DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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MEMORANDUM FOR: ELECTRONIC TAX ADMINISTRATION
Attn: Grace E. Davis
W:E:IEF:CMMB

FROM: Assistant Chief Counsel
(Administrative Provisions & Judicial Practice)
CC:PA:APJP

SUBJECT: Paid Preparer Issues - Internet Returns

This memorandum is in response to your e-mail dated August 15, 2000, in which you asked Andrew J. Keyso, Jr. for advice regarding the definition of an income tax return preparer pursuant to section 7701(a)(36) in the context of returns prepared with the use of the Internet. Your e-mail was forwarded to us for reply.

ISSUES

(1) Whether, in the situations described below, tax professional X is an income tax return preparer within the meaning of I.R.C. § 7701(a)(36).

(2) Whether, in certain of the situations described below, tax professional X is required to sign the return as an income tax return preparer.

FACTS

In Scenarios 1 through 4, the taxpayer will not be filing an electronic return. In Scenarios 5 and 6, the taxpayer will be filing an electronic return.

Scenario 1: A taxpayer provides income tax return information to a third party via an Internet website. The third party then forwards the information to tax professional X who prepares a Form 1040 series income tax return and then forwards the completed return back to the taxpayer. The third party may merely collect the information and forward it to tax professional X in the same format it is collected, or alternatively, the third party may format the information prior to forwarding it to tax professional X. The taxpayer pays tax professional X to prepare the return.

Scenario 2: A taxpayer provides income tax return information to a third party via an Internet website that formats the information into a Form 1040 series return. The third party then forwards the completed Form 1040 series return to tax professional X who

reviews the return and does not make any changes to the return. The taxpayer pays tax professional X to review the return.

Scenario 3: Same facts as in Scenario 2, except tax professional X reviews the return and makes changes to the return. Tax professional X makes changes to the return without contacting the taxpayer.

Scenario 4: Same facts as in Scenario 2, except that in the course of reviewing the return, tax professional X interacts with the taxpayer by telephone and/or e-mail.

Scenario 5: A taxpayer uses a personal computer, a modem, and software to prepare his income tax return "on-line." In the course of preparing his return, the taxpayer determines he needs assistance and is referred to a help line. Although the taxpayer does not make a payment directly to tax professional X for the assistance provided through the help line, the software package the taxpayer purchased includes tax advice. Using the knowledge gained from tax professional X through the help line (which may be nothing more than the same information contained in the Form 1040 instructions), the taxpayer completes his return.

Scenario 6: A taxpayer uses a personal computer, a modem, and software to prepare his income tax return "on-line." After preparing the return on his own, the taxpayer requests a review of the electronic return by tax professional X. Although the taxpayer does not make a payment directly to tax professional X for reviewing the electronic return, the software package the taxpayer purchased includes tax advice.

(a) Tax professional X reviews the return but does not make any changes.

(b) Tax professional X reviews the return, interacts with the taxpayer, but does not make any changes to the return.

(c) Tax professional X reviews the return and recommends changes that the taxpayer then makes to the "on-line" return but does not interact with the taxpayer.

(d) Tax professional X reviews the return and recommends changes to the return after interacting with the taxpayer.

CONCLUSIONS

(1) In Scenarios 1 through 4, tax professional X is an income tax return preparer because each of the five elements to the definition of an income tax return preparer has been satisfied. In Scenario 1, tax professional X is a person who prepares a return in exchange for compensation. In Scenarios 2, 3, and 4, the review of the taxpayer's return for substantive correctness in exchange for compensation is viewed as preparing

all or a substantial portion of a return, regardless of whether the review results in any changes to the return.

Similarly, tax professional X in Scenario 6 is an income tax return preparer within the meaning of section 7701(a)(36). At first glance, there may not appear to be compensation for the review of the return; however, the concept of compensation for purposes of section 7701(a)(36) is broad in scope and covers "package deals." As a result, the compensation paid for the software package is attributable to tax professional X's review of the return.

With respect to Scenario 5, it is not possible to provide a conclusion as to whether tax professional X is an income tax return preparer for purposes of section 7701(a)(36). In Scenario 5, the nature of the advice provided by tax professional X will govern whether tax professional X is an income tax return preparer. The advice provided by tax professional X must be directly relevant to the existence, characterization or amounts of entries that consist of a substantial portion of the taxpayer's Form 1040.

(2) Section 6695(b) requires that an income tax return preparer with respect to a return of tax or claim for refund must sign the return or claim for refund in the appropriate space provided on the return or claim for refund. Tax professional X in Scenario 2 is an income tax return preparer, and consequently, is required to sign the return as the preparer. Assume, however, that tax professional X did not review the return for substantive correctness and as such does not meet the definition of an income tax return preparer. Although the statutes and regulations do not prohibit tax professional X from signing the return, absent evidence to the contrary, a signature on the paid preparer line could result in tax professional X being classified as an income tax return preparer even though he may not meet the statutory definition of a preparer.

DISCUSSION

Section 7701(a)(36) of the Internal Revenue Code generally defines the term "income tax return preparer" as any person who prepares or employs another to prepare any return of tax imposed by subtitle A or any claim for refund of tax imposed by subtitle A in exchange for compensation. The statute also provides that the preparation of a substantial portion of a return or claim for refund of tax in exchange for compensation will be treated as if it were the entire preparation of such return or claim of refund. Thus, there are five elements to the definition, each of which must be satisfied for a person to be considered a preparer: (1) a person; (2) who prepares or employs another to prepare; (3) all or a substantial portion; (4) of a return or claim for refund of tax; (5) for compensation.

A person may be an income tax return preparer without regard to educational or professional qualifications. Treas. Reg. § 301.7701-15(a)(3). But, "[t]yping, reproduction, or other mechanical assistance in the preparation of a return or claim for

refund" are not activities in and of themselves that make someone an income tax return preparer. Treas. Reg. § 301.7701-15(d)(1).

