



ADVISORY

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Gross Estate

In a private letter ruling, the IRS held that trust property was not includible in a gross estate because no general powers of appointment were held by any beneficiaries. In this case, a husband and wife established a trust and then later established another trust for the benefit of their children. Acting as trustees, the beneficiaries distributed the principal in the old trust to the new trust. The IRS found that because the terms of both trusts and state law prohibited the beneficiaries from making distributions to themselves, they did not have a general power of appointment under either trust, effectively excluding trust property from any of the beneficiaries' estates.

Editor's Comment: By maintaining the terms of the first trust and not allowing the beneficiaries to make distributions to themselves or their dependents, the parents were able to exclude the trust property from their estates, potentially lowering any future estate tax liability.

Passive Loss Activity

A Texas federal district court has allowed the grouping of a taxpayer's two business activities for the purpose of the Internal Revenue Code's passive activity loss rules. In this case, the taxpayer had a limited partnership that provided a service and a limited liability company (LLC) that rented equipment. On the taxpayer's income tax return, passive losses from the LLC were applied against the net income received from the limited partnership. The Court upheld this application because the two activities were an "economic unit" in that both places of business were in the same city, the rental activities were complimentary to the

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other business, and there was common ownership. The rental activities were also found to be “insubstantial” in relation to the other business operations.

Editor's Comment: Under IRS Regulations, taxpayers may combine income and losses from rental activities with those of a trade or business activity if they are an appropriate “economic unit” and the rental activity is “insubstantial” when compared to the trade or business activity. This can be a beneficial rule for many small business taxpayers that can greatly reduce tax liability when used correctly. However, it may be helpful to contact a tax professional to determine whether a taxpayer’s two activities meet the requirements articulated above.

Remember, it’s usually advisable to keep property in one company, separate from business operations. This case illustrates the additional tax benefits that can result if the two activities meet the tax requirements.

Majority Stockholder

The Tax Court has allowed a majority stockholder to try to recover from his business partners some of the delinquent withholding taxes, interest, and penalties he paid to the IRS. In this case, the taxpayer was a majority stockholder in a corporation that owed withholding taxes. While the Court found that the taxpayer was a responsible person for the amounts owed, his business partners were also found to have greater responsibility because they ran the day-to-day business, were aware of the taxes due, and deliberately ignored notices from the IRS. As a result, the taxpayer was able to recover 80% of the tax, interest, and penalties he paid to the IRS from his business partners.

Editor's Comment: While this is a favorable holding for this taxpayer, he is still considered a responsible person as far as the taxes that were owed by the corporation are concerned. The taxpayer is able to recover some of the taxes he paid from his business partners, but there is no guarantee that he will be able to recover the funds. This is an important principle of business ownership to remember. While this taxpayer was not involved in the day-to-day operations of the business, he was still liable for the corporation’s taxes because of his majority ownership. Now he has the problem of trying to recover some of the taxes paid from his business partners.

Reimbursement Plans

In a private letter ruling, the IRS has found that an employer’s reimbursements to his employees were includable in the employees’ income because they did not qualify as part of an accountable plan. In this case, the employer had a reimbursement plan, which reimbursed his technicians for their tool expenses. However, the forms used for the plan did not require the employees to provide information to the employer regarding the purchase date, prior depreciation, or prior reimbursement for the tools. Regulations under the Internal Revenue Code require written statements showing a business purpose and an amount for each expense. Because the plan in this case did not collect the required information necessary to substantiate the expenses, the reimbursements were included in the employees’ income.

Editor's Comment: This case is an example of how the failure to observe formalities required by the Internal Revenue Code can cost taxpayers a great deal of time and expense. When operating a business, it’s important to substantiate all transactions with accurate record keeping. The failure on the part of this employer to accurately reflect reimbursement provided to his employees resulted in additional tax liability for those employees.

Any business that reimburses its employees for monies spent by employees for work-related items, such as work tools, must request receipts with specific information from the employees in order not to

cause the employees to be taxed on the amount of reimbursement.

