CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

CHAPTER 12

PLAN. The debtors' Chapter 12 plan proposed to pay administrative claims, one priority tax claim, two secured claims, and, from any portion of their disposable income that exceeded the amounts needed to pay the listed claims, to pay their unsecured claims, minus the trustee's percentage fee. Thus, the unsecured claims would be paid after the effective date of the plan. The trustee objected to the plan because it did not provide for any interest to be paid on the delayed unsecured claims. The debtors argued that the rate for five-year U.S. Treasury securities was the proper rate because the payments would be made within five years. The Bankruptcy Court looked at the holding in *Till v. SCS Credit Corporation, 541 U.S. 465 (2004)* and noted that no definition of "present value" received more than four votes, but the Bankruptcy Court ruled that a plurality of the Supreme Court and the dissenting opinion rejected the riskless rate approach. Therefore, the Bankruptcy Court held that the rate on the unsecured claims payments had to include at least some measure covering the risk of nonpayment by the debtors. ***In re* Schuckenbrock, 2012 Bankr. LEXIS 5225 (Bankr. D. Kan. 2012)**.

FEDERAL TAX

DISCHARGE. The debtor had filed a Chapter 7 case in October 2010 and the debtor received a discharge in February 2011. The debtor had outstanding federal tax liabilities for 2000 and 2001 for which the debtor had filed a Form 1040 in May 2005 after being assessed the taxes in November 2004. The issue was whether the May 2005 Form 1040 constituted a return for purposes of Section 523(a)(1)(B)(i), allowing the discharge of the taxes reported. The court ruled that a document is a "return" for purposes of Section 523(a)(1)(B)(i) if the document complies with "applicable filing requirements" concerning the form and contents of a return, the place and manner of filing, and the types or classifications of taxpayers that are required to file returns, and if it otherwise complies with requirements of nonbankruptcy law. The court rejected the IRS argument, that timeliness was also an essential "applicable filing requirement;" therefore, the May 2005 Form 1040 was a return for purposes of Section 523(a)(1)(B)(i) and the taxes properly reported therein were dischargeable. ***In re* Martin, 2012-2 U.S. Tax Cas. (CCH) ¶ 50,674 (Bankr. D. Colo. 2012)**.

FEDERAL FARM PROGRAMS

No items.

FEDERAL ESTATE AND GIFT TAXATION

CLAIMS. The decedent and pre-deceased spouse had separate brokerage accounts and their daughter claimed that the couple wanted to equalize their estates by having the decedent issue a promissory note to the pre-deceased spouse. The pre-deceased spouse died before any payments were made on the note and the decedent issued a check to the estate for the amount of the note. The check was not cashed. After the decedent's death, the estate sought to claim a deduction for the promissory note claim. The court held that the claim was not bona fide debt because there was no written evidence to support the claim that the couple had wanted to equalize their estates and the decedent received no consideration for the note; therefore, the estate could not deduct the value of the note. **Estate of Derksen v. United States, 2012-2 U.S. Tax Cas. (CCH) ¶ 60,657 (E.D. Penn. 2012)**.

FORMULA GIFT CLAUSES. The IRS Office of Chief Counsel has issued a nonacquiescence in the following case. The taxpayers formed a family limited liability company. Because the taxpayers did not have an appraisal of the value of the company, gifts of interests in the company to their children were expressed in terms of a dollar amount equal to the current exemption amount, $11,000. After an appraisal was obtained, the gifts were changed to a corresponding percentage interest. The gift tax returns reflected the percentage interests. The IRS placed a higher value on the company and assessed a gift tax on the transfers of the percentage interests because their value exceeded the annual exemption as a result of the revaluation of the company. The court distinguished *Knight v. Comm'r, 115 T.C. 506 (2000)*, because, in that case, the taxpayers argued that the value of the transferred interests was less than the value originally used by the taxpayers. In this case, the taxpayers argued that the gift agreement provided that the percentage interests transferred were to be determined by the value of the company and were not to exceed the gift tax exemption. Thus, the court held that the use of percentage interests on the gift tax return did not negate the terms of the gift agreements. The formula clause in the agreement provided for determination of the percentage interests transferred by the company, as finally determined by an appraisal or IRS audit. The court held that the gift agreement controlled for determining the percentage interests transferred and that such interests were decreased by the change in company valuation by the IRS so that the gifts were equal to the annual exemption amount. **Wandry v. Comm'r, T.C. Memo. 2012-88, *nonacq*., (CCH) FINH ¶30,723, Nov. 15, 2012**.

