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Issue Contents

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Major Development in Income Taxation of Chapter 12 Bankruptcy Debtors

-by Neil E. Harl* and Joseph A. Peiffer**

The Eighth Circuit Court of Appeals,[1] on September 16, 2009, handed down a decision in the long-running battle between the Internal Revenue Service and Chapter 12 bankruptcy debtors over the meaning of the 2005 amendment to the Bankruptcy Code.[2] That amendment was to provide relief to Chapter 12 farm and ranch debtors in light of the long-standing favorable treatment given individual debtors under Chapter 7 and Chapter 11 of the Bankruptcy Code.[3] Congress had refused to extend the same treatment to individuals filing under Chapter 12 but instead enacted in 2005 a special provision for Chapter 12 filers[4] that proved to be controversial as to its meaning because of the ambiguities in the language chosen by Congress.[5] As it turned out, the Chapter 12 solution was more favorable to the debtor than the provisions applicable to Chapter 7 and 11 filers inasmuch as tax claims are treated as unsecured claims even if not paid in full.

The Eighth Circuit decision favors debtors on three important issues-- (1) a Chapter 12 debtor may treat post-petition income taxes imposed on the debtor's income earned during the Chapter 12 proceeding as an administrative expense; (2) pre-petition and post-petition sale of slaughter hogs (and other ordinary income property) are eligible for the special treatment under the 2005 enactment; and (3) the "marginal" method is the correct way to allocate the taxes between the priority and non-priority claims under Chapter 12.

The Eighth Circuit decision involved Chapter 12 cases from Iowa[6] and Nebraska.[7] A Kansas case[8] involves one issue pertaining to the post-petition applicability of the statute. That case, which was similarly decided in the Bankruptcy Court, is on appeal to the Tenth Circuit Court of Appeals in Denver. Also, an Arizona case, in which the District Court reversed the Bankruptcy Court in that state and held in favor of the debtor on the post-petition applicability issue,[9] is on appeal to the Ninth Circuit Court of Appeal in San Francisco. That means the litigation is not necessarily over with the September 16 decision in *Knudsen*.[10]

What the controversy is about

Since enactment of the Bankruptcy Tax Act of 1980,[11] individual debtors filing under Chapter 7 (liquidation bankruptcy) or Chapter 11 (reorganization bankruptcy) have been able to avoid income tax liability on asset liquidations in bankruptcy because a new tax

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entity was created at the time of bankruptcy filing.[12] That new entity was responsible for paying the income taxes caused by the liquidation of assets and the triggering of gain.[13] Unfortunately for the debtor, in most Chapter 7 cases, where there is no equity to pay the taxes and make any distribution to the unsecured creditors, the Chapter 7 trustee often abandons the over-encumbered asset, meaning that the asset would revert to the debtor who would then face the income tax consequences of the disposition after the Chapter 7 discharge. That could be even more severe than would have been the case prior to bankruptcy because of the prospect of recognition of gain to the extent of the entire discharged indebtedness as the property would be subject to non-recourse debt treatment[14] unless the debt was reaffirmed by the debtor.

The new entity feature was not extended to Chapter 12 filers on enactment in 1986[15] nor was it included in any of the extensions of Chapter 12.[16] Moreover, that feature was not included in the 2005 legislation that made Chapter 12 permanent[17] even though the 2005 legislation contained a provision giving some income tax relief for Chapter 12 debtors.[18]

In that relief provision, a Chapter 12 debtor was allowed to treat obligations arising out of "claims owed to a governmental unit," such as income tax on gains or recapture income, as a result of "sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation" to be treated as an unsecured claim that is not entitled to priority under the Bankruptcy Code, so long as the debtor receives a discharge.[19] That made tax claims dischargeable which is not otherwise the case in most bankruptcies unless the debtor waits for three years after the tax return could last be timely filed to file bankruptcy. In the meantime, IRS and the state departments of revenue pursue the debtor to collect the unpaid taxes.

