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Year-End Individual Taxation Report

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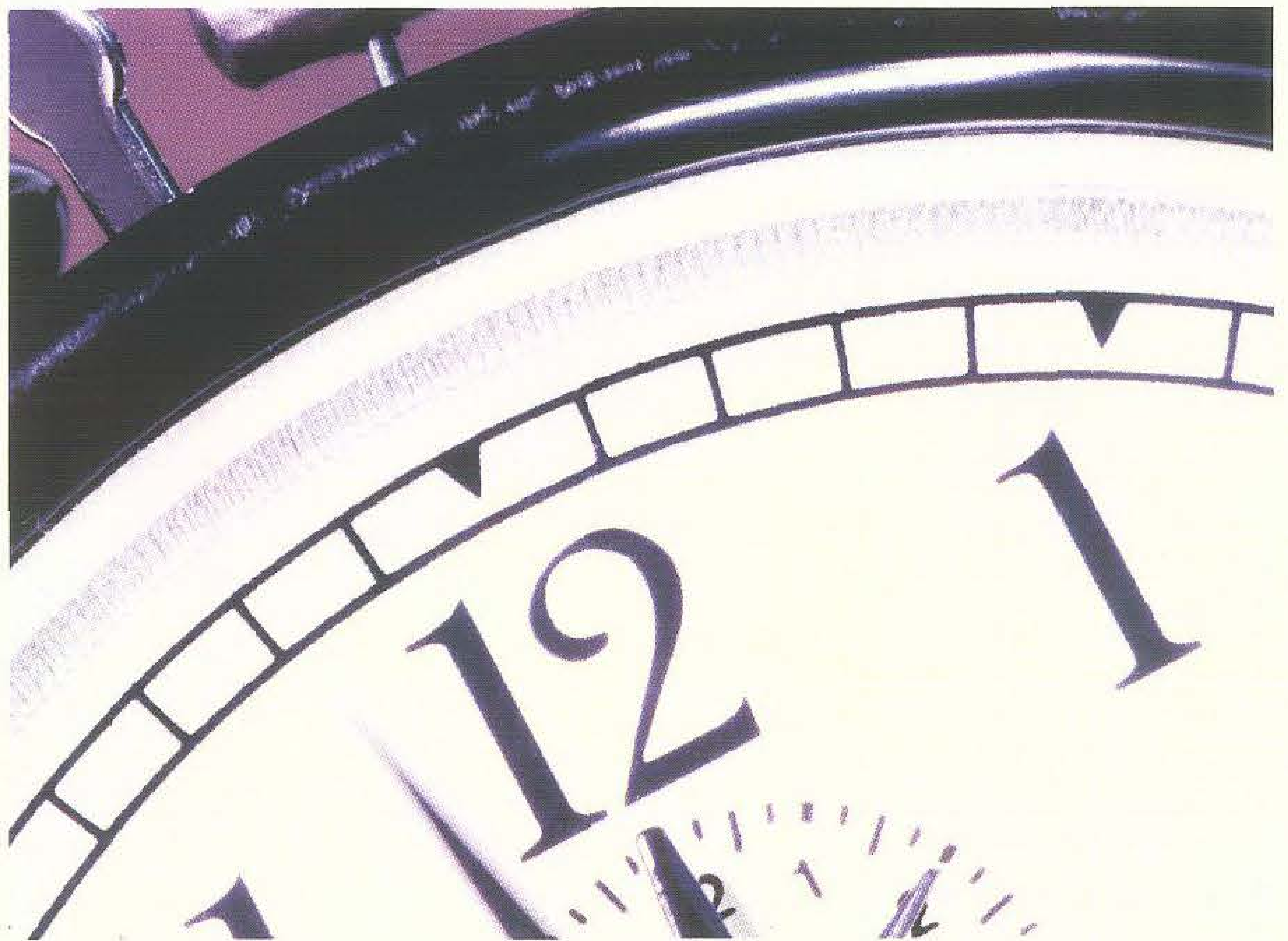
This article covers developments from the past year affecting taxation of individuals, including last year's tax relief, health care, and small business legislation, regulations, cases, and IRS guidance. The items are arranged in Code section order.



Sec. 32: Earned Income

Erroneous EITC payments: In October 2011, the IRS issued proposed regulations that would require return preparers to submit to the IRS documentation of taxpayers' eligibility for the earned income tax credit (EITC).[1] The proposed regulations, under the Sec. 6695(g) preparer due diligence provisions, would require preparers to submit Form 8897, Paid Preparer's Earned Income Credit Checklist, to the IRS. Currently, return preparers are required only to keep the form or the information it requires in their records. The proposed regulations also would subject preparers' firms to the same penalty for a lack of due diligence concerning EITC claims. Firms, however, could not claim the defense available to preparers—that their office's EITC due diligence procedures are reasonably designed and routinely followed and that the failure was isolated and inadvertent. The proposed regulations would be effective when finalized, for tax years ending on or after December 31, 2011.

Also in October, Congress increased the Sec. 6695(g) preparer penalty for failing to exercise due diligence with respect to an EITC claim from $100 to $500 per failure for returns required to be filed after December 31, 2011. The provision was included in a free-trade agreement with South Korea.[2]

1 REG-140280-09.

2 The U.S.-Korea Free Trade Agreement Implementation Act of 2011, P.L. 112-4, §501.

Earlier in 2011, a Treasury Inspector General for Tax Administration (TIGTA) report[3] revealed that, despite improvements in the IRS's ability to detect them, in fiscal 2009 the IRS continued to pay out between $11 billion and $13 billion in erroneous EITC payments. The TIGTA report noted that the Government Accountability Office (GAO) had listed improper EITCs as the second-highest dollar amount of improper payments of all federal programs. TIGTA also noted that the IRS estimates that 23%–28% of EITC payments continue to be erroneous, showing little improvement since the 2002 inception of reporting estimates to Congress. The report summarizes IRS attempts to improve compliance and reduce fraud as well as TIGTA recommendations to do the same. In April 2011, the GAO reported[4] that erroneously claimed EITCs for fiscal 2010 were estimated at $16.9 million, jumping almost 38% from fiscal 2009.

EITC retention in bankruptcy: A bankruptcy court[5] approved a couple's chapter 13 plan, stating that, absent unusual circumstances, debtors receiving the EITC or the Sec. 24(d) additional child tax credit (ACTC) or both may retain $2,000 of their tax refunds—the combination of the $1,000 refund the same court had determined in *In re Leigh*[6] and up to $1,000 of EITC or ACTC. However, if either the EITC or the ACTC or both total less than $1,000, the maximum the debtors may retain is the $1,000 available to all debtors and the amount of their EITC or ACTC, the court held.

