2015/2016 Bonus CPE: Federal Tax Review

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2015/2016 BONUS CPE: FEDERAL TAX REVIEW

Course objectives: The purpose of this course is to provide additional overview and analysis of important regulations and changes in tax law that have affected taxpayers in 2014 and 2015. Topics addressed include: the tax benefit rule, dependency exemptions, taxation of marijuana, COD, basis in repossessed property, like-kind treatment, Social Security, IRAs, registered domestic partners, independent contractors, the Offshore Voluntary Disclosure Program, and much more.

After completing this course, you will be able to:

- Recall the treatment of nonbusiness and business debts and their deductibility
- Determine how to compute basis of a theft loss
- Identify what may be deductible in a marijuana dispensary
- Recall the interplay of IRC §§121 and 1038 when property is repossessed
- Choose what nondepreciable personal property can be exchanged when qualifying for like-kind treatment
- Recall the requirements of a qualified conservation contribution
- Determine how to apply the Adoption Credit for registered domestic partners
- Recall how Notice 2014-7 affects individual care providers
- Identify what can be relied upon as a safe haven when determining a reasonable basis for not treating a worker as an employee

Category: Taxes

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

Level: Basic

Prerequisite: None

Advanced Preparation: None

Expiration Date: November 2016

Table of Contents

Individuals — Income ... **3**
Settlement over disability benefits not excludable ... 3
Sick and vacation time payments includable in income ... 3
Pastors' use of church funds is income ... 4
Tax benefit rule didn't apply to refundable state tax credits ... 6
When alimony isn't alimony ... 6
Certain identity theft protection services provided to victims of data breaches not taxable ... 8
Qui tam award is ordinary income ... 8
Innocent spouse relief denied ... 8
Individuals — Exemptions and deductions ... **11**
No deduction for restitution paid ... 11
Daughter not married under common law ... 11
IRS blunder leads to an otherwise disallowed deduction ... 12
Taxpayer says "Auf Wiedersehen" to educational expense deduction ... 13
Loan to bankrupt company ... 15
No substantiation = no deduction ... 17
Losses ... **19**
Hobby losses ... 19
Incorrectly applied NOL creates interest due ... 23
Theft loss deduction for services ... 24
Casualty losses ... 24
Taxation of marijuana ... **26**
You win some, you lose some ... 26
Cancellation of debt ... **27**
Taxpayer proves "identifiable event": no COD income ... 27
Settlement agreement is not an identifiable event ... 29
No "hardship" exception ... 30
Real estate ... **31**
Intent to develop property results in ordinary income ... 31
Taxpayer must recognize gain upon repossession: no §121 exclusion ... 31
Extraordinary personal services exception to rental activities ... 34
§1031 exchanges ... **35**
What is like-kind? ... 35
Beware of the two-year rule when exchanging with related parties ... 40
Business issues ... **43**
Funding source affects R&D Credit ... 43
Retirement issues ... **45**
60-day waiver granted for honest mistake ... 45

Salary to taxpayer by IRA-owned LLC was prohibited transaction ... 46
Excess contributions to IRAs ... 46
How Social Security benefits are calculated ... 49
Gift issues ... 51
Merger creates taxable gift ... 51
Failure to describe gifts extends SOL ... 52
Estate issues ... 53
Save estate taxes on life insurance by not putting it in the client's name ... 53
Four reasons to recommend life insurance to wealthy clients ... 55
Charitable contributions ... 56
IRS's Exempt Organizations Select Check service ... 56
Charitable contributions made with someone else's money are disallowed ... 57
No charitable contribution deduction for easement when mortgages are not subordinated ... 58
No conservation easement where taxpayer could alter property's boundaries ... 58
Qualified conservation contributions, generally ... 59
Registered domestic partners ... 61
Medicaid waiver payments ... 66
Background ... 66
Guidance — new Q&A ... 66
Worker classification ... 73
IRS's twenty-factor test ... 73
Section 530 safe harbor ... 76
Misclassified workers may file Social Security tax form ... 77
Industry standards: dancers ... 78
IRS practice and procedure ... 80
Returns handed to IRS agent does not constitute filing ... 80
Offshore Voluntary Disclosure Program participation ... 80
Tax protestor representative winds up in Tax Court ... 80
TIGTA: PTINs are not being revoked ... 82
IRS's Dirty Dozen for 2015 ... 85
What's new on the 2015 Form 1040? ... 87
The basics of requesting a letter ruling ... 90

2015/2016 BONUS CPE: FEDERAL TAX REVIEW

INDIVIDUALS — INCOME

SETTLEMENT OVER DISABILITY BENEFITS NOT EXCLUDABLE

A taxpayer who received a settlement in a dispute over disability benefits was not allowed to exclude the amount received from income under IRC §104. (***Ktsanes v. Comm.***, TCS 2014-85)

Facts

James Ktsanes was employed by a community college district, and his employer provided him with coverage under a disability policy paid for at the district's expense. He was diagnosed with Bell's Palsy, which rendered him unable to work.

He applied for and received short-term disability for about four months, after which time his employment with the district ended. He then applied for long-term benefits, but the carrier denied them, holding that he was not totally disabled.

Ktsanes filed suit to obtain the benefits, and he and the carrier eventually came to a settlement for $65,000 paid in a lump sum. The settlement provided that the amount would be reported to the IRS as long-term disability benefits.

Court's conclusion

The taxpayer argued that the payment should be excluded under IRC §104(a)(2) as a payment for physical illness or, in the alternative, under IRC §104(a)(1) as a workers' compensation payment.

On the issue of physical illness, the Tax Court stated that the payment was in settlement of the taxpayer's allegation that the insurance company had violated its contractual obligation. None of the damages were paid on a claim of physical illness or injury.

On the issue of workers' compensation, the court noted that in the taxpayer's state (California), a workers' compensation settlement must be approved by the California Workers' Compensation Appeals Board. The taxpayer admitted that he had not submitted the settlement to that board for approval.

SICK AND VACATION TIME PAYMENTS INCLUDABLE IN INCOME

Cashout payments for unused sick and vacation time were includable in income for a retired police detective. (***Speer v. Comm.*** (2015) 114 TC 14) The taxpayer did not report the payments, arguing that they were received under workers' compensation and that they had accrued while he was on temporary disability leave. However, the payment of these benefits was governed by a collective bargaining agreement, not a workers' compensation act or statute in that nature, as required under IRC §104(a), and were therefore not excludable from income.

Exclusions under IRC §104

Disability exclusion: IRC §104(a)(1)

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

To be excluded, the payments must:

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

Exclusion for injuries or sickness: IRC §104(a)(2)

IRC §104(a)(2) allows a taxpayer to exclude from gross income amounts received for personal injuries. Before 1996, "personal injuries" included nonphysical injuries such as emotional distress, injury to one's reputation, discrimination, wrongful termination, and sexual harassment.

The Small Business Job Protection Act of 1996 changed the law by requiring the damages to be "on account of personal physical injuries or physical illness" effective for damages received after August 20, 1996, making damages for nonphysical injuries and illness taxable.

PASTORS' USE OF CHURCH FUNDS IS INCOME

After attending a conference that marketed a religion-related tax scheme, taxpayers converted their 501(c)(3) nonprofit corporation into a "corporation sole" (discussed below) in an attempt to shield income from taxation. (***Gunkle v. Comm.*** (May 19, 2014) U.S. Court of Appeals, Fifth Circuit, Case No. 13-60245; petition for review denied February 24, 2015)

Note: The promoters of the tax scheme were subsequently enjoined from further promoting their corporation sole program; see "Penalties upheld for corporation sole promoters," below.

The scheme

The taxpayers' rationale for making the change of entity was that their church's tax-exempt status carried a risk of interference from the government and/or a corporate board of directors. With the assistance of the promoters of the corporation sole program, the taxpayers dissolved their existing 501(c)(3) church and formed the new corporation sole church, City of Refuge, as a Nevada entity.

Next, the taxpayers signed a vow of poverty, which City of Refuge accepted. Under the terms of this acceptance, City of Refuge would provide for the taxpayers "all their needs as Apostles and pastors of this church ministry." The taxpayers then deeded their residence to City of Refuge, while continuing to live there rent-free.

During the tax year at issue, the taxpayers performed pastoral functions for City of Refuge and maintained a bank account in City of Refuge's name. Deposits were also made into the City of Refuge account from the taxpayer-husband's military retirement and Social Security disbursements.

Funds from the City of Refuge account were used to pay for the taxpayers' mortgage, utilities, groceries, automobile payments, and other household expenses.

Court's conclusion

The payments from City of Refuge were in exchange for the taxpayers' services as pastors; the payment by City of Refuge for their personal expenses was therefore reportable income. The taxpayers' claims that they were merely receiving the amounts as "agents" of City of Refuge were unsupported and meritless. The taxpayers' vows of poverty did not shield them from taxation on the compensation they received; in fact, they were unable to prove that City of Refuge had any characteristics of a religious order.

Regarding the bank accounts into which the payments were deposited, the taxpayers had unrestricted control over the accounts and clearly enjoyed an economic benefit. While there were others who had signature authority on the accounts, the taxpayers were the only ones who ever issued checks from the accounts.

The taxpayers also lost charitable contribution deductions for amounts that they had donated to several foundations that were not eligible to receive donations. This included lost deductions for amounts they donated to City of Refuge, because the taxpayers did not give up control over these amounts, and they were ultimately used for their own personal benefit.

The taxpayers were also hit with an accuracy-related penalty.

What is a corporation sole?

A corporation sole consists of a single person, while a corporation aggregate typically has several officers and is run by a board of directors. A corporation sole is often used by churches and religious organizations to provide for the orderly transfer of property from the holder of a religious office to his or her successor in that office, not to the officeholder's heirs. For its intended purpose, a corporation sole may own property and enter into contracts, but only for the purposes of the religious entity and not for the individual office holder's personal benefit. A legitimate corporation sole is designed to ensure continuity of ownership of property dedicated to the benefit of a religious organization.

This entity type is often abused; the IRS issued Rev. Rul. 2004-27 in response to an increase in taxpayers using these entities to avoid paying tax and to conceal assets.

Penalties upheld for corporation sole promoters

Taxpayers who were found guilty of promoting an abusive tax shelter using corporation sole entities were collaterally estopped from disputing that they engaged in such activities. (***Gardner v. Comm.*** (August 26, 2015) 145 TC 6; ***U.S. v. Gardner*** (March 24, 2008) U.S. District Court, District of Arizona, Case No. CV05-3073-PCT-EHC) As a result, they were held liable for $47,000 in penalties stemming from 47 acts of promoting the scheme. (See IRC §6700)

A corporation sole is often used legitimately by churches and religious organizations to provide for the orderly transfer of property from the holder of a religious office to his or her successor in that office, not to the officeholder's heirs.

However, corporation soles have been used as tax avoidance schemes where participants claim their income is exempt because it belongs to the corporation sole, which is claimed to be a tax-exempt organization; this was the type of scheme that the taxpayers were promoting.

TAX BENEFIT RULE DIDN'T APPLY TO REFUNDABLE STATE TAX CREDITS

The Tax Court has ruled that a taxpayer must include in income portions of state refundable tax credits to the extent those credits exceeded his state tax liability. (***Maines v. Comm.*** (March 11, 2015) 144 TC 8) The taxpayer claimed that the credits were not taxable income because New York referred to them as overpayments and, accordingly, under the tax benefit rule, this meant that the taxpayer was not required to include them in income.

Background

Under the tax benefit rule, gross income does not include the recovery of taxes deducted in an earlier year to the extent the amount did not reduce the amount of tax in that earlier year. (IRC §111(a))

Facts

The taxpayers were members of LLCs taxed as partnerships. The partnerships were eligible for New York state business credits that they passed through to their partners. The credits were partially refundable. Because the credits exceeded the taxpayers' state income tax liability, the credits led to large refund payments from the state of New York. The state referred to the refundable credits as "overpayments" of state income tax. The taxpayers did not report the refunds on their federal income tax returns.

The taxpayers claimed they took no deduction on their federal tax return in preceding years, and therefore, the "overpayments" should not be included in their income under the tax benefit rule.

Analysis

The Tax Court stated that the state label of the credits as "overpayments" is not controlling for federal tax purposes. The taxpayers, the court said, wanted to bind federal tax law in much the same manner of Abraham Lincoln's famous example: "If New York called a tail a leg, we'd have to conclude that a dog has five legs in New York as a matter of federal law." The court observed that to qualify for the credits, taxpayers must own a business with property in qualified zones and have employees receiving qualified wages.

The court held that the portions of the credits that reduced the taxpayers' state tax liabilities were not taxable income. Excess portions of the credits that were refundable were essentially cash subsidies that were taxable income.

WHEN ALIMONY ISN'T ALIMONY

If all four requirements of IRC §71(b) aren't met, then it's not alimony, no matter the taxpayers' intent. Two recent cases further illustrate the importance of having a clause in the marital settlement agreement (MSA) that specifically states that the liability ends with the death of the payee spouse. (IRC §71(b)(D))

Remember that in cases where alimony payments under the MSA don't meet all four requirements of IRC §71(b) (see box "When is alimony deductible?"), the court will look to state law for interpretation. If state law does not clarify how the payments should be treated, the court will make its own determination.

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Lump-sum payments — Florida

A taxpayer was denied an alimony deduction for a $45,000 payment to his ex-wife. (***Muniz v. Comm.***, TCM 2015-125) The MSA was silent as to whether the taxpayer would have been liable for the $45,000 payment if his ex-wife had died before receiving the payment. The taxpayer argued that it was a "lump-sum alimony" payment, which meets the definition of alimony under Florida law.

Lump-sum alimony under Florida law, however, holds the payor liable for the payment even in the event of the payee spouse's death (Fla. Stat. Ann. §61.08(1)), which means that it fails one of the four requirements of IRC §71(b). Although the lump-sum payment met the other three requirements, because the MSA did not state that the payment terminated with the death of the ex-wife, it was considered a property settlement for federal purposes and was not deductible. (IRC §215)

This conclusion was further supported by an agreement contained in the MSA regarding "bridge-the-gap" alimony payments, where his ex-wife had waived her rights to all other forms of alimony, including "permanent and periodic alimony, lump-sum alimony and/or rehabilitative alimony." (Under Florida law, bridge-the-gap alimony may not exceed two years in duration. (Fla. Stat. Ann. §61.08(5))

State law unclear — Delaware

In a separate case, a taxpayer was not liable for tax on payments from her ex-husband, where the MSA did not specify that the payments cease upon death of the taxpayer. (***Crabtree v. Comm.***, TCM 2015-163) There were other provisions within the MSA that did include such a contingency, and the court noted that had the MSA intended that the death of the taxpayer be a condition that would terminate her ex-husband's obligation to pay, it would have been included in the section providing for alimony.

The court looked to Delaware law for clarification, but found the Delaware statutes to be unclear as applied to the taxpayer's exact situation. The court felt that the presence of the death provision in some clauses of the taxpayer's MSA but not in the one pertaining to alimony pointed to an interpretation that the payments would not cease upon death of the taxpayer. Therefore, the payments were not alimony and not taxable to the ex-wife.

When is alimony deductible?

In order for alimony to be deductible by a payor, all four requirements of IRC §71(b)(1)(A)–(D) must be met:

A. The payment is received by (or on behalf of) a spouse under a divorce or separation instrument;
B. The divorce or separation instrument does not designate the payment as a payment which is not includable in gross income under IRC §71 and not allowable as a deduction under IRC §215;
C. The payee spouse and the payor spouse are not members of the same household at the time such payment is made; and
D. There is no liability to make any such payment for any period after the death of the payee spouse, and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse.

Payments are not alimony if the divorce agreement fixes part of any payment for a child's support in dollar amounts or percentage. Payments that are child support or in lieu of child support are not includable in the recipient's income and not deductible by the payor.

The intent of the taxpayers as to whether a payment is alimony does not determine deductibility. The above tests provide a straightforward, objective manner of making that determination, and all four requirements must be met. (See ***Mehriary v. Comm.***, TCM 2015-126)

CERTAIN IDENTITY THEFT PROTECTION SERVICES PROVIDED TO VICTIMS OF DATA BREACHES NOT TAXABLE

Data breaches and identity theft are becoming all too frequent occurrences — just ask the IRS concerning their recent data breach.

A common response for businesses whose data has been breached is to provide the potential data breach victims with no-cost identity theft protection services such as credit reporting and monitoring services, identity theft insurance policies, and identity restoration services or other similar services.

Not surprisingly, the question has arisen as to whether these identity theft protection services are includable in the individual's gross income and therefore subject to tax.

The IRS did not state that the value of such services is excludable from gross income. Rather it has announced that it "will not assert that":

- Individuals whose personal information may have been compromised in a data breach must include the value of the identity theft protection services in their gross income;
- Employers are required to include the value of the services provided to employees who might be victims of the data breach in the employee's gross income and wages; or
- Businesses are required to report these amounts on information returns (e.g., W-2s or 1099-MISC). (IRS Announcement 2015-22)

In other words, the IRS will not require taxpayers to include these services in their gross income.

Relief is limited

The IRS makes clear that this relief is limited and does not apply to:

- Cash received in lieu of identity protection services;
- Identity protection services received for reasons other than as a result of a data breach, such as identity protection services received in connection with an employee's compensation benefit package; or
- Proceeds received under an identity theft insurance policy.

QUI TAM AWARD IS ORDINARY INCOME

The court of appeals disallowed a taxpayer's reporting of a $7 million *qui tam* award as capital gains because the income was not "gain from the sale or exchange of a capital asset." (***Patrick v. Comm.*** (August 26, 2015) U.S. Court of Appeals, Seventh Circuit, Case No. 14-2190) The award should have been reported as ordinary income, resulting in a tax deficiency of $811,957. The Code defines a capital asset as "property held by a taxpayer"; the taxpayer in this case argued that the information he collected against his former employer was his property. He also argued that his right to a share of the award constitutes a capital asset. The court did not accept either argument.

INNOCENT SPOUSE RELIEF DENIED

A taxpayer was denied innocent spouse relief after the Tax Court determined that he had prior knowledge of the tax avoidance scheme that his wife had become involved in. (***Williams v. Comm.***, TCM 2015-198)

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Background

The taxpayer's wife worked for an attorney who approached her in 1996 regarding a tax avoidance scheme that would allow her to be paid through a corporation that he owned rather than through the normal payroll process; the employer would deposit her pretax pay directly into her bank account, and the taxpayers would not report the salary on their tax returns. On the several occasions that the wife asked the taxpayer if he thought she should participate, he repeatedly said no.

In 1997, the employer again offered the scheme to the taxpayer's wife, and the taxpayer asked the employer directly if the scheme was legal, and the employer indicated that it was. However, the taxpayer did not make any attempt to verify this by obtaining outside advice. Based on this scant advice, the taxpayer and his wife agreed to participate in the scheme.

Between 1997 and 2004, the taxpayer's wife received her salary under this scheme. Someone at the attorney's office prepared the taxpayers' returns, which reported none of the income earned through the scheme. The taxpayer signed these returns.

Ultimately, the attorney was imprisoned for promoting the tax evasion scheme, and the taxpayer's wife faced criminal charges (which she pleaded guilty to) for her participation. In 2006, the taxpayers signed Form 4549, Income Tax Examination Changes, agreeing to $33,541 in tax deficiencies and $25,154 in civil fraud penalties relating to their wages that had been diverted through the attorney's corporation for tax years 2001–2004.

In 2010, the taxpayer filed a request for innocent spouse relief, which was denied.

Relief under §6015(f)

Taxpayers who do not qualify for innocent spouse relief under IRC §6015(b) or §6015(c) may still qualify for relief under IRC §6015(f), which provides relief when it would be inequitable to hold the taxpayer liable for the unpaid tax or deficiency after taking into account all of the facts and circumstances. The procedure for determining relief under IRC §6015(f) is in Rev. Proc. 2013-34, which sets out seven conditions to be eligible for relief. A taxpayer who meets the seven conditions and is no longer married to his or her spouse may receive "streamlined" relief. Streamlined relief does not apply in this case because at the time of the request for relief, the taxpayer and his wife were still married.

The seven conditions under Rev. Proc. 2013-34 are as follows; no one factor controls, and the weight of each factor depends on the facts and circumstances of each case:

1. Marital status;
2. Economic hardship;
3. Legal obligation to federal tax liability;
4. Mental or physical health;
5. Subsequent compliance with federal tax laws;
6. Significant benefit; and
7. Knowledge or reason to know about the deficiency or unpaid liability.

The ruling

Upholding the denial of relief, the court found that the first five factors under Rev. Proc. 2013-34 were neutral and the sixth slightly favored the taxpayer, because the extra income was used to pay household expenses rather than provide the taxpayer with a lavish lifestyle. But the seventh factor weighed heavily against the taxpayer, given that his wife had asked him previously about the scheme, and because he had vetoed the idea the first time they discussed it, they likely would not

have entered into the scheme if not for his subsequent approval. Therefore, not only did he have knowledge of the scheme, he condoned it.

Types of innocent spouse relief

What is generally referred to as "innocent spouse relief" is one of three types:

- **Innocent spouse relief under IRC §6015(b):** This provides relief to one spouse if the other failed to report income, reported it incorrectly, or claimed improper deductions. An innocent spouse is one who:
    - Filed a joint return containing an understatement of tax solely attributable to the other spouse's erroneous item(s) generating the understatement;
    - Establishes he or she had no knowledge, nor reason to know, of the understatement at the time the tax return was signed; and
    - Would be unfairly held liable for the understatement, taking into account all facts and circumstances.
- **Separation of liability relief under IRC §6015(c):** This provides for the allocation of additional tax owed between spouses, with the requesting spouse allocated only the amount for which he or she is responsible. To qualify, the requestor must be:
    - Divorced or legally separated, widowed, or not living in the same household as the other spouse for a 12-month period ending on the date of filing of Form 8857, Request for Innocent Spouse Relief; and
    - Unaware of the item(s) giving rise to the understatement of tax when the return was signed.
- **Equitable relief under IRC §6015(f):** This is the "last resort" provision of the three. To qualify, one must establish that, under all facts and circumstances, it would be unfair to hold him or her liable for a tax understatement or underpayment and:
    - The requesting spouse filed a joint return for the tax year for which he or she seeks relief;
    - Relief is not available to the requesting spouse under IRC §6015(b) or §6015(c);
    - The claim for relief is timely filed;
    - No assets were transferred between the spouses as part of a fraudulent scheme by the spouses;
    - The nonrequesting spouse did not transfer disqualified assets to the requesting spouse;
    - The requesting spouse did not knowingly participate in the filing of a fraudulent joint return; and
    - The income tax liability from which the requesting spouse seeks relief is attributable (either in full or in part) to an item of the nonrequesting spouse or an underpayment resulting from the nonrequesting spouse's income. If the liability is partially attributable to the requesting spouse, then relief can only be considered for the portion attributable to the nonrequesting spouse. However, the IRS will consider granting relief regardless of whether the understatement, deficiency, or underpayment is attributable (in full or in part) to the requesting spouse if an exception applies. Such exceptions include: abuse, nominal ownership, misappropriation of funds, fraud committed by the nonrequesting spouse, and attribution under community property laws.
      (See Rev. Proc. 2013-34)

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INDIVIDUALS — EXEMPTIONS AND DEDUCTIONS

NO DEDUCTION FOR RESTITUTION PAID

A payment a taxpayer made to the U.S., in lieu of proceedings that would result in criminal and/or civil forfeiture for fraud, was nondeductible as a fine or similar penalty. (CCA 201513003) This was true even though the payment was earmarked for restitution to the victims of the fraud.

The taxpayer and the U.S. Department of Justice entered into a deferred prosecution agreement (DPA) which stated that the taxpayer had violated several criminal statutes and provided for a forfeiture payment in lieu of proceedings.

However, IRC §162(f) denies a deduction for "any fine or similar penalty paid to a government for the violation of any law." Also, a fine or similar penalty includes an amount paid in settlement of the taxpayer's actual or potential liability for a civil or criminal fine or penalty. (Treas. Regs. §1.162-21(b)(1)(iii)) Compensatory damages paid to a government do not constitute a fine or penalty. (Treas. Regs. §1.162-21(b)(2))

The taxpayer argued that the regulations do not prohibit it from deducting the forfeiture payment because:

- It had not pleaded guilty or *nolo contendere* in any court proceeding; and
- The forfeiture payment was earmarked for restitution to the victims of the fraud.

The IRS said that the taxpayer's first argument requiring a plea of guilty or *nolo contendere* had no merit because a settlement of the taxpayer's actual or potential liability is included under the provisions of Treas. Regs. §1.162-21(b)(1)(iii). Likewise, the taxpayer's second argument that the forfeited funds would be used to compensate victims had no merit, as the DPA specifically stated that the payment was in lieu of criminal and/or civil forfeiture.

It is the IRS's longstanding position that a monetary forfeiture under the U.S.C. sections that the taxpayer violated, as well as the sections referenced above, is a civil or criminal fine or penalty for purposes of the regulations. Therefore, the money paid in lieu of forfeiture pursuant to the DPA resolves the taxpayer's actual or potential liability for a civil or criminal fine or penalty and is not deductible under IRC §162.

DAUGHTER NOT MARRIED UNDER COMMON LAW

The Tax Court has ruled that a taxpayer was entitled to dependency exemptions for her adult daughter and her grandchild contrary to claims made by the IRS that she wasn't qualified because the daughter was married under common law and had filed a joint return with her "husband." (***Saenz v. Comm.***, TCS 2015-6)

During 2011, the taxpayer supported her daughter and her grandchild who lived with them from January through August. For the remainder of the year, the daughter and grandchild lived with the man the daughter claimed was her common law husband. However, the court found that they did not meet the tests for common law marriage under Texas law.

IRC §152(c) provides that a qualifying child must be, among other things, the taxpayer's child or a descendant of the taxpayer's child. In addition to other requirements which the parties agreed were satisfied, a qualifying child must be an individual who has not filed a joint return with the individual's spouse under IRC §6013 for the same taxable year for which the taxpayer is claiming the qualifying child.

The taxpayer argued that her daughter was not in a valid common law marriage pursuant to the laws of the State of Texas during the year in question and thus was unable to file a joint return for that year. Therefore, IRC §152(c)(1)(E) did not prevent her from claiming her daughter and her granddaughter as qualifying children for purposes of the dependency exemption deductions, the earned income tax credit, and the additional child tax credit on her return.

The taxpayer's grandchild met the requirements under IRC §152(c)(1) to be both her qualifying child and her daughter's qualifying child:

- She was the taxpayer's grandchild and her daughter's daughter;
- Her grandchild had the same principal place of abode as the taxpayer and the daughter for more than one-half of the year;
- Her grandchild was a minor during the tax year;
- She did not provide more than one-half of her own support; and
- She was not married and did not file a joint return.
  (IRC §152(c)(1)(A)–(E))

In these situations, the tie-breaker rule under section 152(c)(4)(A) provides that if an individual may be claimed as a qualifying child by two or more taxpayers for a taxable year, such individual shall be treated as the qualifying child of the taxpayer who is the parent of the individual. However, IRC §152(b)(1) provides that if an individual is a dependent of a taxpayer for any taxable year, that individual shall be treated as having no dependents for that year.

IRS BLUNDER LEADS TO AN OTHERWISE DISALLOWED DEDUCTION

A taxpayer benefitted from an IRS oversight that ultimately allowed him to take a dependency exemption for his common law wife. (***Shimanek v. Comm.***, TCM 2015-165)

The taxpayer claimed zero wages for the tax year at issue, arguing that only federal employees receive taxable wages under IRC §§3401(a) and 3121(e). He also claimed a dependent exemption for his common law wife. In support of this exemption, the taxpayer submitted a self-created "Affidavit of Dependency" signed by his wife that stated that she lived with the taxpayer for all of the years at issue, she had less than $3,500 in wages, and the taxpayer provided more than half of her support.

However, for unexplained reasons, the IRS waived its objections to the affidavit being entered into evidence, and as such, the taxpayer met the requirement to shift the burden of proof to the IRS. Under IRC §7491(a), the burden shifts to the Commissioner when a taxpayer introduces credible evidence with respect to the issue being tried.

Unfortunately, because the IRS had no evidence to refute the affidavit, the Tax Court allowed the deduction. The court did shoot down the taxpayer's frivolous tax-protester–type claim that he had no taxable wages, so there was at least a little justice in this case.

The taxpayer in this case resided in Hawaii; see the discussion below for which states allow some form of common law marriage. (Hawaii doesn't.)

Common law marriage, generally

A common misconception is that if a couple lives together for a certain length of time, they are "common law married." This is false. Although there are some states that recognize common law marriage, none of them has a set period of time after which the cohabiting couple is automatically considered married. Many look to intent or the fact that the couple poses as married to determine common law marriage.

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California, for example, does not recognize common law marriage. Therefore, without marriage, the cohabiting couple is single for tax and legal purposes.

If your client lives in a state that recognizes common law marriage, have them review with an attorney whether they are legally married.

States that recognize some form of common law marriage include:

- Alabama;
- Colorado;
- Georgia (if created before January 1, 1997);
- Idaho (if created before January 1, 1996);
- Iowa;
- Kansas;
- Montana;
- New Hampshire (for probate purposes only);
- Ohio (if created before October 10, 1991);
- Oklahoma (Oklahoma's laws and court decisions may be in conflict about whether common law marriages will be recognized if formed in that state after November 1, 1998, until January 1, 2010, when the state stopped recognizing common law marriages. However, no reference to a ban exists in any statutes);
- Pennsylvania (if created before September 17, 2003; however, there is uncertainty about the validity of common law marriages entered into after September 17, 2003, and on or before January 1, 2005, when the state stopped recognizing them altogether);
- Rhode Island;
- South Carolina;
- Texas;
- Utah (only if validated by a court or administrative order); and
- Washington, D.C.

Note: There is no such thing as "common law divorce." Only the contract of the marriage is irregular; everything else about the marriage is perfectly regular, meaning that people who marry per the old common law tradition must petition the appropriate court in their state for a dissolution of marriage.

For a general discussion of common law marriage in the United States, go to:

Website
http://en.wikipedia.org/wiki/Common-law_marriage_in_the_United_States

TAXPAYER SAYS "AUF WIEDERSEHEN" TO EDUCATIONAL EXPENSE DEDUCTION

A taxpayer was denied educational expense deductions for 2010 and 2011, during which he was pursuing his law degree. (***O'Connor v. Comm.***, TCM 2015-155)

The process started in 2007, when the taxpayer (a U.S. citizen) became licensed to practice law in Germany. In 2009, while living in Salt Lake City, he began a law program at the University of San Diego, received his J.D. in 2012, and sat for the bar exam in New York in 2014.

The taxpayer was not employed during the tax years at issue because he was pursuing his education. However, he was involved in the management of a multimillion dollar residential

building project and was also involved with a qui tam (whistleblower) legal action. But he did not receive a W-2 or a 1099 for these tax years.

On his 2010 and 2011 returns, the taxpayer reported business expenses including meal and travel expenses related to his commute between Salt Lake City and San Diego while completing his degree, plus other educational expenses related to his studies.

Deductible education expenses

Education expenses may be deducted as an ordinary and necessary business expense if the education:

- Maintains or improves skills required by the individual's employment; or
- Meets the requirements of the individual's employer or the law, as a condition of employment. (Treas. Regs. §1.162-5(a))

Education expenses that are not deductible include education that:

- Is required to meet the "minimum educational requirements" in the taxpayer's employment or other trade or business; and
- Qualifies the taxpayer for a new trade or business, no matter if the taxpayer actually obtains employment in the new trade or business.
  (Treas. Regs. §1.162-5(b); ***Diaz v. Comm.*** (1978) 70 TC 1067)

In order to be deductible, the taxpayer must be established in the trade or business to which the education relates at the time the expenses are incurred. Also, the expense must be "directly and proximately related to the skills required in his trade or business." (***Boser v. Comm.*** (1981) 77 TC 1124)

A matter of timing

The taxpayer argued that he was not entering into a new trade or business because New York, where he took the bar exam in 2014, allowed foreign-trained lawyers to sit for the bar exam even if they had not completed a legal education program in the U.S. Therefore, for the years at issue, he had already met the minimum requirements for the legal profession.

The IRS argued that the facts of this case were similar to that of ***Horodysky***, where a taxpayer was denied educational expense deductions for law courses taken in the U.S., even though he had been a practicing attorney in his native Poland. (***Horodysky v. Comm.*** (1970) 54 TC 490) That taxpayer had moved to Ohio and worked odd jobs for a number of years until he was able to go back to school to take the courses necessary to sit for the bar exam in Ohio. The ***Horodysky*** court upheld the IRS's denial of the deductions, stating that the employment status a taxpayer is seeking to maintain through education "had to exist at the time the educational expense in question was incurred." Because the taxpayer was working as a bricklayer while he attended school, his legal education had nothing to do with his then-current employment status.

The court's findings

The court noted that it was true that the taxpayer had met the minimum requirements of the legal profession … for Germany. On this point, the taxpayer would need to prove that the program he completed in Germany was equivalent to a program in the U.S., as approved by the American Bar Association. He would also need to prove that German law is based on principles of English law, as is the law in the U.S. The taxpayer did not have evidence of this, and therefore the court concluded that for 2010 and 2011, the taxpayer had not established himself in the legal profession in the U.S.

Regarding his work with the residential building project and the *qui tam* lawsuit, the court was not convinced that there was a connection between these activities and his legal education. This

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meant that the educational expenses were incurred in connection with entering into a new trade or business and were therefore not deductible.

LOAN TO BANKRUPT COMPANY

A taxpayer was denied a business bad debt deduction for an unpaid loan he made to a construction company. (***Cooper v. Comm.***, TCM 2015-191) The taxpayer was not in the lending business, nor did he prove that the debt was worthless in the year he claimed the loss.

Background

The taxpayer was a full-time executive who also ran several side businesses, including a car wash and a pheasant farm. He often lent money to friends and acquaintances who otherwise would not likely be able to secure a loan; he charged interest of up to 40% in some cases.

The taxpayer claimed to have made at least 14 loans between 2006 and 2010, although he only had promissory notes for five of them. He didn't perform the due diligence that would be customarily performed by someone in the business of lending; he did not perform credit checks or verification of collateral, he did not collect information on the loan recipients through a loan application, and he did not maintain contemporaneous, complete records.

The taxpayer testified that he made loans to individuals "based on their character and whether or not I believe that they have the ability and the willingness to repay. I really follow this motto. You can't make an immoral man moral with a contract or the vice vers[a] is also true."

The time the taxpayer claimed he spent each year on lending activities was between 150 and 200 hours.

The loan

In 2006, the taxpayer loaned $750,000 to Wolper Construction. The promissory note showed a principal amount of $750,000, a maturity date of September 29, 2006, and a collateral guaranty in the form of a deed of trust on real property (although no lien was ever recorded).

The loan was subsequently extended, and a second promissory note was signed, but Wolper Construction didn't pay it when it came due. A little over a year later, on June 23, 2008, Wolper Construction filed for bankruptcy, and the taxpayer didn't file a proof of claim against the bankruptcy estate. The taxpayer continued in 2009 to report the note as an asset. The bankruptcy proceedings were closed in August 2013.

The taxpayer didn't report the Wolper Construction loan on his 2008 return, but in 2010 filed an amended return for 2008 claiming a $750,000 business bad debt deduction, which the IRS denied. The taxpayer appealed, arguing that he was in the business of lending and that the loan was therefore fully deductible as a business loan.

Business of lending

While the taxpayer was in the practice of providing loans to people, there are facts and circumstances that the court will look to in order to determine if a taxpayer's lending activities are so extensive and continuous that they reach the status of a separate business activity, such as:

- The number of loans made;
- The time period over which the loans are made;
- The adequacy and nature of the taxpayer's records;
- Whether the loan activities are kept separate from the taxpayer's other activities;

- Whether the taxpayer sought out the lending business;
- The amount of time and effort the taxpayer expended in the lending activity;
- Whether the taxpayer used normal money-lending methods and practices;
- Whether the activity was carried on in a businesslike manner (using proper loan forms, keeping business books, etc.); and
- The relationship between the lender and the debtors.
  (***Scallen v. Comm.***, TCM 2002-294; ***Serot v. Comm***., TCM 1994-532; ***Zivnuska v. Comm.*** (1959) 33 TC 238)

The court concluded that Mr. Cooper was not in the business of lending. The Court found that a number of factors indicated that lending wasn't a significant activity for him, including:

- The amount of time devoted to the activity (the taxpayer's estimate of 150–200 hours per year would have him spending upwards of 50 hours per loan, despite performing virtually no due diligence);
- The fact that he worked full-time in another business during the years at issue;
- The fact that he lent funds to friends and acquaintances;
- The lack of business formalities;
- The fact that he didn't hold himself out publicly as being in the lending business; and
- His inadequate recordkeeping.

Accordingly, he couldn't deduct the loan as a business loan.