GENERATION-SKIPPING TRANSFERS. The decedent's will bequeathed property to an irrevocable marital trust for the decedent's surviving spouse. The trust became irrevocable prior to September 25, 1985. The spouse was granted an intervivos general power of appointment, but because of an incapacity lasting to the spouse's death, that power was never exercised. Under the terms of trust, upon the death of the spouse, the trust was divided into equal shares for decedent's surviving children and surviving issue of a deceased child. One share continued in trust for the benefit of a son, his spouse, the son's issue and the spouses of such issue. Under this trust, the trustees are to pay the son 50 percent of the income annually and the balance to the class consisting of the son, his spouse, the son's issue and the spouses of such issue. Under the terms of the decedent's will, the son was granted a limited power of appointment over the trust exercisable in favor of the son's issue and any spouse of the son's issue. If the son died without exercising the power, the assets of the trust were to be distributed outright to his living issue, per stirpes. The son executed a will that appointed the assets held in the trusts on his death to a new trust created by the son. The appointment specifically limited the duration that the new trust may hold the trusts' assets to one day prior to the perpetuity period created under the decedent's will. The IRS ruled that the spouse's failure to exercise the intervivos general power of appointment over the marital trust did not subject the trust to GSTT. The IRS also ruled that the son's exercise of the power of appointment also did not subject the trust to GSTT. **Ltr. Rul. 201246004, Aug. 1, 2012**.

The decedent had created an irrevocable trust prior to September 25, 1985 for the benefit of the decedent's grandchildren. The trusts obtained a state court ruling dividing the trust into three separate and equal trusts, one for each grandchild. The IRS ruled that the division of the trust did not subject the trust to GSTT. **Ltr. Rul. 201245007, Aug. 1, 2012**.

IRA. The decedent had created a trust for the decedent's benefit which owned an IRA from which the trust received the required minimum distributions automatically on a monthly basis. The decedent's spouse was named the reminder beneficiary of the IRA and the spouse received two of the monthly payments before cancelling the automatic payments. The spouse then disclaimed any interest in the trust and the trust passed to a family trust established by the decedent. The IRS ruled that the disclaimer was valid and qualified under I.R.C. § 2518, even though the spouse had received two monthly payments. **Ltr. Rul. 201245004, July 18, 2012**.

TRUST. The taxpayer was the citizen of another country and transferred property to an irrevocable trust subject to the laws of that country. The taxpayer was the beneficiary of the trust during the taxpayer's lifetime and the remainder would pass to the taxpayer's issue who are U.S. citizens. The IRS ruled that the assets acquired from the trust are within the description of property acquired from a decedent under I.R.C. § 1014(b)(1); therefore, the trust will receive a step-up in basis in the trust assets under I.R.C. § 1014(a) determined by the fair market value of the property on the date of the taxpayer's death. See *Rev. Rul. 84-139, 1984-2 C.B. 168* (holding that foreign real property that is inherited by a U.S. citizen from a nonresident alien will receive a step-up in basis under I.R.C. §§ 1014(a)(1), 1014(b)(1)). The IRS ruled that this rule applies to property located outside the United States, as well as to property located inside the United States. The IRS also ruled that following the death of the taxpayer, the basis of the property held in the trust will be the fair market value of the property at the date of the taxpayer's death under I.R.C. § 1014(a). **Ltr. Rul. 201245006, July 19, 2012**.

FEDERAL INCOME TAXATION

BAD DEBTS. The taxpayer entered into a business arrangement and provided substantial funds to cover the early expenses. The taxpayer testified that the taxpayer expected reimbursement from the other people involved in the business and the evidence did show some reimbursement. After several years of failing to receive reimbursement, the taxpayer terminated the business arrangement and claimed the un-reimbursed expenses as a bad debt deduction. The court held that the taxpayer failed to provide independent evidence to show that the debt was bona fide and was no longer reasonably collectible in the tax year the debt was claimed as a deduction. **Alioto v. Comm'r, 2012-2 U.S. Tax Cas. (CCH) ¶ 50,659 (6th Cir. 2012), aff'g, T.C. Memo. 2011-151**.