(1) Person

Section 7701(a)(1) defines the term "person" to "include an individual, a trust, estate, partnership, association, company or corporation." Thus, an individual or even a software company is classified as a "person" and can constitute an income tax return preparer if the other 4 elements of the definition are satisfied.

(2) Prepares or Employs Another to Prepare

For purposes of section 7701(a)(36), the concept of preparing a return is broad in scope and goes beyond the general meaning of filling out a return based on information provided by a taxpayer. Treas. Reg. § 301.7701-15(a)(1) expands the generally accepted meaning of "preparing a return" by providing that "a person who furnishes to a taxpayer or other preparer sufficient information and advice so that completion of the return or claim for refund is largely a mechanical or clerical matter is considered an income tax return preparer, even though that person does not actually place or review placement of information on the return or claim for refund." Thus, a person can be a preparer without ever seeing a taxpayer's return. In contrast, a person who only renders advice on specific issues of law is not an income tax preparer unless (i) the advice is given with respect to events which have occurred at the time the advice is rendered and is not given with respect to the consequences of contemplated actions; and (ii) the advice is directly relevant to the determination of the existence, characterization, or amount of an entry on a return or claim for refund. Treas. Reg. § 301.7701-15(a)(2).

The definition of a preparer is also broad enough to include a person who reviews a return for substantive correctness, regardless of whether substantial changes are recommended or whether the review results in any changes to the return. Rev. Rul. 84–3, 1984-1 C.B. 264; Rev. Rul. 86-55, 1986-1 C.B. 373. Moreover, the Service has applied the definition of preparer to a company (and the computer programmer) that furnishes computerized tax return preparation services when the computer program goes beyond mere mechanical assistance. Rev. Rul. 85-187, 1985-2 C.B. 338; Rev. Rul. 85-188, 1985-2 C.B. 339; and Rev. Rul. 85-189, 1985-2 C.B. 341. In addition, the Service has taken the position that the definition of preparer applies to software companies that create computer programs and sell them to taxpayers for use in preparing income tax returns. I.R.S. News Release IR-86-62 (May 5, 1986).

In addition to someone who actually prepares a return, the definition of "income tax return preparer" includes the employer of one or more persons who prepare the returns of others for compensation. Section 301.7701-15(a) of the regulations adds the term "engages" to the term "employs." The effect of this addition is that a person can be

considered an employer for purposes of tax return preparation regardless of whether the person retained is technically considered an employee for purposes of other federal laws. H.R. Rep. No. 658, 94th Cong., 1st Sess., at 276 (1975). As a result, the definition of "income tax return preparer" is broad enough to cover any person retained to prepare income tax returns, regardless of the person's classification as an employee, agent, or independent contractor for purposes of other federal laws. S. Rep. No. 938, 94th Cong., 2d Sess., at 352, n.1 (1975). A single return could, therefore, have multiple preparers.

(3) All or a Substantial Portion

Only a person who prepares all or a substantial portion of a return or claim for refund will be considered a preparer. "A person who renders advice which is directly relevant to the determination of the existence, characterization, or amount of an entry on a return or claim for refund, will be regarded as having prepared that entry." Treas. Reg. § 301.7701-15(b)(1). Although section 7701(a)(36) does not provide a definition of the term "substantial portion," section 301.7701-15(b)(1) of the regulations provides:

> [w]hether a schedule, entry, or other portion of a return or claim for refund is a substantial portion is determined by comparing the length and complexity of, and the tax liability or refund involved in, that portion to the length and complexity of, and tax liability or refund involved in, the return or claim for refund as a whole.

The legislative history of section 7701(a)(36) indicates that "[w]hether or not a portion of a return constitutes a substantial portion is to be determined by examining both the length and complexity of that particular portion of the return and the amount of tax liability involved." H.R. Rep. No. 658, 94th Cong., 1st Sess., at 275 (1975); S. Rep. No. 938, 94th Cong., 2d Sess., at 351 (1975). In applying the "length and complexity" test, it is possible that a single entry can constitute a substantial portion of a return. See, e.g., Goulding v. United States, 957 F.2d 1420 (7th Cir. 1992) (entry from K-1 on partners' returns sufficient to make preparer of partnership return a preparer of partners' returns). As a general rule, however, a single schedule of a tax return is not considered a substantial portion unless that schedule is the dominant part of the entire tax return. S. Rep. No. 938, 94th Cong., 2d Sess., at 351 (1975).

Section 301.7701-15(b)(2) of the regulations provides a de minimus test for determining whether a portion of a return is "substantial." In this regard, a portion of a return is not considered "substantial" if it involves gross income, deductions, or credits: (1) less than $2,000; or (2) less than $100,000 and also less than 20% of the gross income (adjusted gross income if the taxpayer is an individual) as shown on the income tax return. If more than one schedule, entry or other portion of a return is at issue, they are aggregated before applying the de minimus test. Treas. Reg. § 301.7701-15(b)(2).

(4) Return or Claim for Refund

The definition of an income tax return preparer only encompasses persons who prepare returns or claims for refund of taxes imposed by Subtitle A. For purposes of section 7701(a)(36), the following are returns of taxes imposed by Subtitle A: (1) an individual income tax return; (2) corporation income tax return; (3) fiduciary income tax return (for a trust or estate); (4) regulated investment company undistributed capital gains tax return; (5) charitable remainder trust return; (6) return by a transferor of stock or securities to a foreign corporation, foreign trust, or foreign partnership; (7) partnership return of income; (8) small business corporation income tax return; and (9) a DISC return. Treas. Reg. § 301.7701-15(c)(1)(i). In contrast, however, the following items are not returns for purposes of section 7701(a)(36): (1) estate tax return; (2) gift tax return; (3) any return of excise taxes or income taxes collected at the source on wages; (4) individual or corporation declaration of estimated tax; (5) application for extension of time to file an individual or corporation income tax return; and (6) Form 990, any Form 1099, and any other information statement on a similar form. Treas. Reg. § 301.7701-15(c)(1)(ii).

