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# GIVE AND TAKE: US TAX TREATMENT OF GIFTS

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This edition will discuss a US tax issue that is remarkably different from Canadian tax law. The subject of gifts – both giving and receiving – is fairly straightforward in Canada, but causes quite a discussion in the United States. Remember if there is a tax treatment different in Canada or the US than the other country, therein lies the opportunity for double taxation or taxation in one country without an offsetting foreign tax credit.

Specifically, we will look at finding or receiving an unexpected prize or windfall, using as an example catching a record-setting baseball while sitting in the stands as a fan during a major league baseball game.

Most people are familiar with the laws around the US gift taxes, which are transfer taxes (separate from income taxes) on any individual giving another individual something for insufficient consideration in return (i.e. a gift). The gift tax is applied at the transfer tax rates (maximum rate of 35% in 2011) and there are a few exceptions such as for gifts to a US citizen spouse, gifts to charity, and an annual exclusion of up to $13,000 to any individual for gifts of a present interest.

There is more controversy in the income tax treatment of gifts. Income taxes are based on a separate section of law than transfer taxes, and as a result, either or both of these taxes may apply under various circumstances.

To understand the issue, you need to be familiar with a couple sections of the US tax law (Title 26 of the United States Code, known as the Internal Revenue Code, or IRC) and US Treasury Regulations (Title 26 of the Code of Federal Regulations). IRC § 61 states that “Except as otherwise provided in this subtitle, gross income means all income from whatever source derived…” and the courts have held that this section should be viewed in the broadest sense.

Treasury Regulation § 1.61-1(a) tells us that income can include property other than cash: “Gross income includes income realized in any form, whether in money, property or services … in the form of service, meals, accommodations, stock or other property as well as cash.” The famous treasury regulation involving this issue, is § 1.61-14(a), which academics and practitioners call the “Treasure Trove” section.

Section 1.61-14(a) states: “Treasure trove, to the extent of its value in United States currency, constitutes gross income for the taxpayer in which it is reduced to undisputed possession.” There is no definition of Treasure Trove in the law, but it is known to mean found items. For further reading in this area, there is an exceptional article in the Florida Tax Review by Joseph M. Dodge titled “Accessions to wealth, realization of gross income, and dominion and control: Applying the ‘claim of right doctrine’ to found objects, including record-setting baseballs” (4 Fla. Tax Rev. 685 (2000)).

Another great article on the Treasure Trove topic is Andrew Appelby’s article, “Ball Busters: How the IRS Should Tax Record-Setting Baseballs and Other Found Property under the Treasure Trove Regulation”, (Vermont Law Review, Vol. 33, p. 43, 2008). Mr. Applebey provides an excellent treatment on two scenarios wherein a fan immediately returns a ball upon catching it, or keeps it.

If the fan returns the ball immediately to the club or player then there is a legal theory that he disclaimed the property and is not subject to income taxation. However, technically there may be some gift tax implication to this transaction. The IRS tried to raise this issue in 1998 when Mark McGwire was about to break the single season home run record. Their announcement over the gift tax consequences caused quite a stir in the US, and they recanted their position by referencing the disclaimer logic. Congress even tried to pass a bill “to clarify the income and gift tax consequences of catching and returning record home run baseballs.” This bill would only have applied to baseballs hit during the 1998 season which exceeded the 61 home run record. It never ended up passing congress.

Regarding fans who do not return caught balls, there is a running disagreement between two camps of academics. First, Professors (Zelenak and McMahon) believe that the gain would be had only upon the ultimate sale of the baseball, and that the Treasure Trove principal does not apply. Under this theory, acquisition of the ball is treated the same way as property created by the taxpayer. The opposing viewpoint is that the ball is a windfall subject to income tax; however, there is in this case the obvious difficulty of valuation. Mark McGwire's 70th home run ball, for instance, sold for approximately $3,000,000.

This issue recalls another famous event in the United States in 2004 when Oprah Winfrey gave away 2005 Pontiac G6 automobiles to audience members at her television show. The windfall for the audience members (depending on their tax bracket) was approximately $6,000 federal and a several hundred dollars of state tax.

