

CHAPTER 16

TAX RESEARCH

2017 Edition	Topic	Status
Questions		
1	Primary authorities versus secondary authorities	Unchanged
2	Three types of primary authority	Unchanged
3	Types of secondary authorities	Unchanged
4	Tax protesters	Unchanged
5	Internal Revenue Code as part of U.S. Code	Unchanged
6	Subdivisions of Internal Revenue Code	Unchanged
7	Reading the Internal Revenue Code	Unchanged
8	Chapters with subtitles	Unchanged
9	Reading the Internal Revenue Code	Unchanged
10	Uses of tax law	Unchanged
11	Legislative process	Unchanged
12	Legislative process reports	Unchanged
13	Joint Conference Committee versus Joint Committee on Taxation	Unchanged
14	Treasury Regulation	Unchanged
15	Interpretive versus legislative regulations	Unchanged
16	Proposed versus temporary regulations	Unchanged
17	Revenue rulings; revenue procedures	Unchanged
18	Revenue rulings versus regulations/private letter rulings	Unchanged
19	Acquiescence versus nonacquiescence	Unchanged
20	Impact of IRS nonacquiescence on future taxpayers	Unchanged
21	Other IRS pronouncements	Unchanged
22	Trial Courts	Unchanged

2017 Edition	Topic	Status
23	Golsen rule	Unchanged
24	Court precedence	Unchanged
25	Writ of certiorari	Unchanged
26	Supreme Court decisions	Unchanged
27	Citations-interpretation	Unchanged
28	Citations	Unchanged
29	Multiple citations	Unchanged
30	Tax services	Unchanged
31	Tax services	Unchanged
32	Cited case versus citing a case	Unchanged
33	History of a case	Unchanged
34	Tax Periodicals	Unchanged
35	CATR - alternative platforms	Modified
36	CATR - available in your library	Modified
Problems		
37	Search - Code sections on income exclusions	Unchanged
38	Search - Code sections on deductions	Unchanged
39	Search - Code sections on losses	Unchanged
40	Search - Code sections on property and cost recovery	Unchanged
41	Search - Code sections on general tax concepts	Unchanged
42	Search - Supreme Court case	Unchanged
43	Search – Revenue Procedure or Ruling	Unchanged
44	Search - text of statute amending the code	Modified
45	Distinction between planning and compliance	Unchanged
46	Steps in tax research	Unchanged

2017 Edition	Topic	Status
47	Settlement of gambling debt at less than face value	Unchanged
48	Year of inclusion/constructive receipt	Unchanged
49	Payments to all state residents	Unchanged
50	Alimony versus child support	Unchanged
51	Extinguishment of debt	Unchanged
52-COMM	Ordinary and necessary expenses	Unchanged
53	Income from employer provided housing	Unchanged
54-COMM	Contingent settlements in divorce	Unchanged
55	Income from investments	Unchanged
56	Trade or business	Unchanged
57	Asbestos removal costs	Unchanged
58	Deductibility of expenses incurred for church's benefit	Unchanged
59-COMM	Deductibility of minister's job-related expenses	Unchanged
60-COMM	Deductibility of hair transplant	Unchanged
61	Deductibility of classes provided by a church	Unchanged
62	Depreciation deduction for shrubs and bushes	Unchanged
63	Gambling losses/Trade or business	Unchanged
64	Travel expenses	Unchanged
65	Residential mortgage interest and property taxes	Unchanged
66	Eligibility of lost bracelet for casualty loss	Unchanged
67	Investment expenses	Unchanged
68	Losses - who can deduct	Unchanged
69-COMM	Casualty losses	Unchanged
70	Small business stock loss - S Corporation	Unchanged

2017 Edition	Topic	Status
71	Payments by an accrual basis corporation to cash basis owner-employee	Unchanged
72	Personal holding company tax	Unchanged
73	S Corporation qualifying shareholders	Unchanged
74	Qualified retirement distributions	Unchanged
75	Involuntary conversion	Unchanged
76	Deductibility of rental expenses when property rented to a related party	Unchanged
77-COMM	Deduction of legal fees	Unchanged
78	Assignment of income	Unchanged
79	Correct filing status of taxpayer	Unchanged
80	Taxability of deposits	Unchanged
81	Eligibility for earned income credit	Unchanged
82	Constructive receipt	Unchanged
83-COMM	Deductibility of refunds	Unchanged
84-COMM	Taxability of interest/divorce - separate returns	Unchanged

CHAPTER 16

TAX RESEARCH

DISCUSSION QUESTIONS

1. Differentiate primary tax law authorities and secondary tax law authorities.

Primary tax law authorities are those authorities that contain the actual provisions and official interpretations of the tax law. As such, they correspond to the three functions of government: legislative (the actual tax law), administrative (government interpretation of and compliance with the tax law), and judicial (resolution of interpretation differences between taxpayers and the government).

Secondary tax law authorities serve as tools for locating the primary authorities and also offer commentary on the authorities that aid in the interpretation and understanding of the primary tax law authorities.

2. Briefly describe the three categories of primary authorities and the types of authorities within each category.

Primary tax law authorities consist of legislative, administrative, and judicial sources.

Legislative sources include the U.S. constitution, the Internal Revenue Code of 1986, tax treaties, and legislative reports that accompany changes in the tax law. As such, they constitute the actual tax law.

Administrative sources consist of those documents published by the Treasury Department and the Internal Revenue Service that interpret provisions of the tax law as passed by Congress. These sources include Treasury Regulations, Revenue Rulings, Revenue Procedures, Letter Rulings, and various other internal documents that are available to the public.

Judicial sources consist of court decisions on matters in which the taxpayer and the government disagree. As such, they provide interpretation of both legislative and administrative sources.

3. Name the types of secondary authorities.

Secondary tax law authorities consist of tax services that serve primarily as tools for locating the relevant primary tax law authorities. Tax services also offer editorial interpretations of the primary tax law authorities that aid in understanding the application of the primary tax law authorities.

Citators are secondary authorities that provide the researcher with the history of a judicial decision and how that decision has been viewed in subsequent court decisions. In addition, citators provide comparable information on the status of revenue rulings and revenue procedures.

Other secondary authorities include textbooks and tax periodicals that provide explanations of various aspects of the tax law.

4. On what grounds have tax protesters challenged the income tax?

Tax protesters have asserted that the income tax law violates various constitutional rights. These rights include the right to due process, religious freedom, and freedom from self-incrimination.

5. The Internal Revenue Code is just one part of the *U.S. Code*. Explain.

The U.S. Code is the consolidated and coordinated compilation of all laws enacted by the Congress. The Internal Revenue Code is the law passed by Congress to assess taxes. It is formally known as Title 26 of the U.S. Code.

6. Name the subdivisions of the Internal Revenue Code.

The Internal Revenue Code is broken down into subtitles, chapters, subchapters, parts, and subparts. The basic reference to a particular part of the Code is made by reference to a Code section number.

7. What would be the general nature of Sec. 612? Sec. 6601?

Sec. 612 provides that the basis to be used for cost depletion is the adjusted basis for determining gain or loss provided in Sec. 1011. Sec. 6601 provides the rules for calculating interest on underpayments, nonpayments, and extensions of time to pay tax.

8. How many chapters are within Subtitle A?

Subtitle A has six chapters, one of which has been repealed. See Exhibit 16-2.

9. What are some things to look out for when reading the Code?

You must always read the entire code section, not just the apparently applicable subdivision, because other divisions of the code section may contain special rules or definitions that also apply. You must also review other sections within the subpart, part, or other larger division that contains the code section of interest to ascertain if there are other limitations or cross-references that may be relevant to the problem being researched. Lastly, you should always be alert to the use of *or* versus *and* when the code section specifies conditions that must be met before the ultimate treatment can be determined.

10. Give examples of how the Code is sometimes used to achieve economic and social objectives.

The Code is often used to influence economic behavior and/or to achieve social objectives. For example, adjusting tax rates can lead to an increase (or a decrease) in economic activity. Similarly, tax credits are often used to stimulate investment in certain types of assets. Social objectives are achieved by offering tax relief to businesses and individuals who engage in activities that the government deems socially desirable, such as the provision of health insurance to employees and the establishment of retirement accounts.

11. Briefly describe the process by which a new tax law is passed.

New tax laws are initiated by either the President or a member of Congress and are presented to the House of Representatives as a bill. The bill is referred to the House Ways and Means Committee which holds hearings on the bill. If the committee approves the bill, it is sent to the full House for approval. Bills approved by the House are then sent to the Senate which refers the bill to the Senate Finance Committee. The Senate Finance Committee holds hearings and may approve the bill as received or make amendments to the bill. When the committee approves the bill, it is sent to the full Senate for approval. Typically, the House and Senate versions of the bill are not identical and a Joint Conference Committee of House and Senate members is convened to work out differences in the two versions. Once approved, the conference bill is sent to the House and the Senate for approval. If both houses of Congress approve the bill, it is sent to the president. The president can either sign the bill into law or he can veto the bill. In order to overcome a presidential veto, both the House and the Senate must vote to override the veto by a two-thirds majority.

12. What three reports are issued as part of the legislative process?

Each committee that considers a tax bill issues a report that explains the change in the tax law, why the change was necessary, and its interpretation of the provisions contained in the bill. These reports consist of the House Ways and Means Committee report, the Senate Finance Committee report, and the Joint Conference Committee report.

13. How are the Joint Conference Committee and the Joint Committee on Taxation different?

The Joint Conference Committee is a committee composed of members of the House and the Senate that is charged with reconciling conflicting versions of a tax bill passed by the House and the Senate. As such, it is an official part of the legislative process. The Joint Committee on Taxation is charged with oversight of the operation and administration of the tax system as a whole. As such, they are not directly involved in the process of making new tax laws.

14. What is a Treasury regulation? Is it binding on the courts?

A Treasury regulation is the Treasury Department's official interpretation of a provision in the Internal Revenue Code. Because of the extensive review and public comment process that goes into the issuance of a regulation, they are considered to have the force and effect of the law. However, they are not binding on the courts. That is, if the courts find that a Treasury regulation is inconsistent with the expressed or implied intention of the related Code Section, they will overturn the regulation and not give effect to its interpretation.

15. Differentiate an interpretive regulation and a legislative regulation.

The Secretary of the Treasury is given general authority to provide interpretive guidance on the provisions of the Internal Revenue Code. Regulations that are issued under this general authority are referred to as interpretive regulations. A legislative regulation is a regulation that is written when Congress specifically delegates authority to the Treasury Department to provide the detailed rules applicable to a particular Code Section. Because Congress has delegated its legislative authority in requiring a legislative regulation, such regulations are generally deemed to be stronger authorities than interpretive regulations.

16. Differentiate a proposed regulation and a temporary regulation.

A proposed regulation is issued as part of the public comment and review process. It is used to communicate to taxpayers what the Treasury Department believes is the proper treatment of a particular Code Section. As such, proposed regulations are merely comment documents and are not binding on either the IRS or taxpayers until they are issued in final form. Temporary regulations are issued to provide guidance until a final regulation can be issued on a particular Code Section. Unlike proposed regulations, temporary regulations are binding on taxpayers and the IRS until they are revoked, amended, or issued in final form.

17. What are revenue rulings? revenue procedures?

Revenue ruling are the IRS's interpretation of the Code, regulations, and court cases as they apply to specific factual situations. They represent official IRS policy with respect to the facts in the ruling and are binding on the IRS until they are revoked, amended, or otherwise changed.

The IRS issues revenue procedures to explain how to comply with the provisions of the tax law. That is, they do not interpret specific Code Sections per se. Rather, they tell taxpayers the procedures that must be followed in complying with the tax law.

18. How are a revenue ruling and a Treasury regulation different? a revenue ruling and a private letter ruling?

A Treasury regulation differs from a revenue ruling in its scope and its authoritative hierarchy. Regulations provide general interpretive guidance on a particular Code Section and do not attempt to cover every possible application of the Code Section. Revenue rulings deal with interpretations of the Code, regulations, and court cases to very narrow factual situations. Because of the extensive review process that goes into the issuance of a regulation, it is the highest level of administrative authority. Revenue rulings do not go through as extensive a review process and therefore, are accorded less authority than a regulation.

A private letter ruling is similar to a revenue ruling in that it is an interpretation of the tax law as it applies to a narrow factual situation. The difference between the two is that a private letter ruling is issued to a specific taxpayer and the IRS is bound only to that taxpayer with respect to its ruling; other taxpayers cannot rely on a private letter ruling as a source of authority. In contrast, a revenue ruling is issued to be used by all taxpayers with the same or similar factual circumstances and therefore, the IRS is bound to all taxpayers with respect to a revenue ruling.

19. What does it mean when the IRS issues an acquiescence or nonacquiescence?

An acquiescence or nonacquiescence is the IRS response to a court decision that it loses. An acquiescence is used to notify taxpayers that it agrees with (i.e., will follow) the court's decision. A nonacquiescence indicates that the IRS does not agree with (i.e., will not follow) the court's decision and is usually taken as a signal that the IRS will continue to litigate this issue.

20. What impact would an IRS announcement of nonacquiescence to a court decision have on a taxpayer in a similar situation?

When the IRS issues a nonacquiescence to a court's decision it is officially notifying all taxpayers that it will not follow the court's decision and will challenge a taxpayer through the audit process and ultimately the court system. Ultimately, the taxpayer must decide whether to follow the position favored by the IRS or be prepared to face a challenge by the IRS.

