WHAT'S NEW SUPPLEMENT

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CORRECTIONS TO 2007 FEDERAL TAX WORKBOOK

Page	Correction or Addition
6	Change the paragraph before the form for Example 1 to read: "Jane has a 2007 AMT loss of $550,000 on the sale of the 10,000 shares. However, the AMT loss is limited to $3,000. The difference between the regular tax gain of $40,000 and the allowable AMT loss of $3,000 is $43,000. This is entered as a negative figure on line 16 of her Form 6251. Therefore, it is unlikely that Jane will have a 2007 AMT liability. In addition, change the amount listed on Form 6251 to the following: Line 16: from (590,000) to (43,000)
100	Regarding the second boxed Note on page 100: A CRAT is different from a Charitable Gift Annuity. CRATS file Forms 5227 and 1041 and issue Schedule 1041 K-1s to beneficiaries. CRATS are backed up **only** by the assets in the trust. Charitable Gift Annuities issue a Form 1099-R (as shown on page 103) and are backed up by the general assets of the charity itself (often a separate foundation established by the charity which is approved to issue charitable gift annuities). See page 393 in the 2006 *University of Illinois Tax School Workbook* for more information on charitable trusts.
115	Change Line "I" bullet from "99.4444" (shares) to "0."
139	In the table at the top of page 139 change "$30,000" to "3,060."
193	In paragraph 3, the current estate tax rate is 45%.
194	Insert as a bullet in the list at the bottom of the page: "non-material participation crop or livestock share lease."
201	After bold face "**Crop shares**." Crop and livestock shares are only IRD if they are from a "non-materially participating" lease.
204	Under **Discounts —** In the next to the last sentence change "cannot" to "can."
204	Under **Holding Period** — After the last sentence in paragraph 1 insert, "Livestock is an exception as they do not receive a more than one year holding period at death."
213	In the last sentence on Example 36 paragraph one, change "46%" to "45%." Change "$345,000" to "$337,500." Also change $345,000" to "$337,500" at the end of paragraph two.
223	In the table at the top of the page, the Ceiling Amount for 2008 should be changed from "16,000" to "15,500."
225	In the table, change the profit sharing plans percentage from "25%" to "20%" and the contribution amount from "12,925" to "7,435." This changes the total from "$47,929" to "$42,435."
225	In the note box, change ".09" to ".10."
227	In the first paragraph under "Railroad Retirement," change Form RRB-1099-R *Annuities or Pensions by the Railroad Retirement Board* to Form RRB-1099 *Payments by the Railroad Retirement Board.* Paragraph 2 is correct. Tier II benefits are reported on Form RRB-1099-R.

Page	Correction or Addition
236	In the first paragraph under "Solo-401(k) Compared to Other Plans," change the upper limit from $10,000 to $10,500.
242	Change the third bullet at the top of the page to: "Married, and his spouse is NOT more than 10 years younger."
268	The information on page 268 has changed dramatically with the release of the new allowable living standards. Please go to the following link for the new standards which are effective on October 1, 2007. **www.irs.gov/individuals/article/0,,id=96543,00.html**
293	In Example 32, change October 15, 2007 to October 9, 2007.
356	In the second paragraph of the section Office in Home, delete the last sentence.
370	The formula for Tax on Excess Net Passive Income should be changed from "(.25 x Gross passive receipts)" to "(.25 × Gross receipts)." Also, "Excess percentage" should read "Excess net passive income."
383	In paragraph 1 of #5, "$225,000" should be "$457,000." This is because the actual sale price includes the debt assumed of $232,000.
400	In the section "Effect of Liabilities on Member Basis," the multiplication signs in two calculations should be division signs. "$180,000 ($80,000 + ($300,000 ÷ 3))." And "$40,000 ($100,000 – ($300,000 ÷ 5))."
436	The note box at the top of the page is incorrect. IRC §453(b)(2)(B) specifically allows the installment sale of inventory property if it involves farm commodities.
451	1st line after the chart should be "divided by 420" not by 480. It is 35 years times 12.
451	Go to **www.ssa.gov** for the actual indexing chart. This chart only shows the change in the indexing percentage each year.
525	In the first bullet, change December 31, 2006 to December 31, 2005.
18-12	Add to the chart at the top of the page for Illinois Cares RX Basic "Maximum income: household of three: $38,393"

NEW TAX LEGISLATION PASSED IN DECEMBER 2007

The following tax legislation was passed by Congress and signed by President Bush in December 2007:

- *Tax Increase Prevention Act of 2007* (signed December 26, 2007)
- *Mortgage Forgiveness Debt Relief Act of 2007* (signed December 20, 2007)
- *Energy Independence and Security Act of 2007* (signed December 19, 2007)
- *Technical Corrections Act of 2007* (signed December 29, 2007)

The most important tax provisions contained in these four bills are analyzed below. In addition, some provisions that applied in 2007 were not extended to 2008.

TAX INCREASE PREVENTION ACT OF 2007

Higher AMT Exemption Amounts for 2007

The AMT "patch" will prevent many taxpayers from owing AMT on their 2007 individual tax returns. The 2007 AMT exemption amounts are:

Married Filing Jointly, Surviving Spouse	$66,250
Single, Head of Household	$44,350
Married Filing Separately	$33,125

IRS News Release IR-2008-1 (January 2, 2008). The AMT changes mean that as many as 13.5 million taxpayers using five forms related to the AMT legislation will have to wait to file tax returns until the IRS completes the reprogramming of its systems for the new law. The IRS has targeted February 11 as the potential starting date for taxpayers to begin submitting the five AMT-related returns affected by the legislation.

The February date allows the IRS enough time to update and test its systems to accommodate the AMT changes without major disruptions to other operations related to the tax season. Although as many as 13.5 million taxpayers will not be able to file their returns until February 11, the effect of the delay may be lessened by the fact that based on previous filing patterns only 3 to 4 million taxpayers file returns with the five affected forms during these early weeks of the filing season.

The February 11 delay caused by the AMT patch will affect any taxpayer using any of these five forms:

- Form 8863, *Education Credits*
- Form 5695, *Residential Energy Credits*
- Form 1040A Schedule 2, *Child and Dependent Care Expenses for Form 1040A Filers*
- Form 8396, *Mortgage Interest Credit*
- Form 8859, *District of Columbia First-Time Homebuyer Credit*

Although these five forms require significant additional reprogramming due to the AMT patch, the IRS has been able to reprogram its systems to begin processing seven other AMT-related forms, including Form 6251, *Alternative Minimum Tax-Individuals*. Taxpayers filing these seven forms should not experience delays in filing, and the IRS expects to begin processing those returns starting on time.

Electronic returns involving those five forms will not be accepted until systems are updated in February. Similarly, paper filers should wait to file as well. All other e-filed and paper returns will be accepted starting in January.

Nonrefundable Personal Credits

Most nonrefundable personal credits will be allowed in full against both 2007 regular tax and AMT liability. These credits are listed on page 2 of the 2007 *University of Illinois Tax School Workbook.* However, this favorable rule does **not** apply to the personal use portion of the 2007 tax credit for new qualified hybrid vehicles claimed on the 2007 Form 8910, *Alternative Motor Vehicle Credit.* Therefore, taxpayers who purchased new hybrid vehicles during 2007 may be denied part or all of their otherwise allowable 2007 hybrid vehicle credit if they have a tentative minimum tax liability on their 2007 Form 6251, *Alternative Minimum Tax-Individuals.*

MORTGAGE FORGIVENESS DEBT RELIEF ACT OF 2007

1. Exclusion of Forgiveness of Debt on Principal Residence Mortgages

Old Law. Under prior law, forgiven debt by a lender on a principal residence mortgage would generally be considered taxable income. Exceptions to this general rule applied for taxpayers who were bankrupt under Title 11 or insolvent.

New Law. For tax years 2007 through 2009, a new exception to the general rule is provided for cancellation of debt on mortgages secured by the principal residence of the taxpayer. This new exception contains these provisions:

- The mortgage proceeds were used by the taxpayer to acquire, construct, or make substantial improvements to the principal residence.
- The amount of forgiven debt that can be excluded from gross income is limited $2 million ($1 million for married taxpayers who file separate returns).

Example 1. Tim and Sherry bought their principal residence in 2003 for $300,000 financed in part by a $280,000 mortgage. The lender foreclosed on their home in January 2008 when the outstanding principal balance was $260,000. The lender sold the home in 2008 for a net price of $250,000 and forgave Tim and Sherry the unpaid mortgage balance of $10,000. Under the new law, the $10,000 is excluded from their 2008 gross income.

Comment. This new law represents Congressional concern over the growing sub-prime mortgage meltdown. Congress was sympathetic to struggling homeowners and passed this foreclosure relief legislation.

2. Exclusion of State and Local Tax Benefits and Pay for Volunteer Firefighters and Emergency Responders

Old Law. State and local property tax and/or state or local income tax rebates and payments for services of volunteer firefighters and emergency medical responders were represented taxable income under IRC §61.

New Law. For tax years 2008 through 2010, these types of remuneration for volunteer services performed are excluded from gross income.

3. Time Period Extension of the $500,000 Exclusion of Gain on Principal Residence Sales by Surviving Spouses

Old Law. Generally, a surviving spouse who sold a home which was jointly owned and occupied by both spouses could claim the $500,00 gain exclusion only if the sale occurred in the tax year of death. If the surviving spouse sold the principal residence in a tax year after death, the unmarried surviving spouse was considered a single taxpayer and entitled to a maximum $250,000 exclusion on the gain.

New Law. Beginning on January 1, 2008, an unmarried surviving spouse is entitled to the $500,000 exclusion that applies to joint return filers if the sale of the principal residence occurs within two years of the date of death.

Example 2. Seth and Mary bought their jointly owned principal residence in 1960. Seth dies on July 8, 2008. Mary, who remains unmarried, sells the residence on July 7, 2010 and realizes a gain in excess of $500,000. She may exclude the first $500,000 of gain on her single filing status 2010 Form 1040.

Note. Mary is entitled to a step-up in basis for Seth's one-half of the home which she inherited on his death in 2008, assuming Seth owned half of the home at the time of his death.

4. Mortgage Insurance Premium Deduction Extended

Old Law. Taxpayers are entitled to deduct premiums paid on qualified mortgage insurance on principal or second residences if the insurance was issued during 2007. The deduction does not apply to any mortgage insurance contracts issued before January 1, 2007. The deduction is subject to a phaseout based on the taxpayers 2007 AGI. The phaseout begins when 2007 AGI exceeds $100,000 for all but married taxpayers who file separately. For married taxpayers filing separately, the phaseout begins when 2007 AGI exceeds $50,000. This deduction is available only for the 2007 tax year and is deducted on line 13, Schedule A as deemed home mortgage interest.

New Law. This deduction is extended for tax years 2008 through 2010 for mortgage insurance contracts issued between January 1, 2007 and December 31, 2010.

5. Higher Failure to File Penalties for Partnership Returns

Old Law. Under IRC §6698, a partnership which failed to timely file a partnership return could be penalized $50 per partner for a maximum of five months. This penalty is assessed against the partnership. This penalty is waived if the failure to file is due to a reasonable cause.