The Internal Revenue Service had argued that the 2005 law did not apply to ordinary income property such as slaughter hogs or grain produced for sale, rather it applied only to property eligible for capital gain treatment such as farmland, machinery and breeding stock. That was because of the language ". . . used in the debtor's farming operation" which the IRS sought to have interpreted in light of the language used in I.R.C. § 1231.[20] The IRS view was that the only property eligible for the special rule was property in line for capital gain treatment such as farmland, machinery and breeding stock. The Eighth Circuit Court of Appeals, agreeing with the district court, held that the provision applied to income whether it came from ordinary income property or assets eligible for capital gain treatment. The Eighth Circuit also agreed that the income taxes could be treated as administrative expenses, which cleared the way to the taxes being subject to discharge if not paid. Thus, sales or other dispositions of farm assets used in the debtor's farming or ranching operation that occur during the year of filing or after filing the bankruptcy petition qualify for the favorable tax treatment in Chapter 12.

The Eighth Circuit took a position whether, on the allocation of taxes between those eligible for the special treatment and those taxes that were not eligible for the 2005 provision, the calculation should be made using the pro rata approach (favored by the IRS) or whether the figuring should be done using the marginal approach (which gives a break to the debtor). The Eighth Circuit found the language in the statute to be ambiguous and invoked a long-standing rule of construction that ambiguous provisions should be construed in favor of the debtor.[21] That meant the marginal approach could be used by the taxpayer as opposed to the pro rata approach favored by IRS. In *Knudsen* the difference in approaches to the calculation methodologies exceeded $40,000.

What lies ahead

The Eighth Circuit decision in *Knudsen v. IRS*[22] perhaps settles the issues in the Eighth Circuit area (Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota and South Dakota) unless the case is subject to rehearing or is appealed to the U.S. Supreme Court. That is always a possibility but it is highly unlikely that the Supreme Court would hear the case.

The cases now on appeal to the Ninth and Tenth Circuit Courts of Appeal are expected to produce decisions within the next few months on the issue of applicability to post-petition transactions, not on the other issues covered by *Knudsen*. If both agree with the *Knudsen* decision, that may be the end of the litigation with respect to applicability of the provision to post-petition transactions. If either or both courts hold in favor of the Internal Revenue Service, that would raise the odds that the Supreme Court might ultimately resolve the conflict in the Circuits.

Opportunity for lenders and farmers alike

In many circumstances where the farm or ranch operation is overburdened with debt and is not cash flowing, secured lenders could suggest to the borrower that they could partially or totally liquidate now, pay the net proceeds to the secured lender and then utilize Chapter 12 to deal with the income taxes that typically accompany the liquidation of a farming operation. In a partial liquidation, the farmer would streamline the operation, making it cash flow, so that it could service the remaining indebtedness and use Chapter 12 to deal with the taxes. To make the deal more attractive and further entice the struggling borrower to liquidate now, the lender should consider the exemptions to which the farmer would be entitled in bankruptcy and offer to allow the farmer to keep that amount of property as well as some additional funds to pay the farmer's bankruptcy attorney fees. In so doing, the secured lender could well net more money more quickly and also get the under-performing loan off the books. This could be a win-win for the farm borrower and for the lender.

ENDNOTES

[1] Knudsen v. Internal Revenue Service, No. 08-2820 (8th Cir. 2009).

[2] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005). See 11 U.S.C. § 1222(a)(2). See generally 5 Harl, *Agricultural Law* § 39.04[2][b][ii] (2009); 13 Harl, *Agricultural Law* § 120.08[9][a] (2009); 2 Harl, *Farm Income Tax Manual* § 9.05[7] (Matthew Bender 2009 ed.). See also Harl, "District Court in *Knudsen* Holds for the Debtors in Chapter 12 Case," 19 *Agric. L. Dig*. 101 (2008); Harl and Peiffer, "Bankruptcy Court Interpretation of Chapter 12 Rules," 17 *Agric. L. Dig*. 185 (2006).

[3] See I.R.C. § 1398(a).

[4] 11 U.S.C. § 1222(a)(2)(A).

[5] E.g., *In re* Knudsen, 356 B.R. 480 (Bankr. N.D. Iowa 2006), *aff'd and rev'd*, 389 B.R. 643 (N.D. Iowa 2008).

[6] *In re* Knudsen, 389 B.R. 643 (N.D. Iowa 2008).

[7] *In re* Schilke, 2008 U.S. Dist. LEXIS 68176 (D. Neb. 2008).

[8] *In re* Dawes, 382 B.R. 509 (Bankr. D. Kan. 2008), *aff'd*, 09-1 U.S. Tax Cas. (CCH) ¶ 50,280 (D. Kan. 2009).

[9] *In re* Hall, 393 B.R. 857 (D. Ariz. 2008).

