WHAT'S NEW SUPPLEMENT

January 23, 2007

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Table of Contents

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Corrections to 2006 Federal Tax Workbook

Page	Correction or addition
3	In Example 1, change “Kansas” to “Illinois” in all three occurrences.
6	In the attachment box at top of page, change “Form 1099-G” to “**W-2-G**” in two places.
6	Replace the note box with “The IRS has the authority under IRC §6015(f) to grant equitable relief for "any unpaid tax." Therefore, a tax deficiency is not required. However, if the IRS denies equitable relief for "any unpaid tax" which does not involve the assessment of additional tax, the spouse requesting equitable relief does not have the right to contest the denial by IRS at Tax Court. That legal dispute was settled by the 9th Circuit Court of Appeals in the *Ewing* decision. See pages 604-05 for an analysis of the *Ewing* case.”
23	In Example 25, change the reference to, “Assume in Example **24**…”
26	In the first sentence following the heading “Separate Return Itemized Deductions,” the first sentence should begin “If the taxpayers are **married** filing separate…”
39	In Example 1, Jolene is not entitled to the EIC. According to Pub. 17, page 237, if a taxpayer gives a qualifying child away and does not have another qualifying child, they are not eligible for the credit.
41	Scenario 4: The first sentence should read, “In 2006, Bubba and Charlene live together in a **relationship that is not recognized as a** common law marriage **and** is not in violation of local law.
47	In the note box at the bottom of page 47, change 1.5 million to 15 million.
192	Delete the second sentence under the heading "Designated Roth Accounts." (However, the opportunity to fund these employer sponsored...)
238	In Example 3, the accumulated amortization should all be recaptured in the year of sale. Corrected copies of the forms on pages 239–249 are found at the end of this document.
252	First paragraph under “Depreciation for the Year of Exchange” The first line should read “The method of deprecation required for assets in a like-kind exchange varies according to the type of **asset** being depreciated.
276	On line two of the second paragraph under **Recourse versus Nonrecourse Liabilities,** change “Form 1099-A, *Acquisition or Abandonment of Secured Property”* to “Form 1099-C, *Cancellation of Debt.”*
314	In paragraph 3, the second sentence should read, “However, a change in business form from **C corporation to an S corporation** …..”
323	In the first table, under the heading “Tax Allocated” change 35% to **90%** on the first line and change 35% to **10%** on the second line.

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Page	Correction or addition
329	In the third paragraph from the bottom of the page, change "Purco's shareholder" to "**Tarco's** shareholder."
383	In Schedule A, Column E, the date should be "06/01/**05.**"
395	On line 1 of Form SS-4, change the word "Revocable" to "**Irrevocable**," and change number in EIN to **11-**1234567
418	At the bottom of the page, the first sentence of #3 should read, "Partnership share of wages ($20,000) is limited to **$3,600** ($120,000 × 3% × 2 **× 50%**)." In the next sentence, replace $8,200 with "**$4,600.**"
441	Item #4 in the summary should read, "For nonrecourse debt, computing **gain or loss on sale.**"
494	Item #2. **Simplified Deduction Method**, in second line change $100 million to $25 million.
500	Near the bottom of the page, change initials for Form 1120S, Schedule K-1 to O, P and Q
507	On line one the second paragraph under **Gain from Sales of IRC §1202 Small Business Stock,** change" 21%" to "42%."
510	In Example 6, in the line "Tax on the next $850 of…" change the answer from "850" to "**85.**"
	Change "$3,055" to "**$2,290.**"
	In the last sentence change "$2,340" to "**$1,575.**"
539	At the bottom of the page for "Employer Contributions," "Schedule 2," "End of Year 6," "Old Law," change 50% to 80%.
549	Change last heading on the page to read "Practitioner Fees May **NOT** be Used for Pro Se Services
554	In the second line under the observation box change "30%" to "3%."
633	Clarification: In the analysis of both cases on page 633, The taxpayer must reside in the residence 2 of the last 5 years. He need not own the property for 5 years.
642	In the table discussing the simplified per diem rates, the column heading for the **middle column** should read **"January 1 – September 30, 2005"** and **right column** should read **"October 1, 2005 – September 30, 2006."**
	After the book went to press the rates for October 1, 2006 – September 30, 2007 were released in Rev. Proc. 2006-41. These rates are: high cost areas $246 ($188 lodging); $58 for M&EI and low cost areas $148 ($103 lodging); $45 for M&EI.

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Page	Correction or addition
645	The 2006 standard deduction for head of household is $7,550 and the standard deduction for a taxpayer claimed as a dependent is $850.
646	The 2006 maximum deductible contribution to a SIMPLE plan for a person age 50 and over should be $12,500 not $14,500.

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RETURNS WITH EXTENDER PROVISIONS

IRS BEGINS PROCESSING 1040 INDIVIDUAL RETURNS WITH EXTENDER PROVISIONS ON FEBRUARY 3.

The IRS issued a news release IR-2007-03 on January 9, 2007, announcing a February 3 start date for processing both e-file and paper 1040 individual returns involving key extender provisions, including deductions for state and local sales tax, higher education tuition and fees, and educator expenses.

In addition, the following forms cannot be e-filed until February 3:

- Form 3800, General Business Credit;
- Form 8834, Qualified Electric Vehicle Credit;
- Form 8859, District of Columbia First-Time Homebuyer Credit; and
- Form 8907, Non-conventional Source Fuel Credit.

The implementation date for e-filing Form 6765, Credit for Increasing Research Activities, has not been determined.

An ERO may prepare and hold tax returns claiming an extender-related deduction until the IRS can accept the e-file returns. The ERO must advise the taxpayers that the returns will not be e-filed until the IRS can accept the e-file returns. Returns that are held prior to the date that electronic returns may be transmitted to the IRS are not considered stockpiled.

After the drain on February 3 at 11:00 a.m. Eastern Time, the IRS will **only accept** electronic returns using the new format which includes the extender changes.

HOW TO CLAIM EXTENDED DEDUCTIONS ON 2006 RETURNS (IRS News release IR 2006-195, December 22, 2006)

Background

The following deductions were scheduled to expire but were extended to 2006 by the Tax Relief and Health Care Act of 2006 (TRHCA):

- State and local sales taxes (Schedule A)
- Tuition and fees deduction (Form 1040, page 1)
- Educator expenses (Form 1040, page 1)

Analysis and Conclusion

Because the IRS sent the 2006 tax forms to the printer prior to the passage of TRHCA, the 2006 Schedule A and Form 1040 contain no lines for the deduction of the three extended deductions. Therefore, the deductions will be claimed as follows on 2006 returns:

- **State and local general sales tax.** They may be claimed on line 5 **on the 2006 Schedule A** in lieu of deducting state and local income taxes. If the sales tax deduction is elected, "ST" will be entered on the dotted line to the left of the entry space for line 5.
- **The up to $4,000 tuition and fees deduction.** This may be claimed on **line 35 on the Form 1040**, the line for Domestic production activities deduction. If the deduction is claimed, **"T"** will be entered on the dotted line to the left of the entry space for line 35.
- **The up to $250 educator expense deduction.** This may be claimed on **line 23 on the Form 1040**, the line for the Archer MSA deduction. If the deduction is claimed, **"E"** will be entered on the dotted line to the left of the entry space for line 23.

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TAX RELIEF AND HEALTH CARE ACT OF 2006 (TRHCA)

Congress passed the anticipated bill which extended tax breaks for millions of taxpayers. The bill was signed by President Bush on December 20, 2006.

Much of the bill simply extends existing legislation which expired on December 31, 2005. The bill changed the expiration dates of many of these provisions to December 31, 2007. Other sections of the bill made expired provisions a permanent part of the tax code and made technical changes to others. In addition, the bill added new provisions to the Internal Revenue Code including enhancements of Health Savings Accounts.

Following is a recap of the changes made to existing provisions:

Description	IRC Section	New Expiration Date
State and local sales tax deduction	164(b)(5)(I)	12/31/07
Higher education tuition deduction	222(e)	12/31/07
Teacher's classroom expense deduction	62(a)(2)(D)	12/31/07
Leasehold improvements deadline	168(e)(3)(E)(iv)	12/31/07
Qualified restaurant property deadline	168(e)(3)(E)(v)	12/31/07
New markets tax credit	48D(i)(6)	12/31/08
Earned income tax credit for combat pay	32(c)(2)(B)(vi)(II)	12/31/07
GO Zone bonus depreciation deadline	1400N(d)(6) and 1400N(e)(2)	12/31/10
Deduction for energy efficient commercial buildings	179D(h)	12/31/08
Credit for residential alternative energy expenditures	25D	12/31/08
Clean renewable energy bonds	54(f)(1), 45(f)(2), and 45(m)	12/31/08
Archer medical savings accounts	220(i)(2)	12/31/07
Indian employment tax credit	45A9F)	12/31/07
Accelerated depreciation for business property on a Native American reservation	168(j)(8)	12/31/07
D.C. Enterprise Zone and first-time homebuyers tax breaks	1400(f)(1) and 1400(f)(2)	12/31/07
Imputed interest on below market loans to qualified care facilities	7872(h)(4)	Made permanent
Authority to disclose taxpayer identity for employment reporting	6103(d)(5)(B)	12/31/07
Capital gain treatment on self-created musical works	1221(b)(3)	Made permanent
IRC §355 active trade or business test	355(b)(3)(A) and 355(b)(3)(D)	Made permanent

HEALTH SAVINGS ACCOUNTS

TRHCA made changes to health savings accounts (HSAs) which should increase their popularity.

IRA Rollover to HSAs Allowed After 2006

Traditionally, amounts distributed from an IRA are included in gross income by the payee. There are some exceptions to this rule such as distributions which are rolled into another qualified IRA. TRHCA expanded HSAs as plans into which an IRA can be rolled, but there are limitations to the rollover:

1. No HSA deduction is allowed for the rollover amount.
2. Rollovers from SEP and SIMPLE IRA may not be rolled into an HSA.
3. While a rollover from a Roth IRA is eligible for the HSA contribution, a calculation of basis is required. The aggregate amount distributed from an IRA is treated as includible in income to the extent of the aggregate amount that would have been includible in income if all amounts from all IRAs were distributed. This means a distribution is treated as coming first from income, for purposes of the HSA rollover, to the extent that the IRAs consisted of amounts that would have been taxable upon distribution.

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Example 1. Larrett has an IRA with a $75,000 balance. This consists of $20,000 of after-tax contributions and $55,000 which will be taxable upon withdrawal. On January 15, 2007, Larrett decides to roll $2,000 into his HSA. The entire $2,000 is considered to have come from income as $2,000 is less than the $55,000 taxable amount. As of June 1, 2007 the IRA has earned an additional $1,500 of income. On June 2, 2007, Larrett withdraws $5,000 from the IRA. He will report $3,658 of income due to the withdrawal.

	Nontaxable	Taxable	Total
IRA beginning balance on 1/1/2007	$20,000	$55,000	$75,000
Rolled to HSA on 1/15/2007		(2,000)	(2,000)
IRA balance on 1/15/2007	$20,000	$53,000	$73,000
Additional earnings through 6/1/2007		1,500	1,500
IRA balance on 6/1/2007	$20,000	$54,500	$74,500
6/2/2007 taxable withdrawal ($54,500 ÷ $74,500 × $5,000 = $3,658)	(1,342)	(3,658)	(5,000)
IRA balance after withdrawal	$18,658	$50,842	$69,500

4. The amount of an IRA rollover to a HSA which can be excluded may not exceed the maximum annual HSA contribution limit based on the type of HSA for the year of the rollover.
5. This is a one-time only election and is irrevocable.
6. There are a number of other restrictions.

The new rules are effective for tax years beginning after December 31, 2006.

Note. As of December 31, 2006, approximately 3.6 million taxpayers have HSAs.[1]

Rollover from health FSAs and HRAs

A one-time rollover from a health FSA or HRA may be made to a HSA through 2011. Health reimbursement accounts and health flexible spending accounts are used by employers to reimburse employees for medical expenses. Normally, these are funded with pre-tax dollars. Generally, an employee with a FSA or HRA is not eligible to contribute to an HSA. Contributions to an HSA can be made if:

1. The HRA or FSA has a limited purpose,
2. The HRA is suspended,
3. The plan is a post-deductible health FSA or HRA, or
4. The plan is a retirement HRA.

Under TRHCA, employers can roll over unused health FSA and HRA benefits to an HSA. This is a one-time provision which expires at the end of 2011. The rollover must meet the requirements of a qualified HSA distribution.

1. The distribution may not exceed the lesser of the balance in the health FSA or HRA:
   a. On September 21, 2006; or
   b. As of the date of the distribution; and
2. Is contributed by the employer directly to the HSA before January 1, 2012.

These rules are effective on December 20, 2006.

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1. www.hsafinder.com

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Limit on HSA Contributions Not Restricted to the Required High-Deductible Health Plan's Deductible After 2006

Prior to the passage of TRHCA, monthly contributions to an HSA were limited by law. The monthly limits for 2006 are:

1. If the plan was a self-only high deductible health plan (HDHP), the lesser of one-twelfth of the plan's deductible or $2,250.
2. If the plan was for family coverage under a HDHP, the **lesser** of one-twelfth of the plan's deductible or $4,500.

Beginning in 2007, TRHCA removed the HDHP's deductible limits provision and replaced them with fixed dollar amounts. These fixed annual dollar amounts are indexed for inflation. For 2007. these annual amounts are up to $5,650 for family coverage and up to $2,850 for self-only coverage, regardless of when the HDHP was established.

The new rules are effective for tax years beginning after December 31, 2006.

Employers Can Make Larger HSA Contributions for Nonhighly Compensated Employees After 2006

Employers who make contributions to employee HSA plans may not discriminate between comparable participating employees. The contributions must be comparable, meaning the same amount or the same percentage of compensation. TRHCA now allows an employer to make a larger contribution to a nonhighly compensated employee's HSA than to a highly compensated comparable employee.

Highly compensated employees are defined to include any employee who:

1. Is a 5% owner at any time during the year or preceding year, or
2. For the preceding year:
   a. had compensation in excess of $80,000 and
   b. if elected by the employer, was in the top paid group.

TRHCA continues to prevent discrimination between nonhighly compensated employees. These rules become effective for tax years beginning after December 31, 2006.

COLA Adjustment for HSA and HDHP Dollar Amounts Modified

For tax years beginning after December 31, 2007, The IRS will determine the new HSA contribution limits using a cost-of living adjustment based on the twelve months ending on March 31 rather than August 31.

HSAs Established During the Year are Eligible for a Full Year HSA Contribution.

Old Law. If an individual establishes a HDHP during the year, he is only eligible to make HSA contributions for the months the HDHP is in effect. For example, Tanya established a HDHP on October 1, 2006. She is entitled to make and deduct three monthly HSA contributions for 2006.

New Law. The new law allows Tanya to make deductible contributions for the entire year of 2007 as long as she establishes her HDHP before December 31, 2007. However, she must maintain the HDHP, and remain an eligible individual, through a "testing period." The testing period begins with the last month of the tax year and ends on the last day of the twelve months following that month.

> **Example 2.** Tanya established a HDHP on November 1, 2007. Even though she was not eligible for an HSA in the months prior to November, she can make and deduct HSA contributions for the entire year. She must remain an eligible individual through October 2008 or include her HSA contribution in gross income in 2008 and include a 10% penalty based on the contributed amount in taxes.

These rules are effective for tax years beginning after December 31, 2006.