21. Name the other types of pronouncements issued by the IRS, and briefly describe their content.

Other IRS pronouncements include private letter rulings which are an interpretation of the applicable Code, regulations, revenue rulings, and court cases on a specific prospective factual situation of a specific taxpayer. A technical advice memorandum is equivalent to a private letter ruling issued on a completed transaction. Chief counsel's memoranda are issued by the Office of the Chief Counsel of the IRS to provide internal guidance on the preparation of other authoritative pronouncements. These include technical memoranda which are explanations of Treasury regulations; general counsel's memoranda which explain the reasoning and authority used to prepare revenue rulings and letter rulings; and actions on decisions which provides advice on whether the Chief Counsel's Office believes that an adverse court decision should be appealed and whether an acquiescence or nonacquiescence should be issued on a regular Tax Court decision.

22. What are the three trial courts? Which is most important?

The three trial level courts are the U.S. District Court, the U.S. Claims Court, and the Tax Court. The District Court and the Claims Court hear cases on all aspects of federal law, while the Tax Court considers only tax issues. Because of the specialized nature of Tax Court judges versus the more generalized nature of the other courts, a decision of the Tax Court is generally considered to "carry more weight" than a decision of the other trial courts.

23. What is meant by the *Golsen* rule?

The *Golsen* rule is used by the Tax Court. Under this rule, the Tax Court will always follow a decision in the circuit court to which an appeal of the Tax Court decision lies. That is, if the Tax Court is considering a case that would be appealed to the 3rd circuit, the Tax Court will always follow a decision on the issue being litigated that has been issued by the 3rd circuit. The Tax Court is not generally bound by decisions in other circuits although they often look to these decisions for guidance.

24. Do district courts have to follow the decisions of all circuit courts?

District courts are only bound to follow decisions in the same circuit to which an appeal of their decision will be made. For example, all district courts within the 6th circuit must follow any ruling made by the 6th Circuit Court of Appeals. They are not bound by the decisions of any other circuit, although they may look to them for guidance in forming an opinion on an issue.

25. What does it mean when the Supreme Court issues a writ of certiorari?

The granting of a writ of certiorari means that four of the nine justices on the Court feel that the appeal of a case is important enough for the Court to review and issue a decision on.

26. Assume that the Supreme Court interprets a certain Code section in a manner that members of Congress believe is contrary to what they meant when they enacted that part of the Code. What (if anything) can Congress do?

A Supreme Court decision is the final authority on an issue. All lower courts, taxpayers, and the IRS must follow a Supreme Court decision. If Congress believes that its interpretation of the law is inconsistent with the original intent of the law, its only recourse is to pass legislation that will amend the particular Code Section consistent with what they feel is the manner in which it should be interpreted.

27. Interpret the following citations:

- a. Senate Finance Committee, S. Rep. No. 2, 97th Cong., 2d Sess. (April 15, 1982).

This is the second report issued by Senate during the second session of the 97th Congress. It is a report of the Senate Finance Committee that was issued on April 15, 1982.

- b. LTR 8101067.

This is the 67th letter ruling issued during the first week of 1981. The first two digits signify the year (1981), the second two digits the week (1st), and the last three digits the number of the ruling issued that week (67).

- c. Rev. Proc. 78-172, 1978-2 C.B. 22.

This is the 172nd revenue procedure issued in 1978. It can be found on page 22 of the second volume of the 1978 cumulative bulletin.

- d. *Lacy v. Comm.*, 344 F.2d 123, 89-1 USTC ¶1221, 43 A.F.T.R. 89-2233 (9th Cir., 1989).

This is a 1989 decision of the 9th Circuit Court of Appeals on the taxpayer Lacy's case. It can be found on page 123 of volume 344 of West's Federal 2nd Series. Alternatively, it is located at paragraph 1221 of volume 89-1 of Commerce Clearing House's United States Tax Cases or on page 2233 of volume 43 of RIA's American Federal Tax Reports.

28. Provide the correct citations for the following:

- a. The fifteenth revenue procedure issued in 1993 and found on page 12 of the third *Internal Revenue Bulletin* issued in 1993.

Rev. Proc. 1993-15, 1993-3, I.R.B. 12.

- b. Subsection (a) of the first temporary income tax regulation interpreting Section 63.

Temp. Reg. Sec. 1.63-1(a) or Reg. Sec. 1.63-1T(a).

- c. An acquiescence issued by the IRS on page 1 of volume 1 of the 1992 *Cumulative Bulletin* related to *Chasteen v. Comm.*, which was reported on page 132 of volume 77 of *Reports of the United States Tax Court* in 1991.

***Chasteen*, 77 T.C. 132 (1991), acq. 1992-1 C.B. 1**

29. Why do some court decisions have two or three different citations?

Common citation practice is to provide the citation to the official government reporter in which the case can be found and at least one other case reporting service (either CCH or RIA).

30. Describe the two major categories of tax services.

Tax services are categorized by how they organize the material related to the tax law. The first category consists of those services that are organized by Code Section number. This category organizes all authority that relates to a particular Code Section together. The Code Section and its related regulations are printed in full text. Other rulings and pronouncements are provided in annotated form with a brief description of the contents of the authority. A limited amount of editorial explanation accompanies the material.

The second category of tax services organizes material by topic. They contain extensive editorial discussion of each topic with footnote references to the primary tax law authorities. The applicable Internal Revenue Code and Regulations for the topics in each volume of the service are provided elsewhere in the tax service (either in the same volume or in separate Code and regulation volumes).

31. When can a researcher rely on an editorial opinion expressed in the tax services?

Editorial opinions expressed in tax services are secondary tax law authorities and cannot be relied on as a source of authority. Only primary tax law authorities can be used as sources of authority. Secondary authorities are merely aids to the researcher in understanding and interpreting the primary tax law authorities.

32. Differentiate a cited case and a citing case.

A citator provides the history of a case and how that case has been viewed by subsequent court decisions and/or revenue rulings. The cited case is the case being evaluated. A citing case is a subsequent case that has commented on the cited case in some manner.

33. What is meant by the history of a cited case?

The history of a case refers to all other decisions by higher or lower courts on the same case.

34. Assume that you have found an excellent article in *Tax Notes* that provides a favorable interpretation of Sec. 469. Can you rely on that article as authority for your position? In general, what role do tax periodicals and newsletters play in tax research?

Tax periodicals such as *Tax Notes* are secondary tax law authorities and cannot be relied on as a source of authority. Only primary tax law authorities can be used as sources of authority. Secondary authorities are merely aids to the researcher in understanding and interpreting the primary tax law authorities.

35. What are some advantages of CATR?

CATR systems utilize powerful electronic search engines that let a researcher search an entire database and retrieve the full text of desired documents in a few seconds. The researcher can search by using keywords, Code section numbers, dates, topics, type of authority, or other criteria. The search returns a list of documents that fit the specified criteria. The researcher can scan the hits and retrieve the full text of documents that appear relevant. If too many hits are retrieved, the search can be refined. Online subscription services are more easily kept current.

The free Web sites on the Internet provide the least costly source. However, the free Web sites do not contain Tax Court decisions and many other tax law sources and are not always up-to-date.

36. Which CATR services are available in your university?

Some or all of the CATR services identified in chapter 16 might be available to students. Check with your local reference librarians on what is available.

***Instructors' Note:* Your local reference librarian may prefer to make a scheduled presentation to large groups of students rather than have each student visit the library individually. The sales representatives for CATR services may be willing to make presentations to your class on their CATR software.**

37. Use any print or CATR service or the Internet to find a Code section(s) on the following income topics. For each item, indicate the Code section number(s) and full title of the relevant Code section(s).

- a. Discharge of indebtedness

The Code Section that discusses discharge of indebtedness is Sec. 108 and is entitled: Income from discharge of indebtedness.

Other related sections include:

Sec. 1017. Discharge of indebtedness (basis adjustment).

Sec. 1234A. Gains or losses from certain terminations.

Sec. 6050P. Returns relating to the cancellation of indebtedness by certain entities (information returns).

Sec. 61(a)(12) is clause that includes income from discharge of indebtedness as an item of gross income.

- b. Exclusion for employees' educational expenses

The Code Section that discusses the exclusion for employees' educational expenses is Sec. 127 and is entitled: Educational assistance plans.

- c. Prizes

The Code Section that discusses prizes is Sec. 74 and is entitled: Prizes and awards.

38. Use any print or CATR service or the Internet to find a Code section(s) on the following deduction topics. For each item, indicate the Code section number(s) and full title of the relevant Code section(s).

- a. Charitable contributions

The Code Section that discusses charitable contributions is Sec. 170 and is entitled: Charitable contributions etc., and gifts. Instructors Note: The charitable contribution deduction for estate and gift taxes is at Sec. 2522.

- b. Dividends-received deduction for corporations

The Code Section that discusses the dividends received deduction for corporations is Sec. 243 and is entitled: Dividends received by corporations

- c. Medical expenses

The Code Section that discusses medical expenses is Sec. 213 and is entitled: Medical, dental expenses etc.

39. Use any print or CATR service or the Internet to find a Code section(s) on the following loss topics. For each item, indicate the Code section number(s) and full title of the relevant Code section(s).

a. Bad debts

The Code Section that discusses the general rules for bad debts is Sec. 166 and is entitled: Bad debts. Special rules for bad debts, losses, and gains with respect to securities held by financial institutions (i.e., banks) are found in Sec. 582 entitled: Bad debts, losses, and gains with respect to securities held by financial institutions. Reserves for losses on loans for mutual savings associations are found in Code Sec. 593 entitled: Reserves for losses on loans.

b. Net operating loss deduction

The Code Section that discusses the net operating loss deduction is Sec. 172 and is entitled: Net operating loss deduction.

c. Passive activity losses

The Code Section that discusses passive activity losses is Sec. 469 and is entitled: Passive activity losses and credits limited.

40. Use any print or CATR service or the Internet to find a Code section(s) on the following property and cost recovery topics. For each item, indicate the Code section number(s) and full title of the relevant Code section(s).

a. Basis of player contracts on sale of a franchise

The Code Section that discusses the basis of player contracts connection on sale of a franchise is Sec. 1056 entitled: Basis limitation for player contracts transferred in connection with the sale of a franchise

b. Capital gains and losses for security dealers

The Code Section that discusses capital gains and losses for security dealers is Sec. 1236 entitled: Dealers in securities.

c. Percentage depletion

The Code Section that discusses percentage depletion is Sec. 613 entitled: Percentage depletion.

41. Use any print or CATR service or the Internet to find a Code section(s) on the following general tax concepts topics. For each item, indicate the Code section number(s) and the full title of the relevant Code section(s).

- a. Income tax rates for individuals

The Code Section that discusses the income tax rates for individuals is Sec. 1 entitled: Tax imposed.

Instructors Note: Sec. 3 entitled: Tax tables for individuals, describes how the tax tables are constructed, but the tax rates are discussed in Sec. 1.

- b. Losses between related taxpayers

The Code Section that discusses losses between related taxpayers is Sec. 267 entitled: Losses, expenses, and interest with respect to transactions between related taxpayers.

- c. Withholding of income tax on wages

The Code Sections that discuss withholding of income tax on wages are Sections 3401-3406. These Code Sections are found in Chapter 24 entitled: Collection of Income Tax at Source. Chapter 24 has only one subchapter, Subchapter A, entitled: Withholding from Wages.

42. Use any print or CATR service or the Internet to find the name of a 1995 Supreme Court decision involving the taxability of a settlement received as compensation for age discrimination. Find the name of the case, a standard legal citation, and the date that the Court issued its decision.

The full name of the case is *Commissioner of Internal Revenue v. Erich E. Schleier and Helen B. Schleier* 515 U.S. 323 (1995), but is frequently abbreviated to *Commissioner v. Schleier*, or just *Schleier*. The official Supreme Court reporter reference is 115 S. Ct. 2159. The date of the decision is June 14, 1995.

There are several other reference numbers for this case. The Supreme Court docket number was 94-500. The case is reprinted in the CCH tax case reporter at 95-1 USTC ¶ 50,309.

43. Use any print or CATR service or the Internet to find the Revenue Ruling or Revenue Procedure that provides instructions on requesting a letter ruling. Indicate the number of the Revenue Ruling or Revenue Procedure, and the IRS reference.

A new Revenue Procedure is issued each year with the instructions for requesting letter rulings. It is often the first one of the year. For 2015, Revenue Procedure 2015-1 was published in weekly Internal Revenue Bulletin, 2015-1 IRB 1, and will later be reissued in IRS Cumulative Bulletin.

44. Use any print or CATR service to find the following information about the Tax Increase Prevention Act of 2014:

- a. The public law number and enactment date

Public Law 113-295. Enacted 12/19/14.

- b. A reference to the full text of the act

<https://www.govtrack.us/congress/bills/113/hr5771/text>

or

<https://www.congress.gov/113th-congress/house-bill/5771/text?overview=closed>

- c. A secondary authority that discusses the act

A number of articles may be found by doing an Internet search. Some examples are as follows:

“Year-End 2014 Tax Legislation” Taxes - The Tax Magazine 1/19/15

“Obama Signs 2014 Tax Extenders: Money in Your Pocket” by Ashlea Ebofino, Forbes, 12/19/14

45. What is the distinction between tax compliance and tax planning?

Tax *compliance* deals with completed transactions, and taxes planning with the tax consequences of proposed or in-process transactions that have not yet been completed. Tax compliance tends to be narrower in focus because the primary objective of tax compliance is the completion of tax and information returns. Tax planning may cover a broader range of issues, such as both tax and nontax issues, and a broader range of years, current and future.