(5) For Compensation

Section 301.7701-15(a)(4) of the regulations provides that a person must prepare a return or claim for refund for compensation to be an income tax return preparer. Moreover, the regulation provides that "[a] person who prepares a return or claim for refund for a taxpayer with no explicit or implicit agreement for compensation is not a preparer, even though the person receives a gift or return service or favor." Neither section 7701(a)(36) nor the regulations thereunder draw a distinction between nominal and substantial compensation. Further, the element of compensation has been found to exist even though the preparer did not bill the taxpayers for his services in preparing their returns. United States v. Savoie, 594 F.Supp. 678 (W.D. La. 1984). In Savoie, the taxpayers were entitled to have their income tax returns prepared by the director of a club as one of the benefits of paying membership dues in the club. The court concluded that the director was considered to have been paid for his preparation and advice even though he did not bill for his services, and consequently, the compensation element was satisfied. In another case, the court found that an individual was a preparer with respect to an individual return when he was compensated for preparing a corporation's tax return. Papermaster v. United States, 81-1 U.S.T.C. (CCH) ¶ 9217 (1980). In Papermaster, the court reasoned that Mr. Papermaster was "an income tax return preparer who offers a small businessman a package deal whereby he prepares the business' return for a fee which includes his charge for preparing the proprietor's individual return." Papermaster, 81-1 U.S.T.C. (CCH) ¶ 9217, at 86,450.

Compensation has been interpreted to consist of any amount of consideration paid, regardless of how small, indirect, or contingent such payment may be, or how little of an individual's duties consist of income tax return preparation. See Rev. Rul. 85-188,

1985-2 C.B. 339 (employee of a farmers' cooperative credit association is a preparer when such employee prepares a Schedule F for members as part of a standard membership fee); Rev. Rul. 86-55, 1986-1 C.B. 373 (used car dealership was tax return preparer when it filled out or reviewed tax return for the purpose of applying the refund towards a customer's down payment on a car).

To date, there have been no decisions regarding the definition of an "income tax return preparer" in the context of electronic commerce directly on point. As new technology evolves, so must the concept of an income tax return preparer. However, a review of the purpose behind the return preparer provisions is helpful to understand how these provisions should be applied in the context of electronic commerce. The Goulding case, 957 F.2d at 1424-25, summarized the enactment of these provisions.

> Section 6694 was included in the Tax Reform Act of 1976 as part of a package of provisions designed to regulate income tax preparers and to deter improper conduct by them. These provisions were enacted in response to abuses by tax return preparers.
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> . . .
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> [Because return preparers were not penalized for falling to sign], under the pre-1976 Code, it was difficult for the IRS to determine if a preparer or the taxpayer himself was responsible for a return. Moreover, if the IRS found an incorrect return prepared by a professional or commercial preparer, it was difficult to trace other returns prepared by the same preparer. Even if the IRS could trace the improper preparation of returns to an individual tax return preparer, the criminal penalties available under the pre-1976 Code were "often inappropriate, cumbersome, and ineffective deterrents because of the costs and length of time involved in trying these cases in court."
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> . . . [T]he provisions were not aimed solely at commercial preparers preparing large numbers of relatively simple returns for average income taxpayer, but were intended also to apply to professional preparers -- lawyers and accountants -- preparing more complex returns.
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> Along with the penalty provisions, the 1976 Act provided a statutory definition of "income tax return preparer." The definition was intended to limit application of the penalty provisions to professional and commercial preparers, and to exclude those preparing returns for employers, friends and relatives. Another purpose of the definition was to ensure that the person who makes the decisions and calculations involved in preparing a particular return will be considered the preparer of that return, even if that person "does not actually place the figures on the lines of the taxpayer's final tax return." [citations and footnotes omitted]

The determination of whether a tax professional is an income tax return preparer depends "on an individual examination of each return in question." United States v. Ernst & Whinney, 735 F.2d 1296 (11th Cir. 1984). Based on the above discussion, we provide the following guidance with respect to the scenarios described above.

Scenario 1: In this scenario, each of the five elements of the definition of an "income tax return preparer" are present. Tax professional X is a person who prepares all of the taxpayer's Form 1040 in exchange for compensation. Thus, tax professional X is characterized as an income tax return preparer within the meaning of section 7701(a)(36).

The statutory scheme of section 7701(a)(36) "reflects recognition of the fact that more than one person may be a preparer in respect to one return." Goulding, 957 F.2d at 1429, aff'g 717 F.Supp. 545 (N.D. Ill. 1989). Thus, although we are concerned with whether tax professional X constitutes an income tax return preparer, it is important to consider whether the third party may also satisfy the definition of an income tax return preparer. To the extent the third party is merely collecting the information from the taxpayer and is not making any decisions regarding the characterization or amounts of entries, it is unlikely that the third party should be deemed an income tax return preparer, as the third party should fall within the exception for "typing, reproduction, or other mechanical assistance." See Treas. Reg. § 301.7701-15(d)(1).

In contrast, however, if the third party is making any substantive decisions regarding the characterization or amounts of entries when formatting the information prior to forwarding it to tax professional X, the third party may constitute an income tax return preparer, as the third party's activities would likely exceed the exception for "typing, reproduction, or other mechanical assistance."

Scenario 2: We have applied the definition of an income tax return preparer broadly to include a person who reviews a return for substantive correctness, regardless of whether the review results in any changes to the return. Rev. Rul. 84-3, 1984-1 C.B. 264; Rev. Rul. 86-55, 1986-1 C.B. 373. Thus, in this scenario, the fact that the review of the return does not result in any changes has no bearing on tax professional X's status as an income tax return preparer. By reviewing the taxpayer's Form 1040 in exchange for compensation, tax professional X is characterized as an income tax return preparer within the meaning of section 7701(a)(36). As in Scenario 1, it is also important to consider whether there is more than one preparer of the taxpayer's return.

