

TAX MATTERS

TAX BRIEFS

AICPA CRITICIZES TAX PATENTS

Congress should restrict patents on tax strategies or protect taxpayers and preparers from infringement actions arising from them, the AICPA told members of congressional committees. In letters to the House and Senate tax-writing and judiciary committees and a white paper, the AICPA said one government agency—the U.S. Patent and Trademark Office—should not be allowed to grant what may be regarded, perhaps falsely, as a dispensation for complying with the laws enforced by another, the IRS.

Just because a tax position is patented doesn't necessarily mean it comports with the Tax Code, the AICPA said, noting similar concerns expressed last summer by IRS Commissioner Mark Everson during congressional hearings. Moreover, tax patents usurp congressional authority and create a private monopoly by granting to the holder an exclusive use of provisions of public laws, the AICPA said. They also impose a burden on other taxpayers and preparers, who could be hit with infringement warnings and demands for royalties, especially if patents proliferate. Patents complicate tax preparation and increase costs of compliance and administration, the AICPA said.

Since a federal appellate court ruling in 1998 upheld a patent for a business method, the Patent Office had awarded 52 patents for tax strategies as of mid-March, with another 84 pending. For more on the issue, see <http://tax.aicpa.org/Resources/Tax+Patents/>.

IRS DIRECTORS "OWN" SHELTERS

With the new Industry Issue Focus initiative of its Large and Mid-Size Business Division,

the IRS is poised to concentrate more resources on its top enforcement priorities, which are weighted toward business and industry. The new strategy gives IRS directors compliance "ownership" of each of 14 Tier 1 issues, plus listed transactions. The latter category numbers 31 types of deals subject to scrutiny. The initiative also identifies 11 Tier 2 issues involving fewer taxpayers and smaller amounts, but with each also getting its own director. The expanded list, released in mid-March, includes two Tier 1 tax shelters the IRS had not previously identified as ripe for compliance attention: distressed asset/debt and redemption bogus optional basis. Also in Tier 1 are the section 199 deduction for domestic production activities, backdated stock options and offshore transfer of intangibles. Many of the issues are headed by IRS directors with responsibility for financial and industrial sectors, said Rob Hanson, a partner in Ernst & Young's Federal Services Group.

"The IRS very much is moving toward an industry focus," he said.

The new configuration is intended to promote consistency in enforcement, give IRS industry directors line management authority over significant cases and sub-industries and help the IRS keep pace with evolving abusive tax strategies. For more, see www.irs.gov/businesses/article/0,,id=167377,00.html.

TAX CASE

HORSE SENSE APPLIED TO STARTUP

In its first ruling of 2007, the Tax Court concluded that a woman could deduct expenses of for-profit horse boarding and training that later grew into a business. Had the IRS prevailed, taxpayers who engaged in a for-profit activity with the hope it would grow into a full-fledged

IRS Lost and Found

From January 2001 to July 2006, the IRS printed 2,493 pictures of missing children on its tax instructions and publications, helping the National Center for Missing and Exploited Children generate leads on 259 children and recover 87.



Source: Treasury Inspector General for Tax Administration, www.ustreas.gov/tigta.

trade or business would have been required to capitalize expenditures incurred during the for-profit activity period.

Individual taxpayers may deduct expenditures related to a for-profit activity (an itemized deduction) as well as expenditures related to an active trade or business (a deduction for AGI). A trade or business is distinguished from a for-profit activity by the regularity and continuity of its economic activity. Previous courts have held that the same standards to distinguish capital expenditures from ordinary expenses should apply to both types of activities. Costs incurred by a taxpayer in anticipation of the start of an active trade or business ordinarily have been required to be capitalized. Taxpayers may elect to deduct up to \$5,000 of startup expenditures in the year a trade or business begins.

In 1998, Julie Toth opened a horse breeding and training facility near Portland, Ore. From 1998 to 2001, she made numerous improvements to the facility and hired additional staff. By 2004 she treated it as a business. That year, Toth filed tax returns for 1998 and 2001, reporting all amounts for those years on Schedule C. Later in 2004, the IRS sent her a notice of deficiency for both years, and Toth petitioned the court.

