The Extra-Territorial Income Exclusion Act of 2000
— by Neil E. Harl*

The Extra-Territorial Income Exclusion Act of 2000, which repealed the rules regarding Foreign Sales Corporations, initially received little attention in the agricultural sector but has picked up steam as the potential tax benefits of the legislation effective September 30, 2000 have become more widely known. Ironically, the 2000 legislation may be repealed in 2004 under pressure from the World Trade Organization. On January 14, 2002, the WTO ruled that the 2000 legislation was “inconsistent with international trade agreements.”

The legislation applies to both individuals and corporations who are U.S. taxpayers and applies for individual and corporate alternative minimum tax purposes.

The available exclusion

The 2000 legislation specifies that gross income does not include extra-territorial income to the extent that such income is “qualifying foreign trade income.” Extra-territorial income is defined as the gross income of the taxpayer attributable to foreign trading gross receipts of the taxpayer. Note that the taxpayer reports all of its extra-territorial income on its tax return with the exclusion then calculated from income for the portion eligible to be excluded.

“Qualifying foreign trade income” is the amount of gross income which, if excluded, would result in a reduction of taxable income by the greatest of—(1) 15 percent of foreign trade income, (2) 1.2 percent of foreign trading gross receipts or (3) 30 percent of foreign sale and lease income.

“Foreign trade income” is taxable income attributable to foreign trade gross receipts. For cooperatives that are engaged in the marketing of agricultural or horticultural products, in computing taxable income of the cooperative deductions allowed for patronage dividends, per-unit retain allocations and non-patronage distributions are not taken into account. For agricultural or horticultural cooperatives, patronage dividends or per-unit retain allocations allocable to qualifying foreign trade income in a written notice mailed to patrons are treated as qualifying foreign trade income for the year.

Under the legislation, the threshold for determining whether gross receipts are treated as foreign trading gross receipts is whether the gross receipts are derived from a transaction involving “qualified foreign trade property.” “Foreign trading gross receipts” are receipts derived from activities in connection with qualifying foreign trade property including the sale, exchange or other disposition of qualifying foreign trade property; the lease or rental of qualifying foreign trade property for use by the lessee outside the United States; for services related to such sale or lease; for engineering or architectural services outside

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the United States; or for the performance of managerial services in the furtherance of the production of foreign trading gross receipts. It is important to note that “foreign trading gross receipts” does not include receipts of a taxpayer arising from a transaction if the property or services are for ultimate use in the United States or the transaction is accomplished by a subsidy granted by the government of a country (or instrumentality of the country) in which the property is manufactured, produced, grown or extracted.

Property is considered qualifying foreign trade property if three requirements are met—(1) the property must be manufactured, produced, grown or extracted within the United States (or outside the U.S. if certain conditions are met), (2) the property must be held for sale, lease or rental in the ordinary course of a trade or business for direct use, consumption or disposition outside the United States, and (3) no more than 50 percent of the fair market value of the property may be attributable to (a) articles manufactured, produced, grown or extracted outside the United States and (b) direct costs for labor performed outside the United States. Some types of property cannot be qualifying foreign trade property—(1) property leased or rented for use by a related party; (2) patents, inventions, certain copyrights, goodwill, trademarks, trade brands, franchises or like property; (3) oil and gas; (4) any unprocessed timber which is a softwood; and (5) any property that has been designated as in short supply by executive order so long as the executive order remains in effect.

Because U.S. income tax principles generally deny deductions for expenses related to exempt income, otherwise deductible expenses that are allocated to qualifying foreign trade income generally are disallowed. The instructions to Form 8873 require that the cost of goods sold allocated to foreign trading gross receipts be calculated. The deductions, other than those included in figuring cost of goods sold, must also be calculated (this would appear to include Schedule F deductions). “Foreign sale and lease income” is foreign trade income that is allocable to transactions in which a person (or person acting under contract with the taxpayer) has participated outside the United States in the solicitation, negotiation or making of the contract relating to the transaction or activities that include advertising and sales promotions, processing of customer orders or arranging for delivery, transportation outside the United States in connection with delivery to a customer, the determination or final transmittal of a final invoice or statement of account or the receipt of payment and the assumption of credit risk. However, these requirements are considered met if the foreign trading gross receipts of the taxpayer for the year do not exceed $5,000,000.