[10] See note 1 *supra*.

[11] Pub. L. No. 96-589, § 3(a)(1).

[12] I.R.C. § 1398(a), (c)(1).

[13] *Id*.

[14] Ltr. Rul. 8918016, January 31, 1989 (unsecured portion of mortgage obligation discharged in bankruptcy; remaining obligation of mortgage obligation treated as non-recourse which is subject to income tax regardless of fair market value of property).

[15] Pub. L. No. 99-554, 100 Stat. 3105 (1986), adding 11 U.S.C. § 1201 *et seq*.

[16] See 13 Harl, *Agricultural Law* § 120.08 (2009).

[17] Pub. L. No. 109-8, § 1001, 119 Stat. 185 (2005), effective July 1, 2005.

[18] *Id*.

[19] 11 U.S.C. § 1222(a)(2).

[20] I.R.C. § 1231(a)(3)(A), (b)(1).

[21] Knudsen v. IRS, No. 08-2820 (8th Cir. 2009).

[22] No. 08-2820 (8th Cir. 2009).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

FEDERAL TAX

DISCHARGE. The debtor was self-employed as a realtor for 2000 through 2006 and did not pay income taxes on earnings. The debtor did not file a return for 2002 until April 18, 2004, more than six months after the expiration of an extension. The debtor filed for Chapter 7 on April 30, 2007 and sought discharge of the taxes owed. The IRS argued that the taxes for 2004 through 2006 were non-dischargeable under Section 523(a)(1)(A) and 507(a)(8) since the returns were due less than three years before the filing of the bankruptcy case. The IRS argued that the 2002 taxes were nondischargeable under Section 523(a)(1)(B)(i) because no return was filed, inasmuch as late filed return did not constitute a valid return. The court agreed with the court in *In re Creekmore, 401 B.R. 748 (Bankr. N.D. Miss. 2008)*, that a late return did not constitute a valid return for purposes of Section 523(a)(1)(B)(i). This result occurs because of an undesignated amendment to Section 523(a) by BAPCPA 2005 (Pub. L. No. 109-8) which defines an untimely return as not a return for purposes of Section 523 unless the debtor complies with I.R.C. § 6020(a). Section 6020(a) requires that the taxpayer supply the IRS with sufficient information to create a return and the taxpayer signs the return prepared by the IRS. The court held that the 2000 and 2003 tax liabilities were dischargeable because the IRS failed to prove that the debtor intended to evade payment of taxes. ***In re* Links, v. United States, 2009-2 U.S. Tax Cas. (CCH) ¶ 50,631 (Bankr. N.D. Ohio 2009)**.

FEDERAL FARM PROGRAMS

CROP INSURANCE. The FCIC has issued proposed regulations amending the common crop insurance regulations, apple crop insurance provisions to provide policy changes, to clarify existing policy provisions to better meet the needs of insured producers, and to reduce vulnerability to program fraud, waste, and abuse. The proposed changes will be effective for the 2011 and succeeding crop years. **74 Fed. Reg. 46023 (Sept. 8, 2009)**.

DISASTER ASSISTANCE. The FSA has adopted as final regulations implementing specific requirements for the Emergency Assistance for Livestock, Honeybees, and Farm-Raised Fish Program and the Livestock Forage Disaster Program authorized by the Food, Conservation, and Energy Act of 2008 (2008 Farm Bill). Eligible LFP and ELAP losses must have occurred on or after January 1, 2008, and before October 1, 2011. The final regulations specify how LFP and ELAP payments are calculated, what losses are eligible, and when producers may apply for payments. **74 Fed. Reg. 46665 (Sept. 11, 2009)**.

MEAT AND POULTRY PRODUCTS. The FSIS has issued an advance notice of proposed rulemaking to assist the agency in defining the conditions under which it will permit the voluntary claim "natural" to be used in the labeling of meat and poultry products. After considering comments on the "natural" claim submitted by the public in response to a Federal Register notice that the agency issued on December 5, 2006, and the comments presented at a public meeting held by the agency on December

12, 2006, FSIS has decided to solicit additional public input. **74 Fed. Reg. 46951 (Sept. 14, 2009)**.

