Tax Tips NEWSLETTER

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August 2014 v.11.08

case, the taxpayers may have been sunk from the beginning due to the nature of the acquisition.

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Tax Practice

Voluntary Education Program for Unenrolled Preparers

Rev. Proc. 2014-42

The IRS has established a new voluntary Annual Filing Season Program (AFSP) for unenrolled preparers (those other than attorneys, CPAs, EAs, enrolled retirement plan agents, and enrolled actuaries registered with the IRS). The program will go into effect for the 2015 filing season. It is intended to encourage unenrolled preparers to increase their tax knowledge and gain better understanding of tax law.

Note: The AFSP replaces the Registered Tax Return Preparer (RTRP) Program that the IRS established in 2011. The RTRP program was struck down by the D.C. District Court in *Loving* [111 AFTR 2d 2013-589 (DC, DC 2013)]. The Court ruled that the IRS did not have the authority to enforce the RTRP regulations.

Impact on the PTIN Requirement. The AFSP does not change the requirement that paid tax return preparers must obtain a Preparer Tax Identification Number (PTIN). (The PTIN program was also not impacted by the *Loving* decision.)

The AFSP is voluntary. No tax return preparer is required to participate in the AFSP. Furthermore, the AFSP does not restrict any individual from preparing and signing tax returns and claims for refund.

Applying for the AFSP. Tax return preparers will apply for the AFSP by using the online PTIN application system or on paper, using Form W-12, *IRS Paid Prepare Tax Identification Number (PTIN) Application and Renewal.* Upon verifying the requirements are complete, an applicant will be issued an AFSP—Record of Completion that is valid for tax returns or refund claims prepared and signed during the calendar year for which it is issued. Applications received after April 15 of the year for which the Record of Completion is sought will not be considered.

AFSP requirements. To obtain an AFSP—Record of Completion, a return preparer must:

- Be eligible for and obtain a PTIN, or timely renew his or her existing PTIN.
- Successfully complete 18 hours of Continuing Education (CE) from IRS-approved CE Providers, including a 6-credit-hour Annual Federal Tax Refresher (AFTR) course. However, under a transition rule, only 11 hours of CE are required for the 2015 filing season (including the 6-hour AFTR course). Also, preparers who passed the RTRP examination and certain preparers who have passed an exam administered by certain states and other entities recognized by the IRS are only required to complete 15 hours of CE (8 for the 2015 filing season) They're also not required to take the AFTR course.

The Record of Completion is valid only with respect to tax returns or claims for refund prepared and signed during the calendar year for which the Record of Completion is issued.

Note: Unlike the old RTRP program, the AFSP does not require the preparer to pass a comprehensive test administered by the IRS. Additionally, the IRS does not charge a fee for participating in the AFSP. However, preparers will generally have to pass an AFTR course test administered by the CE provider (if they're required to take an AFTR course) and pay any course fees charged by CE providers.

Benefits of the AFSP. Tax return preparers who receive an AFSP—Record of Completion for a calendar year are granted the following benefits:

- They can represent taxpayers in proceedings before the IRS in limited circumstances. [Beginning in 2016, preparers without an AFSP—Record of Completion or other professional credential (e.g., CPA or EA) won't be able to represent clients before the IRS in any matters.]
- They can inform clients and future clients that they hold a valid AFSP—Record of Completion for that calendar year and have complied with the IRS requirements for receiving the Record of Completion.
- They will be included in a new public directory (Directory of Federal Tax Return Preparers with Credentials and Select Qualifications) that will be added to *irs.gov* by January 2015 for taxpayers to use in searching for qualified tax return preparers. This sortable and searchable directory will only include attorneys, CPAs, EAs, enrolled retirement plan agents (ERPAs), enrolled actuaries and individuals who have received an AFSP—Record of Completion.

IRS FAQs. Additional information on the AFSP is available at *www.irs.gov/uac/Newsroom/IRS-Unveils-Filing-Season-Program-for-Tax-Return-Preparers,-Answers-Frequently-Asked-Questions*.

