Recent Developments in the Income Taxation of Individuals, Partnerships, Estates, & Trusts

Meade Emory

Repository Citation
http://scholarship.law.wm.edu/tax/231

Copyright © 1991 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository.
http://scholarship.law.wm.edu/tax
THIRTY-SEVENTH WILLIAM & MARY TAX CONFERENCE–1991

RECENT DEVELOPMENTS IN THE INCOME TAXATION OF
INDIVIDUALS, PARTNERSHIPS, ESTATES & TRUSTS

Meade Emory
Lane Powell Spears Lubersky
Seattle

BUSINESS INCOME:

1. Friedrich v. Comm., 91-1 USTC ¶ 50,074 (7th Cir. 1991), aff'g T.C. Memo. 1989-103. Taxpayer received an advance payment of $100,000 legal fees from client (not a loan) where promissory note called for below-market (8%) interest and provided for "repayment" at the time attorney's fees were due to taxpayer on the closing of the estate of the client's late husband. CA-7 affirmed on the factual issue determined by the Tax Court.

2. Oak Industries, Inc., 96 T.C. 559 (1991). Security deposits received for decoder boxes by over-the-air subscription television operator were not includable in gross income because, in view of taxpayer's express "obligation to repay," it did not enjoy "complete dominion" over the deposits when they were made (the depositors had unlimited rights to receive refunds), even though it had unrestricted use of the deposits.

3. U.S. v. Harris, 91-2 USTC ¶ 50,433 (7th Cir. 1991). Although a criminal case it sheds light on what constitutes a "gift" in a romantic relationship. Seems to hold that transfers from a lover are entitled to be treated by the recipient as gifts "as long as the relationship consists of something more than payments for specific sessions of sex."


### DAMAGES

1. **Burke v. Comm.** 91-1 USTC ¶ 50,175 (6th Cir. 1991). Amounts received in settlement of sex discrimination suit were excludable under § 104(a)(2) personal injury damages (the focus should be on the personal nature of the injury (discrimination) and not on the consequences of a Title VII violation (payment of back pay for lost wages)). *Threlkeld v. Comm.,* 88-1 USTC ¶ 9370 (6th Cir. 1988) followed.

2. **Kurowski v. Comm,** 90-2 USTC ¶ 50,585 (7th Cir. 1990). Settlement proceeds received by teacher removed from her tenured position for mental impairment were not § 104(a)(2) damages but were, instead, payments of back salary made for the purpose of obtaining her resignation. Taxpayer never brought an action based upon tort or tort-type rights.

3. **Charles Dodge,** 96 T.C. 172 (1991). Taxpayer not able to exclude from income under § 104(a)(3) amounts totaling $227,920 received from multiple hospital indemnification policies; hospital admissions did not relate to actual injuries or sicknesses.


5. **Burns P. Downey,** 97 T.C. No. 10 (1991). Taxpayer airline pilot brought suit under the Age Discrimination in Employment Act (ADEA) against United after he was let go at age 60. Later he received settlement award which was allocated between back pay and liquidated damages. Tax Court held that full amount of award is excludable under § 104(a)(2) even that portion allocable to back pay (and upon which United withheld). Court relies, again, upon point that personal nature of injury rather than derivative consequences of injury must control. See, also, *Redfield v. Insurance Co. of North America,* 940 F.2d 542 (9th Cir. 1991), where, in an action against the discriminating employer itself for improperly withholding taxes, the same result was reached.
CANCELLATION OF DEBT INCOME


3. **Gordon A. Schifke,** T.C. Memo. 1991-19. On the payment of $84,000 by borrowers in recision of a $225,000 mortgage loan made in violation of the Truth in Lending Act, the $141,000 previously deducted interest and finance charges applied against the repayment are includable in income under the tax benefit rule. Judge Tannenwald refused to cut through the "thicket" of income from discharge of indebtedness.


6. **U.S. v. Centennial Savings Bank,** 91-1 USTC ¶ 50,188 (Sup. Ct. 1991). Penalties collected by taxpayer bank on the premature withdrawal of federally issued certificates of deposit were not income from discharge of indebtedness excludable under § 108(a)(1) because the depositors got everything to which they were entitled and there was no forgiveness of, or relief from, any obligation to repay.
DEPRECIATION & AMORTIZATION

1. Tele-Communications, Inc., 95 T.C. 495 (1990). A cable franchise is a "franchise" for § 1253 10-year amortization purposes because that provision applies to all franchises except those specifically excluded (public as well as private) that satisfy the three elements of § 1253(b)(1) (i.e., an agreement, giving the right to distribute, sell, or provide goods, services or facilities within a specified area).

2. Hill v. U.S., 90-2 USTC ¶ 50,560 (Ct. Cl. 1990). Unrecovered tangible costs for improvements with respect to mineral deposits are, though not recoverable through depreciation, part of the "adjusted basis of the property" in determining the § 57(a)(1) [formerly § 57(a)(8)] item of tax preference for excess depletion for minimum tax purposes. The court cited LTR 8314011 as non-binding but instructive.

3. Newark Morning Ledger Co. v. U.S., 91-2 USTC ¶ 50,451 (3rd Cir. 1991). Customer list is nondepreciable when acquired with underlying ongoing business. Although wasting life of lists could be estimated with reasonable accuracy and value, such assets were nonetheless part of goodwill and nondepreciable.


5. Ithaca Industries, Inc., 97 T.C. No. 253 (1991). In acquisition of business, value of goodwill determined according to the residual method. The price of stock allocated among assets including "assembled work force" and "raw material contracts." An average per capita amount was assigned to each of its hourly and production work force and staff and amortized when that person's employment terminated. Tax Court held that work force not a wasting asset separate and distinct from goodwill and going concern value and, therefore, not amortizable. The raw material contracts were separate and could be amortized over the useful life of the contracts.
ACCOUNTING

1. **Rev. Proc. 90-63.** 1990-53 I.R.B. 17, revoking Rev. Procs. 89-16 and 89-17. Provides for an exclusive procedure for taxpayers to obtain IRS consent to change their method of accounting for capitalizing under § 263 and § 263A package design costs in accordance with Rev. Rul. 89-23, 1989-1 C.B. 85. Three alternative methods are described—(i) capitalization; (ii) design-by-design capitalization and 60-month amortization, and (iii) pool-of-cost capitalization and 48-month amortization. Taxpayers not using an acceptable method who do not voluntarily change their method may be required by the IRS on audit to change their method.

2. **AOD No. 1991-07,** 1991-7 I.R.B. 5. IRS acquiesces in St. Lukes Hospital, Inc., 35 T.C. 236 (1960). Income properly reported on cash basis, changed pursuant to permission, when books and records kept on accrual method with adjusting entries to reconcile two methods.

3. **First Nat'l Bank in Albuquerque v. Comm.,** 91-1 USTC ¶ 50,005 (10th Cir. 1990). Bank that had elected to report income from the sale of a building on the installment method was required to recognize the deferred gain under § 453 when the purchase note was refinanced by the issuance of tax-exempt bonds (even though the bank itself purchased the bonds).


5. **Tecumseh Corrugated Box Co. v. Comm.,** 91-1 USTC ¶ 50,255 (6th Cir. 1991). Sale of real estate to related party trusts were not within the § 453(e)(6)(B) exception to the § 453(e) related party installment sale rule for involuntary conversions because the subsequent sale by the trusts to the Federal government was not under threat of condemnation.


7. **Bright v. U.S.,** 91-1 USTC ¶ 50,142 (5th Cir. 1991). Taxpayer received income in the year in which she received a check representing proceeds from the sale of stock and deposited it in her bank account even though her bank refused to use the funds from the check to purchase government securities until it collected funds from the payor bank in the following year.

9. **Notice 91-4.** Continues the procedure of Rev. Proc. 75-25, 1975-1 C.B. 720, which permitted subdividers to request permission to add to basis of property the estimated future cost of future improvements for the purpose of determining gain or loss resulting from the sale. This new rule announced pending study of the application of the economic performance rules (§ 461(h)) to subdividers.

**LOSSES & AT-RISK**

1. **Charles F. Alexander,** 95 T.C. 467 (1990) (reviewed), on respondent's motion for reconsideration of T.C. Memo. 1990-114. The § 465(b)(3) at-risk automatic nonrecourse provision, which excludes from the amount at-risk any borrowings from persons having an interest in the activity or from persons related to those persons, does not apply to computer software research and development activities or to any activities other than the four "old activities" of movies, farming, leasing and oil and gas because the at-risk automatic nonrecourse provision applies to § 465(c)(3) "new activities" only to the extent Treasury has promulgated regulations under § 465(c)(3)(D) and Treasury has not done so (despite the fact that § 465(c)(3) was added by the 1978 Act). See, also, **LTR 9132004;** "Due To Lack Of Regs IRS Refuses To Exclude Related Party Debt From Amount At-Risk," Letter Ruling Review, September 1991, attached.


5. **Smith v. Comm.** 91-2 USTC ¶ 50,326 (6th Cir. 1991). Reversing the Tax Court CA-6 holds that in applying § 183 it is not necessary that the transaction was "likely to be profitable" but only whether the taxpayer entered the activity with a profit objective.


8. **Lerman v. Comm.** 939 F.2d 44 (3rd Cir 1991), aff'g T.C. Memo. 1988-570. It was held that losses generated from commodity dealers' sham straddle transactions cannot form the basis of a deduction. The trade or business loss presumption of § 108(b) of DEFRA cannot be claimed by commodities dealers unless they have an actual loss.

9. **Smith v. Comm.** 91-2 USTC ¶ 50,326 (6th Cir. 1991). Partnership allowed losses flowing from investment in synthetic fuel process even though investment was risky and tax savings were a critical element. What mattered was that there was a business purpose behind the venture and there was a reasonable possibility of realizing a profit. Cf., **Karr v. Comm.** 91-2 USTC ¶ 50,113 (11th Cir. 1991). See, Sheppard, "The Karr and Smith Appeals: Deconstruction of Tax Shelters," Tax Notes, July 29, 1991, p. 519.

**CAPITAL GAIN & LOSS**

1. **Chilingirian v. Comm.** 90-2 USTC ¶ 50,569 (6th Cir. 1990). The amount realized from a disposition of property in a foreclosure sale includes the amount of personal liabilities from which the transferor is discharged as a result of the disposition.

2. **Azar Nut Co. v. Comm.** 91-1 USTC ¶ 50,257 (5th Cir. 1991). Residence purchased at FMV from corporation's terminated president and resold at a $111,000 loss was not § 1221(2) property "used in the taxpayer's trade or business" because the property had no meaningful association with the business after it was acquired. The Corn Products doctrine was limited by **Arkansas Best Corp. v. Comm.** 485 U.S. 212 (1988). See, Sheppard, "Losses on Sales of Employees' Houses After Azar Nut," Tax Notes, June 10, 1991, p. 1233; "Did Azar Nut's Accountants Crack Enough Nuts?" Tax Notes, July 15, 1991, p. 329. See, also, **LTR 9036003; Capitalization Of Expenses And Capital Loss Treatment Flow From Charging Sale Of Relocating Employee's Home To Employer," Letter Ruling Review, October 1990, attached.

3. **Circle K Corp. v. U.S.** 91-1 USTC ¶ 50,260 (Ct. Cl. 1991). Oil company stock purchased by convenience store chain company in 1980 to ensure a supply of gasoline, held to generate an ordinary loss on sale under § 1221(1) because the stock investment (under the "source of supply" principle) had a "close connection" to its business as an integral part of its "inventory purchase system" even though any crude oil purchased would have been at the "highest economic price." **Arkansas Best Corp.** purportedly followed in this summary judgment decision. See, Sheppard, "Circle K: How Taxpayer Choice Survives Arkansas Best," Tax Notes, June 17, 1991, p. 1359.

7

**NONRECOGNITION PROVISIONS**


**BUSINESS EXPENSES**


3. **Rev. Rul. 90-93.** 1990-45 I.R.B. 4. A full-time life insurance salesman, treated as an employee for FICA purposes under § 3121(d)(3), is not an employee for purposes of §§ 62 and 67 with respect to deducting business expenses. The holding also applies to all other § 3121(d)(3) statutory employees—individuals in specified occupational groups (i.e., agent-drivers, commission-drivers, home workers, traveling and city salesmen) who are not common law employees.

4. **Cadwallader v. Comm.**, 90-2 USTC ¶ 50,597 (7th Cir. 1990), aff'g T.C. Memo. 1989-356. College professor not entitled to a § 280A home office deduction where the university provided him with adequate office space and the taxpayer's principal place of
business is on campus because his home office is not needed and is, therefore, not maintained for the convenience of his employer as the employee's principal place of business.

5. Soliman v. Comm., 91-1 USTC ¶ 50,291 (4th Cir. 1991), aff'g 94 T.C. 20 (1990). Anesthesiologist's home office expenses were deductible under § 280A(c)(1) because the home office was taxpayer's "principal place of business" under the Tax Court's new "facts and circumstances" test which replaced the "focal point" test. The taxpayer spent a substantial amount of time in that office performing essential managerial/administrative functions and there was no other location for the performance of such functions. Dissent on the ground taxpayer did not do his most important work at the home office nor did he spend the majority of his time there (following Pomerantz v. Comm., 88-2 USTC ¶ 9588 (9th Cir. 1988)).


DIVORCE


PERSONAL & INDIVIDUAL DEDUCTIONS

1. **Perry v. Comm.**, 912 F.2d 1466 (5th Cir. 1990), aff'd 92 T.C. 470 (1989). Taxpayer not entitled to § 166 bad debt deduction by reason of her ex-husband's failure to make court ordered child support and alimony payments because she lacked a basis in the debt.