New Law. The per partner penalty is increased from $50 to $85. The maximum period for assessing the penalty is increased from five months to 12 months. The increased penalty applies to partnership returns required to be filed on or after December 21, 2007. The reasonable cause exception is retained.

6. New Failure to File Penalties for S Corporations

Old Law. Under IRC §7203, S corporations could be penalized for failure to timely file a Form 1120S and timely provide each shareholder with a Schedule K-1 only if the failure was willful.

New Law. The new failure to file penalty for S corporations is similar to the new law shown above in #5 for failure to file partnership returns. For any failure to file required information returns, S corporations can be assessed a penalty equal to $85 per shareholder for a maximum of 12 months. The new penalty applies to 1120S returns required to be filed on or after December 21, 2007. This penalty is waived if the failure to file is due to a reasonable cause.

ENERGY INDEPENDENCE AND SECURITY ACT OF 2007

Temporary FUTA Surtax Extended

The 0.2% temporary FUTA surtax is extended for 2008. This surtax, which became effective in 1977, has been consistently extended for every year after 1977. As a result, the total FUTA tax rate for 2008 will be 6.2%.

TAX TECHNICAL CORRECTIONS ACT OF 2007

Background Information. The Technical Corrections Act of 2007 (TCA) made several revisions to and clarifications of existing tax legislation. The only one discussed is the clarification of the **refundable AMT credit** computation. See pages 7–15 in the 2007 *University of Illinois Federal Tax Workbook.*

Clarification of the Refundable AMT Credit Computation. See **Example 2** for Jane which begins on page 9 in the 2007 *University of Illinois Federal Tax Workbook*. **Example 3** on the following page compares the **former interpretation** and the **clarification** made by the TCA. **Example 3** specifically provides clarification to the issues discussed in the first boxed note on page 15 of the 2007 *University of Illinois Federal Tax Workbook.*

Example 3. Former interpretation of Jane's remaining minimum tax credit carryforward to 2008. Jane's remaining minimum tax credit carryforward to 2008 is $125,220 after subtracting her 2007 minimum tax credit of $31,305 (line 26 on page 11 of the 2007 *University of Illinois Federal Tax Workbook*). According to the **former interpretation,** Jane would be entitled to the following "long-term unused minimum tax credit" amounts in 2007, 2008, 2009, 2010, 2011, and 2012 using the **20% declining balance computation method:**

Year	Jane's Refundable AMT Credit Amount	Computation
2007	$ 31,305	$156,525 × 20%
2008	25,044	($156,525 − 31,305) × 20%
2009	20,035	$100,176 × 20%
2010	16,028	$80,141 × 20%
2011	12,823	$64,113 × 20%
2012	10,258	$51,290 × 20%
Total	$115,493	

Note. Example 3 assumes that Jane is **not** subject to the phaseout rules for the refundable AMT credit for tax years 2008 through 2012. These phaseout rules are shown on page 8 of the 2007 *University of Illinois Federal Tax Workbook.*

Clarification Made by the TCA. Jane will be entitled to a $31,305 minimum tax credit for **each** of the five tax years 2007, 2008, 2009, 2010, and 2011. Her total "long-term unused minimum tax credit" amount of $156,525 which she carried from 2003 to 2007 will be refunded to her as shown in the following chart:

Year	Jane's Refundable AMT Credit Amount	Computation
2007	$31,305	$156,525 × 20%
2008	31,305	156,525 × 20%
2009	31,305	156,525 × 20%
2010	31,305	156,525 × 20%
2011	31,305	156,525 × 20%
Total	$156,525	

Provisions That Were Not Extended To 2008

The following provisions **were not extended** to 2008:

- Charitable tax-free distributions from IRAs
- 15-year depreciable life for qualified leasehold improvements and restaurant property
- Sales tax deduction in lieu of state and local income tax deduction (Schedule A)
- Tuition and fees deduction (Form 8917 and page 1 of Form 1040)
- Educator expenses deduction (page 1 of Form 1040)
- Research credit (Form 6765)

Note. Even though these provisions were not extended to 2008, practically all tax reporting services are predicting that they will eventually be extended retroactively to 2008 by future legislation.

BANKRUPTCY AND INSOLVENCY

Litigation Costs and Fees

***In re Kovacs v. U.S.*, 05-2462 (Bank. Ct., E.D. Wis., Sep. 11, 2007)**
IRC§§7430 and 7433

☞ IRS Liable for Costs When Seeking to Collect on Discharged Bankrupt

Facts. The taxpayer and the IRS entered into an offer in compromise (OIC) resolving the taxpayer's tax liabilities for the years 1990, 1991, 1993, 1994, and 1995. One requirement of the OIC was that the taxpayer timely file her federal tax returns and pay all taxes due for the five years after the 1996 OIC was accepted by the IRS. The taxpayer failed to pay her federal tax liability for 1999 in the amount of approximately $2,300. The IRS notified the taxpayer that, because of her failure to pay the 1999 tax liability, the OIC was being terminated immediately and any outstanding unpaid liabilities for the years in question were being reinstated.

The taxpayer filed a petition in bankruptcy under Chapter 7. She received her bankruptcy discharge on October 10, 2001. On February 26, 2002, taxpayer's Chapter 7 bankruptcy case was closed. During the time the bankruptcy case was still pending but after Kovacs received her discharge, the IRS notified the taxpayer that it had applied $300 from her tax refund due for the year 2000 to her outstanding tax liability for the year 1991.

The taxpayer then wrote to the IRS seeking to reinstate the terminated 1996 OIC. She also informed the IRS that she had filed a petition in bankruptcy under Chapter 7. The taxpayer further informed the IRS that she received her bankruptcy discharge in October of 2001. The taxpayer's attorney began discussion with the IRS seeking to reinstate the 1996 OIC. The IRS denied this stating that it could not be considered because the bankruptcy case was "still open." The taxpayer's attorneys resubmitted the OIC to the IRS, together with a copy of Kovacs' bankruptcy discharge, for reconsideration.

The IRS mailed the Kovacs a series of notices of intent to levy on the taxpayer's assets for her outstanding tax liabilities for the tax years in question and also for 1999. The tax liabilities contained in these notices totaled over $154,000.

The IRS rejected the taxpayer's resubmitted OIC. The taxpayer appealed to the IRS Appeals Office. The IRS then informed the taxpayer that her tax liabilities for all of the tax years in question were dischargeable debts but the tax liability for 1999 was not a dischargeable debt. The nondischargeable 1999 tax liability was then satisfied by transferring the 2001 tax refund from the discharged 1990 tax year to the nondischargeable 1999 tax liability, together with credits applied from other discharged tax years.

The taxpayer then filed an administrative claim with the IRS for damages in the amount of $11,823 This claim was not responded to by the IRS.

Finally, the taxpayer filed an adversary proceeding in the Bankruptcy Court for damages against the government for her considerable attorney's fees and court costs. This amounted to $71,900.

Issue. What portion, if any, of the attorney's fees and cost should be borne by the IRS?

Analysis. This question requires an analysis of IRC §§7430 and 7433:

1. Did the taxpayer exhaust her administrative remedies?
2. Is the taxpayer the "prevailing party," is §524(a) the "most significant issue in this case," and is the IRS's position "substantially justified"?

3. Did the IRS's breach of §524(a) discharge injunction cause the damages sustained by the taxpayer?
4. Did the taxpayer "incur" the litigation costs upon which her claim is based?
5. Was any portion of the administrative or court proceedings unreasonably protracted by the taxpayer or her attorneys?
6. Did the taxpayer reasonably mitigate her damages?

The court found that the taxpayer exhausted her administrative remedies before filing her suit for damages because she had submitted an administrative claim with the IRS and filed her adversary proceeding only after the IRS failed to respond within the six month period from the date of her claim. The individual was the prevailing party because the IRS was not substantially justified in willfully continuing its collection efforts in violation of the 11 USC §524(a) discharge injunction. The IRS was not substantially justified in willfully continuing collection efforts in violation of the 11 USC §524(a) discharge injunction. Such action was a proximate cause of the taxpayer's injury because it forced her to file adversary proceedings and incur unwarranted litigation costs. However, the individual was not entitled to recover exorbitant litigation costs from the IRS because both parties unreasonably protracted the court proceedings regarding damages, and prolonged the litigation rather than mitigated the damages. Therefore, the court had to determine the portion of attorney's fees and costs that were reasonable and that should be borne by the IRS.

Holding. The court found that both the taxpayer and the IRS made mistakes that protracted the litigation. The IRS made a mistake on the issue of dischargeability. However, when the IRS ultimately discovered the mistake, it acted promptly to rectify this error. The taxpayer's attorneys also made a mistake on the issue of dischargeability, and as former employees of the U.S. Department of Justice who had worked in the past with the IRS Insolvency Unit, should have been more cautious before reaching that erroneous conclusion. Also, having been familiar with the IRS Insolvency Unit, her attorney could have contacted that unit directly instead of taking the route of filing a new OIC.

The court concluded that a fair portion of damages to be borne by the IRS is $25,000.

CORPORATIONS

Late Filing for S Classification

Rev. Proc. 2007-62 , IRB 2007-41
IRC §§1361 and 1362

☞ Simplified Method to Request Relief for Late S Elections

Background. The IRS may treat a late S corporation election (made after a 2½ month window) as timely filed if there was a reasonable cause.[1] Rev. Proc. 97-48, 1997-2 CB 521 provides special procedures to obtain automatic relief for certain late S corporation elections. Generally, relief is available in situations in which a corporation intends to be an S corporation, the corporation and its shareholders reported their income consistent with S corporation status for the taxable year the S corporation election should have been made and for every subsequent year, and the corporation did not receive notification from the IRS regarding any problem with the S corporation status within six months of the date on which the Form 1120S, *U.S. Income Tax Return for an S Corporation*, for the first year was timely filed.

Rev. Proc. 2003-43 provides, in part, a simplified method for a taxpayer to request relief for a late S corporation election when the entity fails to qualify as an S corporation solely because of the failure to file the election timely with the applicable campus. Under the revenue procedure, certain entities may be granted relief for failing to file the elections in a timely manner if the request for relief is filed within 24 months of the due date of the election.

1. IRC §1362(b)(5)

Analysis and Conclusion. The new Rev. Proc. provides simplified methods for obtaining relief for late corporation and S corporation classification elections. An entity may request relief under this revenue procedure if the following requirements are met:

1. The entity fails to qualify for its intended status as an S corporation on the first day that status was desired solely because of the failure to timely file a Form 2553;
2. The entity has reasonable cause for its failure to file a timely Form 2553;
3. The entity seeking to make the S corporation election has not filed a tax return for the first taxable year in which the election was intended;
4. The application for relief is filed under this revenue procedure no later than six months after the due date of the tax return (excluding extensions) of the entity seeking to make the election for the first taxable year in which the election was intended; and
5. No taxpayer whose tax liability or tax return would be affected by the S corporation election (including all shareholders of the S corporation) has reported inconsistently with the S corporation election, on any affected return for the year the S corporation election was intended.

