2007 FEDERAL INCOME TAX UPDATE

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INTRODUCTION

Today's discussion will focus on some of the more interesting or important tax developments that have transpired over the last year or so. The new developments addressed in this presentation will include numerous tax court cases, decisions of various federal circuit courts, as well as IRS pronouncements, revenue rulings, and regulatory changes.

PART ONE
TAXABLE INCOME AND GAINS

I. Disability Benefits Were Income Tax-Free to an Attorney-Employee of Professional Corporation Where the Attorney-Employee Reimbursed the Corporation for Policy Premiums Through Loan Offsets

A. Background. Section 104(a)(3) provides that amounts received by an employee through accident and health insurance plans are not taxable, except to the extent such amounts:

(1) are attributable to contributions by the employer which were not includable in the income of the employee, or

(2) are paid by the employer.

B. When Are Premiums Paid For By the Employer? In the case of Richard Cotler v. Commissioner, TC Memo 2007-283 (September 19, 2007), Mr. Cotler was the 100% shareholder of Richard S. Cotler, P.A., a Florida law firm. In 1993, the law firm purchased a long-term group disability insurance policy with the Standard Insurance Company. The law firm wrote checks to pay the premiums on the disability group policy. The portion of the disability monthly premium attributable to Mr. Cotler was $81.00 per month.

In 1996, Mr. Cotler began experiencing health problems. Mr. Cotler's health problems caused his law firm to suffer financially. Beginning in 1996, Mr. Cotler began

loaning money to his law firm to keep it operational. By the end of 1997, the firm owed Mr. Cotler almost $75,000. Each year, Mr. Cotler reduced his shareholder loan by the amount of the disability premiums paid by the PA firm on his behalf, thus reducing the shareholder loan amount owed to Mr. Cotler. Mr. Cotler finally closed his firm in 2000.

Mr. Cotler filed a long-term disability claim with Standard on April 8, 1997 and received $72,000 in disability payments. Mr. Cotler claimed these amounts were excludable from his taxable income. Mr. Cotler claimed that he had paid 100% of the premiums. Each year, Mr. Cotler reduced his shareholder loan by the amount of the disability premiums paid by the PA firm on his behalf, thus reducing the shareholder loan amount owed to Mr. Cotler.

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(2) are paid by the employer.

Ultimately, the Tax Court held that, since Mr. Cotler bore the economic responsibility of his share of the disability premiums (by reducing the loan amount by the disability premiums in fact paid by the Company), all the disability benefits were not taxable to Mr. Cotler.

II. Distribution of Appreciated Partnership Property In Satisfaction of Guaranteed Payment Obligations of Partnership Generates Taxable Income to Partnership; Revenue Ruling 2007-40 (June 1, 2007).

A. <u>Background and General Rules of Section 731</u>. Section 731(b) provides that no gain or loss shall be recognized to a Partnership on a distribution of appreciated partnership property to a partner. In addition, if the partnership distributes cash or other property to the partner, the distributee partner will not recognize any capital gain until the amount of cash money received exceeds the distributee-partner's tax basis in his/her partnership interest. Thus, Section 731 generally provides that neither the partnership nor a partner will recognize economic gain when a partnership distributes appreciated property to a partner.

B. <u>Exception for Guaranteed Payments to A Partner</u>. Unfortunately, Section 707(c) provides that payments to a partner, for services or for the use of capital, are considered as made to one who is not a member of the partnership. Thus, guaranteed payments made to a partner (for the use of capital or for compensation to the service partner) will be treated **<u>outside</u>** the general rules of Section 731.

C. Facts of Revenue Ruling 2007-40. In this case, the partnership owned a piece of real property (Blackacre) which it had purchased for $500,000. Partner A was a partner in the Partnership who was entitled to a guaranteed payment under Section 707(c) (for services or for the use of capital) of $800,000. Subsequently, when the fair market value of Blackacre was $800,000, the Partnership transferred Blackacre to Partner A in satisfaction of its guaranteed payment obligations to Partner A.

D. Ruling of Rev. Rul. 2007-40: Distribution of Appreciated Partnership Property in Satisfaction of Guaranteed Payment Obligation is Treated as a Taxable Sale by Partnership to Partner. In this Rev. Ruling, the IRS held that, notwithstanding the general nonrecognition provisions of Section 731(b), the "in kind" distribution of appreciated property to Partner A, in satisfaction of a guaranty payment obligation to Partner A, should be recharacterized as a sale or exchange of the Blackacre to Partner A. This generated $300,000 of taxable gain to the Partnership!

E. Was this a benefit or detriment to the Partnership or to Partner A?

NOTE: Would the Partnership also be entitled to an $800,000 guaranteed payment deduction which would offset its taxable gain? Would Partner A receive a proper allocation of his pro rata share of the taxable gain of $300,000 generated to the partnership, and a proper allocation of his pro rata share of the deduction?

PART TWO
SECTION 1031 LIKE-KIND EXCHANGES

I. Related Party Like Kind Exchanges and Section 1031(f) Related Party Rules.

Section 1031(f) provides that, if a taxpayer exchanges property with a related person, and within two years after the exchange either

(i) the related person disposes of such property; or

(ii) the taxpayer disposes of the replacement property,

then in either of these events, **both** the taxpayer **and** the related party will have to recognize gain on the exchange (i.e. the exchange in essence will not be tax-free).

A. Who Are "Related Parties"? Section 1031(f) cross-references Section 267(b) and Section 707(b) for a determination of relatedness. The attribution rules pursuant to Section 267(b) provide three types of ownership attribution. Section 267(b) cross-references Section 267(c) for the applicable definitional rules. Pursuant to Section 267(c), a taxpayer may be deemed to own stock held by someone else. Notably absent from the categories of related persons subject to the Section 267 rules is a category for a partnership and its partners. Instead, the rules of Section 707 govern transactions between a partnership and its partners. Section 707(b)(1)(A) provides that "a partnership and a person owning, directly or indirectly, **more than** 50 percent of the capital interest, or the profits interest" are related. Regulation § 1.707-1(b)(3) cross-references Section 267(c)(1), Section 267(c)(2), and Section 267(c)(5) for the necessary relatedness rules regarding constructive ownership. Section 267(c) provides that:

1. Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;
2. An individual shall be considered as owning the stock owned, directly or indirectly, by or for **his family**;
3. An individual owning (otherwise than by the application of paragraph (2)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;
4. The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

5. Stock constructively owned by a person by reason of the application of paragraph (1) shall, for the purpose of applying paragraph (1), (2), or (3), be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of paragraph (2) or (3) shall not be treated as owned by him for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock.

B. 1031(f) Only Applies to "Tax Avoidance" Transactions. Fortunately, Section 1031(f)(2) provides that the related party disqualification rules do not apply where the two exchange parties can establish "to the satisfaction of the IRS that neither the exchange nor the disposition had as one of its principal purposes the avoidance of federal income tax."

The principal thrust of Section 1031(f) is to reduce the potential for taxpayers to "cash out" an investment in real estate without recognizing gain merely by structuring the disposition as a like-kind exchange with a related party. Congress was concerned that, by doing this, a taxpayer could shift "high basis" from the property the taxpayer wished to retain to low basis property the taxpayer wished to sell. The House Committee Report accompanying the enactment of Sec. 1031(f) recognized that related parties have engaged in like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property. The exchange would then position the parties to avoid or substantially reduce the recognition of gain on the subsequent sale.

Of course, Sec. 1031(f) creates a restriction on the disposition of property within two years, but it does not prevent tax deferred exchanges of property between related parties, even if the exchange does create a basis shift, as long as there is no "disposition" within two (2) years.

Therefore, the related party rules of Section 1031(f) only will apply where

1. There has been a "disposition" within 2 years of the exchange; **and**

2. There is tax avoidance.

C. What is Income Tax Avoidance? "Cash outs" and "basis shifting."

Sec. 1031(f) is intended to deny nonrecognition treatment for transactions in which related parties make like-kind exchanges of high basis property for low basis property in anticipation of the sale of the low basis property. The Committee Reports state that "if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, *"cashed out"* of the investment, then the original exchange should not be accorded nonrecognition treatment." (HR Rep. No. 247 101st Cong. 1st Sess. 1340 (1989)).

Unfortunately, Section 1031(f) does not provide much guidance as to when a related party exchange will (or will not) be deemed to be done for tax avoidance purposes. However, when Congress adopted the related parted exchange rules, Congress stated that it is intended that **the non-tax avoidance exception generally will apply to "...(iii) transactions that do not involve the shifting of basis between properties." The Committee Reports on P.L. 101-239.**

D. Classic Tax Avoidance and Basis Shifting/Cash Out Transactions. Here is the classic "basis shifting" and "cash-out" transaction:

> T has property worth $100 and with a tax basis of $10. Related party R has property with a tax basis $100 and value of $100. T and R exchange their properties. R then sells the T property for $100 and thus "cashes out" its investment tax free. If Section 1031(f) is deemed to have been violated, then T will recognize $90 of gain when R sells the T property.

E. Related Party Private Letter Rulings in 2007. Several private letter rulings issued in 2007 conclude that the Section 1031(f) rules are not violated, notwithstanding a related party exchange involving qualified intermediaries, where there was no cash-out or basis shifting involving either related party. PLR 200706001, PLR 200709036, and PLR 200712013.

F. Reminder: The Teruya Brothers Case From February 2005; Here, there was no basis shifting, but there was a tax-free cash-out due to the related party's NOL carryovers.

The most important recent case involving related party exchanges is the Tax Court case of Teruya Brothers which came out in February 2005. In that case, the taxpayer engaged in a tax-free exchange with a related party. Teruya Brothers exchanged property with a related party and avoided a tax gain of $1,345,000 on the exchange. The related party then disposed of its 1031 property within two (2) years and recognized a gain of $1,353,000 on the sale of its replacement property.

The IRS took the position that Teruya Brothers should also be required to recognize tax gain of $1,345,000 even though the related party recognized a larger capital gain ($1,353,000) on the sale of its property. **In reality, the related party did not have to pay income tax on its tax gain of $1,353,000 because it had a NOL carryforward it could use to offset most of that gain.** Therefore, the Tax Court held that the exchange did not meet the 1031 requirements.

In essence, the Teruya Brothers case stands for the proposition that the related party rules will apply where the exchange has a positive tax outcome even if that was not the principal purpose of the exchange. In that case, the related party achieved a great tax result (it was able to cash out its investment with no tax cost) by virtue of the fact that it had an NOL carryforward

which it could use to shelter the loss. The Teruya Brothers case also seems to follow the IRS's reasoning in other cases where the related party exchange accomplishes either a "cash out" for one of the parties or and "income tax basis shift" to the other parties.

II. Section 1031 and Vacation Real Estate; Barry Moore v. Commissioner, TC Memo 2007-134 (May 30, 2007).

A. Background. Tax practitioners have long wondered whether it may be possible to engage in a Section 1031 Exchange for "dual use" vacation property, such as beach property, mountain property, etc. Previously, before the Moore case, we had no regulatory or case law guidance to consider.

Cautious and conservative tax advisors have warned that virtually any personal use of the vacation property could disqualify the exchange for Section the 1031 treatment. Clients, of course, plea their case that they purchased the vacation property with a hope, and anticipation, that the vacation property would increase in value or would generate rental income, notwithstanding that they would use the vacation property for personal equipment. This truth has been borne out in the last five years by virtue of the escalating value of vacation real estate.

B. The new Tax Court case of Moore v. Commissioner provides a new "primarily held for investment" requirement with respect to exchanges of vacation real estate. In the case of Barry Moore v. Commissioner, TC Memo 2007-134 (May 30, 2007), the case resolved around whether or not the Moore family could claim Section 1031treatment on their sale of certain lake front property for other lake front property where both properties were used by the Moores primarily for recreational purposes. As discussed further below, although Mr. Moore presented evidence at the Tax Court trial that he purchased the relinquished and replacement properties for investment purposes, the facts also demonstrated that the Moores used the relinquished and replacement property primarily for recreational purposes. Therefore, although Mr. Moore contended that he purchased the replacement and relinquished property in hopes that those properties would appreciate in value, this was not sufficient to bring the replacement and relinquished properties within the parameters of Section 1031.

Instead, the Tax Court held that, in order for the Section 1031 requirements to be met, the Moores would have to prove that the primary purpose of their purchase was to earn rental income or to recognize appreciation in value. Unfortunately, the facts bore out that the Moores purchased and used both properties primarily for recreational purposes rather than for investment purposes. Therefore, the 1031 relief was not available since neither the relinquished property nor the replacement property were held for "primarily" for investment purposes.

Unfortunately, "bad facts make bad law," and, by virtue of the bad facts in the Moore case, we now have a new test to apply to determine whether vacation property constitutes investment property for purposes of Section 1031. The new test is whether there is a primary personal use purpose or primary investment purpose for owning vacation real estate.

C. Facts of Moore v. Commissioner, TC Memo 2007-134 (May 30, 2007).

In the Moore case, Mr. Moore wanted to exchange vacation property on Clark Hill Lake for other vacation property on Lake Lanier. Originally, the Moores purchased the Clark Hill Lake property in 1988. The Clark Hill Lake property consisted of two adjacent parcels of lake front real property along with a mobile home located on one of those parcels.

Previously, Mr. Moore had bad experiences with the stock market. Mr. Moore produced evidence at trial indicating that he purchased the Clark Hill lake property with the anticipation that it would appreciate in value. At that time, Mr. Moore's personal residence in Norcross, GA was a three hour drive from the Clark Hill property.

Later, the Moores moved to Marietta, GA and then the length of commute to the Clark Hill lake property was more like five or six hours. The Moores used the Clark Hill Lake property during the summer months on a regular basis. The mobile home located on the Clark Hill Lake property was a double wide mobile home. The Moores built a deck around the house and added a screened in porch and installed a satellite television receiver. They also replaced the roof and painted the home two or three times. They installed a new washer and dryer and replaced some of the furniture.