46. Briefly describe the steps involved in tax research.

There are four steps in the tax research process:

1. ***Establish the facts and determine the issue(s) to be researched.*** This is a critical step that is often repeated as the researcher locates the relevant authorities. The authorities often bring up the need to obtain additional facts to resolve the issue or raise new issues that need to be researched.
2. ***Locate the relevant authorities.*** This step involves the use of a tax service to locate the primary tax law authorities relevant to the issue.
3. ***Assess the importance of the authorities.*** The authorities found in the second step must be evaluated to determine whether they are applicable to the facts and issues and the relative importance of each authority.
4. ***Reach conclusions, make recommendations, and communicate the results.*** Objective conclusions about the relevance of each authority to the facts and issues being researched must be made. All authorities must be included, even those that are unfavorable to the client. Based on the evaluation of these authorities, a research memorandum should be written that contains a recommendation on the correct treatment of the issue under consideration. The memorandum should include a statement of all of the relevant facts, the tax issues considered, the relevant authorities, and a conclusion as to how the relevant authorities apply. The memorandum forms the basis for a separate letter to the client that summarizes, in less detail, the recommendations.

RESEARCH CASES

Income Cases

47. Gary is an internal auditor for Bodine Information Systems (BIF). In 2013, BIF opened a large production plant in Las Vegas, Nevada. Subsequently, Gary has had to spend several months each year at the Las Vegas facility. Gary has always fancied himself a proficient blackjack player. During his trips to Las Vegas, he stays at a hotel on the Strip and spends a considerable amount of his off-duty time gambling.

In February 2014, Gary applies for and receives a \$20,000 line of credit at the hotel to be used for gambling. The line of credit lets him receive gambling chips in exchange for signing markers, which are negotiable drafts payable to the hotel and drawn on Gary's personal bank account. The hotel's practice is to hold the markers for 60 days, at which time Gary pays them with a personal check.

By the beginning of 2015, Gary is gambling heavily at the hotel. He requests and receives an increase in his credit limit to \$100,000. Gary continues to lose heavily, and through accounting oversights by the hotel, his debt rises to \$325,000 by October 2015. The checks that Gary writes to cover the markers are returned for insufficient funds, and the hotel immediately cuts off his credit. The hotel subsequently files suit in state court, seeking repayment of the \$325,000 owed on the markers.

In early 2016, Gary negotiates an agreement with the hotel in which he will settle the debt for 4 monthly payments of \$25,000 (\$100,000). Gary pays the \$100,000 per the terms of the agreement. He seeks your advice as to the tax consequences of the settlement with the hotel. That is, does he have to include in his gross income the amount of the debt he didn't have to repay?

The question to be resolved is whether the settlement of the debt at less than face value constitutes a cancellation of debt that is taxable under Sec. 61. Reg. Sec. 1.61-12 deals with "income from discharge of indebtedness" and states that a discharge of indebtedness may result in the realization of income. The regulation gives a few examples, but none of them is indicative of Gary's situation.

The answer to the question is found in *Zarin*, 916 F.2d 110 (3rd Cir., 1990), a Tax Court case that was reversed by the Third Circuit Court of Appeals. In the Tax Court case, the settlement of a gambler's casino debt at a substantial discount was held to be a realization of income to the extent of the debt forgiven. However, because of the Third Circuit reversal, Gary should not have to recognize any income from his settlement with Frumps.

INSTRUCTOR'S NOTE: *Rood, Edward*, 122 F3d 1078 (CA11, 1997) affg. TCMemo 1996-248, had income from cancellation of gambling debt by a Las Vegas casino because he could produce no evidence that the debt was in dispute. The lack of evidence of a disputed debt in *Rood* distinguishes it from Gary's situation.

48. Adrian is a salesperson who represents several wholesale companies. On January 2, 2016, she receives by mail a commission check from Ace Distributors in the amount of \$10,000 and dated December 30, 2015. Adrian is concerned about the year in which the \$10,000 is taxable. Although the check is dated 2015, she contends that it would have been unreasonable for her to drive the 50 miles to the Ace offices on a holiday to collect the check. Further, Adrian maintains that even if she had made the trip to collect the check, by the time she returned home, her bank would have closed and she could not have received credit for the check until after the first of the year. Adrian would like you to determine whether she should include the \$10,000 on her 2015 or 2016 tax return.

Sec. 451(a) states the general rule that items of gross income are included in gross income in the taxable year of receipt, unless the taxpayer's method of accounting would indicate otherwise. A literal reading of the Code would indicate that the \$10,000 should be included in gross income for 2015, since that is the year the check was actually received.

Reg. Sec. 1.451-1 states that the general rule for year of inclusion is the tax year in which the item is actually or constructively received. **Reg. Sec. 1.451-2(a)** states that an item is constructively received when credited to an account, set apart, or otherwise made available so that it may be drawn upon at any time. However, there is no constructive receipt if the item is subject to substantial limitations or restrictions.

In *Kahler*, 18 T.C. 31 (1942), the Tax Court ruled that even if a check is delivered after banking hours on the last day of the year, it is still constructively received. In *McEuen*, 196 F.2d 127 (5th Cir. 1952), a check that could have been received the year before it was actually delivered by appearing in person and claiming it, was held to be constructively received in the year prior to actual receipt.

However, *Baxter*, 816 F.2d 493 (9th Cir. 1987) is a situation more similar to Adrian's. *Baxter* held that a payment similar to Adrian's was not deemed to have been constructively received in the year in which the payment was made available.

49. Hawaii law requires the state to deposit a part of its annual pineapple income in the Hawaiian Long-lasting Fund. All income from the fund is deposited in the state's general fund. The fund's general manager is permitted to use the funds to buy only certain income-producing assets, such as government and corporate obligations, preferred and common stock of U.S. corporations, and equity interests in partnerships and other entities that invest in real estate. Each year, a part of the fund's income is transferred to a dividend fund that distributes the dividends to native Hawaiians.

At issue is whether such payments constitute income to native Hawaiians and, if so, what type of income is being received---is income generated from the distributions either investment income or passive activity income?

In a factually similar situation, Rev. Rul. 85-39, 1985-1 CB 21, held that payments made to residents by the State of Alaska from oil and mineral revenue were gross income to the recipients. Because payment was made to all qualifying residents, regardless of financial status, health, educational background, or employment status, the service ruled that the payments were not an excludable general welfare payment. In addition, the service concluded that the payments were not meant to be gifts, but promoted a legislative economic goal of reduced population turnover.

The service's ruling is further supported by *Griesen*, 831 F.2d 916 (9th Cir. 1987), which held that the payments from the Alaska Fund constituted taxable income.

In Rev. Rul. 90-56, 1990-2 CB 101, the IRS ruled that the payments from the Alaska Fund were neither investment income nor passive income.

50. After Maria and Tatsuo are divorced, their 2 minor children continue to live with Maria. Pursuant to their divorce decree, Tatsuo pays Maria \$1,000 per month in child support and \$1,800 per month in alimony. The divorce decree specifies that in the event of an increase in child support, the court-ordered alimony payment amount will decrease by the amount of the child support increase. That is, Tatsuo's total monthly payment cannot exceed \$2,800. Determine how much gross income Maria has from the received payments from Tatsuo.

Under Sec. 71(a) gross income includes alimony payments received. Sec. 71(c) states that child support payments are not alimony. However, according to Sec. 71(c)(2), alimony payments that are reduced due to a child-related contingency are considered to be child support payments. Therefore, if the reduction in the alimony payment per the divorce decree is considered to be due to a child-related contingency, the amount of alimony will be reduced per Sec. 71(c)(2). Sec. 71(c)(2)(A) provides that "attaining a specific age, marrying, dying, leaving school, or a similar contingency" are considered child-related contingencies.

Temp. Reg. Sec. 1.71-1T(c) contains questions and answers relating to child support payments. Question 17 adds to the list of statutory child-related contingencies: attaining a specified income level, leaving the spouse's household or gaining employment. The regulation further states that a contingency relates to a child if it depends on any event relating to that child.

The Tax Court addressed similar facts in *Heller*, TC Memo 1994-423, where the court concluded that this type of arrangement does not meet any of the statutory or regulatory contingencies. In concluding that the actual alimony payment should not be reduced, it stated "...we do not believe that the ability to modify child support rises to the level of a contingency related to a child..."

51. Lorissa owes Waterbury State Bank \$200,000. During the current year, she is unable to make the required payments on the loan and negotiates the following terms to extinguish the debt. Lorissa transfers to Waterbury ownership of investment property with a value of \$90,000 and a basis of \$55,000, and common stock with a value of \$50,000 and a basis of \$70,000. Lorissa also pays Waterbury \$5,000 cash, and Waterbury forgives the remaining amount of debt. Before the agreement, Lorissa's assets are \$290,000, and her liabilities are \$440,000.

Read and analyze the following authorities and determine how much gross income Lorissa has from the extinguishment of the debt:

- Sec. 108.
- Reg. Sec. 1.61-12.
- Reg. Sec. 1.1001-2.
- *Julian S. Danenberg*, 73 T.C. 370 (1979).
- *James J. Gehl*, 50 F.3d 12 (8th Cir., 1995) affg. 102 T.C. 784 (1994).

Reg. Sec. 1.61-12 provides the general rule that a discharge of debt, in whole or in part, may result in a realization of income. Sec. 108(a)(1)(B) provides an exception to the recognition of income from a discharge of debt when the taxpayer is insolvent before the discharge. Sec. 108 (a)(3) limits the Sec. 108 exclusion to the amount of the taxpayer's insolvency. In this case, Lorissa is insolvent by \$150,000 (\$290,000 - \$440,000) before the discharge.

Reg. Sec. 1.1001-2(a) provides that the amount realized from a sale or other disposition of property includes the amount of liability from which the transferor is discharged as a result of the sale or other disposition. If any of the debt relates directly to any of property Lorissa transferred to Waterbury, then the amount of the debt is considered a realization and gain or loss must be calculated. However, the facts given do not indicate any such relationship.

The question to be resolved is whether the payment of part of the debt with the investment property and the stock constitutes a realization of income (and is taxable) or are transfers considered part of the extinguishment and shielded by the Sec. 108 exclusion. In *Gehl*, the tax court held that a transfer of property by a debtor to a creditor in satisfaction of a debt constitutes a "sale or exchange". The excess of the fair market value of the property over the basis of the property that is applied against the debt constitutes a taxable gain. In determining that such gains are taxable when the taxpayer is insolvent, the court followed *Danenberg*, which held that gains on such transfers are taxable even though the taxpayer was insolvent before and after the transfer of the property in partial satisfaction of the debt.

Applying these authorities to Lorissa, she will recognize a gain of \$35,000 (\$90,000 - \$55,000) on the investment property and a loss \$20,000 (\$50,000 - \$70,000) on the transfer of the stock. These transfers (along with the cash payment) reduce the debt being discharged to \$55,000 (\$200,000 - \$90,000 - \$50,000 - \$5,000). Because the actual amount of the discharge is less than her insolvency after the discharge, Lorissa will not recognize any income from the \$55,000 discharge.

After Assets	(\$290,000 - \$90,000 - \$50,000 - \$5,000)	=	\$ 145,000
After Liabilities	(\$440,000 - \$200,000)	=	240,000
Net Worth			<u>\$ (95,000)</u>

52. Henry invests \$50,000 in an entity called Forward Investments on January 20, 2015. Under the terms of the investment agreement, the \$50,000 is considered a loan that Forward will use to invest in derivative contracts. Henry is to receive 2% of the amount Forward earns each month from his investment plus 10% simple interest on funds left invested for a full year. Henry can withdraw part or all of his investment at any time on 10 days' notice to Forward.

During 2015, Henry receives quarterly statements of earnings on his investment in Forward. As of December 31, 2015, the statements indicate that Henry has earned \$9,600. In January 2016, Henry hears a rumor that Forward Investments is not a legitimate investment broker. On January 26, 2016, Henry withdraws his investment, receiving \$60,050 (the \$50,000 original investment plus \$10,050 in earnings). In late February, he learns that Forward Investments is a pyramid scheme through which early investors were paid earnings out of capital contributions by later investors. The U.S. Securities and Exchange Commission files suit against Forward in March 2016.

Henry wants to know the taxability of the amounts he received from Forward. He thinks that he never really earned any income from his investment because he was paid out of later investors' capital contributions. Write Henry a letter explaining the income tax effects of the payments he received from Forward Investments.

Under Sec. 61, all income received is taxable unless specifically excluded. The fact that the \$10,050 in earnings that Henry received is paid from other investor's contributions does not negate the increase in wealth he receives from his investment. The only question to be resolved is when to recognize the income. In *Wright v. Comm.*, 931 F.2d 61 (9th Cir., 1991), the taxpayer contended that income from an illegal ponzi scheme is not recognized until it is actually received, overriding the constructive receipt of the income as it is credited to their account. The 9th Circuit affirmed the decision of the Tax Court, which held that because the taxpayers are not the embezzlers, the proposition that illegally obtained income is not taxable until the year of actual receipt did not apply to them. The court found that because the taxpayer has an unrestricted right to the income when it is credited to his account, the income is taxable at that time. Applying *Wright* to Henry's situation, the \$9,600 of earnings in 2015 is available for him to withdraw at any time. Therefore, he is in constructive receipt of the \$9,600 and must include it in his 2015 income. The remaining \$450 of income is taxable when it is received in 2016.

53. Sam is an executive with a U.S. corporation. During the current year, he is working in another country. His employer provides a corporation-owned residence for Sam which is located three miles from his office. The residence is far above the standard he was accustomed to in the United States. However, the employer feels that it is important for Sam to live in luxurious surroundings because of the business image it conveys. Sam is expected to entertain customers and conduct business in the home as is customary in that country, where people are thought to be very status-conscious. The home contains an office which Sam uses in the evenings to transact business over the phone with customers in different time zones. The fair rental value of the home is \$48,000. Does Sam have any income from this housing arrangement?