TUBERCULOSIS. The APHIS has adopted as final regulations amending the bovine tuberculosis regulations to establish two separate zones with different tuberculosis risk classifications for New Mexico. New Mexico has been removed from the list of modified accredited advanced states, an area consisting of Curry and Roosevelt Counties, NM were added to the list of modified accredited advanced zones, and the remainder of the state was added to the list of accredited-free zones. **74 Fed. Reg. 48375 (Sept. 23, 2009)**.

FEDERAL ESTATE AND GIFT TAXATION

BASIS OF PROPERTY. In a Chief Council Advice letter, the IRS ruled that property transferred to a grantor trust, with a reserved power to substitute property and no right to revoke or amend the trust, prior to death does not receive a step-up in basis under I.R.C. § 1014 unless the property is included in the decedent's estate for federal estate tax purposes. **CCA Ltr. Rul. 200937028, Nov. 18, 2008**.

GENERATION SKIPPING TRANSFERS. A parent created a trust for a child and funded the trust with stock. The trust provided a general power of appointment over a portion of the trust to the child if the child died before a certain age. The child died before reaching that certain age, no portion of the trust was subject to a general power of appointment, and the trust passed to a child of the decedent. The decedent's estate sought a ruling that it could make an election under I.R.C. § 6166 to extend the time for payment of the GST tax imposed as a result of the termination of the decedent's interest in the trust. The IRS ruled that the Section 6166 election is not available for GST tax for taxable terminations but is available only for tax resulting from direct skips that occur on the death of an individual. **Ltr. Rul. 200939003, June 23, 2009**.

IRA. The decedent had owned an IRA which had as the remainder beneficiary a trust for the surviving spouse. The spouse disclaimed any interest in the trust, causing the trust to fail as a beneficiary of the IRA. The IRA, however, passed to the spouse under the residuary estate bequest. The IRS ruled that the disclaimer was effective, that the IRA itself did not pass to the spouse, but that the proceeds of the IRA did pass to the spouse and could be rolled over to an IRA belonging to the spouse without recognition of tax. **Ltr. Rul. 200938042, June 24, 2009**.

VALUATION. The IRS has adopted as final regulations governing appeals to the Tax Court of IRS valuation of gifts where the valuation change does not result in an increase in tax. I.R.C. 7477, enacted by the Taxpayer Relief Act of 1997 (Pub. L. 105-34, 111 Stat. 855), provides a declaratory judgment procedure pursuant to which taxpayers may contest in the United States Tax Court an IRS determination regarding the value of a gift. Prior law did not provide a judicial remedy in situations where the proposed IRS adjustment would not result in a gift tax deficiency or a tax overpayment. The new procedure applies, for example, where an increase in gift tax determined under I.R.C. § 2502 is offset by the taxpayer's applicable credit amount under I.R.C. § 2505(a), so that no additional tax is assessed as a result of a valuation increase. Because there is no tax deficiency, in the absence of I.R.C. § 7477, the taxpayer would be unable to challenge the IRS determination, even though, upon the expiration of the statute of limitations, that determination would become binding for purposes of calculating the cumulative gift tax on all future gifts of that taxpayer, as well as the taxpayer's estate tax liability. **74 Fed. Reg. 46347 (Sept. 9, 2009)**.

FEDERAL INCOME TAXATION

CHARITABLE DEDUCTION. The taxpayer owned two buildings which were subject to the Historic Landmark and Historic Preservation Act of 1978. The taxpayer transferred facade conservation easements to a non-profit corporation which held and enforced conservation easements. The easements prohibited any modification of the facades and required maintenance to preserve the facades. The court held that the easements were eligible for the charitable deduction because the easement transferred qualified property interests and had value, based on the increased financial burdens on the donor. **Simmons v. Comm'r, T.C. Memo. 2009-208**.

The taxpayer owned the development rights above a commercial building in New York City and granted a conservation easement to a non-profit organization. The easement restricted the development of the building above the existing building. The court disallowed a charitable deduction for the transfer because the easement did not bind the building owner or subsequent owners to preserve the existing building, which was a registered historic building. **Herman v. Comm'r, T.C. Memo. 2009-205**.

COURT AWARDS AND SETTLEMENTS. The IRS has issued proposed regulations relating to the exclusion from gross income for amounts received on account of personal physical injuries or physical sickness to reflect amendments under the Small Business Job Protection Act of 1996. The proposed regulations delete the requirement that to qualify for exclusion from gross income, damages received from a legal suit, action, or settlement agreement must be based upon "tort or tort type rights." The proposed regulations affect taxpayers receiving damages on account of personal physical injuries or physical sickness and taxpayers paying these damages. The proposed regulations also provide that a taxpayer may exclude damages received for emotional distress "attributable" to a physical injury or physical sickness. **74 Fed. Reg. 47152 (Sept. 15, 2009)**.