Nonbusiness bad debt deduction

Under IRC §166, a taxpayer can claim a short-term capital loss for the year in which a nonbusiness debt becomes wholly worthless. To be entitled to a deduction, the taxpayer must show a bona fide debt based on a debtor-creditor relationship. (Treas. Regs. §1.166-1(c))

Nonbusiness debts are defined as debts other than "(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or (B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business." (IRC §166(d)(2)) Taxpayers must treat nonbusiness bad debts as losses from the sale or exchange of a short-term capital asset and can deduct the debt only for the year in which the debt becomes wholly worthless. (IRC §§166(d)(1)(B), 1211(b), 1212(b); Treas. Regs. §1.166-5(a)(2))

However, business bad debts give rise to deductions that can be offset against ordinary income. (IRC §166(a)) Whether a debt is a business or nonbusiness debt is a question of fact, and taxpayers must show that the bad debt loss is 'proximately related' to the conduct of trade or business, or that the debt was created in the course of trade or business. (Treas. Regs. §1.166-5(b); ***Rollins v. Comm.*** (1960) 276 F.2d 368)

The court found that, for purposes of a nonbusiness bad debt deduction, the Wolper Construction loan wasn't wholly worthless in either of the years at issue. Mr. Cooper didn't establish that he had reasonable grounds to abandon any hope of recovery in 2008 — and his actions actually indicate that he thought otherwise, including his listing of the loan as an asset and his failure to report the loan as worthless when he initially filed the 2008 return. The evidence examined by the court otherwise failed to establish that the debt was worthless in 2008 or 2009. The fact that Wolper Construction had filed for bankruptcy was insufficient to establish worthlessness.

Worthlessness of debt

A deduction is allowed for a worthless debt for the tax year in which it becomes wholly worthless. (IRC §166)

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Whether a debt is worthless is a question of fact, which must be determined in the light of all the surrounding circumstances. The value of the collateral securing the debt, if any, and the debtor's financial condition must be considered. (Treas. Regs. §1.166-2(a)) The decision to write-off the debt can't be based on the taxpayer's subjective opinion that the debt is worthless, and not on a consideration of the debtor's assets and debts. The taxpayer must be able to prove the events that lead to the reasonable belief that there was no hope of recovery of the amount in question.

In this case, the taxpayer did not prove that he had grounds for belief that he would not recover the debt in 2008. In fact, until 2009, he still had the note listed as an asset, and did not amend the 2008 return to claim the bad debt until 2010. While the taxpayer claimed he sent a Form 1099-C to Wolper Construction, there was no evidence of this. Therefore, the taxpayer did not prove that the debt was wholly worthless in 2008 or 2009.

NO SUBSTANTIATION = NO DEDUCTION

A taxpayer who was a registered lobbyist was denied travel and entertainment expense deductions when he was unable to reconstruct his records after losing the originals in a flood and a computer crash. (***Young v. Comm.***, TCM 2015-189)

The IRS argued that the taxpayer's testimony and cooperation were spotty and that he did not produce sufficient secondary evidence to support the lost records for 2008 and 2009, the years at issue. The taxpayer had provided as secondary evidence one receipt, one highlighted bank statement, one month's worth of copies of checks, and two years' worth of highlighted credit card statements. These items were not accompanied by any explanation of the business purpose of the expenses.

The court conditionally upheld accuracy-related penalties, stating that the penalties would apply so long as understatements for each year exceeded the greater of:

- 10% of tax required to be shown on the return; or
- $5,000.

Substantiation requirements

IRC §274 disallows a deduction for any item that constitutes entertainment, amusement, or recreation, unless the taxpayer can prove that the item is directly related to the active conduct of the taxpayer's trade or business. To prove such a connection, the regulations under IRC §274(d) require substantiation of the following items:

- **Amount:**
  - **Expenditures:** The amount of each separate expenditure with respect to an item of listed property, such as the cost of acquisition, the cost of capital improvements, lease payments, the cost of maintenance and repairs, or other expenditures; and
  - **Uses:** The amount of each business/investment use (as defined in Treas. Regs. §1.280F-6T(d)(3)) based on the appropriate measure (i.e., mileage for automobiles and time for other listed property), and the total use of the listed property for the taxable period.
- **Time:** Date of the expenditure or use with respect to listed property; and
- **Business or investment purpose and relationship:** The business purpose for an expenditure or use with respect to any listed property (see Treas. Regs. §1.274-5T(c)(6)), and who participated in the expenditure.
  (Treas. Regs. §1.274-5T(b)(6))

The strict substantiation requirements of IRC §274(d) and the related regulations overrule the ***Cohan*** rule (see below).

Adequate records

In order to meet the "adequate records" requirements of IRC §274, the taxpayer must be able to produce:

- An account book, diary, log, statement of expense, trip sheets, or similar record. It is imperative that the log be contemporaneous to the time of the expense (Treas. Regs. §1.274-5T(c)(2)(ii)); and
- Documentary evidence, such as receipts or paid bills. (Treas. Regs. §1.274-5(c)(2)(iii))

These items *in combination* are sufficient to establish the expenditure.

The *Cohan* rule

Taxpayers who fall short of the substantiation requirements may get some help from a 1930 case involving George Cohan. (***Cohan v. Commissioner*** (1930) 39 F.2d 540) As a producer and writer of plays, Cohan necessarily did a lot of entertaining for actors, employees, and dramatic critics. He estimated that in 1921 and 1922, he spent $55,000 on various entertainment and travel expenses. (That equates to $732,255.87 in 2015.)

The IRS disallowed his deductions in full because he didn't have the substantiation to back up how much he had spent and on what. But the Court of Appeals felt that total refusal wasn't justified. He had spent a sum of money on an allowable expense, and so he should be able to deduct something — the court noted that it was inconsistent to disallow any deduction at all when clearly he had incurred an expense, even though the amount wasn't able to be exactly determined beyond Cohan's own recollections and approximations.

The court felt that the IRS could concede to at least an estimate of what the expenses were: "Absolute certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses on the taxpayer, whose inexactitude is of his own making." (Here, "the Board" refers to the Board of Tax Appeals — now known as the U.S. Tax Court — which was Cohan's first stop. The Board upheld the IRS, after which Cohan took the case to the Second Circuit Court of Appeals.)

The ***Cohan*** rule recognizes that in the course of business, in order to make money, taxpayers have to spend money on deductible expenses. This can be assumed to be true even if the taxpayer doesn't have the records to back up the exact amount.

Provided the taxpayer is able to give at least some credible evidence that the expenses were legitimate, the amount of the deduction can be reasonably estimated. In the absence of "adequate records" (see below), the taxpayer can provide:

- Testimony;
- Canceled checks;
- Notes in an appointment book; or
- Other records that can reconstruct the expenses.

Based on what records exist, the taxpayer may receive at least part of the deduction. It is up to the discretion of the court or the IRS auditor to determine how credible the taxpayer's testimony or existing records are.

Nowadays, when taxpayers find themselves in court fighting for deductions for which they have no substantiation, the court may invoke the Cohan rule and allow a portion of the expenses. However, the court's mantra is always that the estimation "will bear heavily against the taxpayer, whose inexactitude is of his own making," and the amount allowed is up to the conservative discretion of the court.

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REVIEW QUESTIONS

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

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

1. Which of the following statements is true regarding a corporation sole?

   a) A corporation sole has a board of directors.
   b) A corporation sole is used to transfer property from a religious office holder to his successor and heirs.
   c) A corporation sole may not own property.
   d) A corporation sole must benefit a religious organization.

2. As outlined in ***Maines v. Comm.***, which of the following is correct as it pertains to the tax benefit rule?

   a) Under the tax benefit rule, gross income must include the recovery of taxes deducted in a prior year.
   b) The state labeled the refundable credits due to the taxpayers as overpayments of state income tax, which the taxpayers did not include in their income based on the tax benefit rule.
   c) The state's classifying of credits as overpayments was controlling for federal tax purposes.
   d) The court believed that the allocation of the credit that reduced the taxpayers' state tax obligations was taxable income.

3. For innocent spouse relief, which of the following correctly applies?

   a) An innocent spouse under IRC §6015(b) must have filed a joint return that contains an understatement that may or may not be attributable to the other spouse.
   b) Separation of liability relief under IRC §6015(c) does not require that spouses be separated or living apart.
   c) Under separation of liability relief, the requesting spouse may have had some suspicion or knowledge of the understatement of tax when the return was signed.
   d) For equitable relief under IRC §6015(f), there should have been no transfer of assets between the spouses.

4. Factors which correctly relate to qualifying children for dependency exemptions are detailed in which choice below?
    a) If an individual is a dependent of a taxpayer for a taxable year, then that individual is considered as having no dependents for that taxable year.
    b) A qualifying child does not have to be the taxpayer's child or a descendant.
    c) A qualifying child may have filed a joint return with the individual's spouse under IRC §6013 for the taxable year.
    d) If a qualifying child is claimed by two or more taxpayers during a taxable year, he or she is the qualifying child of the individual with the highest income.
5. Which of the following statements is correct regarding the deductibility of education expenses?
    a) Education expenses that qualify the taxpayer for a new business are deductible.
    b) Education expenses are not deductible if they are a condition of employment.
    c) The taxpayer is required to be established in the business that relates to the education sought at the time the costs are incurred.
    d) If education expenses are necessary to meet the minimum educational requirements of employment, then they are deductible.
6. Substantiation requirements under IRC §274 are correctly detailed in which of the following?
    a) It is usually sufficient to have receipts and paid bills.
    b) An account book or diary does not necessarily have to be contemporaneous to the time the expense is incurred as long as receipts confirm the expense.
    c) The business purpose of each expenditure must be documented, as well as who participated in the expenditure.
    d) The strict requirements for substantiation do not overrule the ***Cohan*** rule.

SOLUTIONS TO REVIEW QUESTIONS

1. Which of the following statements is true regarding a corporation sole? **(Page 5)**

   a) Incorrect – A corporation sole has only one person in the corporation.
   b) Incorrect – The corporation sole can transfer property from the holder of a religious office to his successors, but not to his personal heirs.
   c) Incorrect – The corporation may own property and be a party to a contract for the benefit of the religious entity that it represents.
   d) Correct – This is the purpose of the corporation sole: It is created to safeguard the continuance of property ownership for the benefit of a religious organization.

2. As outlined in ***Maines v. Comm.***, which of the following is correct as it pertains to the tax benefit rule? **(Page 6)**

   a) Incorrect – Under this rule, gross income does not include the recovery of taxes from a prior year unless the recovery of the prior year expense results in a tax benefit.
   b) Correct – The taxpayers claimed that the credits weren't taxable because the state referred to them as overpayments, and as such, per the tax benefit rule, they did not have to be included in income.
   c) Incorrect – The state's classification of credits as overpayments was not controlling under federal taxation regulations.
   d) Incorrect – The court held that whatever part of the credit that reduced the state tax due was not taxable income, but anything in excess that was refundable to the taxpayers was essentially a cash subsidy that was taxable.

3. For innocent spouse relief, which of the following correctly applies? **(Page 10)**

   a) Incorrect – The understatement must be as a result of the other spouse's inaccurate items for which the innocent spouse had no knowledge at the time the tax return was signed.
   b) Incorrect – The spouses must be divorced or legally separated for the 12-month period prior to the filing of the form for innocent spouse relief.
   c) Incorrect – The requesting spouse must be completely unaware of the reason for the understatement of tax.
   d) Correct – The transfer of assets could imply that the couple is committing fraud in an attempt to underpay their tax liability.

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4. Factors which correctly relate to qualifying children for dependency exemptions are detailed in which choice below? **(Page 12)**

    a) Correct – This is true under IRC §152(b)(1).
    b) Incorrect – Under IRC §152(c), a qualifying child must be the taxpayer's child or a descendent of the taxpayer's child.
    c) Incorrect – The qualifying child must not have filed a joint return for the taxable year for which the taxpayer is claiming that qualified child.
    d) Incorrect – First, the individual is treated as the qualifying child of the parent. Only if this does not apply is the individual considered the qualifying child of the taxpayer with the highest AGI.

5. Which of the following statements is correct regarding the deductibility of education expenses? **(Page 14)**

    a) Incorrect – These are not deductible expenses. The expenses are supposed to be "directly and proximately" associated with the necessary skills for a taxpayer's trade.
    b) Incorrect – Those expenses that are incurred to meet the requirements of the employer or the law are considered deductible as ordinary and necessary expenses.
    c) Correct – This is true. In the *Horodysky* case, the court stated that the specific taxpayer had to be involved in the employment that pertained to his education when the education expenses were incurred.
    d) Incorrect – Expenses to meet minimum education requirements are not deductible.

6. Substantiation requirements under IRC §274 are correctly detailed in which of the following? **(Page 18)**

    a) Incorrect- Receipts must be presented in combination with an account book or diary. Receipts alone would not be considered sufficient documentation.
    b) Incorrect – A contemporaneous log is considered a necessity, as anything reconstructed at a later date would not necessarily be relied upon as accurate.
    c) Correct – This is true under Treas. Regs. §1.274-5(T). This documentation, in combination with the date and amount of the expenditure are necessary for any deduction under IRC § 274.
    d) Incorrect – The requirements do overrule the ***Cohan*** rule, which can be invoked but which would at best only allow for part of the deduction.

LOSSES

HOBBY LOSSES

In many hobby loss cases, the taxpayer attempts to make a pastime look like a business so as to take advantage of the deductions. However, a "hobby" doesn't always have to be something fun. In the ***Pouemi*** case, the taxpayer was denied over $30,000 in Schedule C business expenses for his "side business" in real estate. (***Pouemi v. Comm.***, TCM 2015-161)

The taxpayer worked as a service technician for Verizon and did real estate work in the evenings and on weekends, doing research for potential clients, reviewing real estate listings, and driving potential clients in his car to view properties. He claimed he regularly showed houses and apartments to potential clients and entertained them.

For 2007 through 2009, the taxpayer only had one sale that earned him a commission. He had no listings in 2008 or 2009. He reported the following Schedule C income and losses for those years:

	Income reported	Expenses reported
2007	$9,457	$33,907
2008	$0	$43,427
2008	$0	$30,362

For 2009, the tax year at issue, the taxpayer's expenses included the following items:

- Car and truck expenses: $15,244;
- Parking and tolls: $1,288;
- Tools: $3,552;
- Cell phone: $1,801;
- Text messaging: $341;
- Internet access: $748;
- Wireless e-mail: $220;
- Computer maintenance: $420;
- Office expenses: $630;
- Staff meetings: $120;
- Payroll processing: $120;
- Bottled water for clients: $461;
- "Personal marketing": $850; and
- Nineteen additional categories of "other expenses."

At trial, the taxpayer did not produce credible substantiation for any of the expenses. He did have a mileage log (which was created after the IRS audit was initiated) that claimed he had driven 28,433 business miles in 2009. He also did not provide percentages of business versus personal use for many items, including his cell phone, Internet charges, and text and e-mail expenses. The taxpayer did not provide any explanation as to what kind of "tools" he needed for his real estate business, nor what "personal marketing" entailed.

The ruling

When examining the nine factors (see below) to determine if the activity was engaged in for profit, the court found that many factors in this case were neutral, and none weighed in favor of the taxpayer:

- The taxpayer did not carry on the real estate activity in a businesslike manner. He did not keep books or records, and had no business bank account. He did not have a business plan, and he did not change his methods of carrying out the activity after two years with zero income generated;
- The taxpayer did not demonstrate expertise in real estate and he did not devote meaningful time to the activity. He made only one sale between 2007 and 2009, and his claim that he spent at least 30 hours per week on real estate was not credible;
- The taxpayer never earned a profit from the activity and he claimed deductions that were vastly out of proportion with what little income he earned. Such continuous and substantial losses for a person in the taxpayer's financial situation was not indicative of being engaged in the activity for profit; and
- The taxpayer had a full-time job at Verizon for 2007, 2008, and most of 2009. The losses he claimed offset most of his income and generated large refunds for the tax years at issue. The court determined that the taxpayer was using the real estate expenses as a vehicle to offset his salary.

Nine factors

Taxpayers are allowed deductions for ordinary and necessary expenses incurred in the course of a trade or business. (IRC §162(a)) Under the "hobby loss rules," however, taxpayers must show that they have engaged in the activity with an objective of making a profit in order to be entitled to such deductions. (IRC §183(a)) Nine factors are taken into consideration in determining whether a taxpayer has a profit motive. (Treas. Regs. §1.183-2(b)) The list is nonexhaustive, and the courts are free to give varying weights to different factors in accordance with the facts and circumstances of each case:

1. **Businesslike manner of carrying on the activity:** Does the taxpayer carry on the activity in a businesslike manner and maintain complete and accurate books and records? Is the activity carried on in a manner substantially similar to other activities of the same nature that are profitable? Did the taxpayer change operating methods, adopt new techniques, or abandon unprofitable methods in a manner consistent with an intent to improve profitability?
2. **Taxpayer's expertise or that of his/her advisors:** Did the taxpayer prepare for the activity by conducting a study of its accepted business, economic, and scientific practices, or consult with someone who is an expert in the field?
3. **Time and effort expended:** Does the taxpayer devote much of his or her personal time and effort to carrying on the activity, particularly if the activity does not have substantial personal or recreational aspects?
4. **Expectation that assets used in the activity may appreciate in value:** Does the taxpayer expect that assets used in the activity will appreciate in value? The term "profit" encompasses appreciation in the value of assets, such as land used in the activity.
5. **Success in similar or dissimilar activities:** Has the taxpayer engaged in similar activities in the past and converted them from unprofitable to profitable enterprises?
6. **History of income or loss:** Has the taxpayer sustained several years of losses from the activity? A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. However, where losses continue to be sustained beyond this period, such continued losses, if not explainable as due to customary business risks or reverses, may indicate that the activity is not engaged

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in for profit. Ultimately, a taxpayer must demonstrate an ability to make a profit in the long-term to offset any startup losses. (***Bessenyey v. Comm.*** (1965) 45 TC 261, 274, aff'd. (1967) 379 F.2d 252, cert. denied 389 U.S. 931)

7. **Amount of occasional profits:** If the taxpayer has had net profits, how do they compare to the amounts of losses? The amount of profits in relation to the amount of losses, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent. An opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated.
8. **Financial status of the taxpayer:** Does the taxpayer have substantial income from sources other than the activity, particularly if the losses from the activity generate substantial tax benefits? If so, this may indicate that the activity is not engaged in for profit especially if there are personal or recreational elements involved.
9. **Elements of personal pleasure or recreation:** Does the taxpayer have personal motives in carrying on the activity, especially where there are recreational or personal elements involved? If so, this may indicate lack of a profit motive.

Suspicious activities?

According to the IRS's Audit Technique Guide, certain activities will draw IRS scrutiny as activities not engaged in for profit:

- Airplane charter
- Artists
- Auto racing
- Bowling
- Craft sales
- Direct sales (e.g., Amway)
- Dog breeding
- Entertainers
- Farming
- Fishing
- Gambling
- Horse breeding
- Horse racing
- Motocross racing
- Photography
- Rentals
- Stamp collecting
- Writing
- Yacht charter

(See www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/IRC-183-Activities-Not-Engaged-in-For-Profit-ATG#chapter01_04)

Engaged in for profit

IRC §183(d) provides a presumption that an activity is engaged in for profit if the activity is profitable for three years of a consecutive five-year period (or two years of a consecutive seven-year period for activities that consist of breeding, showing, training, or racing horses).

This presumption rule applies only after an activity incurs a third profitable (or second) profitable year within a five-year (or seven-year) presumption period that begins with the first profitable year.

Example of an activity engaged in for profit

Johnny has the following profits and losses in his car racing activity:

Year	Profit/loss	Engaged in for profit?
2008	(30,000)	No
2009	5,000	No
2010	(60,000)	No
2011	2,000	No
2012	5,000	Yes
2013	(70,000)	Yes
2014	3,000	Yes
2015	(63,000)	Yes

The first five-year presumption period begins with the first profit year of 2009, but the benefit of the presumption does not begin until the third profit year, which is 2012. The presumption is not available for 2009 through 2011 because it does not apply until the third profit year. The presumption is available during the first presumption period only in 2012 and 2013.

The second five-year presumption period begins with the 2011 profit year. It runs through 2015. The presumption applies to the third profit year of 2014 and will be of benefit to Johnny for 2014 and 2015.

If the taxpayer meets the presumption, the IRS can still argue that the activity is not engaged in for profit; however, the burden of proof shifts to the IRS.

Three strikes and you're out?

It is a common misconception that if an individual reports three or more years of losses from an activity, the tax law automatically assumes that the activity is not engaged in for profit.

Rather, the law states that if the taxpayer has a net profit from the activity for three or more years during a period of five consecutive years (or two years out of seven for an activity involving horses), then it will be presumed that the activity is engaged in for profit unless the IRS proves to the contrary. (IRC §183(d)) This section should not be read in the reverse, i.e., that more than two years of losses in a five-year period results in an automatic finding that the activity is not engaged in for profit.

A taxpayer may make an election to postpone the determination of this presumption until returns for all five years (or seven years for activities involving horses) have been filed. (IRC §183(e)) For example, if a taxpayer has losses during the first two years of starting the activity, expects that the next three years will show net profits, and the IRS is auditing the first two years' returns, he or she may wish to make the election to postpone the determination until after the end of the fourth consecutive tax year in which the taxpayer engaged in the activity.

Such an election must be made within three years of the due date (excluding extensions) of the return for the first year in which the taxpayer engages in the activity, but not later than 60 days after the IRS issues a notice that it intends to disallow the loss. (Temp. Treas. Regs. §12.9(c))

The election is made by filing Form 5213, Election to Postpone Determination as To Whether the Presumption Applies That an Activity is Engaged in for Profit, with the IRS. Making the election extends the statute of limitations for assessment of the tax that would result from disallowing the

losses. It is extended until two years after the due date for filing the return (not including extensions) for the fifth year of the activity (seventh year for activities involving horses). (IRC §183(e)(4)) Due to the extension of the statute of limitations, many practitioners advise against making this election.

If IRS disallows the loss

If the IRS issues an audit report that disallows your client's Schedule C loss, and if you have analyzed the nine factors and determined that your client has a reasonable chance of prevailing on this issue, then you should advise the client to appeal.

After evaluating the facts and law, the appeals officer will formulate an opinion as to what the likely outcome will be in the event of litigation. (Treas. Regs. §601.106(f)(2) states, "Appeals will ordinarily give serious consideration to an offer to settle a tax controversy on a basis which fairly reflects the relative merits of the opposing views in light of the hazards which would exist if the case were litigated.") Although this may be an "all or nothing" issue in court, IRS appeals officers have authority to resolve the issue by entering into a "mutual concession settlement" in which part of the loss is allowed. (Treas. Regs. §601.106(f)(2)) This midpoint settlement reflects the relative merits of both the taxpayer's and the IRS's case.

INCORRECTLY APPLIED NOL CREATES INTEREST DUE

Taxpayers were denied abatement of interest that accrued because the taxpayers failed to properly carry back their NOL before carrying it forward. (***Larkin v. Comm.*** (September 15, 2015) U.S. Court of Appeals, Eleventh Circuit, Case No. 14-15812) Under IRC §172(b)(3), taxpayers are required to make an election to waive the two-year carryback period; the election must be made on the timely return for the year of the NOL.

No carryback waiver

The taxpayers incurred an NOL in 2005, but waited until their 2006 return to claim it. They did not carry back the NOL (nor did they make the election to waive the carryback), because they anticipated receiving substantial income in future tax years.

When 2008 arrived and they did not receive this expected income, they amended their 2003 return, which generated an overpayment of $206,311. They also amended their 2006 return (the year they first claimed the NOL), generating an underpayment of $76,400. The taxpayers instructed the IRS to apply the overpayment to the 2006 liability.

However, the IRS instead refunded the 2003 overpayment and assessed interest on the 2006 liability starting from the date that the 2006 payment would have been due.

Application of overpayments

The court noted that while a taxpayer may request that a prior-year overpayment be applied to a subsequent year, the IRS may not allow it: "… a taxpayer can only 'designate the application of overpayments … to requesting a credit for the succeeding tax year, and even that request can be refused by the IRS.'" [emphasis added] (See ***U.S. v. Ryan*** (September 26, 1995) 64 F3d 1516) The court determined that the taxpayers could only have applied the 2003 overpayment to 2004, not 2006 as they requested.

Therefore, the court upheld the IRS's refusal to abate interest because no IRS error or delay caused the additional interest. The interest was charged because the taxpayers by their own mistake failed to properly elect to waive the carryback requirement, which led to an amended return reporting an unpaid, overdue tax liability in the carryover year.

THEFT LOSS DEDUCTION FOR SERVICES

A taxpayer was denied a theft loss deduction for amounts owed to him for services performed, but which were never paid and therefore never included in income. (***Haff v. Comm.***, TCM 2015-138)

The taxpayer, through his single-member LLC, invested in GSH Development, which built condominiums and townhouses. The taxpayer initially invested $1 million, and then between 2005 and 2010, he contributed an additional $337,690 to GSH to cover expenses. The taxpayer was on the cash basis.

In 2008, the SEC investigated and filed a complaint against GSH for operating a Ponzi scheme. As a result, the taxpayer lost his entire investment.

For the 2009 tax year, the taxpayer claimed a theft loss deduction of $2,068,476: his contributions to GSH of $1,337,690 plus $730,786 that he claimed GSH owed him for services he performed in sales, development, marketing, and construction.

The taxpayer argued that the deduction for unpaid fees for his services was allowable under Rev. Proc. 2009-20, which provides an optional safe harbor treatment for taxpayers who experienced losses in certain investment arrangements discovered to be criminally fraudulent.

Computing basis

The deductible amount of a theft loss is limited to the adjusted basis of the property taken. However, basis does not include the value of services performed *unless* the value of those services has been subjected to tax. (***Hutchinson v. Comm.*** (1951) 17 TC 14)

Rev. Proc. 2009-20

The taxpayer argued that Rev. Proc. 2009-20 safe harbor applied, which allows a loss deduction for amounts not previously included in income. However, the safe harbor only permits a deduction to the extent of a "qualified investment," and part of the definition of that term specifies that the income received from such a fraudulent scheme must have been included in income prior to the year of discovery.

Conclusion

Because the $730,786 in fees were never paid to the taxpayer, and he never included it in income, the court disallowed the deduction for that amount. The court did allow the taxpayer to take the remaining $1,337,690 as a theft loss deduction.

CASUALTY LOSSES

The IRS has held that, where customers of a car rental company damage the company's cars, and the customers have purchased a damage waiver, the company does not have a casualty loss. (CCA 201529008)

The taxpayer is a car rental company that offers customers who rent a vehicle the opportunity to purchase a waiver that waives the taxpayer's right to seek recovery from the customer or the customer's insurance company for damage to the vehicle while the customer is renting the vehicle.

If one of the taxpayer's vehicles is damaged and the customer purchased a waiver, the taxpayer estimates the cost to repair the vehicle damage and, based on that estimate, decides whether to repair the vehicle or to sell it in the damaged condition. The taxpayer only repairs vehicles it intends to keep in its fleet; it does not repair damage to vehicles it determines should be disposed of through a sale. The taxpayer does not purchase any insurance coverage on its rental vehicles.

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The taxpayer requested the IRS's advice regarding whether it could take a casualty loss for customer-damaged vehicles where the customer purchased a waiver and the taxpayer sold the vehicle without repairing the damage.

Damages to rental vehicles

The IRS held that the damage to the cars does not result in a casualty loss, reasoning that the damages meet the first two requirements of Rev. Rul. 72-592, but not the third. Rev. Rul. 72-592 provides that, in order for a loss to qualify as a casualty loss under IRC §165, the loss must result from some event that is:

- Identifiable;
- Damaging to property; and
- Sudden, unexpected, and unusual in nature:
  - To be "sudden," the event must be one that is swift and precipitous and not gradual or progressive;
  - To be "unexpected," the event must be one that is ordinarily unanticipated, which occurs without the intent of the one who suffers the loss; and
  - To be "unusual," the event must be one that is extraordinary and nonrecurring, that does not commonly occur during the activity in which the taxpayer was engaged when the destruction or damage occurred, and that does not commonly occur in the ordinary course of day-to-day living of the taxpayer.

The IRS concluded that collision damages of rental vehicles are not unusual, as they commonly occur during the business activity in which the taxpayer was engaged when the destruction or damage occurred, and in the ordinary course of the day-to-day business of the taxpayer. The IRS also noted that no trade or business deduction was available.

The IRS cited two cases in which courts determined that events such as vehicle accidents were not unusual for that taxpayer's business and that they were an ordinary and necessary expense of doing business:

- ***Atlantic Greyhound Corporation v. U.S.*** (1953) 111 F.Sup 953: The Court had to determine if the costs of repairing collision damages to the taxpayer's buses were casualty losses. The Court noted that during 1938, the taxpayer had an average of 243 buses in service averaging 8,029 bus miles per month per bus operated. This amounted to almost 2,000,000 miles per month during that year. The Court held that "under such circumstances, accident collision damage was expected, normal, and inevitable, and the cost of repairing such damage was an ordinary and necessary expense of doing business."
- ***Consolidated Motor Lines, Inc. v. Comm.*** (1946) 6 TC 1066: A freight transporter by motor argued that it should be able to deduct as losses damages to cargo due to such events as theft, fire, turnover, collision and rain, as well as property damage that arose from accidents in which its vehicles were involved. The court held "a common carrier constantly shipping freight over the public highways may not reasonably be said to suffer unusual casualty or abnormal 'loss' as a result of the matters here being considered."

In the taxpayer's case, the amount of the overall repair costs for damaged vehicles was large. The taxpayer did not suffer unusual casualty or an abnormal loss because it is normal and expected that its vehicles will be damaged when it rents such vehicles to numerous customers to be operated over public highways.

Background

Taxpayers are allowed a deduction for losses sustained during the tax year and not compensated by insurance or otherwise. (IRC §165(a)) Any loss arising from fire, storm, shipwreck, or other casualty is allowable as a deduction under §165(a) for the tax year in which the loss is sustained. (Treas. Regs. §1.165-7(a)(1))

An automobile owned by the taxpayer may be the subject of a casualty loss, including losses arising from fire, storm, or other casualty. In addition, a casualty loss occurs when an automobile owned by the taxpayer is damaged and if:

- The damage results from the faulty driving of the taxpayer or other person operating the automobile but is not due to the willful act or willful negligence of the taxpayer or of one acting in the taxpayer's behalf; or
- The damage results from the faulty driving of the operator of the vehicle with which the automobile of the taxpayer collides.
  (Treas. Regs. §1.165-7(a)(3))

TAXATION OF MARIJUANA

YOU WIN SOME, YOU LOSE SOME

The Tax Court has ruled that a medical marijuana dispensary whose marijuana was confiscated in a Federal Drug Enforcement Agency raid was not entitled to claim the cost of the confiscated marijuana as a cost of goods sold (COGS) expense nor as an IRC §165 casualty loss. (***Beck v. Comm.*** TCM 2015-149) The business owner was also disallowed other Schedule C expenses.

Facts

Jason Beck operated two medical marijuana dispensaries as a sole proprietorship and conducted the business under the name Alternative Herbal Health Services (AHHS). One of the dispensaries was located on Haight Street in San Francisco (it has since closed), and the other is located in West Hollywood.

The taxpayer claimed a variety of business expenses on his Schedule C in which he classified the operations as a "health care" business.

The dispensaries only sold marijuana, marijuana seeds, and edibles but did not sell any related products such as pipes, papers, or vaporizers. However, Beck and other employees offered "educational" services, including but not limited to the following:

- Education on the effects of various strains of marijuana on the body;
- Education on the use and benefits of vaporizers;
- Discussions on the various strains of marijuana that were for sale (40 strains in the San Francisco dispensary and 70 strains in the West Hollywood dispensary);
- How to grow marijuana; and
- Counseling as to how to load a bong, pipe, joint, or other smoking device.

Although the dispensaries tracked their inventory and sales using a variety of techniques (e.g., tub sheets that tracked how much marijuana was placed in and removed from each tub, guest checks that described what was purchased and how much was charged, and z-tapes from the cash register), Beck routinely destroyed these records.

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In January 2007, the DEA raided the West Hollywood dispensary and confiscated all the marijuana, edibles, and marijuana plants as well as all the cash that was on hand. None of these items were returned.

On his 2007 return, Beck listed the following on his Schedule C:

- $1.7 million in gross receipts;
- $1,429,614 in COGS ($600,000 of which was attributable to the items confiscated by the DEA); and
- $194,094 in expenses, which included lease payments, employee expenses, advertising, etc.

The IRS disallowed the business expenses and the COGS deduction.

Business expenses disallowed

Under IRC §280E, Beck is precluded from claiming any business expense deductions or credits related to trafficking in controlled substances. The evidence indicated that all of AHHS's activities centered around selling and/or dispensing marijuana.

Although the Tax Court has allowed a medical marijuana dispensary to deduct expenses related to a separate and distinct business that provided caregiving services within the dispensary, there was no separate business operated within AHHS's dispensaries. (***See Californians Helping to Alleviate Med. Problems, Inc. v. Comm.*** (20017) 128 TC 173) Rather, all of the "educational" services provided related to instructing customers on how to use the marijuana that was sold. Furthermore, Beck failed to maintain any records that differentiated between the expenses incurred in selling the marijuana and the "educational" services that were offered.

Treatment of confiscated marijuana

The court rejected Beck's characterization of the seized marijuana as COGS because the marijuana was confiscated and not sold. Nor could Beck claim an IRC §165(a) loss for the seized marijuana because IRC §280E prohibits taxpayers from claiming ANY business expenses incurred in connection with the trafficking in a controlled substance.

Washington's excise tax on marijuana

In contrast to the negative ruling issued by the Tax Court, a marijuana dispensary in Washington scored a victory when the Chief Counsel concluded that the Washington excise tax imposed on marijuana producers, processors, and retailers should be treated as a reduction in the amount realized on the sale of the property under IRC §164(a). (IRS Chief Counsel Memorandum 201531016 (July 31, 2015)) Because it was a reduction in the amount realized, it did not fall under the IRC §280E prohibition against deducting business expenses. Therefore, the dispensary is able to reduce the amount reportable as realized on the sale of the marijuana by the amount of excise tax.

CANCELLATION OF DEBT

TAXPAYER PROVES "IDENTIFIABLE EVENT": NO COD INCOME

A taxpayer proved that debt was actually discharged at an earlier date than the IRS argued, which meant that she therefore had no COD income for the year at issue. (***Clark v. Comm.***, TCM 2015-175)

Facts

In 2005, the taxpayer defaulted on her car loan, and the car was repossessed and sold at auction. The auction proceeds were applied to the loan balance on June 20, 2005, after which the taxpayer still owed $4,768.79. Over the next five years, the creditor assigned five different debt collection agencies to the account, but none were successfully able to collect any payments. Finally, in August of 2011, the creditor discharged the debt and issued a 1099-C.

The taxpayer had since moved, the 1099-C was returned as undeliverable, and the taxpayer filed her 2011 tax return without reporting the discharged debt.

In petitioning the resulting assessment by the IRS for 2011, the taxpayer asserted the cancellation actually occurred, and therefore the debt was discharged, when the creditor failed to receive payment on the debt over a 36-month period that ended in December 2008.

Identifiable event

A debt is considered cancelled or discharged (resulting in COD income) at the moment that it becomes clear that the debt will never be paid. An "identifiable event" fixes the loss with certainty and indicates the time when a debt has been discharged. Whether an event has occurred is based on facts and circumstances. (***Cozzi v. Comm.*** (1987) 88 TC 435)

Treas. Regs. §1.6050P-1(b)(2)(i)(H) provides for such an identifiable event (see box "What is an identifiable event?" below). It states that indebtedness is discharged on the date of an identifiable event, and goes on to describe several examples. Pertinent to this taxpayer's case, an identifiable event includes "the expiration of the non-payment testing period, as described in Treas. Regs. §1.6050P-1(b)(2)(vi)."

Under Treas. Regs. §1.6050P-1(b)(2)(vi), an identifiable event has occurred during a calendar year if a creditor has not received a payment on a debt at any time during a "testing period"; the testing period is generally a 36-month period ending at the close of the year.

Findings

Looking to these regulations, the taxpayer argued that her last payment was the payment of the auction proceeds on June 20, 2005, meaning that the testing period had ended (and therefore the debt should have been reported as discharged) on December 31, 2008, not in 2011 as the IRS claimed.

The IRS argued against the testing period provision being met, because during that time the creditor had employed five collection agencies to pursue the debt, although all were unsuccessful. However, Treas. Regs. §1.6050P-1 came to the taxpayer's rescue again. It states that, yes, the identifiable event test is not met if the creditor engaged in significant collection activity… but clarifies that "significant collection activity" does not include merely sending automated notices. The IRS was unable to prove exactly what methods the collection agencies had used in their attempts to collect.

Therefore, the court found an identifiable event occurred that fixed the discharge of debt in 2008, as the taxpayer argued. Thus, there was no discharge of debt in 2011 and the taxpayer had no COD income in 2011.

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IRS proposes to eliminate 36-month testing rule for issuing 1099-C

In a proposed regulation, the IRS would eliminate the existing regulation under which a creditor must furnish Form 1099-C, Cancellation of Debt, if there is a 36-month period during which the creditor has not received any payment on the debt from the debtor. (Prop. Treas. Regs. §1.6050P-1)

The IRS is concerned that the 36-month rule causes confusion among taxpayers. In cases in which a Form 1099-C is issued before the debt is actually discharged, the IRS does not receive third-party reporting when the debt is actually discharged.