These simplified methods may be used in lieu of requesting a letter ruling from the IRS. Relief under this procedure requires the filing of a Form 2553, *Election by a Small Business Corporation*, and a Form 1120S, *U.S. Income Tax Return for an S Corporation*, for the first tax year the entity intended to be an S corporation. The forms must be filed no later than six months, excluding extensions, after the tax return due date. The Form 2553 must include a statement explaining the reason the entity failed to timely file the elections.

Insurance Premiums for S corporation Shareholders

Notice 2008-1 IRB 2007-2

IRC §§162 and 1372

☞ Insurance Premiums Deducted by 2% Shareholder-Employees of S Corporations

Background. The IRS released special rules for 2% shareholder-employees of an S corporation regarding the deduction of health insurance premiums that are paid by or reimbursed by the S corporation and included in the shareholders' income.

In prior years, the IRS made a distinction between health insurance purchased by a more than 2% S corporation shareholder and insurance purchased by a sole proprietor. Sole proprietor's can claim an above-the-line deduction for a policy purchased in his name. Previously, a more than 2% shareholder could not do the same.

Analysis and Conclusion. A 2% shareholder-employee in an S corporation, who otherwise meets the requirements of IRC §162(l), is eligible for the deduction under §162(l) if the plan providing the medical care coverage is established by the S corporation.[2] A plan providing medical care coverage for the 2% shareholder-employee in an S corporation is established by the S corporation if:

- The S corporation makes the premium payments for the accident and health insurance policy covering the 2% shareholder-employee (and his spouse or dependents, if applicable) in the current taxable year; or
- The 2% shareholder makes the premium payments and furnishes proof of payment to the S corporation and then the S corporation reimburses the 2% shareholder-employee for the premium payments in the current taxable year.

2. Rev. Rul. 91-26, 1991-1 CB 184

If the accident and health insurance premiums are not paid or reimbursed by the S corporation and are included in the 2% shareholder-employee's gross income, a plan providing medical care coverage for the 2% shareholder-employee is not established by the S corporation and the 2% shareholder-employee is not allowed the deduction under §162(l).

In order for the 2% shareholder-employee to deduct the amount of the accident and health insurance premiums, the S corporation must report the premiums paid or reimbursed as wages on the 2% shareholder-employee's Form W-2 in that same year. In addition, the shareholder must report the premium payments or reimbursements from the S corporation as gross income on his Form 1040, *U.S. Individual Income Tax Return.*

CREDITS

Hybrid Vehicle Credit

IRC §§179 and 30B

☞ Qualified Hybrid Vehicles Qualify for Credit

The Energy Policy Act of 2005 replaced the clean-fuel burning deduction with a tax credit. A tax credit is subtracted directly from the total amount of federal tax owed, thus reducing or even eliminating the taxpayer's tax obligation. The tax credit for hybrid vehicles applies to vehicles purchased or placed in service on or after January 1, 2006.

The credit is only available to the original purchaser of a new, qualifying vehicle. If a qualifying vehicle is leased to a consumer, the leasing company may claim the credit. Hybrid vehicles have drive trains powered by both an internal combustion engine and a rechargeable battery.

These models have been certified for the credit in the following amounts:

2008 Toyota Prius Hybrid — $787.50

2008 Toyota Camry Hybrid — $650

2008 Toyota Highlander Hybrid 4WD — $650

2008 Lexus LS 600h L Hybrid — $450

2008 Lexus RX 400h 2WD and 4WD — $550

2008 Honda Civic GX (Compressed Natural Gas) — $4,000

2008 Honda Civic Hybrid CVT — $2,100

2008 Chevrolet Malibu Hybrid — $1,300

2008 Saturn Aura Hybrid — $1,300

2006 Honda FCX (Hydrogen) — $12,000

2005 Honda FCX (Hydrogen) — $12,000

2008 Mazda Tribute 2WD Hybrid — $3,000

2008 Mazda Tribute 4WD Hybrid — $2,200

2007 Saturn Aura Hybrid — $1,300

2008 Ford Escape 2WD Hybrid — $3,000

2008 Mercury Mariner 2WD Hybrid — $3,000

2008 Ford Escape 4WD Hybrid — $2,200

2008 Mercury Mariner 4WD Hybrid — $2,200

2007 Nissan Altima Hybrid — $2,350

2007 Honda Civic GX (Compressed Natural Gas) — $4,000

2007 Honda Accord Hybrid Navi AT — $1,300

2007 Honda Accord Hybrid AT — $1,300

2007 Honda Civic Hybrid CVT — $2,100

2005 Ford Escape hybrid 4WD — $1,950 (purchased after 01/01/2006)

2005 Ford Escape hybrid 2WD — $2,600 (purchased after 01/01/2006)

2007 Lexus RX 400h 2WD and 4WD — $2,200

2007 Toyota Highlander — $2,600

2007 Toyota Prius — $3,150

2007 Saturn Vue Green Line — $650

2005 Honda Civic GX (Compressed Natural Gas) — $4,000.00

2006 Honda Civic GX (Compressed Natural Gas) — $4,000.00

2006 GMC Sierra 4WD hybrid pickup truck — $650.00

2007 GMC Sierra 4WD hybrid pickup truck — $650.00

2006 Chevrolet Silverado 4WD hybrid pickup truck — $650.00

2007 Chevrolet Silverado 4WD hybrid pickup truck — $650.00

2006 GMC Sierra 2WD hybrid pickup truck — $250.00

2007 GMC Sierra 2WD hybrid pickup truck — $250.00

2006 Chevrolet Silverado 2WD hybrid pickup truck — $250.00

2007 Chevrolet Silverado 2WD hybrid pick up truck — $250.00

2007 Ford Escape Front WD Hybrid Model — $2,600

2007 Ford Escape 4 WD Hybrid Model — $1,950

2007 Mercury Mariner 4 WD Hybrid Model — $1,950

2005 Honda Accord Hybrid AT Model — $650

2006 Honda Accord Hybrid AT Model — $1,300 (without updated control calibration credit is $650)

2006 Honda Insight CVT Model Year — $1,450

2005 Honda Insight CVT Model Year — $1,450

2005 Honda Civic Hybrid (SULEV) CVT — $1,700

2005 Honda Civic Hybrid (SULEV) MT Model — $1,700

2006 Honda Civic Hybrid CVT — $2,100

2007 Toyota Camry Hybrid — $2,600

2007 Lexus GS 450h — $1,550

2005 Toyota Prius — $3,150

2006 Toyota Prius — $3,150

2006 Toyota Highlander 4WD Hybrid — $2,600

2006 Toyota Highlander 2WD Hybrid — $2,600

2006 Lexus RX400h 2WD — $2,200

2006 Lexus RX400h 4WD — $2,200

2006 Ford Escape Hybrid Front WD — $2,600

2006 Ford Escape Hybrid 4WD — $1,950

2006 Mercury Mariner Hybrid 4WD — $1,950

Vehicles are listed in the order in which they were announced as qualifying.

DEDUCTIONS

Business Expense Deductions

***Universal Marketing, Inc. v. Comm'r*, TC Memo 2007-305 (Oct. 9, 2007)**

IRC §§162 and 167

☞ Compensation Deemed Excessive

Facts. The taxpayer's predecessor, Vitamin Village, Inc. (VVI), was incorporated by Daniel L. Reeves (Mr. Reeves) in the State of Oregon in 1979. VVI was in the business of producing, distributing, and selling skin care products, tanning lotions, diet aids, sports performance products, nutritional supplements, health food products, and apparel at both the retail and wholesale levels. VVI also provided indoor tanning salon services and its own printing, advertising, and marketing services.

- VVI used the business name of Vitamin Village for the production and sales of nutritional supplements, health food, skin care products, and tanning lotions; Club Tan was used for its tanning salon services; and Universal Graphics was used for its advertising, marketing, and printing activities.
- On June 1, 1995, VVI incorporated Universal Marketing, Inc. (the taxpayer) and elected a May 31 fiscal yearend. On June 1, 1995, VVI also transferred $487 in cash, and equipment and fixtures with a total FMV of $53,555 in exchange for all issued shares of the taxpayer's stock. The shares of stock were transferred to Mr. Reeves in a Section 355 reorganization. This resulted in VVI and the taxpayer becoming brother-sister corporations. Mr. Reeves was the taxpayer's president, secretary, treasurer, sole shareholder, and sole manager.
- In June 1995, at the beginning of the taxpayer's '96 fiscal year, VVI entered into an agreement with the taxpayer, in which the taxpayer agreed to brand, market, and advertise skin care and tanning products sold by VVI for $1 million. The taxpayer's only other customer was its sister corporation Club Tan Centers of Oregon, Inc. (CTC), of which Mr. Reeves was the sole owner and shareholder. The taxpayer provided minimal services for CTC in fiscal year '96.

- During fiscal year '96, the taxpayer provided the following marketing and advertising services for VVI: Photographed models and VVI products, sponsored pro and semipro athletes, sponsored various sporting events, negotiated with retail stores and distributors to sell VVI's products, including developing and distributing advertising displays and posters to these stores, and promoted VVI's traveling trade shows.

On its Form 1120, *U.S. Corporation Income Tax Return*, for fiscal year '96, the taxpayer reported gross receipts and total income of over $1 million dollars. After the taxpayer deducted a $500,000 bonus and a $9,000 salary as executive compensation to Mr. Reeves, salary and wages to its employees, supplies, and various other deductions, the taxpayer's taxable income was $62,379 with a total tax of $21,209 and a net income book value of $38,886. One component of the expense for supplies was evidenced by a check for $80,000 that was made payable to VVI. The $80,000 check was signed by Mr. Reeves and bore the notation "asset purchase UG".[3] The IRS disallowed the $80,000 expense deduction but allowed the taxpayer to depreciate the $80,000 over a 39-year recovery period under the modified accelerated cost recovery system. The allowed depreciation deduction was $2,051.

The taxpayer's rate of return on equity was 42% for fiscal year '96 and the taxpayer did not pay any dividends. The taxpayer did not maintain a compensation policy for Mr. Reeves or its employees. The bonus Mr. Reeves received was not based upon a formula or previously set forth in writing. Each bonus was determined and paid at the end of the fiscal year when the taxpayer could ascertain its cash available.

The IRS issued the notice of deficiency on March 8, 2002. The taxpayer timely filed its petition on May 13, 2002, and filed an amended petition on August 19, 2002.

Issues.

1. Whether the amounts paid to the taxpayer's sole executive and shareholder constituted reasonable compensation under IRC §162(a)(1); and
2. Whether the taxpayer is entitled to deduct $80,000 as an expenditure for supplies under IRC §162(a), or if required to capitalize the expenses, to depreciate the expenditure over a 7-year recovery period under IRC §168(c).

Analysis. The taxpayer argued that the $509,000 paid to Mr. Reeves constituted reasonable compensation under IRC §162(a)(1) during its fiscal year '96. The IRS contends the taxpayer is entitled to deduct only $100,000 as compensation under §162(a)(1), with the remaining $409,000 constituting a nondeductible dividend.