August 2014 AFRs

For August 2014 the Section 7520 rate for valuation purposes is 2.2%, while the applicable federal rates (AFRs) are as follows. (Rev. Rul. 2014-19)

	Short-term (≤ 3 yrs)	Mid-term (> 3 yrs but ≤ 9)	Long-term (> 9 yrs)
Annual	0.36%	1.89%	3.09%
Semiannual	0.36%	1.88%	3.07%
Quarterly	0.36%	1.88%	3.06%
Monthly	0.36%	1.87%	3.05%

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Penalties

IRS Must Prove Fraud for Section 6701 Penalty Assessment

Frances Carlson, 113 AFTR 2d 2014-2542

Background. IRC §6701 penalizes any person who (1) aids or assists in, procures, or advises with respect to the preparation or presentation of any portion of a return, affidavit, claim or other document; (2) knows (or has reason to believe) that such portion will be used in connection with any material matter arising under the internal revenue laws; and (3) knows that such portion (if so used) would result in an understatement of another person's tax liability. In other words, Section 6701 penalty is assessed for aiding or abetting the understatement of tax liability.

Under IRC §6703, the burden of proof for penalties under Section 6701 is on the Government, not the return preparer. It is insufficient for the Government to only present evidence that some error existed in a return; the Government must prove that the tax preparer actually knew the return understated tax.

The standard to be applied in assessing the Section 6701 penalty was recently at issue on appeal. The question was whether the IRS had the burden of proof by a preponderance of the evidence or if fraud burden of proof—clear and convincing evidence—applied.

Facts. The case involved a Jackson Hewitt tax preparer (Ms. Carlson) who is not a CPA and does not have an accounting degree. Before working for Jackson Hewitt, Carlson held several jobs over 30 years—none of which included preparing tax returns. When she started working for Jackson Hewitt, Carlson attended an in-house class on preparing individual income tax returns.

On audit, the IRS examiners found unsubstantiated deductions on 40 out of approximately 1,500 income tax returns prepared by Ms. Carlson over the five-year period she worked at Jackson Hewitt.

The IRS assessed Section 6701 penalties against Carlson for aiding and abetting the understatement of tax liability on those 40 returns.

Ms. Carlson paid 15% of the penalties assessed, filed for a refund (which the IRS denied), and sued for refund in district court.

IRS and district court positions. At district court, the IRS presented no evidence suggesting that Carlson actually knew the returns understated the correct tax—they only presented evidence that an auditor identified unsubstantiated deductions. Although Carlson presented substantial evidence from multiple witnesses showing that she did not know the returns understated the correct tax, the IRS contended that the auditors' findings of unsubstantiated deductions was sufficient proof that Carlson actually knew the returns understated the correct tax.

The IRS argued that Section 6701 cannot be a fraud statute because the statute never uses the word "fraud." Therefore, the correct burden of proof was a preponderance of the evidence.

The district agreed with the IRS and instructed the jury that the Government had to prove its case by a preponderance of the evidence. Based on the court's instructions, the jury upheld penalties totalling over $119,000.

Carlson appealed the decision to the 11th Circuit Court of Appeals.

Appeals court decision. On appeal, Carlson contended that the district court erred by instructing the jury that the Government must prove its case by a preponderance of the evidence instead of by clear and convincing evidence (the fraud standard for civil cases). Since the government did not present evidence that Carlson knew the returns understated the correct tax, they did not meet the burden of proof.

Agreeing with the taxpayer, the 11th Circuit Court of Appeals determined the district court's jury instructions misstated the law and likely harmed Carlson. Accordingly, it vacated the district court's judgment on the penalties and remanded for a new trial.

Note: This decision contradicts Second and Eighth Circuit previous holdings that the standard of proof is by a preponderance of the evidence.

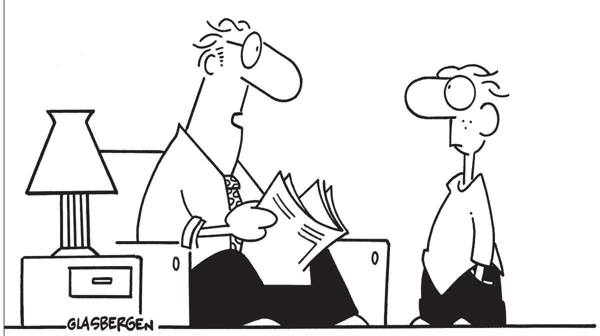
Individual Income Tax

IRA Withdrawal to Buy Real Estate Was a Taxable Distribution

Guy M. Dabney, TC Memo 2014-108

Background. Generally, a distribution from an IRA is taxable in the year of the distribution [IRC §408(d)(1)]. Taxable distributions received before the taxpayer turns age 59 ½ are subject to a 10% early withdrawal penalty tax unless an exception applies [IRC §72(t)].