2. **Andrews v. Comm.**, 91-1 USTC ¶ 50,211 (1st Cir. 1991), vacating and remanding T.C. Memo. 1990-391. A taxpayer with a 6-month winter horse business in Florida and a 6-month summer pool construction in Massachusetts did not have (as the Tax Court said) two "tax homes" for purposes of § 162(a)(2) and is entitled to deduct the duplicate living expenses incurred at the location which is the "minor" post of duty while away from the "major" post (which is the taxpayer's one and only tax home).

3. **Joseph A. Barrett**, 96 T.C. 713 (1991). Settlement of insider trading suits in 1984 by disgorging $54,000 of taxpayer's 1981 short-term capital gain profit of $189,000 entitles taxpayer to use of § 1341(a)(5) to obtain credit in 1984 equal to the tax attributable to the inclusion of the $54,000 in 1981 gross income. The 1984 settlement established that the taxpayer had a legal obligation to restore the item meaning that it "was established...that [he] did not have an unrestricted right to the item." Legal fees gave rise to short-term capital loss.


7. **Accardo v. Comm.**, 91-1 USTC ¶ 50,405 (7th Cir. 1991), aff'd 94 T.C. 96 (1990). Legal expenses of taxpayer acquitted on RICO charges are nondeductible under § 212 and are not made deductible by possibility of forfeiture of 3 certificates of deposit under the RICO statute.
EXEMPT ORGANIZATIONS & CHARITABLE GIVING

1. **NCAA v. Comm.**, 90-2 USTC ¶ 50,513 (10th Cir. 1990), rev'g 92 T.C. 456 (1989). Revenue received from basketball tournament program advertising did not constitute UBI because the NCAA's selling of advertising business was not "regularly carried on" as defined in Reg. § 1.513-1(c) because the programs were distributed over less than a 3 week span at a once-a-year event and the business was not in unfair competition with other publications soliciting the same advertisers.


5. **American Postal Workers Union v. U.S.**, 91-1 USTC ¶ 50,096 (D.C. Cir. 1991). Annual fees received from non-postal Federal employees in return for their access to the union's health plan were § 512 UBI because providing health was not "substantially related to" the union's tax exempt purposes of representing postal workers in collective bargaining and arbitration.


8. **Atlanta Athletic Club.** T.C. Memo. 1991-83. Social club was required to include the $2,300,000 gain from the sale of property across the highway from its golf course as UBI because the property was not directly used for exempt functions prior to its sale (as required by § 512(a)(3)(D)) for nonrecognition treatment (provided that the proceeds are reinvested by the club).


**PARTNERSHIPS**


2. **Lonn A. Trost,** 95 T.C. 560 (1991). Tax Court lacks jurisdiction to determine overpayment attributable to partnership items in a proceeding for redetermination of deficiencies attributable to nonpartnership items (even though an FPAA had been previously issued to the partnership).

3. **Estate of Quirk v. Comm.,** 91-1 USTC ¶ 50,148 (6th Cir. 1991). Taxpayer's withdrawal from partnership in 1974, with about 10% of 1974 and 1975 payments allocated to § 736(b) (capital treatment) and about 90% of such payments allocated to § 736(a) (ordinary income treatment for distributions attributable to partnership unrealized receivables), was given effect for § 736 purposes for those years even though taxpayer litigated the amount he was entitled to receive in state court until 1985.

4. **Young v. Comm.,** 91-1 USTC ¶ 50,045 (9th Cir 1991), aff'g T.C. Memo. 1987-397. Allocation of 75% of losses of partnership to a limited partner with a 10% partnership interest lacked economic substance (under pre-1976 law) because partnership distributions remained unchanged by the loss allocation provision. Partnership capital accounts need not have been marked to market and the existence of a tax-related bargained-for business purpose for the allocation is irrelevant.

6. **Muserlian v. Comm.** 91-1 USTC § 50,204 (2nd Cir. 1991). Partnership was not entitled to step-up basis in depreciable assets under § 743(b) (pursuant to a § 754 election) beyond the $1.283 million fair market value of partner's proportionate share of total assets where the $1.117 million excess purchase price could not be allocated to an amortizable intangible.


8. **Estate of Newman v. Comm.** 91-1 USTC ¶ 50,281 (2nd Cir 1991), rev'g T.C. Memo. 1990-230. A solvent limited partner does not have cancellation of indebtedness income by reason of the discharge of indebtedness of an insolvent partnership because the (pre-1980 Bankruptcy Tax Act) insolvency exception to the discharge of indebtedness doctrine was applicable at the partnership level. However, partner not entitled to a basis increase under § 705(a)(1)(B) by reason of the excluded cancellation of indebtedness income. Herbet Gershkowitz, 88 T.C. 984 (1987), not followed for one of the same partnerships; the court relied on U.S. v. Basye, 410 U.S. 441 (Sup. Ct. 1973);, and Stackhouse v. U.S., 441 F.2d 465 (5th Cir. 1971).

9. **Richard E. Garcia,** 96 T.C. 792 (1991). Partner's $102,000 share of 1985 partnership loss is not rendered nondeductible solely by reason of his filing a lawsuit in 1986 demanding rescission of the partnership agreement and return of his $137,000 capital investment because the § 165 rule that losses must be evidenced by closed transactions, with any reasonable prospect of recovery on a claim for reimbursement, does not apply to a partner's distributive share of partnership bottom line losses under §§ 702(a) and 704.
PROCEDURE & PENALTIES

1. Rev. Proc. 91-19, 1991-10 I.R.B. 24. Relates to adequate disclosure for avoiding: (i) the § 6662(d) substantial understatement aspect of the accuracy-related penalty and (ii) the § 6694(a) preparer penalty.

2. Robert C. Lyons, T.C. Memo. 1991-84. Commissioner's denial of waiver of § 6661 substantial understatement penalty was an abuse of his discretion where taxpayers made reasonable and good faith efforts to report their tax liability properly even though they understated their $254,425 correct tax liability for 1982 by $250,000. Taxpayers also found not to be negligent.

3. Steven J. Cannata, T.C. Memo. 1990-502. Extensions of time to file (reporting zero estimated tax liability) were valid because taxpayers did not fail to "properly estimate" their tax liability even though their accountant overlooked a Form 1099-MISC reflecting a $195,825 income item when he calculated taxpayers' estimated tax liability (so taxpayers were not liable for the § 6651(a)(1) failure to file penalty). Ottis B. Crocker Jr., 92 T.C. 899 (1989), distinguished.

4. Cheek v. U.S., 91-1 USTC ¶ 50,012 (Sup. Ct. 1991). Conviction of Amer. Airlines pilot for § 7201 tax evasion and § 7203 failure to file vacated and remanded (remand, 91-1 USTC ¶ 50,232 (1991)) because jury instructions failed to state that defendant's good-faith belief (whether or not objectively reasonable) that the Internal Revenue Code did not purport to treat wages as income would negate the government's burden of proving willfulness, but defendant's belief that the tax statutes are unconstitutional would be irrelevant because defendant who willfully refuses to comply with duties placed on him takes the risk of being wrong.

5. Denenburg v. U.S., 91-1 USTC ¶ 50,014 (5th Cir. 1991). Summary judgment upheld § 6651 late filing penalties imposed on taxpayer whose CPA was unwilling to prepare and sign tax returns not supported by business documentation which was unavailable at the due date of those returns due to continuing ill-will between the taxpayer and his brothers, which did not constitute "reasonable cause" for failing to file timely.


7. Bode v. U.S., 91-1 USTC ¶ 50,013 (5th Cir. 1990). Attorney's fee award of $150 per hour for 600 hours of work on a § 183 horse breeding and racing case remanded for further findings including the number of hours awarded and availability of counsel with
quarterhorse expertise at less than $5,000 per day of trial (but not tax lawyers who could handle the complexities of the instant case at less than $150 per hour).

8. **Estate of Perry v. Comm.** 91-1 USTC ¶ 50,283 and 60,073 (5th Cir. 1991). Attorneys' fees under § 7430 awarded on government's appeal on issue lost in two circuits [whether ERTAs amendment of § 2035 overruled *Bel v. U.S.* 452 F. 2d 683 (5th Cir. 1971)] despite Solicitor General's authorization of the appeal following "careful consideration." The issue is "substantial justification" not good faith. ("A policy decision to continue to whip a dead horse in circuit after circuit in the hope, however vain, of establishing a conflict is clearly an option within the discretion of the Commissioner. That does not, however, substantially justify his causing an innocent taxpayer in each circuit to expend attorneys' fees for the dubious honor of being the Commissioner's guinea pig.")

9. **Portillo v. Comm.** 91-2 USTC ¶ 50,304 (5th Cir. 1991), rev'g, aff'g and remanding T.C. Memo. 1990-68. IRS made a § 6212(a) "determination" with respect to subcontractor-taxpayer when it matched a contractor's $35,000 Form 1099 to taxpayer's Form 1040, even though IRS did not attempt to establish the reliability of the portion of the Form 1099 relating to undocumented cash payments of $21,000. However, the notice of deficiency was not entitled to the presumption of correctness because it "lacks any 'ligaments of fact'" and the IRS did not present "some predicate evidence supporting its determination.

10. **Donald R. Coffey,** 96 T.C. 161 (1991) (reviewed). Invalid notice of deficiency (here, misaddressed), or an invalid assessment based upon it, does not terminate a Form 872-A agreement extending the statute of limitations. The Tax Court will no longer follow its holding in *Louis E. Roszkos*, 87 T.C. 1255 (1986), rev'd 850 F.2d 514 (9th Cir. 1988).

11. **Calumet Industries, Inc.** 95 T.C. 257 (1990). IRS not barred from assessing a deficiency for an open year (1979) attributable to an NOL carryback adjustment from an otherwise closed year (1981) because § 6501(h) (permitting a deficiency to be assessed in an otherwise closed year based upon the adjustment of an NOL carryback from an open year) is inapplicable and does not nullify the agreed-upon § 6501(c)(4) extension for 1979.

12. **Kenneth C. Hill.** 95 T.C. 437 (1990). The statute of limitations does not bar assessment of tax in an open year resulting from a reduction of the investment tax credit carryover as the result of IRS increase in the amount of tax for the closed year.

13. **Smith v. Comm.** 91-1 USTC ¶ 50,071 (8th Cir. 1991). Statute of limitations does not bar the claim of an increased deficiency for 1976 resulting from the disallowance of NOL claimed in 1979 and carried back to 1976, where there was an agreement 1976 would remain open.
14. **Siben v. Comm.**, 91-1 USTC ¶ 50,215 (2nd Cir. 1991). The statute of limitations for assessing tax against partners based on adjustment to partnership items was measured from the date of the partners' returns, not the partnership return. **Kelley v. Comm.**, 877 F. 2d 756 (9th Cir. 1989); **Fendell v. Comm.**, 906 F. 2d 362 (8th Cir. 1990), not followed.

15. **Kathryn Winnett**, 96 T.C. 802 (1991). The statute of limitations on a return containing Form 2555 filed with the wrong Service Center (Ogden on Aug. 1, 1986) does not begin to run until the return could have been received by the proper Service Center (Philadelphia, no earlier than Aug. 19, 1986), so a notice of deficiency, mailed on Aug. 17, 1989 was timely.

16. **Jack H. Berry**, 97 T.C. No. 23 (1991). Taxpayers, who were nonfilers for 1982, overpaid through withholding. Taxpayers had executed a Form 872-A with respect to that year. After IRS issued notice of deficiency (1989) taxpayers filed income tax return showing overpayment with which the IRS subsequently agreed. Tax Court held that claim (the late return) was not filed within required time period (§ 6512(b)(3)(B)) providing that credit or refund limited to the portion of the tax paid during the 2 year period preceding the mailing of the deficiency notice). The Form 872-A consent agreement did not revive the expired time period for filing a claim for refund or credit.

17. **Lynn Crawford**, 97 T.C. No. 20 (1991). Taxpayer executed Form 5213 ("Election to Postpone Determination with Respect to the Presumption that an Activity is Engaged in for Profit"). For a new activity taxpayer can elect to delay a determination as to the general for-profit presumption until the end of the 5-year test period. In Jan. 1989 taxpayer executed a Form 872 extending statute of limitations for 1983 until Dec. 31, 1989. Tax Court held that Form 872 agreement was timely made even though § 183 provides for no extension of the delay period under § 183(e). However, extension effective only with respect to deficiencies arising from the § 183 activity.

18. **Erdahl v. Comm.**, 91-1 USTC ¶ 50,184 (8th Cir. 1991), rev'g and remanding T.C. Memo. 1990-101. Wife eligible for innocent spouse relief (§ 6013(e)) on tax shelter deductions even though she had knowledge of the purchase of the investment in the limited partnership. Remanded to the Tax Court for a determination as to whether she had a duty to inquire (i.e., "whether a reasonably prudent taxpayer in her position would be led to question the legitimacy of the deduction"). The court adopted the standard in **Price v. Comm.**, 887 F. 2d 959 (9th Cir. 1989).


23. **Acock, Schlegel Architects, Inc.,** 97 T.C. No. 24 (1991). A nonparty to an IRS investigation who voluntarily executes an affidavit concerning taxpayer's corporate tax returns waives 5th Amendment privilege that nonparty may have otherwise possessed; pre-existing privilege not a bar to taxpayer's attempt to obtain affidavit through formal discovery.

24. **Philadelphia & Reading Corp. v. U.S.,** 91-2 USTC ¶ 50,448 (3rd Cir. 1991). Taxpayer executed a Form 870 but with a condition, i.e., to offset later overpayments against the deficiencies before assessing the latter. The IRS' failure to do this resulted in the assessments being illegal and entitling the taxpayer to refund of the entire amount of the illegal assessments.

