CASES, REGULATIONS AND STATUTES

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BANKRUPTCY

GENERAL-*ALM* § 13.03.*

EXEMPTIONS

HOMESTEAD. The debtor borrowed money to purchase farm land on which the debtor lived. The debtor executed mortgages to secure the loans but the mortgages did not include language required by Iowa Code § 561.22 for the waiver of homestead exemption rights. The debtor claimed the property as a homestead exemption in a bankruptcy proceeding and the bank sought to enforce the mortgage against the property. The court held that the failure of the mortgages to contain the language required by Iowa Code § 561.22 prevented the bank from asserting any waiver of the homestead exemption. ***In re* Wagner, 259 B.R. 694 (Bankr. 8th Cir. 2001)**.

CHAPTER 12-*ALM* § 13.03[8].*

The current extension of Chapter 12 expired on May 31, 2001.

RESIGNATION OF TRUSTEE. The court received a notice that the U.S. Trustee had accepted the resignation of the standing Chapter 12 trustee for the court's district. The UST did not file the letter with the court or provide any notice to the court, parties or attorneys involved in current Chapter 12 cases. The UST argued that, because the UST had the power to appoint the standing trustee and to appoint a successor trustee, the UST had the authority to remove the standing trustee. The court held that the standing trustee could be removed only after notice and a hearing as required by Section 324 and that the UST's powers did not include the power to remove the standing trustee without court approval. ***In re* Brookover, 259 B.R. 884 (Bankr. N.D. Ohio 2001)**.

FEDERAL TAX-*ALM* § 13.03[7].*

DISCHARGE. The debtor filed for Chapter 13 in February 2000 and the claims included taxes for 1993 which were assessed in 1998. The debtor had filed two previous bankruptcy petitions, in June 1997 and September 1998, both of which prevented collection by the IRS. The IRS argued that the previous bankruptcy cases tolled the 240 day provision in Section 507(a)(8)(A)(ii) to make the taxes nondischargeable. The court found that the debtor had not filed the previous bankruptcy petitions in order to intentionally use up the 240 days; however, the court held that the 240 day limitation was equitably tolled because the IRS was allowed only 108 days to collect the assessed taxes. ***In re* Hoppe, 259 B.R. 852 (Bankr. E.D. Tax. 2001)**.

FEDERAL AGRICULTURAL PROGRAMS

FARM CREDIT SYSTEM. The FCA has adopted as final regulations which expanded the eligible borrowers and use of loan proceeds to farmers, ranchers, aquatic producers and harvesters, processing and marketing operators, farm-related businesses, rural homeowners, cooperatives and rural utilities. The previous regulations were challenged in *Independent Bankers Ass'n of Am. v. Farm Credit Admin., 986 F. Supp. 633 (D. D.C. 1997), rev'g, 164 F.3d 661 (D.C. Cir., 1999)* as too broad because (1) the loans could be made to rural homeowners who did not reside in the rural home and (2) the regulations did not specifically limit FCS banks and associations that extend long-term mortgage credit to financing necessary capital structures, equipment, and initial working capital for eligible farm-related service businesses. The final regulations amend the original regulations to conform with the two rulings. **66 Fed. Reg. 28641 (May 24, 2001)**.

FEDERAL ESTATE AND GIFT TAX

EQUITABLE RECOUPMENT. The taxpayer had made gifts in several years and filed gift tax returns for the gifts. The amount of gift tax assessed and paid was less than the amount actually due because the IRS failed to account for previous gifts. By the time the decedent died, the statute of limitations on the gift tax for several years had elapsed. The estate claimed the "gift tax payable" for the gifts at the correct amount, i.e. the estate claimed a credit for more gift tax than was actually paid. In a field service advice letter, the IRS determined that it could not use the doctrine of equitable recoupment to reduce the "gift tax payable" to the amount of gift tax actually paid. The IRS reasoned that (1) the doctrine was available only as a defense against an otherwise valid tax claim by the IRS and (2) the Tax Court did not have sufficient equitable powers to use the doctrine. **FSA Ltr. Rul. 200118002, Dec. 15, 2000**.