Sec. 119 provides for an exclusion from gross income of an employee for the value of lodging furnished by the employer for the convenience of the employer, if the employee is required to accept such lodging on the business premises of the employer as a condition of employment. Thus, to qualify for the exclusion of Sec. 119, each of three tests must be met: (1) the employee must be required to accept the lodging as a condition of employment; (2) the lodging must be furnished for the convenience of the employer; and (3) the lodging must be on the business premises of the employer. Treas. Reg. §1.119-1(b)(2) provides that the first test is met where the employee is "required to accept the lodging in order to enable him properly to perform the duties of his employment."

This first requirement has been met because Sam was required to accept the residence as a condition of his employment. In *Adams, Jr. v. U.S.*, 585 F.2d 1060, 42 AFTR2d 78-6033 (Ct. Claims, 1977), the court focused on the reasons for this requirement. First, his employer wanted to insure that the employee resided in housing of sufficiently dignified surroundings to promote his effectiveness within the business community. Secondly, the company wished to provide facilities, which were sufficient for the conduct of certain necessary business activities at home. The court relying on *United States Junior Chamber of Commerce v. United States*, 334 F.2d 660, 14 AFTR 2d 5223 (Ct. Cl., 1964), held that the "condition of employment" test was met. Also, the court noted that the "condition of employment" test is met if due to the nature of the employer's business, a certain type of residence for the employee is required and that it is unreasonable to expect that the employee would have such lodging unless required by his employer.

In *Adams*, the taxpayer was the highest-ranking officer of his company and his status in the business community was extremely important to his employer. The residence supplied to him was closely identified with the company's business interests and was used to advance those interests and thus, met the "on the business premises" test. The court in *Adams* ruled that there was no taxable income recognized by the employee due to these factors: (1) the residence was built and owned by the employer, (2) it was designed, in part, to accommodate the business activities of the employer, (3) the employee was required to live in the residence, (4) there were many business activities for the employee to perform after normal working hours in his home because of the extensive nature of the employer's business and the high-ranking status of the employee, (5) the employee did perform business activities in the residence, and (6) the residence served an important business function of the employer. If Sam can meet these tests, he should be able to exclude income from the employer-provided housing.

54. Rick and Maria had been married for 20 years before their divorce in the current year. At that time, they made the usual property settlement: Maria got the house, the van and the cat; Rick got the mortgage, the Ford, and the dog. Other property was divided equally with the exception of the following:

At the time of their divorce, Maria had instituted a number of lawsuits against various fast-food chains for infringement of her patent on an automated burrito-stuffing machine. Maria had developed the machine in the early '90s and patented it under her name. (Rick thought it was a silly idea and refused to have his name associated with it.) At that time her efforts to license the machine to fast-food outlets were unsuccessful. Five years ago, she observed a similar machine in Tucker's Tacos, a fast-food Mexican restaurant, and instituted her first claim against that chain. Subsequent research revealed that several other chains had stolen her idea without compensating her, and she sued them for patent infringement.

As part of the divorce decree, 20% of any net proceeds (1% for each year of marriage) that Maria ultimately receives from the lawsuits is to be paid to Rick. During the current year, Maria settles the initial suit with Tucker's Tacos for \$200,000. The proceeds are placed into an escrow account from which the costs of litigation are paid. Rick receives a check for \$30,000 from the escrow agent for his share of the net proceeds. Maria receives the balance from the account. The remaining lawsuits are still being litigated.

Rick would like to know if he must include the \$30,000 in his gross income. Write Rick a letter explaining the tax treatment of the \$30,000 he received from the escrow account.

The critical issue in this case is whether the amounts Rick receives are taxable alimony income under Sec. 71 or a nontaxable property settlement under Sec. 1041. The payments are taxable as alimony income if they are treated as a share of Maria's royalty income.

The IRS has issued a letter ruling in a situation where a divorce decree required a husband to distribute to his former spouse a specified percent of the net proceeds of any settlement or judgment award received by him relating to various pending patent infringement lawsuits that he initiated before the divorce.

In LTR 9143050, the IRS ruled that the payment to the wife, and any future payments arising from her percentage interest in the net proceeds of the suit, constitute property transfers that are nontaxable to her under Sec. 1041. The issue was on whether, under the divorce order, the wife became the owner of an interest in income-producing property or whether she became entitled to payments from the husband measured by the cash equivalent of an interest in the income-producing property. If the latter, the payments received under the divorce order would be nontaxable property transfers under Sec. 1041(a). In determining that the wife could not be the owner of an interest, the IRS noted that state law generally precluded the court from transferring ownership of real or personal property from one spouse to the other without the transferor spouse's consent. The husband, therefore, remained the sole owner of the entire income-producing property (the patents), and he remained in sole control of the patent suit. The husband alone determines the course of the

litigation, including the decision of whether to settle with any other defendants and the amount of the settlement awards.

Further, the Service concluded, the husband retains all incidents of ownership regarding the patents, including the rights to enter into future royalty agreements and to enter future lawsuits. Thus, it held that the cash payments to the former spouse arising from her specified percent interest in the net proceeds of any settlement or judgment award were property transfers that were nontaxable under Sec. 1041(a)(2).

Deduction Cases

55. Mason owns Brickman, Inc., which specializes in laying brick patios, terraces, and walkways. Mason bids on a contract with State University to build several large terraces as well as the walkways adjoining the terraces. Although he is the low bidder, Mason is approached by Don, purchasing agent for State University, who lets Mason know that to secure the contract, Mason must make a cash payment to a firm that is building a swimming pool for Don. Mason makes the required payment and secures the contract. Later, Don demands, and Mason makes, a payment to a rancher for the purchase of a horse for Don's children. The payments made by Mason are not illegal under state law. Mason seeks your advice as to the deductibility of these payments.

Read and analyze the following authorities, and determine whether Mason can deduct the payments he made to Don:

- Sec. 162.
- *Raymond Bertolini Trucking v. Comm.*, 736 F.2d 1120 (6th Cir., 1984).
- *Car-Ron Asphalt Paving Co. Inc. v. Comm.*, 758 F.2d 1132 (6th Cir., 1985).

This is an interesting case in that the Sixth Circuit reached opposite decisions on essentially the same facts in *Raymond Bertolini Trucking* and *Car-Ron Asphalt Paving Co.* In fact, the payments in question in both cases were made to the same individual.

The issue in both cases involve deductibility under Sec. 162 of legal bribes and kickbacks as ordinary and necessary expenses. In *Bertolini*, the Commissioner had conceded that the payments were "necessary." The court reasoned that such payments were also "ordinary" and thus, deductible under Sec. 162. In *Car-Ron*, the Commissioner did not concede the "necessary" requirement. The Court held *Bertolini* to be controlling only as to the "ordinary" requirement and went on to conclude that such payments are not "necessary."

Because of its success in *Car-Ron*, it is likely that the government will continue to disallow such payments. However, the strongly worded dissent of Judge Jones in *Car-Ron* would indicate that taxpayers in other circuits may be successful if they choose to litigate the issue.

56. Jefferson is a grade school teacher whose annual income from teaching is \$30,000. He has always enjoyed bowling and his local pro urged him to turn professional. He subsequently begins working for the pro as an unpaid assistant and enters an apprenticeship program with the Professional Bowlers' Association of America (PBA). As an apprentice, he accumulates credits toward becoming a member of the PBA by taking approved classes, working as an assistant pro, and competing in pro tournaments. Jefferson expects to be approved as a full member of the PBA next year.

Although Jefferson continues to teach full-time, he goes to the bowling alley each day after school and practices after fulfilling his duties as an unpaid assistant. During the summer, he spends 12 to 15 hours each day at the bowling alley. In addition, he participates in as many PBA tournaments as he can work into his schedule.

Jefferson has come to you for advice on the deductibility of the expenses he has incurred in his bowling career. Since deciding to turn pro, he has won money in tournaments every year. However, his expenses have exceeded his earnings by \$5,000 to \$10,000 per year.

The question to be resolved is whether Jefferson is engaged in a trade or business per Sec. 162 or whether his bowling activity constitutes an "activity not engaged in for a profit" per Sec. 183. The Tax Court case, *Kimbrough v. Comm.*, T.C. Memo 1988-185, provides guidance in the matter.

In *Kimbrough*, the court found that a teacher who became a professional golfer was allowed business expense deductions for expenses incurred related to his golfing activities. Interestingly, the court allowed deduction of the expenses prior to the taxpayer becoming a full member of the PGA. Thus, if Jefferson can meet the requirements laid out in *Kimbrough*, he will be able to file amended returns for the three prior years in addition to taking current year deductions.

The Tax Court considered six factors in making its determination: (1) businesslike manner in which the activity was carried on, (2) level of expertise, (3) time and effort devoted to the activity, (4) history of losses, (5) outside income, and (6) pleasure derived from the activity.

In analyzing these factors, the Court seemed to be particularly impressed with the taxpayers' "carefully detailed" records of income earned and expenses incurred as an indication of a businesslike manner of approaching the activity. Because Jefferson's situation parallels *Kimbrough* on the other five factors, the adequacy of his records is a key factor in determining deductibility.

57. Seaweed Salvagers is a corporation engaged in producing foodstuffs from seaweed. Seaweed's primary salvaging plant is located in California. Because the salvaging technology hasn't changed through the years, Seaweed's primary salvaging equipment was purchased in the early 1970s. At that time, the primary insulation material used in the machines was asbestos. In 1986, the Occupational Safety and Health Administration lowered the standard for concentrations of allowable airborne asbestos fibers in the workplace. In addition, California requires employers to monitor airborne concentration levels to ensure that they do not exceed permissible exposure levels.

To comply with these requirements and to provide its workers with a safe workplace, Seaweed institutes an asbestos abatement program. After careful study, Seaweed determines that the major asbestos problem occurs during ordinary repairs and maintenance of the equipment. Initially, Seaweed institutes a program of continuous monitoring and encapsulation during repair and maintenance periods. However, Seaweed finds that this is inadequate because (a) it does not ensure that all parts of the plant are in compliance, (b) repairs and maintenance costs are increasing dramatically, and (c) the extra down time during maintenance and repairs reduces production to a level that is financially unprofitable.

During the current year, Seaweed begins removing the asbestos insulation from the machinery and replacing it with an alternative, environmentally friendly insulation material. The new insulation material is about 15% less efficient than the asbestos material and results in no energy or other cost savings. The cost of replacing the insulation in 1 machine is about \$13,000. The annual repair and maintenance cost of 1 machine averages \$45,000. Each machine has an estimated fair market value of \$600,000. Seaweed believes that it should be able to expense the cost of removing the asbestos insulation and replacing it with the alternative insulation.

Read and analyze the following authorities, and determine whether Seaweed can deduct the asbestos removal costs:

- Sec. 263.
- Reg. Sec. 1.162-4.
- Reg. Sec. 1.263(a)-1.
- *Indopco Inc. v. Comm.*, 112 S. Ct. 1038 (1992).
- LTR 9240004.
- Rev. Rul. 94-38

Sec. 263 disallows current deductions for capital expenditures. Reg. Sec. 1.263(a)-1(b) defines capital expenditures as amounts incurred to add value to or substantially prolong the life of a property. Reg. Sec. 1.162-4 states that "... incidental repairs that neither materially add value to the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition may be deducted as an expense."

The question to be resolved is whether Seaweed's asbestos removal and replacement program adds value or substantially prolongs the useful life of the property (capital expenditure) or merely keeps it in an ordinary efficient operating condition (current period repair expense).

In *Indopco*, the Supreme Court held that a corporate taxpayer was required to capitalize certain fees and other acquisition related expenses it incurred in connection with a friendly takeover by another company, where the transaction produced significant benefits to the taxpayer that extended beyond the tax year at issue. The Supreme Court stated that "... although the mere presence of an incidental future benefit ---some future aspect--- may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization."

In LTR 9240004, on facts similar to Seaweed's, the IRS ruled that the replacement of asbestos insulation in manufacturing equipment with something less toxic to comply with an OSHA standard is a capital expenditure. In its ruling, the IRS used the following rationale:

1. The replacement of the asbestos made the property more valuable than it had been:
 - a. because of the elimination of the health risk posed by the asbestos.
 - b. modifications to bring property into compliance with local regulations and requirements increase the resale value of the property.
 - c. the asbestos expenditures affect other operating efficiencies.
2. Repairs are remedies to immediate consequences. The extent and permanence of the asbestos expenditures is not a short term remedy.
3. The Supreme Court ruling in *Indopco* requires capitalization. The asbestos removal creates long-term benefits that are not merely incidental - they relate to the reason (health and safety concerns) for incurring the expenses.

In Rev. Rul. 94-38, the IRS concluded that the cost of cleaning up hazardous waste and treating contaminated groundwater are deductible expenses. However, the cost of constructing new groundwater facilities to extract, treat, and monitor contaminated groundwater was ruled to be a capital expenditure. The IRS determined that the clean-up costs did not extend the useful life of the land or adapt the land to a new or different use because the expenditures merely restored the land to its approximate condition before it was contaminated. That is, the IRS compared the value of the land after it was restored to the value before it was contaminated and determined that there was no increase in value due to the expenditures.

Although a private letter ruling is only binding on the taxpayer to which it is issued, it does provide insight into the service's position on a subject. LTR 9240004 indicates that the IRS believes that asbestos removal does increase the value of property and does extend its useful life, necessitating capitalization of the costs. Rev. Rul. 94-38 indicates that the IRS believes that hazardous waste removal does not increase the value of the property, making such expenditures currently deductible.

