When it comes to the Internal Revenue Code, things don't always turn out the way you-and your client-may have expected. But there are ways to avoid the shock.
We all like surprises, don't we? Well, maybe on birthdays or when we buy that lottery ticket- but when it comes to taxes, surprises are no fun.
The reason is simple: In tax law, surprises mean unforeseen results, which in turn usually mean that more taxes were paid than necessary or that the opportunity to save on taxes was missed. Either way, it's not a good outcome.
But it's not easy to avoid surprises in the tax laws, which are something like the dike that starts springing a leak-you might find a rule in one provision of the Internal Revenue Code that suggests a result, not noticing that another provision reverses the first rule altogether.
Moreover, the tax code keeps changing-through legislation, court decisions, Treasury regulations and rulings of the Internal Revenue Service. Those decisions and interpretations can bring surprising results for irc provisions that practitioners thought they understood.
Careful practitioners must be wary of the contrary impact provisions can have on one another and make sure they understand the full impact of changes in the code or decisions on applying it.
This article focuses on some key areas where tax outcomes are often unexpected.

New rules effective in 1999 have made it easier for more taxpayers to deduct home office expenses.
But a drawback of claiming this deduction becomes apparent when it's time to sell the residence. In 1997, Congress repealed and replaced the rollover provisions of irc § 1034 and the one-time exclusion of $125,000 in gain for taxpayers over 55 (irc § 121).
Under the new provisions, a taxpayer who has owned a residence and used it as a principal residence for at least two of the five years before its sale may exclude up to $250,000 ($500,000 for a married couple) of gain on the sale.
But any portion of the residence being used as a home office does not qualify as part of the principal residence. In that case, the sale exclusion under the two-year rule generally is limited to the gain allocable to the portion not used as a home office.
An exception permits a pro rata allocation of the exclusion if the failure to satisfy the two-year test is due to a change in place of employment, health or, to the extent provided in regulations, unforeseen circumstances.
And even if the two-year period is satisfied, any gain attributable to depreciable deductions after May 7, 1997, would be considered unrecaptured section 1250 gain, which is not eligible for the exclusion.
For many taxpayers, it would be advantageous to cease using a home office for the two years prior to the sale of the residence. This may not always

be practical-no other available office may meet the taxpayer's needs, and not many people can predict that they will be selling their home in two years-but the option should be considered.

The same issue arises if a taxpayer uses a portion of the residence as rental property. The portion of the residence that is rented may not satisfy the two-year personal residence use requirement, and gain would therefore be recognizable. In addition, unrecaptured gain would be recognized under irc § 1250 regardless of whether the two-year use requirement is satisfied.

Regarding the requirement that the taxpayer own the residence for two of the five years preceding sale, the irs has published rulings that a sale by a grantor or beneficiary who is treated as the owner of a trust under the grantor trust rules of irc §§ 671-678 would be treated as a sale made by the owner or beneficiary for purposes of sections 121 and 1034 as in effect before the 1997 amendments.

The continuing validity of those rulings under current law has been verified by the irs in private letter rulings. The irs recently ruled privately (plr 200018021), however, that a taxpayer who resides in a residence owned by a trust that is not considered a grantor trust under irc §§ 671-678 would not be considered the residence owner for purposes of satisfying the ownership requirements of the personal residence ex- clusion provisions.

There are many reasons why a residence may be placed in a trust. In some cases, the goal is to take advantage of spendthrift provisions. In others, the residence may be used to fund a credit shelter or generation-skipping trust for the purpose of reducing estate taxes.

Depending on the situa- tion, it may be advisable to distribute the residence out of the trust to the beneficiary living in the residence (or to a grantor trust with such beneficiary as grantor), who could then hold it for two years prior to sale. It may also be preferable to fund a credit shelter or genera- tion-skipping trust with assets other than the residence, if that would permit the person living in the residence to own it outright. (A residence owned by a decedent at death receives a stepped-up basis, so that only post-death appreciation would be recognizable upon a later sale by a testamentary trust.)

Income of a decedent that was not paid prior to the decedent's death must be accounted for by the estate or the beneficiary to whom it is paid.

This is known as income in respect of a decedent or ird. A number of things, including accrued salary and installment payments, may constitute ird. But probably the most common things are distributions that come from pension, profit-sharing and 401K plans, and from individual retirement accounts.

For purposes of estate taxes, ird items are includable in their gross amounts without reductions for those income taxes that the beneficiaries will ultimately pay.