Until they decided to acquire the Lake Lanier property in late 1999, the Moores never advertised the Clark Hill property for sale although they had received purchase offers. Also, they never rented or attempted to rent the Clark Hill property to others.

On their 1996 through 1999 tax returns, the Moores listed deductions for "home mortgage interest". They did not list on those returns any deductions for **investment interests** nor did they deduct **any maintenance or other expenses** associated with the Clark Hill Lake property.

In December 1999, the Moores decided to sell the Clark Hill Lake property and they then entered into exchange agreement through a qualified intermediary and sought to purchase property on Lake Lanier as replacement property. Evidence at trial indicated that one of the primary purposes for moving to the Lake Lanier property was the fact that the Moores changed their primary residence from Norcross, GA to Marietta, GA. After the Moores changed their primary residence from Norcross to Marietta, GA, the length of the drive to the Clark Hill property made it inconvenient for the family to spend weekends at the Clark Hill property. As a result, they used that property less frequently.

So, in late 1997 or early 1998, the Moores began to investigate properties on Lake Lanier which is much closer to their Marietta, GA residence. Evidence at trial indicated that the Moores felt that a house on Lake Lanier would be much more use to them than the Clark Hill property. However, the Moores also believed that the property on Lake Lanier would appreciate more readily in value than the Clark Hill property since Lake Lanier is much closer to Atlanta. So, the Moores purchased the Lake Lanier property in January 2000.

The Lake Lanier property was much more impressive than the Clark Hill property. The Lake Lanier property was a 1.2 acre tract of land and had the largest double slip boat dock allowable on that lake. The new house on Lake Lanier had five screened-in porches and five bedrooms and 4½ bathrooms. The new Lake Lanier property was also fully furnished. After they bought the Lake Lanier home, the Moores visited the home regularly, during each summer.

The Moores deducted substantially all of their home mortgage expense on Lake Lanier as a home mortgage interest and a small amount as investment in interest. However, the Moores never took any maintenance or other deduction expenses associated with the Lake Lanier property on their tax returns. Also, the Moores never attempted to rent or sell the Lake Lanier property - until Mr. and Mrs. Moore got divorced and therefore needed to sell the Lake Lanier property to raise liquidity in connection with their divorce.

The IRS challenged the Moores attempted Section 1031 tax-free exchange of the Clark Hill Lake property for the Lake Lanier property on the basis that the Moores used both properties for their personal use purposes rather than for investment purposes. The Moores, however, contended that they owned both properties with the expectation that both properties would appreciate in value.

In the Moore case, the Tax Court stated that "for investment" under Section 1031 has the same meaning as:

(i) "for profit" for purposes of taking a loss on the sale of property under Section 165(c); and

(ii) "for the production of income" for purposes of taking deductions under Section 212.

The Court then cited the cases under both Section 165(c) and 212 (or their predecessor sections) which held that properties must be held "primarily for profit" to take a Section 165(c) loss or "primarily for the production of income" to take deductions under Section 212.

The Tax Court concluded that there was no convincing evidence that the Moores held either property for production of income but instead that there was convincing evidence that the Moores used both properties as vacation retreats. The Moores never attempted to rent either property. In addition, they never attempted to sell either property for a profit. In fact, they did

not offer the Clark Hill Lake property for sale until they found the Lake Lanier property. They never attempted to sell the Lake Lanier property until Mr. Moore needed liquidity for his divorce. In fact, they did not offer the Clark Hill Lake property for sale until late 1999 when they decided to acquire the more accessible Lake Lanier property which was closer to their primary residence.

Also, although the Moores made substantial improvements and repairs to both properties, those improvements were more consistent with enjoying the properties as vacation homes. In fact, the improvements made to the Clark Hill Lake property (such as adding a screened-in porch, installing satellite television receiver and such) were more personal use related than designed to increase the value of the Clark Hill Lake property.

Also, with respect to the Lake Lanier property, it was true that the Lake Lanier property represented a substantial investment by the Moores. However, the Tax Court noted that the Moores did not attempt to recover any portion of that investment in the Lake Lanier property by renting the house out or attempting to sell. Also, on their tax return, the Moores treated all of their interest deductions on the Clark Hill Lake property and most of their deductions on the Lake Lanier property as home mortgage interest **rather than as investment interest**.

Thus, the evidence overwhelmingly demonstrated that the Moores' primary purpose in acquiring and owning both the Clark Hill Lake property and the Lake Lanier properties was to enjoy the use of those properties as vacation homes.

PART TWO
DEDUCTIONS FOR EXPENSES AND LOSSES

I. Hobby Loss Deductions; Here, an Equestrian Can Claim Hobby Loss Deductions Where Her Equestrian Activities Benefitted Her Related "For Profit" Activity. Topping v. Commissioner, TC Memo 2007-92.

A. General Section 183 "Hobby Loss" Rules.

1. Background. Section 183 denies any deductibility of losses or expenses incurred in connection with a hobby rather than a trade or business. Section 183(a) provides that, if an individual or an S Corporation is engaged in an activity that is not engaged in for profit, no deduction attributable to the activity shall be allowed. Section 183(c) defines an activity "not engaged in for profit" as any activity other than one with respect to which deductions are allowable for the tax year under Section 162 or Section 212. Deductions are allowable under Section 162 or Section 212 **only** where the taxpayer is engaged in an activity with **an actual and honest objective of making a profit**.

2. "Three-out-of Five Year" Rule. Section 183(d) provides that an activity will be presumed to be an activity "engaged in for profit" if income exceeds deductions in **three out of five** consecutive taxable years.

3. Facts and Circumstances Test. Finally, Treas. Reg. 1.183-2(b) lists some of the factors to be considered in determining whether an activity is engaged in for profit. The factors listed include:

1. the manner in which the Taxpayer carries on the activity;
2. the expertise of the Taxpayer or his advisors;
3. the time and effort expended by the Taxpayer in carrying on the activity;
4. the expectation that the assets used in the activity may appreciate in value;
5. the success of the Taxpayer in carrying on other similar or dissimilar activities;
6. the Taxpayer's history of income or losses with respect to the activity;
7. the amount of vocational profits, if any, which are earned;
8. the financial status of the Taxpayer; and
9. the involvement of elements of personal pleasure or recreation.

B. Here, an Equestrian Can Claim Hobby Loss Deductions Where Her Equestrian Activities Benefitted Her Related "For Profit" Activity. In the case of Tracey Topping v. Commissioner, TC Memo 2007-92, Ms. Topping was both an equestrian and a designer. Ms. Topping used her prominence as an equestrian - to build a **design business** designing horse barns and home interiors for wealthy acquaintances and new contacts that she met on the Palm Beach, Florida area horse show circuit.

Ms. Topping combined her two activities (the equestrian activity and the design activities) and showed a profit of nearly $1,000,000.

However, the IRS took the position that the equestrian activities of Ms. Topping (which by themselves produced a net loss) were a hobby which were unrelated to her design activities. The IRS thus took the position that Ms. Topping would be required to show her equestrian activity winnings and any gains from selling horses separately on her "other income" section on her Form 1040 and that she would be required to deduct related expenses as miscellaneous expenses subject to the 2% AGI limitation. This resulted in an additional tax assessment of more than $250,000 for the tax years 1999 through 2001.

The Tax Court, however, determined that Ms. Topping's two activities should be **integrated and treated as a single activity**. The Tax Court noted that more than 90% of Ms. Topping's client base (for her barn design and interior design business activities) came from her contacts that she established during her equestrian activities in the Palm Beach area. Thus, the two activities could be integrated and thus her expenses from her equestrian activities could be used to offset income from her barn design and interior design activities.

> **NOTE:** The Tax Court distinguished this case from several other cases which held that hobby expenses could not be aggregated with for profit activities. For example, in the case of D. Mendoza v. Commissioner, TC Memo 1994-314, the Tax Court held that a real estate lawyer's polo playing did not materially benefit his law practice. Likewise, in the case of Henry v. Commissioner, 36 TC Memo 879, the Tax Court held that a CPA's yachting activities did not benefit his CPA practice - even though the CPA flew a flag from his boat bearing the numerals "1040 ".

II. Be Careful How You Draft That Stock Purchase Redemption Agreement; Corporation Not Entitled to Recast Stock Redemption Payment as Compensation for Wages.

In the case of WRS Group, Ltd. vs. U.S., the U.S. Court of Appeals for the 5th Circuit upheld the District Court's decision in WRS Group, Ltd. WRS Group Ltd. vs. U.S. 100 AFTR 2d 2007-5884 (June 19, 2007) 97 AFTR 2d 2006-2596 (April 28, 2006). In WRS Group, Ltd., the Corporation and its majority shareholder entered into a Stock Purchase Agreement with two

minority stockholders. The parties executed a document entitled "Agreement Regarding Purchase of Shares; Termination of Employment; Consulting Agreement; Noncompetition and Release." This agreement was dated March 6, 1998. On March 23, 1998, the majority stockholder individually purchased the stock of the minority shareholders for over $450,000.

On its 1998 tax return, however, the Corporation reported the transactions as partially a redemption of shares and partially as compensation for past services provided by the minority shareholders. The IRS audited the Company's 1998 tax return and disallowed the tax deduction for the portions of the transactions which were classified as compensation on the 1998 corporate tax return.

In the District Court proceeding, the Corporation argued that it was entitled to recast the transaction as part payment for past compensation - since the sales price of the stock exceeded its fair market value as determined by an accountant working for the Corporation.

The District Court, however, held that a taxpayer may not disavow the form in which he originally cast this transaction pursuant to the case of Commissioner v. Danielson, 378 F.2d 771 (1967).

In Danielson, the taxpayer executed covenants not to compete as part of a stock sale transaction. The Purchase Agreement allocated part of the consideration to the covenants not to compete, but the seller-taxpayer reported the entire amount as proceeds from the sales of capital assets. In that 1967 case, the IRS argued that the taxpayer should be bound by the allocation he had adopted in the agreement; but the taxpayer contended that the allocation had no basis in fact or economic reality, and therefore taxation should be based on the substance of the transaction. In ruling against the taxpayer, the Danielson Court set forth what has come to be known as the Danielson Rule which provides:

> a party can challenge the tax consequences of his agreement as construed by the Commissioner only by . . . showing mistake, undue influence, fraud, duress.

Thus, under the Danielson Rule, parties to a transaction may not challenge the form of the transaction in the absence of fraud, mistake, duress or undue influence.

In the WRS Group, Ltd. case, the District Court held that the Company was bound by the "form" of the transaction it had adopted and that the Corporation was bound by the form of the documents which it drafted, negotiated and executed. Additional evidence convinced the Court that the transactions at issue were clear and unambiguous agreements for stock purchases as follows:

1. The Title of the Agreements. The title of the agreements were "Agreement Regarding Purchase of Shares; Termination of Employment; Consulting Arrangement; Noncompetition and Release." This makes it clear that the agreements pertain to a purchase of stock, without mentioning compensation.

2. The Contents of the Agreement. The agreements clearly spelled out the arrangement regarding the purchase of stock and makes no mention of payment of compensation to either minority stockholder.

3. Party Who Drafted the Agreement. The Company's attorney drafted the agreement, and thus the attorney had the greatest ability to control the terms of the agreement.

4. Payments to Minority Stockholders. When the majority stockholder paid the minority stockholders via personal check, the majority stockholder wrote "stock purchase" in the memo section of the check.

5. Purchase Price Based Upon Shares Held. The Company paid the minority shareholders consideration based upon the number of shares that they held. If the Company truly intended to compensate the minority shareholders for past services, the price paid to the two minority shareholders would not have been based exclusively on how many shares the individuals owned, and would have likely instead focused on years of service, past evaluations, etc.

Thus, the Court concluded that the transaction between the Company and the minority stockholders were clearly designed to be stock purchases and therefore the Company could not later on recast the transaction to accomplish a better tax result.

III. Taxpayer Not Eligible for a Section 165 Loss Deduction for Alleged Abandoned Partnership Interests

A. Background. Section 165(a) of the Code allows a deduction for losses sustained during the taxable year. A loss deduction is permitted under Section 165 only for a taxable year in which the loss is sustained, as evidenced by "closed and completed" transactions and as fixed by identifiable events occurring during that year. Section 1.165-1(d)(1).

A loss from the sale or exchange of a capital asset is a capital loss. Section 1.165(f). However, Revenue Ruling 93-80 (1993-2 C.B. 239) provides that a loss incurred on the abandonment or worthlessness of a partnership interest is an ordinary loss if sale or exchange treatment does not apply. If there is an actual or deemed distribution to the partner, or if the transaction is otherwise in substance a sale or exchange, the partner's loss is a capital loss (except as provided in Section 751(b)).

Abandonment of an asset for purpose of Section 165 requires:

(1) an intention to abandon the asset; and
(2) an affirmative act of abandonment.

Revenue Ruling 93-80; Revenue Ruling 2004-58.

According to the courts, both abandonment and worthlessness are ultimately factual determinations. For example, in the case of Echols v. Commissioner, 935 F.2d 703 (5th Circuit 1991), the Court held that there was both an "intent to abandon" and an "affirmative act of abandonment" when the taxpayer called a partnership meeting at which he tendered his partnership interest to another partner, or anyone else, without compensation and announced that he would contribute no further funds to the partnership.

B. CCA 200637032. In this case, the taxpayer, Mr. A, owned a partnership interest in a registered limited partnership. Mr. A was shown as the general partner. Previously, Mr. A loaned funds to the partnership. After the loan from Mr. A was not repaid by the partnership, Mr. A demanded repayment of the loan and then tendered his letter of resignation as general partner. The partnership rejected Mr. A's demand for immediate payment, but did not dispute that the amount was an obligation of the partnership.

For the tax year at issue, Mr. A claimed a worthless debt loss and an ordinary loss for his alleged abandonment of his worthless partnership interest. However, at no time did Mr. A offer to relinquish his partnership interest to any partner, nor did Mr. A notify the partnership that he was abandoning or relinquishing any right to (1) be repaid for his loan or (2) any rights to partnership assets or to his partnership capital account upon dissolution of the partnership. In fact, in future years after the tax year, Mr. A continued to seek repayment from the partnership and Mr. A hired an attorney to help him collect the debt owed by the partnership.