An IRA distribution is not taxable to the extent it is rolled over to an IRA or other eligible retirement plan (ERP) within 60 days of the distribution [IRC §408(d)(3)(B)]. A taxpayer can accomplish a rollover by taking funds from the IRA and redepositing them into the IRA (or ERP) or by having the IRA trustee transfer funds directly to the IRA (or ERP) in a trustee-to-trustee transfer.



"If at first you don't succeed, shift the blame, change the rules, redirect the focus of your critics, spin the media, redefine success, and there won't be any need to try, try again!"

Facts. Guy Dabney found a piece of undeveloped land he wanted to purchase through his self-directed IRA at Schwab. After conducting some internet research, he concluded that IRAs are permitted to hold real property for investment. However, Schwab did not allow such alternative investments.

Mr. Dabney arranged what he believed to be a viable way to have his Schwab IRA purchase the property, even though Schwab did not allow alternative investments. His plan was to have funds wired directly from the IRA to the seller of the property and to have title to the property placed in the name of "Guy M. Dabney Charles Schwab & Co. Inc Cust. IRA Contributory". He planned to then resell the property for a small gain and contribute the sale proceeds back into the IRA.

On February 6, 2009, Mr. Dabney, purchased the property for the IRA by completing an IRA withdrawal form for $114,000 and having the funds wired to Chicago Title, the company handling the sale of the property. Although, he directed that the title to the property be "Guy M. Dabney Charles Schwab & Co. Inc Cust. IRA Contributory," because of a bookkeeping error, title was placed in Mr. Dabney's own name.

Schwab issued a 2009 Form 1099-R reporting a $114,000 taxable distribution

See "Individual Income Tax—Continued" on Page 4

Tax Quick Hits

IRS Matters

IRS announces strategic plan for FY 2014–2017. The IRS continues to face the "doing more with less" challenges caused by an increasing complex tax code and business environment, coupled with decreased resources. To achieve their mission of providing "America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all," the IRS has outlined several objectives in their recently announced strategic plan. The objectives include initiatives focusing on (1) workforce quality and diversity, (2) facilities and systems security, (3) risk management, (4) operational efficiency, (5) robust technology protecting taxpayer data and (6) decision making utilizing data analytics. The text of the strategic plan is available at *www.irs.gov/pub/irs-pdf/p3744.pdf.*

IRS changes policy on individual taxpayer identification numbers (ITINs). The IRS issues ITINs to alien individuals (non-U.S. citizens or nationals) who are not eligible to obtain Social Security Numbers used in tax filing requirements [Reg. §301.6109-1(d)(3)]. Under the previous policy announced in November 2012, ITINs issued after 1/1/13 would automatically expire after five years, even if used properly and regularly by taxpayers. Under the new policy, ITINs will (1) expire if not used to file a federal income tax return for five consecutive tax years, (2) no longer face mandatory expiration if issued after 1/1/13, (3) not be deactivated until 2016, and (4) need to be reapplied for using Form W-7 if the existing ITIN is deactivated. News Release IR-2014-76.

Income Tax

Correcting same-sex spouse health premiums wrongly included in 2013 W-2 income. Revenue Ruling 2013-17 provides that a same-sex spouse is treated as a spouse for federal tax purposes if the couple is legally married under state law. Accordingly, health insurance premiums paid by the employer for the employee's same-sex spouse's health insurance are excludable from the employee's income, as are premiums paid by the employee through a cafeteria plan. According to IRS advice, an employee who receives a Form W-2 that incorrectly includes these amounts in taxable wages should request a corrected W-2 or, if that fails, file Form 1040 using the original Form W-2 from the employer and attach Form 4852, *Substitute for Form W-2, Wage and Tax Statement,* or Form 1099-R and take the additional specific steps to report the correct amount of taxable income. Information Letter 2014-0012.