Sec. 36: First-Time Homebuyer Credit

The first-time homebuyer credit expired in 2010 (eligible home purchasers must have entered into a written binding contract before May 1, 2010, and the purchase must have closed on or before September 30, 2010), but it continues to be a subject of litigation and IRS guidance.

Purchase from relative: In *Nievinski*,[7] the Tax Court held that an individual who had purchased a home from his parents did not qualify for the first-time homebuyer credit. The taxpayer had taken the credit based on his accountant's directions and the fact that Form 5405, First-Time Homebuyer Credit and Repayment of the Credit, did not clearly prohibit buying a home from relatives. In court, the taxpayer further argued that IRS Publication 4819, *Important Information About the First-Time Homebuyer Credit*, did not expressly explain that home purchases from family members do not qualify for the credit.

The court held that Form 5405 and Publication 4819 provide general instructions and do not purport to provide all rules and limitations applicable to the credit. The apparent failure of some IRS publications to explain the limitation has no effect on the authority of Sec. 36(c), the court held. Sec. 36(c)(3) clearly states that the credit is not available to a taxpayer who purchases a home from a related person, and Sec. 36(c)(5) clarifies that related persons include direct ancestors such as parents.

Principal residence: In a chief counsel advice (CCA)[8] the IRS allowed the credit to a taxpayer who had lived partly in a storage shed on the construction site of his new home. The taxpayer's previous residence on the site had been destroyed by fire more than three years earlier. In late 2008, the taxpayer began constructing a new home on the same property and lived 40% of the time in a storage shed/dwelling unit on the property. The storage shed had a stove, refrigerator, bathroom, sleeping apparatus, and heat. The taxpayer lived the rest of the time with his girlfriend. The Chief Counsel's Office was asked whether the taxpayer met the first-time homebuyer credit requirement that the taxpayer not have owned a principal residence in the three-year period before purchasing the home for which the credit is claimed.

The Chief Counsel's Office ruled that the storage shed/dwelling unit was a residence for purposes of Sec. 121 because under Regs. Sec. 1.121-1(e)(2), the term "dwelling unit" has the same meaning as in Sec. 280A(f)(1). Under Regs. Sec. 1.280A-1, a dwelling unit could be a house, apartment, condominium, mobile home, boat, or similar property that provides basic living accommodations such as

EXECUTIVE SUMMARY

- Several actions by Congress and the IRS aimed to reduce improper claims of the earned income tax credit by increasing preparer penalties and due diligence procedures.
- Litigation over restricted stock-based compensation focused on the proper date of the stock's market valuation and the effect of company and SEC restrictions on disposition of the stock.
- The Tax Court applied the IRS's recent practice of allowing professional gamblers to deduct ordinary and reasonable nonwagering business expenses over their gambling winnings, overturning a 1951 case holding.
- The Tax Court also held that limited partners of a limited partnership who perform services for the partnership in their capacity as partners may be liable for self-employment taxes despite a general statutory exemption from self-employment income for limited partners' income.

3 TIGTA, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Credit Payments Each Year*, Report No. 2011-40-023 (February 7, 2011).

4 Daly, *Improper Payments: Recent Efforts to Address Improper Payments and Remaining Challenges*, GAO-11-575T (April 15, 2011).

5 *In re Skougard*, 438 B.R. 738 (Bankr. D. Utah 2010).

6 *In re Leigh*, No. 03-33764 (Bankr. D. Utah 4/27/04).

7 *Nievinski*, T.C. Summ. 2011-10.

8 CCA 201104037 (1/28/11).

sleeping space, toilet, and cooking facilities. However, the unit was not considered the taxpayer's principal residence because the taxpayer did not spend the majority of his time there as required by Regs. Sec. 1.121-1(b). Therefore, the taxpayer met the definition of a first-time homebuyer because he had not owned a principal residence within the three years prior to the date of purchase of the new home (in this case, the occupancy date). The taxpayer could include only the cost of constructing the new home in calculating the credit.

Longtime resident credit: In CCA 201104040,[9] the IRS wrote that a taxpayer who completed construction of and occupied a new home on land that was the site of the taxpayer's previous home that had been owned and used for the required time[10] could qualify for the $6,500 maximum credit as a longtime resident. The taxpayer would not include any basis in the land as part of the purchase price of the new home because the land purchase was not near enough in time to the construction of the new home.

TIGTA report: In March 2011, TIGTA issued its final audit report[11] on the homebuyer credit and other refundable credits. The report includes estimates of fraudulently filed returns, TIGTA's recommendations to the IRS in each problem area, and the IRS response to each. Implementation of the recommendations should reduce fraud related to credits promulgated in more recent legislation.

Sec. 53: Credit for Prior-Year Minimum Tax Liability

The IRS Office of Chief Counsel was asked whether restrictions on the computation of regular taxes owed by recipients of Sec. 965 dividends also apply for purposes of computing the minimum tax credit under Sec. 53.[12] Specifically, the taxpayer was interested in whether the floor on taxable income under Sec. 965(e)(2)(A) precludes the reduction of alternative minimum taxable income (AMTI) below the amount of nondeductible dividends for purposes of computing the limit on minimum tax credits under Sec. 53(c).

The chief counsel stated that Sec. 965(e)(2)(A) unambiguously precludes the reduction of taxable income below the amount of nondeductible dividends and that AMTI is derived from regular taxable income. Further, Sec. 55(b)(2) defines AMTI as taxable income modified only under Secs. 56–58, and nothing in those sections provides for eliminating nondeductible Sec. 965 dividends.

Sec. 61: Gross Income Defined

General welfare exclusion: Notice 2011-14[13] provides guidance on the nontaxability of certain payments made to or on behalf of certain individual homeowners by state housing finance agencies or the federal Department of Housing and Urban Development's Emergency Homeowners' Loan Program. Such payments may be nontaxable under the general welfare exclusion because they are intended to help financially distressed individuals. The notice's guidance includes a safe harbor for affected individuals who deduct mortgage interest and lists various types of financial relief programs it covers.

Taxation of employee annuities: Rev. Rul. 2011-7[14] discusses four scenarios in which a defined contribution plan is terminated with certain distributions made to participants or beneficiaries. The ruling explains the tax treatment of the termination action and whether the distributions are subject to tax.