Scenario 3: As in Scenario 2, the definition of an income tax return preparer includes a person who reviews a return for substantive correctness, regardless of whether the review results in any changes to the return. Rev. Rul. 84-3, 1984-1 C.B. 264; Rev. Rul. 86-55, 1986-1 C.B. 373. In addition, the existence of contact with the taxpayer is not relevant when determining whether a person is an income tax return preparer. See Goulding, 957 F.2d at 1429 (preparer of partnership return had no contact with partners

We are assuming that all the claimants are self-employed. In the case of a self-employed taxpayer, § 32(c)(2)(A)(ii) defines earned income as the taxpayer's net earnings from self-employment (within the meaning of § 1402(a)), but determined without regard to the taxpayer's § 164(f) deduction (for one-half the SECA tax). Therefore, to the extent the settlement payments are subject to SECA tax (discussed later in this memorandum), they will also constitute earned income for EIC purposes (with a possible adjustment for the § 164(f) deduction). Thus, the $t payment in Year 1, if earned income, will preclude any otherwise available EIC. If the $v in Year 2 is earned income it could, depending on the claimant's circumstances, give rise to or increase the EIC, or reduce or eliminate an otherwise available EIC. Loan forgiveness would be analyzed similarly.

3. Are the payments modified AGI?

Even if the payments are not earned income they will, to the extent includible in gross income, be included in modified AGI as defined in § 32(c)(5) because they are not affected by any of the modifications set forth in § 32(c)(5)(B) or (C). The phaseout of EIC is based on the greater of earned income or modified AGI. Therefore, unless the claimant has offsetting losses of a type not disregarded under § 32(c)(5)(B), the $t payment in Year 1, if includible in gross income, will preclude any otherwise available EIC even if it is not earned income. If the $v in Year 2 is includible it could, depending on the claimant's circumstances, reduce or eliminate an otherwise available EIC. Loan forgiveness would be analyzed similarly.

Contact Person: Mark Schwimmer, CC:TEGE:EOEG, 622-6060

4. Under the h, b is to discharge "all outstanding debt." If this debt includes principal and interest, are both taxable income to the claimant? Is the taxability question impacted by the fact that the "partial payment of tax" is only u% of the "principal amount of the debt forgiven?" If taxable, in what tax year should the claimant recognize the income?

Section 61(a)(12) provides that gross income includes income arising from the discharge of indebtedness. Income arising from the discharge of indebtedness is included in income for the year in which the debt is discharged. A debt is discharged when it is clear that the debt will not be repaid. Cozzi v. Commissioner, 88 T.C. 435 (1987). A debt is treated as discharged on the date the parties agree in writing that the debt is discharged and the agreement legally relieves the debtor from repayment. Chatom Co. v. Commissioner, 36 T.C. 540 (1961), acq., 1962-1 C.B. 4. In this case, the point at which a claimant and i agree to a specific settlement is the time at which the debt is discharged.

Section 6050P requires that certain entities, including federal executive agencies, report discharges of indebtedness in excess of $600. Section 1.6050P-1(d)(3) requires that in a lending transaction the discharge of an amount other than principal need not be reported. If the total amount of the canceled debt, including interest, is reported, the interest amount should be backed out in box 3 on Form 1099-C.

Section 1.6050P-1(a)(3) indicates that discharged indebtedness must be reported regardless of whether the debtor is subject to tax on the discharged debt. The legislative history underlying the statute states that returns are required regardless of whether the debtor is subject to tax on the discharged debt. "For example, Congress does not expect reporting financial institutions to determine whether the debtor qualifies for an exclusion under section 108." H.R. 103-111 (103rd Congress 1st Sess. p. 758, fnte. 121).

Form 1099-C, on which discharges of indebtedness are reported, states in its instructions to the taxpayer that, generally, canceled debt is reported on the "Other income" line of Form 1040. The instructions also state that some canceled debts are not includible in income and that if a canceled debt is excluded from income a Form 982 should be filed.

Section 108 provides several exclusions that might be applicable to the claimants involved in this settlement. These exclusions have to be applied on a case by case basis and depend on the individual facts and circumstances of each taxpayer claiming the benefit of an exclusion.

Section 108(e)(2) provides that a cash basis taxpayer will not realize income from the discharge of indebtedness to the extent that payment of the debt would have given rise to a deduction. To the extent that the claimants were cash basis taxpayers and the payment of interest would have been deductible, the forgiveness of unpaid interest does not result in income from the discharge of indebtedness. Accrual basis claimants who deducted the unpaid interest in the year that it accrued and, in doing so, received a tax benefit, will have income under the tax benefit rule.

Section 108(a)(1)(B) provides that gross income does not include the income from discharge of indebtedness if the taxpayer is insolvent at the time of the discharge. Insolvency is measured by the excess of the debtor's liabilities over the fair market value of assets immediately prior to discharge. The amount of the discharge of indebtedness income eligible to be excluded under § 108(a)(1)(B) is limited to the amount of the taxpayer's insolvency.

Section 108(a)(1)(C) provides that gross income does not include income from the discharge of indebtedness if the indebtedness is qualified farm indebtedness. This exclusion is limited under § 108(g) to the sum of the taxpayer's adjusted tax attributes and the adjusted basis of the taxpayer's qualified property held as of the beginning of the taxable year following the taxable year of the discharge. Qualified property is property used or held for use in a trade or business or held for the production of income. For the indebtedness to be treated as qualified farm indebtedness § 108(g)(2) requires that (a) the indebtedness must have been incurred directly in connection with the operation by the taxpayer of the trade or business of farming, and (b) 50% of the taxpayer's aggregate gross receipts for the 3 taxable years preceding the taxable year of the discharge must have been attributable to the trade or business of farming. The legislative history states that qualified farm indebtedness is debt that was incurred to finance the production of agricultural products (including timber) or livestock or is farm business debt secured by farmland or farm machinery and equipment used in agricultural production. S. Rep. No. 313, 99th Cong. 2d Sess. 271 (1986). The gross receipts test is an aggregate gross receipts test and not one that must be met on a year by year basis. If the total gross receipts from farming for the three years prior to the year in which the debt was discharged are 50% or more of the taxpayer's total gross receipts for the 3 year period, then the taxpayer can take advantage of this exclusion. The Tax Court has found that gross receipts from the trade or business of farming include gross receipts from the sale of farming equipment. The gross receipts from the sale of the equipment are attributable to the trade or business of farming, even though in liquidation of that activity. The court refused to draw a distinction between the sale of inventory and the sale of capital assets for the purposes of this test. The same court found that rents derived from the rental of farmland were not gross receipts from the trade or business of farming when the trade or business of farming was carried on by the lessee and not the land owner. However the court was dealing with a net lease for a fixed amount per acre, and was not addressing a case where there was a crop share arrangement or other lease that depended on crop production. Lawinger v. Commissioner, 103 T.C. 428 (1994). The insolvency exclusion of § 108(a)(1)(B) must be applied prior to the qualified farm indebtedness exclusion. If the insolvency exclusion doesn't cover all the discharged debt, the qualified farm indebtedness exclusion may then be applied, but only to the extent that there are still remaining attributes and basis to reduce.