GIFT. The decedent had created a revocable trust for the decedent's life, with a remainder to various heirs. The decedent subsequently married and created an irrevocable trust for the spouse which was conditioned upon funding and qualification of the trust as QTIP. If the irrevocable trust was not fully established, the corpus reverted to the revocable trust established earlier. The decedent failed to timely file an election to treat the irrevocable trust as QTIP. The decedent's estate filed an action in state court which determined that the transfer to the irrevocable trust was not completed; therefore, no gift occurred. The court noted that the state court judgment was not given full weight but held that the irrevocable trust was conditioned upon requirements which were not met by the time of the decedent's death; therefore, no gift was completed for federal gift tax purposes. **First Security Bank v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 60,406 (D. N.M. 2001)**.

NET OPERATING LOSSES. The decedent was involved in a Chapter 11 bankruptcy case at the time of death. The decedent had net operating losses which passed to the estate and which were offset by discharge of indebtedness occurring during the bankruptcy case. The bankruptcy estate also incurred net operating losses. The bankruptcy case terminated after the death of the decedent. The decedent's spouse filed a joint return for the year of the decedent's death and the issue was whether the spouse could claim on the joint return the net operating losses which passed to the decedent at the close of the bankruptcy case. In a field service advice letter, the IRS ruled that the net operating losses did not belong to the decedent at the decedent's death; therefore, the decedent did not have any losses to include in the joint return, which covered the spouse's entire tax year but only the decedent's year up to the date of death. The IRS ruled that the net operating losses were passed from the bankruptcy estate to the decedent's estate and would be included in the decedent's estate's income tax return. **FSA Ltr. Rul. 200118003, Dec. 26, 2000**.

VALUATION OF STOCK. The decedent owned 18 of the outstanding 76.445 shares of the voting stock and 3,942.048 of the outstanding 141,288.584 shares of the nonvoting stock of a private, family-owned corporation. The remaining shares of outstanding voting stock were owned by the decedent's three siblings. The voting stock was subject to a 360-day restriction on transferability or hypothecation. Both classes of stock were entitled to the same dividends on a per-share basis, if and when dividends were declared. Holders of the nonvoting stock were entitled to a liquidating preference. The Tax Court valued the stock by calculating the equity value of the corporation, adding a premium for voting privileges, and applying a 35-percent marketability discount to the voting stock and a 40-percent marketability discount to the nonvoting stock. The appellate court reversed as to the valuation of the voting stock, holding that the premium added for the voting stock was not based on any economic value to the decedent or any potential buyer. **Est. of Simplot v. Comm'r, 2001-1 U.S. Tax Cas. (CCH) ¶ 60,405 (9th Cir. 2001), *rev'g in part*, 112 T.C. 130 (1999)**.

FEDERAL INCOME TAXATION

BAD DEBTS. The taxpayer was an attorney who owned a joint tenancy interest in a family corporation which operated a small retail store. The taxpayer provided some management assistance but received no income from the corporation. The corporation ceased business in 1993. The taxpayer made several loans to the corporation and deducted the amount of the loans as a bad debt in 1993. The taxpayer also paid some of the business expenses in 1993 and claimed those payments as a business expense deduction in 1993. The court held that the taxpayer was not entitled to a business bad debt deduction because the taxpayer was not in the lending business nor the retail business but made the loans as shareholders or family members. The court also denied the business expense deduction because the expenses were liabilities of the corporation. **Martens v. Comm'r, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,416 (5th Cir. 2001), *aff'g*, T.C. Memo. 2000-46**.

CORPORATIONS-*ALM* § 7.02.*

REASONABLE COMPENSATION. The taxpayer was an S corporation with one shareholder. Although the shareholder had been responsible for the taxpayer's early success, the shareholder had been in failing health during the tax years involved and most of the income came from passive investments. The shareholder received compensation equal to 81 and 88 percent of the taxpayer's adjusted taxable income and the court held that this was unreasonable because the shareholder's efforts were no longer essential to the production of income. **Metro Leasing & Development Corp. v. Comm'r, T.C. Memo. 2001-119**.