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INCENTIVE STOCK OPTIONS

IRC §§6039(a), 6039(b) and 6724 (d)(1)(B)(xix)

When a corporation transfers a share of stock to any employee who exercises an incentive stock option (ISO), the corporation must furnish that person with a written statement containing information about the transfer. A similar statement must be furnished if it transfers stock acquired through the exercise of an option granted under an employee stock purchase plan (ESPP), provided the option is priced between 85% and 100% of the value of the stock.

The IRS can assess a penalty if these statements are not furnished on time or do not report the required information. However, there is no requirement to furnish a similar statement to the IRS.

TRHCA now requires the corporation to furnish a similar statement to the IRS. This new rule is effective for calendar years beginning after December 20, 2007.

MENTAL HEALTH PARITY REQUIREMENTS

IRC §9812(f)(3)

Group health plans may provide medical, surgical, and mental health benefits. Plans that contain all three benefits may not impose limits on the aggregate lifetime or annual dollar limits to mental health benefits that are not imposed on substantially all medical and surgical benefits. Failure to comply with the parity requirements can result in IRS imposing an excise tax.

Old Law. Under the prior law the mental health parity requirements did not apply for services furnished:

1. On or after September 30, 2001 and before January 10, 2002;
2. On or after January 1, 2004 and before October 4, 2004; and
3. After December 31,2006.

New Law. TRHCA applies the excise penalty for failure to comply with the parity rules through December 31, 2007. This rule is effective on December 20, 2006.

RESEARCH CREDIT

IRC §§ 41(h)(1)(B) and 45C(b)(1)(D)

TRHCA changes the expiration date on the research credit from December 31, 2005 to December 31, 2007. The credit is 20% of the amount research exceed a specific base amount.

Rates for the Elective Alternative Incremental Research Credit are Increased

IRC §41(c)(4)(A)

Qualifying taxpayers have an option to claim an alternative incremental research credit rather then the research credit. TRHCA increases the rates for the alternative credit.

The alternative research credit applies only to amounts paid through December 31, 2007. Fiscal year taxpayers must use a formula to determine the amount of the credit.

Alternative Simplified Credit can be Elected for Qualified Research expenses

IRC §§ 41(c)(4) and 41(c)(5)

This is a new credit established by TRHCA. This credit is 12% of the excess of the qualified research expenses for the tax year over 50% of the average qualified research expenditures for the three tax years proceeding the tax year for which the credit is being determined.

The credit is 6% for those taxpayers who have no qualifying research expenses in the prior years.

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MORTGAGE INSURANCE PREMIUM DEDUCTION FOR 2007 ONLY

IRC §163 and 6050H

TRHCA provides a **new** tax deduction for those individuals who purchase a home and buy qualified mortgage insurance. **The provision treats the mortgage insurance premium as qualified residence interest for 2007 only.** The mortgage insurance premium is not treated as part of the limitation on acquisition indebtedness.

There is a phaseout on the deduction based on the taxpayer's AGI. For all but married filing separate taxpayers, the deduction must be reduced by 10% for each $1,000 of AGI that exceeds $100,000 or fraction thereof. For married filing separate taxpayers, the phaseout amount is $500 for each $1,000 of AGI that exceeds $50,000 or fraction thereof.

> **Example 3.** John and Mary file 2007 a joint tax return. Their AGI is $105,500 and they paid $2,500 of qualified home mortgage insurance. They must reduce their allowable deemed interest deduction by 60%, or $1,500. They will be entitled to deduct $1,000 ($2,500 – the $1,500 reduction) on their 2007 Schedule A as qualified residence interest.

Prepaid mortgage insurance premiums are deductible only in the year allocable. Because this deemed home mortgage interest deduction is in effect only for 2007, no deduction will be allowable for prepaid premiums. If the mortgage insurance is provided by the Veterans Administration (VA) or Rural Housing Administration (RHA) and the premium is for the entire life of the loan, the entire premium is deductible if paid in 2007.

ALTERNATIVE MINIMUM TAX

Portion of Minimum Tax Credit Made Refundable

IRC §53(e)

The alternative minimum tax (AMT) may exceed a taxpayer's regular tax. If this is the case, he will add the excess amount to his regular tax liability. The AMT which is generated by deferral items produces a tentative minimum tax credit. This credit can be used in a later year if the regular tax exceeds the tentative minimum tax. In case the regular tax in the later year is reduced by the minimum tax credit.

Old Law. The minimum tax credit for a year is limited to the excess of the taxpayer's regular tax liability reduced by the **nonrefundable** personal credits and business-related credits less the tentative minimum tax. The minimum tax credit is a nonrefundable credit. In many cases, the minimum tax credit was created because of AMT paid in a prior year when an incentive stock option was exercised.

> **Note.** See pages 59–63 in the *University of Illinois Federal Tax Workbook* for a thorough analysis of the minimum tax credit rules that existed prior to enactment of TRHCA.

New Law. For tax years beginning after December 20, 2006, TRHCA provides that an individual's minimum tax credit for years beginning before January 1, 2013 cannot be less than the AMT refundable credit amount.

The "AMT refundable credit amount" is defined as an amount equal to the **greater** of:

1. The **lesser** of
   - a. $5,000, or
   - b. The amount of the "long-term unused minimum tax credit" for the tax year, or
2. 20% of the amount of the long-term unused minimum tax credit.

The AMT refundable credit is phased out for high-income taxpayers.

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Example 4. Tamara has a $17,000 minimum tax credit carryforward to her 2007 tax return. The carryforward was created by Tamara's exercise of an incentive stock option in 2003. Her 2007 regular tax is $3,000 and her 2007 tentative minimum tax is zero. Under prior law, the amount of her allowable minimum tax credit on the 2007 Form 8801 would have been $3,000.

Under the new rules of TRHCA, the amount of her "AMT refundable credit" for 2007 is $5,000, determined by applying the formula shown above. She is not subject to the phaseout limitation.

Note. The result of the new rules is that beginning with 2007 tax returns, individuals with minimum tax credit carryforwards will be able to use them over a five-year time period. These new rules are intended to benefit taxpayers who created AMT liability in a prior tax year when they exercised an incentive stock option.

These rules are effective for tax years beginning after the December 20, 2006 and before January 1, 2013.

AMT Refundable Credit May Result in Negative Amount of Tax in Deficiency Computation

IRC §6211(b)(4)(A)

A deficiency is defined as the amount by which a taxpayer's correct tax liability exceeds:

1. The tax shown on the return, plus
2. The amounts previously assessed as a deficiency, reduced by
3. The amount of any rebate.

Old Law. The amount by which refundable credits exceed the tax imposed is taken into account as a negative amount of tax. Therefore, Tax Court deficiency procedures apply to these credits even though they reduce net tax to zero. This treatment applies only to the additional child tax credit, the gasoline and special fuels credit and the earned income credit.

New Law. TRHCA added the AMT refundable credit to the refundable credits which can be taken into account as a negative amount of tax.

This rule is effective for tax years beginning after December 20, 2006.

PENALTY FOR FILING FRIVOLOUS TAX RETURN

IRC §6702

In a further attempt to curb the filing of frivolous tax returns, TRHCA increases the penalty from $500 to $5,000. A frivolous tax return is defined as a return which does not contain substantially correct information to calculate the tax liability.

TRHCA broadens the types of returns to which the penalty applies from income tax returns to all types of Federal taxes. The increased penalty now applies also to frivolous submissions for lien and levy collection due process, installment agreements, offers-in-compromise and taxpayer assistance orders.

The new law is effective for submissions made and issues raised after IRS provides a list of frivolous submissions under IRC §6072(e).

INCENTIVE FOR MINE SAFETY TRAINING AND EQUIPMENT

IRC §§ 45N, 38(b)(31), and 280(c)(e)

A 20% general business credit is available for training expenses of mine rescue teams. The law provides definitions of qualified mine rescue teams, eligible employees and wages.

This law is effective for amounts paid or incurred after December 31, 2005 and before January 1, 2009.

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ENHANCES HOME-SALE EXCLUSION RULES FOR MEMBERS OF THE INTELLIGENCE COMMUNITY

IRC §121

To qualify for the $250,000/$500,000 income exclusion on the gain from the sale of a personal residence, the taxpayer must have owned the residence and used it as his personal residence for two of the prior five years ending on the date of exchange or sale. If the sale or exchange is triggered because of health, employment or unforeseen circumstances, the taxpayer may be entitled to a reduced exclusion amount.

Taxpayers who are away from the residence because of service in the uniformed services or U.S. Foreign Service may suspend the five year period for up to ten years. TRHCA extends this exclusion to employees of the intelligence community.

Members of the intelligence community include:

- Office of the Director of National Intelligence;
- Central Intelligence agency;
- National Security Agency;
- Defense Intelligence Agency;
- National Geospatial-Intelligence Agency;
- National Reconnaissance Office;
- Any other office within the Department of Defense for the collection of specialized national intelligence through reconnaissance programs;
- Any of the intelligence elements of the Army, Navy, Air Force, Marine Corps, Federal Bureau of Investigation, Department of treasury, and Coast Guard;
- Bureau of Intelligence and Research of the Department of State; and
- Any of the elements of the Department of Homeland Security concerned with the analyses of foreign intelligence information.

To qualify for the extension, the member of the intelligence community must be on official extended duty at a duty station outside of the U.S. The sale of exchange must occur before January 1, 2011 for the suspension period to apply.

> **Example 5.** Dana, a single taxpayer, is employed by the National Security Agency. She is stationed in Chicago, Illinois and purchases a condo there on January 5, 2001. She moves into the condo immediately after the closing. On January 10, 2002, she is assigned to a duty station in Columbia where she remains until January 2010. She returns to the U.S. and sells the condo in February 2010.
>
> Dana lived in the condo for only 12 months. She may elect the ten-year suspension and qualify for a reduced IRC §121 exclusion of $125,000 or ((12 ÷ 24) × $250,000.)

This provision is effective for sales or exchanges after December 20, 20056 and before January 1, 2011.

EXPANDS IRC §199 DEDUCTION TO U.S. BUSINESSES WITH MANUFACTURING OPERATIONS IN PUERTO RICO

IRC §199(d)(8)

For the first two tax years beginning after 2005, TRHCA retroactively allows the domestic production activity deduction for production activities in Puerto Rico. Any wages paid to bona fide residents of Puerto Rico are included when calculating the 50% of W-2 wages limitation.

These new rules are effective for the first two tax years of a taxpayer beginning after December 31, 2005 and before January 1, 2008.

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SUSPENSION OF LIMIT ON PERCENTAGE DEPLETION FOR OIL AND GAS FROM MARGINAL WELLS

IRC §613A(c)(6)(H)

In certain cases, taxpayers may recover their gas and oil well investments through the use of percentage depletion. However, they are restricted in the amount they may deduct. The deduction is limited to 100% of the taxable income from the property in any year. Gas and oil produced from marginal wells are subject to special percentage depletion rules.

TRHCA suspends the 100%-of-taxable-income limitation on percentage depletion from marginal gas and oil wells for years beginning before January 1, 2008. As a result, independent producers will realize the full benefit of percentage depletion.

The suspension is effective for years beginning after December 31, 2005 and before January 1, 2008.

BONUS DEPRECIATION

"Qualified Cellulosic Biomass Ethanol Property" Eligible for Bonus Depreciation and AMT Relief

IRC §168(l)

TRHCA entitles qualified cellulosic biomass ethanol property (QCBEP) to a 50% depreciation allowance in the year it is placed into service. There are specific requirements to be met before the bonus depreciation is allowed.

No AMT adjustment is required if the property qualifies for the bonus depreciation. To qualify, the property must be placed into service before January 1, 2013. This provision applies to cellulosic ethanol which is derived from switch grass, wood fibers, shell hulls, agricultural residue and other organic sources.

WHISTLEBLOWER REWARDS INCREASED

IRC §§7623 AND 7443a

Old Law. IRS can pay informers up to 15% of the amount collected due to information provided regarding underpayments and the violation of tax laws. The rewards can be between $100 and $10 million.

New Law. TRHCA authorizes IRS to pay rewards for information regarding violations of tax law. The reward range for such information is 15% to 30%, of the amount collected by the IRS, including penalties and interest where the amount disputed exceeds $2 million.

The new law is effective for information provided on or after December 20, 2006.

RULINGS AND CASES

AGRICULTURAL ISSUES

Livestock Replacement Period

Notice 2006-91, September 28, 2006

IRC §1033

☞ **IRS Extends Replacement Period for Livestock Sold Because of Weather**

Facts. If livestock are sold because of extreme weather conditions IRS is authorized to extend the replacement period if the weather conditions continue for more than three years. The IRS Notice lists counties in 35 states which qualify for the extended replacement period.

Analysis and Holding. IRC §1033(a) allows nonrecognition of gains when property is involuntarily converted and replaced with similar property. §1033(e)(1) provides that a sale or exchange of livestock held by the taxpayer for draft, breeding, or dairy purposes in excess of the number that would be sold following the taxpayers usual business practices is treated as an involuntary conversion if sold solely on account of drought, flood, or other weather-related conditions.

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Gain on the livestock sale is recognized only to the extent the amount realized exceeds the cost of replacement property. The normal replacement period is four years after the close of the first year in which the gain from the conversion is realized. The regulations allow the IRS to extend the replacement period on a regional basis for an appropriate amount of time if the area is designated as eligible for assistance by the federal government for more than three years.

Notice 2006-91 lists all of the counties which are eligible for the extended replacement period.

Conservation Security Program

Revenue Ruling 2006-45, September 25, 2006
IRC §126

☞ Cost-share Payments May Be Excluded from Gross Income

Background. IRC §126(a)(9) allows certain conservation payments to be excluded from gross income. The Conservation Security Program (CSP) is a conservation program administered by the U.S. Department of Agriculture (USDA). A producer who wishes to participate in the CSP must enter into a long-term conservation security contract with the USDA.

Analysis and Holding. The excludible portion of the payment is limited to the portion that:

1. Is determined by the Secretary of Agriculture to be made primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, improving forests, or providing habitat for wildlife;
2. Does not substantially increase the income derived from the property; and
3. Is properly associated with the deductible expense.

Payments in the nature of rent or compensation for services do not qualify for the exclusion.

The IRS has accepted the USDA's position that the CSP is a small watershed program. Consequently cost-share payments received are excluded from gross income to the extent permitted by §126.

Income Averaging

TIGTA Report No. 2006-30-158, September 22, 2006
IRC §1301

☞ Over 4,600 Fishers Could Benefit From Income Averaging

Background. Prior to the American Jobs Creation Act of 2004 (AJCA), farmers and fishers who chose to income average lost a portion of the benefits due to the alternative minimum tax. AJCA solved this problem by excluding the income averaging savings from the AMT calculation. In a recent report to the IRS, the Treasury Inspector General For Tax Administration (TIGTA) reported that over 4,600 fishers could have saved an average of $530 by income averaging.

Analysis and Holding. The Joint Committee on Taxation estimated this provision could say fishers up to $61 million in taxes over the next decade. TIGTA blames the failure to use income averaging on lack of knowledge by taxpayers and paid tax returns preparers. The 4,600 taxpayers represent 90 percent of the fishers who could have benefited. Consequently, the IRS will be publicizing the benefits of income averaging in the future.

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Conservation Reserve Program

Notice 2006-108, December 5, 2006

IRC §§61, 102 and 1402

☞ IRS Holds That All CRP Payments are Subject to Self-Employment Tax

Background. In a Chief Counsel Advice (CCA) letter in 2003, the IRS stated that **all** CRP payments were subject to self-employment tax.[2] This letter ruling was directly contrary to a prior letter ruling.[3] The CCA ruling stated all payments under the CRP program were taxable for self-employment tax. Whether the recipient was a materially participating farmer was of no consequence.