Evidence of “foreign trading gross receipts”

A major issue is whether a taxpayer’s commodities must have actually been exported, not merely sold to a purchaser that exports, although that is not clear. The Senate Finance Committee Report on the 2000 legislation states that “. . . a taxpayer may determine the amount of qualifying foreign trade income either on a transaction-by-transaction basis or on an aggregate basis for groups of transactions, so long as the groups are based on product lines or recognized industry or trade usage.” Neither the Internal Revenue Service nor the Department of the Treasury has provided guidance on the message or messages that language is supposed to convey.

Returns

Taxpayers claim the extra-territorial income exclusion on Form 8873 which must be attached to the taxpayer’s tax return for the year. The instructions to Form 8873 are helpful in working through the form itself.

FOOTNOTES

3. Extra-Territorial Income Exclusion Act of 2000, Sec. 5(a), note 1 supra.
6. I.R.C. § 114(a), added by Pub. L. No. 106-519, Sec. 3(a).
7. See I.R.C. § 114(b).
8. I.R.C. § 114(e).
11. See I.R.C. § 1382(b), (c).
13. I.R.C. § 943(g).
15. I.R.C. § 942(a).
22. Instructions to Form 8873, page 4.
23. Id.
25. I.R.C. § 942(c)(1).
CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr

BANKRUPTCY

GENERAL

FARM PROGRAM PAYMENTS. The debtors filed for Chapter 7 in January 2003. Although the debtors had ceased farming in December 2002, the debtors were owed direct federal farm program payments based on their 2002 crops. The debtors sought to exempt the payments under Iowa Code § 627.6(8) which provides an exemption for “any public assistance benefit.” The debtors argued that the payments were public assistance because the payments were not made in exchange for goods or services. The Bankruptcy Court noted that the federal farm program payments were not determined by the need of the debtors but were paid regardless of the financial condition of the debtors. The Bankruptcy Court held that the farm program payments were not public assistance payments entitled to the state exemption. The appellate court reversed, holding that the payments were entitled to the exemption because (1) the state exemption was worded broadly enough to include federal farm program assistance payments and (2) the federal farm program payments were intended by Congress to provide assistance to needy farmers. The Digest will publish an article by Neil Harl and Roger McEowen on this case in a future issue. In re Wilson, 2004 U.S. Dist. LEXIS 1083 (N.D. Iowa Jan. 27, 2004), rev’g and rem’g, 296 B.R. 810 (Bankr. N.D. Iowa 2003).

CHAPTER 12

CONVERSION. The debtors originally filed under Chapter 12 but creditors and the trustee objected to the debtors’ eligibility because the debtors’ debts exceeded the statutory limit. The debtors agreed to a motion to dismiss the case unless the debtors filed a motion to convert the case. The debtors then filed a motion under Section 1208 to convert the case to Chapter 11. The court held that the debtors could not use Section 1208 to convert the case because the debtors were not eligible for Chapter 12. The court acknowledged that several other courts have allowed conversions from Chapter 12 to Chapter 11 if the equities favored the debtor. However, the court held that there was no statutory authority for allowing a conversion to chapter 11 under any circumstances and denied the debtors’ motion to convert to Chapter 11. In re Stumbo, 301 B.R. 34 (S.D. Iowa 2002).

PLAN. The debtor’s Chapter 12 plan provided for the sale of farm equipment collateral with the proceeds used to pay other unsecured creditors. The creditor with a priority lien on the equipment objected to that plan provision because it would not receive any of the proceeds or a lien in other property. The debtor argued that the loss of the collateral to the secured creditor was allowed because the creditor was oversecured with the remaining collateral in the estate. The court held that lien could not be avoided by the Chapter 12 plan against the wishes of the secured creditor because the creditor did not receive the collateral or proceeds and did not receive a lien in other property. The court also denied confirmation of the plan because the plan did not provide a market rate of interest on the unpaid secured claims. The debtor’s plan provided for an interest rate of 5.75 percent. The court noted that the minimum allowable interest rate was the 20-year U.S. Treasury bond rate of 5.48 percent plus 2 percent for risk. Finally, the court rejected the debtor’s plan because its projections of income and expenses were not consistent with the historical income and expenses of the farm and other business operations; therefore, the plan was not feasible. The court held that the case was dismissed for unreasonable delay because the debtor had submitted eight plans over three years without success. In re Michels, 301 B.R. 9 (Bankr. N.D. Iowa 2003).