To make up for this estate tax on assets that will ultimately be used to pay

income tax, an income tax deduction is available in the year the ird is included in income-in an amount equal to the portion of the estate tax that was attributable to the ird item (the section 691(c) deduction).
Therefore, the deduction generally results in a total tax liability equal to the liability that would have arisen had the decedent paid the income taxes on the ird item before death.
Assume, for example, that an estate consists of an ira of $1 million payable to the decedent's daughter, that the estate is in a 50 percent estate tax bracket, and that the beneficiary is in a 40 percent income tax bracket.
The estate would pay $500,000 of estate taxes attributable to the individual retirement account. When the daughter of the decedent withdraws the ira funds, she will claim $1 million in income and deduct $500,000 as a section 691(c) deduction.
The net amount of $500,000 will be subject to income tax at 40 percent, resulting in a tax of $200,000. After paying $500,000 of estate tax and $200,000 of income tax, the decedent's daughter will be left with $300,000.
If the decedent would have withdrawn the ira funds prior to his death, he would have paid income tax of $400,000 (assuming that he was in the same 40 percent income tax bracket as his daughter).
The net amount of $600,000 would have been includable in his estate for estate tax purposes, and it would be subject to an estate tax of $300,000.
The daughter of the decedent would have been left with the same $300,000.
Unfortunately, the section 691(c) deduction is often overlooked. Pension and individual retirement accounts generally have designated beneficiaries, so the assets never pass through the probate estate into the hands of the personal representative.
Unless the personal representative contacts the beneficiary, the beneficiary may very likely have no idea that a deduction is available, and certainly would have no way of calculating the amount of the deduction.
The section 691(c) deduction is based on the estate tax as finally determined. If the Internal Revenue Service audits the estate, the estate tax may not be finally determined for a number of years.
Beneficiaries who take distributions during the interim may be forced to file amended income tax returns to claim the deduction after the estate tax is finally determined.
If an estate tax dispute is not settled at the audit level, it may even be necessary for the beneficiaries to file protective refunds claims to make certain that any income tax deduction resulting from an increase in the estate tax payable will not be barred by the statute of limitations.

Entertaining business clients and prospects often is a necessity in today's business world. But the financial horror of realizing the income tax implications of all these expenses probably has caused many a businessperson to seek consolation in one of those legen- dary three-

martini lunches.
The general rule is that a business (or individual, if there is no reimbursement by an employer) may deduct only 50 percent of expenses of the cost of business meals and entertainment for federal income tax purposes. If a business is willing to educate its personnel and improve its bookkeeping procedures, however, in many instances these costs can be 100 percent deductible.
Section 162 provides the overall guidance for deductibility of business expenses. The primary rule is that ordinary and necessary expenses paid or incurred in carrying on a trade or business (not for personal reasons) are deductible.
Irc § 274 offers more guidance, enumerating additional requirements for deductibility of meals and entertainment: They must be directly related to the active conduct of the taxpayer's trade or business, ordinary and necessary (reasonable, not extravagant), and properly substantiated. Section 274(n)(1) further specifies that the amount deductible for food, beverage or entertainment is limited to 50 percent of the amount spent on items subject to deductibility under section 162.
But there are several exceptions to these rules that often provide complete deductibility of qualified business expenses. Specifically, the following qualify for full deduction:
* Expenses for recreational, social or similar activities provided mainly for the benefit of employees not considered to be highly compensated.
* Expenses directly related to business meetings of employees, stockholders or directors.
* An employee's moving expenses that are includable in the employee's gross income and paid or reimbursed by the employer.
* Expenses for meals not included in an employee's income as a de minimis fringe benefit. So as to qualify as de minimis, and not be included in an employee's income, the property or service must be so small as to make accounting for it unreasonable or administratively impractical.
* Expenses of meals employers provide to employees on-site for the convenience of the employer. Meals so provided must not be a means of disguising additional compensation.
Factors generally suggesting meals are provided for the employer's convenience are that they assure the employee will be available for emergency calls during the designated meal periods, that meal periods are short due to job requirements and the employee could not reasonably eat elsewhere in such a short time period, and that there are insufficient eating facilities near the place of employment.
If properly planned and documented, many meal and entertainment expenses can be converted to 100 percent deductions. Moreover, many of the benefits can be passed on to employees tax free inasmuch as they won't be includable in their incomes-clearly a win-win situation under the irc, for a change.

