities like batteries for the courtroom clocks, water (because the building water fountains had been shut off), and employee snacks.

No accuracy-related penalty

The IRS attempted to impose an accuracy-related penalty against the judge, but the Tax Court reversed the penalty. The judge was able to demonstrate that two different CPAs had advised him that this was a legitimate position, and it wasn't just some elaborate scheme he came up with to take extra deductions.

MAKING HSA CONTRIBUTIONS FOR A SPOUSE

Many married couples assume that each spouse may make contributions up to their respective limits as determined by their coverage. For example, they may believe that if one spouse has family coverage and the other spouse has self-only coverage, they may make contributions in 2016 of $6,750 (family) plus $3,350 (self-only) for a total of $10,100. This is incorrect.

To understand how the limits work with a married couple consider these facts:

- Family coverage is coverage that includes a spouse and at least one other family member. (IRC §223(c)(4)) Therefore, it's possible for both spouses to have family coverage (for example, Husband's coverage includes himself and Son, and Wife's coverage includes herself and Daughter);
- Accounts are set up in the name of one individual. There is no such thing as a joint or family account;
- Qualifying distributions may be made from an individual's account for qualifying expenses of any member of the family including the owner of the account, the spouse, or any dependent even if any such individual is covered under a non-high deductible health plan (HDHP) in the year of the distribution (IRC §223(f)(1); Notice 2004-50); and
- If either spouse has family coverage, both spouses are treated as having family coverage. (Notice 2004-50)

Both spouses eligible

If both spouses are eligible because they are both covered by HDHPs, they may:

- Each get self-only coverage. In that case, they must make contributions to their individual HSA accounts subject to the self-only contribution limits; or
- Get family coverage under several possible scenarios:
  - A single family policy covering the entire family;
  - A family policy for one spouse and one or more dependents, and a single-only policy for the other spouse; or
  - Two family policies with one policy covering one spouse and one or more dependents, and the other policy covering the other spouse and one or more dependents.

In the event that just one or both spouses have family coverage, the family coverage limit applies. The family coverage contribution limit is divided between the spouses by agreement; that is, they may make the entire contribution up to the limits to one spouse's account or allocate between their separate accounts in any way they choose.

Example of family coverage

Jack and Jane are married and are both eligible for HSAs. They each get single-only coverage in qualifying HDHPs. They may each make contributions to their HSAs of $3,350 to their individual HSA accounts.

Assume, instead, that one or both of them gets a family policy. They may make contributions to their respective accounts up to $6,750 and split the amount among their individual HSA accounts in any amounts based on their agreement; for example, Jack contributes $3,000 to his HSA account, and Jane contributes $3,750 to hers.

One spouse eligible, one spouse ineligible

If one spouse has HDHP coverage, and the other spouse is ineligible because the other spouse has non-HDHP coverage, the eligible spouse may contribute the statutory maximum. The amount cannot be contributed to an HSA of an ineligible spouse.

Example of one spouse eligible

John and Laura are married. John has self-only coverage under an HDHP and Laura has non-HDHP coverage from her employer that does not cover John. John may make a contribution to his HSA up to the self-only maximum contribution amount. The contribution must be made to John's account. If John got family coverage, he may make a contribution up to the maximum for family coverage. Again, the contribution must be made to John's account.

One account or two?

When a married couple get qualifying HDHP family coverage, it is possible for them to maintain the HSA in a single account and avoid the burden of tracing two HSAs and possibly paying double the amount of account fees. After all, why go to the trouble when distributions from the account are qualifying when they are made for the benefit of any family member regardless of whether that family member is HSA-eligible.

There are two scenarios where it makes a difference whether there is one account or two:

- Catch-up contributions can only be made to an individual's own account; and
- Employer contributions can only be made to the account of an employee.

> ***Example of catch-up contributions***
>
> Assume from the example above, that Jack and Jane get the family policy. Also, assume that Jack turned 55 during the tax year. They may make contributions to their respective accounts up to the family coverage maximum of $6,750 plus an additional catch-up contribution for Jack of $1,000. They may allocate the maximum between their accounts, but at least $1,000 of the total contributions must go to Jack's account.

TAXPAYER ALLOWED REIMBURSED CHARITABLE CONTRIBUTION DEDUCTION

A district court has ruled that a partnership could take a charitable contribution deduction where a related corporation mistakenly made the contribution and the partnership reimbursed the corporation. (***Green v. United States*** (February 10, 2016) U.S. District Court, Western Dist. of Oklahoma, Case No. CIV-13-1237-D)

Facts

A trust was a 99% partner in Hob-Lob Limited Partnership, a company that owned and operated Hobby Lobby Stores, a corporation.

Hob-Lob had intended to make a charitable contribution to Reach the Children Foundation (RTCF), a qualified charity. However, due to a clerical mistake, the check to RTCF was issued by Hobby Lobby. Once the mistake was discovered, it was immediately and thoroughly addressed — letters of correction were sent, books and records were corrected, affidavits were signed, and Hob-Lob reimbursed Hobby Lobby for the full amount of the contributions.

A K-1 was issued from Hob-Lob to the trust showing its 99% share of the contribution, and the trust deducted it. The IRS disallowed the amount.

Court allows contribution

The IRS argued that deductions cannot be exchanged or distributed among taxpayers because it would allow "all related taxpayers to rewrite history and adjust their books … in order to maximize deductions and credits." It cited ***National Alfalfa*** in which the Supreme Court refused to speculate about what could have happened had the transaction been structured a different way, and instead held to the principle that "a transaction is to be given its tax effect in accord with what actually occurred." (***National Alfalfa Dehydrating & Milling Co. v. U.S.*** (1974) 417 U.S. 134)

The district court distinguished the present case from ***National Alfalfa*** on two grounds. First, it noted that the present case involved a mistake while ***National Alfalfa*** involved intentional financial decisions. The trust was not seeking a deduction based on a hypothetical situation as was the case in ***National Alfalfa***. Rather the trust was seeking a deduction in accordance with corrected financial statements that reflected actual contributions made by Hob-Lob.

Second, the court noted that charitable deductions are distinguished from other deductions in that charitable deductions are matters of public policy rather than merely matters of legislative grace. As matters of public policy, they should be construed liberally. The court concluded that, "To disallow a charitable deduction simply because of a clerical error goes against the liberal policy of encouraging charitable giving and distorts the Supreme Court's holding in ***National Alfalfa***."

PATH ACT — CONSERVATION CONTRIBUTIONS

Under the Protecting Americans from Tax Hikes Act of 2015 (PATH Act), the liberalized rules for qualified conservation contributions are made permanent. (Act §111)

Conservation easement contributions

Conservation easements qualify for the following enhanced charitable contribution deduction rules:

- An exception to the disallowance for donations of partial interests;
- Allows capital gain property to qualify for the 50% contribution limit (as opposed to the 30% ceiling); and
- Extends the carryover period from five years to 15 years.
  (IRC §170(b)(1)(E))

A qualified conservation contribution is a contribution of a qualified real property interest, including easements, to a qualified organization exclusively for conservation purposes. The donee must be prohibited from making certain transfers, and the conservation purpose must be protected in perpetuity. A charitable deduction cannot be claimed if the donation has no material effect on the real property's FMV, or enhances rather than reduces its FMV. (***Chandler v. Comm.***, (2014) 142 TC 16)

Charitable deduction disallowed for donation of conservation easement

Taxpayers Bayne French and his wife, along with other family members, donated conservation easements of rural land owned by the family members' various trusts to the Montana Land Reliance (MLR) in 2005. The appraiser hired by Bayne's father valued the easement at over $1.1 million and the taxpayers' share of the easement at over $350,000.

The easement was memorialized in a deed of conservation easement. This was the only contemporaneous written acknowledgement of the donation. Unfortunately for the Frenches, the deed failed to satisfy the charitable deduction substantiation requirements, so the entire charitable deduction for the $350,000 in property donated was disallowed. (***French v. Comm.***, TCM 2016-53)

This case is a prime example of how important it is to pay attention to the detailed information required by the IRC §170(f)(8) substantiation requirements.

The deed

The conservation deed contained covenants intended to preserve the "rural, agricultural, and natural scenic qualities of the area by the retention of significant open space for a variety of uses including wildlife, habitat, recreation, forest management, and agricultural purposes." The deed also stated that the consideration for the conservation easement was the mutual covenants in the deed.

However, the deed did not state whether the MLR had provided goods or services in return for the conservation easement or whether the conservation deed constituted the entire agreement between the three trusts and the MLR. A letter was subsequently sent to Bayne's father from the MLR on June 6, 2006, stating that "no goods or services were furnished in respect of your easement donation."

The taxpayers filed their 2005 return without claiming a charitable deduction for the conservation easement but filed an amended return on or before April 15, 2006, claiming a charitable contribution deduction of $56,796. They claimed carryover contribution deductions of $44,687, $57,154, and $31,572 in the subsequent three years. On audit, the IRS disallowed the charitable contribution carryover deductions claimed on the French's 2006–2008 returns for a variety of reasons, including the taxpayers' failure to comply with the IRC §170(f)(8) substantiation requirements.

Substantiation requirements

Conservation contributions are subject to the standard IRC §170(f)(8) charitable contribution substantiation requirements, including requiring contemporaneous written acknowledgment from the donee organization. The written acknowledgement must include:

- The amount of cash and a description (but not value) of any property other than cash contributed;
- Whether the donee organization provided any goods or services in exchange (in whole or part) for the property donated; and
- A description and good faith estimate of the value of any goods or services provided in exchange.

To be considered "contemporaneous," the taxpayer must obtain the acknowledgment on or before the earlier of:

- The date the return was filed; or
- The due date of the return (including extensions) for filing the return for the year the contribution was made.

Inadequate substantiation

The June 6, 2006, letter received from the MLR by Bayne's father did not satisfy the "contemporaneous" requirement because it was received after the taxpayers had filed their return. The only other document that might have qualified was the deed, but this was inadequate because it failed to state whether the taxpayers received any goods or services in exchange for their contribution to the MLR.

The Tax Court has previously held that a deed of conservation easement may satisfy the substantiation requirement even if it does not explicitly state whether the donee received any goods or services in exchange for the charitable contribution. (***Avery v. Comm.***, TCM 2012-198; ***RP Golf, LLC v. Comm.***, TCM 2012-282) However, to qualify in such instances, the deed must at least state something to the effect that:

- No consideration was received other than the preservation of the property; and
- The deed is the entire agreement of the parties.

Because the taxpayers' deed did not contain a statement that the deed was the entire agreement of the parties, the IRS could not verify that no goods or services were exchanged. Therefore, the deed failed to satisfy the written acknowledgment requirements, and the taxpayers had to be satisfied that their donation indeed conserved Montana's rural open space, even if it didn't help them conserve their financial resources.

Easement not for conservation purpose

Members of an LLC that donated conservation easements on operating golf courses were not entitled to deductions for qualified conservation contributions because the easements did not comply with the "conservation purposes" requirement. (***Atkinson v. Comm.***, TCM 2015-236)

While there were patches of native vegetation and wildlife, golf courses and the homes surrounding much of each easement area interrupted the natural scenic character. The easement areas were primarily man-made and were neither natural nor historic.

RENTAL EXPENSE DEDUCTIONS LIMITED WHEN PROPERTY ALSO USED AS A RESIDENCE

The Tax Court has determined that because a husband and wife used a rental property as their personal residence for more than half the year, their rental expense deductions were limited by IRC §280A. (***Szanto v. Comm.***, TCM 2016-145)

The taxpayers didn't show where they lived while they rented out their primary residence, they didn't credibly address the number of days when they occupied the residence, and didn't otherwise address the requirements of IRC §280A. Instead they made unsupported and irrelevant claims such as that the husband was a real estate professional and therefore entitled to additional deductions, even though the husband was in the jewelry repair business and "real estate professional" status is irrelevant to the current issue.

SELF-EMPLOYMENT

MINISTERS

Vow of poverty does not mean what minister thinks it means

Facts

The taxpayer established a church in Florida in 1983 and ministered from the pulpit and at nursing homes, helped build churches on foreign soil, established a feeding program for children, and supported widows and orphans. In 2001, the taxpayer signed a document entitled "Vow of Poverty" detailing that he agreed to divest his property and future income to the church, and in turn, the church would provide for his physical, financial, and personal needs. By resolution of the church's board of advisors, the church agreed to provide for the taxpayer's needs as apostle of the church ministry, and the church would pay the taxpayer's housing, all ministry expenses, and any other needs necessary for his care.

The church established an apostolic bank account. The taxpayer had signatory authority over the account. The taxpayer did not file a federal income tax return for the years at issue, nor did he file a timely certificate of exemption from self-employment tax in accordance with IRC §1402(e). The IRS prepared substitute tax returns for the taxpayer and issued a notice of deficiency determining that the taxpayer had unreported income for compensation he received from the church.

Gross income and vow of poverty

The taxpayer acknowledged that the church made payments on his behalf for his personal expenses, but contended that his vow of poverty insulated him from being taxed on the compensation he received from the church.

Gross income includes income from whatever source derived, including compensation for services. (IRC §61(a)) The definition of gross income includes all accessions to wealth, clearly realized, and over which the taxpayer has complete dominion. (***Comm. v. Glenshaw Glass Co.*** (1955) 348 U.S. 426) A taxpayer has dominion and control when the taxpayer is free to use the funds at will. (***Rutkin v. U.S.*** (1952) 343 U.S. 130) The use of the funds for personal purposes indicates dominion and control, even over an account titled in the name of a church or other religious organization. (***Cortes v. Comm.***, TCM 2014-181)

The Tax Court has previously held that a vow of poverty does not insulate a pastor from tax liability even when the pastor receives funds directly from his church in exchange for services rendered if the pastor does not remit those funds to the church in accordance with his vow of poverty, has control over the funds, and uses the funds for personal expenditures. (***Cortes v. Comm.***, TCM 2014-181; ***Rogers v. Comm.***, TCM 2013-177; ***Gunkle v. Comm.***, TCM 2012-305)

To support his position, the taxpayer relied on the Internal Revenue Service's original official public pronouncement regarding the vow of poverty, O.D. 119, which was published in 1919. Rev. Rul. 77-290 states that income earned by a member of a religious order on account of services performed directly for the order or for the church with which the order is affiliated, and remitted back to the order in conformity with the member's vow of poverty, is not includible in the member's gross income. As was the case with the taxpayers in ***Cortes*** and ***Rogers***, the critical difference in the present case is that the taxpayer did not remit income to his church pursuant to his vow of poverty. The taxpayer had signatory authority over the church apostolic bank account, and the payments the church made on his behalf served only to benefit the taxpayer in meeting his living expenses.

Self-employment tax

A duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry is engaged in carrying on a trade or business unless the minister is exempt from self-employment tax pursuant to §1402(e). (IRC §1402(c)(4)) Unless an exemption certificate is timely filed, the minister is liable for self-employment tax on income derived from the ministry. (IRC §1402(e)(3)) The taxpayer did not file a timely application for exemption from self-employment tax for any of the years at issue and therefore did not qualify for an exemption from self-employment tax.

BANKRUPTCY DEBTOR LIABLE FOR SELF-EMPLOYMENT TAX

The Tax Court held that even though a debtor's earnings belong to his bankruptcy estate and the estate reports and pays the income tax on the debtor's earnings, the debtor is still liable for reporting and paying the self-employment tax. (***Sission v. Comm.***, TCM 2016-143)

Chapter 11 bankruptcy debtor's earnings belong to estate

The taxpayer in ***Sission*** was a U.S.-based employee of the International Monetary Fund (IMF). Employment is defined generally as services performed by an employee for an employer. (IRC §3121(b)) However, U.S. employees that perform services for international organization employers, such as the IMF, are excluded. (IRC §3121(b)(15)) Therefore, Sission's wages were not subject to FICA or Medicare withholding but were subject to self-employment tax.

During the period of his employment with the IMF, Sission filed a voluntary petition under Chapter 11 of the Bankruptcy Code. The filing of his petition created a bankruptcy estate, which is a separate taxpaying entity for federal income tax purposes. (U.S. Bankruptcy Code §541; IRC §1398) The Chapter 11 bankruptcy estate of an individual debtor includes the debtor's earnings and other property acquired by the debtor from the time of filing the petition until the bankruptcy is concluded. (11 U.S.C. §§1115, 1123(a)(8)) Accordingly, the IMF wages Sission earned after the filing of his bankruptcy petition became property of his bankruptcy estate, and he paid them over to the estate.

Debtor's living expenses

If a debtor's earnings are paid over to his bankruptcy estate, then how does a debtor pay personal living expenses, such as rent, mortgage, or auto payments, or buy groceries and pay utility bills? A Chapter 11 bankruptcy estate may typically use, sell, or lease property of the estate in the ordinary course of its business without prior court approval. (11 U.S.C. §§363(c), 1108) While some courts are split on the issue, an individual Chapter 11 debtor's living expenses may be paid from estate property as expenses in the ordinary course business. See, e.g., ***In re: Bradley*** (1995) United States Bankruptcy Court, W.D. New York, Case Nos. 91-13893 K, 91-14183 K.

Who pays the tax?

The next question, which is the core of the ***Sission*** case, is whether the bankruptcy estate or Sission individually is liable for the self-employment tax on Sission's IMF wages.

Taxable income of a bankruptcy estate is computed in the same manner as an individual, and the tax is computed on the taxable income by the bankruptcy estate. (IRC §1398) It follows then, that if a debtor's bankruptcy estate reports the debtor's earnings as its gross income, as well as the debtor's deductible living expenses, such as mortgage interest and property taxes, among others, then the estate pays the associated tax liabilities. After all, if the debtor were left holding the tax bag after turning over all his earnings to the estate, then he would have no funds from which to pay the liability. Regardless, that was the holding of the Tax Court in ***Sission***.

The court held that a bankruptcy estate is only liable for the taxes of a debtor imposed on income under IRC §1 and that taxes imposed on self-employment income under IRC §1402 remain reportable and payable by the individual debtor.

So much for a fresh start

The court's ruling leaves an individual debtor with a tax liability and no funds to pay it. In reaching its decision in ***Sission***, the court relied on its interpretation of Congressional intent as it relates to IRC §1398. The court did not address the fact that a fundamental goal of the federal bankruptcy laws enacted by Congress is to give debtors a financial "fresh start" from burdensome debts. (***Local Loan Co. v. Hunt***, (1934) 292 U.S. 234)

LOSSES

PASSIVE ACTIVITY LOSSES AND HOBBY LOSSES

Grouping activities and profit motive

One or more trade or business activities may be grouped as one activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of IRC §469. (Treas. Regs. §1.469-4(c)(1)) Whether activities constitute an appropriate economic unit depends upon all the facts and circumstances, with the greatest weight given to the following factors:

- The extent of common control;
- The extent of common ownership;
- Geographical location; and
- Interdependence between or among the activities.
  (Treas. Regs. §1.469-4(c)(2))

A condition precedent to being able to group activities together is the fact that both activities are engaged in for profit because only trade or business activities may be grouped together.

If an activity is not engaged in for profit, then deductions in excess of income are disallowed except for deductions that are allowable under other Code sections, such as mortgage interest or property taxes. Further, an activity that produces a profit for three or more out of the five years ending on the tax year at issue is presumed to be an activity engaged in for profit. In the case of horse activities, it is two out of seven years. We colloquially refer to these as the hobby loss rules. An activity is engaged in for profit if, based on all the facts and circumstances, the taxpayer is motivated by profit. The regulations list nine factors to be considered among all the facts and circumstances to determine whether a profit motive exists:

1. The taxpayer carries on the activity in a businesslike manner;
2. The taxpayer and his advisors have expertise in the business or its processes;
3. The taxpayer spends much time and effort carrying on the business;
4. There is an expectation that assets used in the activity may appreciate in value;
5. The success of the taxpayer in carrying on similar or dissimilar activities;
6. The taxpayer's history if income and losses with respect to the activity;
7. The amount of occasional profits, if any, which are earned by the activity;
8. The lack of substantial income or capital from sources outside the activity; and
9. The presence of personal pleasure or recreation in carrying on the activity.
   (Treas. Regs. §1.183-2(b))

Steinberger case

Dr. Steinberger practiced medicine as a shareholder in a professional association. The good doctor was also a licensed pilot and purchased a single engine airplane inside a limited liability company. The doctor used the aircraft for both business and professional use. The doctor's personal use involved recreational flying as well as transporting his son to and from college. The aircraft was used for business when the doctor would fly to visit rural clinics. The court noted that the doctor flew to some clinics that were less than 100 miles round trip and that the doctor did not use the aircraft to transport medical supplies. The doctor grouped his medical and aircraft usage together as a single activity and offset the losses from the aircraft against his medical practice income.

Result

The Tax Court held that the aircraft activities were not properly grouped with the doctor's medical practice because the activities were not sufficiently interrelated to treat them as a single activity. The court also found that the doctor derived significant pleasure from flying and noted that the doctor testified that he preferred flying to driving. As such, the court held the aircraft business was not engaged in for profit and could not be grouped together with his medical practice.

Hobby losses from real estate activity

The presence of personal pleasure or recreation in carrying on a given activity is only one of the nine factors to be considered when determining whether an activity is engaged in for profit. (Treas. Regs. §1.183-2(b)) However, we typically associate losses that are nondeductible because of lack of profit motive with activities that carry elements of personal satisfaction or pleasure. Such activities often involve horseracing, flying (as we saw with the ***Steinberger*** case), classic cars, and collectibles, just to name a few, but they don't have to, as evidenced in the ***Pouemi*** case below.

Pouemi Case

The taxpayer typically held two jobs at any given time because, as he testified, he "did real estate on the side." (***Pouemi v. Comm.***, TCM 2015-161) The taxpayer had Virginia and Maryland real estate licenses, and he was associated with a local realty company as an agent. The taxpayer worked his real estate business on weekends, during evenings, and during "down time" at his day job. The taxpayer earned approximately $60,000 per year at his day job. The taxpayer allegedly performed research for potential clients, reviewed real estate listings, and drove potential clients in his car to view properties. The taxpayer testified that he regularly showed houses and apartments to potential clients and entertained them.

The taxpayer maintained no formal ledgers or books for his real estate business and had no business bank account. He had no real estate listings during 2009, the year at issue. He likewise had no real estate listings during 2008. During 2007 he listed one property for sale, which netted him $9,457 when it sold. That single commission represented the only income the taxpayer derived from his real estate activity for the years 2007 through 2009. The taxpayer reported the following income and expenses for those years for his real estate activity:

Revenue and Expenses		
Year	**Revenue**	**Expenses**
2007	$9,457	$33,907
2008	$0	$43,427
2009	$0	$30,062

Result

The Tax Court held that the taxpayer did not engage in his real estate activity with the primary and genuine purpose of making a profit because he did not conduct the activity in a businesslike manner, he produced no evidence that he developed expertise in, or devoted meaningful time or effort to, his real estate activity, and he never earned a profit from his real estate activity. In the court's opinion, the fact that the taxpayer had a full time job paying $60,000 per year, yet he reported losses from his real estate activity of $24,450, $43,427, and $30,062 for 2007 through 2009, indicated that he was merely using the real estate activity as an attempt to reduce his regular income tax liability for each year to zero.

Hobby loss presumption and available election

The Tax Court held that an attorney-taxpayer's losses from his secondary business restoring classic cars were deductible because the taxpayer had a profit motive. (***Main v. Comm.***, TCM 2016-127) The case is a reminder to practitioners that losses from a client's side business, especially one that has a pleasure or recreational component, may still be deductible. Practitioners can add quantifiable value to clients starting a secondary business if they advise their clients how to properly focus their business for a profit motive.

The Main Plymouths

A recent case dealing with hobby losses involved a patent attorney who had a side business restoring classic Plymouth cars. The Plymouth restoration businesses experienced losses, and the IRS disallowed the losses for lack of profit motive.

In analyzing all the facts and circumstances related to the auto activity, the court found the following facts compelling in its holding that the taxpayer did have a profit motive:

- The taxpayer advertised online, in print, and at live events;
- The taxpayer traveled to acquire bargain-priced cars;
- The taxpayer maintained a large inventory, reaching 40 cars at its peak;
- The taxpayer sold cars that could not be restored along with their related parts;
- The taxpayer contracted with outsiders to manufacturer unavailable parts, both for his own business and to sell to others, but then abandoned the parts manufacturing after he determined it was unprofitable;
- The taxpayer devoted considerable time to the business; and
- The taxpayer's primary patent business was undergoing a downturn during the year at issue, and the taxpayer would not have squandered his hard-earned money on an expensive hobby with no profit motive.

Presumption and election to postpone under IRC §183(e)

If an activity produces a profit in at least three of the five previous taxable years (two out of seven for horse activities), then the taxpayer is presumed to have a profit motive. Practitioners are advised to proceed with caution if their client's activity produces nominal profits for three years out of five, but produces huge losses in the other two years. Remember, the three-out-of-five-year rule is only a presumption that can be rebutted by the IRS.

Taxpayers may elect to postpone an IRS determination on the profit motive presumption until the activity has reported tax returns for five years (seven in the case of horse activities). The election is made by filing Form 5213 within three years after the due date of the first return reporting results from the subject activity, but not later than 60 days after the taxpayer receives a notice from the IRS that it intends to disallow losses from the activity.

✐ Practice Pointer

The election provided by IRC §183(e) extends the statute of limitations on assessments related to any losses that would be disallowed from the activity until two years after the due date for filing the fifth tax return (seventh for horse activities), not including extensions. Practitioners should debate making the election ahead of time because the election can still be made within 60 days of receiving a notice from the IRS, and in any event, the taxpayer can always argue, based on all the facts and circumstances, that they had a profit motive.

Defining the taxpayer for purposes of the self-rental rules

The Fifth Circuit Court of Appeals held that the self-rental rules under IRC §469 and its related regulations are applied at the shareholder level when the lessor is an S corporation. (***Williams v. Comm.***, 117 AFTR 2d 2016-600)

The taxpayer owned 100% of two companies, a real estate (RE) company, an S corporation, and a medical corporation (MC), a C corporation. The taxpayer worked full time for MC and did not materially participate in RE. During the years at issue, RE leased commercial real estate to MC. RE generated net income, which the taxpayer treated as passive and used to offset passive losses from other S corporations, partnerships, and personally owned rental properties.

The IRS reclassified the taxpayer's RE income as nonpassive pursuant to Treas. Regs. §1.469-2(f)(6). In other words, the IRS concluded RE's lease of commercial real estate to MC fell under the self-rental rules. The self-rental rules provide that a taxpayer's gross rental activity income for the taxable year from an item of property equal to the net rental activity income for the year from that item of property is treated as not from a passive activity if the property:

- Is rented for use in a trade or business activity in which the taxpayer materially participates; and
- Is not described in Treas. Regs. §1.469-2T(f)(5).
  (Treas. Regs. §1.469-2(f)(5))

In essence, the regulations provide that when a taxpayer rents property to his own business, the income is not passive activity income. (***Fransen v. United States*** (1999) 191 F.3d 599)

The taxpayer challenged the IRS's deficiency based on two arguments. First, he argued that because IRC §469 does not define "taxpayer" to include S corporations, the IRS lacked the authority to define "taxpayer" to include S corporations in the associated regulations. Second, he argued that the self-rental rules do not apply since RE did not materially participate in the trade or business of MC.

The court rejected both the taxpayer's arguments. On the first point, the court held that S corporations are merely passthrough entities, and its individual shareholders are the ultimate taxpayers, and therefore, in a real sense, an S corporation is not a taxpayer, its shareholders are taxpayers. On the second point, the court held that there is no basis for the taxpayer's reading of the regulations. The regulations classify rental income as nonpassive if the property "[i]s rented for use in a trade or business activity in which the taxpayer materially participates." (Treas. Regs. §1.469-2(f)(6)) Because the individual and not the S corporation is the true taxpayer, the proper focus is not on RE, a nonpassive S corporation, but on the actual individual taxpayer.

IRS tries to regroup taxpayer's similar activities but loses

A Technical Advice Memorandum (TAM) concluded that the IRS lacked the authority to regroup a taxpayer-doctor's activities for purposes of the passive activity loss rules because the activities were not an appropriate economic unit, despite their similarities. (TAM 201634022)

Background

A taxpayer may group activities together and treat them as one activity if the activities represent an appropriate economic unit for measuring gain or loss for passive activity loss purposes based on all the relevant facts and circumstances. (Treas. Regs. §1.469-4(c)(1))

Once a taxpayer has grouped activities into an appropriate economic unit, the taxpayer must continue to use that grouping in subsequent tax years unless a material change in the facts and circumstances make it clearly inappropriate. (Treas. Regs. §1.469-4(e)) The IRS may regroup a taxpayer's activities if any of the activities resulting from the taxpayer's grouping do not represent an appropriate economic unit, and a principal purpose of the taxpayer's grouping is to circumvent the passive activity loss rules.

Facts

The taxpayer was a doctor and an employee of his medical practice. The doctor also owned a small interest in a limited liability company that owned a portion of an outpatient surgery center, which was also a partnership. The outpatient surgery center was also owned by unrelated parties. The doctor's income from the surgery center was not tied to the number of surgeries he performed at the facility or to the revenue generated by those surgeries, but was based strictly on his proportionate ownership interest.

On the doctor's tax returns, he treated the limited liability company as a separate activity from his medical practice. The doctor treated his medical practice as nonpassive, but he treated his interest in the limited liability company that owned the surgery center as passive. Both activities generated positive income. The doctor also had a rental property and other passive activities that generated losses. The IRS sought to group the limited liability company with the doctor's medical practice, thus making them both nonpassive and creating a scenario where the doctor could not use the income flowing through the limited liability company from the surgery center against his rental and other passive losses.

Result

The issue in the TAM was whether the doctor's treatment of his medical practice and limited liability company interest as separate activities was inappropriate, such that the IRS could regroup them as a single economic unit. The TAM held that the IRS could not regroup the doctor's activities. Pursuant to the TAM, it was relevant that the majority owner of the surgery center was an unrelated party that controlled the day-to-day operations and management of the center, and there was no clear indication that the doctor acquired his interest with a principal purpose of circumventing the passive activity loss rules.

PROVING LOSS CARRYOVERS AND S CORPORATION STOCK BASIS

Tax returns alone not sufficient to prove NOL carryovers and stock basis

The Tax Court held recently that a taxpayer's use of old tax returns alone was not sufficient to prove net operating losses and S corporation stock basis. (***Power v. Comm.***, TCM 2016-157) The case is a lesson for practitioners who often purge records, and recommend clients do the same, after a specified period of time.

Many practitioners purge tax returns and backup documents after the period of limitations expires, while some keep them a little longer. Many practitioners even keep a permanent file with estate planning and corporate documents as well as net operating loss schedules and basis schedules. In light of ***Power***, practitioners and their clients would also be required to keep invoices, receipts, cancelled checks, etc., for all years.

Facts of the case

The taxpayer was a commercial real estate broker and operated his business as an S corporation. The taxpayer incurred net operating losses in 1999–2002, which he used to offset income in 2007–2011 (the years at issue in the case). The Tax Court refused to allow the net operating loss deductions claimed by the taxpayer in 2007-2011 because the only support provided by the taxpayer were copies of tax returns for all years from 1999-2011 and the net operating loss calculation schedules from those year. The taxpayer did not keep his backup documents, such as invoices and receipts, from the loss years.

Result

The Tax Court held that the taxpayer bears the burden of establishing both the existence of net operating losses that may be carried over to the taxable years 2007–2011, and that because the taxpayer did not retain his backup documents or provide credible evidence to support the deductions, that his net operating losses were disallowed.

The taxpayer argued that his old tax returns and related schedules should be sufficient evidence under the ***Cohan*** rule. Under ***Cohan***, if a taxpayer establishes that an expense is deductible but is unable to substantiate the precise amount, the Tax Court may estimate the amount, bearing heavily against the taxpayer whose inexactitude is of his or her own making. (***Cohan v. Comm.*** (1930) 39 F.2d 540) The court noted that in order for the ***Cohan*** rule to apply, the Tax Court must have some information to estimate the proper deduction, and copies of tax returns, which would have been filed with the government and signed under penalties of perjury, were insufficient.

The court went one step further and held that the taxpayer must also prove that the net operating losses, if sufficiently proven to exist, were not utilized in another year. Generally, net operating losses must be carried back two years, and then they may be carried forward 20 years. If a taxpayer has a net operating loss in year 4, he may consider keeping all tax returns and backup documents from years 2 forward until the statute of limitations expires the last year he uses the loss.

Finally, the court in ***Power*** applied the same reasoning to the second issue of determining whether the taxpayer had sufficient stock basis to absorb distributions without needing to include capital gain for distributions in excess of basis. As with the net operating losses, the taxpayer provided basis schedules for the years at issue and copies of tax returns, but the Tax Court rejected those in the absence of supporting documentation.