UNSECURED CLAIMS. After the debtors’ Chapter 12 plan was confirmed, the debtors received an inheritance. The debtors filed a motion to have much of the inheritance applied for full payment of unsecured claims in the bankruptcy case except for the unsecured portion of the Farm Service Agency’s claim. The debtors’ only remotely plausible argument was that the FSA had received payment from the sale of collateral but the court found that was untrue. The court denied the debtors’ motion to the extent it did not provide for payment of the FSA unsecured claims in the same manner as the other unsecured claims. In re Baker, 300 B.R. 639 (W.D. Penn. 2003).

CHAPTER 13

DISCHARGE. The debtor owed a judgment awarded in a patent infringement lawsuit against the debtor for saving and using seeds from cotton and soybean plants grown from genetically modified cotton and soybean seeds without paying additional licensing fees. The jury had found that the debtor willfully infringed upon the seed producer’s patented technology. The seed producer sought to have the judgment award declared nondischargeable under Section 523(a)(6) for willful and malicious injury to the creditor’s property. Although the debtor admitted that the jury finding established the element of willfulness, the debtor denied that the patent infringement was malicious. The Bankruptcy Court held that the producer failed to demonstrate that the debtor’s action in saving and planting the seed from the genetically modified seed plants was done with intent to harm the seed producer. Therefore, the judgment was dischargeable. The appellate court reversed, holding that the element of maliciousness was evident from the debtor’s knowledge that the saving of the seed would be to the detriment of the seed producer. The appellate court held that the judgment debt was nondischargeable. In re Trantham, 2004 Bankr. LEXIS 62 (Bankr. 6th Cir. 2004), rev’g, 286 B.R. 650 (Bankr. W.D. Tenn. 2002).
FARM LOANS. The FSA has adopted as final regulations which provide that borrowers who are current on an FSA loan before the beginning date of the incidence period of a Presidentially-declared disaster or emergency, but who receive debt forgiveness on that loan following the disaster, are eligible for direct and guaranteed operating loan assistance if all other regulatory requirements are met. The regulations also amend the rules for direct farm ownership loans by making applicants eligible if they participated in the business operations of a farm or ranch for at least three of the past 10 years and meet other regulatory requirements. In addition, the rule amends regulations concerning recapture of shared appreciation agreement debt to allow reamortization of the debt in the case of default due to circumstances beyond the borrower’s control and where the debtor made a good faith attempt to repay the debt. The final regulations allow such reamortization where the farmer has no current program debts and where the SSA debt resulted from the payoff of the SSA loan. 69 Fed. Reg. 5259 (Feb. 4, 2004).

WIND ELECTRICITY GENERATORS. The plaintiff was a farmer who purchased a wind electricity generator. The plaintiff contacted the rural cooperative electric company and sought compensation for the net electricity generated on the plaintiff’s farm. The parties failed to reach an agreement on the price for the electricity generated by the plaintiff and the plaintiff sought enforcement of the Public Utility Regulatory Policies Act of 1978 (PURPA), 16 U.S.C. § 824 a-3(h) (1994), which requires utilities to purchase excess generated electricity from customers. The defendant cooperative had argued in state courts that jurisdiction lay only with the Federal Energy Regulatory Commission (FERC) and argued before FERC that jurisdiction governing electricity rates lay only with the state. The FERC chided the defendant for its inconsistent arguments and the delay it caused. The FERC ruled that the electric company was required to comply with PURPA and that, if the parties did not reach an agreement as to the price to be paid for the excess electricity, the FERC would begin an enforcement proceeding in the courts. Swecker v. Midland Power Coop., 105 F.E.R.C. ¶ 61,238, 2003 FERC LEXIS 2340 (Nov. 19, 2003).

VALUATION OF STOCK. The decedent’s estate included stock in a closely-held corporation. The stock was preferred stock subject to a redemption agreement at over $1,000 per share plus interest if the redemption occurred after specified dates. The estate valued the stock at book value, $10 per share, but the stock was redeemed under the redemption agreement a year after the decedent’s death at $1,000 plus interest. The Tax Court held that the redemption was relevant to the value of the stock at the decedent’s death at $1,000 plus interest. The Tax Court held that the redemption was relevant to the value of the stock at the decedent’s date of death because the redemption was foreseeable and the corporation had sufficient funds to make the redemption on the date of the decedent’s death. The Tax Court, however, allowed a 4 percent discount to the value of the stock as a “reasonable discount” for a potential purchaser. The appellate court remanded the case on this issue for the Tax Court to provide an explanation for the choice of a 4 percent valuation discount. On remand the Tax Court increased the discount to 12.5 percent for risk that the company would not redeem the shares for the full price. Estate of Trompeter v. Comm’r, T.C. Memo. 2004-27, on rem. from, 2002-1 U.S. Tax Cas. (CCH) ¶ 60,428 (9th Cir. 2002), rev’g and rem’g, T.C. Memo. 1998-35.