SHAREHOLDER’S TRANSFER OF STOCK TO KEY EMPLOYEES TAXABLE GIFT TO OTHER SHAREHOLDERS

The distribution of stock to key employees as an award for services certainly has tax consequences to the employees receiving the property and to the corporation itself. If the source of the transferred stock is a shareholder of the corporation it is the Service’s view that gift tax consequences could result. In LTR 9114023 the taxpayer who owned some, but less than all, of the stock of a corporation, decided to transfer a portion of his ownership to key employees of the corporation in return for their contribution to its growth and success. The IRS zeroed in on the potential gift tax consequences of such a transfer.

Shareholder considered to have made a contribution to the capital of the corporation. The seed for treating the transfer, by a shareholder, of stock in a corporation to its employees as a contribution to the capital of that corporation, and immediately thereafter a transfer by the corporation of property to the employees, appears to lie in regulations under §83. It is by using this rationale that the IRS concluded that the corporation would be entitled to a deduction equal to the amount included in income by the employees. In LTR 9114023 the IRS takes a step beyond that conclusion by treating the taxpayer as having made a gift for gift tax purposes to the other shareholders. The taxpayer is considered to have made a capital contribution to the corporation which indirectly is viewed as a gratuitous transfer to its shareholders. Not considered in LTR 9114023 is the principle that a transfer made in the ordinary course of business (which this presumably was) is considered made for a consideration in money or money’s worth and therefore not subject to the gift tax. Adding to the unwelcome result was the conclusion that the indirect gift to shareholders constituted a gift of a future interest (since the donee shareholders “do not have an unrestricted right to the immediate possession of an increase in the corporate capital”) and, therefore, was ineligible for the annual per-donee exclusion.

---

1 The employees, if the stock was not subject to restrictions, would have to include that value received in income (§83) and the corporation should be entitled to a deduction under §162 (see §83(h)).

2 Actually the stock was held in a revocable trust but since the transfer to the trust was not a completed gift that factual nuance is not significant (the transfer of the stock to the employees by the trust would be regarded as a transfer by the taxpayer).

3 Reg. §1.83-6(d).

IF HEALTH INSURANCE TAXABLE, MEASURE OF VALUE IS GROUP COVERAGE NOT INDIVIDUAL RATES

Recently the IRS faced the issue of whether the premiums for health insurance provided to a "nonspouse cohabitant" of an employee were excludable under § 106. Gingerly, the Service concluded that while the employee's cohabitant was not a spouse (unless perhaps state law recognized common law marriage and the cohabitant as a marriage partner) the possibility existed for classification as a "dependent." Absent such a classification, and it would be lacking in many cases, the employee would be taxed on the "fair market value" of the coverage provided, through the employee, to an individual who is not a spouse or dependent of the employee. If the employee was to be taxed on the coverage provided to the employee's cohabitant, the prior holding (LTR 9034048) was clear in that it would measure that taxation by the "amount that an individual would have to pay for the particular coverage in an arm's-length transaction (i.e., individual policy rates)."

This justification for this position was, of course, the mandate in the fringe benefit regulations that fair market value is to be determined by what would have to be paid "for the particular fringe in an arm's-length transaction" and that both the employee's "perception of the value" and "the cost incurred by the employer" are not determinative.

IRS backs off harsh position. The fact that individual medical insurance rates are significantly higher than group rates no doubt prompted the city government employer to request reconsideration. In LTR 9111018 the IRS calls forth the same principles and, almost mystically, reaches an apparently less harsh result, i.e., that the amount required to be included is the "fair market value of the group medical coverage" (noting that it could be "substantially less" than the fair market value of individual coverage). LTR 9111018 stops with this conclusion and does not give any guidance as to what that value would be. Value data on individual rates is, of course, readily available but the same cannot be said regarding the "fair market value" of an individual's participation in a group plan. Since the cost of plan coverage varies greatly from plan to plan it would seem that the most reliable measure of value of a particular individual's participation in a group plan would be the cost of that individual's participation and yet the regulations specifically reject that method of valuation. Maybe it is enough at this point to know that the IRS has backed off its prior harsh position.

42 Reg. §106-1 excludes from income employer contributions to a health plan to compensate the employee for injuries or sickness "incurred by him, his spouse, or his dependents..." Similarly, benefits paid under such a plan are excludable if made to the taxpayer to reimburse him "for the medical care...of the taxpayer, his spouse, and his dependents..." §105(b).
43 Reg. §1.61-21(b)(2).
44 Reg. §1.61-21(b)(2). C.f., 1.61-21(b)(3).
45 The Service's modified stance has appeal (it is, after all, participation in a group policy, and not individual policy rights, that was transferred by the employer). While the prior harsh position made valuation easier it lacked a certain logic. The new position makes more sense but, unless employer cost becomes the valuation measure, it may make valuation more difficult. In a similar ruling (LTR 9109060) the IRS stated that the employer-provided coverage to a nondependent was includable in the employee's income in an amount equal to the "excess of the fair market value of the group medical coverage...over the amount paid by the employee for such coverage..." but sidestepped any effort to determine value as not being an issue on which the IRS rules. Rev. Proc. 90-3, 1990-1 L.R.B. 54, §4.021.
TRANSFER OF RESTRICTED STOCK CAN BE RESCINDED IN SAME YEAR EVEN IF §83(b) ELECTIONS MADE

If there are substantial restrictions on property transferred in connection with the performance of services, which restrictions would result in risk of forfeiture, income is not recognized under §83 until the first taxable year in which the rights either are no longer subject to such risk of forfeiture or can be transferred free of such restriction. The significant downside for this deferral is that the property will have appreciated considerably at the time at which the restriction lapses thus increasing the spread and compelling a larger income inclusion. This causes recipients of restricted property to closely consider a §83(b) election which will cause income inclusion in the year in which the property is received measured by the excess of the value of the property at that time (without regard to the restrictions which may lapse) over the amount paid for the property. Among the chief characteristics of this election are the short time-fuse on its exercise (not later than 30 days after the date the property was transferred), and the strict rules against revoking the election once made.

Rescission of transfer after 83(b) election made. In LTR 9104039 transfers of restricted stock were made to employees in April 1990, all of whom made timely §83(b) elections to include the spread in income at that time. In 1991 the employer’s accounting staff informed the employer that the value of the restricted stock would compel a charge to corporate earnings 65% percent larger than anticipated, which information compelled a decision to rescind the already accomplished transfer and to require the return of the transferred stock. Swiftness of action and compliant employees (hopefully to be rewarded another day) caused the Service to acknowledge the effectiveness of the rescission "with the result that the stock grant will be disregarded for federal tax purposes." Key, of course, to this conclusion is the fact that both the receipt and the rescission occurred within the same taxable year. Absent this the IRS would have been bound to honor the sanctity of the taxable year thus causing the employees to have year one income which could only be adjusted in the later year of rescission.

46 For example, LTR 8228055, which involved an accountant (who could also have occupied the “family counselor” role) looked at how the fee was determined (a percentage of the estate) and whether the corpus consisted of business or investment property, in concluding that self-employment income was not involved. Also found relevant (as it was in McDowell v. Ribicoff, 292 F.2d 174 (3rd Cir. 1961)) was the length of time needed to wrap up the estate. If, for example, a trust was to exist for many years that might possibly be relevant in determining the status of the fiduciary. Further, although Cresence E. Clarke, 27 T.C. 861 (1957), found the trustee of a single real estate trust to be in receipt of self-employment income, the IRS can draw little solace from that holding as it is, at bottom, a case involving a failure of proof by the taxpayer.

47 §83(a). During the period that the property is in the employee’s hands, but not vested, it is treated as owned by the employer (e.g., dividends on forfeitable stock are treated as compensation for services and deductible as such by the employer). Reg. §1.83-1(c)(1).

48 E.g., the transfer of stock to an employee contingent upon that individual’s continued employment for a three year period with the employer.

49 If the property is subsequently forfeited the taxpayer may not deduct the amount previously included in income (§83(b)) but the regulations (Reg. §1.83-2(a)) permit any amount paid for the property to be deducted as a loss from the forfeiture.

50 §83(b)(2).

51 Consent to revoke the election will be granted only in the case where the transferee "is under a mistake of fact as to the underlying transaction..." Reg. §1.83-2(f). See, LTR 8313088 in which revocation was denied since the taxpayer’s erroneous beliefs bore upon the ability to value the stock rather than a mistake of fact as to the underlying transaction.

52 Since the stock transfer was disregarded so, too, were the 83(b) elections (thus permitting to IRS to sidestep the alternative request for relief that the employees be permitted to revoke their §83(b) elections).

53 See, e.g., Rev. Rul. 80-58, 1980-1 C.B. 181, 182 ("...the annual accounting period principle require[s] the determination of income at the close of the taxable year without regard to subsequent events")
IRS WITHDRAWS POSITION THAT JOB PLACEMENT IS NOT WORKING CONDITION FRINGE

Fairly recently (LTR 8913008) the Service concluded that job placement assistance is not a tax-free working condition fringe. In a plan to reduce the number of employees the employer provided laid-off employees with two options: (i) all cash severance pay (with the total amount being measured by the length of the employee’s service, and (ii) one-half the cash the employee would have received under (i) above, plus intense outplacement counseling service (career direction, job search strategies, interview training, etc.).

Not working condition fringe. To be tax free as a “working condition fringe” the property or service must be of a type which, if paid for by the employee, the amount paid would be deductible as a business expense under §162. At first blush one might conclude that classification as a working condition fringe should be relatively easy since job seeking expenses have been held to be deductible. The authority approving a deduction in such instances is, though, based upon the notion that the taxpayer in seeking new employment is carrying on the trade or business of being, for example, a corporate executive (Primuth) or an engineer (Kenfield). It is the position of the Service that job seeking expenses are deductible if the taxpayer is seeking employment in the same trade or business in which he has been working but that they are not deductible if employment in a new or different trade or business is sought. For job seeking expenses to be deductible, therefore, the taxpayer is seen as acting in his trade or business, as distinct from the taxpayer’s trade or business of being an employee of the employer. It was this distinction which provided the basis for the IRS to deny working condition fringe status to job placement assistance. The regulations specifically exclude amounts from working condition fringe classification if the amount, if paid by the taxpayer, would have been incurred in “other than the employee’s trade or business of being an employee of the employer.” The IRS concluded that working condition fringe status should be denied since the taxpayer is, in seeking employment, no longer acting as an employee, but furthering his own prospects in his trade in the larger sense.

IRS backs off. Even though the Service’s position has a patina of technical correctness about it, its seeming harshness may have been what prompted, in LTR 9040025, its announcement that the adverse holding in LTR 8913008 was being withdrawn. The IRS stopped short of actually reversing itself, simply saying the issue was being studied. One thing is clear, however, even if job placement aid is held to be tax free under §132, the details of the plan in LTR 8913008 will have to be reworked. The IRS states in LTR 9040025 that an option to receive either all cash or cash and job placement assistance will not pass muster since the IRS will view the taxpayer, regardless of choice, as in constructive receipt of the cash.


18 In fact, in Rev. Rul. 75-120, in which the IRS conceded deductibility of job seeking expenses, it is noted that the “IRS relied on the familiar principle that an employee is engaged in the business of providing services to various employers, not merely in the business of working for his or her current employer.” Bikker and Lokken, Federal Taxation of Income, Estates and Gifts, p. 20-89 (2nd Ed.).

19 Reg. §1.132-5T(a)(2).
IRS FINDS PUNITIVE DAMAGES FOR PHYSICAL INJURY TAXABLE BUT INCORRECTLY IGNORES 1989 AMENDMENT

In its ruling policy the IRS conforms to the same view it follows in its litigation policy, to-wit, that punitive damages for conduct resulting in personal injury are not within the exclusion for damages for personal injury provided for by §104(a)(2). Thus, in LTR 9106013 the Service concluded that the plaintiff, in a suit for injuries due to employment-related exposure to asbestos, had taxable income to the extent that the award was attributable to punitive damages.

IRS ignores effect of 1989 statutory change. In 1989 Congress amended, prospectively only, §104(a)(2) to provide that the exclusion did not apply to punitive damages in connection with a case not involving physical injury or physical sickness. Because the damages involved in LTR 9106013 were pursuant to a suit filed prior to that date, the IRS blithely brushed aside any impact the 1989 amendment might have had on the issue. Instead it leaped on Comm. v. Miller which recently blessed the Service’s administrative stance on this issue.

1 The IRS has not always viewed punitive damages as not within the §104(a)(2) exclusion. Rev. Rul. 75-45, 1975-1 C.B. 47 held that such amounts were within the statute which excludes “any damages received...on account of personal injuries or sickness.” (Emphasis in revenue ruling.) This position was withdrawn in Rev. Rul. 84-108, 1984-2 C.B. 32.

2 Omnibus Budget Reconciliation Act of 1989, Pub. Law 101-239, 7641(a), effective for amounts received after July 10, 1989, unless pursuant to a suit filed prior to that date or subject to a binding agreement or decree prior thereto.

3 914 F.2d 588 (4th Cir. 1990), rev’g, 93 T.C. 330 (1989).

4 In doing so it found that the “on account of” language in 104(a) does suggest causation but not necessarily “but-for” causation; it could just as easily be, the court stated, “sufficient” causation (i.e., the plaintiff has to show egregious conduct by the defendant in order to receive punitive damages and not simply personal injury alone). Finding the statute ambiguous Miller based its conclusion that punitive damages were taxable on the notion that punitive damages are not compensation for damages but an amount received “over and above” a compensatory award.