Even during this period of general economic prosperity, personal and business bankruptcies are at near-record levels.
In general terms, the federal bankruptcy statutes (U.S.C. Title 11) provide that, when a person transfers assets without sufficient consideration within one year before filing bankruptcy, those transfers are, at best, voidable. Debtors seeking relief in such instances are expected to demonstrate that they did not engage in their pre-petition activities in a manner that would intentionally defeat their obligations to creditors. Several courts have ruled that gifts to charities clearly fall within such provisions and have required the affected charities to refund donations to the bankruptcy trustee for subsequent distribution to creditors as part of the bankruptcy estate.
In 1998, Congress passed the Religious Liberty and Charitable Donation Protection Act (Public Law 105-183, 112 Stat. 517), which addresses, at least in part, one problem associated with requiring a charity to refund contributions made to it, especially when such funds have already been spent.
The act set out certain rules to protect charities-and hence, the income tax deductions of the donees in bankruptcy:
* If there is a transfer of a charitable contribution of money or a financial instrument to a qualified religious or charitable entity or organization by a natural person during the 12 months preceding the filing of the bankruptcy petition, and the contribution amount does not exceed 15 percent of the gross annual income of the debtor for the year in which the contribution transfer is made, the contribution may stand.
* If the contribution exceeded the 15 percent limit, it will still be protected if the transfer was consistent with the practices of the debtor in making charitable contributions.
(In addition, charitable gifts may be made, post-petition, if they do not exceed the 15 percent limit.)
In advising a client contemplating a bankruptcy action, the ability to continue honoring social obligations by making qualified charitable contributions should be addressed in virtually all circum-stances. There is solace in being able to continue to support a religious or other type of charity when in dire financial circumstances-as well as an opportunity to reduce the tax burden through a deduction.

Online trading, unlike the more traditional types of securities transactions, enables members of the public to make their own investment decisions and implement them quickly and inexpensively. The ease, speed and availability of services used to obtain current information on stocks and consummate transactions has created a newcomer to the markets: the day trader.

Whether someone dealing in securities can be defined under tax laws as a trader rather than an investor has important tax ramifications.
If a person qualifies as an investor, expenses related to investments are generally not fully deductible as trade or business ex- penses. Instead, they may only be deducted as expenses for the production or collection of income under irc § 212. But as miscellaneous itemized deductions, they are subject to the rule that such deductions only may be claimed if they have an aggregate total of more than 2 percent of adjusted gross income. At the same time, however, gains and losses to investors from securities sales and exchanges are subject to the (generally favorable) capital gains rules.
Being classified as a trader, by itself, does not transform what would otherwise be capital gains or losses into ordinary income or loss. It does, however, make the expenses related to the trade or business fully deductible, so long as they are ordinary and necessary. They may include items such as subscriptions to financial periodicals, clerical assistance and telecommunication expenses. In addition, home office and related expenses may be deducted in determining adjusted gross income rather than being itemized.
Three primary factors are relevant in determining whether a person who manages his or her own securities portfolio is a trader or an investor: The intention of the person's investment decisions; the nature of the income ex- pected to be derived from the activity; and the frequency, extent and regularity of the securities transactions.
Distinct from the trader or investor, a dealer engages in the trade or business of brokering or dealing in commodities or securities transactions. As part of this, a dealer purchases securities from sources and sells them at a markup to customers. Securities held by a dealer are inventory (unless specifically otherwise identified) and are valued using the same general inventory methods as other businesses.
Two special rules apply to dealers: If the securities are inventory, they must be included at fair market value; if not, they must be treated as if they had been sold on the last business day of the year (the "mark to market" rules). The character of any gain or loss due to the mark-to-market requirement normally will be ordinary income or loss. If the security was ever clearly identified in the dealer's records as a security held for investment, any loss may not be considered an ordinary loss.
The 1997 Taxpayer Relief Act accorded traders the privilege of electing to have the mark-to-market rules apply to their holdings. For traders, however, unlike dealers, the character of the securities (if properly identified) changes from capital investments (treating gains or losses recognized as capital gains or losses) to "inventory like assets," resulting in net gain or loss on trading transactions being treated as ordinary gains or losses for tax purposes.
With the continuing clarification of who is a trader and who is an investor, it is becoming easier to advise clients on whether they are entitled to deduct a great number of differing investment-related expenses as business

expenses or a substantially fewer number of such expenses as very limited itemized deductions on their personal income tax returns.
In either case, unless the mark-to-market election is made, the character of the gains or losses recognized continues to remain the same: capital.
When a trader makes the proper election and the required securities identification is done, traders in loss situations-the North American Securities Administrators Association estimates that 70 percent of day traders lose money-would essentially be treated as dealers and, thereby, convert their "limited use" capital losses to ordinary losses.
It would be nice to say that surprising results add a little zest to the code, but in truth, they can bring on reactions that feel a little more like seasickness. To avoid such surprises, keep up with legislation, irs rulings and court decisions relating to the tax code, and be careful about how different code provisions affect one another. And don't forget to turn on all the lights before entering the room where you keep your tax materials.
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