It does not appear that either the § 108(a)(1)(A) bankruptcy exclusion or the § 108(a)(1)(D) qualified real property business indebtedness exclusion apply to any of these settlements. The debt is not being discharged in a bankruptcy proceeding so that exclusion will not apply, and to the extent that the debt being discharged is

qualified farm indebtedness, § 108(c)(3) operates to make it ineligible for the qualified real property business debt exclusion.

Both the insolvency exclusion and the qualified farm indebtedness exclusion require that the taxpayer's tax attributes and property basis be adjusted to take into account the excluded income from the discharge of indebtedness. The attribute reductions are described in § 108(b). The statute requires that the attributes be reduced in the following order: NOLs, general business credits under § 38, minimum tax credits, capital loss carryovers, basis of property, passive activity loss and credit carryovers, and foreign tax credit carryovers. However, the taxpayer may make an election under § 108(b)(5) to apply the reductions to the basis of depreciable property first and then make the reductions in the order listed in § 108(b). The basis of property is reduced in accord with § 1017 and § 1.1017-1. In addition, in the case of farm indebtedness, § 1017(b)(4) specifies that the property the basis of which is reduced, is, first, the depreciable qualified property, then the basis of qualified property that is land used in the farming trade or business, and, lastly, the basis of other qualified property. The reductions of attributes and property basis are made after the tax for the year of the discharge has been determined.

If any claimant is eligible for either, or both, of these exclusions and failed to make them, that claimant should file an amended return, including Form 982, for the year in which the debt was discharged, or file a Form 982 with a claim for a credit or refund, if applicable. However, the election under § 108(b)(5) to change the order of the attribute reduction under § 108(b) must be made on a timely filed return (including extensions) for the year in which there is income from the discharge of indebtedness. Therefore, if a taxpayer failed to make this election in a timely manner and wants to make a late election under § 108(b)(5), the taxpayer must request relief under § 7805. The proper method to do so is by requesting a private letter ruling. Rev. Proc. 2000-1, 2000-1 I.R.B. 4, describes the procedure to be followed in this instance.

Contact Person: Chris Kane, CC:IT&A:3, 622-4930

5. If a claimant is deceased, is the income to be reported on a tax return filed on behalf of the deceased claimant? How should the IRS treat any refund that is due to a claimant that is now deceased?

Depending on the date of death and the year in which the amounts at issue (the $t cash payment, the debt relief, and the tax payment) are taxable, these amounts may be reportable on the claimant's final income tax return. Also, these amounts may constitute income in respect of a decedent under § 691.

Generally, if the income is determined to have been paid at a date after the death of an intended recipient and cannot be included on the decedent's final return, it should be income in respect of that decedent under § 691. The consequences of this are: (1) the full value of the payment is includible in the decedent's gross estate, and (2) the estate (or qualified successor who receives the payment from the estate) takes the item into gross income, with the same character that it would have had in the hands of the decedent, but receives an income tax deduction equal to the portion of the estate tax attributable to the IRD included in the estate. This mitigates any double taxation which would otherwise occur.

If there is no estate tax due because of the small size of the estate or for other reasons, then the practical effect of § 691 is simply to pass the item of IRD as income through to the estate or successor.

Contact Persons: Michael Gompertz, CC:APJP:2, 622-8162; Brad Poston, CC:P&SI:2, 622-3060

Additional Questions and Answers

Are the payments received by claimants subject to tax under the Self-Employment Contributions Act (SECA)?

By way of background, §§ 1401-1403 impose a separate tax on the annual self-employment income of every individual. To be taxable as self-employment income, an individual's income must be derived from a trade or business carried on by that individual.[5] To be taxable as self-employment income, there must be a nexus between payments received and a trade or business that is, or was, actually carried on. Payments derived by a farmer from the trade or business of farming are generally subject to SECA tax. However, if the farmer is no longer engaged in farming at the time payments are received, the inquiry turns on whether the payments were generated by prior farming activities.

In Newberry v. Commissioner, 76 T.C. 441 (1981), the taxpayer owned and operated a grocery store that was destroyed by fire, as a result of which he was unable to operate the business for seven months. During that time, he received insurance payments for lost earnings measured by his historical profits. The Tax Court held that the required nexus between the payments and the trade or business

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[5] As a preliminary matter, we note that if the payments are excludable from gross income under § 104, they would not constitute income from a trade or business. Our analysis applies only to payments that are not excludable on this basis.

for SECA purposes did not exist because the taxpayer was not currently engaged in the day-to-day carrying on of the trade or business during the period to which the insurance payments related.

