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Cases, Regulations and Statutes

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CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr

BANKRUPTCY

Federal Tax

Discharge. The debtor filed for Chapter 7 in December 2008 and sought discharge of 1998 and 1999 taxes. The court found several actions by the debtor which indicated a pattern of conduct which supported a finding that the debtor willfully attempted to evade payment of the taxes. The court noted that the debtor had transferred title to the residence to the debtor’s spouse, had spent substantial amounts on remodeling the home, titled a vehicle in a parent’s name, filed misleading bankruptcy schedules and used nominee checking accounts. The court held that this conduct was sufficient to prevent discharge of the taxes under Section 523(a)(1)(C). In re May, 2011-1 U.S. Tax Cas. (CCH) ¶ 50,103 (S.D. Ala. 2010).

Net Operating Losses. The debtors filed for Chapter 7 in October 2009. In November 2009, Congress passed the Worker, Homeownership and Business Assistance Act (“WHBAA”), which allows taxpayers to apply 2008 and 2009 net operating losses to the previous three, four, or five taxable years to reduce the tax liability that may be due and owing by a taxpayer. The Chapter 7 trustee hired consultants to analyze whether the debtor’s business tax returns would produce larger refunds if the new law was applied. The debtors objected, arguing that the possible refunds were post-petition assets not subject to bankruptcy proceedings. The court held that the pre-petition refunds generated by the WHBAA changes were estate property to the extent the refunds were generated by pre-petition taxes. In re Hooper, 2011-1 U.S. Tax Cas. (CCH) ¶ 50,113 (Bankr. D. Ariz. 2010).

Federal Estate and Gift Taxation

Alternate Valuation Date. In a Chief counsel advice letter, the IRS ruled that the Treas. Reg. § 301.9100-2(b) six month extension was available for making the alternate valuation date election for a timely filed Form 706, if the corrective actions of Treas. Reg. § 301-9100-2(c) are taken. CCA 201052007, July 15, 2010.

Generation-Skipping Transfers. The taxpayers were great-grandchildren of a decedent who had died decades ago and whose will created trusts for the decedent’s child and grandchildren. The trust provisions violated the rule against perpetuities at the time of the decedent’s death but state law was changed to a “wait and see” rule. The current trust beneficiaries disagreed as to the terms of the trust and its affects under state law and negotiated a settlement which modified some elements of the trust. The IRS ruled that the modifications resulted from bona fide legal dispute and would not cause the trust distributions to be a gift or income to the beneficiaries, nor would the modifications subject the trust to GSTT. Ltr. Rul. 201052002, July 29, 2010.

The grantor established an irrevocable trust for the benefit of descendants and filed Form 709, allocating the GST exemption amount such that the inclusion ratio was zero. The beneficiaries of the trust petitioned a state court to split the trust into four sub-trusts, three equal unitrusts for each of three children and one family trust which continued the same terms as the original trust. The IRS ruled that the split of the trust did not change the trust’s inclusion ratio because the modification did not shift any beneficial interest to a later generation. Ltr. Rul. 201049008, Aug. 26, 2010.

The decedent had created a trust which was irrevocable on September 25, 1985. After the decedent’s death an ambiguity was discovered as to distributions where a grandchild dies without exercising a limited power of appointment. The trustee petitioned a state court for modification of the trust to clear the ambiguity and received a state court order approving the modification. The IRS ruled that the modification did not subject the trust to GSTT. Ltr. Rul. 201049016, Aug. 30, 2010.

The IRS ruled that the merger of three pre-September 25, 1985 trusts, which were identical except for the beneficiaries, into one trust did not subject the trusts to GSTT. Ltr. Rul. 201050005, Sept. 8, 2010, Ltr. Rul. 201050006, Sept. 8, 2010, Ltr. Rul. 201050008, Sept. 8, 2010.

