

**RECENT LEGISLATION, COURT DECISIONS,**  
**AND**  
**IRS REVENUE PROCEDURES, REVENUE RULINGS,**  
**ANNOUNCEMENTS**  
**AFFECTING *INDIVIDUAL TAXATION*\***

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**Tax Rates**

**The tax rates of top four tax brackets has decreased by ½ of a percent in 2002 pursuant to the Economic Growth and Tax Relief Reconciliation Act of 2001-** The tax rate brackets in 2002 are 10%, 15%, 27%, 30%, 35%, and 28.6%.

**Gross Income**

1. **Settlement Proceeds** - The Tax Court held that portion of settlement payment paid to a former employee's attorney arising from the employee's wrongful termination must be included in the employee's gross income. This was another case in which a taxpayer attempted to net the legal fees against gross income rather than deduct the same as a miscellaneous itemized deduction that is not deductible for alternative minimum tax purposes. The Court cited a number of recent cases that held that the payment of the legal fees should be included in the employee's gross income. The taxpayer however raised a novel argument. The taxpayer argued that the fee was paid under a reimbursement or other expense allowance arrangement under Internal Revenue Code Section 62 (a)(2)(A) and (c). The Court held that the amount paid to the attorney was not paid pursuant to a plan. "An expense satisfies the business connection requirement only if it was incurred pursuant to a reimbursement arrangement by an employee performing services on behalf of the employer who is required to provide reimbursement." *Biehl v. Commissioner*, 118 TC #29 (2002).

See also *Sigitas Banaitis v. Commissioner*, TC Memo 2002-5, where the Tax Court held that attorney fees paid directly from settlement was income to the taxpayer under the assignment of income doctrine.

**2. Donation of stock warrants and the anticipatory assignment of income** - The Tax Court held that a partnership did not realize any income from the assignment of stock warrants to four public charities which sold the warrants approximately one month after receipt. Although, there was an offer by another corporation to purchase all of the stock and the outstanding warrants of the corporation, the public charities were not compelled to sell the warrants. *Rauenhorst v. Commissioner*, 119 TC # 9 (2002).

**3. Frequent flyer miles will not result in income to a taxpayer** - Consistent with its unofficial policy, the IRS has announced that it will not assert that a taxpayer owes tax as a result of the receipt of frequent flyer miles earned as a result of business or governmental travel. *Announcement 2002-18*, February 20, 2002.

**4. No taxable distribution occurred where IRA distributed a check payable to a non publicly traded company to the taxpayer** - The custodian of an IRA refused to directly purchase stock of a non publicly traded companies that a customer wanted purchased directly by the IRA. The taxpayer then filled out a distribution request form which requested that the check be made directly to the corporation. The custodian delivered the check the taxpayer who forwarded it to the corporation with instruction to purchase the stock in the name of the IRA. The corporation issued the stock in the name of the IRA and sent the certificate to the taxpayer who then delivered it to the custodian. The Internal Revenue Service alleged that the delivery of the check was a distribution. The Court noted that if the IRA purchased the stock directly or if the proceeds were delivered to another broker who purchased the stock, the distribution would not be taxable. The Court found that the taxpayer was acting as a conduit for the IRA trustee. *Ancira v. Commissioner*, 119 TC #6 (2002).

5. **Clergy may exclude rental allowances** - The Clergy Housing Clarification Act of 2002 effective January 1, 2002, clarifies that ministers may exclude allowances paid to clergy to rent, purchase a home, or for expenses of running a home, other than expenses for food and servants.

6. **Like kind exchange and basis of property** The 10<sup>th</sup> Circuit affirmed the Tax Court's decision which determined the amount of the loss that a taxpayer realized when he sold property which he received in a like kind exchange. The taxpayer in a like kind exchange, exchanged property that was formerly used as a residence and which was subsequently converted to rental use. At the time the property was converted it had depreciated in value. To determine the basis of the property at the time of conversion, the Court made a determination of the value of the property at the time it was converted. *Bundren v. Commissioner*, 2002-1 USTC P50,331, affirming TC Memo 2001-2.

7. **Disability payments under the Federal Employees' Retirement System were inculpable from the taxpayer's income** - The 9<sup>th</sup> Circuit affirmed a Tax Court's decision that held to qualify as workman's compensation, and thus be excluded from a taxpayer' income pursuant to Internal Revenue Code Section 104(a)(1), the statute creating eligibility for the benefit must require that the injury be incurred in the course of employment. As such, the benefits payable under the Federal Employees' Retirement System were not classified as workman's compensation because the statute does not require the injury be incurred in the course of employment. *Norris v. Commissioner*, 2002-2 USTC P 50,684 (9<sup>th</sup> Cir. 2002) affirming TC Memo 2001-152.