Example of net operating loss

Johnson Sinclair, Inc. has the following income and losses:

Year	Net Operating Income (Loss)	NOL Utilization	Loss Year
2001	$50,000	$50,000	2003
2002	$75,000	$75,000	2003
2003	($500,000)		
2004	$20,000	$20,000	2003
2005	$40,000	$40,000	2003
2006	$15,000	$15,000	2003
2007	$20,000	$20,000	2003
2008	$80,000	$80,000	2003
2009	($60,000)		
2010	$40,000	$40,000	2003
2011	$45,000	$45,000	2003
2012	$35,000	$35,000	2003
2013	($5,000)		
2014	$25,000	$25,000	2003
2015	$30,000	$30,000	2003
2016	$60,000	$25,000 $35,000 $60,000	2003 2009

Johnson Sinclair's 2003 net operating loss carried back two years and forward 13 years before it was finally used up. If the IRS were to audit the company's 2016 income tax return and disallow the $25,000 net operating loss generated in 2003, then the court in ***Power*** would require the company not only to prove the loss in 2003 with supporting documents, but it would also require the company to prove proper utilization in 2001 through 2016, which would effectively mean opening up tax returns for examination over a 16-year period. Of course, the closed years should not allow the IRS to examine for any issue other than the net operating loss issue, but it could prove to be an administrative nightmare for the company and practitioner.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. How is a "qualifying child" defined for purposes of the exemption from taxable income for each dependent?
   a) The individual and the taxpayer have the same principal place of abode for the entire taxable year
   b) The individual must be under age 21 as of the close of the calendar year
   c) The individual has not filed a joint return (except for a claim of refund) with the individual's spouse for the taxable year
   d) The individual has not provided any of his or her own support for the taxable year

2. Details of the American Opportunity Tax Credit (AOTC) are correctly stated in which choice?
   a) The maximum amount for the credit is $2,000
   b) An education credit is allowed for qualified tuition and related expenses paid during a taxable year for an academic period that begins during the first half of the subsequent taxable year
   c) Cash basis taxpayers may claim an AOTC for a year other than when the payment was actually made
   d) The AOTC is only allowed for payments of tuition and expenses for an academic period beginning the same year the payment is made

3. For the substantiation of vehicle expenses, which of the following applies?
   a) As with other expenses, taxpayers may use the ***Cohan*** rule for deductible vehicle expenses
   b) A taxpayer must substantiate the amount of the expense, the time and place of travel, and the business purpose
   c) The taxpayer is not required to maintain a log book
   d) The taxpayer is required to maintain an account book or some documentary evidence

4. Which of the following statements correctly characterizes health savings accounts (HSAs) for spouses and families?
   a) Accounts may be set up as a joint account for a husband and wife
   b) Qualifying distributions made from an individual's account must be for qualifying expenses of that individual
   c) Contributions are determined by coverage, and if both spouses have family coverage, the family coverage limit applies
   d) Two spouses are not both eligible for family coverage

5. Which of the following statements is true regarding donated conservation easements?
    a) A written acknowledgement from the donee organization subsequent to a conservation contribution must include the amount of cash, a description of the donated property, and the value of the property contributed
    b) The donee organization must provide the taxpayer with a contemporaneous written acknowledgement on or before the earlier of the date the taxpayer's return is filed or the filing due date of the return, including extensions, for the year of the contribution
    c) Conservation easements qualify for the 30% contribution limit for capital gain property
    d) The conservation purpose of a qualified conservation contribution must be protected for a minimum period of 25 years
6. What are the issues of the ***Sission*** case regarding a bankruptcy debtor and payment of self-employment tax?
    a) The taxpayer, Sission, filed for bankruptcy under Chapter 11, and the court ruled that the bankruptcy estate was liable for taxes on income under IRC §1, but that taxes on self-employment income were payable by the taxpayer
    b) The taxpayer worked for the International Monetary Fund (IMF), so his wages were not subject to FICA, Medicare withholding, or self-employment tax
    c) A debtor's estate under Chapter 11 may not pay for the debtor's living expenses
    d) The IMF wages that the taxpayer earned after filing bankruptcy was not property of his bankruptcy estate, so he was responsible for self-employment taxes
7. Which choice correctly characterizes hobby loss rules and the determination of whether or not a profit motive exists?
    a) An activity that produces a profit for two or more out of the five years ending with the current tax year is considered a for-profit activity
    b) For horse activities, they are considered for-profit if they produce a profit for three out of seven years ending with the current tax year
    c) To be considered for-profit, the taxpayer does not necessarily need to be motivated by profit
    d) The taxpayer must carry on the activities in a businesslike manner

SOLUTIONS TO REVIEW QUESTIONS

1. How is a "qualifying child" defined for purposes of the exemption from taxable income for each dependent? **(Pages 6-7)**

   a) Incorrect – The child must have the same principal place of abode for more than half of the taxable year.
   b) Incorrect – The individual must not have reached age 19 as of the close of the calendar year in which the taxpayer's taxable year begins, or the individual is a student who has not reached the age of 24 as of the close of the calendar year.
   c) Correct – This is true as joint return is defined under IRC §6013 and applies to the taxable year beginning in the calendar year in which the taxpayer's taxable year begins.
   d) Incorrect – The individual cannot have provided over half of his or her own support for the taxable year.

2. Details of the American Opportunity Tax Credit (AOTC) are correctly stated in which choice? **(Pages 9-10)**

   a) Incorrect – The maximum credit is $2,000 plus 25% of expenses paid exceeding $2,000, but not exceeding $4,000, which makes the total credit $2,500.
   b) Incorrect – The exception for claiming an AOTC is if the expenses are paid for an academic period that begins during the first three months of the following tax year, in which case the credit is allowed only in the tax year in which the expenses are paid.
   c) Incorrect – The regulations require that tuition and expenses are treated as paid in the year they are actually paid.
   d) Correct – This is true under Treas. Regs. §1.25A-5(e)(1), although there is an exception for specific prepayments.

3. For the substantiation of vehicle expenses, which of the following applies? **(Page 12)**

   a) Incorrect – The ***Cohan*** rule allows for an estimate of expenses, but IRC §274(d) takes precedence and requires strict substantiation for traveling expenses.
   b) Correct – The taxpayer must substantiate vehicle expenses with adequate recordkeeping and documentary evidence.
   c) Incorrect – The taxpayer must keep a log book which details specific mileage and the purpose and location of each business trip.
   d) Incorrect – Vehicle expenses require strict substantiation, so the taxpayer is required to provide account or log books AND documentary evidence.

4. Which of the following statements correctly characterizes health savings accounts (HSAs) for spouses and families? **(Page 14)**

   a) Incorrect – Accounts are set up on an individual basis, in the name of a single individual.
   b) Incorrect – The distributions may be for any member of the family, including the owner, the spouse, or a dependent.
   c) Correct – When both spouses have family coverage, the contribution limit is divided between the spouses and allocated as they choose.
   d) Incorrect – Both spouses may have family coverage whereby each policy covers one spouse and one or more dependents.

5. Which of the following statements is true regarding donated conservation easements? **(Pages 16-17)**

   a) Incorrect – The written acknowledgement does not need to include the value of the property but must include an estimate of the value of any goods and services provided in exchange for donated property.
   b) Correct – If a donee's written acknowledgement is received by the taxpayer after having filed their returns, the charitable deduction will be disallowed.
   c) Incorrect – The enhanced charitable contribution deduction rules apply, so the property qualifies for the 50% contribution limit.
   d) Incorrect – It must be permanently protected.

6. What are the issues of the ***Sission*** case regarding a bankruptcy debtor and payment of self-employment tax? **(Page 20)**

   a) Correct – This was the core issue of the case: whether the bankruptcy estate or the taxpayer was responsible for self-employment taxes.
   b) Incorrect – U.S. citizens that work for international organization employers are excluded from FICA and Medicare withholding but are still subject to self-employment tax.
   c) Incorrect – Although there is disagreement on this among some courts, a debtor's living expenses may be paid from the bankruptcy estate as expenses in the ordinary course of business.
   d) Incorrect – The bankruptcy estate under Chapter 11 includes the debtor's earnings and other property received from the time of filing until the bankruptcy is ended.

7. Which choice correctly characterizes hobby loss rules and the determination of whether or not a profit motive exists? **(Page 21)**

   a) Incorrect – – It must show a profit for three or more of the five years ending with the current tax year
   b) Incorrect – The profit must be demonstrated for two out of seven years.
   c) Incorrect – An activity is considered engaged in for profit if the taxpayer can demonstrate a profit motive.
   d) Correct – This is one of nine factors that are used to determine if a profit motive exists. Other factors include how much time and effort is expended on the business, the expectation of appreciation in value, the taxpayer's success in past ventures, etc.

BUSINESS ISSUES

DEDUCTIONS

ADVERTISING AND TRAVEL

Expenses must be substantiated and bear proximate relationship to business

A taxpayer operated a successful sole proprietorship providing project management consulting primarily for aerospace and defense companies nationwide. (***Nebeker v. Comm.***, TCM 2016-155) The taxpayer claimed expenses for advertising and travel expenses associated with sponsoring and attending two cycling events in Europe associated with the Tour de France and the Giro D'Italia. The taxpayer was an avid cyclist, and the bicycling trips were participatory, which allowed participants to ride in the actual Tour de France and Giro D'Italia courses.

The taxpayer paid a sponsorship fee, which covered his participation in the events, uniforms, and other items such as a crew who took care of meals. The taxpayer's logo as well as all other sponsors' logos appeared on the group's gear.

Deductions for travel expenses are allowable only if incurred while away from home in pursuit of a trade or business. (IRC §162(a)(2)) A taxpayer must substantiate the amount of the expense, the time and place of the trip, and the business purpose of the expense. (IRC §274(d))

The taxpayer was not able to provide backup support for his expenses beyond credit card receipts and his self-created spreadsheet to support the expenses. His only substantiation for his travel expenses were his spreadsheets reflecting a summary of his travel broken down by category of travel expense. The court held that there was not enough information provided to establish that the expenses were actually paid or what the business purpose was for each expense.

The court also held that the taxpayer failed to show a bona fide business purpose for the bicycling trips because the events seemed to be more for the taxpayer's entertainment. The court also found it persuasive that others in the taxpayer's line of business were not involved in the events and that the events involved cycling up to 120 miles per day over nearly three weeks, and that this left little, if any, time for networking and marketing while on the trips, as the taxpayer claimed.

REFUNDS OF SOME CORPORATE AMT CREDITS, SMALL BUSINESS HEALTH TAX REFUNDABLE CREDITS REDUCED

The IRS has announced that refund amounts that will be issued for the following credits are going to be reduced by 6.8%:

- Certain corporations claiming the alternative minimum tax (AMT) credit; and
- The small business health care tax refundable credit.
  ("Effect of Sequestration on Small Business Health Care Tax Credit" Available at: www.irs.gov/Affordable-Care-Act/Affordable-Care-Act-Tax-Provisions#Tax Provisions for Employers; "Effect of Sequestration on the Alternative Minimum Tax Credit for Corporations" Available at: www.irs.gov/Businesses/Effect-of-Sequestration-on-the-Alternative-Minimum-Tax-Credit-for-Corporations)

Whistleblower awards paid to informants by the IRS under IRC §7263 will also be reduced by 6.8%.

Why? Remember the budget battle a few years ago and the across-the-board budget cuts that sequestration was going to bring? Well, the sequestration-related cuts to all federal departments, including the IRS, has resulted in "haircuts," as some practitioners are calling them, on these credits.

Sequestration 101

Budget sequestration is a procedure in U.S. law that limits the size of the federal budget. Sequestration involves setting a hard cap on the amount of government spending within broadly defined categories. Sequestration was the mandated consequence laid out and agreed to in the Budget Control Act of 2011 if the President and Congress couldn't reach a balanced budget agreement by a specified deadline. When they failed to reach the agreement, the cuts automatically went into effect.

The reductions in spending required under the sequestration exceed $1 trillion dollars over an eight-year period (2013–2021) and divide the reductions equally between defense and nondefense spending. Programs like Social Security, Medicaid, federal pensions, and veteran's benefits are exempt from sequestration. (https://en.wikipedia.org/wiki/Congressional_Budget_Office)

Refund payments related to these credits that are processed on or after October 1, 2015, and on or before September 30, 2016, will be reduced by 6.8%, regardless of when the original or amended tax return on which the credit was claimed was filed.

AMT credit

Under IRC §168(k)(4), a corporation can choose to "swap out" its IRC §168(k) bonus and accelerated depreciation deduction in exchange for an increased AMT credit limitation. The increased credit limitation only applies to deferred pre-2006 AMT credits.

Small business health care refundable credit

Eligible small tax-exempt employers may claim a reduced, but refundable, small business health care tax credit. The credit may not exceed the employer's payroll taxes.

PLR ON DEDUCTIBLE/AMORTIZABLE ENTERPRISE SOFTWARE COSTS STILL VALID

Despite the publication of final regulations subsequent to its issuance, a 2002 PLR on the tax treatment of the cost of enterprise resource planning (ERP) software and related development and training costs is still valid. (PLR 200236028; CCA 201549024) The earlier PLR held that the acquisition cost of the ERP software and its installation and modification costs must be amortized over 36 months, but that the training and additional development costs are currently deductible.

MARIJUANA EXCISE TAX TREATED AS COST OF GOODS SOLD

The IRS has ruled that the Washington state excise tax on marijuana is a cost of goods sold that reduces the amount of gross sales subject to tax, rather than a nondeductible tax. (CCA 201531016) Because the excise tax is imposed in connection with the disposition of property and is not one of the taxes specifically listed in IRC §164(a), it is not considered a deductible tax under IRC §164. Therefore, the IRC §280E prohibition against businesses trafficking in controlled substances from deducting business expenses does not apply.

USING THE IRC §754 ELECTION IN A PARTNERSHIP

When a new partner purchases an interest in a partnership with appreciated assets, his basis in his partnership interest will exceed his allocable share of the partnership's basis in its assets. This is because the Code provides specifically that the basis of partnership property is not adjusted as the result of a transfer of an interest. (IRC §743(a)) Without an election under IRC §754, a partner may be forced to recognize phantom gains on the sale of partnership assets.

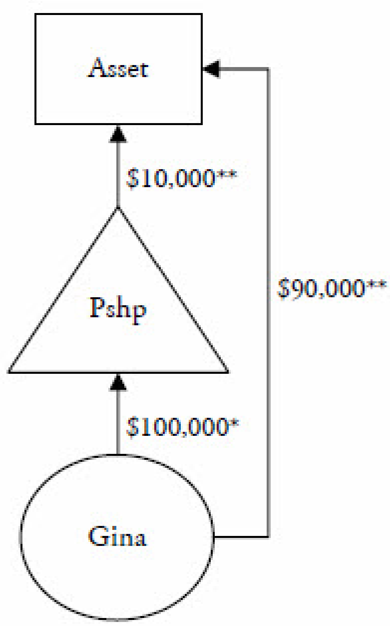
Example of IRC §754 election

John is one of the founding partners of Partnership. He contributes $10,000 for a 10% interest, and the partnership uses its $100,000 of total capital contributions to purchase a capital asset (Asset).

Many years later, Asset has appreciated in value to $1 million, and John sells his 10% interest to Gina for $100,000. Very soon after the interest transfer, Partnership sells Asset for $1 million recognizing $900,000 of gain. Partnership uses the funds from the sale to continue its business and is not liquidated. Gina is allocated $90,000 of the gain on her K-1 even though she hasn't enjoyed any economic gain.

If the partnership has a §754 election in place, Gina will have $90,000 of outside basis in Asset. As such, upon the sale of Asset, Gina will have no gain or loss on the sale.

Gina's relationship to Partnership and Asset after the §754 election is as follows:



* Gina's basis in her partnership interest
** Gina's share of the partnership's basis in asset
*** Gina's outside basis in asset

A similar result is obtained upon the death of a partner. At the time of a partner's death, his estate must step up or step down the estate's basis in the partnership interest under IRC §1014 just as basis in an interest is "stepped up" to the purchase price upon a sale of an interest.

IRC §754 depreciation

In addition to avoiding phantom gain, a §754 election can create deductions for a new partner. The amount of the step-up is allocated to assets under IRC §755 in accordance with the relative fair market values of the assets.

To the extent that those assets are depreciable or amortizable (Treas. Regs. §1.743-1(j)(4)), the partner may take depreciation or amortization on the asset in accordance with allowable methods at the time the adjustment is made.

Generally, modern tax software can compute and allocate §754 depreciation. In most cases, the depreciation is reported on K-1, line 13, Other deductions, with a W code (for "miscellaneous").

> ***Example of depreciation***
>
> Assume in the example above that Asset is a commercial building. Gina would begin depreciating $90,000 over 39 years in the year of transfer. Assume that the rental generates $10,000 net income in the year after Gina joins the partnership. Gina is allocated $1,000 on line 2 of her K-1. Her §743(b) depreciation is $2,308 ($90,000 ÷ 39). She enters a loss of $1,308 on her Schedule E ($1,000 - $2,308).

Allocating basis

At the time of each transfer or disproportionate distribution, the adjustment to a partnership's basis in its assets is allocated to reduce the difference between the basis of the partnership assets and the value of the assets. (IRC §755(a)(1))

This is done by allocating the basis adjustments between the classes of partnership property and then allocating the basis adjustment among the properties in each class as follows:

- The value of the partnership property is determined utilizing the residual method for goodwill;
- The partnership property is separated into two categories: capital assets (including §1231 property) and other assets;
- The partnership determines to which category of partnership property the basis adjustment is attributable; and
- The basis increase or decrease attributable to each category is then allocated among the assets in the category.
  (Treas. Regs. §1.755-1(a)(1))

The regulations do not spell out how value is determined, but if the stakes are high, the partnership may need to consider an appraisal.

Possible disadvantages

It's not all good news. Once a partnership makes a §754 election, it remains in place indefinitely and can only be revoked with IRS consent. In the event that asset values decline, the new partner must make a negative adjustment if a §754 election is in place.

This can be of real concern with family limited partnerships (FLPs) or LLCs that have successively used valuation discounts. In that case, a partnership that has always used valuation discounts may be stuck with continuing to use such discount on the death of a partner. Applying such discount may result in a negative adjustment for the remaining partners of inherited interests. As such, a §754 election is often undesirable for FLPs unless the FLP owns property with low basis relative to fair market value — in particular FMV after consideration of deep valuation discounts.

Finally, a partnership may be forced to make a basis adjustment even if it doesn't have a §754 election in place. Prior to the American Jobs Creation Act of 2004 (P.L. 108-357), the transfer of a partnership interest would only result in a basis adjustment if the partnership had a §754 election in place. Under the act, a basis adjustment is mandatory if the partnership has a substantial built-in loss after the transfer. (Act §833(b)(1); IRC §743(a)) A substantial built-in loss exists if the partnership's adjusted basis in its assets exceeds the fair market value of the property by more than $250,000. (Act §833(b)(3); IRC §743(d)(1))

Example of adjustment with and without IRC §754 election

Fran contributes four rental properties to her FLP. The FMV of each is $250,000 with basis of $200,000 (for overall FMV of $1 million and basis of $800,000).

She gives 20% partnership interests to each of her two children. As such, each of her children has basis of $160,000 in their interests (20% × $800,000). She successfully gets a 40% discount on the valuation of the gift.

On her death, Fran's 60% interest is transferred to her children. The total basis of her transferred interest is $288,000 (60% of $800,000, less 40% valuation discount). Thus, each child has a basis in his or her interest of $304,000 ($160,000 plus 50% of $288,000).

If the partnership makes a §754 election, there will be a negative adjustment under §743(b) of $192,000 ($96,000 per partner) allocable ratably to each of the four properties ($800,000 partnership basis in assets, less $608,000 outside basis).

Assume that shortly after the transfer on death, the partnership sells one of the properties for $250,000 at a gain of $50,000. Absent a §754 election, each partner would be allocated gain of $25,000. If a §754 election is in place, each partner would also be required to include $24,000 ($96,000 ÷ 4) of the negative adjustment as additional gain.

Transfer upon death	**Without §754**	**With §754**
Original basis	$800,000	$800,000
Percentage transferred	× 60%	× 60%
Original basis transferred	480,000	480,000
Stepped down for valuation discount	(192,000)	(192,000)
Basis transferred upon death	288,000	288,000
Basis of pre-death transfer	320,000	320,000
Total basis to new partners	$608,000	$608,000
Total basis to new partners		$608,000
Partnership's basis in its assets		(800,000)
§743(b) adjustment		($192,000)
Basis of each asset	$200,000	$200,000
§743(b) adjustment (allocated ¼ to each)	N/A	(48,000)
Basis after adjustment	$200,000	$152,000
Sales prices	$250,000	$250,000
Basis	(200,000)	(152,000)
Gain	$50,000	$98,000

Making a §754 election

If a partnership makes an election under IRC §754, the basis of partnership property is adjusted upon:

- A transfer of an interest under IRC §743(b); and
- A disproportionate distribution of property under IRC §734(b).

The election applies to both; a taxpayer cannot elect to adjust transfers but not distributions or vice versa.

The election is made by filing a written statement of election with the partnership or LLC return for the taxable year during which a transfer of interest or applicable distribution occurs. (Treas. Regs. §1.754-1(b)) For the election to be valid, the return must be timely filed (including extensions). (Treas. Regs. §1.754-1(b)) However, the §754 election is one of the elections eligible for an automatic 12-month extension to file under Treas. Regs. §301.9100-2. (Treas. Regs. §301.9100-2(a)(2)(vi)) The election remains in effect in all subsequent years and may only be revoked with consent of the IRS.

The statement must:

- State the name and address of the partnership;
- Be signed by one of the general partners; and
- Contain a declaration that the partnership elects to apply the provisions of IRC §§734(b) and 743(b).

The election is a partnership election and applies to all transfers of interests occurring in the year of the election and all future transfers and can be revoked only with IRS permission. (Treas. Regs. §1.754-1(a) and (c))

Attach the election to the return.

Caution

The election applies with respect to all distributions of property by the partnership and to all transfers of interests in the partnership during the taxable year with respect to which such election is filed, and all subsequent taxable years.

Sample election

Pursuant to IRC §754 and Treas. Regs. §1.754-1(b)(1), the ____________________ partnership/LLC hereby elects to adjust the basis of its property under IRC §§734(b) and 743(b).

Making a late election

The regulations provide that the Commissioner has discretion to grant a reasonable extension of time to make an IRC §754 election, provided the taxpayer demonstrates that:

- The taxpayer acted reasonably and in good faith; and
- Granting relief will not prejudice the interests of the government.

In a private letter ruling, the IRS granted a partnership additional time to make the IRC §754 election. (PLR 201352008) The partnership's tax advisor was unaware of the partnership's ability to make the election. A partner discovered the failure to make the election after the partnership sold and recognized gain on partnership property.

Revoking an election

To revoke an election, the partnership must apply to the IRS (for the address, see Notice 2003-19) with a statement signed by a general partner no later than 30 days after the close of the partnership year for which the revocation is requested. It must state the reason for the request. Avoiding a negative adjustment is not a valid reason. (Treas. Regs. 1.754-1(c)(1)) Examples of reasons that may be considered sufficient include:

- Change in the nature of business;
- Substantial change or increase in assets or change in their character; or
- Substantial increase in transfers of partnership interests, causing the §754 election to have become an administrative burden to the partnership.

After making the §754 election, the partnership must attach a statement to each return in which an adjustment is made under §743(b) or §734(b); i.e., each time there is a transfer of a partnership interest or each time there is a disproportionate distribution. (Treas. Regs. §1.743-1(k)(1)(i)) The statement must set forth the name and taxpayer identification number of the transferee partner and the partnership properties to which the adjustment is allocated.

Upon the death of a partner with a community property interest in a partnership, not only is the estate's interest in the inside assets of the partnership adjusted if there is an election in place, but the deceased partner's spouse's interest in such assets is also adjusted. This is true regardless of which spouse is a partner. (Rev. Rul. 79-124)

IRS REVERSES COURSE ON "BAD BOY" GUARANTEES

In a legal advice memorandum issued by the Associate Chief Counsel, the IRS reversed its position from a Chief Counsel Advice (CCA) issued in February 2016 and has concluded that if a partner's guarantee of a partnership's nonrecourse obligation is conditioned on the occurrence of certain "bad boy" events, the guarantee will not cause the obligation to fail to qualify as a nonrecourse liability for purposes of IRC §752 or fail to qualify as nonrecourse financing for purposes of the at-risk rules under IRC §465. (A.M. 2016-001)

The outcome was important because basis attributable to nonrecourse debt is allocated among all the partners in accordance with their interest in the partnership, while recourse liabilities are allocated only to those partners who bear the economic risk of loss for that liability.

"Bad boy" guarantees are common in commercial mortgage financing. The lenders generally require a partner in control of a real estate partnership to guarantee the loan upon the occurrence of certain "bad acts." These guarantees are so common that the original CCA caused panic among real estate investors who could have been required to recapture billions of dollars in losses from prior years and could not further share in losses in excess of their equity capital in future years.

IRS takes new position

In the original CCA issued in February 2016, the IRS ruled that a partner guarantee of a nonrecourse loan will make the otherwise nonrecourse loan recourse to the guaranteeing partner. (CCA 201606027) The result of this is that the guarantee would deprive other partners of any share of the liability in computing their tax basis and cause the debt to fail to be qualified nonrecourse debt for purposes of the at-risk rules.

On April 15, 2016, the IRS released a generic legal advice memorandum in which the IRS reversed course and concluded that most "bad boy" guarantees do not cause the debt to fail to qualify as nonrecourse until one of the "bad boy" events actually occurs (thereby causing the guaranteeing partner to actually become liable for the partnership debt). (A.M. 2016-001)

The IRS noted that it is a common practice throughout the real estate industry to include "bad boy" provisions that are conditioned on the occurrence of one or more of the following bad acts:

- The borrower fails to obtain the lender's consent before obtaining subordinate financing or transfer of the secured property;
- The borrower files a voluntary bankruptcy petition;
- Any person in control of the borrower files an involuntary bankruptcy petition against the borrower;
- Any person in control of the borrower solicits other creditors of the borrower to file an involuntary bankruptcy petition against the borrower;
- The borrower consents to or otherwise acquiesces or joins in an involuntary bankruptcy or insolvency proceeding;
- Any person in control of the borrower consents to the appointment of a receiver or custodian of assets; or
- The borrower makes an assignment for the benefit of creditors, or admits in writing or in any legal proceeding that it is insolvent or unable to pay its debts as they come due.

A partner is effectively protected against loss until such time as one or more of the events actually occurred. Moreover, the partner would be highly motivated to avoid such acts occurring because their occurrence would be economically harmful to the guarantor-partner. Finally, the IRS noted that, in practice, the occurrence of such events is rare.

Background

A partner's share of partnership loss is allowed to the partner only to the extent of the adjusted basis of such partner's interest in the partnership as of the last day of the partnership year. (IRC §704(d)) Moreover, the partner may only take losses to the extent the partner is at risk. (IRC §465(a))

A partner's basis in his or her interest acquired by a contribution of property, including money, is the amount of such money or the adjusted basis of such property to the contributing partner, increased by any gain recognized by the contributing partner on the contribution. (IRC §722)

A partner's tax basis is also increased by the partner's share of liabilities. (IRC §752(a)) At-risk amounts are increased by "qualified nonrecourse financing," which is nonrecourse debt that is secured only by real property used in the activity of holding such property. (IRC §465(b)(6))

Recourse liabilities are those for which a partner bears the economic risk of loss, whereas nonrecourse debt is debt for which no partner bears the economic risk of loss. (Treas. Regs. §1.752-2(a)) Recourse liabilities are allocated only to the partner who bears the risk of loss with respect to the liability (generally, the general partners), while nonrecourse liabilities are allocated among all partners in accordance with the percentages in which they share profits.

In determining whether a debt is recourse or nonrecourse, all obligations relating to the liability are taken into consideration, including a partner guarantee. Generally a partner guarantee of an otherwise nonrecourse debt will make that debt recourse to the guaranteeing partner or partners if the partner would not be entitled to reimbursement from the partnership or the other partners. (Treas. Regs. §1.752-2(b)(1)) However, a payment obligation is disregarded if, taking into account all the facts and circumstances:

- The guarantee is subject to contingencies that make it unlikely that the guarantee will ever be discharged; or
- The guarantee would not arise until the occurrence of a future event that is not determinable with reasonable certainty.
  (Treas. Regs. §1.752-2(b)(4))

COHAN RULE STILL ALIVE AND WELL

A tax preparer who owned a restaurant was not entitled to deductions for supplies and contract labor but was allowed deductions for cost of goods sold and wages. (***Arizaga v. Comm.***, TCM 2016-57) Although the taxpayer lacked documentation, he credibly testified that the claimed "supplies" deduction consisted of food and other items that the court, using the ***Cohan*** rule, partially allowed as cost of goods sold. Further, based on the individual's credible testimony, the court allowed part of his claimed "contract labor" deductions as wages. The taxpayer was also allowed a deduction for advertising as determined by the court. The taxpayer produced no evidence of what he paid for a full-page ad that ran in a Spanish-language newspaper except for his testimony that the ad ran for most of the year and cost about $100 per month.

S CORPORATION ISSUES

DISPROPORTIONATE DISTRIBUTIONS OF S CORPORATION NOT DISQUALIFYING

The IRS recently issued yet another private letter ruling where it held that disproportionate distributions of an S corporation to its shareholders did not create a second class of stock and thus did not terminate the corporation's S election. (PLR 201633017) The IRS has issued many PLRs to taxpayers seeking guidance on this seemingly settled issue (See PLR 201519008; PLR 201444020; PLR 200802002; PLR 200730009; PLR 200524020; PLR 200308035; PLR 200125091; PLR 200010023; PLR 9519048), and when the IRS's user fee for a PLR on this issue can be as much as $28,300 (Rev. Proc. 2016-1), practitioners may be better positioned to advise their clients on the propriety of seeking such a ruling if they are reminded of a couple of key points.

Second class of stock

Disproportionate distributions to shareholders alone does not automatically terminate a corporation's S election, and the Code does not require proportionate distributions as a stand-alone requirement for a corporation to maintain its S election. Rather, the Code states that an S corporation cannot have more than one class of stock (IRC §1361(b)(1)(D)), and that a corporation is generally treated as having one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. (Treas. Regs. §1.1361-1(l)(1))

Caution

Differences in voting rights among shares of stock of a corporation are disregarded for purposes of determining whether a corporation has more than one class of stock.

Corporation's governing documents

The multiple rulings on this issue are instructive in that the IRS does not look to whether disproportionate distributions to an S corporation's shareholders took place, but whether the corporation's governing documents and other agreements confer identical distribution and liquidation rights. The case that illustrates this issue best is ***Minton v. Comm.***, where a corporation made regular payments to a shareholder to cover his living expenses over multiple years, and such payments were disproportionate in relation to the other shareholders. (***Minton v. Comm.***, TCM 2007-372) Additionally, at the time of the court's decision, corrective distributions to the other shareholders were never made.

The court ruled in favor of the IRS, which was the party arguing the S election was **not** terminated! The court held that the corporation's governing documents and other binding agreements would have had to specifically create a second class of stock in order to terminate the S election. Otherwise, the shareholders not receiving their proportionate share of distributions would simply be entitled to receiving corrective distributions at some unspecified point in the future.

Two types of rulings

The IRS's rulings on the issue of disproportionate distributions creating a second class of stock take one of two directions. The rulings either state that the S election was not terminated, or they state that if the S election was terminated, it was inadvertent, and the corporation can make corrective distributions to save the corporation's S election. In either case, corrective distributions must be given appropriate tax effect.

S CORPORATION INCOME AFTER BANKRUPTCY ESTATE SETTLED WAS TAXABLE TO ESTATE

A bankruptcy court found that S corporation income earned after the commencement of a bankruptcy action was taxable to the bankruptcy estate. (***In re: Medley, et al.*** (May 17, 2016) U.S. Bankruptcy Court, Middle Dist. of Alabama, Case Nos. 13-12371, 13-12182) The S corporation's tax year ended after the bankruptcy was settled and the gains and losses for that tax year flowed through to the bankruptcy estate. The taxpayer in this case didn't make a short-year election under IRC §1398, meaning the tax liability for the entire year is considered post-bankruptcy debt, and the taxing authority has no claim against the bankruptcy estate. With an election, the taxing authority may make a claim against the bankruptcy estate for any tax liability arising out of the first short year.

DEATH OF AN S CORPORATION SHAREHOLDER

When an S corporation shareholder dies, income is reported by the decedent through the date of his or her death. (IRC §1377(a)(1)) Thereafter, the income is taxed to the new owner of the shares, which will often be an estate or a trust. Normally, only U.S. residents or citizens and limited entities (specified trusts, estates, or charities) qualify as shareholders, and a total of only 100 S corporation shareholders are permitted (for this purpose, related persons within six generations are treated as one shareholder). (IRC §1361(b)) If a nonqualified shareholder succeeds to the ownership of the S corporation stock, the corporation will lose its S corporation status. Below, we discuss which entities can qualify as S corporation shareholders.

Estates

Estates are qualified shareholders during the time the estate is being administered. (IRC §1361(b)(1)(B)) A trust that has elected under IRC §645 to be treated as part of the estate also qualifies as an estate for this purpose. (IRC §645(b)(2)(A)) This election only applies to treat the trust as an estate if an estate tax return is required. If one is not required, the election is effective only for two years. Form 8855 is used to make the election.