Sec. 83: Property Transferred in Connection with Performance of Services

Two recent court cases dealt with stock-based compensation paid to corporate officers and when and how the stock should be valued. In *Gudmundsson*,[15] on July 1, 1999, the taxpayer received as an officer of his employer a grant of restricted stock of the employer corporation subject to a one-year holding period. Based on the stock's market price on the day the taxpayer received approximately 73,000 shares, his Form W-2, Wage and Tax Statement, reported the value at just under $1.3 million. Gudmundsson reported this amount on his 1999 tax return. By the end of 1999, the stock price had dropped by almost half, and by the one-year anniversary of his receiving the stock, when it became freely marketable, the price had dropped by $14 per share to a little more than one-fifth its original value.

In 2003, Gudmundsson filed an amended return for 1999 modifying his income based on a stock price for December 31, 1999, rather than the date he received the stock. The IRS and a district court denied his refund, and Gudmundsson appealed to the Second Circuit.

As he had in district court, Gudmundsson argued that the shares were not taxable when received due to various Securities and Exchange Commission (SEC) and company restrictions on their transferability. The Second Circuit disagreed, noting that prior rulings have held that potential legal liability under Section 10(b) of the Securities Exchange Act for transferring stock subject to such restrictions does not create a substantial risk of forfeiture for Sec. 83 purposes. In addition, the restrictions on transferability were not absolute. For example, transfers to certain persons, such as family members, were allowed. Also, if property can be pledged or assigned, it may be considered transferable under Regs. Sec. 1.83-3(d), the court said.

Gudmundsson also argued that the district court had incorrectly determined the stock's fair market value (FMV). The Second Circuit disagreed, holding that the restrictions did not affect FMV for Sec. 83 purposes. The court noted that lapse restrictions imposed by contract or operation of law are disregarded in measuring income under Sec. 83.

In *Strom*,[16] the taxpayer received stock options in 1998 exercisable on future dates

9 CCA 201104040 (1/28/11).

10 Any consecutive five-year period during the eight-year period ending on the date of the purchase of a subsequent principal residence (Sec. 36(c)(6)).

11 TIGTA, *Recovery Act: Administration of the First-Time Homebuyer Credit Indicates a Need for Improved Controls over Refundable Credits*, Report No. 2011-41-035 (March 31, 2011).

12 CCA 201115019 (4/15/11).

13 Notice 2011-14, 2011-1 I.R.B. 544.

14 Rev. Rul. 2011-7, 2011-10 I.R.B. 534.

15 *Gudmundsson*, 634 F.3d 212 (2d Cir. 2011).

16 *Strom*, 641 F.3d 1051 (9th Cir. 2011).

at $15 per share. She began exercising them late in 1999 and continued doing so during early 2000, when the stock market value exceeded $1,000 per share. However, the value dropped to between $55 and $64 throughout part of early 2001. Strom argued that her option spreads for 2000 should be based on the 2001 prices rather than actual spreads in 2000. For options Strom exercised in 1999, her employer withheld both income and Medicare taxes. For the 2000 options, the employer withheld only Medicare tax. Strom did not report the spread on the 2000 options on her tax return. She sought refunds of the taxes withheld in 1999 and 2000.

Sec. 83(c)(3) provides a special rule to defer recognition and valuation of income when a person could be subject to suit under SEC Section 16(b), which forbids corporate insiders from profiting by selling the corporation's stock within six months of purchasing it. In such a case, the person's rights in the property are considered subject to a substantial risk of forfeiture and not transferable. At issue in the case was the meaning of "could subject a person to suit under Section 16(b)" as used in Sec. 83(c)(3). The Ninth Circuit reviewed the purpose of this subsection and concluded that a taxpayer could defer calculating and recognizing the income

> if there is an objectively reasonable chance that a suit under §16(b) based on a sale of her stock would have succeeded. That standard roughly equates to a determination of whether a reasonably prudent and legally sophisticated person would *not* have sold her stock, because, if a §16(b) suit had been brought against her, she likely would have been forced to forfeit the profit obtained by the sale (or, at a minimum, she would have faced substantial legal expenses defending herself against a claim not readily dismissed). [Emphasis in original.]

After analyzing the relevant SEC provisions, the court concluded that Strom did not meet the requirements of the Sec. 83(c)(3) rule.

Next, the court analyzed whether Regs. Sec. 1.83-3(k) allowed Strom to defer reporting her option income. This provision applies when property rights are subject to a restriction on transfer to comply with the pooling-of-interests rules of SEC Accounting Series Releases 130 and 135. The court remanded the case to the district court for a ruling based on further factual analysis.

Sec. 104: Compensation for Injuries or Sickness

In *Bakken*,[17] a police officer sustained an injury in the line of duty that made him permanently disabled and unable to work. He was in a plan in which officers could retire after 20 years of service once they had reached age 50. At the time of the injury, Bakken was in his mid-40s and had completed 18½ years of service and therefore was not eligible to retire. He began receiving tax-exempt disability benefits under the same plan and did not return to work. When Bakken turned 50, the payer of the disability benefits started issuing Form 1099-R for the payments, on the premise that they were now retirement benefits. Bakken protested, noting that he did not yet meet the retirement eligibility requirements. He reported the 1099-R income on his income tax returns but later filed amended returns obtaining a refund and thereafter no longer reported the 1099-R income. The IRS determined a tax deficiency.

The Tax Court examined the state law relevant to the payments and cases with similar facts. The court followed *Picard*,[18] in which the Ninth Circuit (to which Bakken could have appealed had he not petitioned as an S case) had stated that payments were for disability rather than retirement when the benefits could not be determined by reference to the taxpayer's age or length of service. The court held for the taxpayer.

Sec. 108: Income from Discharge of Indebtedness—Exclusions

In CCA 201104032,[19] the IRS determined that payments received by health care professionals under a state's tuition reimbursement and recruitment incentive programs were not excludible from gross income under Sec. 108(f) as student loan discharges. The two programs in question did not meet the requirement of having outstanding student debt to participate. In addition, the participants could spend their payments as they wished. The IRS noted that, if the programs were modified, future payments could potentially qualify.

The Office of Chief Counsel also issued guidance on new Sec. 108(f)(4),[20] which was added by the Patient Protection and Affordable Care Act,[21] to exclude from income discharge of indebtedness under certain state and federal programs intended to increase the availability of health care in underserved areas. It covers both loan forgiveness and loan repayment and requires both employers and employees to coordinate with each other to ensure that duplicate refund claims are not filed and double refunds are not paid when following procedures to claim FICA refunds.