INSTRUCTOR'S NOTE: *Cinergy Corp. v. U.S.*, 55 Fed. Cl. 489 (2005), provides that the costs of removing and encapsulating asbestos are deductible because they did not appreciably increase the value of the property, but only restored value. Also, the costs were only a small fraction of the overall value of the building, did not prolong useful life, nor adapt to a new or different use. Thus, Seaweed may rely on *Cinergy* and argue that the costs are deductible because they did not appreciably increase the value of the property and were only a small fraction of the overall fair market value of the machine.

58. George and June are active volunteers in their local church. George serves as an usher one Sunday morning a month. June sings in the church choir every Sunday morning and attends choir practice each Wednesday evening. Based on the distance from their home to church, June drives 500 miles a year to attend choir practice and sing on Sunday. George leaves home by himself to arrive at church early on the mornings he serves as usher and put 120 miles on his car this year on these trips. June paid \$1,000 for singing lessons to improve her voice so that she might be chosen to sing a solo at church. Are any of these expenses related to serving as an usher or singing in the church choir deductible by George or June?

Deductions for out-of-pocket expenses have been denied when a charitable organization is not the primary beneficiary of the expenses. In *Churukian v Comm.*, (TC Memo 1980-205, 40 TCM 475), expenses for traveling to and from church choir practices were not allowed because the services performed are a form of religious worship, and any benefit to the church is only incidental to the personal benefit to the choir member. The expenses incurred by George and June would be considered personal expenses and not charitable contributions.

59. Grace, the minister of the local United Methodist Church, has some tax questions regarding her employment status. This is her first year as a United Methodist minister after having served as a Baptist preacher for twenty years. She wonders if the conversion affects her tax situation in any way. For instance, she questions whether she is an employee for income tax purposes. She also asks if she can deduct the out-of-pocket costs related to her work, such as books, travel expenses, and computer equipment. Write a memo to Grace explaining her tax status and the deductibility of her job-related expenses.

Ministers of the United Methodist Church, who were required to perform services to the local church to which they were assigned; comply with the laws, policies, and precepts of the United Methodist Church; whose work was supervised and controlled; and to whom employee-type fringe benefits were provided are classified as employees (*Weber, Michael v. Com.*, 60 F3d 1104 (CA4, 1995) 76 AFTR 2d 95-5782, 95-2 USTC ¶50409, affd. (1994) 103 TC 378). The *Weber* case also provides that a Methodist minister's expenses must be treated as miscellaneous itemized deductions subject to the 2-percent limitation.

60. Warren is chief executive of a major corporation and is very concerned about his premature balding. He contacts a hair transplant specialist and wants to have surgery performed this year. Write a memo advising Warren whether the hair transplant surgery would be deductible.

Sec. 213(d)(9)(A) provides that amounts paid for "cosmetic surgery" or other similar procedures are not deductible as a medical expense deduction, unless the surgery or procedure is necessary to ameliorate a deformity arising from (or directly related to) a (1) congenital abnormality, (2) personal injury resulting from an accident or trauma, or (3) disfiguring disease. "Cosmetic surgery" is defined in Sec. 213(d)(9)(B) as any procedure which is directed at improving the patient's appearance and does not meaningfully promote the proper function of the body or prevent or treat illness or disease.

Prior to 1991, the Tax Court held that where a procedure affects the structure or function of the body, the procedure's cost was a medical care cost regardless of the taxpayer's motive for undergoing the procedure. Thus, the cost of a hair transplant was held to be deductible under prior law (*Mattes, William*, 77 TC 650 (1981), acq. 1982-2 CB 2; Rev Rul. 82-111, 1982-1 CB 48).

However under current law, the costs of procedures such as hair transplant operations generally are not deductible. In Warren's case, the surgery is for cosmetic reasons and would not be deductible.

61. Rosemary attends classes provided by her church. She makes payments to the church which are required to attend classes. She plans to deduct the payments as charitable contributions to her church. Can Rosemary deduct the payments as charitable contributions?

The courts have addressed the issue of required payments to a church for religious training. In *Hernandez*, the taxpayer argued it was impossible to assign economic value to religious benefits. The court disagreed, saying that while taxpayer's argument may have some validity with respect to church services, group programs and pastoral counseling, it was not valid for this training because the church charged a set price for the training. Also, if the church did not charge a set price, an economic value could be determined by comparing prices set by providers of similar services or by the costs of providing the service. *Hernandez, Robert*, 819 F2d 1212, (CA1, 1987) 60 AFTR 2d 87-5067, 87-1 USTC ¶9343, affd. on other issue 492 US 933 (S. Ct., 1989) 63 AFTR 2d 89-1395, 490 US 680, 89-1 USTC ¶9347, reh. den. (S. Ct., 1989). Thus, Rosemary will not be allowed a charitable contribution deduction for the cost of these courses.

Several other cases involving the church of Scientology could also be used, such as *Graham v. Comm.* 822 F. 2d 844, (9th Cir., 1987); *Miller v. I.R.S.*, 829 F. 2d 500 (4th Cir., 1987) and *Foley v. Comm.*, 844 f. 2d 94 (2nd Cir., 1988).

62. Jon purchases a farm for \$2,200,000. The previous owners planted parallel rows of bushes and trees on the land when they acquired it to block the wind from the part of the farm that was planted with crops. The trees and bushes have never produced salable timber or any fruit, nuts, or other products that could be sold. Can a portion of the cost of the land be allocated to the trees and bushes and be depreciated?

Trees purchased and held for the production of revenue, such as orange groves are depreciable, see *Hawkins v. Com.*, 6 TCM 1087 [1947 PH TCM ¶47,277](1947). However, only trees and other plant life that produce revenue qualify for the depreciation allowance. Rev. Rul. 67-51, 1967-1 CB68, allows for depreciation of a tree that can produce a product. In *Everson v. U.S.*, (DC-MT, 1995), 75 AFTR 2d 95-1441, 95-1 USTC ¶50,150, affirmed 108 F. 3d 234 (9th Cir., 1998) the Eversons were not allowed to depreciate trees and bushes planted under a soil conservation program since the purpose of planting the trees and bushes was to prevent soil erosion and not to produce revenue.

63. Larry is a professional gambler, specializing in dog racing. He spends 50 to 60 hours per week studying racing forms and placing bets at the track. During the current year Larry has winnings of \$240,000 on \$380,000 of bets placed. He has no other business income. His wife, Jane, is employed as a university professor and earns \$55,000 annually. They also have \$15,000 in income from investments. Because Larry devotes all his time to his dog-racing activities, he feels that he should be able to deduct the loss he incurred in his "business" against their other income.

Read and analyze the following authorities to determine the deduction Larry is allowed for his dog-racing losses:

- Sec. 162.
- Sec. 165.
- *Commissioner v. Groetzinger*, 480 U.S. 23 (1987).
- *Pete C. Valenti*, 68 TCM 838 (1994).

Sec. 162(a) allows the deduction of all ordinary and necessary expenses paid or incurred in carrying on a trade or business. In *Groetzinger*, the Supreme Court held that the activities of a full-time gambler constituted a trade or business (this case involved the deduction of gambling losses for alternative minimum tax purposes).

Sec. 165(a) allows the deduction of losses incurred during the year. However, Sec. 165(c) limits losses of individuals to those (1) incurred in a trade or business, or (2) incurred in a transaction entered into for a profit, or (3) those resulting from fire, storm, shipwreck, or other casualty. Sec. 165(d) specifically limits the deduction of wagering (gambling) losses to the amount of wagering gains.

The question to be resolved is whether the provision in Sec. 162(a) allowing the deduction of all ordinary and necessary business expenses overrides the Sec. 165(d) limitation on gambling loss deductions. Citing previous court decisions, the tax court, in *Valenti*, held that gambling losses in excess of gains cannot be deducted even when the taxpayer is in the trade or business of gambling. The court rejected the taxpayer's argument that Sec. 162(a) should prevail over Sec. 165(d) in such situations by pointing out that Sec. 162 was first enacted in 1918 while Sec. 165(d) was enacted in 1934. The court felt that the enactment of Sec. 165(d) was intended as a limitation on the long standing deduction provided by the predecessor of Sec. 162.

64. Francine is a self-employed marketing consultant based in Fort Worth, Texas. During the year, she travels to various cities in the United States to meet prospective clients and make presentations at seminars.

Francine can substantially reduce her airfare expense if she stays in a particular city on a Saturday night. For example, if she flies to Chicago on Thursday, does marketing business on Thursday and Friday, and returns on Saturday morning, her round-trip airfare will be \$850. If she stays through Saturday night and returns early on Sunday morning, the airfare drops to \$350 and she pays \$150 for an additional night in a hotel and incurs \$50 of additional meal costs. This saves \$500 in airfare (reduced from \$850 to \$350), at an additional cost of only \$200. If she stays over Saturday night, she can either stay in the hotel and do administrative work on her laptop computer or visit friends in the Chicago area.

Francine wants to know how much of the additional hotel and meal costs she can deduct if she stays over on Saturday night. She would also like to know if the deductibility of these expenses depends on what she does on Saturday in Chicago.

The general issue in this case is whether the additional travel expense qualifies under Sec. 162(a)(2). *LTR 9237014* addressed the specific issue of the deductibility of hotel and meals expenses for corporate employees who spend Saturday nights away from home to take advantage of the lower domestic airfares for Saturday night stay-overs. The travel policy allowed reimbursement for a reasonable amount for an additional night of lodging and day of meals if these additional costs were less than the benefit of reduced airfare, and the extension was for the convenience of the company. The company's policy did not require the employees to work on company business during the day or evening on Saturday. Although an IRS letter ruling is binding only on the taxpayer who receives it, it does indicate how the IRS is likely to rule for other taxpayers.

In *Ahmed F. Habeeb v. Comm.*, 559 F2d 435 (CA-5, 1977), affg. 35TCM 1134 (1976) a medical school professor spent 14 days giving lectures in Egypt and then extended his stay for another 31 days. He alleged that he had a legitimate business purpose in deducting some of the additional days since he obtained a reduced air charter rate. The court observed that the professor's mother was a resident of Egypt, and found the facts did not support his claim that saving air fare costs was the primary purpose of extending his stay.

To qualify for deduction, Francine must maintain good records to meet the Sec. 274(d) substantiation requirements. She should be ready to prove the business purpose of the Saturday night stay-over by showing the cost savings in airfare for these particular days. Since she is self-employed, only fifty percent of the meals expenses are deductible.

65. Harvey is employed by the U.S. Customs Service. Early in the year he accepts a position in the London office. In addition to a raise in his pay grade, the terms of the London assignment let Harvey collect a monthly living quarters allowance (LQA) for rent and utility expenses. The LQA is exempt from tax under Section 912(1)(c).

Upon arriving in London, Harvey and his wife are unable to find suitable quarters to rent. They subsequently purchase a flat for \$160,000. During the current year, they pay \$10,000 in mortgage interest on the loan used to purchase the flat and \$1,300 in property taxes on the flat. The total LQA Harvey receives for the year is \$11,000.

Harvey was talking to a military attaché in the office and was surprised to hear that military personnel are allowed to deduct the interest and taxes they paid on their homes even though they receive an LQA comparable to that received by Harvey. He would like to know whether the same treatment is available for his mortgage interest and property taxes.

The facts in this case are similar to *Noel D. Induni v. Comm.*, 990 F2d 53, (CA-2, 1993). In *Induni*, the court held that a US Immigration and Naturalization Service employee stationed in Canada could not deduct the home mortgage interest and real estate taxes he paid in Canada to the extent those expense were attributable to a tax-exempt living quarters allowance (LQA).

The general rule of Sec. 265(a) is that expenses allocable to tax-exempt income are not deductible. In 1986, Congress exercised its legislative grace and carved out an exception in Sec. 265(a)(6) that allows mortgage interest and real estate tax deductions for taxpayers who receive *military* housing allowances and *parsonage* housing allowances. However, this exception does not extend to nonmilitary federal employees.

Loss Cases

66. Nina was getting ready to go to a party and couldn't find her bracelet. She remembered wearing it last weekend and taking it off at a bar to show to friends. Her memory of the remainder of that evening is foggy, but she hadn't seen or worn the bracelet since then. It had belonged to her grandmother, and Nina thinks the bracelet might be worth about \$800. She has no idea how much her grandmother paid for it, and the bracelet is not insured. Nina contacted the bar and filed a police report, but the bracelet was not recovered. Can she deduct a casualty loss for the bracelet?

Sec. 165(c)(3) allows for losses of property not connected with a trade or business or a transaction entered into for profit, if the loss arises from fire, storm, shipwreck, or other casualty, or from theft. The question is whether Nina's loss qualifies as a loss from an "other casualty, or from theft".

In *M.F. Allen*, 16 TC 163 (1951), Mrs. Allen had entered the Metropolitan Museum of Art wearing a diamond brooch and noticed that it was missing as she left the building. All of her efforts, including filing a police report and offering a reward, were unsuccessful in recovering the diamond brooch. In filing her tax return for the year she deducted the fair market value of the brooch as a theft loss. The Tax Court said that Mrs. Allen had not met the burden of proving that a theft had occurred and denied the deduction. The deduction was denied in a similar case where an emerald brooch was missing after returning home from a restaurant. The dress was torn where the brooch had been, but the court held that "Merely losing the brooch is not sufficient to establish deduction, since "other casualty" must be of the same general nature as fires, storms or shipwrecks " (*Mary I. Manahan v. Commissioner*, 9 TCM 1095, (1950)). The Tax Court referred to *Shearer v. Anderson*, 16 F2d 995, 1 USTC ¶210 (CA-2, 1927) which held that in order that a loss may be deductible as an "other casualty", it must be of a character similar to a fire, a storm, or a shipwreck. There are a number of other similar cases involving missing rings, bracelets, and wallets where the casualty loss deduction was denied because there was not a sudden or identifiable event that qualifies the loss as "an other casualty" (*E.F. Stevens*, 6 TCM 805 (1947), *J.M. Gray*, 13 TCM 1137, TC Memo 1954-225, and *Keenan v. Bowers*, 91 FSupp 771, 50-2 USTC ¶9444, (E.D. S.C., 1950), *Malcolm A. Sussel*, TCM 1966-243), *Pepi Schafner* TC Memo 1998-86.