MARITAL DEDUCTION. The decedent had created a revocable trust, which, upon decedent’s death, distributed property to a marital trust for which the estate claimed a marital deduction. The trust instrument states that, if the assets in the residue of the probate estate were insufficient to pay the federal estate tax and legal costs, the revocable trust was to pay the federal estate tax and legal costs from property that would otherwise pass to the decedent’s surviving spouse. The decedent’s will had no provision as to the source of payment of federal estate tax and legal costs if the assets in the residue of the probate estate were insufficient to pay the estate tax and costs. The decedent’s residue estate did not have sufficient assets to pay the federal estate tax and legal costs. The estate argued that, under Illinois law, where the will is silent as to the source of payment of estate tax, the tax is apportioned equally among all heirs; therefore, the marital trust bequest and eligible deduction are reduced only by the trust’s share of the taxes. The court held that the trust language controlled to provide that all federal estate taxes and legal costs were to be paid from the marital trust, reducing the eligible marital deduction. Estate of Lurie v. Comm’r, T.C. Memo. 2004-19.

FEDERAL ESTATE AND GIFT TAXATION
ACCOUNTING METHOD. The IRS has announced that for depreciable or amortizable property placed in service by the taxpayer in taxable years ending before the effective date of Treas. Reg. § 1.446-IT(e)(2)(ii)(d), the IRS will not assert that a change in computing depreciation under I.R.C. § 167, 168, 197, 1400L(b), or 1400L(c), or ACRS for depreciable or amortizable property that is treated as a capital asset under the taxpayer’s present and proposed methods of accounting is a change in method of accounting under section 446(e). For property placed in service after the effective date of the regulation, the IRS’s position continues to be that a change in computing depreciation under section 167, 168, 197, 1400L(b), or 1400L(c), or ACRS generally is a change in method of accounting under I.R.C. § 446(e) for which the consent of the Commissioner is required. Chief Counsel Notice CC-2004-007.

CHILD TAX CREDIT. The IRS has published a reminder to taxpayers that they cannot claim the full $1,000 child tax credit for each child if they received an advance payment check in 2003. Taxpayers must put the amount of their advance payment check on line 2 of their Child Tax Credit Worksheet. Taxpayers use this worksheet, found in the instructions for Forms 1040 and 1040A or in IRS Publication 972, to figure the amount of credit they can claim on their 2003 tax returns. Taxpayers whose advance payment was larger than the amount of their credit will not have to repay the difference and will not claim any Child Tax Credit on their 2003 returns. If the advance payment was reduced because of past-due taxes or certain non-tax debts, the taxpayer must use the full advance amount before the offset in the worksheet. IR-2004-15.

CLEAN-FUEL VEHICLE DEDUCTION. The IRS has certified the Honda Insight, Model Years 2003 and 2004, and the Honda Civic Hybrid, Model Year 2004, as being eligible for the clean-fuel vehicle deduction. The certification means taxpayers who purchase any of these new hybrid vehicles may claim a tax deduction of up to $2,000 for vehicles purchased in tax year 2003, up to $1,500 for 2004, up to $1,000 in 2005 and up to $500 for 2006. To claim the deduction, write “clean fuel” on Line 33 of the 2003 Form 1040 and enter the appropriate credit. IR-2004-16.

COOPERATIVES. The taxpayer was a tax-exempt rural telephone cooperative. The taxpayer invested in a corporation which was formed to operate cellular telephone services to the taxpayer’s customers. The investment was made to prevent loss of the taxpayer’s land line customer base to the new cellular phone technology. The taxpayer also purchased two wireless frequencies licenses. However, the cost of the construction of the wireless system proved to be too expensive and the taxpayer sold its stock in the corporation and sold the two licenses. The IRS ruled that the gain from the sales was patronage-sourced income to the taxpayer. Ltr. Rul. 200404003, Oct. 10, 2003.