The taxpayer claimed net operating loss carryforwards based on a series of bad debt deductions in prior tax years which gave rise to negative adjusted gross income in those years. The loans were made as part of the taxpayer's real estate business. The court held that the taxpayer failed to establish a prima facie case proving the entitlement to a bad debt deduction for any of the loans. The court found that the record contained no credible financial documents demonstrating that the taxpayer even extended loans to any of the named debtors. The taxpayer failed to produce any canceled checks, bank statements, foreclosure documents, personal or corporate records, or any probative documentary evidence supporting any alleged adjusted income tax bases in the loans. In addition the court found no evidence that any of the alleged loans were worthless in the tax years involved. **Deutsch v. Comm'r, T.C. Memo. 2012-318**.

CORPORATIONS

LEGAL FEES. The taxpayer was a wholly-owned S corporation. The sole shareholder and taxpayer were sued for the wrongful death of the shareholder's girlfriend while the shareholder and girlfriend were on a vacation. The taxpayer's board of directors agreed to pay any settlement of the case up to $5 million and reimburse the shareholder for any contribution to a settlement. The plaintiff accepted a $2.3 million settlement and the taxpayer reimbursed the shareholder for a $250,000 contribution to that settlement. The taxpayer claimed the settlement, reimbursement and legal fees as a deduction. The court held that no deduction was allowed because the legal action did not arise from the conduct of the taxpayer's business by the shareholder. **Cavanaugh v. Comm'r, T.C. Memo. 2012-324**.

COURT AWARDS AND SETTLEMENTS. The taxpayer filed a race discrimination lawsuit against an employer seeking back pay, back benefits, compensatory and punitive damages, and legal fees. The parties reached a settlement which paid money to the taxpayer in settlement of the race discrimination suit and all claims for damages. The court held that the settlement payment was properly included in income by the IRS because the taxpayer failed to prove that the payment was made to settle any claims for physical injuries. The appellate court affirmed in a decision designated as not for publication. **Ahmed v. Comm'r, 2012-2 U.S. Tax Cas. (CCH) ¶ 50,676 (11th Cir. 2012),** ***aff'g*****, T.C. Memo. 2011-295**.

DISASTER LOSSES. On November 3, 2012, the President determined that certain areas in Rhode Island are eligible for assistance from the government under the Disaster Relief and Emergency Assistance Act (42 U.S.C. § 5121) as a result of Hurricane Sandy which began on October 26, 2012. **FEMA-4089-DR**. Accordingly, taxpayers in the areas may deduct the losses on their 2010 federal income tax returns. See I.R.C. § 165(i).

FIRST TIME HOMEBUYER CREDIT. The taxpayers, husband and wife, claimed the first time homebuyer credit for a home purchased in 2008. At the time of the purchase, the husband's name was still on the title of a home owned by the husband and an ex-spouse, although their divorce decree awarded the home to the ex-spouse. The husband had not lived in the prior home since moving to another state in 2005. Prior to the purchase of the taxpayers' home, the wife had not owned any residences. The IRS denied the credit because the husband owned the prior residence as a principal residence during the three years prior to the purchase of the home for which the credit was claimed. The court held that the term "principal residence" was to be defined as it is in I.R.C. 121 (involving the sale of residence exemption). The court examined the husband's actions after moving to another state and concluded that the husband had not used the first residence as a principal residence for the prior three years but only participated in the residence as a means to provide the husband's child with a secure home. Because husband had not used the prior residence as a principal residence for the three years prior to the purchase of the new home, the taxpayers were eligible for the first time homebuyer's credit. **Harris v. Comm'r, T.C. Summary Op. 2012-115**.

The taxpayer had purchased a home in 2003 and lived there until March 2009. The taxpayer married in 2004 and the couple lived in that house until March 2009. In March 2009 the taxpayer purchased a second home and moved there. On the taxpayers' 2008 joint return, the taxpayers claimed the first time homebuyer's credit of $8000 which the IRS disallowed. The taxpayers argued that the definition of first time homebuyer in U.S. Department of Housing and Urban Development and Federal Housing Administration publications required that only one spouse qualify as not owning a principal residence in the prior three years. Thus, because the taxpayer's spouse did not own a home before the 2009 purchase, both taxpayers qualified for the credit. The court rejected the argument, holding that the definition of first time homebuyer in I.R.C. § 36(c)(1) controlled and that section required both spouses to meet the definition of first time homebuyer. **Cheung v. Comm'r, T.C. Summary Op. 2012-114**.

