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Individual Taxation: Digest of Recent Developments

Annette M. Nellen

San Jose State University, annette.nellen@sjsu.edu

E. Cook

University of Louisiana at Lafayette

E. Gershman

Deloitte Tax LLP

J. Hagy

Hagy & Associates PC

J. Horn

See next page for additional authors

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Authors

Annette M. Nellen, E. Cook, E. Gershman, J. Hagy, J. Horn, D. Moore, and K. Rubin

Individual Taxation: Digest of Recent Developments

By: Ellen D. Cook, MS, CPA
Anna C. Fowler, CPA, MBA, Ph.D.
Edward A. Gershman, CPA
Janet C. Hagy, CPA
Jonathan Horn, CPA
Annette Nellen, CPA, Esq.
Darren L. Neuschwander, CPA, MST
Dennis Newman, CPA
Nora Stapleton, CPA, MST



This article covers recent significant developments affecting taxation of individuals, including legislative changes, cases, regulations, and other IRS guidance. The items are arranged in Code section order.

The Treasury Inspector General for Tax Administration (TIGTA) semiannual report to Congress for the period October 2008–March 2009 includes a recommendation that legislation is needed to clarify whether refundable tax credits, such as the additional child tax credit, may be paid to filers without valid Social Security numbers.¹ Currently, an individual taxpayer identification number (ITIN) is available to any resident or nonresident alien who is unable to obtain an SSN but has a tax return filing requirement. Each year the IRS approves billions of dollars in tax credits claimed by ITIN filers without adequate verification of eligibility. In tax year 2007, for example, more than 1.2 million (66%) ITIN filers received additional child tax credits of \$1.8 billion. The TIGTA report says payment of federal funds to ITIN filers is inconsistent with federal law and policy.

Specifically, TIGTA recommends that the IRS develop processes to:

- Identify individuals who are improperly using ITINs for work purposes and develop outreach efforts with the Social Security Administration to address the improper use;
- Limit the automatic population feature for ITIN tax returns;
- Ensure that accurate tax information is put into the IRS systems from both paper and electronically filed ITIN tax returns; and
- Ensure that the requirements for the child tax credit and the additional child tax credit are met on ITIN returns claiming the credits.

Further, in cases in which the credits may not be paid, TIGTA recommends that the IRS be given math error authority to disallow associated claims for credits. The IRS management agrees with the recommendation.

The IRS management agreed to continue to work with software companies to limit the auto-populate feature and also

¹ Treasury Inspector General for Tax Administration (TIGTA), *Semiannual Report to Congress, October 1, 2008–March 30, 2009*, at 7.

agreed to work with Treasury's Office of Tax Policy to consider legislation to limit claims for the additional child tax credit to taxpayers with an SSN. However, the IRS disagreed with the other recommendations, although the report says TIGTA does not believe that the IRS management provided adequate justification for the disagreement.

Sec. 24: Child Tax Credit

A bankruptcy court has held that a non-refundable child tax credit is not exempt property under state law in Colorado.² It disallowed a couple's claimed exemption for that amount and ordered the couple to turn over the pre-petition portion of their 2008 income tax refund to the bankruptcy estate.

Sec. 25: Interest on Home Mortgages

The Government Accountability Office (GAO), in a July 2009 report, made seven recommendations to the IRS regarding home mortgages:³

- Revise the National Research Program's case selection system so a tax return's mortgage interest deduction is not automatically excluded as an examination issue if it matches information reported on Form 1098, Mortgage Interest Statement;
- Revise Form 1098 to require third parties to provide information on mortgage balances, the address of a home securing a mortgage, and an indicator of whether the mortgage is for a current-year refinancing;
- Investigate whether using information from private sources would be productive in detecting mortgage interest non-compliance, especially for home equity debt;
- Revise the wording on Schedule A, Itemized Deductions, to clearly state that the mortgage interest deduction is subject to limitations;
- Conduct a test to evaluate whether mortgage interest deduction-related outreach programs to taxpayers and tax return preparers could be a cost-

effective way to reduce noncompliance. Outreach might include sending correspondence covering key rules and common mistakes or promoting seminars on common types of misreporting;

- Set a date to complete the Chief Counsel determination on whether the acquisition debt limit is \$1 million or \$1.1 million when used in combination with the home equity debt limit; and
- Revise examiner training materials by adding examples cited as common problems by auditors and paid tax return preparers, such as those involving multiple homes or home-based businesses. After the Chief Counsel's final determination on the acquisition limit, revise examiner training and the worksheet in guidance to reflect the project's outcome.