Toth argued that her claimed expenses were deductible under section 212, while the IRS said they were nondeductible startup expenditures under section 195(a). The court said whether a for-profit activity later becomes a trade or business is immaterial when classifying its expenditures as currently deductible or as capital expenditures. The key to deductibility is the start of the for-profit activity—once it has begun, any ordinary and necessary expenses are deductible. Moreover, forcing Toth to capitalize the expenses would cause them to be treated differently than similar expenses of a trade or business, the court said.

■ *Toth v. Commissioner*, 128 T.C. No. 1

Prepared by **Charles J. Reichert**, CPA, professor of accounting, University of Wisconsin, Superior.

TAX CASE

IRS, B&D TOOL UP FOR TRIAL

By reversing a district court's grant of summary judgment that originally favored the taxpayer (see "Tax Matters," *JofA*, March 05, page 88), the Fourth Circuit Court of Appeals opened the door for further interpretation of the "sham transaction" rule as it relates to contingent liability transactions. The case, involving Black & Decker (B&D), was remanded last year to the district court for further analysis to determine if the transaction in question served a legitimate business purpose or was a sham. Should the court rule that this was a sham transaction, it would give the IRS firmer footing in aggressively litigating transactions it considers tax shelters. The

case is one of several appellate rulings during 2006 that breathed new life into IRS positions on contested transactions, including *Coltec* ("Tax Matters," *JofA*, Jan. 07, page 67), which, like *B&D*, concerned the economic substance doctrine as applied to contingent liabilities.

Black & Decker created a separate corporation, Black & Decker Healthcare Management Inc. (BDHMI), to manage its health care claims. In doing so, B&D transferred \$561 million, along with \$560 million in contingent health care claims, to BDHMI in exchange for its stock. B&D then sold this stock to an independent third party for \$1 million. B&D claimed a \$560 million capital loss, the amount of the assets originally transferred to BDHMI less the \$1 million proceeds from the stock sale. The IRS disallowed the loss under the sham transaction rule.

As discussed in the district court ruling, to be considered a sham, a transaction must meet two criteria: First, it serves no business purpose other than to provide tax benefits to the taxpayer (the subjective test), and second, it offers no reasonable possibility of a profit and thus lacks economic substance (the objective test). In granting summary judgment, the district court found that while the transaction was indeed tax-motivated—a point conceded by B&D—it nonetheless had economic substance

because BDHMI provided a legitimate economic service to every participant in the B&D benefit program. The IRS appealed.

In remanding, the Fourth Circuit ruled that the district court had applied the objective test at the wrong level. The district court had evaluated whether BDHMI itself engaged in legitimate, economically based business activities. Instead, it should have applied the objective test to the transaction that carried the tax implications—the transfer of assets to BDHMI in exchange for its stock and then the sale of that stock at a loss, the Fourth Circuit said.

■ *Black & Decker Corp. v. U.S.* (CA 4 2/2/2006), 97 AFTR 2d 2006-841.

Prepared by **Karen M. Cooley**, CPA, instructor of accounting, and **Darlene Pulliam**, CPA, Ph.D., professor of accounting, both of the College of Business, West Texas A&M University, Canyon, Texas.

TAX CASE

IN THE LINE OF DUTY

The Second Circuit Court of Appeals ruled against a military veteran's income-exclusion claim, affirming the Tax Court's distinction of taxable disability benefits versus exempt

Cost of Ownership

Property taxes top taxpayers' list of least "fair" state and local levies, according to a Tax Foundation poll. From 2002 to 2004, property taxes grew faster than incomes, the foundation said.



Source: The Tax Foundation, www.taxfoundation.org.

benefits paid for a service-connected injury.

William D. Reimels was exposed to Agent Orange during service in Vietnam in the 1970s. He then worked in the private sector until 1993, when he was diagnosed with lung cancer caused by his wartime exposure to the defoliant and had his left lung removed. The Department of Veterans Affairs awarded Reimels compensation for a service-connected total disability. On his joint tax return for 1999, Reimels excluded from his gross income both the VA payments and \$12,194 in Social Security disability benefits. In 2002, the IRS sent him and his wife a notice of deficiency based on the amount of the SSA disability benefits. They filed a petition in the Tax Court.