Because Nina will not be able to prove that the bracelet was lost due to theft or other casualty, she will not be allowed a casualty loss deduction.

67. Sterling is a college professor with an extensive stock portfolio. Last year, he met Wheeler, a stockbroker with the firm of Ransom, LaForge, and Adkins. To get Sterling's business, Wheeler offered to use his investment expertise on Sterling's behalf, for which he would receive 1/4 of any profits and would also assume 1/4 of any losses if Sterling would give Wheeler \$300,000 to invest. Sterling accepted Wheeler's offer. During 2015, Wheeler makes a net profit of \$120,000 on trades with Sterling's money. On January 31, 2016, Sterling pays Wheeler \$30,000 per their agreement. In addition, Sterling pays normal brokerage commissions on the purchases and sales that Wheeler executes in making the \$120,000 net profit on the \$300,000 investment. The commissions are properly included in the calculation of the net profit. Sterling would like to know the proper tax treatment of the \$30,000 payment to Wheeler.

In *Dolin*, T.C. Memo 1988-2, the Tax Court held that a fee splitting arrangement was deductible as an investment expense. A reading of this case indicates that it is very similar to Sterling's situation in that it involves a payment to the broker of a fixed percentage of the net profit made by the broker on the investor's behalf. In addition, the investor paid regular brokerage commissions on all transactions. The court's holding indicates that the percentage fee is deductible because it constituted a payment for investment advice. In reaching this conclusion, the court reasoned that the amount of the payment was dependent upon profit gained by the broker's expertise and was unrelated to the costs of buying and selling the securities (i.e., commissions). Based on *Dolin*, the payment to Wheeler was for investment advice and is therefore deductible as a miscellaneous itemized deduction, subject to the 2% of adjusted gross income limitation.

68. Kimberly is a developer of apartment complexes. Two years ago, she formed Decksides Apartments, a partnership, and initiates development of the Decksides Apartments complex. The Staten Investment Fund agrees to the development at an annual interest rate of 10%, secured by a mortgage on the property. However, state law limits the annual interest rate for noncorporate borrowers to 8%. To avoid this state usury law, Kimberly incorporates Hump Day, Inc., under state law. Kimberly is the only shareholder of Hump Day, Inc. The next day, Decksides Apartments and Hump Day, Inc., enter into a written agreement under which the corporation holds title to the apartments solely for the purpose of obtaining financing. Hump Day cannot convey, assign, or encumber the property without the permission of Decksides, has no obligation to maintain the property, assumes no liability regarding the financing, and is held harmless from any liability it might sustain as the agent for Decksides.

Staten Investment Fund agrees to provide the financing to Hump Day, Inc., as the corporate nominee of Decksides, provided that Kimberly personally guarantees the note. Upon completion of the apartments, Kimberly, through Hump Day, Inc., obtains the permanent financing from Staten and pays off the short-term construction loans that she had obtained to build the apartments. An apartment manager is hired to oversee the operation of the apartments. All rents collected are deposited to and expenses paid from an account opened by the partnership.

During the current year, the apartments generate substantial operating losses. Kimberly seeks your advice as to the proper treatment of these losses.

In *J.C. Bollinger, Jr.*, 108 S.Ct. 1173 (1988), Aff'g 807 F.2d. 65 (6th Cir. 1986), the Supreme Court held that a corporation that held record title to real property as an agent for its sole shareholder (a partnership) was not the owner of the property for tax purposes. In so ruling, the Supreme Court overruled Circuit decisions in *George v. Comm.*, 803 F.2d 144 (5th Cir. 1986) and *Frink v. Comm.*, 798 F.2d 106 (4th Cir. 1986).

The Supreme Court laid out three factors in *Bollinger* that assures the genuineness of an agency relationship: (1) the fact that the nominee corporation is acting as an agent for its shareholders with respect to an asset is set forth in a written agreement at the time the asset is acquired, (2) the corporation functions as agent and not principal with respect to the asset for all purposes, and (3) the corporation is held out as agent in all dealings with third parties.

Based on the facts, Hump Day Inc. would not be considered to be the owner of the property per the *Bollinger* test. Therefore, the losses from the apartment buildings are attributed to the Decksides Apartments partnership and would be allocated to the partners according to their partnership agreement for sharing losses.

69. Fingeland's Forest Choppers is a corporation engaged in the production of timber and lumber. Two years ago, Fingeland's reforested a clear-cut area by planting nursery-grown seedlings. Last year, a severe drought kills 80% of the seedlings, forcing Fingeland's to replant the entire area in the current year. The loss is not covered by insurance. Fingeland's had capitalized the cost of preparing the site for reforestation and the seedling planting costs in a deferred reforestation account two years ago. Fingeland's would like to know whether it can deduct as a casualty loss the costs it incurred to replant the clear-cut area in the current year.

Read and analyze the following authorities, and determine whether Fingeland's can deduct the costs as a casualty loss, and if so, in what year the loss is deductible:

- Sec. 165.
- Sec. 611.
- Reg. Sec. 1.611-3.
- Rev. Rul. 81-2.
- Rev. Rul. 87-59.
- Rev. Rul. 90-61.

Write a memorandum to your supervisor explaining your conclusions on Fingeland's deduction of the costs of replanting the clear-cut area in the current year.

Sec. 165(a) allows a deduction for losses not otherwise covered by insurance. Sec. 611 and Reg. Sec. 1.611-3 allow planting costs to be recovered through depletion deductions. Under Reg. Sec. 1.611-3, if the number of trees planted is reduced, there is an adjustment to the depletion rate for the trees lost.

Rev. Rul. 81-2 held that the death of seedlings caused by unsatisfactory planting results did not constitute a deductible loss. The ruling held that the loss of trees constituted a depletion adjustment under Reg. Sec. 1.611-3. The cost of replanting the seedlings is added to the basis, further adjusting the depletion rate.

Rev. Rul. 87-59 held that cost basis of trees destroyed by insect damage was deductible as a noncasualty Sec. 1231 loss. The conclusion was based on the fact that the insect damage although "unusual and unexpected," was not sudden enough to be a casualty loss.

In Rev. Rul. 90-61, the loss of tree seedlings due to drought was held to be deductible under Sec. 165 because the seedling deaths were unusual, unexpected, and identifiable with the drought. The adjusted basis of the seedlings lost due to drought was held to be deductible as a Sec. 1231 loss due to an involuntary conversion. The deductible loss consists of the original planting and site preparation expenses excluding any costs incurred in the initial planning of the acreage that did not have to be duplicated on replanting. The cost of replacing the seedlings must be capitalized. The ruling also stated that the loss was not a casualty loss because it was not "sudden."

Fingeland's situation mirrors that of Rev. Rul. 90-61. Therefore, Fingeland's should treat the adjusted basis of the seedlings destroyed as a Sec. 1231 loss due to an involuntary conversion (but not as a casualty loss) in the year the seedlings died. The costs of replanting must be capitalized.

70. Mae and Vernon are equal owners of Denson, Inc., an S corporation. Denson owns 5,000 shares of stock in Cowboy Country. Denson paid \$300,000 for the Cowboy Country stock, which is qualified small business stock. During the current year, Denson sells 4,000 shares of Cowboy Country for \$100,000. Denson's accountant is preparing the current year tax return and is unsure of the reporting of the stock sale to Mae and Vernon.

Read and analyze the following authorities and determine how the sale of the stock should be reported to Mae and Vernon:

- Sec. 1244.
- Sec. 1363.
- Reg. Sec. 1.1244(a)-1.
- *Virgil D. Rath*, 101 T.C. 196 (1994).

Sec. 1244 allows individuals and partnerships to treat up to \$50,000 (\$100,000 if married, filing jointly) of losses on the sale of qualified small business stock as ordinary losses (instead of capital loss treatment). Reg. Sec. 1.1244(a)-1(b) provides that only individuals and individuals who were partners in a partnership at the time the partnership acquired the qualifying stock are entitled to the ordinary loss deductions provided by Sec. 1244.

Sec. 1363 specifies the taxable income calculation of an S corporation. Sec. 1363 (b)(1) requires S corporations to separately state each stockholder's share of the items specified in Sec. 1366(a)(1)(A). The items required to be separately stated are any items of income, loss, deduction, or credit that separately affect the tax liability of any stockholder. If the loss on the small business stock is an item that affects the tax liability of Mae or Vernon, then Denson must separately state the item and Mae and Vernon would be entitled to the Sec. 1244 ordinary loss treatment.

In *Rath*, the taxpayers argued that the language of Sec. 1366 requires that the characterization of an item by an S corporation be determined as if the shareholder realized the item directly from the source. This would require that the ordinary loss treatment of Sec. 1244 be determined by reference to shareholders (who were individuals) and would allow them to deduct their share of such losses as ordinary losses. They also contended that because Sec. 1363(b) provides that an S corporation's taxable income is to be computed in the same manner as an individual, that they are entitled to the loss deduction as would any individual. The tax court rejected these arguments by (1) noting that prior case law determined "...the partnership is to be viewed as an entity and such items are to be characterized from the viewpoint of the partnership rather than from the viewpoint of an individual partner." and (2) while Sec. 1363 does require the computation be made in the same manner as an individual, an S corporation is not an individual as defined in Sec. 1244. The court reasoned that if Congress had wished to extend the relief provisions of Sec. 1244 to S corporation shareholders, it would have explicitly done so.

Entity Cases

71. Evelyn is the president and sole shareholder of Ephron Corporation. Ephron is an accrual basis taxpayer and uses a calendar year. Evelyn is a cash basis, calendar year taxpayer.

During the second half of 2015, Ephron recorded several million dollars of sales to customers with cash payment expected in the first half of 2016. To reduce the taxable income at the corporate level, Ephron accrues a \$200,000 bonus to Evelyn on December 15, 2015. As of December 15, 2015, the corporation does not have cash on hand to pay the bonus but expects to receive cash from customers in March or April 2016.

Evelyn is considering the following alternatives for the corporation's payment of the bonus:

Have the corporation immediately borrow more on its commercial line of credit and pay the bonus by December 31, 2015.

Wait for the cash flow from customers and pay the bonus around March 1, 2016.

Wait to pay the bonus until around April 15, 2016.

Read and analyze the following authorities and determine when the corporation is allowed to deduct the bonus for each of the 3 payment alternatives:

- Sec. 267
- Reg. Sec. 1.267(a)-1

Sec. 267(a)(2) requires that the deduction of an expense by an accrual-basis entity to a cash-basis related party must be matched in the same year. Thus, when an accrual method corporation accrues a bonus to a cash method employee-owner with more than 50 percent of the stock, that bonus is not deductible until the year the employee includes it in his/her income. Sec. 267(b) lists the related party relationships for this deduction matching rule.

Applying these rules to this case, the Ephron Corporation has the following results for the bonus accrued on December 15, 2015.

If the bonus is paid with borrowed funds by December 31, 2015, the corporation gets the \$200,000 deduction on its 2015 corporate tax return and deducts the accrued interest expense on its line of credit loan.

If the bonus is paid after December 31, 2015, Ephron can only claim the deduction as of the day it is included in income by Evelyn in 2016 (Sec. 267(a)(2)(B)).

72. The Miller family has owned several large apartment buildings for many years. They organized Miller Properties, Inc., to own and manage the properties. The corporation is an accrual basis taxpayer and uses a calendar year. All shares of Miller Properties are owned by Frank, Susan, and their mother, Ida. Frank and Susan, are president and chief financial officer of the corporation, respectively.

Miller Properties expects to have the following items of income and expense during the current year:

Rental revenue	\$ 1,200,000
Maintenance expenses	150,000
Depreciation	250,000
Real estate taxes	400,000
Officers' salaries	200,000

Read and analyze Sections 541 through 547 and determine if Miller Properties has a problem with the personal holding company (PHC) tax. If it does, estimate the amount of PHC tax and suggest alternatives for reducing or eliminating the PHC problem.

Under Sec. 542 for an entity to be treated as a personal holding company two requirements must be met: (1) More than 60 percent of the entity's adjusted ordinary gross income (AOGI) consists of portfolio (e.g., interest and dividends) and passive income (e.g., rents), and, (2) More than 50 percent of the value of the outstanding stock is owned by five or fewer individuals at any time during the last half of the taxable year stock ownership.

Rental revenue		\$ 1,200,000
Other revenue		0
Gross income		<u>\$ 1,200,000</u>
Less: capital and Sec. 1231 gains		0
Ordinary gross income (OGI)		<u>\$ 1,200,000</u>
Expenses directly related to rent		
Maintenance	\$ 150,000	
Depreciation	250,000	
Real estate taxes	<u>400,000</u>	
Deductible from OGI		<u>800,000</u>
Adjusted ordinary gross income (AOGI)		<u><u>\$ 400,000</u></u>

Officer salary expenses are not allowed as a deduction in computing AOGI.

