11-21. As part of his assigned work at a state university, a professor developed and patented an invention. Under the collective bargaining agreement between the state and its faculty, the patent is the property of the university if it is related to the field in which the employee/professor regularly works, or if it is developed using university support.

Following these rules, the professor assigned all interests in the invention and the patent to the university. The parties also negotiated a royalty distribution schedule, so that the professor would receive some amount of the royalties paid to the university relating to the patent. Royalties began to be paid to the professor, and the IRS National Office was petitioned as to whether the payments constituted ordinary income or §1235 capital gain. TAM 200249002.

The Service held that the royalties appropriated to the professor qualified for capital gain treatment, because the arrangement was negotiated separately from his extant salary and therefore did not constitute compensation for his time and recurring efforts. The collective bargaining agreement did not address the compensation issue directly, but it was clear by the actions of all parties that payments resulting from the university’s licensing of the patent to a manufacturer in the private sector were not related to (or even contingent upon) the professor’s continued employment with the university. Rather, the payments were derived from the use of the patent by the manufacturer.

The TAM should not be applied outside of the context of royalties on US patents, though, where all rights are assigned by the inventor to another party. §1235 treatment of receipts paid due to the use of a patent are an exception in the Code, meant to encourage technological development only within the realm of patent law. The work products of authors, composers, and other nonpatentable products are not protected by this rule and likely would receive less tax-friendly advice from the National Office.

11-22. Property settlements generally are carried out quickly after a divorce decree is final, with §1041 making the sorting out of the family balance sheet a tax-deferred, basis-carryover event. The taxpayers in *PLR 200221021* took this approach to an extreme, needing more than six years to execute a settlement involving shares in a closely held business.

The divorce court did not require that the shares transferred from husband to wife be re-titled in her name. Rather, it was sufficient for that court that a fair portion of the shares be "apportioned" to her, representing her "true ownership" of them. The couple lived in a state that had adopted marital property rules, which override the literal title rights evident on assets such as the shares involved here. There may have been other reasons not to re-title the shares transferred to the wife, including a preservation of the good name of the business, and enhancement of the shares’ future marketability, and an avoidance of stock transfer and title taxes.

Nevertheless, the wife eventually sued to re-title the shares in a fully legal manner, settling the case in her favor more than six years after the effective date of the divorce. Under §1041, asset settlements are tax-deferred if they occur within one year after the date on which the marriage ceases, or at some later date but still related to the cessation of the marriage. Reg §1.1041-1T does not rule out tax-deferability for transfers that occur more than one year after the date of the divorce, but it does shift to the taxpayers the burden of proof to show that the "related to" test is met, with the Service making a rebuttable presumption that the later transfer is outside of §1041 and produces gross income to the recipient.

Looking to the stated business reasons for the delay in the transfer, and noting that the wife was protected by the state’s marital property laws in the meantime, the national office held that the later transfer was indeed related to the cessation of the marriage. §2516 also was applied, such that no gift taxes were due as a result of the transfer.

11-37. The refund of Federal income tax, due to the results of an audit or the generation of a net operating loss, often triggers a corresponding state income tax refund. To the extent that state income taxes have been deducted by the taxpayer on a prior tax return, this refund constitutes gross income under the tax benefit rule, in the tax year that the refund is “earned” or collected, using the taxpayer’s tax accounting methods. §§111, 451

For an accrual basis taxpayer, there is no gross income until all of the events have occurred that fix the right to receive the income item, and the receipt can be computed as a dollar amount with reasonable accuracy [Reg §1.451-1(a)]. The IRS had ruled that a state income tax refund arising from the carryback of a current year loss created gross income in the year of the loss, rather than at some later point, such as when the funds were received or the loss was approved by the state revenue agency [RevRul 65-190, 1965-2 CB 150]. The basis for this somewhat harsh position was the language of the Regulations, assuming that if only administration actions (like the approval of the revenue department) remained to be completed, the §451 requirements for income recognition were deemed to be met. The 1965 ruling involved a New York state refund, and it was followed by RevRul 69-372, 1969-2 CB 104, involving a similar issue in Colorado.