Analysis and Holding. Notice 2006-108 is a proposed revenue ruling. It agrees with the position taken by the IRS in the 2003 CCA, but allows interested persons to comment on the proposal. The notice says that CRP payments are not made for the right to use or occupy land. Instead they are received in exchange for performing tasks "that are intrinsic to the farming trade or business" such as tilling, seeding, fertilizing and weed control.

Comments regarding the proposed revenue ruling may be submitted to the IRS before March 19, 2007. They should be mailed to:

Internal Revenue Service
Office of the Associate Chief Counsel
(Tax Exempt and Government Entities) CC:TEGE
1111 Constitution Ave., N.W., Rm. 4000
Washington, DC 20224
Attn: Elliot Rogers

Comments may be submitted electronically to **notice.comments@irscounsel.treas.gov** and should reference Notice 2006-108.

ALTERNATIVE MINIMUM TAX

State and Local Tax Deduction

Naila M. Qureshi v. United States; **U.S.C Court of Appeals, Federal Circuit, 06-5002, September 6, 2006**

IRC §55

☞ State and Local Income Tax Increased AMT

Facts. Total itemized deductions reported for 2002 included state and local income taxes of $5,158 and miscellaneous itemized deductions of $26,681. The taxpayer failed to report the $5,158 as an itemized deduction. She also failed to compute the alternative minimum tax. Her return was selected for audit and the IRS increased her itemized deduction by $5,158. IRS also calculated the AMT and reduced the refund reported on the tax return.

The taxpayer also said the Taxpayer Advocate Agency did not provide proper service and failed to comply with the IRS Manual. She argued any assistance provided during the audit process should favor her.

The Court found in favor of the IRS and the taxpayer appealed the decision.

2. CCA 200325002 (See page 217 in the 2003 *University of Illinois Federal Tax Workbook*

3. LTR 8822064 (March 7, 1988)

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Analysis and Holding. The Court recognized that the tentative minimum tax is based solely on taxable income with certain adjustments. In this case the total tax is solely based on the alternative minimum taxable income, which does not adjust for state and local taxes. Therefore, the amount the taxpayer owes due to the AMT in no way depends on whether she chose to take a deduction for state and local income taxes for purposes of computing her regular tax liability.

Regarding the representation issue, the Court noted the statute the taxpayer relied on permits the National Taxpayer Advocate to issue a Taxpayer Assistance Order. The order provides relief to a taxpayer upon a finding that the taxpayer "is suffering or about to suffer a significant hardship as a result of the manner in which the internal revenue laws are administered by the Secretary." If an IRS employee is not following proper administrative guidance, the National Taxpayer Advocate is required to construe factors regarding whether to issue a Taxpayer Assistance Order in the manner most favorable to the taxpayer. The Court concluded that this provision does not aid this taxpayer.

AT-RISK LIMITATION

Liabilities of Disregarded Entity

Treasury Decision 9286, October 10, 2006
IRC §§ 704 and 752

☞ Regulations Clarify When Partnership Liabilities of a Disregarded Entity Create Economic Risk

Background. There has been a question regarding whether partnership liabilities increase a partner's at-risk limitation when the partner is a disregarded entity. IRC §752 requires a taxpayer to be at-risk when deducting losses. In order to eliminate or reduce the risk of being obligated for a share of partnership liabilities, some taxpayers have formed a single-member LLC (SMLLC) which then becomes the partner in the partnership. In some states, the SMLLC is considered separate from its owner.

Analysis and Holding. A partner's basis in a partnership interest includes his share of partnership liabilities. Whether this entitles the partner to deduct his share of the partnership losses depends upon whether the liabilities are classified as recourse or nonrecourse and who ultimately bears the economic risk of loss.

The final regulations clarify when the partner is treated as bearing the economic risk of loss for a partnership liability based on a payment obligation of the business entity that is regarded as separate from its owner. Only the assets of the disregarded entity may be available to satisfy payment obligations of the disregarded entity. Therefore, a partner should be treated as bearing the economic risk of loss for a partnership liability as a result of those payment obligations only to the extent of the net value of the disregarded entities assets.

The net value of a disregarded entity is determined by subtracting all obligations of the disregarded entity that do not constitute payment obligations from the fair market value of the assets of the entity.[4] The net value is reported by the owner of the partnership for which the disregarded entity may have one or more payment obligations. Each partnership independently can takes the net value of the disregarded entity into account and allocates the net value among liabilities of the partnership.

The final regulations apply to liabilities incurred or assumed by a partnership on or after October 11, 2006.

4. Treas. Reg. §1.752-2(k)(2)

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BAD DEBT

Worthless Stock Deduction

***John S. and Christobel D. Rendall v. Commissioner,* TC Memo 2006-174, August 21, 2006**

IRC §§61, 165, 166 and 1012

☞ Taxpayers Could Not Prove Debt was Worthless

Facts. The taxpayer husband (PH) was the CEO and chairman of the board of Solv-Ex Corporation (SE). SE was experiencing financial problems and PH loaned the corporation $2 million which he borrowed through his brokerage margin account. PH pledged his SE stock as collateral for the loan. The brokerage company requested repayment of the margin loan and eventually sold the pledged SE stock and used the proceeds to repay the loan.

SE filed petitions for reorganization in bankruptcy. While the stock was delisted from NASDAQ, it was still traded over the counter. SE sold its Canadian operating assets to generate cash to pay creditors and later emerged from bankruptcy. It still owned its technology and various U.S. assets. The stock was trading at $3.00 a share at the time SE exited from bankruptcy proceedings.

Issue. The court ruled on four separate issues:

1. Whether the taxpayers must report taxable gain on the brokerage sale of the pledged shares.
2. If taxable on that sale, whether they can report the basis in the shares under the LIFO method.
3. Whether the taxpayers are entitled to a $2 million business bad debt deduction for the worthlessness of the loan to SE.
4. Whether they are entitled to a worthless stock loss deduction for the SE common stock sold by the brokerage company.

Analysis and Holding. The court ruled against the taxpayers on all four issues. The taxpayers argued the broker sold the SE shares "for their own purposes." The court, however, found no evidence to indicate the stock pledge agreement was "fraudulently procured." Nor was there any evidence, that the stock was sold other than to satisfy the taxpayer's debt. The court ruled against the LIFO method as the taxpayers failed to provide records necessary for the identification of the shares sold.

In order to claim a bad debt deduction, a taxpayer must present evidence that the loanexisted at the beginning of the year and became worthless during the year. The year of worthlessness is determined by identifiable events that form the basis of reasonable grounds for abandoning any hope of recovery. The court did not find evidence to establish that all reasonable hope of future repayment was lost. SE's bankruptcy was for the purpose of reorganization, not liquidation.

If a capital asset becomes worthless during the taxable year, the resulting loss is treated as a loss from the sale or exchange of the capital asset. The principles for establishing the worthlessness of stock are similar to the principles of establishing a worthless debt. Therefore, the taxpayers were not entitled to a capital loss deduction for the stock.

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BANKRUPTCY AND INSOLVENCY

Gross Earnings from Services

Notice 2006-83, September 18, 2006
IRC §1398

☞ Bankruptcy Estate Required to Report Debtor's Gross Earnings from Postpetition Services.

Background. Section 1115 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BPACPA) requires the bankruptcy estate, not the debtor, to include the debtor's gross earnings from postpetition services in gross income. The bankruptcy estate also includes the gross income from property acquired by the debtor after the commencement of the case. This applies to Chapter 11 bankruptcies filed on or after October 17, 2005. Prior to BPACPA, this income was taxed to the debtor.

However, the individual debtor must continue to file his own individual tax returns during the bankruptcy proceedings.[5]

Analysis and Holding. The debtor in possession or trustee must prepare and file the income tax returns of the bankruptcy estate. After the commencement of a Chapter 11 bankruptcy case, the trustee should notify the individuals who prepare 1099 forms using the bankruptcy estate's EIN. Postpetition W-2 wages should be reported using the social security number of the debtor even though the income is taxed to the bankruptcy estate.

The employer will issue a W-2 form to the debtor who will then allocate the proper amounts between the bankruptcy estate and his individual Form 1040. Income tax withholdings are allocated in a similar manner. The debtor must attach a statement to his income tax return stating that he filed a Chapter 11 bankruptcy petition. The statement must reflect the allocations of income and withheld income tax. The bankruptcy trustee will attach a similar statement to the bankruptcy tax return.

While the bankruptcy estate will include in gross income any postpetition self employment earnings, the debtor must include this income on his individual schedule SE and pay the self-employment tax.

5. IRC §6012(a)(1)

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The IRS notice offers the following suggested attachment:

Notice XXXX-XX Statement
Pending Bankruptcy Case

The taxpayer, _________________, filed a bankruptcy petition under Chapter 11 of the Bankruptcy Code on ______________ in the Bankruptcy Court for the ___________ District of ___________. The bankruptcy court case number is ___________. Gross income, and withheld federal income tax, reported on Form W-2, Forms 1099, K-1, Schedule K-1, and other information returns received under the taxpayer's name and social security number (or other taxpayer identification number) are allocated between the taxpayer and the bankruptcy estate (EIN__-_____) as follows, using [describe allocation method]:

	Year	Taxpayer	Estate
1. Form W-2 from ___________ Co.	_________	$_________	$_________
Withheld income tax shown on Form W-2	_________	$_________	$_________
2. Form 1099-INT from ___________ Bank	_________	$_________	$_________
Withheld income tax (if any)			
3. Form 1099-DIV from ___________ Co.	_________	$_________	$_________
Withheld income tax (if any) shown on Form 1099-DIV	_________	$_________	$_________
4. Form 1099-MISC from ___________ Co.	_________	$_________	$_________
Withheld income tax (if any) shown on Form 1099-MISC	_________	$_________	$_________

CORPORATIONS

Unreasonable Compensation

***Wechsler & Co. v. Commissioner,* TC Memo 2006-173, August 17, 2006**

IRC §41 and 162

☞ Compensation Paid to Shareholder-Employee and Family Members Was Unreasonable

Facts. The corporation is a broker-dealer specializing to trading convertible securities and acting as a broker's broker. Mr. Norman Wechsler was the corporation's principle manager and made all major financial decisions. He held the positions of president and chairman of the board. His functions included:

1. Conducting all of the corporation's marketing.
2. Determining the securities for which the corporation would be a market maker.
3. Managing the corporation's investment portfolio.

During the years in question, the corporation had up to twelve employees. During two of those years Norman Wechsler's brother, Gilbert, received $80,359 and $108,097 consultant fees. During that time period, Gilbert worked as a lighting designer at the Metropolitan Opera. He did not have access to the corporate computer system nor could he access the system from outside of the corporate office.

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Norman Wechsler's sister, Sharon, was employed as a secretary and also served as vice chairman of the board of directors. During 1999, when she devoted 70% of her time to office management and 30% to portfolio research, her salary was $486,154.

The corporation never paid cash dividends. For the years 1992 through 1999 Mr. Wechsler received compensation and bonuses ranging from $1.4 million to $7 million.

Issue. Whether the compensation paid to Norman, Gilbert, and Sharon Wechsler for the years 1992 through 1999 was reasonable.

Analysis. If the compensation is unreasonable, it will be reclassified as a dividend and will be non deductible by the corporation. The IRS determined that the reasonable compensation of Norman Wechsler ranged from $1 million to $3.8 million during the eight-year period. The IRS based its conclusion on compensation paid to employees and the top executives of similar corporations.

The Court relied on an independent investor test to determine if the dividends and return on investment received by disinterested shareholders would cause them to approve the amount of disputed compensation. The Court also heard the testimony of expert witnesses.

Since Norman Wechsler was paid large bonuses even in the company's down and loss years, there was no link between total compensation and financial performance. Nor was any consistent method for calculating bonuses.

Holding. The Court concluded that Mr. Wechsler's total compensation should have been based the corporation's earnings and profitability for that year. The Court found that $16,050,020 was reasonable compensation for the years 1992 through 1999 rather than the $33,991,770 he received. The Court also held that Gilbert Wechsler was entitled to no compensation and reduced Sharon Wechsler's compensation from $486,154 to $253,154.

Personal Service Corporation

Regina Felton, PC v. Commissioner, **T.C. Summary Opinion 2006-153, September 18, 2006**
IRC §§11 and 448

☞ Single Attorney Law Corporation Ruled to be a Personal Service Company

Facts. Ms Felton was a sole practitioner who incorporated her law practice as a New York professional corporation in 1987. She was the sole shareholder and the only person providing the legal services for the corporation.

The corporation employed a CPA to prepare the corporate tax returns since its formation in 1987. During those years, the CPA used the corporation graduated tax rates to compute tax. In 2002, the CPA prepared an extension of time to file the corporate tax return. Unfortunately, the IRS never received the extension.

In its notice of deficiency, the IRS determined the corporation was a personal service company and computed the tax using the flat tax rate of 35 percent. Ms. Felton challenged the deficiency and in her letter to the IRS stated that her CPA disagreed with the flat tax calculation.

Analysis and Holding. Ms. Felton testified she did not consider herself an employee of the corporation and therefore the flat tax rate did not apply. After a lengthy analysis regarding why Ms. Felton was an employee, the Court held that she was an employee and that the corporation should be taxed as a PSC. In addition, the Court upheld the delinquency penalty for filing a late tax return.

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Distributive Share of S Corporation

***Thomas J. Sweeney v. Commissioner,* T.C. Summary 2006-169 (October 19, 2006)**
IRC §1366

☞ Taxpayer required to report share of S corporation earnings

Facts. The taxpayer and his wife were shareholders in a successful S corporation. The corporation collected fees doctors charged their patients for medical services. During 2002 the corporation was profitable and reported the taxpayer's share of the profit on a Schedule K-1 even though he had no involvement in the corporation and received no salary or distribution. The taxpayer experienced severe marital difficulties with his spouse in 2002. He filed married filing separately and did not report the Schedule K-1 amount on his 2002 tax return.

Analysis and Holding. The taxpayer's argument to the Tax Court judge was: "This is my whole argument, Your Honor. During the second week of January 2002, my wife proceeded to throw me out of my house, which is where the business was located. She changed the locks. She stripped our corporate bank accounts, our personal bank accounts, charged up all the cash she could on my credit cards to over $50,000, $60,000, and she physically, lock, stock, and barrel, locked me out of the corporation."

The Tax Court ruled in favor of the IRS, holding that the Schedule K-1 amount was taxable. Although the taxpayer hired an attorney to assist with the divorce, there was no record of any decision made regarding corporate income. Therefore, the taxpayer remained a shareholder for the entire year of 2002.