### **Accounting Methods**

1. **Safe harbor rule for use of cash method of accounting** - The Internal Revenue Service has issued a Revenue Procedure that exempts a qualifying small business from the use of the accrual method of accounting if it meets any of three (3) alternate tests. Under the first test, a qualifying business (average gross receipts of \$10,000,000 or less) which reasonably determines

that its principal business activity, as described in the North American Industry Classification System (“NAICS”) Code, is other than one of the ineligible codes may report on the cash basis. The NAICS ineligible codes are as follows: (i) Mining activities within the meaning of NAICS Codes 211 and 212, (ii) Manufacturing within the meaning of NAICS Codes 31-33; (iii) Wholesale trades within the meaning of NAICS Code 42; (iv) Retail trade within the meaning of NAICS Codes 44 and 45; and (v) Information industries within the meaning of NAICS Codes 5111 and 5122. Under the second test, even if a taxpayer’s activity is described in one of the ineligible NAICS Codes, the taxpayer can still qualify if its principal business activity is providing services. A principal business activity is determined by the source of gross receipts. The taxpayer will meet the third test if the principal business activity is the fabrication or modification of tangible personal property upon demand in accordance with customer design or specifications. *Revenue Procedure 2002-28*, 2002-18 I R B 815.

**2. Deferral of prepaid ticket sales was proper** - An accrual method reporting baseball team properly deferred prepayment of advanced season tickets until the year the related baseball games were played. The Tax Court, relying on *Artnell v. Commissioner*, 400 F. 2d 981 (7<sup>th</sup> Cir. 1968), held the taxpayer’s accounting method more clearly matched income with expenses than recognition of the income upon receipt. *Tampa Bay Devil Rays, Ltd. v. Commissioner*, TC Memo 2002-248.

**3. IRS use of the net worth method to determine taxpayers’ net income upheld** - The taxpayers owned several businesses including an auto sales business and a body shop. The IRS using the net worth method determined the taxpayers substantially under reported their income. The Tax Court upheld the deficiency and also imposed the accuracy-related penalty. *Bisceglia v. Commissioner*, TC Memo 2002-22.

See also *Yu-Yang Wu v. Commissioner*, TC Memo 2002-68, and *Hien X. Pham v. Commissioner*, TC Memo 2002-101, where the IRS’ bank deposits reconstruction of the taxpayers’ unreported income were sustained.

4. **Income forecast method proposed regulation** - Internal Revenue Code Section 167(g)(6) limits the property eligible to use the income forecast method to motion picture films, video tapes, sound recordings, copyrights, books, and patents. The Internal Revenue Service issued proposed regulations that provide a revised computation for computing a taxpayer's allowance for depreciation in years due to a revised forecasted total income. Proposed Regulation 1.167(n)-7, REG-103823-99, published in the Federal Register on May 31, 2002.

5. **Electing the income forecast method** - Taxpayer denied increased depreciation deduction claimed on electronic gaming equipment on amended tax returns. Taxpayer failed to properly elect the income forecast method of deduction on its original return and also did not properly compute depreciation pursuant to this method. *New Gaming Systems Inc. v. Commissioner*, TC Memo 2001-277.

### **Capital Transactions**

1. **Ordinary income recognized upon sale of lottery winnings** - The Tax Court held that the taxpayers realized ordinary income on partial sale of future lottery winnings, rejecting taxpayers' capital gain treatment. *James F. Davis v. Commissioner*, 119 TC #1 (2002). See also *United States v. Maginis*, 2002-2 USTC P 50,494 (Dist. Ore. 2002) which also held sale results in ordinary income.

2. **Ordinary income recognized upon receipt of insurance proceeds paid to former shareholders** - Former shareholders who received business lost profits settlement payment from insurance company were held to recognize ordinary income. The lost profits insurance policy was purchased by the corporation to protect it from the loss of the use of its commercial fishing boat. Immediately prior to the sale of all of its stock, the corporation assigned its rights to its insurance claim to the taxpayers. The Tax Court rejected the taxpayers' argument that the assignment was part of the sale of its stock. The Tax Court stated that it would not find that the taxpayers received the insurance proceeds as part of the sale. *Steel v. Commissioner*, TC Memo 2002-113.

**3. Payments made to a retired insurance agent deemed ordinary income** - State Farm Insurance agent upon his retirement received termination payments which he reported as long term capital gains. The taxpayer argued that the payments were to buyout his business. The Tax Court held that such amounts were ordinary income because the clients' belonged to State Farm Insurance and therefore he did not own anything which was sold. *Baker v. Commissioner*, 118 TC # 28 (2002).

**4. Gain recognized on deemed sale and repurchase of residence pursuant to election** - Taxpayers who elect, pursuant to Section 311 of the Tax Reform Act of 1997 to treat a residence as having been sold and reacquired on January 1, 2001 to be eligible for 18% long term capital gain rate, cannot exclude any of the gain realized on such sale pursuant to the general non-recognition of gain from the sale of residence provisions pursuant to Internal Revenue Code Section 121. *Job Creation and Worker Assistance Act of 2002 Act Section 414(a)* amending Section 311, which is also consistent with Revenue Ruling 2001-57, 2001-46 I.R.B. 488.