COURT AWARDS AND SETTLEMENTS-ALM § 4.02[14]. The U.S. Supreme Court has denied certiorari in the following case. The taxpayer had received severance pay based on the taxpayer's salary and length of service with the employer. The taxpayer excluded the payments from income, arguing that the taxpayer received physical injury from the early termination of employment and the employer knew about the injury when the payments were made. The court held, in an opinion designated as not for publication, that the payments were included in income because the payments were based on the taxpayer's salary and length of service and were not made as compensation for the injuries. **Cook v. United States, 2000-2 U.S. Tax Cas. (CCH) ¶ 50,770 (Fed. Cir. 2000), *cert. denied*., ___ S. Ct. ___ (2001).**

The taxpayers received a jury award and accrued interest in a personal injury action. A portion of the award was paid to the taxpayers' attorneys under a contingent fee contract. The taxpayers excluded the attorney fees from their reported gross income. The court held that the attorneys' fees were properly excluded from income because the fees would be taxable to the attorneys. The court cited *Estate of Clarks v. United States, 202 F.3d 854 (6th Cir. 2000)* in support of its holding. The case is designated as not for publication. **Brisco v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,420 (6th Cir. 2001)**.

The taxpayer was employed for several years by a drugstore chain. The taxpayer experienced various physical and mental problems from the strain of working long hours and irregular hours. A class action suit was filed by other parties against the drugstore chain for unpaid overtime compensation. The taxpayer joined in the suit as a class member but did not assert any claims for physical or mental injuries. The drugstore agreed to a monetary settlement and the settlement did not indicate that the taxpayer's payment was for personal injuries. The taxpayer excluded the settlement payment from income as a payment for personal injuries. The court held that the payment was included in income because the class action petition made no mention of claims for personal injuries but sought damages only for unpaid compensation. **Hamblin v. Comm'r, T.C. Summary Op. 2001-73**.

The decedent and family had filed a suit against various sheetrock manufacturers for injury to the decedent from asbestos. The parties reached a settlement which stated that a portion of the settlement was for the survival action, a portion for the wrongful death action, and a portion for the loss of consortium claim. The IRS ruled that the entire settlement was excludible from taxable income because all the claims were based on the physical injuries suffered by the decedent. **Ltr. Rul. 200121031, Feb. 16, 2001**.

DISASTER PAYMENTS. On April 27, 2001, the President determined that certain areas in Kansas were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of severe storms, hail, tornadoes and flooding beginning on April 21, 2001. **FEMA-1366-DR**. On May 9, 2001, the President determined that certain areas in Illinois were eligible for assistance under the Act as a result of flooding beginning on April 18, 2001. **FEMA-1368-DR**. On May 16, 2001, the President determined that certain areas in Maine were eligible for assistance under the Act as a result of flooding on March 5-31, 2001. **FEMA-1371-DR**. On May 16, 2001, the President determined that certain areas in Minnesota were eligible for assistance under the Act as a result of severe winter storms, flooding and tornadoes beginning on March 23, 2001. **FEMA-**

1370-DR. On May 16, 2001, the President determined that certain areas in Nebraska were eligible for assistance under the Act as a result of severe storms, flooding and tornadoes on April 10-23, 2001. **FEMA-1373-DR**. On May 16, 2001, the President determined that certain areas in Puerto Rico were eligible for assistance under the Act as a result of severe storms, flooding and mudslides beginning on May 6, 2001. **FEMA-1372-DR**. On May 11, 2001, the President determined that certain areas in Wisconsin were eligible for assistance under the Act as a result of severe storms and flooding on April 10, 2001. **FEMA-1369-DR**. Accordingly, a taxpayer who sustained a loss attributable to the disasters may deduct the loss on his or her 2000 federal income tax return.