IRC §162(a)(1) permits a taxpayer to deduct "a reasonable allowance for salaries or other compensation for personal services actually rendered." A taxpayer is entitled to a deduction for compensation only if the payments were reasonable in amount and in fact paid purely for services. Although framed as a 2-prong test, the inquiry under §162(a)(1) generally turns on whether the amounts of the purported compensation payments were reasonable.[4]

Because the taxpayer's place of business was in Oregon (in the 9th Circuit), the court used the five factors found in the *Elliots* case to determine the reasonableness of compensation, with no single factor being determinative. The factors are:

1. The employee's role in the company;
2. Comparable compensation provided by similar companies,
3. The character and condition of the company,
4. Potential conflicts of interest, and
5. Internal consistency in compensation.

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3. The IRS determined the $80,000 asset purchase was for property purchased from UG. UG was the acronym for Universal Graphics. Universal Graphics was the business name for VVI's printing, advertising, and marketing services before the taxpayer's §355 reorganization.

4. *Elliotts, Inc. v. Comm'r*, 716 F.2d 1241, 1245 (9th Cir. 1983)

Holding. The court denied a deduction for excessive compensation paid to its sole executive. In applying the five factors, the court found that the corporation failed to introduce evidence showing the amount of time the executive spent on corporate operations or the amount of compensation paid by similar companies for such services. The corporation's operations were not extensive or complex; it had a small amount of net income; and instead of a structured compensation policy, its sole shareholder controlled the amount and timing of the compensation payment. Only the portion of the compensation that was reasonable could, therefore, be deducted. Also, the taxpayer had to depreciate its expenditure for equipment, rather than deducting it as a payment for supplies, because it did not introduce evidence showing the amount was incurred for incidental material and supplies, the costs for which would have been deductible under §162.

Deductions for Child Support and Alimony

***Proctor v. Comm'r*, 129 TC —, No. 12, Oct. 10, 2007**

IRC §§71 and 215

☞ Alimony and Child Support Payments Treated Differently as Deductions

Facts. Mr. and Mrs. Proctor divorced in December 1993. The divorce decree required them to equally share their children's uninsured medical and dental costs. The divorce decree also required Mr. Proctor, under the Uniformed Services Former Spouses' Protection Act, 10 USC §1408, to pay Mrs. Proctor 25% of his military retirement pay. The divorce decree did not indicate whether the payments for the Mr. Proctor's military retirement should be included in gross income or deducted as alimony, or whether such payments were to terminate upon the death of Mrs. Proctor. Mr. Proctor paid $6,074 in 2002, and deducted the entire amount as alimony. The IRS determined, in a notice of deficiency, that the payments were not alimony and, were therefore not deductible

Issue. Was Mr. Proctor entitled to deduct the child-support and the portion of his retirement paid to his wife as alimony?

Analysis. The payments he made for his children's medical expenses constituted nondeductible child support under IRC §71(c)(3). The portion paid to his former spouse for her interest in his retirement plan, however, was deductible because it was considered alimony, as opposed to a property settlement. The payments met the requirements of IRC §§71(b)(1)(A) through (D) in that they were received under a divorce decree; the parties were living in separate households; the divorce decree did not state that the payments were not includible in the recipient's gross income or specify that the payments were not to be treated as alimony; and the payments would terminate, by operation of law, upon the death of the former spouse.

Holding. The Tax Court held that the taxpayer was **not entitled** to deduct child-support payments as alimony. However, he could deduct the portion of his military retirement pay that was paid to his ex-wife under §215 as alimony.

Deductions for Child Support and Alimony

***Amarasinghe v. Comm'r*, TC Memo 2007-333 (Nov. 6, 2007)**

IRC §§71, 215, 401 and 7430

☞ Distribution from Ex-spouse Retirement Plan Includible Income

Facts. Mr. Amarasinghe (Mr. A) failed to pay child support and alimony to his ex-wife as required by their divorce agreement. Mrs. Amarasinghe (Mrs. A) obtained an order from a domestic relations court demanding that Mr. A withdraw all funds from his profit sharing plan (the Plan) and pay them to Mrs. A to satisfy his delinquent child support and alimony obligations. Mr. A complied.

On his 2002 income tax return, Mr. A reported the distribution from the Plan as income and took a deduction for alimony paid. He then filed an amended return taking the position that the distribution from the Plan was made under a qualified domestic relations order (QDRO), and was taxable income to Mrs. A and not to himself.[5] Mr. A also removed the alimony deduction. Mrs. A reported a portion of the funds she received as alimony on her 2002 income tax return but did not report any of the funds as pension income.

The IRS rejected Mr. A's amended return, disallowed part of the alimony deduction taken on the original return, and determined a deficiency in his 2002 income tax. It also determined a deficiency in Mrs. A's 2002 income tax for failing to report the entire distribution from the Plan as income.

Mrs. A also sought an award of litigation costs.

Issues. There were three issues:

1. Whether the distribution from Mr. A's profit sharing plan was made under a QDRO and was therefore taxable income to Mrs. A instead of Mr. A.
2. If the distribution was not made under a QDRO, what portion of the distribution was alimony and therefore income to Mrs. A and deductible by Mr. A.
3. Whether Mrs. A is entitled to an award of litigation expenses from Mr. A.

Analysis. As to the first issue, the court noted that the Plan funds were distributed to Mr. A, not Mrs. A. The fact that Mrs. A ultimately received the funds from the distribution is not dispositive.

The distribution from the Plan was not made under a QDRO because the order failed to give Mrs. A the right to receive the benefits directly from the Plan, the procedural requirements of the Code concerning QDROs were not satisfied, and Mrs. A did not in fact receive the benefits directly from the Plan.

On the second issue, the court noted that the order provides that the distribution would first bring current Mr. A's payments for child support, insurance premiums, and lump-sum alimony, and the remainder would bring current Mr. A's periodic alimony payments.

The court found that Mrs. A's original calculation mirrors this intention because it first accounts for child support, insurance premiums, and lump-sum alimony, and allocates the remaining distribution to periodic alimony. By contrast, Mrs. A's alternative first accounts for the lump-sum alimony and alimony not waived; therefore more of the distribution was allocated to child support and insurance premiums than necessary to bring those obligations current, which required Mrs. A to waive more of her periodic alimony than was necessary. Because it found that Mrs. A's original calculation reflected the allocation made in the order and makes no unnecessary allocations, it concluded that Mr. A may deduct $75,318 of the distribution as alimony under §215(a), and Mrs. A must include $75,318 of the distribution as gross income.

Finally, the court considered Mrs. A's petition to recover reasonable litigation costs from Mr. A. IRC §7430(b)(2) does not allow a taxpayer to recover costs from another taxpayer, only from the government.

Holding. The court held that the domestic relations court order did not give Mrs. A the right to receive the distribution directly from the Plan. Thus, the court order was not a QDRO under §414(p)(1). Consequently, the distribution was not made under a QDRO, so the exception in §402(e)(11) did does not apply, and Mr. A must include the distribution in his gross income. The court also held that Mrs. A's original calculation that $75,318 of the distribution was allocable to alimony was correct, so that amount is income to her and is deductible by Mr. A. Finally, Mrs. A could not recover litigation costs from Mr. A under §7430.

5. IRC §402(e)(1)(A)

Deduction for Alimony

***Salzman v. Comm'r*, TC Summ. Op. 2007-190 (Nov. 7, 2007)**

IRC §§71 and 6672

☞ Payments to Former Wife Not Alimony

Facts. William Salzman, II was previously married to Beverly Salzman. Their marriage was dissolved through proceedings in the District Court of Bexar County, Texas. An Agreed Final Decree of Divorce (divorce decree) was approved and entered by that court on October 4, 2002. It included a contractual agreement between the Salzmans, both having been represented by counsel, as to spousal support and property division. Under the heading "Spousal Support," the divorce decree provided:

> *It is ordered that William Franklin Salzman, II, is obligated to pay and shall pay to Beverly June Salzman spousal maintenance of $500.00 per month for a period of no longer than four (4) years, with the first payment of $250.00 being due and payable on June 1, 2002, and a second payment of $250.00 being due and payable on June 15, 2002, and thereafter a like payment of $500.00 being due and payable on the first day of each month for a period of no longer than four years.*

Neither the agreement nor the divorce decree specifies whether Mr. Salsman's obligation to make such payments would terminate upon his former wife's death.

In 2004, Mr. Salzman made "spousal support" payments totaling $6,000 to his former wife for which he claimed an alimony deduction on his federal income tax return for that year. The IRS disallowed the claimed alimony deduction in a notice of deficiency.

Issue. Whether support payments Mr. Salzman made to his former wife in 2004 constitute alimony as defined by IRC §71(b) and are deductible by him under IRC §215(a).

Analysis. Section 71(a) provides the general rule that alimony payments are included in the gross income of the payee spouse. Section 215(a) provides the complementary general rule that alimony payments are deductible by the payor spouse in "an amount equal to the alimony or separate maintenance payments paid during such individual's taxable year."

Mr. Salzman and the IRS agreed that the payments to his former wife satisfied the §§71(b)(1)(A), (B), and (C) requirements. Their disagreement is solely about whether the payments satisfied the provisions of §71(b)(1)(D); i.e., whether his liability to make payments would have terminated in the event of his former wife's death. If so, the payments would have been "alimony."

The court found that Mr. Salzman's payments would not have terminated upon her death. It noted the support agreement and the divorce decree were silent on whether his monthly payments of $500 to his former wife, totaling $24,000 for the fixed 4-year period, would survive her death as a matter of law. Consequently, the court's analysis had to rely on Texas state law. Under Texas state law

Holding. While the court found Mr. Salzman's assertions are forthright and appealing, it found that the Code was specific in its requirements, and by virtue of Texas state law his support payments to his former wife in 2004 did not meet the requirement outlined in §71(b)(1)(D). Accordingly, the court held that the payments made to his wife in 2004 did not satisfy all the conditions set forth in §71 and thus were not properly deductible as alimony.

Charitable Donation Deduction

***Jones v. Comm'r*, 129 TC —, No. 16, November 1, 2007**

IRC §170

☞ Charitable Donation Deduction Dependent on Ownership of Items

Facts. Mr. Jones is an attorney. He claimed a charitable contribution deduction for his donation to a university library of copied case files and materials he had received from the government in connection with his representation of the Oklahoma City bomber.

Issue. Was Mr. Jones entitled to a charitable deduction?

Analysis. Under state (Oklahoma) law, as in most jurisdictions, the client is the true owner of an attorney's case files, especially where, as here, those files contained no attorney work product. Mr. Jones' possession of the files did not establish ownership, because he held them as his client's agent, fiduciary and custodian. Moreover, his testimony, standing alone, did not establish that his client had waived the attorney-client privilege regarding the files. The taxpayer's right to retain copies of former clients' files did not give him the right to sell or otherwise dispose of those files.

Holding. The Tax Court held that Mr. Jones was not entitled to deduct the contribution of his case files to the University of Texas. He was not the true owner of the case files, merely the custodian. Moreover, even if he could be treated as the owner of any attorney work product in the files, his deduction for the donation would be limited to his basis in those materials, which appeared to be zero.