In Rev. Rul. 91-19, 1991-1 C.B. 186, the Service ruled that amounts paid to self-employed commercial fishing boat operators as compensation for losses due to negligence were earnings from self-employment. Although the fishers were unable to fish during the period at issue due to the negligence they were otherwise willing and able to fish. Disagreeing with the Tax Court's analysis in Newberry, the Service ruled that such payments constituted net earnings from self-employment despite the lack of actual fishing. The ruling states that the required nexus between the payment and the carrying on of a trade or business exists if the payment would not have been made but for the individual's carrying on of the trade or business. The holding was applied prospectively. Under the Rev. Rul. 91-19 approach, settlement payments would constitute net earnings from self-employment unless the individual never engaged in farming. In contrast, under the Newberry approach, the settlement payments would be net earnings from self-employment only if they related to periods in which farming was actually carried on. We understand that the a payments do not relate to specific years, making it difficult to apply the Newberry analysis.[6]

In recent years, the courts have been expansive in defining what constitutes net earnings from self-employment in those instances in which an individual was actively involved in farming. For example, in Wuebker v. Commissioner, 205 F.3d 897 (6th Cir. 2000), the Sixth Circuit ruled that payments received by a farmer under the USDA Conservation Reserve Program in exchange for the farmer's agreement to implement a conservation plan constituted income from the trade or business of farming that was subject to the self-employment tax pursuant to § 1401. In that case, there was no dispute that the individual was otherwise engaged in the trade or business of farming. See also Bot v. Commissioner, T.C. Memo. 1999-256, appeal docketed, No. 99-3891 (8th Cir. Oct. 20, 1999).

However, the Service position has not prevailed on the nexus issue when payments were received in connection with the termination of a business. In Milligan v. Commissioner, 38 F.3d 1094 (9th Cir. 1994), nonacq., 1995-2 C.B. 1, the court considered whether termination payments from an insurance company to its former independent contractor insurance agent, Milligan, were subject to SECA tax. The

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[6] Settlements under k will be tailored based on individual circumstances, including a cash payment equal to actual damages and forgiveness of outstanding b loans, thus, the k payments may relate to specific years.

termination payments derived from termination of Milligan's business activity for State Farm, Milligan's compliance with the contractual covenant not to compete, and return of State Farm's property. The court found that the termination payments paid on retirement did not "derive" from Milligan's prior business activity within the meaning of the self-employment tax. Thus, the court held that termination payments derived from the cessation of Milligan's business activity were not subject to self-employment tax.

Based on these authorities, payments received under the h will constitute net earnings from self-employment to the extent that the recipients of such payments were actually engaged in the trade or business of farming at the time of the payment. Conversely, to the extent that any of the claimants can show that they were never engaged in the trade or business of farming, these claimants should clearly not be required to pay self-employment tax with respect to the $t lump sum payment. This would be true, for example, where an individual was attempting to start up a farming business, but was prevented from doing so because he or she was unable to obtain financing from the b. The issue is less clear cut if the farmer was engaged in the trade or business of farming at one time but had ceased to farm before the year in which the payments were made. In such a case, we believe a court is more likely than not to apply the analysis in Newberry and Milligan to conclude that there are no net earnings from self-employment. For this reason, we believe there is legal support for applying SECA only in those cases in which claimants continue to engage in farming in the year in which payments are received.

Forgiveness of b Loans

With respect to the forgiveness of the b loans, Rev. Rul. 76-500, 1976-2 C.B. 254, provides that such cancellation of indebtedness constitutes net earnings from self-employment. In Rev. Rul. 76-500, a farmer had suffered an $8,000 crop loss resulting from a drought. The farmer received an $8,000 loan from the Farmers Home Administration, of which $5,000 of the principal was immediately canceled. The ruling concludes that the canceled portion of the debt must be taken into account in computing net earnings from self-employment. However, as noted above, if the individual is no longer engaged in farming in the year in which the payment is made, the individual should not be required to pay self-employment tax with respect to the cancellation of indebtedness.

Based on Rev. Rul. 76-500, the forgiveness of the b loans should generally constitute net earnings from self-employment. However, § 1402(a) defines net earnings from self-employment as "gross income derived by an individual from any trade or business . . ., less the deductions allowed" (emphasis added), while

§ 108(a) provides an exclusion from gross income for discharge of indebtedness in certain cases. We understand that the determination of whether a claimant is eligible for the § 108(a) exclusion must be made on a case-by-case basis. To the extent that a claimant is eligible for the § 108(a) exclusion, the discharge of indebtedness would also not be subject to SECA tax.

Payment of Tax

For those individuals still engaged in farming, we believe that the $v tax payment on behalf of the claimants made to partially cover the tax liability is also subject to SECA.[7] Although there is no authority on point, this is similar to the situation in Rev. Proc. 86-14, 1986-1 C.B. 304, where the employer paid employee FICA without withholding it from employee's wages. The Service ruled that the amount of the employee's wages under § 3121(a) was increased by the amount of the employee FICA taxes paid by the employer. The increase in the wage payment was also subject to employee FICA taxes, which had the effect of again increasing the employees' wages under § 3121(a) by the amount of the additional taxes paid by the employer. [8]

Social Security Credit

We have been informed by the Social Security Administration that if the settlement payments constitute net earnings from self-employment, claimants will be able to obtain social security credits for the year the settlement payment was made. If settlement payments are subject to SECA and a claimant did not report the settlement payments on a Schedule SE (Form 1040), Self-Employment Tax, for Year 1, the claimant may need to file Form 1040X, Amended U.S. Individual Income Tax Return and Schedule SE with the Service, to correct the claimant's record of net earnings from self-employment with the Social Security Administration.

Contact Person: Margaret Owens, CC:TEGE:EOEG, 622-6040

Do the payments received by claimants qualify for treatment under § 1301, Averaging of Farm Income?

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[7] In the event any of the claimants are entitled to forgiveness of b debt, the actual tax payment will be in excess of $v. The h provides that claimants are entitled to an additional payment of u% of the total award.

[8] Rev. Proc. 86-14 provides a formula for determining an employee's FICA wages in this situation.