Foreclosure of passive activity frees up suspended losses. The Office of Chief Counsel issued a memo advising that foreclosure of real estate subject to recourse debt comprising the taxpayer's entire interest in the activity qualifies as a fully taxable transaction and, thus, triggers the recognition of any suspended passive activity losses from the activity. The losses are treated as nonpassive under IRC §469(g)(1)(A), regardless of whether any Cancellation of Debt (COD) income is excluded under IRC §108(a)(1)(B). The nonpassive losses are not reduced by any excluded COD income. CCA 201415002.

Real estate professional exception for passive losses. If the "real estate professional exception" under IRC §469(c)(7)(B) applies, a rental activity is automatically treated as nonpassive if the taxpayer materially participated in the activity. To be eligible for this exception, both of the following conditions must be met: (1) more than half of the personal services performed by the taxpayer during that year are performed in real property trades or businesses in which the taxpayer materially participates, and (2) the taxpayer performs more than 750 hours of services during that year in such trades or businesses. Taxpayers are also allowed to elect under Reg. §1.469-9(g) to treat all interests in rental real estate as a single activity.

In a chief counsel advice memorandum, the IRS indicated that this election doesn't affect the determination of whether the taxpayer qualifies for the real estate professional exception. Instead, the taxpayer first determines if the real estate professional exception applies using a reasonable combination of the activities based on the facts and circumstances. If the exception applies, real estate activities in which the taxpayer materially participated are treated as nonpassive. This determination is made separately for each rental property unless the taxpayer makes the election to treat all interests in rental real estate as a single activity. CCA 201427016.

Small employer health Insurance tax credit final regulations. Under IRC §45R, an Eligible Small Employer (ESE) may claim a tax credit for nonelective contributions to purchase health insurance for employees. The IRS has issued final regulations (TD 9672) that are generally effective 6/30/14; however, employers may rely on the proposed reliance regulations issued last year for tax years beginning in 2014. The new regulations include clarifying definitions, as well as guidance on calculating the credit, applying the uniform percentage requirement and claiming the credit.

Other Tax Matters

Disregarded entities final regulations. The IRS issued final regulations (TD 9670) without any substantive changes to the temporary and proposed regulations, which (1) extend certain exceptions from FICA and FUTA taxes to disregarded entities and (2) treat disregarded entities as separate entities for purposes of the indoor tanning excise tax under IRC §5000B. In applying these exceptions only, the owner of the disregarded entity is treated as the employer (instead of the corporation). The final regulations reorganize and revise the previously issued regulations for clarity. The final regulations are effective 6/26/14.

Inconsistencies delay Health Insurance Marketplace processing. If information provided with Marketplace applications was missing or doesn't match that found in other records, applicants will receive follow-up information requests. A new discussion titled "How do I resolve an inconsistency?" was added to the healthcare website at *www.healthcare.gov/help/how-do-i-resolve-an-inconsistency/*. The discussion provides a list of documents that can be submitted to rectify an inconsistency, including documents related to immigration status, veteran status, income, incarceration, Indian status, employer-sponsored coverage, residency, Social Security number and identity. The requested information should be provided as soon as possible to prevent interruption of coverage or any subsidies.

Longevity annuities can be purchased through qualified plans and IRAs. Qualified retirement plans and IRAs are subject to the Required Minimum Distribution (RMD) rules of IRC §401(a)(9). In February 2012, the IRS issued proposed regulations removing RMD impediments to longevity annuities. Final regulations (TD 9673) have been issued, modifying and clarifying the proposed regulations that permit participants and owners to use account balances to purchase deferred annuities beginning no later than age 85. Before annuitization, the value of the *qualifying longevity annuity contract* is excluded from the account balance used to determine RMDs. For contracts purchased after 7/1/14, premiums paid may not exceed $125,000 or 25% of the employee's account balance on the date of payment. Similar rules apply to Section 403(b) and 457(b) plans.

National Taxpayer Advocate's Objectives Report. Nina Olson's midyear report to Congress emphasizes the importance of taking concrete steps to give meaning to the recently adopted Taxpayer Bill of Rights, issuing refunds to victims of return preparer fraud, continuing to make improvements in the Exempt Organizations area and expanding the recently announced voluntary return preparer certification program to include competency testing. In the preface, she noted that, "All this is generally good news. But as we note in the report, the good news also raises additional questions and concerns." For the full report, click on *www.taxpayeradvocate.irs.gov/2015-Objectives-Report*.