DEFERRED COMPENSATION

§409A Compliance

Notice 2007-86 IRB 2007-43

IRC §409A

☞ IRS Extends Transition Relief for §409A Compliance

Background. In general, IRC §409A, which is effective January 1, 2005, requires nonqualified deferred compensation plans (NQDC) to meet certain requirements. Any employer with an NQDC plan — a deferred compensation plan that is generally designed to favor certain individuals or groups of individuals — should make sure that the plan is in compliance with the law. The penalties for noncompliance can be severe: Plan participants are taxed on plan benefits at the time of vesting, and a 20% penalty tax and potential interest charges also apply.

Analysis and Conclusion. The IRS extended transition relief for compliance by nonqualified deferred compensation plans with the final regulations under §409A for an additional year. Under previous guidance,[6] nonqualified deferred compensation plans were required to comply with the final regulations beginning on January 1, 2008. The extended compliance date is now January 1, 2009. In addition, the IRS plans to issue guidance regarding a correction program as soon as possible.

This notice supersedes Notice 2007-78, 2006-43 IRB 307, which extended only the deadline for bringing plan documents into compliance, but kept the effective date of the final regulations at January 1, 2008. The purpose of broadening the extension is to provide employers adequate time to analyze their NQDC plans and make informed, reasoned decisions regarding the changes needed to bring their plans into compliance with the final regulations.

6. Notice 2006-79, 2006-43 I.R.B. 307

Employers should identify all plans or arrangements that might be subject to §409A and have them reviewed to determine whether they are operationally and administratively compliant. If a plan is not compliant, the employer must bring the plan and plan documents into conformity with §409A by December 31, 2008.

EMPLOYMENT TAX ISSUES

Responsible Person

McLaren v. U.S. **CV-06-53-BU-RFC (D. Mont. Sep. 28, 2007)**
IRC §§6330 and 6672

☞ Married Couple Jointly Liable for Unpaid Employment Taxes

Facts. Thomas and Rita McLaren initiated action against the IRS to challenge its determination of taxes due from Anaconda Ace Hardware LLP, and assessed against Mr. McLaren.

Issue. The McLaren's did not contest the assessed trust fund recovery penalty. Instead, they argued that another partner should share responsibility for the taxes owed.

Analysis. Although the McLaren's did not contest the assessed trust fund recovery penalty and argued that another partner should share responsibility for the taxes owed, the liability under §6672 is joint and several. Therefore, the IRS was not required to seek payment from every possible responsible person but could assess the tax against one responsible person and not another.

Holding. The district court dismissed the taxpayers' petition contesting IRS's administrative determination. The taxpayers were deemed to have conceded any objection to dismissal by not responding to the IRS's motion. The McLaren's underlying claim that the IRS should not pursue Mr. McLaren for total liabilities, and that it should instead collect some from another partner, was groundless since §6672 liability was joint and several and could be asserted against one responsible person alone, even if there were others.

> **Note.** This determination does not prevent the McLaren's from pursuing litigation against the other partners for reimbursement of their share of the liability under IRC §6672. See ***Van Dijk v. Lloyd and Lee,*** No. 05-07-0109 (Del. 2007), at the end of this supplement.

Self-Employment Taxes

Byers v. Comm'r, **TC Memo 2007-331 (Nov. 5, 2007)**
IRC §§446, 1402, 3401, 3403, 6651 and 6654

☞ Reconstruction of Income Related to Self-Employment

Facts. Byers entered into a written "Contractor Operating Agreement" (operating agreement) with Edina Couriers, Inc. (ECI) under which Byers agreed to be a truck driver for ECI, picking up and delivering goods to and from ECI customers. For his services, Byers was to be paid 70% of the gross amounts ECI billed its customers relating to deliveries made by Byers.

The IRS audited Byers for the years 1999 through 2002. On audit, the IRS treated Byers as an independent contractor of ECI, determined his income and deductions relating to his truck driving activity, and determined his taxable income and self-employment taxes.

In the IRS's determination of income, the IRS utilized the Forms 1099 ECI had submitted, and the IRS allowed business expense deductions for Byers' truck lease payments to Conrad Companies, Inc. (CCI), a company related to ECI. The IRS also analyzed Byers' bank accounts and concluded that significant additional unexplained funds had been deposited into his bank account. The IRS determined which unexplained funds to treat as additional taxable income relating to the taxpayer's work for ECI and CCI.

Byers' taxable income as determined by the IRS follows:

Year	IRS's Determination of Taxable Income
1999	$31,129
2000	73,650
2001	46,804
2002	42,171

The IRS allowed Byers a standard deduction, and determined the tax deficiencies (which included self-employment taxes) and the additions to the tax at issue.

Byers argued that he was an employee of ECI. He asserted that under §3402(a)(1), employers are required to withhold federal income taxes from employee wages, and that ECI rather than he should be held liable for payment of the taxpayer's unpaid federal income and employment taxes.

Issue. Was the taxpayer's relationship with ECI an independent contractor relationship or an employment relationship?

Analysis. In deciding whether Byers was an independent contractor or an employee, the court applied nine factors. The first seven are derived from the Employment Tax regulations under Treas. Reg. §31.3121(d)-1(c)(2), and Treas. Reg. §31.3306(i)-1(b). The final two factors are from the *Day* case,[7] and are applicable in this situation because it is in the 8th Circuit. These factors are:

1. Control over manner of accomplishing work;
2. Investment in work facilities and tools;
3. Opportunity for profit or loss;
4. Termination of the work relationship;
5. Participation in service integral to regular business;
6. Length of the relationship; and
7. Intent of the parties as to the type of relationship formed.
8. Substantial cost incurred; and
9. Special skills required.

7. *Day v. Comm'r,* TC Memo 2000-375 (Dec. 13, 2000)

Holding. The court held that Byers worked as an independent contractor, and was liable for self-employment tax. Of the nine factors required to determine whether an individual is an independent contractor or an employee, three indicated an employment relationship (service integral to regular business, length of relationship and a special skills requirement), five indicated independent contractor status, and one factor was neutral (termination of the work relationship). The court also found Byers liable for penalties for failure to file and failure to pay income tax. He did not file returns or pay tax and admitted that he did not have reasonable cause.

FILING REQUIREMENTS

Online Sellers and Auctions

IRS Fact Sheet FS-2007-23
IRC §§61, and 162

☞ Income Earned from Auctions and Consignment Sales is Taxable

Background. The IRS released a fact sheet explaining that most people do not realize that the income earned from auctions and consignment sales may be taxable. The fact sheet is the 16th in the tax gap series designed to help taxpayers better understand what income they are required to report and what deductions they may be entitled to take.

Analysis and Conclusion. Generally, all income from traditional or online auctions and consignment sales is taxable as either ordinary or business income, with some exceptions. Traditional or online auction and consignment sellers in the business to make a profit can generally deduct ordinary and necessary expenses, such as verifiable auction and consignment fees and commissions.

Electronic Filing

Notice 2007-79 IRB 2007-42, 809
IRC §6061

☞ Alternative Signature Methods for Electronic Returns

Background. IRC §6061 and Treas. Reg. §1.6061-1(a) provide that any tax return, statement, or other document shall be signed in accordance with forms, instructions, or regulations prescribed by the Secretary. Pub. 1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns*, sets forth the procedures for completing Form 8453, Form 8878, and Form 8879.

If providing the signature on a paper declaration, the taxpayer and the Electronic Return Originator (ERO) (and the paid preparer if different from the ERO) must complete and sign Form 8453 before the electronic data portion of the return is submitted. Taxpayers may wish to sign their returns electronically, but may choose to authorize their ERO to enter their Personal Identification Number (PIN) in the electronic return record by completing the appropriate IRS e-file signature authorization form. Form 8879 authorizes an ERO to enter PINs on individual income tax returns, and Form 8878 authorizes an ERO to enter PINs on Forms 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*; and Form 2350, *Application for Extension of Time To File U.S. Income Tax Return.*

Analysis and Conclusion. This Notice authorizes alternative methods of signing returns. These must include either a facsimile of the individual ERO's signature or of the ERO's printed name. EROs using one of these alternative means are personally responsible for affixing their signatures to returns or requests for extension.

This notice applies only to EROs that sign Form 8453, Form 8878, or Form 8879, and does not alter the signature requirements for any other type of document currently required to be manually signed, such as elections, applications for changes in accounting method, powers of attorney, or consent forms. In addition, this notice does not alter the requirement that Form 8453, Form 8878, or Form 8879 must be signed by the taxpayer making these forms, either by handwritten signature or other authorized means.

This Notice is effective for returns filed after October 15, 2007.

Filing Required

***Mandeville v. Comm'r*, TC Memo 207-332 (Nov. 5, 2007)**

IRC §§25A, 61, 151, 217, 222, 6012, 6651, 6654, 6673 and 7491

☞ Multiple Year Non-filing Results in Penalties

Facts. Mandeville conceded that he failed to file federal income tax returns for the 1998, and 2000 through 2003 taxable years.

In 1998, the taxpayer was employed by Scientemps, Inc., Intor, Inc., and the New Mexico Institute of Mining Technology. He received wages totaling $8,130, $1,901, and $2,760, respectively. The New Mexico Institute of Mining Technology withheld $248 in federal income tax.

In 2000, Mandeville was employed by Sinaf Products, Inc., and Intel Corporation and received wages totaling $903 and $35,343, respectively. Sinaf Products, Inc., and Intel Corporation withheld $7 and $2,744 in federal income tax, respectively.

In 2001, he was employed by Intel Corporation and received $68,066 in wages. The record does not reflect any withholding of federal income tax from the taxpayer's wages by Intel Corporation during 2001. That year, the taxpayer also received $2 in ordinary dividends from UBS Painewebber, Inc.

In 2002, Mandeville was employed by Intel Corporation and received $55,718 in wages; Intel withheld $8,502 in federal income tax. That year, the taxpayer also received $22 in ordinary dividends from UBS Painewebber, Inc.

In 2003, he was employed by Intel Corporation and received $56,834 in wages. From that amount, Intel Corporation withheld $9,058 in federal income tax. That year, the taxpayer also sold stock in Intel Corporation for $10,417 in gross proceeds. His basis in the stock sold was $6,578, resulting in a net short-term capital gain of $3,839. The taxpayer also received $37 in ordinary dividends from UBS Painewebber, Inc.

The taxpayer had single filing status for the 1998 taxable year and married filing separate status for the 2000-2003 taxable years. Sometime in 2001 or 2002, the taxpayer and his wife moved from New Mexico to Oregon and then back to New Mexico.

The IRS issued notices of deficiency. The taxpayer then filed a timely petition with the court.