Ultimately, the IRS held that Mr. A had not established an identifiable event to prove that a loss had been sustained. In fact, there was no overt act by Mr. A indicating that he had abandoned his right to his capital account in the partnership nor any of his right in and to other partnership assets upon dissolution. Mr. A did not surrender his partnership interest back to the partnership nor did he relinquish his right to be repaid his "paid in capital" or his rights of repayment of his debt from the partnership. Thus, Mr. A could not prove that there was any abandonment loss.

NOTE: This case makes it clear that, in order to claim a worthless partnership loss upon abandonment, the partner must take some affirmative act to make it clear that he will not seek any future recourse against the partnership for (1) future partnership income, (2) for his “capital” account, or (3) for any assets of the partnership upon partnership liquidation.

PART THREE
PASSIVE ACTIVITIES LOSS RULES

I. At- Risk and Passive Activity Loss Rules. Another Taxpayer Caught in the "Self-Rental" Passive Activity Loss Rules - And Cannot Offset Other Passive Rental Losses by Rental Income Generated From Rents To a Closely Held Corporation In Which Taxpayers Materially Participate; Beecher v. Commissioner, 99 AFTR 2d 2007-1807 (March 23, 2007)

A. Background of Passive Activity Loss's Rules. Section 469 denies passive activity losses to an individual, an estate or trust, a C corporation or a personal service corporation. Under Section 469(a), a "passive activity" is defined as any activity involving the conduct of a trade or business in which the taxpayer does not materially participate. The term "passive activity" however, generally includes any rental activity, regardless of material participation. Section 469(d)(2).

Congress enacted Section 469 to prevent taxpayers from applying losses from rental properties and other passive business activities to offset and shelter non-passive income such as wages, dividends or profits from non-passive activities. See S. Rep. No. 99-313, at 716-18 (1986).

B. Review of Self-Rental Rules. In connection therewith, Regulation 1.469-2(f)(6) provides that:

> An amount of the taxpayer's gross rental activity income for the taxable year from an item of property equal to the net rental activity income for the year from that item of property is treated as not from a passive activity if the property . . . [i]s rented for use in a trade or business activity. . . in which the taxpayer materially participates . . . for the taxable year.

This regulation is known as the "self rental rule" and effectively characterizes, as **non-passive income**, any income generated from rentals to an activity in which the taxpayer materially participates.

C. In Some Cases, Rental Activities May Be Aggregated And Treated as One Activity. Section 469(d)(1) defines "passive activity loss" as the amount by which the aggregate losses from all passive "activities" exceed the aggregate income from all activities. Section 469, however, does not define the term "activity". However, Regulation 1.469-4(c) sets forth rules for grouping tax items together to determine what constitutes a "activity". That Regulation 1.469-4(c) provides:

> One or more trade or business activities or rental activities may be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of Section 469. Whether activities constituted "appropriate economic unit" depends on facts and circumstances.

However, as the Carlos and Beecher cases (discussed below) illustrate, the self-rental recharacterization rule will often serve to cause rental income to be recharacterized as non-passive income which cannot be used to offset other rental losses, even if the two activities otherwise could be "aggregated" and treated as one activity under Reg. 1.469-4(c).

D. Non-Passive Income from Self Rental Activity Can't Offset Other Rental Property Passive Losses. In Beecher v. Commissioner, 99 AFTR 2d 2007-1807 (March 23, 2007) Mr. and Mrs. Beecher were husband and wife. Mr. Beecher owned Cal Interiors, Inc., which was a C corporation that engaged in the business of repairing automobile interiors. Mrs. Beecher wholly owned S&C Dent Corp, also a C corporation, that engaged in the business of removing dents from automobiles.

Both Mr. and Mrs. Beecher worked full time for these two C corporations and thus materially participated in the activities of the Corporation. Both C corporations' offices were located in the Beecher's home. Both C corporations paid Mr. and Mrs. Beecher rent for the corporations' use of this home office space in the Beechers' home.

In addition to renting this portion of their home to their two C corporations, Mr. and Mrs. Beecher also owned five (5) rental homes.

On their 1997, 1998 and 1999 tax returns, the Beechers reported net income from the leases of their home office space to their two C corporations. However, during these same years, Mr. and Mrs. Beecher also yielded net losses from their other five rental properties. In fact, their combined rental losses from the five rental properties exceeded the rental income derived from the leases of the home office space to Cal Interiors and to S&C Dent Corporation. As a result of this combination of income and losses, Mr. and Mrs. Beecher paid no income tax on the rental income paid to them by their C corporations.

The IRS audited the Beechers' returns and disallowed the net rental losses by taking the position that the Beechers could not offset their rental income from their C corporation against the rental losses from their rental properties. The Tax Court held that the rental income from the leases of the home office space was non-passive income pursuant to the **"self-rental rule" of Treasury Regulation 1.469-2(f)(6)**. This was based on the Tax Court's determination that the Beechers materially participated in the business activities of their two C corporations, which were lessees from the Beechers.

Thus, the net income from the leases of the office in the home to their two C corporations could **not** be offset by the losses from the five other rental properties.

The 9th Circuit Court of Appeals upheld the decision of the Tax Court.

E. And Worse Yet, Self Rental Income Is Non-Passive, But Self Rental Loss Is Passive, and Thus The Two Cannot Offset Each Other. Carlos v. Commissioner, 123 T.C. No.16 (September 20, 2004). In Carlos, Mr. Carlos owned 100% of the stock of two S corporations. One S corporation was a steel company and the other S corporation was a restaurant company. Mr. Carlos also owned two commercial pieces of property. One piece of property was rented to the steel company and one piece of property was rented to the restaurant.

During the 1999 and 2000 tax years at issue, Mr. Carlos earned net rental income from the rental of property to the steel company, but had a net loss from renting property to the restaurant. On his tax return, Mr. Carlos offset his rental losses from the restaurant leasing operation to offset and decrease his net rental income from the rental to his steel corporation.

Mr. Carlos argued that he could "group" the rental properties together to constitute a single "activity". The IRS, of course, disallowed the deductions. Notwithstanding that the two leasing activities constituted an "appropriate economic unit" under Section 1.469-4(c)(1), the IRS argued that Mr. Carlos improperly computed his passive activity loss within this "activity" grouping.

The Tax Court noted that, while the general rule of Section 469(c)(2) characterizes all rental activities as passive, Section 1.469-2(f)(6) requires that net rental income (but not rental loss) received by the taxpayer, for rental of the taxpayer's property to a business in which the taxpayer materially participates, shall be treated as non-passive income. This is often called the "self rental rule" or the "recharacterization" rule. According to the Tax Court, therefore, the net rental income arising from the rental of the steel company property should be recharacterized as "non-passive" since it was being leased to a business (the steel corporation) in which Mr. Carlos materially participated. After giving effect to the recharacterization or self-rental rule, Mr. Carlos was then left with no "passive" income which could be used to offset his passive losses from the rental to the restaurant.

F. Apply the "Self Rental" Recharacterization Rules Before You Apply the Aggregation/Grouping Rules. According to the Courts in Beecher and Carlos, the activity grouping rules do not bring into application the rules of Regulation 1.469-2(f)(6), since the Section 1.469-2(f)(6) regulations must first be applied to determine whether the rental activity is a passive or non-passive activity. Thus, this self-rental recharacterization test must **first** be applied to the determine the extent of any "non-passive income" or "passive loss" **before** applying the grouping activity rules. In other words, the activity grouping rules only apply **after** income or losses is determined to be passive or non-passive. Thus, no "netting" was allowed for the non-passive income against the passive loss.

II. More on Grouping and Aggregating Activities; Leasing Enterprise and Business It Rented To Are Treated as a Single Activity for PAL Rules: Candelaria vs. U.S. (October 5, 2007).

For a variety of tax and non-tax reasons, entrepreneurs beginning a new business often set up a separate entity to buy the required machinery and equipment and lease it to the business. In a case involving such an arrangement, the District Court for Texas in Candelaria held that the leasing enterprise and the business enterprise could be combined or "aggregated" for passive activity loss purposes since the leasing enterprise was "insubstantial" to the business enterprise. As a result, the losses incurred by the leasing enterprise were not "passive" losses for purposes of Section 469.

A. Background: General Passive Activity Loss Disallowance Rules. Section 469 states that no passive activity loss shall be allowed to an individual, an estate or trust, any closely held C corporation or any personal service corporation. Section 469(a). If an activity loss is disallowed as "passive", any loss shall be treated as a deduction or credit allocable to such activity the next taxable year. Section 469(b).

Congress enacted Section 469 to prevent taxpayers from applying losses from rental properties and other passive business activities to offset and shelter non-passive income such as wages, dividends or profits from non–passive activities.

The Tax Code defines "passive activity"as any activity which involves the conduct of any trade or business, and in which the taxpayer does not materially participate. Section 469(c)(1). More importantly, "passive activity" includes any "rental activity", regardless of how much the taxpayer materially participates in it. Section 469(c)(2). The Code defines "rental property" as "any activity where payments where payments are principally for the use of tangible property".

B. Grouping of Multiple Activities as a Single Activity for the Passive Activity Loss Rules. Section 1.469-4 provides that:

> one or more trade or business activities or rental activities may be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for the purposes of Section 469.

Reg. 1.469-4(c)(3) states that, whether activities constitute an appropriate economic unit, and therefore may be treated as a single activity, depends upon all the relevant facts and circumstances. A taxpayer may use any reasonable method of applying the relevant facts and circumstances in grouping activities.

The factors listed below, not all of which are necessary for a taxpayer to treat more than one activity as a single activity, are given the greatest weight in determining whether activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of Section 469:

(i) Similarities and differences in types of trades or businesses;
(ii) The extent of common control;
(iii) The extent of common ownership;
(iv) Geographical location; and
(v) Interdependencies between or among the activities (for example, the extent to which the activities purchase or sell goods between or among themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records).

Treas. Reg. § 1.469-4(c)(2).

However, Reg. Section 1.469-4(c) is not the end of the analysis. Reg. 1.469-4(d) places certain relevant limitations on which types of activities a taxpayer may group for passive/non passive activity purposes. Specifically, Reg. 1469-4(d) provides:

> (1) *Grouping rental activities with other trade or business activities* - (i) Rule. A rental activity may not be grouped with a trade or business activity unless the activities being grouped together constitute an appropriate economic unit under paragraph (c) of this section and -
>
> (A) The rental activity is insubstantial in relation to the trade or business activity;
> (B) The trade or business activity is insubstantial in relation to the rental activity; or
> (C) Each owner of the trade or business activity has the same proportionate ownership interest in the rental activity, in which case the portion of the rental activity that involves the rental of items of property for use in the trade or business activity may be grouped with the trade or business activity.

Unfortunately, however, the regulations to Section 469 do not define what is meant by the term “insubstantial” in the context of comparing rental and other business activities.

This issue, of what is “insubstantial” in the context of the “grouping activity rules,” was the heart of the case of Candelaria v.U.S. (100 AFTR 2d 2007-5378, October 5, 2007).

C. Candelaria v. U.S. (100 AFTR 2d 2007-5378, October 5, 2007). In this case, Mr. Candelaria established an LLC (the "Equipment LLC") to buy medical equipment to be leased to another limited partnership owned by Mr. Candelaria. The limited

partnership provided radiological services to the community at large (the "Medical Practice"). The Equipment LLC's sole income was attributable to its leasing imaging equipment to the Medical Practice. The Equipment LLC had substantial losses for the tax year at issue and Mr. Candelaria treated these losses as ordinary "non passive" losses.

The IRS argued that the Equipment LLC's rental activities could not be aggregated together with the business activities of the Medical Practice and thus the IRS took the position that the rental losses were passive under Section 469. However, the District Court concluded that the Equipment LLC and Medical Practice may be grouped as an appropriate economic unit and therefore that the Equipment LLC rental activity was "insubstantial" to the Medical Practice's business activities. As a result, all of the rental losses were allowed.

The District Court considered the following factors in arriving at its ruling that, looking at the facts and circumstances, the Equipment LLC's rental activity was insubstantial to the business activity of the Medical Practice:

1. Indeed, the Equipment LLC's sole reason for existence was to serve the needs of the Medical Practice. The entire business of the Equipment LLC consisted of holding title to equipment which it in turn leased to the Medical Practice. The Equipment LLC had no employees, provided no services and had no customers other than the Medical Practice. Ultimately, if the Medical Practice were to go out of business, the Equipment LLC likewise would also go out of business.

2. The Equipment LLC's rental income only accounted for 3.4% of both entities' income.

PART FOUR
SHAREHOLDER AND THIRD PARTY LOANS/ADVANCES VS. CAPITAL CONTRIBUTIONS

I. In 2006, Appeals Court Reverses Tax Court's Holding and Finds that Shareholder Advances Are Loans; Indmar vs. U.S., 444 F.3d 771 (2006).

A. Background. We often have many clients who have had to infuse their businesses with operating capital. Oftentimes, a taxpayer will make advances to a closely-held corporation. In many cases, a desperate taxpayer continues to loan money to an entity that is not credit worthy. The tax question at issue is often whether or not the capital infusion is truly a loan or instead a capital contribution.

Oftentimes, however, shareholder-creditors fail to carefully document whether these transfers are **(i) bona fide loans or (ii) capital contributions**. In these cases, the following problems may arise:

(1) Subsequent repayment of these "advances", or payment of "interest", may be treated as C Corporation **dividends** to the C Corporation shareholder creditor;

(2) In the S Corporation context, the S Corporation repayment may be treated as a **bonus** which is subject to payroll taxes;

(3) In the S corporation context, where the shareholder has no basis in the S corporation's note to the shareholder (because the S shareholder used its basis in the note to absorb S corporation operating losses), any repayment of the debt by the S corporation will be **taxable income** to the S Corporation shareholder. The **character of taxable income** will depend upon whether or not the debt is evidenced by a promissory note. Generally, the debt repayment will be treated as capital gain to the S corporation shareholder-creditor, as long as the debt is evidenced by a note. Rev. Rul. 64-162. However, if the debt is not evidenced by a note, there is no sale or exchange when the debt is repaid, and therefore the S corporation shareholder-creditor recognizes ordinary income to the extent of the amount paid over the shareholder-creditor's basis in the debt. Rev. Rul. 68-537.

