

TAX AND ESTATE PLANNING NEWSLETTER

MAY 1, 2003

The following tax and estate planning news may be of interest to you in your business or personal pursuits. If you have questions about any of these items, please call or e-mail one of the Tax and Estate Planning Attorneys listed below by clicking on the attorney's e-mail address or calling the telephone number.

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WHEN IS A GIFT OF A RESIDENCE A GIFT FOR TAX PURPOSES

The IRS recently ruled that a conveyance by a father of his residence to his two sons was not a completed gift for tax purposes. Before executing the deed, the father received an oral promise from his sons that they would reconvey the residence to him if he requested; however, when the father requested that the residence be returned, approximately three years later, the sons refused. The IRS concluded that under the facts there was not a completed gift because the donor reserved the power to revert the beneficial title to the property in himself. The property would also be in the father's estate for federal estate tax purposes because he had not made a completed gift.

TRYING TO CONVERT WAGES TO ROYALTIES FOR TAX PURPOSES

The IRS recently ruled that a CPA's attempt to treat wages from his professional corporation (PC) as royalties does not work. Wages are subject to FICA, FUTA, and income tax withholding, while royalty

payments are reported on a Form 1099 and not subject to withholding, although both forms of income are ordinary income. The CPA had his PC become a general partner in a limited partnership (LP) which provided investment and financial planning services. The CPA entered into a license and royalty agreement with the LP whereby the LP was granted an exclusive right to use the CPAs client list and to render accounting and consulting services to the clients, while the CPA agreed to use his best efforts to direct his clients to the LP. The CPA's PC continued to perform accounting services and his firm made royalty payments to the LP which in turn paid them to the CPA reporting them on a 1099.

The IRS ruled that there were no royalties paid here because "royalty" refers to a payment made to the owner of property for permitting another to use the property; it cannot include compensation for services rendered by the owner of the property. In short, this was a disguised payment by the CPA to presumably avoid FICA, FUTA and withholding taxes.

HOME SALE EXCLUSION RULES CLARIFIED

The 1997 Tax Act allows single taxpayers an exclusion of up to \$250,000 (\$500,000 for a married couple) of gain on the sale of the principal residence. The IRS recently issued final regulations dealing with interpretations of provisions of this rule, one of which is the definition of a "principal residence." The regulations continue to provide that a residence used by a taxpayer a majority of the time during the year is to be considered the taxpayer's principal residence; however, the following factors should also be taken into account:

- taxpayer's place of employment;
- principal place of abode of the members of the taxpayer's family;
- address on taxpayer's federal and state tax returns, drivers license, automobile and voter registration;
- taxpayer's mailing address;
- location of taxpayer's banks; and,
- location of religious or other organizations with which taxpayer is affiliated.

There are several other interpretative provisions set forth in these regulations dealing with this exclusion of gain rule with respect to a sale of principal residence.

WHEN EDUCATIONAL EXPENSES ARE TAX DEDUCTIBLE

A recent Tax Court case held that a lawyer could not deduct the cost of obtaining JD, LL.M., or MBA degrees as trade or business expenses. These expenses must be connected with or incurred in the conduct of a trade or business. The lawyer had not yet established himself in the practice of law and thus had not established a trade or business. Even though he had worked as a summer associate for two law

firms, there was uninterrupted continuity in his legal education. Had he worked as a lawyer for a period of time and then gone back to school to improve his skills in the specialty in which he was working, the expenses probably would then have been tax deductible.

IS A SECURITY DEBT OR EQUITY FOR TAX PURPOSES?

For almost as long as there have been income tax laws, taxpayers and the IRS have argued as to whether a corporate security is a debt (debenture) or equity (stock) because of the differing tax consequences. Either party can be on either side of the argument, depending on the facts. Many years ago, Congress passed IRC §385 authorizing the Treasury to issue regulations which were never issued because there are simply too many factors to take into account and each case is decided on its facts. A recent Tax Court case allowed a corporation to deduct the interest it paid on the debentures even though the IRS contended the debentures represented equity or stock. Often the securities that are issued are from funds advanced to the corporation by shareholders. Some of the tax differences are:

- interest on debt is deductible by a corporation; dividend payments on stock are not;
- repayment of the principal (the debt itself) is not income to the lender/shareholder; other distributions to shareholders are generally taxable dividends;
- debt may be paid off in full out of earnings without tax to the lender; stock redemptions may be taxed as dividends.

The debt-equity ratio of the corporation is always a significant factor among several others.