Therefore, the IRS has concluded that the 36-month rule creates confusion and does not increase tax compliance. The proposed regulation that removes the 36-month rule will be effective when final regulations are published.

What is an identifiable event?

Under Treas. Regs. §1.6050P-1(b)(2)(i)(A)–(H), an identifiable event is:

(A) A discharge of indebtedness under title 11 of the United States Code (bankruptcy);
(B) A cancellation or extinguishment of an indebtedness that renders a debt unenforceable in a receivership, foreclosure, or similar proceeding in a federal or state court;
(C) A cancellation or extinguishment of an indebtedness upon the expiration of the statute of limitations for collection of an indebtedness, or upon the expiration of a statutory period for filing a claim or commencing a deficiency judgment proceeding;
(D) A cancellation or extinguishment of an indebtedness pursuant to an election of foreclosure remedies by a creditor that statutorily extinguishes or bars the creditor's right to pursue collection of the indebtedness;
(E) A cancellation or extinguishment of an indebtedness that renders a debt unenforceable pursuant to a probate or similar proceeding;
(F) A discharge of indebtedness pursuant to an agreement between an applicable entity and a debtor to discharge indebtedness at less than full consideration;
(G) A discharge of indebtedness pursuant to a decision by the creditor, or the application of a defined policy of the creditor, to discontinue collection activity and discharge debt; or
(H) In the case of "applicable financial entities," the expiration of the non-payment testing period.

SETTLEMENT AGREEMENT IS NOT AN IDENTIFIABLE EVENT

Any discharges (in whole or in part) of indebtedness of any person in excess of $600 must be reported on Form 1099-C. (IRC §6050P) For information reporting purposes, a discharge of indebtedness is deemed to have occurred upon the occurrence of an "identifiable event," whether or not an actual discharge of indebtedness has occurred on or before the date on which the identifiable event has occurred. (Treas. Regs. §1.6050P-1(a)(1))

In a PLR, the IRS determined that a financial institution is not required to file Forms 1099-C with respect to the write-off of deficiency balances pursuant to a settlement agreement. (PLR 201540009) The discharge was not the result of an identifiable event listed in Treas. Regs. §1.6050P-1(b)(2), but rather was by operation of state law, which barred the financial institution from collecting on the deficiency balances.

Of the identifiable events provided for in Treas. Regs. §1.6050P-1(b)(2)(i)(A)–(H) (see box "What is an identifiable event?" above), two were potentially relevant to the requested ruling:

- An agreement by the parties to discharge the debt for less than full consideration; or
- A decision by the creditor to discontinue collection activity and discharge the debt.

Discharge by agreement of the parties

The violation of state law found by the court in its preliminary order and admitted to by the financial institution in the settlement agreement means that the deficiency balances never accrued in the first place, and the financial institution is barred from recovering any deficiency balances. This bar is effective whether or not the creditor "agrees" to discharge the debt. Therefore, the write-off of the balances for the debtors is not triggered by an agreement between the financial institution and the debtors, but rather by application of state law.

Discharge by decision of the creditor

A discharge of indebtedness occurs upon a decision by the creditor, or the application of a defined policy of the creditor, to discontinue collection activity and discharge debt. (Treas. Regs. §1.6050P-1(b)(2)(G)) The IRS determined that this identifiable event does not apply. The discharge occurred by operations of state law, and not by a decision or application of a defined policy by entity.

Conclusion

The financial institution is not required to file Forms 1099-C with respect to the write-off of deficiency balances pursuant to the settlement agreement because the discharge was not the result of an identifiable event listed in Treas. Regs. §1.6050P-1(b)(2), but rather was by operation of state law.

NO "HARDSHIP" EXCEPTION

A taxpayer had income from cancellation of debt, even though the 1099-C he received indicated in box 5 that he was not personally liable for the debt. (***Dunnigan v. Comm.***, TCM 2015-190)

The debt arose from a $50,000 loan the taxpayer took to cover expenses for his appraisal business. He ultimately was unable to pay back the funds, and entered into a settlement to pay $15,628.

The taxpayer argued that the 1099-C indicated that he was not liable for repayment; however, the credit agreement between the taxpayer and the lender did hold him liable, individually and on behalf of his business.

The taxpayer further argued that representatives of the lender and the IRS told him that "hardship" rules would apply in his case, because he was very ill at the time. However, the taxpayer did not provide any legal support for this argument, and he did not fall under any of the exceptions to recognition of COD income:

- Income is not realized from the discharge of debt in bankruptcy or insolvency, qualified farm indebtedness, qualified real property business indebtedness, or qualified personal residence indebtedness (IRC §108(a));
- Income is not realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction (IRC §108(e)(2)); or
- Income is not realized from discharge of certain student loan debts, if, under the terms of the loan, the discharge is pursuant to the taxpayer working for a certain period of time for a certain profession or class of employer. (IRC §108(f))

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California conformity

California does not conform to the exclusion for COD income from qualified principal residence indebtedness. AB 99, which would have extended this exclusion through 2014, was vetoed by the Governor.

California conforms to these federal exclusions from COD:

- A discharge of a debtor in a bankruptcy proceeding;
- A discharge of an insolvent taxpayer;
- A discharge of qualified farm indebtedness; and
- A qualified student loan discharge.
  (R&TC §§17131, 17134, 17144, 24301, 24307)

REAL ESTATE

INTENT TO DEVELOP PROPERTY RESULTS IN ORDINARY INCOME

Over 12 years, taxpayers did very little in the way of improvements or repairs to a development property, but they still actively sought to build an apartment complex and retail space on the property. (***Fargo and King v. Comm.***, TCM 2015-96) Even though the property was used as rental property over the years, the Tax Court found that such use was not the taxpayers' primary purpose of holding it — rather, the taxpayers were just making the best use of the property as office and rental space, while never abandoning their primary intent to sell it. Therefore, the gain from the eventual sale of the property was ordinary income.

TAXPAYER MUST RECOGNIZE GAIN UPON REPOSSESSION: NO §121 EXCLUSION

Taxpayers lost again in an appeal regarding gain on repossessed property. (***DeBough v.Shulman*** (August 28, 2015) U.S. Court of Appeals, Eighth District, Case No. 14-3036) The taxpayers claimed the IRC §121 principal residence exclusion for gain on the reacquisition of property when the buyers defaulted. In 2014, the Tax Court ruled that IRC §1038 did not allow the taxpayers to claim the principal residence exclusion under IRC §121 because the taxpayer did not resell the property within one year after the reacquisition. (***DeBough v. Comm.*** (May 20, 2014) 142 TC 17)

In 1966, the taxpayers purchased their personal residence and 80 acres of land for $25,000. In July 2006, they sold the property in an installment sale for $1,400,000. Due to basis adjustments, the taxpayers reported a gain of $657,796, to which they applied the IRC §121 exclusion of $500,000.

Between the sale date in 2006 and 2009, when the buyers defaulted on the note, the taxpayers received payments amounting to $505,000. Using the gross profit percentage, they reported $56,920 of gain. When the buyers defaulted, the taxpayers reacquired the property. The taxpayers treated the reacquisition of the property as an IRC §1038 reacquisition. The IRS issued a deficiency notice, claiming that the taxpayers were required to recognize gain in 2009 when they reacquired the property.

The court ruled that in order to use IRC §121 when a former principal residence was repossessed, it must have been sold within one year. (IRC §1038(b)(1))

Provisions of §1038

Under IRC §1038, certain limitations are imposed on the gain or loss of real estate sold on the installment basis and then reacquired by the seller.

Generally, IRC §1038(a) restores the seller to his position before the sale of the property by ignoring gain or loss upon repossession. However, if the seller has received money and other property as payments before the repossession, IRC §1038(b) taxes the seller on gain attributable to these payments "to the extent that these amounts have not previously been reported as income." (IRC §1038(b)(1))

An exception in IRC §1038(e) applies to taxpayers who repossess a former principal residence for which gain was excluded under IRC §121 and then resell it within one year of the reacquisition. This subsection allows the seller to treat the resale as part of the original transaction. In the case at hand, the taxpayer was clearly outside of the one-year timeframe, and therefore the IRC §1038(e) exception did not apply, meaning that he was required under IRC §1038(b) to recognize the gain on the money and property received before the repossession, and not included in income.

Interaction of IRC §§121 and 1038

The taxpayers' argument was that IRC §1038 does not contain language that specifically says that an IRC §121 exclusion was disallowed on reacquisition, meaning that IRC §1038 is not meant to recapture IRC §121 gain.

The Tax Court interpreted the code to mean that sellers who reacquire a principal residence but resell it within one year do not recognize the gain under IRC §1038(b). The other side of this is that taxpayers who reacquire a property and do not sell it within one year are required to report any gain under IRC §1038(b), because unless the exception in IRC §1038(e) applies, IRC §1038 overrides IRC §121.

The court further elucidated with "expressio unius est exclusio alterius" — if Congress meant for there to be other exceptions to the rule, those exceptions would have been stated in the rule.

Therefore, the taxpayers owed tax on the portion of $505,000 in installment payments that had not been reported, and the IRC §121 exclusion was disallowed.

Repossession — the "other" side of foreclosure

With the tax relief provided to borrowers, it seems we've forgotten that there are two sides to this coin, and borrowers aren't the only ones getting hurt.

Although the stereotype of the typical lender may draw a somewhat less sympathetic figure than the family suffering foreclosure, in many cases those "lenders" may just be people who sold a residence or rental property on an installment basis.

If the lender was the seller of the property, then the lender's reacquisition of the property, such as by foreclosure or abandonment, is treated as a repossession. The general rule in such situations is that the lender does not recognize any gain or loss on the repossession and may not take a bad debt deduction as a result of the repossession. (IRC §1038(a)) However, there are exceptions.

Calculating gain on the repossession

Gain on a repossession is the excess of:

- The total payments and/or other consideration received before the repossession in connection with the original sale of the property; over
- The total gain previously reported as income.
  (IRC §1038(b)(1))

However, the amount of gain on the repossession cannot exceed the gain realized on the original sale minus:

- The total gain previously reported as income; and
- Repossession costs and other consideration paid or transferred by the seller in connection with the repossession.
  (IRC §1038(b)(2))

Repossession of former principal residence

Special rules apply when the mortgaged property was the seller's principal residence and after repossession, the seller resells the property within one year of the repossession. In that event, the gain on repossession is treated as part of the original sales transaction; that is, the original sale and resale are treated as one transaction, and the realized gain is determined on the combined transaction. (IRC §1038(e)) As such, there is gain on the repossession only to the extent that the gain on the original sale plus the gain on repossession exceeds the taxpayer's IRC §121 exclusion amount. If the resale occurs more than one year after the repossession, the transaction is treated under the general rules for repossessions.

Basis of repossessed property

Basis in the repossessed property is:

- The adjusted basis of the debt to the seller secured by the property (face value less unreported profit); plus
- Gain resulting from the repossession; plus
- Repossession costs and other consideration transferred by the seller.
  (IRC §1038(c))

Comments

There appears to be no limit on the length of time period between the original sale and reacquisition for purposes of the principal residence exception. Thus, if a taxpayer qualifying for the IRC §121 exclusion sells the principal residence and they repossess it 10 years later, they would still qualify for the exclusion so long as they resold it within one year of the reacquisition.

It appears that a taxpayer may get the IRC §121 exclusion on the resale if the resale independently qualifies (although the circumstances, in real life, are unlikely). Assume the taxpayers sell the principal residence they had owned and lived in for 30 years up to the date of sale. They repossess it six months later and they don't resell it until two years after the reacquisition. The first sale doesn't qualify for the IRC §121 exclusion because they reacquired the property and didn't resell it within one year of the reacquisition. However, the second sale may qualify for the exclusion because on the date of resale they still meet the two-out-of-five-year tests.

If a seller anticipates reselling the residence within one year of its reacquisition, he presumably doesn't report any gain or loss in the tax year of the reacquisition. However, if he fails to resell the residence within one year of the reacquisition (and thus, doesn't qualify for the principal residence exception), he presumably has to amend the tax return for the year of the reacquisition and report the repossession under the general rules.

REVIEW QUESTIONS

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

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

7. In the ***Pouemi*** case, where the taxpayer did real estate work in the evenings and on weekends, the court considered the nine factors used to determine if an activity is actually for profit. Which of these statements about the case is true as it pertains to these factors?

    a) The taxpayer was businesslike in performing his real estate activities and kept adequate records.
    b) The taxpayer never earned a profit in real estate but claimed deductions for his related expenses.
    c) The taxpayer had experience in real estate and spent much of his time involved in the industry.
    d) The taxpayer had a contemporaneous mileage log that supported his contention that he drove clients around to view properties.

8. Which of the following statements correctly characterizes the IRS's determination of whether an activity is engaged in for profit?

    a) The IRS follows tax law, which assumes that if there are three or more years of losses from an activity, then they will assume that it is not engaged in for profit.
    b) In general, there is an election to postpone the determination of the presumption period for assessing for-profit activity until tax returns for at least seven years have been filed.
    c) The election to postpone the determination of presumption is required to be made within three years of the due date (including extensions) of the return that reflects the first year of the activity, but not more than 90 days after receipt of a notice from the IRS indicating that they will not allow the loss.
    d) Many practitioners would not recommend making the election to postpone the determination of presumption because it extends the statute of limitations.

9. Which of the following statements is correct as it pertains to the IRS's treatment of casualty losses?

    a) A casualty loss can occur, and a deduction can be taken, when a taxpayer's automobile is damaged as a result of his or her faulty driving, but not willful negligence.
    b) A casualty loss is an allowable deduction if a taxpayer's automobile is damaged by a fire or storm whether or not the taxpayer's has been compensated by insurance.
    c) Rental vehicles generally qualify for a casualty losses under IRC §165, because the loss from an event is typically identifiable, damaging to the property, and unusual in nature.
    d) A business deduction can be taken by a car rental company for collision damages to its vehicles.

10. When considering cancellation of debt and the generation of COD income, which choice below is correct?

    a) An identifiable event identifies the time when a debt has been discharged and occurs if a creditor hasn't received any payment on a debt during a 48-month testing period.
    b) When there is agreement between parties for payment that is less than the full amount owed, there is no COD income.
    c) There is a proposed regulation that would eliminate the regulation which dictates that a creditor is required to furnish Form 1099-C, Cancellation of Debt, if the creditor does not receive payment on a debt within the specified period.
    d) When attempting to collect a debt, Treas. Regs. §1.6050P-1 clarifies that the test for an "identifiable event" is met if the creditor pursues substantial *bona fide* collection action.

11. How do IRC §§121 and 1038 play out in the case of repossessed property?

    a) IRC §1038 will not ignore gain or loss when property is repossessed.
    b) If a former principal residence is repossessed, it must be sold within one year in order to use IRC §121.
    c) The provisions of IRC §1038 will always override IRC §121.
    d) Sellers who reacquire a principal residence and sell it within two years will not have any gain under IRC §1038(b).

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SOLUTIONS TO REVIEW QUESTIONS

7. In the ***Pouemi*** case, where the taxpayer did real estate work in the evenings and on weekends, the court considered the nine factors used to determine if an activity is actually for profit. Which of these statements about the case is true as it pertains to these factors? **(Pages 19 and 20)**

    a. Incorrect – Once of the nine factors is whether the taxpayer carries on his activity in a businesslike manner, keeping records and accurate books, which would be demanded in a for-profit business endeavor. In this case, the taxpayer had no books or records and did not maintain a business bank account.
    b. Correct – This proved to be problematic for the court. His continual losses, beyond just a customary start-up period, led the court to believe that he never was involved in the real estate industry to make a profit.
    c. Incorrect – The taxpayer could not demonstrate that he intended to make a profit by devoting his personal time and effort to succeeding. The court will look at the time and effort expended in an activity in order to determine if it is more than just a hobby.
    d. Incorrect – The taxpayer only created the mileage log after the IRS began their audit.

8. Which of the following statements correctly characterizes the IRS's determination of whether an activity is engaged in for profit? **(Page 22)**

    a. Incorrect – The law states that if there is a net profit from an activity for three or more years during a five-year consecutive period, then the presumption is that the activity is for profit, and the IRS would have to prove otherwise.
    b. Incorrect – The determination can be postponed until the returns for five years have been filed. It is seven years for horse-related activity.
    c. Incorrect – The election must be made within three years of the due date of the return (not including extensions) for the first year of the activity, but not more than 60 days after an IRS notice disallowing the loss.
    d. Correct – Making the election extends the statute of limitations for assessing the tax.

9. Which of the following statements is correct as it pertains to the IRS's treatment of casualty losses? **(Pages 25 and 26)**

    a. Correct – A casualty loss can also occur when the opposing driver is at fault, or when there is a loss due to fire, storm, or other casualty.
    b. Incorrect – Taxpayers can take a deduction for a loss that is sustained during the tax year which is not compensated for by insurance.
    c. Incorrect – The IRS has concluded that although collision damages to rental vehicles may be both identifiable and damaging, they are not unusual in nature and therefore are not considered deductible casualty losses.
    d. Incorrect – There are no business deductions available to a car rental company for collision damages of rental vehicles.

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10. When considering cancellation of debt and the generation of COD income, which choice below is correct? **(Pages 29)**

    a. Incorrect – The testing period is typically 36 months, ending at the conclusion of a calendar year.
    b. Incorrect – If there in agreement between a debtor and an entity to discharge debt for less than the full amount, this is considered an identifiable event that will generate COD income.
    c. Correct – The IRS believes that the 36-month rule does not encourage tax compliance because if Form 1099-C is issued prior to the debt being discharged, the IRS won't receive confirmation when there is actual discharge of debt.
    d. Incorrect – Under this section, the identifiable event threshold is not met by significant collection activity, which specifically does not include minimal collection action like automated mailing.

11. How do IRC §§121 and 1038 play out in the case of repossessed property? **(Page 32)**

    a. Incorrect – Typically, gain or loss is ignored when property is repossessed and the seller regains his prior position before the property's sale.
    b. Correct – This is true under IRC §1038(b). If the property is not resold within one year, any gain must be reported.
    c. Incorrect – Under IRC §1038(b), taxpayers must recognize gain on property received before any repossession occurs that was not previously included in income, so in this case IRC §121 is overridden. However, there is an exception when the taxpayers repossess the property and sell it within one year, in which gain is excluded under IRC §121.
    d. Incorrect – There will be no gain realized if the principal residence is sold within one year.

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EXTRAORDINARY PERSONAL SERVICES EXCEPTION TO RENTAL ACTIVITIES

Rental activities are defined as passive regardless of whether the taxpayer materially participates. (IRC §469(c)(2)) Generally, an activity is a rental activity if the payments are received principally for the use of tangible property. (IRC §469(j)(8); Treas. Regs. §1.469-1T(e)(3))

However, there are several situations in which an activity involving the rental of tangible property is not treated as a rental activity. One of those exceptions is for property that is rented incidental to extraordinary personal services; that is, where a taxpayer provides certain services in connection with making the property available for use by customers.

Extraordinary personal services

The regulations provide an example of rental-incidental-to-services: a hospital. Patrons of the hospital are using its boarding and meal services as a result of receiving care by the doctors and hospital staff.

In a case law example, an LLC owned an office building and provided substantial services to the tenants, who were attorneys. (***Al Assaf, et ux. v. Comm.***, TCM 2005-14) The LLC provided a legal support staff (paralegals, interns, and clerks), an up-to-date law library and computer, conference rooms, and legal research. The tenants leased their office space in the building so they would have access to the considerable services provided; therefore, the court found that the payments were for the services provided rather than for the office space leased.

The services must be provided in connection with the use of the property (not in some other capacity) and must be performed by individuals. (Treas. Regs. §1.469-1T(e)(3)(v)) Also, in cases where the value of the services is a majority of the rental amount charged, this does not necessarily mean the rental is incidental.

If a taxpayer is able to show that the extraordinary personal services exception applies, he must also show that he materially participated in the activity.

Rental incident to counseling?

A taxpayer was denied a refund claim for overpayment of tax by reclassifying passive losses he incurred on three rental real estate properties as active losses. (***Johnson v. U.S.*** (July 29, 2015) U.S. District Court, Eastern Dist. of N. Carolina, Case No. 7:13-CV-78-BO) The taxpayer argued that the rental activities were not passive because he provided extraordinary personal services to the tenants.

The taxpayer claimed that he provided the following services and amenities to his tenants:

- Fire and horseshoe pits;
- Satellite television service;
- Kitchen dishes and appliances;
- Furniture;
- Cleaning supplies;
- Landscaping;
- Bathroom toiletries;
- Laundry facilities; and
- Continental breakfast.

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The court rejected these amenities because they are commonly provided by landlords. The taxpayer further argued that he provided counseling services to his tenants, including:

- Legal, tax, and financial counseling;
- Psychological counseling; and
- Counseling for drug use, drinking, and depression.

The taxpayer provided a statement by one of his tenants, in which the tenant described the services provided and claimed that he rented a room at the property not for the room itself, but for all of the services that came with it.

However, the taxpayers did not provide any other evidence that such services were provided. The taxpayer admitted at trial that the services were not advertised, but merely offered when a tenant moved in, and the only specific example of "counseling" the taxpayer could remember providing was when he evicted one of his tenants.

Exceptions to passive rental activities

Treas. Regs. §1.469-1T(e) defines a passive activity and also provides for the following exceptions that rental activities are per se passive. An activity involving the use of tangible property is not a rental activity if:

- The average period of customer use for such property is seven days or less;
- The average period of customer use for such property is 30 days or less, and significant personal services are provided by or on behalf of the owner of the property in connection with making the property available for use by customers;
- Extraordinary personal services are provided by or on behalf of the owner of the property in connection with making such property available for use by customers (without regard to the average period of customer use);
- The rental of such property is treated as incidental to a nonrental activity of the taxpayer;
- The taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers; or
- The provision of the property for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest is not a rental activity.

§1031 EXCHANGES

WHAT IS LIKE-KIND?

Both the relinquished property and the replacement property must be similar enough to qualify as "like-kind." Like-kind property is property of the same nature, character, or class. Quality or grade does not matter. (Treas. Regs. §1031(a)-1)

Real property can never be like-kind to personal property.

Real property

Most real property is like-kind to other real property. For example, the fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. (Treas. Regs. §1.1031(a)-1(b))

State law decides real versus personal property

State law property classifications generally control in determining whether property is real or personal but are not determinative of whether properties are of the same nature and character. (CCA 201238027)

Leasehold interests

The regulations provide that a leasehold interest in real property with "30 years or more to run" may qualify as exchange property with a fee interest. (Treas. Regs. §1.1031(a)-1(c))

A leasehold interest in real property with a motel and a remaining term of 21 years was not considered like-kind with respect to ownership in two other real properties. (***VIP's Industries v. Comm.***, TCM 2013-157) However, the Tax Court stated that it wasn't deciding whether the 30-year rule in the regulations excludes all exchanges of leaseholds with terms of less than 30 years.

Caution

The courts have been inconsistent in ruling whether the 30-year leasehold term is a requirement or a safe harbor. (See ***Peabody Natural Resources v. Comm.*** (2006) 126 TC 261; ***Capri Inc. v. Comm.***, (1975) 65 TC 162) The prudent taxpayer may want to err on the side of caution.

Fractional interests

Individuals may exchange fractional interests in property but must be careful not to run afoul of the prohibition against exchanging partnership interests. In determining whether an interest in property is a partnership interest, federal tax law, not state law is controlling.

Partnership interest under federal law

The distinction between co-ownership and a *de facto* partnership turns on the intent of the parties and the extent to which they conduct a joint business. Treas. Regs. §301.7701-1(a)(2) provides:

> "A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. … Mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes."

The IRS has concluded that the ownership and operation of an apartment project does not constitute an active business so long as the owner furnishes only "customary" tenant services. (Rev. Rul. 73-374) Those services include the provision of heat, air conditioning, hot and cold water, unattended parking, normal repairs, trash removal, and cleaning of public areas. In a separate ruling the IRS indicated that the owner of an apartment building may arrange for the provision of laundry equipment and services by a third party, and receive a fee based on a percentage of the gross laundry income, without actively engaging in business. (PLR 8117040)

IRS issues guidelines

Although explicitly not a safe harbor, the IRS issued guidelines to help resolve the uncertainty regarding whether tenancy-in-common interests would be classified as partnership interests specifically with regard to like-kind exchanges. (Rev. Proc. 2002-22) In addition, the Rev. Proc. detailed guidelines for requesting private rulings of whether TIC interests in real property will constitute partnership interests ineligible for §1031 exchanges.

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The IRS provided that the guidelines were merely to assist taxpayers in preparing their requests for rulings and that the guidelines should not be taken as substantive rules or requirements. The IRS makes clear that even if all of the guidelines are satisfied in a request by a taxpayer for a private ruling, the Service might still refuse to issue such ruling depending on the facts of the case. Nevertheless, tax practitioners have come to see the guidelines as a "safe harbor" for TIC interests in like-kind exchanges.

There are 15 specific guidelines. The key guidelines are:

- Each of the co-owners must hold title to the property (either directly or through a disregarded entity) as a tenant-in-common under local law;
- There can be no more than 35 co-owners. A husband and wife are treated as a single person as are all persons who acquire interests from a co-owner by inheritance;
- The co-ownership may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any co-owner as a partner or otherwise hold itself as a business entity;
- Unanimous decisions are required on any material matter; and
- All co-owners must share in all revenues generated by the property and all costs associated with the property *pro rata* based on their respective TIC interests.

Partnership interests

Partnership interests are explicitly nonqualifying for like-kind exchange treatment. On the other hand, there is no doubt that the partnership itself can engage in a qualifying like-kind exchange. However, see below for discussion of "drop and swap."

Drop and swap

The more interesting question is, what happens when some partners wish to engage in an exchange and others don't? One possibility is the "drop and swap." In that scenario, the partnership distributes the property to the partners as tenants in common (the drop) where some partners can then exchange their TIC interest in the property while others may cash out.

While drop and swap transactions are commonly used, the IRS will attack the strategy on two fronts:

- **Step transaction:** The IRS may determine that the arrangement was designed solely to avoid taxation and disallow the exchange; and
- **Investment:** They will assess whether the property is held long enough to be treated as an investment.

How to accomplish the drop and swap

To accomplish the drop and swap, the entity converts the partnership interests to tenants-in-common interests, and the investors can make a tax-free distribution of the investment property's title to the individual investors. With title placed in the name of the individual investors, rather than the partnership, each investor is free to either "cash out" or make a like-kind exchange of his or her own using the equity obtained from the original property as payment.

Under Rev. Proc. 2002-22, the partnership may file an IRC §761(a) election, notifying the IRS that the property owners choose not to be taxed as a partnership.

The IRS considers an interest in a real estate partnership which has made a §761 election (a "761 Partnership") to be "like kind" to an interest in real property because the election results in the partnership being disregarded for tax purposes. Once this election is made, the partners are considered to directly own *pro rata* interests in the property of the partnership.

✐ **Practice Pointer**

This is a transaction that requires advanced planning, as the investors must hold the property as a tenant-in-common long enough to meet the "held for investment" criteria. There is no specific time period, but it is generally a minimum of two years — or more aggressively — a year and a day.

Swap and drop

A partnership may do the reverse and make the exchange and then after waiting "long enough" elect out of the partnership treatment so as to avoid the step transaction treatment, drop title to the individual partners, or refinance the new property to acquire cash to redeem the partner wanting to leave.

In PLR 2005-21002, the IRS indicated that a post-exchange distribution may occur relatively soon after the exchange without destroying the tax shield.

✐ **Practice Pointer**

These transactions are extremely complex. We recommend the use of a tax attorney specializing in real estate to construct these types of transactions.

Recent case

A recent California Board of Equalization case illustrates the complexity of this issue.

The Board unanimously held that an exchange of numerous taxpayers' interests in an apartment building for an ownership interest in a shopping mall and surrounding property was a valid §1031 like-kind exchange, even though the owners subsequently transferred the property to an LLC. The case involved what is commonly referred to as a "swap and drop" transaction. (***Appeal of Rago Development Corp. et al.*** (June 23, 2015) 2015-SBE-00) The Board ruled that there was no question that the replacement property was held for investment purposes because all of the owners (at least those who are still alive) have held on to their same interests in the LLCs for over 12 years after the initial exchange.

The replacement property, which consisted of four parcels in total, was initially held as a tenancy-in-common (TIC) for seven months, during which period the taxpayers entered into leasing agreements, procured insurance, and underwent repair and remodeling activities. All of this demonstrated that the taxpayers incurred substantial economic risk during this seven-month period.

They claimed that under long-standing federal case rulings, the subsequent transfer of their interests in the real property to an LLC should not negate their like-kind exchange and deferment of gain under IRC §1031. (***Magneson v. Comm.*** (1985) 753 F.2d 1490; ***Maloney v. Comm.*** (1989) 93 TC 89); ***Bolker v. Comm.*** (9th Cir. 1985) 760 F.2d 1039; ***Wagensen v. Comm.*** (1980) 74 TC 653)

The FTB argued that a provision in the loan document for two of the four replacement parcels called for taxpayers to reorganize their TIC interests into a single-asset entity within approximately seven months of acquiring the property.

However, the taxpayers countered that this did not negate their intent to hold the property for investment. Only two of the four loan documents contained the provision calling for the transfer of the property to the LLC, yet all four parcels were transferred to the newly formed LLC, and the taxpayers were not legally obligated to make the transfer.

In addition, for the seven months prior to the transfer they negotiated leases, signed management contracts, entered into operating agreements, paid property taxes, acquired property

and liability insurance, and filed federal and state returns as members of a TIC. Therefore, the doctrine did not apply because the taxpayers bore a risk of economic change during this seven-month period, a period that was far longer than other cases in which courts have found the step-transaction doctrine inapplicable.

The taxpayers successfully argued that under longstanding federal case law, there is no required holding period for replacement property and "as long as taxpayers continue to hold replacement property for investment, a change in the mechanism of ownership that does not significantly affect the amount of control or the nature of the underlying investment does not preclude nonrecognition under IRC §1031."

U.S. and foreign real property

Real property located in the U.S. and real property located outside the U.S. are not property of a like-kind for purposes of IRC §1031. (IRC §1031(h)(1))

Depreciable personal property

Generally, "like-kind" is more restrictive in personal property than for real property— such as an airplane for an airplane or a backhoe for a backhoe.

However, the regulations provide a safe harbor in which exchanges of depreciable tangible personal property may qualify for nonrecognition treatment if the exchanged properties are either "like-kind" or "like-class." (Treas. Regs. §1.1031(a)-2(a)) Like-class properties are depreciable tangible personal properties within the same General Asset Class or Product Class. But exchanges of nondepreciable personal property qualify for nonrecognition treatment only if the exchanged properties are of a like-kind.

The General Asset Class takes precedence. Thus, Product Class only comes into play when an asset is not classified within a General Asset Class.

General Asset Classes

There are 13 General Asset Classes. Property within a General Asset Class consists of depreciable tangible personal property described in one of asset classes 00.11 through 00.28 and 00.4 of Rev. Proc. 87-56. The General Asset Classes are as follows:

- Office furniture, fixtures, and equipment (asset class 00.11);
- Information systems (computers and peripheral equipment) (asset class 00.12);
- Data handling equipment, except computers (asset class 00.13);
- Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines) (asset class 00.21);
- Automobiles, taxis (asset class 00.22);
- Buses (asset class 00.23);
- Light general purpose trucks (asset class 00.241);
- Heavy general purpose trucks (asset class 00.242);
- Railroad cars and locomotives, except those owned by railroad transportation companies (asset class 00.25);
- Tractor units for use over-the-road (asset class 00.26);
- Trailers and trailer-mounted containers (asset class 00.27);
- Vessels, barges, tugs, and similar water-transportation equipment, except those used in marine construction (asset class 00.28); and
- Industrial steam and electric generation and/or distribution systems (asset class 00.4).

Product Class

Property within a Product Class is property described in a 6-digit product class within Sectors 31, 32, and 33 of the North American Industry Classification System.

Examples of personal property

Computer for printer: Not like-kind but qualify as like-class. Both are General Asset Class 00.12.

Airplane for heavy truck: Not like-kind and not like-class. They are in different General Asset Classes - airplane is 00.21 and truck is 00.242. As they are both in a General Asset Class, they may not be classified within a Product Class.

Grader for scraper: Not like-kind. Neither property is within a General Asset Class. However, both properties are within the same Product Class (NAICS Code 333120). Accordingly, they are of like-class and deemed to be of like-kind for purposes of IRC §1031.

Nondepreciable personal property and intangible property

An exchange of intangible personal property (patents, licenses, copyrights, etc.) or nondepreciable personal property (such as collectibles, e.g., artwork or rare musical instruments) qualifies for tax deferral only if the exchanged properties are "like-kind" to each other; the safe harbor for General Asset Classes and Product Classes do not apply.

The test as to whether intangible personal property is "like-kind" depends upon the "nature or character of the rights involved" and also on the "nature or character of the underlying property to which the intangible personal property relates." (Treas. Regs. §1.1031(a)-2(c)) For example, a copyright on a novel can be exchanged for a copyright on another novel but not for a copyright on a song. Goodwill of one business is not like-kind to the goodwill of another business, but trademarks, trade names, and mastheads that can be valued separately from goodwill may be like-kind to trademarks, trade names, and mastheads of another business. (CCA 200911006)

In determining whether intangibles are like-kind, the IRS has stated that "whenever possible, the underlying tangible personal properties to which the intangible asset relates should be compared using the same General Asset Classes and Product Classes already afforded for testing whether personal properties are of like class." (PLR 200602034) Thus, while the nature and character of the rights of two patents are the same, a patent for a printing press would not be like-kind to a patent for a tractor because the underlying properties are neither like-kind nor like-class. Similarly, an exchange of intangible property used predominantly outside of the United States would not qualify as like-kind to intangible property to be used predominantly within the United States.

BEWARE OF THE TWO-YEAR RULE WHEN EXCHANGING WITH RELATED PARTIES

If a taxpayer exchanges property with a related party (as defined below), the original exchange will not qualify for tax deferral if either of the exchanged properties is sold or disposed of within two years of the transfer. Interestingly, the postponed gain becomes taxable at the time of the disqualifying disposition and applies to both parties.

It is important to note that exchanges between related parties may still use the tax-free benefits of IRC §1031, provided the two-year waiting period and other requirements listed below are met. (IRC §1031(f) and (g))

Related parties include:

- **Family members:** Brothers, sisters, spouse, ancestors, and lineal descendants as well as C or S corporations and over 50% shareholders, corporate controlled members, and grantors and fiduciaries of trusts (IRC §267(b)); and
- **Partnership-partner:** The related-party definition also includes over 50% partner-to-partnership attribution rules. (IRC §707(b))

Two exceptions to the two-year rule

Dispositions due to death or involuntary conversion, or for non–tax-avoidance purposes will not invalidate IRC §1031 treatment. Three examples of this non–tax-avoidance exception are:

- Transactions involving certain exchanges of undivided interests in different properties that result in each taxpayer holding either the entire interest in a single property or a larger undivided interest in any of the properties;
- Dispositions of property in a compulsory or involuntary conversion (e.g., IRC §1033); and
- Transactions that do not involve the shifting of basis between properties. (IRC §1031(g)(2))

The running of the two-year holding period will be suspended during any period when a party's risk of loss with respect to the property is substantially diminished due to:

- The holding of a put with respect to the property;
- The holding by another person of a right to acquire the property; or
- A short sale or any other transaction. (IRC §1031(g)(2))

Example of related-party exchange

On July 1, 2014, brothers Joe and Mark exchanged Main Street (Joe's property) with an FMV of $100,000 and a basis of $90,000 for Park Avenue (Mark's property) with an FMV of $100,000 and a basis of $80,000. There are no mortgages or cash transactions. No gain is recognized by either brother.

On January 15, 2015, Joe disposes of Park Avenue for $105,000. Joe recognizes gain of $15,000 (sales price $105,000 – basis $90,000). Because the exchange is between related parties and does not meet the two-year holding period, Mark is taxable on the $20,000 of deferred gain on his exchange of Park Avenue.

Filing requirements

If the exchange is made with a related party, both parties must file Form 8824, Like-Kind Exchanges, in the year of the exchange and for the two following years. (Form 8824 Instructions) Subsequent disposition does not disqualify related-party exchange.

Court rejects exchanges structured to avoid related-party restrictions

The Eighth Circuit Court of Appeals has upheld a district court's ruling that a series of transactions involving related parties did not qualify for like-kind exchange treatment. (***North Central Rental & Leasing v. Comm.*** (March 2, 2015) U.S. Court of Appeals for the Eighth District, Case No. 13-3411) The court concluded that the transactions were needlessly complex and involved unnecessary parties.

Facts

Butler Machinery, a corporation, and North Central Rental & Leasing, an LLC, had common owners. North Central engaged in the rental and leasing of heavy equipment. It frequently participated in a like-kind exchange program, in which it traded used equipment for new equipment, with the following details:

- North Central transferred used equipment to a qualified intermediary (QI), which sold the equipment to an unrelated third party;
- QI transferred the funds to Butler Machinery, which had unrestricted use of the funds;
- Butler Machinery purchased new equipment from an unrelated third party with terms under which it had six months to pay for the equipment. This gave Butler Machinery a six-month interest-free loan; and
- Butler Machinery transferred the new equipment to QI, which transferred it to North Central.