CORPORATIONS

DISTRIBUTION OF STOCK. The taxpayers owned a corporation and several subsidiaries which operated retail electronics stores. One of the stores incurred labor troubles and the taxpayers decided to distribute the stock in the affiliated corporation to the shareholders in order to prevent the labor problem from spreading to the other stores. The court held that distribution of stock met the business purpose requirement of I.R.C. § 355 for nontaxable distributions. The IRS had acquiesced in this decision but has now withdrawn that acquiescence. Olson v. Comm’r, 49 T.C. 94, acq., 1968-2 C.B. 2, withdrawn I.R.B. 2004—. DEPRECIATION. The taxpayer’s return did not claim the additional first year 30 percent depreciation deduction but the taxpayer failed to include a statement to elect out of the additional depreciation. The IRS ruled that, under Rev. Proc. 2003-50, I.R.B. 2003-29, 119, the failure to claim the 30 percent additional depreciation deduction on a return where a depreciation was claimed was deemed an election out of the additional depreciation deduction; thus, no extension of time was necessary to file the missing election statement. Ltr. Rul. 200404032, Oct. 22, 2003.

DISASTER LOSSES. On January 13, 2004, the President determined that certain areas in California were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of an earthquake that began on December 22, 2003. Accordingly, taxpayers who sustained losses attributable to the disaster may deduct the losses on their 2002 federal income tax returns.

On January 13, 2004, the President determined that certain areas in American Samoa were eligible for assistance under the Disaster Relief and Emergency Assistance Act, 42 U.S.C. § 5121, as a result of high winds, high surf and heavy rainfall that began on January 2, 2004. Accordingly, taxpayers who sustained losses attributable to the disaster may deduct the losses on their 2003 federal income tax returns.

HOBBY LOSSES. The taxpayers, husband and wife, purchased 666 acres of rural land. The taxpayers raised some cattle on the land but did not report any sales of cattle. The taxpayers also planted trees on the property and studied the marketing and sale of emission reduction credits. The farm improvements substantially added to the value of the farm. The court held that the taxpayers did not operate the farm with the intent to make a profit because (1) the taxpayers did not keep sufficient records to analyze the profit making capability of the operation; (2) the amount of appreciation in value of the farm was not proven; (3) no sales of cattle, trees or emission reduction credits were made; (4) the operation had only losses of over $1.5 million; (5) the losses offset substantial income from other
HOME OFFICE. The taxpayer had purchased a large residence and rented 89 percent of the property to a corporation in which the taxpayer was a major shareholder. The court determined which areas of the property were allocated to the corporation based on the corporation’s and its employees’ use of the property. The taxpayer used the remainder of the residence for the taxpayer’s personal residence. The court determined the fair rental value of the property and allowed the corporation a deduction for rent equal to 89 percent of that value. The taxpayer was allowed deductions for 89 percent of the insurance, mortgage interest, real estate taxes and depreciation of the property. 

LIKE-KIND EXCHANGES. The taxpayer was a farmer who owned the ground water irrigation rights to farm land. The water rights were limited to 1,100 gallons per minute and 195 acre-feet per year. There was no duration limit on the rights but the state had the power to reduce the pumping rate and annual limit. The taxpayer exchanged the water rights for additional farm land. The IRS distinguished this situation from that in Wiechens v. United States, 228 F. Supp. 2d 1080 (D. Ariz. 2002), where the water rights were limited to 50 years and were not considered like-kind as to a fee interest in land. Because the taxpayer’s water rights were not limited in time and were limited only as to annual use, the IRS ruled that the water rights were of sufficient like-kind to a fee interest in land to qualify the transaction for like-kind exchange treatment under I.R.C. § 1031. Ltr. Rul. 200404044, Oct. 23, 2003.

LOTTERY WINNINGS. The taxpayer won the Oregon Lottery and was to receive annual payments for 20 years. After five years, the taxpayer decided to assign the remaining payments to a third party in exchange for a lump sum payment. The taxpayer characterized the lump sum as long-term capital gain. The trial court acknowledged that the case was without precedent and needed a decision by an appellate court, but held that, because the original proceeds were classified as ordinary income, the lump sum payment was also ordinary income, even though received from an assignment of the right to receive the annual payments. The appellate court affirmed. Maginnis v. United States, 2004-1 U.S. Tax Cas. (CCH) ¶ 50,149 (9th Cir. 2004), aff’d, 2002-2 U.S. Tax Cas. (CCH) ¶ 50,494 (D. Or. 2002).