(4) Loans by a family member to the corporation may be recharacterized as gifts to the shareholder-children.

(5) The tax treatment to the shareholder upon the subsequent insolvency of the company will differ depending upon whether the capital infusion is treated as a loan or as a capital contribution.

B. Review of Section 165 Capital Loss Rules and Section 166 Bad Debt Deduction Rules.

1. Advance Treated As a Capital Contribution. If the corporation fails to repay an advance that is properly characterized as a capital contribution rather than as a loan, the Shareholder will not be able to claim a Section **166(a) business bad debt deduction** or a Section **166(b) non-business bad debt deduction** for the worthless debt. Instead, there will be no allowable deduction at all - if the advance is treated as a capital contribution to the corporation - until the underlying stock becomes worthless. (See Section 165 and Section 1244 for worthless stock rules). Generally, Section 165 ensures that any such worthless stock loss will be treated as a capital loss, rather than as an ordinary loss, unless the stock qualifies as Section 1244 stock.

2. Advance Treated As a Loan. If the corporation fails to repay an advance that is properly characterized as a loan rather than as a capital contribution, the lending Shareholder will be able to claim a Section **166(a) business bad debt deduction** or a Section **166(b) non-business bad debt deduction** for the worthless debt. "Business" bad debt losses are treated as ordinary loses, but "non-business" bad debt losses are treated as capital losses, and, to claim a business bad debt loss, one must show that the loan was made in connection with the taxpayer's trade or business.

a. Business Bad Debts: Debts Incurred to Protect Shareholder's Employment. Section 166 defines a business bad debt as a debt incurred in connection with the taxpayer's trade or business. The "trade or business" test can include the shareholder's trade or business of being an employee. Thus, an employee's loan to the corporation will be deemed to have been made in connection with the employee's "trade or business" of being an employee if the advance to the employer corporation was necessary to insure the employee's continued employment. Trent v. Commissioner, 291 F.2d 660 (2d Cir. 1961).

b. Nonbusiness Bad Debts: Debts Incurred to Protect Shareholder's Investment Rather Than Employment. If the loss loan was not made in connection with the taxpayer's trade or business (such as where the shareholder was not employed by the corporation), the loss is deemed to be a Section 166(b) nonbusiness bad debt which is only deductible as a capital loss. Section 165 (c) and Section (d).

3. Summary Comparison of Tax Results of Section 165 Capital Loss versus Section 166(d) Bad Debt Loss Treatment. Since bad debt deductions attributable to one's services as an employee are 2% miscellaneous itemized deductions under Section 63(d) and 62(a)(1), you may be better off claiming a non-business bad debt capital loss rather than a business bad debt attributable to the provision of services as an employee so as to avoid (i) the 2% miscellaneous itemized deduction threshold; (ii) the Section 68 overall limitation on itemized deductions; and (iii) the disallowance of the itemized deduction for AMT purposes.

C. Loans vs. Capital Contributions. In the past, courts have set forth a 13 point test or a 16 point test to determine whether a capital infusion is a loan versus a contribution to capital. The Tedford case, TC Summary Opinion 2004-132, and the Warning case, 2001-2 U.S.T.C. 50,729 (2001), provide excellent restatements of the 13 point and 16 point tests.

D. The Case of David Warning Provides Us With a 16-Factor Test to Determine Whether Advances Should be Treated as Loans or as Capital Contributions. In Warning, 2001-2 U.S.T.C. 50,729 (2001), over a period of eight years, Mr. Warning made nearly 30 advances to his corporation, which was engaged in the trucking business. When the trucking company finally failed, Mr. Warning attempted to claim a §166 business bad debt loss of over $250,000. The District Court for the Northern District of Oklahoma ultimately concluded that Mr. Warning's transfers were not bonafide debts, but instead were contributions to the capital of the Company. In this case, the court applied a 16-factor test to determine whether the transfers were loans or capital contributions:

1. Was there any written evidence of the indebtedness?

2. Did the advances have a fixed maturity date?

3. What was the anticipated source of repayment?

4. Did the lender have the right to enforce payments?

5. Did the advances give the lender the right to participate in management?

6. Were the advances subordinate to claims of other creditors?

7. Is there any evidence of the parties' intent that the advances be treated as loans?

8. Were loans made pro rata in proportion to the stock ownership?

9. Was the corporation adequately capitalized?

10. Was the corporation able to obtain financing from outside sources?

11. What was the purpose of the advances?

12. Did the corporation make payments when due?

13. Did the shareholder-creditor face substantial risk that the advances would not be repaid?

14. Were interest rates stated and were interest payments made?

15. Was there any security for the advancements?

16. Did the corporation establish a sinking fund to provide means of repayment?

E. Tax Court in Indmar. In 2005, we talked about the case of Indmar Products. In the case of Indmar Products Co, Inc. v. Commission, TC Memo 2005-32, the taxpayer shareholder made advances to a closely-held corporation. The Tax Court, however, held that the advances were capital contributions and not loans. The following facts were present:

(1) The shareholder's transfers to the Corporation were poorly documented;

(2) There was no maturity date or repayment schedule for the "advances;"

(3) The advances were in violation of other corporate loan agreements; and

(4) The advances paid above-market interest.

Thus, in Indmar, the presence of excess repayments caused the advances to be recharacterized as capital contributions and not as loans. Since the advances were deemed to be capital contributions rather than loans, all repayments, including deemed interest payments, would have to be recharacterized as dividends. Also, no worthless debt loss would be allowable once the loans went bad.

F. In 2006, Sixth Circuit Court of Appeals Reverses Tax Court Decision in Indmar. In reversing the decision of the Tax Court in Indmar, the 6th Circuit Court of Appeals held that the advances in Indmar were loans and not capital contributions. Indmar, 444 F3d 771 (2006). In its analysis, the Sixth Circuit pointed out that, although the notes were not secured by a pledge of company assets, the following other factors indicated debt treatment:

(i) the fixed 10 percent interest rate and regular interest payments were characteristic of debt, and the 10 percent rate was reasonable and not excessive;

(ii) the after-the-fact issuance of notes should be taken into account for treatment as debt;

(iii) the lack of a maturity date or schedule of payments did not favor equity treatment because the notes were payable on demand;

(iv) repayment of the advances was not contingent on profits because the corporation borrowed funds from the bank to repay the advances;

(v) use of advances as working capital, rather than for purchase of assets, is evidence of debt; here, the corporation needed capital, which it used for both purposes; thus, this factor supports debt treatment; and

(vi) the company shareholder-lenders gave credible testimony that they expected their loans would be repaid.

Thus, based upon all facts, the terms and conditions surrounding the shareholder loans were similar to what would be expected of third party loans.

II. Worthless Shareholder Advance treated as Itemized Deduction And Not As An Above-The-Line Deduction.

In Graves v. U.S., 99 AFTR 2d (Sept. 8, 2007), the Ninth Circuit Court of Appeals held that a worthless debt, owed to the sole shareholder-employee, would be treated as a business bad debt, where the debt was advanced to the corporation to preserve the shareholder's employment as an employee. However, the shareholder-employee could not claim a loss deduction for the worthless debt on Schedule C (an above-the-line deduction), but instead could only claim the loss as an unreimbursed employee business expense - a miscellaneous itemized deduction on Schedule A.

NOTE: This result was better than a worthless non-business bad debt, which would have been treated as a capital loss. However, Mr. Graves would have fared better if the loss could have been structured as a Section 1244 loss, which would have generated ordinary loss treatment subject to the $50,000 loss limitation rules under Section 1244 ($100,000 for joint filers).

QUERY: Could Mr. Graves Have Converted His Debt to Section 1244 Stock? Under IRC § 1244(a), an individual may claim an ordinary loss deduction of up to $50,000 per year ($100,000 for joint returns) for worthless §1244 stock. Section 1244 stock is defined as original issue stock of $1,000,000 or less.

In the Graves case, the taxpayer **arguably** could have structured capital infusions as additional purchases of §1244 stock, since §1244 arguably allows a taxpayer to purchase additional §1244 stock. Ordinary losses, however, will not arise where the taxpayer makes subsequent additional capital contributions, even if the taxpayer's stock is already 1244 stock. Reg. 1.1244(c)-1(b). **Thus, the additional §1244 capital infusions would have to be structured as new purchases of newly issued stock.**

III. But in <u>Hubert</u> (April 27, 2007), Debt Recharacterized as Equity Results in a Constructive Dividend to Family Members - And Thus Achieves a Worse Case Scenario When the Debt Becomes Worthless: No Worthless Debt or Stock Loss Treatment Either

Hubert v. Commissioner (April 27, 2007); Poorly Documented "Loan" Recharacterized as Gifts to Family Members and No Loss Allowed When Debt Became Worthless. In the case of Hubert v. Commissioner, 99 AFTR 2d 2007-2528 (April 27, 2007), Hubert Enterprises, Inc. was a closely-held family corporation which advanced funds to an LLC owned by certain family members who were also shareholders of Hubert Enterprises, Inc. However, Hubert Enterprises, Inc. did not own any direct ownership interest in the LLC. Hubert Enterprises, Inc. treated the advanced funds to the LLC as loans, and then claimed a worthless debt loss when the loans to the LLC were not repaid.

However, the 6th Circuit Court of Appeals held that the advance was properly characterized as a constructive dividend to the family member-owners of the LLC. Even worse, the 6th Circuit Court of Appeals held that the lender (Hubert Corp.) therefore also could not claim a worthless debt loss when the advance was not repaid.

In the first part of the Court's analysis, the Court held that the advance was not characterizable as a loan, but instead was a constructive dividend, since the advance:

1. had no fixed maturity date;
2. was evidenced by a demand note;
3. the loan was not secured;
4. the loan called for interest payable at the applicable federal rate; and
5. the borrower made only one payment of interest on the note.

Thus, the loan to the family LLC was truly a **constructive dividend** to the other family members (who were also stockholders of Hubert, Inc. and members of the family LLC) because the advance represented a constructive dividend conferring an economic benefit on its shareholders (the owners of the LLC).

Finally, adding **insult to injury**, the 6th Circuit Court of Appeals also affirmed the Tax Court's holding that, since the advance was properly characterized as a capital contribution to the LLC (and thus a dividend to the owners of the LLC) and not a loan, the 6th Circuit Court of Appeals confirmed the Tax Court's holding that Hubert Enterprises, Inc. also should **<u>not</u>** be entitled to a bad debt deduction under Section 166 for the worthless loan. Moreover, Hubert Enterprises, Inc. was not entitled to treat the worthless advance of the LLC as a loss of capital because Hubert Enterprises, Inc. retained no ownership interest in the LLC.

NOTE: What does this case teach us? This case teaches us that there is a significant risk whenever parents make a loan to a business owned by children. If the loan is recharacterized as an equity contribution, the loan likewise could be recharacterized as a gift to the children which owned the business. Likewise, no worthless loan loss or stock loss would be eligible to the parents.

PART FIVE
S CORPORATIONS

I. Claiming S Corporation Basis For S Corporation Debt.

A. Background. An S Corporation shareholder may deduct his/her pro rata share of any losses sustained by the S Corporation, but these loss deductions will be limited to the sum of (1) the shareholder's adjusted tax basis in the stock **plus** (2) any corporate indebtedness actually owed to the shareholder. IRC Section 1366(d)(1). As many past Court cases have held, a loan made to an S Corporation by an outside lender will not increase the S Corporation shareholder's basis in the stock, even if the shareholder guarantees the bank note or pledges personally-owned assets to secure the note. In order to obtain tax basis, the S Corporation shareholder must make an "economic outlay" to the S Corporation.

B. The "Economic Outlay" Requirement. Hafiz v. Commissioner, TC Memo 1998-104 (March 16, 1998). In the case of Hafiz, Mr. Hafiz secured a loan from the bank to the S Corporation. The bank proceeds were used to purchase real property in the name of the S Corporation. The shareholder pledged all of his personally-owned assets to secure the bank loan. The shareholder also was a co-maker of the S Corporation's note issued back to the bank.

After the loan, the S Corporation suffered financial reversals and recognized significant operating losses. The taxpayer sought to deduct these losses on his personal income tax return on the basis that his tax basis in his S Corporation stock should increase as a result of the S Corporation indebtedness to the bank. The Tax Court, however, held that there was no "economic outlay" on the part of the shareholder, since he did not directly incur the bank indebtedness.

According to the Tax Court, no form of "indirect borrowing" will save the transaction, regardless of whether the shareholder is a guarantor or co-maker and regardless of whether or not the shareholder pledges individually-owned assets to secure the indebtedness. According to the Tax Court, the shareholder must make actual disbursements in the form of loans directly to the S Corporation.

C. Circular Loans Do Not Create S Corporation Tax Basis to Absorb Losses; PLR 200619021. In this PLR, the two taxpayers, a husband and wife, owned 50% of a real estate partnership which leased real estate to a related S corporation which also was owned 50/50 by the husband and wife.

During each of the tax years at issue, the Partnership would loan money to the taxpayers and the taxpayers would then reloan the borrowed money to the S corporation. Thereafter, the S corporation would pay rent to the Partnership. For each loan between the Partnership and the taxpayers, and between the taxpayers and the S corporation, Promissory Notes were drafted close to the end of the tax year. Each Promissory Note included the

outstanding loan balance for the current year's loan plus any unpaid amounts from prior years. Each Promissory Note required no principal payments until the end of the following tax year. Except for one partial repayment of principal by the S corporation to the taxpayers, no repayments of either principal or interest were made with respect to any of the notes.