National Organic Program. The AMS has adopted as final a rule which would amend the USDA National List of Allowed and Prohibited Substances to reflect recommendations submitted to the Secretary of Agriculture by the National Organic Standards Board (NOSB) on May 22, 2008, November 19, 2008, and May 6, 2009. Consistent with the recommendations from the NOSB, the rule adds the following four substances, along with any restrictive annotations, to the National List: Microcrystalline cheesewax; acidified sodium chlorite; dried orange pulp; and Pacific kombu seaweed. The rule would also amend the annotation for lecithin-unbleached, and remove lecithin-bleached, from the National List. 75 Fed. Reg. 77521 (Dec. 13, 2010).
TRANSFEEE LIABILITY. The decedent died in June 1991 and the estate filed an election to pay the estate tax in ten installments on the estate tax return filed in March 1992. The business assets were sold in March 1999 without payment of the federal estate tax. In July 2008, the IRS filed an action to collect the unpaid estate tax from the heirs of the estate. The heirs argued that the action was untimely filed because the ten-year statute of limitations under I.R.C. § 6324(a)(1) had expired. The court held that the Section 6324(a)(1) limitation applied only as to the collection under the special estate tax lien; therefore, the ten-year limitation did not apply to an action to collect estate tax from transferees. The court held that the limitations period for actions against transferees was the same as applied for an action against the estate, which is 10 years under I.R.C. § 6502(a)(1). However, the Section 6502(a)(1) period is suspended during the time the installment payment of estate tax is active. Because the property was sold in March 1999, the Section 6502(a)(1) limitation period began to run from that sale, which was less than ten years before the commencement of the IRS collection action in July 2008; therefore, the IRS action was not barred by the Section 6502(a)(1) limitation period. United States v. Kulhanek, 2010-2 U.S. Tax Cas. (CCH) 60,610 (W.D. Penn. 2010).

ACCOUNTING METHOD. The taxpayer had timely e-filed a federal income tax return for the year of change, along with the original Form 3115 filed under Rev. Proc. 2008-52, 2008-2 C.B. 587 to change its method of accounting for personal property taxes. Through a miscommunication with the taxpayer’s accounting firm, a duplicate copy of the Form 3115 was not timely filed with the national office of the IRS. The IRS granted an extension of time for the taxpayer to file a duplicate Form 3115 with the national office. Ltr. Rul. 201051001, Aug. 30, 2010.

BUSINESS EXPENSES. The taxpayers, husband and wife, operated two franchise restaurants and claimed a variety of business deductions which were disallowed by the IRS. The court upheld most of the disallowances because the taxpayers did not have written records to substantiate the deductions. Some deductions for rent and taxes were allowed because of partial proof that these expenses were paid. The taxpayers sold one of their restaurants and the IRS assessed a deficiency for failure to include I.R.C. § 1250 recapture amounts in income. The court held that the sale of the restaurant included I.R.C. § 1245 and § 1250 recapture; therefore, the IRS assessment was inaccurate and was dismissed because the taxpayers were not properly assessed. Daoud v. Comm’r, T.C. Memo. 2010-282.

CASUALTY LOSSES. The taxpayer’s home was damaged by Hurricane Wilma and the taxpayer claimed a casualty loss deduction for $5340, the exact amount of the deductible on the taxpayer’s property insurance policy. The insurance adjuster’s report listed $ 5234 in damages but provided no claim because the damage was less than the deductible. The taxpayer presented a hand written receipt from a contractor for $5340 in repair work which included additional items not in the adjustor’s report. The court held that the casualty loss deduction was properly disallowed for lack of substantiation because the taxpayer had no corroborating evidence to support the receipt, which the court deemed suspicious. Igberaese v. Comm’r, T.C. Memo. 2010-284.

The taxpayer owned an apartment building as tenant in common with a sibling. The lower apartments sustained flood damage. Although the taxpayer did not provide evidence of the amount of loss from repair bills, the taxpayer provided an estimate of damage from a Small Business Administration (SBA) examination which determined that the taxpayer and sibling were eligible for a SBA loan. The court held that the taxpayer was entitled to a casualty deduction equal to one-half of the SBA damage determination. The taxpayer attempted to claim an additional casualty loss in the following tax year but the court disallowed this deduction because the taxpayer failed to prove that the casualty loss deduction was used up in the first year or that the taxpayer had made the election under I.R.C. § 172(b)(3) to carryforward any unused deduction. Torassa v. Comm’r, T.C. Summary Op. 2010-174.