**5. Sales of residences by 9-11 affected taxpayers may be eligible for gain exclusion** - The Internal Revenue Service has announced that "affected" taxpayers who sold their residences as a result of the tragic events of 9-11, may qualify for a partial exclusion of the gain realized even though the taxpayers did not meet the ownership and use requirement of Internal Revenue Code Section 121. Code Section 121 provides that a taxpayer must own and use the property as his or her principal residence for a minimum of two years during the five-year period that ends on the sale or exchange date. An exception allows a pro-rata reduced exclusion for taxpayers who fail to meet the requirements due to a change in the place of employment, health, or unforeseen circumstance. The announcement provides that "affected taxpayers" include (i) a spouse, co-owner, or an individual living with the taxpayer was killed in the attacks; (ii) the taxpayer's principal residence was damaged in the attack; (iii) the taxpayer or someone listed in (i) became eligible for unemployment benefits; and (iv) the taxpayer, or someone described in (i) had a change in employment or self-employment resulting in the taxpayer's inability to pay reasonable

basic living expenses. IRS Notice 2002-60, Treasury Department News Release PO-3368.

**6. Legal expenses incurred by taxpayer in maintaining law suit against seller of a hotel were to be capitalized** - Taxpayers brought a law suit against the seller of a hotel which they purchased as a result of the seller's misrepresentation as to the seller's actual gross receipts. Ultimately a settlement was entered by which the taxpayers reduced the amount owed to the seller under a promissory note. The taxpayer deducted the legal and consulting expenses on their tax return. The taxpayers argued that the legal and consulting expenses were not incurred in connection with the acquisition of the hotel but were a result of the seller's misrepresentations. The Court held that the law suit was as a result of the taxpayers' acquisition of the hotel and therefore had to be capitalized. *Winter v. Commissioner*, TC Memo 2002-173.

**7. Business v. capital expenditure** - The Tax Court held that the IRS improperly determined that the accrual method taxpayer was not entitled to currently deduct cost of garments and dust control items used in its laundry business. The expenditures were properly characterized as a business expense. *Prudential Overall Supply v. Commissioner*, TC Memo 2002-103.

**8. Payment allocated to covenant not to compete resulted in ordinary income** - The Tax Court held that the allocation contained in the stock acquisition and noncompete agreements which were bargained for by the parties should be respected. *Thomas v. Commissioner*, TC Memo 2002-108.

## **Valuation**

**1. Valuation of stock options for publicly and non-publicly traded stock** - In response to comments, the IRS has modified proposed regulations to expand the safe harbor available for valuing options granted in conjunction with golden parachute payments. It also provides a more favorable valuation table. Rev. Proc. 2002-13, I.R.B. 2002-8.

## **Ordinary and necessary business expenses**

**1. Origin of claim** - The 9<sup>th</sup> Circuit affirmed the Tax Court decision and held that a

clinical professor of medicine at the University of California, San Francisco, could not deduct legal expenses incurred as a result of an audit of her university as an unreimbursed business expense on Schedule C. Rather such expense should be claimed as a miscellaneous itemized deduction. The 9<sup>th</sup> Circuit noted that although the doctor may not have incurred the legal expense but for her concern for her Schedule C business, “the Tax Court was required to look to the origin of the underlying claim, not the consequences”. Here the underlying claim arose from her duties as an employee of the University not from the doctor’s trade or business. Test v. Commissioner, 2002-2 USTC P50,692 (9<sup>th</sup> Cir. 2002) affirming TC Memo 2000-362.

**2. Entertainment vs. business expense** - Churchill Downs, Inc. which owns and operates 4 horse racing tracks, conducts horse races at these tracks and earns revenue from wagering, admissions, concession commissions, sponsorship revenues, licensing revenues and broadcast fees. In connection with its biggest races, the Kentucky Derby, and the Breeders’ Cup, the taxpayer incurred significant expenses in hosting galas, winner’s party, breakfast for a press corps, dinners, etc. The taxpayer claimed these expenses as ordinary and necessary business expenses. The 6<sup>th</sup> Circuit affirmed the Tax Court decision and held that the expenditures were entertainment expenses subject to IRC Section 274 (n) 50% deduction limitation. The 6<sup>th</sup> Circuit stated that expenditures were advertising or public relations expenses. No horse racing was held at these events. Nor did the events, held away from the track at rented facilities, provide attendees with an opportunity to learn more about the races. Churchill Downs, Inc. v. Commissioner, 2002-2 USTC P50,691 (6<sup>th</sup> Cir. 2002) affirming 115 TC 279.

**3. Away from home expenses** - Taxpayer, who resided in Wisconsin, was a musician in a band. The band would travel to Chicago and other Midwest cities. He generally would play in Chicago 4 days a week. The Tax Court held that the taxpayer’s “home”, the taxpayer’s principal place of business or employment, was Chicago not Wisconsin. Bjornstad v. Commissioner, TC Memo 2002-47.