The court noted that the legislative history of IRC §1031 "reveals that the provision was designed to avoid the imposition of tax on those who do not 'cash in' on their investments in trade or business property." However, sophisticated parties exploited the provision by using related-party transactions that allowed them to cash in on their investments while simultaneously claiming nonrecognition treatment. They cited the following example, which illustrates simply how this is done.

Example of rationale behind related-party rules

Assume Tammi owns Blackacre, which is worth $100 and has a basis of $20. Her wholly owned corporation, Cammi Corp, owns like-kind property, Whiteacre, which is also worth $100 but has a basis of $140. Tammi and Cammi swap, and Cammi immediately sells Blackacre to an unrelated party. If Tammi had sold Blackacre, she would have recognized gain of $80, but Cammi, whose $140 basis for Whiteacre becomes its basis for Blackacre, recognizes a loss of $40.

Analysis

The court ruled that the transactions violated the related-party rules and were not tax-deferred. The court noted the complexity of the transactions and that both Butler Machinery and the QI were unnecessary parties. They rejected the taxpayer's argument that Butler Machinery did not have indefinite access to the funds. The court could not ignore the significant and continuous financial benefits of the transactions to Butler Machinery. The related parties were a single economic unit, under common ownership, so the economic benefits to Butler Machinery were attributed to North Central.

Although the transactions did not literally run afoul of the basic related-party restrictions under IRC §1031(f), they would have if Butler Machinery and North Central had exchanged equipment directly with each other. Since QI was an unnecessary party, they could have done so. Accordingly, the court ruled that the transactions were designed to avoid the related-party rules and ran afoul of IRC §1031(f)(4).

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REVIEW QUESTIONS

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

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

12. Factors pertaining to rental activities in general, and extraordinary personal services specifically are included in which of the following choices?

    a) In order for rental activities to be passive, the taxpayer must not materially participate.
    b) Extraordinary personal services do not necessarily have to be connected to the use of the property.
    c) In ***Al Assaf, et ux. v. Comm.***, an LLC-owned office building provided services to attorneys, such as legal support staff, a current law library, and legal research, which qualified the rental of the property to not be treated as a passive rental activity.
    d) In ***Johnson v. U.S.***, the court upheld the taxpayer's contention that his laundry facilities, satellite television services, and continental breakfasts constituted extraordinary personal services to his tenants thereby enabling him to reclassify his passive losses as active losses.

13. What is true of real property as it pertains to like-kind treatment?

    a) Real property and personal property can be like-kind.
    b) Regarding leasehold interests, the Tax Court has decided that exchanges of leaseholds with terms under 30 years will not be considered like-kind.
    c) Partnership interests qualify for like-kind treatment.
    d) Real property within the U.S. cannot be exchanged for real property outside of the U.S.

14. Details of a "drop and swap" transaction are accurately described in which of the following choices?

    a) With a drop and swap, title changes from partnership interests to tenants-in-common interests.
    b) Under Rev. Proc. 2002-22, the tenants-in-common can make an IRC §761(a) election.
    c) Investors are required to hold property as tenants-in-common for at least one year to satisfy the "held for investment" criterion.
    d) In a drop and swap, no partner can cash out.

15. Which example of a personal property exchange will qualify for nonrecognition treatment?

    a) A computer for a copy machine
    b) An airplane for a helicopter
    c) A heavy truck for a tractor
    d) An automobile for a bus

16. Which of the following statements is accurate as it pertains to participating in an exchange with related parties?

    a) Related parties do not qualify for the tax-free benefits under IRC §1031.
    b) Related parties include family members and lineal descendants, but not fiduciaries of trusts, or C or S corporations.
    c) Dispositions of property due to death will not invalidate IRC §1031 treatment.
    d) In an exchange with a related party, both are required to file Form 8824, Like-Kind Exchanges, in the year of the exchange and for the subsequent year.

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SOLUTIONS TO REVIEW QUESTIONS

12. Factors pertaining to rental activities in general, and extraordinary personal services specifically are included in which of the following choices? **(Pages 34)**

    a. Incorrect – Whether or not the taxpayer materially participates, rental activities are typically passive.
    b. Incorrect – The services have to be afforded to the tenants in connection with the property use and is required to be performed by individuals.
    c. Correct – The court ruled that the lease payments were really for all the additional services, not for the office space itself, and as such, the rental was not treated as a passive activity.
    d. Incorrect – The court ruled against the taxpayer because it viewed these activities as common amenities that landlords typically provide.

13. What is true of real property as it pertains to like-kind treatment? **(Pages 39)**

    a. Incorrect – Under Treas. Regs. §1031(a)-1, like-kind property must be the same nature, character, or class. As such real property and personal property can never be like-kind.
    b. Incorrect – The Tax Court has not made a decision as to whether leaseholds with less than a 30-year term qualify as exchange property. The regulations specifically state that a leasehold interest with "30 years or more to run" will qualify.
    c. Incorrect – Partnership interests do not qualify, although the partnership can participate in a like-kind exchange.
    d. Correct – This is true under IRC §1031(h)(1) for purposes of like-kind exchanges.

14. Details of a "drop and swap" transaction are accurately described in which of the following choices? **(Pages 37)**

    a. Correct – The property get distributed to the partners as tenants-in-common, and title is placed in the name of the individual investors rather than the partnership itself, whereby each investor can cash out or make a like-kind exchange using his portion of the equity.
    b. Incorrect – It is the partnership that makes the election informing the IRS that the property owners are electing not to be taxed as a partnership, in which case the partnership is disregarded for tax purposes.
    c. Incorrect – Although there is no defined rule, held for investment typically means at least two years, or a year plus a day if the taxpayer takes an assertive position.
    d. Incorrect – After the partnership distributes the property, if a partner is not interested in exchanging their tenants-in-common interest, they may cash out.

15. Which example of a personal property exchange will qualify for nonrecognition treatment? **(Page 39 and 40)**

    a. Incorrect – They are in separate asset classes: a computer is in 00.12, while a copy machine is considered to be data handling equipment under asset class 00.13.
    b. Correct – Both an airplane and a helicopter are in the same asset class, 00.21, and although they are not like-kind, they qualify for nonrecognition treatment because they are like-class.
    c. Incorrect – A heavy truck is in general asset class 00.242 while a tractor is in asset class 00.26; they are neither like-kind nor like-class.
    d. Incorrect – They are not like-kind and are in different general asset classes; an automobile is 00.22 and a bus is 00.23.

16. Which of the following statements is accurate as it pertains to participating in an exchange with related parties? **(Pages 41)**

    a. Incorrect – The related parties may participate in an exchange but must abide by the two-year rule whereby the exchanged properties cannot be sold for a period of at least two years from the time of the transfer. If not in compliance, the postponed gain is taxable to both parties.
    b. Incorrect – Related parties include family member, descendants, C or S corporations, over 50% shareholders, grantors and trust fiduciaries.
    c. Correct – This provides an exception to the two-year rule, which states that an original exchange of property will not meet the requirements for tax deferral if either one of the exchanged properties is sold within two years. This also holds true for involuntary conversions or when there is a disposition for non-tax avoidance purposes.
    d. Incorrect – Both file Form 8824 in the year of the exchange and for the following two years.

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BUSINESS ISSUES

FUNDING SOURCE AFFECTS R&D CREDIT

A taxpayer was not eligible to take credits for research expenses because the research was funded by the taxpayer's clients. (***Geosyntec Consultants, Inc. v. U.S.*** (January 29, 2015) U.S. Court of Appeals, Eleventh Circuit, Case No. 14-11107) Under certain work contracts, the taxpayer was entitled to the payments regardless of whether the research was successful, which meant that the taxpayer didn't bear the financial risk of failure required under IRC §41 and regulations thereunder.

Generally, eligibility for the credit does not require that the research be successful; that is, the research does not have to achieve its desired result.

Facts

Geosyntec Consultants is a specialized consulting and engineering firm that contracts with clients to provide services on projects involving the environment, natural resources, and geological infrastructure.

Specifically at issue were research credit expenses incurred under two "capped contracts" under which Geosyntec was paid for its labor and expenses, plus a mark-up, subject to an agreed-upon maximum price.

Geosyntec contends that it faced substantial financial risk under the capped contracts because its compensation was fixed; that is, it would only be paid for expenses incurred, eliminating an opportunity to make a profit on the research should it come in under budget, and it bore the risk that its expenses would exceed the ceiling price for each contract.

The court looked to the standard set forth in ***Fairchild***, where the funded research inquiry "turns on who bears the research costs upon failure" of the research. (***Fairchild Industries, Inc. v. U.S.*** (1995) U.S. Court of Appeals, Federal Circuit, Case No. 94-5116)

Funded research

To determine the extent to which research is funded, the court looked to Treas. Regs. §1.41-4A(d), which provides, in relevant part:

> Research does not constitute qualified research to the extent it is funded by any grant, contract, or otherwise by another person (including any governmental entity). All agreements (not only research contracts) entered into between the taxpayer performing the research and other persons shall be considered in determining the extent to which the research is funded. *Amounts payable under any agreement that are contingent on the success of the research and thus considered to be paid for the product or result of the research (see § 1.41-2(e)(2)) are not treated as funding*. [Emphasis added]

To be an expense paid or incurred by the client, the research must be performed on behalf of the client and the client must "bear the expense [of the research] even if the research is not successful." (Treas. Regs. §1.41-2(e))

If an expense is paid or incurred pursuant to an agreement under which payment is contingent on the success of the research, then the expense is considered paid for the product or result rather than the performance of the research. The tax credit is meant to incentivize research, not production.

The entity or person that bears "the financial risk of failure of the research to produce the desired product or result" is the party entitled to take the credit. As such, the client may claim the credit only if the agreement requires the client to pay for the research, even if it is unsuccessful. (***Fairchild*** (supra); Treas. Regs. §1.41-2(e)(2))

If, on the other hand, the client is not required to pay unless the research is successful, then the client is paying for a product or result rather than performance of the research, and the researcher is eligible to claim the research tax credit because the research is not funded.

Conclusion

Regarding Geosyntec's argument that it faced substantial financial risk under the capped contracts because its compensation was fixed, the court found that additional compensation was available in certain circumstances.

Geosyntec could submit a claim for additional compensation for necessary work that fell outside the scope of the services contemplated by one of the contracts. Geosyntec was also entitled to extra compensation where Delaware's environmental authorities imposed "unreasonable demands" that required additional work or services, and it reserved the right to change the hourly rate for work performed during two separate phases (subject to stated conditions).

In the second contract, if the client changed the work required under the contract, the parties would agree on a price increase and/or time extension necessary for Geosyntec to complete the additional work.

In short, contrary to Geosyntec's arguments, the capped contracts' not-to-exceed ceiling prices were not set in stone, and neither contract expressly mandated a successful outcome, in total or phase-by-phase. Therefore, Geosyntec was not eligible for credit for research expenses.

Qualified research expenses

Under IRC §41, a taxpayer may claim a 20% tax credit for the amount of "qualified research expenses" paid or incurred in the performance of "qualified research" that exceed a statutorily defined base amount. The term "qualified research expenses" refers to in-house and contract research expenses paid or incurred by the taxpayer during the taxable year. (IRC §41(b)(1))

Qualified research expenses eligible for the research expense credit are amounts the taxpayer, or a startup company, pays or incurs during the tax year for in-house and contract research expenses in carrying on a trade or business. The expenses must be incurred for the purpose of discovering information that is technological in nature.

Research is qualified if:

- It is an expenditure that may be treated as an expense under §174;
- It is undertaken to discover technological information intended to be useful in the development of a new or improved business component of the taxpayer; and
- It includes activities that constitute elements of a process of experimentation for a statutorily defined purpose.

Research that is not "qualified"

Certain categories of research are expressly excluded from the definition of qualified research:

1. Research conducted after the beginning of commercial production;
2. Research adapting an existing product or process to a particular customer's need;
3. Duplication of an existing product or process;
4. Surveys or studies (such as quality control and efficiency studies);
5. Research relating to certain internal-use computer software;
6. Research conducted outside the United States, Puerto Rico, or a U.S. possession;
7. Research in the social sciences, arts, or humanities; and
8. Research funded by another person (or governmental entity).

"In-house" research expenses that can qualify for the research credit are:

- Any wages paid or incurred to an employee for qualified services performed by the employee (IRC §41(b)(2)(A)(i));
- Any amount paid or incurred for supplies used in the conduct of qualified research, which includes any tangible property other than land or land improvements and depreciable property (IRC §41(b)(2)(A)(ii)); and
- Under the regulations, any amount paid or incurred to another person for the right to use computers in the conduct of qualified research. (IRC §41(b)(2)(A)(iii))

RETIREMENT ISSUES

60-DAY WAIVER GRANTED FOR HONEST MISTAKE

The IRS waived the 60-day rollover requirement where a taxpayer's failure to timely roll over funds was due to his misunderstanding that the account at issue was an IRA, since he clearly intended direct rollover of his retirement savings into an IRA. (PLR 201522012)

The taxpayer participated in a defined benefit plan and a profit sharing plan, both maintained by his former employer. In 2013, he received notice that the plans were both being terminated. The taxpayer directed the funds in both plans to be rolled into his IRA.

However, the account that the taxpayer had indicated the funds be rolled into was not, in fact, an IRA. The taxpayer only realized his mistake when he received a 1099-DIV for a dividend distribution from the supposed IRA account; he immediately requested a waiver and provided documentation proving that the funds from the two accounts had not been used for any other purpose.

In determining whether to grant a waiver of the 60-day rollover requirement, the IRS will consider all relevant facts and circumstances, including:

- Errors committed by a financial institution;
- Inability to complete a rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country, or postal error;
- The use of the amount distributed (for example, in the case of payment by check, whether the check was cashed); and
- The time elapsed since the distribution occurred.
  (IRC §402(c)(3)(B); Rev. Rul. 2003-16)

The IRS determined that the taxpayer had clearly intended the funds to be rolled over into an IRA, and the documentation the taxpayer provided proved that the failed rollover was due to a misunderstanding.

SALARY TO TAXPAYER BY IRA-OWNED LLC WAS PROHIBITED TRANSACTION

The Eighth Circuit has affirmed the Tax Court's finding that where an individual's IRA owned shares of his business, the company's payment of compensation to the taxpayer was a prohibited transaction resulting in the disqualification of the IRA and a deemed distribution of its assets. (***Ellis v. Comm.*** (June 5, 2015) U.S. Court of Appeals, Eighth Circuit, Case No. 14-1310; ***Ellis v. Comm.***, TCM 2013-46)

Facts

In May 2005, the taxpayer organized CST, an LLC. The LLC's operating agreement listed the taxpayer's self-directed IRA as owning 98% of the membership interest and an unrelated individual as owning 2%. The taxpayer was designated as the general manager for CST and given full authority to act on behalf of the company.

Shortly thereafter, the taxpayer transferred $319,000 from his 401(k) with a former employer to the self-directed IRA.

During 2005, CST paid the taxpayer $9,754 as compensation for his role as general manager of CST. CST made these payments using checks issued from the LLC's checking account and not from the custodial account of the taxpayer's IRA.

Arguments

The taxpayer relied on the Department of Labor regulation 29 CFR §2510.3-101 in arguing that a prohibited transaction did not occur because his salary was drawn from CST's account and not from the IRA. He also argued that the payment of wages was exempt under IRC §4975(d)(10), which excludes from the list of prohibited transactions the receipt by a disqualified person of reasonable compensation for services rendered.

The court rejected the taxpayer's reliance on the DOL regulation because the plain language of IRC §4975(c) prohibits both direct and indirect self-dealing with respect to plan income or assets. The court also rejected the taxpayer's reasonable compensation argument, noting that reasonable compensation may only be paid for services rendered on behalf of the plan. CST compensated the taxpayer for his services as general manager of the company, not for any services related to his IRA.

Accordingly, the taxpayer engaged in a prohibited transaction. The plan lost its status as an IRA, and all of its assets were deemed distributed to the taxpayer.

EXCESS CONTRIBUTIONS TO IRAs

No deduction is allowed for excess contributions to an IRA, and the amount of excess contribution is subject to a 6% penalty. (IRC §§219(a), 219(b), 4973(b)) An excess contribution is subject to the 6% penalty each year until it is withdrawn. The excess, when withdrawn, is taxed as ordinary income and subject to the additional 10% tax for early withdrawal under IRC §72(t) unless an exception applies. (IRC §408(d)(1))

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The IRC prescribes three principal strategies to deal with an excess contribution:

- Withdraw the excess by the due date of the return;
- Withdraw the excess after the due date of the return; or
- Carry forward excess contributions to later years.

Each of these strategies is discussed below. Excess contributions are reported on Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts.

Withdraw excess by due date of return

An excess contribution may be withdrawn from an IRA by the tax return due date (including extensions) for the year the excess contribution was made without the 6% penalty. (IRC §408(d)(4)) Any income attributable to the excess contribution must also be withdrawn and included in gross income for the year in which the contribution was made. The income earned on the withdrawn contribution must be recognized in the year to which the contribution related, regardless of when it was actually earned, and the income is subject to the 10% additional tax if the taxpayer is not yet 59½ years old (the 10% additional tax is discussed in Chapter 7 — Distributing). (IRC §408(d)(4)(C))

Calculate reportable earnings

If a contribution is made to a new account and the entire contribution is returned, all of the earnings must also be returned. However, if an excess contribution is commingled with funds already in the account, or an excess contribution is just part of a contribution, the earnings attributable to the excess contribution must be sorted out from other earnings.

The earnings allocable to a distributed amount is determined by allocating to the contribution a *pro rata* portion of the earnings accrued by the IRA during the period the IRA held the excess contribution. (Treas. Regs. §1.408-11) Treasury Regulation §1.408-11(a) provides the following formula where "Adjusted Opening Balance" is the balance (at fair market value) on the date of the excess contribution and "Adjusted Closing Balance" is the balance on the date the contribution is removed:

$$\text{Net income} = \frac{\text{Excess Contribution} \times (\text{Adjusted Closing Balance} - \text{Adjusted Opening Balance})}{\text{Adjusted Opening Balance}}$$

Example of excess contribution removed by due date of return

Harry is anxious to make his IRA contribution early in the year so he can start enjoying tax-deferred earnings as soon as possible. He makes a $5,000 contribution on January 1, 2013. Unfortunately, Harry is laid off from his job on January 10, 2013, and does not find another job for the rest of the year. His W-2 income is $3,000, so based on his taxable compensation limit, his maximum IRA contribution is $3,000. He has a $2,000 excess contribution.

On February 10, 2014, Harry requests a return of the $2,000 plus allocable earnings.

At the time he made the $5,000 contribution, the account value was $20,000 (including the $5,000 contribution; i.e., the moment before the contribution, the value was $15,000). As such, his adjusted opening balance is $20,000. At the time he requested removal, the adjusted closing balance was $30,000.

Harry has $1,000 of earnings attributable to the excess contribution calculated as follows:

$2,000 × (($30,000 - $20,000) ÷ $20,000 = $1,000

Harry must remove a total of $3,000 from the account. He has $1,000 of taxable earnings in 2013.

Multiple contributions

If, during the course of a year, a taxpayer makes multiple contributions that, together, account for an excess contribution, the last contributions are the excess contributions. (Treas. Regs. §1.408-11(c)(2))

> ***Example of multiple contributions***
>
> Assume, in the example above, that all the facts are the same except that Harry made five $1,000 contributions instead of a single $5,000 contributions. He made the contributions on January 1, February 1, March 1, April 1, and May 1. The excess contributions were made on April 1 and May 1. Harry must run the formula twice; once for the April 1 contribution and once for the May 1 contribution.

Multiple accounts: If a taxpayer owns multiple IRA accounts, the net income calculation is performed only on the IRA account containing the contribution being returned, and that IRA is the IRA that must distribute the contribution. (Treas. Regs. §1.408-11(c)(3))

Withdraw excess after due date of return

Excess contributions withdrawn after the due date of the return are not included in the taxpayer's income if no deduction was claimed, and the taxpayer's aggregate IRA contributions (other than rollovers) for the year do not exceed the maximum deductible amount. However, the 6% penalty is imposed for each year the excess contribution remains in the IRA, excluding the year of the distribution.

If a deduction was taken on the contribution, the taxpayer may file an amended return to correct as long as the amended return is filed within the statute of limitations for the year.

The withdrawal can take place at any time.

Carryover excess

Excess contributions from one year may be treated as IRA contributions in a later taxable year, but the 6% excise tax applies to each year the excess contribution remains in the IRA. (IRC §§219(f)(6), 4973(a)) This correction occurs automatically for any year for which a taxpayer fails to contribute the maximum allowable amount to the taxpayer's IRA. Note, however, that if the statute of limitations has expired on the year of the excess contribution and a deduction was taken for the contribution in that year, the excess contribution is instead remedied by reducing the allowable deduction for the later year. (IRC §219(f)(6)(C))

> ***Example of carryover of excess contribution***
>
> Kay earned $3,000 salary in 2013 and contributed $5,000 to an IRA. On April 1, 2014, she withdraws $2,000 (plus the income attributable to the $2,000). She is not subject to the 6% penalty. The income attributable to the excess contribution is taxable in 2013.
>
> Assume instead that Kay does not withdraw any amount after the contribution. She has an excess contribution for 2013 of $2,000, and must pay a penalty of $120 (6% × $2,000) for 2013. In 2014 she earns $15,000 in compensation and makes a $1,000 contribution to her IRA. Kay will automatically be treated as having made an additional contribution of $2,000 for 2014 and will be allowed to deduct $3,000 as her 2014 IRA contribution.

Planning for the penalties

An excess contribution may entail the unusual practice of planning around penalties.

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Example of options

Ethel is 58 and has no earned income. She "converted" her $10,000 mutual fund (not an IRA) to an IRA in 2013. The IRA earned $500 in 2013 and $100 in 2014 before she discovered the error. In 2014, she has $50,000 of earned income (and is otherwise qualified to make an IRA contribution of up to $6,000). Here is what she can do to avoid the 6% excess contribution penalty.

1. She may remove the $10,600 from the IRA on or before she files her return on April 15, 2014. In this case:
   - She will not owe a 6% excess contribution penalty;
   - She must report the $600 on her 2010 return; and
   - She is subject to an early distribution penalty of $60 (($500 + $100) × 10%).
2. Within six months of filing her return she may withdraw the excess, file an amended 2013 return, and attach the statement to her return.
   - She will not owe a 6% excess contribution penalty;
   - She must report the $600 on her 2013 return; and
   - She is subject to an early distribution penalty based on the interest earned in 2013 and 2014.
3. Because she is eligible for a $6,500 IRA contribution in 2014, she may carry the contribution forward.
   - She will be subject to a 6% penalty on the $10,000 in 2013; and
   - She must remove $4,000 plus the $600 of earnings or she will be subject to another penalty (she may choose to carry forward the $4,000 to 2015).

Example of options, again

Jeremy makes a Roth contribution of $5,000 in 2013, but it turns out he was only eligible to make a $3,000 contribution. The account does well and it has earnings of $1,000. He knows that he will be able to make $5,000 in contributions in 2014.

Jeremy has two options:

- Withdraw the excess contribution on or before the extended due date of the return. Pay tax and the 10% additional tax on the earnings but avoid the 6% penalty; or
- Carry over the excess to 2014. Avoid the tax on the earnings and the 10% additional tax but pay the 6% penalty for one year.

The 10% penalty (Option 1) would be $100, and if he's in a 25% tax bracket, the tax would be $250. The 6% penalty (Option 2) would be $120 (6% × $2,000 excess contribution). As such, Jeremy would be better off paying the 6% penalty.

HOW SOCIAL SECURITY BENEFITS ARE CALCULATED

When you consider that Social Security benefits are intended to replace 40% of the average person's earnings and 30% of high-earners' incomes, it's somewhat amazing that the method of calculating those benefits remains a mystery to most people. In fact, the calculation is a mystery to most financial professionals.

Many financial professionals know that you can use the Social Security Administration's online calculator, but what about those client questions such as, "What if I work another three years?" A basic understanding of the calculation can help you answer those questions off the top of your head and avoid having to do research.

Let's start by stating the method in one sentence:

Your benefit is a (1) graduated percentage of the (2) average of your income in (3) your 35 highest-earning years (4) after adjusting those earnings for inflation.

Simple enough. Now let's complete the picture.

Average Indexed Monthly Earnings (AIME)

The first step is to get the annual income subject to Social Security withholding during a worker's lifetime (up to the year the worker turns 60) and index the amounts for inflation. Next, get the earnings amounts for years after age 60 (for years after age 60, there is no inflation adjustment). Select the 35 highest yearly numbers (some may be zero; these amounts are found in individuals' Social Security statements). Add them together, and divide the total by 420 (the number of months in 35 years). The result is the Average Indexed Monthly Earnings (AIME).

To determine the indexed amount for each year prior to age 60, multiply the amount earned (but not more than the maximum wages subject to FICA) by a ratio of:

- The "average wage index" amount for the year the worker turns 60; over
- The average wage index for each year of earnings.

$$\frac{\text{Income in year earned} \times \text{Average wage in year individual turns 60}}{\text{Average wage in year earned}} = \text{Indexed amount}$$

The Social Security Administration (SSA) provides an average wage indexing series for 1951 through 2013. The list can be obtained at:

Website
www.socialsecurity.gov/OACT/COLA/AWI.html#series

Example of AIME computation

Joe turned 60 in 2009 and earned $15,000 in 1980 when the average wage index was $12,513.46. For 2009, the average wage index was $40,711.61. The 1980 indexed amount is computed as follows:

$$\frac{\$15{,}000 \times \$40{,}711.61}{\$12{,}513.46} = \$48{,}801.38$$

If $48,801.38 represents one of Joe's 35 highest earnings years, it would be included in the computation of AIME.

Primary Insurance Amount (PIA)

Now let's talk about that "graduated percentage" we mentioned in the one-sentence definition above. The graduated percentages are 90%, 32%, and 15%. Multiplying the AIME amount by these brackets, or what the SSA calls "bend points," will determine the amount the individual will receive at full retirement age. The computation is much like computing taxes using tax brackets.

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For workers retiring in 2015, the computation is:

- 90% of the first $826;
- 32% of the amount from $827 to $4,980; and
- 15% of amount over $4,980.

The result is the Primary Insurance Amount (PIA). The PIA is the initial monthly benefit amount (before COLAs) for a worker who retires at full retirement age, based on the income earned in prior years.

Example of PIA calculation

Joe's AIME is $5,000. Here's the PIA calculation if he retires in 2015:

90% × $826	$ 743.40
32% × $4,154 ($4,980 - $826)	1,329.28
15% × $20 ($5,000 - $4,980)	3.00
PIA	**$2,075.68**

The ballpark calculation

The chief value of knowing how benefits are calculated is that you can understand the effects of retirement alternatives in terms of additional earnings years and early or late retirement.

With regard to additional earnings, additional benefits will be the excess of the amount of earnings in the additional year over the lowest earnings year, divided by 420, times the bracket rate.

Example of additional benefits

From an earlier example, Joe's AIME is $5,000 and his PIA is $2,075.68. His lowest earning year was an indexed $20,000. If he earns $60,000, his PIA will go up $14.29, calculated as follows:

($60,000 - $20,000) ÷ 420 × 15% = $14.29

GIFT ISSUES

MERGER CREATES TAXABLE GIFT

Taxpayers who merged their company with their sons' company created an unreported gift of almost $30 million by assigning more stock to their sons based on their estate planning attorneys' advice. (***Cavallaro v. Comm.***, TCM 2014-189)

The attorney had incorrectly assumed that when the taxpayer-father handed the corporate minute book to his son at a meeting, this was a symbolic act transferring to the son ownership of the technology the father's company manufactured. Because the parents' company actually manufactured the technology and also held the patents, when the companies merged and the parents assigned 81% of the shares to the sons, they created a taxable gift of $29.6 million.

REVIEW QUESTIONS

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

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

17. Factors related to the R&D credit and the source of research funding are correctly outlined in which of the following choices?

    a) In order to be eligible for the credit, the research must demonstrate that it is achieving its intended result.
    b) The party that bears the financial risk of failure is the party that takes the research credit.
    c) The tax credit has been created to encourage commercial production.
    d) A client will qualify for the research credit even if that client is not required to pay unless the research is successful.

18. Details regarding the withdrawal of an excess IRA contribution by the due date of the return are correctly outlined in which choice?

    a) Even if income is withdrawn from the IRA by the due date, it is still subject to the 6% penalty.
    b) If an excess contribution is commingled with existing funds in the account, the earnings on the entire balance must be withdrawn and recognized as taxable income.
    c) If the taxpayer makes multiple contributions during the year that together result in an excess contribution, the excess contribution earnings are calculated on a pro rata basis for each contribution.
    d) If there is income earned on a withdrawn contribution, that income must be recognized in the year of the contribution even if it was actually earned later.

19. Which statement is true regarding Social Security benefits?

    a) An individual's Social Security benefit is essentially a graduated percentage of the average of that individual's income in his or her 40 highest earning years after adjusting the earnings for inflation.
    b) When calculating Social Security benefits, the first step is to find out the annual income that has been subject to Social Security withholding during a worker's lifetime, up until he turns 60, and index the amounts for inflation.
    c) Earnings amounts after an individual is age 65 are not indexed for inflation.
    d) Social Security benefits are supposed to replace 30% of the average person's earnings.

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SOLUTIONS TO REVIEW QUESTIONS

17. Factors related to the R&D credit and the source of research funding are correctly outlined in which of the following choices? **(Pages 43)**

    a. Incorrect – Success in reaching the result is not the criteria for eligibility for the research credit.
    b. Correct – The standard has been set forth in ***Fairchild Industries, Inc. v. U.S.***, which concluded that the question of funded research depends on who bears the costs if there is no success in reaching the desired result.
    c. Incorrect – The credit is to incentivize research.
    d. Incorrect – In this case, the researcher is the one who claims the credit because the client is paying for a product result rather than the performance of the research necessary to achieve that result.

18. Details regarding the withdrawal of an excess IRA contribution by the due date of the return are correctly outlined in which choice? **(Pages 47)**

    a. Incorrect – The 6% penalty will not apply. The excess contribution and any income that is attributed to it must be withdrawn and included in gross income for the year of the contribution and is subject to the 10% tax for early withdrawal.
    b. Incorrect – The earnings must be allocated to the *pro rata* portion attributable to the earnings accrued by the IRA when it held the excess.
    c. Incorrect – Under Treas. Regs. §1.408-11(c)(2), the latest contributions are considered the ones in excess.
    d. Correct – This income is subject to a 10% additional tax if the taxpayer is under age 59 ½.

19. Which statement is true regarding Social Security benefits? **(Page 50)**

    a. Incorrect – The 35 highest earning years are averaged in the calculation of benefits.
    b. Correct – This is the first step required when figuring out the Average Indexed Monthly Earnings (AIME). These amounts are assessed in addition to earnings after age 60 (which are not indexed for inflation). The 35 highest yearly numbers are added together and divided by 420 (35 years × 12 months) to arrive at the AIME.
    c. Incorrect – The threshold age is 60, after which there is no inflation adjustment for earnings.
    d. Incorrect – The benefits are intended to replace 30% of high earners' incomes and about 40% of average workers' earnings.

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FAILURE TO DESCRIBE GIFTS EXTENDS SOL

The IRS must assess the amount of any gift tax within three years after Form 709 is filed. (IRC §6501(a)) In the case of a gift that is required to be "shown" on a return, but which is not shown, the gift tax may be assessed at any time. (IRC §6501(c)(9))

In Field Attorney Advice 20152201F, the IRS determined that a taxpayer did not adequately disclose the nature and amount of gifts (transfers of interests in two partnerships) to his daughter by failing to correctly identify one of the partnerships and by not adequately describing the method used to value the interests. As a result, the period of limitations for the gift tax was held open indefinitely.

The taxpayer attached a one-paragraph supplement to his Form 709 with the heading "Valuation of gifts." The supplement stated that partnership interests were given in two partnerships and provided their TINs. The supplement stated that the assets of the partnership were primarily farm land and that the land was independently appraised by a certified appraiser. The statement indicated the percentage discounts that were taken for "minority interests, lack of marketability, etc." to obtain a fair market value of the gift.

However, the Form 709 failed to provide a sufficient description of the transferred property. Specifically:

- The return and statement provided the proper nine-digit Employer Identification Number (EIN) for only one of the partnership interests transferred, the second number contained only eight digits;
- The return used incorrect, abbreviated names for both partnerships, without explaining what the abbreviation was for;
- The labels omitted the "LP" (limited partnership) and "LLP" (limited liability partnership) designations, wrongly implying that the partnerships were traditional partnerships under state law;
- The return described the transferred property as partnership interests without explaining whether the donor transferred general, limited, or limited liability interests;
- The valuation description didn't include a detailed description of the method used to determine the fair market value of the property transferred, including any financial data utilized in determining the value of the interests;
- There was no financial data (e.g., actual land values) used in determining the value of the gifts; and
- The description didn't identify any restrictions on the transferred property that were considered in determining its fair market value.

Adequate disclosure

Where the gift consists of an interest in an entity that is not actively traded, the gift description must include any discount claimed in valuing the interests in the entity or any assets owned by such entity. Additionally, if the value of the entity is properly determined based on the net value of its assets, the return must include a statement regarding the value of 100% of the entity.

A transfer will be considered adequately disclosed to IRS if the following information is provided:

- A description of the transferred property and any consideration received by the transferor;
- The identity of, and relationship between, the transferor and each transferee;
- If the property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the complete trust instrument;

- A detailed description of the method used to determine the fair market value of property transferred, including any financial data (for example, balance sheets, etc. with explanations of any adjustments) that were utilized in determining the value of the interest, any restrictions on the transferred property that were considered in determining the fair market value of the property, and a description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property. (Alternately, a donor can provide an appraisal in lieu of this information (Treas. Regs. §301.6501(c)-1(f)(3)); and
- A statement describing any position taken that is contrary to any proposed, temporary, or final Treasury Regulations or Revenue Rulings published at the time of the transfer. (Treas. Regs. §301.6501(c)-1(f)(2))

ESTATE ISSUES

SAVE ESTATE TAXES ON LIFE INSURANCE BY NOT PUTTING IT IN THE CLIENT'S NAME

One of the enduring myths about life insurance is that its death benefits are tax-free. While it is true that the proceeds are exempt from income tax for the beneficiaries, those same benefits may be subject to tax in the estate of the insured.

That is the irony of buying life insurance to pay for estate taxes, which is often a strategy used by those whose gross estate exceeds the tax-free limit. The policy proceeds become part of the estate tax bill they are intended to pay. Assume an estate is facing a federal estate tax of $200,000. If a $200,000 life insurance policy is purchased to satisfy that bill, the proceeds will be added to the total value of the estate, so the estate ends up owing an additional $80,000 in estate tax, meaning the estate is still $80,000 shy of paying the estate tax.

ILIT

One way out of this dilemma is to set up an irrevocable life insurance trust (ILIT), which takes over the ownership of the insurance policy.

The trust may also serve other ends. For example:

- At the death of the insured, the policy proceeds may remain in trust to provide regular income for a surviving spouse or income to continue the management of the decedent's business until a successor is found or the business is sold;
- If properly drafted, the principal will also not be included in the surviving spouse's estate;
- The trust may be used to distribute proceeds to children from a previous marriage; and
- A life insurance trust can be designed to distribute a limited amount of the insurance proceeds over a period of time to a financially irresponsible child. Yet should that child suddenly have need for extra money, the trust can provide additional funds at the discretion of the trustee.

Despite the advantages of an irrevocable life insurance trust, anyone considering setting one up should keep several other things in mind.

It is irrevocable

Technically, a life insurance trust is called an irrevocable life insurance trust, or ILIT. The insured must give up all control of the policy in order to keep its proceeds out of the estate. That means the insured cannot:

- Change the beneficiary;
- Cancel the policy;
- Borrow against the policy; or
- Alter the terms of the policy should circumstances change.

The insured may not even legally compel the trustee to use the proceeds to pay estate taxes. Consequently, the trustee should be someone who is competent and who is certain to carry out the wishes of the trustor, the creator of the trust. A common choice is a close friend or a financial institution, but someone who is not a beneficiary.

Three-year rule

If an existing life insurance policy is transferred into a life insurance trust and the owner/insured dies within three years of that transfer, the ownership of the policy reverts back to the estate of the insured and the estate is responsible for estate tax on the proceeds. (IRC §2035(a)) One way around this risk is to have the trust buy a new policy.

The beneficiaries can spend some of the trust funds

Whether a policy is transferred into a life insurance trust or the trust buys a new policy, sufficient funds must be gifted to the trust to pay the premiums due on the policy. But, to meet the gift-tax exclusion rules, the trust must contain what is known as a ***Crummey*** provision. (***Crummey v. Comm.*** (1968) 397 F.2d 82)

If the beneficiaries hold ***Crummey*** powers, the transfers to the trust qualify as present interest gifts, which qualify for the annual gift tax exclusion.