The taxpayer filed a lawsuit against a county for violation of First Amendment rights, violation of two state whistleblower statutes, intentional and negligent infliction of emotional stress, and defamation. The parties reached a settlement under which the taxpayer received cash and the taxpayer's attorneys received payment in settlement of all claims. The taxpayer did not report either payment as taxable income. The court held that, because the settlement agreement made no mention of any portion of the settlement proceeds as compensation for medical expenses or personal injury, the entire settlement was taxable income. **Save v. Comm'r, T.C. Memo. 2009-209**.

DEPENDENTS. The taxpayer lived with a sibling and the sibling's children. The house was rented under the sibling's name only. The taxpayer contributed to the household expenses and claimed two of the children as dependents and as qualifying children for earned income tax credit purposes. For one tax year, the taxpayer claimed a different address on the tax return but for the second year, the taxpayer claimed the same address as the sibling. The court held that the taxpayer satisfied the relationship test under I.R.C. § 32(c)(3)(B)(i)(II) for both years but failed to prove that the taxpayer lived with the children in the first year. Thus, the dependent deduction and EITC were valid only for the second year. **Scott v. Comm'r, T.C. Memo. 2009-211**.

DISCHARGE OF INDEBTEDNESS. The regulations under I.R.C. § 6050P required applicable financial entities, as defined in 1996, to issue Forms 1099-C, "Cancellation of Debt," upon the occurrence of one of several "identifiable events" as provided in Treas. Reg. § 1.6050P-1(b)(2)(i)(A) through (H). One of these identifiable events requiring the issuance of a Form 1099-C was the expiration of a "non-payment testing period" pursuant to Treas. Reg. § 1.6050P-1(b)(2)(i)(H). The 1996 regulations created a rebuttable presumption (the "36-month rule") under Treas. Reg. § 1.6050P-1(b)(2)(iv) that this period expired if a creditor had not received a payment for 36 months. Treas. Reg. § 1.6050P-1(b)(2)(iv) provides that the presumption that an identifiable event occurred can be rebutted by a creditor if the creditor had engaged in significant, bona fide collection activity. After the regulations were adopted, the Debt Collection Improvement Act of 1996, Pub. L. No. 104-134, 110 Stat. 1321 (1996), expanded I.R.C. § 6050P to cover any executive, judicial, or legislative agency as well as any applicable financial entity. The Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. No. 106-170, 113 Stat. 1860 (1999), further expanded I.R.C. § 6050P by expanding the definition of "applicable financial entity" to include any organization "a significant trade or business of which is the lending of money." The IRS has adopted as final regulations which limit the application of the 36-month rule to the entities for which it was originally intended prior to the changes in 1996 and 1999, in order to avoid premature information reporting of cancellation of indebtedness income. **74 Fed. Reg. 47728 (Sept. 17, 2009)**.

DOMESTIC PRODUCTION DEDUCTION. The taxpayers, two individuals, were engaged in manufacturing in the United States and all of their respective gross receipts constitute domestic production gross receipts (DPGR) and foreign trading gross receipts (FTGR). The taxable year in issue is 2005. Prior to the repeal of I.R.C. § 114, the extraterritorial income (ETI) taxing regime provided an exclusion of income attributable to foreign trading gross receipts, and simultaneously disallowed any deductions attributable to FTGR. Upon the repeal of the provisions transitional rules provided for reduced exclusions of ETI in 2005 and 2006. The IRS ruled that, for a taxpayer who has only DPGR and FTGR in a year in which the ETI regime was still applicable, qualified production activities income (QPAI) must be reduced by the ETI exclusion, regardless of whether the excluded amount is the full amount as provided by I.R.C. § 114 prior to repeal or the reduced amount provided in the transitional rules. A taxpayer's QPAI is only reduced by the amount of the excluded ETI to the extent that the FTGR to which the ETI exclusion is attributable is included in the QPAI. **AM-2009-009, Sept. 22, 2009**.