Previously, the Partnership had borrowed money on a “non-recourse” basis from a third party lender to acquire and construct real property owned by the Partnership. Under the terms of the Loan Agreement, no portion of the loan proceeds could or were used in the loan arrangements between the taxpayers, the Partnership or the S corporation, and loans from the partnership to the taxpayers were only permitted if the third party lender approved of the loan.

Because the notes the taxpayers issued to the Partnership were assets of the Partnership that the third party lender could pursue and collection in the event of the default, the taxpayers claimed tax basis in the indebtedness for the loans made to the S corporation. Consequently, the taxpayers claimed losses from the S corporation based upon these loans.

In its private letter ruling, the IRS took the position that the loans from the Partnership to the taxpayers were substantially equivalent to the offsetting bookkeeping entries disapproved of in the Orin case, TC Memo 2000-172 (2002). According to the IRS, the circular route of these transfers indicated that there had been no change in the economic positions of the parties. In addition, the IRS noted that the terms of the notes between the taxpayers, the Partnership and the S corporation and a lack of repayment demonstrate that the notes were economically insignificant.

The taxpayers contented that, because their notes to the Partnership may be subject to collection if the Partnership defaults to the third party lender, their loans to the S corporation are truly "at risk" and therefore constitute an actual economic outlay. The IRS, however, noted that the borrowing arrangement between the Partnership and the third party lender was not the same as borrowing by the taxpayer from a third party lender.

This was so for several reasons. First, the taxpayers were not the primary obligors on the loan made by the third party lender - especially since the loans from the third party lender to the Partnership were "non recourse" loans. Second, according to the IRS, any loans made to the owners of the Partnership would have to be approved by the third party lender and therefore it was extremely unlikely that the third party lender would permit such loans where they would jeopardize the third party lender's right to repayment. Finally, any loans made to the owners of the Partnership would have to be made from profits of the Partnership under the terms of the Partnership's loan agreements with the third party lender. Therefore, the loans by the Partnership to the taxpayers could only have been made if the loan from the third party lender was current.

Finally, the fact that the S corporation paid rent to the Partnership, which the Partnership then used to repay the non-recourse debt, further evidenced that no economic outlay existed by the taxpayers.

NOTE: Would the taxpayers have been better off if the Partnerships borrowing from the bank was not on a non-recourse basis? In his PLR, the Service seems to be impressed by the fact that the Partnership borrowed funds from a third party lender on a non-recourse basis which thus nullifying any argument by the taxpayers that they were "at risk" for the borrowings from the Partnership.

D. S Corporation Basis Increase Is Allowed Where S Corporation Shareholder Replaces Corporation Notes for Shareholder Notes. In the case of Miller v. Commissioner, TC Memo 2006-125 (June 25, 2006), the S Corporation owed Notes to the Bank. In this case, Mr. Miller was a shareholder of the S Corporation which had borrowed money from the Bank to finance the S Corporation's operations. All loans were guaranteed by the shareholders, including Mr. Miller. Unfortunately, the Corporation's losses soon exceeded the shareholders' direct investment.

At the end of 1998, the S Corporation had substantial losses and the shareholders believed that the S Corporation would lose additional money in 1999. At that point, Mr. Miller restructured the bank debt by refinancing the bank debt and becoming the primary obligor of the obligations to the Bank, with the S Corporation becoming a guarantor of the Bank debts.

Mr. Miller had the S Corporation's Notes payable to the Bank cancelled and Mr. Miller substituted his own notes to the Bank followed by a Note from the S Corporation to Mr. Miller. Therefore, Mr. Miller became the primary obligor of the bank loans to him personally. Since the Bank's loan to Mr. Miller was fully recourse, and since the Bank could assert collection obligations against Mr. Miller, this strategy allowed Mr. Miller to increase his basis in his S Corporation by the amount of the substituted notes.

According to the Tax Court, this restructure arrangement met the "economic outlay" test under the Hafiz case. It is important to note that, in this case, the Bank's debt to Mr. Miller was fully recourse and therefore the Bank could pursue collection directly against Mr. Miller.

E. Form Over Substance Supports Tax Basis Increase. Gleason v. Commissioner, TC Memo 2006-191 (September 11, 2006). In this case, an S Corporation shareholder borrowed loans from a bank and then re-lent these funds to the S Corporation. The "borrower" on the loan documents was the shareholder himself rather than the S Corporation. Although the S Corporation guaranteed repayment of the loans to the Bank, and even though the S Corporation shareholder pledged his S corporation stock to the Bank to secure these loans, the Tax Court held that the form of the transaction overrode the substance of the transaction and therefore allowed Mr. Gleason to increase his basis in his S Corporation stock by the amount of the loans.

F. Loans From Related Partnership Can Increase Basis Where Loans Made Directly to Shareholders. In the case of Ruckriegel v. Commissioner, TC Memo 2006-78 (April 18, 2006), two brothers were 50/50 owners of an unprofitable S Corporation that operated fast food restaurants. At various times, the taxpayers used funds from their profitable real estate partnership to fund operating losses of the S Corporation. The two brothers argued that loans from the partnership should increase their tax basis in their S Corporation stock.

The partnership funding came from two different transactions:

Direct Loans from the Partnership to the S Corporation. In the first transaction, the partnership loaned money directly to the S Corporation. The sons argued that the "substance" of the loans from their partnership to the S Corporation were really "back to back" loans from the partnership to them individually, and from them individually to the partnership. Unfortunately, these loans did not involve funds going from the partnership to the taxpayers and then to their S Corporation. Moreover, S Corporation minutes purporting to authorize the S Corporation loans were not contemporaneous with those loans. There were no payments of interest from the S Corporation to the taxpayers individually. Thus, loans during the tax year directly from the partnership to the S Corporation did not increase the sons' tax basis in their S Corporation.

Wire Transfers From Partnership to Shareholders to S Corporation. The second transaction involved wire transfers . The partnership made wire transfers to the S Corporation shareholders and the same funds were then wired by the sons to the S Corporation. Thus, this fact was sufficient to establish that the shareholders could increase their basis by the wired transferred amounts.

II. 2005 and Brooks vs. Commissioner: Open Account Advances and Repayments to S Corporations: In 2005, Tax Court Holds That Loan Advances to an S Corporation, and Subsequent Loan Repayments, Pursuant to an "Open Account" Debt Arrangement May Be Netted Against Each Other for Tax Purposes.

A. Review of Section 1367 Rules. Section 1367 provides the normal general rules which state that a shareholder's tax basis in his stock is increased by items of income for the year and decreased by expenses and losses for the year.

Section 1367(b)(2) provides special rules for adjustments to the tax basis of shareholder indebtedness. Under Section 1367(b)(2)(A), if an S Corporation's losses and expenses reduce the taxpayer's basis in his stock down to zero, any such additional losses or expenses shall be applied to reduce the shareholder's tax basis in any indebtedness of the S Corporation to the shareholder.

Moreover, under Section 1367(b)(2)(B), once there is a reduction in the shareholder's tax basis in the indebtedness of an S Corporation to the shareholder, any net increase of basis attributable to items of income for any subsequent taxable year shall be applied to restore such reduction in basis of indebtedness before any such increases may be used to increase the shareholder's tax basis in the stock of the S Corporation.

Regulation Section 1.1367-2(a) provides that shareholder advances which are not evidenced by separate written instruments and repayments on the advances ("open account debt") are treated as a **"single indebtedness."**

Under Reg. Section 1.1367-2(c)(2), if a shareholder holds more than one indebtedness as of the beginning of a tax year, then any net increase is applied first to restore the reduction of basis in any indebtedness repaid (in whole or in part) in that taxable year to the extent necessary to offset any gain that would otherwise be realized on the repayment. Any remaining net increase is applied to restore each outstanding indebtedness in proportion to the amount that the basis of each outstanding indebtedness has been reduced.

The Brooks case (discussed below) illustrates how beneficial these "open account" rules are to prevent gain that would otherwise be recognized when an S Corporation makes a mid-year loan repayment. Relying on the Cornelius case, the tax court held that the tax basis of a shareholder's open account debt is properly determined **at the close** of an S Corporation's tax year by first netting advances and repayments of open account debt during the tax year and then making any necessary debt basis adjustments.

B. "Open Account" Rules Allow For "Netting" of Advances and Repayments. In the case of Brooks v. Commissioner, TC Memo 2005-204 (August 25, 2005), Mr. and Mrs. Brooks (the shareholders) owned all the stock of their S Corporation. Mr. and Mrs. Brooks made "open account loans" to their S Corporation and, from time to time, the S Corporation paid these loans back. The loans and repayment thereof were made pursuant to an "open account" loan.

An "open account" loan is essentially equivalent to a revolving line of credit made by a third party lender. Accordingly, under an open account loan, advances are made from time to time and loan repayments are made from time to time.

The Tax Court case involved the 1999 and 2000 tax years. The following is a summary of advances and loan repayments made pursuant to the "open account" loan:

1. During 1997, Mr. and Mrs. Brooks advanced $1,000,000 to their corporation.

2. At the end of 1998, the balance of the debt was $1,000,000.

3. In 1997 and 1998, the S Corporation generated a loss of over $1,000,000 and, at the end of 1998, Mr. and Mrs. Brooks' tax basis in their loans was zero.

4. On January 5, 1999, the Company repaid the $1,000,000 loan.

5. On December 31, 1999, the shareholders loaned an additional $1,600,000 to their corporation.

6. On January 3, 2000, the Company repaid the $1,600,000 loan from the shareholders.

7. On December 29, 2000, the Shareholders loaned an additional $2,200,000 to their S Corporation.

At all times, the stockholders each had a zero tax basis in their stock.

The IRS took the position that, when the Company repaid the $1,000,000 loan on January 5, 1999 (item 4 above), this generated taxable income to the shareholders. The taxpayers, however, contended that no gain should be recognized by the loan repayment due to the fact that the shareholders made an additional loan of $1,600,000 to the company on December 31, 1999 (item 5 above). The shareholders-taxpayers took the position that this loan of $1,600,000 on December 31, 1999 should "offset" the January 5, 1999 loan repayment and allow for a deduction of $600,000 of 1999 losses by the S Corporation, since the first repayment and second loan occurred in the same tax year.

Likewise, for 2000, the IRS similarly took the position that the loan repayment of $1,600,000 on December 3, 2000 (item 6 above) generated taxable gain to the shareholders. The shareholders, of course, contended that the January 3 loan repayment should be "netted" against their loan of $2,200,000 which took place on December 29, 2000 (item 7 above), since the first repayment and second loan occurred in the same tax year.

In the Tax Court proceeding, the Tax Court noted that, for the purpose of determining taxable income upon an S Corporation's repayment of a shareholder advance, a separate transaction involving an advance and repayment of indebtedness is generally treated separately. Regulation Section 1.1367-2(a), (b)(3), and (c)(2). Thus, shareholders may not offset the repayment of a shareholder advance with the basis of another separate shareholder advance.

The Tax Court noted, however, that multiple shareholder advances and repayments with respect to "open account indebtedness" are treated as a **single indebtedness** rather than separate indebtedness. Cornelius v. Commissioner, 494 F.2d 465 (5th Circuit 1974); Regulation Section 1.1367-2(a).

Thus, relying on the Cornelius case, the tax court held that the tax basis of a shareholder's open account debt is properly determined **at the close** of an S Corporation's tax year by first netting advances and repayments of open account debt during the tax year and then making any necessary debt basis adjustments. Ultimately, the Tax Court agreed with the

taxpayers and held that, since the debt arrangement in the Brooks case involved "open account debt," Mr. and Mrs. Brooks were allowed to use their additional loans in December 1999 and December 2000 to offset loan repayments from the Company during January 1999 and January 2000 and also allowed the taxpayers to claim additional losses during 1999 and 2000.

NOTE: This case provides the benefits of using “open account” indebtedness when making shareholder advances to an S Corporation. For this reason, we frequently use revolving credit promissory note arrangements to evidence loans being made from time to time. In the Brooks case, if the loans had been made separately (via with loan documentation evidencing separate loans through multiple promissory notes), the tax court may well have held that the January 1999 and 2000 loan repayments constitute taxable income to Mr. and Mrs. Brooks.

Unfortunately, the tax court case does not indicate how taxpayers must establish that they are making loans on an “open account” basis. For some unexplained reason, in the Brooks case, the IRS did not argue that Mr. and Mrs. Brooks had made separate advances.

NOTE: Even if a taxpayer succeeds in making an argument for a single, open account, the taxpayer still needs to pay attention to timing. If the advances occur at the end of the year, and the repayment occurs shortly after the start of the next year, the IRS may argue that the advance is a “sham” to generate a tax loss, and in that case, the IRS may disregard the entire transaction.

III. S Corporations: New Proposed Regulations Restrict the Use of "Open Account Debt" to Increase Basis and Deduct Losses.

On April 11, 2007, the IRS issued new Proposed Regulations 1.1367-2(a). The proposed regs would apply to shareholder advances to an S corporation made on or after the date the regs are published as final regs and repayments on those advances by the S corporation.

A. Background of Loss Deduction Rules for S Corporations. A shareholder can deduct his pro-rata share of S corporation losses **only** to the extent of the total of his basis in (a) the S corporation stock, **plus** (b) debt owed him by the S corporation. (Code Sec. 1366(d)). If an S corporation repays a debt owed to a shareholder after his basis is reduced by losses and deductions passed through to him, the shareholder realizes income to the extent of the amount repaid over the reduced basis of the debt. Smith (CA 9 1970, 25 AFTR 2d 70-936, affg (1967) 48 TC 872).

B. **<u>Current Open Account Debt Rules</u>.** Under existing regs, S corporation shareholders' advances, which are **<u>not</u>** evidenced by separate written instruments, and repayment on the advances, are treated as a single debt. Reg. §1.1367-2(a). Therefore, there is no reduction for debts that, during the year, are satisfied by the corporation, or disposed of or forgiven by the shareholder. (Reg. §1.1367-2(b)). Adjustments to an S corporation shareholder's basis in debt are generally determined as of the **close** of the S corporation's tax year and are effective at that time. If any part of a debt is disposed of or repaid **<u>before</u>** the close of the tax year, the basis of that debt is restored, effective immediately before the disposition or first repayment. (Reg. §1.1367-2(d)).