The estate will terminate for federal tax purposes if the administration is "unreasonably prolonged," which means that failure to timely finalize the estate could result in a disqualified shareholder. (Treas. Regs. §1.641(b)-3(a)) However, it is permissible to keep the estate open while paying deferred estate taxes under IRC §6166. (Rev. Rul. 76-23) If in doubt, it makes sense to distribute the S corporation stock even if the estate is still open.

Trusts

Revocable trust that becomes irrevocable at death and transfers by will

During one's lifetime, a grantor trust qualifies as an S corporation shareholder. After death, the continuing, now irrevocable trust qualifies as an S corporation shareholder, "but only for the 2-year period beginning on the day of the deemed owner's death." (IRC §1361(c)(2)(A)(ii)) In addition, a trust will be considered a qualified shareholder if the stock is transferred to the trust "pursuant to the terms of a will," but only for the two-year period beginning on the day on which such stock is transferred to the trust. (IRC §1361(c)(2)(A)(iii))

Other trusts — two possibilities

All other trusts can be S corporation shareholders only if:

- They qualify as either a qualified subchapter S trust or as an electing small business trust; and
- A timely election is made to treat these trusts or their beneficiaries as qualified shareholders.

Voting trusts, created primarily to exercise voting power over S corporation stock, will also qualify.

Qualified subchapter S trust (QSST)

A QSST is a trust that has one (and only one) current income beneficiary. All income must be distributed annually, and no distributions may be made to another beneficiary during the income beneficiary's life. This will apply for most estate-tax created qualified terminable interest property (QTIP) trusts (Treas. Regs. §1.1361-1(j)(4)) and many simple trusts with one lifetime beneficiary. Although not identical, the QSST is very similar to the commonly used QTIP trust used for the estate tax marital deduction. A QTIP trust that is set up by a gift will not qualify if the grantor is still married to the beneficiary, which will almost always be the case.

If there are multiple beneficiaries, it may be possible to create separate share subtrusts in order to qualify, but separate returns will be required for each subtrust. (Treas. Regs. §1.1361-1(j)(3)) In effect, to the extent of distributable net income (DNI), the income from the S corporation will be taxed to the trust's beneficiary. The election to be treated as a QSST must be made by the trust's beneficiary on or before two months and 16 days from the date the stock was transferred to the trust. (IRC §1361(d)(2)) A late election can be made pursuant to Rev. Proc. 2013-30 if made within three years and 75 days of the desired effective date.

Electing small business trust (ESBT)

An ESBT may apply to other trusts, thus allowing more estate planning flexibility, but it comes with a heavy price tag. A trust or an estate can elect to be treated as an ESBT if all beneficiaries are themselves qualified S corporation shareholders. (IRC §1361(e)(1)(A)(i); Treas. Regs. §1.1361-1(m)(2)(v)) A protective election cannot be made in cases where it is unclear if the trust is a QSST or an ESBT. This includes all contingent interests, defined as any person who may receive a distribution from the principal or income of the trust. (IRC §1361(e)(2)) Each beneficiary counts toward the S corporation 100 shareholder limitation. No interest in the trust can be acquired by purchase. (IRC §1361(e)(1)(A)(ii)) Trusts that do not qualify for the ESBT election are charitable remainder unitrusts or annuity trusts, a QSST, or any tax-exempt trust. (IRC §1361(e)(1)(B))

A nongrantor charitable lead trust can qualify. The election to be a qualified shareholder is made by the trust under the same procedure and dates as that used for the QSST election. The taxation of an ESBT is unique. A trust that has made the election will file two tax returns using the same taxpayer ID number, one for the S corporation's income, with no deduction for distributions to the beneficiaries, and another for the remainder of the trust's income. (Treas. Regs. §1.1361-1(m)(3)(ii)) The S corporation income will be taxed to the ESBT trust at the highest individual rate (39.6%), usually far higher than would be paid by the beneficiary, who often receives the income. There is no AMT exemption.

Example of ESBT election

The Abe Smith Trust has $10,000 of interest income and $15,000 of income from an S corporation for which an ESBT election was made. The two beneficiaries received a distribution of $12,000 each. The trust would file two tax returns. The return reporting the S corporation income would pay tax on the full $15,000 at 39.6% or a federal tax of $5,940. The trust's regular tax return would show zero income, as it would report $10,000 of interest income and receive a distribution deduction of $24,000 but limited to DNI of $10,000. The beneficiaries would receive $12,000 each but pay tax on only $5,000, as the trust paid the tax on the S corporation's income.

The tax cost as demonstrated above will likely be far higher than would be the case if the S corporation's income had passed through to the beneficiary. Accordingly, those holding S corporation stock should review their wills or trusts and discuss with their estate planning advisors how the stock will be distributed on their demise.

No longer an S corporation?

A trust that is not qualified under one of the previous scenarios will cause a termination of the S election as the corporation would therefore have a nonqualified shareholder. That would cause the corporation to cease to be an S corporation, and as a C corporation, it would create double taxation, which the S election was intended to prevent.

Conclusion

What happens to the decedent's S corporation stock can have major tax consequences both to the heirs and also to the corporation's other shareholders. Estate planners should consider this as should the corporation's bylaws. The bylaws should anticipate this problem and proactively deal with the potential loss of the S election if the shares are owned or transferred to a nonqualified shareholder.

Comparison of Fiduciary Entities That Qualify as S Corporation Shareholders				
	Estate	**Revocable trust after death**	**QSST**	**ESBT**
Can be an S corp. shareholder	Yes	Yes	Yes	Yes
Qualified first 2 years	Yes	Yes	No	No
Can elect to qualify	No	No	Yes	Yes
Who elects	None required	After 2 years, must elect to be either a QSST or ESBT	Beneficiary	Trustee
Late election			Rev. Proc. 2013-30	Rev. Proc. 2013-30
When to file election			2 months and 16 days of receipt of stock	2 months and 16 days of receipt of stock
Terms of trust			2 months and 16 days of receipt of stock	Income can be accumulated or distributed
S corp income taxed to	Trust/estate rules	Trust rules	Trust rules; if separate share, separate returns and tax ID # for each beneficiary's trust	Two returns, one for trust and one for the trust's S corp earnings (same ID #)
Distribution deduction	Yes	Yes	Yes	Yes
Fiduciary tax rate	Normal rates	Normal rates	Normal rates	39.6%

INHERITING OR PURCHASING S CORPORATION STOCK

Did your client die with S corporation stock that has appreciated in value or purchase S corporation stock for more than the S corporation's basis in the assets? If so, it's never too early to talk about one major issue: phantom gain.

Background

Joe and Mary Smith bought an apartment house 25 years ago in an S corporation. The basis of the apartment in the S corporation is $2 million, but it is worth $5 million. On Joe's death, the S corporation stock is valued at $5 million. If Mary inherits Joe's half-interest, her basis in the corporation's stock would be $5 million, the fair market value of the S corporation, assuming it is community property. The problem is that the S corporation continues to own an apartment with a $2 million basis. Only the basis of the stock is increased to fair market value.

If the apartment is sold, the S corporation and its shareholder will report the gain of $3 million ($5 million less the corporation's basis of $2 million). If the Smiths had owned the property in their own names, Mary would have received a stepped-up basis and no gain would be reported ($5 million sale less $5 million fair market value basis). Similarly, if the apartment were in a general partnership or LLC, Mary could have received a stepped-up basis in the apartment (even if the Smiths didn't own 100% of the partnership) if the partnership made an IRC §754 election. That election allows the partners to adjust their inside basis in the apartment in the hands of the partnership to account for the difference between the inside basis of $2 million and the outside basis $5 million. When the property is sold, no gain or loss would be reported by the partner.

Unfortunately, the stepped-up basis that applies to direct ownership or ownership through a partnership is not available if the property is owned though an S corporation. In that case, the basis increase only applies to the stock, just as if the stock were publicly traded. Even though it might not make sense, §754 only applies to partnerships; it doesn't apply to S corporations.

If the S corporation sells the apartment soon after Joe's death, the results can be disastrous unless a solution can be found. Suppose the building is sold three months after Joe's death for $5 million. The S corporation and Mary report the $3 million gain. The effect is to raise her basis in the stock from $5 million (date of death value) to $8 million (increased by $3 million for the passthrough of the gain). Several years later, when the corporation is liquidated and Mary receives a liquidating distribution of $5 million, she will be entitled to a $3 million long-term capital loss, which she can claim at a rate of $3,000 per year for the following 1,000 years or when she dies, whichever comes first. Of course, she could also use it if she has any capital gains. Unless something is done, Mary will effectively report $3 million of phantom income because the apartment was owned in an S corporation rather than outright or in a partnership.

Liquidating the business

Sometimes there is a solution that can be used when, due to the sale of the assets, the corporation no longer has a reason to continue as a trade or business. In that case, liquidating the business in the same year results in a capital loss that can offset most or all of the phantom capital gain. This only works if the liquidation is in the same tax year as the sale and if the character of the loss is the same as the character of the gain on the sale. If, in the above example, the sale and liquidation occur in the same year, then the K-1 will report the $3 million §1231 gain, and the shareholder will also report a $3 million long-term capital loss. The result is that the gain and the loss offset.

This may not be as easy to accomplish as it seems. The reason is that estate administration takes time. A newly appointed executor, administrator, or trustee may not realize this issue exists and may not consult with their tax advisor when they get an offer of $5 million for the building.

Even if the owner is aware of the problem, there may be reasons why the corporation cannot be liquidated in the year of sale. This is the case when the building is only a small part of the overall business or if there are multiple shareholders who may not want to liquidate the corporation.

In addition, some of the gain may be ordinary gain. For example, this would be the case if the corporation had made a §179 election the prior year to expense $250,000 of §1245 property. The sale would result in $250,000 of ordinary income and $2.75 million of capital gain. In this situation, at least by liquidating in the same year, the net taxable income and comparable capital loss would only be $250,000.

When there are other operations in the corporation, the liquidation of an S corporation results in a deemed sale of all the assets at fair market value. This has the effect of accelerating any unrealized gain. This is probably not a major tax problem if the gain is capital gain and if there is a sole shareholder who would have a comparable capital loss due to the liquidation. The same cannot be said if other shareholders (even other family members) own a substantial portion of the stock, as they would not have a comparable capital loss. They will have phantom gain.

In an ideal world, someone who inherits S corporation stock can avoid the phantom gain problem by selling the stock to a buyer who pays the full fair market value, thus transferring the problem to the buyer. The next best option is that they sell the corporate assets and liquidate the corporation within the same tax year. Either way, it is important that they are informed of the problem in advance of a sale. Who wants to tell their client one year that they have a $3 million gain and the next year they have a $2,997,000 capital loss carryover because they didn't liquidate the company a few months earlier?

EXEMPT ORGANIZATIONS

REMINDER: MOST TAX-EXEMPT ORGANIZATIONS MUST FILE IN MAY

Although they are exempt from income taxation, exempt organizations are generally required to file annual returns of their income and expenses with the IRS. The form the organization must file depends on its financial activity.

Form 990 Series Filing Requirements	
Gross receipts and asset amount	**Form to file**
Gross receipts normally less than or equal to $50,000. **Note:** Organizations eligible to file the e-Postcard may choose to file a full return	990-N, e-Postcard (electronic only, no paper form)
Gross receipts less than $200,000, and total assets less than $500,000	990-EZ or 990
Gross receipts greater than or equal to $200,000, or total assets greater than or equal to $500,000	990
Private foundation, regardless of financial status	990-PF

An exempt organization's failure to file Form 990, Return of Organization Exempt From Income Tax, for three consecutive years results in the revocation of the organization's exempt organization status on and after the filing deadline for filing the third annual return or notice. (IRC §6033(j)(1)) Many organizations qualify to file the simple 990-N (e-Postcard).

Note: Churches, certain church affiliated programs, and other religious or apostolic organizations are not required to file an annual information return. For a discussion of entities that are not required to file, go to:

Website
www.irs.gov/Charities-&-Non-Profits/Annual-Exempt-Organization-Return:-Who-Must-File

Who can file the 990-N?

Tax-exempt organizations with annual receipts of $50,000 or less may file Form 990-N. The form is e-filed annually with the IRS. Certain organizations are ineligible.

An organization's gross receipts are considered to be $50,000 or less if the organization:

- Has been in existence for one year or less and received, or donors have pledged to give, $75,000 or less during the organization's first tax year;
- Has been in existence between one and three years and averaged $60,000 or less in gross receipts during each of its first two tax years; or
- Is at least three years old and averaged $50,000 or less in gross receipts for the immediately preceding three tax years (including the year for which calculations are being made).

New system for filing Form 990-N

Starting February 29, 2016, Form 990-N will be filed with the IRS rather than with the Urban Institute, the organization that hosted the form previously. (www.irs.gov/Charities-&-Non-Profits/Annual-Electronic-Filing-Requirement-for-Small-Exempt-Organizations-Form-990-N-e-Postcard)

The IRS has launched a website for submitting Form 990-N filings. Any Form 990-N filings in the Urban Institute system that were not completed and submitted by 11:59 pm (EST) on February 28, 2016, will not be submitted to the IRS. Those Form 990-N filings must be re-entered into the new IRS system.

All Form 990-N filers (including those previously registered with Urban Institute) who file after February 28, 2016, will be required to register with the new IRS system before completing Form 990-N. This is a one-time registration, and these taxpayers will not need to register each year.

As with filings made through the Urban Institute, there is still no charge to file Form 990-N through the IRS's system.

To access the IRS's filing system, go to the website below and use the link provided to access the Form 990-N Electronic Filing System (e-Postcard):

Website
www.irs.gov/charities-non-profits/annual-electronic-filing-requirement-for-small-exempt-organizations-form-990-n-e-postcard

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

8. How have the courts ruled regarding the definition of taxpayer for S corporations as they relate to self-rental rules?

    a) When a lessor is an S corporation, IRC §469 self-rental rules are applied at the corporate level
    b) The courts have ruled that S corporations are only passthrough entities and the shareholders are actually the taxpayers, so the self-rental rules apply at the shareholder level
    c) IRC §469 defines taxpayer to include S corporations
    d) A taxpayer may rent property to his or her own business and still maintain the income as passive activity income

9. Based on the case ***Power v. Comm.***, which statement correctly describes the issues surrounding the taxpayer's ability or lack thereof to prove NOLs and S corporation stock basis carried forward from previous years?

    a) The taxpayer did not keep his backup documentation going back to 1999 for NOLs he used to offset income in 2007-2011, so his NOLs were disallowed
    b) The Tax Court supported the taxpayer's use of the ***Cohan*** rule to establish his deductible expenses
    c) The taxpayer was required to prove that the NOLs existed but was not required to establish that they had not already been utilized
    d) Tax practitioners should keep tax returns and backup documents only until the statute of limitations expires

10. Factors involving the use of an IRC §754 election include which of the following?

    a) For an election under §754, the basis of partnership property may be treated separately for transfers under IRC §743(b) and distributions under IRC §734(b)
    b) A §754 election is eligible for an automatic 12-month extension to file
    c) The election is made by all partners and applied only to transfers of interest in the year of election
    d) The election may be revoked at any time in order to avoid a negative adjustment

11. Which of the following statements is accurate as it pertains to partnerships and recourse/nonrecourse debt?

    a) Recourse debt is allocated to all partners based on their partnership interest
    b) A partner guarantee is not determinative as far as whether a debt is considered recourse or nonrecourse
    c) A partner's basis in his partnership interest from a property contribution is equal to the value of the property at the time of contribution
    d) A partner may only take losses up to the amount that he or she is at risk

12. What do multiple private letter rulings issued by the IRS reveal about their position on disproportionate distributions and S elections?

    a) According to the Tax Code, proportionate distributions are required in order for a corporation to maintain its S election
    b) The IRS will always look to whether disproportionate distributions to shareholders of an S corporation have occurred
    c) When determining if a corporation has more than one class of stock, the IRS will consider whether there are differences in voting rights among stock shares
    d) An S election would be terminated if a corporation's governing documents explicitly create a second class of stock

SOLUTIONS TO REVIEW QUESTIONS

8. How have the courts ruled regarding the definition of taxpayer for S corporations as they relate to self-rental rules? **(Page 24)**

   a) Incorrect – The self-rental rules apply at the shareholder level.
   b) Correct – Rental income is nonpassive if the property is used in a trade or business in which the taxpayer materially participates. When the lessor is an S corporation, this rule is applied at the shareholder level.
   c) Incorrect – Although IRC §469 does not define taxpayer as including an S corporation, the IRS views the shareholder of the S corporation as, ultimately, the taxpayer.
   d) Incorrect – The income would be considered nonpassive.

9. Based on the case **Power v. Comm**., which statement correctly describes the issues surrounding the taxpayer's ability or lack thereof to prove NOLs and S corporation stock basis carried forward from previous years? **(Page 26)**

   a) Correct – The taxpayer believed that his tax returns were sufficient to prove the existence of his NOLs, but the Tax Court stated that they needed to see his backup documentation, including invoices, receipts, etc., from the loss years.
   b) Incorrect – The court did not support the taxpayer's use of the ***Cohan*** rule and noted that some documentation was required in order to appropriately estimate any deduction.
   c) Incorrect – The Tax Court held that the taxpayer was required to prove not only that the NOLs existed, but also that they had not already been applied in another year.
   d) Incorrect – Although tax preparers may purge their documents after the SOL has run, this case demonstrates why records should be maintained for all years.

10. Factors involving the use of an IRC §754 election include which of the following? **(Page 33)**

    a) Incorrect – The election must apply to both transfers and distributions.
    b) Correct – This is true under Treas. Regs. §301.9100-2.
    c) Incorrect – It is a partnership election, which applies to the year of election and all future transfers. It can only be revoked with permission from the IRS.
    d) Incorrect – Permission from the IRS is required for the revocation for a valid reason. Avoiding a negative adjustment is not considered a valid reason, although change in the nature of the business or change in assets, whether in amount or character, would be considered a legitimate excuse.

11. Which of the following statements is accurate as it pertains to partnerships and recourse/nonrecourse debt? **(Pages 35-36)**

    a) Incorrect – This is true of nonrecourse debt. Recourse debt is allocated to the partner who has the risk of loss for the specific debt.
    b) Incorrect – A partner guarantee is considered when determining whether a debt is nonrecourse or recourse. Typically, a partner guarantee on nonrecourse debt will make that debt recourse to the partner making the guarantee.
    c) Incorrect – If property or money is contributed, basis is the amount of the money or the adjusted basis of the property to the contributing partner plus any gain recognized by the partner on the contribution.
    d) Correct – Any share of loss is allowed only up to the adjusted basis of the partner's interest in the partnership on the last day of the partnership year.

12. What do multiple private letter rulings issued by the IRS reveal about their position on disproportionate distributions and S elections? **(Page 37)**

    a) Incorrect – The Tax Code instead requires that an S corporation can only have one class of stock.
    b) Incorrect – The IRS does not look at whether disproportionate distributions have taken place but rather will look to the corporation's governing documents and agreements to see whether they grant the same distribution and liquidation rights.
    c) Incorrect – Differences in voting rights are disregarded.
    d) Correct – In cases where shareholders don't receive their proportionate share of distributions, the courts have generally ruled that the corporation can make corrective distributions in order to maintain the S election.

RETIREMENT ISSUES

RETIREMENT ACCOUNTS

60-DAY ROLLOVERS

Using rollover funds for personal purposes or as short-term loan

Partial waiver for funds that were not used to pay personal expenses

The 60-day rollover waiver was partially denied to a taxpayer who used the funds to pay personal expenses. (PLR 201634024) For discussion purposes, we will simplify the facts of the PLR. The taxpayer received a distribution from his IRA of $90 ($100 total distribution, less $10 withholding). The taxpayer failed to deposit the $90 into another qualified plan within 60 days because he experienced two deaths in his family, he failed to receive notice pursuant to IRC §402(f) notifying the taxpayer of his rollover rights, and the taxpayer relocated his family to a new community.

An amount actually distributed to a taxpayer from a qualified retirement account described in IRC §401(a) which is exempt from tax under IRC §501(a) shall be taxable to the taxpayer in the taxable year in which it is distributed. (IRC §402(a)(1))

Generally, if any portion of an eligible rollover distribution from a qualified plan is paid to the taxpayer and the taxpayer transfers any portion of the property received in such distribution to an eligible retirement plan, and in the case of a distribution of property other than money, the amount so transferred consists of the property distributed, such distribution (to the extent so transferred) shall not be included in gross income for the taxable year in which paid. (IRC §402(c)(1))

IRC §402(c)(1) shall not apply to any transfer of a distribution made after the 60th day following the day on which the taxpayer received the property distributed. (IRC §402(c)(3)(A)) The IRS may waive the 60-day requirement where the failure to waive such requirement would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the taxpayer subject to such requirement. (IRC §402(c)(3)(B))

Revenue Procedure 2003-16 provides that in determining whether to grant a waiver of the 60-day rollover requirement pursuant to IRC §402(c)(3)(B), the IRS will consider all relevant facts and circumstances, including:

- Errors committed by a financial institution;
- Inability to complete a rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country, or postal error;
- The use of the amount distributed (for example, in the case of payment by check, whether the check was cashed); and
- The time elapsed since the distribution occurred.

The taxpayer had used $50 to pay for personal expenses and therefore that portion of the distribution was not available for rollover treatment. Based on the information and documentation submitted by the taxpayer, he asserted that his failure to accomplish the rollover of $40 of the distribution within the 60-day period was due to two deaths in the family, failure to receive proper notice, and relocating his family to a new community. Therefore, the IRS waived the 60-day rollover requirement only for $40 of the total distribution of $100.

No waiver of 60-day rollover requirement when funds used as short-term loan

The IRS refused to waive the 60-day rollover requirement for a taxpayer who used her IRA distribution as a short-term source of funds pending the sale of her vacation home. (PLR 201625022)

The taxpayer's daughter's home was in foreclosure, so the taxpayer put her vacation home up for sale in order to raise funds to purchase her daughter's home. Prior to the sale of the vacation home, in order to avert foreclosure, the taxpayer took a distribution from her IRA. The distribution was used to purchase her daughter's home.

The taxpayer intended to redeposit the distributed amount into her IRA within the 60-day rollover period. However, the sale of the vacation home was not completed until after the 60-day period. The taxpayer indicated that her spouse was willing to take distribution from his IRA within the 60-day period to complete the rollover but that her medical condition prevented this from occurring. She attempted to complete the rollover once she received the funds from selling the vacation home, but the 60-day period had expired.

The IRS found that the documentation and materials submitted by the taxpayer did not demonstrate that her failure to complete a timely rollover was due to any of the factors enumerated in Rev. Proc. 2003-16. Although the taxpayer represented that her inability to complete a timely rollover was caused by her medical condition during the 60-day period, the IRS was not convinced given her continued work and travels. The IRS found that her failure to complete a timely rollover was instead due to her use of the funds as a short-term loan to purchase her daughter's home, which left her unable to recontribute the amount to her IRA until after the sale of her vacation home was completed.

PROS AND CONS OF NAMING A TRUST AS AN IRA BENEFICIARY

Naming a trust as an IRA beneficiary can be a very effective estate planning tool. This tool is most commonly used to allow the grantor to maintain control of the IRA assets post-death, especially when young children are involved. However, it is important to address the requirements for naming the trust as an IRA beneficiary, as well as the pros and cons of the decision.

If the trust is not a "designated beneficiary," the IRA distributions will be accelerated, and the tax paid on the distributions will be much higher than necessary.

Designated beneficiaries

A participant in a retirement account may name an individual, trust, estate, or any other person as a beneficiary to receive the account balance on his or her death. Generally, however, only an individual may be a "designated beneficiary." (Treas. Regs. §1.401(a)(9)-4)

If someone other than an individual (or a trust that meets the criteria listed below) is named as a beneficiary, the IRA owner will be treated as if he has no designated beneficiary for purposes of the required minimum distribution (RMD) rules. If the IRA owner dies before required distributions begin, and his beneficiary is not an individual (or a qualifying trust), distribution of his remaining benefits must be made under the five-year rule, eliminating the opportunity for any further tax deferral.

This means that a trust itself usually can't be a designated beneficiary even though it is named as a beneficiary. However, if the proper requirements are met, the beneficiaries of a trust that has been named as a beneficiary of an IRA will be treated as designated beneficiaries. They may defer the taxability of their distribution in exactly the same manner as if they were named individually.

The requirements

The requirements are as follows:

- The trust must be a valid trust under state law;
- The trust must be irrevocable, or will, by its terms, become irrevocable upon the death of the IRA owner;
- The beneficiaries of the trust can be identified; and
- The required documentation is filed with the IRA trustee, custodian, or issuer. (Treas. Regs. §§1.401(a)(9)-4, 1.408-8)

If a trust's beneficiaries are treated as the IRA owner's designated beneficiary, then the oldest beneficiary's life expectancy is used to figure RMDs. The separate account rules aren't available to the trust beneficiaries, so distributions will always be based on the oldest beneficiary's life expectancy. (Treas. Regs. §1.401(a)(9)-4, Q&A 5(c))

RMDs before death

If an IRA owner designates his trust as the beneficiary of his IRA, and his spouse is the sole beneficiary of that trust, to meet the documentation requirement he must provide the IRA trustee, custodian, or issuer with:

- A copy of the trust instrument and an agreement to provide copies of any amendments within a reasonable time; or
- All of the following:
  - A list of all of the beneficiaries of the trust (including contingent and remainder beneficiaries, with a description of the conditions on their entitlement sufficient to establish that the spouse is the sole beneficiary);
  - Certification that the list is correct and complete, and that the requirements of Treas. Regs. §1.401(a)(9)-4, Q&A 5(b)(1), (2), and (3) are satisfied;
  - An agreement to provide corrected certifications if an amendment changes any information; and
  - An agreement to provide a copy of the trust instrument on demand.

(Treas. Regs. §1.401(a)(9)-4, Q&A 6(a))

RMDs after death

The documentation requirement is met for RMDs after the IRA owner's death if, by October 31 of the year following the year of his death, the trustee of the trust provides the IRA trustee, custodian, or issuer with either:

- A final list of all beneficiaries of the trust (including contingent and remainder beneficiaries, with a description of the conditions on their entitlement) as of September 30 of the year following the year of the IRA owner's death, certifying that, to the best of his knowledge, this list is correct and complete and that the requirements of Treas. Regs. §1.401(a)(9)-4, Q&A 5(b)(1), (2), and (3) are satisfied; and an agreement to provide a copy of the trust instrument on demand; or
- A copy of the actual trust document for the trust that is named as a beneficiary of the IRA owner under the plan as of the IRA owner's date of death.

Pros and cons of naming trusts as IRA beneficiaries

Pros

- The trustee can control the age of distribution to the beneficiaries, which is especially important with minor children, young adults, or spendthrift heirs;
- The trust can designate that funds are to be used for a specific purpose, such as financing the beneficiary's education;
- The trust can define where any beneficiary's share will go if the beneficiary dies before receiving the entire share;
- Keeping a beneficiary's share in the trust will preserve its status as the beneficiary's sole and separate property so that it will not be a community property asset in any future divorce proceedings;
- Keeping a beneficiary's share in the trust can protect it from creditors or help to preserve the beneficiary's need-based benefits; and
- The IRA assets may be used to solve the problem of the underfunded bypass trust.

Cons

- If any of the listed requirements are not met, the trust will not be treated as a designated beneficiary, and the taxes on the IRA assets will be accelerated. Unfortunately, these problems are often not discovered until after the death of the IRA owner, which means it is generally too late to fix the problem;
- Laws are constantly changing, and these changes may affect trust provisions. As a result, the trust must be continually monitored to ensure that it complies with all requirements;
- If one beneficiary, or contingent beneficiary, does not qualify as a designated beneficiary, then the entire IRA must be distributed within five years of death; and
- Only the age of the oldest living beneficiary will be used to determine life expectancy for RMD purposes. So, if an older person is named as a beneficiary of the trust, the IRA could be depleted rapidly.

IRC §1035 EXCHANGES

Background

Amounts received under an annuity contract, but not as an annuity, generally are included in gross income to the extent allocable to income under the contract. (IRC §72(e)) That is, they are taxed on an income-first basis. This rule applies to any amounts received on the complete surrender, redemption, or maturity of an annuity contract. (IRC §72(e)(5)(E))

No gain or loss is recognized on the exchange of an annuity contract for another annuity contract. (IRC §1035(a)(3)) The legislative history makes it clear that IRC §1035 was intended to provide nonrecognition treatment for taxpayers who have merely exchanged an annuity contract for another better suited to their needs and who have not actually realized gain. For nonrecognition treatment to apply, the contracts exchanged must relate to the same insured, and the obligee under the contract received in the exchange must be the same as that under the original contract. (Treas. Regs. §1.1035-1))

In the past, the IRS has ruled that under IRC §1035, no gain or loss is recognized where a taxpayer who owned a life insurance contract issued by one insurance company assigned the contract, before its maturity, to a second insurance company in exchange for a variable annuity contract issued by the second company. (Rev. Rul. 75-358) Similarly, the IRS has ruled that an individual's assignment of an annuity contract issued by one insurance company to a second insurance company, which then deposits the cash surrender value of the assigned contract into a pre-existing annuity contract owned by the same taxpayer, qualified as a tax-free exchange under IRC §1035. (Rev. Rul. 2002-2, 2002-75) However, there was no tax-free exchange where one insurance company disbursed a check representing a surrender of an old nonqualified annuity policy to a taxpayer who, in turn, endorsed the check to a second insurance company as consideration for a new nonqualified insurance contract. (Rev. Rul. 2007-24)

Lump sum distribution from inherited annuity used to buy replacement annuity

A taxpayer sought a private letter ruling from the IRS on a lump sum distribution from an annuity he inherited from his father. (PLR 201625001) The taxpayer thought he filled out a bank's form for an exchange under IRC §1035 and mistakenly signed a "Lump Sum Payment" form for his inherited annuity. When the taxpayer received the lump sum, he deposited it into his checking account. Later, the taxpayer signed an application for annuity with another company and used, in part, the funds that he received in the lump sum payment.

The IRS ruled based on their previous ruling on a similar issue in Rev. Rul. 2007-24, that proceeds from the receipt of a check from a life insurance company under a nonqualified annuity contract followed by endorsement of the check to a second company for a second annuity contract didn't qualify as a §1035 exchange because there was no actual exchange of contracts, the taxpayer didn't assign the first contract to the second company, and the cash value wasn't directly transferred from the first company to the second company.

ESTATE AND GIFT ISSUES

ESTATES

ASSETS TRANSFERRED DURING LIFE SUBJECT TO ESTATE TAX

Family limited partnership transactions are subject to heightened scrutiny

The decedent was married in 1946, and her husband passed away in 1999. At the time of the husband's death, the couple had amassed a sizeable estate. The husband's will directed that his assets be placed in three trusts. The income from two of the three trusts was payable to the decedent on a regular basis, and the principal from all three could be used for her benefit. The decedent also had considerable assets of her own. (***Estate of Holliday v. Comm.***, TCM 2016-51)

In 2003, the decedent moved into a nursing home and granted her two sons a power of attorney to care for her medical and financial needs. The decedent created a limited partnership on November 30, 2006. The purpose of the limited partnership, according to the limited partnership agreement, was to provide a means for members of the decedent's family to acquire interests in the partnership business and property, and to ensure that the partnership's business and property was continued by and closely held by members of the decedent's family. The partnership agreement also provided that limited partners did not have the right or power to participate in the partnership's business, affairs, or operations.

On the same day, November 30, 2006, the decedent executed articles of organization for a limited liability company. The decedent was the sole member of the limited liability company at its inception. The limited liability company was created for the primary purpose of being the general partner in the family limited partnership.

On December 6, 2006, the family limited partnership was funded with marketable securities transferred from the decedent's account. A portion of the contribution was made on behalf of the single-member limited liability company. The gross value of the family limited partnership's assets without discount or adjustment on December 6, 2006, was just shy of $6 million. This was the only capital contribution made to the family limited partnership. In consideration for her contribution, the decedent received a 99.9% interest in the family limited partnership, and the single-member limited liability company received a 0.1% interest in the family limited partnership.

Also on December 6, 2006, the decedent assigned her interest in the limited liability company to her sons in exchange for $3,000 from each. The aggregate price paid by the decedent's sons equaled the gross value of 0.1% of the family limited partnership's assets, without discount or adjustment. The decedent's sons' purchase of the limited liability interests created the appearance that the decedent had no control over the assets she transferred to the family limited partnership.

Lastly, on December 6, 2006, the decedent gave 10% of her family limited partnership interest to a newly created irrevocable trust. The following table summarizes the ownership interests in the family limited partnership as of December 6, 2006:

Ownership Interests		
Owner	**Interest**	**Partner Type**
Decedent	89.9%	Limited partner
Irrevocable Trust	10.0%	Limited partner
LLC (owned by sons)	0.1%	General Partner

At all relevant times, the family limited partnership's assets consisted solely of investment assets. The decedent held substantial assets that she did not transfer to the family limited partnership. The decedent was not involved in deciding how her assets would be held. The decedent died on January 7, 2009. On July 7, 2009, the alternative valuation date, the fair market value of all of the assets owned by the family limited partnership was just over $4 million. The value of the decedent's interest in the family limited partnership was reported on Schedule F, Other Miscellaneous Property, of her estate tax return as $2.4 million as a result of discounts that were applied to her 89.9% limited partnership interest. The IRS issued a notice of deficiency determining a $785,000 deficiency in estate tax. The IRS argued that the entire $6 million the decedent transferred to the partnership should be included in her gross estate.