Issue. The issues considered were:

1. Whether the taxpayer was required to file federal income tax returns and is liable for income tax deficiencies in 1998, and the 2000 to 2003 taxable years;
2. Whether the taxpayer was required to report $3,839 in net short-term capital gain on the sale of stock in 2003;
3. Whether the taxpayer can claim a dependency exemption for his wife for the 2000, 2002, and 2003;
4. Whether the taxpayer is entitled to an education credit under IRC §25A for 2001 and 2002 or a tuition and fees deduction under IRC §222 for 2002;

5. Whether the taxpayer may deduct moving expenses for 2001 and 2002;

6. Whether the taxpayer is liable for additions to tax under IRC §6651(a)(1) in the amounts specified above for the five taxable years at issue;

7. Whether the taxpayer is liable for an addition to tax under IRC §6654(a) in the amount of $519 for 2001 because he failed to pay estimated income tax; and

8. Whether the taxpayer is liable for a penalty under IRC §6673(a)(1).

Analysis. Mandeville asserted that the burden of proving that he had unreported income tax is on the IRS and that it failed to meet that burden in this case. According to Mandeville, he was entitled to dependency exemptions for his wife for the 2000, 2002, and 2003, education credits or a deduction for tuition and fees for 2001 and 2002, and a moving expense deduction for 2001 and 2002. Mandeville also asserted that the IRS did not meet the burden of production regarding the additions to tax under IRC §§6651(a)(1) and 6654(a).

The IRS argued that Mandeville was required to file federal income tax returns for the five taxable years at issue and that he is liable for deficiencies for each of those years. The IRS asserted that Mandeville was required to report the short-term capital gain from his sale of Intel Corporation stock in 2003. It also claimed that Mandeville is not entitled to dependency exemptions for his wife for 2000, 2002, and 2003 because he provided no evidence that his wife was dependent on him.

With respect to education credits or a deduction for tuition and fees, the IRS's position was that Mandeville failed to substantiate that any qualified tuition and related expenses were paid by him. Regarding the claimed moving expense deduction, the IRS conceded that Mandeville and his wife moved from Oregon to New Mexico but it argued that it is not clear when the move occurred and that only Mandeville's self-serving testimony supports the taxpayer's assertion that the move was work related.

Holding. The court noted that the law imposes a federal tax on the taxable income of every individual. Gross income for the purpose of calculating taxable income is defined by IRC §61 as "all income from whatever source derived." IRC §6012(a) requires a taxpayer to file a tax return in each taxable year in which that taxpayer's gross income exceeds a certain threshold amount. In this case, the court found the taxpayer's gross income exceeded the filing threshold for each of the five taxable years at issue. As a result, Mandeville was required to file a federal income tax return for each of the five taxable years at issue. The court found the taxpayer's arguments to the contrary incomprehensible and frivolous.

As to the claims for education expense credits and deductions, moving expenses, and a dependency exemption for his wife, Mandeville provided no evidence supporting these claims. Therefore, the court held against the taxpayer.

With respect to the deficiencies determined by the IRS, the court noted that as a general rule, the IRS's determination of a taxpayer's liability for an income tax deficiency is presumed correct, and the taxpayer bears the burden of proving that the determination is improper. Thus, Mandeville was incorrect that the IRS bears the burden of proving the existence of income tax deficiencies. Moreover, the taxpayer failed to demonstrate that any of the determined deficiencies were improper.

Finally, IRC §6673(a)(1) authorizes the Tax Court to impose a penalty not in excess of $25,000 on a taxpayer for proceedings instituted primarily for delay or in which the taxpayer's position is frivolous or groundless. The IRS had asked the court to impose such a penalty under this section. However, the court declined to do so, because some of the issues raised by the taxpayer, including his entitlement to dependency exemptions, education credits, a deduction for tuition and fees, and a moving expense deduction were not frivolous. The court warned the taxpayer against taking such stances in the future.

FOREIGN INCOME

Foreign Earned Income Exclusion

***Arnett v. Comm'r*, 473 F3d 790 (7th Cir. 2007), affirming 126 TC 89 (2006)**
IRC §911

☞ Income from Antarctica not Excludable

Facts. During 2000 and 2001, Mr. Arnett performed services at McMurdo Station in Ross Island, Antarctica. On his 2000 and 2001 federal income tax returns, he excluded wage income earned and received during 2000 and 2001 for services performed in Antarctica.

Issue. Can a taxpayer exclude from income wages earned during 2000 and 2001 from working in Antarctica?

Analysis. Treas. Reg. §1.911-2(h) requires that a territory be under the sovereignty of a government other than the United States government in order to meet the definition of a foreign country. The regulation could not be read to include the limitless class of sovereign-less territories, such as Antarctica, in the definition of a foreign country. Consequently, amounts earned in Antarctica are not eligible for the foreign earned income exclusion under §911.

Holding. The Tax Court held that the taxpayer could not exclude from income amounts earned for services performed in Antarctica because Antarctica is not a foreign country.

> **Note.** The later cases of *Giammatteo v. Comm'r*, TC Memo 2007-307 (Oct. 10, 2007) and *Prentiss v. Comm'r* TC Memo 2007-308 (Oct. 10, 2007), containing the same facts, relied on *Arnett* in holding against the taxpayers.

INNOCENT SPOUSE

Innocent Spouse Relief and TEFRA Partnership Matters

***Adkison v. Comm'r*, 129 TC No. 13 (Oct. 16, 2007)**
IRC §6015, §6213, §6225, §6230, §6231

☞ Denial of Deficiency Redeterminations and Innocent Spouse Relief

Facts. A joint notice of deficiency was sent to the Adkinsons after a Tax Equity and Fiscal Reponsibility Act of 1982 (TEFRA) partnership proceeding was presented in the federal district court by a non-tax matters partner. Because the adjustments set forth in the notice of deficiency were attributable to partnership items that were the subject of that on-going proceeding, the notice of deficiency was invalid.

Issue. Does the Tax Court have jurisdiction to hear a claim for relief from joint and several liability under IRC §6015 during proceedings in another court?

Analysis. The Tax Court lacked jurisdiction to redetermine a notice of deficiency. In addition, the taxpayer's request for innocent spouse relief was not a valid stand-alone petition for relief. The request was premature because a deficiency had not been asserted. The parties' attempts to settle their tax liabilities and the invalid notice of deficiency taken together did not demonstrate that the IRS had asserted a deficiency. The taxpayer's entitlement to relief was an affected item that could be determined only after the partnership-level proceeding concluded.

Holding. The court held it lacked jurisdiction to review the taxpayer's claim for relief under §6015. Thus, the taxpayer could not seek relief until the underlying partnership-level proceeding was final and the IRS issued either a notice of computational adjustment or a valid affected items notice of deficiency to the taxpayer.

***Fain v. Comm'r*, 129 TC --, No. 11 (Oct. 2, 2007)**

IRC §6015

☞ Nonrequesting Spouse's Right to Intervene not Extinguisheded by Death

Facts. Suzanne Fain filed a joint tax return with her husband for 1999. It showed that they owed about $15,000, but neither taxpayer paid. The couple later separated, and eventually the IRS attempted to collect the unpaid tax.

In February 2006, Suzanne filed a request for innocent spouse relief under §6015. The IRS denied it in September 2006, and Suzanne filed a petition seeking review with the Tax Court. Section 6015(e)(4) required the court to issue rules that provide nonrequesting spouses "with adequate notice and an opportunity to become a party." This requires the IRS to serve notice that a petition has been filed "on the other individual filing the joint return" no later than 60 days from the date that the petition itself was served. The IRS overlooked this obligation until the case was already on a trial calendar. The IRS then learned that the husband had died in 2002.

Issue. Is a nonrequesting spouse's right to intervene extinguished by death or does it instead pass to a successor-in-interest?

Analysis. The court noted that there is no clear answer to this issue in the Code or regulations, so it turned to analogy, some background principles of law, and a nod to reasonableness. IRC §6015(e)(4) gives a nonrequesting spouse the unconditional right to "become a party." It noted that it is generally the case that a right to intervene passes to a decedent's estate.[8] An estate's right to intervene in some cases does not, of course, imply a general rule that all rights to intervene survive death. And the Internal Revenue Code makes sure that taxes survive even death in §6901(a)(1)(A)(i). The survival of a decedent's tax liability means that as a practical matter his heirs or beneficiaries may be affected by the outcome of an innocent spouse case. The opportunity to intervene is an opportunity to protect those interests, because granting innocent spouse relief will make the estate of the nonrequesting spouse the only source of payment for any unpaid tax the deceased has left behind.

The Tax Court had already applied these sections to allow executors and administrators to seek innocent spouse relief, and the IRS itself had ruled likewise.[9] Construing the Code to allow executors and administrators to intervene to oppose relief seems equally justified.

Holding. The Tax Court, in a case of first impression, held that, under §6015(e)(4), the right to intervene and, therefore, the right to notice that a petition has been filed, survived the nonelecting spouse's death and passed to his estate. The Court followed its reasoning in *Jonson v. Comm'r*, where it held that a decedent's estate was entitled to request innocent spouse relief.

8. See *Salt River Pima-Maricopa Indian Cmty. v. United States*, 231 Ct Cl 1033 (1982).

9. See *Jonson v. Commissioner* 118 TC 106 (2002) (estate of deceased spouse able to request relief under §6015, *affd*. 353 F.3d 1181, 1184 (10th Cir. 2003); Rev.Rul 2003-36, 2003-1 C.B. 849.

IRS PROCEDURES — MISCELLANEOUS

Offer-in-Compromise

***Samuel v. Comm'r*, TC Memo 2007-312 (Oct. 15, 2007)**
IRC §7122

☞ Abuse of Discretion in Offer in Compromise Matter

Facts. Taxpayer filed a petition for judicial review in response to the IRS's determination to proceed with collection by lien or levy of assessed income tax liabilities, plus additions to tax and interest, for 1996-2002. The IRS's appeals officer rejected the taxpayer's offer in compromise because it was not a viable alternative to collection. The settlement officer, applying guidelines established by the Internal Revenue Manual, determined that the taxpayer should include in the amount of his offer in compromise the value of certain "dissipated assets," which, because of the dissipation, became unavailable for payment of the taxpayer's delinquent income tax obligation. The settlement officer required this inclusion, notwithstanding that some of the assets had been used for proper purposes.

Issue. Was the inclusion of the "dissipated assets" required for the offer to be valid?

Analysis. The court examined what the IRS insisted on including in the full amount of the taxpayer's dissipated assets in his net realizable equity (NRE) during the evaluation of his offer in compromise. The taxpayer's NRE should not have included amounts paid for:

- Attorney's fees incurred in the representation of his tax case;
- Attorney's fees incurred in a civil lawsuit he filed for unpaid wages;
- An estimated tax payment made for one of the tax years at issue; and
- A lump-sum payment of delinquent child support.

Holding. The court held that the IRS Appeals officer's rejection of the offer in compormise was an abuse of discretion The case was remanded to Appeals for 60 days, during which time the individual had the opportunity to amend his offer based on the revised amount of his tax liability and in consideration of his available monthly income.

Work Product Protection

***Roxworthy v. U.S.*, 457 F3d 590 (6th Cir. 2006)**
IRC §§7525 and 7602

☞ Examination of Books and Witnesses Protected by Work Product Doctrine

Facts. During an examination, the IRS requested production of documents prepared for a taxpayer corporation by a national accounting firm. The taxpayer refused, citing work product privilege for the documents. The IRS then issued an administrative summons for documents, which the federal district court in Kentucky enforced. Still citing work product protection, the taxpayer appealed to the 6th Circuit.