Reimels argued that the SSA disability benefits fit the description in IRC section 104(a)(4) as amounts received for an injury or sickness resulting from active military service. The IRS argued that SSA disability benefits are wage-replacement benefits granted on the basis of a person's general inability to work, not as compensation for military injuries.

For disability payments to be exempt, the program awarding them must require the

recipient to have an injury or sickness resulting from active military service, the Tax Court said.

■ *William D. & Joyce M. Reimels v. Commissioner*, 97 AFTR 2d 2006-820.

Prepared by **Gloria Stuart**, instructor, and **Cheryl T. Metrejean**, CPA, Ph.D., assistant professor of accounting, both of Georgia Southern University, Statesboro, Ga.

TAX CASE

35% FLAT TAX HITS NON-CPAS

AC corporation that provides accounting services doesn't have to be owned by or employ CPAs to be taxed at the flat 35% personal-services corporation rate of section 11(b)(2), according to a recent Tax Court ruling. In *Rainbow Tax Service, Inc. v. Commissioner*, 128 T.C. No. 5, the taxpayer was assessed deficiencies of \$11,903 and \$5,003 for tax years 2002 and 2003 because the IRS determined the taxpayer's business of providing bookkeeping services and preparing tax returns was a "qualified personal services corporation"

under section 448(d)(2). In support of that determination, the IRS said "substantially all of the activities" of the taxpayer were in the field of accounting. See section 448(d)(2)(A).

Rainbow, a Nevada company, argued that state law restricts accounting services to licensed CPAs. Since Rainbow did not offer services that state law authorized only CPAs to perform and did not employ any CPAs, Rainbow said it was entitled to use the graduated corporate income tax rates of section 11(b)(1).

The court agreed the taxpayer was not a public accounting firm and its services were restricted by state law, but it said section 448(d)(2) requires only that the services be in the "field of accounting," not that they be performed by CPAs. Since tax return preparation and bookkeeping are clearly "branches" of accounting under Treasury Regulation 1.448-1T(e)(5)(vii), example 1(i), the court concluded Rainbow was a personal-services corporation and must pay the flat 35% tax rate.

Prepared by JofA Copy Editor **Jeffrey Gilman**, J.D. ❖

Line Items

E-FLILING LAGS

Since about 54% of individual taxpayers e-filed in 2006, it seems unlikely that a congressionally mandated goal of 80% for this year will be met, the IRS Oversight Board said in its annual report to Congress. The board suggested extending the goal to 2012.

E-filing declined in 2006 among individuals preparing their own returns, partly because the IRS ended its TeleFile option for form 1040EZ, the board said. Also, it said, limiting Free File eligibility to taxpayers with adjusted gross incomes of \$50,000 or less (\$52,000 for tax year 2006) contributed to a 23% drop in the number of returns received through that program.

In another study, business executives weren't exactly sanguine about e-filing, either. Deloitte & Touche surveyed hundreds of tax executives, noting that many businesses

were required to begin e-filing for tax year 2006. Eighty-seven percent of the executives surveyed said their cost and effort increased when they began e-filing for calendar year 2005, when larger businesses were first required to do so. Among the challenges they identified were software glitches, clearing error codes and using correct file formats. About 75% said they were neutral toward e-filing or unconvinced its benefits outweighed the costs.

PAY UPFRONT ON OICS

The IRS revised its offer-in-compromise (OIC) application package to reflect changes of the Tax Increase Prevention and Reconciliation Act of 2005. Form 656 includes a checklist designed to help taxpayers determine whether they are eligible to file an OIC before they prepare the

form. Also, for OICs submitted after July 15, 2006, any lump-sum offer must be accompanied by payment of 20% of the offer amount, and any periodic payment offer must be accompanied by the first installment. The IRS said it planned to issue regulations waiving the payment requirements for low-income taxpayers and those whose offer is based solely on doubt as to liability.

COLLECT CALL

Corporations that have their 2006 tax returns on extension (involving calendar-year taxpayers with returns otherwise due on March 15) and which plan to claim the telephone excise tax refund must use a different set of interest rates than those found on form 8913, the IRS reminded. The correct rates are at www.irs.gov/pub/irs-dft/corp3-15.pdf.