The GAO received written comments from the IRS on July 23, 2009. The IRS agreed with five of the recommendations and agreed to study the other two.

The IRS acknowledged that without information about taxpayers' mortgage debts, it cannot easily detect taxpayer noncompliance with the mortgage interest deduction limits. It also said that the absence of information about noncompliance prevents it from efficiently deciding how to select cases for review and noted that the complexity of the rules causes problems for some taxpayers.

Regarding the recommendation to revise Form 1098 to include more information on taxpayer mortgages, the IRS agreed to study the issue, saying it does not have enough data to support revisions at this time. Because the IRS acknowledged in its comments that it does not have information about taxpayers' mortgage debts to easily detect noncompliance, the GAO believes that the recommended revisions to Form 1098 would be cost-effective ways to provide the IRS with additional useful information to help it detect noncompliance.

Concerning the recommendation to conduct a test to evaluate whether mortgage interest deduction-related outreach programs could be a cost-effective way

EXECUTIVE SUMMARY

- TIGTA made recommendations regarding the use of individual tax identification numbers (ITINs) with respect to refundable tax credits such as the child tax credit. TIGTA also recommended that the IRS develop a new process to prevent erroneous claims for the earned income credit.
- The IRS issued guidance providing the procedure for electing under Sec. 108(i) to include income from indebtedness discharged in a reacquisition of a debt instrument in gross income ratably over a five-year period.
- The IRS issued advice to its employees regarding the determination of whether a taxpayer can claim a dependency exemption for a noncustodial child, and several courts ruled on this issue in specific situations.
- The IRS rejected a Tax Court position and advised that indebtedness incurred to acquire, construct, or substantially improve a residence that exceeds \$1 million is not acquisition indebtedness. However, the IRS states that up to \$100,000 of such debt can be treated as home equity indebtedness (assuming no separate home equity debt exists), thereby allowing interest on \$1,100,000 of the debt to acquire the home to be deductible.

2 *In re Landgrebe*, No. 08-26271 EEB (Bankr. D. Colo. 9/23/09).

3 GAO Report GAO-09-769, *Home Mortgage Interest Deduction* 24 (July 2009).

to reduce noncompliance, the IRS said it would study the feasibility of such a test. It also addressed the question of whether the acquisition debt limit is \$1 million or \$1.1 million in chief counsel advice released in October, discussed in the coverage of Sec. 163 on p. 183.

Sec. 32: Earned Income Credit

The TIGTA semiannual report to Congress includes a recommendation that the IRS conduct a study to identify alternative processes that will expand its ability to effectively and efficiently identify and adjust erroneous earned income tax credit claims.⁴

TIGTA also recommended that the IRS work with the Assistant Secretary of the Treasury for Tax Policy to obtain the authority necessary to implement alternative processes to adjust erroneous earned income tax credit claims. The IRS management agreed with the recommendations and has planned appropriate corrective actions.

Sec. 36: First-Time Homebuyer's Credit

The Worker, Homeownership, and Business Assistance Act of 2009,⁵ signed into law on November 6, 2009, extended the first-time homebuyer's credit, which had been set to expire on November 30, 2009. The act provides that taxpayers who enter into a binding contract before May 1, 2010, to close on the purchase of a principal residence before July 1, 2010, are eligible for the \$8,000 credit.

Income limitations to qualify for the credit were increased so that the credit phases out for individual taxpayers with modified adjusted gross income between \$125,000 and \$145,000 (\$225,000 and \$245,000 for joint filers) for the year of purchase. Further, taxpayers may elect to treat the purchase of a principal residence in 2009 or before the new deadline in 2010 as made on December 31 of the calendar year preceding the purchase. Finally, no credit is allowed for taxpayers

under age 18 on the date of the purchase or for the purchase of any residence costing more than \$800,000.

The law expands the credit to include "long-time residents of the same principal residence" for purchases made after November 6, 2009, the effective date of the new provisions. That is, taxpayers who have owned and used the same residence as their principal residence for any five-year consecutive period during the previous eight-year period ending with the date on which the new residence is purchased are eligible for a \$6,500 credit. The new phaseouts and age/cost limitations also apply.