MEAL EXPENSES. The taxpayer was employed as a merchant seaman and during a tour of duty would incur personal expenses for meals ashore during port calls. The taxpayer provided proof of the expenses with a written log; however, the court discredited the log as prepared for the litigation and not prepared contemporaneously with the expenses. The court disallowed the meal expenses for lack of substantiation. Jewett v. Comm’r, T.C. Memo. 204-26.

PARTNERSHIPS

DIVIDEND DISTRIBUTIONS. The IRS has announced that it is appropriate for a partner of an electing large partnership (ELP) to take into account separately the partner’s distributive share of the partnership’s dividends received that are qualified dividend income as defined in I.R.C. § 1(h)(11)(B). Under I.R.C. § 772(a)(11), partners in an ELP may take into account separately the partner’s distributive share of partnership items only to the extent that the IRS determines that the separate treatment of these items is appropriate. Notice 2004-5, I.R.B. 2004-7.

PENSION PLANS. The IRS has issued a revenue ruling as to whether certain plans meet the requirements of I.R.C. § 416(g)(4)(H) so that the plans are not considered top-heavy under I.R.C. § 416. A nongovernmental profit-sharing plan containing a cash or deferred arrangement (“CODA”) described in I.R.C. § 401(k) provided for safe harbor matching contributions that were intended to satisfy the requirements of I.R.C. § 401(k)(12)(B) and otherwise satisfy the requirements of I.R.C. § 401(k)(12). The plan also permitted the employer to make a nonelective contribution for any plan year at the employer’s discretion. The nonelective contribution was subject to five-year vesting described in I.R.C. § 411(a)(2)(A) and was allocated to participants’ accounts in the same ratio that each participant’s compensation had to the compensation of all participants. The plan was a calendar-year plan and covered all employees of the employer (including highly compensated employees as defined in I.R.C. § 414(q)) who had one year of service and were age 21 or older. Other than elective contributions and the matching contributions, no other contributions are made to the plan for 2004 and there are no forfeitures. In the second situation, the facts were the same as in first situation, except the employer made a discretionary, nonelective contribution to the plan for 2004. In the third situation, the facts are the same as in the first situation, except forfeitures occurred in 2004 due to the severance from employment of a participant who was not fully vested in amounts attributable to discretionary nonelective contributions made in a prior year. Pursuant to the terms of the plan, forfeitures were allocated to participants’ accounts for 2004 in the same manner as nonelective contributions. In the fourth situation, the facts are the same as in the first situation, except employees were permitted to make elective contributions immediately upon commencement of employment but were not eligible for matching contributions until they completed one year of service with the employer. The IRS ruled that the plan in the first situation met the requirements of I.R.C. § 416(g)(4)(H) and was therefore not subject to the top-heavy rules in I.R.C. § 416 for 2004 because no other contributions are made to the plans other than contributions described in I.R.C. § 401(k)(12) or I.R.C. § 401(m)(11). The plans in the second, third and fourth situations did not meet the requirements of I.R.C. § 416(g)(4)(H) and were, therefore, subject to the top-heavy rules in I.R.C. § 416 for 2004. Rev. Rul. 2004-13, I.R.B. 2004-7.
The IRS has ruled that, if an eligible retirement plan separately accounts for amounts attributable to rollover contributions to the plan, the distributions of those amounts are subject to the restrictions on permissible timing that apply, under the applicable requirements of the IRC, to distributions of other amounts from the plan. Rev. Rul. 2004-12, I.R.B. 2004-7.