The unrestricted right to the immediate use, possession, and enjoyment of the contribution, whether or not exercised, qualifies as a transfer of a present interest for the annual exclusion under IRC §2503(b). (Rev. Rul. 80-261) To qualify, the beneficiary must be given prompt notice of his or her right of withdrawal and a reasonable opportunity to exercise the power before it lapses. (Rev. Rul. 81-7)

The IRS has determined that 30 days constitutes a reasonable period of time between notice of the withdrawal right and its lapse. (PLR 9030005)

This provision allows beneficiaries the opportunity to withdraw their share of the gift, typically within a certain time (e.g., 30 days). Most financial advisors recommend using the "five by five" rule, meaning that a beneficiary may take the greater of $5,000 or 5% of the trust assets as the limiting factor for the amount that can be withdrawn. Of course, if beneficiaries exercise this power and withdraw funds from the trust, they have defeated the purpose of the trust.

Trusts cost money

Beyond the cost of paying for what could be substantial insurance premiums, legal fees for establishing a life insurance trust can easily run up to $1,500 or more plus the annual fees to administer the trust.

In view of these drawbacks and risks, some might argue that it is easier to have the beneficiaries directly own policies on the life of the insured and dispense with the hassle of an ILIT. However,

some beneficiaries may not be mature or responsible enough to use the money to pay estate taxes or as otherwise intended by the insured. Also, divorce, bankruptcy, or a lawsuit against a beneficiary may allow access to the policy's cash value or the proceeds by an ex-spouse or creditors. An ILIT would prevent this. Separate policies also are more complicated if several beneficiaries are involved.

FOUR REASONS TO RECOMMEND LIFE INSURANCE TO WEALTHY CLIENTS

Life insurance can assist with liquidity and also provide for continuity of income, making bequests outside the normal will and trust, and caring for special needs children.

Running the business

Many estates are largely composed of two main assets: the personal residence and the family business. The "family business" may actually be operated solely by one individual. If that individual dies, someone (or several someones) may be needed to continue operating the business until it is sold or a permanent new manager is put in place. Life insurance will provide cash needed to pay for one or more consultants to operate the business — and provide funds to make the house payment when the owner/employee is no longer drawing a salary.

"True story …"

John was the sole shareholder/employee of a manufacturing company in Fullerton, California, that produced specialty screws. John oversaw all aspects of the business, including marketing, finances, and assembly line operation. He had three managers, but he made most of the decisions himself. When he died suddenly and his wife was ill, their daughter was forced to hire a consultant at a rate of $250 per hour to run the business and hire a CEO and marketing director if the family decided to keep the business.

In the fierce competitive market, it was imperative that the company continue to operate without a hitch. The daughter was forced to borrow from the bank to continue making the house payment, her mother's medical expenses, and the manager's salary until the business could be sold. Life insurance would have been an easier way to pay these expenses.

Beneficiary's dependents who are not also beneficiaries of that trust

Those whose livelihood depends heavily on a trust from a previous generation should examine whether, when they die, the surviving spouse and other dependents also need to and are able to rely on that trust as a source of support.

It is highly unlikely that stepchildren who might be dependents are also the residual beneficiaries. The trust may also not provide for the surviving spouse, especially in the case of a second marriage. In the case of adopted children, some state laws presume intent to include them as beneficiaries.

However, the trust document may expressly provide otherwise. In any case, it is usually the spouse and stepchildren whose lifestyles will suffer in the absence of life insurance, especially in situations where the trust beneficiaries have not had a chance to accumulate estates of their own. Where there are no other sources of significant income, the beneficiary should be encouraged to buy life insurance to provide for nonbeneficiary dependents.

"Outcast relative"

In some cases, the parents may be estranged from a child or have a child from a previous marriage or relationship. A life insurance policy will provide direct benefit to that child with minimal interaction with the other beneficiaries. The life insurance is paid directly to the child, and other than possible inclusion of the life insurance in the estate, the "outcast" child does not have to interact with the other beneficiaries.

Funding the special needs of a child

Special bequests made with life insurance can be used effectively and compellingly to benefit disabled family members. Life insurance trusts for this purpose are most common today in those states that allow for "supplemental" or "special needs" trusts.

The policies are owned by or pay into such a trust and are then used to supplement an individual's Medicaid or other public funding. There is no requirement that the monies be used to pay for support that is provided by the government or to make any reimbursement for these services.

Instead, they can be applied toward supplemental items, over and above those the government will pay for or provide. Even where the parents are wealthy enough that no dependence on government support is envisioned, a life-insurance-funded trust can still be an excellent way to provide for a handicapped child, with other family members (or perhaps the facility providing the care) designated as secondary beneficiaries.

Effective estate planning requires a perspective reaching beyond our own lifetimes. Business and investment planning, which uses a rate-of-return analysis but ignores the impact of death taxes, does less than half the job. Similarly, planning that overlooks the need for cash almost immediately after death, or that assumes cash can be painlessly generated from the sale of real estate, stocks, and bonds, may be equally shortsighted.

CHARITABLE CONTRIBUTIONS

IRS's EXEMPT ORGANIZATIONS SELECT CHECK SERVICE

The IRS's Exempt Organizations Select Check is an online search tool that allows users to search for and select an exempt organization and check certain information about the organization's federal tax status and filings. The tool allows taxpayers to search for organizations that:

- Are eligible to receive tax-deductible charitable contributions. Users may rely on this list in determining deductibility of their contributions;
- Have had their tax-exempt status automatically revoked under the law because they have not filed Form 990 series returns or notices annually as required for three consecutive years (Auto-Revocation List); and
- Have filed a Form 990-N (e-Postcard) annual electronic notice. (Most small exempt organizations whose annual gross receipts are normally $50,000 or less are required to electronically submit Form 990-N, unless they choose instead to file a completed Form 990 or Form 990-EZ.)

To access the tool, go to:

Website
http://apps.irs.gov/app/eos/

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Real life example

In the wake of South Carolina flooding devastation, the IRS cautioned those interested in contributing toward disaster relief to only donate to established charitable organizations and to not give cash or provide personal financial information. (IR-2015-114) The IRS also reminds taxpayers to use Exempt Organizations Select Check, to find qualified, legitimate charities.

The IRS issued a consumer alert about possible fake charity scams emerging following the severe flooding in South Carolina and neighboring states.

Following major disasters, it is common for scam artists to impersonate charities to get money or private information from well-intentioned taxpayers. Such fraudulent schemes may involve contact by telephone, social media, e-mail, or in-person solicitations.

The IRS cautions people wishing to make disaster-related charitable donations to avoid scam artists by following these tips:

- To help disaster victims, donate to recognized charities;
- Be wary of charities with names that are similar to familiar or nationally known organizations. Some phony charities use names or websites that sound or look like those of respected, legitimate organizations. Use Exempt Organizations Select Check to find legitimate, qualified charities; donations to these charities may be tax-deductible. Legitimate charities may also be found on the Federal Emergency Management Agency (FEMA) website at: www.fema.gov;
- Don't give out personal financial information such as Social Security numbers or credit card and bank account numbers and passwords to anyone who solicits a contribution from you. Scam artists may use this information to steal your identity and money;
- Don't give or send cash. For security and tax record purposes, contribute by check or credit card or another way that provides documentation of the gift; and
- If you plan to make a contribution for which you would like to claim a deduction, see IRS Publication 526, Charitable Contributions, to read about the kinds of organizations that can receive deductible contributions.

Bogus websites may solicit funds for disaster victims. Such fraudulent sites frequently mimic the sites of, or use names similar to, legitimate charities, or claim to be affiliated with legitimate charities in order to persuade members of the public to send money or provide personal financial information that can be used to steal identities or financial resources.

Additionally, scammers often send an e-mail that steers the recipient to bogus websites that appear to be affiliated with legitimate charitable causes.

CHARITABLE CONTRIBUTIONS MADE WITH SOMEONE ELSE'S MONEY ARE DISALLOWED

A taxpayer was denied charitable contribution deductions for contributions that were made using funds from his company. (***Zavadil v. Comm.*** (July 16, 2015) U.S. Court of Appeal, Eighth Circuit, Case No. 14-1053) The taxpayer wasn't able to show that the funds were actually his and not funds advanced to him by the company. The taxpayer had an arrangement where the company paid all of his expenses which he would then reimburse. However, for the years in question, the taxpayer didn't have enough funds to repay the company and was living on a series of advances from the company. The court determined that the taxpayer had not made the contributions using his own funds, and he was therefore not allowed to benefit from the deduction.

NO CHARITABLE CONTRIBUTION DEDUCTION FOR EASEMENT WHEN MORTGAGES ARE NOT SUBORDINATED

In two Appeals court cases involving almost identical facts and taxpayers making almost identical arguments, the courts ruled that to be eligible for a deduction for the donation of a conservation easement, any outstanding mortgages must be subordinated to the rights of the holder of the easement at the time of the gift. (***Mitchell v. Comm.***,_F3d_(10th Cir. 2015); ***Minnick v. Comm.***,_F3d (9th Cir. 2015))

In both cases, the taxpayer donated a conservation easement in which the terms of the deed purported to transfer the easement in perpetuity and in a manner necessary to satisfy the requirements of IRC §170(h). However, neither taxpayer obtained a subordination agreement from the lender holding an outstanding mortgage on the subject property.

Taxpayers' arguments

Both taxpayers made roughly the same arguments. The principle argument was that the risk of foreclosure was so remote as to be negligible given the donors history of timely payments and the net worth of the donors. The Minnicks pointed to Treas. Regs. §1.170A-14(g)(3) which provides that a "deduction shall not be disallowed … merely because the interest which passes to … the donee organization may be defeated by the performance of some act or the happening of some event, if on the date of the gift it appears that possibility that such act or event will occur is so remote as to be negligible."

The IRS countered that the mortgage subordination requirement is a strict bright-line requirement that requires any existing mortgage at the time of the donation to be subordinated to the rights of the holder of the easement, regardless of the risk of foreclosure.

Courts' rulings

The courts explained that, although taxpayers are generally not permitted to deduct charitable contributions of partial interests in property, the Code provides an exception for contributions of conservation easements. However, the donation must meet certain statutory requirements. One such requirement is that the conservation easement must be "protected in perpetuity." Because the Code does not define "protected in perpetuity" Congress tasked the IRS with promulgating rules to ensure that conservation easement be protected in perpetuity. Pursuant to that authority, the IRS promulgated Treas. Regs. §1.170A-14(g) which includes the mortgage subordination requirement.

The courts explained that requiring existing mortgages to be subordinated to conservation easements prevents extinguishment of the easement in the event the landowners default on the mortgages.

The courts countered the taxpayers' argument under Treas. Regs. §1.170A-14(g)(3) - that the risk was so remote as to be negligible - by first noting that the remote future event provision does not modify the mortgage subordination requirement. Moreover, the court noted that foreclosure is "relatively unexceptional." Finally, the remote future event provision contains examples that are too unlike the risk of foreclosure for the court to believe that the IRS intended the provision to cover it.

NO CONSERVATION EASEMENT WHERE TAXPAYER COULD ALTER PROPERTY'S BOUNDARIES

In two similar cases, the Tax Court concluded that taxpayers weren't entitled to claim a charitable contribution deduction for a conservation easement because they retained a right to modify the boundaries of the donated land. (***Balsam Mountain Investments LLC v. Comm.***, TCM 2015-43; ***Bosque Canyon Ranch v. Comm.***, TCM 2015-130)

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Facts

In both cases, the taxpayers were land developers who acquired large tracts of land on which to develop homes. In order to make the homes more attractive to potential buyers, they promised that a large portion of the tract would remain open space. They then entered into a conservation easement for a designated portion of the land and took a charitable contribution deduction for that conservation easement.

However, in both cases, the easement agreement reserved for the donor/developer the right to make minor alterations to the boundary of the conservation area. For example, Balsam's agreement provided that the taxpayer could make minor alterations only if the following conditions were met:

- The area of the subject land was not reduced;
- Any added land was contiguous and connected by an area of substantial width;
- Any added land made an equal or greater contribution to the conservation purposes than that which was removed;
- The aggregate land removed (and substituted with other land) could not exceed 5% of the subject land;
- The boundary adjustment could only be made within five years of the easement's creation;
- Proposed boundary changes were subject to the Trust's prior review and approval;
- The Trust would not approve any change if it would, directly or indirectly, result in any material adverse effect on the conservation purposes; and
- The new boundary had to be set out in a written amendment to the conservation easement.

Court's conclusion

Both courts relied on their decision in ***Belk*** in which the Tax Court held that a taxpayer wasn't entitled to claim a charitable contribution deduction because a provision in the grant allowed for a substation of the donated property. (***Belk v. Comm***. (2013) 140 TC 1) The court found that this was inconsistent with the requirement that the conservation easement be protected in perpetuity. (Treas. Regs. §1.170A-14(b)(2))

In denying a reconsideration of its earlier decision, the Tax Court clarified that IRC §170(h)(2)(C) requires that taxpayers donate an interest in "an identifiable, specific piece of real estate." (***Belk v. Comm***., TCM 2013-154)

Finally, the Fourth Circuit found that the easement did not restrict "a defined and static parcel" of real estate, and so it wasn't a qualified real property interest. (***Belk v. Comm***. (2014) U.S. Court of Appeals, Fourth Circuit, Case No. No. 13-2161)

> **Caution**
>
> Even though the charitable contribution deduction was denied, the transfer is legally completed. Therefore, the taxpayer is out both the property and the deduction.

QUALIFIED CONSERVATION CONTRIBUTIONS, GENERALLY

Although charitable deductions are generally not allowed for donations of partial interests, an exception is made for a "qualified conservation contribution." (IRC §170(f)(3)(B)(iii); Treas. Regs. §1.170A-14(a)) This is a contribution of a qualified real property interest, including easements, to a qualified organization exclusively for conservation purposes. The donee must be prohibited from making certain transfers and the conservation purpose must be protected in perpetuity.

Conservation purposes include protecting a natural habitat, or preserving a land area, open space (including farmland and forest land), or a historically important land area or certified historic structure.

In perpetuity

Pay special attention to the "in perpetuity" traps that may arise when donating an easement.

An easement that may be extinguished, in whole or in part, by mutual consent of the parties does not satisfy the "in perpetuity" requirement. (***Carpenter, et al. v. Comm.***, TCM 2012-1)

A North Dakota law that limited real property easements to 99 years meant that a donor could not meet the requirement under IRC §170(h) that a conservation easement must be granted in perpetuity, even though the donors remaining interest was negligible. (***Wachter v. Comm.***, 142 TC 7)

In addition, an easement is not considered protected "in perpetuity" until it is recorded. In ***Zarlengo v. Comm.***, TCM 2014-161, taxpayers were denied a charitable contribution deduction in the year the easement was donated, because the easement had not been recorded until the following year.

A charitable deduction cannot be claimed if the donation has no material effect on the real property's FMV, or enhances rather than reduces its FMV. For example, little or no deduction may be allowed if the property's use is already restricted by zoning laws or by contract, and the donation does not further restrict how the property can be used (see **Chandler v. Comm.** (2014) 142 TC 16)

Enhanced income limits

Even if the property is capital gain property, for donations made prior to January 1, 2015, the contribution receives 50% treatment under IRC §170(b)(1)(E)(i). Certain contributions of qualified conservation property by farmers and ranchers get 100% treatment. (IRC §170(b)(1)(E)(iv)(I))

Enhanced carryovers

For contributions made prior to January 1, 2015, qualified conservation contributions are allowed a 15-year carryover period instead of the usual five years. (IRC §170(b)(1)(E)(ii))

$500 fee

In the case of a qualified conservation contribution that is a restriction relating to the exterior of a building located in a registered historic district for which a deduction of more than $10,000 is claimed, no deduction will be allowed unless the taxpayer includes a $500 filing fee with the return for the tax year of the contribution. (IRC §170(f)(13)) The payment is made by filing Form 8283-V.

Deduction allowed for conservation easement

The taxpayer granted a perpetual conservation easement covering a golf course that the donee (i.e., the North American Land Trust) owned and which resulted in a charitable contribution of approximately $30 million (the IRS auditors initially disallowed the entire deduction). The course was surrounded by a residential development, and the easement's value was determined by subtracting the value of the property being used for the golf course from the value of the land if it had instead been used as a residential subdivision. (***Kiva Dunes Conservation v. Comm.***, TCM 2009-145)

Consider, for a moment, what is going on here from a tax planning standpoint. The taxpayer probably never had any intent except to have a golf course on this property (because it was a widely advertised amenity for this community). Yet, by granting an easement to the local land trust, the taxpayer was able to create a charitable contribution deduction which flowed through from the partnership tax return to his personal return for more than $30 million.

California conformity

California's personal income tax law incorporates the federal provision allowing a charitable deduction for a partial interest for qualified conservation purposes. (R&TC §17201) California corporation tax law has provisions that mirror these provisions. (R&TC §§24357.2, 24357.7, 24358(b)) However, due to California's conformity date lag, California does not currently provide the enhanced contribution limits and extended carryover period for excess qualified conservation contributions. For California purposes, the contribution deduction is still capped at 30% AGI, and the carryover remains five years.

REGISTERED DOMESTIC PARTNERS

The following Q&As provide information to individuals of the same sex and opposite sex who are in registered domestic partnerships, civil unions, or other similar formal relationships that are not marriages under state law. These individuals are not considered as married or spouses for federal tax purposes. These individuals are referred to below as "registered domestic partners" (RDPs).

Q&A 9 through 27 concern RDPs who reside in community property states and who are subject to their state's community property laws.

These questions and answers reflect the Supreme Court's decision in ***United States v. Windsor***. As a result of the Court's decision, the IRS has ruled that same-sex couples who are married under state law are married for federal tax purposes. (Rev. Rul. 2013-17) Unmarried RDPs, however, are still required to file as single for federal purposes and married for California purposes.

RDP general tax issues

Q1. Can RDPs file federal tax returns using a married filing jointly or married filing separately status?

A1. No. RDPs may not file a federal return using a married filing separately or jointly filing status. Registered domestic partners are not married under state law. Therefore, these taxpayers are not married for federal tax purposes.

Q2. Can a taxpayer use the head of household filing status if the taxpayer's only dependent is his or her RDP?

A2. No. A taxpayer cannot file as head of household if the taxpayer's only dependent is his or her RDP. A taxpayer's RDP is not one of the specified related individuals in IRC §152(c) or (d) that qualifies the taxpayer to file as head of household, even if the RDP is the taxpayer's dependent.

Q3. If RDPs have a child, which parent may claim the child as a dependent?

A3. If a child is a qualifying child under IRC §152(c) of both parents who are RDPs, either parent, but not both, may claim a dependency deduction for the qualifying child. If both parents claim a dependency deduction for the child on their income tax returns, the IRS will treat the child as the qualifying child of the parent with whom the child resides for the longer period of time during the taxable year. If the child resides with each parent for the same amount of time during the taxable year, the IRS will treat the child as the qualifying child of the parent with the higher adjusted gross income.

Q4. Can an RDP itemize deductions if his or her partner claims a standard deduction?

A4. Yes. An RDP may itemize or claim the standard deduction regardless of whether his or her partner itemizes or claims the standard deduction. Although the law prohibits a taxpayer from itemizing deductions if the taxpayer's spouse claims the standard deduction (IRC §63(c)(6)(A)), this provision does not apply to RDPs, because RDPs are not spouses for federal tax purposes.

Q5. If RDPs adopt a child together, can one or both of the RDPs qualify for the adoption credit?

A5. Yes. Each RDP may qualify to claim the Adoption Credit for the amount of the qualified adoption expenses paid for the adoption. The partners may not both claim a credit for the same qualified adoption expenses, and the sum of the credit taken by each RDP may not exceed the total amount paid. The Adoption Credit is limited to $13,400 per child in 2015. Thus, if both RDPs paid qualified adoption expenses to adopt the same child, and the total of those expenses exceeds $13,400, the maximum credit available for the adoption is $13,400. The RDPs may allocate this maximum between them in any way they agree, and the amount of credit claimed by one RDP can exceed the adoption expenses paid by that person, as long as the total credit claimed by both RDPs does not exceed the total amount paid by them. The same rules generally apply in the case of a special needs adoption.

Q6. If a taxpayer adopts the child of his or her RDP as a second parent or co-parent, may the taxpayer ("adopting parent") claim the Adoption Credit for the qualifying adoption expenses he or she pays to adopt the child?

A6. Yes. The adopting parent may be eligible to claim an Adoption Credit. A taxpayer may not claim an Adoption Credit for the expenses of adopting the child of the taxpayer's spouse. (IRC §23) However, this limitation does not apply to adoptions by RDPs, because RDPs are not spouses for federal tax purposes.

Q7. Do provisions of the federal tax law such as IRC §66 (treatment of community income) and IRC §469(i)(5) ($25,000 offset for passive activity losses for rental real estate activities) that apply to married taxpayers apply to RDPs?

A7. No. Like other provisions of the federal tax law that apply only to married taxpayers, IRC §§66 and 469(i)(5) do not apply to RDPs because RDPs are not married for federal tax purposes.

Q8. Is an RDP the stepparent of his or her partner's child?

A8. If an RDP is the stepparent of his or her partner's child under state law, the RDP is the stepparent of the child for federal income tax purposes.

RDP community property issues

Q9. How do RDPs determine their gross income?

A9. RDPs must each report half the combined community income earned by the partners. In addition to half of the community income, a partner who has income that is not community income must report that separate income.

Q10. Can an RDP qualify to file his or her tax return using head of household filing status?

A10. Generally, to qualify as a head of household, a taxpayer must provide more than half the cost of maintaining his or her household during the taxable year, and that household must be the principal place of abode of the taxpayer's dependent for more than half of the taxable year. (IRC §2(b)) If RDPs pay all of the costs of maintaining the household from community funds, each partner is considered to have incurred half the cost and neither can qualify as head of household. Even if one of the partners pays more than half by contributing separate funds, that partner cannot file as head of household if the only dependent is his or her RDP. A taxpayer's RDP is not one of the specified related individuals in IRC §152(c) or (d) that qualifies the taxpayer to file as head of household, even if the partner is the taxpayer's dependent.

Q11. Can an RDP be a dependent of his or her partner for purposes of the dependency deduction under IRC §151?

A11. An RDP can be a dependent of his or her partner if the requirements of IRC §§151 and 152 are met. However, it is unlikely that RDPs will satisfy the gross income requirement of IRC

§152(d)(1)(B) and the support requirement of §152(d)(1)(C). To satisfy the gross income requirement, the gross income of the individual claimed as a dependent must be less than the exemption amount ($4,000 for 2015). Because RDPs each report half the combined community income earned by both partners, it is unlikely that an RDP will have gross income that is less than the exemption amount.

To satisfy the support requirement, more than half of an individual's support for the year must be provided by the person seeking the dependency deduction. If an RDP's (Partner A's) support comes entirely from community funds, that partner is considered to have provided half of his or her own support and cannot be claimed as a dependent by another. However, if the other RDP (Partner B) pays more than half of the support of Partner A by contributing separate funds, Partner A may be a dependent of Partner B for purposes of section 151, provided the other requirements of IRC §§151 and 152 are satisfied.

Q12. Can an RDP be a dependent of his or her partner for purposes of the exclusion in IRC §105(b) for reimbursements of expenses for medical care?

A12. An RDP (Partner A) may be a dependent of his or her partner (Partner B) for purposes of the exclusion in IRC §105(b) only if the support requirement (discussed in Question 11, above) is satisfied. Unlike the requirements for IRC §152(d) (dependency deduction for a qualifying relative), §105(b) does not require that Partner A's gross income be less than the exemption amount in order for Partner A to qualify as a dependent.

Q13. How should RDPs report wages, other income items, and deductions on their federal income tax returns?

A13. RDPs should report wages, other income items, and deductions according to the instructions to Form 1040 and related schedules, and Form 8958, Allocation of Tax Amounts Between Certain Individuals in Community Property States. Form 8958 is used to determine the allocation of tax amounts between RDPs. Each partner must complete and attach Form 8958 to his or her Form 1040.

Q14. Should RDPs report Social Security benefits as community income for federal tax purposes?

A14. Generally, state law determines whether an item of income constitutes community income. Accordingly, if Social Security benefits are community income under state law, then they are also community income for federal income tax purposes. If Social Security benefits are not community income under state law, then they are not community income for federal income tax purposes.

Q15. How should RDPs report community income from a business on Schedule C, Profit or Loss From Business?

A15. Half of the income, deductions, and net earnings of a business operated by an RDP must be reported by each RDP on a Schedule C (or Schedule C-EZ). In addition, each RDP owes self-employment tax on half of the net earnings of the business. The self-employment tax rule under IRC §1402(a)(5) that overrides community income treatment and attributes the income, deductions, and net earnings to the spouse who carries on the trade or business does not apply to RDPs.

Q16. Are RDPs each entitled to half of the credits for income tax withholding from the combined wages of the RDPs?

A16. Yes. Because each RDP is taxed on half the combined community income earned by the partners, each is entitled to a credit for half of the income tax withheld on the combined wages.

Q17. Are RDPs each entitled to take credit for half of the total estimated tax payments paid by the partners?

A17. No. Unlike withholding credits, which are allowed to the person who is taxed on the income from which the tax is withheld, an RDP can take credit only for the estimated tax payments that he or she made.

Q18. Are community property laws taken into account in determining earned income for purposes of the Dependent Care Credit, the refundable portion of the Child Tax Credit, the Earned Income Credit, and the Making Work Pay Credit?

A18. No. The federal tax laws governing these credits specifically provide that earned income is computed without regard to community property laws in determining the earned income amounts described in IRC §21(d) (Dependent Care Credit), §24(d) (the refundable portion of the Child Tax Credit), §32(a) (Earned Income Credit), and §36A(d) (Making Work Pay Credit).

Q19. Are community property laws taken into account in determining adjusted gross income (or modified adjusted gross income) for purposes of the Dependent Care Credit, the Child Tax Credit, the Earned Income Credit, and the Making Work Pay Credit?

A19. Yes. Community property laws must be taken into account in determining the adjusted gross income (or modified adjusted gross income) amounts in IRC §21(a) (Dependent Care Credit), §24(b) (Child Tax Credit), §32(a) (Earned Income Credit), and §36A(b) (Making Work Pay Credit).

Q20. Are amounts received by an RDP for education expenses that cannot be excluded from the partner's gross income (includible education benefits) considered to be community income?

A20. Generally, state law determines whether an item of income constitutes community income. Accordingly, whether includible education benefits are community income for federal income tax purposes depends on whether they are community income under state law. If the includible education benefits are community income under state law, then they are community income for federal income tax purposes. If not community income under state law, they are not community income for federal income tax purposes.

Q21. If only one RDP is a teacher and pays qualified out-of-pocket educator expenses from community funds, do the RDPs split the educator expense deduction?

A21. No. IRC §62(a)(2)(D) allows only eligible educators to take a deduction for qualified out-of-pocket educator expenses. If only one RDP is an eligible educator (the eligible partner), then only the eligible partner may claim a §62(a)(2)(D) deduction. If the eligible partner uses community funds to pay educator expenses, the eligible partner may determine the deduction as if he or she made the entire expenditure. In that case, the eligible partner has received a gift from his or her partner equal to one-half of the expenditure.

Q22. If an RDP incurs indebtedness for his or her qualified education expenses or the expenses of a dependent and pays interest on the indebtedness out of community funds, do the RDPs split the interest deduction?

A22. No. To be a qualified education loan, the indebtedness must be incurred by a taxpayer to pay the qualified education expenses of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. (IRC §221(d)(1)) Thus, only the partner who incurs debt to pay his or her own education expenses or the expenses of a dependent may deduct interest on a qualified education loan (the student partner). If the student partner uses community funds to pay the interest on the qualified education loan, the student partner may determine the deduction as if he or she made the entire expenditure. In that case, the student partner has received a gift from his or her partner equal to one-half of the expenditure.

Q23. If RDPs pay the qualified educational expenses of one of the partners or a dependent of one of the partners with community funds, do the RDPs split the IRC §25A credits (education credits)?

A23. No. Only the partner who pays his or her own education expenses or the expenses of his or her dependent is eligible for an education credit (the student partner). If the student partner uses community funds to pay the education expenses, the student partner may determine the credit as if he or she made the entire expenditure. In that case, the student partner has received a gift from his or her partner equal to one-half of the expenditure. Similarly, if the student partner is

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allowed a deduction under IRC §222 (deduction for qualified tuition and related expenses), and uses community funds to pay the education expenses, the student partner may determine the qualified tuition expense deduction as if he or she made the entire expenditure. In that case, the student partner has received a gift from his or her partner equal to one-half of the expenditure.

Q24. Are community property laws taken into account in determining compensation for purposes of the IRA deduction?

A24. No. The federal tax laws governing the IRA deduction (IRC §219(f)(2)) specifically provide that the maximum IRA deduction (under §219(b)) is computed separately for each individual, and that these IRA deduction rules are applied without regard to any community property laws. Thus, each individual determines whether he or she is eligible for an IRA deduction by computing his or her individual compensation (determined without application of community property laws).

Q25. If an RDP is self-employed and pays health insurance premiums for both partners out of community property funds, are both partners allowed a deduction under IRC §162(l) (deduction for self-employed health insurance)?

A25. If one of the RDPs is a self-employed individual treated as an employee within the meaning of IRC §401(c)(1) (the employee partner) and the other partner is not (the non-employee partner), the employee partner may be allowed a deduction under IRC §162(l) for the cost of the employee partner's health insurance paid out of community funds. If the non-employee partner is also covered by the health insurance, the portion of the cost attributable to the non-employee partner's coverage is not deductible by either the employee partner or the non-employee partner under §162(l).

Q26. If an RDP has a dependent and incurs employment-related expenses that are paid out of community funds, how does the RDP calculate the Dependent Care Credit? How about the Child Tax Credit?

A26. If an RDP has a qualifying individual as defined in IRC §21(b)(1) and incurs employment-related expenses as defined in §21(b)(2) for the care of the qualifying individual that are paid with community funds, the partner (employee partner) may determine the Dependent Care Credit as if he or she made the entire expenditure. In that case, the employee partner has received a gift from his or her partner equal to one-half of the expenditure. In computing the dependent care credit, the following rules apply:

- The employee partner must reduce the employment-related expenses by any amounts he or she excludes from income under IRC §129 (exclusion for employees for dependent care assistance furnished pursuant to a program described in §129(d));
- The earned income limitation described in IRC §21(d) is determined without regard to community property laws; and
- The adjusted gross income of the employee partner is determined by taking into account community property laws.

A Child Tax Credit is allowed for each qualifying child of a taxpayer for whom the taxpayer is allowed a personal exemption deduction. Thus, if an RDP has one or more dependents who is a qualifying child, the RDP may be allowed a Child Tax Credit for each qualifying child. In determining the amount of the allowable credit, the modified adjusted gross income of the RDP with the qualifying child is determined by taking into account community property laws. Community property laws are ignored, however, in determining the refundable portion of the Child Tax Credit.

Q27. Does Rev. Proc. 2002-69 apply to RDPs?

A27. No. Rev. Proc. 2002-69 allows spouses to classify certain entities solely owned by the spouses as community property, as either a disregarded entity or a partnership for federal tax purposes. Rev. Proc. 2002-69 applies only to spouses. Because RDPs are not spouses for federal tax purposes, Rev. Proc. 2002-69 does not apply to RDPs.

REVIEW QUESTIONS

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

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

20. Which choice below is correct as it pertains to the gift tax?

    a) The IRS is required to assess a gift tax within two years of filing Form 709.
    b) When a gift is not exhibited on a return but is required to be, the statute of limitations on the assessment of tax is extended.
    c) A transfer of property is required to be adequately disclosed to the IRS, which would include a detailed description of how the fair market value of the property is determined rather than just the submission of an appraisal.
    d) If a trust is involved in the transfer, the full trust documents must be provided to the IRS.

21. For an irrevocable life insurance trust (ILIT), which of the following statements is accurate?

    a) If the insured dies within three years of when an existing life insurance policy is transferred into a life insurance trust, the policy ownership goes back to the estate.
    b) The insured individual may borrow against the policy.
    c) Beneficiaries have the right to withdraw from the funds that are gifted to the trust for the purpose of paying the premiums on the policy.
    d) Beneficiaries may be given the opportunity to withdraw funds within 45 days of a notice of their right for a withdrawal.

22. Which of the following correctly characterizes charitable contributions specifically for disaster relief?

    a) Taxpayers can use Exempt Organizations Select Check, an IRS website, to check on the tax-exempt status of organizations, but they should not rely on this list to determine the deductibility of their contributions.
    b) It is usually better to send cash than to give out credit card information.
    c) Taxpayers should donate to recognized charities.
    d) If you receive an e-mail for a donation, it's best to click through to the website before giving.

23. In two recent Tax Court cases regarding charitable contribution deductions for donated land, the court relied on their decision in ***Belk***. Which of the following statements is accurate as it pertains to the details of these cases?

    a) In one case, the taxpayers/land developers entered into an agreement whereby the taxpayer could make minor changes to the conservation easement as long as the total land removed and replaced with other land would not exceed 10% of the subject land.
    b) In one case, the taxpayers/land developers were allowed to adjust the boundaries of the easement at any time, provided the added land made an equal or greater contribution to the preservation directives than what was originally outlined.
    c) IRC §170(h)(2)(C) dictates that taxpayers must donate an interest in an "identifiable, specific piece of real estate" in order to claim a charitable contribution.
    d) The Fourth Circuit found that the easement represented a qualified real property interest.

24. Factors pertaining to general tax issues for registered domestic partners are correctly stated in which of the following choices?

    a) RDPs can file federal returns as married joint taxpayers or married filing separately.
    b) A taxpayer whose dependent is his RDP can file as head of household.
    c) An RDP can itemize deductions even if her partner does not and instead claims the standard deduction.
    d) If RDPs have a child, both parents can claim a dependency deduction.

25. Which of the following statements is accurate as it relates to RDPs and the dependency deduction under IRC §151 in a community property state?

    a) An RDP cannot qualify as a dependent of his or her partner.
    b) The gross income of the person who is the dependent has to be less than the exemption amount, which for 2015 is $4,750, in order to fulfill the gross income requirement when claiming a dependency deduction.
    c) For RDPs and community property, each RDP must report their partner's income.
    d) If one partner's support comes wholly from community funds, then that partner is considered to have contributed to half of his own support and consequently cannot be claimed as a dependent of the other partner.

26. What is a correct characteristic of how education expenses for RDPs residing in a community property state are handled?

    a) RDPs can split the educator expense deduction if out-of-pocket expenses are paid with community funds.
    b) Only the partner who has debt from his own education expenses or those of a dependent is permitted to deduct interest on a qualified education loan.
    c) If the RDP who is a student uses community funds to pay interest on an education loan, that RDP can only take a deduction for half the expenditure.
    d) RDPs split education credits if they pay for qualified education expenses out of community funds.

27. How is the Dependent Care Credit applied if an RDP has a qualifying dependent and has employment-related expenses paid from community funds in a community property state?

    a) Both partners share the Dependent Care Credit if the expenses are paid from community funds.
    b) The employee-partner must bear in mind community property laws when computing adjusted gross income.
    c) Any exclusions under IRC §129 are disregarded when determining employment-related expenses for the Dependent Care Credit.
    d) Community property laws must be considered when determining the earned income limitation.

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SOLUTIONS TO REVIEW QUESTIONS

20. Which choice below is correct as it pertains to the gift tax? **(Page 52)**
    a. Incorrect – The IRS must assess within three years of the date that Form 709 is filed.
    b. Correct – If the nature and value of the gift is not sufficiently communicated to the IRS, then the gift tax statute of limitations can be held open indeterminately.
    c. Incorrect – The taxpayer may submit a qualified appraisal instead of providing a detailed description of how the fair market value of the property was determined.
    d. Incorrect – The trust documents can be provided or a explanation of the trust terms and the trust's ID number will suffice.

21. For an irrevocable life insurance trust (ILIT), which of the following statements is accurate? **(Page 54)**
    a. Correct – This is true under IRC §2035(a). The ownership reverts to the estate, which must pay the tax on the proceeds. This can be avoided by having the trust purchase a new life insurance policy.
    b. Incorrect – The ILIT is an irrevocable trust, so there can be no changes in the beneficiaries, no borrowing, no amending, and no canceling of the policy.
    c. Incorrect – The beneficiaries must hold Crummey powers in order for the funds, which are gifted to the trust and used to pay for premiums, to be available to them and for those funds to fall under the gift tax exclusion rules.
    d. Incorrect – If the beneficiaries have ***Crummey*** powers, they will receive a notice of their right to withdraw funds, and a 30-day time period in which to exercise their right.

22. Which of the following correctly characterizes charitable contributions specifically for disaster relief? **(Page 57)**
    a. Incorrect – The IRS maintains this list to make sure taxpayers know who is eligible to receive a tax-deductible contribution, and taxpayers can rely on this list when making their contributions.
    b. Incorrect – Taxpayers should never send cash, as the organization could be fraudulent and there would be no way to verify the deductibility of the contribution.
    c. Correct – This is true in order to avoid fraudulent schemes which are prevalent after a disaster.
    d. Incorrect – The e-mail can direct the viewer to a phony website, which could ask for Social Security and personal credit card information.