The reason this controversy has come to light once again is the recent catching of Derek Jeter's 3,000th career hit on July 9, 2011. A fan caught the ball and gave it back to the Club. However, the Yankees didn't have him leave empty handed. They gave him three bats, three balls and two jerseys signed by Mr. Jeter. They also gave him four suite tickets for their remaining home games and any postseason games. For Sunday's game, the team gave him four front-row Legends seats, which sell for up to $1,358.90 each.

Now the question remains if those items are taxable to the fan. One has to consider the intent of the Yankees organization, and whether they offered these items out of detached generosity, which would be considered a gift and exempt from income tax under Section 102. We know that managers, players, and coaches who use the free tickets allocated to them by the club for friends and family must include the value of those tickets in their income. We don't know with such certainty the value of the jerseys, baseballs, or bats. Would they be considered income at the time of receipt, or only when they are sold? There is quite a debate among tax academics on this issue as above, although the general feeling is that the fan will be paying taxes on his take-away from the game.

It's nice to see when tax issues become the topic of sports water-cooler talk in the office and on the field.

**THIS EDITION'S PRACTITIONER'S NOTES**

The IRS imposes an "accuracy related penalty" of 20% of the tax owing if an examination results in additional tax due to negligence, intentional disregard for the rules or regulations, or a substantial understatement of tax liability. An understatement is considered to substantial when the changes on examination are at least equal to the greater of (i) 10% of the correct tax, or (ii) $5,000.

One of the ways to have the penalty abated is to show reasonable cause and good faith. This means that the taxpayer must demonstrate that they took reasonable steps to assess their proper liability. One of the ways to prove this is to show that the taxpayer relied on professional advice. Treasury Regulation § 1.6664-4(c)(2) defines such advice as "any communication, including the opinion of a professional tax advisor, setting forth the analysis or conclusion of a person, other than the taxpayer, provided to (or for the benefit of) the taxpayer and on which the taxpayer relies, directly or indirectly, with respect to the imposition of the section 6662 accuracy-related penalty. Advice does not have to be in any particular form."

In *Stephen G. Woodsum v. Commissioner*, 136 T.C. No. 29, (2011), the taxpayers filed a joint federal tax return and 27 state returns for the 2006 tax year. The return was 115 pages long and included over 160 information slips that were keyed into the return, with gross income of almost $33,000,000. The owner of the preparation company had over 20 years of experience, and the actual preparer of the return was a CPA.

However, in preparing the return, the preparer missed keying in a 1099-MISC form for $3.4 million. The taxpayers signed the return at a meeting with the preparer in which they discussed the return. They stated that at this meeting, the preparer turned the 115 pages of the return and discussed various items of income and deduction with the taxpayers. The taxpayers characterize this as their "perform[ing] more than a cursory review of the return." However, they do not recall -

- which specific items of income and deduction were discussed at the meeting, or
- the amount of time they spent reviewing the return, or
- the amount of time they spent reviewing the Schedule D and the attachments and statements thereto.

The court, in its holding against the taxpayer stated "Even if all data is furnished to the preparer, the taxpayer still has a duty to read the return and make sure all income items are included." *Magill v. Commissioner*, 70 T.C. 465, 479-480

(1978), affd. 651 F.2d 1233 [47 AFTR 2d 81-1483] (6th Cir. 1981). We do not hold that a taxpayer must duplicate the work of his return preparer, or that any omission of an income item in a return prepared by a third party is necessarily fatal to a finding of reasonable cause and good faith on the taxpayer's part. Rather, for purposes of this opinion, we assume that the reasonable cause defense may be available to a taxpayer who conducts a review of his third-party prepared return with the intent of ensuring that all income items are included, and who exerts effort that is reasonable under the circumstances, but who nonetheless fails to discover an omission of an income item. "

They could not also claim they were relying on professional advice of the tax preparer as the Court held: "There is no evidence that when [tax preparer] instead omitted the $3.4 million, it thereby was exercising 'analysis' or 'judgment' or was making a professional recommendation to petitioners; rather, it was failing, in that specific instance, to carry out petitioners' general instruction. In signing the return thus erroneously prepared, petitioners were not deliberately following substantive professional advice; they were instead unwittingly (they contend) perpetuating a clerical mistake. The defense of reliance on professional advice has no application here."

What we can learn from this is that accuracy in the clerical filling of tax forms for clients is of the utmost importance.