Sec. 112: Excludible Combat Zone Compensation

The Tax Court held that income a taxpayer received from a private military contract company for dangerous security work he performed in Iraq as a private contractor was not excludible from gross income under the Sec. 112 exclusion for compensation paid to U.S. military serving in a combat zone, because he was a civilian.[22] However, the taxpayer was not liable for penalties for failure to file or pay tax. The taxpayer was given a copy of an internal IRS memorandum incorrectly stating that civilian personnel serving in support of combat zone military operations and physically present in the combat zone could exclude combat pay from gross income. The taxpayer relied on the memo, and the court determined that he therefore had reasonable cause to have excluded his wages as combat pay while he was in Iraq. The taxpayer was, however, liable for penalties for failure to pay

17 *Bakken*, T.C. Summ. 2011-55.

18 *Picard*, 165 F.3d 744 (9th Cir. 1999).

19 CCA 201104032 (1/28/11).

20 CCA 201049028 (12/10/10).

21 Patient Protection and Affordable Care Act of 2010, P.L. 111-148.

22 *Holmes*, T.C. Memo. 2011-26.

estimated taxes, for which no reasonable-cause exception is generally provided (see items on Sec. 6654 below).

Sec. 117: Qualified Scholarships

The exemption from the payments-for-service rules for amounts received under certain government health professions scholarship programs had been scheduled to sunset after 2010; however, it was extended through 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the Tax Relief Act).[23]

A series of private letter rulings addresses exempt organization/private foundation procedures for granting scholarships to comply with Sec. 4945(g).[24] Requirements and awards granted in accordance with those procedures will not constitute taxable expenditures under Sec. 4945(d)(3), and awards made under such procedures are excludible from recipients' gross income under Sec. 117(c)(2).

Sec. 121: Sale of Principal Residence

Use of Sec. 121 to exclude gain from the sale of a principal residence by heirs, estates, and qualified revocable trusts is no longer applicable. Sec. 121(d)(11) was repealed for estates of decedents dying and transfers made after December 31, 2009.[25]

Sec. 127: Educational Assistance Programs

The Code provision under Sec. 127 allowing the exclusion of employer-provided educational assistance had been set to sunset after 2010 but has been extended through 2012.[26] In a field attorney advice, the IRS determined that in the case of an educational institution that provided tuition assistance to its employees, amounts exceeding the $5,250 per year dollar cap of Sec. 127 could be deducted as a working condition fringe benefit, as long as the educational assistance otherwise met the requirements of Sec. 127 and qualified as a working condition fringe benefit under Sec. 132.[27]

Sec. 135: Income from U.S. Savings Bonds Used to Pay Higher Education Tuition and Fees

The following Code sections were set to expire December 31, 2010, and now under the Tax Relief Act will generally sunset for tax years beginning after December 31, 2012: Secs. 135(c)(2)(C), (c)(4), (d)(1)(D), (d)(2)(A), and (d)(2)(B).[28]

Sec. 162: Trade and Business Expenses

Gambling: The Tax Court overturned a key portion of its 1951 decision in *Offutt*[29] concerning the deductibility of trade or business expenses by a professional gambler.[30] Under *Offutt*, ordinary and necessary business expenses of a gambling activity were treated the same as gambling losses and were therefore limited by Sec. 165(d) to gambling winnings. However, in *Mayo*, the court ruled that a professional gambler may deduct his or her ordinary and necessary business expenses on Schedule C even if they exceed the gambler's net gambling winnings and produce a loss for the activity. The court noted that various rulings had used a narrow definition of the phrase "gains from wagering transactions" and said a similar reading should be used for the phrase "losses from wagering transactions" in Sec. 165(d). The court also said it felt it needed to address the issue even though the IRS had previously announced its intention to no longer follow *Offutt*,[31] since history invited the possibility of administrative inconsistency on this issue.

Substantiating business expenses: Sharon Griffin, a resident of Los Angeles, filed nine Schedules C with her returns for 2001, 2002, and 2003 in addition to reporting wage income of over $70,000 from part-time work.[32] Griffin worked in the entertainment industry and had an assortment of sideline businesses including delivery service, computer repair, landscaping, steam cleaning, and consulting. Over the three years, these businesses had a combined gross income of nearly $3 million but reported a net taxable loss of over $225,000. Griffin had filed her returns late and provided "less than full cooperation" during the audit, the court said. She regularly failed to show up for meetings with an IRS auditor and failed to produce promised documents, and those she did produce were summaries without backup. She claimed that all the expenses were paid by cash, and she issued only one Form 1099 over the three-year period, despite testifying that she paid dozens of workers direct cash compensation. The Tax Court found that her documentation "lacked credibility" and her testimony was "vague and evasive," and it upheld the IRS's denial of her deductions.

In another case,[33] the taxpayer for 2006 and 2007 reported approximately $335,000 in income and $250,000 in business expenses on his Schedule C consulting business for each tax year. The IRS audited and asked for substantiation of the business expenses. The taxpayer refused, claiming a violation of his Fifth Amendment rights. He further argued at trial that signing the return under penalty of perjury was sufficient substantiation. The Tax Court denied all the expenses and upheld an accuracy-related penalty of $36,113.

Sec. 170: Charitable Contributions and Gifts

A married couple, both medical doctors, with three children transferred appreciated stock and cash to a charitable

23 Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P.L. 111-312.

24 IRS Letter Rulings 201106020 (2/11/11), 201104047 (1/28/11), 201104048 (1/28/11), 201104049 (1/28/11), 201104050 (1/28/11), 201052019 (12/30/10), 201052020 (12/30/10), 201047026 (11/26/10), 201046017 (11/19/10), 201045032 (11/12/10), and 201045033 (11/12/10).

25 Tax Relief Act, §301(a).

26 Tax Relief Act, §101(a)(1).

27 IRS Field Attorney Advice Memo. 20103901F (10/1/10).

28 Tax Relief Act, §101(a)(1).

29 *Offutt*, 16 T.C. 1214 (1951).

30 *Mayo*, 136 T.C. 81 (2011).

31 IRS Chief Counsel Memo. AM 2008-013 (12/19/08).

32 *Griffin*, T.C. Memo. 2010-252.

33 *Raeber*, T.C. Memo. 2011-39.

foundation "created to benefit not only charitable causes, but also doctors and their families."[34] The foundation kept the donated assets in a separate account for each donor and allowed donors to direct the use of these funds, specifically including as college loans. The foundation's program summary stated that "donors and their family members may work for and be compensated . . . for good works they perform on behalf of their family public charities" (i.e., the segregated foundation account). The taxpayers later had the foundation make payments to the college of one of their sons for tuition and fees. The son signed a "loan agreement" promising to repay the funds starting five years after graduation or to provide designated amounts of charitable services. The Tax Court upheld the IRS's denial of a charitable contribution deduction because the taxpayers retained control over the stock and cash donated to the foundation. The court also found the couple liable for capital gain tax on the foundation's subsequent sale of the appreciated stock and liable for an accuracy-related penalty under Sec. 6662.