EMPLOYEE EXPENSES. The IRS has announced an update of the simplified per diem rates that employers (or their agents or third parties) can use to reimburse employees for lodging, meals and incidental expenses incurred on or after October 1, 2009 during business travel away from home without the need to produce receipts. The simplified "high-low" per diem rates have increased to $258 for high-cost localities and increased to $163 for localities within CONUS. For purposes of applying the high-low substantiation method and the 50-percent limitation on meal expenses, the federal meal and incidental expense rate is treated as $65 for a high-cost locality and $45 for any other locality within CONUS. **Rev. Proc. 2009-47, I.R.B. 2009-42, *superseding*, Rev. Proc. 2008-59, 2008-2 C.B. 857**.

EXCISE TAXES. The IRS has issued proposed regulations which clarify that a single-owner eligible entity that is disregarded as an entity separate from its owner for any purpose, but regarded as a separate entity for certain excise tax purposes, is treated as a corporation for tax administration purposes related to those excise taxes. Also, conforming changes are made to the tax liability rule for disregarded entities and the treatment of entity rule for disregarded entities with respect to employment taxes. The temporary regulations apply on or after September 14, 2009. **74 Fed. Reg. 46957 (Sept. 14, 2009)**.

FILING STATUS. The taxpayer filed an income tax return using the single status in a year in which the taxpayer was legally married but lived apart from the spouse. The court held that the taxpayer could not use the single status since no divorce decree or legal separation decree had been filed in that tax year. **Argyle v. Comm'r, T.C. Memo. 2009-218**.

FIRST-TIME HOMEBUYERS' CREDIT. The IRS has reminded potential homebuyers they must complete their first-time home purchases before December 1, 2009, to qualify for the first-time homebuyer credit under I.R.C. § 36. In other words, the last day to close on a home is November 30, 2009. The credit cannot be claimed until after the purchase is completed but, once completed, taxpayers may claim the credit on either their 2008 returns or their 2009 returns. The credit is 10 percent of the purchase price of the home, up to a maximum credit amount of $8,000 ($4,000 for a married person filing a separate return). Homebuyers who have never owned a home or have not owned one in the past three years may claim the credit, which is reduced or eliminated for certain higher income taxpayers. Other requirements and restrictions apply. The IRS has a new YouTube video (http://www.youtube.com/watch?v=xRZiziAWOq0) and other resources that explain the credit in detail. Form 5405, First-Time Homebuyer Credit, also includes details for claiming the credit. **IR-2009-83**.

HOBBY LOSSES. The taxpayers, husband and wife, operated a horse breeding and boarding activity at their rural residence. The husband was employed full time but the wife was not employed off the farm. The court held that the taxpayers operated the horse activity with the intent to make a profit because (1) although the taxpayers did not keep records other than receipts of purchases and sales and did not have a written business plan, the taxpayers made sufficient efforts to improve the business, increase revenues and reduce costs, the lack of records and business plan did not demonstrate a lack of profit motive; (2) the taxpayer consulted enough experts and had sufficient personal experience to operate the business with a profit motive; (3) the wife spent substantial time at the activity and the husband spent a significant amount of free time at the activity; (4) the taxpayers had a reasonable expectation of appreciation of value of the farm assets, especially from the special zoning status of the property; (5) the taxpayers did not have significant income from other sources which was offset by the horse activity losses; and (6) the running of the operation was hard work and the taxpayers derived little personal pleasure from the operation other than the enjoyment of the horses. Comment: the facts in this case in many other courts would not have had the same result. The lack of a written business plan and detailed records alone have disqualified other horse operation taxpayers for loss deductions in most of the cases reported to date. Most taxpayers have been required to form a profit plan, create financial records that detail whether that plan is working, and make business operation changes based on expert advice and those records that in fact do make the operation profitable. **Helmick v. Comm'r, T.C. Memo. 2009-220**.

HOME OFFICE. The taxpayer claimed deductions for costs associated with a home office. Although the taxpayer used parts of the residence for the taxpayer's accounting services, the deductions for the expenses were denied because the taxpayer failed to substantiate that a portion of the residence was used exclusively for the business. **Argyle v. Comm'r, T.C. Memo. 2009-218**.

IRA. The taxpayer received an early distribution from an IRA and used some of the proceeds to pay travel costs relating to a child's higher education. The court held that the amount of travel costs was not eligible for the exemption from the 10 percent addition to tax. The court also held that the portion of the early distribution used to pay health insurance premiums was not exempt from the 10 percent addition to tax. The court held that the 10 percent addition to tax was applied only to the portion of the distribution which was included in taxable income. **Argyle v. Comm'r, T.C. Memo. 2009-218**.