C. **<u>Purpose of New "Open Account Debt" Proposed Regulations</u>.** The purpose of these new proposed regulations would be to limit "open account debt" from an S Corporation to a shareholder for debt not evidenced by a written instrument. Under the new regs, qualifying open account debt is limited to debt for which the principal amount of the aggregate advances does not exceed $10,000 at the close of any stage in the S Corporation's tax year.

The proposed regulations will reverse the result of <u>Brooks v. Commissioner</u>, TC Memo 2005-204 (August 25, 2005), which allowed an S Corporation shareholder to (i) borrow money from a bank, (ii) advance the funds to the shareholder's S Corporation - which increased basis and allowed loss deductions, (iii) received repayment of the debt in the subsequent tax year, (iv) repaid the bank, and (v) then at the end of the year again borrowed funds from the bank and then loaned these funds to the S Corporation to avoid gain on the release from the low basis debt and deduct for the losses. In <u>Brooks</u>, the taxpayer was able to create endless deferrals of gain through the use of the open account debt rules.

Thus, under the new Proposed Regulations 1.1367-2(d), whenever advances, which are not evidenced by written instruments, exceed $10,000, the indebtedness will be treated as a separate indebtedness, which payments and advances are separately determined for purposes of basis and gain recognition upon repayment.

IV. IRS Adds Simplified Method For Requesting Late S Corp Election Relief; No User Fees Apply; Rev. Proc. 2007-62.

A. **<u>Introduction</u>.** The IRS has provided an additional simplified method to request relief for late S corp elections. In addition, it has provided a simplified method that combines a request to make a late S corp election with a request for relief to make a late corporate classification election intended to be effective on the same date as the S corp election. Rev. Proc. 2007-62 provides procedures in lieu of the letter ruling process ordinarily required to obtain relief for late elections.

> **Note:** Rev. Proc. 2007-62 supplements, but does not replace, Revenue Procedures 2003-43 and 2004-48. Because no ruling is being requested, **user fees do not apply** to requests for relief under Rev. Proc. 2007-62.

B. New Simplified Relief for late S election Under Rev. Proc. 2007-62. An entity may request relief under the new procedure if it satisfies several requirements:

1. It failed to qualify as an S corp solely because it failed to file a timely Form 2553, Election by a Small Business Corporation, with the correct IRS Service Center;

2. It has reasonable cause for filing to timely file;

3. It has not filed a tax return for the first year for which the election is intended;

4. The application for relief is filed no later than six months after the due date of the tax return (excluding extensions) for the first year of the election; and

5. No taxpayer (including the S corp shareholders) has reported inconsistently with S corp status on any affected return.

The entity must file Form 2553 with the correct IRS office, accompanied by Form 1120S, Income Tax Return for an S Corporation. The entity must also submit a statement establishing reasonable cause for failing to make a timely election. The IRS indicated that Form 2553 will be revised to accommodate this statement.

C. Corporate Classification. Under the entity classification regs, Reg. §301.7701-3, a domestic eligible entity is a partnership if it has two or more members and is a disregarded entity if it has a single owner. An eligible entity can elect to be an association taxable as a corporation by filing Form 8832, Entity Classification Election, with the IRS.

If the eligible entity timely elects to be an S corp, it will be treated as having timely elected to be classified as an association, provided the entity meets all other S corporation requirements.

An entity may request relief under this portion of Rev. Proc. 2007-62 if it satisfies the following requirements:

1. The entity is an eligible entity;

2. The entity intended to be a corporation when it intended to become an S corp;

3. The entity failed to qualify as a corporation solely because it failed to file Form 8832;

4. The entity failed to qualify as an S corp solely because the S corp election was not timely filed;

5. The entity has reasonable cause for failing to timely file Forms 2553 and 8832;

6. The entity has not filed a tax return for the first year for which the S corp election would apply;

7. The application for relief is filed within six months of the due date of the S corp return (excluding extensions) for its first year; and

8. No taxpayer has reported inconsistently with the S corp election on any affected return.

The entity requests relief by filing Forms 2443 and 1120S with a statement explaining the reason for failing to timely file the S corp election and the entity classification election. If the IRS grants relief, the entity is treated as having made a timely election to be classified as an association taxable as a corporation.

Note: The new procedures under Rev. Proc. 2007-62 apply to elections intended to be effective for tax years that end on or after December 31, 2007.

Note No User Fees: Because no ruling is being requested, user fees do not apply to requests for relief under Rev. Proc. 2007-62.

D. Rev. Proc. 2003-43 May Provide Relief Where Rev. Proc. 2007-62 Does Not. Rev. Proc. 2007-62 supplements, but does not replace, Revenue Procedures 2003-43 and 2004-48. So, even if you don't qualify for relief under Rev. Proc. 2007-62, you may still be entitled to relief under Revenue Procedures 2003-43 and 2004-48.

Rev. Proc. 2003-43, 2003-23 IRB (June 6, 2003) provides a simplified method of securing relief for taxpayers requesting relief from **late**:

1. S Corporation elections;
2. Electing small business trust elections;
3. Qualified Subchapter S trust elections; and
4. Qualified Subchapter S Subsidiary elections.

Qualifying entities generally can get relief by acting within **twenty-four months** of the election's due date. Rev. Proc. 2003-43 provides procedures in lieu of the private letter ruling process ordinarily used to obtain late election relief. Therefore, user fees **do not apply** to corrective actions taken under Rev. Proc. 2003-43.

Relief is available under Rev. Proc 2003-43 if the following requirements are met:

1. The entity fails to qualify for its intended status as an S Corporation, ESBT, QSST or Q-Sub on the first day that status was desired **solely because of failure to timely file the appropriate election**;

2. Less than **twenty-four months** have passed since the original due date of the election;

3. The entity is seeking relief and has **reasonable cause** for failure to timely make an election; and

4. One of the following two sets of additional requirements is met:

   (a) First Alternative. All of the following requirements must be met under the First Alternative:

      (1) The entity seeking to make the election has **not** **filed** a tax return for the first year in which the election was intended;

      (2) The Application for Relief is filed no later than six months after the **unextended** due date of the tax return for the entity seeking relief; and

      (3) No taxpayer has reported inconsistently with the S Election.

   (b) Second Alternative. All of the following requirements must be met under the Second Alternative:

      (1) The entity seeking to make the election has filed a tax return for the first year in which the election was intended within six months of the original due date for filing the tax return (excluding extensions).

      (2) All taxpayers whose tax liability would be affected by the election have reported consistently with the S Corporation election on all effective returns for which the election was intended.

NOTE: An S Corporation that has already filed its S Corporation return would not qualify for Rev. Proc. 2007-62 relief, but may be eligible for "second alternative" relief under Rev. Proc. 2003-43.

E. Rev. Proc. 97-48 Relief Still Available Where Rev. Proc 2003-43 and Rev. Proc. 2007-62 Relief Not Available. A corporation or trust that does not qualify for Rev. Proc. 2003-43 or Rev. Proc. 2007-62 relief may request relief by requesting a private letter ruling (and paying a user fee). Also, certain corporations may be eligible for automatic late S Corporation relief under Rev. Proc. 97-48.

For example, a taxpayer would not qualify for Rev. Proc. 2003-43 relief if it failed to file its first S Corporation tax return within six (6) months after the original due date ("Second Alternative Relief") or where the Application for Relief was not filed within six months of the due date of the tax return (excluding extensions) ("First Alternative Relief"). Likewise, a taxpayer would not qualify for Rev. Proc. 2003-43 relief if the S election was more than 24 months late. Fortunately, Rev. Proc. 2003-43 makes it clear that taxpayers who do not qualify for Rev. Proc. 2003-43 late relief may still seek relief under Rev. Proc. 97-48 in lieu of requesting a private letter ruling (and paying a user fee). Rev. Proc. 97-48 provides for **automatic relief** for certain late S elections, but the Revenue Procedure **only** applies to two situations:

1. the corporation intends to be an S Corporation and the corporation and the shareholders reported their income consistent with S Corporation status for the taxable year the S election should have been made and for every subsequent year, **and** the corporation did not receive notification from the IRS regarding any problem with the S Corporation status within **six months** from the date on which Form 1120S for the first tax year was timely filed; and

2. If all of the following requirements are met: (i) the corporation intends to be an S Corporation, but, due to the late S Corporation election, the S Corporation was not permitted to be an S Corporation for its first taxable year (because the late S Corporation election relief was not available during this period), and (ii) the corporation received notification from the IRS that the corporation must file as a C Corporation for its first taxable year but that the corporation will be treated as an S Corporation for its next taxable year, and (iii) the corporation and shareholders treated the corporation as an S Corporation for all subsequent years and relevant taxable years for both the corporation and all of its shareholders.

> **NOTE**: For Rev. Proc. 97-48 relief, the statute of limitations must not have expired for any tax years of the corporation. This revenue procedure does not apply to late shareholder elections, including a QSST election, or an electing small business trust election.

PART SIX
IRS AUDITS, COLLECTION AND PENALTIES
AND OTHER MISCELLANEOUS ITEMS

I. Individual Taxpayer's Agreement to Extend the IRS Statute of Limitations on Assessment Did Not Apply to Tax Assessments Related to Partnership Pass-Through Income; Alan Ginsburg, 127 TC 75 (2006).

A. Background. In IRS audits, the IRS will frequently request the taxpayers to agree to extend the statute of limitations either during the audit process or during pendency of IRS appeals. The statute of limitations waiver form is known as Form 872. The Form 872 will extend the statute of limitations only with respect to matters specifically addressed on the Form 872 itself.

In the case of Alan Ginsberg discussed below, the taxpayer successfully argued that his executed Form 872 did not specifically apply to partnership pass-through income and thus he was able to dodge the bullet on partnership pass-through items.

B. General Waiver Rules. Section 6229(b)(1)(A) provides that the assessment period, with respect to any tax attributable to any partnership item or affected item, may be extended for any partner by an agreement entered into between the IRS and that partner before the expiration of the assessment period. **However, a waiver will not apply to a partnership's items unless the agreement expressly provides that it does so. Section 6229(b)(3).**

C. The Alan Ginsburg case. In the case of Alan Ginsburg, 127 TC 75 (2006), the taxpayers were husband and wife that claimed partnership losses on their tax return. During the audit period, they executed nine (9) consecutive waivers on Form 872, and the IRS sent them a Notice of Deficiency before the statute of limitations period expired. However, the Tax Court held that the Notice was untimely because the last executed Form 872 did not reference adjustment for partnership or affected items.

Earlier, the taxpayers executed a Form 872 which stated that it included any items attributable to a partnership in which the taxpayers were partners. However, the last Form 872 did not reference partnership items.

When the IRS finally got around to issuing a Notice of Deficiency to the Ginsburgs, the Notice of Deficiency referenced the partnership's pass-through income. The Ginsburgs successfully argued that partnership pass-through items were not covered under the last executed Form 872, since the last executed Form 872 did not specifically reference partnership pass-through items.

Essentially, the Ginsburgs were allowed to "dodge the bullet" on any assessments relating to partnership pass-through items.

NOTE: Notwithstanding the Ginsburg decision, in other cases, the fact that the waiver form, Form 872, does not specifically refer to the term "partnership item," will not always be fatal to a finding that the IRS has met the requirements of Code Section 6229(b)(3). For example, in the case of Foam Recycling Associates, TC Memo 1992-645 (1992), affirmed 159 F3d 1346 (1998), the Court held that the Form 872-A, signed by the taxpayer, adequately described those items that were partnership items because the Form 872 referred to the taxpayer's "distributive share of any item of income, gain, loss deduction or credit of or distribution from" the partnership. Likewise, a Form 872 waiver consent, which did not specifically refer to partnership items, was still held valid where the only items on the taxpayer's individual tax return were partnership items. In that case, the IRS successfully took the position that, in this situation, the only items for which the parties could possibly have contemplated extending the period of limitations were partnership items. Field Service Advice 533, Vaughn No. 533.

D. Considerations in Whether or Not to Agree to Extend the Statute of Limitations. Again, the IRS will often ask that we agree to extend the statute of limitations during the audit process or during appeals.

1. Possible Benefits of Agreeing to SOL Extension. Normally, taxpayers will be inclined to extend the statute of limitations period for the following reasons:

1. If you do not agree to extend the statute of limitations, the IRS will go ahead and assess tax anyway;
2. To extend the professional courtesy to the IRS (which hopefully will be reciprocated);
3. To give a client (and his representative) more time to prepare their case;
4. To give the taxpayer (and his representative) more time to challenge the assessment without having to go to Tax Court; and
5. In hopes that, by extending the statute of limitations, the IRS restructuring or transfers of Revenue Agents, etc. will benefit the taxpayer by the passage of time.

2. But, Never Extend the SOL for More Than One Year. However, we must not forget that a carefully negotiated Form 872, Waiver Extension Agreement, may provide us with valuable negotiating opportunities on behalf of our client. For example, it is probably "best practice" to never agree to **more than a one year** statute of limitation extension for the following reasons:

1. If we extend the limitations period out 2-3 years, there is a tendency to let things languish and this keeps the accrual of interest running.

2. Limiting the statute of limitations to one year keeps the IRS under pressure to try and get these cases resolved.

3. Sometimes the IRS will simply blow a statute of limitations such as where Revenue Agents or Appeals Officers have left, been sick, gone in training or have been transferred.

For all these reasons, it is perhaps a best practice never to agree to **more than a one year** statute of limitations.

3. In Some Cases You Might Want To Refuse To Extend the SOL At All. In other cases, it may make sense to **not agree to any statute of limitations extension at all** and to force the IRS to go ahead and issue the statutory Notice of Deficiency. This is particularly true in the case of **complex** audits where taxpayers have multiple potential tax audit issues that the examining agent simply missed during the examination process. Indeed, it is possible that if you do not extend the statute of limitations at all, the IRS may go ahead and assess tax based upon the issues they have discovered at that point, but indeed they may miss other potential tax issues.