Military families are provided some relief; the credit recapture rules are waived for members of the U.S. uniformed services (Army, Navy, Air Force, Marines, Coast Guard, and commissioned corps of the U.S. Public Health Service and the National Oceanic and Atmospheric Administration), Foreign Service, and intelligence community who are called to duty before 36 months after the date of purchase. The act also extends the credit for those individuals on qualified official extended duty outside the United States to purchases made before May 1, 2011 (or July 1, 2011, for taxpayers with binding contracts in place before May 1, 2011).

In an effort to curb fraud and abuses of the credit, the law gives the IRS math error authority to disallow the credit during processing, excludes dependents and related parties from claiming the credit, and requires taxpayers to attach a copy of the settlement agreement to the tax return.

Sec. 59: Other Definitions and Special Rules

The D.C. Circuit affirmed a Tax Court decision holding that U.S. citizens living in Canada were subject to the 90% foreign tax credit limitation for AMT purposes.⁶ The appeals court rejected the taxpayers' attempt to distinguish the facts of their case from *Kappus*,⁷ in which the D.C.

Circuit concluded that even if Sec. 59(a)(2) conflicted with the U.S.-Canada tax treaty, the statute prevailed because it was "last in time."

The taxpayers argued that the court "could reconcile the treaty and the statute by allowing the taxpayers to claim foreign tax credits after their entire U.S. tax liability (including AMT) has been calculated.... Under this reading § 59(a)(2) normally would affect the total tax liability only of taxpayers who worked in a foreign country that, unlike Canada, did not have a treaty with the United States limiting 'double taxation.'" The court, however, wrote that the statute "does not on its face suggest that it was intended to have such a narrow impact."

Sec. 61: Gross Income Defined

The IRS notified taxpayers that while a voucher received by a car owner under the cash for clunkers program is excluded from income, the amount received by the car dealer is income.⁸

The IRS also ruled that payments parents receive from the school board for services of a nonpublic school are not taxable income to them.⁹ Instead, they are a reimbursement of costs required to be incurred by the school.

Sec. 72: Annuities

In a Tax Court case, the taxpayer was a nurse working in a VA hospital.¹⁰ The taxpayer suffered emotional distress after a patient died, and there were periods during which he was suspended from work or directed by his doctor to have only light duty. Issues with the VA hospital eventually led to the taxpayer's early retirement for disability. About one month later, the taxpayer took a job with another health clinic.

He filed a financial hardship form and received a distribution of \$158,000 from his 401(k)-type plan (the taxpayer was not yet age 59½). The IRS found that the taxpayer was subject to the 10% additional tax under Sec. 72(t). The court

4 TIGTA, *Semiannual Report to Congress, October 1, 2008–March 30, 2009*.

5 Worker, Homeownership, and Business Assistance Act of 2009, P.L. 111-92.

6 *Jamieson*, No. 08-1253 (D.C. Cir. 2009).

7 *Kappus*, 337 F.3d 1053 (D.C. Cir. 2003).

8 IRS Automotive Alert, "Consumer Assistance to Recycle and Save (CARS)

Act of 2009, Taxability of Payments to Dealerships" (July 2009), available at <http://tinyurl.com/yes7xkk>.

9 IRS Information Letter 2009-0124 (6/26/09).

10 *Dollander*, T.C. Memo. 2009-187.

agreed with the IRS that the taxpayer was not disabled per Secs. 72(t)(2)(A)(iii) and (m)(7). The court also found that the taxpayer reasonably relied on his long-time tax preparer, so there was reasonable cause for the taxpayer's understatement due to the distributions.

Sec. 108: Cancellation of Debt (COD) Income

Sec. 108(i) election: Rev. Proc. 2009-37¹¹ provides the exclusive procedure for electing under Sec. 108(i) to include income from indebtedness discharged in a reacquisition of a debt instrument in gross income ratably over a five-year period. The period for including the income begins with the fifth or fourth year after the year of reacquisition for reacquisitions occurring in 2009 or 2010, respectively.

Sec. 108(i) applies to debt instruments issued by C corporations or by any other person in conjunction with the conduct of its trade or business. A reacquisition is an acquisition by the issuer; an acquisition can include an exchange resulting from a debt instrument's being modified.

To make the election, the taxpayer must attach a statement to the timely filed (including extensions) tax return. The IRS can grant an automatic extension of 12 months from the tax return due date for making the deferral election. The revenue procedure lists the required contents for the election statement.

The taxpayer can elect to defer all or just a portion of the income from the cancellation of the debt. Thus, if a taxpayer realizes \$100 of COD income, the taxpayer can make an election to defer \$40 and exclude the remaining \$60 from income under the other Sec. 108 provisions, if applicable.