Valuation

The Second Circuit Court of Appeals has held that the Tax Court is not required to accept an estate's valuation of a decedent's interest in a closely held corporation. In this case, the Tax Court rejected both the government and the estate's valuation of the decedent's 20% interest in the corporation, stating they were both "deficient and unpersuasive." The estate argued that, under the Internal Revenue Code, the Tax Court was required to accept its valuation when it rejected the government's valuation. However, the appellate court found that the Tax Court was allowed to reject both valuations and make its own determination as to the value of the interest, which it did.

Editor's Comment: This is an interesting finding because the Tax Court did not accept either of the two valuations provided. This case illustrates the importance of having an accurate and dependable valuation done by professionals.

Informal Claim

A U.S. District in California has held that an estate met the requirements for an "informal claim," entitling it to an estate tax refund that was paid more than three years earlier. In this case, the estate submitted a payment on the date the return was due, requesting an extension of time for filing that was later granted. The return was not filed until nearly four years later, during which the IRS and the estate had several informal contacts concerning the return and the payment. The estate claimed that through these informal communications, it had met the requirements under the "informal claim doctrine," which are: 1) the informal claim was filed within the statutory period, 2) the IRS was put on notice that the estate believed an erroneous tax was assessed, 3) there was a written component, and 4) the tax and year were described with sufficient specificity to allow an investigation by the IRS. The Court found that the estate had satisfied these requirements, entitling it to a refund.

Editor's Comment: The taxpayer was fortunate in this case because it can be very difficult to satisfy the requirements needed for an "informal claim." While the taxpayer won this case, it's always wise to communicate clearly with the IRS when it comes to extension and deadlines so there is no confusion as to when something is required to be submitted.

Alternate Valuation

In a private letter ruling, the IRS has granted an estate an extension to make an alternate valuation election. In this case, the executor of the estate had an accountant prepare the estate tax return, who failed to consider the alternate valuation election. After timely filing the return, the accountant recalculated the estate using the alternate valuation date and filed a supplemental return making the election. The IRS granted the estate an extension to make the election because it had acted in good faith in relying on a tax professional and the government would not be prejudiced by such an election.

Editor's Comment: Under the alternate valuation election, the value of property not immediately sold or distributed is valued at six months from the date of the decedent's death. The IRS can grant up to a six month extension to make this election if an estate can establish that it acted reasonably and the government would not be prejudiced by granting such an extension. The estate in this case was fortunate that the original error did not have a negative outcome. However, time and costs associated with requesting an extension could have been avoided if the accountant had originally considered the alternate valuation election.

Partnerships — Notice of Deficiency

The U.S. Court of Federal Claims has held that a statutory notice of deficiency was not required for deficiencies assessed against two limited partnerships. In this case, the IRS had entered into agreements with the partnership regarding losses that accrued over several years that were disallowed. Later, the partnerships filed refund claims and the IRS adjusted the claimed losses for the years in question under the agreement without issuing a notice of deficiency. The Court found that no notice of deficiency was required because the partners and the IRS had already agreed on the at-risk amounts for the years in question under the settlement agreement, allowing the IRS to make the computational adjustment.

Editor's Comment: Under the Internal Revenue Code, assessments resulting from determinations of partnership items are made through computational adjustments, like the one made in this case. Such adjustments do not require the IRS to issue a notice of deficiency. However, a notice of deficiency is required when items that require factual determinations at the partner level are affected by such adjustments.

Partnerships are not for everyone. Special tax laws apply to this form of entity. Readers are placed on notice that the partnership is not as it used to be, it is changed and there are now “anti-abuse” regulations dealing with this form of business. Consider sub-chapter S and/or limited liability companies rather than the partnership form of business entity in today’s society.

Travel Expenses

The Eighth Circuit Court of Appeals has held that a taxpayer’s travel expenses, incurred through commuting, constitute taxable wages. In this case, the taxpayer was an airline pilot that lived in Minnesota and was assigned to a route in Alaska. His employer provided him with transportation from Minnesota to Alaska. After the employer started withholding taxes on the amount of the travel expenses to and from Alaska, the taxpayer filed a refund claim. The taxpayer argued that the travel expenses should not be included in income because they were ordinary and necessary business expenses. However, the Court found that the expenses were not business-related, but personal, commuting expenses making them taxable income when paid for by the employer.