Miller, which involved punitive damages received in a defamation suit, also finessed the effect of the 1989 amendment, simply noting in a footnote that the “[g]overnment concedes that the amendment does not apply to the case at bar.” Naturally the Service would rush to assert the irrelevance of the 1989 amendment thinking that it carries with it the implication that Congress felt that punitive damages for physical injury (which was involved in LTR 9006013) were excludable. Why would Congress have limited its amendment taxing punitive damages to those received as a result of nonphysical injury unless it intended that punitive damages for physical injury be excludable? There is much, in the way of inference, to draw from the 1989 amendment and the fact that it is pro-taxpayer explains the government’s ready willingness to assign the 1989 legislative change to irrelevance. Thus the taxpayer to whom LTR 9106013 was issued should by no means settle for the determination reached by the Service in that document.

5 914 F.2d at 588, n. 4.

6 Oddly the taxpayer in the Miller appeal did not assert the relevance of the 1989 amendment to §104(a)(2). If Congress had to amend the statute to provide for the taxation of punitive damages received as a result of non-physical injury, does not that action carry the strong inference that punitive damages received in such a case before the amendment’s effective date are not taxable?

7 The conclusion that punitive damages were excludable under §104(a)(2) appears to remain the view of a majority of the Tax Court. See, Bonnie A. Miller, 93 T.C. 330 (1989), a reviewed opinion.
LETTER RULING REVIEW
December, 1990

DEBTOR SPARED DEBT CANCELLATION INCOME IN SETTLEMENT OF OFFSETTING CLAIMS

If the cancellation of indebtedness is accomplished by some other form of payment the tax consequences which befall the taxpayer whose debt is canceled occur outside of cancellation of debt concepts. This does not mean that the taxpayer whose debt is canceled does not have income—it simply means that the income takes another form. For example, if the debtor obtains cancellation of a debt through the performance of services, that taxpayer has personal service income rather than income from the cancellation of income. Similarly, if appreciated property is transferred in cancellation of debt the debtor/taxpayer would have gain realization from the transfer of property (although if the appreciated property is worth less than the amount of the debt the taxpayer could have both gain realization and debt cancellation income). Or, as LTR 9043027 points out, the taxpayer whose debt is canceled may have no income if the taxpayer’s recovery takes the form of recovery of capital.

Debtor has claim against creditor for breach of contract. The brokerage firm with whom the taxpayer had an account had a claim against the taxpayer for a balance due on that account. As can often happen in such cases the taxpayer asserted that the brokerage firm made misrepresentations. If settlement negotiations lead to cancellation of the firm’s claim for balance due, the issue arises whether the taxpayer has debt cancellation income and, if not, whether income in any other form is realized. In these conflicting claims situations the Service views the debtor as having transferred his claim for misrepresentation in return for cancellation of the debt allegedly owed by the taxpayer to the firm. Or, put another way, the taxpayer/debtor is regarded as having received an amount in satisfaction of the misrepresentation claim which in turn is used to satisfy the firm’s claimed indebtedness. However, even though the taxpayer does not have debt cancellation income, there may be receipt of income of another type. For example, if the debtor/taxpayer’s claim was based upon lost profits the constructive receipt of the damaged amount would constitute income in that form. In LTR 9043027, on the other hand, the recovery for misrepresentation was viewed as a capital recovery with the result that not only did the taxpayer not have debt cancellation income, he had no income at all.
EXEMPT PROPERTY NOT CONSIDERED IN MEASURING INSOLVENCY THEREBY INCREASING 108 EXCLUSION

Under §§ 108(a) and (b), the amount that would otherwise be debt discharge income is excluded from gross income and is, instead, applied in reduction of various of the taxpayer's tax attributes if the discharge occurs in a bankruptcy proceeding or when the taxpayer is insolvent. If the taxpayer is not actually in bankruptcy the amount of the §108 exclusion from gross income (if it is to be) depends upon the extent to which the taxpayer is insolvent. The amount which is excluded per §108(a)(1)(B) may not exceed the amount by which the taxpayer is insolvent. Since "insolvent" is defined in the traditional manner (i.e., the excess of liabilities over the fair market value of assets) it becomes important (especially when individual taxpayers are involved) to focus on the precise manner in which this calculation is made. This brings into play, and it is this issue which LTR 9125010 addresses, the extent to which property exempt from the claims of creditors under local law is not a part of the insolvency calculation.

"Freeing of assets" doctrine involved. The rationale for the insolvency exception to income inclusion from debt cancellation (now codified in §108(a)(1)(B)) is that where no assets are freed from the claims of creditors, no income is realized. Thus, it follows that only assets subject to the claims of creditors should be used to determine insolvency. Quite naturally, in making a determination concerning what property is exempt, state law controls. Assume, for example, that the taxpayer at the time of discharge of indebtedness has $100x in liabilities and $60x in assets. Absent the existence of property exempt from the claims of creditors the cap on the amount which could be excluded from income per §108 would be $40x. If, though, the taxpayer possesses property which is exempt from the claims of creditors (usually, as respects real property, this will take the form of a homestead exemption although some minimal amount of personal property is usually also eligible for exemption), the calculation is altered in favor of a greater §108 exclusion. Thus, if the taxpayer's assets include property with a value of $10x that is exempt from creditors under local law, liabilities would exceed assets by $50x ($100x less $50x), thereby resulting in an increase in the amount which could be excluded from income by reason of §108. Since LTR 9125010 plainly blesses removing exempt property from the insolvency calculation, individual taxpayers faced with discharge income should not overlook the relevance of the local law exemptions.

1 §§108(a)(1)(A), (B).
2 §108(a)(3).
3 §108(d)(3).
5 Marcus Estate, T.C. Memo. 1979-5.
6 The amount by which the taxpayer is insolvent (and, hence, the limit on the §108 exclusion) shall be determined on the basis of assets and liabilities immediately before the discharge, §108(d)(3).
7 The level of exemption is going to vary considerably among the several states. C.f., Texas law described in C. L. Hunt, T.C. Memo. 1989-335 (generally exempting the FMV of improvements on the property plus $10,000 of the value of the land but liens are deducted first from the nonexempt portion in determining the total exemption amount) with the relatively small $30,000 homestead exemption accorded by Washington state (R.C.W. 6.13.030).
INCOME GENERATED BY
ABANDONMENT MAY BE
PARTLY ELIGIBLE FOR
EXCLUSION UNDER §108

It is not infrequent for a homeowner in a dire financial
situation to simply walk away from an encumbered
residence when a negative equity exists. There is little
doubt, of course, that such an abandonment constitutes a
gain realization to the abandoning taxpayer. An attend-
ant question is, however, whether a taxpayer in such a
situation can exclude the gain under §108 where the
taxpayer finds himself in bankruptcy (which can often be
the case in such situations).

Residence had an FMV less than the amount of the
mortgages. In LTR 9120010 the taxpayers walking
away from their residence were debtors in a case under
Chapter 13 of the Bankruptcy Code. It seems plain
that in such a situation the amount realized from the aban-
donment of the residence would consist of the FMV of
the transferred residence and cancellation of debt (COD)
income to the extent the indebtedness exceeds the FMV
of the residence. See, Reg. § 1.1001-2(c), Ex. 8. Does
this same bifurcation apply in determining the scope
of §108(a)(1)(A) (which excludes COD income from gross
income where the discharge occurs in a Title 11 case)?

The Service quickly concluded that §108 excludability
applies only to COD income and not to that portion
which might be viewed as garden variety gain realiza-
tion. Thus, if a taxpayer abandons a residence having an
original cost of $75,000 and a FMV of $85,000 but
subject to a $100,000 debt, “garden variety” gain
recognition will occur in the amount of $10,000 (the
excess of the FMV over basis). At the same time COD
income will be realized in the amount of $15,000 (the
excess of the debt over FMV) which will be potentially
eligible for exclusion under §108.

---

11 In example 8 in the regulation the taxpayer was found to have
$1,500 in COD income where the property abandoned had an FMV
of $6,000 and was subject to a recourse mortgage of $7,500 (the
amount realized being the $6,000 FMV of the residence and COD
income which equaled the excess of the debt over the residence's
FMV).

12 The price for such an exclusion is a reduction of tax attributes
to the extent provided in §108(b).

13 In order for the debt to exceed basis its is most likely that the
aggregate debt includes both acquisition debt and a second en-
cumbrance, the funds from which were used for other purposes.

Due To Lack Of Regs IRS Refuses To Exclude Related Party Debt From Amount At-Risk

In 1978 Congress extended the at-risk rules (§465) to each activity engaged in by the taxpayer in carrying on a trade or business from their prior more limited scope. §465(c)(3). The relationship between this broader scope and §465(b)(3), which provides that amounts borrowed shall not be considered at risk if such amounts are borrowed from a person who has an interest in the activity or from a "related person," is the subject of LTR 9132004. A partnership, which owned freight barges on the Mississippi, had an arrangement by which the actual operation of the barges (scheduling, fueling, maintenance, etc.) was carried on by a closely-held corporation owned by the individuals who were also the partners in the partnership. The partnership, which operated at a loss, received considerable financial support from the closely-held corporation which treated such advances as debits against it collection of barge fees and, to the extent not covered by that source, as amounts owing from the partnership. Although the relationship between the corporation and the partnership might have warranted not including such amounts in the partners' at-risk amounts, the IRS, taking a cue from Charles F. Alexander, 95 T.C. 476 (1990), refused to exclude related party debt from the at-risk base because of the absence of regulations under §465(b)(3).
INSTALLMENT TREATMENT OF CASINO WINNINGS NOT FOILED BY STANDBY LETTER OF CREDIT

Many casinos, lotteries and sweepstakes make payment of their prize amounts in annual installments rather than through a lump sum. The acceptability of such an arrangement is enhanced if the promise to pay by installment is supported by security of some type. If this is done the issue arises whether the existence of security for the promise compels a conclusion that the individual is taxed on the full amount pursuant to the economic benefit doctrine. In LTR 9043014 the casino purchased a standby letter of credit for each winner in an amount equal to the aggregate amount of the deferred jackpot payments due that winner. Stressing that no amounts would actually be set aside by the casino (in trust or in an escrow, for example), and that the individual winner did not have a choice as to how the payments were made, the IRS ruled that the payments would have to be included in income only as received. Like so much in the tax law the IRS has to be sure that a concession in one area does not come back to haunt them in another. In LTR 9043014, therefore, the IRS rushes to admonish that its conclusion therein does not soften its stance that the presence of security for a promise to pay in a compensatory context will result in the receipt of property for purposes of §83.

56 The economic benefit doctrine (for which Comm. v. Smith, 324 U.S. 177 (1945) is usually cited) has application in a nonemployment context as well. For example, in Stephen W. Pulifer, 64 T.C. 238 (1975), the prize amount, irrevocably deposited with a court because of the winner's minority and not actually available until placed with a guardian or until the winner reached majority, was held to be immediately taxable. See also, Joseph Anastazio, 67 T.C. 814 (1977), involving lottery winnings, reaching the same result. See also, Rev. Rul. 62-74, 1962-1 C.B. 68; Rev. Rul. 67-203, 1967-1 C.B. 105.


58 If such choice existed it would be the Service's position that the taxpayer was in constructive receipt of total winnings.

59 See LTR 8923020 reaching a similar result regarding installment payments of a prize secured by a surety bond.

60 Reg. §1.83-3(c), which defines property, for purposes of the restricted property rules, as encompassing a promise to pay which is either funded or secured. Note that in LTR 9043014 the casino used its funds to purchase the letter of credit without affecting a favorable result for the individual taxpayer. In an employment context it is necessary for the security to be obtained at the employee's expense if the restricted property rules are to be avoided. E.g., LTR 8406012.
BUYER’S PREPAYMENT OF INSTALLMENTS NOT GROUNDS FOR 453 ELECTION OUT

Once a return is filed reporting income from the sale of property on the installment method it is well nigh impossible for the seller to later make a decision to elect out. In times of downward rate fluctuation taxpayers may be enticed into adopting the installment method (i.e., not electing out) in the hope that future payments will be taxed at the lower rates existing when the payments are received (it being a given that the rate level existing at the time of the receipt of the installment applies in determining the tax impact). The danger, though, is that the success of the seller’s objective lies fully in the hands of the purchaser if the right to prepay exists (as it most often will). In LTR 9121044 the seller, making a 1986 sale (the year preceding a significant downturn in tax rates) was lulled into believing that the overall gain would be taxed at the lower future rates by the buyer’s assurance that he would not dispose of the property during the 10-year installment period. Instead, however, the buyer sold the property in 1987 and paid off in full the balance due the seller. The taxpayer/seller, thinking that full income inclusion in 1986 was preferable (there may have deductions to which the taxpayer was entitled in that year) sought permission to elect out. Hewing to its hard line that such emission will be granted only in “rare circumstances” the IRS, noting that there never was an intent to adopt any method other than the installment method, swiftly concluded that the buyer’s prepayment (unexpected though it was) was no ground for a subsequent election out. The buyer’s right to prepay truly does put the tax impact to the seller in the buyer’s hands.

19 Although it is difficult to switch from an election out to use of the installment method after the return is filed it is probably even more difficult to alter a decision made not to elect out after §453 was used on an initially filed return. See, “Is IRS Now Requiring Written Documentation Regarding Initial Intent When 453 Revocation Is Sought?,” Letter Ruling Review, Dec. 1990, p. 6.

20 An election out of the installment method must be made on or before the due date of the return for the taxable year in which the sale occurred. §453(d)(2); Reg. §15A.453-1(d)(3)(ii).