Background

A decedent's gross estate includes the value of all property transferred by a decedent during her life for which she retains the possession or enjoyment of, or the right to the income from, for her life. (IRC §2036(a)) This rule does not apply in cases where the transfer was a bona fide sale for adequate and full consideration. (IRC §2036(a)) Section 2036 applies if the following three conditions are met:

- The decedent made an *inter vivos* transfer of property (a transfer during life);
- The decedent retained an interest or right enumerated in IRC §2036(a)(1) or (2) or (b) in the transferred property, which the decedent did not relinquish before her death; and
- The decedent's transfer was not a bona fide sale for adequate and full consideration. (***Estate of Bongard v. Comm.***, 124 TC 112; ***Estate of Jorgensen v. Comm.***, TCM 2009-66)

Both the estate and the IRS agreed that a transfer during the decedent's life took place, so the first requirement was met without discussion.

Retaining possession or enjoyment

An interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express or implied, that the interest or right would later be conferred. (Treas. Regs. §20.2036-1(c)(1)(i)) This principle applies even if the retained right is not legally enforceable. (***Estate of Reichardt v. Comm.***, 114 TC 144) In determining whether an implied agreement exists, the courts consider all the facts and circumstances surrounding the transfer and the property's use after the transfer. (***Estate of Reichardt v. Comm.***, 114 TC 144)

The decedent transferred securities from her account to an account in the family limited partnership's name. After the dust settled, the decedent only held a limited partnership interest in the family limited partnership and did not hold any interest in the limited liability company. The court found persuasive one of the decedent's son's testimony where he stated that the limited partnership did not make any distributions, but they weren't necessary because [none of the partners] needed them. The court stated that the son's testimony made it clear that had the decedent required a distribution, one would have been made. Based on the facts and circumstances, the court held the second requirement of IRC §2036(a) was met.

***Bona fide* sale for adequate and full consideration**

Section 2036(a) permits intrafamily transfers, but they are subject to heightened scrutiny. (***Estate of Bigelow v. Comm.*** (2007) 503 F.3d 955; ***Kimball v. U.S.*** (2004) 371 F.3d 257; ***Estate of Jorgensen v. Comm.***, TCM 2009-66) In the context of a family limited partnership, the record must establish a legitimate and significant nontax reason for creating the family limited partnership, and that the transferors received partnership interests proportionate to the value of the property transferred. The objective evidence must indicate that the nontax reason was a significant factor that motivated the partnership's creation. A significant purpose must be an actual motivation, not a theoretical justification. (***Estate of Bongard v. Comm.***, 124 TC 118)

The decedent's estate argued that there were three significant nontax business purposes to create the family limited partnership: first, to protect the assets from "trial attorney extortion"; second, to protect the assets from the "undue influence of caregivers"; and third, to preserve the assets for the benefit of the decedent's heirs. The court rejected all three arguments because they were merely theoretical justifications. The court also held that numerous other factors indicated that the transfer of money to the family limited partnership was not a bona fide sale, including the fact that the decedent made the only contribution to the family limited partnership, but held only 89.9% interest immediately after the entity creation shuffling. Also, the fact that the family limited partnership did not maintain any books and records other than brokerage statements and that there were no formal meetings of the partners contributed to the court's decision.

Practitioner takeaway

Practitioners, especially those with high net worth clients, often see similar entity structures using family limited partnerships, limited liability companies, and trusts. The problem the decedent's estate faced in ***Estate of Holliday*** was that they created business entities for the sole purpose of shuffling assets. The court's decision likely would have been different if the family limited partnership engaged in some sort of business activity, such as real estate investment.

NEW GUIDANCE ON QTIP ELECTIONS

A qualified terminable interest property (QTIP) election can have the benefit of reducing a decedent's taxable estate and increasing the deceased spouse's unused exclusion (DSUE) available to the surviving spouse. For this reason, the executor of a decedent's estate may want to make a QTIP election regardless of whether the election is necessary to reduce the estate tax to zero.

Since the enactment of the portability provisions, some practitioners have been concerned about the effect of Rev. Proc. 2001-38 on nontaxable estates wishing to make QTIP elections.

Rev. Proc. 2001-38 allowed the IRS to treat QTIP elections as null and void for estate and transfer tax purposes if the election was not necessary to reduce estate tax liability. Would the IRS recognize the election for what would otherwise be an unnecessary QTIP election to maximize the DSUE?

Rev. Proc. 2016-49 clarifies that the executor can use the QTIP election to maximize the unused exclusion amount. It also provides procedures to continue to disregard unnecessary QTIP elections, which was the original purpose of Rev. Proc. 2001-38.

Deceased spouse's unused exclusion

The American Taxpayer Relief Act of 2012 (ATRA '12) made permanent the portability of the DSUE for deaths after December 31, 2010. (IRC §2010(c)) This provision allows a surviving spouse to use the unused estate tax exclusion of his or her predeceased spouse by electing to carry it forward for the surviving spouse's benefit.

The DSUE is the lesser of:

- The basic exclusion amount effective in the year of death ($5,450,000 in 2016); or
- The excess of the decedent's applicable exclusion amount, over the sum of the amount of the taxable estate and the amount of the adjusted taxable gifts of the decedent.

Why use the QTIP?

QTIP trusts provide all the income to the surviving spouse but allow the decedent to designate who inherits the property after the death of the surviving spouse. Assets in a QTIP trust qualify for the estate tax marital deduction and get a step-up in basis at the death of the surviving spouse.

Prior to the portability provisions, many estates used the QTIP trusts to provide for a surviving spouse, while maximizing the estate tax exclusion at the death of the first spouse.

Portability eliminates the needs for the QTIP to avoid estate tax in many situations, but passing the assets outright to the surviving spouse allows the survivor to designate the beneficiaries when the surviving spouse dies. This removes protection for the children of a prior marriage and is contrary to the wishes of most first spouses, as the first spouse usually wants to control the disposition.

The QTIP continues to be beneficial for controlling assets after the death of the second spouse and allows the added benefit of maintaining the DSUE.

Example of using a QTIP trust

Frank and Betty are married. Frank has two children from a prior marriage. The couple has assets of approximately $8 million: $3 million are his separate property, and $5 million are community property assets.

That means that Frank's total estate is approximately $5.5 million.

Frank's separate assets	$3,000,000
Frank's half of the community assets	2,500,000
Frank's total estate	$5,500,000

Because of the portability provisions and the DSUE, even if all of Frank's assets went to Betty, she would not be subject to estate tax at her death (assuming she did not increase the estate). Their total estate is less than $10,900,000, which is the combined exclusion amount for a couple in 2016.

However, if all of the assets are passed directly to Betty, there is no guarantee that any of them will be passed to Frank's children at Betty's death.

Under their estate plan, if Frank predeceases Betty, $3 million will go into a QTIP trust. Betty will receive income from the trust for her life (and principal if necessary), and after her death the assets will go to Frank's children. The remaining $2.5 million will pass to Betty outright, so the estate tax marital deduction will apply to all of the assets in his estate, and the entire DSUE ($5,450,000 in 2016) will be preserved for Betty to use at her death.

WORKER CLASSIFICATION

WORKER CLASSIFICATION — IT'S NOT A CHOICE YOU MAKE

For many businesses, one of the most expensive mistakes they can make is incorrectly classifying a worker as an independent contractor rather than an employee. And this mistake can not only be costly for the business, but for their tax or payroll preparers as well. Paid persons who inappropriately "advise" a client regarding worker classifications can be subject to severe penalties themselves. So it is important you protect yourself.

If the employer does not have the right of direction and control, the worker will generally be an independent contractor. However, this notion of "control" applies to the way the worker performs the job — that is, the fact that the employer merely requests that a certain job be completed is not typically enough control to create an employer–employee relationship. (See Treas. Regs. §31.3121(d)-(1)(c)(2)) The employer would have to have control over the method of the worker in accomplishing the task for the control test to be met.

COSTS OF MISCLASSIFICATION

A worker classified as an employee is subject to various payroll taxes, minimum wage, overtime, and worker protection programs. In contrast, the responsibilities for a business that hires an independent contractor are minimal. The business is not required to file or pay payroll taxes or workers' compensation insurance (although the independent contractor must pay self-employment taxes and should carry liability insurance).

How income is reported for both independent contractors and employees is outlined in the chart below titled "Employee types and reporting requirements." A worker who is classified as an independent contractor can potentially save a business a lot of money … that is, if the worker is actually an independent contractor. A worker who is erroneously classified as an independent contractor can actually cost an employer a lot more money because as illustrated in the chart below, the employer becomes responsible for the worker's share of the payroll taxes and will be subject to severe penalties as well.

In addition to the tax cost, the company/employer may also be subject to retroactive payment of:

- Workers' compensation premiums;
- Medical insurance and resulting federal tax penalties for failure to provide coverage;
- Stock options and other pension benefits;
- Reimbursement of expenses normally reimbursed to employees;
- Other benefit programs such as paid vacation, sick leave, and medical reimbursement plans.

Employer's Cost Comparison for Erroneously Classifying Worker (Does Not Address Penalties)			
One worker, earning $20,000 for one year (Tax Year 2013)	**Employer A (Correctly classifies worker as employee)**	**Employer B (Misclassifies worker as independent contractor and files 1099)**	**Employer C (Misclassifies worker as independent contractor and does not file 1099)**
Social Security Taxes (6.2%)	$1,240	$1,488	$1,736
Medicare taxes (1.45%)	$290	$348	$406
Federal income tax withholding	Withheld from employees	$300	$600
Unemployment Insurance (UI) (3.4%)	$238	$238	$238
Employment Training Tax (ETT) (0.1%)	$7	$7	$7
State Disability Insurance (SDI) (1.0%)	Withheld from employee	$200	$200
California Personal Income Tax Withholding (PIT) (6.0%)	Withheld from employee	$1,200	$1,200
Total due for one year	**$1,775**	**$3,781**	**$4,387**

COMMON MISPERCEPTIONS REGARDING INDEPENDENT CONTRACTORS

The chart above is an important chart to share with a client when they insist that their worker is an independent contractor!

How many times have we heard clients say, this worker is not an employee because:

- The worker signed an independent contractor agreement;
- I paid the worker less than $600 per year;
- The worker only comes in to help out on an "as-needed" basis;
- I don't tell the worker how to do the work; and/or
- The worker has his or her own business license.

None of the reasons above in and of themselves establish an independent contractor relationship. There are specific tests that must be considered to determine whether a worker is an employee or an independent contractor, the most familiar one being the "right of control" test.

DIFFERENT TESTS FOR DIFFERENT LAWS/PROGRAMS

To make matters even more confusing, different governmental agencies use different tests to determine whether a worker is an employee or an independent contractor. So it might be possible to be considered an employee under one test for one agency (e.g., Department of Labor's wage and hour requirements), and be an independent contractor for another agency (e.g., EDD payroll withholding).

The following chart lists the primary agencies and the tests they use.

Agencies Responsible for Monitoring Worker Classification			
Agency	**Compliance oversight for**	**Employee test used**	**Governing statutes/ regulations**
Internal Revenue Service	Federal payroll taxes (FICA, FUTA, and withholding) and submissions of W-2s for employees and 1099s for independent contractors	Common law test, focused on "right to control." Historically relied on 20-factor test, but recently shifted to three-part behavioral analysis	IRC §§3121(d)(2), 3306(i); Treas. Regs. §31.3401(c)-1; Rev. Rul. 87-41; IRS Pub. 15-A, Employer's Supplemental Guide
U.S. Department of Labor	Oversees employer compliance with minimum wage and overtime requirements, child labor laws, etc.	Economic realities test (very expansive)	U.S. Fair Labor Standards Act (29 USC §201 et seq.); Administrator's Interpretation No. 2015-1
EDD	California personal income tax withholding, UI, SDI, ETT	Common law test focused on "right to control." Similar, but not identical, to IRS test	UIC §621 et seq.
California Department of Industrial Relations	California wages, hours and breaks, overtime, workplace safety, workers' comp., etc.	Economic realities test (similar to DOL's standard)	Labor Code §2750.5

Statutory and nonstatutory employees

Even if a worker would be considered an employee or independent contractor under the various tests outlined above, federal or state statutes might dictate a different result. A "statutory employee" is someone who is an independent contractor but who, by law, is treated as an employee. Conversely, a "nonstatutory employee" is a person who would be treated as an employee under the common law tests, but who, by law, is treated as an independent contractor.

REPORTING REQUIREMENTS

How a worker is classified dictates how wages and items of income are reported by both the employer and the worker. The following chart summarizes these reporting requirements.

Employee Types and Reporting Requirements				
	Common law employee	**Independent contractor**	**Statutory employee**	**Statutory nonemployee**
Employer reports wages on	W-2	1099-MISC	W-2 with "statutory employee" box checked	1099-MISC
Worker reports wages on	1040	Schedule C	Schedule C	Schedule C
Worker reports expenses on	Schedule A	Schedule C	Schedule C	Schedule C
Limitation on expenses	2% of AGI	None	None	None
Employment tax withholding	Yes	No	Yes	No
PIT withholding	Yes	No	No	No

COMMON LAW RULES FROM IRS

IRS'S 20-FACTOR TEST

In 1987, based on an examination of cases and rulings, the IRS developed a list of 20 factors that may be examined in determining whether an employer–employee relationship exists. (Rev. Rul. 87-41) The degree of importance of each factor varies depending on the occupation and the factual context in which the services are performed; factors other than the listed 20 factors may also be relevant. The 20 factors identified by the IRS are as follows:

1. Instructions
2. Training
3. Integration
4. Services rendered personally
5. Hiring, supervision, and paying assistants
6. Continuing relationship
7. Set hours of work
8. Full time required
9. Doing work on employer's premises
10. Order or sequence test
11. Oral or written reports
12. Payment by the hour, week, or month
13. Payment of business and/or traveling expenses
14. Furnishing tools and materials
15. Significant investment
16. Realization of profit or loss
17. Working for more than one firm at a time
18. Making service available to the general public
19. Right to discharge
20. Right to terminate

The IRS emphasizes that factors in addition to the 20 factors identified in 1987 may be relevant, that the weight of the factors may vary based on the circumstances, that relevant factors may change over time, and that all facts must be examined.

Three categories regarding control

More recently, the IRS has identified three categories of evidence that may be relevant in determining whether the requisite control exists under the common law test. The 20 factors are grouped under these three categories:

1. Behavioral control;
2. Financial control; and
3. Relationship of the parties.
   (Department of the Treasury; Internal Revenue Service. Independent Contractor or Employee? Training Materials)

The IRS shifted away from the 20-factor analysis because many of those factors are no longer as relevant as they once were.

Behavioral control

The central issue here is whether the company controls or has the right to control what the worker does and how the worker does his or her job.

Behavioral control refers to facts that show whether there is a right to direct or control how the worker does the work. A worker is an employee when the business has the right to direct and control the worker. The business does not have to actually direct or control the way the work is done — as long as the employer has the right to direct and control the work.

The behavioral control factors fall into the categories of:

- Type of instructions given;
- Degree of instruction;
- Evaluation system; and
- Training.

Types of instructions given

An employee is generally subject to the business's instructions about when, where, and how to work. All of the following are examples of types of instructions about how to do work:

- When and where to do the work;
- What tools or equipment to use;
- What workers to hire or to assist with the work;
- Where to purchase supplies and services;
- What work must be performed by a specified individual; and
- What order or sequence to follow when performing the work.

Degree of instruction

Degree of instruction means that the more detailed the instructions, the more control the business exercises over the worker. More detailed instructions indicate that the worker is an employee. Less detailed instructions reflects less control, indicating that the worker is more likely an independent contractor.

Note: The amount of instruction needed varies among different jobs. Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work results are achieved. A business may lack the knowledge to instruct some highly specialized professionals; in other cases, the task may require little or no instruction. The key consideration is whether the business has retained the right to control the details of a worker's performance or instead has given up that right.

Evaluation system

If an evaluation system measures the details of how the work is performed, then these factors would point to an employee.

If the evaluation system measures just the end result, then this can point to either an independent contractor or an employee.

Training

If the business provides the worker with training on how to do the job, this indicates that the business wants the job done in a particular way. This is strong evidence that the worker is an employee. Periodic or on-going training about procedures and methods is even stronger evidence of an employer-employee relationship. However, independent contractors ordinarily use their own methods.

Financial control

Financial control refers to facts that show whether or not the business has the right to control the economic aspects of the worker's job.

The financial control factors fall into the categories of:

- Significant investment;
- Unreimbursed expenses;
- Opportunity for profit or loss;
- Services available to the market; and
- Method of payment.

Significant investment

An independent contractor often has a significant investment in the equipment he or she uses in working for someone else. However, in many occupations, such as construction, workers spend thousands of dollars on the tools and equipment they use and are still considered to be employees. There are no precise dollar limits that must be met in order to have a significant investment. Furthermore, a significant investment is not necessary for independent contractor status as some types of work simply do not require large expenditures.

Unreimbursed expenses

Independent contractors are more likely to have unreimbursed expenses than are employees. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are especially important. However, employees may also incur unreimbursed expenses in connection with the services that they perform for their business.

Opportunity for profit or loss

The opportunity to make a profit or loss is another important factor. If a worker has a significant investment in the tools and equipment used and if the worker has unreimbursed expenses, the worker has a greater opportunity to lose money (i.e., their expenses will exceed their income from the work). Having the possibility of incurring a loss indicates that the worker is an independent contractor.

Services available to the market

An independent contractor is generally free to seek out business opportunities. Independent contractors often advertise, maintain a visible business location, and are available to work in the relevant market.

Method of payment

An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time. This usually indicates that a worker is an employee, even when the wage or salary is supplemented by a commission. An independent contractor is usually paid by a flat fee for the job. However, it is common in some professions, such as law, to pay independent contractors hourly.

Type of relationship

Type of relationship refers to facts that show how the worker and business perceive their relationship to each other.

The factors, for the type of relationship between two parties, generally fall into the categories of:

- Written contracts;
- Employee benefits;
- Permanency of the relationship; and
- Services provided as key activity of the business.

Written contracts

Although a contract may state that the worker is an employee or an independent contractor, this is not sufficient to determine the worker's status. The IRS is not required to follow a contract stating that the worker is an independent contractor, responsible for paying his or her own self-employment tax. How the parties work together determines whether the worker is an employee or an independent contractor.

Employee benefits

Employee benefits include things like insurance, pension plans, paid vacation, sick days, and disability insurance. Businesses generally do not grant these benefits to independent contractors. However, the lack of these types of benefits does not necessarily mean the worker is an independent contractor.

Permanency of the relationship

If you hire a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence that the intent was to create an employer-employee relationship.

Services provided as key activity of the business

If a worker provides services that are a key aspect of the business, it is more likely that the business will have the right to direct and control his or her activities. For example, if a law firm hires an attorney, it is likely that it will present the attorney's work as its own and would have the right to control or direct that work. This would indicate an employer-employee relationship.

Form SS-8

If after applying the various standards above it is still unclear how a worker should be classified, either the employer or the worker may submit a Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, to the IRS for an official determination of the worker's status.

It can take up to six months to get a determination, but a business that continually hires the same types of workers to perform particular services should definitely consider filing Form SS-8.

The form can be found at:

💻 **Website**
www.irs.gov/pub/irs-pdf/fss8.pdf

Common Law Factors to Consider		
Factors	**Evidence of employer/employee relationship**	**Evidence of independent contractor status**
Instruction/training	• Requires worker to comply with company procedure manuals or dictates to worker: o When and where to work; o What tools or equipment to use; o What workers to hire or to assist with the work; o Where to purchase supplies and services; o What work must be performed by a specified individual; and o What order or sequence to follow when performing the work	Simply states the end product that the business requires
Services provided as key activity of the business	Work that is a necessary part of the regular trade or business is normally done by employees	Work that is not normally performed by the business is more likely an independent contractor business (e.g., plumber hired to fix leaks)
		(continued)

Common Law Factors to Consider (continued)		
Factors	**Evidence of employer/employee relationship**	**Evidence of independent contractor status**
Worker has separately established business	Works primarily for one business. Reviews staffing with "client"	Worker holds herself out to the general public as available to perform similar services. Evidence indicating separate business includes: • Advertising; • Maintaining a visible business location; and • Hires/fires and supervises employees without advice or consent
Opportunity for profit or loss	If the worker's discretion is limited to which hours or how many hours, more likely considered an employee	Has ability to make decisions that impact his/her ability to profit or suffer loss. Must involve real economic loss, not just the risk of not getting paid (e.g., acquisition/use/disposition of equipment; advertising expenses; priority of assignments, etc.)
Significant investment/provision of necessary tools, equipment and supplies	Business provides all equipment and tools required	Significant investment in equipment, tools, and trades might be an indication of independent contractor status, although many types of work do not require significant investments, and in certain types of industries, employees frequently provide their own equipment (e.g., construction trades)
Training	Training of skilled or semi-skilled workers indicates an employer/employee relationship	Independent contractors use their own methods to complete the work
Method of payment	Usually, if paid a fixed salary, hourly wage, piece-rate, or commission, worker is considered an employee	If paid by the "job," indicates independent contractor

Example of employee classification

An accounting firm contracts with CPAs to provide temporary help during the tax season. The firm provides office space and computers and provides the software for the accountants to use. The temporary accountants meet with clients and prepare the returns. However, the firm's managing partner reviews all returns before they are processed. The accountants are paid on a per-return basis.

The temporary CPAs would be considered employees because the firm provides the equipment, the clients, and sets the deadlines to be followed. The work performed is also in the same line of business as the accounting firm.

However if the firm hires an attorney to provide guidance on compliance with various employer/employee issues for the firm, the attorney would be most likely classified as an independent contractor. The attorney is not in the same line of business, the compensation is paid based on the job and not on an hourly basis, and other than setting the parameters of the issues the firm would like researched and the deadline they would like the work completed by, the firm provides no other oversight or control.

An attorney or other tax professional who has their own practice but does subcontract work out of their own office on projects that are not part of the firm's day-to-day business could qualify. For example, a tax firm that does no audit representation uses the services of another tax professional to assist in work the firm is not equipped to do would likely be an independent contractor.

Common law factors examined by the Tax Court

The Tax Court uses the following common law factors as a guide to determine worker status. (***Jones et ux. v. Comm.***, TCM 2014-125) No one factor dictates the outcome, but the "degree of control" factor weighs heavily:

- Degree of control exercised by the employer;
- Which party has an investment in the facilities used by the worker;
- Whether there is opportunity for profit or loss for the worker;
- Employer's right to discharge;
- Whether the work performed is part of the employer's regular business;
- Permanency of the relationship; and
- The relationship the parties believed they were creating.

✐ Practice Pointer

A worker can be an employee and an independent contractor for a single employer at one time under separate agreements.

In instances where an individual provides services in two separate roles to the same business, the IRS examines separately the relationship between the worker and the business for each performance of services. Just as with any examination of worker status, the IRS examines each relationship based on facts that fall into the three categories of evidence — behavioral controls, financial controls, and relationship of the parties.

If an employer–employee relationship is found with regard to performance of services for only one role of the worker, remuneration with regard to only those specific services are subject to all FICA and income tax withholding requirements under the Code.

If an employer–employee relationship is found for both roles, then remuneration for all services performed by the worker for the business are subject to withholding requirements under the Code. (See IRS Information Letter 2012-0069 (September 28, 2012), available at: www.irs.gov/pub/irs-wd/12-0069.pdf)

Example of worker classified as both employee and independent contractor

Paula is hired to perform IT support for PoundsAway, Inc. to oversee and manage the customer service database, which tracks how many customers are ordering the miracle weight loss system and exercise programs. She works 40 hours per week and reports to the head of the customer service. In her job, she has regular hours, set procedures she must follow, and weekly reports she must produce for her manager. She is clearly an employee.

If, however, Paula has a landscaping business with her husband and they perform landscaping services for PoundsAway, Inc. and 20 other clients, her landscaping services provided to PoundsAway, Inc. would be considered services provided by an independent contractor.

FEDERAL TAX REPERCUSSIONS OF MISCLASSIFICATION

A business that misclassifies a worker is not only liable for the back employment taxes and withholding, but may also be subject to severe penalties. Federal law provides numerous "incentives" to bring employers into compliance with employee classification such as reduced withholding rates under IRC §3509 or safe harbor relief under §530.

IRS PENALTIES

Employers that misclassify an employee as an independent contractor are generally liable for Social Security and Medicare (FICA) taxes and withheld income tax if the taxes were not deducted and withheld because the employer treated the employee as a nonemployee. (IRC §3402) The amount of the employer's liability for these taxes and withholding is dramatically reduced under IRC §3509 if the employer completed a 1099 for the independent contractor or otherwise reported officer compensation.

The employer is liable for the full share of the employer's share of Social Security and Medicare taxes.

The employer cannot recover the employee share of Social Security tax, Medicare tax, or income tax withholding from the employee if the tax is paid using the reduced IRC §3509 rates. Nor can the employer's liability be reduced if the employee pays income tax on the wages. The employee remains liable for the employee share of Social Security and Medicare taxes. (CCA 200825043)

IRC §3509 RATES

If the employer issued the required information returns, the IRC §3509 rates are:

- For Social Security taxes, use the employer rate of 6.2% plus 20% of the employee rate of 6.2%, for a total rate of 7.44% of wages;
- For Medicare taxes, use the employer rate of 1.45% plus 20% of the employee rate of 1.45%, for a total rate of 1.74% of wages;
- For Additional Medicare Tax, 0.18% (20% of the employee rate of 0.9%) of wages subject to Additional Medicare Tax; and
- For income tax withholding, the rate is 1.5% of wages.

If the employer did not issue required information returns, the IRC §3509 rates are:

- For Social Security taxes, use the employer rate of 6.2% plus 40% of the employee rate of 6.2% (4.2% for 2011 and 2012), for a total rate of 8.68% (7.88% for 2011 and 2012) of wages;
- For Medicare taxes, use the employer rate of 1.45% plus 40% of the employee rate of 1.45%, for a total rate of 2.03% of wages;
- For Additional Medicare Tax, 0.36% (40% of the employee rate of 0.9%) of wages subject to Additional Medicare Tax; and
- For income tax withholding, the rate is 3.0% of wages.

IRC §3509 rates inapplicable

IRC §3509 rates are not available to employers who:

- Intentionally disregard the requirement to withhold taxes from the employee (e.g., employee status determined on previous audit or through SS-8 determination);
- Previously treated a worker as an employee and then switched to an independent contractor status without any significant change in the work; or
- Withheld income taxes but not Social Security or Medicare tax.

These employers are liable for the employee's share of taxes and withholding as well as the employer's share and may be subject to the 100% trust fund recovery penalty under IRC §6672, which may also be collected from responsible persons. A responsible person has a business duty to collect and remit withheld taxes to the government. A responsible person may be a corporate officer, a partner, an LLC member, or an employee. (IRC §§6671, 6672)

Caution

Once the IRS asserts the penalty, they can take collection action against the responsible person's personal assets. For instance, they may file a federal tax lien or take levy or seizure action.

Finally, additional fines related to failure to file and failure to pay may result, as well as interest on the balance due. The employer cannot recover these taxes or penalties from the employee.

Criminal penalties can also be imposed.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

13. Which statement is correct regarding what entities qualify to succeed to the ownership of S corporation stock following the death of an S corporation shareholder?

    a) Estates are not qualified shareholders
    b) A revocable grantor trust that qualified as an S corporation shareholder will no longer qualify after the death of the grantor when the trust becomes irrevocable
    c) Form 8855 is used for a trust to make the election to be treated as part of an estate and thereby qualify as an S corporation shareholder
    d) If a nonqualified shareholder succeeds to the ownership of S corporation stock, the S corporation must pay 39.6% tax on the value of the stock plus penalties

14. Features of a qualified subchapter S trust (QSST) include which of the following?

    a) There is no limit to the number of current income beneficiaries a QSST may have
    b) All trust income must be distributed annually
    c) The election to be treated as a QSST is made by the trustee on or before three months from the date of stock transfer
    d) If there are multiple beneficiaries, separate subtrusts can be created, but only one return for the trust must be filed

15. Which statement accurately reflects the issues surrounding the inheritance or purchase of S corporation stock?

    a) An optional IRC §754 adjustment can be made both to property owned in a partnership or in an S corporation
    b) If assets in a corporation are sold and the corporation thereby has no reason to continue as a business, liquidating the corporation in the same year as the sale of the assets will likely result in a capital loss that can offset phantom capital gain
    c) For someone who inherits S corporation stock, selling the stock will not serve to avoid phantom gain
    d) Community property owned in an S corporation will receive a stepped-up basis at the death of the first spouse

16. What are the details for filing Form 990-N?

    a) Starting in February of 2016, Form 990-N must be filed with the Urban Institute
    b) Private foundations may file Form 990-N
    c) Form 990-N is for tax-exempt organizations with gross receipts equal to or under $50,000
    d) Churches must file Form 990-N

17. What is true of the IRS's treatment of IRA rollovers?

    a) Considering all the facts and circumstances, the IRS will waive the penalty for failing to redeposit a distribution from an IRA into a new IRA if the taxpayers follow all the required procedures but because of an error by the financial institution, the funds are not deposited correctly
    b) An amount distributed to a taxpayer from an IRA which would typically be exempt under IRC §501(a) will be taxable in the year following the distribution
    c) The IRS will not waive the penalty for missing the 60-day rollover deadline due to a postal error
    d) If the taxpayer fails to redeposit a distribution from an IRA within 60 days, the IRS will not consider how the funds were used

18. Which detail below is correct as it pertains to naming a trust as an IRA beneficiary?

    a) A revocable trust may be a designated beneficiary
    b) Typically a trust can't be a designated beneficiary
    c) A trust's beneficiaries cannot be treated as designated beneficiaries
    d) A designated beneficiary may be an individual, a trust, or an estate

19. Features of a qualified terminable interest property trust (QTIP) are correctly stated in which of the following choices?

    a) Rev. Proc. 2016-49 provides that an executor can use a QTIP election to take full advantage of the deceased spouse's unused exclusion amount
    b) A QTIP election cannot reduce a decedent's taxable estate
    c) Assets in a QTIP trust do not get a step-up in basis at the death of the surviving spouse
    d) A QTIP election allows the surviving spouse to designate the beneficiaries after his or her death

20. When determining worker classification, which of the following applies?

    a) A request by an employer that a job be completed is typically enough control to demonstrate an employer-employee relationship
    b) By signing an agreement as an independent contractor, a worker generally establishes the validity of that relationship with his employer
    c) A worker who has his own business license will be judged to be an independent contractor by the EDD
    d) An employer who misclassifies its employees may be subject to retroactive stock options and pension benefits payments due to their workers

21. Which choice reflects correct reporting requirements based on how a worker is classified?
    a) For a statutory employee, the employer reports wages on a 1099-MISC
    b) For a statutory nonemployee, the worker reports wages on his or her Schedule C
    c) For an independent contractor, the worker reports expenses on Schedule A
    d) Employment taxes must be withheld from payments to statutory nonemployees
22. Aspects of behavioral control in determining if an employer-employee relationship exists are included in which of the following?
    a) A worker is an employee if the business has the right to control the worker
    b) The degree of instruction does not indicate that a worker is an employee
    c) Independent contractors and employees both generally require training, so training is not really determinative
    d) A business must have direct control over the way that work is done for an individual to be considered an employee
23. What are the appropriate factors that must be considered when determining the financial control that a business has over a worker's job?
    a) Workers must meet the limitation thresholds that have been established to determine if a significant investment has been made in equipment used when working for someone else
    b) Independent contractors should not be paid hourly or else they will more likely be considered employees
    c) Both employees and independent contractors may incur unreimbursed expenses related to the services they perform
    d) A significant investment is necessary in order for an individual to be considered an independent contractor

SOLUTIONS TO REVIEW QUESTIONS

13. Which statement is correct regarding what entities qualify to succeed to the ownership of S corporation stock following the death of an S corporation shareholder? **(Pages 38-40)**

    a) Incorrect – They are qualified shareholders during the administration period unless the estate ends because its administration is considered "unreasonably prolonged" for federal tax purposes.
    b) Incorrect – When the trust becomes irrevocable, it will still qualify as a shareholder for a period of two years following the date of the owner's death.
    c) Correct – The election applies for a trust to be treated as an estate if it is necessary to file an estate tax return. If a return isn't required to be filed, the election is good for two years.
    d) Incorrect – The corporation will lose its S corporation status in this event.

14. Features of a qualified subchapter S trust (QSST) include which of the following? **(Page 39)**

    a) Incorrect – There can only be one current income beneficiary.
    b) Correct – Also, the single beneficiary must be the only recipient of any distribution.
    c) Incorrect – The election is made by the beneficiary on or before two months and 16 days from the date of stock transfer.
    d) Incorrect – Each subtrust would require its own return.

15. Which statement accurately reflects the issues surrounding the inheritance or purchase of S corporation stock? **(Pages 42-43)**

    a) Incorrect – The IRC §754 adjustment only applies to partnerships.
    b) Correct – The liquidation must be in the same tax year as the asset sale and the character of both the loss and the gain must be the same for this scenario to work.
    c) Incorrect – If the stock is sold at full market value, the problem of phantom gain is shifted to the buyer.
    d) Incorrect – For an S corporation, the basis of stock will increase to fair market value as of the date of death, but the property owned by the S corporation maintains its original basis.