Signature requirements for partnership tax returns. In informal Chief Counsel Advice, the IRS said that, although a partnership income tax return not signed by a general partner or an LLC member manager isn't a valid partnership return, the tax return that starts the running of the statute of limitations period is that of the taxpayer whose liability is being assessed, and not the partnership's or LLC's whose return also might report the transaction giving rise to the liability. Another issue addressed was whether the return is invalid if signed with the name of the entity, rather than with the name of the individual partner or member. The IRS indicated that, in their view, the signer should sign by writing his or her name, rather than the name of the business entity, because only a natural person can sign tax returns. CCA 201425011.

Business Taxes

Fringe Benefits Provided to Pass-through Entity Owners

The federal income tax outcome when a partnership (or a multimember LLC treated as such for tax purposes) or an S corporation provides fringe benefits (which normally are tax-free to employees) to its owners can get quite confusing. For some benefits, partners are treated as partners and, thus, are ineligible for the benefits. Other times, they're treated as employees who can share in the benefit in the same manner as any other employee.

Additionally, a more-than-2% shareholder-employee of an S corporation (or an employee treated as such under stock ownership attribution rules) is considered a partner for fringe benefit taxation purposes (IRC §1372). Thus, the fringe benefit tax rules for partners apply equally to S corporation employees who own, directly or indirectly, more than 2% of the corporation's stock. (The attribution rules mean that the owner's spouse, children, grandchildren, and parents are treated as more-than-2% shareholders, even if they own no stock directly.)

Partner or shareholder treated as a partner. When a partner is treated as a partner, the partnership's costs to provide the benefit to partners is generally treated as Section 707(c) guaranteed payments. That means the costs are deducted by the partnership and reported as taxable income to the recipient partners. The payments must be for compensation for services rendered by the recipient partners to the partnership.

Note: If the benefits are not provided for services rendered in the capacity of a partner or depend on partnership income, they are treated as distributions to the recipient partners, not guaranteed payments. As this situation is not as common, our discussion assumes the benefits are guaranteed payments.

When an S corporation shareholder is treated as a partner, the S corporation's costs to provide the benefit to the more-than-2% shareholder-employees is treated as a deductible compensation expense by the corporation and reported as taxable compensation income to the more-than-2% shareholder-employee recipient. (Rev. Rul. 91-26)

Partner or shareholder treated as an employee. For fringe benefits where the partners (including more-than-2% S corporation shareholders) are treated as employees, the partnership (or corporation) can deduct the cost of providing the benefits, and the benefits are tax-free to the recipient partners or shareholders (assuming the basic tax qualification rules for each of these benefits are met). Obviously, this is a much better tax result.

Partner versus employee treatment. The table below summarizes the tax treatment of fringe benefits for partners (including more-than-2% S corporation shareholders).

Partners and More-than-2% S Corporation Shareholders—Fringe Benefit Treatment

Benefit Taxed	Benefit Tax-free
Qualified employee achievement award [IRC §74(c)].	Qualified educational assistance program (IRC §127).[4]
Group term life insurance coverage of up to $50,000 per partner (or shareholder) (IRC §79).	Qualified dependent care assistance program (IRC §129).[5]
Disability insurance coverage (IRC §105).	No-additional-cost services [IRC §132(b) and Reg. §1.132-1(b)(1)].
Medical reimbursement plans (IRC §105).	Qualified employee discounts [IRC §132(c) and Reg. §1.132-1(b)(1)].
Premiums for accident, health and long-term care insurance coverage for the partner (or shareholder), spouse and dependents (IRC §106).	Working condition fringe benefits [IRC §132(d) and Reg. §1.132-1(b)(2)(ii)]. These include the business-use portion of a company-provided vehicle, professional dues, company-paid job-related education expenses, company-provided cell phones and job placement assistance.
Meals or lodging furnished for the convenience of the company (IRC §119).	*De minimis* fringe benefits [IRC §132(e) and Reg. §1.132-1(b)(4)]. These include personal use of employer-provided cell phones or computers maintained exclusively at the business establishment, occasional employee cocktail parties or picnics, occasional use of the copy machine and local telephone calls.
Cafeteria plan [IRC §125; Prop. Reg. §1.125-1(g)(2)].[1]	On-premises athletic facilities [IRC §132(j) and Reg. §1.132-1(b)(3)].[6]
Qualified transportation fringes [IRC §132(f)].[2]	Qualified retirement planning services [IRC §132(m)].[7]
Qualified moving expense reimbursements [IRC §132(g)].[3]	
Qualified adoption assistance program [IRC §137(c)(2)].[3]	
Health savings accounts (IRC §223).	