Section 1301 provides that an individual engaged in a farming business may elect to reduce the individual's regular income tax liability by treating all or a portion of the current year's farm income as if it had been earned in equal proportions over the prior three years. An individual who elects to proceed under §1301 may average only "farm income," defined under §1301(b)(1)(A)(i) as income that is attributable to a farming business. Section 1301(b)(3) provides that the term "farming business" has the meaning given the term under §263A(e)(4). The term is defined in §1.263A-4T(a)(3) of the temporary regulations. In general, the farming business means a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. Whether a particular item of taxable income is "attributable to" a farming business must be considered.

First, we consider the cash payment of $t. The determining factor when characterizing damages received in the settlement of a lawsuit "'is the nature of the basic claim from which the compromised amount was realized.'" See Raytheon Production Corp. v. Commissioner, 1 T.C. 952 (1943), aff'd, 144 F.2d 110 (1st Cir.), cert. denied, 323 U.S. 779 (1944). For example, where a lawsuit seeks recovery for injured capital, the amounts received by the plaintiff are a return of capital. Id. The h provides that, in order to receive settlement relief, a claimant must demonstrate that the b's treatment of the claimant's credit application(s) led to economic damage. Thus, the relief will compensate claimants for claims of economic, rather than personal, damage. The economic damage that a claimant would have experienced is lost earnings due to an inability to finance a farming business. We conclude that payments received from the b to replace income that would have been earned in a farming business are attributable to a farming business. Thus, the cash payment of $t qualifies for income averaging under §1301.

We reach the same conclusion with respect to the settlement relief in the form of a payment to the Service for taxes. It is possible that a claimant will ultimately owe no tax on any of the three forms of relief and the claimant will receive a refund of the amount paid to the Service. For this reason, we view the payment to the Service in substance as an additional amount of compensation for economic damage, which replaces lost earnings. Section 1301 applies to payments replacing income that would have been earned in a farming business.[9]

Next, we address the relief provided in the form of a discharge of a claimant's outstanding debt to the b. The debt was used to finance farming activity and,

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[9] The characterization as farm income is not inconsistent with the treatment as a tax payment.

therefore, income from a discharge of the debt must be characterized as income from a farming activity. See Rev. Rul. 92-92, 1992-2 C.B. 105 (COD income is income from a passive activity to the extent the debt is allocated to passive activity expenditures). Any amount of the income from discharged debt that is not excludable from gross income under §108 may be averaged under §1301. We believe the conclusions in the preceding paragraphs follow whether or not a claimant was engaged in the farming business in the year of the settlement.

If a claimant elects to average farm income, the current year's tax must be figured on Schedule J (Form 1040). The tax is figured as follows:

> (1) Designate all or a portion of electible farm income for the current year as elected farm income;
>
> (2) Allocate one-third of the elected farm income to each of the three prior (base) years; and
>
> (3) Determine the current year's § 1 tax by determining the sum of --
> (i) the current year's § 1 tax without regard to the elected farm income; plus
> (ii) for each base year, the increase in § 1 tax attributable to the elected farm income allocated to the year.

Income averaging has no application to employment tax (including SECA) liability. For more information, claimants should obtain Publication 225, Farmers Tax Guide.

Contact Person: Judith Lintz, CC:IT&A:3, 622-4930

How might a claimant's past, current, or future bankruptcy affect the administration of the settlement?

A claimant's past, current, or future bankruptcy could somewhat complicate the administration of the settlement. While a claimant's bankruptcy would not, with one exception, affect the character or timing of income, it might affect whether the Service could apply the u% payment to the claimant's liability or offset the amount against other liabilities.[10]

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[10] We note that a prior bankruptcy would have a substantive effect on the amount and timing of income only if the b debt had been discharged in the prior bankruptcy. In that case, since there would be no longer be any b debt to forgive, that part of the h which provides for forgiveness of b loans would not apply and the claimant should not receive a 1099-C for Cancellation Of Indebtedness (COD) income.

The act of filing a bankruptcy petition creates an estate. B.C. § 541(a). In all cases that estate generally consists of all legal or equitable interests of the debtor in property as of the date the petition is filed. Id. For cases in Chapter 12 and 13, the estate additionally consists of all legal or equitable interests the debtor acquires—as well as all earnings from services performed by the debtor—after the petition filing date and before the date the case is closed, dismissed or converted to another chapter. B.C. §§ 1207, 1306.

Property of the estate continues to be property of the estate for various periods of time depending on what chapter governs the case and other factors. For example, in a Chapter 11 case, property of the estate revests in the debtor when the court confirms the Chapter 11 Plan of Reorganization. B.C. § 1141(a). In Chapter 12 and 13 cases, however, while one Code section provides that property of the estate revests in the debtor upon plan confirmation, B.C. §§ 1227(b), 1327(b), another Code section provides that property of the estate continues to be property of the estate until the case is closed, dismissed, or converted to one under another Chapter. B.C. §§ 1207(a), 1306(a). In these cases, it may not be clear when property of the estate has or has not revested in the debtor. Further complicating matters is B.C. § 554, which provides that, for cases in all chapters, property which the debtor reports on the schedule of property attached to the petition and which is not administered in the case is considered abandoned to the debtor and is no longer property of the estate, but property which is not so scheduled and is not administered remains property of the estate, even after the case is closed, B.C. § 554(d). See e.g. Vreugdenhill v. Navistar International Transportation Corporation, 950 F.2d 524 (8th Cir. 1991) (unscheduled cause of action remained property of the estate even after Chapter 7 case closed).

If a debtor has a cause of action for discrimination as of the petition filing date, that cause of action becomes property of the estate. See e.g. Cable v. Ivy Tech State College, 200 F.3d 467 (7th Cir. 1999) (cause of action under Americans With Disabilities Act for wrongful termination of employment was property of the estate when all events constituting the cause of action occurred before the petition filing date); Lamont Richardson v United Parcel Service, 195 B.R. 737 (E.D. Mo. 1996) (where events underlying discrimination suit filed by debtor occurred before the petition filing date, the suit was property of estate and so must be prosecuted for benefit of estate). If a cause of action is property of the estate, then any proceeds recovered through the action are also property of the estate. Id. Therefore, in this situation, if a claimant's discrimination suit was property of a bankruptcy estate, then both (1) the $t cash payment paid directly to the claimant, and (2) the payment to the Service of u% of the direct payments and Cancellation Of Indebtedness (COD) income, would also be property of the estate.