Furthermore, a taxpayer who believes that a transaction does not trigger COD income can make a protective election. In other words, if the taxpayer has a transaction that may be considered COD income but is taking a position that it is not, he or she can attach a protective election to

the return. That way, even if the statute has closed on the year in question, the IRS can require the taxpayer to pick up the deferred income in the subsequent years.

Except in the case of protective elections, the taxpayer must attach statements to the tax returns for each tax year after the tax year of the election through the first tax year in which all the deferred income has been recognized.

For noncalendar-year taxpayers, Rev. Proc. 2009-37 provides a transitional rule for returns filed on or before September 16, 2009, if the taxpayer uses "any reasonable procedure to make the election." However, if the election does not comply with the procedures listed in the revenue procedure, the election will not be effective unless the taxpayer filed an amended return that complies with the procedures on or before November 16, 2009.

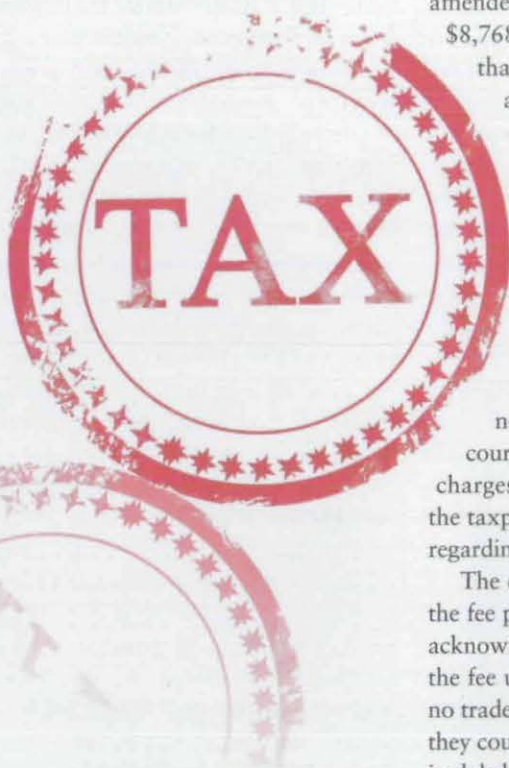
court confirmed an installment plan for paying debts over a 60-month period. Because the taxpayer ceased making the required payments, the court dismissed his bankruptcy case for "material default." The taxpayer did not provide any evidence that he was insolvent. Thus, the court held that he must recognize gross income equal to the amount of the forgiven debt.

In *Melvin*, the taxpayers owed \$13,084 on a credit card and engaged a firm (Arbitronix) to negotiate a settlement with the credit card company.¹³ Arbitronix was able to get the debt reduced by \$8,505, for which it charged the taxpayer a fee of 25%, or \$2,126. The bank issued a Form 1099-C, Cancellation of Debt, showing \$8,768 of income for 2005. (There is no explanation for the difference in the amounts of \$8,505 and \$8,768.) The taxpayers did not report any COD income on their 2005 return but amended that return in 2007 to include \$8,768. At trial, the taxpayers conceded that they had \$8,768 gross income and amended their pleadings to contend that the fee to Arbitronix was deductible. On brief, the taxpayers argued that some of the charges were erroneous and that they hired Arbitronix to contest the alleged amount owed.

The court agreed with the IRS that because the taxpayers conceded the issue, they could not deny that they had income. The court did address whether some of the charges were contested and found that the taxpayer had introduced no evidence regarding disputed charges.

The court disallowed a deduction for the fee paid to Arbitronix. The taxpayers acknowledged that they could not deduct the fee under Sec. 162 (because they had no trade or business) or Sec. 212 (because they could not deduct miscellaneous itemized deductions for the AMT). As authority for the deduction, the taxpayers had cited Sec. 61(a)(12), income from discharge of indebtedness.

Another case involved a different *Melvin* with forgiven debt.¹⁴ The taxpayers owed about \$40,000 of unsecured debts,



Forgiven debt: In a Tax Court decision, a bank forgave the taxpayer's credit card debt of \$4,156.¹² He had argued that the debt was discharged in bankruptcy and thus he did not have gross income. He had filed for bankruptcy, and the bankruptcy

11 Rev. Proc. 2009-37, 2009-36 I.R.B. 309.

12 *Hill*, T.C. Memo. 2009-101.