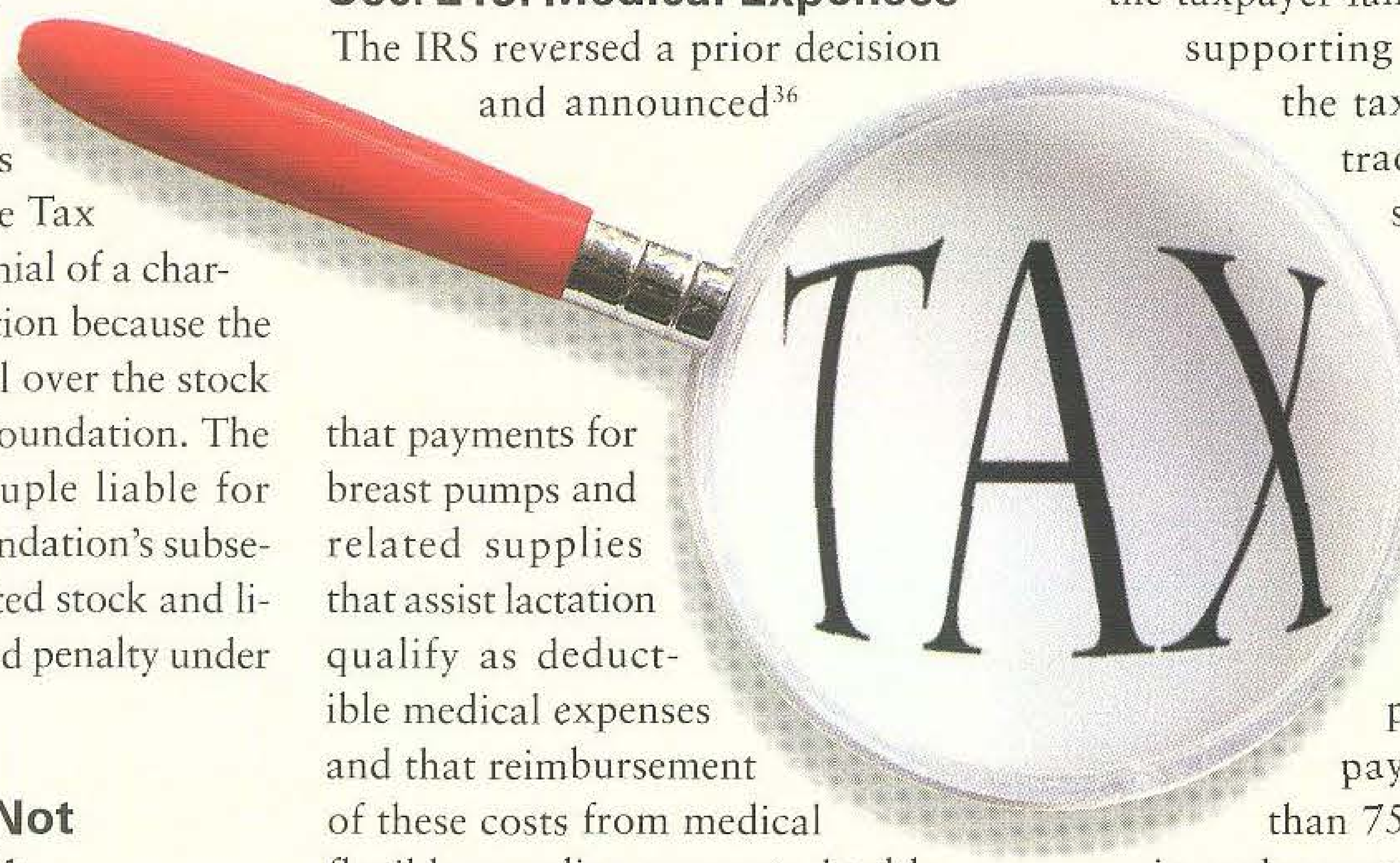
Sec. 183: Activities Not Engaged in for Profit

The Tax Court ruled that two cat breeders could not deduct expenses related to their cat activities either through a corporate entity or directly as a Schedule C business.[35] During the three years in question, Debra Dursky and Elizabeth Watkins were reimbursed by Dursky's corporation (DKD Enterprises) for over $60,000 a year in expenses for cat breeding, showing, and upkeep. Total sales during the three years combined were less than $2,000. The women had engaged in similar cat-related activities for at least 10 years before attempting to deduct the expenses from DKD's income.

In August 2006, their accountants informed them that the IRS was auditing their returns for 2003 and 2004. They then ceased running the cattery expenses through DKD and took no deductions for expenses incurred through August on the entity's 2006 tax return. DKD's primary business had been and remained information technology consulting, for which Dursky (the sole shareholder) paid herself a salary of over $80,000 annually. The court agreed with the IRS that the cattery activity was clearly a hobby without any intent or motive to make a profit. It further decided that Dursky must report as income the "constructive dividend" she received by having DKD reimburse her for the cattery-related expenses.

Sec. 213: Medical Expenses

The IRS reversed a prior decision and announced[36] that payments for breast pumps and related supplies that assist lactation qualify as deductible medical expenses and that reimbursement of these costs from medical flexible spending accounts, health savings accounts, health reimbursement arrangements, and Archer medical savings accounts is not taxable income.



Sec. 469: Passive Activity Losses and Credits Limited

Real estate election: In two letter rulings, the taxpayers were determined to be in a real property business as defined by Sec. 469 and were qualified under Sec. 469(c)(7)(B) to make an election to treat all interests in rental real estate as a single rental real estate activity.[37] However, the taxpayers failed to include in their tax returns the necessary statement under Regs. Sec. 1.469-9(g)(3) to make the election. The taxpayers requested relief under Regs. Sec. 301.9100-3, which allows an extension to file this election. Based on the facts submitted, the taxpayers were granted a 60-day extension from the date of the rulings to treat all interests in rental real estate as a single real estate activity. The rulings advised that the election must meet the criteria of Regs. Sec. 1.469-9(g)(3) and be attached to an amended return.