CHARITABLE DEDUCTION. The taxpayer purchased 457 acres of rural land along a river and granted easements to the state over four acres. The taxpayer planned to develop rural residential tracts on 66 acres and granted a conservation easement on the remaining 384 acres. The court held that the value of the conservation easement should be determined by subtracting the value of remaining development parcel from the value of the entire property with the development parcel included. Trout Ranch, LLC v. Comm’r, T.C. Memo. 2010-283.

CORPORATIONS.

RETURNS. The IRS has adopted as final amendments to the regulations under I.R.C. § 6012 relating to the returns of income corporations are required to file. The regulations require certain corporations to file a report of uncertain tax positions, Schedule UTP. In Ann. 2010-9, 2010-1 C.B. 408, and Ann. 2010-17, 2010-2 C.B. 515, the IRS announced it was developing a schedule requiring certain taxpayers to report uncertain tax positions on their tax returns. The IRS released the draft schedule, Schedule UTP, accompanied by draft instructions that provide a further explanation of the IRS’s proposal in Ann. 2010-30, 2010-2 C.B. 668. The draft schedule and instructions provide that, beginning with the 2010 tax year, certain corporations with both uncertain tax positions and assets equal to or exceeding $10 million will be required to file Schedule UTP if they or a related party issued audited financial statements. The draft schedule and instructions stated that, for 2010 tax years, the IRS will require corporations filing the following returns to file Schedule UTP: Form 1120, U.S. Corporation Income Tax Return; Form 1120 L, U.S. Life Insurance Company Income Tax Return; Form 1120 PC, U.S. Property and Casualty Insurance Company Income Tax Return; and Form 1120 F, U.S. Income Tax Return of a Foreign Corporation. The draft schedule and instructions do not require a Schedule UTP from any other Form 1120 series filers, pass-through entities, or tax-exempt organizations in 2010 tax years. 75 Fed. Reg. 78160 (Dec. 15, 2010).

DEBT INSTRUMENTS. The IRS has adopted as final regulations relating to the modification of debt instruments that clarify the extent to which the deterioration in the financial condition
of the issuer is taken into account to determine whether a modified debt instrument will be recharacterized, under Treas. Reg. § 1.1001-3 as an instrument or property right that is not debt. 76 Fed. Reg. 1063 (Jan. 7, 2011).

DOMESTIC PRODUCTION DEDUCTION. The taxpayer cooperative had received a letter ruling from the IRS allowing the taxpayer to add amounts paid to member patrons back into income for domestic production deduction purposes in one tax year. The taxpayer’s members in a prior tax year had elected not to treat similar items as per-unit retain and the taxpayer sought a ruling that those items could be added back in a retroactive election, resulting in a refund for the previous tax year. In a Field Attorney Advice letter, the IRS denied the taxpayer’s request because the individual members had already filed personal income tax returns and computed their own domestic production deductions based on the original election. FAA 20105101F, Dec. 29, 2010.

The taxpayer was an exempt farmer’s marketing and purchasing agricultural cooperative. The cooperative made payments to members and participating patrons for grain produced by the members and patrons which were qualified per-unit retain allocations because they were (1) distributed with respect to the crops that the cooperative stored, processed and marketed for its patrons; (2) determined without reference to the cooperative’s net earnings; and (3) paid pursuant to a contract with the patrons establishing the necessary pre-existing agreement and obligation, and within the payment period of I.R.C. § 1382(d). The IRS ruled that the cooperative was allowed to add back these amounts paid to members as net proceeds in calculating its qualified production activities income under I.R.C. § 199(d)(3)(C). Ltr. Rul. 201049007, Sept. 1, 2010; Ltr. Rul. 201050027, Sept. 14, 2010.

HEALTH CARE BENEFITS. Under I.R.C. § 139D, added by the Patient Protection and Affordable Care Act, Pub. L. 111-148, 124 Stat. 199, gross income does not include the value of any qualified Indian health care benefit. Section 139D defines the term “qualified Indian health care benefit” to include certain medical care and accident or health coverage provided to a member of an Indian tribe, including a spouse or dependent of the member. The IRS has ruled that it will apply the rules of Rev. Proc. 2008-48, 2008-2 C.B. 586, to Section 139D such that taxpayers who are within the scope of Rev. Proc. 2008-48 and who are members of an Indian tribe may treat their child as a dependent of both parents for purposes of I.R.C. § 139D, whether or not the custodial parent releases the claim to the exemption for the child under I.R.C. § 152(e)(2). Ltr. Rul. 201051021, Oct. 19, 2010.