TAXPAYERS CAN SIDESTEP CAPITALIZATION OF CONTRACT TERMINATION PAYMENTS AND DEDUCT CURRENTLY

One of the continuing dilemmas in the tax law—no matter how much the statute changes—is the line between capital expenditure and deductible business expense. One of the areas in which this can arise is when payments are made in termination of contract rights. For example, it seems settled that amounts paid by a lessor to cancel a lease (i.e., remove the lessee from the premises so that a more advantageous lease arrangement can be entered into) constitute a nondeductible capital expenditure. The opposite seems to be true, however, when a payment is made by a lessee to cancel a lease; such a payment would be eligible for current deductibility. LTR 9123004 sheds considerable light on the litmus that the IRS will apply in drawing the line.

Payments made to be relieved from contract to purchase. The taxpayer, a utility company, had entered into an agreement whereby it was to purchase 7.7 million tons of an unnamed product (coal?) at the rate of $40,000 a month over the period beginning July 1981 and ending September 1997. A termination provision permitted the buyer pay a fee of $3 per ton for the amount remaining to be purchased at the time of the notice of termination. In 1984 the taxpayer, because it could purchase the product at a lower price on the spot market and because its requirements were less, paid $20.2 million in termination of the contract and sought to deduct such amount as an ordinary and necessary business expense under §162.

Two aspects of the termination caused a potential problem with deductibility—the fact that the termination agreement gave the taxpayer the right to purchase further amounts at the “current contract price” and the taxpayer’s statement to shareholders that even if customers bore the cancellation costs (and the taxpayer felt they should) they would still have a “significant net savings over the 13-year period.” Viewing the taxpayer as “reaping benefits in future years by terminating the...contract,” the IRS took the position on audit that the termination amounts should be amortized over the 13-year period.

15 The motion is that in such a situation the lessor “receives back rights to its underlying asset which presumably will produce future benefits.”

16 The 13 years ran from the date of cancellation (1984) to the termination of the original contract (1997).
PARTNERSHIPS CAN'T BE AGGREGATED FOR AT-RISK RULES

The concept of what constitutes a "trade or business" permeates the tax law. In most instances, however, the issue is whether the taxpayer's activity rises to the level of a "trade or business" or is, for example, simply an investment activity. In LTR 9035005, however, the issue was not whether the activity was a trade or business but whether the activities carried on by the taxpayer were separate trades or businesses. Although the at-risk rules (§465) are clearly made applicable to "each" listed activity there is, in §465(c)(3)(B), some room for aggregation of nonlisted activities "which constitute a trade or business." The advantage of aggregation is obvious and is demonstrated by the desire of the taxpayer in LTR 9035005 to aggregate the negative at-risk amount attributable to his 50% interest in an oil and gas partnership with the positive amount at-risk attributable to his 50% interest in a partnership operating restaurant properties, which would have resulted in a sufficient amount at risk in the combined activity to deduct all of his distributive share of losses from the oil and gas partnership.

Aggregation of partnership activities okay. It was not the fact that the taxpayer sought to aggregate the activities of two separate partnerships that caused the problem. If the taxpayer actively participates in the management of the partnership activity (which this taxpayer did) the taxpayer's share of the amounts at-risk of more than one partnership can properly be aggregated. The point stressed in LTR 9035005, and which resulted in an adverse result for the taxpayer, is that aggregation is available only for activities "which constitute a trade or business" (emphasis supplied), meaning, the IRS says, a single trade or business. The legislative history leaves the door wide open for the aggregation of the real estate activities of more than one partnership (as long, of course, as the taxpayer actively participates in the real estate activity of each partnership sought to be aggregated). The taxpayer in LTR 9035005 thus hoped to prompt a successful inquiry into whether the two partnerships were, in fact, engaged in the same business. The IRS adroitly sidestepped such an inquiry by observing that the activities carried on by the two partnerships could not be a single trade or business since one was a cash method taxpayer and the other accrual. The illuminating aspect of this letter ruling is the Service's tight construction of "which constitute a trade or business" as mandating that aggregation apply only to amounts at risk within a single trade or business.

---

10 See, e.g., Boyle, "What is a Trade or Business?," 39 The Tax Lawyer 737 (1986).
11 §465(c)(2)(A).
12 Nonlisted activities, for purposes of §465, are activities other than holding, producing, or distributing motion picture films or video tapes, farming, leasing §1245 property, and exploring for, or exploiting, oil and gas property or geothermal deposits. See §465(c)(1).
13 §465(c)(3)(B) permits aggregation of nonlisted activities, constituting a trade or business, if the taxpayer actively participates in the management of such trade or business, or, if such trade or business is carried on by a partnership or an S corporation, 65% or more of the losses of such are allocable to persons who actively participate in the management of the trade or business.
15 The Service noted that under §446(d) a taxpayer is permitted to use separate methods of accounting only if the taxpayer is engaged in separate and distinct trades or businesses and keeps separate books and records. Even if the taxpayer had not been "hung" by reason of the adoption of separate accounting methods, it would seem that aggregation of the oil and gas at-risk amounts with those of the restaurant activity would have been difficult since the former is a "listed" activity (and §465(c)(3)(B) seems to permit aggregation only of nonlisted activities constituting a single trade or business). The taxpayer's hope would have been to classify both as engaged in the real estate business, a road which would have been difficult in the best of circumstances but which here was made impassable by the difference in methods of accounting.
Fact that termination payments did not result in an identifiable asset is not determinative. One might have thought this would be a significant factor. Instead, the IRS adopts another litmus—whether the payments produce future income (in which case they must be capitalized) or whether they are designed to reduce costs (in which case they may be expensed). Looked at closely in such a situation is whether, as a result of the termination, the taxpayer acquired a right which could create future income. True, here the taxpayer did acquire the right to purchase further quantities of the product but such subsequent purchases were to be at the spot price—no great advantage.

---

17 This line seems to have been drawn by the Tax Court in Rodeway Inns of America, 64 T.C. 404 (1974), in which the court required capitalization of amounts paid by a hotel franchiser to terminate a franchisee's exclusive rights in a particular territory (on the notion that the agreement canceled provided the taxpayer with the opportunity to augment its income in the territory). In making this distinction the Tax Court blessed the deductibility of payments, the purpose of which was "to reduce or eliminate its losses or expenses."

18 In reaching its decision the IRS ignored the taxpayer-utility's effort to justify passing the cost on the customers over the 13-year period in the future as so much corporate bluster.
INTEREST ON INSTALLMENT SALE CONTRACTS INHERITED BY SUCCESSOR PARTNERSHIP AVOIDS PORTFOLIO LABEL

The treatment of income as "portfolio" will block using losses from a passive activity as an offset. In a ruling context, therefore, the IRS will frequently "bob and weave" and avoid, if it can, assuring taxpayers that income constitutes passive activity income against which PALs can be used. A common question regarding a business would be whether interest, which is generally portfolio, received by it in its business activity is portfolio or whether, because of its business nexus, it can escape that classification. Generally speaking, interest derived in the ordinary course of business is not portfolio. The regulations treat interest received on customer accounts as "derived in the ordinary course of a trade or business" if "credit is customarily offered to customers of the business." If property is sold by a partnership pursuant to installment contracts in the ordinary course of its business the question can arise whether

---

14 See, §674(b)(5)(A), relating to corpus, and § 674(d), relating to income.
15 Reg. §1.674(d)-2(a).
17 §469(e)(1)(A); reg. §1.469-2T(c)(3)(i).
18 See, §469(e)(1)(A)(i)(I), which specifically provides that interest "derived in the ordinary course of a trade or business" is not portfolio.
19 Reg. §1.469-2T(c)(3)(ii)(B).
LETTER RULING REVIEW
June, 1991

interest on those contracts would have the same status (presumably not portfolio income) if that partnership "merged" into another successor partnership. It is this issue which LTR 9116029 addresses.

Partnership sells office condominium suites on installment plan. Subsequent to these sales the partnership, a general partnership, "merged" into a limited partnership, raising the issue of the status of the interest received on the installment notes (now held by the limited partnership). The most the IRS would do is to conclude that the interest income received by the limited partnership on the contracts inherited by it were not portfolio but income derived by the successor partnership in the ordinary course of the successor partnership's trade or business. Thus, the surviving partnership is not considered to hold the sales contracts as portfolio-type investments but as assets acquired in an ordinary trade or business context. This holding would, therefore, seem to open the way for interest on the prior sales contracts to be taken into consideration in determining the limited partners' gains or losses from the partnership activity.

Pursuant to §708(b)(2)(A), if two or more partnerships merge the resulting partnership is treated as a continuation of any merging partnership whose members own more than 50 percent of the capital and profits of the resulting partnership. While other partnerships are considered terminated the partners of such partnerships are less likely to realize gain as a result of actual cash distributions because no actual cash is treated as distributed to them (although they be more likely to realize gain as a result of constructive §752(b) distributions). See, McKee, Nelson & Whitmire, Federal Taxation of Partners and Partnerships, para. 12.06[1] (2nd. Ed. 1990).

Although the installment method is not available for dispositions by dealers after 1987 (§453(b)(2)(A)), the issue involved herein could arise with respect to pre-1988 disposals or with respect to accounts receivable of the prior partnership. See, Reg. §1.469-2T(c)(3)(ii)(B).

The IRS specifically withheld ruling on whether the partnership merger resulted in a disposition of the activity such as would bring §469(g) into play.

This is, of course, consistent with the tax-free treatment normally accorded partnership "mergers." LTR 9116029 appears, however, to make no distinction between partnerships that terminate as a result of the merger and those that (pursuant to §708(b)(2)(A)) do not. Thus, it would appear that the IRS would reach the same conclusion even if the partners of the transferring partnership realized gain, by reason of the termination of the transferring partnership, as a result of the merger. See note 20, supra.

If the limited partner's share resulted in a gain it would most likely be treated as a passive activity gain against which PALs could be offset. See §469(b)(2).
Timber Owner's §631 Gain Caused By 'Hugo' Eligible For §1033

When property is involuntarily converted the realization of gain is most frequently attributable to the receipt of insurance proceeds. The gain so realized can avoid recognition if the taxpayer purchases property "similar or related in service and use" within the required time period. §§1033(a)(2)(A), (B). Timber destroyed by a casualty event (e.g., Hurricane Hugo) presents an unusual opportunity as LTR 9131034 demonstrates. Frequently, since large timber holdings will not be insured against such a calamity there will not be the conversion into cash as when insurance is present. There is, nevertheless, compelled gain recognition to the timberholder if an election has been made under §631 to treat the cutting of timber as the sale or exchange of that asset. Since most large timberholders will have made such an election (in order to obtain the capital gain treatment) the question arises whether §631 gain (measured by the excess of the FMV of the cut tree over its basis) can be sheltered by reinvestment in the requisite replacement property. LTR 9131034 answers this issue favorably to the taxpayer by concluding that §1033 provides nonrecognition "[r]egardless of whether the realization of gain or loss arises from...the cutting of timber under §631(a)...or actual sales..." The §1033 reinvestment period will begin to run in the year in which Hugo is deemed to have resulted in the taxable event. Thus, since there may not be an immediate conversion of the toppled trees into salable logs, other sources of funds may have to be used for the reinvestment. All that is fine and, as LTR 9131034 further announces, expenditures for reforestation, cleaning and clearing drainage systems, repairing fences, gates and roads, all qualify as reinvestment in property which is "similar or related in service and use."
had discretion to make distributions to the trustors ("care, maintenance and support") was limited by a reasonable standard. All this might have been sufficient to avoid §674(a) but for the fact that the trustors also possessed the right to remove or replace (in the event of vacancy) the trustee. This was enough to render the exceptions to §674(a) inapplicable thus causing the trustors to be treated as owners of the trust. If this was unwelcome news it at least carried with it a positive result when the trust sold the residence—the §121 exclusion could be used.

FOR §121 TO BE AVAILABLE FOR RESIDENCE IN TRUST GRANTOR TRUST PROVISIONS MUST APPLY

When creating an irrevocable trust in which the settlor is a lifetime beneficiary, care must be taken to walk the narrow line provided for by §674 and avoid having the settlor treated as the owner of the trust (with the result, of course, that the income from the trust would be taxed to the settlor, or "trustor," to use the Service's term). If this is the objective it should be one which can be easily obtained but one should be mindful that the §121 exclusion would be foregone if a primary residence is part of the trust's corpus. Avoidance of the grantor trust provisions necessarily results in abandonment of the one-time exclusion of gain from the sale of primary residences for taxpayers over age 55. The result is, of course, based on the notion that ownership of the residence by the trust precludes treating the beneficiary as realizing gain from the disposition of a primary residence (even though it is still being occupied by the beneficiary and would plainly be treated as a "primary residence").

Irrevocability not enough. In LTR 9118017 it would seem that taxpayers (husband and wife) did everything they could to insure compliance with the exceptions to §674 and thereby avoid being treated as owners of the trust (which included their residence which they were entitled to use). The trustees were independent of the trustors and the standard by which they

13 See, Rev. Rul. 85-45, 1985-1 C.B. 183; also, Rev. Rul. 66-159, 1966-1 C.B. 162 (reaching the same conclusion with respect to qualification for tax-free rollover under §1034).
IRS WRESTLES WITH 1033 QUALIFICATION WHEN PROCEEDS INVESTED IN IMPROVEMENTS ON RETAINED PROPERTY

In applying nonrecognition provisions most would view the "like-kind" standard for defining replacement property as broader than "similar or related in service and use." Thus, normally taxpayers replacing condemned property, and seeking nonrecognition under §1033, are most likely to obtain their objective pursuant to §1033(g). This would permit taxpayers to replace condemned undeveloped real property with real property that is developed (or the other way around). Curiously, though, the "similar or related in service and use" standard is broader than "like-kind" when the taxpayer seeks to use the condemnation award to improve property already held by the taxpayer.

