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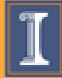

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IRS Shows No Mercy

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When your tax preparer tells you that you must meet the "letter of the law" in a transaction, you should heed their warning.

Congress has been challenging the IRS to close the "tax gap." The tax gap is the difference between the amount of estimated money and what the IRS actually collects. The tax gap is the result of non-filers, under filers (those not reporting all of their income), and those people that file a correct return, but do not pay the full amount. In a recent court case, it appears the IRS has taken the stance that you dare not make a "foot fault" in taking a tax deduction.

In the case of *Durden v. Commissioner* (T.C. Memo 2012-140 (May 17, 2012) the Tax Court ruled against a couple that failed to follow all of the rules even though they were claiming a legal deduction. As you read the summary of this case, consider if you could be in a similar position with deductions you claim. This type of ruling can affect any type of transaction when you do not dot every "I" and cross every "t."

Mr. and Mrs. Durden filed their 2007 income tax return and claimed a charitable contribution of $25,171. Most of the cash and checks were for the donations they had given to Nevertheless Community Church (NCC). Except for five checks, all of the checks were for more than $250. NCC is an IRC §501(c)(3) organization and is eligible to receive tax-deductible contributions. The Durdens received a letter from the IRS questioning the large charitable deduction. The Durdens promptly sent the IRS copies of the checks they had written. They also sent a letter from the church that acknowledged the generous donations totaling $22,517.

The IRS did not accept the first acknowledgement from the Durdens. It disallowed the contribution because the acknowledgement did not specify that the Durdens did not receive any goods or services for their contributions. The Durdens asked the church for a second letter stating that no goods or services were received. Because no goods or services were furnished in exchange for the donation, NCC provided the letter. The IRS again denied the deduction because the second letter was furnished **after** the tax return was filed.

To understand the situation, you need to look at the law. IRC §170(a)(1) allows a deduction for contributions to charitable organizations if they follow the regulations prescribed by the IRS. IRC §170(f)(8) provides that no deduction is allowed for a contribution of $250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement of the contribution by the

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donee organization. The acknowledgement must show the amount of cash and a description (but not the value) of any property other than cash contributed. It must also show whether the donee organization provided any goods or services in consideration for the donation.

IRC §170(f)(8)(C) defines contemporaneous as the earlier of the date on which the taxpayer filed their return for the year in which the contribution was made or the due date (including extensions) for the return.

Based on the Code, the Tax Court made the right decision. The original letter from NCC was dated January 10, 2008, well before the return was due or filed but it did not say that no goods or services were provided. However, the second letter stating that no goods or services were provided was dated June 21, 2009, well after the required dates.

In the past, the Durdens would probably not have had a problem if they met with an IRS auditor in a face-to-face meeting. The court decision indicated this was a correspondence audit. Consequently, the person looking at the return had never met or had any empathy for the taxpayers. They may have been a new employee and their only training was to read the rules. Most field auditors would look at this situation and say there was “no harm, no foul.” The contributions were actually made on a timely basis. The Durdens were not trying to abuse the law; they simply did not realize their first letter from the church was not complete.

In discussing this case with former revenue agents, the opinion was that if the audit was appealed, the appeals agent would have sided with the taxpayer. A case of this type would not normally make its way to the Tax Court as the taxpayer would win before this was necessary. However, the Tax Court had no way to overturn the IRS ruling as the law is very specific and the Durdens were not in compliance.

In the Durden case, the taxpayers had a $7,522 tax deficiency and were assessed a $1,510.40 accuracy-related penalty. This was a high price to pay for what appeared to be a minor error.

Now think about your tax return. Are you in strict compliance with all of the deductions you claim? Think about any forward grain contracts you have. Are you meeting all of the rules? If you are receiving payment in the following year, does the contract specify that you cannot receive any payment until that time? If not, the IRS could rule that you had constructive receipt of the money even though payment was not received.

If you have hedge contracts, are you meeting all of the rules to prevent the IRS from ruling they are speculative contracts? For example, are you properly marking each contract within 24 hours of the time the contract was made? Are you meeting the 35-day rule?

There are specific rules if you are prepaying expenses for the following year. Do you know the rules and are you following them?

You should talk to your tax professional and ask for their opinion about whether the IRS could disallow any of your tax deductions because you did not explicitly follow the rules. If you are unsure of the rules, you should go to the IRS web site (http://www.irs.gov/businesses/small/article/0,,id=159936,00.html) and look at the audit training guide for farmers. This is the publication the IRS will use if you are selected for an audit.