Sec. 543(a)(2) provides that adjusted income from rents is excluded from AOGI if two more tests are satisfied: (1) adjusted rent income is 50 percent or more of AOGI, and (B) the corporation distributes at least 10 percent of OGI (computed without rental income) as dividends during the year.

Miller Properties satisfies both tests under Sec. 543(a)(2). Adjusted rent income is 100 percent of AOGI. Since nonrental PHC income is zero, the corporation meets the dividends distribution requirement. Since both tests are satisfied, Miller's adjusted income from rents is not PHC income.

Instructors Note: If Miller Properties had received interest and other passive nonrental income during the year, it could reduce or eliminate that problem by distributing at least ten percent of that income as dividends.

73. Omega Investments, Inc. was formed in 1998 by 10 unrelated individual investors. The corporation operates a chain of electronics stores. The corporation suffered losses in its early years but has become profitable in recent years.

The corporation elected S corporation status in 1998. Over the years, the original shareholders have gifted shares to their children and transferred them to trusts for their grandchildren. At the end of last year, there were 70 shareholders. Additional gifts made in the current year have increased the number of shareholders to 90.

The company needs more cash and would like to sell additional shares. Write a memo advising the investors of the tax implications of issuing additional shares of stock.

Section 1361 (b)(1)(A) was amended in 2005 to increase the limit on the number of shareholders in the definition of an S corporation. Effective for tax years beginning after 12/31/2005, a corporation is not eligible to be an S corporation if it has more than 100 shareholders. (The maximum number of shareholders prior to 2005 was 75. Prior to 1998, the limit had been 35.)

In determining whether an S corporation meets the 100-shareholder limit, a family may elect for all family members to be treated as one shareholder per Section 1361(c)(1)(A)(ii). The election is available regardless of whether the family member holds the stock directly or is treated as a shareholder by reason of being a beneficiary of a qualified Subchapter S trust (ESBT) or a qualified Subchapter S trust (QSST) or certain other types of trusts per Section 1361(c)(2).

Sec. 1361(c)(1)(D)(i) provides that any family member may make the election for all family members to be treated as one shareholder. If the Omega shareholders will elect to treat all family members, including the qualified trusts, of each of the family units as one shareholder, then the corporation will be able to sell additional shares (up to 100 shareholders minus each family unit).

74. Fernando has been an attorney in the legal department of Mega Manufacturing, Inc., for the past 15 years. As part of Mega's restructuring plan, he will lose his job as an employee of Mega, but he will continue contracting with Mega to work on specific engagements as a self-employed attorney.

Fernando is concerned about protecting his retirement assets. He has \$200,000 vested in Mega's qualified retirement plan. Mega made the contributions to the retirement plan as part of its defined contribution plan. When Fernando leaves the company, he can request that his funds be withdrawn and paid to him in cash or to the administrator of a designated qualified retirement program. Fernando wants to continue saving for his retirement when he becomes self-employed.

What are the tax consequences of the distribution from the Mega retirement plan?

Tax planning for retirement plan distributions and rollovers is a very important personal tax planning opportunity. The planner needs to gather facts about the participant's age and family needs and to consider both tax and nontax issues. Software and guide books are available to help with this planning. The various alternatives are summarized below.

Rollover: The best alternative for most individuals who are continuing to work is to avoid taxation by rolling over their employer's retirement plan distributions into an individual retirement account (IRA) as allowed by Sec. 402(c). If the transfer is made directly between the administrator of the employer's plan and the administrator of the IRA, then no income tax will be withheld. If a rollover is made by distributing a check to the employee who in turn writes a check to the IRA administrator, then Sec. 3405(c) requires the administrator of the distributing plan to withhold 20 percent as income tax. The distribution is not taxed if the rollover is made within 60 days of receipt of the distribution.

Distribution to an individual less than age 59 1/2 as of the date the distribution is made that is not rolled over to another qualified plan: If Fernando takes a distribution when he is less than age 59 1/2, does not rollover the distribution to another qualified plan, and does not qualify for any of the exceptions specified by the Code; then the distribution is included in his regular taxable income and subject to an additional 10 percent early distribution tax. This early distribution tax is described in Sec. 72(t) and must be reported on IRS Form 5329. The IRS will know if an early distribution has been made because the retirement plan administrators will report it to the IRS on a Form 1099-R.

Instructors Note: *Lump-sum distributions to individuals who are over age 59 1/2:* Sec. 402(d)(4)(B) allows 10-year averaging to individuals who are at least 59 1/2 when they receive the distributions, but not age 50 or older before January 1, 1986.

Property Cases

75. Dagwood has come to you with a pressing problem. In November 2005, he purchased an office building that he has rented out to various businesses. On May 2 of the current year, a fire swept through the building, totally destroying it. To make matters worse, his lifelong accountant was trapped in the building and perished in the fire (along with all of Dagwood's income tax records). The following is all the information Dagwood has available about the building:

Dagwood is sure that he purchased the building in November 2005, because he has a property tax statement indicating that the land was revalued at \$30,000 and the building at \$300,000 for property tax purposes at that time. The date is further supported by a canceled check dated November 28, 2005, for \$550,000, payable to the company from which he had purchased the property. Although he doesn't have the tax records to support any deductions on the property, he's confident that his former accountant took the maximum deductions allowable on the property as it had always produced a loss for income tax purposes.

He recently received a check for \$400,000 from his insurance company for the destruction of the building. In the interim, Dagwood has been obtaining estimates of the cost of putting another office building on the property. However, his analysis of the construction costs, combined with the potential rental income generated by the building, indicates that putting another office building on the property would not be profitable in either the short or the long term. He has received an offer to sell the land for \$84,000. If he does sell the land, he is considering purchasing an upscale apartment building in another part of town.

Before he proceeds with the sale of the land and the purchase of the apartment building, he needs to know the tax effects of the fire and the sale of the land. Dagwood is afraid that he may have a big tax bill to pay and won't be able to afford the apartment building after he settles up with the IRS.

Read and analyze the following authorities and determine how much gain or loss Dagwood will have to recognize from the fire if he purchases the apartment building:

- Sec. 1033.
- Rev. Rul. 64-237.
- Rev. Rul. 59-361.
- *Henry J. Masser*, 30 T.C. 741 (1958).

Sec. 1033(a)(2) allows the nonrecognition of a gain from an involuntary conversion if the property is replaced with "...property similar or related to in service or use to the property so converted..." In addition, it provides that gain will be recognized on such a conversion only if, and to the extent that, the amount realized from the conversion exceeds the replacement cost of the property. Therefore, if the apartment buildings are similar or related to in service or use to the office building, Dagwood will not have to recognize any gain on the office building if he pays at least \$400,000 for the apartment building.

Rev. Rul. 64-237 held that, for investors, the two properties must have a close functional similarity. Because both properties have the function of producing rents, they should meet the similar or related in service or use test and qualify for nonrecognition.

A key question to be resolved is whether the sale of the land qualifies as part of the involuntary conversion, allowing the gain on sale to be deferred. In *Masser*, the Tax Court held that the sale of a freight terminal because of the condemnation of the taxpayer's parking lots were part of the involuntary conversion of the lots because they "... were acquired for the purpose of being used and were used as an economic unit." In Rev. Rul. 59-361, the service reversed its earlier position in Rev. Rul. 57-177 and ruled that where a substantial economic relationship exists between the two properties such that they constitute one economic unit, involuntary conversion treatment of both properties will be permitted. The ruling indicated that the taxpayer must show the unavailability of suitable property nearby of a like kind to that converted in order to be considered part of the involuntary conversion.

Because Dagwood can support that it would not be economically feasible to rebuild another office building on the same property and the land and the office building did constitute one economic unit, the proceeds from the sale of the land can be considered to be part of the proceeds of involuntary conversion of the office building. Therefore, Dagwood will have to reinvest at least \$484,000 in the apartment buildings to defer the entire gain from the conversion of the building and the sale of the land.

76. Dale's son is a senior in high school and is planning to go away to college next year. Dale would like to buy a house near the campus and rent it to his son. He comes to you for advice on the tax ramifications of this arrangement. What advice can you give him on setting up a rental arrangement with his son?

A taxpayer who rents a dwelling unit to a family member is entitled to a depreciation deduction, provided that a fair rental is charged and the unit is used as the tenant's principal residence [Sec. 280A(d)(3)]. This arrangement could provide tax advantages for Dale if structured properly. One concern is whether his son will be able to make the rental payments, which may depend on arrangements that have been made to finance his education. For example, the son might use funds from a trust that had been set up to finance higher education costs. Perhaps he could get a job while attending school.

If Dale does not rent the property to his son at fair market value, he will not be able to deduct the expenses related to the house because it will not be considered an income-producing property (*B.O. Saunders*, 44 TCM 82, Dec. 39,088(M), TC Memo 1982-322 and *L.B. McDonald*, 61 TCM 2764, Dec. 47,376(M), TC Memo. 1991-242).

Dale could rent to his son and other college students and then hire his son to manage the house. The son could live there rent free and could even be given cash compensation that might be tax free when offset by the standard deduction. Dale could deduct depreciation and other expenses connected with the house.

It is important to provide evidence that the rent charged is fair market value and that there is documentation of the rental payments. In *D.E. Smith*, 50 TCM 904, Dec. 42,342(M), TC Memo. 1985-446, the taxpayers were not allowed rental expense deductions for a duplex they partially rented to their offspring, since they failed to offer evidence of what was the fair rental value of the duplex and what portion of the rent was paid by their son. Fair rental value can even be discounted, as in *L.A. Bindseil*, 46 TCM 764, Dec. 40,279(M), TC Memo 1983-411, where, the court allowed fair market rental to be discounted by 20% to reflect savings that the landlord could realize by avoiding a management fee and renting to trustworthy tenants.

77. Marjorie is a software systems engineer for Hacker Corporation. In November 2013, she inherited two parcels of land in Brower Township from her grandfather. Her grandfather's estate valued the parcels, which are adjacent to each other and total 25 acres, at \$11,000. Marjorie thought the parcels were worth more than \$11,000, so she asked the estate's appraiser why the parcels weren't valued higher. The appraiser told her that the zoning on the land allows only one residence every two acres, which severely diminishes the resale value.

In 2014, Marjorie applied to Brower Township for a change of zoning. The Brower Township Board of Supervisors denied her application in November 2014. Marjorie filed a constitutional challenge to Brower Township's zoning ordinance in 2015. The board of supervisors denied her constitutional challenge. Marjorie filed an appeal of the denial in Brower County District Court on September 25, 2015. On October 5, 2015, the Brower Township Board of Supervisors began consideration of a new zoning ordinance. Under the ordinance, Marjorie's land would be rezoned to a designation that would allow three residences per acre. At this point, Marjorie withdrew her court appeal, pending the outcome of the new zoning ordinance. On January 10, 2016, the new zoning ordinance was adopted. Marjorie estimated that the value of the land increased to at least \$21,000 as a result of the rezoning.

Marjorie incurred \$14,000 in attorney's fees and other costs in challenging the zoning ordinance. She paid \$3,500 of the expenditures in 2015 and \$10,500 in 2016. She would like to know the proper income tax treatment of these expenses. Can Marjorie deduct the costs of challenging the zoning ordinance? Write a memorandum explaining the deductibility of the costs of challenging the zoning ordinance.

***Chevy Chase Land Co. v. Comm.*, 72 T.C. 481 (1979) determined that rezoning expenditures are not deductible when made because they represent capital expenditures. In *Hustead v. Comm.*, 61 F3d 895 (CA-3, 1995) affg., T.C. Memo 1994-374, the taxpayers contended that the cost of challenging the constitutionality of a zoning ordinance were not "rezoning expenditures" and therefore, not subject to the capitalization rule established by *Chevy Chase Land Co.* The Tax Court considered the distinction between the two types of expenditures, but concluded that the increase in the value of the property was attributable to the constitutional challenge. Because the increase in value was a significant benefit that extended well beyond the tax years in question, the court held that Sec. 263 required the expenditures to be capitalized. Therefore, Marjorie would not be allowed any current deduction for the attorney's fees and other costs of challenging the zoning ordinance, but must add them to the basis of the property.**

In a related case involving the same taxpayers, the Tax Court didn't distinguish the unfavorable prior ruling involving the same issue for a different tax year (*Hustead v. Comm.*, T.C. Memo 1998-205).

78. Rachel lives in a downtown apartment in Gotham City. She has 3 years remaining on her apartment lease when her landlord, Blaylock Company, approaches her about moving out. Blaylock wants to demolish the apartment building and build an office tower in its place.

Rachel hires a lawyer who negotiates a lease termination settlement with Blaylock over the leasehold rights. After intense negotiations, Blaylock agrees to pay \$100,000 in cash and the \$25,000 in legal fees related to the negotiation and provide Rachel with a similar apartment rent-free for 3 years. Rachel requests that Blaylock issue no checks directly to her. Instead, Blaylock is to pay her lawyer the \$25,000 billed, and issue a \$100,000 check to her brother, who lives in Mexico.

Rachel believes that none of these transactions will have any effect on her taxable income because the checks are not issued to her. Furthermore, because she did not own the apartment building, she did not realize a gain from the sale of the property.

Does the settlement result in any taxable income or deductions for Rachel?

The facts in the above case are similar to *George and Myrsini Stotis v. Comm.*, TCM 1996-431 (September 24, 1996). In *Stotis*, the court held that the tenant transferred a property interest in the form of leasehold rights and received compensation in the form of payments to family members and attorneys. The leasehold rights are a property interest even though they did not involve ownership of the entire building. Thus, the taxpayers had capital gain income from this settlement. Similar results for lease termination settlement payments were found in *J. B. White, Inc.*, 458 F2d 989, 72-1 USTC para. 9368 (CA-3, 1972); *L. W. Ray*, 210 F2d 390, 54-1 USTC para. 9235 (CA-5, 1954); and *H. G. Kingsbury*, 65 TC 1068.