1 Partners and shareholders cannot participate in a cafeteria plan, as doing so would disqualify the plan.
2 However, under the *de minimis* benefit rules, a partner can be provided a tax-free monthly pass (not to exceed $21) to commute on public transportation [Reg. 1.132- (b), Q & A 24(b)].
3 Neither the Code nor regulations state whether a partner is considered an employee or partner for this benefit, but the IRS classifies them as partners in Publication 15-B. Thus, the conservative approach would be to treat partners as ineligible for these benefits.
4 However, no more than 5% of the benefits during the year may be provided to more-than-5% owners (or their spouses or dependents).
5 However, the facility must not primarily benefit officers, owners or highly compensated employees.
6 However, no more than 25% of the benefits may be paid to a more-than-5% stockholder or owner.
7 The services must be available on substantially the same terms to each member of the group of employees normally provided education and information regarding the employer's qualified plan. Also, neither the Code nor regulations define what constitutes an employee for this benefit, but IRS Pub. 15-B does not list partners as being ineligible to receive retirement planning services as a tax-exempt fringe benefit.

Individual Income Tax—Continued

indicating that no exception to the early withdrawal penalty applied.

Taxpayer position. Mr. Dabney argued that the $114,000 withdrawal wasn't taxable because it was essentially an investment that he purchased on the IRA's behalf. The withdrawal was either: (1) a purchase made by the IRA or (2) a transfer between IRA trustees.

IRS position. The IRS argued that Mr. Dabney's Schwab IRA did not purchase the property because Schwab's policies do not permit the purchase or holding of real property and that a trustee-to-trustee transfer did not occur. Therefore the distribution was taxable and, because Mr. Dabney was under age 59 ½ during 2009, it was subject to the 10% early withdrawal penalty tax.

Court decision. The Court sided with the IRS concluding that the distribution was taxable and subject to the 10% early withdrawal penalty.

The Court reasoned that Schwab had the power to prohibit the purchase and holding of real property in its role as an IRA trustee. Therefore, even if the property had been titled as intended, the IRA could not hold real property and would not have accepted ownership of the property. Consequently, Mr. Dabney did not act as an agent on behalf of Schwab, and the IRA did not purchase the property.

The Court also concluded that there was no trustee-to-trustee rollover because the funds were wired from his IRA directly to Chicago Title, the company handling the sale of the property. Mr. Dabney did not have an IRA (or other ERP) with Chicago Title, nor was Chicago Title an IRA trustee.

Conclusion. Mr. Dabney's goal was to increase the value of his IRA by investing in real property using funds from the IRA. The flaw was not in Mr. Dabney's intent but in his execution. Had Mr. Dabney initiated a rollover or a trustee-to-trustee transfer from his Schwab IRA to a different IRA—one permitted to purchase and hold real property—he would have achieved his goal without any unintended tax consequences.

Business Taxes

Calendar Notes Not Enough to Substantiate Vehicle Expenses

David H. Garza, TC Memo 2014-121
Lee A. Baker, TC Memo 2014-122

Background. Generally, a taxpayer must keep records sufficient to substantiate the amount of any deduction claimed to support the taxpayer's tax liability (IRC §6001). However, under the *Cohan* rule, if a taxpayer establishes that an expense is deductible, but is unable to substantiate the precise amount, a court may estimate the amount if the taxpayer presents sufficient evidence from which to form an estimate.

Strict substantiation requirements must be met for expenses related to the use of Section 280F listed property [IRC §274(d)]. A taxpayer generally must maintain adequate records or produce sufficient evidence corroborating his own statement, establishing the amount, date and business purpose of each expenditure or business use of listed property [Reg. §1.274-5T(b)(6)]. The Section 274(d) substantiation rules override the *Cohan* rule [Temp. Reg. §1.274-5T(a)].