Material participation: In a case decided by the Tax Court, the petitioner argued that he was a qualifying real estate professional because he met the requirements of Sec. 469(c)(7)(B) and that his rental real estate activities were not passive because he materially participated in them.[38] The court disagreed, finding that the taxpayer failed to provide requested supporting documentation. Also, the taxpayer's testimony contradicted his earlier signed statements in which he said he spent 800 hours during the year working on his real estate properties. At trial, the court explained to him that although the 800 hours met part of the material participation test—that a taxpayer must perform more than 750 hours during the year in real property trades or businesses in which the taxpayer materially participates—they did not meet the additional requirement of being more than half of all personal services he performed in trades or businesses during the year. (The taxpayer had previously stated he also worked approximately 1,800 hours during the year as an engineer.) The taxpayer then revised his testimony to say he actually spent 1,920 hours in his real estate business—a claim the court judged to lack credibility.

The taxpayer also was assessed a Sec. 6662 penalty, which he contended he should not be assessed because he used tax preparation software. The court said that misuse of tax preparation software, even if unintentional or accidental, is no defense to penalties under Sec. 6662.

34 *Viralam*, 136 T.C. 151 (2011).

35 *DKD Enterprises*, T.C. Memo. 2011-29.

36 Announcement 2011-14, 2011-9 I.R.B. 532 (2/28/11).

37 IRS Letter Rulings 201108027 (2/25/11) and 201050022 (12/17/10).

38 *Anyika*, T.C. Memo. 2011-69.

In a similar case,[39] the taxpayer could not corroborate with written documentation his statements that more than one-half of the personal services he performed in trades or businesses during the years were performed in real property trades or businesses. Further, with respect to the 750-hour requirement, the court concluded that the petitioner's failure to introduce supporting evidence such as calendars, narrative summaries, mileage logs, or receipts prevented the court from accepting his testimony that he worked the requisite number of hours. The court concluded that the taxpayer was not a qualifying real estate professional under Sec. 469(c)(7)(B) and treated his real estate activities as *per se* passive.

Active participation: In *Bosque*,[40] the taxpayer similarly argued that he was a real estate professional under Sec. 469(c)(7)(B). However, the taxpayer had failed to file an election with his 2006 or 2007 returns to treat all interests in rental real estate as a single rental real estate activity under Sec. 469(c)(7)(A). The court concluded that the taxpayer failed to show that he met the 750-hour service performance requirement of Sec. 469(c)(7)(B)(ii) for the years at issue. Therefore, the court said, he was not a real estate professional under Sec. 469(c)(7), and his rental real estate activities must therefore be treated as a passive activity under Sec. 469(c)(2).

However, Sec. 469(i) provides an exception to this rule: A taxpayer who actively participates in a rental activity can offset up to $25,000 of losses per year against nonpassive income. However, the offset amount is subject to phaseout for taxpayers with adjusted gross incomes over $100,000. A taxpayer actively participates if he or she does so in a significant and bona fide sense in making management decisions or arranging for others to provide services such as repairs. In *Bosque*, the court held that the taxpayer actively participated in his rental real estate activities during 2006 and 2007 and consequently was entitled to offset his nonpassive income by $25,000 for each of those years, subject to the phaseout limitation.

Sec. 1001: Determination of Amount and Recognition of Gain or Loss

The IRS issued final regulations effective January 7, 2011, relating to the modification of debt instruments.[41] The regulations clarify that a decrease in the FMV of a debt instrument is not taken into account to determine whether a modified debt instrument is recharacterized as an instrument or property right that is not debt, to the extent that the decrease in FMV is attributable to the deterioration in the issuer's financial condition and not to a modification of the terms of the instrument.

In a Tax Court case,[42] the taxpayer's basis in regulated investment company shares was not increased by undistributed regulated investment company gains because there was no evidence that the undistributed gains were ever reported in his gross income.

In another case,[43] the taxpayer and his siblings inherited a house from his mother in 2001. In 2004, his siblings conveyed the house to him for no consideration; he then sold the house in 2004. The Tax Court denied his unsubstantiated claim that his basis should be increased for mortgage payments he made on the inherited property. The court determined his basis to be the FMV on his mother's date of death.

The Tax Court saw more litigation in 2011 arising from purported stock loans marketed to small investors by Derivium Capital LLC.[44] In one case,[45] the court determined that a taxpayer's 90% Derivium stock-loan program was a sale in the year the stock was transferred to the purported lender, not the year the purported loans matured.

In another Derivium case,[46] the taxpayer, president, and owner of a manufacturing company sold shares of his stock to the company's employee stock ownership plan (ESOP) in 1999. He properly deferred gain on the sale by purchasing qualified floating rate notes (FRNs) from Bank of America. In 2004, Derivium affiliate Optech Ltd. marketed an ESOP-qualified replacement property 90% loan-to-value program to the taxpayer. The nonrecourse loan was secured by the FRNs. Optech agreed to serve as the lender or as an agent for another lender. The agreement provided that the lender had the right to register the FRNs in its own name and could do as it wished with them. The taxpayer also waived his right to receive interest or other benefits from the FRNs during the term of the loan, and he could not repay the loan. Since the taxpayer transferred the incidents of ownership to the lender and had no obligation to repay the loan, there was no bona fide debtor-creditor relationship, the Tax Court held. The court found that a sale of the shares occurred in 2004 when the taxpayer transferred the FRNs to Optech.

Sec. 1012: Basis of Property: Cost

Husband and wife taxpayers donated a qualified conservation easement on about 54 acres of their Colorado property to a charitable organization.[47] In exchange, they received about $260,000 of conservation easement income tax credits from the state of Colorado. Later in 2004, they sold some of the credits and claimed as basis in the easements a portion of the professional fees incurred to make the donation. The Tax Court held that they improperly allocated costs associated with the donation and had no basis in the state credits. Although the credits were determined to be capital assets, their sale was determined to result in a short-term capital gain because the holding period of the underlying donated land could not be attributed to the state credits.

39 *Magno*, T.C. Summ. 2011-43.

40 *Bosque*, T.C. Memo. 2011-79.

41 T.D. 9513.

42 *Knowles*, T.C. Memo. 2011-23.

43 *Jarman*, T.C. Memo. 2010-285.

44 Between 1998 and 2002, the company engaged in approximately 1,700 purported stock loans that the IRS and courts have generally held to have been taxable sales. See, e.g., *Calloway*, 135 T.C. 26 (2010), and *Shao*, T.C. Memo. 2010-189.

45 *Kurata*, T.C. Memo. 2011-64.

46 *Sollberger*, T.C. Memo. 2011-78.

47 *Tempel*, 136 T.C. 341 (2011).