CREDITS

Hybrid Vehicle Credit

These tables update the tables located on page 574 of the *2006 University of Illinois Federal Tax Workbook.*

2005 Vehicles

<table>
<tr><th>Year</th><th>Make</th><th>Model</th><th colspan="2">Credit Amount</th><th>News Release #</th></tr>
<tr><td>2005</td><td>Ford</td><td>Escape HEV 2WD</td><td colspan="2">$2,600</td><td>IR-2006-165, Oct. 20, 2006</td></tr>
<tr><td>2005</td><td>Ford</td><td>Escape HEV 4WD</td><td colspan="2">$1,950</td><td>IR-2006-165, Oct. 20, 2006</td></tr>
<tr><td>2005</td><td>Honda</td><td>Accord Hybrid AT</td><td colspan="2">$ 650</td><td>IR-2006-86, June 1, 2006</td></tr>
<tr><td>2005</td><td>Honda</td><td>Accord Hybrid Navi AT</td><td colspan="2">$ 650</td><td>IR-2006-86, June 1, 2006</td></tr>
<tr><td>2005</td><td>Honda</td><td>Civic Hybrid CVT</td><td colspan="2">$1,700</td><td>IR-2006-86, June 1, 2006</td></tr>
<tr><td>2005</td><td>Honda</td><td>Civic Hybrid MT</td><td colspan="2">$1,700</td><td>IR-2006-86, June 1, 2006</td></tr>
<tr><td>2005</td><td>Honda</td><td>Insight CVT</td><td colspan="2">$1,450</td><td>IR-2006-86, June 1, 2006</td></tr>
<tr><td rowspan="5">2005</td><td rowspan="5">Toyota*</td><td rowspan="5">Prius</td><td>Purchase Date</td><td></td><td rowspan="5">IR-2006-57, April 7, 2006</td></tr>
<tr><td>1-1-06 / 9-30-06</td><td>$3,150</td></tr>
<tr><td>10-1-06 / 3-31-07</td><td>$1,575</td></tr>
<tr><td>4-1-07 / 9-30-07</td><td>$ 787.50</td></tr>
<tr><td>10-1-07</td><td>$ 0</td></tr>
</table>

** Effective 10-1-06, Toyota and Lexus vehicles qualify for reduced credit amounts.*

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2006 Vehicles

Year	Make	Model	Credit Amount		News Release #
2006	Chevrolet	Silverado 2WD Hybrid Pickup Truck	$ 250		IR-2006-108, July 11. 2006
2006	Chevrolet	Silverado 4WD Hybrid Pickup Truck	$ 650		IR-2006-108, July 11. 2006
2006	Ford	Escape Hybrid 2WD Front Wheel Drive	$2,600		IR-2006-56, April 7, 2006
2006	Ford	Escape Hybrid 4WD	$1,950		IR-2006-56, April 7, 2006
2006	GMC	Sierra 2WD Hybrid Pickup Truck	$ 250		IR-2006-108, July 11. 2006
2006	GMC	Sierra 4WD Hybrid Pickup Truck	$ 650		IR-2006-108, July 11. 2006
2006	Honda	Accord Hybrid AT w/updated calibration*	$1,300 $ 650 - Vehicles without updated calibration		IR-2006-86, June 1, 2006
2006	Honda	Accord Hybrid Navi AT w/updated calibration*	$1,300 $ 650 - Vehicles without updated calibration		IR-2006-86, June 1, 2006
2006	Honda	Civic Hybrid CVT	$2,100		IR-2006-86, June 1, 2006
2006	Honda	Insight CVT	$1,450		IR-2006-86, June 1, 2006
2006	Lexus*	RX400h 2WD	**Purchase Date**		IR-2006-57, April 7, 2006
			1-1-06 / 9-30-06	$2,200	
			10-1-06 / 3-31-07	$1,100	
			4-1-07 / 9-30-07	$ 550	
			10-1-07	$ 0	
2006	Lexus*	RX400h 4WD	**Purchase Date**		IR-2006-57, April 7, 2006
			1-1-06 / 9-30-06	$2,200	
			10-1-06 / 3-31-07	$1,100	
			4-1-07 / 9-30-07	$ 550	
			10-1-07	$ 0	
2006	Mercury	Mariner 4WD Hybrid	$1,950		IR-2006-56, April 7, 2006
2006	Toyota*	Highlander 2 WD Hybrid	**Purchase Date**		IR-2006-57, April 7, 2006
			1-1-06 / 9-30-06	$2,600	
			10-1-06 / 3-31-07	$1,300	
			4-1-07 / 9-30-07	$ 650	
			10-1-07	$ 0	
2006	Toyota*	Highlander 4WD Hybrid	**Purchase Date**		IR-2006-57, April 7, 2006
			1-1-06 / 9-30-06	$2,600	
			10-1-06 / 3-31-07	$1,300	
			4-1-07 / 9-30-07	$ 650	
			10-1-07	$ 0	
2006	Toyota*	Prius	**Purchase Date**		IR-2006-57, April 7, 2006
			1-1-06 / 9-30-06	$3,150	
			10-1-06 / 3-31-07	$1,575	
			4-1-07 / 9-30-07	$ 787.50	
			10-1-07	$ 0	

** Effective 10-1-06, Toyota and Lexus vehicles qualify for reduced credit amounts.*

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2007 Vehicles

Year	Make	Model	Credit Amount		News Release #
2007	Chevrolet	Silverado 2WD Hybrid Pickup Truck	$ 250		IR-2006-108, July 11. 2006
2007	Chevrolet	Silverado 4WD Hybrid Pickup Truck	$ 650		IR-2006-108, July 11. 2006
2007	Ford	Escape Hybrid 2WD	$2,600		IR-2006-98, June 21, 2006
2007	Ford	Escape Hybrid 4WD	$1,950		IR-2006-98, June 21, 2006
2007	GMC	Sierra 2WD Hybrid Pickup Truck	$ 250		IR-2006-108, July 11. 2006
2007	GMC	Sierra 4WD Hybrid Pickup Truck	$ 650		IR-2006-108, July 11. 2006
2007	Honda	Accord AT	$1,300		IR 2006-183, Nov. 22, 2006
2007	Honda	Accord Navi	$1,300		IR 2006-183, Nov. 22, 2006
2007	Honda	Civic CVT	$2,100		IR 2006-183, Nov. 22, 2006
2007	Lexus*	GS450h	**Purchase Date**		IR-2006–67, April 25, 2006
			1-1-06 / 9-30-06	$1,550	
			10-1-06 / 3-31-07	$ 775	
			4-1-07 / 9-30-07	$ 387.50	
			10-1-07	$ 0	
2007	Lexus *	RX 400h 4WD	**Purchase Date**		IR-2006-154, September 30, 2006
			1-1-06 / 9-30-06	$2,200	
			10-1-06 / 3-31-07	$1,100	
			4-1-07 / 9-30-07	$ 550	
			10-1-07	$ 0	
2007	Lexus*	RX 400h 2WD	**Purchase Date**		IR-2006-154, September 30, 2006
			1-1-06 / 9-30-06	$2,200	
			10-1-06 / 3-31-07	$1,100	
			4-1-07 / 9-30-07	$ 550	
			10-1-07	$ 0	
2007	Mercury	Mariner Hybrid 4WD	$1,950		IR-2006-98, June 21, 2006
2007	Saturn	Vue Green Line	$ 650		IR-2006-110, July 11, 2006
2007	Toyota*	Camry Hybrid	**Purchase Date**		IR-2006–67, April 25, 2006
			1-1-06 / 9-30-06	$2,600	
			10-1-06 / 3-31-07	$1,300	
			4-1-07 / 9-30-07	$ 650	
			10-1-07	$ 0	
2007	Toyota*	Prius	**Purchase Date**		IR-2006-154, September 30, 2006
			1-1-06 / 9-30-06	$3,150	
			10-1-06 / 3-31-07	$1,575	
			4-1-07 /9-30-07	$ 787.50	
			10-1-07	$ 0	
2007	Toyota*	Highlander Hybrid 2WD	**Purchase Date**		IR-2006-154, September 30, 2006
			1-1-06 / 9-30-06	$2,600	
			10-1-06 / 3-31-07	$1,300	
			4-1-07 / 9-30-07	$ 650	
			10-1-07	$ 0	
2007	Toyota*	Highlander Hybrid 4WD	**Purchase Date**		IR-2006-154, September 30, 2006
			1-1-06 / 9-30-06	$2,600	
			10-1-06 / 3-31-07	$1,300	
			4-1-07 / 9-30-07	$ 650	
			10-1-07	$ 0	

** Effective 10-1-06, Toyota and Lexus vehicles qualify for reduced credit amounts.*

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Form 5695

☞ The IRS Releases the Draft of 2006 Form 5695, *Residential Energy Credits*

An analysis of the homeowner energy credits begins on page 520 of the *2006 University of Illinois Federal Tax Workbook.* The following form will be used to reports these credits.

Form **5695**

Department of the Treasury
Internal Revenue Service

Residential Energy Credits

▶ See instructions.
▶ Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0074
2006
Attachment Sequence No. 158

Name(s) shown on return | Your social security number

Draft as of 08/31/2006

Part I **Nonbusiness Energy Property Credit** (See instructions before completing this part.)

1	Were the energy efficiency improvements or residential energy property costs made to your main home located in the United States? (see instructions) . . . . ▶ **Caution:** *If you checked the "No" box, you cannot claim the nonbusiness energy property credit. Do not complete Part I.*				☐ Yes ☐ No
2	Energy efficiency improvements (see instructions).				
a	Insulation material or system primarily designed to reduce heat loss or gain in your home	2a			
b	Exterior windows (including skylights). Do not enter more than $2,000	2b			
c	Exterior doors	2c			
d	Metal roof with appropriate pigmented coatings that meet the Energy Star program requirements primarily designed to reduce heat gain in your home	2d			
3	Add lines 2a through 2d			3	
4	Multiply line 3 by 10% (.10)			4	
5	Residential energy property costs (see instructions).				
a	Energy-efficient building property. Do not enter more than $300 . .	5a			
b	Qualified natural gas, propane, or oil furnace or hot water boiler. Do not enter more than $150	5b			
c	Advanced main circulating fan used in a natural gas, propane, or oil furnace. Do not enter more than $50	5c			
6	Add lines 5a through 5c			6	
7	Add lines 4 and 6			7	
8	Enter the smaller of line 7 or $500			8	
9	Enter the amount from Form 1040, line 46, or Form 1040NR, line 43	9			
10	Enter the total, if any, of your credits from Form 1040, lines 47 through 51, or Form 1040NR, lines 44 through 46	10			
11	Subtract line 10 from line 9. If zero or less, **stop**. You cannot take a nonbusiness energy property credit			11	
12	**Nonbusiness energy credit.** Enter the smaller of line 8 or line 11			12	

For Paperwork Reduction Act Notice, see instructions. Cat. No. 13540P Form **5695** (2006)

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Form 5695 (2006) Page **2**

Before you begin: Figure the amount of any of the following credits that you are claiming.
- Child tax credit
- Mortgage interest credit
- Adoption credit
- District of Columbia first-time homebuyer credit

Draft as of 08/31/2006

Part II **Residential Energy Efficient Property Credit** (See instructions before completing this part.)

13	Qualified photovoltaic property costs	13			
14	Multiply line 13 by 30% (.30)	14			
15	Maximum credit amount	15	2,000		
16	Enter the smaller of line 14 or line 15			16	
17	Qualified solar water heating property costs	17			
18	Multiply line 17 by 30% (.30)	18			
19	Maximum credit amount	19	2,000		
20	Enter the smaller of line 18 or line 19			20	
21	Qualified fuel cell property costs	21			
22	Multiply line 21 by 30% (.30)	22			
23	Kilowatt capacity of property on line 21 above ► .... X $1,000	23			
24	Enter the smaller of line 22 or line 23			24	
25	Add lines 16, 20, and 24			25	
26	Enter the amount from Form 1040, line 46, or Form 1040NR, line 43	26			
27	**1040 filers:** Enter the total, if any, of your credits from Form 1040, lines 47 through 51, 53, and 54, plus the amount, if any, from line 12 of this form. **1040NR filers:** Enter the total, if any, of your credits from Form 1040NR, lines 44 through 46, 48, and 49, plus the amount, if any, from line 12 of this form.	27			
28	Subtract line 27 from line 26. If zero or less, enter –0– here and on line 29			28	
29	**Residential energy efficient property credit.** Enter the smaller of line 25 or line 28			29	
30	Credit carryforward to 2007. If line 29 is less than line 25, subtract line 29 from line 25	30			

Part III **Current Year Residential Energy Credits**

31	Add lines 12 and 29. Enter here and on Form 1040, line 52, or Form 1040NR, line 47	31	

Form **5695** (2006)

DEDUCTIONS

Salaries to Family Members

Michael D. and Christine R. Alexander v. Commissioner, **T.C. Summary Opinion 2006-127, August 21, 2006**
IRC §§ 163, 262, and 7442

☞ Wages Paid to Taxpayer's Children Not Deductible

Facts. The taxpayer's operated in Oregon tree farm. In addition, Mrs. Alexander operated a seamstress business from her home. The Alexander's son, Steven, was a 21 year-old college student who returned home during the summer. He assisted his mother with her seamstress business by performing a variety of jobs. He assisted in purchasing supplies, drafting, sewing, and cleaning the workspace. He worked 378 hours and was paid $4,000, an hourly rate of $10.58. While Stephen worked only during the summer, his wages were paid throughout the year.

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Mrs. Alexander reported gross receipts of $1,301 for the seamstress business. She did not pay employment taxes on Steven's wages nor did she issue a Form W-2 to him.

Mrs. Alexander also operated a beagle-breeding business from her home. Her three daughters assisted her with this business throughout the year. The daughters ranged in age from eight to seventeen years old. The daughters cleaned the dogs and the exercise yard, erected fence, took out the garbage, and cared for newborn puppies.

Mrs. Alexander credited each daughter with $4,250 of earnings. She did not pay her daughters in cash, but instead kept a running total of their earnings. When a daughter wished to make a purchase, the taxpayers bought the goods or services and deducted the purchase price from the daughter's running total. If the running total was negative, that amount was treated as an advance.

The daughters were required to pay for nonessentials such as their share of family ski trips or family trips to Disneyland. The daughters also paid for other non essential items. Mrs. Alexander reported $4,900 of gross receipts from the dog-breeding business. No Forms W-2 were issued to the daughters.

Analysis. Compensation is a deductible trade or business expense if it meets three tests:

1. It must be reasonable in amount.
2. It must be based on services actually rendered.
3. It must be paid or incurred.

In Steven's case, the majority of the compensation was paid either before the work was performed or after the work was performed. Mrs. Alexander testified that she calculated she could pay Stephen approximately $4,000 for the summer. Therefore he was paid a predetermined amount rather than an amount based on the services actually performed. The Alexander's testified they tracked Steven's hours on a list kept on the refrigerator, but did not present the list as evidence.

The daughter's hours were also recorded on a refrigerator list. The Court found it odd that each daughter earned exactly the same amount. Mrs. Alexander's testimony was inconsistent. Her original testimony was that her daughter's wages were predetermined. She later testified each daughter was paid $7.00 an hour.

Holding. The Tax Court ruled that the payments to Stephen and the daughters were similar to an allowance rather than compensation for services performed. Consequently, all of the wage deductions claimed for the children were disallowed.

DEPENDENCY ISSUES

Uniform Definition of a Child

Notice 2006-86, September 20, 2006
IRC §152

☞ Guidance Issued Under "Tie-breaking Rule"

Background. The notice gives guidance when more than one taxpayer can claim a child for the:

1. Head of household filing status
2. Child and dependent care credit
3. Child tax credit
4. Earned income credit

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5. Exclusion from income for dependent care assistance
6. Dependency deduction

The tie-breaking rule applies to all of the provisions rather than section-by-section.

The noncustodial parent can claim the child if four conditions are met.[6] They are:

1. The child is in the custody of one or both parents for more than one-half of the calendar year.
2. The child receives over one-half of the child's support during the calendar year from the child's parents.
3. The parents:
   a. are divorced or separated under a decree of divorce or separate maintenance,
   b. are separated under a written separation agreement, or
   c. live apart at all times during the last 6 months of the calendar year.
4. The custodial parent releases the claim to the exemption to the noncustodial parent in a written declaration that the noncustodial parent attaches to the noncustodial parent's tax return.

The noncustodial parent can claim the child as a qualifying child only for the purposes of the child tax credit and the dependency deduction.

Analysis and Holding. Unless IRC §152(e) applies, when more than one taxpayer claims a child as a qualifying child, the child is treated as the qualifying child of only one taxpayer for all provisions using the uniform definition of a child.