The case of Strangi v. Commissioner, 417 F.3d 468 (5th Cir. 2005), is a classic example of this possibility. In the Strangi case, the IRS, in a family limited partnership case, issued a statutory Notice of Deficiency, but missed the whole Section 2036 argument. While the IRS ultimately won the Strangi case on appeal, the IRS would have collected a lot more money had the IRS advanced the Section 2036 argument in its statutory Notice of Deficiency.

II. Tax Planning for Clients Facing Bankruptcy and the Benefits of a Section 1398 Election

The case of Skiba v. Knee (B.R., 2006 WL 3087689, Sept. 12, 2006) (Bankruptcy Court for the Western District of Pennsylvania 2006) illustrates the importance of making a Section 1398 election before filing bankruptcy.

A. Background. IRC Section 1398 allows an individual debtor, in a Chapter 7 bankruptcy case, to make an election to divide the debtor's tax year into two taxable periods: (i) the Pre-Petition period ending on the day before the bankruptcy petition date, and (ii) the Post-Petition period beginning on the petition date.

B. Benefits of Making the Section 1398 Election. The effect of a Section 1398 election is to burden the debtor's bankruptcy estate with any income tax liability for transactions during that part of the tax year preceding the bankruptcy filing. That is usually a good thing to do, because it assures that the assets of the debtor will go to pay their income tax liability. This is an important consideration, since that pre-petition income tax liability will not be discharged in bankruptcy, and thus a Section 1398 election will insure that the Bankruptcy Court's assets will be used to pay pre-petition tax debts, including the debtor's pre-petition income tax liabilities.

C. Facts of the Skiba v. Knee case (B.R., 2006 WL 3087689, Sept. 12, 2006). In this case, Mr. Skiba was a bankruptcy trustee for Mr. and Mrs. Knee. Mr. and Mrs. Knee had sold their tavern and restaurant business in exchange for an installment note about three months before they filed for protection under Chapter 7 of the Bankruptcy Code. Mr. and Mrs. Knee recognized taxable gain on the sale of their tavern and restaurant business which generated a tax liability of around $10,000. Part of this tax liability was recognized before the Bankruptcy Petition date under the installment sales rules, but most of the tax liability was generated after the Bankruptcy Petition date under the installment sales rules.

Because Mr. and Mrs. Knee did not make an election under Section 1398 to close their tax year on the day before they filed for bankruptcy, the tax liability generated from the installment sale note remained their responsibility as a Post-Petition debt.

However, if Mr. and Mrs. Knee had made the Section 1398 election, the Pre-Petition tax liability would have been a priority claim in bankruptcy which probably would have been satisfied from their other assets in the bankruptcy estate. Thus, if Mr. and Mrs. Knee had made a Section 1398 election, the assets of the bankruptcy estate would have been used to pay the Knee's non-dischargeable tax liabilities ahead of other debts (such as credit card debt) that would have been dischargeable in bankruptcy any way.

III. Corporation Liable for the Underpayment of Payroll Tax Penalties Notwithstanding Embezzlement by a Payroll Company; Pediatric Affiliates v. U.S., 99 AFTR 2d 2007-2240 (3rd Cir., April 16, 2007).

A. Background. IRC §6651 provides for the "failure to pay" penalty whenever a taxpayer fails to pay taxes owed to the IRS. However, the Section 6651 penalty will not be assessed when the taxpayer can show that the failure to pay (1) did not result from willful neglect and (2) was due to reasonable cause. Under past cases, "reasonable cause," which excuses a taxpayer from the § 6651 penalty, exists if the taxpayer exercised "ordinary business care and prudence," but nevertheless was unable to file the return within the prescribed time.

B. Reliance Upon Payroll Company Does Not Excuse §6651 Penalty. In the case of Pediatric Affiliates v. U.S., 97 AFTR 2d 2006-1329 (February 23, 2006), Pediatric Affiliates was a medical service company which outsourced its payroll functions to an independent payroll company. Pediatric Affiliates hired PAL Data Processing, Inc. to handle its payroll needs. Mr. Hirsh owned all of PAL. Mr. Hirsh would routinely send Pediatric a tax form that accurately calculated Pediatric's payroll taxes and Pediatric would remit the funds to PAL. However, Mr. Hirsh would send only part of the payments to the IRS, keeping the rest. Mr. Hirsh engaged in the same practice for more of his other clients and embezzled money from all of them. Pediatric learned of Mr. Hirsh's misappropriation when the IRS sent Pediatric a notice of its underpaid payroll taxes. Further on, Mr. Hirsh received prison time for his embezzlement.

The IRS levied against the asset of Pediatric for the unpaid payroll taxes. Pediatric took the position that it was not liable for the tax deficiency or interest because it had paid the correct amount to PAL. Previously, a federal district court in New Jersey held for the IRS and Pediatric appealed. Ultimately, the First Circuit Court of Appeals cited the U.S. Supreme Court case of U.S. v. Boyle for the well established principle that reliance on a third party does not excuse a taxpayer of its obligations. Thus, Pediatric was held liable to the IRS for the del1quent taxes plus interest - effectively causing Pediatric to pay the tax twice - once to Mr. Hirsh through his embezzlement and again to the IRS.

On appeal, the Third Circuit Court of Appeals upheld the tax court's decision from 2006. Pediatric Affiliates v. U.S., 99 AFTR 2d 2007-2240 (April 16, 2007).

NOTE: May there be a limited defense where the embezzlement is conducted by a senior corporate officer? In the Pediatric Affiliates case, the U. S. District Court also discussed the case of American Biomaterials Corporation, 69 AFTR 2d 92-611 (January 23, 1992). In that case, a corporation president embezzled payroll taxes and a court held that, since the president was a corporate officer and in a position of authority when he embezzled corporate funds, the corporation would not be liable for failure to pay or failure to file penalties. According to the court, a corporation is a legal entity which an act only through its corporate officers and in that case only the president had authority over tax filings.

The American Biomaterials case is a 3rd Circuit case and cannot be relied upon as precedent in the 4th Circuit. Also, the facts of American Biomaterials are very limited and rarely will apply. In American Biomaterials, the IRS failed to raise the issue as to whether the corporation had adequate controls in place to ensure payment of taxes.

IV. The IRS Has a Statutory Duty to Protect Collateral, But The IRS Has Wide Discretion on How to Collect Upon This Collateral. Process Pipe Fabricators, Inc. v. U.S., AFTR 2d 2007-3349 (June 14, 2007).

A. Review of Section 6335(f) Rules. Section 6335(f) provides that a taxpayer may request, in writing, that the IRS sell any property seized by a levy within sixty (60) days after such written request. And, the IRS shall comply with the taxpayer's request (that the IRS sell any property seized by a levy) within sixty (60) days after such written request unless the IRS determines (and notifies the taxpayer within such 60 day period) that its sale would not be in the best interest of the IRS. Reg. 301.6335-1(d) provides the form and manner in which the taxpayer must provide written sale instructions to the IRS.

B. IRS Did Not Violate Section 6335(f) Where the Seized Collateral Had No Value. In the case of Process Pipe Fabricators, Inc. v. U.S., 99 AFTR 2d 2007-3349 (June 14, 2007), Process Pipe Fabricators, Inc. owed back employment taxes to the IRS.

Ultimately, the IRS seized upon whatever collateral they could seize in order to satisfy the tax debts of Process Pipe. One of the most significant assets of Process Pipe, which the IRS levied upon, was an accounts receivable owed by one of the Process Pipe Fabricators' customers. Later on, after extensive collection actions against the customer, the IRS settled for less than the full amount owed by the customer.

Process Pipe Fabricators brought action against the IRS and sought to have its tax liability reduced by the full amount of the account receivable existing as of the date of the levy. Essentially, Process Pipe Fabricators took the position that, under Section 6335(f), the **IRS had a duty** to maximize its recovery against the Process Pipe Fabricator customer and that the **IRS had breached its duty** by failing to collect the maximum amount that could have been collected.

However, the U.S. District Court determined that, when the IRS levied upon invoices owed by the customer, the customer already was close to bankruptcy or at least insolvent at that time. Thus, Process Pipe could not prove that the IRS was negligent or that it had failed to properly act to maximize recovery against the customer. Therefore, the IRS was not precluded, under Section 6335(f), from attempting to collect any portion of the deficiency from the Process Pipe Fabricators.

NOTE: What can we learn from the Process Pipe Fabricators case? It is clear that the IRS has some duty to sell collateral that has been seized after written instructions from the taxpayer, and presumably if the IRS does not take reasonable steps to maximize recovery on the sale, then the IRS may be responsible for the damages that result from the reduced value of that collateral**.** Section 6335(f).

In cases such as these, however, the IRS has broad discretion in selling collateral as they deem in their best interest. Perhaps, however, the taxpayer in Process Pipe could have done better by providing the IRS with written notice under Section 6335(f) and Reg. 301.6335-1(d) and by providing the IRS with insight as to how it could maximize its recovery on the collateral.

At the very least, the taxpayer should have started a better paper trail in issuing written demands to the IRS that it more quickly pursue collection actions against the customer and indeed the taxpayer probably should have offered assistance to the IRS in collecting on that collateral.

V. Dissolved Corporation Cannot Litigate Tax Liability; L.V. Castle Investment Group, Inc. v. Commissioner, 98 ATR 2d 2006-6819 (September 26, 2006)

A. L.V. Castle Investment Group Case. In the case of L.V. Castle Investment Group, Inc. v. Commissioner, 98 ATR 2d 2006-6819 (September 26, 2006), the taxpayer was an Illinois corporation that was administratively dissolved on **October 1, 1996** because it failed to file its annual report and pay its franchise taxes. Under Illinois law, a dissolved

corporation must wind up its affairs within five (5) years and must initiate any litigation within the five year wind-up period.

The corporation failed to file an annual income tax return for the period ending June 30, 1996. The corporation finally filed its return on June 14, 2001. Three years later, on June 9, 2004, the IRS issued a Notice of Deficiency against the corporation. The corporation and its sole shareholder filed a Tax Court Petition on September 13, 2004.

The Tax Court, however, dismissed the Tax Court Petition on the basis that the corporation had no corporate authority or power to file the Tax Court Petition since it had no capacity to take any corporate action after the expiration of the five year wind-up period which expired in October 2001.

B. What is the practical effect if the Corporation had already been liquidated? If the Corporation had no assets which would be subject to IRS collection actions (because the corporation had already liquidated), then presumably the IRS would attempt to assert transferee liability against the shareholders under Section 6901. In that case, the shareholders could then challenge the tax assessment in the "transferee liability" proceedings under Section 6901.

C. However, what if the corporation had not yet been liquidated? In that case, the assets of the corporation would have been subject to IRS tax assessment and, in that case, the taxpayer-shareholder would have no grounds to contest the IRS tax assessments against the corporation.

D. North Carolina Rules for Dissolved Corporations.

1. General. North Carolina corporate laws do not contain a five year windup period for dissolved companies. Therefore, in North Carolina it may be easier to "contest" IRS tax assessments where the corporation has been dissolved.

2. Voluntary Dissolution. N.C.G.S. 55-14-03(a) provides that a corporation may voluntarily dissolve by filing Articles of Dissolution with the North Carolina Secretary of State. Under N.C.G.S. 55-14-03(b), a corporation is dissolved upon the effective date of its Articles of Dissolution. The corporation may "revoke" its dissolution within 120 days after the effective date. N.C.G.S. 55-14-04(a). Under N.C.G.S. 55-14-05, a dissolved corporation continues its corporate existence, but may not carry on any business except that appropriate to wind up and liquidate its business and affairs, including discharging or making provision for discharging its liabilities. N.C.G.S. 55-14-05(a)(3). Also, voluntary dissolution does not prevent commencement of a proceeding by or against the corporation in its corporate name. N.C.G.S. 55-14-05(b)(5).

Presumably, therefore, in the case of a voluntary dissolution, a North Carolina corporation could contest assessed tax liabilities.

3. Involuntary Dissolution. Different rules, however, apply in the case of a North Carolina corporation which is "administratively" dissolved. Under N.C.G.S. 55-14-20, a corporation may be administratively dissolved by the North Carolina Secretary of State if it fails to file its annual reports. The corporation then has sixty (60) days after notice from the Secretary of State to file its annual reports and therefore avoid administrative dissolution. N.C.G.S. 55-14-21.

Once the corporation is administratively dissolved, it may apply for reinstatement at any time thereafter by filing an application with the North Carolina Secretary of State and by curing any defects. N.C.G.S. 55-14-22(b). If the North Carolina Secretary of State reinstates the corporation, then the reinstatement is effective and relates back to and takes effect as of the date of the administrative dissolution and the corporation resumes carrying on its business as if the administrative dissolution had never occurred. N.C.G.S. 55-14-22(c).

4. Conclusion. The point of all of this is that a North Carolina corporation may have a difficult in getting its charter reinstated in time to file a U.S. Tax Court Petition or challenge an IRS tax assessment. So, it is incumbent upon the corporation's advisors that they immediately take any steps necessary to have a dissolved corporation's charter reinstated as soon as the first notice of a possible tax assessment problem. Otherwise, the taxpayer-corporation may have a difficult time convincing the IRS (or the Tax Court) that it has corporate authority to challenge the tax assessment either administratively or through a U.S. Tax Court Petition.

VI. New Changes to Section 6694 Tax Penalties On Tax Return Preparers.

A. Overview. The Small Business and Work Opportunity Act of 2007 ("Small Business Act, " PL 110-28) made surprising changes to Code Section 6694. These changes will dramatically affect all tax return preparers. The new rules went into effect on **May 27, 2007.**

In the Small Business Act, Congress amended Section 6694 as follows:

1. It extended Section 6694 to apply to all tax returns, not just income tax returns (for example, the new preparer penalties will now apply to estate and gift tax returns and employment tax returns).