Bringing retained property up to pre-condemnation use should qualify. In LTR 9118007 the condemned property was undeveloped except for some preliminary improvements for construction of a residence (which objective had since been abandoned). The taxpayer's request to treat investment in improvements to a farm (on which he lived) or a subdivision thereof as qualifying "like-kind" was denied on the basis of the Service's position that improvements to other real property held by the taxpayer failed like-kind equivalency. This result should be contrasted with LTR 9117030 in which the condemnation resulted in one portion of the retained property being severed from another part, raising the issue of whether the use of the condemnation proceeds for the construction of a bridge connecting the two parcels would qualify for nonrecognition. In response, in LTR 9117030, the IRS held the bridge would qualify as "similar or related in service and use," on the notion, apparently, that such expenditure brought the property back to the level of its previous utility. When it is considered that such an expenditure would not have qualified as like-kind, it can be seen that, in the context of using the proceeds to improve retained property, there is greater opportunity for nonrecognition when the generally narrower standard is applied.

---

42 Rev. Rul. 67-255, 1967-2 C.B. 270, in which holds neither construction of a new building, nor roads, water systems, etc., on land already owned qualify as like-kind to land. This position, that land is not of the same nature or character as a building or roads or a water system, seems odd since it is readily conceded that undeveloped land is "like-kind" to a building and land. Reg. §1.1031(a)-1(b). If land is condemned reinvestment in improvements only, without land, is not, the IRS says, "like-kind."

43 The IRS relied on Rev. Rul. 67-254, 1967-2 C.B. 269, in which the Service found the taxpayer's use of the condemnation proceeds to rebuild a truck garage which was formerly on the condemned property to be eligible as "similar or related in service and use."

44 For example, the taxpayer in LTR 9118007 might have been entitled to "similar or related in service and use" treatment if the proceeds had been used to install (on retained property) the same kind of preliminary improvements as existed on the property taken.

---

40 One has to assume that an 11th hour abrogation of the cross-purchase agreement may not render the gift tax inapplicable since such a step would obviously have been taken solely for the purpose of avoiding the gift tax impact.

41 This provision, which can apply when the property taken is trade or business property or held for investment, brings the like-kind standard of §1031 (see, Reg. §1.1031(a)-1(b)) into play.
QUEST FOR SECURITY IN DEFERRED 1031 EXCHANGE MUST BE HANDLED NIMBLY

Very often in a §1031 exchange the two properties are not transferred simultaneously because the replacement property has not yet been identified. Quite often the reason for this is because the “buyer” (the other party to the exchange) needs the property he wishes to exchange (or before it becomes available). Although the famous Starker case permitted a deferred exchange (the buyer setting up an “exchange balance” for the taxpayer to be used to acquire the replacement property once identified), Congress, in 1984, limited the extent to which such deferred exchanges could qualify for §1031 nonrecognition.

Taxpayers seek comfort of security from buyer. It was all well and good for the taxpayer in Starker to have accepted the “buyer’s” unsecured promise to purchase (utilizing the “exchange balance”) replacement property once identified, but in many contexts such a promise will not provide the taxpayer with peace of mind to know that the wherewithal will be there to acquire the replacement property when necessary. When, as LTR 9052019 shows, as taxpayers begin to seek more satisfactory assurance, through various “security” devices, the potential for trouble arises. Unfortunately, the taxpayers in LTR 9052019 were not nearly as imaginative as they ought to have been. The cash proceeds from the sale were placed in CDs (and a savings account) under the authority and control of the taxpayers. Even though the 45-day and 180-day requirements of §1031(a)(3) were met (relating to the identification and acquisition, respectively, of the replacement property) the IRS held that the receipt of cash, or the equivalent thereof, resulted in a failure to meet the “exchange” requirement of §1031. In these days of regular use of the deferred §1031 exchange approach, it now appears that “the problem of working out an adequate security arrangement may be the principal impediment to a nonsimultaneous exchange,” a goal toward which the taxpayers fell woefully short.

It makes no difference whether the taxpayers actually received the cash (as appears to have been the case in LTR 9052019 even though it was received by a trust of which they were trustees and beneficiaries) or whether they were in constructive receipt of such amounts. In either instance there would have been a liquidation and a failure to engage in a reciprocal transfer of property. Obviously, therefore, the buyer’s check will result in the receipt of the equivalent of cash even though it is not deposited but is endorsed over to the holder of the replacement property.

Careful planning can, though, result in a much higher likelihood of success than the taxpayers had in LTR 9052019. See, Cummings, “How To Secure A Delayed Section 1031 Exchange,” 70 J. Tax. 230 (1989) (although the author concedes that “[t]here appears to be an inverse relation between the taxpayer’s financial security and tax security”).

50 E.g., to proceed with development plans.
51 Starker v. U.S., 602 F.2d 1341 (9th Cir. 1979).
52 See, §1031(a)(3) which provides (i) that the replacement property must be identified within 45 days after the taxpayer’s transfer, and (ii) that the replacement property must be received no later than 180 days after the taxpayer’s transfer (or, if earlier, the due date of the taxpayer’s return for the year of the transfer).
IRS POSITIVE IN ALLOWING EXPENSES FOR GRAD TAX LAW STUDY

The prospect of deducting graduate education is very alluring. Since it is so alluring it is quite likely that the IRS will scrutinize a taxpayer’s attempt to take it. Consequently, there should be more than the usual interest in the Service’s ruling policy since from that one can go some way in determining what is likely to be challenged and why. Aside from the maxim that the education must “maintain or improve” skills required in the taxpayer’s trade or business, the issues seem to be whether (i) the taxpayer was actually engaged in the trade or business to which the education relates, and (ii) if the education is full-time, whether the taxpayer should be viewed as having interrupted the business activity to an extent where it would it would be proper to regard the taxpayer as no longer “carrying on” that business. Both of these issues seem to be involved, as they were in LTR 9112003, when a lawyer goes off (either by resigning the prior employment association or on a leave of absence basis) to graduate school.

Taxpayer an associate in law firm. The taxpayer, a spanking new law grad, began his association with a firm in September 1986 (he was not admitted to the bar until May 1987). In July 1990 he resigned the position to pursue (full-time) a graduate degree in taxation. Clearly, therefore, the IRS was not presented with a period of time of prior involvement in the business activity that was so short that one could say the taxpayer was not really “carrying on” the business activity that is supposed to be the basis of the deduction. Although the IRS notes that “questions of federal tax law arose” in the taxpayer’s practice there is no indication he was spending even the majority of his time in that area. Thus, it is possible to glean from LTR 9112003 that it is sufficient that the taxpayer is simply practicing law and not specializing. Moving from being a generalist in the law to a specialist will not, it seems, result in the education being the tainted “upward-bound” variety. Next, the prospect of full-time education always raises the specter that the taxpayer will be viewed as improperly breaking the cord with the prior activity and hence not “carrying on.” Here, too, there was no problem since the nine-month period of study fell within the one year guideline the IRS previously established. Consequently, even the IRS concedes there should be few, if any, obstacles to deductibility of expenses of graduate tax study if a practicing lawyer leaves a firm to do so. But misfortune would most certainly follow the recent law grad who goes directly to graduate school after spending the summer following graduation on the beach or even working in his father’s business.

---

5 See Reg. §25.2511-1(h)(1) which stands for the proposition that a transfer for the benefit of a corporation is regarded as a transfer to the corporation itself and indirectly to the other shareholders of the corporation.

6 Although not mentioned in LTR 9114023 it would seem that this transfer would be considered a gift only to the extent that the value transferred exceeds the taxpayer’s own interest in the corporation. See, Reg. §25.2511-1(h)(1).

7 Reg. §25.2512-8. This principle was the one cited in Rev. Rul. 80-196, 1980-2 C.B. 32, for holding that no gift was made when two 50 percent shareholders each transferred the same amount of stock to key employees. Rev. Rul. 80-196 was distinguished in LTR 9114023 on the ground that in the former each shareholder received an offsetting benefit as a result of the other’s transfer whereas in the latter the taxpayer deemed to have made a gift was the only one transferring stock.

8 §2503(b).

9 Reg. §162-5(a)(1).

10 See, e.g., Ross Lawrence Link, 90 T.C. 460 (1988) in which the Tax Court found that a summer’s employment prior to enrolling in an M.B.A. program was not sufficient. Cf. Albert C. Ruelmann, T.C. Memo. 1971-157, cited with approval in LTR 9112003, in which employment for that period of time prior to enrolling in a graduate tax program was sufficient.

11 See, e.g., Bittker and Lokken, Federal Taxation of Income Estates and Gifts, §22.1.3 (2nd Ed.).


13 E.g., Paul R. Wassenaar, 72 T.C. 1195 (1979).
IRS rules that subsequently transferred property in divorce context eligible for treatment as property settlement. The transfer of property "incident to a divorce" is treated as a gift—tax-free to the recipient. §1041. To be eligible the transfer must occur within one year after the date the marriage ceases or it must be "related to the cessation of the marriage." §1041(c). It is not unusual for the parties to overlook, in the intensity of negotiations, property in which marital interests exist. In LTR 9123053 subsequent to the divorce it was determined that the ex-wife had a community property interest in her former husband's employment benefits. After later negotiations it was agreed that the husband would pay his former wife $X in installments over a 60-month period (which, obviously, placed the payments subsequent to the one year post-divorce period). Some leeway is granted by the regulations (Reg. §1.1041-1T, Q&A 7) which provide that transfers occurring not more than six years after the date on which the marriage ceases will be treated as "related to cessation of the marriage" if pursuant to a modification of the agreement. Here, however, the payments stretched beyond the six-year period and, therefore, a presumption existed that they were not made pursuant to the cessation of the marriage. It is in rebuttal of that presumption that the IRS ruled in LTR 9123053 that the payments were "incident to divorce" under §1041. Note that such a finding was necessary (if tax-free treatment to the recipient was to be insured) even though the IRS readily conceded that the payments, subject an obligation which was not conditioned upon the ex-wife being alive for the 60-month period, were not alimony within §71(b).
TAX BURDEN ON 'RIPE' STOCK SALE CAN BE SHIFTED TO SPOUSE IF TRANSFER INCIDENT TO DIVORCE

In the charitable area the IRS has always been vigilant to insure that taxpayers contributing appreciated property to charity are not successful in shuffling off, to the charity, gain that would ordinarily be recognized by the donor. Employing traditional assignment of income principles most courts would conclude that income from a contract for the sale of stock will be taxed to the donor despite the fact that the sale is actually consummated after the donation of the stock to charity. The question boils down to whether the liquidation, or other means by which the stock is to be disposed of, is "too ripe" to shift the shareholder tax burden thereon.

Divorce decree provides for immediate redemption of stock from transferee spouse. In LTR 9046004 the husband was the president and majority shareholder of a closely held corporation. Pursuant to the divorce decree his ex-spouse was to receive a substantial portion of the husband's interest in the corporate stock. Since such an asset would provide almost no liquidity to the transferee, and probably no income, it was provided that the stock was to be immediately redeemed from her by the corporation. In view of the "ripeness" of the asset at the time of its transfer to the other spouse the initial conclusion might be that the IRS would seek to tax the inherent gain to the transferor. Obviously, however, the tax stakes are not as high as when the transfer of ripe property is to a charity in whose hands the gain might well be exempt. It is, perhaps, for this reason that the IRS in LTR 9046004 acknowledges the hegemony in such a situation of §1041, providing that no gain or loss will be recognized on the transfer of property from an individual to a spouse (or former spouse) incident to a divorce. Thus, not only does §1041 negate judicial authority like U.S. v. Davis but it also renders quiet normally applicable assignment of income rules (thus allowing the parties to negotiate where the tax burden on the sale of property will fall and to agree on the terms of such a sale in advance of the transfer).

1 To a great extent the cases on this question flow from such old assignment of income "chestnuts" as Helvering v. Horst, 311 U.S. 112 (1940) and Comm. v. Court Holding Co., 324 U.S. 331 (1945). Many cases arose in the context of the charitable donation of stock in a corporation which had already agreed to liquidate and concluded that gain realization as a consequence of the liquidation distribution must be taxed to the shareholder/donor. E.g., Hudspeth v. U.S., 471 F.2d 275 (6th Cir. 1972); Jones v. U.S., 531 F.2d 1343 (6th Cir. 1976). Rollins v. U.S., 302 F. Supp 812 (W.D. Tex. 1969).

2 The corporation's articles and by-laws provided that no shareholder would sell stock in the corporation without first offering it to the corporation and then to the other common shareholders. It appears that the ex-spouse's stock was not offered pursuant to such provisions since the decree provided that the stock was to be sold immediately after the transfer at a set price.


4 Of course, the shift of the tax burden on the sale of property transferred pursuant to a divorce will not result in significant tax savings in any event (especially in these times of collapsed tax brackets). Depending upon the outcome of the negotiations one of the two partners to the marriage will bear the tax burden of the sale (thus making it starkly different from the assignment of "ripe" property to a charity).
SECURITY IN ADDITION TO THE RESIDENCE DOES NOT FOIL 'QUALIFIED RESIDENCE INTEREST'

It is clear, of course, that interest on either "acquisition indebtedness" or "home equity indebtedness" is deductible as "qualified residence interest." One of the essential requirements of either acquisition or home equity indebtedness is that the debt be secured by such indebtedness. What is the result, however, if the lender needs security in addition to that provided by the residence itself? This could occur, for example, if the indebtedness equaled, or nearly equaled, the market value of the property (since lenders are generally reluctant to lend an amount equal to the full value of the property). In such a situation the lender might be willing to lend an amount equal to the full value of the property only if the security of the property itself were supplemented by the security of additional property. As LTR 9038023 makes clear, this should not impair qualification of the full amount of the interest as "qualified residence interest." The statute's simple requirement is that the debt be secured by the "qualified residence." Thus, in LTR 9038023, where the lender loaned $950,000 on the security of the residence and on an amount which the taxpayer was required to keep on deposit with the lender, interest on the entire debt met the "qualified residence interest" standard. Although the subject letter ruling dealt with acquisition indebtedness, the same conclusion would presumably be reached with respect to "home equity indebtedness." Thus, a taxpayer could borrow an amount (e.g. $60,000) to purchase an expensive automobile. Although the lender would quite naturally take a chattel mortgage on the vehicle, interest on the loan would meet the qualified residence interest standard if such additional debt were secured by the residence (even though the aggregate debt—the mortgage on the residence and the auto loan—exceeded the value of the residence).  