In the examples below, each individual is a citizen of the United States and uses a calendar taxable year, and the child is a qualifying child (as defined in §152(c)) of each taxpayer. Unless otherwise indicated, these examples assume that each individual meets the other requirements for claiming a benefit described in the example.

Example 1.

1. A child, mother, and grandmother share the same principal place of abode. The mother is not married and is not the qualifying child of the grandmother, and the grandmother is not the mother's dependent.
2. The mother claims the child as a qualifying child for purposes of the earned income credit under §32.
3. The child is treated as the qualifying child of the mother for purposes of the earned income credit. Because the mother claims the child as a qualifying child for purposes of the earned income credit, under §152(c)(4)(A), the child may **not** be treated as the qualifying child of the grandmother for **any** purpose.
4. If, however, the mother does not claim the child as a qualifying child for **any** purpose, the child may be treated as the qualifying child of the grandmother for purposes of the earned income credit under §32 as well as head of household filing status under §2(b), the dependency deduction under §151, the child tax credit under §24, the child and dependent care credit under §21, and the exclusion from income for dependent care assistance under §129, if applicable, assuming that no other taxpayer claims the child as a qualifying child.

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6. IRC §152(e)

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Example 2.

1. The facts are the same as in **Example 1,** except that the mother and father of the child are divorced, the father is the noncustodial parent, the mother has released the claim to the exemption to the father in a written declaration under §152(e), and the father attaches the written declaration to his return and claims the child as a qualifying child for purposes of the dependency deduction and the child tax credit.

2. Under §152(e), the child is treated as the qualifying child of the **father** for purposes of the **dependency deduction** and the **child tax credit**. The child is treated as the qualifying child of the **mother** for purposes of **the earned income credit** and, if applicable, **head of household filing status, the child and dependent care credit, and the exclusion from income for dependent care assistance.** The child may not be treated as the qualifying child of the grandmother for any purpose.

Example 3.

1. The father and mother of a child are married to each other. The father, mother, and child share the same principal place of abode for the first 8 months of the year. For the last 4 months of the year, the parents live apart from each other, and the mother and child share the same principal place of abode. The parents file separate tax returns for the taxable year. Consequently, neither parent may claim head of household filing status, an earned income credit, or a child and dependent care credit, because in general §2(b) applies only to unmarried individuals, while §§32(d) and 21(e)(2), respectively, require married individuals to file a joint return.

2. The father claims the child as a qualifying child for purposes of the dependency deduction under §151 and the exclusion for dependent care assistance under §129. The mother claims the child as a qualifying child for purposes of the dependency deduction under §151, the child tax credit under §24, and the exclusion for dependent care assistance under §129.

3. Under the tie-breaking rule of §152(c)(4)(B), the child is treated as the qualifying child of the **mother** because the child resided with the mother for the longer period of time during the taxable year. Therefore, the child is the qualifying child of the mother for purposes of the dependency deduction, the child tax credit, and the exclusion for dependent care assistance. Section 152(e) does not apply because the mother and father are not divorced or separated under a decree of separate maintenance or written separation agreement at the end of the taxable year and did not live apart for the last 6 months of the calendar year. Therefore, the child may not be treated as the qualifying child of the father for any purpose.

4. If, however, the mother does not claim the child as a qualifying child for any purpose, the child is treated as the qualifying child of the father for purposes of the dependency deduction under §151 and the exclusion for dependent care assistance under §129.

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Example 4.

1. The facts are the same as in **Example 3,** except that the mother and father are separated under a written separation agreement at the end of the taxable year, the mother is the custodial parent and has released the claim to the exemption to the father in a written declaration under §152(e), and the father attaches the Form 8332 to his return and claims the child as a qualifying child for purposes of the dependency deduction, the child tax credit, and the exclusion for dependent care assistance under §129.

2. Because §152(e) applies, the child is treated as the qualifying child of the father for purposes of the dependency deduction and the child tax credit. The child is not treated as the qualifying child of the father for purposes of the exclusion for dependent care assistance because the father is the noncustodial parent and, under §21(e)(5), only the custodial parent may claim the child as a qualifying child for purposes of the exclusion for dependent care assistance. Therefore, the tie-breaking rule of §152(c)(4)(B) applies, and the child is treated as the qualifying child of the mother for purposes of the exclusion for dependent care assistance.

Example 5.

1. The father and mother of two children are married to each other. The father, mother, and both children share the same principal place of abode for the entire year. The father and mother file separate tax returns for the taxable year. Consequently, neither parent may claim head of household filing status, an earned income credit, or a child and dependent care credit, because in general §2(b) applies only to unmarried individuals, while §§32(d) and 21(e)(2), respectively, require married individuals to file a joint return.

2. The father claims the older child as a qualifying child for purposes of the child tax credit, dependency deduction, and exclusion for dependent care assistance. The mother claims the younger child as a qualifying child for purposes of the child tax credit, dependency deduction, and exclusion for dependent care assistance.

3. The older child is treated as the qualifying child of the father and the younger child is treated as the qualifying child of the mother. The tie-breaking rule of §152(c)(4)(B) does not apply because no two taxpayers are claiming the same child as a qualifying child for any of the benefits.

The notice applies to years beginning after December 31, 2004.

DEPRECIATION

Uniform Capitalization Rules

IRS News Release IR 2006-130, August 21, 2006

IRC §263

☞ Proposed Regulations on Capitalization of Repairs

Analysis and Conclusion. The proposed regulations deal with the treatment of expenditures incurred in selling, acquiring, producing, or improving tangible assets. The regulations attempt to clarify when improvement expenditures must be capitalized or whether they create an immediate deduction. The proposal provides exclusive factors for determining whether amounts paid to restore property to its former working condition must be capitalized as an improvement. They also provide guidance concerning the economic useful life of the unit of property and activities that substantially prolong the economic useful life.

These regulations will become effective for tax years beginning after the date of finalization.

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§179 Depreciation
Revenue Procedure 2006-53, November 9, 2006
IRC §179

☞ IRS Releases 2007 Deduction Amount

Background. IRC §179 allows eligible taxpayers to expense a large portion of asset purchases in the year of purchase. The amount is adjusted for inflation annually.

Analysis and Conclusion. For tax years beginning in 2007, the taxpayer may deduct up to $112,000 of eligible purchases. The maximum deduction is reduced by aggregate purchases in excess of $450,000.

EMPLOYMENT TAX ISSUES

Independent Contractor
***Orion Contracting Trust v. Commissioner,* TC Memo 2006-211, September 27, 2006**
IRC §§3401, 6501, 6651, and 7436

☞ Court Rules Construction Workers are Employees

Facts. A trust that operated a construction business classified its workers as independent contractors. Some of the workers furnished their own tools and the workers were under the control of the trust management. They performed the kind of construction work the trust performed, used trust materials, and worked at job sites where management instructed them to work. Many of the workers had been under this arrangement all three years at issue.

Two of the trustees, Mr. Carmel and Mr. Damigos, entered into a contract with American Asset Protection to provide asset protection and create a common law trust. One of the original trustees resigned his position before going to jail for his connection with American Asset Protection. The employment tax issue was discovered when Mr. Carmel and Mr. Damigos were examined for failing to file personal income tax returns.

Issue. Whether the workers are independent contractors or employees.

Analysis. The taxpayer argued that the employment tax issue was outside of the three-year statute of limitations. However, the three-year statute of limitations did not apply as no payroll tax returns were ever filed.

The taxpayer also argued the workers were independent contractors. In determining whether a worker is a common law employee or an independent contractor, seven factors must be considered:

1. The degree of control exercised by the principal;
2. Which party invests in the work facilities used by the worker;
3. The opportunity of the worker for profit or loss;
4. Whether the principal can discharge the individual;
5. The permanency of the relationship; and
6. The relationship that the parties believed that they were creating.

Holding. The Tax Court found the taxpayer failed most of these tests and held that the workers were employees.

The fraud penalty assessed by the IRS was not upheld even though no payroll tax returns or Forms 1099 were filed.

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ESTATE AND GIFT

Private Annuity Proposed Regulations

IRS News Release IR 2006-161, October 17, 2006

IRC §§ 72 and 1001

☞ **Can no longer exchange appreciated property for a private annuity.**

Background. In the past, the IRS has allowed exchanges of appreciated property for a private annuity. This is inconsistent with the tax treatment of exchanges for commercial annuities and other kinds of property. The IRS allowed the exchanges because taxpayers could not determine the value of the private annuity for Federal income tax purposes. Prior to the proposed regulations, the IRS was relying on Rev. Rul. 69-74 where the transferor recognized gain over his life expectancy.

Analysis and Holding. Both the Treasury Department and the IRS were concerned that current law was used inappropriately in transactions designed to avoid U.S. income tax. The proposed regulations[7] will not affect charitable gift annuities or installment sales.

The proposed regulations will leave the transferor of the property and the transferee in the same position before tax as if the transferor had sold the property for cash and then used the proceeds to purchase an annuity contract. If an annuity contract is received in exchange for property **other than money**:

1. The amount realized attributable to the annuity contract is the fair market value of the contract at the time of the exchange,
2. The entire gain or loss is recognized at the time of the exchange, regardless of the taxpayer's method of accounting, and
3. The aggregate amount of premiums or other consideration paid for the annuity equals the amount realized attributable to the annuity for purposes of determining the initial investment in the contract.

If the proposed regulations are adopted, they will be effective October 18, 2006 for any transactions which have not been completed. However, for legitimate estate planning transactions currently in progress, the effective date is postponed for six months until April 18, 2007. The postponement is for transactions that pose the least likelihood of abuse. These include transactions in which:

1. The issuer of the annuity contract is an individual,
2. The obligations under the contract are not secured, either directly or indirectly, and
3. The property transferred in the exchange is not subsequently sold or otherwise disposed of by the transferor during the two-year period beginning on the date of the exchange.

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7. Prop. Reg. §§1.72-6 and 1.1001-1

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Valuation of Family Limited Partnership Interest

***Succession of McCord v. Commissioner;* U.S. Court of Appeals for the Fifth Circuit; No. 03-60700, August 22, 2006**
IRC §§2512 and 2522

☞ Tax Court's Decision on FLP Gift Tax Valuation Reversed

Facts. Mr. and Mrs. McCord and their sons formed a family limited partnership, McCord Investments Limited (MIL) in 1995. Mr. and Mrs. McCord owned over 82% of MIL at the time of formation. McCord Brothers, a partnership owned equally by the four sons, held 16% of MIL and the remainder was held by the sons individually.

On January 12, 1996, Mr. and Mrs. McCord executed an Assignment Agreement divesting them of MIL by gifting their ownership percentage to their sons and to charities. In March 1996, the gift recipients, with the help of an appraiser, converted the gifts into percentages of ownership of MIL. The McCords valued the gifts at $7,369,215 and filed gift tax returns. IRS however, valued the gifts at $9,883,832.

The McCord's challenged the IRS gift tax valuation in Tax Court, where Judge Foley ruled in favor of the taxpayers. Two years after the trial, the Acting Chief Judge of the Tax Court issued an unusual order that resembled an en banc rehearing. Basically, the original decision of Judge Foley was ignored and the case was given to another judge. The new judge immediately filed an opinion on behalf of the majority.

The revised opinion reversed Judge Foley's original opinion which held that the Commissioner failed to meet his burden of proof. The revised opinion was not based on testimony given by the Commissioner, but on the Tax Court's own interpretation of the conversion agreement.

Holding. The Appeals Court ruled that post-gift occurrences do not affect, and may not be considered in, the appraisal and valuation process. Therefore, the revised opinion of the Tax Court was reversed and the taxpayers gift tax valuation of $7,369,215 was upheld.

Funeral Banquet

***Estate of Sarah M Davenport, Deceased v. Commissioner.,* TC Memo 2006-215, October 5, 2006**
IRC §2053

☞ Cost of Funeral Luncheon Not deductible by Estate

Facts. Sarah M. Davenport died at the age of 12. She had a sizable estate due to the proceeds of a lawsuit settlement resulting from physical injuries sustained at birth. A portion of the estate consisted of an annuity. The annuity was not listed as an asset in the estate, but the IRS included its value when it examined the estate's Form 706. The executor challenged the IRS valuation. However, the issue being considered by the Tax Court was the deduction of $3,638.92 for a funeral luncheon.

Analysis. The parents testified that the purpose of the funeral luncheon was to thank all of the family members, teachers, healthcare professionals, and friends who worked with Sarah over the years. The estate's position was "that the funeral reception expense incurred on the day of the deceased's funeral, because of the deceased's unique medical circumstances and the support and assistance she received during her short life time is an expense intimately tied to decedent's funeral arrangements and is deductible for federal estate tax purposes."

The court responded that both Michigan state law and the Federal regulations suggest the standard of reasonableness in examining the amount of funeral expenditures. The estate did not present any detail of the luncheon expenses. It could not be determined whether the amount included charges for the venue, decorating, catering, entertainment, or a combination of supplies and services. The court also found insufficient information to establish the requisite necessity in connection with decedent's funeral. Testimony inferred the focus of the luncheon was on recognizing and thanking

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third parties for their support during decedent's life and after her passing. This represents a shift from the traditional focus of a funeral in eulogizing and lying to rest the deceased.

Holding. The court upheld the position of the IRS which disallowed the deduction of the funeral luncheon.

Investment Advice

***William L. Rudkin Testamentary Trust v. Commissioner,* U.S. Court of Appeals, For the 2nd Circuit 2006-2 USTC ¶50,569, October 18, 2006**
IRC §67

☞ Investment Advice Not Fully Deductible In Calculating Adjusted Gross Income

Facts. The appeals issue is whether investment advice for a trust is fully deductible. The IRS held that only those fees in excess of 2% of the adjusted gross income was deductible. The trust was originally funded from the proceeds of the sale of Pepperidge Farm. In the year at issue, the trust reported total income of $624,816 and claimed a deduction for investment-management fees of $22,241.

Issue and Analysis. The trust claimed the trustee's fiduciary duty required investment advisory services for the proper administration of the trust's sizable stock portfolio and therefore the investment advice fees were fully deductible. The court noted that the adjusted gross income of the trust should be computed in the same manner as in the case of an individual, with one exception. That exception was that the deduction for costs paid in connection with the administration of the trust which would not have been incurred if the property were not held in trust are fully deductible in calculating adjusted gross income.[8] The court analyzed how adjusted gross income was calculated for an individual. It concluded that the adjusted gross income of a trust should be computed in a similar manner. The court did note that there was a split between the circuit courts on this issue.

Holding. The Second Circuit held that the investment advice fees were subject to the 2 percent of AGI limitation.

EXEMPT ORGANIZATIONS

Filing Requirement

Joint Tax Committee Report JCX 38-06, August 3, 2006
IRC §§6033, 6652, and 7428

☞ Small Exempt Organizations Are Required To File An Annual Report

Background. Exempt organizations with under $25,000 of gross receipts have not been required to file an annual information return. The Pension Protection Act of 2006 (PPA) has changed this requirement.

Analysis and Conclusion. The PPA now requires these organizations to electronically furnish the IRS the following information:

1. The legal name of the organization
2. Any name under which the organization operates or does business
3. The organization's mailing address and Internet web site address

8. IRC §67(e)(1)

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4. The organization's taxpayer identification number
5. The name and address of the principal officer
6. The evidence of the organization's continuing basis for its exemption from the applicable information filing requirements

Upon the organization's termination of existence, the organization is required to furnish notice of the termination. This information must be filed annually. If an organization fails to provide the required notice for three consecutive years, its tax-exempt status will be revoked.