13 *Melvin*, T.C. Memo. 2009-199.

14 *In re Melvin*, No. 08-11547-WRS (Bankr. M.D. Ala. 4/16/09).

a good portion of which was attributable to medical expenses. They did not own their own home and had "only a small amount of personal property." One creditor forgave the taxpayers' debt and filed a Form 1099-C. The IRS assessed \$3,000 of taxes on forgiven debt but apparently did not try to determine whether the taxpayers were solvent before assessing the taxes.

The taxpayers did not use any administrative procedures within the IRS but brought a case in bankruptcy court for a determination that they were insolvent at the time the creditor forgave the debt. The government argued against the bankruptcy court's deciding the issue on policy grounds. The government's position was that the case was a no-asset chapter 7 case with no distribution to be made to creditors due to the lack of assets. It argued that the court should not hear the case because there was no "bankruptcy purpose" for hearing it.

The bankruptcy court concluded that most of the evidence needed to make the determination of insolvency was already developed, and it denied the government's position that it should abstain from deciding the insolvency question. The bankruptcy court pointed out that if it did not hear the case, the taxpayers would have to go to federal district court to prove they were insolvent and that to litigate there they would first need to pay the tax in question, "something the Debtors do not have the wherewithal to do."

The Tax Court issued several other opinions during 2009 related to COD income resulting from reductions in credit card debt.¹⁵ Taxpayers are required to include in income any credit card debts that a company cancels or forgives during the year unless one of the Sec. 108 exclusions applies. In the recent cases, none of the taxpayers involved was able to present any testimony to support a finding of insolvency.

Late election: In a private letter ruling,¹⁶ a taxpayer was permitted to make a late election to apply Sec. 108(c) to mortgage debt forgiven during the year

in question because it was determined that the taxpayer had acted reasonably and in good faith. The taxpayer had not attached Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment), to the originally filed return and attempted to file an amended return to make the election to reduce the basis of the business property. Instead, he was required to file a letter ruling to obtain permission.

Practice tip: IRS Publication 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals) for Use in Preparing 2008 Returns* (2009), is a helpful publication that includes explanations, examples, and filled-in tax forms. Although the title refers to 2008 returns, the publication should also prove useful for later years.

Sec. 121: Exclusion of Gain from Sale of Principal Residence

In Letter Ruling 200936024,¹⁷ the taxpayer had owned and occupied a house as a principal residence for about 20 years before moving out and employing a contractor to make improvements. Shortly after starting to work, the contractor discovered a hazard that had previously been concealed. State law precluded further work until the hazard was removed. After removal of the hazard, construction of the improvements resumed. The taxpayer listed the house for sale after the improvements were finished. The taxpayer sold the house in Month E after having moved out in Month A.

The IRS ruled that the taxpayer met the requirements of owning and using the property until Month D, the date the contractor finished the improvements and the taxpayer listed the house for sale. Thus, it ruled that the entire gain was excludible.

Sec. 151: Allowance of Deductions for Personal Exemptions

For tax years beginning after 2009, the rules phasing out personal exemptions

for higher income taxpayers no longer apply.¹⁸ However, unless Congress takes action, the phaseout rules will return in their pre-2006 form in 2011.

Sec. 152: Dependent Defined

For tax years beginning after July 2, 2008, a custodial parent's release of a claim to exemption for a child must be separate from a court decree or separation agreement. The IRS provides guidance¹⁹ on the documentation that a noncustodial parent must provide to the IRS to claim an exemption for a child under Sec. 152(e). The chief counsel advice clarifies an inconsistency between IRS publications and Regs. Sec. 1.152-4(e)(1)(ii). It states that a divorce or separation agreement that allows the noncustodial parent to claim an exemption for the child only if a condition is met may not be used as documentation, even if it is accompanied by a statement intended to show that the condition was met.

A custodial parent's release must be on Form 8332, Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent, or in a document that conforms to the substance of Form 8332 and has as its only purpose the release of a claim to exemption. However, a divorce decree or separation instrument executed before July 3, 2008, that unconditionally releases the right to claim an exemption of a child may still be used.

In a Tax Court case, a divorced taxpayer was not entitled to a dependency exemption for his son.²⁰ The son lived with the taxpayer's ex-wife, who was also the custodial parent. The son did not meet the definition of either a qualifying child or a qualifying relative for the taxpayer because he was not able to prove that the son lived in the taxpayer's principal place of abode more than one-half of the tax year. Nor was the taxpayer able to prove that he provided more than one-half of the son's support.