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23. In two recent Tax Court cases regarding charitable contribution deductions for donated land, the court relied on their decision in ***Belk***. Which of the following statements is accurate as it pertains to the details of these cases? **(Page 59)**

    a. Incorrect – The taxpayers in one case did enter into an agreement stating that any land removed would not be greater than 5% of the subject land. In the end, this agreement allowed for changes in the easement boundaries, which made a charitable contribution deduction for the easement impossible because the developers retained the right to make the changes.
    b. Incorrect – The terms of the agreement stated that any adjustments could only be made within five years of the initiation of the easement. However, the fact that adjustments could be made at all was inconsistent with the court's finding in ***Belk*** that a conservation easement must be protected in perpetuity.
    c. Correct – A qualified real property interest exists only when there is an identifiable, specific piece of real property that is not subject to any changes.
    d. Incorrect – The Fourth Circuit stated that the easement did not restrict "a defined and static parcel" of real estate but allowed the boundaries to change, and as such, it wasn't a qualified real property interest.)

24. Factors pertaining to general tax issues for registered domestic partners are correctly stated in which of the following choices? **(Page 61)**

    a. Incorrect – RDPs are not considered married under state law and as such, they cannot file as married taxpayers.
    b. Incorrect – An RDP does not fit within the definition of a qualifying child or qualifying relative as outlined under IRC §152 that would enable the taxpayer to file as HOH.
    c. Correct – Although the law prevents spouses from claiming their deductions differently, this does not apply to RDPs because they aren't married.
    d. Incorrect – Only one parent can claim the deduction. If both claim the deduction and the child lives with each parent for the same amount of time, the IRS will choose the parent with the higher adjusted gross income as the parent who qualifies for the deduction.

25. Which of the following statements is accurate as it relates to RDPs and the dependency deduction under IRC §151 in a community property state? **(Page 62 and 63)**

    a. Incorrect – An RDP may qualify as a dependent as long as the gross income requirements and support requirements are met under IRC §§151 and 152.
    b. Incorrect – The exemption amount for 2015 is $4,000, which means that the dependent individual could not have gross income that exceeds that amount.
    c. Incorrect – RDPs each report half of the combined income earned by both partners.
    d. Correct – The support requirement under IRC §152 dictates that more than half of a person's support for the tax year must be provided by the person who wants to use the dependency election, and if the support comes from community funds, the dependency issue does not apply.

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26. What is a correct characteristic of how education expenses for RDPs residing in a community property state are handled? **(Page 64)**

    a. Incorrect – Only eligible educators are allowed to take the deduction, and if only one of the RDPs is an eligible educator, they may take the deduction as if they had paid for the whole expenditure.
    b. Correct – The RDPs do not split the deduction.
    c. Incorrect – The partner incurring the debt takes a deduction for the entire expenditure even if paid for from community funds.
    d. Incorrect – Only the RDP who pays for education expenses may take the education credit.

27. How is the Dependent Care Credit applied if an RDP has a qualifying dependent and has employment-related expenses paid from community funds in a community property state? **(Page 65)**

    a. Incorrect – The employee-partner gets the Dependent Care Credit as if that partner was wholly responsible for the expenses.
    b. Correct – When computing the Dependent Care Credit, community property laws apply in computing adjusted gross income, but not when determining the earned income limitation.
    c. Incorrect – All employment-related expenses must be reduced by the amount excluded under IRC §129, which is an exclusion for dependent care assistance programs.
    d. Incorrect – The earned income limitation under IRC §21(d) is calculated without considering community property laws.

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MEDICAID WAIVER PAYMENTS

BACKGROUND

Under §1915(c) of the Social Security Act, a state may obtain a Medicaid waiver that allows the state to include in the state's Medicaid program the cost of home or community-based services (other than room and board) provided to individuals who otherwise would require care in a hospital, nursing facility, or intermediate care facility (eligible individuals).

Home or community-based services include personal care services, habilitation services, and other services that are "cost effective and necessary to avoid institutionalization." Personal care services include assistance with eating, bathing, dressing, toileting, transferring, maintaining continence, personal hygiene, light housework, laundry, meal preparation, transportation, grocery shopping, using the telephone, medication management, and money management. Skilled services that only a health professional may perform are not personal care services. Habilitation services assist individuals in acquiring, retaining, and improving the self-help, socialization, and adaptive skills necessary to reside successfully in home and community-based settings. (IRS Notice 2014-7)

A state, directly or indirectly through an agency under contract with the state, certifies individuals and entities as Medicaid providers to provide services to eligible individuals. An entity that is a certified Medicaid provider may contract with an individual care provider to care for an eligible individual in the care provider's home. A state or an agency under contract with the state approves the plan of care for the eligible individual in the provider's home and monitors the eligible individual's care.

GUIDANCE — NEW Q&A

On January 3, 2014, the IRS issued Notice 2014-7, which provides guidance on the federal income tax treatment of certain payments to individual care providers for the care of eligible individuals under a state Medicaid Home and Community-Based Services Waiver program under §1915(c) of the Social Security Act. These payments are known as "Medicaid waiver payments." Section 1915(c) enables individuals who otherwise would require care in a hospital, nursing facility, or intermediate care facility to receive care in the individual care provider's home. Notice 2014-7 provides that the IRS will treat these Medicaid waiver payments as difficulty of care payments excludable from gross income under IRC §131, whether the individual care provider and the recipient of care are related or unrelated.

The following questions and answers were released on February 23, 2015, to supplement the initial Q&As released after the Notice. These new questions further clarify the notice and provide guidance on the information reporting requirements, and the employment tax requirements for Medicaid waiver payments described in the Notice.

The original Q&As are below on page 76.

Individual care provider questions

Q1. I receive payments under a state Medicaid program other than a Medicaid Home and Community-Based Services waiver program for the personal care of my adult disabled son in our home. May I exclude these payments from gross income?

A1. Whether the IRS will treat payments under a state program other than a state Medicaid Home and Community-Based Services waiver program as difficulty of care payments excludable from gross income will depend on the nature of the payments and the purpose and design of the program.

Q2. I moved into my elderly mother's home to care for her, and I do not have a separate home where I reside. I receive payments under a state Medicaid Home and Community-Based Services waiver program for personal care and supportive home care. Am I considered to be providing care in "the provider's home" for purposes of Notice 2014-7?

A2. Yes. Under IRC §131, "the provider's home" means the place where the provider resides and regularly performs the routines of the provider's private life, such as shared meals and holidays with family. (***Stromme v. Comm.*** (2012) 138 TC 213) In this situation, the mother's home became the provider's home because it is where the provider resides and regularly performs the routines of the provider's private life.

Q3. I am an individual who cares for an unrelated elderly person five days a week in her home, and I have a room in the care recipient's home where I sleep four nights a week. I receive Medicaid waiver payments for this care. On weekends and holidays, I reside with my family in our separate home. May I exclude these payments from gross income?

A3. No. In this situation, the provider works in the care recipient's home, but the provider has a separate home where the provider resides and regularly performs the routines of the provider's private life, such as shared meals and holidays with family. Therefore, the provider does not provide care for the care recipient in the provider's home, and the provider may not exclude the Medicaid waiver payments from gross income.

Q4. I am an individual who cares for an unrelated elderly person seven days a week in her home where I live. I receive Medicaid waiver payments for this care. I do not have another home. May I exclude these payments from gross income?

A4. Yes. In this situation, the care recipient's home is also the care provider's home, and the care provider does not have a separate home. Therefore, the Medicaid waiver payments are excludable from the care provider's gross income for the care furnished in the shared home.

Example of caregiver's separate home

Brian provides care for Pearl, to whom he is not related, in her home. Brian lives in Pearl's home full-time and is there to provide care seven days a week. The Medicaid waiver payments he receives are excludable from income.

However, if Brian continues to provide care for Pearl seven days a week, but returns to his own separate home in the evenings and on weekends, the payments are not excludable. This is true even if Pearl maintains a room in her home for Brian to stay in on certain nights of the week. This is also true even if Brian keeps some clothing in the room at Pearl's home in case he needs to spend the night.

Q5. I am the parent of a disabled child, and I receive state Medicaid Home and Community-Based waiver payments excludable from gross income under Notice 2014-7 for the care of my child in our home. My sister lives with me, and she also receives state Medicaid Home and Community-Based waiver payments for the care of my child. May she exclude the Medicaid waiver payments from gross income?

A5. Yes. More than one care provider living in the home with the care recipient may exclude state Medicaid Home and Community-Based waiver payments from gross income under Notice 2014-7.

Q6. I am a respite care provider, and I provide personal care and supportive services to disabled individuals in their homes, or in my home where the care recipient does not live. I receive payments for this care under a state Medicaid Home and Community-Based Services waiver program. May I exclude these payments from gross income?

A6. No. The exclusion only applies to payments for care in the individual care provider's home where the care recipient lives under the recipient's plan of care.

Q7. I am an individual care provider, and I receive payments under a state Medicaid Home and Community-Based Services waiver program for the care of a disabled individual who lives with me in my home under the individual's plan of care. The program has a cost-sharing provision that may require an individual to pay the administrator of the program a portion of the total amount that the administrator pays me for the care of the disabled individual. May I exclude the entire payment that I receive from the administrator for the individual's care?

A7. Yes. You may exclude the entire payment that you receive under the state Medicaid waiver program for the care of the disabled individual in your home even though the individual is required to pay the administrator part of the cost of the care. By contrast, an individual care provider may not exclude direct payments from a care recipient who pays part or all of the cost of the recipient's care with the care recipient's private funds.

Example of direct payments

Elliot is a care provider who works for Big State Care Services, and he provides care for Stella, who lives with Elliot in his home. Under her plan of care, if Stella has to pay Big State for part or all of Elliot's services, the payments he receives from Big State are excludable from income.

If Stella pays Elliot directly for a portion of his total payment for services, that portion is not excludable. If Stella pays Elliot directly for the total amount of the fee for his services, none of that payment is excludable.

Q8. I am an individual care provider, and I receive vacation pay from the state, as well as Medicaid waiver payments for the care that I provide to a disabled individual living in my home under the individual's plan of care. May I exclude the vacation pay from gross income?

A8. No. The only amounts excludable from gross income under Notice 2014-7 are payments for the care of the disabled individual.

Q9. I received payments described in Notice 2014-7 on or after January 3, 2014, that are excludable from gross income as difficulty of care payments under IRC §131. May I choose to include those payments in my gross income for 2014 and later years?

A9. No. A taxpayer may not choose to include in gross income difficulty of care payments that are excludable from gross income under IRC §131 as provided in Notice 2014-7.

Comment

Taxpayers may want to claim payments in order to claim tax benefits such as the Earned Income Tax Credit.

Q10. If I received payments described in Notice 2014-7 in an earlier year, may I file an amended return to exclude the payments from gross income that I reported as income in the earlier year?

A10. Yes. You may file a Form 1040X, Amended U.S. Individual Income Tax Return, if you received payments described in the Notice in an earlier year and the time for claiming a credit or refund has not expired under IRC §6511. In Part III of Form 1040X, you should explain that the payments are excludable under Notice 2014-7. Excluding payments described in the Notice in an earlier year may affect deductions or credits that you claimed for the earlier year, as well as other tax items for the earlier year. To help expedite the processing of your amended return, you should include the following to substantiate your claim:

- The full name of the individual receiving care (and the care recipient's Social Security number or other taxpayer identifying number, if available);

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- Copies of documents from third parties to show that you and the individual receiving care resided in the same home in the year to which the claim relates (such as a driver's license or other government-issued document, social agency document, bank statement, medical bill, or utility bill); and
- Evidence that the individual is receiving care under a state Medicaid waiver program.

Q11. I received wage payments that are excludable from gross income under Notice 2014-7. However, the agency that pays me treats me as an employee and continued to withhold federal income tax on the payments and reported the payments as wages in box 1 of Form W-2, Wage and Tax Statement. How should I report to the IRS that the payments are excludable from gross income?

A11. If you are not able to obtain a Form W-2c, Corrected Wage and Tax Statement, from the agency reporting the correct amount in box 1 of Form W-2, you should include the full amount of the payments reported in box 1 of Form W-2 as wages on line 7 of Form 1040. You should then subtract the excludable portion of the amount in box 1 on line 21 of Form 1040. If you have other income reportable on line 21, you should enter the net amount after subtracting the amount excludable from gross income under Notice 2014-7 from the other amounts reportable on line 21. You may need to enter a negative amount on line 21 if you have no other income reportable on line 21, or if the amount of other income you must report on line 21 is less than the amount excludable from gross income. You should write "Notice 2014-7" on the dotted line for line 21 if you file a paper return, or enter "Notice 2014-7" on line 21 for an electronically filed return.

Q12. I receive payments that are excludable from gross income under Notice 2014-7. Are the payments subject to Social Security and Medicare taxes under the Federal Insurance Contributions Act (FICA)?

A12. Maybe. Whether the payments are subject to Social Security and Medicare taxes depends on whether you are an employee of the agency, an employee of the individual care recipient, or an independent contractor.

- If the agency is your employer, the payments are subject to Social Security and Medicare taxes. See Q&A 18 under Agency Questions;
- If the care recipient is your employer and these payments are wages for that employment, the payments are subject to Social Security and Medicare taxes unless one of the exceptions for domestic services applies. See Q&A 19 under Agency Questions; or
- If you are an independent contractor, the payments are not subject to Social Security and Medicare taxes. See Q&As 13 and 14.

Your status as an employee or independent contractor and the identification of your employer (if you are an employee) depend on whether the agency or the care recipient has the right to direct and control how you perform your services. If you think you are being improperly treated, you can file Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, to have the IRS determine your employment status.

If you believe Social Security and Medicare taxes were withheld in error from your payments, such as because one of the exceptions for domestic services applied, you must first contact the agency that withheld the taxes for a refund. However, if the agency indicates an intention not to file a claim or adjust the overpaid Social Security and Medicare taxes, you may claim a refund of the erroneously withheld Social Security and Medicare taxes by filing Form 843, Claim for Refund and Request for Abatement. The requirements for filing a claim for refund of your share of Social Security and Medicare taxes can be found in the Instructions for Form 843.

Q13. I provide services under a state Medicaid Home and Community-Based Services waiver program. The agency that pays me for these services does not treat me as an employee, and I do not have a separate trade or business of providing these services. However, the agency reported the payments as income on Form 1099-MISC, Miscellaneous Income. How should I report to the IRS that these payments are excludable from gross income?

A13. You should enter -0- on line 21 of Form 1040 if you have no other income reportable on line 21. If you have other income reportable on line 21, you should enter the amount of the other reportable income on line 21. You should write "Notice 2014-7" on the dotted line for line 21 on a paper return or enter "Notice 2014-7" on line 21 for an electronically filed return. Because the payments are excludable from income, and because you do not have a trade or business of providing these services, the payments are not self-employment income subject to self-employment tax.

Q14. I am a sole proprietor in a business of providing home care services. In my business, I received payments that are excludable from gross income under Notice 2014-7. However, I received a Form 1099-MISC, Miscellaneous Income, reporting these payments as income. How should I report to the IRS that these payments are excludable from gross income?

A14. You should include the full amount of the payments reported to you on Form 1099-MISC as income on line 1 of Form 1040 (Schedule C). You should then report the excludable amount as an expense in Part V, and write "Notice 2014-7" next to that amount. Even though you are a sole proprietor, because the amounts are excludable from income, they are not self-employment income and are not subject to self-employment tax. For additional Q&As discussing the application of self-employment tax to family caregivers, go to:

Website
www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Family-Caregivers-and-Self-Employment-Tax

Agency questions

Q15. As an agency that is a certified Medicaid provider, I make payments under a state Medicaid Home and Community-Based Services waiver program. What information should I request from individuals who claim the payments they receive are excludable from gross income under Notice 2014-7?

A15. If you do not have independent knowledge that the payments you make are excludable from gross income under Notice 2014-7, you may rely on a written statement by the payee, signed under penalties of perjury, unless you know that the statement is not true. The statement should affirm the facts you need to determine that Notice 2014-7 applies to the payee. For example, a statement may be worded as follows:

Under penalties of perjury, I declare that I am an individual care provider receiving payments under a state Medicaid Home and Community-Based Services waiver program for care I provide to ___________________ who lives in my home under the care recipient's plan of care.

Signed: ______________________ Date: ____________________

Q16. I am an agency that employs individuals who provide care to disabled individuals under a state Medicaid Home and Community-Based Services waiver program. Some of the payments I make are excludable from the employee's gross income under Notice 2014-7. Am I required to withhold federal income tax on the payments that are excludable under Notice 2014-7?

A16. No. Federal income tax should not be withheld from the payments that are excludable from gross income under Notice 2014-7. If you do not have independent knowledge that the payments are excludable from gross income under Notice 2014-7, you may rely on a written statement by the employee, signed under penalties of perjury, unless you know that the statement is not true. The statement should affirm the facts you need to determine that Notice 2014-7 applies to payments made to the employee. See Q&A 15.

Q17. How do I complete the Form W-2, Wage and Tax Statement, that I provide to my employees who receive payments excludable from income under Notice 2014-7?

A17. Any amount excludable from gross income should not be included in box 1, Wages, tips, other compensation, of the employee's Form W-2. If the entire amount you pay to the employee during the year is excludable from his or her gross income, box 1 of Form W-2 should be left blank.

Q18. If the payments I make to my employees are excludable from gross income under Notice 2014-7, am I required to withhold and pay social security and Medicare taxes under the Federal Insurance Contributions Act (FICA) on the payments?

A18. Yes. Even if payments you make to your employees for their services are excludable from gross income for federal income tax purposes, they generally are wages for Social Security and Medicare tax purposes. Thus, generally, you should withhold and pay Social Security and Medicare taxes, and report the Social Security and Medicare wages and taxes withheld on the employee's Form W-2. However, see Q&A 19 below if you pay the individuals but you properly treat them as employees of the care recipients.

Q19. I pay individual care providers to care for disabled individuals and properly treat the care providers as employees of the care recipients. I fulfill the employment tax responsibilities for the care recipient. If the payments I make to the care providers on behalf of the care recipients are excludable from gross income under Notice 2014-7, am I required to withhold and pay Social Security and Medicare taxes on the payments?

A19. Maybe. Although payments you make to the care providers as employees of the care recipients may be excludable from gross income for federal income tax purposes, those payments are generally wages for Social Security and Medicare tax purposes. However, there are several important exceptions to this rule. If the care recipient is the employer of the individual care provider, the FICA tax rules for domestic service (household work done in or around the employer's home) will apply. Under those rules, payments for services performed for a spouse or a child and services performed for a parent by a child under the age of 21 generally are not subject to Social Security and Medicare taxes. In addition, if wages for domestic services paid during a calendar year are below a threshold ($1,900 for 2015), they are not subject to Social Security and Medicare taxes. See Publication 926 for more information on these exceptions. If you withheld and paid Social Security and Medicare taxes in error because you did not correctly apply one of these exceptions, see the Instructions for Form 941-X, Adjusted Employer's QUARTERLY Federal Tax Return or Claim for Refund.

Q20. I am an agency that is a certified Medicaid provider and I pay individual care providers to care for disabled individuals. Due to the facts and circumstances of how they perform their services, I do not treat the individuals as my employees or as employees of the care recipients, so the payments are not subject to Social Security and Medicare taxes. Some of the payments I make are excludable from the individual care provider's gross income under Notice 2014-7. What are my information reporting requirements?

A20. Generally, a payor must file Form 1099-MISC, Miscellaneous Income, to report payments to an independent contractor as compensation for services if the payments are $600 or more during the calendar year. However, if you know that payments to an individual care provider are excludable from gross income under Notice 2014-7, you should not file a Form 1099-MISC reporting those payments. If you do not have independent knowledge that the payments are excludable from gross income under Notice 2014-7, you may rely on a written statement by the payee, signed under penalties of perjury, unless you know that the statement is not true. The statement should affirm the facts you need to determine that Notice 2014-7 applies to the payee. See Q&A15.

The original text and Q&As

The following are the original Q&As that appeared after Notice 2014-7 was issued:

Q1. I received payments described in Notice 2014-7 in 2013. May I exclude these payments from gross income on my 2013 federal income tax return?

A1. If you received payments described in the Notice in 2013, you may choose to exclude those payments from gross income on your 2013 Form 1040, U.S. Individual Income Tax Return. You may file electronically or on paper. If you received a Form 1099-MISC, Miscellaneous Income, or Form W-2, Wage and Tax Statement, reporting these payments as income, the IRS may contact you for you to explain why the payments were not included as gross income on your tax return. You can then explain that the payments are excludable from gross income under Notice 2014-7.

Q2. I received payments described in Notice 2014-7 in 2013, and I received a Form 1099-MISC reporting these payments in box 3, Other income. If I choose to apply the Notice to payments received in 2013, how should I report these payments on my Form 1040?

A2. Generally, an amount reported to you in box 3 of Form 1099-MISC is reported on line 21 of Form 1040. If you choose to apply the Notice to payments received in 2013, you should not include the amount of those payments on line 21. If you file a paper return, enter "Notice 2014-7" on the dotted line next to line 21 of Form 1040. No additional entry is needed on the Form 1040 if you file electronically.

Q3. I received payments described in Notice 2014-7 in 2013, and I received a Form 1099-MISC reporting these payments in box 7, Non-employee compensation. If I choose to apply the Notice to payments received in 2013, how should I report these payments on my Form 1040?

A3. Generally, an amount reported to you in box 7 of Form 1099-MISC is reported on Schedule C (Form 1040), Profit or Loss from Business. If you choose to apply the Notice to payments received in 2013, you should report the amount of those payments as income on Schedule C and also report the excludable amount as a Schedule C expense. Follow the instructions for line 31, Net profit or (loss). If you file a paper return, enter "Notice 2014-7" on the dotted line next to line 12, Business income or (loss), of Form 1040. No additional entry is needed on the Form 1040 if you file electronically.

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Q4. I received payments described in Notice 2014-7 in 2013, and I received a Form W-2, Wage and Tax Statement, with the amount of the payments reported in box 1, Wages, tips, other compensation. If I choose to apply the Notice to payments received in 2013, how should I report these payments on my Form 1040?

A4. Generally, an amount reported to you in box 1 of Form W-2 is reported on line 7, Wages, salaries, tips, etc., of Form 1040. If you choose to apply the Notice to payments received in 2013, you should include the full amount of those payments on line 7. On line 21, enter the excludable portion of the payments as a negative amount that will reduce your adjusted gross income. If you file a paper return, enter "Notice 2014-7" on the dotted line next to line 21 of Form 1040. No additional entry is needed on the Form 1040 if you file electronically.

Q5. If I received payments described in Notice 2014-7 in an earlier year, may I file an amended return to exclude the payments from gross income that I reported as income in the earlier year?

A5. Yes. You may file a Form 1040X, Amended U.S. Individual Income Tax Return, If you received payments described in the Notice in an earlier year if the time for claiming a credit or refund is open under §6511 of the Internal Revenue Code. See "When to File" in the instructions to Form 1040X for more information. In Part III of Form 1040X, you should explain that the payments are excludable under Notice 2014-7. Excluding payments described in the Notice in an earlier year may affect deductions or credits that you claimed for the earlier year, as well as other tax items for the earlier year.

Q6. I received payments described in Notice 2014-7 in 2011 and 2012 and did not include those amounts in gross income on my Form 1040. The IRS contacted me about those payments and I agreed to include those amounts in income and have entered into an installment agreement to pay the tax liability. May I now file amended returns for those prior years and get a refund of the amounts I have paid?

A6. Yes. You may file a Form 1040X, Amended U.S. Individual Income Tax Return, if you received payments described in the Notice in 2011 and/or 2012. In Part III of Form 1040X, you should explain that the payments are excludable under Notice 2014-7. Excluding payments described in the notice in an earlier year may affect deductions or credits that you claimed for the earlier year, as well as other tax items for the earlier year.

Q7. I am a payor who made payments to care providers in 2013 that are described in Notice 2014-7. I reported those payments on Forms 1099-MISC or Forms W-2. If a care provider who received payments described in the Notice in 2013 informs me that he or she chooses to exclude the payments from gross income in 2013, should I correct the Form 1099-MISC or Form W-2 that reported the payments?

A7. Yes. If the payments are described in the Notice and the payee informs you that he or she chooses to apply the Notice to payments received in 2013, you should file a corrected Form 1099-MISC or Form W-2c and provide a copy of the corrected statement to the payee. If you reported the payments on Form 1099-MISC, see the General Instructions for Certain Information Returns regarding corrections. If you reported the payments on Form W-2, see the General Instructions for Forms W-2 and W-3.

WORKER CLASSIFICATION

IRS's TWENTY-FACTOR TEST

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

REVIEW QUESTIONS

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

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

28. Which of these statements is correct regarding individual care providers and the exclusion of Medicaid payment from gross income?

    a) An individual who cares for another person in that person's home and sleeps there five nights per week, but who returns to his or her own home on the weekends to share meals and holidays with family may not exclude Medicaid waiver payments from gross income.
    b) Whether or not a state program is part of the Medicaid Home and Community-Based Services Waiver program does not affect whether the provider payments can be excluded from gross income.
    c) A care provider who moves into his mother's home to take care of her and has no separate home may not exclude from his gross income any Medicaid payments because the home is not his, but his mother's.
    d) Only one care provider within a home can exclude Medicaid waiver payments from gross income.

29. Filing issues for recipients of Medicaid waiver payments are correctly outlined in which of the following?

    a) Medicaid waiver payments that were included in income in an earlier year cannot be later excluded on an amended return.
    b) Excluding payments that were previously included will not affect the Earned Income Tax Credit.
    c) As long as the time for claiming a credit or refund has not expired, a care provider can file Form 1040X and explain that previously included payments should have been excluded per Notice 2014-7.
    d) When submitting an amended return, to avoid confusion, the care provider should not include the care recipient's Social Security number.

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30. For care providers who are not treated as employees or who are sole proprietors, which of the following is true?

    a) For care providers who are not employees and who do not have a business for providing care services, and who receive a Form 1099-MISC, Miscellaneous Income from an agency, they should enter the amount paid on line 21 of Form 1040 and write in Notice 2014-7.
    b) For sole proprietors with care provider businesses who receive a 1099 from an agency, the full amount of the payments should not be included on Form 1040.
    c) For care providers who are neither employees of an agency nor sole proprietors, payments from an agency included on a Form 1099 are not considered self-employment income and are not subject to self-employment tax.
    d) Sole proprietors must include payments included on a 1099 for caregiving services as self-employment income.

31. When an agency treats care providers as employees of their care recipients, which of the following applies?

    a) If an agency pays a care provider on behalf of a care recipient wages that are excludable from gross income, then the agency is not required to withhold FICA taxes on those payments.
    b) Wages for domestic services that are below $2,100 for 2015 are not subject to FICA taxes.
    c) If one spouse is performing the caregiving services for the other and receiving payments for those services, Social Security and Medicare taxes will apply.
    d) If a care provider is employed by the care recipient, FICA taxes apply.

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SOLUTIONS TO REVIEW QUESTIONS

28. Which of these statements is correct regarding individual care providers and the exclusion of Medicaid payment from gross income? **(Page 67)**

    a. Correct – Because the care provider has a separate home where he or she interacts with family and does not care for the individual there, The Medicaid payments cannot be excluded from gross income.
    b. Incorrect – The IRS makes the decision as to whether they qualify as difficulty of care payments by assessing the program and the nature of the payments.
    c. Incorrect – In this case, the mother's home has become the provider's home where he resides and performs his customary personal routines.
    d. Incorrect – If two individuals live together and provide for a care recipient, both individuals are eligible for Medicaid waiver payments and both may deduct the payments from gross income.

29. Filing issues for recipients of Medicaid waiver payments are correctly outlined in which of the following? **(Page 68)**

    a. Incorrect – An amended return can be filed: Form 1040X, Amended U.S. Individual Income Tax Return.
    b. Incorrect – A taxpayer may claim payments for the purpose of claiming benefits like the Earned Income Tax Credit, but when subsequently excluding those payments, the EITC may not apply.
    c. Correct – The amended return can be filed as long as it follows the limitation on credits and refunds under IRC §6511. Deductions and credits may be affected when excluding payments that were previously included.
    d. Incorrect – The name and taxpayer ID number should be included when submitting an amended return, as well as documentation that the person is getting care under a Medicaid waiver program and that he or she resided in the same home as the caregiver.

30. For care providers who are not treated as employees or who are sole proprietors, which of the following is true? **(Page 70)**

    a. Incorrect – The care provider enters on line 21 only reportable income, and if there is no other reportable income, then he or she should enter 0 on that line along with "Notice 2014-7."
    b. Incorrect – The payments must be included on Schedule C of Form 1040 and entered on line 1 and then reported in Part V as an excludable expense, with "Notice 2014-7" written next to the specific amount.
    c. Correct – Because these care providers do not own their own businesses to provide caregiving services, any payments are not self-employment income and are not taxed as such.
    d. Incorrect – As sole proprietors with an established caregiver business, Medicaid waiver payments from an agency are excludable from gross income and are not considered self-employment income.

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31. When an agency treats care providers as employees of their care recipients, which of the following applies? **(Page 71)**

    a. Incorrect – Withholding may apply. Even if payments to caregivers are excludable from gross income, they are typically still considered wages for FICA purposes.
    b. Incorrect – The 2015 threshold is $1,900.
    c. Incorrect – Typically, FICA taxes do not apply to payments for spousal care or for a child, as well as services performed for a parent by a child.
    d. Correct – The wages provided are subject to Social Security and Medicare, and the same rules apply as with all household employees whether the worker is full time or part time, or whether the individual was hired through an agency or not.

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The 20 factors identified by the IRS are as follows:

1. **Instructions:** If the person for whom the services are performed has the right to require compliance with instructions, this indicates employee status.
2. **Training:** Worker training (e.g., by requiring attendance at training sessions) indicates that the person for whom services are performed wants the services performed in a particular manner (which indicates employee status).
3. **Integration:** Integration of the worker's services into the business operations of the person for whom services are performed is an indication of employee status.
4. **Services rendered personally:** If the services are required to be performed personally, this is an indication that the person for whom services are performed is interested in the methods used to accomplish the work (which indicates employee status).
5. **Hiring, supervision, and paying assistants:** If the person for whom services are performed hires, supervises, or pays assistants, this generally indicates employee status. However, if the worker hires and supervises others under a contract pursuant to which the worker agrees to provide material and labor and is only responsible for the result, this indicates independent contractor status.
6. **Continuing relationship:** A continuing relationship between the worker and the person for whom the services are performed indicates employee status.
7. **Set hours of work:** The establishment of set hours for the worker indicates employee status.
8. **Full time required:** If the worker must devote substantially full time to the business of the person for whom services are performed, this indicates employee status. An independent contractor is free to work when and for whom he or she chooses.
9. **Doing work on employer's premises:** If the work is performed on the premises of the person for whom the services are performed, this indicates employee status, especially if the work could be done elsewhere.
10. **Order or sequence test:** If a worker must perform services in the order or sequence set by the person for whom services are performed, that shows the worker is not free to follow his or her own pattern of work, and indicates employee status.
11. **Oral or written reports:** A requirement that the worker submit regular reports indicates employee status.
12. **Payment by the hour, week, or month:** Payment by the hour, week, or month generally points to employment status; payment by the job or a commission indicates independent contractor status.
13. **Payment of business and/or traveling expenses:** If the person for whom the services are performed pays expenses, this indicates employee status. An employer, to control expenses, generally retains the right to direct the worker.
14. **Furnishing tools and materials:** The provision of significant tools and materials to the worker indicates employee status.
15. **Significant investment:** Investment in facilities used by the worker indicates independent contractor status.
16. **Realization of profit or loss:** A worker who can realize a profit or suffer a loss as a result of the services (in addition to profit or loss ordinarily realized by employees) is generally an independent contractor.
17. **Working for more than one firm at a time:** If a worker performs more than *de minimis* services for multiple firms at the same time, that generally indicates independent contractor status.
18. **Making service available to the general public:** If a worker makes his or her services available to the public on a regular and consistent basis, that indicates independent contractor status.

19. **Right to discharge:** The right to discharge a worker is a factor indicating that the worker is an employee.
20. **Right to terminate:** If a worker has the right to terminate the relationship with the person for whom services are performed at any time he or she wishes without incurring liability, that indicates employee status.

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

Three categories regarding control

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

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

Form SS-8

If, after reviewing the three categories above, it is still unclear whether a worker is an employee or an independent contractor, IRS Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, can be filed with the IRS. The form may be filed by either the business or the worker. The IRS will review the facts and circumstances and officially determine the worker's status.

Form SS-8 provides questions for each of the three categories; some examples of the types of questions asked include:

1. Behavioral control:
   a. Who is the worker required to contact if problems or complaints arise and who is responsible for their resolution?
   b. Describe any meetings the worker is required to attend and any penalties for not attending (for example, sales meetings, monthly meetings, staff meetings).
   c. Describe the worker's daily routine such as his or her schedule or hours.
2. Financial control:
   a. Does the worker lease equipment, space, or a facility?
   b. Is the worker allowed a drawing account for advances?
   c. Does the firm carry workers' compensation insurance on the worker?
   d. Whom does the customer pay?
3. Relationship of the parties:
   a. Is the worker a member of a union?
   b. What does the worker do with the finished product (for example, return it to the firm, provide it to another party, or sell it)?
   c. Did the worker perform similar services for others during the time period

4. Questions for service providers or sales persons:
   a. What are the worker's responsibilities in soliciting new customers?
   b. Who provides the worker with leads to prospective customers?
   c. Who determines the worker's territory?
   d. Did the worker pay for the privilege of serving customers on the route or in the territory?

Be aware that it can take at least six months to get a determination, but a business that continually hires the same types of workers to perform particular services may want to consider filing the Form SS-8.

SECTION 530 SAFE HARBOR

Section 530 of the Revenue Act of 1978 (P.L. 95-600) allows employers to avoid liability for past-due employment taxes when the employer erroneously, but reasonably, classified employees as independent contractors rather than employees.

> ✐ **Practice Pointer**
>
> Unlike the Voluntary Classification Settlement Program, employers who are in an employment classification audit may qualify for Section 530 relief.

By its very terms, Section 530 is a relief provision available only to employers who erroneously classify their employees. Under Section 530, for employment tax purposes (i.e., for FICA, FUTA, railroad retirement and unemployment, and income tax withholding purposes), a taxpayer is entitled to treat an individual as an independent contractor, rather than an employee, if:

1. The taxpayer does not treat a worker as an employee for employment tax purposes during a particular period;
2. The taxpayer files all required federal employment tax returns on a basis consistent with this treatment; and
3. The taxpayer has a reasonable basis for not treating the worker as an employee.

If these requirements are satisfied, tax liability is terminated "for purposes of applying such taxes for such period with respect to the taxpayer." The term "taxpayer" refers only to employers and not to employees. (See ***Ahmed v. United States*** (1998) 147 F.3d 791, 797) Although the employer's obligation to deduct the FICA tax from the employee's salary is ended, the employee remains liable for that tax. (Rev. Proc. 85-18)

Relief under Section 530 is available with respect to a corporate employer's treatment of corporate officers as independent contractors if requirements listed above are met. (CCA 200038045)

Relief under Section 530 is available only where a worker's status as employee is determined under the common law rules, rather than under a statutory definition of employee.

A taxpayer (employer) is treated as having a reasonable basis for not treating an individual as an employee for a period if the taxpayer's treatment of that individual for that period was in reasonable reliance on *any* one or more of the following safe havens:

- **Judicial precedent, or IRS rulings.** Note that state court opinions or state administrative agency rulings do not qualify as a reasonable basis for the purposes of Section 530 relief. (IRS Training Guidelines) Because reliance must be reasonable, the taxpayer must be able to demonstrate similarity to the case and its situation; this does not mean that the facts must be identical or involve the same industry;

- **A past IRS audit.** For audits that began after December 31, 1996, the audit must have specifically dealt with the classification of the workers at issue, or workers similarly situated, for employment tax purposes, in order for the audit to be a reasonable basis for the purposes of Section 530 relief. For audits that began before January 1, 1997, the audit is not required to have specifically addressed the worker classification issue;
- **A long-standing practice of a significant segment of the relevant industry.** Employers may also rely upon industry custom or practice, if such custom or practice is a long-standing custom or practice of a significant segment of the industry. What constitutes an industry can be subject to debate, but generally consists of businesses in the same geographic area that compete for the same customers. Section 530 states that a practice in existence at least 10 years is long-standing. (IRC §530(e)(2)(C)(i)) A significant segment of the industry is defined in section 530 as 25% of the taxpayer's industry, without including the taxpayer (IRC §530(e)(2)(B)); or
- **Reasonable reliance on advice provided by an employment attorney concerning the worker's classification.** This applies only if such advice was relied upon when treatment of workers as independent contractors began, and the business must demonstrate that the attorney had relevant education or experience to render such advice and did so only after review of all relevant facts furnished by the business.

A key element of Section 530 is the industry standard test or how the industry as a whole treats similarly situated workers. This gives the employer the grounds to argue there is a reasonable basis for treating the worker as an independent contractor. The 1978 Congressional committee reports indicate that this reasonable basis requirement must be liberally construed in favor of employers. For more information on how the IRS interprets Section 530, see Rev. Proc. 85-18.