Sec. 1031: Like-Kind Exchange

The Tax Court held[48] that taxpayers had to recognize income from a failed attempt to complete a like-kind exchange. Money from a sale of their property had not been deposited with a qualified intermediary. Although the funds were deposited into an escrow account, the taxpayers' control over the money was not subject to substantial limitations or restrictions, so the Tax Court held that the account was not a qualified escrow account for like-kind exchange purposes. Therefore, the Tax Court agreed with the IRS that the taxpayers had constructively received the proceeds from the sale.

The Office of Chief Counsel released a letter[49] stating that the IRS had no authority to allow nonrecognition of "flash crash" gains resulting from May 6, 2010, security sales that automatically were executed due to stop-loss orders. The stock market had a temporary but severe drop, apparently due to an erroneously entered trade. The large stock market plunge caused many investors to have automatic, unexpected security sales. Security sales do not qualify for nonrecognition under Sec. 1031, so an investor could not rely on the provision to defer the gain realized on the securities sold.

Sec. 1041: Transfers of Property Incident to Divorce

A divorced taxpayer could not use the FMV of real property at the time of transfer from her former spouse as the property's basis in computing gain or loss.[50] The Tax Court held that the property's basis for this purpose was the former spouse's adjusted basis in the property.

Sec. 1250: Gain from Dispositions of Certain Depreciable Realty

A married couple who owned restaurant franchise businesses was not required to recognize any recapture income under Sec. 1250 on the sale of a franchise in one year at issue.[51] The IRS incorrectly assumed that the franchise's property was composed of only Sec. 1250 property, and there was no evidence that the taxpayers used anything other than the straight-line method when depreciating their business's Sec. 1250 property, the Tax Court held. The taxpayers also had no recapture income under Sec. 1245 for property improvements made during that year because the IRS neither argued nor determined that any part of their deficiency stemmed from Sec. 1245 recapture.

Sec. 1401: Tax on Self-Employment Income

The Social Security contribution and benefit base for remuneration paid in 2011 and for self-employment income earned in tax years beginning in 2011 is $106,800, unchanged from 2010.

The Tax Relief Act enacted a one-year tax break in 2011 to provide an economic stimulus by increasing workers' take-home pay. Congress approved a reduction of 2 percentage points in Social Security payroll taxes for employees and self-employment tax. Thus, the Social Security payroll tax rate for 2011 is 4.2% for employees and 10.4% for the self-employed.

In a chief counsel advice,[52] the IRS noted that nonresident aliens generally do not owe self-employment tax, but if they are subject to the tax, a totalization agreement is necessary. In both it and another chief counsel advice,[53] the IRS advised that the provision for the Self-Employment Contributions Act tax under a totalization agreement is found in Sec. 1402(b).

LLC members and limited partners: The Tax Court disregarded a limited liability company (LLC) and management corporation[54] created by a psychiatrist to reduce his tax liability, holding that net income arising from his practice was taxable as self-employment income. The court also found the taxpayer liable for accuracy-related penalties, saying his reliance on a tax adviser who had recommended the strategy was not reasonable or prudent.

The Tax Court's opinion in *Renkemeyer*[55] increased uncertainty about whether partners in a limited liability entity are subject to self-employment tax. The case addressed Sec. 1402(a)(13), which in general provides that the income of a limited partner is not subject to self-employment tax as long as it is not a guaranteed payment for services rendered. However, the Code does not define "limited partner." Members of limited liability companies and partners in limited liability partnerships (LLPs) have relied on this section to exempt their share of income from self-employment tax. In *Renkemeyer*, the attorneys in a law firm organized as an LLP argued that their interests should be considered those of limited partners because the interests were designated as such in the organizational documents. This was despite the fact that 99% of the firm's net income was generated by legal services performed by the three partners of the firm.

Proposed regulations issued in 1997 would deny limited partner status for purposes of the Sec. 1402(a)(13) exemption from self-employment tax (with some exceptions) to any individual partner who participates in the partnership's trade or business for more than 500 hours a year, is able to contract on behalf of the partnership, or has personal liability for the partnership's debts.[56] In response to criticism of the proposed regulations, Congress issued a one-year moratorium stripping Treasury of its authority to issue temporary or final guidance on the definition of limited partner under this section. Although the moratorium expired on July 1, 1998, the IRS and Treasury have not finalized, withdrawn, or replaced the proposed regulations. The opinion in *Renkemeyer* effectively adopted the principle of the proposed regulations. The court held that LLP income allocated to the partners was subject to self-employment tax and that Congress had not intended for partners who perform services for a partnership in that capacity to qualify for the limited partner exclusion.

48 *Crandall*, T.C. Summ. 2011-14.
49 INFO 2010-0188 (9/24/10). Letter from John Aramburu, IRS senior counsel.
50 *Parsley*, T.C. Summ. 2011-35.
51 *Daoud*, T.C. Memo. 2010-282.
52 CCA 201101010 (1/7/11).
53 CCA 201109027 (3/4/11).
54 *Robucci*, T.C. Memo. 2011-19.
55 *Renkemeyer, Campbell & Weaver LLP*, 136 T.C. 137 (2011).
56 REG-209824-96. They replaced earlier proposed regulations the IRS withdrew (REG-209729-94).

Health insurance premiums: For 2011, self-employed taxpayers can no longer deduct their health insurance premiums as a business expense from net earnings for purposes of self-employment tax.[57] For 2010 only, eligible self-employed individuals were able to deduct health insurance premiums for months in which they were ineligible to participate in any subsidized health plan offered by an employer or a spouse's employer. However, on March 2, 2011, a bill was introduced that would restore the deduction permanently.[58]

Sec. 6013: Joint Returns

In a chief counsel advice[59] the Office of Chief Counsel directed that a taxpayer for whom the IRS had filed a substitute return under Sec. 6020(b) and issued a notice of deficiency could elect joint filing status under Sec. 6013(a) with a spouse who had died during the year. The Chief Counsel's Office cited the Tax Court holding in *Millsap*[60] that the return prepared under Sec. 6020(b) did not constitute a separate return filed by the taxpayer. Assuming that no return had been filed by the decedent or an executor or administrator, no executor or administrator had been appointed, and no executor or administrator would be appointed before the last day prescribed by law for filing the return of the surviving spouse, the taxpayer was eligible to file a joint return.

Same-sex couples: The issue of same-sex couples filing joint returns may soon be in the forefront of tax changes. On February 23, 2011, U.S. Attorney General Eric Holder indicated that the Department of Justice will no longer defend the constitutionality of Section 3 of the Defense of Marriage Act (DOMA)[61] in two Second Circuit cases.[62] Section 3 defines "marriage" under federal law as between one man and one woman as husband and wife and defines "spouse" as a person of the opposite sex. Both Holder and President Barack Obama have stated that Section 3 of DOMA is unconstitutional as applied to same-sex couples legally married under state law. In spite of this, the IRS must continue to follow DOMA when applying the provisions in the Code or regulations. A number of practitioners are advising same-sex couples married under applicable state law to file single or head-of-household returns for now but to keep in mind that a federal law change could allow them to later file joint amended returns.