Rachel has taxable income due to the leasehold rights that she gave up to Blaylock. The amount realized from the transaction includes the cash paid to family members, legal fees paid on her behalf, and the rental value of the replacement apartment. She cannot assign her income away to others. *Stotis* further held that the legal fees are capital expenditures that can be offset against her capital gain. If she attempts to conceal her income by hiding it in a foreign country, the IRS could assert the fraud penalty under Sec. 6663 and other penalties.

Rachael could exclude the rental value of the apartment if she receives the use of the apartment as a gift (i.e., purely donative intent). In this case, the apartment is clearly compensation for giving up her lease.

Accounting Methods/Procedure Cases

79. Mr. and Mrs. Lucky have been married for 25 years. Last year, they won \$200,000 at a casino. They knew that this would put them in the highest tax bracket for the year. To avoid this, they went to Mexico on December 28 and obtained a divorce. They continued to live together and plan to file separate returns using the single filing status. They remarry in February. What is their correct filing status?

In Rev. Rul. 76-255, 1976-2 CB 40, the IRS ruled that a married couple couldn't save income taxes by getting a divorce at year-end to file as single individuals and then remarrying early in the next year. According to the IRS, such a year-end divorce is a sham and will be disregarded.

Rev. Rul. 76-255 deals with a couple that had been married for 10 years and determined that for income tax purposes it would be advantageous for them to be unmarried (i.e., file single) at the close of their taxable year. They obtained a divorce in a foreign jurisdiction at the end of that year, and intended to and did remarry each other in the first month of the following year. The IRS ruled that although they were divorced under the laws of the foreign jurisdiction, the divorce was not intended by them to have effect except to enable them to qualify as unmarried individuals who would be eligible to file separate returns. In addition, they intended to and did remarry each other early in the succeeding taxable year. Such transaction should not be given any effect for federal income tax purposes if it merely serves the purpose of tax avoidance. See also *Boyter* 668 F2d 1382 (4th Cir., 1981)

The IRS, relying on the substance of the transaction rather than its form, held that the taxpayers were married individuals as of the close of the taxable year. Therefore, Mr. and Mrs. Lucky must file either a joint federal income tax return or separate returns using rules for married individuals filing separate returns.

80. The Kona Rural Electric Coop (KREC) is an accrual basis public utility. All new customers are required to pay a deposit equal to 3 times the customer's estimated monthly bill or \$100, whichever is greater. The purpose of the deposit is to ensure that timely payment is made on accounts. The funds so received are not segregated from other KREC funds and are used in the ordinary course of business. Interest at the rate of 5% is paid annually on the deposits. Customers may elect to receive a check for the interest or may accept the payment as a credit on their monthly bill.

KREC's policy is to refund the deposit when a customer discontinues service or has made timely monthly payments for 8 consecutive months or for 9 of 12 consecutive months. When deposits are refunded, interest is paid on the deposit through the date of the refund. KREC's experience with the deposit requirement is that 80% of all deposits are returned within 1 year of receipt. Approximately 5% of all deposits are ultimately used to satisfy delinquent customer accounts.

KREC would like to know whether the deposits should be included in income when they are received or deferred until they are used to satisfy customer accounts.

City Gas Co., 911 F.2d 710 (11th Cir. 1991) determined that taxable income resulted from deposits received to guarantee payment of customer's bills. However, the 7th Circuit, in *Indianapolis Power & Light Co.* 857 F.2d 1162 (7th Cir. 1988), held that such deposits did not constitute gross income because they were security deposits and not advance payments of customers bills. The 7th Circuit decision was upheld by the Supreme Court in *Indianapolis Power & Light*, 110 S.Ct. 589 (1990). A reading of the case indicates that the factual pattern is similar to KREC's and therefore, KREC should be able to defer recognition of the deposits until they are used to satisfy accounts.

81. Al is in the state penitentiary after being convicted of a series of crimes. He still corresponds with his girlfriend to ask for money and this year she has sent him a total of \$1,200. Al's only other income is the \$1,000 he has been paid for making license plates. Is Al eligible for the earned income credit?

Sec. 32(c)(2)(A)(i) states that "earned income" for purposes of calculating the earned income credit means wages, salaries, tips, and other employee compensation. However, **Sec. 32(c)(2)(B)(iv)** provides that "no amount received for services provided by an individual while the individual is an inmate at a penal institution shall be taken into account". In the case of *Gary James Taylor v. Commissioner*, T.C. Memo. 1998-401, an inmate at a state penal institution was not entitled to an earned income credit for amounts paid to him for his services as a telemarketer while he was incarcerated. Therefore, Al's earnings from making license plates will not qualify.

In a series of cases issued on September 24, 1999, the Tax Court ruled that prisoners who had listed their occupation as beggar and claimed funds received from family and friends as income were not entitled to the earned income credit. These funds did not meet the definition of income under Sec. 32 and were gifts given out of charity without expectation of economic benefit (*Miguel A. Bauta v. Commissioner*, T.C. Memo. 1999-317, *Floyd Daniel, Jr. v. Commissioner*, T.C. Memo. 2000-318, *Alfredo Dominguez v. Commissioner*, T.C. Memo. 1999-319, *John Walter Wolf v. Commissioner*, T.C. Memo. 1999-320, and *Pradel Lucas v. Commissioner*, T.C. Memo. 1999-321).

82. Tomiko owns the copyright to several classic Motown songs. In 2014, he became aware that Tinseltown Records was selling several of his songs without his permission. He sues Tinseltown seeking \$1,000,000 in damages. In 2016, the court awards Tomiko \$500,000 in compensatory damages, \$50,000 in prejudgment interest, postjudgment interest to the date of payment, and court costs. Tinseltown is aware that Tomiko is likely to appeal the judgment and offers to settle for \$600,000 with no payment of postjudgment interest or court costs. On the advice of his attorney, Tomiko rejects the settlement offer.

On December 29, 2016, Tomiko receives a check for \$600,000 from Tinseltown. An accompanying letter notes that the payment is in full settlement of the order of the court. Tomiko believes that if he cashes the check, he will forfeit his right to appeal the judgment, the postjudgment interest and court costs. Accordingly, he immediately returns the check to Tinseltown via overnight mail, stating in a letter that his appeal rights are not exhausted and he is returning the check until such time as the issue is settled. Tinseltown remails the check on December 31, 2016. Included with the check is a letter advising Tomiko that Tinseltown intends to deduct the \$600,000 in 2016 and that the funds are available for his unrestricted use. On January 15, 2017, Tomiko files an appeal seeking an increase in the damage award. The next day, he deposits Tinseltown's check into his business account. On June 5, 2017, the appeals court rejects Tomiko's appeal for higher damages. Tomiko is a cash basis taxpayer. In what year should he include the \$600,000 in income?

Read the following authorities, and determine the proper year for Tomiko to include the \$600,000 in income:

- Sec. 451.
- Reg. Sec. 1.451-2.
- *Walter I. Bones*, 4 T.C. 415 (1944).
- *Fromson v. Comm.*, 32 Fed. Cl. 1, 74 A.F.T.R. 2d, 5642 (Cl. Ct., 1994), 94-2 USTC ¶50,425.

The year for inclusion of the \$600,000 payment depends on whether Tomiko was in constructive receipt of the income when he received the check on December 31, 2016. Sec. 451(a) provides that items of gross income shall be included in gross income in the taxable year in which they are received. Reg. Sec. 1.451-2(a) provides that income is constructively received when it is credited to a taxpayer's account, set apart for the taxpayer, or otherwise made available to the taxpayer so that it can be drawn upon at any time. The regulation also states that income is not constructively received if the taxpayer's control of the income is subject to substantial limitations or restrictions. Therefore, the year of inclusion rests upon whether Tomiko's control of the \$600,000 is substantially limited or restricted when he receives it in 2016.

In *Bones*, the Tax Court held that a check accompanied by a letter stating that the check was in full settlement of all liabilities was not constructively received. The taxpayer did not accept the check because he believed that the check did not represent the amount of the liability. By accepting the check, he thought that he would create an "accord and satisfaction" that would prevent him from seeking the correct amount owed. The court held that because the taxpayer had a legal right to refuse to accept the check in full settlement of the liability, a substantial restriction was placed on the use of the funds received.

On facts similar to those of Tomiko's, the Claims Court, in *Fromson*, held that the taxpayer was in constructive receipt. In this case, there was no limiting language as to extinguishment of the liability, only that the payment was pursuant to the order of the judge. Under these circumstances, the claims court did not feel that the notation that the check was paid "pursuant to" was insufficient to create an impression that the check was offered in full settlement of the claim.

Based on these two cases, whether the \$600,000 is constructively received in 2016 depends on the interpretation of the letter accompanying the check. As stated in the case, it appears to be reasonable to assume that this is an offer to settle. In addition, the payment amount is greater than the known liability to date, giving credence to the payment as a settlement offer. Tomiko is not in constructive receipt if it is interpreted to be a settlement offer per *Bones* and the \$600,000 is not included in income until 2017.

83. Ernie's Farm and Garden Implement Store sells, repairs, and services farm and garden equipment. In 2015, the state attorney general began to investigate customers' complaints that Ernie's was adding a delivery and handling fee to each product---fees that are illegal under state law. In 2016, Ernie's entered into a consent judgment under which it was to make restitution of every delivery and handling fee charged to customers after April 1, 2014. The judgment also required Ernie's to give the attorney general's office a list of every customer entitled to restitution and to issue a coupon in the name of each customer.

The coupons offered each customer the option of a \$50 discount on the purchase of any part or service or \$90 toward the purchase of any new or used equipment. If not satisfied with the coupon offer, the customer could redeem the coupon for \$40 in cash. Ernie's mailed out 1,860 coupons in April and May 2016. As of December 31, 2016, 835 coupons had been redeemed as follows: 405 for cash refunds, 390 for \$50 discounts for parts and services, and 40 for \$90 discounts on equipment purchases.

The controller of Ernie's is not certain that the company can deduct the amounts it gave customers for refunds or discounts in 2016 and has asked your firm for advice. Your supervisor has assigned you to determine Ernie's 2016 deduction. Write a memorandum to your supervisor explaining Ernie's 2016 deduction for the coupons.

Because Ernie's has inventories, Reg. Sec. 1.446-1(a)(4)(i) requires the use of the accrual method of accounting. To accrue a liability, The all-events test and the economic performance tests must be satisfied [Sec. 461(h)(1)]. The all-events test is "... met with respect to any item if all events have occurred which determine the fact of the liability and the amount of the liability can be determined with reasonable accuracy." [Sec. 461(h)(4)]. *Hughes Properties Inc. v. U.S.*, 106 S. Ct. 2092 (1986) held that the payee must be known before an expense can be accrued. In *Spitzer Columbus Inc. v. Comm.*, T.C. Memo 1995-397, the Tax Court held that the issuance of coupons redeemable for cash, discounts on parts or services, or towards the purchase price of a new car are not deductible when issued because the all-events test has not been met at issuance. The all-events test is met when the coupons are redeemed. Deductions are only allowed for actual cash redemptions. Coupons redeemed for parts or services or towards the purchase of a new car are allowed as a reduction of selling price of the part, service, or car. Based on *Spitzer*, Ernie's can deduct the 405 coupons redeemed for cash. The 390 coupons redeemed for parts and services should be treated as reductions of the selling price of the parts and services. The 40 coupons redeemed on equipment purchases should also be treated as reductions of the selling price of the equipment. Ernie's cannot take a deduction for any of the coupons that have not been redeemed.

84. Lydia and Andre are divorcing this year. Because they are hotly contesting the terms of the settlement, they will not file a joint return for the current year. Lydia receives a Form 1099-INT from Andre's accountant and a letter stating that Lydia should include 50% of the \$6,200 interest on their savings account in her taxable income. Andre's Social Security number is listed on the account (Lydia's is not), and the Form 1099-INT was issued in his name, although they own the account as joint tenants with the right of survivorship. Under applicable state law, both spouses have an equal right to jointly held property. Lydia doesn't think that she should be taxed on this income because the account is in Andre's name and he was issued the Form 1099-INT. Lydia has come to you for advice. Write a letter to Lydia explaining who is taxed on the \$6,200 in interest.

Sec. 61 requires the inclusion in gross income of all income from whatever source derived. Taxation of income from jointly held property is determined in accordance with state law [*Bour v. Comm.*, 23 T.C. 237 (1954)]. Because Lydia and Andre each have an equal right to the property under their applicable state law, Lydia must recognize any income she has received from the property. Reg. Sec. 1.451-2(a) requires the inclusion of income that has been constructively received. Income is constructively received when it is credited to her account, set apart for her, or otherwise made available to her to draw upon at any time. If the taxpayer's control of the receipt is subject to substantial limitations or restrictions, then it is not constructively received. On facts similar to Lydia's, in *Rosenbaum v. Comm.*, 998 F.2d 1016 (7th Cir., 1993), the Seventh Circuit upheld the Tax Court's determination that the taxpayer was in constructive receipt of the income from a jointly held account. The Tax Court determined that, under applicable state law, the taxpayer had a right to half of the income and the income was available when it was credited to the account. The fact that the taxpayer's husband received the Form 1099 and that his Social Security number was on the account did not negate her rights to the income under state law. Therefore, in the absence of any showing of a substantial restriction on her ability to withdraw the money from the account, Lydia will have to include \$3,100 of interest in her gross income.