16. What are the details for filing Form 990-N? **(Page 43)**

    a) Incorrect – The form must be filed with the IRS; prior to this date, it was filed with the Urban Institute.
    b) Incorrect – Private foundations file 990-PF.
    c) Correct – Form 990-N is an e-Postcard. There is no paper filing.
    d) Incorrect – Churches are not required to file information returns.

17. What is true of the IRS's treatment of IRA rollovers? **(Page 45)**

    a) Correct – – A financial institution mistake, whereby the funds are deposited into a non-IRA account, would constitute a situation in which the IRS would waive the 60-day rollover requirement.
    b) Incorrect – It is taxable in the year of distribution.
    c) Incorrect – A postal error is one of the circumstances that the IRS will consider in waiving the penalty.
    d) Incorrect – The IRS will look to see if the check was cashed and how the money was used as well as whether the money was kept separately from other funds.

18. Which detail below is correct as it pertains to naming a trust as an IRA beneficiary? **(Page 47)**

    a) Incorrect – Trusts are required to be irrevocable or to become irrevocable when the IRA owner dies.
    b) Correct – The trust may be named as the beneficiary but typically can't be named as the designated beneficiary. However, the beneficiaries of the trust can be treated as designated beneficiaries.
    c) Incorrect – There are requirements that must be fulfilled in order for a trust's beneficiaries to be considered designated beneficiaries: The trust must be valid and irrevocable, the beneficiaries should be identified, and documentation must be filed with the IRA trustee.
    d) Incorrect – An individual, a trust, or an estate may be a beneficiary, but usually, only an individual may be identified as a "designated beneficiary." Note (c) above, where requirements must be met in order for a trust to be a designated beneficiary by way of its beneficiaries.

19. Features of a qualified terminable interest property trust (QTIP) are correctly stated in which of the following choices? **(Pages 52-53)**

    a) Correct – This is part of the IRS's new guidance on QTIP elections, which allows for the QTIP election to maximize the DSUE amount while still providing protection for children from a prior marriage.
    b) Incorrect – A QTIP both reduces the taxable estate of the decedent and increases the surviving spouse's DSUE.
    c) Incorrect – The assets get a step-up in basis when the surviving spouse dies.
    d) Incorrect – The election allows the first deceased spouse to identify the beneficiaries after the death of the surviving spouse while still providing all the income to the surviving spouse during his or her lifetime.

20. When determining worker classification, which of the following applies? **(Pages 54-55)**

    a) Incorrect – Under Treas. Regs. §31.3121, the right of direction and control is an important factor and applies to the way in which the worker does the job, not just the fact that he does it.
    b) Incorrect – This reason, as in (c) below, does not necessarily establish an independent contractor relationship. The taxing agencies will consider the "right of control" test.
    c) Incorrect – Not necessarily. The taxing agencies will consider this in their considerations, but this reason alone does not determine independent contractor status.
    d) Correct – The costs of misclassification are severe and go beyond just payroll taxes and penalties and may also include paid vacation, sick leave, medical insurance, workers' comp and more.

21. Which choice reflects correct reporting requirements based on how a worker is classified? **(Page 57)**

    a. Incorrect – A statutory employee (an independent contractor who is treated as an employee), wages are reported on a W-2 with the statutory employee box checked.
    b. Correct – Statutory nonemployees are persons who would be treated as employees under common law tests but who are treated as independent contractors, so they report wages on Schedule C.
    c. Incorrect – Expenses for independent contractors are reported on Schedule C.
    d. Incorrect – For statutory employees, employment taxes must be withheld because they are treated as employees. This is not the case for statutory nonemployees, who are treated as independent contractors.

22. Aspects of behavioral control in determining if an employer-employee relationship exists are included in which of the following? **(Page 58)**

    a. Correct – The right of control is the main issue that determines the employer-employee relationship.
    b. Incorrect – Generally, the more involved the instructions are, the more control the employer demonstrates.
    c. Incorrect – Typically, independent contractors are allowed to use their own methods in accomplishing a task. The more training, the more control.
    d. Incorrect – The business itself doesn't need to demonstrate control over a person, but the employer must be the one who actually demonstrates direct control.

23. What are the appropriate factors that must be considered when determining the financial control that a business has over a worker's job? **(Page 59)**

    a. Incorrect – There are no limitation thresholds that have been established. Moreover, significant investments would vary based on the profession.
    b. Incorrect – Some professions pay independent contractors on an hourly basis, such as law.
    c. Correct – It is more likely, however, that independent contractors will incur more unreimbursed expenses and have fixed ongoing costs.
    d. Incorrect – Not all jobs require that a significant investment be made.

VOLUNTARY CLASSIFICATION SETTLEMENT PROGRAM

The IRS offers a Voluntary Classification Settlement Program (VCSP) that enables employers to voluntarily reclassify independent contractors as employees, take advantage of reduced penalties, and gain protection from a federal employment tax audit. (Ann. 2011-64; IR-2011-95)

A taxpayer who participates in the program must agree to prospectively treat the class of workers as employees for future tax periods.

Generally, all taxpayers are eligible, including exempt organizations and government entities. However, employers who are currently under employment tax audit by the IRS or a worker classification audit by the Department of Labor or by a state government agency are ineligible to participate.

Regarding members of an affiliated group, one member is ineligible if another affiliated group member is under an employment tax audit. Taxpayers under IRS audit (other than an employment tax audit) are eligible to participate. (Ann. 2012-45)

With respect to workers being reclassified, the taxpayer must certify that:

- The taxpayer has consistently treated the workers as nonemployees; and
- The taxpayer has satisfied any Form 1099 requirements for each of the workers for the three preceding calendar years.

Website
www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/
Voluntary-Classification-Settlement-Program

Also see the IRS's FAQs at:

Website
www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Voluntary-Classification-
Settlement-Program-VCSP-Frequently-Asked-Questions

Applying

A taxpayer applies to participate in the VCSP program by filing Form 8952, Application for Voluntary Classification Settlement Program. Acceptance of an application is at the IRS's discretion. The IRS hasn't announced an end date to the program.

Applicants must enter the beginning date of the tax period (quarter) for which they want to begin treating the class of workers as employees. The date must be at least 60 days from the date the applicant files Form 8952. (Form 8952 Instructions)

For applications filed after May 1, 2014, attach a statement listing the names and corresponding Social Security numbers of the workers for all classes to be reclassified.

Reduced rates, no penalties or interest, and freedom from audit

After determining which independent contractors should be reclassified as employees, an employer determines the total amount paid to these workers for the most recently closed tax year. The taxpayer agrees to pay a total of only 10% of the amount that would be determined under the already-reduced rates of IRC §3509(a).

Taxpayers should not submit payment with the VCSP application. Once submitted, the IRS will review the application and verify the taxpayer's eligibility. Once the IRS accepts the taxpayer into the VCSP, the IRS will contact the taxpayer to enter into the VCSP closing agreement with the IRS. Taxpayers must make full and complete payment of any amount due under the VCSP when they return the signed VCSP closing agreement to the IRS.

There are no penalties or interest on the amount paid. In addition, if the taxpayer keeps the agreement as to prospective classification, the taxpayer will not be subject to an employment tax audit with respect to the workers for prior years. (Ann. 2012-45)

Worker class or group of workers

The program permits taxpayers to reclassify some or all of their workers. However, once a taxpayer chooses to reclassify certain of its workers as employees, all workers in the same class must be treated as employees for employment tax purposes.

Caution

The IRS has not defined "class." In its FAQs, it only provides this example:

ABC Company is a construction firm that currently contracts with its drywall installers, electricians and plumbers to perform services at housing construction sites. ABC Company determines it wants to voluntarily reclassify its drywall installers as employees. ABC Company submits an application, is accepted into the VCSP and enters into a closing agreement with the IRS. Once the VCSP closing agreement is executed, ABC Company must treat all drywall installers as employees for employment tax purposes.

What are the drawbacks of the reclassification?

The IRS program has some flaws that may discourage people from participating:

- It is likely that states will obtain information from the IRS, and this could presumably trigger a state employment tax audit;
- The taxpayer must agree to extend the statute of limitations for three years for the first, second, and third calendar years beginning after the date in which the taxpayer agrees to begin treating the workers as employees (effectively giving the IRS six years to ensure continued compliance with the agreement);
- As noted, "class" is not defined. If there are workers that weren't included that the IRS deems part of the reported class, the agreement could be nullified;
- The IRS program only applies to the extent the business provided 1099s. If a business goes into the program and there are missing 1099s, it is possible the agreement will be nullified and the IRS will audit the open years;
- It is unclear whether or to what extent the IRS will review payments to any independent contractors that were not reclassified. If some were provided with a 1099 and some were not, then this could jeopardize the whole agreement; and
- It is not known what the IRS will do to the taxpayer if they reject the application.

CORPORATE OFFICERS/SHAREHOLDERS

Corporate officers are by definition generally considered employees under both federal and state law. (IRC §3121(d); UIC §§621, 13004) However, an officer of a corporation who as such does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration is considered not to be an employee of the corporation. (Treas. Regs. §§31.3121(d)(-1(b), 31.3306(i)-1(e), 31.3401(c)-1(f)) Presumably, they would be treated as an independent contractor or shareholder, depending on the facts of the case.

The courts consider the following factors when determining whether services actually performed by a corporate officer in that capacity are considered to be of a minor or nominal nature:

- The character of the services;
- The frequency and duration of their performance; and
- The actual or potential importance or necessity of the services in relation to the conduct of the corporation's business.

Thus, occasional, routine signing of documents, presiding over or attendance at infrequent meetings, and similar isolated or noncontinuous acts having no significant bearing or effect on the day-to-day functioning of the corporation in the conduct of its business will be considered, as a general rule, to be services of a minor or nominal nature. (Rev. Rul. 74-390)

SHAREHOLDER/OFFICER NOT INDEPENDENT CONTRACTOR

The Tax Court found in three consolidated cases involving shareholders/officers of three different S corporations that the shareholders/officers were employees of the S corporations under IRC §3121(d), and the common law rules in determining whether a worker is an employee did not apply. (***Joseph M. Grey Public Accountant, P.C. et al. v. Comm.*** (April 7, 2004) U.S. Court of Appeals, Third Circuit, Case Nos. 02-4417, 03-2756, 03-2757, unpublished opinion)

The three cases involved primary or sole shareholder/officers of S corporations who did not pay wages, distributions, or dividends to the officers. Rather the officers took payments from the S corporations on an "as needed" basis and reported their income from the S corporation as nonpassive income on their federal returns rather than as wages.

These three cases involved:

- The president and sole shareholder of a public accounting, bookkeeping, and tax return preparation business, Joseph M. Grey Public Accountant, P.C. During the tax years at issue, Mr. Grey solicited the corporation's business, transacted its affairs, handled the financial aspects of the operation, and "performed all accounting, bookkeeping, and tax preparation services";
- The majority shareholder and president of Mike J. Graham Trucking, Inc. (MJG). Mr. Graham solicited business for the company, handled its business transactions, managed its finances, and performed the driving services rendered by the company. MJG did not provide Mr. Graham with a salary or wages during the tax years in dispute; and
- A husband and wife (Mr. and Mrs. Ridge) who were each 50% shareholders in Water Pure Systems, Inc., which provided sales and service of water filtration and purification systems. Mr. Ridge was Water Pure's president and sole officer and was the only person performing any services for Water Pure.

Similarly, the president and sole shareholder of a professional law corporation was found to be an employee rather than an independent contractor. (***Donald G. Cave, A Professional Law Corp. v. Comm.***, TCM 2011-48) As the president of the corporation, he made virtually all corporate decisions with respect to the law firm which were fundamental to the firm's operations, received a percentage of the legal fees recovered in cases he handled, and received significant "draws" from the firm.

Caution

Some businesses pay a small portion of the compensation paid to officers as wages subject to withholding and pay the rest out in the form of a bonus and issue a 1099. This is potentially very dangerous and can subject the business to additional penalties and interest. According to attorneys practicing in this area, the EDD assesses employment taxes on this 1099 amount plus severe penalties and interest.

CORPORATE OFFICER CAN BE INDEPENDENT CONTRACTOR

The president of a corporation was found to be an independent contractor with respect to payments made to him by the corporation that related to his work as a mortgage loan officer of the corporation. (***Cibotti v. Comm.***, TCS 2012-21) The IRS argued that because he was an officer he was an employee of the corporation, and all payments made to him were subject to withholding, and his expenses related to his employment could only be claimed on Schedule A.

Facts

Dean Cibotti was a 33.3% owner and president of Liberty Mortgage, a loan mortgage company. Cibotti did not perform any services as an officer of Liberty Mortgage, nor did he control any facet of the company, including how his income was reported to the IRS. However, he was named president of the company because he had the largest individual ownership share of the business. Liberty Mortgage did not provide Cibotti with an office, and it appears he did much of his work for the company out of his home. He was compensated for his work solely on the basis of commissions (for loan closings), and he was not compensated at all for work in his capacity as president, nor was he provided any employee benefits.

Employee status of shareholder-officers

Mr. Cibotti did not perform any significant work as officer of the corporation. Rather his compensation was received for his work as a mortgage loan officer. Because he was not considered an "employee" due to his corporate officer status, the regular common law analysis applies to determine whether the wages were subject to withholding. Under the common law analysis, Mr. Cibotti was not an employee because the company did not exercise the requisite level of control over the manner and method of his work. He solicited his own clients, was only paid based on the number of loans he closed and was not guaranteed any compensation, and he had his own office in his home.

EMPLOYEE OR INDEPENDENT CONTRACTOR CASES

WRITTEN CONTRACTS REGARDING EMPLOYEE OR INDEPENDENT CONTRACTOR

The leading case regarding the nature of independent contractor written agreements is ***S.G. Borello and Sons***. (***S.G. Borello & Sons, Inc. v. Dept. of Indust. Rel.*** (1989) 48 Cal.3d 341, 350) In ***Borello***, a grower designed the business of its cucumber "sharefarmers" in order to give the impression that they were separate business owners. However, the court rejected the grower's "subterfuge."

Likewise, in ***Santa Cruz Transportation***, a taxicab company converted its employee drivers to lease drivers by requiring them to sign leasing agreements. (***Santa Cruz Transportation, Inc. v. Unemp. Ins. Appeals Bd.*** (1991) 235 Cal.App.3d 1363) The court of appeals found that the cab drivers were not independent contractors.

The court observed that "attempts to conceal employment by formal documents purporting to create other relationships have led the courts to disregard such terms whenever the acts and declarations of the parties are inconsistent. An employer cannot change the status of an employee to one of independent contractor by illegally requiring him to assume burdens which the law imposes directly on the employer."

FINDING OF EMPLOYEE STATUS

The following cases are illustrative of the types of scenarios in which the courts have found an employer/employee relationship.

FedEx drivers are not independent contractors

FedEx has settled for $228 million with over 2,000 California drivers whom FedEx had incorrectly classified as independent contractors. (See ***Alexander et al. v. FedEx Ground Package System, Inc.*** (August 27, 2014) U.S. Court of Appeals, Ninth Circuit, Case Nos. 12-17458, 12-17509.)

The case turned on whether the Operating Agreement (OA) between FedEx and the drivers gave FedEx the right to control the drivers. In August of 2014, the Ninth Circuit found that the drivers were employees rather than independent contractors, regardless of the OA's attempt to establish an independent contractor relationship.

FedEx argued that while the OA controlled the drivers with respect to the "results" that FedEx required, the drivers had latitude as to how they achieved those results. The court found that FedEx's control of the drivers had no bearing on the ultimate result: package delivery. Specifically, a driver's personal appearance didn't affect whether he got a package to its destination.

The court found that FedEx can and did control:

- The appearance of the drivers and their vehicles;
- The times the drivers work; and
- Aspects of how and when a driver delivers packages.

The court deemed the drivers to be employees.

The FedEx operating agreement

FedEx trained its drivers on performing job duties and interacting with customers. Drivers were required to follow FedEx's Safe Driving Standards and comply with personal-appearance standards and wear a FedEx uniform; the OA also dictated the color of shoes and socks.

Drivers were subject to periodic "ride-along" evaluations during which a supervisor would observe the driver and make recommendations, down to details such as whether the driver "[p]laces [his or her] keys on [the] pinky finger of [his or her] non-writing hand" after locking the delivery vehicle.

FedEx required drivers to provide their own vehicles, which must be specifically approved by FedEx. The OA allowed FedEx to dictate the identifying colors, logos, numbers, marks, and insignia of the vehicles; for example, all vehicles must be painted "FedEx white," a specific shade of Sherwin-Williams paint.

The OA specified that the vehicles must have specific dimensions and contain shelves with specific dimensions, and supervisors could refuse to let drivers work if their vehicles did not meet the requirements. Drivers were responsible for maintenance and other expenses related to operation of the vehicle.

The OA required FedEx drivers to pick up and deliver packages within their assigned areas. While FedEx did not dictate working hours, it structured the drivers' workloads to ensure that they worked between 9.5 and 11 hours every working day.

The OA allowed drivers to operate more than one vehicle and route, but only with the consent of FedEx. Drivers also were allowed to hire third parties to help perform their work, but only with the approval of FedEx.

Uber litigation

Uber drivers brought a similar case against Uber Industries, Inc. as FedEx drivers brought against FedEx. A federal district court denied Uber's motion for summary judgment, finding that there has been sufficient evidence presented such that a jury could find that the Uber drivers are employees and not independent contractors. (***O'Conner et al. v. Uber Technology, Inc.*** (March 11, 2015) U.S. Dist. Ct. Northern District of California, Case No. C-13-3826 EMC, Order Denying Defendant Uber Technologies, Inc.'s Motion for Summary Judgment) Key to the court's ruling denying Uber's motion for summary judgment was the finding that Uber is actually a transportation service and not a technology platform that connects independent contractor drivers with people who need rides. The court found Uber's argument a bit disingenuous, as Uber frequently touts itself as "Everyone's Private Driver," and the only way it makes money is if the drivers provide rides.

If this court's decision is any indication, anyone thinking that this new "sharing economy" requires a different lens for viewing the worker classification issue should think again. The court made short shrift of Uber's argument stating, "Uber is no more a 'technology company' than Yellow Cab is a 'technology company' because it uses CB radios to dispatch taxi cabs, John Deere is a 'technology company' because it uses computers and robots to manufacture lawn mowers, or Domino Sugar is a 'technology company' because it uses modern irrigation techniques to grow its sugar cane. Indeed, very few (if any) firms are not technology companies if one focuses solely on how they create or distribute their products. If, however, the focus is on the substance of what the firm actually does (e.g., sells cab rides, lawn mowers, or sugar), it is clear that Uber is most certainly a transportation company, albeit a technologically sophisticated one."

In addressing whether the workers were independent contractors or employees, the court noted that "As the Supreme Court of California has held … the fact that one is performing work and labor for another is *prima facie* evidence of employment and such person is presumed to be a servant in the absence of evidence to the contrary." (***Narayan v. EGL, Inc.*** (2010) 616 F.3d 895, 900, 901) The court noted that it was clear that the drivers provided a service to Uber because without the drivers, Uber would not be in business. Uber's revenues do not depend on its software distributions, but on the "fees" charged drivers for each and every one of the fares received. The fee is usually 20% of the fare.

The court found that there was sufficient evidence that the drivers should be classified as employees rather than independent contractors based on the following control of the manner and method in which the drivers worked:

- Uber sets the fares it charges unilaterally, the drivers have no control;
- Uber prohibits drivers from arranging rides independently of the Uber app, (e.g., riders cannot arrange a pick up time after they drop a fare off), and the solicitation of rides can result in a driver's immediate dismissal;
- Uber's employee handbook indicated that Uber maintained the right at all times at Uber's sole discretion to discontinue the driver's access to Uber's app;
- Uber could, and frequently did, discharge employees at will for not "accepting" leads provided via the app;
- Uber controlled the method and manner in which the drivers performed by requiring drivers to "dress professionally," send a client a text message when 1-2 minutes from the pickup location, limiting the type of radio programming that may be played, dictating which side of the street riders should be picked up on, and requiring drivers to open the door for their riders; and
- Uber's app contains a "rating" system for passengers to rate and evaluate drivers, and drivers are routinely dismissed if their rating "falls below the applicable minimum star-rating."

The court did note that the driver's ability to control when and how many hours they work is a factor to consider, but one that in and of itself does not mean that a worker is not an employee. The court noted that the more relevant inquiry is how much control Uber has over its drivers while they are on duty for Uber.

Comment

The same lawyer who has brought these cases has also brought cases against clients that have worked at Shyp, Washio, Postmates, and Caviar, claiming that these companies exercise the same control over their workers, particularly those involved in delivery, as in the FedEx and Uber cases.

Settlement

In April 2016, Uber settled the ***O'Connor*** case along with a similar Massachusetts-based case for $100 million. (***Hakan Yucesoy v. Uber Technologies, Inc., et al.*** (January 20, 2015) U.S. District Court, Northern District of California, Case No. 4:2015cv00262) With this settlement, the drivers (California and Massachusetts) will remain classified as independent contractors rather than employees.

California Labor Commission appeal

The California Labor Commission also found that an Uber worker was an employee. On June 16, 2015, Uber filed an appeal of the Labor Commission's decision. (***Berwick v. Uber Technologies, Inc***. (June 3, 2015) Super. Ct. S.F. City and County, Case No. CGC-15-546378)

Lyft being hit as well

Drivers are also challenging their status as independent contractors for Lyft in federal court as well. (***Cotter v. Lyft Inc***. (June 16, 2015) U.S. Dist. Ct. Northern District of California, Case No. 13-CV-04065-VC) In June of 2016, a judge approved a $27 million settlement deal with drivers, which leaves them classified as independent contractors. The final settlement hearing is pending. (Rosenblatt, J. "Lyft's $27 Million Accord with Drivers Wins Court Approval" (June 23, 2016) *Bloomberg Technology*. Available at: www.bloomberg.com/news/articles/2016-06-23/lyft-s-27-million-settlement-with-drivers-wins-court-approval)

Unionization

While most taxi drivers are covered by a union, Uber and Lyft drivers do not have union representation. In fact, the Seattle City Council is hearing a proposal that would give individuals who drive with taxi and for-hire companies, along with ride-sharing services like Uber and Lyft, a pathway to unionization.

Project-by-project workers were employees

Workers hired by a construction company to work on various residential projects were found to be employees rather than independent contractors. (***Kurek v. Comm.***, TCM 2013-64)

Despite the fact that the workers were hired "on a project-by-project basis," the Tax Court found that based on the overall facts of the case, including that the workers were controlled by the company's sole proprietor and that they were an integral part of the business, there was an employer–employee relationship. Other common law factors considered by the court included:

- The taxpayer worked closely with his customers on each project. He discussed the details of the work to be performed and the supplies needed with each customer;
- The taxpayer negotiated the cost of the project with each customer, factoring in the payments that he was going to make to the workers. The customers paid the taxpayer directly; the workers did not bill the taxpayer's customer for the work they performed;
- If there was a problem with the work, the customer spoke with the taxpayer. The taxpayer did not inform his customers that he would use subcontractors or independent contractors; and
- The workers did not work under business names (they were paid by checks made out to them personally), nor did they advertise to the public.

As a result, the company was liable for employment taxes for the year in dispute.

Auto repair shop workers reclassified, others retain independent contractor status

Three of 10 auto body shop workers who had been treated as independent contractors were reclassified as employees. The taxpayer's classifications of the other seven were upheld. (***Keller v. Comm.***, TCM 2012-62)

The court performed a thorough analysis of the factors distinguishing an employee and an independent contractor with respect to all 10 workers. The "crucial test" for the employer–employee relationship is the right of the principal to exercise control over the agent, whether or not the principal in fact does so.

The taxpayer successfully argued with respect to seven of the workers who all did auto repair that he could not control the persons working for him, and that they set their own hours and chose their own work. The taxpayer credibly testified that "each outside service provider provided an individual direct service, and that the individuals worked at their own pace with their own methods to create a finished, deliverable product. It was further noted that the auto body workers also obtained some of their own work independently from the taxpayer.

However, the other three workers were office workers doing secretarial, receptionist, and cleaning jobs. Those three were reclassified to employee status.

Adjunct online professor was common law employee

An online instructor who performed his duties from a computer at home was a common law employee and not an independent contractor or statutory employee as he reported on his tax return. (***Schramm v. Comm.***, TCM 2011-212)

From 1999 to 2007, William Schramm taught four to 12 online courses per year for Nova Southeastern University (NSU). He was paid a fixed amount for each course. He set his own hours and could work anywhere he had an Internet connection.

NSU set the course dates, provided the website interface, and provided the services necessary to enroll and register students in his class. NSU required him to follow employment policies, and although based on annual contracts, his employment relationship was longstanding. NSU regarded him as an employee and issued him a W-2. These factors overwhelmingly favored employee status.

Attorneys and law clerks were employees

Associate attorneys and a law clerk hired by a law firm were employees rather than independent contractors. (***Donald G. Cave, A Professional Law Corp. v. Comm.***, TCM 2011-48) The associate attorneys were employees because of:

- The extent of control that the president imposed over their work;
- The firm's investment in tools and facilities; and
- The stability of the workers' relationship.

Also, the work performed by these attorneys was an essential part of the firm's dealings.

The firm's legal clerk was an employee due to the president's control over his work, fixed compensation, and ongoing relationship with the company. Relief under §530 of the Revenue Act of 1978 (P.L. 95-600) clearly did not apply.

The company had no reasonable basis for classifying these workers as independent contractors, and the law clerk was treated similarly to others who had similar positions as employees. The government imposed a penalty for failing to deposit employment tax because there was no reasonable cause for these arrangements.

FINDING OF INDEPENDENT CONTRACTOR STATUS

Wife was husband's independent contractor

A worker was found to be correctly classified as an independent contractor, where she provided services for her husband's law practice. (***Jones v. Comm.***, TCM 2014-125) The court examined the employee versus independent contractor tests and determined that the taxpayer was not an employee of the practice.

The case

Darryl Jones hired his wife, Tarri, to help him with his caseload. Specifically, she worked with one client who was extremely eccentric, but with whom she got along very well. Tarri reviewed case documents with the client, and helped keep the client calm and focused through the duration of the case.

Darryl and Tarri arranged their business relationship to give Tarri as much freedom as possible. She worked from their home, which was about 45 miles away from the law office. Darryl told Tarri what he needed, but she was able to accomplish her tasks in her own time and in her own way. They agreed that Darryl could discharge Tarri if the arrangement became unproductive.

Darryl and Tarri filed married filing separate for the tax years at issue, with Darryl reporting the payments to Tarri as contract labor expenses. Tarri reported the payments as gross receipts on Schedule C and paid self-employment tax.

Employee versus independent contractor

The Tax Court found that the following factors indicated independent contractor status even though the agreement gave Darryl the right to discharge Tarri, and the work she performed was performed in the ordinary course of the law firms' business**:**

- Darryl did not control the details of Tarri's work. He told her what he needed done, and she was free to decide how to accomplish it.
- Tarri worked from her home office, and the law office did not pay any of her expenses.
- The payments Tarri received depended on the amount of the settlements in her cases, and she conceivably could have received nothing for her efforts. Thus, she risked loss, and her profits were linked to her performance.
- Tarri worked for the law office; although only while the two cases Darryl assigned her were ongoing, and she ceased working there after the cases settled. Her tenure was dependent on the continuation of her cases and could have ended at any time.
- The law office treated Tarri as an independent contractor, and she considered herself an independent contractor. The law office issued her Forms 1099-MISC, and she paid self-employment tax during the years at issue.

MISCELLANEOUS FEDERAL TAX ISSUES

IRS NONACQUIESES ON FARMER CRP PAYMENTS

The IRS has issued its nonacquiescence with the Eighth Circuit's decision in ***Morehouse***. (AOD 2015-02; ***Morehouse v. Comm.*** (2014) U.S. Court of Appeals, Eighth Circuit, Docket No. 13-3110) In that decision, the court reversed a Tax Court decision that found that a taxpayer who received payments under the Conservation Reserve Program (CRP) was subject to self-employment tax on the payments. (***Morehouse v. Comm.*** (2013) 140 TC 16) This means that the IRS will continue to litigate the issue in all other circuits.

INTERNET TAX FREEDOM ACT MADE PERMANENT

The President signed the Trade Facilitation and Trade Enforcement Act of 2015 on February 24, 2016. (P.L. 114-125) The act makes permanent the ban on states taxing Internet access or e-commerce.

DELUSIONAL TAXPAYERS

FEDERAL TAXES ARE NOT A FEDERAL TAX DEDUCTION

In a double delusion, a taxpayer was not allowed to deduct the additional tax he owed on early IRA distributions because payment of federal income taxes and penalties are not deductible in arriving at federal taxable income (no kidding). (***Martin v. Comm.***, TCM 2016-15) Additionally, the same taxpayer had unreported gambling winnings and argued that the winnings were not taxable because they fell below the information reporting requirement, and therefore, the casino was not required to report his slot winnings. Whether the casino was required to report the taxpayer's winnings was irrelevant to the determination of whether the winnings were includible in the taxpayer's gross income.

TAXPAYER COULDN'T CREATE TAX-EXEMPT ORGANIZATION TO SHELTER INCOME

The First Circuit Court of Appeals affirmed a Tax Court decision affirming a determination by the IRS that a taxpayer owed $3.79 million in income taxes and penalties on $5.65 million in bank deposits from 1995-2002. (***George, Jr. v. Comm.*** (September 13, 2016) U.S. Court of Appeals, First Circuit, Case No. 15-2305)

Facts

Between 1995 and 2002, the taxpayer, a self-taught chemist, created his own health supplements that he sold to supplement companies and individuals. The taxpayer did not issue receipts or otherwise document the payments he received from the supplements he created and sold. The only record of the taxpayer's transactions were his bank deposits into 14 different personal bank accounts.

In 2002, the IRS began investigating the taxpayer and ultimately charged and convicted him of tax evasion. The taxpayer was sentenced to 30 months imprisonment. In May 2003, six weeks after his tax evasion indictment, the taxpayer created a corporation and applied for tax-exempt status for the corporation, which the IRS granted in December 2003. In October 2011, the corporation retroactively filed tax forms claiming it was an IRC §501(c)(4) organization for the tax years 1996–2002. For each year, the corporation reported revenue equal to the tax deposits plus interest earned in the taxpayer's personal bank accounts.

Result

In a not-so-shocking decision, the Tax Court held that the taxpayer failed to prove that an organization distinct from himself existed prior to 2003 and that the taxpayer's activities were commercial and did not further social welfare, as required under IRC §501(c)(4). While a tax exempt entity may conduct itself in a tax-exempt manner prior to incorporation or formally receiving IRS recognition as a tax-exempt entity, the Tax Court simply did not believe any of the taxpayer's arguments.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

24. What are the federal tax consequences of worker misclassification?

    a) If a worker is misclassified, the employer is responsible for the full share of Social Security and Medicare tax as well as the income tax if that tax was not deducted and withheld
    b) If the employer completed a Form 1099 for an independent contractor, they will be subject to reduced withholding rates under IRC §3509
    c) IRC §3509 rates apply when employers demonstrate that they have withheld any one of the following: income tax withholding, Social Security, or Medicare tax
    d) If the taxpayer does not file an information return, the IRC §3509 rate is 1.5% of wages

25. Details of the Voluntary Classification Settlement Program (VCSP) include which of the following?

    a) To participate in the program, an employer is only required to agree to treat the workers in question as employees for all past applicable tax periods
    b) Exempt organizations are not eligible for the program
    c) Employers who are under an employment tax audit by the IRS are not eligible for the program
    d) Taxpayers who are under an IRS audit are not eligible to participate in the program

26. As it pertains to the process of applying for participation in the VCSP program, which of the following is true?

    a) The program is scheduled to end on December 31, 2017
    b) The employer must determine how much was paid to the class of workers for the most recently closed tax year and then pay a total of 20% of the amount determined under IRC §3509 rates
    c) The taxpayer must submit the appropriate payment with the VCSP application
    d) There are no penalties to pay under the VCSP program

27. Which choice below best describes the issues involved with the determination of corporate officers as employees or independent contractors?

    a) Typically, corporate officers are considered employees
    b) A corporate officer who performs only minor services for which he or she receives no remuneration is still considered an employee
    c) Corporate officers who are not treated as employees must be treated as independent contractors
    d) A sole shareholder of a corporation is always considered an independent contractor

28. What were the important arguments of the FedEx legal case regarding the status of their workers as independent contractors?

    a) FedEx asserted that their drivers were independent contractors because they did not control when their drivers worked or how they delivered packages
    b) The Operating Agreement (OA) allowed drivers to hire third parties without requiring FedEx's approval, which supported their argument that the drivers were independent contractors
    c) The drivers were found to be employees because of the level of control FedEx had over them
    d) The drivers were required to provide their own vehicles, which indicated that the drivers were independent contractors

29. Which of the following statements accurately reflects the issues surrounding Uber's classification of independent contractors?

    a) The court believed that the most important factor to consider was that the drivers have the ability to control their own hours, which would indicate that the drivers are not employees
    b) Uber drivers are able to arrange for riders independent of the Uber app, which indicates that they are independent contractors
    c) Uber drivers are not obligated to accept the leads they get from the Uber app, which weighs on the side of the drivers being independent
    d) The court believes that the drivers provide a service to Uber without which Uber would not be in business, hence there is enough evidence that they should be considered employees

SOLUTIONS TO REVIEW QUESTIONS

24. What are the federal tax consequences of worker misclassification? **(Page 64)**

    a. Incorrect – The employer is responsible for its full employer share of these taxes; the employee remains liable for his or her share.
    b. Correct – IRC §3509 is perceived as an incentive under federal law to encourage employers to comply with worker classification directives.
    c. Incorrect – The rates do not apply if the employer withheld income taxes but not Social Security and Medicare tax.
    d. Incorrect – That rate applies if a 1099 was filed. When no return is filed, the rate jumps to 3.0% of wages.