INSTALLMENT REPORTING. The taxpayer and another unrelated individual were equal partners in several partnerships. The unrelated individual was the trustee of a trust in which the taxpayer had no interest. The taxpayer, trustee and two other unrelated individuals formed a fourth partnership as an LLC which was a disregarded entity for federal income tax purposes. The LLC owned a commercial real estate building depreciated with the straight-line method. The taxpayer sold the taxpayer's entire interest in the fourth partnership to the trust under an installment agreement which granted the taxpayer a security interest in the trust assets as security for the promissory note used to purchase the partnership interest. The IRS ruled that the related-party provisions of I.R.C. § 453(e)(1) did not apply to the transaction, the taxpayer could report the gain using the installment method of reporting, and the taxpayer recognized 100 percent of the unrecaptured I.R.C. § 1250 gain to the extent that I.R.C. § 1231 gain existed in each tax year attributable to the sale. **Ltr. Rul. 200937007, March 10, 2009**.

INVOLUNTARY CONVERSIONS. The IRS has issued guidance on determining the replacement period for application of I.R.C. § 1033(e) to the sale of livestock sold on account of drought. *Notice 2006-82, 2006-2 C.B. 529*. Under that guidance, under I.R.C. § 1033(e)(2)(B), the standard replacement period (four years after the close of the first taxable year in which any part of the gain from a drought sale occurs) can be extended by the Secretary of the Treasury if the Secretary determines that the drought area was eligible for federal assistance for more than three years. The IRS, after consultation with the National Drought Mitigation Center, publishes in September of each year a list of counties for which exceptional, extreme, or severe drought was reported during the preceding 12 months. Taxpayers may use this list instead of U.S. Drought Monitor Maps to determine whether a 12 month period ending on August 31 of a calendar year includes any period for which exceptional, extreme, or severe drought is reported for a location in the applicable region. The IRS has published a list of the counties and parishes in the United States that have suffered exceptional, severe or extreme drought during the 12 months ending August 31, 2009, sufficient to extend the livestock replacement period. **Notice 2009-81, I.R.B. 2009-40**.

LEGAL EXPENSES. The taxpayer incurred legal expenses from defending a lawsuit brought by a client's employee for assault. The court held that the legal expenses were not deductible because the expenses were not related to the taxpayer's business. **Argyle v. Comm'r, T.C. Memo. 2009-218**.

MEDICAL DEDUCTIONS. The taxpayer claimed medical deductions for amounts paid to prostitutes and for pornography books as sexual therapy. The visits were not prescribed by a doctor. The court held that a deduction was not allowed for illegal activities under state law or for medical costs not prescribed by a doctor. The taxpayer was a tax attorney and the court upheld an accuracy-related penalty for lack of any reasonable basis for claiming the deductions. **Halby v. Comm'r, T.C. Memo. 2009-204**.

NET OPERATING LOSSES. The IRS has announced that taxpayers must act soon if they want to benefit from the special carryback available through the American Recovery and Reinvestment Act of 2009 (Pub. L. No. 111-5). The deadline for choosing the special carryback is September 15, 2009 for corporations that qualify as an eligible small business and October 15, 2009 for individuals. The special carryback for net operating loss (NOL) extends back five years instead of the usual two-year period. The benefits from using the special carryback include offsetting taxes already paid over the last five years, obtaining a refund for the past five years resulting from NOL carrybacks, and using the accrued losses now instead of waiting for future years. Taxpayers must choose the carryback by either attaching a statement to an income tax return for the tax year beginning or ending in 2008 or by claiming a refund on either Form 1045, Application for Tentative Refund or Form 1139, Corporation Application for Tentative Refund, or on an amended return for the tax year to which the NOL is being carried back. **IR-2009-79**.

PARTNERSHIPS.

WIND ENERGY PRODUCTION CREDIT. The IRS has issued revised procedures establishing safe harbor requirements for partnerships claiming I.R.C. § 45 wind energy production tax credits. The safe harbor applies to partnerships between a project developer and one or more investors with the partnership owning and operating the qualified energy facilities only if the developer, investors and partnership satisfy each requirement in section four of the procedure. Furthermore, the revenue procedure applies only to partners or partnerships with I.R.C. § 45 production tax credits and does not apply to any other tax credits. The procedure is effective for transactions entered into on or after November 5, 2007. **Ann. 2009-69, I.R.B. 2009-40, *revising* Rev. Proc. 2007-65, 2007-2 C.B. 967**.