The new filing requirement became effective on the date of enactment of PPA, August 17, 2006.

IRS PROCEDURES — AUDITS

IRS Audit Plans
Tax Talk Today, **September 12, 2006**
IRC §7602

Background. Joseph Wilson, director of Examination Planning and Delivery for the Small Business Self-Employed Division of the IRS discussed the National Research Program (NRP) on the September 22, 2006 Tax Talk Today program.

Analysis and Conclusion. The purpose of the NRP is threefold:

1. To get an estimate of the tax gap
2. To refine the amount of, or the criteria for, selection of returns that are placed in the examination to stream
3. Allow the IRS to find ways to improve instructions or target out reach in order to close the tax gap

The IRS completed the NRP program on year 2001 individual tax returns in the years 2003 and 2004. In that program IRS examined approximately 46,000 returns were examined. The current NRP program involves exams of 1120-S returns.

The IRS estimates that 50% of small businesses misreport income due to a combination of income, expenses, credits, and misclassification of items. The amount of misreporting is the highest where there are no third-party reporting requirements. In an attempt to increase third-party reporting, but without increasing the burden on these entities, the IRS is placing improved reporting requirements on government and businesses which aggregate payer information This includes governmental entities and debit and credit card issuers.

The next phase of the NRP program will entail exams of 2006 individual tax returns. It will begin in 2008.

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IRS PROCEDURES — MISCELLANEOUS

Privacy Notice

Financial Services Regulatory Relief Act of 2006, September 27, 2006

☞ CPAs No Longer Required to Issue Privacy Notices to Clients

Background. The Gramm-Leach-Bliley Act contained provisions protecting the privacy of financial data. It required anyone dealing with financial information to notify the client that their financial information would not be disclosed to a third party. The tax preparation industry was subject to this regulation.

Analysis and Conclusion. The Financial Services Regulatory Relief Act of 2006 made certified public accountants exempt from this regulation. The CPA must be certified or licensed by a state and subject to rules issued by a regulatory body of the state which prohibits disclosure of nonpublic information without the knowledge or expressed consent of the client.

> **Note.** All other tax preparers are still required to issue the annual privacy notice.

2007 Social Security Information

Social Security Fact Sheet

☞ Social Security Releases 2007 Changes

Background. The Social Security Administration (SSA) adjusts Social Security tax rates and benefits annually based on a cost-of-living adjustment.

Analysis and Conclusion. Beginning in 2007, Social Security and Supplemental Security recipients will receive a 3.3% increase in their benefits. The percentage rates for Social Security and Medicare taxes will not change in 2007. However, the maximum taxable earnings subject to Social Security tax will increase from the $94,200 for 2006 to $97,500 for 2007. The amount to qualify for one quarter of coverage increases from $970 to $1,000.

The retirement earnings test exemption amount for those individuals under full retirement age also increases from $12,480/year ($1,040/mo.) in 2006 to $12,960/year ($1,080/mo.) for 2007.

IRS PROCEDURES — PAYMENTS

Telephone Excise Tax Refund

IRS News Release IR 2006-179, November 16, 2006

IRC §164

☞ IRS Announces a Simplified Refund Calculation for Small Businesses

Background. The IRS released a formula which allows businesses and tax exempt organizations to estimate their federal excise tax refund. The formula is less burdensome than collecting 41 months of old phone records.

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Analysis and Conclusion. The refund is capped at 2% of the total telephone expenses for businesses and tax-exempt organizations with 250 or fewer employees. It is capped at 1% for those with more than 250 employees. To use the formula the taxpayer must take the April 2006 telephone bill and divide the total federal telephone excise tax by the total phone bill to arrive at a percentage of the bill attributable to the federal telephone excise tax. If the business has multiple service providers, all bills dated in April must be considered in arriving at the allocable percentage.

Then the taxpayer takes the September 2006 telephone bill and performs the same computation. The September percentage is subtracted from the April percentage to arrive at the percentage that represents the federal long distance excise tax. This percentage is then multiplied by the total phone expenses for all phone bills dated after February 28, 2003 and before August 1, 2006.

Example 6. Sales Corporation's April 2006 telephone bill is $7,000 and the federal telephone excise tax is $196. The September 2006 bill is $8,000 and the federal telephone excise tax is $120. Sales corporation computes its 2006 federal telephone excise tax refund as follows:

April 2006 ($196 ÷ $7,000)	2.8%
September 2006 ($120 ÷ $8,000)	(1.5%)
Long distance tax percentage	1.3%
Total telephone bills from March 1, 2003 to July 31, 2006	$307,500
Long distance tax percentage	× 1.3%
Federal telephone excise tax refund	$ 3,998

The credit is claimed on the 2006 Form 8913, *Credit for Federal Telephone Excise Tax Paid.*

Note. Additional information regarding the refund can be found in IRS News Release IR 2006-179 and on page 553–554 of the 2006 Univer*sity of Illinois Federal Tax School Workbook.*

Qualified Offer In Compromise

***Thomas E. Johnston v. Commissioner,* U.S. Court of Appeals, 9th Circuit, 04-73833, September 1, 2006**
IRC §7430

☞ Taxpayer Attempts to Use NOLs After IRS Accepts Penalty and Interest Resolution

Facts. The IRS accepted the taxpayer's offer-in-compromise (OIC) which fully resolved all aspects of his assessed tax deficiencies and penalties. After acceptance, the taxpayer wanted to apply his net operating losses (NOLs) to reduce his agreed payments under the settlement offer. The NOLs were never discussed prior to the acceptance of the OIC.

Analysis and Holding. The Circuit judge began his opinion by stating, "This case presents an attempt at 'post-deal negotiation.' It doesn't usually work in business. Why should we treat the tax collector differently?"

When the taxpayer offers to pay the IRS a sum certain to "fully resolve all the adjustments at issue" for certain tax years, and the Commissioner accepts his offer, the taxpayer may not apply net operating losses to reduce the agreed payments under the settlement.

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User Fee

IRS News Release IR 2006-176, November 13, 2006

IRC §6159

☞ IRS Increases User Fee for Installment Payment of Taxes

Background. The IRS first implemented user fees in 1995. Until now, the user fee for iniating an installment payment of a tax liability had not increased.

Analysis and Conclusion. Effective January 1, 2007, for direct debit installment agreements, the user increases from $43 to $52. These are agreements where the payment is deducted directly from the taxpayer's bank account. For other installment agreements the user fee increases from $43 to $105.

ITEMIZED DEDUCTIONS

Deductibility of Mortgage Interest and Real Estate Taxes

***Thomas R. Jones v. Commissioner,* TC Memo 2006-176, August 22, 2006**

IRC §§163, 164, 6651 and 6654

☞ Option to Purchase Insufficient to Allow Deductions for Mortgage Interest and Real Estate Taxes

Facts. Thomas Jones had a lease-purchase option agreement on the property where he lived. He agreed to pay his landlord (Peterson) $5,000 for an option to purchase the property at any time prior to August 2002. Under the agreement, Jones's monthly rental payments increased from $850 to $1,051 per month. $1,051 was equivalent to what the landlord paid to his mortgage lender each month. Peterson informed Jones that approximately $990 of the payment was deductible interest. However, Peterson did not specify who was entitled to the interest deduction.

The agreement also required Jones to pay the real estate taxes on the property and Peterson apparently told Jones he could deduct the property taxes. Peterson continued paying the insurance on the property in exchange for Jones agreeing to repair the roof.

In order to exercise the purchase option agreement, Jones was required to pay a second $5,000 and pay off the outstanding mortgage on the property.

In 1999, Jones was diagnosed with an illness which involved mental distress preventing him from working through 2000. His 1999 tax return reported no tax liability. Even though Mr. Jones received Social Security benefits and disability payments in 2000, he did not file a 2000 income tax return. Peterson, on the other hand, filed his 2000 tax return and claimed a deduction for the mortgage interest payments on the property.

In 2002, the taxpayer paid off Peterson's mortgage and paid him $5,000 to exercise the purchase option. At that time, legal title to the property transferred from Peterson to the taxpayer.

Upon audit, the IRS determined that Mr. Jones had a 1999 and 2000 tax liability. While he did not dispute owing additional tax, he argued he should be able to deduct the mortgage interest and real estate taxes for the portion of the payments he made in 2000 relating to the property.

Analysis. The IRS agreed mortgage interest paid on a qualifying residence is deductible. However, the taxpayer must be the legal or equitable owner of the residence and at least indirectly liable for the mortgage. Real estate taxes are deductible by the person on whom the taxes are imposed.

For federal income tax purposes, the sale occurs upon the earlier of transfer of legal title or the practical assumption of the benefits and burdens of ownership. In this case, Peterson referred to the property as "my property" in a December

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1998 letter to Mr. Jones. He also acknowledged that he was continuing to use the property address for purposes of receiving mail. Peterson consistently referred to the agreement as an "option" agreement, and in September 2001 Peterson wrote a letter to Jones in which he made it clear that he understood Jones was not bound under the agreement to purchase the property.

Holding. The Tax Court upheld the IRS position that the taxpayer did not own the property and was not entitled to the mortgage interest and real estate tax deductions.

Imported Prescription Drugs

H. R. 5441, Department of Homeland Security Appropriations Act, 2007, October 4, 2006
IRC §213

☞ Prescription Drugs Imported from Canada Do Not Qualify as an Itemized Deduction

Background. The Department of Homeland Security Appropriation Act prevents any appropriated funds from being used to prevent an individual from importing an approved prescription drug from Canada. This raises the issue regarding whether these imported drugs can be deducted as an itemized deduction or are reimbursable under a flexible spending plan or health savings account.

Analysis and Conclusion. The appropriations language does not make the imported drugs legal, it only bars border officials from preventing their importation for personal use.

PROFIT MOTIVE

Horse Breeding Activity

Judith A. Sanders-Castro v. Commissioner, **T.C. Summary Opinion 2006-161, October 4, 2006**
IRC §§183 and 6651

☞ Attorney's Horse Activity Lacked Profit Motive

Facts. The taxpayer, an attorney, bred and showed Appaloosa horses. She had no experience in the horse business prior to visiting with a long-time friend who showed and bred horses. The taxpayer studied the friend's horse business for over a year and accompanied her to shows. She later joined the Appaloosa Horse Club.

The taxpayer purchased her first horse in 1998 but it got sick and died a year later. She purchased a second bred horse which foaled a few weeks later. She later sold the foal for $5,300 but failed to report the income on her Schedule C. She purchased other horses and later gave them away.

The taxpayer hired her friend and another individual to train and care for the horses. She also paid other individuals to show the horses.

Issue, Analysis, and Holding. The taxpayer failed to prove a profit motive for the business. Among other things she:

- Failed to file 1099 forms for the professionals she hired
- Never made business cards or letterhead for the business
- Did not keep a separate bank account for the business
- Did not keep records on the horse business
- Did not advertise her horses for sale

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In these cases, the IRS looks at nine subjective factors to determine if a business is operated for a profit. These factors include:

1. The manner in which the taxpayer carries on the activity
2. The expertise of the taxpayer or his advisers
3. The time and effort expended by the taxpayer in carrying on the activity
4. The expectation that the assets used in the activity may appreciate in value
5. The success of the taxpayer in carrying on other similar or dissimilar activities
6. The taxpayer's history of income or losses with respect to the activity
7. The manner of occasional profits, if any, which are earned
8. The financial status of the taxpayer
9. Any elements indicating personal pleasure or recreation

No single factor, nor even the existence of a majority of factors favoring or disfavoring the existence of a profit objective, is controlling.

In its decision, the Tax Court focused on the fact the taxpayer did not keep complete and accurate books and records. She never developed a budget or a business plan. While the taxpayer was a sufficiently competent attorney, her lack of businesslike treatment of the horse activity weighed against finding a profit objective.

The court acknowledged the taxpayer attended shows and read trade literature. It did not find, however, that she reviewed the records of her breeding operations or sought specific advice on how to make her horse operation profitable.

The taxpayer consistently incurred losses related to the horse showing and breeding activity and claimed total losses of $43,289 during the tenure of the course of business. This excluded $8,300 of expenses that she failed to deduct in a previous tax year.

The court also noted the taxpayer had substantial income from other sources and the repeated losses from the horse activity was used to offset this income.

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RATES AND TABLES

2007 Inflation Adjustments

Rev. Proc. 2006-53, November 9, 2006
IRC § Various

☞ 2007 Inflation Adjustments Announced

Analysis. All of the 2007 inflation adjustments are listed in Rev. Proc 2006-53. A few of the adjustments include:

Standard deduction	Single	$ 5,350
	Married filing jointly	$10,700
	Married filing separately	$ 5,350
	Head of household	$ 7,850
	Person claimed as dependent by another taxpayer	Greater of $850 or $300 plus earned income
Additional standard deduction for aged and blind		$1,050 each or $1,300 if unmarried and not surviving spouse
Exemption amount		$ 3,400
IRC §179 deduction		$112,000 phaseout begins when purchases exceed $450,000

RESIDENCES

Foreclosure on Personal Residence

***Robert G. and Lana L. Gale v. Commissioner,* T.C. Summary Opinion 2006-152, September 14, 2006**
IRC §§108 and 6662

☞ Cancellation of Debt Does Not Qualify as Gain on Sale of Personal Residence

Facts. The taxpayers defaulted on their home mortgage loans. After the home foreclosed and was sold, the outstanding amount of their second mortgage loan was forgiven. The taxpayers received a Form 1099-C C*ancellation of Debt* from the lender, but failed to report the income on their tax return.

After receiving notice of unreported income, the taxpayers filed an amended return which reported the debt forgiveness as an excludable gain from the sale of a personal residence.

Analysis. The taxpayers did not present any evidence to the IRS to prove that they were insolvent after the amount of the second mortgage was forgiven. The night before their court appearance, they prepared a list of assets and liabilities in an attempt to prove their insolvency. However, they failed to include the value of their retirement plans as assets.

Holding. The Tax Court held that even though the debt forgiveness originated from a mortgage on a personal residence, it did not qualify as a gain from its sale. The court agreed. Therefore, the positions of the IRS were upheld on both issues resulting in taxation of the Form 1099-C amount.

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The court did waive the 20% penalty on underpayment attributable to negligence or disregard of rules or regulations. It was convinced the taxpayers provided their tax professional with all of the necessary information concerning the sale of the home and the cancellation of indebtedness. Therefore, they reasonably relied on the preparer and were not liable for the accuracy-related penalty.

Note. Tax preparers may encounter more of these issues when preparing 2006 tax returns as there has been a dramatic increase both in foreclosures of personal residences and delinquent payments on mortgages.

The court agreed with the IRS that the taxpayers failed to prove their insolvency immediately before the debt forgiveness.

RETIREMENT

Early Distribution Penalty

***Charles J. Olintz v. Commissioner,* T.C. Summary Opinion 2006-155, September 25, 2006**

IRC §§72 and 6662

☞ Taxpayer's Pre Age 59 ½ Pension Distribution not Subject to 10% Penalty

Facts. The taxpayer received a distribution of $55,545 from his former employer's pension plan. He was age 56 at the time of separation. He reported the distribution as income on his tax return omitted reporting the 10 percent early distribution penalty. In its exam, the IRS assessed the penalty plus the accuracy-related penalty.

Analysis. IRC §72(t)(2) assesses a 10 percent penalty on early distributions (pre-age 59 ½) from a pension plan. However there are exceptions to the penalty. These include:

1. The employee is age 59 ½ or older at the time of the distribution;
2. The distribution is to the beneficiary of the employee after the death of the employee;
3. The employee becomes disabled;
4. The distribution is a part of a series of substantially equal payments made for life;
5. The distribution is made to the employee after separation from service and the employee is over age 55;
6. The distribution is a dividend paid with respect to corporate stock described in §404(k);
7. The distribution is for employee medical care; or
8. The distribution is to an alternate payee pursuant to a qualified domestic relations order.