HOBBY LOSSES. The taxpayers, husband and wife, operated a paint horse breeding activity on their six acre rural residence in their spare time after employment. The court held that the taxpayers engaged in the horse breeding activity with the intent to make a profit because (1) the taxpayers consulted experts and hired professional trainers to train and market their horses, (2) the taxpayers spent a significant amount of their free time working with the horses, (3) the taxpayer invested a significant amount of time and money improving the value of the farm, (4) the taxpayer did not have significant amounts of income which were offset by the losses from the horse activity, and (5) the taxpayer did not receive personal pleasure and recreational benefits from the activity. The court noted that, although the taxpayers had made several changes in the operation to make the best use of their horses, the taxpayers had unsatisfactory business records. The court held that these two factors offset each other. Frimil v. Comm’r, T.C. Summary Op. 2010-176.

HOME OFFICE. The taxpayer operated marketing and software companies out of the taxpayer’s home. The home had 12 rooms and the taxpayer demonstrated that several of the rooms were used exclusively in the businesses. The court noted that the passage of family members and visitors through these rooms was de minimis non-business use of these rooms and would not disqualify these rooms for home office deductions. However, the evidence demonstrated that several rooms were used by family members for eating and entertainment; therefore, these rooms did not qualify for the home office deductions because the rooms were not used exclusively for business purposes. Rayden v. Comm’r, T.C. Memo. 2011-1.

INCOME AVERAGING. The IRS has adopted as final regulations amending the income averaging rules available for farming and fishing businesses. The regulations provide that a lessor of a vessel is engaged in a fishing business within the meaning of I.R.C. § 1301(b)(4) if the payment due to the lessor under the lease is based on a share of the lessee’s catch (or a share of the proceeds from the sale of the catch) and the lease is a written agreement entered into before the lessee begins significant fishing activities resulting in the shared catch. A fixed lease payment is not eligible for income averaging. The regulations also provide that crew members are engaged in a fishing business, whether or not they are treated as employees for employment tax purposes. The regulations also clarify that the maximum amount of income that an individual may elect to average is the total of the individual’s farm and fishing income and gains, reduced by any farm and fishing deductions or losses allowed as a deduction in computing taxable income. 75 Fed. Reg. 78157 (Dec. 15, 2010).

IRA. The taxpayer was under age 59 1/2 and had been receiving equal periodic monthly payments from an IRA based on a fixed amortization method. In the first year, a single payment was received but in the following six years, the payments were split into monthly payments. In the seventh year, the IRA custodian failed to make all 12 payments in that year. When the taxpayer discovered the error, provision was made for an additional payment to make up the lost payment. The IRS ruled that the failure to make all the payments in the seventh year and the subsequent make-up payment did not subject the payments to the 10 percent additional tax. The IRS also ruled that the lump sum payment in the first year did not subject the payment to the 10 percent additional tax. Ltr. Rul. 201051025, Sept. 30, 2010.

The taxpayer received a distribution from an IRA but failed to rollover the distribution to another IRA because of the death of the taxpayer’s spouse during the 60 day period. The distribution was not used by the taxpayer and was rolled over to another IRA as soon as the error was discovered. The IRS granted the taxpayer an extension of time to roll over the distribution without penalty. Ltr. Rul. 201051026, Oct. 1, 2010.

INFLATION-ADJUSTED ITEMS. The IRS has published the inflation-adjusted items for 2011 not already published in Rev. Proc. 2010-40, 2010-2 C.B. 663. The items include the tax
rates, child tax credit, the Hope scholarship and lifetime learning credits, earned income credit, the standard deduction, the personal exemption, and the phase out limits for the deduction for interest on education loans. Rev. Proc. 2011-12, I.R.B. 2011-2.