EARNED INCOME CREDIT. In a Chief Counsel Advice letter, the IRS discussed whether rental income was qualified income for earned income credit purposes where (1) unimproved land was leased to an unrelated party and (2) improved land was leased to a partnership in which the taxpayer was a partner. The IRS stated that, under I.R.C. § 32(i)(2)(C), EIC qualified income must come from the ordinary course of a trade or business and, under I.R.C. § 32(i)(2)(E), cannot be passive activity income as defined by I.R.C. § 469. The IRS ruled that, under both situations, the rental income was derived from the ordinary course of a trade or business. In addition, the IRS ruled that the rental income in the first situation was not qualified for EIC because the income was considered income from a passive activity under I.R.C. § 469. The main issue was whether, in the second situation, the self-rental recharacterization rule of I.R.C. § 469 applied for the purposes of EIC. Under the recharacterization rules, otherwise passive rental income from property leased to a related entity in which the lessor materially participates is recharacterized as nonpassive under I.R.C. § 469. The IRS ruled that the recharacterization rule did not affect the EIC definition of nonpassive activity because the recharacterization rule applied only to transform the income into nonpassive income and did not affect the definition of the passive activity. Thus, the IRS ruled that the rental income from the second situation was not qualified for EIC because the income came from a passive activity. See also Harl, “Recharacterization of Income: Treacherous Rules,” 11 *Agric. L. Dig*. 33 (2000). **CCA Ltr. Rul. 20012037, March 30, 2001**.

A similar ruling concerned a lease of improved real property to a C corporation wholly-owned by the lessor. In a Chief Counsel Advice letter, the IRS ruled that the rental income from the second situation was not qualified for EIC because the income came from a passive activity. As with the above ruling, the IRS ruled that the recharacterization rule did not apply to change the passive rental income activity into a nonpassive activity. **CCA Ltr. Rul. 200120036, March 28, 2001**.

HOME OFFICE. The taxpayer was a clinical psychologist who was employed by a clinic for at least eight hours each day. The taxpayer also provided counseling services at the taxpayer’s own office. The taxpayer lived in a small apartment and used an area in the entryway for scheduling appointments by phone call for the taxpayer’s private practice. The taxpayer also stored the business records in the apartment but did not meet any clients there. The court held that the taxpayer could not deduct any home office expenses relating to the costs of the apartment. **Mullin v. Comm’r, T.C. Memo. 2001-121.**

The taxpayer was the sole shareholder of an S corporation and leased a portion of the taxpayer’s residence to the corporation for use in its business. The taxpayer used this leased portion of the residence to carry on the business of the corporation. In a Chief Counsel Advice letter, the IRS ruled that the taxpayer could claim deductions for the leased portion for mortgage interest, real property taxes and personal casualty losses; however, I.R.C. § 280A(c)(6) prevented any deductions under I.R.C. §§ 162, 165(c)(1) 167 for business expenses, business casualty losses or depreciation for the leased portion of the residence. **CCA Ltr. Rul. 200121070, March 19, 2001**.

INTEREST. The taxpayer had obtained several student loans in obtaining a Ph. D. in psychology and was making payments on those loans. The court held that the taxpayer could not deduct the interest paid on the loans as a business deduction. **Mullin v. Comm’r, T.C. Memo. 2001-121.**

LOSSES. The taxpayer owned several related small corporations. The IRS assessed a deficiency against the taxpayer in 1987 and executed a levy at the taxpayer’s business operated by one corporation. The taxpayer claimed a loss deduction for the value of the taxpayer’s labor to the corporation which was lost due to the execution of the levy. The court held that the taxpayer could not claim a loss deduction for the loss of the taxpayer’s labor because the taxpayer had no tax basis in the labor. **Tonn v. Comm’r, T.C. Memo. 2001-123**.