25. Details of the Voluntary Classification Settlement Program (VCSP) include which of the following? **(Page 65)**

    a. Incorrect – The taxpayer must agree to treat the workers as employees for all future tax periods.
    b. Incorrect – Exempt organizations are eligible as well as government entities.
    c. Correct – Also, if the employer is under a worker classification audit by the Department of Labor or another state government agency, they would be ineligible.
    d. Incorrect – They are eligible in spite of the audit unless it is an employment tax audit.

26. As it pertains to the process of applying for participation in the VCSP program, which of the following is true? **(Page 66)**

    a. Incorrect – There is no end date.
    b. Incorrect – The taxpayer must only pay 10% of the amount.
    c. Incorrect – No payment should be sent. The IRS must accept the application first after which the taxpayer will ultimately send payment with a closing agreement.
    d. Correct – The amount the taxpayer is required to pay does not include any penalties and interest.

27. Which choice below best describes the issues involved with the determination of corporate officers as employees or independent contractors? **(Pages 67-68)**

    a. Correct – This is true under IRC §312(d), although officers that perform only minor services for no pay are not considered employees.
    b. Incorrect – Under the regulations, an officer who performs infrequent, isolated acts for which there is no compensation would not be an employee but would be either an independent contractor or a shareholder.
    c. Incorrect – They may be treated as independent contractors or shareholders depending on the individual case.
    d. Incorrect – In ***Donald G. Cave v. Comm.***, the taxpayer president and sole shareholder was found to be an employee because he made almost all of the corporate decisions that were essential to how the business operated and received draws from the corporation.

28. What were the important arguments of the FedEx legal case regarding the status of their workers as independent contractors? **(Page 70)**

    a. Incorrect – On the contrary, FedEx was found to control their drivers' appearance, when they worked, and how they delivered packages.
    b. Incorrect – FedEx had the right to approve of any third-party hires.
    c. Correct – The central part of the case was the OA and whether it gave FedEx control over its drivers.
    d. Incorrect – Although they had to provide their own vehicles, FedEx dictated the paint color, logos, and marks on the vehicles as well as the dimensions for shelving, etc., which demonstrated a significant degree of control by FedEx.

29. Which of the following statements accurately reflects the issues surrounding Uber's classification of independent contractors? **(Page 71)**

    a. Incorrect – Although the court believed that this ability to control their hours is a factor, the more important issue is how much control Uber exerts over their drivers while they are working.
    b. Incorrect – Uber drivers may not arrange for customers independent of the app and may be fired for soliciting business on their own, which is evidence that they are treated more as employees than as independent contractors.
    c. Incorrect – Uber has fired drivers for not accepting leads that have been generated by the app.
    d. Correct – Uber's earnings are based on the fees that drivers charge, so if there are no drivers, there are no revenues.

IRS PRACTICE AND PROCEDURES

CERTIFICATION FOR PROFESSIONAL EMPLOYER ORGANIZATIONS

The IRS is establishing a voluntary certification program for professional employer organizations (PEOs), as mandated by the Tax Increase Prevention Act of 2014 (TIPA). (www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Voluntary-Certification-Program-for-Professional-Employer-Organizations) A PEO, sometimes referred to as an employee leasing company, enters into an agreement with a client to perform some or all of the federal employment tax withholding, reporting, and payment functions related to workers performing services for the client. (www.irs.gov/pub/foia/ig/spder/SBSE%2005-0615-0049[1].pdf)

However, under this arrangement, it is possible that the client company may believe that they are relieved from employment tax obligations. A third party PEO is the employer only if it has exclusive control over the payment of wages. (IRC §3401(d)(1)) TIPA created new IRC §§3511 and 7705 to provide requirements for these certified PEOs. The IRS plans to begin accepting applications for PEO certification on July 1, 2016.

IRS CAN FORCE SALE OF CO-OWNED PROPERTY

When an individual owes a debt to the IRS, the IRS may bring a lien foreclosure suit and force the sale of the property. (IRC §§6631(a), 7403) This is true even if the property is co-owned by another individual who does not owe any unpaid taxes.

The nondelinquent owner is entitled to their portion of the sales proceeds, but they cannot stop the sale unless they can demonstrate that they would not be adequately compensated by the sale.

A recent case addressed how this rule applied to a married couple, but the same standards would apply to unmarried co-owners as well. (***U.S. v. Davis*** (March 9, 2016) U.S. Court of Appeals, Sixth Circuit, Case No. 15-1696)

PAYING THE HUSBAND'S DEBT

Ronald Davis (the husband) failed to pay federal employment taxes on wages paid to employees from 2008–2011. By 2013, Mr. Davis owed the IRS more than $1 million in taxes, interest, and penalties. The debt belonged solely to Mr. Davis, but the IRS placed a lien on the primary residence owned by both Mr. Davis and his wife.

Mrs. Davis argued that the property should not be sold to satisfy her husband's debts, but the court disagreed.

STOPPING A SALE

In ***U.S. v. Rogers***, the Supreme Court held that a district court could use its discretion and stop the sale of a property to satisfy another owner's debt if there would be "practical undercompensation" to the nondelinquent owner. (***U.S. v. Rogers*** (1983) 461 U.S. 677) The Court stated that "in practical terms financial compensation may not always be a completely adequate substitute for a roof over one's head."

In this case, Mrs. Davis argued that she would be undercompensated by her share of the sale proceeds because the sale would assume that she and her husband held equal interests in the property. Mrs. Davis argued that she actually held a greater interest in the property because they held title as a tenancy by the entirety, and she had a longer life expectancy than her husband.

Unfortunately for Mrs. Davis, when determining parties' respective interests for federal tax law purposes, the court must look to state law. This couple lived in Michigan, and Michigan law dictates that spouses are entitled to equal interests in a tenancy by the entirety, even if one has a longer life expectancy.

PREVIOUSLY CONCEDED ISSUE CAN'T BE CHALLENGED

Taxpayers were not allowed to rechallenge a penalty that they had conceded in an earlier proceeding, which led to the issue being dismissed. (***Thompson v. Comm.*** (May 3, 2016) U.S. Court of Appeals, Eighth Circuit, Case No. 15-2329) The taxpayers argued that they had not conceded the "individual" penalty, only the penalty determination against their partnership. However, the court noted that the taxpayers had "expressly and unconditionally conceded the penalty issue as it affected their 2001 joint tax return."

FRAUDULENT RETURNS

The government sought to have an individual tax preparer's fees he was paid for preparing fraudulent returns disgorged because the government provided that the individual and his businesses were unjustly enriched by fraudulently inflating the Earned Income Tax Credit (EITC) on some returns they prepared for customers in order to increase the taxpayer's refund. (***U.S. v. Mesadieu*** (April 12, 2016) United States District Court, M.D. Florida, Case No. 6:14-cv-1538-Orl-22TBS)

FACTS

The complaint in this case was voluminous, but the key allegation is that Mr. Mesadieu, through his wholly owned companies and his tax return preparer employees, prepared thousands of tax returns that were fraudulent in various ways. Though Mesadieu owned and operated his tax preparation stores through eight entities, he was the sole defendant in the government's lawsuit.

In 2009, Mesadieu began his tax preparation business as a district sales manager for LBS Tax Services. In 2011, after two years in the managerial position, Mesadieu became an owner of an LBS franchise. By 2013, Mesadieu owned forty-six LBS franchises.

Each of Mesadieu's stores operated with its own electronic filer identification number (EFIN) that is required by the IRS and serves to identify in which location a tax return was prepared. The EFINs were not in Mesadieu's name individually but rather were in the name of each of his companies that owned that particular store.

The government's lawsuit is based on allegations that Mesadieu and his companies ran a fraudulent tax preparation business serving primarily low-income taxpayers. The government contended that Mesadieu and his companies manipulated the EITC in order to receive the highest tax refund for its customers. At trial, the government submitted evidence showing that Mesadieu's companies were able to increase the EITC, and ultimately its customers' tax refunds, by using a number of tactics. Mesadieu's company benefited from inflated tax refunds because the companies were paid by subtracting their fees from the customers' tax refunds before the customer received it. Tax refunds were issued to the taxpayer via a third-party processor's bank account. The third party processor in this case, EPS Financial, was responsible for deducting and transmitting the tax return preparation fees. The government provided EPS Financial's "Fee Detail Report" comprised of all fees received by Mesadieu's companies.

The government's evidence showed that one of the ways Mesadieu's companies' manipulated the EITC was to create fake businesses to list on the taxpayer's Schedule C, such as a transport service business, hair salon, or barbershop. Other times, the taxpayer's Schedule C claimed losses for a business but did not list a business name. These taxpayer customers testified that no such business existed. Another tactic was to claim false unreimbursed employee expenses on Schedule A. For example, expenses for nondeductible commuter miles or other business-related expenses for unreimbursed meals or uniforms would be claimed. Another often-used strategy was to claim false charitable donations or education credits that the taxpayer testified were not actually paid, nor reported to the tax return preparer.

To establish the amount of disgorgement, the government relied on a random sampling of tax returns prepared by Mesadieu's companies. In total, for all years of tax preparation, Mesadieu's companies prepared around 13,000 tax returns. However, the random sample that the government presented at trial consisted of only 230 tax returns prepared in Houston, Texas, for the tax year 2012. The overall pool of tax returns from which the 230 were selected was approximately 3,600. Despite that 230 tax returns were selected for the random sample, only 115 taxpayers were interviewed regarding their tax returns to determine whether the information on the tax return was fraudulent. Those customers interviewed were not put under oath. From that, the government's expert testified that the percentage of "non-compliant" tax returns — meaning, a taxpayer underreports his taxes due — was 82.6%. Additionally, it is possible that as many as 25% of the tax returns were "compliant," or correctly reported.

DISGORGEMENT OF FEES REMEDY

The government sought to disgorge Mesadieu of the gains he received from this scheme. Mesadieu made multiple arguments why disgorgement was not an appropriate remedy for his fraud, but the court found that disgorgement in the amount of a defendant's "ill-gotten gains" constitutes a "fair and equitable" remedy as it reminds a defendant of his legal obligations, serves to deter future violations of the Internal Revenue Code, and promotes successful administration of the tax laws.

Among Mesadieu's arguments, he argued that disgorgement was not appropriate because his due process rights were being violated. The court held that IRC §7402(a) expressly provides the court with power to "render such judgments and decrees as may be necessary or appropriate for the enforcement of the internal revenue laws." Thus, Mesadieu was certainly on notice that a district court has the power to enter a judgment against him and that tax fraud was not without monetary consequence. The court stated further that "[a]t issue is the monetary amount that Mesadieu has been unjustly enriched with by fraudulently preparing tax returns. Mesadieu has no constitutional right in fraudulently obtained funds."

To be entitled to disgorgement, the government needed only to produce a reasonable approximation of the defendant's ill-gotten gains. "Exactitude is not a requirement; so long as the measure of disgorgement is reasonable, any risk of uncertainty should fall on the wrongdoer whose illegal conduct created that uncertainty." (***S.E.C. v. Calvo*** (2004) 378 F.3d 1211) However, there must be a "relationship between the amount of disgorgement and the amount of ill-gotten gain," and a district court may not order disgorgement of an amount obtained without wrongdoing or obtained during a period where there is no evidence of fraud. (***C.F.T.C. v. Sidoti*** (1999) 178 F.3d 1132)

The court found that the government proved that Mesadieu and his companies had been unjustly enriched by fraudulently inflating the EITC on the tax returns they prepared for customers in order to increase a taxpayer's tax refund. The remaining issue was whether the government provided a reasonable approximation of the amount of this unjust enrichment. The government asked for a disgorgement award in the amount of $11.2 million. Relying on cases that ordered disgorgement of a defendant's gross receipts, the government asked for the total of all fees received by Mesadieu's companies, in all three states, for the tax years 2012-2015. The court concluded that the government did not provide a reasonable approximation of Mesadieu's unjust enrichment.

The court held that "Mesadieu's tax preparation stores did not *always* prepare taxes fraudulently [emphasis in original]." In other words, some of the tax returns were prepared correctly and were perfectly legal. As such, the court's power to order disgorgement is not unlimited. It extends only to the amount the defendant profited from his wrongdoing. (***S.E.C. v. ETS Payphones, Inc.*** (2005) 408 F.3d 727)

Even though the sample of 3,600 out of 13,000 total tax returns was held to contain between 71%–91.7% of fraud, the sample was only from stores in one geographical location and for only one year. The court held that the government sample was not sufficient and that it would not be inordinately expensive or impractical to make the government review all 13,000 returns to determine the amount of fraud instead of simply using a sample. Therefore, the $11.2 million the government sought as disgorgement was unreasonable, and because the government did not meet its burden, the court stated that it was not permitted to order disgorgement. However, the court did order a permanent injunction against the tax preparer that prevents him from ever preparing income tax returns for others.

BRINGING A CASE BEFORE THE TAX COURT

The IRS has completed its examination of your client's income tax returns and you receive the Revenue Agent Report (RAR), which you disagree with. Now what?

THE 30-DAY AND 90-DAY LETTERS

An RAR contains the examining agent's proposed adjustments to your client's income tax return(s). RARs are often referred to as 30-day letters because a taxpayer has 30 days to submit a formal protest and take their issue to the IRS's appeals division.

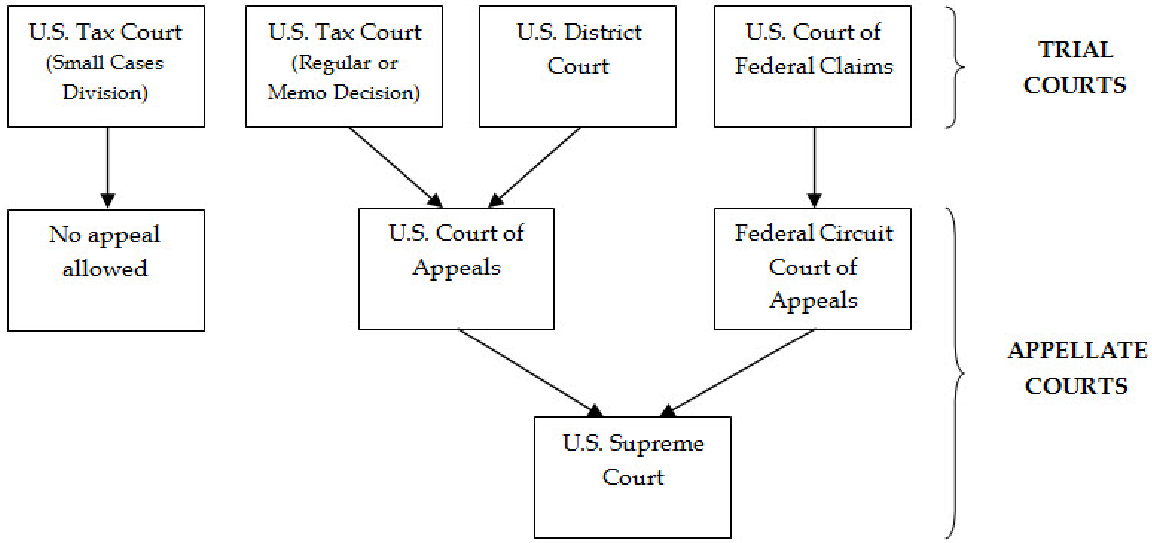
There are many procedural and strategic issues to consider at this point, not the least of which is the time and cost associated with pursuing the issues further. In any event, if a practitioner and his or her client do not file a protest within 30 days or if the protest is unsuccessful, the IRS will issue a Statutory Notice of Deficiency. The Notice of Deficiency is also referred to as a 90-day letter because taxpayers have 90 days to file a petition in the Tax Court.

If a Tax Court petition is not filed, then any tax owed, as determined by the IRS, is considered assessed as of the expiration of the 90 days, and the IRS's collection process will begin.

THE THREE-COURT MENU

One of the aforementioned strategic decisions to consider when your client receives a 30-day letter is to pay the tax in full and sue the government for a refund either in the United States district courts or the United States Court of Federal Claims. Nonattorney practitioners cannot represent their clients before these two courts, so we will discuss them only briefly by way of comparison in the following chart.

Key differences between the courts			
	Tax Court	**Federal District Court**	**Court of Federal Claims**
Permitted representation	Attorneys, nonattorneys, and self-represented *pro se* taxpayers	Attorneys, *pro se* taxpayers	Attorneys, *pro se* taxpayers
Jury trial permitted	No	Yes	No
Tax specialist judge	Yes	No	No
Must pay tax liability before filing	No	Yes	Yes
Opposing counsel	Attorney from IRS District Counsel's Office	Attorney from regional litigation section of tax division of Justice Dept.	Attorney from Court of Federal Claims section of the tax division of Justice Dept.
Discovery	Limited discovery procedures under Tax Court rules	Complete Federal Rules of Civil Procedure	Court of Federal Claims rules (similar to more comprehensive Federal Rules of Civil Procedure)
Where do appeals go (and what precedent applies)?	Court of appeals, then circuit court, where taxpayer resides	Court of appeals, then circuit court, where taxpayer resides	Court of appeals for the federal circuit (Washington, D.C.)
Government's ability to raise new issues at trial	No restriction	"Offset" only (government can raise new issues, but if it wins it cannot collect any more than the taxpayer has already paid and sued to get back)	"Offset" only



THE U.S. TAX COURT

The Tax Court is composed of 19 judges appointed by the President and confirmed by the Senate for 15-year terms. The chief judge position is for a two-year term. Former judges whose terms have ended may become senior judges, able to return and assist the court by hearing cases while serving on recall. In addition, the court is assisted by a number of special trial judges, who are employees of the court and are appointed by the chief judge of the Tax Court rather than by the President. Special trial judges serve a function similar to that served by United States magistrate judges of the district courts, and may hear cases regarding alleged deficiencies or overpayments of up to $50,000 (Summary Opinions).

Although the Court is physically located in Washington, D.C., the judges travel nationwide to conduct trials in various designated cities. Cases are decided by the judge, and there is no jury in Tax Court.

The Tax Court was first established by the Revenue Act of 1924 as the U.S. Board of Tax Appeals. The Board was made up of "members" rather than judges until the Revenue Act of 1942, when it was renamed as a court. Over the years, it has been known as:

- Board of Tax Appeals (1924–October 21, 1942);
- Tax Court of the United States (October 22, 1942–1969); and
- United States Tax Court (1970–present).

COMMENCING A CASE BEFORE THE TAX COURT

A case is commenced in the Tax Court by filing a petition, and other requisite forms, with the court and submitting a filing fee of $60. The Tax Court provides a simplified petition and other required forms and instructions on its website at:

Website
www.ustaxcourt.gov/forms.htm

Tax Court decisions

Depending on the issues being argued and the amount at stake, the Tax Court will issue different types of decisions. Tax court decisions include:

- **Regular opinions:** These decide important legal issues not yet explored by the court or which create an exception to a general rule. These decisions are appealable and have great precedential value;
- **Memorandum opinions:** These decide well-established legal issues, and are primarily based on routine facts. These decisions are also appealable, sometimes as far as the Supreme Court, and can be treated as precedent;
- **Summary opinions:** These are issued from the Small Cases Division and are for disputes involving $50,000 or less (prior to 1998, the dispute limit was $10,000). These decisions cannot be appealed and cannot be treated as precedent. However, the procedure is simplified and less formal, and the case resolution tends to be faster than other decision types; and
- **Reviewed opinions:** These carry even more weight than a regular opinion. All of the Tax Court judges participate in a reviewed decision.

Small tax cases

The term "small tax case" means a case in which the amount in dispute is $50,000 or less for each year at issue, and the taxpayer elects to have their case heard under the more simplified small tax case procedures. The election can be made on the petition. If the Tax Court's simplified petition form is used, the election is made by checking a box. If the taxpayer fails to elect to have their case proceed as a small tax case when their petition is filed, they may still make the election at any time before trial commences. The IRS may oppose the taxpayer's request to have their case heard as a small tax case.

Second shot at appeals

Tax Court cases, especially small tax cases, are regularly kicked back to an IRS appeals office to give the taxpayer and the IRS another chance at settling the case before it goes to trial. Issues that were not settled by the appeals office before a petition was filed may settle the second time around if the IRS decides the hazards of litigation warrant settlement before trial.

Taking your case to trial

The myriad procedural rules relating to pleadings, motions, discovery, trial, decisions, etc., are beyond the scope of this course, but the complete Tax Court Rules of Practice and Procedure can be found online at:

Website
www.ustaxcourt.gov/rules.htm

Golsen rule

Regarding the possibility of a case being appealed, even if the Tax Court disagrees with prior decision precedents set by the circuit court the taxpayer would appeal to, it will most likely follow that precedent anyway. This is known as the ***Golsen*** rule. (***Golsen v. Comm.*** (1970) 54 TC 742) It provides for the Tax Court to make a decision without forcing a party to appeal when the outcome of the appeal is presumed to be known (interestingly, even in Summary Opinions, which are not appealable). (See Cohen, Mary Ann, How to Read Tax Court Opinions. (March 25, 2001) Transcript of presentation given to Corporate and Taxation Law Society at the University of Houston Law

Center. Available at: www.hbtlj.org/v01/v01_cohen.pdf; Smith, Carlton M., Does the Tax Court's Use of its Golsen Rule in Unappealable Small Tax Cases Hurt the Poor? (December 29, 2008) *Journal of Tax Practice and Procedure*, 2009; Cardozo Legal Studies Research Paper No. 249. Available at SSRN: http://ssrn.com/abstract=1321464)

Example of applying the Golsen rule

If Taxpayer A resides in Texas and takes a case to Tax Court, the case would be appealable to the Fifth Circuit Court of Appeals. If Taxpayer A's issue has been reversed by the Fifth Circuit previously, the Tax Court will follow the law of the Fifth Circuit, because if Taxpayer A appeals, it is predictable how the Fifth Circuit would rule. If Taxpayer B lives in Oklahoma and takes the same issue to Tax Court, Taxpayer B's case would be appealable to the 10th Circuit. If the 10th Circuit has not ruled on the issue in this case, the Tax Court may follow the Fifth Circuit's opinion or follow its own view.

Tax Court reliance on precedents

The ***Golsen*** rule applies to Tax Court decisions in situations where the court of appeals for the taxpayer's circuit has already tried the issue, but what if there is no precedent in the taxpayer's circuit?

If the Tax Court is reversed by, for example, the Eighth Circuit, and the issue comes up again, appealable to the Ninth Circuit, the court has the choice of following the Eighth Circuit's decision or following its own original (reversed) decision. (Cohen, Mary Ann, How to Read Tax Court Opinions (March 25, 2001) Transcript of presentation given to Corporate and Taxation Law Society at the University of Houston Law Center. Available at: www.hbtlj.org/v01/v01_cohen.pdf) The Tax Court is not bound by law to follow one circuit when the case would be appealable to another.

However, in the absence of any precedent in the taxpayer's circuit, the Tax Court may rely on decisions from another circuit — even if the Tax Court does not agree with those decisions (for example, ***Banker's Union Life Insurance Co. v. Comm.*** (1974) 62 TC 661 and ***Bradford v. Comm.*** (1973) 60 TC 253) — simply because there are no appellate courts that supported the Tax Court's view. (Geier, Deborah A., The Emasculated Role of Judicial Precedent in the Tax Court and Internal Revenue Service, (January 1, 1986) 39 Oklahoma Law Review 427)

ADMISSION TO PRACTICE BEFORE TAX COURT

Nonattorneys

Nonattorneys may be admitted to practice before the Tax Court, provided they file an application and pay an application fee with the Tax Court's applications clerk and pass a written examination:

- The examination consists of four parts: Tax Court Rules of Practice and Procedure, Federal Taxation, the Federal Rules of Evidence, and legal ethics;
- The examination lasts four hours, and applicants must pass each of the four sections with a score of 70% or greater;
- The examination is held once every two years, in November of even numbered years;
- The examination is held in Washington, D.C.;
- Review courses can cost in excess of $6,000; and
- Applicants must be sponsored by at least two persons who are already admitted to practice before the Tax Court, and each sponsor must send a letter of recommendation directly to the admissions clerk.

Attorneys

Attorneys who wish to be admitted to practice before the Tax Court must meet the following requirements:

- Provide certificate of good standing from state bar of state where they are admitted to practice law;
- Meet the two-sponsor requirement; and
- Pay a fee of $35.

CLASSIC CASES

EISNER V. MACOMBER (1920) 252 U.S. 189

On January 1, 1916, the Standard Oil Company of California had outstanding roughly 500,000 shares of common stock at a par value of $100 per share. On that date, Standard Oil carried in its corporate accounts a record of surplus amounting to about $45 million, of which about $20 million had been earned prior to March 1, 1913 (the effective date of the Revenue Act of 1913). Since the undivided profits had been reinvested internally in the company's business, the company decided in January of 1916 to readjust the corporation's capital structure and readjusted some of those funds from the surplus account to the capital stock account. To do this, they issued a stock dividend.

Each stockholder received additional shares of stock equal to 50% of shares currently owned. Myrtle Macomber was the owner of 2,200 shares of the original stock, so she received a distribution representing 1,100 additional shares at a par value of $100.

QUESTIONS

Was the stock dividend taxable?

The Revenue Act of 1916 stated clearly that a distribution by a corporation was taxable whether it was paid "in cash or in stock of the corporation ... which stock dividend shall be considered income to the amount of its cash value."

Applying the statute, the IRS determined that 18.07%, or 198.77 shares, of Macomber's dividend represented surplus earned by the corporation since March 1, 1913, and imposed a tax on this amount computed at its par value of $19,877. She paid the tax under protest and brought action against the IRS claiming that this tax was unconstitutional because her stock dividend was not income within the meaning of the 16th amendment. The district court agreed with her, and the IRS appealed to the Supreme Court.

Thus, the Supreme Court had to decide whether a tax on a stock dividend was a tax on "capital" under the original articles or a tax on income under the 16th amendment.

COURT'S OPINION

In finding for the taxpayer, the court characterized the stock dividend as a bookkeeping entry on the part of the corporation. They noted that the value of Macomber's stock declined from $382 per share before the dividend to $234 after the dividend, indicating that her "wealth was not significantly altered by the stock dividend."

Therefore, to tax a stock dividend would be to tax capital, which would be unconstitutional under the articles without apportionment, and the 16th amendment only authorized taxation of income.

Struggling to define income, the court stated that gain is:

> "*Derived – from – capital*"; "*the gain – derived – from – capital.*" Here we have the essential matter: *not* a gain *accruing to* capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in,* being *derived,* that is *received* or

> *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal; *that* is income derived from property. Nothing else answers the question."
>
> "A stock dividend, far from being a realization of profits to the stockholder tends rather to postpone such realization in that the fund represented by the new stock has been transferred from surplus to capital, and no longer is available for actual distribution."

REALIZATION

Prior to ***Macomber***, it was not known whether appreciation in assets would be taxable. The ***Macomber*** court grappled with the phrase "derived from" to produce the doctrine of realization.

CURRENT LAW

The rule of ***Eisner v. Macomber*** is now contained in IRC §305(a), which provides that gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock. There are limitations under IRC §305(b), including the option of a shareholder to take cash or property in lieu of stock or disproportionate distributions. (IRC §305(b)(1) and (2)) Under IRC §307(a), the basis of the old and new stock is allocated ratably. Under IRC §1223(5), the holding period of the old stock is tacked on to the new stock.

COMM. V. GLENSHAW GLASS CO. (1955) 348 U.S. 426

Glenshaw Glass was a consolidation of two independent factual backgrounds that presented an identical issue.

In ***Comm. v. Glenshaw Glass***, the Glenshaw Glass Company became embroiled in a legal dispute with the Hartford-Empire Company in which Glenshaw Glass was seeking damages for fraud and treble damages for injuries to its business by reason of Hartford's violation of federal antitrust laws. In December of 1947, the parties concluded a settlement in which Hartford paid Glenshaw approximately $800,000. Of the total settlement, $324,530 represented payment of punitive damages for fraud and antitrust violations. Glenshaw did not report this portion of the settlement as income. The Tax Court and the court of appeals upheld the taxpayer.

In ***Comm. v. William Goldman Theaters, Inc.***, William Goldman Theatres sued Loew's, Inc. alleging violation of antitrust laws and seeking treble damages. They received $375,000 in the settlement but excluded $250,000 from income, contending that punitive damages are not taxable.

Both taxpayers cited ***Eisner v. Macomber*** and argued that income could only be derived from capital or labor and, because punitive damages are derived from neither, it could not be taxable.

COURT'S RULING

The court stated that ***Macomber*** was never meant to "provide a touchstone to all future gross income questions."

> "Here we have instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion. The mere fact that the payments were extracted from the wrongdoers as punishment for unlawful conduct cannot detract from their character as taxable income to the recipients. Respondents concede, as they must, that the recoveries are taxable to the extent that they compensate for damages actually incurred. It would be an

> anomaly that could not be justified in the absence of clear congressional intent to say that a recover for actual damages is taxable but not the additional amount extracted as punishment for the same conduct which caused the injury. And we find no such evidence of intent to exempt these payments."

LEGACY OF THE CASE

At the time, it was decided ***Glenshaw*** seemed like an ordinary case that held punitive damages to be taxable. However, since its release, the case has been heavily cited. Prior to the case, the definition of income was still not well settled, and the taxpayer's reference to ***Macomber*** is revealing. In ***Macomber***, the court strongly implied that income could *only* be derived from labor or capital.

The court laid out a clear test for income that is largely in effect today. Income is realized when there are instances of undeniable accessions to wealth that are:

- Clearly realized; and
- Over which the taxpayers have complete dominion.

IRC §104

In footnote 15, the court said, "The long history of departmental rulings holding personal injury recoveries non-taxable on the theory that they roughly correspond to a return of capital cannot support exemption of punitive damages following injury to property."

IRC §104 essentially follows this thinking. It provides that damages received on account of personal injuries are excluded from income but punitive damages are taxable. (IRC §104(a)(2))

CRANE V. COMM. (1947) 331 U.S. 1

Beulah Crane inherited an apartment building worth $255,000 encumbered by a nonrecourse mortgage of $255,000. She held the property for seven years, hoping to turn it around. She reported rental income, and related expenses included about $25,000 of depreciation on the property.

When the mortgagor threatened foreclosure, she sold the property for $3,000 cash, and the purchaser assumed the mortgage. She had $500 of selling expenses.

Her theory was that she had inherited nothing of value. Her position was that neither her initial basis in the property nor her amount realized upon disposition should include the amount of the debt. As it was nonrecourse debt she was not personally liable for it. In essence, she argued that she had inherited "equity" rather than "property."

Although this position was arguably inconsistent with her prior claim of depreciation deductions, it was too late for the government to deny those prior deductions. The IRS challenged her attempted whipsaw by asserting that the debt should be included in both the amount realized and the basis (this was during the Depression, and her $25,000 in depreciation deductions had saved her $122 in taxes over the years).

The Tax Court found 14-2 in Crane's favor. However, the appeals court reversed.

RULING

The court found no basis to think that "equity" was synonymous with "property." In addition, the court was troubled by the administrative complications that would be caused by replacing "property" with "equity" when determining depreciation. In essence, the court stated a "tax benefit" theory.

Comment

In other words, the court envisioned the only alternative, for depreciation purposes, of not including nonrecourse debt in the basis of property. For example, say a taxpayer purchases a building for $100,000, putting $10,000 cash down and securing a $90,000 nonrecourse mortgage.

Without including the nonrecourse debt in basis, the taxpayer could only include $10,000 in basis for depreciation purposes. As the taxpayer made principal payments on the mortgage, the basis would increase. Assume that in the first year, the mortgage payments included $1,000 of principal. The taxpayer would then be required to increase basis by $1,000 and recompute depreciation.

Second, the court sided with cases repudiating the claim that there must be an actual receipt of money or other property for a taxable gain to result from a transaction.

Finally, the court determined that a mortgagor who transfers property subject to a mortgage is in the same position as if the purchaser had paid an amount equal to the mortgage and the mortgagor had used the funds to pay off the mortgage. In essence, the court stated an "economic benefit" theory.

FOOTNOTE 37

However, in the famous footnote 37, the court left open a question regarding its own conclusions regarding economic benefit that was not resolved until ***Tufts v. Comm.***, 36 years later:

> "Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. This is not the case."