In another case, the Tax Court held that a taxpayer, who lived apart from her husband, was not entitled to a dependency exemption for her two minor

15 See *Bibb-Merritt*, T.C. Summ. 2009-78; *Fuller*, T.C. Summ. 2009-91; and *Hakim*, T.C. Summ. 2009-92.

16 IRS Letter Ruling 200818006 (5/2/08).

17 IRS Letter Ruling 200936024 (9/4/09).

18 Sec. 151(d)(3)(F).

19 CCA 200925041 (6/19/09).

20 *Irons*, T.C. Memo. 2009-96.

children who lived with the taxpayer's husband.²¹ The children did not meet the definition of either a qualifying child or a qualifying relative for the taxpayer.

Sec. 162: Trade or Business Expense

Mileage: In a Tax Court case, the taxpayer worked as a courier for an auto parts delivery business using his own vehicle during 1999 and 2000.²² He began his day by driving to the company's warehouse, then made up to 15 stops on a circular route, and finally returned home from his last stop. He drove past that last stop on his morning drive to the warehouse. The IRS denied a deduction for the mileage between his home and the warehouse (98 miles), as well as between his home and the last stop (12 miles), as commuting miles. They further denied the mileage of the circular route because no substantiation was provided by the taxpayer.

On the commuting miles issue, the Tax Court allowed a deduction for the 86 miles between the last stop and the warehouse, only denying a deduction for 24 miles total (12 miles to and from his last stop). The taxpayer provided proof that his home and records were destroyed by fire in 2004. He further testified that he was required to keep a log of each stop to record parts picked up or delivered and payments received. He stated that he included the mileage driven for each stop in these logs. The Tax Court found his testimony to be credible and accepted the claimed mileage under Temp. Regs. Sec. 1.274-5T(c)(5).

Education: In another case, the taxpayer was a teacher in California with an emergency credential.²³ He had continuing education requirements to maintain that credential, which could also qualify him for a preliminary credential (which was a more permanent position). The IRS denied the education expenses on the basis that the taxpayer incurred them to meet the minimum educational requirements in his trade or business. Although the court had previously ruled against the IRS in a similar case,²⁴ the IRS claimed

Each year billions of dollars in tax credits are provided to ITIN filers without adequate verification of eligibility.

that a change in California law rendered that decision irrelevant. The Tax Court held that the difference cited by the IRS (essentially the time period to complete additional educational requirements) was without distinction. It changed the form but not the substance or effect of the California requirements. Therefore, it allowed all the claimed educational expenses.

Sec. 163: Interest

Mortgage deduction limit: The IRS, in chief counsel advice,²⁵ has ruled that indebtedness that is incurred to acquire, construct, or substantially improve a residence, thus satisfying Sec. 163(h)(3)(B)(i), but that exceeds \$1 million, so not satisfying Sec. 163(h)(3)(B)(ii), is not acquisition indebtedness. Therefore, home equity indebtedness, as defined in Sec. 163(h)(3)(C), includes indebtedness incurred to acquire, construct, or substantially improve a qualified residence, to the extent that the indebtedness exceeds the \$1 million limit on acquisition indebtedness and to the extent the other requirements of Sec. 163(h)(3)(C) are satisfied.

A taxpayer had posed a scenario in which he had borrowed \$1.3 million to acquire his new residence and wanted to deduct the interest on \$1.1 million. In the ruling, the IRS stated, "We recognize that the position taken in this memorandum is inconsistent with *Pau v. Commissioner*, T.C. Memo. 1997-43 and *Catalano v. Commissioner*, T.C. Memo. 2000-82, regarding the definition of acquisition indebtedness in §163(h)(3)(B). However, we believe that the position in this memorandum is the better interpretation of §163(h)(3)(B) and (C)."