---

8 §§163(h)(3)(B), (C).
9 See, Reg. §1.163-10T(o)(1) for definition of secured debt.
LETTER RULING REVIEW
August, 1991

IRS sweeps most of tax preparation fees into miscellaneous itemized deduction category. Ever since the 1986 enactment of §67, placing a two-percent floor on those deductions in the category known as miscellaneous itemized deductions, there has been concern regarding the appropriate classification of tax return preparation fees. The regulations (Reg. §1.62-1T(d)) require that "above the line" items must be "directly connected with the conduct of the trade or business" and offer state income taxes on net business income as an example of an item that is "merely remote" to the business and, hence, subject to the two-percent floor. In LTR 9126014 the IRS wrestles with the treatment of tax preparation costs in a typical situation where the taxpayer had a sole proprietorship (a CPA consulting firm) reportable on Schedule C, rental properties reportable on Schedule E, and equity interests in a partnership and an S corporation. Regarding the Schedule C and E costs the IRS, stating that such preparation costs are analogous to state income taxes on net income, concluded that they were only "remotely" connected with the business and that their deductibility was controlled by § 212(3), thereby causing such amounts to be subject to the two-percent floor. For criticism and analysis of this result, see Storrer, "Deducting Tax-Related Professional Fees," Tax Notes, June 24, 1991, p. 1575, which indicates that the last word on this difficult subject has not yet been written. With respect to the pass-through entities (the taxpayer received K-1s reflecting his share of net income including an offset for preparation of the entity's return), the IRS did not impose a grouping which would have subjected these expenses to the two-percent floor (finding, instead, that the costs were directly related to the obligation of the entity to file an information return and were, thus, deductible under §162).
IRS ALLOWS DEFENSE COSTS OF DIRECTOR UNDER §212

In the past the IRS has drawn the line between professional and nonprofessional fiduciaries, allowing the former to deduct their expenses under §162 but maintaining that the best the latter could get is a §212 deduction. The Service has in the past been more aggressive when the issue becomes, instead, the tax treatment of legal fees and settlements paid in defending suits which urge (on the part of a trustee or corporate director) mismanagement or negligence.

IRS ruling policy more lenient. In LTR 9039023 the taxpayer, a corporate director with other full-time employment, incurred attorneys' fees and paid settlement amounts in connection with a suit brought by an investor in the corporation of which the taxpayer was a director. The plaintiff, seeking recompense for the stock of the corporation in which he had invested and which had become worthless, alleged that the taxpayer had a duty to inform the plaintiff of certain facts about the corporation in which he was about to invest. The Service cast aside the prior tough litigating policy by readily conceding that the taxpayer was, indeed, able to deduct the legal fees and settlement amount.

What is level of activity? Although LTR 9039023 does not rely on prior case authority which, if applied, would have denied the deduction, there is still the issue of whether legal fees and settlement amounts paid by a corporate director are §162 or §212 expenses. Obviously, the latter classification would result in application of the 2% floor for miscellaneous itemized deductions. Upon the conclusion that being a corporate director is not a sufficient level of activity to constitute a trade or business, this is the result reached in the subject letter ruling.

12 Since no such legislative history exists with respect to other U.S. possessions, property located therein would not qualify (per §1031(h)) as “like” U.S. real property.
14 See, e.g., Carl F. Foyen, 34 T.C. 630 (1960), denying a business expense deduction to a trustee charged with mismanagement on the ground that the taxpayer is not engaged in carrying on a trade or business as a trustee; see also, Sheldon Solomon, T.C. Memo. 1974-127. Cf., Nathan Cummings, 60 T.C. 91 (1973), in which the IRS conceded that the taxpayer’s activities as a corporate director constituted a trade or business.
SMALL ADS IN PROGRAM BOOK DON'T GENERATE UBI, BUT LARGER ONES DO

One of most pesky unrelated business income (UBI) issues relates to income from program advertising. The court of appeals decision in NCAA v. Comm. must, however, be regarded as a very pro-taxpayer break-through in this area. Although LTR 9044071 was issued less than two months before the opinion in NCAA, and therefore does not have the benefit of its enlightened viewpoint, it is instructive of whatever movement may be taking place in the Service's position on this issue.

Program book distributed to organization's 800 members at annual conference. The advertising effort, which includes attempts to obtain advertising from the organization's members, was handled in full by the book's publisher with the latter remitting to the exempt org a fixed percentage of advertising sales. The "front of the book" was devoted to textual material relating to the organization's activities whereas the latter third consisted of "paid listings of various businesses within the state served by the organization" which often contained a "commercial logo and/or slogan describing the services or goods provided by the business." The size of the ads varied from a full page to two or four per page all the way down to 24 or 48 per page (or even small listings, at over 70 per page, containing the name and address of the business).

Advertising is "regularly carried on." In reaching this conclusion the IRS avoided any of the enlightened viewpoint, it is instructive of whatever movement may be taking place in the Service's position on this issue.

Advertising relates (in NCAA) to the organization's activities whereas the latter third consisted of "paid listings of various businesses within the state served by the organization" which often contained a "commercial logo and/or slogan describing the services or goods provided by the business." The size of the ads varied from a full page to two or four per page all the way down to 24 or 48 per page (or even small listings, at over 70 per page, containing the name and address of the business).

Advising is "regularly carried on." In reaching this conclusion the IRS avoided any of the enlightened thinking of CA-10 in NCAA. The six-to-eight week solicitation period, coupled with the time necessary for the preparation of the advertising copy, was enough, the IRS held, for the activity not to be "intermittent." This conclusion runs exactly contra to NCAA which held that in deciding the "regularly carried on" issue it is necessary to look to the time span of the event to which the advertising relates (in NCAA it would be the tournament, in LTR 9044071 it would be the annual conference) and not the time spent in preparing and selling the ads. By sweeping to the conclusion that the advertising activity was "regularly carried on" the IRS avoided the thorny issue of whether the "activities occur so infrequently that neither their recurrence nor the manner of their conduct will cause them to be regarded as trade or business regularly carried on." If the infrequent nature of the activity were looked at it would be hard for a court applying the reasoning in NCAA to escape the conclusion that the advertising was not "regularly carried on." No commercial benefit to advertiser. There is a crack in the Service's position which allowed them to toss a sop to the organization. If the advertising is of such a nature that it "would...be difficult [for the patron] to justify on a commercial basis..." it can be presumed that it takes on the character of a complimentary contribution and does not generate UBI. Looking solely at the size of the ads—and not the other factors that could well indicate that the ads were purchased on a "complimentary contribution" basis—the IRS decreed that those ads on a 48-per-page, or smaller, basis did not generate UBI. The "larger" ads did, though, since, in the Service's view, even the 24-per-page advertisers could "reasonably be expected to derive more than a negligible or inconsequential commercial benefit" from the ad.

21. 66 AFTR 2d 90-5602 (10th Cir. 1990).
22. LTR 9044071 was issued Aug. 8, 1990; NCAA was decided Sept. 20, 1990.
23. For advertising income to be UBI it must be (i) income from a trade or business; (ii) such trade or business must be regularly carried on by the organization; and (iii) the conduct of the trade or business must not be substantially related to the performance of the org's exempt function. See, Reg. §1.513-1(c). Most UBI cases involving advertising come down to whether the requirement in (ii) exists.

24. The IRS reached this conclusion even though this six-to-eight week solicitation period was shorter than the three-month period involved in Rev. Rul. 73-424, 1973-2 C.B. 190, in which the IRS found that income from advertising in an annual yearbook was UBI. Finding that the advertising income was not "passive" (in reaching this conclusion the services of the publisher were imputed to the exempt org) the IRS in 9044071 also quickly dismissed the argument that the advertising income was royalty income and, therefore, exempt from UBI by reason of § 512(b)(2).
25. The NCAA court stated that "...the tournament is the relevant time frame for those who choose to pay for advertising in the program in contrast to the advertising involved in U.S. v. American College of Physicians, 475 U.S. 834 (1986), "where advertisements were sold for each issue in a monthly medical journal."
27. Presumably, too, the Tax Court, applying the reasoning and approach of its decision in Suffolk County Patrolmen's Ass'n., 77 T.C. 1314 (1981), would arrive at the same conclusion.
28. Considering, for example, the manner in which the publication is distributed, its territorial scope, the commercial or noncommercial flavor of methods used to solicit ads, etc.
§170 DEDUCTION TO BUYER OF NONPROFIT’S STOCK, BUT IRS SCRUTINIZES

It should be elementary that the *purchase* of stock in an organization cannot constitute a deductible charitable contribution. The person acquiring stock in the organization is receiving value in return for the outlay and such is, of course, fully inconsistent with a deduction under §170. Generally speaking, nonprofit corporations may be organized on a membership or stock basis. If a nonprofit is organized on the former basis, payments in the form of dues or fees may be deductible in whole or part (assuming the organization is one described in §170(c)(2)) if the transferor receives or expects to receive only indirect or insubstantial benefits such as the satisfaction of furthering a charitable cause.

Nonprofit issues stock. If a nonprofit is organized on a stock basis the contributor acquires stock in the corporation. As LTR 9035074 makes clear the acquisition of a “piece of paper” in the form of a share certificate will not deprive the taxpayer of a charitable deduction where the purchase of such stock is “analogous to the payment of a membership fee...” It is essential that the ownership of the nonprofit’s stock confers no “substantial right or privilege upon the shareholder, other than the right to participate in the management” of the organization. Thus, the stock can’t be redeemable by the corporation nor does it entitle the shareholder to a share of the assets if the corporation dissolves. If, therefore, the share ownership confers any proprietary rights (as it may under some state statutes) no charitable deduction will be available to the acquirer of such stock.

Close scrutiny of whether share ownership confers benefit. Even though the share ownership in LTR 9035074 conferred no proprietary rights the IRS did not stop there. The organization involved in LTR 9035074 issued a newsletter which was “not of commercial quality” and was not available to nonmembers by paid subscription or through newsstand sales. Hewing to its recent toughness on the question of the effect of value received by a contributor the IRS, in LTR 9035074, examines the newsletter received by the nonprofit’s shareholders but concludes that it is “without measurable fair market value or cost.” (See Rev. Proc. 90-12, 1990-8 I.R.B. 20, 21, setting forth the circumstances in which receipt of a newsletter by a shareholder or member will not affect the availability of a charitable deduction.) The bottom line seems to be that the existence of a newsletter won’t hinder a charitable deduction if it exists to inform members about the activities of the organization. Lest the Service appear too soft in this entire area it hangs a cloud over the situation by announcing that “personal benefit” could exist (thereby resulting in no charitable deduction) if a group acts in concert to acquire shares of a nonprofit in order to secure control of the organization. Thus, in what may be a questionable construction, the IRS does not necessarily equate personal benefit with financial benefit.
SETTLEMENT DISTRIBUTION
OF APPRECIATED PROPERTY
TO CHARITABLE
BENEFICIARY RESULTS IN
DEDUCTION

Charitable trusts are, of course, permitted a charitable deduction for amounts "which pursuant to the terms of the governing instrument" are paid for a §170(c) purpose. Query whether this will be the result if a charitable trust strikes a settlement, pursuant to which a lump-sum distribution is made, with a beneficiary with which it has had a disagreement? LTR 9044047 faces up to whatever obstacles may have existed to a charitable deduction under §642(c) for the distributing trust.

Charitable lead trust. One-half of the income of the trust for the term, which was funded with appreciated publicly held stock, was to be distributed to an identified §501(c)(3) organization. Following the settlement of the dispute between the beneficiary and the trust (which was sanctioned by a court interpreting the trust instrument with the participation of the state's attorney general) a distribution, constituting 16.3% of the trust's principal, was made in complete termination of the charity's interest. Two threshold requirements of a §642(c) charitable deduction—that it be made pursuant to the governing instrument and that the distribution be from income—had to be dealt with. With respect to the first, it was held that the settlement distribution, being approved by the court (and pursuant to settlement authority in the instrument) was, indeed, pursuant to the instrument.42 Although the distribution was itself corpus it resulted in income realization to the trust since it was made in satisfaction of a specified obligation.43

Charitable deduction washes out gain realized upon distribution. Assume, for example, that the assets distributed in settlement of the charity's interest had a basis of $20x and a value of $50x, thus causing a $30x gain to the trust upon distribution. Although capital gains are not normally included in DNI they would be here since they would be considered allocated to charity.44 Thus, if the trust had $40x ordinary income in addition, its gross income would be $70x, which could be reduced by a $30x charitable deduction.45 The charitable beneficiary would be charged with receiving that capital gain through the DNI passthrough rules but it would be offset by the §642(c) deduction. Thus, even though a settlement distribution results in income to a charitable trust that income can be effectively "washed-out" through the bestowal of a §642(c) charitable deduction.

42 Noting that a settlement agreement arising from a will contest qualifies as a governing instrument (Rev. Rul. 59-15, 1959-1 C.B. 164), LTR 9044047 states that "the definition of governing instrument is flexible."