INNOCENT SPOUSE. The taxpayer entered into a series of three-way property exchanges with unrelated and related parties through qualified intermediaries. A small amount of boot was received as a result of all the transfers but was not material in relation to the value of the properties exchanged. The IRS ruled that the related-party rule of I.R.C. § 1031(f) would not prohibit the like-kind exchange treatment for the transactions so long as none of the related parties sold their properties within two years after the transactions. Ltr. Rul. 201048025, Aug. 25, 2010.

MAKE WORK PAY CREDIT. The IRS has issued a reminder that the make work pay tax credit is available for 2010 and requires filing of Schedule M of Form 1040. The credit is phased out for modified adjusted gross incomes above $75,000 ($150,000 for married taxpayers). IRS Fact Sheet FS-2011-03.

MEDICAL EXPENSES. The taxpayer claimed deductions for medical expenses and real estate taxes, although the expenses were paid directly by the taxpayer’s parent. The parent did not claim the expenses as a deduction and the taxpayer was not a dependent of the parent. The IRS argued that the actual form of the transactions controlled to deny the deductions to the taxpayer because the taxpayer did not make the payments. The court disagreed and held that the payments by the parent were deemed gifts to the taxpayer and that the taxpayer was eligible for the deductions. Lang v. Comm’r, T.C. Memo. 2010-286.

NET OPERATING LOSSES. In Notice 2010-58, 2010-2 C.B. 326, the IRS issued guidance, in Q & A format, under § 13 of the Worker, Homeownership, and Business Assistance Act of 2009 (WHBAA), Pub. L. No 111-92, 123 Stat. 2984 (2009), which allows taxpayers to elect a 3, 4, or 5-year net operating loss (NOL) carryback instead of a normal 2-year carryback. The election applies to an applicable NOL, which is an NOL for a taxable year ending after December 31, 2007, and beginning before January 1, 2010. In a Chief counsel Advice letter, the IRS ruled that, under question 16 of Notice 2010-58, a taxpayer may not revoke a previous NOL carryback election unless the taxpayer is making an election under WHBAA for the same year. CCA 201050031, Nov. 9, 2010.

PENALTIES. The IRS has issued a revised revenue procedure which identifies circumstances under which the disclosure on a taxpayer’s return, for 2010 and later, of a position with respect to an item is adequate for the purpose of reducing the understatement of income tax under I.R.C. § 6662(d) (relating to the substantial understatement aspect of the accuracy-related penalty), and for the purpose of avoiding the preparer penalty under I.R.C. § 6694(a) (relating to understatements due to unrealistic positions). Rev. Proc. 2011-13, I.R.B. 2011-3, amending Rev. Proc. 2010-15, 2010-1 C.B. 404.

 LiK-E-KIND EXCHANGES. The taxpayer entered into a series of three-way property exchanges with unrelated and related parties through qualified intermediaries. A small amount of boot was received as a result of all the transfers but was not material in relation to the value of the properties exchanged. The IRS ruled that the related-party rule of I.R.C. § 1031(f) would not prohibit the like-kind exchange treatment for the transactions so long as none of the related parties sold their properties within two years after the transactions. Ltr. Rul. 201048025, Aug. 25, 2010.

LIFE INSURANCE. The taxpayer owned a life insurance policy on the taxpayer’s life. The taxpayer borrowed funds against the policy which were not repaid. When the policy loans exceeded the policy’s cash value, the insurance company terminated the policy when the taxpayer failed to pay the excess owed. The insurance company sent the taxpayer a Form 1099-R listing the taxable amount resulting from cancellation of the loan and policy. The taxpayer did not report this amount as taxable income. The court held that the cancellation of the loan was taxable income to the taxpayer to the extent the loan amount exceeded the taxpayer’s payment of premiums for the policy. Sanders v. Comm’r, T.C. Memo. 2010-279.
2010-126.

The IRS announced that taxpayers will have until Monday, April 18 to file their 2010 tax returns and pay any tax due because Emancipation Day, a holiday observed in the District of Columbia, falls this year on Friday, April 15. By law, District of Columbia holidays impact tax deadlines in the same way that federal holidays do; therefore, all taxpayers will have three extra days to file this year. Taxpayers requesting an extension will have until Oct. 17 to file their 2010 tax returns. IR-2011-1.