RAMIFICATIONS

Crane has been held responsible as the biggest single creator of tax shelters. It established the foundation for the onslaught of tax shelters that peaked in the early 1980s by allowing taxpayers to take depreciation deductions exceeding the amount of the taxpayer's true investment in the property. This made unprofitable ventures viable because of the tremendous potential for tax savings.

The enormous latent impact of ***Crane*** materialized upon the accelerated depreciation rules (ACRS) under the Economic Recovery Tax Act of 1981, which allowed for highly accelerated depreciation. Under ACRS, for example, almost all buildings could be depreciation over 15 years with accelerated depreciation in the early years.

The most common entity type during the tax shelter years was the limited partnership, because the limited partners could enjoy limited liability but could claim their share of depreciation deductions. With minimal upfront cash supported by nonrecourse debt, they could enjoy tax savings even though office buildings were being constructed where there were unoccupied buildings in the vicinity.

The ability to invest in these types of tax shelters spiraled out of control until Congress enacted the Tax Reform Act of 1986. The enactment of IRC §469 limiting losses on passive activities essentially shut the door on these types of investments.

It has also been said that the 1986 tax reforms were partially responsible for the savings and loan crisis in the late 1980s. The real estate market became depressed throughout much of the U.S. after the 1986 act. After the enactment of the passive loss rules, many investors began abandoning these properties. Because the investors lacked personal liability, the banks were unable to recover deficient judgments against them.

TUFTS V. COMM. (1983) 461 U.S. 300

More than 35 years after the ***Crane*** decision, the court was faced with reconciling the economic benefit theory of ***Crane*** with the concerns of footnote 37.

The taxpayers, a partnership, borrowed in excess of $1.8 million on a nonrecourse basis to purchase an apartment complex. When their basis in the property was $1,455,000 (after accumulated depreciation) and the fair market value of the property had declined to $1,400,000, they sold it for no consideration other than assumption of the nonrecourse mortgage.

They claimed a loss of $55,000 — the excess of the basis over the fair market value of the property. The IRS insisted, however, that they actually had a gain of $400,000 — the excess of the loan balance over the basis.

The Tax Court found in favor of the IRS. However, the Fifth Circuit reversed the Tax Court and, relying on footnote 37 of ***Crane***, ruled that the fair market value at the time of disposition of property securing nonrecourse debt limits the extent to which any relief of ability can be included in the amount realized. The court focused on the two principal theories underlying ***Crane***: the economic benefit theory and the tax benefit theory. Addressing the economic benefit theory, the court agreed with the basis proposition that relief from a debt on which one is personally liable is a benefit to the taxpayer. However, in the case of a nonrecourse mortgage, the owner incurs no economic benefit on the transfer of the property and the mortgage obligation because he has no personal liability. The Fifth Circuit concluded that the fair market value of property secured by a nonrecourse mortgage limits the extent to which relief of liability can be included in the amount realized upon disposition of the property.

TAX BENEFIT

Rejecting the economic benefit theory as "seriously flawed," the Supreme Court ruled that the tax benefit rule is controlling.

The tax benefit rule is of judicial origin and has been codified in various parts of the Internal Revenue Code. IRC §111 (1976) provides that when a prior deduction for bad debts, prior taxes, or delinquency amounts resulted in an income tax benefit in a prior year, then, to the extent of the benefit, the recovery of these amounts in a later year must be included in gross income. IRC §1245 and §1250 provide for depreciation recapture.

These rules evolved from judicial precedent:

- Refunded personal property taxes must be included in income when deducted in a prior year (***First Trust and Savings Bank of Taylorville v. U.S.*** (1980) 614 F.2d. 1142);
- Deductions taken by a taxpayer for a charitable contribution based on conveyance of realty were classified as income upon recoupment of the property (***Alice Phelan Sullivan Corp. v. U.S.*** (1967) 381 F.2d. 399); and
- Previously deducted taxes are treated as income in the year refunded. (***Union Trust Co. v. Comm.*** (1940) 111 F.2d. 60)

The tangled web

The tax benefit rule provides a comfortable kind of arithmetic symmetry. Consider the following numbers:

Description	**Amount**
Cash down	$10,000
Nonrecourse mortgage	$90,000
Total purchase price	$100,000
Accumulated depreciation	$30,000
Basis at time of transfer	$70,000
Mortgage balance at time of transfer	$85,000
FMV at time of transfer	$60,000
Gain computation	
Mortgage balance	$85,000
Adjusted basis	$70,000
Gain	$15,000
Total cash expended	
Down payment	$10,000
Principal payments	$5,000
Total cash expended	$15,000
Depreciation taken	$30,000
Net tax benefit	$15,000

Thus, the net tax benefit equals the gain.

In addition to the various tax benefit rules (noted above), ***Crane*** and its progeny created a web of tax rules largely offsetting each other (IRC §469) or providing relief from adverse effects of discharge of debt (the various exclusion provisions of IRC §108).

Note that Beulah Crane only saved $122 due to the depreciation she took on the apartment building. Note, too, that under the "allowed or allowable" depreciation rules, she had no choice but to take depreciation.

So, taxpayers must include debt in basis and must depreciate that basis. Then they must take the excess of that debt over the depreciated basis into income even when the depreciation might have provided very little tax benefit.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

30. In ***Kurek v. Comm.***, another worker classification case, which statement correctly describes the applicable common law factors?

    a) The workers were hired on a project-by-project basis, which meant they were independent contractors
    b) The taxpayer at issue controlled his workers to the extent that they were a fundamental part of his business
    c) The workers had their own business names, which indicated that they were independent
    d) As independent contractors, the workers dealt with the customers more than the business owner

31. In the following court case scenarios, how were the employer-employee relationships adjudicated?

    a) In ***Schramm v. Comm.***, an online professor who worked from home was judged to be an employee because the university that employed him required that he follow their employment practices, and they issued him a W-2
    b) In ***Donald G. Cave, A Professional Law Corp. v. Comm***., associate attorneys and a law clerk were independent contractors rather than employees because the president of the company asserted no control over their work
    c) In ***Jones v. Comm.***, a wife who worked for her husband's law practice was judged to be an employee because of their personal relationship
    d) In ***Keller v. Comm***., the critical test in determining an employer-employee relationship was the actual control that the principal had in controlling his agents, and in this case, the taxpayer was judged to have total control over his auto repair shop workers

32. What were the government's allegations in the case ***U.S. v. Mesadieu***, and what remedies were applied?

    a) Mesadieu received payments from his customers based on a percentage of their refunds
    b) In this case, the government needed to provide a reasonable approximation of the taxpayer's ill-gotten gains, which it failed to do
    c) The court agreed with Mesadieu that disgorgement violated his due process rights
    d) The court ordered disgorgement of Mesadieu's fraudulently obtained funds

33. What are some of the key differences among the Tax Court, the U.S. Court of Federal Claims, and the district court?

    a) Nonattorney practitioners may represent their clients both in Tax Court and in district court
    b) A jury trial is permitted only in a federal district court
    c) Tax specialist judges preside in all three courts
    d) By the time an issue reaches Tax Court, the government may not raise new issues at trial

34. Which choice below accurately describes details of the U.S. Tax Court?

    a) The chief judge is a three-year position
    b) The judges appointed by the President must be confirmed by the Senate and the House of Representatives
    c) Special trial judges are appointed by the chief judge and may hear cases related to disputes up to $50,000
    d) In order to file a petition with the Tax Court, a $50 fee must be attached to the required form

35. Characteristics of the various Tax Court decisions are correctly stated in which of the following?

    a) Summary opinions can be appealed
    b) Regular opinions decide on legal issues that have already been reviewed by the Tax Court
    c) Reviewed opinions carry less weight than regular opinions
    d) Memorandum opinions can be appealed all the way to the Supreme Court

36. For nonattorneys who want to practice before the Tax Court, they must pass a written examination and fulfill other obligations, the details of which are described in which choice?

    a) Applicants require sponsors
    b) The examination is in two parts: Tax Court Rules of Practice and Procedure, and Legal Ethics
    c) The examination is held annually
    d) The applicants must pass each section of the test with a 75% or greater score

37. What are the significant factors of the case ***Eisner v. Macomber***?

    a) The court grappled with the taxability of assets under the 16th amendment, which authorizes taxation of income and capital
    b) IRC §305(a) is based on the rule of ***Eisner v. Macomber*** and states that the amount of any distribution of corporation stock made to its shareholders is not included in gross income
    c) There are no limitations under IRC §305, which provides that a shareholder may take cash or property in lieu of stock without including that cash or property in gross income
    d) ***Macomber*** made the appreciation of assets taxable

SOLUTIONS TO REVIEW QUESTIONS

30. In ***Kurek v. Comm.***, another worker classification case, which statement correctly describes the applicable common law factors? **(Pages 72-73)**

    a. Incorrect – Although they were hired on a project-by-project basis, they were not considered independent contractors because of the level of control the taxpayer had over them as well as their role in his business.
    b. Correct – Based on the taxpayer's relationship with his workers and his reliance on them for the functioning of his business, the taxpayer was held liable for employment taxes for the years in question.
    c. Incorrect – The workers had no individual business names but were paid by the taxpayer with checks made out to them personally.
    d. Incorrect – The taxpayer-owner was the one who interfaced with customers and negotiated the project costs, building in the worker fees.

31. In the following court case scenarios, how were the employer-employee relationships adjudicated? **(Pages 73-74)**

    a) Correct – The university regarded the professor as an employee, as confirmed by their issuance of a W-2, even if the taxpayer believed he was an independent contractor.
    b) Incorrect – The president, in fact, asserted control over their work, the firm made an investment in their accommodations, and there was stability in the workers' association.
    c) Incorrect – In this case, the wife was judged to be the husband's independent contractor based on these facts: She was issued a 1099 and paid self-employment taxes; the husband had no control over his wife's work; the wife's payments were based on settlement amounts, so possibly, she could have received nothing for her work.
    d) Incorrect – In this case, 7 out of 10 auto repair workers were judged to be independent contractors. Moreover, the critical test in determining the employer-employee relationship is the right to control, whether or not that right is asserted.

32. What were the government's allegations in the case ***U.S. v. Mesadieu***, and what remedies were applied? **(Pages 78-80)**

    a) Incorrect – The defendant's companies subtracted their fees from clients' tax refunds prior to the clients receiving them.
    b) Correct – Although the court agreed that the government proved that the defendant fraudulently inflated the EITC on customers' tax returns, they felt that the disgorgement amount was unreasonable because it was based on too limited a sampling of the fraudulent tax returns.
    c) Incorrect – The court noted that the defendant had no constitutional right to funds that he obtained fraudulently; consequently, disgorgement as a remedy was appropriate.
    d) Incorrect – The court ruled that the government's sampling of the tax returns in question was not sufficient, and although there is no requirement of exactitude when it comes to disgorgement, the government only presented a sample of 3,600 returns out of a total of 13,000.

33. What are some of the key differences among the Tax Court, the U.S. Court of Federal Claims, and the district court? **(Page 81)**

    a) Incorrect – Nonattorney practitioners are limited to representation in Tax Court only.
    b) Correct – Of the three courts, a jury trial is only permitted in district court.
    c) Incorrect – Tax specialist judges preside only in Tax Court.
    d) Incorrect – There is no restriction on raising new issues at Tax Court. For the Court of Federal Claims and district court, the government can raise new issues but cannot collect any more money than what the taxpayer has already paid.

34. Which choice below accurately describes details of the U.S. Tax Court? **(Page 82)**

    a) Incorrect – It is a two-year term.
    b) Incorrect – Only the Senate provides confirmation.
    c) Correct – It is these judges who provide Summary Opinions, which cannot be relied upon as precedent.
    d) Incorrect – The fee is $60.

35. Characteristics of the various Tax Court decisions are correctly stated in which of the following? **(Page 82)**

    a) Incorrect – Summary opinions cannot be appealed nor treated as precedent.
    b) Incorrect – Important legal issues that have not been examined by the court provide the basis for regular opinions.
    c) Incorrect – Reviewed opinions are based on the participation of all of the Tax Court judges and carry more weight than regular opinions.
    d) Correct – They are also treated as precedent.

36. For nonattorneys who want to practice before the Tax Court, they must pass a written examination and fulfill other obligations, the details of which are described in which choice? **(Page 84)**

    a) Correct – The applicant must have two sponsors who already practice before the Tax Court; each sponsor must sent a letter of recommendation on behalf of the applicant.
    b) Incorrect – There are four parts: the two listed plus Federal Taxation and the Federal Rules of Evidence.
    c) Incorrect – It is a biennial examination held in Washington, D.C.
    d) Incorrect – Incorrect – The minimum correct score is 70% on each section.

37. What are the significant factors of the case ***Eisner v. Macomber***? **(Page 86)**

a) Incorrect – The court already understood that the 16th amendment only authorized the taxation of income. Taxing stock dividends would mean taxing capital, which would not be authorized.
b) Correct – The court tackled the issue of what "derived from" meant and came up with the doctrine of realization, a principle that states that gain must be realized before it is subject to income tax.
c) Incorrect – If a shareholder takes cash or property in lieu of stock or takes disproportionate distributions, this would represent an exception to the rule of IRC §305, and that distribution would be included in gross income and taxable.
d) Incorrect – Before ***Macomber***, there was no rule as to whether the appreciation of assets was taxable. After ***Macomber***, and under IRC §305, gross income does not include any amount from the distribution of stock from a corporation to its shareholders.

LUCAS V. EARL (1930) 281 U.S. 111

Guy Earl served as president of the Board of Regents of the University of California and was a board member of Pacific Gas and Electric. In 1901, he and his wife, Ella, entered into an agreement that everything they earned or owned would be held by them as joint tenants with right of survivorship. The agreement was intended as a substitute for a will, so that their property would pass directly from one to the other without having to go through probate. At the time the contract was entered into, there was no income tax.

When the modern income tax was enacted in 1913, individuals filed their own returns — there was no joint filing status. When they filed their tax returns, they split their income (mostly Guy's earned income). Because rates were progressive, the ability to split income between two taxpayers saved a significant amount in income taxes.

This income-splitting rule was mandatory under state law in all community property states except California, the state of the Earls' residence. During the years in question, 1920 and 1921, California spouses were not only denied the benefit of income splitting enjoyed by spouses in other community property states, but they were also penalized for owning community property because California provided that the husband was manager of the community and, thus, had to report his wife's income on his return.

RULING AND THE ASSIGNMENT OF INCOME DOCTRINE

Finding that income could not be assigned by agreement, the court famously stated that "The fruits cannot be attributed to a different tree from that on which they grew." The court indicated that there was "no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it."

HELVERING V. CLIFFORD (1940) 309 U.S. 331

In the ***Clifford*** case, the taxpayer had declared himself trustee of certain securities. The trust was for a five-year period, terminating sooner upon the death of either the grantor or his wife. The trust income was to be held for the wife's exclusive benefit. Although the grantor had absolute discretion as to the amount to be distributed to her, any amount undistributed at the trust's termination was to be her separate property. The grantor retained wide powers of management and control.

The basis for the decision holding the grantor taxable on the trust income under IRC §22(a) was, according to the case opinion, that "In this case we cannot conclude as a matter of law that respondent ceased to be the owner of the corpus after the trust was created. Rather, the short duration of the trust, the fact that the wife was the beneficiary, and the retention of control over the corpus by respondent, all lead irresistibly to the conclusion that respondent continued to be the owner for purposes of Section 22(a)." (**Note:** IRC §22 was the 1939 Code's version of the current IRC §61.)

Comment

It is now established by the ***Clifford*** case that the substantial retention of rights, along with other ownership attributes, may justify taxing the grantor as the owner of the trust property — not under the specific provisions of IRC §§166 and 167, but under the more elastic provisions of IRC §22(a) defining gross income.

The Treasury promulgated the so-called "Clifford Regulations" in 1946, based on the Supreme Court's interpretation of the gross income concept. The regulations taxed the grantor on a trust's income if the trust corpus or income would or might return to the grantor after a short term of years. This could occur either by the grantor retaining a reversionary interest that would vest within 10 years or less, or certain administrative powers that would vest within 15 years. The grantor could also be taxed if the grantor or a nonadverse person (or both) had a power of disposition over the beneficial enjoyment of corpus or income. Finally, the grantor could be taxed if the grantor retained any of a series of broad administrative powers primarily for the benefit of the grantor. (§29.22(a)-21; Treas. Decision 5488, 1946-1 C.B. 19)

In 1954, IRC §§673–675, which supported the Clifford Regulations, were enacted.

POE V. SEABORN (1930) 282 U.S. 101

Several months after ***Earl***, the Supreme Court ruled in ***Poe v. Seaborn*** that residents of Washington, a community property state with mandatory income splitting, could split their income on their tax returns.

Mr. Seaborn worked and his wife didn't. On their separate tax returns, they each reported half of the income Mr. Seaborn earned.

The court ruled that in community property states, the community, not the individuals, earned the income. The court noted that "under the law of Washington, the entire property and income of the community can no more be said to be that of the husband than it could rightly be termed that of the wife." The court said that Mr. Seaborn never had complete title to the income. The moment it was earned, it was owned by the community.

DISTINGUISHED FROM *LUCAS V. EARL*

The court distinguished its finding from those in ***Earl*** on the grounds that, in ***Earl***, there was a contractual assignment. In ***Seaborn***, the income was split as a matter of state law.

NEW COMMUNITY PROPERTY STATES, THE JOINT RETURN, AND OTHER LASTING EFFECTS

Prior to ***Seaborn***, there were eight community property states that, in most cases, were community property states due to Spanish historical influence. Those eight states are still community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington). However, because of the inequitable treatment of taxpayers that resulted from ***Seaborn***, five other states enacted community property laws between 1939 and 1947 (Michigan, Nebraska, Oklahoma, Oregon, and Pennsylvania — as did Hawaii, though it wasn't yet a state).

Oklahoma's law was overturned by the Supreme Court because its community property rules were elective. (***Comm. v. Harmon*** (1944) 323 U.S. 47) Oklahoma's statute did not create community property between a husband and wife as an incidence of marriage; it made it contractual, much like the situation in ***Earl***.

Those states quickly repealed their community property laws when Congress created the joint tax return under the Revenue Act of 1948, which stated that "equalization is provided for the tax burdens of married couples in common-law and community property states."

This led to the marriage penalty, and Congress has been fighting it ever since. For example, the Economic Growth and Tax Relief Reconciliation Act of 2001 introduced IRC §1(f)(8) to the Code, which mitigates the marriage penalty in lower tax brackets. The Jobs and Growth Tax Relief Reconciliation Act of 2003 accelerated benefits to joint return filers by eliminating the marriage penalty for 2003 and 2004.

Marriage penalty under Obamacare

Under the Affordable Care Act, higher income taxpayers pay a tax on net investment income and on earned income, at the rates of 3.8% and 0.9%, respectively, of income above certain MAGI thresholds. Those thresholds are the same for both taxes:

- $250,000 for married filing joint;
- $125,000 for married filing separate; and
- $200,000 for all others.

Take the example of two single individuals who each earn $200,000. Neither will be subject to either tax because their separate incomes are not above the filing thresholds. Now assume they marry and combine their incomes at $400,000. Their joint income is now $150,000 above the threshold for joint, meaning they will pay a tax on up to $150,000. With respect to the 3.8% net investment income tax, up to $150,000 of their income may be taxed, meaning they will pay up to $5,700 per year every year until death do they part.

In addition, the joint filing status led to problems of the "innocent spouse" and the complex rules that go with that status.

COMMUNITY PROPERTY STATES AND DEATH

When a couple lives in a community property state, IRC §1014(b)(6) provides that community property received from a decedent gets a step-up in basis on both halves of the property. In addition, IRC §2033 requires that only half of the value of community property be included in the decedent's gross estate.

FARID-ES-SULTANEH V. COMM. (1947) 160 F.2D 812

The taxpayer-wife in this case is Princess Farid-es-Sultaneh, who was born Mabel Doris Mercer in 1889 and was the daughter of a Pittsburgh police captain. Her third marriage was in 1933 (prior to this 1947 case), to Prince Farid Khan Sadri-Qajar, a cousin of the Shah of Persia. Within two years, the princess and the prince were divorced, and although the prince wanted her to relinquish the title of princess when they divorced, Mercer kept the title, hence the name that appears on this case.

When Mercer married S.S. Kresge in 1924 (divorcing in 1928), she was 32 years old; he was 57 years old and worth approximately $375,000,000 and owned real estate of the approximate value of $100,000,000. Sebastian Spering Kresge was the founder of the S. S. Kresge Company, one of the 20th century's largest retail organizations. The company was renamed the Kmart Corporation in 1977.

Mercer sold stock which she had received from S. S. Kresge, pursuant to a pre-nuptial agreement under which she accepted the shares in consideration for surrendering all marital property rights in her husband's estate. The stock had a basis in the husband's hands of 15 cents a share, but a fair market value of $10 a share when transferred to her.

However, in 1947, the IRS took Mercer to court over what the fair market value should have been for the shares when she received them from her husband. The IRS held the opinion that the stock should be taxed at a higher rate as a gift. Mercer argued that the transfer of stock from husband to wife was not a gift, but an exchange of stock for marital property rights, and she prevailed.

There was sufficient consideration, underlying the taxpayer's receipt of the corporate stock pursuant to a pre-nuptial contract in exchange for relinquishing her inchoate interest in her affianced husband's property, because this inchoate interest greatly exceeded the value of the stock transferred to her. Hence, she did not acquire the stock by "gift," and need not take her husband's cost basis in determining her taxable gain on subsequent sale of the stock.

U.S. V. DAVIS (1962) 370 U.S. 65

In 1962, the Supreme Court held in ***U.S. v. Davis*** that divorce was a taxable transaction for taxpayers in non-community property states, but not in community property states. Again, the states rushed to legislate community property.

Finally, in 1984, Congress passed legislation enacting IRC §1041, which provided for no tax consequences on divorce.

COHAN V. COMM. (1930) 39 F.2D 540

In the entertainment world, George M. Cohan was the father of the American musical comedy. His repertoire includes over three dozen musicals and classic songs like "Give My Regards to Broadway" and "The Yankee Doodle Boy." His career began at age 8, performing and writing skits for his family's vaudeville troupe. Later, he transitioned into Broadway, where his contributions earned him a Congressional Gold Medal — the first ever awarded to a person from an artistic field.

In the tax world, his legacy may be just as far reaching because of his suit against the IRS in 1930 regarding business expense deductions. (***Cohan v. Comm.*** (1930) 39 F.2d 540)

CASE DETAILS

As a producer and writer of plays, Cohan necessarily did a lot of entertaining for actors, employees, and dramatic critics. He estimated that in 1921 and 1922 he spent $55,000 on various entertainment and travel expenses.

Adjusted for inflation

The value of $55,000 in 1921 would be $740,051.12 in 2016, according to the CPI inflation calculator provided on the Bureau of Labor Statistics website:

Website
www.bls.gov/data/inflation_calculator.htm

The IRS disallowed his deductions in full because he didn't have the substantiation to back up how much he had spent and on what. But the court of appeals felt that total refusal wasn't justified. He had spent a sum of money on an allowable expense, and so he should be able to deduct something — the court noted that it was inconsistent to disallow any deduction at all when clearly he had incurred an expense, even though the amount wasn't able to be exactly determined beyond Cohan's own recollections and approximations.

The court felt that the IRS could concede to at least an estimate of what the expenses were: "Absolute certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses on the taxpayer, whose inexactitude is of his own making." (Here, "the Board" refers to the Board of Tax Appeals — now known as the U.S. Tax Court — which was Cohan's first stop. The Board upheld the IRS, after which Cohan took the case to the Second Circuit Court of Appeals.)

The case also dealt with other tax aspects of Cohan's royalty income, the gifting of royalties, and a change in accounting period. But the decision regarding the deductibility of his unsubstantiated deductions is what made the case famous. (As an aside, he lost on most of the other points of his case.)

HOW THE CASE AFFECTED LAW

The ***Cohan*** rule recognizes that in the course of business, in order to make money, taxpayers must spend money on deductible expenses. This can be assumed to be true even if the taxpayer doesn't have the records to back up the exact amount.

Provided the taxpayer is able to give at least some credible evidence that the expenses were legitimate, the amount of the deduction can be reasonably estimated. In the absence of "adequate records" (see below), the taxpayer can provide:

- Testimony;
- Canceled checks;
- Notes in an appointment book; or
- Other records that can reconstruct the expenses.

Based on what records exist, the taxpayer may receive at least part of the deduction. It is up to the discretion of the court or the IRS auditor to determine how credible the taxpayer's testimony or existing records are.

Nowadays, when taxpayers find themselves in court fighting for deductions for which they have no substantiation, the court may invoke the ***Cohan*** rule and allow a portion of the expenses. However, the court's mantra is always that the estimation "will bear heavily against the taxpayer, whose inexactitude is of his own making," and the amount allowed is up to the conservative discretion of the court.

LISTED PROPERTY, BRIEFLY

Certain types of business expenses *must* be substantiated, though, especially those subject to a heightened substantiation requirement under the code or regulations, or "listed property." In these cases, if a taxpayer does not have records, even the ***Cohan*** rule won't help and the deduction will be denied:

- Passenger automobiles;
- Property used for entertainment, recreation, or amusement;
- Property used as a means of transportation; and
- Computer and related peripheral equipment.
  (IRC §280F(d)(4))

SUBSTANTIATION REQUIREMENTS

The strict substantiation requirements of IRC §274(d) have overruled the ***Cohan*** rule for listed property. The regulations under IRC §274(d) require substantiation of the following items:

- **Amount:**
  - **Expenditures:** The amount of each separate expenditure with respect to an item of listed property, such as the cost of acquisition, the cost of capital improvements, lease payments, the cost of maintenance and repairs, or other expenditures; and
  - **Uses:** The amount of each business/investment use (as defined in Treas. Regs. §1.280F-6T(d)(3)) based on the appropriate measure (i.e., mileage for automobiles and time for other listed property), and the total use of the listed property for the taxable period.
- **Time:** Date of the expenditure or use with respect to listed property; and
- **Business or investment purpose and relationship:** The business purpose for an expenditure or use with respect to any listed property (see Treas. Regs. §1.274-5T(c)(6)), and who participated in the expenditure).
  (Treas. Regs. §1.274-5T(b)(6))

Note: The Small Business Jobs Act of 2010 removed cell phones from treatment as listed property, which imposed stricter substantiation requirements for a cell phone deduction. So, generally, a self-employed individual's business-use cell phone would be an allowable deduction.

ADEQUATE RECORDS

In order to meet the "adequate records" requirements of IRC §274, the taxpayer must be able to produce:

- An account book, diary, log, statement of expense, trip sheets, or similar record. It is imperative that the log be contemporaneous to the time of the expense (Treas. Regs. §1.274-5T(c)(2)(ii)); and
- Documentary evidence, such as receipts or paid bills. (Treas. Regs. §1.274-5(c)(2)(iii))

These items *in combination* are sufficient to establish the expenditure.

CHARITABLE CONTRIBUTIONS

Taxpayers typically use the ***Cohan*** rule when they have not adequately tracked business expenses, but in one case a taxpayer was able to use the ***Cohan*** rule for his charitable contribution as well as home office deductions. (***Ragassa v. Comm.***, TCS 2009-166)

Seifu Ragassa was a student who was also working two jobs. On his tax return, he properly reported all of his income sources, and claimed deductions for charitable contributions in the amount of $3,175 and $2,100 for homeowner's insurance relating to his home office. When the IRS disallowed the deductions in full, he ran into a problem. He had lost all of the paperwork corresponding to that tax year in question, and his tax preparer was no longer in the country.

At trial, according to the taxpayer's testimony, he regularly (at least once per month) donated clothing and cash to various churches in his area, in addition to sending money to churches and organizations in his home country of Ethiopia. He admitted that he never asked for receipts and offered contact information for the churches in order to verify his involvement.

The court found him to be forthright and candid during the trial, and noted that a blanket disallowance went too far. The court, in absence of any records, found it credible that he donated $25 per month in cash, and allowed a $300 charitable contribution deduction.

The court also applied the ***Cohan*** rule to estimate a more reasonable amount for the home office deduction. The taxpayer estimated he used 300–400 square feet of his home for his translation and interpretation business. The court found it more reasonable that he used about 100 square feet, based on his testimony and description of the work he did and the equipment he used and allowed for a deduction of homeowner's insurance based on that percentage of use.

BUSINESS EXPENSE DEDUCTIONS

A taxpayer — who was also a tax preparer — had no records for business deductions for work she had done on the building in which she both lived and operated her tax preparation business. (***Linzy v. Comm.***, TCM 2011-264)

The taxpayer claimed $34,000 in contract labor expenses, and, to substantiate the expenses, the taxpayer presented a mess of canceled checks, bank account statements, and poorly photocopied checks and time sheets that the court was neither able to read nor clearly apply to any of the claimed contract labor expenses.

The court noted that the taxpayer did not provide enough information to reasonably estimate a deduction amount, and disallowed the entire $34,000. Additionally, she was slapped with a negligence penalty, partly because of her 15 years of tax return preparation experience.

The taxpayer ended up in Tax Court again in 2013 with a slew of unsubstantiated business deductions, as well as gambling losses this time. (***Linzy v. Comm.***, TCM 2013-219) The taxpayer had only provided evidence of cash withdrawals from ATMs as evidence of gambling losses, but no evidence or testimony of how much of the withdrawals were spent on gambling. The court has used ATM records in conjunction with credible testimony to estimate gambling losses (see ***Lamb v. Comm.***, TCM 2013-155), but in this case the court had nothing to go on to come up with a reasonable estimate, so all losses were disallowed.

Takeaway

1. Even though the ***Cohan*** rule may provide a deduction for expenses where otherwise it would have been denied, the taxpayer is only going to get a fraction of what he or she would have if he or she had been able to substantiate the expenses. There's no substitute for good recordkeeping.
2. The ***Cohan*** rule will only help with certain types of expense deductions. Travel and entertainment, auto expenses, and expenses for other types of listed property must always be carefully tracked.
3. When invoking the ***Cohan*** rule, the taxpayer still needs to provide some sort of evidence for the expenses so a reasonable estimate can be made. Without anything to guide the IRS or the court in the decision, the deduction will most likely be disallowed.

U.S. V. KIRBY LUMBER (1931) 284 U.S. 1

In 1923, the Kirby Lumber Company issued bonds which had a par value of $12,126,800. Later, the company repurchased the same bonds in the open market for a sum less than par value. The difference was $137,521.

In an extremely concise and brief opinion, the Supreme Court sided with the IRS and declared the difference to be income.

The court stated that, "As a result of its dealings it made available $138,000 of assets previously offset by the obligation of bonds now extinct."

BOWERS V. KERBAUGH-EMPIRE CO. (1926) 271 U.S. 170

The ***Kirby Lumber*** court distinguished the facts in that case from the facts of its earlier decision in ***Bowers v. Kerbaugh-Empire Co.*** In the latter case, the taxpayer borrowed funds from a German bank before World War I. The lender transmitted marks to its New York representative, which converted the marks into dollars and advanced the dollars to the taxpayer. The taxpayer agreed to repay the loan in marks.

The funds were invested in a business venture that failed, and the taxpayer and the lender agreed on a payoff amount that was less than the amount borrowed.

The court ruled that the difference between the amount borrowed and the amount paid was not income. Looking at the entire transaction, the court ruled, the taxpayer had, in fact, suffered a loss.

THE LEGACIES OF *KIRBY LUMBER* AND *KERBAUGH-EMPIRE*

The simplest analysis would have been that income results from the discharge of indebtedness because the taxpayer has received more than is paid back. If we were blessed with sufficient foresight, we could exclude from borrowed funds in the year of the loan only the amount that would eventually be paid back and tax at the outset the amount that will not be repaid.

Courts have struggled with the "freeing up of assets" language in ***Kirby Lumber*** and the transactional theory in ***Kerbaugh-Empire***, and have used both to carve out exceptions to income recognition. For example, it's likely that the insolvency and bankruptcy exclusions under IRC §108 evolved from the freeing-of-assets theory under ***Kirby Lumber***; that is, if a taxpayer is insolvent or bankrupt, the taxpayer has no assets to be freed-up.

However, the two theories are not compatible. Suppose a taxpayer borrows $100,000 and uses it to drill a well, and the well ends up being dry. The lender discharges $40,000 of the debt and the taxpayer repays $60,000. Under the freeing-of-assets theory, he would have $40,000 of income because the discharge has made available $40,000 of assets previously offset by the liability. Under the whole-transaction theory of ***Kerbaugh-Empire***, there is no income because the transaction as a whole was a loss.

ZARIN V. COMM. (1990) 916 F.2D 110

David Zarin was an engineer who, during the course of just under two years, managed to rack up $3,435,000 in gambling debt at an Atlantic City casino. The casino originally extended to him a $10,000 line of credit that they kept increasing (without doing a credit check) because Zarin was considered one of their "valued gaming patrons." That's because, when Zarin would play craps, he often attracted a crowd by betting the table limit with each roll of the dice; consequently, other gamblers playing at his table tended to bet more as well.

Zarin claimed to have no idea how much debt he was accumulating, especially during the last few months when he was spending 12–16 hours per day, 7 days per week at the craps table, betting $15,000 per dice roll. When he was unable to pay the $3,435,000, the casino cut him off and filed suit to collect.