43 Since the distribution was of a specific percentage of the trust's corpus the situation in LTR 9044047 does not seem to be specifically analogous to the specific dollar amount involved in Kenan v. Comm., 114 F.2d 217 (2nd Cir. 1940) (which is the decision standing for the principle that gain realization occurs to a trust or estate upon the distribution of appreciated property in satisfaction of a fixed obligation). See, also, Reg. §1.661(a)-2(f)(1) which represents the administrative statement of this rule. It even appears to be removed from the obligation to pay a fixed annuity that was involved in Rev. Rul. 83-75, 1983-1 C.B. 114, since that too, like Kenan, involved a specific dollar amount. Nevertheless, the IRS felt that the court judgment, along with the "deficiency" provisions of the trust instrument (designed to insure an equitable distribution to the income beneficiaries down through the years) did create an "obligation" even though not expressed in dollar terms.

44 §643(a)(3).

45 Even though $50x in value was distributed to the charity, only $30x would be eligible for a charitable deduction since only that portion of the distribution was from income.
IRS INVOKES LOCAL LAW TO STRIKE DOWN CHARITABLE CONTRIBUTION OF LIFE INSURANCE

Everyone has thought for years that the gift of an insurance policy to a charity entitles the donor to income and gift tax deduction (plus, in addition, it removes the policy proceeds from the decedent’s gross estate). These results, along with the attractiveness of being able to make a large bequest “on the installment plan” (i.e., through relatively small premium payments), of being able to guarantee that the donee charity will collect a certain amount, of not impairing other assets of the estate (all that is “leaving” the estate is the annual premium less the charitable deduction tax saving) and the fact that the insurance proceeds do not increase probate or administration costs, have combined to make inter vivos transfers of insurance a common planning approach. Now, however, in a very technical holding (LTR 9110016), relying heavily on the notion that the donee charity did not acquire an “insurable interest” under New York law, the IRS has trashed this planning device to such an extent, that if it is correct (and it probably is not), then none of the sought-for results will be obtained.

Gift tax and income tax deductions thought to be available. The rules regarding donations of life insurance seem fairly clear. For income tax purposes the charitable donation of a policy should entitle the donor to a deduction equal to its fair market value. If the policy is assigned on the day it is taken out (which will often be the case), the deduction would be limited to the amount of the initial premium then in force. The income tax charitable deduction would be reduced by that amount which would be treated as ordinary income, generally resulting in limiting the charitable deduction to the donor’s basis. Most donors enter into an agreement (or letter of intent) with the donee charity regarding their wishes with respect to the policy proceeds (and stating their intent to make a contribution equal to the annual premium). Generally, though, it has been assumed that both income and gift tax charitable deductions for the premium contributions were readily available.

IRS wreaks havoc on donation. In what can only be described as a parade of horribles the IRS (as stated, relying upon the conclusion that the charity had no insurable interest) sweeps away every conceivable tax benefit that would seem to follow such a transfer. Since the transaction “violates” local law, the insurance company may not have to pay the proceeds to the charity or, if it does, the fiduciary may maintain an action to recover the proceeds. This state of affairs, says the IRS, results in a nondeductible partial interest and one with respect to which it had not been shown that the chance the charity would be divested was “so remote as to be negligible.” Similarly, the donor would be denied a gift tax deduction for even a partial interest since there was no showing that any such retained interest was “susceptible of valuation.” As if this was not enough the IRS would include the policy proceeds in the decedent’s gross estate under §2035 if she died within three years of the policy assignment and §2033 if she did not (on the ground that the estate fiduciary could recover the proceeds for the benefit of her estate). Let anyone think that inaction by the estate’s fiduciary would at least entitle the estate to an estate tax charitable deduction, the IRS negated that too by concluding that, in such a situation, the policy proceeds would be deemed to have passed as a result of the fiduciary’s action and not the decedent’s. Despite all this naysaying one should by no means consider that the death knell has been sounded to the charitable transfer of life insurance (but maybe a passing glance to distinguish applicable local law from that existing in New York would be worthwhile).

---

1 Securities or real property, for example, are subject to depreciation.
2 Reg. §1.170A-1(c)(1).
3 This was the case, in fact, in LTR 9110016 and was used by the Service to support the charity’s lack of an insurable interest (i.e., the charity was treated as having received the policy directly from the insurance company).
5 §170(e)(1)(A). A policy transferred right after being acquired would, thus, have a basis equal to that first premium.
6 See, e.g., LTR 8714037, which blessed an income tax deduction for the annual premium payments.
7 §170(f)(3).
8 Reg. §§1.170A-1(e); 1.170A-7(a)(3).
9 Partial because of the possibility that the proceeds would be paid to the insured’s estate.
EXEMPT HOSPITAL CAN OPEN ITS FITNESS CENTER TO PUBLIC WITHOUT UBI

Whether the operation of recreation centers (now, one supposes, generally referred to as fitness centers) by an exempt organization can be related to the organization's exempt purpose so as not to produce UBI, has been an interesting issue. While the IRS has not gone so far as to hold that the provision of fitness services to healthy people fits with the notion that health promotion is simply a part the general concept of charity, there seems to be the concept that a fitness facility can be a charitable activity if it provides recreation available to a large segment of the community. At the same time, however, the IRS has shown no willingness to find the lack of unrelated business income when the fitness center is operated in a "commercial manner" by an admittedly exempt organization (a §501(c)(3) organization whose purpose was to provide for the welfare of young people). The rap against this organization, which was found to have UBI, was that its health club, in which anyone could participate for an annual fee (similar to that charged by local commercial clubs), was that its "commercially comparable annual dues or daily fees...are sufficiently high to restrict the health club's use to a limited number of the members of the community."16

Hospital operates health and fitness center open to public. In these days, of course, hospitals—even exempt hospitals—have become multi-dimensional in the services they provide. Thus, one can easily envision the fitness center operated by the hospital in LTR 9110042—a facility open to the public as well as to the hospital's patients and employees. Although it was easy to class those who used the facility at a doctor's recommendation as "patients," the difficulty came as a result of the wide public use of the facility and the rate differential for use by the general public. The apparent key to the favorable result reached was the organization's statement that its rates were "low enough so that a significant segment of the population of the area [could] afford to participate" and that they were "lower than commercial rates in the area." Thus, the fact that permitted the IRS to distinguish LTR 9110042 from its prior adverse published position was the setting of the facility's fees so as to make its "services generally available to the local public." The aphorism "moderation in all things" appears, again, to have pertinence (the only drawback is that LTR 9110042 is without any guidance on what fee structure would appear reasonable).20

---

13 E.g., for the reason that the promotion of health lessens the government's burdens.

14 Rev. Rul. 67-325, 1967-2 C.B. 113, which relies on Isabel Peters, 21 T.C. 55 (1953), a §170 case involving a corporation formed to operate a public beach, playground and bathing facility which was held to be "charitable."


16 In the same vein is Rev. Rul. 79-361, 1979-2 C.B. 237, in which the operation of a miniature golf course in a commercial manner by a charitable organization operating to provide for the welfare of young people, was determined to result in UBI.


18 Although the IRS had no data on the percentage of users who would be from the general public (and not from the employee or patient group) it was conceded "that a significant portion of the patrons would be drawn from the general public and have no other connection to your health care activities..."

19 Oddly, the IRS also noted that there were "no comparable commercial facilities in the area." How is it possible to make the comparison if there is nothing appropriate to compare it to?

20 The implication is, though, that a moderate, non-country club fee structure should pass muster. Further, there is no hint that it cannot be a structure that would adequately cover the organization's costs and then some.
WHEN CARRYBACK USED AGAINST PRIOR DEFICIENCY INTEREST STOPS ON DUE DATE EVEN WHEN RETURN IS TARDY

A carryback can eliminate a deficiency or underpayment occurring in a prior year (the carryback year). This still leaves, though, an interest obligation with respect to the prior underpayment. Generally speaking, interest is due from the due date of the return for the year of underpayment until the "filing date" for the taxable year in which the carryback arises. Although "filing date" is defined as the last date prescribed for filing the return or the taxable year (determined without regard to extensions), it is necessary, when tardy returns are filed, to determine whether interest will run until the due date of the return or until the actual date on which the delinquent return was filed.

Returns for years in which carrybacks arose were not timely. In the situation involved in LTR 9127004 the taxpayer's corporate returns for fiscal years ending June 30, 1985 and June 30, 1986, though due September 15 in each of those years, were not filed until August 6, 1986 and December 12, 1986, respectively. Although the District Office took the position that interest on the underpayment occurring in the fiscal year ending June 30, 1985 ran until August 6, 1986 (the actual filing date of the return for fiscal year ending June 30, 1985), and for that portion of the underpayment reduced by the carryback from fiscal year ending June 30, 1986, until December 12, 1986 (the actual filing date of the return for June 30, 1986), the IRS, on technical advice, adopted a more reasonable stance. Since interest is an amount paid for the use of money the IRS reasons that the prior underpayment should be considered satisfied, for interest computation purposes, on the date that the return for the year in which the carryback arises is due (that being, it appears, the date on which the carryback amount is properly creditable to satisfy the past liability). Thus, while a panoply of penalties may await taxpayers who file tardily (without obtaining a proper extension), for years in which a carryback arises, it is not necessary to count among such sanctions continued running of interest on prior underpayments. The carryback is deemed applicable on the due date of the return for the year in which the carryback arises thus terminating the running of interest on prior underpayments (to which the carryback is applicable) on that date.

15 The existence of an NOL or capital loss carryback shall not affect the calculation of interest "for the period ending with the filing date for the taxable year in which the net operating loss or net capital loss arises." §6601(d)(1). A similar principle applies with respect to credit carrybacks. §6601(d)(2).

16 §6611(f)(3)(A).

17 This conclusion was aided, no doubt, by the change made by TEFRA in 1982 which amended §6601(d) by substituting "filing date for the taxable year" for "the last day of the taxable year."
LETTER RULING REVIEW  
April, 1991

ABATEMENT OF  
DELINQUENCY PENALTY BY 
SERVICE CENTER NOT ‘FINAL’

One would hope that when the taxpayer convinces the IRS service center to abate a penalty (asserted, quite likely, by way of a computer-generated notice) that that would be the end of it. Having made a forceful, and apparently effective plea, that “reasonable cause” existed, the taxpayer can only feel that he has been “had” if, after the return is selected for examination, the penalty is reasserted. This is exactly what occurred in LTR 9111005 (which involved the service center’s abatement of the §6651 penalty with respect to a tardily-filed estate tax return). When the estate tax examiner later asserted the same penalty the taxpayer made what amounts to an estoppel-type argument.

Regs clearly provide for abatement. The language does contain some support for the taxpayer’s position, i.e., “If the district director, the director of the service center, or where applicable, the [director of the Bureau of Alcohol, Firearms, etc.], determines that the delinquency was due to reasonable cause and not to willful neglect, the addition to the tax will not be assessed.” One could interpret this language as bestowing some “finality” to the service center’s determination that “reasonable cause” exists. Not surprisingly, the IRS regards the situation as much more fluid. When the Tax Court has been faced with this (or a related issue) it falls back on its time-honored maxim that it will not “look behind the notice of deficiency to examine administrative actions.” In the ebb and flow of administrative fact finding nothing is “final” until specifically made so (even if, it would appear, there is taxpayer reliance on the IRS’ administrative abatement).

Thus, in LTR 9111005, the first flush of glee which accompanied abatement of the service center’s action was tempered by the realization that the estate tax examiner (more apt to probe and with more time to do so) was asserting a penalty thought to have been a former problem. The Tax Court tosses off the observation that the taxpayer did not establish the “existence of a closing agreement or any other binding agreement which would preclude” the IRS from later determining the penalty. Since there would be only two ways to accomplish this—either through an offer in compromise or through a closing agreement—and since neither is realistically available, taxpayers in receipt of service center notices of abatement, especially those thought vulnerable to audit, should by no means put all penalty thoughts behind them.

---

33 As the regulations (Reg. §310.6651-1(c)(1)) instruct.
34 The source for this annoyance is that the taxpayer, even though successful in convincing one level of the IRS on the reasonable cause issue may be called upon to convince another (and higher) level of its position (which is the opposite of taking an adverse finding to the appeals level).
35 Reg. §310.6651-1(c)(1).
36 As does its manual which states: “This responsibility [to assert the delinquency penalty] exists even though a service center...may have determined reasonable cause for delay in filing, or asserted delinquency penalty. The examiner may find that the original determination was based on incomplete facts or on a slanted statement of facts.” Internal Revenue Manual, Audit, §4562.1(2).
38 E.g., Service Bolt & Nut Co. Trust, 78 T.C. 812, 821 (1982), in which abatements of assessments caused the taxpayers to believe that no deficiency notices would be issued (causing taxpayers to cease doing business and to distribute their assets).
39 Estate of Wilbanks, 94 T.C. at 315. LTR 9111005 similarly notes that the IRS “had no binding agreement with the taxpayer concerning the finality of the initial determination of reasonable cause….”
40 An offer in compromise (§7122) is most often used when doubt exists as to collectibility and rarely used in situations involving doubt as to liability. When it is employed in the latter context it is usually after the issuance of a 90-day letter, and the taxpayer’s failure to respond, with the taxpayer being generally required to establish that there would be hardship if the tax were required to be paid. The crux of the matter is, though, doubt as to liability and it was on that basis that the taxpayer in LTR 9111005 made an offer in compromise (rejected) with respect to the delinquency penalty. Closing agreements (§7121), which are intended to enable the taxpayer to finally resolve a controversy, are typically utilized in connection with matters in appeals, are not likely to be used to conclusively resolve a penalty issue which may only be a small part of the taxpayer’s tax picture for that year. See, generally, Saltzman, IRS Practice and Procedure, paras. 9.09, et seq., 15.03[4].