SAFE HARBOR INTEREST RATES

October 2009

	Annual	Semi-annual	Quarterly	Monthly
		Short-term		
AFR	0.75	0.75	0.75	0.75
110 percent AFR	0.83	0.83	0.83	0.83
120 percent AFR	0.90	0.90	0.90	0.90
		Mid-term		
AFR	2.66	2.64	2.63	2.63
110 percent AFR	2.92	2.90	2.89	2.88
120 percent AFR	3.20	3.17	3.16	3.15
		Long-term		
AFR	4.10	4.06	4.04	4.03
110 percent AFR	4.52	4.47	4.45	4.43
120 percent AFR	4.93	4.87	4.84	4.82

Rev. Rul. 2009-33, I.R.B. 2009-40.

S CORPORATIONS

ELIGIBLE SHAREHOLDERS. The taxpayer was an S corporation which had a custodial Roth IRA account as its sole shareholder. The court held that the taxpayer was taxable as a C corporation because it had an ineligible shareholder. The next issue of the *Digest* will publish an article by Neil Harl on this case. **Taproot Administrative Services, Inc. v. Comm'r, 133 T.C. No. 9 (2009)**.

TAX ASSESSMENTS. The IRS has issued temporary regulations defining an omission from gross income for purposes of the six-year minimum period for assessment of tax attributable to partnership items and the six-year period for assessing tax. The temporary regulations resolve a continuing issue as to whether an overstatement of basis in a sold asset results in an omission from gross income. See, e.g., *Intermountain Insurance Service of Vail, LLP v. Comm'r, T.C. Memo. 2009-195*. The regulations will affect any taxpayer who overstates basis in a sold asset creating an omission from gross income exceeding 25 percent of the income stated in the return. **74 Fed. Reg. 49321 (Sept. 28, 2009)**.

TAX ON HEAVY TRUCKS AND TRAILERS. The taxpayer was a manufacturer of trailers and produced a trailed designed specifically for hauling corn gluten in order to solve problems with the wet and sticky nature of corn gluten. The IRS ruled that the trailers were exempt from taxation under I.R.C. § 4051 because the trailers were "primarily designed" for the hauling of corn gluten. The IRS noted that the trailers were not practical for other uses or modification. **Ltr. Rul. 200939005, June 23, 2009**.

TRAVEL EXPENSES. The taxpayer was denied deductions for vehicle expenses for lack of substantiation of the time, place and business purpose of each travel event. The taxpayer was also denied deductions for travel expenses, also for lack of substantiation of the time, place and business purpose of each travel event. The court held that the taxpayer could not deduct the cost of commuting to and from the taxpayer's place of employment. **Coppin v. Comm'r, T.C. Memo. 2009-221**.

The taxpayer was employed as an independent contractor to perform auto parts delivery services for one company. The taxpayer used a car owned by the taxpayer and the taxpayer was not reimbursed for use of the vehicle. The taxpayer's duties involved driving to the company's warehouse then to various stores throughout the day. At the end of the day, instead of returning to the warehouse, the taxpayer drove home because the trip home was much less than a round trip to the warehouse. The next day, the return trip to the warehouse was completed and the delivery trips restarted. The taxpayer claimed vehicle travel expenses for the miles between the warehouse, through the delivery circuit and back to the warehouse, excluding the trip from the residence to the warehouse and from the last stop to the residence. The court held that the taxpayer could deduct the cost of the travel from the warehouse, through the delivery route and back to the warehouse, excluding the short trip to the residence each day. **Freeman v. Comm'r, T.C. Memo. 2009-113**.

TRUSTS. The taxpayers, husband and wife, each own and operated sole proprietorships. The taxpayers attempted to avoid income tax on their income by creating a "business trust" and transferring the husband's business to the trust. The trust paid some of the business income to the husband as wages and transferred the remainder to an offshore company. The taxpayers could access these funds through a credit card issued by the offshore company. The court held that the trust was a sham and that all income from the husband's company was taxable income to the taxpayers. A fraud penalty was assessed against the husband and an accuracy-related penalty was assessed against both taxpayers. **Tarpo v. Comm'r, T.C. Memo. 2009-222**.

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