MISCLASSIFIED WORKERS MAY FILE SOCIAL SECURITY TAX FORM

The IRS has a form for employees who have been misclassified as independent contractors by an employer. Form 8919, Uncollected Social Security and Medicare Tax on Wages, may be used to figure and report the employee's share of uncollected Social Security and Medicare taxes due on their compensation. (IR-2007-203)

Generally, a worker who receives a Form 1099 for services provided as an independent contractor must report the income on Schedule C and pay self-employment tax on the net profit, using Schedule SE. However, sometimes the worker is incorrectly treated as an independent contractor when they are actually an employee. When this happens, Form 8919 may be used by workers who performed services for an employer but the employer did not withhold the worker's share of Social Security and Medicare taxes.

In addition, the worker must meet one of several criteria indicating they were an employee while performing the services. The criteria include:

- The worker has filed Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, and received a determination letter from the IRS stating they are an employee of the firm;
- The worker has received other correspondence from the IRS that states they are an employee;
- The worker received a W-2 and a 1099-MISC from the employer and the amount on the 1099-MISC should have been included as wages on the W-2; or
- The worker has filed Form SS-8 with the IRS and has not yet received a reply.

By using Form 8919, the worker's Social Security and Medicare taxes will be credited to their Social Security record. To facilitate this process, the IRS will electronically share Form 8919 data with the Social Security Administration.

In the past, misclassified workers often used Form 4137 to report their share of Social Security and Medicare taxes. Misclassified workers should not use this form. Instead, Form 4137 should only be used by tipped employees to report Social Security and Medicare taxes on allocated tips and tips not reported to their employers.

INDUSTRY STANDARDS: DANCERS

Court looks to industry

On May 18, 1998, exotic dancers were found to be independent contractors. (***Taylor Blvd. Theater, Inc. v. United States*** (1998) U.S. District Court, Western Dist. of Kentucky, Case No. 3:97-CV-63-H) The dancers and the club owner had a written contract. The dancers leased space from the club owner. They derived their income from tips and at the end of the evening, would divide the tips with the club owner as rent.

The court held that the club owner was not required to give the dancers Form 1099 because the patrons paid the dancers, not the club. The court also reviewed the factors of custom in the industry and the existence of a prior IRS audit. The court cited cases treating dancers within the industry as independent contractors.

The court's interpretation of IRC §530(e)(2)(A) concerning the effect of a prior audit upon the issue of employment status was interesting: The court held that a generic IRS audit that began before December 31, 1996, could be cited by the taxpayer for protection against changes in employment status even if that audit did not touch on employment tax issues.

This provision is part of the "safe harbor" relief, discussed above. These provisions, however, give relief only for federal employment taxes. There may be considerable exposure to your client for such things as overtime, minimum wage laws, workers' compensation laws and California employment compensation liability. There are no safe harbors in these areas.

CUIAB administrative decisions dance around the issue

In CUIAB Decision T-70-57, topless dancers were found to be independent contractors. The petitioner did not retain the right of control. The only restrictions were dress standards and compliance with police regulations.

However, not so in Case No. T-84-36. Exotic dancers performing in an adult bookstore were held to be employees. The dancers were assigned to various activities by the employer who controlled their hours of work. The employer retained the right to control the manner in which the dancers performed so as to ensure that their performances did not violate local ordinances or the California Penal Code or otherwise cause problems with respect to the operation of the business.

The same decision was reached in Case Nos. T-90-00116 and 00117. Disco and go-go dancers were held to be employees of a bar operator. The bar operator controlled their activities. When the women were not dancing, they were required to serve drinks for tips. According to the decision, "[T]hey were required to dance disco or go-go in bikinis to the bar's jukebox and were not free to dance a waltz." (Query: Would the Macarena have pleased the administrative law judge?)

One final administrative case of note is T-88-00177. Here, dancers performing in programs for a nonprofit corporation that arranged performances for fundraising and educational purposes were held to be independent contractors. The dancers provided their own costumes. The amount of pay was based upon audience participation. The case went on to say that, in many instances, the dancers performed for free or a modest amount. (However, nothing was said relating to modest attire.)

There are EDD regulations concerning rules for determination of employment status for artists. An artist is defined as an individual who creates, performs, or interprets works in the visual, literary or performing arts. One who holds herself out as an entrepreneur in the arts shows evidence of being an independent contractor. Performances include, but are not limited to, film, videotapes, recordings, and visual arts.

It is important to have business cards, a brochure or stationery demonstrating that one is available for work as an independent person. (Treas. Regs. §4304-5)

Reasonable reliance

When we uncover the bare facts, it becomes clear that those who rent their work space and engage in more intellectual pursuits have a better chance of being acknowledged by both the IRS and the EDD as independent contractors. This is illustrated by the Ninth Circuit's decision in ***Marlar Inc. v. United States*** (1998) 151 F.3d 962.

In Seattle, Washington, stands "Club Extasy." The club provides nude and semi-nude dancers, but has no employees. Instead, the club, as landlord, merely provides stages and dancing facilities. The dancers are "tenants." They pay $40 per night as "rent" for use of the premises. Their entire income is derived from customer tips, and they receive no compensation from the club. The customer buys a soft drink costing a mere $10, and this allows him to sit and talk with the dancer of his choice, but only if the dancer consents.

The dancers receive a $10 credit against their rent up to a maximum of $40 per night. No cash is exchanged between the dancers and the club with regard to rent. It's all done by credits against customer drink purchases. Customers would pay the dancers with either cash or scrip known as "Extasy Bucks," which they purchase from the club with credit cards.

The Ninth Circuit, in reaching a decision in favor of Club Extasy, relied heavily upon the safe harbor rules set forth in IRC §530. Marlar, the owner of Club Extasy, raised the point that, according to IRC §530(a)(1)(B), if an employer has not treated an individual as an employee and has filed all required returns in a consistent manner, then "the individual shall be deemed not to be an employee unless the taxpayer had no reasonable basis for not treating such individual as an employee."

The key factor in whether an employer has a "reasonable basis" is to prove a "long-standing recognized practice of a significant segment of the industry in which such individual was engaged." Marlar did not file 1099s, and the IRS attempted to use this fact as an argument in favor of treating the dancers as employees. It didn't work.

Of key importance in the ***Marlar*** decision is the Ninth Circuit's treatment of "reasonable reliance" on industry practice and not just "mere reliance." The Ninth Circuit gave us the following words of wisdom: "Because a reasonable person could find that the dancers are lessees instead of employees, it certainly follows that a reasonable person could also find that the industry's practice of treating the dancers as lessees is legally correct." The court went on to say that "the reliance was reasonable because a reasonable person could find the practice to be correct."

The naked truth appears to be that regardless of the occupation you find yourself advising, it may be wise to have workers rent their work space in order to ensure independent contractor status.

REVIEW QUESTIONS

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

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

32. For the determination of an employer-employee relationship, which choice below is correct?

    a) How a person is paid is determinative when deciding if an individual is an independent contractor or an employee.
    b) The IRS has created a list of 15 factors when determining if a employer-employee relationship exists.
    c) The training of an individual as it pertains to a job is not determinative when assessing if the employee is an independent contractor or an employee.
    d) The IRS equally weights all factors when assessing the employer-employee relationship.

33. What is true for the Section 530 safe harbor?

    a) The Section 530 safe harbor is like the Voluntary Classification Settlement Program in that being in an audit disqualifies the employer from relief.
    b) Corporate officers cannot be treated as independent contractors and get Section 530 relief.
    c) The statutory definition of "employee" is applied with determining relief under Section 530.
    d) If an employer does not deduct FICA taxes from a worker's salary because the worker is established as an independent contractor, the worker must pay the tax.

34. Factors pertaining to misclassified workers are correctly described in which choice below?

    a) Misclassified workers should use Form 4137 to report their share of Social Security and Medicare taxes.
    b) The IRS will not share any data from Form 8919 with the Social Security Administration.
    c) The worker must have filed Form SS-8 and received a reply for the IRS to fulfill the criteria that would indicate that they were an employee not an independent contractor.
    d) If a worker files Form 8919, Uncollected Social Security and Medicare Tax on Wages, the worker's associated taxes will be credited to their Social Security account record.

35. In ***Marlar Inc. v. United Stat***es, what are the accurate facts pertaining to this case regarding the employment status of exotic dancers?

    a) The dancers were paid by the club owner.
    b) The dancers paid the club owner cash as rent for the facilities.
    c) The Ninth Circuit relied on "reasonable" reliance on industry practices rather than "mere" reliance.
    d) The club owner filed 1099s on behalf of the dancers.

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SOLUTIONS TO REVIEW QUESTIONS

32. For the determination of an employer-employee relationship, which choice below is correct? **(Page 74)**

    a. Correct – If the individual is paid hourly, weekly, or monthly, this usually suggest employee status, whereas an independent contractor may be paid by the job or on commission.
    b. Incorrect – The IRS uses a 20-factor list which was initiated in 1987.
    c. Incorrect – Usually training implies that the employer has specific performance requirements, which would indicate an employer-employee relationship.
    d. Incorrect – The IRS will consider the circumstances and weight the factors accordingly and may also consider other pertinent issues.

33. What is true for the Section 530 safe harbor? **(Pages 76)**

    a. Incorrect – An employer under audit can qualify for relief under Section 530. This is not true of the Voluntary Classification Settlement Program.
    b. Incorrect – Corporate officers can be treated as independent contractors if these requirements are met: The taxpayer doesn't treat the worker (corporate officer) as an employee for FICA purposes for a specific period; the taxpayer files all pertinent tax returns as if the worker (corporate officer) is independent; and there is a reasonable basis for not treating the worker (corporate officer) as an employee.
    c. Incorrect – It is common law rules that are applied when making the determination.
    d. Correct – This is true under Rev. Proc. 85-18. Independent contractors incur the tax liability if the employer does not pay tax.

34. Factors pertaining to misclassified workers are correctly described in which choice below? **(Pages 77)**

    a. Incorrect – The correct form is 8919. Form 4137 is used to report Social Security and Medicare taxes from tips.
    b. Incorrect – The IRS will electronically transfer any data to correct a worker's Social Security record.
    c. Incorrect – The worker may not have received a reply, but the filing of the form fulfills one of the criteria. Other criteria include: The worker has filed Form SS-8 and received confirmation that they are an employee either through a determination letter or other correspondence; or the worker received a W-2 and a 1099-MISC that reflects income that should have been on the W-2.
    d. Correct – The IRS electronically shares this data with the SSA to correct the worker's record.

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35. In ***Marlar Inc. v. United Stat***es, what are the accurate facts pertaining to this case regarding the employment status of exotic dancers? **(Pages 79)**

    a. Incorrect – The dancers derived their income from tips from patrons, not from the club owner.
    b. Incorrect – There was no transfer of money between the club owner and the dancers for rent; rather there was a system of credits established against customers' drink purchases whereby customers would pay the dancers in cash or scrip.
    c. Correct – The reasonable reliance safe haven allows for employers to rely on long-standing customary practices within a significant portion of the industry, and in this case, the court found that the reliance on the industry practice of treating the dancers as lessees was legally correct.
    d. Incorrect – The owner did not file 1099s, which led the IRS to conclude that the dancers were employees. However the Ninth Circuit disagreed based on reasonable reliance on industry customary practices.

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IRS PRACTICE AND PROCEDURE

RETURNS HANDED TO IRS AGENT DOES NOT CONSTITUTE FILING

A CPA convicted for making false statements on his personal tax returns had his conviction reversed where the court found that he had never technically "filed" the returns. (IRC §7206(1); ***U.S. v. Boitano*** (August 12, 2015) U.S. Court of Appeals, Ninth District, Case No. 14-10139) The returns in question, which contained credits claimed for estimated tax payments that were never made, were not filed as required under IRC §7206(1) and within the meaning of the applicable IRS statutes and regulations; rather, the taxpayer handed the returns to the examining agent during a meeting. Circuit precedent held that "filing" is a required element for conviction under IRC §7206(1), and so the court reversed the convictions.

OFFSHORE VOLUNTARY DISCLOSURE PROGRAM PARTICIPATION

More than 54,000 taxpayers have participated in the IRS's Offshore Voluntary Disclosure program (OVDP), since its inception in 2009. (IR-2015-116) The IRS has collected more than $8 billion from this program.

The streamlined OVDP procedures, initiated in 2012, were developed to accommodate a wider group of U.S. taxpayers who have unreported foreign financial accounts but whose circumstances substantially differed from those taxpayers for whom the original OVDP requirements were designed. More than 30,000 taxpayers have used streamlined procedures to come back into compliance with U.S. tax laws. Two-thirds of these have used the procedures since the IRS expanded the eligibility criteria in June 2014.

The IRS strongly recommends that taxpayers with undisclosed accounts use these existing programs to come into compliance. Both original OVDP and the streamlined OVDP enable taxpayers to correct prior omissions and meet their federal tax obligations while mitigating the potential penalties of continued noncompliance. There are also separate procedures for those who have paid their income taxes but omitted certain other information returns.

TAX PROTESTOR REPRESENTATIVE WINDS UP IN TAX COURT

The founder of a tax avoidance program based in California ended up in Tax Court after failing to file his own returns for six years. (***Mottahedeh v. Comm.***, TCM 2014-258) Peymon Mottahedeh and his wife unsuccessfully tried to fight the IRS's method of reconstructing their income and spending when the Mottahedehs refused to provide financial information during audit.

The refusal to provide information is one of the cornerstone tactics used by Peymon's tax protestor organization, Freedom Law School (FLS). Other tactics include:

- Minimize financial records;
- Do not give information to the IRS; and
- Do not file tax returns (or "1040 Confession Forms" as they are referred to on the FLS website).

However, faced with a lack of records, the auditor used spending trends from the Bureau of Labor Statistics (BLS), along with what little information she had, to reconstruct the income (based on spending) for the tax years at issue. This method of income reconstruction has been deemed permissible by the courts. (See, for example, ***Pollard v. Comm.*** (1984) 786 F.2d 1063 and ***Giddio v. Comm.*** (1970) 54 TC 1530)

Peymon argued that the auditor should have only used bank and credit union records to reconstruct income. Since FLS operates almost exclusively in cash (remember: minimize financial records), the auditor had to turn to other sources to reconstruct the income.

The auditor was able to obtain some scant information; for example, one of Peymon's clients said he paid FLS $22,000 in cash for representation against the FTB. To fill in the gaps, the auditor turned to the average spending statistics published by the BLS. Because the auditor was unable to use the bank-deposit method of reconstructing income in this case, it was reasonable that she turned to BLS data to compute income.

Background on FLS

Freedom Law School — founded and run by Peymon, who is not an attorney — offers various educational materials designed for "freedom loving and self-responsible people who are committed to living their lives free of oppressive control and taxation by governments and their agents." (www.freedomlawschool.org/about-us.html) For example, there is a course titled "Sue and jail criminal government agents," available for $340 ($300 if you are also purchasing their Level 1 foundation course on oppressive taxation).

In addition, FLS offers services to taxpayers who need help with representation in front of various taxing agencies, offered in the form of packages which range in cost per year from $900 for the Beginner's Freedom Package to $6,000 for the Royal Freedom Package (payable in cash, by the way).

The courses include information on why you don't have to pay income taxes, how to defend yourself in front of a tax agency, plus various support services from FLS, like consultation or full-service representation.

FLS is also offering a reward of up to $300,000 for anyone who can prove the following propositions:

1. Show what statute written by the Congress of the United States requires Americans to file an income tax "confession" (return) and pay an income tax;
2. Show how Americans can file an income tax "confession" (return) without giving up their Fifth Amendment right to not give any information to the government that may be used to prosecute them; and/or
3. Prove that the Sixteenth Amendment to the United States Constitution, which, according to the IRS and modern American courts permitted the income tax to exist, was lawfully added to the United States Constitution.

Digging a little deeper on caltax.com

First (and this is relevant, as you'll see), a quick and shameless plug for Spidell's Online Research Package: Among other things, Online Research subscribers have access to all of the Franchise Tax Board appeal documents, going back to 1958.

Aside from posting these appeals to www.caltax.com, one of Spidell's editors goes through each batch of appeals when they are released, looking for pertinent tax issues and how they are being handled by the Board.

Here's the connection: In doing so, we see Peymon's name quite often. His are the cases that can involve up to 14 taxpayers consolidated into one case, all arguing that the taxpayer was denied a fair hearing, and the FTB didn't provide evidence to support the assessment against the taxpayer.

In a search of his name within the tax appeals on caltax.com, there are 112 instances of Peymon representing FLS clients in front of the Board. Just to be fair, we checked each and every one … all

were losses and, in all but two cases, the taxpayers were hit with frivolous appeal penalties ranging from $750 to $5,000.

On the FLS website, there is a Victories tab that includes descriptions of cases that FLS students "won" against the FTB, specifically in front of the Board. Some of the taxpayers named in the cases did appeal (their appeals are posted on caltax.com), but none of them won. There are appeals cases that vaguely fit a fact pattern described on the FLS website, but none have a successful outcome.

In looking at the "wins," there appear to be some cases where the liability was reduced, but the taxpayers still came out of the appeal with a tax bill.

FLS did have one successful student — Paul Ballmer. He sued the FTB in 1997 for violations of the California Information Practices Act of 1977. He was awarded $250,000 in damages and $82,000 in attorney's fees and other costs. This case is featured at the top of the list of FLS Victories, announcing that Ballmer had "crushed" the FTB. The FLS website does not mention that Ballmer found himself in Tax Court in 2007 because he did not include these payments in income. (***Ballmer v. Comm.***, TCM 2007-295)

Not your problem

Most practitioners won't see a tax protestor walk through their door. These cases just serve as a reminder that the tax protest movement is still out there, arguing that a taxpayer is not a "person" or that the United States consists only of the District of Columbia, federal territories, and federal enclaves. These arguments never stand up in court. They do, however, provide some levity as you gear up for the next 1040 "Confession Form" filing season.

TIGTA: PTINs ARE NOT BEING REVOKED

A Treasury Inspector General of Tax Administration (TIGTA) review of the IRS's processes for revoking PTINs for unsuitable tax return preparers identified that the Return Preparer Office (RPO) has established processes and procedures to ensure that individuals assigned a PTIN meet the following requirements:

- **Age**. Individuals assigned a PTIN are required to be at least 18 years of age. The match of all PTIN holders in the IRS PTIN system as of November 30, 2014, to the National Account Profile confirmed that all PTIN holders were at least 18 years of age as required;
- **Deceased**. The tax return preparer's identifying information used to apply for a PTIN must not be associated with an individual who is deceased. The match of all PTIN holders to the National Account Profile confirmed that the RPO correctly identified all deceased PTIN holders and changed their status to deceased;
- **Professional credentials**. The RPO confirms self-reported preparer credentials with state licensing authorities. The review of a statistically valid sample of 73 PTIN holders who self-identified a professional credential found that preparers' self-identified professional credentials in the IRS PTIN system are accurate; and
- **Completion of educational courses and consent to adhere to Circular 230 to participate in the IRS Annual Filing Season Program (AFSP)**. The RPO ensured that individuals completed the required educational courses and consented to Circular 230 duties and restrictions prior to issuing an AFSP Record of Completion. For all preparers issued an AFSP Record of Completion, TIGTA verified that a record of consent was obtained and recorded in the IRS PTIN system and that the preparer met the training requirements.

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However, TIGTA found three main areas where the IRS failed to revoke PTINs when warranted:

1. RPO did not revoke PTINs of tax return preparers who were not compliant with their tax filing and payment obligations;
2. The RPO also did not assess the suitability of individuals who self-reported a felony conviction on their PTIN application unless the preparer wanted to participate in the AFSP; and
3. PTINs were not always revoked for individuals in prison or individuals who were enjoined from preparing tax returns.
   (TIGTA. (August 27, 2015) "Preparer Tax Identification Numbers Are Not Revoked for Unsuitable Tax Return Preparers" Reference Number 2015-40-075)

Tax noncompliance

The RPO did not complete tax compliance checks on tax return preparers in calendar years 2014 and 2015 and revoke PTINs for noncompliance with tax laws. While the RPO identified potentially noncompliant tax return preparers, inquiry letters were not sent to preparers in 2014, and as of June 22, 2015, letters had not been sent to preparers identified in 2015.

For example, in January 2015, the RPO identified 19,496 preparers with PTINs that were potentially noncompliant with tax filings and payments. These preparers have over $367.6 million in total taxes due as of January 26, 2015. The RPO also identified 3,055 preparers who failed to file required tax returns for one (2,374 preparers) or more (681 preparers) tax years; eight tax return preparers who failed to file required tax returns for five years; and one tax return preparer who failed to file required tax returns for six years. While the RPO has a process to identify noncompliant return preparers, no actions were taken by the RPO to then resolve these cases.

IRS Breakdown of Return Preparers by the Amount of Tax Owed		
Aggregate tax due	**Preparers***	**Total balances due**
Greater than $1 million	3	$20,629,621
Between $1 million and $5 million	23	$32,402,122
Between $500,000 and $1 million	55	$38,829,470
Between $250,000 and $500,000	132	$44,468,887
Between $100,000 and $250,000	480	$72,577,395
Between $50,000 and $100,000	714	$49,869,257
Between $25,000 and $50,000	1,145	$40,616,698
Between $10,000 and $25,000	2,077	$32,526,459
Between $1,000 and $10,000	9,269	$33,851,104
Less than $1,000	2,543	$1,830,352
Totals	**16,441**	**$367,601,365**
* Population includes unlicensed return preparers, credentialed return preparers, and AFSP participants		

Recommendation

TIGTA recommended that the RPO should ensure that tax compliance checks are complete by timely issuing inquiry letters to preparers after identifying noncompliance with federal tax laws and that appropriate actions are taken to revoke PTINs when warranted. The IRS agreed, and began sending letters to the noncompliant tax preparers on June 17, 2015.

Felony convictions

TIGTA's review of tax return preparers assigned a PTIN as of September 30, 2014, identified 3,001 preparers in the IRS PTIN system who self-reported a felony conviction on their application. The descriptions of the type of felony convictions detailed by these applicants include convictions for preparing false tax returns, drug possession, and mortgage fraud. Of the 3,001 preparers, 235 were licensed professionals. Of the 3,001 preparers who self-reported a felony conviction, 87 (3 percent) reported a crime related to federal tax matters.

Recommendation

TIGTA recommended that the RPO should ensure that all self-reported felony convictions are assessed and actions are taken to revoke PTINs when warranted. The IRS said that it would continue to do so, but only for EAs and AFSP applicants, rather than for all PTIN holders.

Enjoined preparers

The RPO did not revoke PTINs assigned to 65 (15%) of 445 confirmed prisoners identified as part of its January 2014 prisoner suitability check. In addition, PTINs were not revoked for 15 (17%) of 87 individuals identified as being permanently enjoined (barred) from preparing tax returns. These individuals were barred by a court-ordered injunction requested by the IRS.

The RPO performs its prisoner check once a year between December and February. This allows prisoners to obtain and use a PTIN after the annual match, without detection, until the RPO performs its next annual check. For example, if the IRS completes its prisoner match in January 2015 and a PTIN application from an incarcerated tax return preparer is received in February 2015, the IRS will grant the PTIN but not identify this preparer as a prisoner until its next annual prisoner check in January 2016. This can result in a prisoner using a PTIN in both the 2015 and 2016 filing seasons, before the IRS completes its research and revokes the PTIN.

TIGTA's comparison of the January 2014 prisoner file to the IRS PTIN system, as of November 30, 2014, identified six prisoners who obtained a PTIN after the RPO's prisoner check on February 1, 2014. Five of the six prisoners prepared 829 tax returns during the 2014 filing season, with refunds totaling over $2.5 million.

Recommendations

TIGTA recommended that the RPO ensure that review processes are performed and employees complete required actions to revoke PTINs for incarcerated and enjoined tax return preparers. The IRS agreed, noting that 80 PTINs found to be unrevoked were the result of one employee's failure to take all appropriate closing actions following the determination to revoke. The IRS has implemented additional quality controls, conducted refresher training for the employees, performed quality reviews of employee work products, and completed managerial reviews of the revocation process.

TIGTA also recommended that RPO ensure that the prisoner check is completed quarterly and prisoners' PTINs are revoked as warranted. The IRS agreed and implemented procedures, starting July 22, 2015, for quarterly checks of new PTIN applicants with their annual prisoner list.

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IRS'S DIRTY DOZEN FOR 2015

Illegal scams can lead to significant penalties and interest for taxpayers, as well as possible criminal prosecution. IRS Criminal Investigation works closely with the Department of Justice to shutdown scams and prosecute the criminals behind them. Taxpayers should remember that they are legally responsible for what is on their tax returns even if it is prepared by someone else.

Here are the IRS's Dirty Dozen scams for 2015.

Phone scams

Aggressive and threatening phone calls by criminals impersonating IRS agents remains an ongoing threat to taxpayers. The IRS has seen a surge of these phone scams in recent months as scam artists threaten police arrest, deportation, license revocation and other things. The IRS reminds taxpayers to guard against all sorts of con games that arise during any filing season. (IR-2015-5)

Detecting a scammer

The IRS reminds taxpayers that scammers pretending to be IRS agents often do things that actual IRS agents would never do, such as:

- Angrily demand immediate payment over the phone. Nor will the agency call about taxes owed without first having mailed a bill;
- Threaten to bring in local police or other law-enforcement groups to have the taxpayer arrested for not paying;
- Demand that the taxpayer pay taxes without giving them the opportunity to question or appeal the amount owed;
- Require the taxpayer to use a specific payment method for payment of taxes, such as a prepaid debit card; and
- Ask for credit or debit card numbers over the phone.

Real life example

On July 9, 2015, in the Northern District of California, Douglas York was charged with the false impersonation of a Federal employee and telecommunications device harassment. (www.treasury.gov/tigta/oi_highlights.shtml#116)

According to the court documents, York pretended to be an IRS agent engaged in the investigation of tax records. York made a telephone call and left a voicemail for the victim indicating that he was from the IRS and was calling about a tax audit.

In the communication, York used a voice alteration device to further conceal his identity. His voicemail message for the victim stated that Judy Smith from the IRS was calling and that a tax audit was going to be requested for years 2005, 2006, and 2007. York further said if the victim could not be reached, the IRS would be checking into his past and looking into his records.

Among other things, York incessantly called the victim over the course of several months, placed a phony advertisement for the sale of a car on Craigslist with the victim's address listed, and posted a sign on the victim's street claiming he was a child predator.

York could face up to three years in prison and a $250,000 fine. Additional legal activity is pending.

Phishing

Taxpayers need to be on guard against fake emails or websites looking to steal personal information. The IRS will not send you an email about a bill or refund out of the blue. Don't click on one claiming to be from the IRS that takes you by surprise. Taxpayers should be wary of clicking on strange emails and websites. They may be scams to steal your personal information. (IR-2015-6)

Identity theft

Taxpayers need to watch out for identity theft especially around tax time. The IRS continues to aggressively pursue the criminals that file fraudulent returns using someone else's Social Security number. The IRS is making progress on this front but taxpayers still need to be extremely careful and do everything they can to avoid becoming a victim. (IR-2015-7)

Return preparer fraud

Taxpayers need to be on the lookout for unscrupulous return preparers. The vast majority of tax professionals provide honest high-quality service. But there are some dishonest preparers who set up shop each filing season to perpetrate refund fraud, identity theft and other scams that hurt taxpayers. Return preparers are a vital part of the U.S. tax system. About 60 percent of taxpayers use tax professionals to prepare their returns. (IR-2015-8)

Offshore tax avoidance

The recent string of successful enforcement actions against offshore tax cheats and the financial organizations that help them shows that it's a bad bet to hide money and income offshore. Taxpayers are best served by coming in voluntarily and getting their taxes and filing requirements in order. The IRS offers the Offshore Voluntary Disclosure Program (OVDP) to help people get their taxes in order. (IR-2015-09)

Inflated refund claims

Taxpayers need to be on the lookout for anyone promising inflated refunds. Taxpayers should be wary of anyone who asks them to sign a blank return, promises a big refund before looking at their records, or charges fees based on a percentage of the refund. Scam artists use flyers, advertisements, phony store fronts and word of mouth via community groups and churches in seeking victims. (IR-2015-12)

Fake charities

Taxpayers should be on guard against groups masquerading as charitable organizations to attract donations from unsuspecting contributors. Contributors should take a few extra minutes to ensure their hard-earned money goes to legitimate and currently eligible charities. IRS.gov has the tools taxpayers need to check out the status of charitable organizations. Be wary of charities with names that are similar to familiar or nationally known organizations. (IR-2015-16) See "IRS's Exempt Organization select check service" on page 60.

Hiding income with fake documents

Hiding taxable income by filing false Form 1099s or other fake documents is a scam that taxpayers should always avoid and guard against. The mere suggestion of falsifying documents to reduce tax bills or inflate tax refunds is a huge red flag when using a paid tax return preparer. Taxpayers are legally responsible for what is on their returns regardless of who prepares the returns. (IR-2015-18)

Abusive tax shelters

Taxpayers should avoid using abusive tax structures to avoid paying taxes. The IRS is committed to stopping complex tax avoidance schemes and the people who create and sell them. The vast majority of taxpayers pay their fair share, and everyone should be on the lookout for people peddling tax shelters that sound too good to be true. When in doubt, taxpayers should seek an independent opinion regarding complex products they are offered. (IR-2015-19)

Falsifying income to claim credits

Taxpayers should avoid inventing income to erroneously claim tax credits. Taxpayers are sometimes talked into doing this by scam artists. Taxpayers are best served by filing the most-accurate return possible because they are legally responsible for what is on their return. (IR-2015-20)

Excessive claims for Fuel Tax Credits

Taxpayers need to avoid improper claims for fuel tax credits. The fuel tax credit is generally limited to off-highway business use, including use in farming. Consequently, the credit is not available to most taxpayers. But yet, the IRS routinely finds unscrupulous preparers who have enticed sizable groups of taxpayers to erroneously claim the credit to inflate their refunds. (IR-2015-21)

Frivolous tax arguments

Taxpayers should avoid using frivolous tax arguments to avoid paying their taxes. Promoters of frivolous schemes encourage taxpayers to make unreasonable and outlandish claims to avoid paying the taxes they owe. These arguments are wrong and have been thrown out of court. While taxpayers have the right to contest their tax liabilities in court, no one has the right to disobey the law or disregard their responsibility to pay taxes. The penalty for filing a frivolous tax return is $5,000. (IR-2015-23)

WHAT'S NEW ON THE 2015 FORM 1040?

The IRS has released a number of tax forms and instructions for the 2015 tax year, including Form 1040 and its related schedules. They reflect several changes that take effect in 2015.

Items not specific to specific lines on the form

- **Due date:** The Form 1040 due date is April 18, 2016, except for residents of Maine or Massachusetts, for whom the due date is April 19, 2016. That latter date is because of the Patriots' Day holiday in those states.
- **Extensions:** In past years, a taxpayer could obtain an automatic six-month extension if, no later than the date the Form 1040 was due, he or she filed Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return. For 2015 returns, a taxpayer can also apply for an automatic extension by making an electronic payment by the due date of his or her return.

Gross income

- **Line 15:** Pensions and annuities. A qualified charitable distribution (QCD) is a distribution made directly by the trustee of an IRA (other than an ongoing SEP or SIMPLE IRA) to an organization eligible to receive tax-deductible contributions (with certain exceptions), on behalf of a taxpayer who was at least age 70½ when the distribution was made. The QCD rule expired as of December 31, 2014. If extended, the QCD is reported on Line 15a, and no amount of the QCD was reported on Line 15b.
- **Line 21:** Other income—adoption exclusion. For 2015, the maximum exclusion for employer-provided adoption assistance is $13,400 per eligible child. The excludable amount is phased out for taxpayers with adjusted gross income (as specially computed) over $201,010 and is fully eliminated when AGI reaches $241,010.
- **Line 21:** Other income—distributions from ABLE accounts. The Achieving a Better Life Experience (ABLE) account is a new type of savings account for individuals with disabilities and their families. Distributions from this type of account may be taxable if (a) they are more than the designated beneficiary's qualified disability expenses, and (b) they were not included in a qualified rollover. Those taxable amounts should be shown on Line 21.
- **Line 21:** Other income—death of a public safety officer. Effective May 22, 2015, certain amounts received because of the death of a public safety officer are nontaxable.

Adjusted gross income

- **Line 26:** Moving expenses. The 2015 standard mileage rate for moving expenses is 23¢ per mile.
- **Line 32:** IRA deduction. In general, an individual who isn't an active participant in certain employer-sponsored retirement plans, and whose spouse isn't an active participant, may make an annual deductible cash contribution to an IRA up to the lesser of: (1) a statutory dollar limit, or (2) 100% of the compensation that's includible in his gross income for that year. For 2015, the statutory dollar limit is $5,500, plus an additional $1,000 for those age 50 or older. If the individual (or his spouse) is an active plan participant, the deduction phases out over a specified dollar range of modified AGI (MAGI). For 2015, a taxpayer may be able to take an IRA deduction if he was covered by a retirement plan and his 2015 MAGI is less than $71,000 ($118,000 if married filing jointly or qualifying widow(er)). If the taxpayer's spouse was covered by a retirement plan, but the taxpayer was not, he may be able to take an IRA deduction if his 2015 MAGI is less than $193,000.

Tax and credits

- **Line 40:** Itemized deductions or standard deduction. For 2015, the standard deduction is $6,300 for single filers and for married persons filing separately, $12,600 for joint filers and qualifying widow(er)s, and $9,250 for heads of household.
- **Line 42:** Exemptions. The amount for each exemption for 2015 is $4,000. Exemptions are reduced for taxpayers with AGIs in excess of the "applicable amount" ($309,900 for joint filers or a surviving spouse, $284,050 for a head of household, $258,250 for a single individual who isn't a surviving spouse, and $154,950 for marrieds filing separately).
- **Line 45:** Alternative minimum tax. Under Code Sec. 55(d), the alternative minimum tax (AMT) exemption amount for 2015 is $53,600 ($83,400 if married filing jointly or a qualifying widow(er); $41,700 if married filing separately). The AMT exemption amount is reduced if alternative minimum taxable income is above statutorily-defined amounts that depend upon filing status.
- **Line 54:** Other credits. For 2015, the maximum adoption credit is $13,400 per eligible child for both non-special needs adoptions and special needs adoptions.

Other taxes

- **Line 57:** Self-employment tax. Maximum amount of self-employment income subject to FICA tax is $118,500; there is no ceiling on Medicare wage base. An individual may use the farm optional method only if (a) his gross farm income was not more than $7,320 or (b) his net farm profits were less than $5,284. Using this method, farm self-employment earnings equals the smaller of (1) two-thirds of gross farm income, or (2) $4,880.
  An individual may use the nonfarm optional method only if (a) his net nonfarm profits were less than $5,284 and also less than 72.189% of his gross nonfarm income and (b) he had net earnings from self-employment of at least $400 in 2 of the prior 3 years. Individuals may compute their self-employment earnings as the smaller of two-thirds of gross nonfarm income or $4,880.
  A self-employed individual with both farm and nonfarm incomes is allowed to use both optional computation methods if the farm income qualifies for the farm optional method and the nonfarm income qualifies for the nonfarm optional method. If both optional methods are used to compute net earnings from self-employment, the maximum combined total net earnings from self-employment for any tax year can't be more than $4,880.
- **Line 59:** Additional tax on IRAs, other qualified retirement plans, etc. This line is used to report additional taxes on excess contributions to, and certain distributions from, IRAs, etc. New for 2015, this line should be used for excess contributions to, and certain distributions from, ABLE accounts. (For more on ABLE accounts, see Line 21 above.)
- **Line 61:** Health care — individual responsibility. As was the case in 2014, a taxpayer must either:
  - Indicate on line 61 that he, his spouse (if filing jointly) and his dependents had health care coverage throughout 2015;
  - Claim an exemption from the health care coverage requirement for some or all of 2015 and attach Form 8965; or
  - Make a "shared responsibility payment" if, for any month in 2015, he, his spouse (if filing jointly) or his dependents did not have coverage and do not qualify for a coverage exemption.

  However, the monthly shared responsibility payment amount has increased for 2015. For 2015, it is lesser of (i) the sum of the monthly penalty amounts for months in the tax year during which one or more failures occurs, or (ii) the sum of the monthly national average bronze plan premiums for the plan. The monthly penalty amount is equal to 1/12 of the greater of $325 or 2% of the amount by which the taxpayer's household income exceeds the filing threshold.
  The Form 1040 instructions for this line have been greatly expanded.

Payments

- **Line 66:** Earned Income Credit (EIC). The maximum credit is higher, and the AGI-based phaseout figures are revised.
- **Line 67:** Additional Child Tax Credit. Effective for tax years beginning after December 31, 2014, any taxpayer who elects to exclude foreign earned income for a tax year may not claim the additional (refundable) child tax credit for that year.
- **Line 71:** Excess Social Security and RRTA tax withheld. Maximum Social Security (OASDI) tax for 2015 is $7,347 (computed on the first $118,500 of wages) for purposes of credit for excess tax withheld.