Qualified mortgage insurance premiums: The IRS has published proposed

regulations explaining how individuals may allocate prepaid qualified mortgage insurance premiums to determine the amount of the prepaid premium that is treated as qualified residence interest each tax year under Sec. 163(h)(4)(F).²⁶ The text of simultaneously released temporary regulations also serves as the text of the proposed regulations.²⁷

Sec. 183: Activities Not Engaged in for Profit

The IRS issued a notice of deficiency after denying taxpayers losses from their horse breeding and boarding operation for tax years 1997-2002.²⁸ The activity had produced a Schedule F loss starting in 1993. Despite this continual string of losses, the Tax Court ruled that the taxpayers had engaged in an activity for profit and allowed the losses. While several of the nine factors listed in Regs. Sec. 1.183-2(b) favored the IRS, the Tax Court judged the majority to be in the taxpayers' favor. Among the key facts favoring the taxpayers were:

- They spent nine years in court seeking clear title to an Arabian horse for breeding. During those years they had possession of the horse and were able to derive pleasure from its possession, but the horse's breeding value was nil due to the ownership question.
- Both husband and wife spent extensive hours in grueling work (cleaning barns, shoveling hay, caring for sick horses) and practically none riding or attending horse shows.
- The taxpayers' other income during this period never exceeded \$65,000, indicating that they were not looking to shelter income.

21 *Watts*, T.C. Memo. 2009-103.

22 *Freeman*, T.C. Memo. 2009-213.

23 *Ray*, T.C. Summ. 2009-71.

24 *Orr*, T.C. Memo. 1992-566.

25 CCA 200940030 (10/2/09).

26 REG-107271-08.

27 T.D. 9449.

28 *Helmick*, T.C. Memo. 2009-220.

The court found that the taxpayers derived little personal pleasure from the activity. They specifically noted that the taxpayer's daughter often refused to visit her father to avoid working in the barns.

Sec. 213: Medical, Dental, etc., Expenses

The taxpayer claimed medical deductions in 2004 and 2005 for pornographic materials and visits to prostitutes.²⁹ The IRS denied the deductions. The taxpayer claimed that there was extensive evidence about the positive health effects of sex therapy. He further argued that the IRS should allow the deductions despite the fact that the activity (prostitution) was illegal and no doctor had prescribed the treatment. The Tax Court rejected his arguments. Because the taxpayer had been an attorney specializing in tax law for 40 years, the court also upheld the Sec. 6662 accuracy-related penalty.

Sec. 280A: Disallowance of Certain Expenses in Connection with Business Use of Home, Rental of Vacation Home, Etc.

A district court denied deductions for items purchased for the taxpayer's home office because the taxpayer failed to substantiate that he used the home office exclusively for business purposes.³⁰ The Tax Court held similarly in another case.³¹

In a third case, the Tax Court denied the taxpayers' claim of an additional business expense for internet and satellite TV charges because they were not able to show that these expenses were not already included within "utilities" on Form 8829, Expenses for Business Use of Your Home, as part of the home office deduction.³²

Sec. 1001: Determination of Amount of Gain or Loss

In a Tax Court case, a taxpayer attempted to change his transaction form after the

sale of his RV park.³³ The sale occurred in an S corporation in which the taxpayer was the sole stockholder. The Tax Court held that the taxpayer's claim that the RV park had been transferred to an offshore insurance company before the sale reflected an impermissible belated attempt to change the transaction's original form.

In another case,³⁴ the taxpayers argued that they were not liable for an asserted deficiency for capital gains on the liquidation of S corporation stock because the IRS had not explained how it calculated the gain. The Tax Court held that the taxpayer had the burden of proof on the issue and was thus required to show that the IRS's determination of the ownership of the stock and the calculation was incorrect.

Sec. 1031: Exchange of Property Held for Productive Use or Investment

The Ninth Circuit affirmed a Tax Court decision denying nonrecognition of gain in a four-party exchange.³⁵ It determined that related parties' primary purpose in the exchange swap was to cash out of a low-basis property while avoiding recognition of gain.

The IRS ruled that application of Sec. 1031(a) to a taxpayer is not affected by a trust's sale of its interest in farmland within two years of its acquisition, including interest that the trust acquired from a taxpayer, where the taxpayer and the trust are not related persons under Sec. 1031(f).³⁶

Sec. 1033: Replacement of Livestock with Other Farm Property in Certain Cases

In Notice 2009-81,³⁷ the IRS listed the counties that qualified for an extended replacement period for taxpayers to replace livestock that they sold due to drought, flood, or other weather-related conditions. The IRS may extend the replacement period on a regional basis for such additional

time as it determines appropriate if the weather-related conditions that resulted in the area being designated as eligible for assistance by the federal government continue for more than three years.