The Tax Court applied a different rule in *Doyle Dane Bernbach*, 79 TC 101 (1982), holding that such a refund constituted gross income only when the revenue agency formally approved the refund claim. According to the court, because the agency could examine the circumstances of the refund claim and deny all or part of it, the amount of the refund was not fixed until the administrative approval had been granted. Until that point, the taxpayer had no right to receive any funds or tax credit. Not at issue in either the Revenue Rulings or the Tax Court case were specific tax base differences between state and Federal income tax law that would have reduced or deferred the processing of the refund. The IRS nonacquiesced to the *Doyle* holding.

The Service has loosened its rule though, with RevRul 2003-3, 2002-3 CB 252. In that holding, the taxpayer had generated a 2001 net operating loss for state purposes, applying the accrual basis of tax accounting. It filed a Federal Form 1139 to carry back its NOL for Federal purposes, and a state refund claim based on the Federal carryback, in 2002. The New York state tax department informed the taxpayer in 2003 that the state refund claim had been approved.

In the 2003 ruling, the IRS withdrew its prior rulings and its nonacquiescence to *Doyle*. Gross income is created upon the earlier of the notice of the approval of the refund claim, or the receipt of any funds related to the refund. Under this interpretation, approval of an NOL carryback is not just an administrative act but one of a substantial review. Under the facts as presented in the ruling request, the taxpayer recognizes gross income from the state carryback and refund only in year 3.

11-38. Gains on the sale of a residence are excluded from gross income up to $500,000, but losses on residences are not deductible. At a time when real estate show high degrees of volatility, it is a hardship to many taxpayers when a loss on the sale of a residence does not produce any tax savings. But because only losses on income-producing property can be deducted under §165, current law will not support the deduction of such a loss.

The taxpayers in *Turner*, TC Summary 2002-60 (Small Cases Div), found that this rule is applied without exception. After moving out of their long-time home and moving to a new residence in a rural setting, the Turners put their house up for sale "as is." About six months later, the house had not sold, so a three-month period of repair and renovation began. This included kitchen improvements, interior and exterior painting, new carpets and floorings, and other repairs.

The Turners cut their asking price and offered early occupancy in their new listing for a $500 fee, and they received an offer on the home quickly. Never having to rent out the house, the closing took place and the new owners moved in.

In filing their Form 1040 for the year, the Turners were advised by their accountant to classify the period of non-occupancy as business usage, with a resulting business loss on the sale of over $35,000. The $500 credit on the closing statement was listed on the Form 1040 as rental income. The IRS found no business usage had occurred, and assessed about $14,000 in tax and interest, and an accuracy related penalty of over $2,000, for ignoring tax rules and regulations.

The Small Cases Division upheld all of the Service’s charges. Because there never was a tenant occupying the home, the assertion of a conversion to business property could not be supported. The Turners asserted that the home could not be occupied during the renovation period, but the Court saw that the mere offering of the home did not constitute a business conversion. The Turners put the house on the market very shortly after moving into their new residence, another indicator that the property was not being held for its long-term appreciation potential. The Turners received some bad tax advice, but following it on their tax return meant that they were liable for the penalty.

11-43. In Rev. Rul. 68-232, the IRS held that “a valuable and treasured art piece does not have a determinable useful life” and that accordingly, “depreciation of works of art generally is not allowable.” In *Associated Obstetricians and Gynecologists, P.C*., (TC Memo 1983-380), a doctors’ office claimed depreciation deductions for various paintings it displayed on the office walls. While the court held in favor of the IRS and disallowed the deductions, the court noted that Rev. Rul. 68-232 did not apply because the paintings “were more wall decorations than works of art.” In *Simon* (103 T.C. 247, affirmed by the Second Circuit (68 F.3d 41), the IRS argued that antique violin bows could only be depreciated if the taxpayer could establish their useful life. The Tax Court held that if the artwork was not “valuable or treasured” and subject to wear and tear as used by the taxpayer, depreciation should be allowed.

It should be noted that all of these decisions and cases were ruled on before the provisions of the Economic Recovery Tax Act of 1981 (P.L. 97-34) did away with the concept of useful lives in determining depreciable lives. Accordingly, in *Selig* (TC Memo 1995-519), the Tax Court held that the concept of useful life was no longer relevant in determining whether an asset could be depreciated and allowed depreciation deductions for exotic automobiles. The IRS issued AOD 1996-009 disagreeing with the appeal court decisions in *Simon* and *Liddle* (65 F.3d 329) but noted that the *Selig* decision applies to post 1986 years. Accordingly, the artwork in the law firm’s office should be depreciable.