Editor's Comment: This is an important distinction for employees, as well as employers, to remember. Because the taxpayer in this case did not have to pay for the travel expenses required for him to get to Alaska to perform his job, this constituted income. Whenever an employer offers to cover expenses, it’s important to remember it may result in a higher tax liability for the taxpayer because the value of such expenses are considered wages to the employee.

Work Product Privilege

The Tax Court has held that the IRS did not have to release a memorandum to a taxpayer because it was protected by the work product privilege. In this case, the taxpayer had challenged the IRS’s tax assessment in Tax Court. Throughout the litigation, and IRS attorney requested advice from the National Office of Chief Counsel regarding potential legal arguments, to which the National Office responded with a memo. When the taxpayer asked for litigation costs and sanctions from the IRS, it provided a redacted copy of the memo, to which the taxpayers requested an unredacted copy. The Court found that the memo was privileged work product that was used to prepare legal theories and strategy for the litigation. The Court found no compelling need on the part of the taxpayer for the memo.

Editor's Comment: This case shows not only can taxpayers and their attorneys claim the work product privilege, but the IRS and its attorneys can also use the concept. This is an important detail to keep in mind should you decide to pursue a dispute with the IRS that results in litigation in the Tax Court. Product protected by such privilege will only be disclosed if there is a substantial need or compelling interest and it works two ways: between the attorney and client, and between the IRS and its attorneys.

Offer in Compromise

The Tax Court has held that the IRS did not abuse its discretion by including a taxpayer's overtime earnings in its determination of what the taxpayer could afford to pay in deciding an offer in compromise. The Internal Revenue Manual requires that adjustments should be made for expected increases or decreases in a taxpayer's future income. In reliance on the manual, an IRS settlement officer included adjustments for the taxpayer's overtime earnings based on his actual earnings during previous tax years. The taxpayer argued that his employer's overtime policy would actually reduce his earnings, but the Court found this argument to be too speculative and upheld the adjustment made by the settlement officer.

Editor's Comment: When submitting an offer in compromise to the IRS, it's important to accurately reflect all income and expenses in order to increase the chances of it being accepted by the IRS. Submitting an offer and receiving a response can be a long and tedious process, but it's important to be patient and comply with all IRS instructions and requests.

Installment Agreement

A U.S. District Court has held that an IRS Appeals Officer acted in error when he failed to consider a taxpayer's proposed installment plan to pay its employment tax liability. In this case, the taxpayer failed to pay its employment taxes when the business slowed. The IRS issued notices of intent to levy. The taxpayer responded with an installment plan proposal, which the Appeals Officer rejected due to the large amount of the liability. The Court found that even though the taxpayer was not keeping current with its tax payments, the Appeals Officer abused his discretion by not giving fair consideration to the proposed plan. The IRS was, at the very least, required to balance the IRS's interest in the efficient collection of taxes with the taxpayer's concern that the collection not be more intrusive than necessary.

Editor's Comment: While the officer in this case could have rejected the proposed installment plan, he was still required to give it full and adequate consideration. It may be important for taxpayers to follow up with the IRS after such proposals are rejected to ensure that they have been given such consideration, as it may result in a lower liability or a more convenient payment option. Reminder, the Court said that, at the very least, government employees should balance the IRS's interest in collecting taxes with the taxpayer's concern that the payment not be any more intrusive than necessary. Don't forget this concept when dealing with the IRS regarding taxes past due.

LLC Liability

A federal district court has held the sole member of a limited liability company (LLC) personally liable for the company's unpaid employment taxes. In this case the taxpayer was the sole member of an LLC formed under state law. The taxpayer failed to elect that the company be treated as a corporation for federal tax purposes under the "check-the box" regulations. The taxpayer failed to pay employment taxes and the IRS held him personally liable. The taxpayer argued that as a sole member of an LLC, he was protected under state law from personal liability. However, the Court rejected this argument, stating that while the company was formed under state law, this did not control federal tax laws. Therefore, state law provided him no protection and the "check-the-box" regulations provided no distinction between federal employment and income taxes.

Editor's Comment: This case highlights an important rule that all business owners must be aware of. While most businesses are formed under state law, such laws have no affect or influence on how the federal government taxes such entities. It's important to keep federal tax laws in mind when determining which form of operation your business should take.