Issue. Can the taxpayers claim a work product privilege for documents prepared because of the prospect of litigation even if they were also prepared in connection with a business transaction or also served a business purpose?

Analysis. The documents contained an analysis of current tax law as it applied to the loss generated by the taxpayer's sale of a captive insurance subsidiary and discussed the "more-likely-than-not" consequences of the taxpayer's return position. The documents also discussed whether the taxpayer's position was supported by "substantial authority." The taxpayer proved that the documents were prepared in anticipation of litigation, which was defined as "because of the prospect of litigation." Moreover, the taxpayer's use of the documents to avoid a substantial understatement penalty did not preclude assertion of the work-product privilege.

Holding. The 6th Circuit reversed the Kentucky court, holding that the work-product privilege can be asserted for documents prepared because of the prospect of litigation even if they were also prepared in connection with a business transaction or also served a business purpose. Finally, the taxpayer's subjective anticipation of litigation was objectively reasonable. The taxpayer established that it was faced with an actual or a potential claim about a transaction that could reasonably result in litigation.

The IRS did not acquiesce.

> **Note.** The taxpayer in this case is actually Yum! Brands, the corporation that owns A&W, KFC, Long John Silver's, Pizza Hut & Taco Bell. Roxworthy is actually the VP for tax of this corporation.

IRS Summons

***Gippetti v. U.S.*, 06-3801 (3rd Cir. 2007)**
IRC §7602

☞ Evidentiary Hearing not Required when IRS Summons Issued

Facts. The IRS issued a summons to the taxpayer as a result of its civil investigation into his 1999 and 2000 federal income tax liabilities. The summons required that he appear before an IRS revenue agent to provide testimony and produce records relating to his bank and credit card accounts with the Cayman National Bank, Ltd (CNB). After the taxpayer failed to comply with the summons, the IRS initiated an enforcement action in the District Court to enforce the summons and the related subpoena. The District Court entered an order that required the taxpayer to produce documents requested by the IRS. The taxpayer appealed the District Court's order to this Court, which vacated the order and remanded the case. Following a remanded hearing, the taxpayer appealed again to the 3rd Circuit.

Issue. Does the taxpayer have possession, custody or control of the summoned records?

Analysis. The taxpayer conceded that the government has met its prima facie burden in requesting the documents However, the taxpayer argues that he challenged the summons on an appropriate ground by raising the lack of possession or control as a valid affirmative defense. Because he raised this affirmative defense, the taxpayer contends that, on remand, the District Court should have afforded him an evidentiary hearing. On the one hand, if "material Government allegations are factually refuted by the taxpayer, thus presenting a disputed factual issue, or where proper affirmative defenses ... are factually supported by the taxpayer's affidavits, the taxpayer is entitled to an evidentiary hearing."[10] On the other hand, mere allegations supporting an affirmative defense are "insufficient if conclusionary."[11]The taxpayer must "particularize those specific facts" that could lead a district court to infer that the taxpayer has rebutted the Government's prima facie case.[12] Additionally, "[l]egal conclusions or mere memoranda of law will not suffice."[13] No evidentiary hearing is required if "the taxpayer cannot refute the government's prima facie showing or cannot factually support a proper affirmative defense."[14]

Holding. The court found that the district court's determination that the taxpayer had possession or control over financial records sought by an IRS summons was not erroneous. However, because he presented only non-particularized facts and conclusory statements in his defense, his argument was rejected, and the court's determination was upheld.

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10. *United States v. Garden State Nat'l Bank*, 607 F.2d 61, 71 (3d Cir. 1979)
11. Ibid.; *see also Alphin v. United States*, 809 F.2d 236, 238 (4th Cir. 1987)
12. *Garden State*, 607 F.2d at 71
13. Ibid.
14. Ibid.

Tax Court Jurisdiction

***Madden v. Comm'r*, TC Memo 2007-311 (Oct. 15, 2007)**

IRC §§6402 and 6512

☞ Tax Court Lacks Jurisdiction on Overpayment Issue

Facts. The taxpayers timely filed their joint federal income tax return for 2003. On their return, the taxpayers claimed an overpayment of $2,373. The taxpayers also reported a premature distribution of $17,787 from their qualified retirement plan. The taxpayers did not indicate on their return that they were liable for any additional amount as a result of this premature distribution.

The IRS applied the taxpayers' 2003 overpayment to their unpaid tax liabilities for 1991 and 1992. The IRS subsequently determined that the taxpayers' early distribution from their qualified retirement plan resulted in a 10% additional tax under IRC §72(t). Accordingly, the IRS determined a $1,779 deficiency in the taxpayers' 2003 federal income tax, and on September 12, 2005, the IRS issued a notice of deficiency to the taxpayers.

On December 12, 2005, the taxpayers filed their petition. They argued that their 2003 overpayment should have been applied to cover the $1,779 deficiency that resulted from the additional tax required by §72(t)(1).

Issue. Can the Tax Court recredit the taxpayers' overpayment to cover the 2003 deficiency resulting from the additional §72(t)(1) tax?

Analysis. Under IRC §6402(a), the IRS, within the applicable period of limitations, may credit any amount of an overpayment against any liability attributable to an internal revenue tax owed by the person who made the overpayment. The IRS credited the taxpayers' 2003 overpayment to outstanding tax liabilities for 1991 and 1992.

In bringing this case, the taxpayers were asking the Tax Court to recredit their 2003 overpayment towards their $1,779 deficiency for 2003 to cover the 10% additional tax resulting from the early withdrawal from their retirement account. The taxpayers offered no support for their argument that the court possess jurisdiction to recredit the taxpayers' overpayment. The Tax Court noted that it is a court of limited jurisdiction and may exercise its jurisdiction only to the extent expressly authorized by Congress. Pursuant to IRC §6512(b)(4), the Tax Court does not have jurisdiction to review any credit made by the IRS under §6402(a).

Holding. The Tax Court held that it lacked jurisdiction to determine whether the IRS improperly credited the taxpayers' 2003 overpayment of taxes to their outstanding tax liabilities from 1991 and 1992 instead of applying the credit to the taxpayer's 10% additional tax from 2003. Credits made pursuant to §6402 did not fall under the Tax Court's jurisdiction.

IRS PROCEDURES — PAYMENTS

Unlawful Levy

***Lofgren Trucking Service, Inc.* v. U.S., 06-CV-3100(JMR/FLN), (D. Minn. Sep. 10, 2007)**

IRC §6330

☞ IRS Abuse of Discretion in Payment of Taxes

Facts. Taxpayer failed to pay its 2005 employment taxes due to slow business. New owners bought the company in 2005, and the business began to turn around. After significant losses in 2005, the new owners made a small profit and realized a positive cash flow during the first quarter of 2006.

Seeking to collect 2005 taxes, the IRS issued two notices of intent to levy on the taxpayer's property. The IRS issued a Notice of Intent to Levy to collect $36,207 due for the period ending June 30, 2005. In response to that notice, the taxpayer submitted a proposed payment plan offering:

1. Payments of $6,000 per month on the 2005 liabilities;
2. Timely filing of returns for the first quarter of 2006, and payment of half its liability for that period; and
3. Timely deposits for the second quarter of 2006.

In addition, the taxpayer filed a timely request for a Collection Due Process ("CDP") hearing regarding the Notice pursuant to §6330(b).

The IRS then issued a second Notice of Intent to Levy in order to collect $29,408 owed for the period ending December 31, 2005. The taxpayer made a timely request for a CDP hearing with respect to this second notice.

The appeals officer conducted a review and maintained a daily case record documenting his actions. His notes reflect that when he first received the case, a revenue officer told him the plaintiff was not current with deposits, and was thereby ineligible for a payment plan.

While the taxpayer's proposal was pending, the taxpayer performed according to the proposed plan. The taxpayer made employment tax deposits for the second quarter of 2006, paid in full its $5,315.50 liability for the second quarter of 2005, and filed Form 940 for 2005 and Form 941 the first quarter of 2006.

On June 5, 2006, the appeals officer conducted a CDP hearing by telephone regarding both notices. According to the appeals officer's notes taken during the hearing, he told the taxpayer that the large outstanding balance and its failure to make deposits in the first quarter of 2006 "require[d]" that the payment plan be rejected. The appeals officer inquired whether the taxpayer could pay the taxes owing for the first quarter of 2006 in full. The taxpayer advised it could not. The next day, the appeals officer advised the taxpayer that it must immediately pay the taxes for the first quarter of 2006 or he would authorize the IRS to proceed with the levy.

The Appeals Office Notice of Determination was issued June 26, 2006, freeing the IRS to proceed with the levy. The appeals officer's Notice of Determination noted, as its sole reason for plan-rejection, the plaintiff's inability to pay its first quarter 2006 federal employment tax. The taxpayer filed suit pursuant to §6330(d)(1)(B), contesting the appeals officer's rejection of the proposed payment plan.

Issue. Did the IRS appeals officer abuse his discretion when he refused to consider the taxpayer's proposed payment plan to pay employment taxes that it owed. The taxpayer argued the appeals officer erred in both fact and law.

Analysis. The taxpayer first contended that, when its appeal was pending, it was actually meeting its current tax obligations. The taxpayer noted it proposed the payment plan and appealed the revenue officer's plan rejection during the second quarter of 2006. At that time, the taxpayer was successfully meeting its obligations to make employment tax deposits during the second quarter of 2006. Second, even assuming it had incurred a new tax liability while its proposal was pending, the taxpayer disputed the appeals officer's assertion that this fact precluded the IRS from accepting the plan. The taxpayer claimed an ongoing business can remain eligible for a payment plan even if it is accruing new tax liabilities.

The IRS acknowledged that ongoing tax liabilities do not preclude plan acceptance. It asserted, however, that, notwithstanding the appeals officer's error in suggesting that ongoing tax liabilities bar a taxpayer plan, he actually engaged in the appropriate balancing test mandated by law. The IRS claimed the appeals officer considered the plan and determined the taxpayer failed to demonstrate an ability to meet its current obligations while satisfying the past-due tax over a reasonable period of time. The IRS asserted the appeals officer fulfilled his obligation to consider the proposal, and did not abuse his discretion in rejecting it.

Holding. The court found that the appeals officer clearly erred when interpreting the regulations. The court found it highly implausible that the appeals officer could have engaged in the requisite balancing test to determine whether the taxpayer's payment plan satisfied the IRS's interest in the efficient collection of taxes. The evidence overwhelmingly showed the appeals officer summarily rejected the taxpayer's plan based on his erroneous belief that the plaintiff's delinquencies for first quarter 2006 made it ineligible for an installment agreement. The appeals officer cited no "balancing" factors, and gave no other basis for his rejection. As a result, the court concluded the taxpayer was deprived of its right to a fair hearing under §6330(b).

The court found that the appeals officer failed to meet his obligation to adequately consider whether the proposed installment agreement "balances the need for the efficient collection of taxes with the legitimate concern of the person that any collection action be no more intrusive than necessary" required by §6330(c)(3)(C). In doing so, he clearly abused his discretion, rendering his decision improper. The court remanded the matter to the Office of Appeals for consideration of plaintiff's proposal.