- **Line 73:** Credits. Line 73, box b is labeled as "Reserved." The draft instructions contain no information on this box. The final version of 2014 Form 1040 also had this box labeled as "Reserved." Line 73, box d is labeled "8885" for Form 8885; Form 8885 is entitled "Health Coverage Tax Credit." The health coverage tax credit (HCTC) expired at the end of 2013, but in 2015, it was reinstated retroactive to January 1, 2014.
- **Line 76:** Amount refunded to you. The Department of the Treasury has provided for a new type of Roth IRA, the myRA, that it now administers directly for employees of private sector companies. Various Form 1040 instructions that refer to IRAs now also refer to myRAs, including the instruction for direct depositing refunds; refunds can be direct-deposited into myRAs.

THE BASICS OF REQUESTING A LETTER RULING

The specific instructions for requesting a letter ruling from the IRS are outlined in Rev. Proc. 2015-01. (www.irs.gov/pub/irs-irbs/irb15-01.pdf) The instructions may vary depending on the matter that is being requested and may refer to other revenue procedures.

However, the documents and information required in all requests for letter rulings should include:

1. A complete statement of facts and other information;
2. Copies of all contracts, wills, deeds, agreements, instruments, other documents pertinent to the transaction, and any applicable foreign laws;
3. Analysis of material facts and their bearing on the issue in the request;
4. Statement regarding whether the same issue is in an earlier return;
5. Statement regarding whether the same or similar issue was previously ruled on or whether a request involving it was submitted or is currently pending;
6. Statement regarding interpretation of a substantive provision of an income or estate tax treaty;
7. Letter from the Bureau of Indian Affairs relating to a letter ruling request for recognition of Indian tribal government status or status as a political subdivision of an Indian tribal government;
8. Statement of supporting authorities. This must include a statement of whether the law in connection with the request is uncertain and whether the issue is adequately addressed by relevant authorities;
9. Statement of contrary authorities. The taxpayer should provide this information to speed the research and ruling process. If the taxpayer determines that there are no contrary authorities, a statement in the request to this effect should be included;
10. Statement identifying pending legislation that may affect the transaction;
11. Statement identifying information to be deleted from the public inspection copy of a letter ruling or determination letter, because the text of letter rulings is open to public inspection; and
12. Signature by the taxpayer or an authorized representative.

A letter ruling request must be accompanied by a penalty of perjury statement signed by the taxpayer.

Multiple issues

Generally, a taxpayer needs to submit the original and one copy of the request for a letter ruling or determination letter. If more than one issue is presented in the letter ruling request, the taxpayer is encouraged to submit additional copies of the request.

If more than one issue is presented in a request for a letter ruling, the associate office generally will issue a single letter ruling covering all the issues. A taxpayer who wants separate letter rulings on multiple issues should make this clear in the request and submit the original and two copies of the request.

No-rule situations

A letter ruling will not be issued with respect to an issue that is clearly and adequately addressed by statute, regulations, decision of a court, Revenue Rulings, Revenue Procedures, Notices, or other authority published in the Internal Revenue Bulletin. This is known as a “comfort ruling.”

The IRS will not generally issue a letter ruling or determination letter if, at the time of the request, the identical issue is under examination or consideration or in litigation. Nor will the IRS issue a ruling regarding an alternative plan for a transaction or a hypothetical situation.

The IRS ordinarily does not issue letter rulings or determination letters regarding the tax consequences of a transaction for taxpayers who are not directly involved in the request, i.e., if the requested letter ruling or determination letter would not address the tax status, liability, or reporting obligations of the requester. For example, a taxpayer may not request a letter ruling relating to the tax consequences of a transaction of a customer or client if the tax status, liability, or reporting obligations of the taxpayer would not be addressed in the ruling, because the customer or client is not directly involved in the letter ruling request. The tax liability of each shareholder is, however, directly involved in a letter ruling on the reorganization of a corporation. This means that a corporate taxpayer could request a letter ruling that solely addressed the tax consequences to its shareholders of a proposed reorganization.

The IRS generally does not issue letter rulings or determination letters to foreign governments or their political subdivisions about the U.S. tax effects of their laws, nor on the effect of a tax treaty on the tax laws of a treaty country for purposes of determining the tax of the treaty country.

The IRS will not issue a letter ruling for any frivolous issue. This includes the typical tax protestor–type arguments such as, but not limited to:

- The requirement to file tax returns and pay taxes constitutes an unreasonable search barred by the Fourth Amendment, violates Fifth and Fourteenth Amendment protections of due process, violates Thirteenth Amendment protections against involuntary servitude, or is unenforceable because the Sixteenth Amendment does not authorize nonapportioned direct taxes or was never ratified;
- Income taxes are voluntary and the term “income” is not defined in the IRC;
- Filing federal income tax returns violates the Federal Paperwork Reduction Act;
- Income is not taxable to an individual who falls into an extra-statutory class of individuals such as “free-born” individuals;
- Tax may only be imposed on gold or silver minted coins;
- Taxes only apply to federal employees and residents of Puerto Rico, Guam, the U.S. Virgin Islands, the District of Columbia, or other “federal enclaves”; or
- Claims that wages or personal service income are “not income,“ are ”nontaxable receipts,” or are a “nontaxable exchange for labor.”

Fee schedule

The fee for requesting a letter ruling can be as high as $50,000 for a prefiling agreement (a request that the IRS examine specific issues relating to tax returns before those returns are filed).

However, for individual taxpayers, there are reduced fees available that are based on AGI ranges and when the request is filed:

	Request received prior to February 2	**Request received after February 1**
Request involves a tax issue from a person with gross income of less than $250,000	$2,000	$2,200
Request involves a tax issue from a person with gross income of less than $1 million and $250,000 or more	$5,000	$6,500

Taxpayers falling outside of these income ranges must consult Rev. Proc. 2015-1 for the full fee schedule.

In the case of a request from a married individual, the gross incomes of the applicant and the applicant's spouse (as determined above) must be combined; if there are two or more applicants filing the request, the gross incomes of the applicants must be combined.

A fee of $5,000 applies with respect to requests that involve a business-related tax issue (for example, home-office expenses, residential rental property issues) from a person with gross income of less than $1 million but more than $250,000. For requests received after February 1, 2015, the fee is $6,500. See Rev. Proc. 2015-1 for how to determine gross income for the purposes of these fees.

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REVIEW QUESTIONS

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

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

36. What are the accurate details of ***Mottahedeh v. Comm.***, where the taxpayer created a tax avoidance program for "freedom loving and self-responsible" persons?

    a) The taxpayer is an attorney who created the Freedom Law School.
    b) The auditor used information from the Bureau of Labor Statistics to compute the taxpayer's income.
    c) The taxpayer has stayed in business because he has sustained a good track record in his appeals cases on behalf of clients in front of various taxing agencies.
    d) The taxpayers ended up in Tax Court because they filed tax returns with inaccurate and missing information.

37. The Treasury Inspector General of Tax Administration (TIGTA) has issued recommendations regarding the Return Preparer Office (RPO) in order to ensure that tax return preparer processes and procedures are in place and effective. Which of the following statements is true regarding these recommendations and the circumstances that precipitated them?

    a) The RPO did not revoke PTINs of some individuals who were permanently barred from preparing tax returns.
    b) The RPO has performed compliance checks on tax return preparers and is current through 2015.
    c) Per TIGTA's recommendations, the IRS will review all self-reported felony convictions for all PTIN holders.
    d) The IRS has implemented procedures for yearly checks of PTIN applicants against their annual prisoner list.

38. What is true about the following tax scams?

    a) Filing a frivolous tax return can result in a $10,000 fine.
    b) Even if a professional prepares a tax return, the taxpayer is legally responsible for what's in it.
    c) The Fuel Tax Credit is available to most taxpayers and is widely used to inflate refunds.
    d) Tax avoidance shelters are typically legitimate even when they are complex.

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39. Changes that take effect in 2015 for Form 1040 reflecting gross income are accurately detailed in which of the following?

    a) The qualified charitable distribution (QCD) rule expires in December 2015 and is reported on line 15b.
    b) For line 21 pertaining to the adoption exclusion, the excludable amount is eliminated when AGI hits $201,010.
    c) Distributions from ABLE accounts are not taxable.
    d) Certain amounts received as a consequence of the death of a public safety officer are not taxable.

40. Which details are correct for line 61 regarding health care and individual responsibility?

    a) The monthly shared responsibility payment amount remains the same for 2015.
    b) The monthly shared responsibility penalty amount is 1.5% of the amount by which the taxpayer's household income is more than the filing threshold and must be shown on line 61.
    c) The taxpayer can claim an exemption from health care coverage by attaching Form 8965.
    d) The instructions pertaining to line 61 on Form 1040 have been reduced and simplified.

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SOLUTIONS TO REVIEW QUESTIONS

36. What are the accurate details of ***Mottahedeh v. Comm***., where the taxpayer created a tax avoidance program for "freedom loving and self-responsible" persons? **(Page 80 and 81)**

    a) Incorrect – The taxpayer is not an attorney, although he advised his clients on minimizing financial records and not filing tax returns. He will also represent clients in front of taxing agencies, requesting cash for all his services.
    b) Correct – Because the taxpayer refused to provide his own records, the IRS was allowed to reconstruct his income based on average spending statistics from the Bureau of Labor Statistics, a method that has been approved by the courts.
    c) Incorrect – In an online search, there were 112 occasions uncovered where the taxpayer represented clients before the Board, and all were losses.
    d) Incorrect – The taxpayers did not file any tax returns for a period of six years and ended up in Tax Court to fight the IRS's attempt to reconstruct their income.

37. The Treasury Inspector General of Tax Administration (TIGTA) has issued recommendations regarding the Return Preparer Office (RPO) in order to ensure that tax return preparer processes and procedures are in place and effective. Which of the following statements is true regarding these recommendations and the circumstances that precipitated them? **(Page 84)**

    a) Correct – Because of this, TIGTA has recommended that the RPO ensure that actions are taken to revoke PTINs for tax preparers that are in jail or who are barred from preparing tax returns. TIGTA is has also recommended quarterly checks of PTIN applicants against an annual prisoner list.
    b) Incorrect – The RPO identified noncompliant tax preparers but did not send out inquiries in 2014 and for about half of 2015. TIGTA recommended sending the letters, so the IRS restarted their compliance checks and inquiry letters in June 2015.
    c) Incorrect – The IRS has continued to review felony convictions for EAs and AFSP applicants, not PTIN holders.
    d) Incorrect – The checks are quarterly beginning July 22, 2015.

38. What is true about the following tax scams? **(Page 86)**

    a) Incorrect – The fine is $5,000.
    b) Correct – This is true under IR-2015-18. The IRS is generally alert to falsifying documents to get a tax credit or refund.
    c) Incorrect – The Fuel Tax Credit is primarily for off-highway business use, e.g., farming, so most taxpayers can't use it.
    d) Incorrect – Usually tax shelters that sound like they're too good to be true, are. Taxpayers are advised to seek independent advice regarding these shelters.

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39. Changes that take effect in 2015 for Form 1040 reflecting gross income are accurately detailed in which of the following? **(Page 88)**

    a) Incorrect – The QCD rule expired in December 2014. No amount was reported on line 15b and if it's extended, it will be reported on line 15a.
    b) Incorrect – The maximum exclusion is $13,400 per child in 2015. The phaseout begins when AGI is over $201,010 and is completely phased out when AGI hits $241,010.
    c) Incorrect – These distributions may be taxable if they were not included in a qualified rollover or they exceed the beneficiary's expenses. Taxable amounts are shown on line 21.
    d) Correct – This is true and in effect as of May 22, 2015.

40. Which details are correct for line 61 regarding health care and individual responsibility? **(Page 89)**

    a) Incorrect – For 2015, the shared responsibility payment has gone up.
    b) Incorrect – The penalty amount is 1/12 of $325 or 2% of the amount by which the taxpayer's household income is more than the filing threshold, whichever is greater.
    c) Correct – Form 8965 is Health Coverage Exemptions and can be used for either all or part of 2015.
    d) Incorrect – On the contrary, the instructions are expanded with more explanations.

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GLOSSARY

§1031 exchange: a §1031 exchange (like-kind exchange) does not recognize gain if the replacement property is like-kind. The transferred and received properties must be held for productive use in either a trade or business or for investment. There are certain rules for like-kind exchanges between related parties

Adjusted gross income (AGI): total income reduced by allowable adjustments, such as for an IRA, student loan interest, alimony and Keogh deductions. The AGI is important in determining whether various tax benefits are phased out.

Alimony: funds paid to a former spouse in connection with a divorce or separation under §71. Such payments are taxable to the recipient and deductible by the payor under §215

Alternative minimum tax: a tax triggered when certain tax benefits reduce regular income tax below a certain threshold

Bankruptcy: typically, a formal petition filed in Bankruptcy Court under Chapter 7, 11, or 13

Beneficiary: an individual who will receive an inheritance upon the death of another

Business purpose: a requirement that an expense claimed as a deduction from taxable business income must serve a genuine business purpose

Capital gains: gain from the disposition or exchange of a capital asset

Capital loss: loss from the disposition or exchange of a capital asset

Carryback: the application of a deduction or credit from a current tax year to a prior tax year

Child support: payments for support of a child pursuant to the court order, of course decree, or other legal obligation

Community property: a property held by a married couple domiciled in a community property state or a foreign country with a community property system. Property that belongs equally to husband and wife. In community property states, generally amount earned by the labor of either spouse, and the income from such amounts becomes community property

Conversion: the changing of assets from a traditional, SEP, or SIMPLE IRA to a Roth IRA. A Roth conversion is treated as ordinary income to the IRA owner. Except for amounts attributable to after-tax rollovers or nondeductible contributions, the conversion will be taxable

Cost of goods sold: all expenses directly associated with the production of goods or services a business sells

Death tax: a tax imposed on property upon the death of the owner, such as an inheritance or estate tax

Disregarded entity: a business entity which is considered to be an undivided part of the owner of the entity for federal tax purposes. The owner of the disregarded entity just needs to file Schedule C with their personal income tax like a sole proprietorship

Estate planning: a manner of minimizing estate taxes at death. It involves deriving the most favorable tax treatment of wealth. Inheritance is passed on to beneficiaries with the smallest amount given over to taxes

Estate tax: a levy paid to the federal government or state on a deceased person's assets that have been left to heirs. The estate pays the tax, not the recipients. No estate tax exists for property going from one spouse to another

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Excise tax: one levied on specific products or services, for specific purposes. Excise taxes are levied at all levels of government, primarily federal and state. They are normally a percentage of the purchase price

Exclusion: income which is allowed by the Code to be excluded from gross income. The term may also be used to refer to amounts which may be excluded for estate tax, gift tax, and self-employment tax purposes

FICA: provides benefits for retired workers and their dependents as well as for disabled workers and their dependents. Also known as the Social Security tax

Foreclosure: a legal proceeding where property secured by a mortgage or deed of trust is sold because of a default in the underlying terms of the debt

Gain: excess of money or fair value of property received on sale or exchanged over the carrying value of the item

Gift tax: a tax levied on the transfer on of property or money made without adequate legal consideration. This tax is imposed on the donor of a gift and is based upon the fair market value of the property as of the date of transfer. Under the law, each parent may give each recipient $14,000 a year without gift tax consequences. Also, gifts between spouses are untaxed

Gross income: money, goods, services, and property a person receives that must be reported on a tax return. Includes unemployment compensation and certain scholarships. It does not include welfare benefits and nontaxable Social Security benefits

Gross profit percentage: A figure obtained by dividing the gross profit from an installment sale by the contract price

Holding period: a time interval that property has been owned by the entity

Installment sale: a sale of property where at least one payment will be received in a taxable year following the year of sale

IRC §121: the code section that states that a taxpayer can exclude up to $250,000 of the gain ($500,000 for married filing joint) on the sale of a house if the house is used as the taxpayer's primary residence for two of the past five years, among other requirements

Partnership: form of business organization created by an agreement between two or more persons who contribute capital and/or their services to the organization

Personal residence: a home of an individual. It is the place to which an individual plans to return as a home after temporary absences

Principal residence exclusion: a taxpayer may exclude from income up to $2 million of COD income from the discharge of qualified principal residence indebtedness on or after January 1, 2007, and before January 1, 2013

Qualified principal residence indebtedness: limited to $2 million or $1 million on a separate return, whereas acquisition indebtedness for purposes of the mortgage interest deduction is limited to $1 million or $500,000 on a separate return, and applies solely to a taxpayer's principal residence, and not a second home

Registered domestic partnership: a California domestic partnership is a legal relationship available to same-sex couples and to opposite-sex couples in which at least one party is at least 62 years old. It provides the couple with most but not all of the rights, protections, and benefits as married spouses

INDEX

A

Adequate records 18
Adjusted Opening Balance 47
Adopting parent 62
Affidavit of Dependency 12
Alternative Herbal Health Services (AHHS) ...
.... 26, 27
Average Indexed Monthly Earnings (AIME)
.... 50, 51
Average wage index 50

B

Bridge-the-gap 7
Bureau of Labor Statistics (BLS) 80, 81

C

Capped contracts 43, 44
Cash out 37
City of Refuge 4, 5
Comfort ruling 91
Common law divorce 13
Common law marriage 11-13
Corporation sole 4, 5
Cost of goods sold (COGS) 26, 27

D

Disability 3, 45, 88
Disability benefits 3
Drop and swap 37

E

Educational 13-15, 26, 27, 64, 78, 81, 82
Expressio unius est exclusio alterius 32

F

Family business 55
Federal enclaves 82, 91
Federal Insurance Contributions Act (FICA)
.... 50, 69, 71, 76, 89
Freedom Law School (FLS) 80-82

G

Graduated percentage 50

H

Hardship 9, 30
Health care 26, 89
Held for investment 38
Hobby loss rules 20

I

Identifiable event 27-30
In perpetuity 58-60
Innocent spouse relief 8-10
Irrevocable life insurance trust (ILIT) 53, 54

L

Like-class 39, 40
Like-kind 35-42

M

Marital settlement agreement (MSA) 6, 7
Medicaid waiver payments 66-68

O

Offshore Voluntary Disclosure program
(OVDP) 80, 86
Outcast 56
Overpayments 6, 23

P

Partnerships 6, 52, 61
Personal injuries 4
Personal marketing 19
Primary Insurance Amount (PIA) 50, 51

Q

Qualified conservation contribution 59, 60
Qualified intermediary 42
Qualified investment 24

R

Reasonable reliance 76, 79
Registered domestic partners (RDPs) 61-65
Return Preparer Office (RPO) 82-84

S

Significant collection activity 28
Social Security Administration (SSA) 50, 77
Special needs 55, 56, 62, 88
Streamlined 9, 80

T

Tax Court 18
Tenancy-in-common (TIC) 36-39
Testing period 28, 29
Treasury Inspector General of Tax
Administration (TIGTA) 82-84

W

Workers' compensation 3, 4, 75, 78

2015/2016 BONUS CPE: FEDERAL TAX REVIEW

Course description and study guide

Course objectives: The purpose of this course is to provide additional overview and analysis of important regulations and changes in tax law that have affected taxpayers in 2014 and 2015. Topics addressed include: the tax benefit rule, dependency exemptions, taxation of marijuana, COD, basis in repossessed property, like-kind treatment, Social Security, IRAs, registered domestic partners, independent contractors, the Offshore Voluntary Disclosure Program, and much more.

Completion deadline and exam: This course, including the examination, must be completed within one year of the date of purchase. In addition, unless otherwise indicated, no correct or incorrect feedback for any exam question will be provided.

Category: Taxes

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

Level: Basic

Prerequisite: None

Advanced Preparation: None

Course qualification: Qualifies for QAS and NASBA Registry CPE credit based on a 50-minute per CPE hour measurement

CPE sponsor information: Spidell Publishing, Inc. (Registry ID: 104931)

Expiration Date: November 2016*

*Exam must be completed within one year of the date of purchase

Learning assignment and objectives

As a result of studying the assigned materials, you should be able to meet the objectives listed below.

Assignment:

At the start of the materials, participants should identify the following topics for study:

- Individuals – Income, exemptions and deductions
- Hobby losses
- Business issues

Learning Objectives:

After completing this course, you will be able to:

- Recall the treatment of nonbusiness and business debts and their deductibility
- Determine how to compute basis of a theft loss
- Identify what may be deductible in a marijuana dispensary
- Recall the interplay of IRC §§121 and 1038 when property is repossessed
- Choose what nondepreciable personal property can be exchanged when qualifying for like-kind treatment
- Recall the requirements of a qualified conservation contribution
- Determine how to apply the Adoption Credit for registered domestic partners
- Recall how Notice 2014-7 affects individual care providers
- Identify what can be relied upon as a safe haven when determining a reasonable basis for not treating a worker as an employee

After studying the materials, please answer exam questions 1-40.

Evaluation Form

Program title: __________________

If applicable, program instructor: ____

Program date: ____________ Participant name (optional):___________________________

Instructions: Please comment on all of the following evaluation points for this program and assign a number grade, using a 1-5 scale, with 5 as the highest.

1. Were the stated learning objectives met? _______________________________________

2. If applicable, were prerequisite requirements appropriate? _______________________

3. Were program materials accurate? ____

4. Were program materials relevant and did they contribute to the achievement of the learning objectives? _______

5. Was the time allotted to the learning activity appropriate? _______________________

6. If applicable, were the individual instructors effective? _________________________

7. Were the facilities and/or technological equipment appropriate? _________________

8. Were the handout and/or advance preparation materials satisfactory? ______________

9. Were the audio and visual materials effective? _________________________________

10. IRS Course Number (if applicable): ____

11. TTP Number: ____

12. Date course completed: ____

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Examination for Spidell's 2015/2016 Bonus CPE: Federal Tax Review

PLEASE: Place the correct response for each question on the attached answer sheet and retain this examination for your records. If you purchased the online version, or would like to complete your exam online, please log-in to your SpidellCPE online account to submit your answers to the exam. 70% or more (28 of 40) correct responses are necessary to receive credit for this course. This course must be completed within one year of the date of purchase.

Final Exam Questions

1. Gross income does not include workers' compensation payments under all but which of the following circumstances?
   a) The payments must be received under a workers' compensation act
   b) The payments must be for personal injuries, emotional distress, or illness
   c) The payments must be incurred during the course of employment
   d) The payments must not be related to the employer's age or term of service
2. Which of the following is not a requirement for alimony to be deductible?
   a) The divorce agreement must not designate the payment as not includable in gross income
   b) Both the payee and payor spouses cannot be members of the same household when the payment is made
   c) The divorce agreement must identify the percentage of the payment which goes to child support
   d) There is no liability to make an alimony payment after the death of the payee
3. Which of the following is correct regarding the taxability of certain identity theft protection services?
   a) Businesses must report any amounts provided for ID theft protection services on an employee's W-2
   b) Taxpayers are not required to include identity theft protection services or cash received in lieu of these services in their gross income
   c) If an employee's compensation benefit package includes identity protection services, they must be included in gross income
   d) Any proceeds received from an ID theft insurance policy subsequent to a data breach is not includable in gross income
4. Which state does not recognize some form of common law marriage whereby a dependency exemption could be taken?
   a) Colorado
   b) Idaho
   c) Texas
   d) Hawaii

5. Nonbusiness and business debts and the ability to deduct those debts can be characterized by all but which one of the following?
   - **a)** Nonbusiness bad debts should be treated as losses from the sale of a short-term capital asset
   - **b)** In order to take a deduction, the taxpayer must demonstrate that there is a viable debtor-creditor relationship
   - **c)** Both business and nonbusiness bad debts generate deductions that can be offset against ordinary income
   - **d)** A taxpayer can take a deduction for a worthless nonbusiness debt for the tax year when the debt becomes completely worthless
6. Based on the ***Cohan*** rule, if a taxpayer does not have adequate records to justify expenses, which of the following can be provided?
   - **a)** Testimony
   - **b)** Canceled checks
   - **c)** Appointment book notes
   - **d)** All of the above
7. IRC §183(d) provides a presumption that an activity is for profit if it is profitable under which of the following circumstances?
   - **a)** If the activity is profitable for three years of a consecutive five-year period, whereby the presumption rule applies if the activity has a third profitable year within a five-year presumption period that starts with the first profitable year
   - **b)** If the activity is profitable for two years of a consecutive five-year period
   - **c)** If the activity is profitable for two years of a consecutive seven-year period, whereby the presumption rule applies if the activity has a second profitable year within a five-year presumption period that starts with the first profitable year
   - **d)** Specifically for horse racing, if the activity is profitable for two years of a consecutive 10-year period, whereby the presumption rule applies if the activity has a second profitable year within a 10-year presumption period that starts with the first profitable year
8. For theft losses, which of the following holds true?
   - **a)** The amount of a theft loss that can be deducted is the property's fair market value
   - **b)** In computing basis of a theft loss, basis must include the value of services performed
   - **c)** The Rev. Proc. 2009-20 safe harbor allows for a loss deduction for all taxpayers who have losses from investments that were later exposed as fraudulent
   - **d)** A "qualified investment" under Rev. Proc. 2009-20 means that any income received from a fraudulent scheme must have been included in income before the scheme was exposed as fraudulent
9. When considering the taxation of marijuana, which of the following applies?
   - **a)** In general, marijuana dispensaries may not claim any business expense deductions related to the trafficking in controlled substances
   - **b)** Educational services that may be deductible within a marijuana dispensary include educating customers on how to use the product
   - **c)** In the case ***Beck v. Comm***., the business owner was allowed to claim his Schedule C expenses, including lease payments and employee expenses
   - **d)** A Chief Counsel ruling in Washington determined that a taxpayer who paid the state of Washington excise tax levied on marijuana producers and retailers could not treat the expenditure as a reduction in the amount realized on the sale of property
10. Discharge of indebtedness must be reported on Form 1099-C if it exceeds _______.
    - **a)** $500
    - **b)** $1,000
    - **c)** $600
    - **d)** $1,250

11. For claiming the principal residence exception when qualifying for the IRC §121 exclusion, prior to reselling the property within one year, the limit on the length of time between the original sale and the reacquisition of property is _______.

    a) 5 years
    b) 10 years
    c) 7 years
    d) No time limit

12. Basis in repossessed property is best described by which choice below?

    a) Basis in repossessed property is the basis the taxpayer has in the debt
    b) Basis in repossessed property includes the basis in the debt plus any gain realized on the repossession
    c) Basis in repossessed property includes the basis in the debt plus any gain on reported on repossession less any expenses incurred due to the repossession
    d) Basis in repossessed property includes the basis in the debt plus any gain realized on the repossession plus any expenses incurred due to the repossession

13. An activity that is connected to the use of tangible property is not considered a rental activity for the taxable year in all but which one of the following circumstances?

    a) If customers typically use the property for less than fourteen days
    b) If a taxpayer owns an interest in an S corporation or partnership that owns property, and the taxpayer provides that property for use in an activity in his capacity as an owner
    c) If customers will typically use the property for under 30 days, and significant personal services accompany the customers' use
    d) If extraordinary personal services are provided to customers in connection with making the property available for use

14. Tax practitioners have used IRS guidelines pertaining to tenant-in-common interests in like-kind exchanges as a safe harbor. These guidelines are described in all but which one of the following choices?

    a) All material matters require a unanimous decision
    b) The maximum number of co-owners is 25
    c) The co-ownership cannot conduct business under a common name
    d) Each one of the owners is required to hold title to the property as a tenant-in-common

15. For depreciable personal property, which choice accurately characterizes like-kind treatment?

    a) To qualify for nonrecognition treatment, depreciable tangible personal property is required to be of like-kind to the exchanged properties
    b) Like-class properties are depreciable tangible personal properties that are in the same General Asset Class or Product Class
    c) The Product Class will take precedence over the General Asset Class
    d) There are 13 Product Classes

16. Which statement is true for the exchange of nondepreciable personal property or intangible property?

    a) As for depreciable personal property, there is a safe harbor for General Asset Classes and Product Classes
    b) A copyright on a novel can be exchanged for a copyright on a cartoon
    c) A patent for an electric car is like-kind to a patent on a toaster
    d) An exchange of intangible property used primarily outside the U.S. will not qualify for like-kind treatment with intangible property used primarily within the U.S.

17. Qualified research expenses that are eligible for the research credit include which of the following?

    a) Computer software
    b) Research in the humanities
    c) Amounts paid to an individual for the right to use computers when conducting qualified research
    d) Quality control studies

18. There is no deduction allowed for an excess contribution to an IRA, and the excess contribution amount is subject to a penalty of _______.

    a) 6%
    b) 10%
    c) 5%
    d) 15%

19. Which statement correctly reflects how to handle excess IRA contributions?

    a) If any excess contribution is withdrawn after the due date of the return, it must be included in the taxpayer's income
    b) Excess contributions from one year can be treated as contributions in subsequent years without penalty
    c) If a deduction was taken on an excess IRA contribution that is later withdrawn after the due date of the return, the taxpayer may file an amended return within the statute of limitations for the year of the contribution
    d) Excess contributions not withdrawn after the return due date are subject to a 10% penalty as long as they remain in the IRA

20. What are the Social Security Administration's "bend points" that are used when multiplying the AIME amounts to determine the Primary Insurance Amount?

    a) 95%; 35%; and 10%
    b) 75%; 25%; and 15%
    c) 85%; 32%; and 10%
    d) 90%; 32%; and 15%

21. Details of an irrevocable life insurance trust (ILIT) include all but which of the following?

    a) When the insured dies, the proceeds of the policy must be distributed to the beneficiaries
    b) The principal will not be included in the surviving spouse's estate if the ILIT is worded correctly
    c) Children from a previous marriage can be the beneficiaries of the ILIT
    d) The trust can provide for a financially irresponsible child by distributing money in smaller amounts

22. When it comes to a charitable contribution deduction for an easement, which choice below is correct?

    a) It is preferable for mortgages to be subordinated to the rights of the easement holder when the gift is given
    b) If the risk of foreclosure is negligible, a deduction for the charitable contribution for an easement will not be disallowed
    c) For a contribution of a conservation easement, the easement must be protected for a term that must be clearly outlined in the transfer of the property
    d) There is a bright-line requirement that states that existing mortgages must be subordinated to the rights of the holder of the easement

23. What is true for qualified conservation contributions?

    a) Charitable deductions are never allowed for donations of partial interests
    b) The conservation purpose of the contribution must be protected in perpetuity
    c) After a conservation contribution, the easement may be eliminated by mutual consent of the donee and the donor
    d) A charitable contribution may be claimed even if the donation does not affect the property's fair market value

24. For contributions made before January 1, 2015, qualified conservation contributions are allowed a _______ carryover period.

    a) 5-year
    b) 20-year
    c) 15-year
    d) 10-year

25. If registered domestic partners adopt a child, what is true for the adoption credit and how is it applied?

    a) Only one RDP can qualify for the adoption credit
    b) The amount of credit claimed by one RDP can actually be more than what he or she paid as long as the total amount claimed by both RDPs is not more than the limit
    c) The Adoption Credit for 2015 is $12,500 per child
    d) Special needs adoptions have their own set of rules and fall outside of the regular guidelines

26. Community property issues that affect registered domestic partners are correctly described in which choice below?

    a) For Social Security benefits for RDPs, state law dictates whether those benefits should be reported as community income
    b) An RDP cannot be a dependent of his partner for reimbursements of medical care expenses under IRC §105
    c) For RDPs with community income from a Schedule C business, the self-employment tax rule per IRC §1402(a)(5) supersedes community income treatment, and net earnings are attributed to the partner that deals with the business
    d) RDPs are each entitled to take half of the total estimated tax payments paid by both partners

27. When an RDP is self-employed and pays health insurance for both partners with community property funds, the employee partner may be allowed a deduction for his own health insurance if he paid for it with community funds. If the nonemployee partner is also covered by health insurance, what is the deductibility of the nonemployee partner's coverage in a community property state?

    a) It is deductible by the employee partner
    b) It is deductible by the non-employee partner
    c) It is deductible by both the employee partner and the non-employee partner
    d) Neither the employee partner nor the nonemployee partner may take a deduction

28. Under §1915(c) of the Social Security Act, home or community-based services that may be eligible for a Medicaid waiver include personal services necessary to avoid institutionalization, including all but which of the following?

    a) Assistance with eating, bathing, and dressing
    b) Light housework
    c) Nursing care
    d) Transportation

29. Choose which scenario is accurate as it pertains to how an individual care provider receives payments.

    a) Jim is a care provider who works for All Smiles Care. He cares for Douglas, who is 90 and lives in Jim's home. If Douglas pays Jim for part of his services, Jim still may deduct both Douglas' payments and any payment from All Smiles from his gross income
    b) If Douglas is under a program where he must pay All Smiles Care for part of his care, the payment that Jim receives from All Smiles is excludable from his gross income
    c) If Douglas pays Jim directly for all of the services he provides, Jim may exclude these payments from his gross income
    d) If Douglas pays All Smiles Care under a cost-sharing program for Jim's services, Jim can only deduct that portion of the payment that comes from All Smiles

30. What is true regarding Social Security and Medicare taxes for care providers who receive payments that are excludable from gross income?
    - **a)** All payments for care providers which are excludable from gross income are not subject to FICA taxes
    - **b)** If the person receiving the care is considered the employer of the care provider, the wages are not subject to FICA taxes
    - **c)** If a care provider works for an agency, the payments from the agency are subject to Social Security and Medicare taxes
    - **d)** Independent contractors providing care are subject to Social Security and Medicare taxes

31. For agencies that employ individuals as individual care providers, which of the following is true?
    - **a)** Agencies that have no knowledge whether their payments to care providers should be excludable from gross income should not rely on a written statement by the payee that they are eligible for such payments
    - **b)** Agencies that have no knowledge whether their payments to care providers should be excludable from gross income must withhold federal income tax
    - **c)** Agencies must complete Form W-2, Wage and Tax Statement, and include all wages and compensation in box 1 for their employees
    - **d)** Box 1 of Form W-2 should be left blank if payments to employees are excludable from gross income

32. Which of the following is true for a care provider who wants to apply Notice 2014-7 to payments received in 2013 on a Form 1099?
    - **a)** If the payments were reported in box 3, Nonemployee compensation, report the amount on line 21 of Form 1040
    - **b)** If the payments were reported as "Other income," don't include the payments on line 21 of Form 1040 but write Notice 2014-7 on the dotted line adjacent to the line
    - **c)** If payment amounts are reported in box 7, Nonemployee compensation, do not report the payments on Schedule C because they are excluded from gross income
    - **d)** For any payments reported as nonemployee compensation, do not calculate net profit and loss

33. When the IRS is assessing whether a worker is an independent contractor or an employee, which choice accurately describes the determination process?
    - **a)** The IRS will want to know if the worker is covered under workers' compensation
    - **b)** Only the business can submit Form SS-8 and have the IRS determine the status of the worker
    - **c)** The IRS has grouped its 20 factors into two categories: behavioral control and financial control to determine if an employer-employee relationship exists
    - **d)** Upon receiving Form SS-8, the IRS typically takes 60 days to make its assessment

34. An employer has what is considered a reasonable basis for not treating a worker as an employee by relying on which of the following safe havens?
    - **a)** State court opinions
    - **b)** A past IRS audit that began after January 1, 1996 and that would have specifically dealt with the worker classification issue
    - **c)** Long-standing industry practices
    - **d)** Reliance on advice from any attorney

35. In ***Taylor Blvd. Theater, Inc. v. United States***, the court rendered a decision regarding the employment status of exotic dancers. Which of the following is true regarding the details of that decision?

   a) The dancers and the club owner had no contractual agreement
   b) The club owner was not required to supply the dancers with a Form 1099
   c) The safe harbor relief under Section 530 applies to both federal and state employment taxes
   d) The patrons paid the club owner and the dancers made a commission from what was paid

36. What is true of the Offshore Voluntary Disclosure Program (OVDP)?

   a) The OVDP was initiated in 2008
   b) The streamlined OVDP was created in 2012 so more taxpayers would come forward to be in compliance with U.S. tax laws
   c) The streamlined OVDP replaced the original program
   d) The penalties for noncompliance are not mitigated by these programs, but there is a reduced chance for criminal prosecution

37. Individuals who are assigned a PTIN must meet all but which one of the following requirements?

   a) There is a minimum age requirement of 21 years
   b) The Return Preparer's Office will confirm all self-reported preparer credentials against state licensing authorities
   c) The tax preparer must complete educational courses and adhere to Circular 230 in order to take part in the IRS's Annual Filing Season Program
   d) PTINs cannot be associated with a deceased person

38. For the 2015 tax year, the Form 1040 due date is _______.

   a) April 15, 2016
   b) April 19, 2016
   c) April 18, 2016
   d) April 16, 2016

39. For 2015, Form 1040 details pertaining to payments are correctly outlined in which choice below?

   a) Line 66: Earned Income Credit: The amount has remained the same
   b) Line 67: Additional Child Tax Credit: If foreign earned income is excluded for a tax year then the Additional Child Tax Credit cannot be claimed
   c) Line 76: Amount refunded to you: Refunds cannot be direct-deposited into myRAs
   d) Line 73: Credits: Box "a" is labeled as "reserved"

40. Which statement is correct regarding letter rulings?

   a) The IRS won't issue a letter ruling if the issue described is similar to one already in litigation
   b) If a taxpayer presents multiple issues in a request for a letter ruling, the IRS will provide multiple letter rulings
   c) The IRS will issue letter rulings that pertain to foreign governments
   d) The fee for a letter ruling is $5,000 for all taxpayers