Listed property generally means passenger autos and any other property used as a means of transportation. However, listed property does not include property which is used in a trade or business of transporting persons or property for compensation or hire. [IRC §280F(d)(4)].

Two recent tax court cases illustrate how these substantiation rules are applied.

The *Garza* case. In *Garza*, the taxpayer, who was employed as an outside direct sales representative, used his personal truck (listed property) to call upon customers. Per company policy, he wasn't reimbursed for vehicle expenses. To keep track of his truck expenses, he kept records in a calendar planner book by documenting his truck's odometer readings at the beginning and end of each month with intermediate readings in some months, but included no other information related to vehicle usage (personal or business).

Taxpayer and IRS position. On his Schedule A for the year, Garza claimed unreimbursed employee expenses of $24,939 including $20,086 for vehicle expenses using the standard mileage rate. The IRS disallowed the unsubstantiated deductions.

Court decision. The Tax Court agreed with the IRS, concluding that although they believed Garza had unreimbursed travel expenses related to his employment, he failed to follow the strict substantiation requirements of IRC Sec. 274(d). The taxpayer's calendar, while contemporaneous, did not sufficiently document the business purpose of each business use of his truck.

The *Baker* case. In *Baker*, the taxpayer worked as a self-employed truck driver. His business involved using his personally owned truck tractor to haul tank trailers from a pickup site to designated destinations.

Baker did not file a tax return for 2009. Furthermore, he declared bankruptcy in 2011 and, in the process of losing his home, lost all of his business records.

In 2012, the IRS prepared a substitute 2009 return on the basis of information returns and issued a notice of deficiency. Baker disputed the deficiency and took the case to court.

Court decision. At trial, Baker claimed that he drove approximately 65,000 miles in 2009, and incurred approximately $63,638 of expenses related to his truck business—fuel $38,516, maintenance $12,200, insurance $1,500, oil changes $1,722, storage fees $1,200, license plates $1,450, and heavy highway use taxes $550. He also claimed travel expenses of $6,500. He provided no documentation to support the mileage or any of the expenses.

The Tax Court found that Baker's truck wasn't listed property as it fell within the IRC §280F(d)(4)(C) exception. As a result, the expenses incurred with respect to the truck (fuel, maintenance, insurance, oil changes, storage fees, license plates, and heavy highway use taxes) weren't subject to the heightened listed property substantiation requirements. Therefore Baker's expenses were subject to the *Cohan* rule.

The Tax Court found Baker to be a credible witness, but all of his amounts were based on rough estimates that were made years after the fact with no documentation. On the facts, the Tax Court found that Baker was entitled to a deduction of only $18,000 for fuel expenses, $500 for insurance, $500 for oil changes, and $400 for license expenses. He wasn't entitled to any deduction for the maintenance, storage, taxes, and travel expenses as there wasn't sufficient evidence to substantiate them.

Individual Income Tax

Land is Not Necessarily a Capital Asset

Cordell Pool, TC Memo 2014-3
Fredric Allen, 113 AFTR 2d 2014-2262

Background. Preferential rates apply to long-term gains from dispositions of capital assets, which do *not* include property held primarily for sale to customers in the ordinary course of the taxpayer's business (inventory).

Recently the Tax Court and the Ninth Circuit have identified five factors relevant in determining when land is inventory rather than a capital asset. A recent California District Court decision was based on the same five factors, which are as follows—

1) The nature of the acquisition of the property.
2) The frequency and continuity of property sales by the taxpayer.
3) The nature and the extent of the taxpayer's business.

See "Individual Income Tax—Continued" on Page 5

Individual Income Tax—Continued

4) Sales activities of the taxpayer with respect to the property.
5) The extent and substantiality of the transaction in question.

Taxpayers must prove that they fall on the right side of these factors to obtain the desired capital asset status.

***Pool* case facts.** Concinnity LLC (CL) was treated as a partnership for tax purposes. CL was organized by three individuals (the taxpayers). The taxpayers also organized the Elk Grove Development Company (EGDC). CL acquired 300 undeveloped acres in Montana for $1.4 million. At the time of the purchase, the land was already divided into four sections (Phases 1–4).