The IRS has published a reminder that taxpayers may use Form 8888, Allocation of Refund (including Savings Bond Purchases) to allocate all or a portion, in $50 increments, of their refund to the purchase of U.S. Savings Bonds. IRS Fact Sheet FS-2011-06.

S CORPORATIONS

PASSIVE INVESTMENT INCOME. The taxpayer was an S corporation which owned itself or through other entities several commercial real estate properties. The taxpayer provided all the management and maintenance services for the properties through its employees or independent contractors. The services included management, financing, tenant negotiations, cash flow decision making, remodeling decisions, lease approval and negotiations, major development approval, mortgage and sale negotiations, advertising, repairs and maintenance, capital improvements, services for snow plowing, lawn care, trash removal, overseeing construction, and bookkeeping. The IRS ruled that the rental income from the properties was not passive investment income. Ltr. Rul. 201050002, Sept. 8, 2010.

SELF-EMPLOYMENT. Under the Small Business Jobs Act of 2010, self-employed taxpayers who pay their own health insurance costs can reduce their net earnings from self-employment by these costs. Previously, the self-employed health insurance deduction was allowed only for income tax purposes. For tax year 2010, self-employed taxpayers can also reduce their net earnings from self employment subject to SE taxes on Schedule SE by the amount of self-employed health insurance deduction claimed on line 29 on Form 1040. Taxpayers can claim the self-employed health insurance deduction if the insurance plan is established under their business and if any of the following are true: (1) they were self-employed and had a net profit for the year, (2) they used one of the optional methods to figure net earnings from self-employment on Schedule SE, or (3) they received wages from an S corporation in which the taxpayer was a more-than-2-percent shareholder. IRS Fact Sheet FS-2011-02.

TAX ASSESSMENTS. The IRS has adopted as final regulations defining an omission from gross income for purposes of the six-year minimum period for assessment of tax attributable to partnership items and the six-year period for assessing tax. The temporary regulations resolve a continuing issue as to whether an overstatement of basis in a sold asset results in an omission from gross income. See, e.g., Internountain Insurance Service of Vail, LLP v. Comm’r, T.C. Memo. 2009-195. The regulations affect any taxpayer who overstates basis in a sold asset creating an omission from gross income exceeding 25 percent of the income stated in the return. 75 Fed. Reg. 78897 (Dec. 17, 2010).

TAX RETURN PREPARERS. The IRS has announced publication of Form 8944, Preparer e-file Hardship Waiver Request, for tax return preparers who are required by law to electronically file certain returns. Proposed regulations, 75 Fed. Reg 75439 (Dec. 3, 2010), implement the statutory requirement under I.R.C. § 6011(e)(3) for specified tax return preparers to file income tax returns using magnetic media (electronically) for individuals, estates, and trusts if the specified tax return preparers prepare and file the returns. Notice 2010-85, I.R.B. 2010-51, provides, for calendar year 2011, that tax return preparers who meet the definition of a “specified tax return preparer” and who believe they may qualify for an undue hardship waiver may voluntarily submit waiver requests to the IRS prior to publication of a final revenue procedure. Form 8944 is now available online at www.irs.gov and must be used to voluntarily request waivers for calendar year 2011. Ann. 2010-96, I.R.B. 2010-52.

The IRS has issued guidance regarding the implementation of new Treasury regulations governing tax return preparers involving the requirement to obtain a preparer tax identification number (PTIN), identifies the forms that qualify as tax returns or claims for refund for purposes of those regulations, and provides interim rules applicable to certain PTIN holders during the implementation phase of the new regulations governing tax return preparers. See 75 Fed. Reg. 60309 (Sept. 30, 2010) and 75 Fed. Reg. 60316 (Sept. 30, 2010). Notice 2011-6, I.R.B. 2011-3.

TRAVEL EXPENSES. The taxpayer was self-employed as a music producer and claimed automobile and other travel expenses associated with the business. The taxpayer was able to sufficiently document 77 percent of the travel expenses but also demonstrated a consistent pattern of travel during the tax year through a contemporaneous travel log. The court held that the documented travel was sufficient evidence to support all of the travel deductions claimed by the taxpayer. Barajas v. Comm’r, T.C. Summary Op. 2011-2.