Holding. The court held that the 5th exception applied. Therefore, the penalty was not applicable.

Caution. If the taxpayer had rolled the pension plan distribution into an IRA at the time of separation and then taken a distribution, he would have been liable for the 10 percent penalty.

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IRA Distribution

Letter Ruling 200644022, August 22, 2006

IRC §401

☞ Beneficiary Required to Take IRA Distributions Within Five Years.

Facts. The IRA owner died before attaining age 70 ½ and before taking any distributions. A trust was the beneficiary of his IRA and his spouse was the beneficiary of the trust. The spouse died before receiving any distributions and had not named a remainder beneficiary for the IRA. The son inherited the IRA as the sole heir when his mother died. He wanted to use his life expectancy to calculate the required minimum distributions from the inherited IRA.

Analysis and Holding. The IRS ruled that the son could not use his life expectance but rather must take all distributions within five years as specified in the Code.[9]

9. IRC §401(a)(9)(B)(ii)

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2006 Workbook

IRS News Release IR 2006-162, October 18, 2006

IRC §§61, 401, 402, 404, 408, 409, 414, 415, 416, and 457

☞ IRS Releases COLA Adjustments for 2007 Retirement Plan Contributions

Retirement Plan Limitations	2007	Age 50+ Catch-up
Traditional IRA and Roth IRA contributions	$ 4,000	$1,000
Elective deferrals to SIMPLE IRA and SIMPLE 401(k) plans under IRC §408(p)(2)(E)	10,500	2,500
Elective salary reduction contributions under IRC §402(g) to §401(k), §403(b), §408(k) SARSEPs, and the Thrift Savings Plan	15,500	5,000
Elective deferrals to IRC §457 state or local government plans or IRC §501(c) tax-exempt organization plans	15,500	5,000
The sum of employee elective deferrals and employer contributions to defined contribution plans (IRC §415(c)(1)(A)) and SEP plans (IRC §408(j))	Lesser of: $45,000 or 100% of compensation	
Annual benefit limitation under defined benefit plan allowed by IRC §415(b)(1)(A)	180,000*	
Annual compensation caps under IRC §§401(a)(17),** 404(l), 408(k)(3)(C), and 408(k)6)(D)(ii)	225,000	
SEP minimum compensation threshold	500	
Dollar limitation under IRC §414(q)(1)(B) used to define a highly compensated employee	100,000	
Dollar limitation under IRC §416(i)(1)(A)(i) used to define a key employee in a top-heavy plan	145,000	
Maximum account balance in an ESOP subject to 5-year distribution under IRC §409(o)(1)(C)(ii)	915,000	
Dollar limitation used to determine the lengthening of the 5-year distribution period for ESOPs under IRC §409(o)(1)(C)(ii)	180,000	

* For participants who separated from service before January 1, 2007, the limitation for defined benefit plans under IRC §415(b)(1)(B) is computed by multiplying the participant's 2006 adjusted compensation limitation by 1.0334.

**The 2007 compensation limit is $335,000 for certain governmental plans in effect on July 1, 1993, that allowed for cost-of-living increases.

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401(k) Distribution

***Richard M. Smart v. Commissioner,* T.C. Summary Opinion 2006-177, October 25, 2006**
IRC §72

☞ Taxpayer Liable for the 10 percent Penalty on Early Distribution

Facts. The taxpayer retired at age 54. He made two distributions from his IRC §401(k) plan. The first distributions consisted of all of the earnings from the plan. This amount was rolled into an IRA. The taxpayer reported this distribution on his tax return and was exempt from the early distribution penalty.

The second distribution consisted of all of his and his employers contributions. All but $30,000 of this was used to pay off personal debts. The $30,000 was retained to purchase a home. The taxpayer qualified as a first-time home buyer. This distribution was reported as income, but the 10 percent early distribution penalty was omitted.

Analysis. Because the second distribution was not rolled into another retirement plan, it was subject to the 10 percent penalty. The first-time homebuyer exception would have applied except for two reasons:

1. Only $10,000 of the distribution qualifies for the exception.
2. The taxpayer purchased the home more than 120 days after receiving the distribution.

Holding. The Tax Court stated it found the taxpayer to be very reputable, but that fact and being a “nice guy” did not excuse him from owing the $11,625 early distribution penalty.

TRAVEL AND TRANSPORTATION EXPENSE

2007 Per Diem Rates

Revenue Procedure 2006-41, September 29, 2006
IRC §§62, 162 and 274

☞ Per Diem Rates for Travel After October 1, 2006 Announced

Background. Employers may reimburse their employees for lodging, meals and incidental (M & IE) incurred on business travel away from home without the need for receipts. These rates are updated annually.

Analysis and Conclusion. For travel on or after October 1, 2006, the simplified “high-low” per diem rate has increased to $246 for high-cost localities and to $148 for low-cost localities. The incidental expense per diem remains at $3 per day. The locations consider high-cost have changed. Some locations have been dropped and others added.

Transportation Workers Meal Deduction

Revenue Procedure 2006-41, September 29, 2006
IRC §274

☞ Transportation Worker Meal Deductible Percentage Increased

Background. Only 50 percent of food, beverage, and entertainment expenses are normally deductible. However, transportation workers are allowed a higher percentage.

Issue Analysis and Holding. For 2006 and 2007, transportation workers may deduct 75 percent of their food, beverage, and entertainment expenses. Beginning in 2008, they may deduct 80 percent.

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Auto Mileage Allowance

Revenue Procedure 2006-49, November 1, 2006

IRC §§61, 62, 162, 170, 213, 217, 274, and 1016

☞ IRS Announces the 2007 Optional Standard Mileage Rates

Background. The IRS allows taxpayers who use their automobile for business, medical, or charitable purposes to deduct a standard amount per mile rather then requiring detailed expenditure records. For 2006, the standard mileage rate is 44 cents per mile for business miles, 18 cents for medical mileage, and 14 cents for charitable miles.

Analysis and Conclusion. For 2007, the mileage rate is increased to 48½ cents per mile for business miles, 20 cents for medical miles, and 14 cents for charitable miles. For business automobiles, depreciation is considered to have been allowed at the rate of 16 cents per mile in 2003 and 2004, 17 cents in 2005 and 2006, and 19 cents in 2007.

Per Diem Expense Reimbursements

Revenue Ruling 2006-56, November 9, 2006

IRC §§62 and 3401

☞ Employers Need to Track Per Diem Allowances

Background. The taxpayer employees long-haul truck drivers in the transportation industry. The employer compensates the drivers on a mileage basis. The compensation is reported on Form W-2 and the employer pays the applicable employment taxes. The drivers are also reimbursed for meal and incidental expenses (M&IE) paid or incurred while traveling away from home. The drivers are reimbursed through an allowance for each day the driver is away from home. The reimbursement is based on a fixed cents-per-mile driven.

The amount of cents-per-mile driven is based upon the employer's expectation of the amount of daily M&IE that will be paid or incurred and the expectation of the average number of daily miles driven during the pay period. The drivers are required to provide logs to substantiate the time, place, and business purpose of the travel away from home. They are not required to substantiate the actual amount of M&IE. Instead, the taxpayer relies on administrative guidance published by the IRS under which the amount of ordinary and necessary business expenses are deemed substantiated when the employer provides a per diem allowance. For 2006, $52 is deemed substantiated by the IRS.

Analysis and Conclusion. Many of the drivers are paid more than $52 per day, even when computed on a monthly basis. The taxpayer requires the drivers to return any amounts paid to them with respect to days they are not away from home on business travel. He does not require drivers to return the portion of the allowance paid that exceeds $52 for days they were away from home on business travel.

The taxpayer does not have any method of tracking payments in excess of $52 per day. He did not report it on the drivers' Form W-2.

A per diem arrangement is not treated as a reimbursement or other expense allowance arrangement if:

1. The arrangement does not require the employee to substantiate the expenses covered by the arrangement, or
2. The arrangement provides the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement.[10]

If these requirements are not met, the arrangement is treated as a nonaccountable plan and payments must be included in the employee's gross income as wages or other compensation and are subject to withholding and payment of employment taxes. If the arrangement is considered nonaccountable, all amounts paid under the arrangement are subject to income tax and employment tax, not just the excess amounts.

10. Treas. Reg. §1.62-2(c)(1)

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For Example 3

Form **6252** — Department of the Treasury, Internal Revenue Service

Installment Sale Income

▶ Attach to your tax return.
▶ Use a separate form for each sale or other disposition of property on the installment method.

OMB No. 1545-0228 — **2005** — Attachment Sequence No. **79**

Name(s) shown on return: **Sam Seller** — Identifying number: **123-45-6789**

1 Description of property ▶ Goodwill
2a Date acquired (month, day, year) ▶ 07 / 07 / 2001 **b** Date sold (month, day, year) ▶ 09 / 01 / 2005
3 Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4 . . . ☐ Yes ☑ No
4 Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale . . . ☐ Yes ☐ No

Part I **Gross Profit and Contract Price.** Complete this part for the year of sale only.

5	Selling price including mortgages and other debts. **Do not** include interest whether stated or unstated		355,000
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)		
7	Subtract line 6 from line 5	355,000	
8	Cost or other basis of property sold	15,000	
9	Depreciation allowed or allowable	4,300	
10	Adjusted basis. Subtract line 9 from line 8	10,700	
11	Commissions and other expenses of sale		
12	Income recapture from Form 4797, Part III (see instructions)	4,300	
13	Add lines 10, 11, and 12		15,000
14	Subtract line 13 from line 5. If zero or less, **do not** complete the rest of this form (see instructions)		340,000
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain (see instructions). Otherwise, enter -0-		0
16	**Gross profit.** Subtract line 15 from line 14		340,000
17	Subtract line 13 from line 6. If zero or less, enter -0-		0
18	**Contract price.** Add line 7 and line 17		355,000

Part II **Installment Sale Income.** Complete this part for the year of sale **and** any year you receive a payment or have certain debts you must treat as a payment on installment obligations.

19	Gross profit percentage. Divide line 16 by line 18. For years after the year of sale, see instructions		95.7746%
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-		0
21	Payments received during year (see instructions). **Do not** include interest, whether stated or unstated		266,250
22	Add lines 20 and 21		266,250
23	Payments received in prior years (see instructions). **Do not** include interest, whether stated or unstated		
24	**Installment sale income.** Multiply line 22 by line 19		255,000
25	Enter the part of line 24 that is ordinary income under the recapture rules (see instructions)		0
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797 (see instructions)		255,000

Part III **Related Party Installment Sale Income. Do not** complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party

28 Did the related party resell or dispose of the property ("second disposition") during this tax year? . . . ☐ Yes ☐ No

29 **If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.**

- a ☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (month, day, year) ▶ / /
- b ☐ The first disposition was a sale or exchange of stock to the issuing corporation.
- c ☐ The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.
- d ☐ The second disposition occurred after the death of the original seller or buyer.
- e ☐ It can be established to the satisfaction of the Internal Revenue Service that tax avoidance was not a principal purpose for either of the dispositions. If this box is checked, attach an explanation (see instructions).

30	Selling price of property sold by related party (see instructions)	
31	Enter contract price from line 18 for year of first sale	
32	Enter the **smaller** of line 30 or line 31	
33	Total payments received by the end of your 2005 tax year (see instructions)	
34	Subtract line 33 from line 32. If zero or less, enter -0-	
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	
36	Enter the part of line 35 that is ordinary income under the recapture rules (see instructions)	
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797 (see instructions)	

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For Example 3

Form **6252** — **Installment Sale Income**

Department of the Treasury
Internal Revenue Service

▶ Attach to your tax return.
▶ Use a separate form for each sale or other disposition of property on the installment method.

OMB No. 1545-0228
2005
Attachment Sequence No. 79

Name(s) shown on return: **Sam Seller** — Identifying number: **123-45-6789**

1 Description of property ▶ **Covenant not to compete**

2a Date acquired (month, day, year) ▶ / / **b** Date sold (month, day, year) ▶ **09 / 01 / 2005**

3 Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4. ☐ Yes ☑ No

4 Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale ☐ Yes ☐ No

Part I — Gross Profit and Contract Price. Complete this part for the year of sale only.

5	Selling price including mortgages and other debts. **Do not** include interest whether stated or unstated		30,000
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)		
7	Subtract line 6 from line 5		
8	Cost or other basis of property sold		
9	Depreciation allowed or allowable		
10	Adjusted basis. Subtract line 9 from line 8		
11	Commissions and other expenses of sale		
12	Income recapture from Form 4797, Part III (see instructions)		
13	Add lines 10, 11, and 12		
14	Subtract line 13 from line 5. If zero or less, **do not** complete the rest of this form (see instructions)		30,000
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain (see instructions). Otherwise, enter -0-		
16	**Gross profit.** Subtract line 15 from line 14		30,000
17	Subtract line 13 from line 6. If zero or less, enter -0-		
18	**Contract price.** Add line 7 and line 17		30,000

Part II — Installment Sale Income. Complete this part for the year of sale **and** any year you receive a payment or have certain debts you must treat as a payment on installment obligations.

19	Gross profit percentage. Divide line 16 by line 18. For years after the year of sale, see instructions		100%
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-		0
21	Payments received during year (see instructions). **Do not** include interest, whether stated or unstated		22,500
22	Add lines 20 and 21		22,500
23	Payments received in prior years (see instructions). **Do not** include interest, whether stated or unstated		
24	**Installment sale income.** Multiply line 22 by line 19		22,500
25	Enter the part of line 24 that is ordinary income under the recapture rules (see instructions)		0
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797 (see instructions)		22,500

Part III — Related Party Installment Sale Income. Do not complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party

28 Did the related party resell or dispose of the property ("second disposition") during this tax year? ☐ Yes ☐ No

29 **If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.**

a ☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (month, day, year) ▶ / /

b ☐ The first disposition was a sale or exchange of stock to the issuing corporation.

c ☐ The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.

d ☐ The second disposition occurred after the death of the original seller or buyer.

e ☐ It can be established to the satisfaction of the Internal Revenue Service that tax avoidance was not a principal purpose for either of the dispositions. If this box is checked, attach an explanation (see instructions).