INCOME. The taxpayer participated in a 10-day medical study of a medical condition suffered by the taxpayer. The company conducting the study provided the taxpayer with lodging and meals and $5,500. The taxpayer argued that the study contract provided that the payment of money was for a physical illness or was a gift. The taxpayer did not present the contract as evidence. The court found that the taxpayer's medical condition did not arise because of the study because it existed prior to the study; therefore, the payment was not received as compensation for physical injury or sickness caused by the study company. The court also held that the payment was not a gift because the payment was not made out of a detached and disinterested generosity by the study company. **O'Connor v. Comm'r, T.C. Memo. 2012-317**.

INSURANCE. The taxpayers, husband and wife, each owned 29 percent of a family corporation, served as directors, and were employees of the corporation. The husband also served as president. The corporation provided an "Advantage Death Benefit Plan and Trust" which purchased life insurance policies on the husband and one other family member. The Plan required that any participant had to be an active employee. After the IRS issued proposed regulations governing such plans, the company managing the plan decided to terminate the plan but offered the corporation a similar plan. However, the new plan did not have the active employment requirement. The corporation changed to the new plan and the taxpayer was sent forms to change the ownership and beneficiaries of the insurance policy. The court held that the change resulted in taxable income to the taxpayer for the value of the transferred insurance policy because the policy was no longer subject to forfeiture when employment stopped and the taxpayer had control over the policy. **Gluckman v. Comm'r, T.C. Memo. 2012-329**.

MILEAGE DEDUCTION. The IRS has announced that the standard mileage rate for 2013 is 56.5 cents per mile for business use, 14 cents per mile for charitable use and 24 cents per mile for medical and moving expense purposes. Under *Rev. Proc. 2010-51, 2010-2 C.B. 883*, a taxpayer must reduce the basis of an automobile used in business by the amount of depreciation the taxpayer claims for the automobile. If a taxpayer uses the business standard mileage rate to compute the expense of operating an automobile for any year, a per-mile amount (23 cents per mile for 2013) is treated as depreciation for those years in which the taxpayer used the business standard mileage rate. If the taxpayer deducted the actual costs of operating an automobile for one or more of those years, the taxpayer may not use the business standard mileage rate to determine the amount treated as depreciation for those years. The 2010 revenue procedure also provides rules under which the amount of ordinary and necessary expenses of local travel or transportation away from home that are paid or incurred by an employee will be deemed substantiated under Treas. Reg. § 1.274-5 when a payor (the employer, its agent, or a third party) provides a mileage allowance under a reimbursement or other expense allowance arrangement to pay for such expenses. Use of a method of substantiation described in this revenue procedure is not mandatory and a taxpayer may use actual allowable expenses if the taxpayer maintains adequate records or other sufficient evidence for proper substantiation. **Notice 2012-72, I.R.B. 2012-50**.

PASSIVE ACTIVITY LOSSES. The taxpayers, husband and wife, owned real estate rental properties and claimed loss deductions from the properties. The taxpayers argued that they were eligible to claim the entire losses as deductions because the taxpayers were in a real property business since they spent more than 750 hours on the properties. The Tax Court determined that the taxpayers failed to establish that for any year at issue the taxpayers met the 750 hour requirement; therefore, the losses at issue are attributable to per se passive activities and are subject to the I.R.C. § 469 limitations. In a decision designated as not for publication, the appellate court upheld the Tax Court ruling as supported by the failure of the taxpayers to provide sufficient evidence to support their claim of spending more than 750 hours on the rental activities. **Harnett v. Comm'r, 2012-2 U.S. Tax Cas. (CCH) ¶ 50,665 (11th Cir. 2012), *aff'g*, T.C. Memo. 2011-191**.