On its 2005 Form 1065, CL reported $500,761 of long-term capital gain (LTCG) from two installment sales of the lots in Phases 2 and 3 to EGDC. The taxpayers reported their passed-through shares of CL's gains as LTCG on their respective 2005 Forms 1040.

IRS position. Upon audit, the IRS claimed that CL's land sales produced ordinary income rather than LTCGs and asserted tax deficiencies against the taxpayers.

Court's analysis of the five factors. The Tax Court applied the five factors listed above and found: (1) the record suggested that CL's purpose in acquiring the land was to develop and sell it; (2) there was insufficient evidence to establish that the sales were not frequent and substantial; (3) CL paid for certain water and wastewater improvements, which were more akin to a developer's degree of involvement than to an investor's action to increase the value of the property; (4) there was insufficient evidence to show that CL did not spend large portions of its time actively participating in selling lots; and (5) EGDC, also owned by the taxpayers, agreed to buy the land from CL at an apparently inflated price (not arm's-length), indicating that EGDC was formed for tax avoidance reasons.

Court decision. Since the taxpayers were found to be on the wrong side of all five factors, the Tax Court agreed with the IRS that the lots were held as inventory for sale to customers and taxable at the higher ordinary income tax rates.

***Allen* case facts.** Frederic Allen and his wife Phyllis (the taxpayers) went to District Court seeking a refund of federal income tax assessed by the IRS from the sale of 2.63 acres of undeveloped land in East Palo Alto, California. Mr. Allen was a civil engineer who primarily worked for real estate developers. He purchased the land in 1987 and initially testified he intended to develop and sell the land himself. He later testified he bought the land as an investment.

Ultimately, he admitted between 1987 and 1995, he attempted to develop the property, paying for engineering plans and obtaining a second mortgage. From 1995–1999, he attempted to find investors or partners to help develop and sell the property. In 1999, Mr. Allen finally sold the property to Clarum Corporation, a real estate development company, in an installment sale deal that was later renegotiated. The taxpayers ultimately reported the income from the sale as LTCG.

IRS position. The IRS held that the sale of the property was "other income" not LTCG.

Court's analysis of the five factors. The District Court found factors one (nature of the acquisition) and four (taxpayer's sales activities) indicated the land was inventory taxed at ordinary income tax rates. The remaining factors did not help the taxpayers either.

The taxpayer argued that the second factor (frequency and continuity of sales) should be in his favor because the East Palo Alto property was his only development effort. However, the Court found that factor inconclusive. The Court also found the third factor (nature and extent of the business) to be inconclusive since he was employed as a civil engineer working for developers while in business for himself.

While the Court agreed that the fifth factor (extent and substantiality of the transaction) favored the taxpayer since there was only one sale, they determined it was inconclusive because the single sale occurred after the taxpayer had failed to develop the property himself or find other parties to partner with him.

Court decision. The Court granted summary judgment in favor of the IRS taxing the gain as ordinary income.

Conclusion. These two recent court decisions serve as a reminder that undeveloped land is not necessarily a capital asset. Instead, it might be inventory held for sale to customers in the ordinary course of a real estate development business taxed at ordinary income rates. In the *Pool* case, the taxpayers could potentially have salvaged LTCG treatment if they had conducted their affairs a little more carefully. In the *Allen*

See "Individual Income Tax—Continued" on Page 6

Upcoming Tax Dates

August 11
- Tip employees report July tips to employers.
- Employers file Form 941 for second quarter if all taxes deposited in full and on time.

August 15
- Employers deposit July payroll and nonpayroll withholding taxes if monthly deposit rule applies.
- 2013 Form 990, 990-EZ or 990-PF due for calendar-year exempt organizations with an automatic three-month extension from May 15. Use Form 8868 to request an additional (not automatic) three-month extension with sufficient reason.

September 10
- Tip employees report August tips to employers.

September 15
- Employers deposit August payroll and nonpayroll withholding taxes if monthly deposit rule applies.
- Third 2014 estimated tax payment due for individuals, calendar-year corporations, estates, trusts, private foundations and most exempt organizations.
- 2013 Form 1041 due for calendar-year trusts and estates on extension.
- 2013 Form 1065 due for calendar-year partnerships on extension.
- 2013 Form 1120 or 1120S due for calendar-year C or S corporations on extension.

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