Zarin and the casino settled on $500,000, which he paid. The IRS came after taxes on the cancelled debt of $2,935,000, and Zarin lost in Tax Court. (***Zarin v. Comm.*** (1989) 92 TC 1084) But on appeal in the Third Circuit, he won.

The court looked at the definition of "discharge of indebtedness" in IRC §108(d)(1) and decided that Zarin's debt didn't meet the definition set forth in that section.

Additionally, because the debt had been settled with the casino, it constituted a contested liability. Under the contested liability doctrine (see ***N. Sobel, Inc. v. Comm.*** (1939) 40 BTA 1263), if a taxpayer, in good faith, disputed the amount of debt, a subsequent settlement would be treated as the amount of debt cognizable for tax purposes. Following this doctrine, the court concluded that the $500,000 settlement fixed the amount of loss and debt cognizable for tax purposes.

Comment

The court concluded that IRC §§61(a)(12) and 108 set forth the general rule that gross income includes income from the discharge of indebtedness. However, the court held that neither of those sections applied to the case at hand. IRC §108(d)(1), which repeats and further elaborates the rule set forth in IRC §61(a)(12), defines the term indebtedness as any indebtedness "(A) for which the taxpayer is liable, or (B) subject to which the taxpayer holds property." The court held that neither prong of IRC §108(d)(1) was satisfied in the case, and, as a result, Zarin could not have income from the discharge of his debt.

According to the court, the debt was unenforceable as a matter of New Jersey law because of an emergency order issued by the New Jersey Casino Control Commission, which made illegal the manner in which the casino was extending credit to Zarin. As a result, the credit line was clearly not debt "for which the taxpayer is liable." Furthermore, the court held that the gambling chips were not property but "merely an accounting mechanism to evidence debt." Zarin could not do with the chips as he pleased, nor did the chips have any independent economic value beyond the casino. The court concluded that Zarin's indebtedness was not subject to property held by the taxpayer.

ARROWSMITH V. COMM. (1952) 344 U.S. 6

In 1937, two individuals liquidated and divided the proceeds of a corporation in which they had equal ownership. By 1940, they had made the final distribution and formally dissolved the corporation. They reported the gains from the distributions, classifying them as capital gains.

In 1944, a judgment was entered against the old corporation. The two individuals were required to and did pay the judgment for the corporation, and on their personal returns they reported the payments as ordinary losses. The IRS disagreed, viewing the 1944 payment as part of the original liquidation transaction requiring classification as a capital loss.

The Supreme Court agreed with the IRS. "It is plain that their liability as transferees was not based on any ordinary business transaction of theirs apart from the liquidation proceedings. It is not even denied that had this judgment been paid after liquidation, but during the year 1940, the losses would have been properly treated as capital ones. Payment during 1940 would simply have reduced the amount of capital gains taxpayers received during the year."

The "Arrowsmith doctrine"

The Arrowsmith doctrine is a principle of income tax law that holds that financial restorations associated with prior income items take the same income character as the prior income items.

DISSENT

The majority rejected the minority's assertion of the principle of the taxable year, stating that the treating the proceeds of liquidation consistently does not violate this principle.

The minority further pointed out that, had the judgment been rendered while the corporation was still in existence, it would have provided a deduction for the corporation. Furthermore, they argued that, had the shoe been on the other foot, the IRS would likely be making the opposite argument; that is, if the corporation had received income four years after it ceased to exist, the IRS would be arguing that the income should be treated as ordinary income.

STARKER V. U.S. (1979) 602 F.2D 1341

T.J. Starker, his son Bruce, and his daughter-in-law Elizabeth owned 1,843 acres of timberland in Oregon. In 1967, Crown Zellerback offered to purchase the acreage, but because the Starkers had owned the property since the 1930s, they had very low basis in the property. A sale would mean a big tax bill.

In 1967, they entered into an agreement, titled "Real Estate Exchange Agreement," in which the Starkers would transfer their title to the timberland property in exchange for "accounting credits" at a set dollar value. These accounting credits could be exercised by the Starkers by designating properties to be acquitted. At such designation, Crown Zellerbach was obligated to purchase the designated property and transfer it to the Starkers. The agreement contained a cash reserve clause entitling the Starkers at any time to take the then-remaining balance of accounting credits in cash.

It took five years from the time the agreement was executed for the Starkers to fully utilize the accounting credits.

COURT'S RULING

The court faced two major issues and found in the Starkers' favor on both of them. First, in holding that simultaneity was not required under IRC §1031, the court rejected the government's contention that Treas. Regs. §1.1002-1(b) requires a narrow construction of IRC §1031. Second, the court ruled that the possibility that the Starkers could receive cash did not violate IRC §1031. The court expressly found that the contract rights to assume ownership of property was no different than the ownership of the property itself, even though the ownership of the property might occur years in the future and even though the taxpayer could ultimately receive cash. The present exchange of property for the promise to receive like-kind property in the future constituted a value "deferred" exchange under IRC §1031.

Treas. Regs. §1.1002-1(b)

The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

CONGRESSIONAL RESPONSE

Starker posed two problems for the tax law. First, it was decided in the Ninth Circuit, so technically it only applied to taxpayers in that circuit. Second, ***Starker*** allowed for open-ended transactions that could potentially stretch endlessly.

In the Tax Reform Act of 1984, Congress expressly allowed deferred exchanges so long as they are completed within 180 days. (IRC §1031(a)(3)) By placing the date on which the taxpayer must receive the replacement property at no later than the due date of the return, the IRS would not have an open transaction accounting problem.

HESS V. COMM., TCS 1994-79

Exotic dancer Chesty Love underwent multiple medical procedures to enlarge her breasts, which ultimately expanded her breast size to 56FF. Subsequently, her fees doubled.

In addition to medical problems, the petitioner and her husband were subjected to considerable humiliation because of the size of her breasts. The petitioner was ridiculed by people on the street, her husband suffered off-color comments and insults, and she was ostracized by most of her family. Consequently, when her career as a professional exotic dancer is over, the petitioner plans to have the implants permanently removed.

The petitioner has shown that her implant surgery was "incurred solely in the furtherance of the business engaged in" and "incurred in producing revenues to the business." The sole reason she enlarged her breasts to such a "horrendous" size was to increase her success (and concomitantly her income) as a professional exotic dancer. In this endeavor, the petitioner has succeeded, inasmuch as her fees have increased substantially since her implant surgery.

The petitioner's line of business — that of a professional exotic dancer — was such that part of her "costume" was her "freakishly" large breasts. Her implants clearly satisfy the first two criteria. As to the third, the petitioner has proven that if she could remove her implants on a daily basis she would have done so as she preferred not to have "worn" them in her offstage personal life. (In an interview with Jerry Springer, she stated that if she could take them off at the end of each night and throw them in the trunk of her car, she would.) However, this was physically impossible.

Because the petitioner's implants were so extraordinarily large, the court found that they were useful only in her business. Accordingly, the court held that the cost of the petitioner's implant surgery was depreciable.

Note: When she appeared in Tax Court, Chesty (whose real name is Cynthia Hess), represented herself.

Comment

According to the court, the petitioner's expenditures for implants can be analogized to clothing expenditures which, as a general rule, are not deductible as a business expense even when specific types of clothing are a necessary condition of the business or employment. However, there is a recognized exception to this rule when:

- The clothing is required or essential in the taxpayer's business or employment;
- The clothing is not suitable for general or personal wear; and
- The clothing is not so worn.

This outlook provided by the tax court is more favorable than the official IRS view (Rev. Rul. 70-474) because it permits deductions for clothing that is "essential" but not "required" in the taxpayer's business, and it considers whether the taxpayer really wore the clothing for personal reasons versus whether it was just suitable for personal wear.

Clearly, the petitioner's breast augmentation was not "required," but was "essential" enough for a deduction to be sustained.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

37. What are the significant factors of the case ***Eisner v. Macomber***?

    a) The court grappled with the taxability of assets under the 16th amendment, which authorizes taxation of income and capital
    b) IRC §305(a) is based on the rule of ***Eisner v. Macomber*** and states that the amount of any distribution of corporation stock made to its shareholders is not included in gross income
    c) There are no limitations under IRC §305, which provides that a shareholder may take cash or property in lieu of stock without including that cash or property in gross income
    d) ***Macomber*** made the appreciation of assets taxable

38. Which of the following accurately represents the tax benefit rule and other rules evolved from various court cases?

    a) Refunded personal property taxes are not included in income if deducted in a prior year
    b) Previously deducted taxes are treated as income in the year they are refunded
    c) Deductions taken by a taxpayer for a charitable contribution based on the conveyance of realty cannot be reclassified as income if the property is recovered
    d) A prior deduction for bad debts that resulted in an income tax benefit in a previous year does not mean that any recovery of the amount of the bad debt should be included in gross income

39. Under the Clifford Regulations and IRC §§673–675, which supports them, a grantor will be taxed on a trust's income under what circumstances?

    a) If the grantor has a reversionary interest that would vest within 15 years or less
    b) If the grantor has the power of disposition over the beneficial enjoyment of the trust corpus (not income)
    c) If the grantor retained any broad administrative powers that were for his or her own benefit
    d) If the grantor retained certain administrative powers that would vest within 10 years

40. What is true about the ***Cohan*** rule?

    a) The rule will provide a full deduction for expenses that might otherwise have been denied for lack of substantiation
    b) The ***Cohan*** rule applies to listed property
    c) Even with the application of the *Cohan* rule, taxpayers must provide some evidence of their expenses
    d) The ***Cohan*** rule cannot be used for charitable deductions

SOLUTIONS TO REVIEW QUESTIONS

37. What are the significant factors of the case ***Eisner v. Macomber***? **(Page 86)**
    a) Incorrect – The court already understood that the 16th amendment only authorized the taxation of income. Taxing stock dividends would mean taxing capital, which would not be authorized.
    b) Correct – The court tackled the issue of what "derived from" meant and came up with the doctrine of realization, a principle that states that gain must be realized before it is subject to income tax.
    c) Incorrect – If a shareholder takes cash or property in lieu of stock or takes disproportionate distributions, this would represent an exception to the rule of IRC §305, and that distribution would be included in gross income and taxable.
    d) Incorrect – Before ***Macomber***, there was no rule as to whether the appreciation of assets was taxable. After ***Macomber***, and under IRC §305, gross income does not include any amount from the distribution of stock from a corporation to its shareholders.

38. Which of the following accurately represents the tax benefit rule and other rules evolved from various court cases? **(Page 89)**
    a) Incorrect – The property taxes are included in income based on ***First Trust and Savings Bank of Taylorville v. U.S.***
    b) Correct – This is based on the decision in ***Union Trust Co. v. Comm.***
    c) Incorrect – Based on ***Alice Phelan Sullivan Corp. v. U.S.***, the recoupment of property upon which a taxpayer took a charitable deduction upon its conveyance was classified as income.
    d) Incorrect – The premise of IRC §111 is that the recovery of an amount that was previously deducted as a bad debt or delinquency must be included in gross income.

39. Under the Clifford Regulations and IRC §§673–675, which supports them, a grantor will be taxed on a trust's income under what circumstances? **(Page 92)**
    a) Incorrect – The reversionary interest would vest in 10 years or less.
    b) Incorrect – If the grantor and/or a nonadverse person has access to trust corpus or income, the grantor will be taxed on that income.
    c) Correct – In this case, the grantor can be taxed as the owner of the trust property.
    d) Incorrect – If the administrative powers vest within 15 years, the grantor can be taxed.

40. What is true about the ***Cohan*** rule? **(Page 97)**

a) Incorrect – The deduction will be much less than what would have been applicable had adequate records been available.
b) Incorrect – Listed property requires even stricter substantiation than general business expenses and includes vehicles, computer equipment, etc.
c) Correct – Evidence is required so that an estimation can be made, but with limited substantiation, the deduction will be considerably less.
d) Incorrect – In ***Ragassa v. Comm***., the taxpayer credibly testified of his charitable work and his home office expenses, which the Tax Court estimated based on the square footage of his home.

GLOSSARY

Arrowsmith doctrine: a principle of income tax law that holds that financial restorations associated with prior income items take the same income character as the prior income items

Assignment of income doctrine: a judicial doctrine which provides that individuals should not be allowed to divide income among taxable entities. Also referred to as the "fruit of the tree" doctrine from a court statement that "The fruits cannot be attributed to a different tree from that on which they grew"

Bad boy guarantee: triggered when a stated condition occurs that would cause the borrower or guarantor to be personally liable for a loan or that would convert a nonrecourse loan to a recourse loan against the borrower. The conditions are generally deliberate actions by the borrower such as fraud, bankruptcy, misapplication of funds, etc.

Cancellation of debt (COD): occurs when a creditor cancels, forgives, or discharges a debt. The amount forgiven is considered income to the debtor and must be reported and taxed as ordinary income unless an exclusion or exception applies. COD on passive activity is a complete disposition of the activity

Clifford Regulations: based on a Supreme Court's interpretation of the concept of gross income. The regulations taxed the grantor on a trust's income if the trust corpus or income would or might return to the grantor after a short term of years

***Cohan* rule:** may go into effect if a taxpayer is able to demonstrate that he or she has paid or incurred a deductible expense but cannot substantiate the exact amount, in which case the court may estimate the amount of the expense if the taxpayer presents credible evidence providing a basis for the court to do so

Contested liability doctrine: based on the principle that if a taxpayer, in good faith, disputes an amount of debt, a subsequent settlement would be treated as the amount of debt cognizable for tax purposes

Disgorgement: the act of giving up ill-gotten gains obtained illegally or unethically, compelled by the courts. Funds that are disgorged are paid back with interest

Distributable net income (DNI): a calculation for computing how much taxation passes out of Form 1041 on Schedule K-1 to the beneficiary. DNI serves as a limitation on the size of the distribution deduction that trusts and estates can claim when computing the taxable income of the trust

Doctrine of realization: the principle that states that gain must be realized before it is subject to income tax

Economic benefit theory: based on the proposition that relief from debt on which an individual is personally liable is a benefit to that taxpayer

Electing small business trust (ESBT): a trust where the beneficiaries are essentially the shareholders of an S corporation. The trust will file a return calculating tax on the portion of income attributable to its interest in an S corporation under special rules

Electronic filer identification number (EFIN): an IRS required number that identifies in which location a tax return was prepared

***Golsen* rule**: provides for the Tax Court to make a decision without forcing a party to appeal when the outcome of the appeal is presumed to be known

***Inter vivos* transfer**: a transfer of property made during an individual's lifetime

Memorandum opinion: a Tax Court decision related to well-established legal issues and primarily based on routine facts. These opinions can be appealed and can be treated as precedent

Net operating loss (NOL): a period when a company's allowable tax deductions are more than the company's taxable income with negative taxable income as a result. The loss may be carried back against income in prior years or carried forward as a deduction against future income

Par value: the face value of a bond, share of stock, or coupon at which it can be redeemed

Phantom gain: occurs when a capital gain is offset by a loss on the same investment, usually due to income tax. Because there is no actual return, the gains are considered phantom

Professional employer organization (PEO): sometimes referred to as an employee leasing company; enters into an agreement with a client to perform some or all of the federal employment tax withholding, reporting, and payment functions related to workers performing services for the client

Qualified subchapter S trust (QSST): a trust eligible to hold stock in an S corporation where there can be only one beneficiary, and all income must be distributed annually

Qualified terminable interest property trust (QTIP): a type of trust that takes advantage of the unlimited marital deduction while still controlling the distribution of assets after the death of the surviving spouse. The surviving spouse must be a U.S. citizen at the time the estate tax return is filed

Real estate professional: a professional status that is achieved by meeting two tests: More than half of the personal services performed by the taxpayer during the year must be in real property trades or businesses, and at least 750 hours of the personal services performed during the year must be in real property trades or businesses

Regular opinion: a Tax Court decision regarding legal issues that have not yet been explored by the court or which create an exception to a general rule. These opinions can be appealed and have great precedential value

Revenue agent report (RAR): an examination of a taxpayer's income tax return including an examining agent's proposed adjustments. Referred to as 30-day letters because a taxpayer has 30 days to submit a formal protest and take their issue to the IRS's appeals division

Reviewed opinion: a Tax Court decision that carries more weight than a regular opinion. All Tax Court judges participate in reviewed decisions

Statutory employee: an independent contractor who by law is treated as an employee

Statutory nonemployee: an individual who would be treated as an employee under common law tests but who by law is treated as an independent contractor

Statutory Notice of Deficiency: issued to a taxpayer if the taxpayer does not file a protest to an RAR within 30 days or if the protest is unsuccessful. Referred to as a 90-day letter because a taxpayer has 90 days to file a petition in the Tax Court

Summary opinion: a Tax Court decision issued from the Small Cases Division for disputes involving less than $50,000. The decisions cannot be appealed and cannot be treated as precedent

Tax benefit rule: as it pertains to the Internal Revenue Code, the rule provides that when a prior deduction for bad debts, prior taxes, or delinquency amounts resulted in an income tax benefit in a prior year, then to the extent of the benefit, the recovery of these amounts in a later year must be included in gross income

INDEX

2016/2017 BONUS CPE: FEDERAL TAX REVIEW
Course description and study guide

Course objectives: This material provides additional information pertaining to the review and analysis of important issues in federal and California tax law and regulations that have affected taxpayers during the last year. Topics discussed include: workers' compensation, charitable contributions, the ***Cohan*** rule, health savings accounts, bankruptcy and self-employment tax, hobby loss rules, IRC §754 election, recourse and nonrecourse debt, S corporation elections, qualified subchapter S trusts (QSSTs), electing small business trusts (ESBTs), IRA rollovers, IRC §1035 exchanges, qualified terminable interest property trusts (QTIPs), worker classification, disgorgement, the Tax Court, and much more.

Completion deadline and exam: This course, including the examination, must be completed within one year of the date of purchase. In addition, unless otherwise indicated, no correct or incorrect feedback for any exam question will be provided.

Category: Taxes

Recommended CPE Hours: CPAs— 8 Tax
EAs – 8 Federal Tax
CRTPs — 8 Federal Tax

Level: Basic

Prerequisite: Completion of 2016/17 Federal and California Taxes seminar, webinar, on-demand webinar, or self-study is required.

Advanced Preparation: None

Course qualification: Qualifies for QAS and NASBA Registry CPE credit based on a 50-minute per CPE hour measurement

CPE sponsor information: Spidell Publishing, Inc. (Registry ID: 104931)

Expiration Date: November 2017*

*Exam must be completed within one year of the date of purchase

Learning assignment and objectives

As a result of studying the assigned materials, you should be able to meet the objectives listed below.

Assignment:

At the start of the materials, participants should identify the following topics for study:

- Individual issues: income, exemption, deductions, and losses
- Business issues: deductions, S corporations, retirement, and worker classification
- Classic court cases: rulings, dissenting opinions, legislative response, and legal ramifications

Learning Objectives:

After completing this course, you will be able to:

- Recall the rules for excluding workers' compensation from gross income
- Recall how and to whom qualifying distributions from a health savings account may be applied
- Determine if a profit motive exists as it relates to hobby loss rules
- Recall how self-rental rules apply to S corporations
- Recall how recourse debt is allocated in partnerships
- Identify which entities qualify to succeed to the ownership of S corporation stock after the death of a shareholder
- Choose which trusts qualify for the electing small business trust election
- Determine when nonrecognition treatment applies in an IRC §1035 exchange
- Recall the common law factors used to determine evidence of worker classification status
- Identify the circumstances under which disgorgement applies

After studying the materials, please answer exam questions 1-40.

Course Evaluation for Spidell Publishing, Inc.

Program title: ____

If applicable, program instructor: ________________________

Program date: ____________ Participant name (optional): __________________

Instructions: Please comment on all of the following evaluation points for this program and assign a number grade, using a 1-5 scale, with 5 as the highest rating.

1. Were the stated learning objectives met? ____________

2. If applicable, were prerequisite requirements appropriate and sufficient? ____________

3. Were the program materials accurate? ____________

4. Were program materials relevant, and did they contribute to the achievement of the learning objectives? ____________

5. Was the time allotted to the learning activity appropriate? ____________

6. If applicable, were the individual instructors knowledgeable and effective? ___________

7. Were the facilities and/or technological equipment appropriate? ____________

8. Were the handout and/or advanced preparation materials satisfactory? ____________

9. Were the audio and visual materials effective? ____________

IRS Course Number (if applicable): CRA7E-T-00255-16-S

TTP (CTEC) Course Number (if applicable): 1019-CE-0714

Date course completed: ____________

Number of hours it took to complete the course: ____________

Examination for Spidell's 2016/2017 Bonus CPE: Federal Tax Review

PLEASE: Place the correct response for each question on the attached answer sheet and retain this examination for your records. If you purchased the online version, or would like to complete your exam online, please log-in to your SpidellCPE online account to submit your answers to the exam. 70% or more (28 of 40) correct responses are necessary to receive credit for this course. This course must be completed within one year of the date of purchase.

Final Exam Questions

1. Under IRC §104 pertaining to workers' compensation, gross income excludes payments under all but which of these conditions?

   a) The payments must be received under a workers' compensation act
   b) The payments cannot be related to the employee's age
   c) The payments must be compensation for personal injuries, including emotional and physical illness
   d) The payments reflect damages received as a consequence of personal injuries incurred in the course of employment

2. What is a condition under which Temp. Treas. Regs. §1.1041-1T(c) will treat a payment made by a former husband to a charity as a charitable contribution by the former wife?

   a) The former wife must provide her written or oral consent for the charitable contribution
   b) The former husband makes the donation on behalf of the former wife based on the marital settlement agreement
   c) The former wife requests that the former husband make the contribution
   d) Any one of the above will suffice as meeting the condition

3. What is one of the criteria of being an eligible student for purposes of the American Opportunity Tax Credit?

   a) The student must be enrolled in any institution of higher education
   b) The student must carry the normal full-time workload for the course of study he or she is pursuing
   c) The student must carry at least half of the normal full-time workload for the course of study he or she is pursuing
   d) Both (a) and (b) are correct

4. For a health savings account contribution in 2016, in the case where one spouse has family coverage and the other spouse has self-only coverage, what is the maximum contribution they can make if they are both under age 55?

   a) $6,750
   b) $3,350
   c) $10,100
   d) $7,750

5. Under the PATH Act, what happened to the liberalized rules for qualified conservation contributions?

   a) They have been extended through 2017
   b) They have been extended through 2019
   c) They have been extended through 2021
   d) They have been made permanent

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6. How is the determination of gross income for a minister or pastor affected by a vow of poverty?

   a) A pastor's use of funds for personal purposes indicates control over those funds unless the account is titled in the name of the religious organization
   b) The Tax Court has held that a vow of poverty will not protect a pastor from tax liability if the pastor receives funds from a religious organization for services performed and does not give them back to the church as per his vow of poverty
   c) Even with a vow of poverty, a pastor may have signatory authority over a church's account and not be held liable for taxes
   d) A licensed minister is exempt from self-employment tax

7. In order to be able to group activities together as one activity for the measurement of gain or loss for purposes of IRC §469, which is the foremost requirement?

   a) The activities must be interdependent
   b) The activities must share common ownership
   c) The activities must be engaged in for profit
   d) The activities must be geographically close

8. There is an election under IRC §183(e) that will delay an IRS judgment on the profit motive presumption and the associated losses that would be disallowed from that activity until _______ after the due date for filing the fifth tax return, or seventh for horse activities.

   a) One year
   b) Two years
   c) Three years
   d) Six months

9. Which choice is true regarding grouping activities together for the purpose of measuring gain or loss as it pertains to passive activity loss rules?

   a) Taxpayers may group activities together into an appropriate economic unit and regroup the activities in subsequent tax years
   b) The IRS may not regroup a taxpayer's activities
   c) It is legitimate for a taxpayer to group activities into an economic unit for the purpose of avoiding the passive activity loss rules
   d) A taxpayer may group activities together into a single activity if the activities represent an appropriate economic unit for measuring gain or loss for passive activity loss purposes

10. Which of the following is not affected by the 6.8% reduction in credit/award amounts?

    a) Certain corporations claiming the alternative minimum tax credit
    b) Nonbusiness Energy Property Credit
    c) Whistleblower Award
    d) Small business health care tax refundable credit

11. Under the American Jobs Creation Act of 2004, a partnership is required to make a basis adjustment even without an IRC §754 election if the partnership has a substantial built-in loss after the transfer of a partnership interest. There is a substantial built-in loss if the partnership's adjusted basis in its assets exceeds the fair market value of the property by more than _______.

    a) $100,000
    b) $150,000
    c) $200,000
    d) $250,000

12. Which one of the following would **not** necessarily be considered a "bad boy" event that would trigger a "bad boy" guarantee and cause a guaranteeing partner to become liable for a partnership's debt?

    a) The borrower obtains subordinate financing
    b) The borrower files a voluntary bankruptcy petition
    c) The borrower joins in an involuntary bankruptcy proceeding
    d) The borrower admits in writing that it is insolvent

13. Which of the following trusts will qualify for the electing small business trust (ESBT) election, which makes the trust qualify as an S corporation shareholder?

    a) Charitable remainder unitrust
    b) Tax-exempt trust
    c) Qualifying subchapter S trust
    d) A nongrantor charitable lead trust

14. When comparing various entities that qualify as S corporation shareholders, which of the following statements is correct?

    a) An estate may elect to qualify as an S corporation shareholder
    b) For an electing small business trust (ESBT), the beneficiary elects to qualify as an S corporation shareholder
    c) An ESBT making the qualified shareholder election files two tax returns using the same taxpayer ID number, one for the S corporation's income, and the other for the rest of the trust's income
    d) The fiduciary tax rate for an estate that qualifies as an S corporation shareholder is 39.6%

15. What is the appropriate return to file for a tax-exempt organization with gross receipts of $200,000 or more?

    a) 990N
    b) 990-EZ
    c) 990
    d) Any of the above

16. When evaluating the pros and cons of naming a trust as an IRA beneficiary, which choice below is **not** accurate?

    a) The age of the youngest living beneficiary is used to determine life expectancy for the purpose of required minimum distributions
    b) The trustee has control over the age of the distribution to beneficiaries
    c) The trust can outline how funds are to be used
    d) There are many requirements for a trust, and if any are not fulfilled, the trust will no longer be considered a designated beneficiary, which will accelerate taxation on the IRA

17. What is true of IRC §1035 exchanges?

    a) Gain or loss may be recognized when one annuity contract is exchanged for another annuity contract
    b) In order for nonrecognition treatment to apply, the exchanged contracts must pertain to the same individual
    c) Nonrecognition treatment applies when an insurance company disburses a check from the surrender of a nonqualified annuity policy to a taxpayer who endorses the check to a second insurance company for a new nonqualified policy
    d) Amounts received under an annuity contract but not as an annuity are not included in gross income

18. Which of the following statements is false regarding family limited partnership transactions and how assets transferred during one's life are treated?

  a) An interest is treated as a retained interest if there is an understanding at the time of the transfer that the interest would be granted later
  b) Under IRC §2036(a), intrafamily transfers are not allowed
  c) There must be an important nontax reason for creating a family limited partnership in order to establish that the requirements of IRC §2036 are being met
  d) IRC §2036(a) provides that a decedent's gross estate includes the value of property transferred by the decedent during their lifetime but from which they retain both enjoyment and the right of income

19. For the 2016 taxable year, what is the amount of the basic estate tax exclusion?

  a) $5,000,000
  b) $5,250,000
  c) $5,340,000
  d) $5,450,000

20. When comparing the various agencies and their compliance oversight, which statement is accurate?

  a) The EDD oversees employer compliance with child labor laws
  b) The U.S. Department of Labor uses the common law test determining the "right to control" when assessing if an employer is complying with worker classification rules
  c) The California Department of Industrial Relations is responsible for compliance oversight for workers' compensation
  d) The U.S. Department of Labor uses a three-part behavioral analysis to determine appropriate worker classification

21. The IRS has used a 20-factor test to determine if an employer-employee relationship exists, which they have now grouped into three categories. Which of the following is **not** one of those categories?

  a) Behavioral control
  b) Relationship of parties
  c) Material control
  d) Financial control

22. Which of these factors is determinative when establishing the type of relationship that exists between the worker and the employer?

  a) Whether or not there is a written contract
  b) The employee benefits
  c) How permanent the relationship is
  d) All of the above

23. What is the correct form an employer or worker can use to determine how the worker should be classified?

  a) Form 8822
  b) Form W-7
  c) Form 8952
  d) Form SS-8

24. When considering the common law factors providing evidence of worker classification status, which of the following statements is correct?

  a) An individual is an independent contractor if that person runs the risk of not getting paid
  b) Training of skilled or unskilled workers implies an employer-employee relationship
  c) A worker who has the discretion to limit their hours of work is always an independent contractor
  d) Work that is an essential part of running a business can be normally performed by employees or independent contractors

25. A "responsible person" is an individual with a business duty to collect and remit withheld taxes to the government. Which of the following would **not** be considered a responsible person?

   a) Employee
   b) Corporate officer
   c) Voluntary board member of tax-exempt organization
   d) LLC member

26. When participating in the Voluntary Classification Settlement Program, the taxpayer must file Form 8952 and note the beginning date of the tax quarter for which they will begin treating the workers as employees, which must be at least _______ from the date of the filing.

   a) 30 days
   b) 45 days
   c) 60 days
   d) 90 days

27. When assessing the advantages and/or disadvantages of reclassification, which of the following applies?

   a) Supplying information to the IRS will not trigger a state employment tax audit
   b) Under the VCSP program, taxpayers are able to reclassify some or all of their workers
   c) If a taxpayer's application is rejected, the taxpayer will be liable for high penalties
   d) The taxpayer will need to extend the statute of limitations for five years for each of the three calendar years beginning after the date that the workers will be treated as employees

28. What is the leading legal case pertaining to the nature of written agreements for independent contractors?

   a) *S.G. Borello & Sons, Inc. v. Dept. Of industrial Relations*
   b) *Alexander et al. v. FedEx Ground Package System, Inc.*
   c) *Santa Cruz Transportation, Inc. v. Unemployment Insurance Appeals Board*
   d) *O'Conner et al. v. Uber Technology Inc.*

29. What is a feature of a IRC §501(c)(4) organization?

   a) It may benefit a private group of citizens
   b) It is exclusively for the benefit of social welfare
   c) Unlike 501(c)(3) organizations, it may operate for profit
   d) All of the above

30. Which statement is true regarding professional employer organizations (PEOs)?

   a) Companies that hire PEOs are no longer obligated to deal with employment taxes
   b) PEOs are required to be certified
   c) PEOs are also called employer leasing companies
   d) A third-party PEO that has exclusive control over wage payments of a client company may be considered the employer

31. In order to be entitled to disgorgement, which of the following applies?

   a) The government must produce an accurate detail of the defendant's ill-gotten gains
   b) The measure of disgorgement must be reasonable but not necessarily exact
   c) If ill-gotten gains are evident, a district court may order disgorgement from any period whether or not there was evidence of fraud during that period
   d) A court's power to order disgorgement is unlimited

32. Revenue Agent Reports are also known as:

   a) 30-day letters
   b) 60-day letters
   c) 90-day letters
   d) Any one of the above

33. When evaluating the differences among the Tax Court, the U.S. Court of Federal Claims, and the district court, which of the following statements is accurate?

   a) Only attorneys can represent taxpayers in the U.S. Court of Federal Claims
   b) Jury trials are permitted in Tax Court
   c) In district court, the government cannot raise any new issues at trial
   d) There are limited discovery procedures under Tax Court rules

34. The Tax Court has 19 judges appointed by the President for a term of _______ years.

- **a)** 5
- **b)** 10
- **c)** 15
- **d)** 20

35. Which of the following Tax Court decisions may not be treated as precedent?

- **a)** Regular opinions
- **b)** Memorandum opinions
- **c)** Summary opinions
- **d)** Reviewed opinions

36. What is the rule that applies when the Tax Court makes a decision based on a precedent that has already been established by the circuit court to which an appeal would be made?

- **a)** Cohan rule
- **b)** Cohen rule
- **c)** Golsen rule
- **d)** Arrowsmith doctrine

37. What are the requirements for attorneys wanting to practice before the Tax Court?

- **a)** They must be sponsored by one other attorney admitted to practice before the Tax Court
- **b)** They must provide a certificate of good standing from their state bar
- **c)** They must pay an application fee of $50
- **d)** All of the above

38. What is the explicit test for income that came about through ***Comm. V. Glenshaw Glass Co***.?

- **a)** Income is realized when there are instances of indisputable additions to wealth that are clearly realized
- **b)** In order to be considered income, the taxpayer must have total dominion over it
- **c)** Income can only be derived from labor or capital
- **d)** Only (a) and (b)

39. What case bears the responsibility for being the biggest single creator of tax shelters?

- **a)** *Crane v. Comm.*
- **b)** *Tufts v. Comm.*
- **c)** *Lucas v. Earl.*
- **d)** *Zarin v. Comm.*

40. What is the doctrine that states that financial restorations associated with prior income items should be treated the same and should relate back to the prior income items?

- **a)** The *Starker* doctrine
- **b)** The *Arrowsmith* doctrine
- **c)** The *Cohan* rule
- **d)** The *Macomber* rule