PENALTIES. The IRS has issued a revised revenue procedure which updates *Rev. Proc. 2012-15, 2012-2 C.B. 369* and identifies circumstances under which the disclosure on a taxpayer's income tax return with respect to an item or a position is adequate for the purpose of reducing the understatement of income tax under I.R.C. § 6662(d) (relating to the substantial understatement aspect of the accuracy-related penalty), and for the purpose of avoiding the tax return preparer penalty under I.R.C. § 6694(a) (relating to understatements due to unreasonable positions) with respect to income tax returns. The revenue procedure does not apply with respect to any other penalty provisions. If the revenue procedure does not include an item, disclosure is adequate with respect to that item only if made on a properly completed Form 8275 or 8275–R, as appropriate, attached to the return for the year or to a qualified amended return. The revenue procedure applies to any income tax return filed on 2012 tax forms for a taxable year beginning in 2012, and to any income tax return filed on 2012 tax forms in 2013 for short taxable years beginning in 2013. **Rev. Proc. 2012-51, I.R.B. 2012-51**.

PENSION PLANS. The IRS has announced relief for taxpayers who have been adversely affected by Hurricane Sandy and have retirement assets in 401(k) and similar qualified employer plans they would like to use to alleviate hardships caused by Hurricane Sandy. In addition, the announcement provides relief from certain verification procedures that may be required under retirement plans with respect to loans and hardship distributions. **Ann. 2012-44, 2012-2 C.B. 663**.

The taxpayer received a distribution from an employee stock ownership plan and the plan retained 20 percent of the distribution in withheld taxes. The taxpayer, who was married and lived in a community property state, listed the distribution on the income tax return but did not include the 10 percent penalty for early withdrawals. The taxpayer argued that, because the couple lived in a community property state and the taxpayer's spouse was over age 55, one half of the distribution was not subject to the 10 percent penalty. The court held that the community property laws did not apply to provide the exception to the 10 percent penalty under I.R.C. § 72(t)(2)(A)(v) because the spouse was not employed and did not own any portion of the ESOP; therefore, the entire distribution was subject to the 10 percent penalty. **Vigil v. Comm'r, T.C. Summary Op. 2012-111**.

QUARTERLY INTEREST RATE. The IRS has announced that, for the period January 1, 2013 through March 31, 2013, the interest rate paid on tax overpayments remains at 3 percent (2 percent in the case of a corporation) and for underpayments remains at 3 percent. The interest rate for underpayments by large corporations remains at 5 percent. The overpayment rate for the portion of a corporate overpayment exceeding $10,000 remains at 0.5 percent. **Rev. Rul. 2012-32, I.R.B. 2012-52.**

REPAIRS. The IRS has issued a notice which alerts taxpayers that the IRS expects to issue in 2013 final regulations regarding the deduction and capitalization of expenditures, including repairs, related to tangible property, and that the IRS anticipates that the final regulations will contain changes from the temporary regulations (*T.D. 9564, 76 Fed. Reg. 81060-01 [2012-1 C.B. 614]*). The IRS anticipates that the final regulations will apply to taxable years beginning on or after January 1, 2014, and will permit taxpayers to apply the final regulations to taxable years beginning on or after January 1, 2012. The temporary repair regulations were originally scheduled to be effective for tax years beginning on or after January 1, 2012. See *Harl, "Temporary Regulations on Repairs, Depreciation and Capitalization," 23 Agric. L. Dig. 41 (2012)*. **Notice 2012-73, I.R.B. 2012-51**.

SAFE HARBOR INTEREST RATES

December 2012

	Annual	Semi-annual	Quarterly	Monthly
		Short-term		
AFR	0.24	0.24	0.24	0.24
110 percent AFR	0.26	0.26	0.26	0.26
120 percent AFR	0.29	0.29	0.29	0.29
		Mid-term		
AFR	0.95	0.95	0.95	0.95
110 percent AFR	1.05	1.05	1.05	1.05
120 percent AFR	1.14	1.14	1.14	1.14
		Long-term		
AFR	2.40	2.39	2.38	2.38
110 percent AFR	2.65	2.63	2.62	2.62
120 percent AFR	2.89	2.87	2.86	2.85

Rev. Rul. 2012-31, I.R.B. 2012-49.

TRUSTS. A trustee made a distribution from a trust during the first 65 days of the trust tax year but failed to make the election under I.R.C. § 663(b) to treat the distribution as made on the last day of the previous tax year. The IRS granted an extension of time to make the election. **Ltr. Rul. 201245004, July 31, 2012**.