**4. Hobby loss rules limits taxpayer’s deduction** - The 6<sup>th</sup> Circuit affirmed the Tax

Court's decision in holding that a full time engineer who worked approximately 15 to 20 hours a week did not operate tree farm for profit. Taxpayer did little planning, kept few records and made little effort to sell trees. *Zarins v. Commissioner*, 2002-1 USTC P 50,471 (6<sup>th</sup> Cir. 2002) affirming TC Memo 2001-68.

See also *Kuberski v. Commissioner*, TC Memo 2002-200.

**5. Tax Court allows business deductions from taxpayer's horse breeding operations even though no profit earned in eight years of operations** - The taxpayers in 1985 started an Arabian horse breeding business which never earned a profit. The IRS disallowed all losses claimed by the taxpayers in 1994 and 1995. The Tax Court reviewed all of the factors contained in regulation section 1.183-2 (b) and concluded that the taxpayers operated the business with a profit objective and therefore the losses should be allowed. *Routon v. Commissioner*, TC Memo 2002-7.

See also *Rinehart v. Commissioner*, TC Memo 2002-9 where the Tax Court also held that a cattle rancher pursued his horse-breeding operation with the intent of earning a profit.

## **Depreciation Methods**

**1. Job Creation and Worker Assistance Act of 2002 contains a number of provisions that affect depreciation.**

**a. 30% additional depreciation in the year property is placed in service-  
Code Section 168(k)**

- (i). Applies for both regular tax and alternative minimum tax
- (ii). Must be qualified property-property having depreciable life of 20 years (including automobiles) or less, computer software, qualified leasehold improvements
- (iii) Property is place in service after 9/10/2001 and before 1/1/2005
- (iv) Original use of property commences with the taxpayer

**b. New York Liberty Zone-Code Section 1400L**

- (i) Additional 30% depreciation allowed on the same classes of property set forth in a. (ii) above, as long as taxpayer *purchased* the property (which can be used) after 9/10/2001 and before 1/1/2007. Property which is eligible for the additional 30 % depreciation under section 168(k) will not be eligible.
- (ii) Cost of qualified Liberty Zone leasehold improvements is depreciated under MACRS on straight line basis over 5 years. Leasehold improvements must be place in service after 9/10/2001 and before 1/1/2007.
- (iii) \$35,000 increased Section 179 deduction available. Must be new property purchased by taxpayer after 9/10/2001 and before 1/1/2007.

2. **Distinguishing between a capital expenditure and a repair-** 9<sup>th</sup> Circuit affirmed the Tax Court decision which held that the replacement of a cell lining, which had a 3 year life expectancy, by an aluminum smelt manufacturer, had to be capitalized. The Court rejected the taxpayer argument that the appropriate depreciation unit of property was the entire cell line (need 112 cells working for aluminum manufacturing facility to operate) and that therefore expenditure was a repair to keep cell line operational. The Court held that the appropriate depreciation unit was each cell. Also rejected taxpayer’s argument that since the cell relining did not enhance the value of a cell which was properly operating, the cost did not have to be capitalized. *Smith, Vanalco, Inc. v. Commissioner*, 2002-USTC Par. 50,583 (9th Cir. 2002), affirming TC Memo 1999-265.

## **Partnerships**

1. **The determination of whether an individual is a partner is a “partnership item” that must be determined at the partnership level** - The taxpayer was an attorney who reached an oral agreement in 1987 that he was going to join a law firm as a partner. Shortly after joining the firm, the attorney read an article that detailed the law firm’s financial problems. In

December 1987, he wrote a letter stating that he was withdrawing from the firm. The attorney received more than \$64,000 in a draw from the firm but reported only \$15,310 which was the amount set forth on his K-1. In 1992, as a result of a Bankruptcy Court decision, the law firm had cancellation of indebtedness income which exceeded \$55,000,000. The taxpayer's share of the cancellation of indebtedness income, \$37,212, was reported on his K-1. The taxpayer did not report this income on his 1992 tax return. The IRS commenced an audit of the partnership 1992 tax year. Due to extensions of the statute of limitations, the IRS mailed a timely final partnership audit adjustment to the tax matters partner in 1998. The taxpayer received a notice of deficiency for the 1992 year in 1999. The Tax Court held that it lacked jurisdiction to consider the taxpayer's claim that he was not a partner since that determination must be made at the partnership examination level, not at the partner's level. *Blonien v. Commissioner*, 118 TC #34 (2002).

### **Subchapter S Corporations**

1. **Job Creation and Worker Assistance Act of 2002** reversed the Supreme Court's decision in *Gitlitz v. Commissioner*, 531 US 206 (2001). IRC Section 108 (d)(7)(A) provides that a shareholder's basis in S corporation stock does not increase as a result of discharge of indebtedness income that is excluded from the corporation's income pursuant to IRC Section 108(a).

2. **IRS last minute challenge to taxpayer's computation of loss was not proper** - The 3<sup>rd</sup> Circuit in reversing the Tax Court held that the Tax Court should not have considered a newly raised issue at the conclusion of the case as to whether the taxpayer properly computed the amount of loss. The Court relied on the "meet to hold" doctrine which prohibits a party from changing his ground. "The fairness concerns that underlie this principle are consistent with the most elementary requirements of due process". *Cullen v. Commissioner*, 2002-1 USTC P50,200 (3<sup>rd</sup> Cir. 2002) reversing TC Memo 2000-139.