Sec. 6015: Innocent Spouse Relief

Despite favorable opinions in several circuit courts for its stance limiting the filing period for claims for equitable innocent spouse relief to two years, the IRS abandoned the position,[63] saying it will now consider taxpayer requests for equitable relief from joint and several liability under Sec. 6015(f) at any time if the limitation period for collection of taxes under Sec. 6502 remains open for the tax years at issue (generally, 10 years after an assessment). If the taxpayer is seeking a refund as part of the request, the limitation period on credits or refunds under Sec. 6511 governs (generally, three years). Until the regulations are revised and the limit is formally removed, the IRS provided transitional rules for requesting relief or resolving cases currently in litigation. The change of position was not wholly unexpected; the IRS had been mulling revising the limit in Regs. Sec. 1.6015-5(b)(1) at least since April 2011, when 49 members of Congress in a letter urged IRS Commissioner Douglas Shulman to do so.

Despite its having been reversed on the issue by the Third, Fourth, and Seventh circuits,[64] the Tax Court had continued to hold the regulation invalid.[65] The court had concluded that, because Congress specifically omitted any limitation period from Sec. 6015(f), and because that subsection provides relief that cannot be obtained under Sec. 6015(b) or Sec. 6015(c), Congress intended that the two-year limitation would not apply in connection with Sec. 6015(f).

The appeals courts generally found that Congress had granted the IRS the authority to devise appropriate substantive and relevant procedures to be followed, including deadlines, and that the two-year limitation period was a reasonable exercise of that authority.

Sec. 6654: Estimated Tax Payments

Unearned income Medicare tax: As provided by the Health Care and Education Reconciliation Act of 2010,[66] individuals, estates, and trusts will be subject to an unearned income Medicare contribution tax for tax years beginning after December 31, 2012. The tax on individuals is 3.8% of the lesser of net investment income or the excess of modified adjusted gross income over a threshold amount.[67] The tax imposed on a trust or estate is 3.8% of the lesser of undistributed net investment income or the excess of adjusted gross income over the dollar amount at which the highest applicable income tax bracket begins ($11,351 in 2011). This tax is subject to the estimated tax provisions under Sec. 6654 and is not deductible in computing income tax.

Court cases: An individual receiving pension benefits claimed that the payments were tax-free disability income.[68] Accordingly, the taxpayer did not file tax returns for the years in question and did not make estimated tax payments. The IRS prepared a substitute for return for each tax year. The taxpayer never submitted substantiation to refute the substitutes for return. Noting that the Sec. 6654 addition to tax is mandatory and provides for no reasonable cause exception, the Tax Court held that the taxpayer was liable for an addition to tax because of his failure to pay his estimated taxes.

57 Sec. 162(l)(4), as amended by §2042 of the Small Business Jobs Act of 2010, P.L. 110-240. Premiums remain deductible for income tax purposes.
58 Equity for Our Nation's Self-Employed Act of 2011, H.R. 880.
59 CCA 201049030 (12/10/10).
60 *Millsap*, 91 T.C. 926 (1998), *acq.*, AOD-1992-03.
61 Defense of Marriage Act, P.L. 104-199.
62 *Pedersen v. Office of Personnel Management*, No. 10-CV-1750 (D. Conn.), and *Windsor*, No. 10-CV-8435 (S.D.N.Y.).
63 Notice 2011-70, 2011-32 I.R.B. 135.
64 *Lantz*, 607 F.3d 479 (7th Cir. 2010); *Mannella*, 631 F.3d 115 (3d Cir. 2011); *Jones*, 642 F.3d 459 (4th Cir. 6/13/11).
65 See, e.g., *Pullins*, 136 T.C. No. 20 (2011).
66 Health Care and Education Reconciliation Act of 2010, P.L. 111-152.
67 Sec. 1411.
68 *Lukovsky*, T.C. Memo. 2010-117.

In another case,[69] an individual did not timely file tax returns for three consecutive years during which he also made no estimated tax payments. The IRS prepared substitute tax returns that included pension income ranging from $95,000 to $150,000. In response to the IRS notices, the taxpayer submitted tax returns for the same years with zeros on every line requiring a dollar amount, except those for the standard deduction and personal exemption. The court found that the IRS did not provide proof of an estimated tax payment requirement for the first year in question, since there was no return on file for the prior year and thus no evidence of a prior-year tax liability. Because the IRS bears the burden of proof for additions to tax under Sec. 6654, the Tax Court held that the taxpayer was not liable for a Sec. 6654 penalty for the first year but was liable for penalties assessed in the following two years.

In yet another case, a taxpayer who failed to make estimated tax payments claimed legal, emotional, and physical distress caused by events involving her former husband, who was sentenced to prison for various criminal activities.[70] Generally, no reasonable cause exception exists for the Sec. 6654 addition to tax. However, the IRS may waive it if the taxpayer became disabled in the tax year for which estimated tax payments were required or in the preceding tax year and the underpayment was due to reasonable cause and not willful neglect. Or the penalty may be waived because of disaster, casualty, or "other unusual circumstances" where its imposition would be against equity and good conscience.[71] However, the taxpayer did not provide sufficient evidence to support either of these exceptions, the court held.

In another case,[72] an individual claim-ed zero wages on returns and an amended return covering three tax years, despite receiving Forms W-2 showing wages of $78,267, $82,553, and $68,364. He claimed the wages were not taxable income. The IRS notified the taxpayer that it considered the returns frivolous, but the taxpayer continued to argue they were valid. The Tax Court held that his submissions did not satisfy the four-part test established in *Beard*[73] for a valid return, since they did not contain sufficient data to allow the IRS to calculate his liability and "did not represent an honest and reasonable attempt to satisfy the requirements of the tax law." Penalties for failure to file and pay estimated taxes were deemed to have been conceded by the taxpayer because he did not address them in his petitions or at trial.

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69 *Buckardt*, T.C. Memo. 2010-145.

70 *Jones*, T.C. Summ. 2010-139.

71 Sec. 6654(e)(3).

72 *Holmes*, T.C. Memo. 2011-31.

73 *Beard*, 82 T.C. 766 (1984), aff'd, 793 F.2d 139 (6th Cir. 1986).

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