30	Selling price of property sold by related party (see instructions)	
31	Enter contract price from line 18 for year of first sale	
32	Enter the **smaller** of line 30 or line 31	
33	Total payments received by the end of your 2005 tax year (see instructions)	
34	Subtract line 33 from line 32. If zero or less, enter -0-	
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	
36	Enter the part of line 35 that is ordinary income under the recapture rules (see instructions)	
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797 (see instructions)	

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For Example 3

Form **4797** Department of the Treasury Internal Revenue Service (99)	**Sales of Business Property** (Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2)) ▶Attach to your tax return. ▶See separate instructions.	OMB No. 1545-0184 **2005** Attachment Sequence No. **27**

Name(s) shown on return	Identifying number
Sam Seller	**123-45-6789**

1	Enter the gross proceeds from sales or exchanges reported to you for 2005 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions)	1	

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (see instructions)

(a) Description of property	**(b)** Date acquired (mo., day, yr.)	**(c)** Date sold (mo., day, yr.)	**(d)** Gross sales price	**(e)** Depreciation allowed or allowable since acquisition	**(f)** Cost or other basis, plus improvements and expense of sale	**(g) Gain or (loss)** Subtract (f) from the sum of (d) and (e)
2						

3	Gain, if any, from Form 4684, line 42	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	**255,000**
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:	7	**255,000**
	Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.		
	Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.		
8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions)	9	**255,000**

Part II **Ordinary Gains and Losses** (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

From Form 6252						**22,500**

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	**9,300**
14	Net gain or (loss) from Form 4684, lines 34 and 41a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Combine lines 10 through 16	17	**31,800**
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:		
a	If the loss on line 11 includes a loss from Form 4684, line 38, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 27, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 22. Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14	18b	**31,800**

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For Example 3

Form 4797 (2005) Page **2**

Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255** (see instructions)

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Office furniture and electronic equipment	Various	09/01/2005
B Purchased goodwill	07/07/2001	09/01/2005
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20	5,000	355,000		
21 Cost or other basis plus expense of sale	21	15,000	15,000		
22 Depreciation (or depletion) allowed or allowable	22	15,000	4,300		
23 Adjusted basis. Subtract line 22 from line 21	23	0	10,700		
24 Total gain. Subtract line 23 from line 20	24	5,000	344,300		
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a	15,000	4,300		
b Enter the **smaller** of line 24 or 25a	25b	5,000	4,300		
26 **If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975 (see instructions)	26a				
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a (see instructions)	26b				
c Subtract line 26a from line 24. If residential rental property **or** line 24 is not more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the **smaller** of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g				
27 **If section 1252 property:** Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage (see instructions)	27b				
c Enter the **smaller** of line 24 or 27b	27c				
28 **If section 1254 property:**					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	28a				
b Enter the **smaller** of line 24 or 28a	28b				
29 **If section 1255 property:**					
a Applicable percentage of payments excluded from income under section 126 (see instructions)	29a				
b Enter the **smaller** of line 24 or 29a (see instructions)	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30 Total gains for all properties. Add property columns A through D, line 24	30	349,300
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	9,300
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 36. Enter the portion from other than casualty or theft on Form 4797, line 6	32	0

Part IV **Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less** (see instructions)

		(a) Section 179	(b) Section 280F(b)(2)
33 Section 179 expense deduction or depreciation allowable in prior years	33		
34 Recomputed depreciation (see instructions)	34		
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

Form **4797** (2005)

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For Example 3

Form **8594** (Rev. February 2006) Department of the Treasury Internal Revenue Service

Asset Acquisition Statement Under Section 1060

▶ Attach to your income tax return. ▶ See separate instructions.

OMB No. 1545-1021

Attachment Sequence No. 61

Name as shown on return	Identifying number as shown on return
Sam Seller	**123-45-6789**

Check the box that identifies you:
☐ Purchaser ☑ Seller

Part I General Information

1 Name of other party to the transaction	Other party's identifying number
Joseph Buyer	**987-65-4321**

Address (number, street, and room or suite no.)
101 South Lane

City or town, state, and ZIP code
Anytown, WI 55555

2 Date of sale	3 Total sales price (consideration)
09/01/2005	**390,000**

Part II Original Statement of Assets Transferred

4 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of sales price
Class I	$	$
Class II	$	$
Class III	$	$
Class IV	$	$
Class V	$ **5,000**	$ **5,000**
Class VI and VII	$ **385,000**	$ **385,000**
Total	$ **390,000**	$ **390,000**

5 Did the purchaser and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties? . . . . ☑ Yes ☐ No

If "Yes," are the aggregate fair market values (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document? . . . . . . ☑ Yes ☐ No

6 In the purchase of the group of assets (or stock), did the purchaser also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller)? . . . . . . ☑ Yes ☐ No

If "Yes," attach a schedule that specifies **(a)** the type of agreement and **(b)** the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See instructions.

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The sale price is determined in 2006, after the first year's gross billings are determined. Because the selling price decreases from a maximum of $385,000 to the set price of $357,500, the gross profit ratio for the installment sale must be recomputed. The allocation of the recalculated profit is shown below, followed by Sam's 2006 tax forms.

Year 2

Goodwill	
Actual billing	$325,000
Multiple	× 110%
Finalized sale price	$357,500
Covenant not to compete	(30,000)
Finalized goodwill	$327,500
Year 1 payment	(266,250)
Remaining balance	$ 61,250
Remaining years for payments	÷ 5
Year 2 payment	$ 12,250
Covenant not to compete	
Sale price	$ 30,000
Downpayment	(22,500)
Remaining balance	$ 7,500
Remaining years for payments	÷ 5
Year 2 payment	$ 1,500

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For Example 3

Form **6252** — Department of the Treasury, Internal Revenue Service

Installment Sale Income

► Attach to your tax return.
► Use a separate form for each sale or other disposition of property on the installment method.

OMB No. 1545-0228 — 2006 — Attachment Sequence No. 79

Name(s) shown on return: **Sam Seller** — Identifying number: **123-45-6789**

1 Description of property ► **Covenant not to compete**

2a Date acquired (month, day, year) ► / / **b** Date sold (month, day, year) ► 09 / 01 / 2005

3 Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4 . . . ☐ Yes ☑ No

4 Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale . . . ☐ Yes ☐ No

Part I Gross Profit and Contract Price. Complete this part for the year of sale only.

5	Selling price including mortgages and other debts. **Do not** include interest whether stated or unstated			5	
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6			
7	Subtract line 6 from line 5	7			
8	Cost or other basis of property sold	8			
9	Depreciation allowed or allowable	9			
10	Adjusted basis. Subtract line 9 from line 8	10			
11	Commissions and other expenses of sale	11			
12	Income recapture from Form 4797, Part III (see instructions)	12			
13	Add lines 10, 11, and 12			13	
14	Subtract line 13 from line 5. If zero or less, **do not** complete the rest of this form (see instructions)			14	
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain (see instructions). Otherwise, enter -0-			15	
16	**Gross profit.** Subtract line 15 from line 14			16	
17	Subtract line 13 from line 6. If zero or less, enter -0-			17	
18	**Contract price.** Add line 7 and line 17			18	

Part II Installment Sale Income. Complete this part for the year of sale **and** any year you receive a payment or have certain debts you must treat as a payment on installment obligations.

19	Gross profit percentage. Divide line 16 by line 18. For years after the year of sale, see instructions			19	100%
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-			20	
21	Payments received during year (see instructions). **Do not** include interest, whether stated or unstated			21	1,500
22	Add lines 20 and 21			22	1,500
23	Payments received in prior years (see instructions). **Do not** include interest, whether stated or unstated	23	22,500		
24	**Installment sale income.** Multiply line 22 by line 19			24	1,500
25	Enter the part of line 24 that is ordinary income under the recapture rules (see instructions)			25	
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797 (see instructions)			26	1,500

Part III Related Party Installment Sale Income. Do not complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party

28 Did the related party resell or dispose of the property ("second disposition") during this tax year? . . . ☐ Yes ☐ No

29 **If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.**

a ☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (month, day, year) ► / /

b ☐ The first disposition was a sale or exchange of stock to the issuing corporation.

c ☐ The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.

d ☐ The second disposition occurred after the death of the original seller or buyer.

e ☐ It can be established to the satisfaction of the Internal Revenue Service that tax avoidance was not a principal purpose for either of the dispositions. If this box is checked, attach an explanation (see instructions).

30	Selling price of property sold by related party (see instructions)	30	
31	Enter contract price from line 18 for year of first sale	31	
32	Enter the **smaller** of line 30 or line 31	32	
33	Total payments received by the end of your 2006 tax year (see instructions)	33	
34	Subtract line 33 from line 32. If zero or less, enter -0-	34	
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	35	
36	Enter the part of line 35 that is ordinary income under the recapture rules (see instructions)	36	
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797 (see instructions)	37	

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Draft as of 06/08/2006

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The recalculated gross profit ratio for the goodwill payments received in tax year 2006 and beyond is shown below. Form 6252, Part I that reports the 2006 principal payment received for goodwill should be left blank. The gross profit percentage reported on Form 6252, line 19 should be changed to reflect the recalculated profit of 93.877%, with the notation "See statement."

Sam attaches the following statement showing the recalculated gross profit percentage to his 2006 return.

Sam Seller
123-45-6789
Attachment to Form 6252:

Year 2 fixed sale price	$327,500	
Year 1 payments	(266,250)	
Balance due	$ 61,250	$61,250
Original basis	$ 15,000	
Basis recovered in Year 1	(11,250)	
Remaining basis	$ 3,750	(3,750)
New gross profit		$57,500
Balance due		÷ 61,250
New gross profit percentage		93.877%
Balance due		$61,250
Number of remaining payments		÷ 5
Year 2 payment		$12,250
New gross profit percentage		× 93.877%
Taxable gain in Year 2		$11,500

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For Example 3

Form **6252**
Department of the Treasury
Internal Revenue Service

Installment Sale Income

▶ Attach to your tax return.
▶ Use a separate form for each sale or other disposition of property on the installment method.

OMB No. 1545-0228
2006
Attachment Sequence No. 79

Name(s) shown on return: **Sam Seller**
Identifying number: **123-45-6789**

Draft as of 06/08/2006

1	Description of property ▶ Goodwill			
2a	Date acquired (month, day, year) ▶ 07 / 07 / 2001		**b** Date sold (month, day, year) ▶	09 / 01 / 2005
3	Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4		☐ Yes	☐ No
4	Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale		☐ Yes	☐ No

Part I — Gross Profit and Contract Price. Complete this part for the year of sale only.

5	Selling price including mortgages and other debts. **Do not** include interest whether stated or unstated			5	
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6			
7	Subtract line 6 from line 5	7			
8	Cost or other basis of property sold	8			
9	Depreciation allowed or allowable	9			
10	Adjusted basis. Subtract line 9 from line 8	10			
11	Commissions and other expenses of sale	11			
12	Income recapture from Form 4797, Part III (see instructions)	12			
13	Add lines 10, 11, and 12			13	
14	Subtract line 13 from line 5. If zero or less, **do not** complete the rest of this form (see instructions)			14	
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain (see instructions). Otherwise, enter -0-			15	
16	**Gross profit.** Subtract line 15 from line 14			16	
17	Subtract line 13 from line 6. If zero or less, enter -0-			17	
18	**Contract price.** Add line 7 and line 17			18	

Part II — Installment Sale Income. Complete this part for the year of sale **and** any year you receive a payment or have certain debts you must treat as a payment on installment obligations.

19	Gross profit percentage. Divide line 16 by line 18. For years after the year of sale, see instructions			19	93.877% See Stmt
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-			20	
21	Payments received during year (see instructions). **Do not** include interest, whether stated or unstated			21	12,250
22	Add lines 20 and 21			22	12,250
23	Payments received in prior years (see instructions). **Do not** include interest, whether stated or unstated	23	266,250		
24	**Installment sale income.** Multiply line 22 by line 19			24	11,500
25	Enter the part of line 24 that is ordinary income under the recapture rules (see instructions)			25	0
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797 (see instructions)			26	11,500

Part III — Related Party Installment Sale Income. Do not complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party

28 Did the related party resell or dispose of the property ("second disposition") during this tax year? ☐ Yes ☐ No

29 **If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.**

- **a** ☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (month, day, year) ▶ / /
- **b** ☐ The first disposition was a sale or exchange of stock to the issuing corporation.
- **c** ☐ The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.
- **d** ☐ The second disposition occurred after the death of the original seller or buyer.
- **e** ☐ It can be established to the satisfaction of the Internal Revenue Service that tax avoidance was not a principal purpose for either of the dispositions. If this box is checked, attach an explanation (see instructions).

30	Selling price of property sold by related party (see instructions)	30	
31	Enter contract price from line 18 for year of first sale	31	
32	Enter the **smaller** of line 30 or line 31	32	
33	Total payments received by the end of your 2006 tax year (see instructions)	33	
34	Subtract line 33 from line 32. If zero or less, enter -0-	34	
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	35	
36	Enter the part of line 35 that is ordinary income under the recapture rules (see instructions)	36	
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797 (see instructions)	37	

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For Example 3

Form **8594** (Rev. February 2006) Department of the Treasury Internal Revenue Service

Asset Acquisition Statement Under Section 1060

▶ Attach to your income tax return. ▶ See separate instructions.

OMB No. 1545-1021

Attachment Sequence No. **61**

Name as shown on return	Identifying number as shown on return
Sam Seller	**123-45-6789**

Check the box that identifies you:
☐ Purchaser ☑ Seller

Part I General Information

1 Name of other party to the transaction	Other party's identifying number
Joseph Buyer	**987-65-4321**

Address (number, street, and room or suite no.)
101 South Lane

City or town, state, and ZIP code
Anytown, WI 55555

2 Date of sale	3 Total sales price (consideration)
09/01/2005	**367,500**

Part II Original Statement of Assets Transferred

4 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of sales price
Class I	$	$
Class II	$	$
Class III	$	$
Class IV	$	$
Class V	$ **5,000**	$ **5,000**
Class VI and VII	$ **357,500**	$ **357,500**
Total	$ **362,500**	$ **362,500**

5 Did the purchaser and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties? . . . . ☑ Yes ☐ No

If "Yes," are the aggregate fair market values (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document? . . . . ☑ Yes ☐ No

6 In the purchase of the group of assets (or stock), did the purchaser also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller)? . . . . . . ☑ Yes ☐ No

If "Yes," attach a schedule that specifies **(a)** the type of agreement and **(b)** the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See instructions.

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For Example 3

Form 8594 (Rev. 2-2006) Page 2

Part III **Supplemental Statement**—Complete only if amending an original statement or previously filed supplemental statement because of an increase or decrease in consideration. See instructions.

7 Tax year and tax return form number with which the original Form 8594 and any supplemental statements were filed.

2005 Form 1040

8 Assets	Allocation of sales price as previously reported	Increase or (decrease)	Redetermined allocation of sales price
Class I	$	$	$
Class II	$	$	$
Class III	$	$	$
Class IV	$	$	$
Class V	$ **5,000**	$ **0**	$ **5,000**
Class VI and VII	$ **385,000**	$ **(27,500)**	$ **357,500**
Total	$ **390,000**		$ **362,500**

9 Reason(s) for increase or decrease. Attach additional sheets if more space is needed.

The sale price was based on a retained business basis. After the first year the final price was determined and the sale price reduced by $27,500.

7

TRANSFER OF CLIENT FILES

Generally, it is a matter of state law whether a client's permission must be obtained before transferring files to a new owner. Since a buyer usually requires prior records to adequately service clients, the contract should provide the seller with rights to access files in order to resolve any problems with work performed while he owned the business. It is advisable for both the buyer and seller to consult with their respective legal counsel, and any applicable regulatory agencies regarding the transfer of files.

Maintaining Records

IRS Requirements. IRC §6107 requires an income tax return preparer to keep a copy of each return or claim for refund prepared. Alternatively, a preparer may maintain a list including the name and identification number of each taxpayer for whom such a return or claim was prepared. This information must be made available to the IRS upon request.

These returns or lists must be kept for a period of three years after the close of a return period. A "return period" is defined as any 12-month period beginning July 1 and ending the following June 30.[8] Information regarding extended returns due after July 1 must be retained until the end of the 3-year period that includes the extended due date.

> **Example 4.** Bob prepares 250 individual tax returns for tax year 2005 between January 1, 2006 and April 17, 2006. Bob extends 10 returns for tax year 2005, which he completes in May 2006.
>
> Since the due date for the unextended returns falls on April 17, 2006 — between July 1, 2005 and June 30, 2006 — Bob must maintain records of these returns until June 30, 2009. The 10 extended returns, due October 16, 2006, must be kept until June 30, 2010 since the extended due date falls between the dates of July 1, 2006 and June 30, 2007.

8. IRC §6060(c)

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