### **Deductions**

1. **Net Operating Loss Carryback - Job Creation and Worker Assistance Act of 2002** provides that an increased carryback period for net operating loss generated in 2001 and 2002 from 2 to 5 years.

2. **Loss denied where rental of former residence was temporary** - An attorney who rented his former residence was denied a rental loss deduction on the basis that the property was not converted to property held for production of income. Rather the taxpayer merely rented the property on a temporary until the taxpayer was able to sell it. *Saunders v. Commissioner*, TC Memo 2002-143.

3. **No deduction allowed for interest accrued on business-related tax deficiency** - The Tax Court abandoned its prior decision in *Redlark v. Commissioner*, 106 TC 42 (1996) and held that a taxpayer could not deduct the interest paid on a tax deficiency that arose from the disallowance of deductions and the failure to report income of his legal business which was reported on Schedule C of his tax return. The Court's decision brought it into conformity with decisions by the Fourth, Sixth, Seventh, Eighth, and Ninth Court of Appeals. *Robinson v. Commissioner*, 119 TC # 4 (2002).

4. **Passive activity loss rules. Taxpayer disallowed deduction loss arising from real estate activities where he is not deemed real estate professional** - The Tax Court found that the time records maintained by the taxpayer to substantiate time spent in real estate activities were not reasonable. Taxpayer produced calendars which he used to schedule his time. The taxpayer who owned 100% of a heating and air conditioning contracting business used the calendar to schedule work for the next month. Calendars were not adjusted to correct estimated time and actual services rendered. At the trial, the taxpayer produced the calendar with hand written notes. The Court found these handwritten notes were made many years later and were not reasonable. *Fowler v. Commissioner*, TC Memo 2002-223.

5. **Passive activity loss rule - Rental of office to taxpayer's 100% owned professional corporation deemed non-passive.** The 7<sup>th</sup> Circuit affirmed the Tax Court's decision that a

taxpayer could not utilize the loss realized by a taxpayer from renting a building to a health club to offset the income realized by the taxpayer from renting another building to his law professional legal corporation. Since the taxpayer materially participated in the practice of law, his rental to the law firm was non-passive due to the “self rental rule” of Treasury Regulation 1.469-2(f)(6). *Krukowski v. Commissioner*, 2002-1 USTC P50,219 (7<sup>th</sup> Cir. 2002) affirming 114 TC 366.

**6. Passive activity loss rule - Taxpayer could not offset income realized from services to partnerships which he did not actively participate in.** The taxpayer who filed a joint return owned a substantial majority of the stock of a subchapter S corporation which provided real estate management services to approximately 90 pass through entities. The taxpayer actively participate in the S corporation. The taxpayer sought to offset his proportionate share of the management fees paid by partnerships in which he did not actively participate. The Tax Court stating that although the “petitioners have been snared by the reach of section 469 in, what appears to be, most inequitable circumstances”, they could not offset the income by a proportionate share of the management fees. *Hillman v. Commissioner*, 118 TC # 17 (2002).

**6. Job Creation and Worker Assistance Act of 2002** - For 2002 and 2003, eligible educators are allowed an above the line deduction, not in excess of \$250 for books supplies and computer equipment used by the eligible educator in the classroom. An eligible educator means an individual who is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aid in a school for at least 900 hours during a school year. IRC Section 62 (a)(2)(D).

**7. Developer’s impact fees are indirect costs that must be capitalized and added to the basis of newly constructed buildings** - Revenue Ruling 2002-9, IRB 2002-10.

**8. IRS will allow taxpayer’s medical deduction for weight-loss costs relating to obesity or related to another disease** - The IRS departed from its past practice of not recognizing obesity as a disease. However, the Ruling provides that the cost of purchasing reduced-calorie diet food is not deductible. *Revenue Ruling 2002-19*, I.R.B. 2002-16.

9. **Charitable deduction limited to taxpayer's basis in stock** - Taxpayers claimed they were entitled to a charitable deduction of approximately \$550,000, the fair market value of closely held stock contributed to a private foundation. The Tax Court agreed with the Commissioner's adjustment which limited the deduction to the taxpayer's basis in the stock because the taxpayer failed to follow the substantiation requirements and the shares were not shown to be "qualified appreciated stock". *Todd v. Commissioner*, 118 TC # 19 (2002).

10. **Nonbusiness bad debt** - The taxpayer was allowed a nonbusiness bad debt for the amounts that he loaned his daughter and her boyfriend. The loan was evidenced by a note and a second mortgage. Interest was charged on the loan at a rate above the federal lending rate. *McFadden v. Commissioner*, TC Memo 2002-166.