Sec. 1221: Capital Asset Defined

The Tax Court held that married taxpayers who were investment planners properly claimed capital gain treatment from the sale of excess lots, which they purchased as part of a single property on which to build their dream home but subsequently decided to subdivide.³⁸ The court held that the overall facts and circumstances, including the fact that the taxpayers had full-time jobs, engaged in minimal solicitation and advertising, sold relatively few lots, and had originally intended to keep the entire lot for themselves, showed that the taxpayers held the property as a capital asset and not as property held for sale to customers in the ordinary course of business. But the taxpayers were not entitled to recognize loss from a related-party sale where they failed to address the issue on brief.

Sec. 6015: Innocent Spouse Relief

According to the IRS Office of Chief Counsel, the IRS plans to revise the regulations governing innocent spouse relief provisions under Sec. 6015 in response to a number of recent Tax Court decisions, including *Lantz*³⁹ and *Porter*.⁴⁰ In a chief counsel notice, the IRS provided guidance on the scope and standard of review in cases involving requests for relief from joint and several liability under Sec. 6015(f).⁴¹ The notice supplements Chief Counsel Notice CC-2004-26.⁴²

In chief counsel advice, the IRS clarified prior advice on whether to treat a liability as an underpayment or an understatement in a situation in which innocent spouse relief is claimed by one spouse and the other spouse agrees to the liability.⁴³

29 *Halby*, T.C. Memo. 2009-204.

30 *Tilman*, No. 08 Civ. 2231 (S.D.N.Y. 8/3/09).

31 *Argyle*, T.C. Memo. 2009-218.

32 *Allen*, T.C. Memo. 2009-102.

33 *Klaas*, T.C. Memo. 2009-90.

34 *Foxworthy, Inc.*, T.C. Memo. 2009-203.

35 *Teruya Brothers, Ltd.*, No. 05-73779 (9th Cir. 9/8/09).

36 IRS Letter Ruling 200920032 (5/15/09).

37 Notice 2009-81, 2009-40 I.R.B. 455.

38 *Rice*, T.C. Memo. 2009-142.

39 *Lantz*, 132 T.C. No. 8 (2009).

40 *Porter*, 132 T.C. No. 11 (2009).

41 Chief Counsel Notice CC-2009-021 (6/30/09).

42 Chief Counsel Notice CC-2004-26 (7/12/04).

43 CCA 200922039 (5/29/09).

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The Tax Court held that the doctrine of res judicata barred an individual from raising the issue of Sec. 6015 innocent spouse relief in a case challenging his and his wife's joint liability for three tax years, finding that the taxpayer had raised the issue in a previous Tax Court case for the same tax years and meaningfully participated in that case.⁴⁴

Sec. 7703: Determination of Marital Status

The IRS has advised that during incarceration, either pre- or post-conviction, a taxpayer may be considered only temporarily absent from his place of abode, depending on his or her intention to return and other factors.⁴⁵

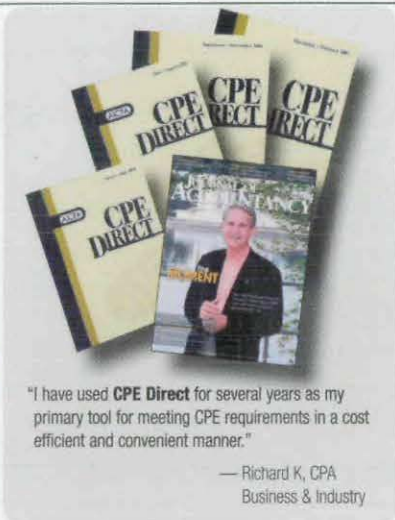
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44 *Molsbee*, T.C. Memo. 2009-231.

45 CCA 200927037 (7/2/09).

EditorNotes

Ellen Cook is assistant vice president for academic affairs and a professor at the B.I. Moody III College of Business Administration at the University of Louisiana in Lafayette, LA. Anna Fowler is professor emeritus at the University of Texas at Austin. Edward Gershman is a partner with Deloitte & Touche LLP in Chicago, IL. Janet Hagy is a shareholder in Hagy & Associates PC in Austin, TX. Jonathan Horn is a sole practitioner specializing in taxation in New York, NY. Annette Nellen is a professor at San Jose State University in San Jose, CA. Darren Neuschwander is a shareholder in Neuschwander, Faircloth & Hardy, P.C., in Robertsedale, AL. Dennis Newman is a senior tax manager with Sharrard, McGee & Co., P.A., in Greensboro, NC. Nora Stapleton is a partner with Blackman Kallick LP in Chicago, IL. The authors are all members of the AICPA's Individual Income Tax Technical Resource Panel. For more information about this article, please contact Ms. Cook at edcook@louisiana.edu.



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