PENALTIES. The IRS has issued a revenue procedure to inform taxpayers how to request an administrative appeal of the penalties imposed by I.R.C. § 6715 relating to the misuse of dyed diesel fuel and kerosene and I.R.C. §§ 4083(c)(3), 7342 relating to the refusal to admit entry for purposes of inspecting facilities and equipment and taking and removing fuel samples. **Rev. Proc. 2001-33, I.R.B. 2001-__**.

RETURNS. The IRS has issued specifications for the submission of Forms 1098, 1099, 5498, and W-2G magnetically or electronically using magnetic tape, tape cartridges, or diskettes, or electronically through the IRS FIRE System. These guidelines govern the preparation of tax year 2001 information returns and information returns for tax years prior to 2001 that are required to be filed. The specifications are to be used to prepare current and prior year information returns filed beginning January 1, 2002, and received by the IRS Martinsburg Computing Center or postmarked by December 15, 2002. **Rev. Proc. 2001-32, I.R.B. 2001-21**.

The IRS has released an April 2001 revision of Publication 538, Accounting Periods and Methods and Form 8851 (2001), Summary of Archer MSAs. These documents are available at no charge (1) by calling the IRS's toll-free telephone number, 1-800-829-3676; (2) through FedWorld; (3) via the internet at http://www.irs.gov/prod/cover.html; or (4) by directly accessing the Internal Revenue Information Services bulletin board at (703) 321-8020.

The IRS has requested comments regarding Form 4835, Farm Rental Income and Expenses. The form is used by landowners or sublessors to report farm income based on crops or livestock produced by a tenant when the landowner or sublessor does not materially participate in the operation or management of the farm. Written comments should be submitted on or before July 20, 2001, to Garrick R. Shear, IRS, Room 5244, 1111 Constitution Ave., NW., Washington, D.C. 20224.

The plaintiff was hired by the defendant and during the processing stage of the hiring, the plaintiff requested that the

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defendant not use the plaintiff's social security number (SSN) on the employment records. The plaintiff objected to the use of the SSN on religious grounds. The defendant fired the plaintiff as a result of the defendant's refusal to use a substitute number. The plaintiff sought an injunction and reinstatement, arguing that the termination for refusal to use the SSN violated the Civil Rights Act of 1964. The court assumed that the plaintiff's religious objection was bona fide and that the plaintiff's employment was terminated solely because of the plaintiff's refusal to allow the use of the SSN. The court held that the termination did not violate the Act because the termination resulted from the federal law requirement that an employer report withholding taxes using an employee's SSN. **Baltgalvis v. Newport News Shipbuilding Inc., 2001-1 U.S. Tax Cas. (CCH) ¶ 50,408 (E. D. Va. 2001)**.

SALE OF RESIDENCE. The taxpayer sold a residence on April 25, 1997 and failed to purchase a new home within two years so as to qualify for rollover of the gain from the sale of the first home. In 1997, the Congress amended the law for gain from the sale of a home to exclude up to $250,000 of gain but made the new law retroactive only to May 7, 1997. The taxpayer challenged the constitutionality of the retroactive date, arguing that the law should have been made retroactive to January 1, 1997 because the new law was being considered then. The court held that the choice of May 7, 1997 as the retroactive date of the new law was not unconstitutional because it served a legitimate congressional purpose. **Buerer v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶ 50,424 (W.D. N.C. 2001)**.

SOCIAL SECURITY BENEFITS. The taxpayer received social security benefits because of a medical condition and excluded the benefits from income. The taxpayer argued that the benefits were nontaxable as health and accident insurance benefits under I.R.C. §§ 104(a)(3), 105(e). The court held that the social security disability payments were included in taxable income. The court noted that a provision excluding social security disability benefits from income was repealed in 1983, strongly indicating Congressional intent that social security benefits were taxable. The taxpayer also argued that the taxation of social security benefits violated the equal protection clause of the U.S. Constitution because other disability payments were not taxable. The court cited several cases which supported the holding that the taxation of social security benefits was constitutional. **Thomas v. Comm'r, T.C. Memo. 2001-120**.