11. **Casualty loss deduction** - The sole shareholder of an S corporation which was engaged in the construction of a sports facilities was denied a casualty loss deduction for the year a structure collapsed because there was a reasonable prospect of recovery from an insurance carrier. *Julicher v. Commissioner*, TC Memo 2002-55.

12. **Legal librarian was not allowed to deduct legal education expense** - The taxpayer who was a legal librarian for 25 years was not allowed to deduct the cost of law school because such education would qualify her for a new trade or business. *Galligan v. Commissioner*, TC Memo 2002-150.

13. **Payment of former spouse's legal fees did not qualify as alimony** - The 10<sup>th</sup> Circuit affirmed the Tax Court's decision and that held that an individual could not deduct the legal fees which he paid to his spouse's attorney as alimony. The state court had made a temporary order directing the individual to pay the legal expense. The Court stated that the issue before it was to determine whether the Supreme Court of Oklahoma would have required the spouse to pay the attorney fees if his spouse had died before the payment of the legal fee. It found that the spouse's obligation to pay the legal fee would not have been extinguished so therefor, the payment did not qualify as alimony. *Berry v. Commissioner*, 2002-1 USTC P

50,453 (10<sup>th</sup> Cir. 2002) affirming TC Memo 2000-373.

### **Innocent Spouse Relief**

**1. Innocent spouse relief denied where husband knew of the spouse's failure to report pension distribution** - The Tax Court rejected the husband's uncorroborated statement that he did not know of his spouse's failure to report pension distributions when he requested that she take the same and he had access to joint accounts where the funds were deposited. *Penfeld v. Commissioner*, TC Memo 2002-254.

**2. Spouse's ignorance of law will not, on that basis alone, permit the spouse to claim innocent spouse relief** - The taxpayer had actual knowledge of her spouse's receipt of retirement distributions. She had mistakenly believed her husband's advice that the distributions were not taxable because the proceeds were used to pay off their mortgage. The 5<sup>th</sup> Circuit upheld the Tax Court's refusal to grant innocent spouse relief. The Court found that ignorance of the law is no defense. Additionally the Court refused to grant equitable relief where the spouse received a significant benefit from the deficiency. She received the marital residence with an enhanced value due to the payoff of the mortgage as part of the divorce. *Cheshire v. Commissioner*, 2002-1 USTC P50,222 (5<sup>th</sup> Cir. 2002) affirming 115 TC 183.

**3. IRS abused its discretion in denying equitable innocent spouse relief** - The Tax Court held that the IRS abused its discretion in denying equitable innocent spouse relief under IRC Section 6015 (f), where the individual suffered from mental illness, had a limited education, was completely dependent upon her husband in regard to filing tax return and the payment of taxes, and had no knowledge or reason to know that taxes would not be paid. *August v. Commissioner*, TC Memo 2002-201.

See also *Ferrarese v. Commissioner*, TC Memo 2002-249 where the Tax Court also held that the IRS abused its discretion in denying equitable innocent spouse relief where she testified that her only source of income was social security, she borrowed money from her children to pay her bills, and that she would be forced to sell her condominium if she were denied relief.

## **Involuntary Conversions**

**1. Taxpayer who processed and used damaged inventory in its manufacturing process could elect to defer a portion of gain** - Taxpayer operated a vertically integrated forest products manufacturing business which included the ownership and processing trees at manufacturing plants. During the years in issue, some of the taxpayer's trees were damaged as a result of fire, wind, ice, storms, and insects. Taxpayer would salvage the damaged trees by cutting them down, and cutting them into standard logs. It would then use the timber in its manufacturing process. The taxpayer sought to defer gain to the extent of the difference between the fair market value at the time they were processed and its basis. The Tax Court rejected the IRS arguments that this was not an involuntary conversion. The taxpayer was forced to harvest the trees as a result of certain conditions. The taxpayer used the trees but not in the same manner as it had planned. Therefore, it was proper to elect to defer the gain. *Willamette Industries, Inc. v. Commissioner*, 118 TC #7 (2002).

## **Abatement of Interest**

**1. Taxpayer denied abatement of interest where delay was caused by taxpayer** - The Internal Revenue Service did not abuse its discretion in refusing to abate interest accrued on tax deficiency pursuant to Internal Revenue Code Section 6404 (e)(1), where the delay, in large part, was caused by the taxpayer's failure to supply requested records. *Jean v. Commissioner*, TC Memo 2002-56.

**2. Taxpayer denied abatement of interest where tax deficiency did not arise from ministerial act** - In April 1986, the taxpayer paid \$150,000 for 1986 estimated tax payments from his joint checking account which he maintained with his spouse. The taxpayer and his spouse separated in 1986, and he filed a separate return for 1986 and 1987. Taxpayer in 1987 requested that the Commissioner credit \$11,985 and \$70,000 of the estimated payment to the taxpayer's 1986 and 1987 tax liability. As of April 1988, the Commissioner applied the payments as requested by the taxpayer which resulted in a \$68,015 refund to the taxpayer. In

April 1988, the accountant for the spouse requested the Commissioner allocate \$150,000 of the estimated payments to the spouse's 1986 tax liability. The Commissioner then reallocated the estimated tax payment so that only \$14,471.10 of the estimated tax payment was allocated to the taxpayer with the balance allocated to his spouse. The Court held that the Commissioner's reallocation of the estimated tax payments was not a ministerial act but required the exercise of judgment and therefore abatement was not proper. *Spiegel v. Commissioner*, TC Memo 2002 - 259.