The taxpayer maintained a qualified defined contribution plan that provided that a participant who terminates employment will receive payment of a vested account balance under the plan commencing at normal retirement age or, if later, at termination of employment (subject to I.R.C. § 401(a)(9), in the case of a 5 percent owner). The plan permitted a participant who terminates employment prior to normal retirement age to elect at any time after termination of employment to receive an immediate distribution of the vested account balance. The plan provided that certain administrative expenses, e.g., investment management fees, were to be allocated to the individual accounts of participants and beneficiaries based upon the ratio of each account balance to the total account balances of all participants and beneficiaries. The plan further provided that the share of these expenses allocable to each participant’s and beneficiary’s account will be paid from the plan and charged against the account to the extent not paid by the employer. The taxpayer paid the portion of these expenses allocable to the accounts of current employees, but not those of former employees or their beneficiaries. All of the administrative expenses were proper plan expenses, within the meaning of ERISA and were reasonable with respect to the services to which they relate. The IRS ruled that the plan did not fail to satisfy the requirements of I.R.C. § 411(a)(11) merely because it charged reasonable plan administrative expenses to the accounts of former employees and their beneficiaries on a pro rata basis, but did not charge the accounts of current employees. The IRS also ruled that the plan would not fail to comply with the requirements of I.R.C. § 411(a)(11) merely because it charged reasonable plan administrative expenses to the accounts of former employees and their beneficiaries, but not the accounts of current employees, on another reasonable basis that complies with the requirements of Title I of ERISA. Rev. Rul. 2004-10, I.R.B. 2004-7.

For plans beginning in February 2004, the weighted average is 5.23 percent with the permissible range of 4.70 to 5.49 percent (90 to 120 percent permissible range) and 4.70 to 5.75 percent (90 to 110 percent permissible range) for purposes of determining the full funding limitation under I.R.C. § 412(c)(7). Notice 2004-14, I.R.B. 2004-4.

RETURNS. The IRS has published an updated list of time-sensitive acts involving federal taxes which may be postponed while a taxpayer is serving in the U.S. Armed Forces in a combat zone. Rev. Proc. 2004-13, I.R.B. 2004-4.

S CORPORATIONS

EMPLOYEE. The taxpayer was an S corporation with one shareholder who was also the sole officer and director. The taxpayer operated a business of veterinary surgical consultations for other veterinarians. The business operations were performed by the shareholder and the business was located at the shareholder’s residence. The corporation did not have a separate bank account and the business and personal income and expenses were handled through the shareholder’s personal bank account. The corporation reported income for 1997 and 1998, deductions for compensation paid to officers, but no deductions for wages or salaries. The shareholder reported the shareholder’s share of income from the corporation on Schedule K-1 and Schedule E. The corporation did not withhold or pay any employment taxes. The court held that the shareholder was an employee of the taxpayer and the taxpayer was required to withhold, report and pay employment taxes. Nu-Lock Design, Inc. v. Comm’r, 2004-1 U.S. Tax Cas. (CCH) ¶ 50,138 (3d Cir. 2004), aff’g, T.C. Memo. 2003-52; Superior Prosise, Inc. v. Comm’r, 2004-1 U.S. Tax Cas. (CCH) ¶ 50,146 (3d Cir. 2004), aff’g, T.C. Memo. 2003-50.

STOCK BASIS. The taxpayers formed an S corporation which operated a lumber business. The corporation incurred debts with log suppliers and trucking firms and the taxpayers were required to personally guarantee the corporation’s debts. The taxpayers claimed pass-through losses from the corporation based on stock basis increased by the amount of the loan guarantees. Although the court expressed its disagreement with the holding in Selfe v. United States, 778 F.2d 769 (11th Cir. 1985), it also held that the facts in this case were not as strong as in Selfe in that the taxpayers had not pledged any assets as collateral for the loans. The court held that the taxpayers’ basis in their S corporation stock was not increased by the loan guarantees because the taxpayer made no economic outlay of money or assets. Luiz v. Comm’r, T.C. Memo. 2004-21.

SALE OF PROPERTY. The taxpayer had purchased equipment and goodwill in a gas station which the taxpayer operated for several years. The sales agreement allocated $5,000 to goodwill. The taxpayer sold the goodwill and equipment and claimed gain on the sale based upon an income tax basis of the full purchase price plus the cost of improvements. The court held that the taxpayer’s basis was limited to the $5,000 paid for goodwill, a nondepreciable asset, because (1) the taxpayer failed to prove the existence and costs of the improvements and (2) the taxpayer failed to prove that the depreciable assets had not been fully depreciated. Secapure v. Comm’r, T.C. Memo. 2004-18.

CITATION UPDATES

Alfaro v. Comm’r, 349 F.3d 225 (5th Cir. 2003), aff’g, T.C. Memo. 2002-309 (interest deduction), see 14 Agric. L. Dig. 181 (2003).

Pauly v. USDA, 348 F.3d 1143 (9th Cir. 2003) (shared appreciation agreements), see 14 Agric. L. Dig. 180 (2003).
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