It is important to know whether the proceeds of the settlement are property of the estate because of the automatic stay. A bankruptcy petition operates as an automatic stay of a wide variety of actions. B.C. § 362(a). Specifically, section 362(a)(3) prohibits "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate," while section 362(a)(4) prohibits "any act to create, perfect, or enforce any lien against property of the estate."

While the Service has no control over b's payment of case directly to the claimants, it does have control over those amounts paid to it on behalf of the claimant. If such money is property of the estate, then the Service may be restricted in how uses the money. It may need to turn over the money to a bankruptcy trustee. See B.C. § 542. It may need to seek permission of the bankruptcy court to use the money to offset any other debt owed by the debtor. If the cause of action is also the property of a taxable estate created by I.R.C. § 1398, then the Service may have an administrative claim under B.C. § 503 for the taxes due on the income.

Whether a particular claimant's settlement is property of the estate will depend on various factors, including: when the claimant filed for bankruptcy protection; when the cause of action for discrimination arose; whether the case was filed under Chapter 7, 11, 12, or 13; whether the claimant listed the cause of action on his or her schedule of assets; and whether the bankruptcy case was successfully completed and closed, or was dismissed or converted. In order to evaluate these factors, we recommend that the Service review the transcripts of those claimants who have received payments from b and analyze each claimant's situation individually. Any questions that Special Procedures Branch cannot resolve should be directed to David Breen of the Philadelphia Office of the SBSE Division Counsel, the attorney who is assigned to assist the Philadelphia Service Center. David may be reached at 215-597-3442, although he will be out of the office for the next several weeks. In his absence, questions may be directed to Linda Bednarz at 215-597-3442.

To what extent can the IRS provide information, both taxpayer specific and more general, to f and c with regard to the IRS' efforts in addressing the tax issues raised by the settlement of Lawsuit?

To the extent f and c are seeking information from the IRS in order to apprize g of the status of the settlement, they are not authorized to receive tax returns and return information, as defined in § 6103(b). However, the IRS can provide them with general characterizations of the status of settlement matters and may explain, in general terms, legal questions under consideration by Counsel, e.g. the general approach to determining whether a payment would be considered income, and the

proper year to report income, etc. Such matters must be identified very generally without reference to any particular outcome or tax impact to a particular taxpayer. Similarly, as Counsel reaches conclusions about pending legal issues, the more general the answers, similar to a hornbook recitation of the law, the more likely it will be that we can provide those answers to f and c. However, to the extent the answers to the various legal questions are fact based and fact specific to what happened in this case, or to any particular taxpayer/plaintiff in this case, the less likely it will be that the IRS will be able to provide that information to f and c, to assist them in their respective roles as defense counsel to b and disbursement official for the government, in providing information to plaintiff's counsel or the court, on the status of the settlement and issues related to the distribution of settlement proceeds.

We also understand that in order to reconcile each affected taxpayer's tax account, the IRS will eventually be determining, on a case by case basis, the correct tax obligations and liabilities of each taxpayer/plaintiff in this case. IRS employees charged with reconciling these taxpayer accounts have the same authority to make disclosures of tax information in order to perform their tax administration functions as any other IRS employee performing tax administration duties. Under the authority of § 6103(k)(6) and implementing regulations, IRS employees are specifically authorized to disclose return information (not returns) to the extent that disclosure is necessary in obtaining information which is not otherwise reasonably available with respect to determining the correct amount of tax, liability for tax, or the amount to be collected, or with respect to the enforcement of any other provision of the Code. Section 301.6103(k)(6)-1(b) provides

> In connection with the performance of official duties relating to any examination, collection activity, civil or criminal investigation, enforcement activity, or other offense under the internal revenue laws, an officer or employee of the Service or Office of the Chief Counsel therefor is authorized to disclose return information (as defined in § 6103(b)(2)) in order to obtain necessary information relating to the following –
>
> > (1) To establish or verify the correctness or completeness of any return (as defined in § 6103(b)(1)) or return information;
> >
> > (2) To determine the responsibility for filing a return, for making a return where none has been made, or for performing such acts as may be required by law concerning such matters;

> . . .
>
> Disclosure of return information to a person other than the taxpayer to whom such return information relates ... for the purpose of obtaining information necessary to properly carry out the foregoing duties and responsibilities as authorized by this paragraph ... should be made, however, only if such necessary information cannot, under the facts and circumstances of the particular case, otherwise reasonably be obtained in accurate and sufficiently probative form, or in a timely manner, and without impairing the proper performance of such duties and responsibilities, ...

The disclosure authority found in § 6103(k)(6) does not anticipate a wholesale sharing of return information. Judicial review of § 6103(k)(6) disclosures has closely scrutinized the facts of each case, and each disclosure, to ensure that disclosure of each element of return information is necessary to obtain essential information that is not otherwise reasonably available. See DiAndre v. United States, 968 F.2d 1049, 1053 (10th Cir. 1992) citing Barrett v. United States, 795 F.2d 446 (5th Cir. 1986) (subsequent history omitted). Disclosure is permitted of only that return information that must be made known in order for the IRS to obtain information it needs to properly carry out its official duties and responsibilities with respect to verifying the completeness or correctness of a return or return information. Insomuch as the disclosure of return information pursuant to § 6103(k)(6) is heavily dependent on the facts and circumstances of each case, such disclosure determinations must be made on a case by case basis. Thus, to the extent the IRS needs to disclose return information to f or c in order to receive information needed to properly complete a tax administration function with regard to the taxpayer/plaintiffs, return information can be disclosed, on a case by case basis, in accordance with the requirements of § 6103(k)(6) and its regulations.

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I hope this information is helpful. If we can be of further assistance, please contact me at (202) 622-4800 or any of the contact persons whose names and phone numbers are listed in this memorandum.