See also *Crawford v. Commissioner*, TC Memo 2002-10 where abatement denied.

### **Tax Procedure**

1. **Internal Revenue Service is bound by its issued revenue rulings** - Taxpayers who operated as a partnership assigned their rights to purchase stock of a corporation to four nonprofit entities. The corporation subsequently redeemed the stock and each donee received approximately \$1,000,000. The Internal Revenue Service tried to distinguish Revenue Ruling 78-197. The Court found that there was no distinction and therefore rejected the Internal Revenue Service's argument that the donation of the warrants was an anticipatory assignment of income and not a completed gift. *Rauenhorst v. Commissioner*, 119 TC # 9 (2002).

2. **IRS last minute challenge to taxpayer's computation of loss was not proper** - The 3<sup>rd</sup> Circuit in reversing the Tax Court held that the Tax Court should not have considered a newly raised issue at the conclusion of the case as to whether the taxpayer properly computed the amount of loss. The Court relied on the "meet to hold" doctrine which prohibits a party from changing his ground. "The fairness concerns that underlie this principle are consistent with the most elementary requirements of due process". *Cullen v. Commissioner*, 2002-1 USTC P50,200 (3<sup>rd</sup> Cir. 2002) reversing TC Memo 2000-139.

3. **Mailbox rule** - A District Court ruling held that where taxpayers in an earlier decision provided sufficient evidenced for a reasonable juror to find that he mailed his tax return prior to the expiration of the statute of limitations to file a claim for a refund, and the Internal Revenue

Service failed to rebut the presumption that it had received the return, the refund claim was timely. *Sorrentino v. Commissioner*, 2002-1 USTC P50,228 (D. Colo 2002).

**4. Tax matters partner's criminal investigation did not invalidate consents to extend time to assess tax** - The 2<sup>nd</sup> Circuit upheld a Tax Court decision which found consents to extend time to assess tax made by two attorneys-in-fact, pursuant to an executed form 2848 were valid. The Court declined to follow its decision in *Transpac Drilling Venture v. Commissioner*, 98-2 USTC P 50,517 (2<sup>nd</sup> Cir. 1998) because the taxpayer could not show that the consents by the tax matters partners were part of a scheme to obtain favor with the IRS. *Madison Recycling Associates v. Commissioner*, 2002-2 USTC P 50,515 (2<sup>nd</sup> Cir. 2002) affirming TC Memo 2001-85.

**5. Unauthorized disclosure of tax information by IRS** - An IRS Special Agent made an unauthorized disclosure of the taxpayer's tax information at a retirement party held in his honor. Approximately 100 persons were in attendance. The Court held that the disclosure constituted 1 act of disclosure, not 100 as asserted by the taxpayer. Therefore, the taxpayer was entitled to only \$1,000 because there was no showing of actual damages. *Siddiqui v. United States*, 2002-2 USTC P 50,551 (D. Ariz. 2002).

**6. For the purpose of determining whether the 6- year statute of limitation on assessment applies, a taxpayer's gross income includes a partner's share of a partnership's gross receipts** - Taxpayers, 2 days prior to the expiration of the six year period from the date he filed their 1990 tax returns, filed amended returns and paid the tax that was determined to be due. Approximate 90 days later, the IRS assessed the tax, interest and penalties. The taxpayers argued that the additional tax should be refunded because the statute of limitations had expired. The IRS argued where the taxpayer did not materially participate in a partnerships, they were passive, and the income of the partnerships should not be taken into account. The Tax Court held that the definition of gross receipts does not require the taxpayer to materially participate. Since the IRS failed to establish the amount of the gross receipts, it failed to establish that a 6-

year statute of limitations was appropriate. *Hoffman v. Commissioner*, 119 TC # 7 (2002).

7. **Notice of deficiency - mailing to last-known address.** Notice of deficiency was valid since it was mailed to the address shown on taxpayer's most recently filed tax return.

*Perkins v. Commissioner*, TC Memo 2002-174.

8. **Refund claim** - Taxpayer who filed his tax return 4 years after its due date, could not apply the overpayment to the succeeding year because he failed to claim the credit within the 2-year statute of limitation period. *Burr v. Commissioner*, TC Memo 2002-69.

9. **Notice of deficiency which did not specify the last day for filing Tax Court petition was valid** - The IRS Restructuring Act of 1998 requires the IRS to include in all notice of deficiencies, the last day for filing a Tax Court petition. Notwithstanding this requirement, the 5<sup>th</sup> Circuit affirmed the decision of the Tax Court which held that a notice of deficiency mailed to an attorney which did not include the last day for filing a petition with the Tax Court was valid. The IRS Restructuring Act of 1998 did not specify the consequences of that resulted from the IRS failure to include the last filing date. The notice did provide that the taxpayer had 90 days to file a petition from the date of mailing. *Rochelle v. Commissioner*, 2001- USTC P 50,447 (5<sup>th</sup> Cir. 2002) affirming 116 TC 356.