2. It replaced the "realistic possibility" standard with a "more likely than not" standard. Thus, unless a tax return preparer believes that a position taken on the return is more likely than not correct, he would be subject to penalty unless the position is disclosed on the return.

3. Altered the minimum standard for a disclosed position on a return from a "not frivolous" to a "reasonable basis" which is a higher standard. Thus, if a Court were to conclude that the position taken by a return preparer was not

reasonable, he could be penalized under Section 6694 even if the position was adequately discussed.

4. Increased the penalty for violation of Code Section 6694(a) from $250 to the greater of (i) $1,000 or (ii) 50% of the fee for the tax return preparation work.

5. In the event of an understatement resulting from a wilful understatement, or intentional or reckless disregard of the rules or regulations, the penalty has been increased to the greater of (i) $5,000 or (ii) 50% of the preparer fees.

B. Section 6694 Rules Before the New Act Amendment Changes. Before the new Tax Act, the primary threshold for tax return preparers was the "realistic possibility" standard. This required that the tax return preparer must have a **33% likelihood** that the position taken on a tax return would be upheld. In addition, a tax practitioner could only be fined $250.00 for understatement of tax due to a "unrealistic position" on a tax return. In addition, the penalty was waived if the return included a disclosure of the preparer's "non-frivolous" position or if the preparer had acted in good faith. In general, a "non-frivolous" position has a greater than 5% likelihood of being sustained on the merits.

In addition, the "realistic possibility" standard (more than 1 of 3 chance) was also incorporated into Circular 230 and in AICPA Statements on Standards for Tax Services. In summary, under the old rules, tax practitioners were protected by the "realistic possibility" standard (the 1 in 3 standard) for purposes of Section 6694 penalties and under Circular 230 and under the AICPA standards.

C. New Changes to Section 6694(a). The Small Business and Work Opportunity Tax Act has substantially amended Section 6694. Section 6694 now provides as follows:

(a) Understatement Due to Unreasonable Positions –

(1) In General - Any tax return preparer who prepares any return or claim for refund with respect to which any part of an understatement of liability is due to a position described in paragraph (2) shall pay a penalty with respect to each such return or claim in an amount equal to the greater of –

(A) $1,000, or
(B) 50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.

(2) Unreasonable Position - A position is described in this paragraph if –

(A) the tax return preparer knew (or reasonably should have known) of the position,

(B) there was not a reasonable belief that the position would more likely than not be sustained on its merits, and

(C) (i) the position was not disclosed as provided in Section 6662(d)(2)(B)(ii), or

(ii) there was no reasonable basis for the position

(3) Reasonable Cause Exception – No penalty shall be imposed under this subsection if it is shown that there is reasonable cause for the understatement and the tax return preparer acted in good faith.

(b) Understatement due to Willful or Reckless Conduct –

(1) In General – Any tax return preparer who prepares any return or claim for refund with respect to which any part of an understatement of liability is due to a conduct described in paragraph (2) shall pay a penalty with respect to each such return or claim in an amount equal to the greater of –

(A) $5,000, or

(B) 50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.

Thus, the new Act has made two key changes to Section 6694(a) as follows:

D. **<u>The New Section 6694 Rules Create a Disconnect and Conflict with Taxpayer's Standards</u>**. The first obvious problem with the new Section 6694 rules is that tax clients will now be subject to a lesser standard than these tax return preparers. Under Section 6662, the understatement penalty will not be applied to a taxpayer for taking a tax return position as long as there is "substantial authority" for the return position. Of course, this "substantial authority" basis is much less than the "more likely than not" standard. This means that a tax return preparer can be subject to a preparer penalty in those cases in which a tax return client would not be.

Therefore, we can expect that there may be many situations in which a client may be more inclined to take an aggressive tax position than the tax return preparers would be. So, a tax return preparer could be subject to a penalty under the new rules in a situation in which the understatement did not result in any penalty to the taxpayer. This will make the tax return preparer more inclined to disclose an aggressive tax position on a tax return even if the tax return client would not need to disclose such a position in order to avoid the Section 6662 penalties.

The other problem with the new rules is that Congress did not take into account the fact that a tax return practitioner often will not be able to determine whether a position is more likely than not correct. Indeed, there are no clear answers to many questions with respect to items reported on tax returns, such as whether an asset is held for investment or sale, whether an expense should be capitalized or deducted, or the value of an assets donated to a charity. Likewise, consider whether an individual should be characterized as an employee or an independent contractor. These are just a few of the tax areas in which a conflict may arise between a tax client (subject to a lower standard) and a tax practitioner who may be inclined to disclose the position on the tax return (with a Form 8275) in order to avoid potential tax return preparer penalties.

E. The New "More Likely than Not" Standard Penalty Threshold. Under the new revised Section 6694a), tax practitioners are subject to a penalty if they take an "unreasonable position" on a tax return. An "unreasonable position" is one that meets **all** of the following requirements under the new Section 6694(a)(2):

(1) The tax return preparer knew (or reasonably should have known) of the position;

(2) There was not a "reasonable belief" that the position would more likely than not be sustained on the merits; and

(3) The position was not disclosed or there was no "reasonable basis" for the position even if it was disclosed on the return.

An exception for the penalty for reasonable cause is provided under the revised Section 6694(a)(3). The practitioner is not subject to the penalty if it is shown that there is reasonable cause for the understatement and the tax return preparer acted in good faith.

Thus, under the new rules, if a return position is not disclosed (such as by filing a Form 8275), the tax practitioner will be subject to penalties unless the tax return preparer meets the "more likely than not" standard. If the position is disclosed on the return (such as by filing the Form 8275), the tax practitioner does not have to meet the "more likely than not" standard as long as there is a "reasonable basis" for the taxpayer's position. Many commentators have argued that a "reasonable basis" is present as long as the tax return preparer can prove that there is a **25% or greater** chance that the position will be sustained on the merits.

F. Increased Penalty Amounts. The other major change made by the Act was the significant increase in the Section 6694(a) penalty. The revised penalty for failing to meet the Section 6694 requirements is now the greater of (i) $1,000 or (ii) 50% of the income derived by the tax return preparer. This is a big increase from the previous $250 penalty under the old Section 6694.

Also, now under Section 6694(b), the penalty on a tax return preparer for "wilful or reckless" conduct is now the greater of (i) $5,000 or (ii) 50% of the income derived from a tax return. This is a big jump from the prior penalty of $1,000 per return under the old Section 6694(b).

G. New Modified Definitions of a "Tax Return Preparer." The New Act also amended Section 6694 to change the definition of "income tax return preparers." The old definition limited the penalties to "income tax return preparers," but the new Section 6694 rules now apply to all "tax return preparers." This subtle change could be significant in many situations where a tax return preparer prepares non-income tax returns such as employment tax returns, estate and gift tax returns, etc.

Tax practitioners should note that the new definition of a "tax return preparer" under Section 7701(a)(36) is broader than strictly the person who signs a tax return. The Code defines a tax return preparer as anyone who prepares a return for compensation. Thus, even if the tax return preparer does not "sign" the return, he is still a tax return preparer.

> **NOTE: So, lawyers ALSO can now be stuck in this new trap. Arguably, any lawyer who discusses with a client the manner in which a transaction should be reported (such as whether a gain from the sale of land is ordinary income or capital gains) could be subject to a penalty if he did not reasonably believe that the advice was more likely than not correct. So, a lawyer who plans a transaction for a taxpayer client may not be willing to discuss the reporting after the transaction is completed because although the planning is not subject to the penalty, the reporting would bring Code Section 6694 into play.**

H. Expect Similar Changes to Circular 230 and AICPA Standards. Presumably, the new changes to Section 6694 will have to be incorporated into the IRS's Circular 230 rules and thus we expect that tax return preparers will only be in compliance with the Circular 230 rules if the "more likely than not" standard is met. Likewise, we expect that the AICPA will also raise their standards to meet the new Section 6694 rules.

I. Resolving Conflicts Between the Tax Return Preparer and the Client. As discussed above, tax return preparers will now be inclined to encourage their clients to disclose an aggressive tax position on the tax return so that the tax return preparer can avoid the possible penalties under Section 6694. Of course, all of us believe that the Form 8275 may "raise a red flag" and increase the chances that the client's return will be audited. Therefore, clients often insist that we do not file the disclosure Form 8275. And, even if we ultimately convince our clients to file the Form 8275, what do we do if the subject return is ultimately audited? Could a client back in come later on and sue us for malpractice by advising the client to file a Form 8275? Could the client come back in later on and argue that we had a "conflict of interest" in advising the client to file a Form 8275?

Interestingly, **Section 10.29 of the Circular 230** may address this issue. That section involves "conflict of interest" matters. Under Section 10.29 of the Circular 230, tax practitioners are prohibited from representing a client if the client representation is materially limited by the personal interests of the tax return practitioner. The tax return practitioner obviously has a financial interest in making sure that he is not subject to tax return preparer penalties under Section 6694.

So, if we advise our clients to file a Form 8275, have we violated Rule 10.29 of Circular 230 by rendering advise to our clients to which is "limited by the personal interests of a tax return practitioner"? If so, is this conflict even "waivable" by the client?

J. Practical Advice on How to Handle the New 6694 Rules. As you negotiate the new waters of Section 6694, consider taking the following actions:

1. Re-do your engagement letters. First, consider advising your clients of the new Section 6694 changes in your engagement letters and consider sending a new engagement letter out to all of your clients before the 2008 tax season. In the new engagement letters, you should explain how the new Section 6694 penalties will affect your tax practice and your new obligations. Also, consider including a provision in your engagement letters which allows you to withdraw from representation if you feel you cannot meet your Section 6694 obligations without adequate disclosure via a Form 8275.

2. Advise Your Clients to Seek Independent Counsel Before Recommending They File A Form 8275 Disclosure Statement. Next, since the Circular 230 rules imply that there may be conflict of interest between you and your client if you advise them to file a Form 8275, you should not file a Form 8275 unless and until your client has discussed this matter with his or her attorney.

3. Get Involved Early in the Transaction. There is nothing worse than a client who engages in a transaction before seeking the advice of their CPA. So, insist that your clients get you involved in a transaction before it is completed so that you have maximum input into how the transaction is structured.

4. Document Your Decision-Making Process. Once you have been placed in a position of having to meet the "more than likely than not" standard, be sure and paper your file and document how you came to your "more likely than not" decision. Get fully informed of all of the facts surrounding the subject transaction and make sure that you have copies of all the legal authority supporting the position in your file.

5. Segregate Bills for Tax Return Preparation Fees from Other Matters. The Section 6694 penalties apply to fees received by you from a tax return preparation engagement. Therefore, do not lump all of your annual fees into one bill, but instead segregate your tax return preparation fees from other engagement fees.

6. Do Not Be Afraid to Fire A Client. The Section 6694 penalties are bad enough, but violating an AICPA or Circular 230 standard is much worse. So, do not ever be afraid to fire a client. If you have trouble taking a tax return position, then do not assume that there will be an infinite number of CPAs who will be willing to do so.

VII. New IRS Revenue Procedure Outlines Rules for Determining Adequacy of Tax Return Disclosure to Avoid Section 6662(d) Accuracy Related Penalty and Section 6694(a) Preparer Penalty.

The following is reproduced from Federal Taxes Weekly Alert, 11/22/2006, Volume 52, No. 47.

A. Introduction. A revised Revenue Procedure, Rev. Proc. 2006-48, 2006-47 IRB 935, identifies when disclosure on a taxpayer's return for an item or a position is adequate to reduce a Code Sec. 6662(d) understatement of income tax under the accuracy-related penalty, and to avoid the Code Sec. 6694(a) preparer penalty for understatements due to unrealistic positions.

B. Background of Accuracy Related Penalty and Preparer Penalty and the "Adequate Disclosure" Exception. Under Code Sec. 6662, a 20% penalty applies to the portion of a tax underpayment that is attributable to a substantial understatement of income tax. An understatement is "substantial" if it exceeds the greater of 10% of the amount of tax required to be shown on the return for the tax year or $5,000. However, a corporation (other than an S corporation or personal holding company) has a substantial tax understatement if the understatement **exceeds** the lesser of (1) 10% of the tax required to be shown on the return for a tax year (or, if greater, $10,000), or (2) $10 million. Code Sec. 6662(d).

For a non-tax shelter item, the understatement penalty under Section 6662(d) is reduced to the extent the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return, and there is a reasonable basis for the taxpayer's tax treatment. Code Sec. 6662(d)(2)(B)(ii).

Under Code Sec. 6694, a $250 penalty is imposed on an income tax return preparer for filing a return or claim for refund that results in an understatement of liability due to a position for which the preparer knew or should have known that there was not a realistic possibility of being sustained on the merits and the position was not disclosed under Code Sec. 6662(d)(2)(B)(ii).

C. The "Adequate Disclosure" Rules. Each year, the IRS issues a Revenue Procedure that sets forth the circumstances under which disclosure of information on a return is considered to be "adequate" to avoid the substantial understatement penalty under Code Sec. 6662(d) and the preparer penalty under Code Sec. 6694(a) for understatements due to unrealistic positions.

D. <u>Revised 2006 "Adequate Disclosure" Revenue Procedure Guidance</u>. The IRS has made editorial changes to its prior guidance in Rev. Proc. 2005-75 (2005-50 IRB 1137) and has issued Rev. Proc. 2006-48 which expands the guidance pertaining to book and income tax reporting by adding new items for which additional disclosure is not required. The new items are Schedules M-3 for Forms 1065, U.S. Return of Partnership Income, U.S. Life Insurance Company Income Tax Return, 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return, and 1120S, U.S. Income Tax Return for an S Corporation, which reconcile net income (loss) in the financial statements to that shown on an entity's return.

Effective Date. Rev Proc 2006-48 applies to any return filed on 2006 tax forms for a tax year beginning in 2006, and to any return filed on 2006 tax forms in 2007 for short tax years beginning in 2007.