### **Filing Status**

1. **Same-sex partners filing status was single** - The 7<sup>th</sup> Circuit affirmed the Tax Court which held that an individual filing status was single despite his long-term economic and personal relationship with his same-sex partner. *Mueller v. Commissioner*, 2002-2 USTC P 50,505 (7<sup>th</sup> Cir. 2002) affirming TC Memo 2001-274.

### **Tax Liens**

1. **Tenants by the entirety** - The United States Supreme Court reversed the 6<sup>th</sup> Circuit and held that a federal tax liens attached to husband's interest in property which he held with his wife as tenants by the entirety. Taxpayer and her spouse purchased property in 1972 as tenants by the entirety. In 1989, the IRS filed a tax lien against the husband. After the lien was filed,

the husband signed a quit claim deed transferring his interest to his spouse. When the spouse attempted to sell the property, a title search disclosed the lien. Pursuant to an agreement with the United States, half of the proceeds from the sale were placed in escrow. The 6<sup>th</sup> Circuit in ruling for the taxpayer held that under Michigan law, the husband had no separate interest in the property. The United States Supreme Court held that under Michigan law, the husband possessed a number of property rights, including the right to encumber or alienate the property with his spouse's approval, the right of survivorship, as well as the right to use the property. The Court found that the husband had a property interest to which the lien could attach. The Supreme Court remanded the case to the 6<sup>th</sup> Circuit to make a determination of the proper value of the husband's interest. *United States v. Craft*, 2002-USTC P 50,361 ( S. Ct. 2002) reversing 233 F. 3d 358 (6<sup>th</sup> Cir. 2000).

**Employee status - Sole shareholder held to be an employee of his 100% owned accounting firm.** The Tax Court held that the sole shareholder of an S corporation which provided accounting, bookkeeping and tax preparation services was an employee of the corporation and therefore the corporation must pay Federal employment tax. Additionally, the Tax Court held that the corporation could not avail itself of Section 530 relief. *Joseph M. Gray Public Accountant, P.C. v. Commissioner*, 119 TC # 5 (2002).

See also *Dennis Katz, D.D.S., P.C. v. Commissioner*, TC Memo 2002-118.

## **Penalties**

1. **Responsible officer penalty** - The taxpayer, who was the founder and a 50% shareholder of a corporation, was held to be a responsible officer of the corporation and, as such, was liable for the trust fund recovery penalty with respect to unpaid taxes. Although the taxpayer had no check-signing authority for the corporation, it was proper to hold that he was a responsible officer where he had substantial control over the corporation's finances. *United States v. Lindsey*, 2002-2 USTC P 50,698 (10<sup>th</sup> Cir. 2002) affirming unreported District Court decision.

2. **Frivolous proceedings penalty** - The Tax Court held that the frivolous proceeding penalty was proper where the taxpayer was a “frequent litigator of groundless challenges to the validity of the Internal Revenue Code.” The Court found that he maintained the proceeding primarily for delay. *Standifird v. Commissioner*, TC Memo 2002-245.

3. **Failure to file, negligence and tax protestor penalties imposed** - *Nunn v. Commissioner*, 2002-250.

4. **Fraud penalty upheld** - The Tax Court upheld fraud penalty against a bookkeeper and tax return preparer in connection with substantial omissions of income on his joint return. The taxpayer failed to maintain adequate books and records, and fraudulently held himself out as an accountant to the IRS. *Levine v. Commissioner*, TC Memo 2002-12.

5. **Failure to file, failure to pay estimated tax payments, and delay penalties imposed upon tax protestor** - *Monaghan v. Commissioner*, TC Memo 2002-16.

See also *Bland-Barclay v. Commissioner*, TC Memo 2020-20, *Gage v. Commissioner*, TC Memo 2002-72.

6. **Taxpayers liable for negligence and substantial understatement penalty where they lacked expertise and knowledge and failed to consult with experts** - The taxpayer husband was a successful businessman who was “financial well off and sophisticated”. The taxpayers invested in jojoba tax shelters. The Court in finding the taxpayers liable for negligence and the understatement penalty found he did not exercise due care at the time he entered into the tax shelters. *Finazzo v. Commissioner*, TC Memo 2002-56.

7. **Criminal conviction estops taxpayer from contesting civil fraud penalty** - *Yu-Yang Wu v. Commissioner*, TC Memo 2002-68.

## **Bankruptcy**

1. **Suspension of the running of the limitations period** - The United States Supreme Court held that the three-year look back period with respect to tax debts was tolled during a taxpayer’s prior bankruptcy preceding. *Young v. United States*, 2002-1 USTC P 50,868 (United

States Supreme Court 2002).