PASSIVE ACTIVITIES

Suspended Passive Loss Deduction

***Bilthouse v. U.S.*, No. 05 c 4442, (N.D. Ill. Sep. 28, 2007)**

IRC §469, §165, §1366

☞ Denial of Deduction for Suspended Passive Losses on S Corporation Stock

Facts. The Bilthouses brought an instant action against the IRS in order to recover refunds for overpayment of income taxes for tax years 1994 through 1999. Mr. Bilthouse claimed that certain stock became worthless in 1997, resulting in a complete disposition of his interest in the stock. The parties cross-moved for summary judgment.

Issue. Can the taxpayers claim that the increase in tax basis, coupled with the complete disposition of interest in the company that occurred when the stock became worthless, allowed them to amend their tax returns to deduct over $5 million in accumulated disallowed passive losses allocated to them by the company over a number of years?

Analysis. Mr. Bilthouse attempted to take advantage of the purported complete disposition of his interest by filing amended tax returns. He argued that his tax basis in the stock increased in 1997 when the company realized cancellation of indebtedness income in that year. He claimed that the increase in tax basis, coupled with the complete disposition of his interest in the company that occurred when the stock became worthless, allowed him to amend his tax returns. The IRS argued that the taxpayers' claimed deductions were not allowable because Mr. Bilthouse's stock became worthless in 1995, and not in 1997. The IRS had presented sufficient evidence to demonstrate that the company had no liquidating value in 1995, and had also provided sufficient evidence to demonstrate that the company lacked any potential value in 1995.

Holding. Because, on the record before the court, no reasonable jury could find that the taxpayers' stock became worthless in 1997 and not before then, the taxpayers' claim for a refund failed. The IRS's motion for summary judgment was granted and the taxpayers' motion for summary judgment was denied. The court held that the corporation did not engage in any business activity subsequent to the year the stock became worthless and there was insufficient evidence that there was a reasonable expectation the lawsuit would result in a substantial recovery allowing it to resume its business activities. Accordingly, any suspended passive losses under §469 were not available to offset the taxpayer's ordinary income in the year the lawsuit was settled.

Passive Losses and Business Expenses

TAM 200725976 (Aug. 1, 2007)

IRC §§469 and 162

☞ Rental Activity Grouped with Trade or Business Activity

Facts. An S corporation owned several QSubs primarily engaged in the activity of selling new and used heavy trucks and trailers. One of its QSubs also leased heavy trucks and trailers using leveraged net leases by way of master lease agreements. Some of the leases contained terminal rental adjustment clauses. For the tax years at issue, the S corporation grouped all the QSubs' activities as one activity for purposes of IRC §469.

Issues:

- Whether the truck leasing activity conducted by one of the QSubs is a separate rental activity under IRC §469.
- If the truck leasing activity conducted by the QSub is treated as a separate rental activity, can it be grouped with the non-rental activities conducted by the other QSubs of the S corporation under Treas. Reg. §1.469-4(d).

Analysis. The taxpayer argued that the truck leasing business should be treated as a financing trade or business because, among other reasons, the leases were treated as finance leases under the generally accepted accounting principles. The IRS, however, noted that some of the leases contained a terminal rental adjustment clause, which IRC §7701(h) requires be treated as leases. The IRS then conceded that the activities of the truck leasing QSub, though rental activities, should be grouped together with the activities of the other QSubs under Treas. Reg. §1.469-4(d)(1)(A) because the rental activity of the leasing QSub is insubstantial in relation to the activities of the other QSubs.

Ruling. The IRS rejected the taxpayer's argument that the truck leasing activities of one of the QSubs should not be treated as a rental activity. The IRS determined that the truck leasing activity engaged in by a qualified subchapter S subsidiary of an S corporation is a rental activity under §469, but that leasing activity may be grouped with other nonpassive activities of the S corporation's other QSubs because it is insubstantial in relation to the trade and business activities conducted by the other QSubs.

PROFIT MOTIVE

Hobby or Business

***Keating v. Comm'r*, TC Memo 2007-309 (Oct. 11, 2007)**

IRC §183

☞ Horse Breeding Losses Denied

Facts. Ms. Keating moved to North Dakota, began work as an emergency room physician in a local hospital, and purchased a home on a 10-acre farm. Throughout the years in question, she worked approximately 60 hours per week as a physician — typically two 24-hour shifts and one 12-hour shift. During this same period, her average annual income from her medical practice was $238,134. Ms. Keating's husband, Richard Shearer, was employed as a firefighter-medic in North Dakota and did not participate in any meaningful way in the taxpayer's horse activity.

The taxpayer and the IRS agreed on the following facts:

- In starting her activity, she consulted with individuals regarding training, breeding, and veterinary issues.
- She consulted with an accountant regarding recordkeeping, but did not have a written business plan or financial projections.

- Only two horses were sold, each for less than their purchase price.
- The taxpayer reduced her emergency room work schedule to allow more time for her horse activity.
- In 2000, she built a barn to shelter her horses as well as board horses for others.
- She paid horse expenses from both her personal checking account and horse farm account.

For 1996 through 2000, the taxpayers timely filed joint federal income tax returns. For 2001 and 2002, the taxpayer timely filed an individual federal income tax return. The taxpayers' joint federal income tax returns for 1996 through 2000 and the taxpayer's individual federal income tax returns for 2001 and 2002 included a Schedule F, *Profit or Loss from Farming*, on which it was indicated that the principal activity was "horses." She deducted net business losses of $370,512 between 1996 and 2002. The IRS denied these losses.

Issue. Was the horse-breeding activity carried on for profit as defined by IRC §183?

Analysis. IRC §183 specifically precludes deductions for expenses relating to an activity not carried on for profit except to the extent allowed by §183(b). For example, deductions are not allowable under §162 or §212 for expenses of an activity that a taxpayer carries on primarily as a hobby or for recreation. For a taxpayer's expenses of an activity to be deductible, and not subject to the limitations of §183, the activity must be carried on with an actual and honest profit objective.

The regulations under §183 provide nine factors to consider in determining whether an activity is carried on for profit. These are:

1. The manner in which the activity is carried on;
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 assets used in the activity may appreciate in value;
5. The success of the taxpayer in carrying on other similar or dissimilar activity;
6. The taxpayer's history of income or losses with respect to the activity;
7. The amount of occasional profits, if any, which are earned;
8. The financial status of the taxpayer; and
9. Whether elements of personal pleasure or recreation are involved.

Holding. The court held that the taxpayer's horse activity was an activity not carried on for profit within the meaning of §183. This was because five of the nine factors weighed in favor of the IRS (factors 1, 2 4 8 and 9), and four were neutral.

The court noted that neither a single factor, nor the existence of even a majority of the factors, is controlling, but rather an evaluation of all the facts and circumstances is necessary.

RESIDENCES

Unforeseen Circumstances in Residence Sale

Ltr.Rul. 200745011 (Nov. 9, 2007)
IRC §121

☞ No Gain Recognized on Sale of Residence Owned Less Than 2 Years

Facts. The taxpayers were married and had one child when they purchased their primary residence. The residence had three small bedrooms and one and one-half baths. The taxpayers used one of the small bedrooms as an office. After the purchase of the residence, the couple had another child. The taxpayers' first child was age 10 at the time. Taxpayers tried, but failed, to make reasonable accommodations for the additional child in their residence. The taxpayers then purchased another residence, which had 3 bedrooms, 2 full baths, and additional space used as their office.

Issue. The taxpayers requested a ruling that the gain on the sale of a primary residence may be excluded under the reduced maximum exclusion in IRC §121(c).

Analysis. IRC §121(a) provides that gain from the sale or exchange of property is not included in gross income if, during the 5-year period ending on the date of the sale or exchange, the taxpayer has owned and used the property as the taxpayer's principal residence for periods aggregating two years or more.

IRC §121(b)(1) provides the general rule for the maximum exclusion of gain. IRC §121(b)(3) provides that subsection (a) shall not apply to any sale if, during the 2-year period ending on the date of the sale, there was any other sale or exchange by the taxpayer to which subsection (a) applied.

IRC §121(c) provides for a reduced maximum exclusion when a taxpayer fails to satisfy the ownership and use requirements of subsection (a) if the primary reason for the sale is the occurrence of unforeseen circumstances.

Treas. Reg. §1.121-3(b) provides that all the facts and circumstances of a sale will determine whether the primary reason for the sale is the occurrence of unforeseen circumstances. Factors that may be relevant in determining the primary reason for a sale include the following:

1. The suitability of the property as the taxpayer's residence materially changes;
2. The circumstances giving rise to the sale are not reasonably foreseeable when the taxpayer begins using the property as the taxpayer's principal residence; and
3. The circumstances giving rise to the sale occur during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence.

Ruling. The IRS ruled that the occurrence of unforeseen circumstances was the primary reason for the sale and that the suitability of the residence as the taxpayers' principal residence materially changed. Accordingly, the gain on the sale of the residence, which taxpayers owned and used as a principal residence for less than two of the preceding five years, may be excluded under the reduced maximum exclusion of gain in §121(c).

RETIREMENT

Pension Distributions

***Joubert v. Comm'r*, TC Memo. 2007-292 (Sep. 24, 2007)**

IRC §§61, 86, 402, 6651, and 6654

☞ Pension Distributions Required by a QDRO Includable as Income

Facts. In 2002, the taxpayer obtained a divorce. Pursuant to a qualified domestic relations order (QDRO) issued the prior year, the taxpayer received a portion of his ex-wife's pension benefits, which were payable by SBC Communications, Inc., his ex-wife's former employer. The QDRO itself made clear that the taxpayer was responsible for all taxes incurred by reason of any benefits paid to him. On May 24, 2002, SBC issued a check to the taxpayer in the amount of $131,317. The gross amount of the check had been $168,355. However, $33,671 in federal income tax and $3,367 in California state income tax had been withheld. During 2002, the taxpayer also received $9,552 in social security benefits.

For the 2002 taxable year, the taxpayer's only federal income tax withholding was the aforementioned $33,671 withheld on the SBC Communications, Inc., pension distribution. The taxpayer did not make any estimated tax payments for the 2002 taxable year. The taxpayer did not file a federal income tax return for either 2001 or 2002. The IRS, pursuant to §6020(b), filed a return for 2002 for the taxpayer. The taxpayer had single filing status for the 2002 taxable year.

On April 7, 2006, The IRS issued a notice of deficiency. The taxpayer then filed a timely petition with the Tax Court.

Issues. Four issues were present:

1. Whether a $168,355 pension distribution to the taxpayer in 2002 pursuant to a qualified domestic relations order (QDRO) is includable in the taxpayer's 2002 taxable income;
2. Whether $8,119 of the $9,552 in social security benefits received by the taxpayer in 2002 is includable in the taxpayer's 2002 taxable income;
3. Whether the taxpayer is liable for additions to tax under IRC §6651(a)(1) and (2) in the amounts of $4,120, and $3,204, respectively; and
4. Whether the taxpayer is liable for an addition to tax under IRC §6654(a) in the amount of $486 for failure to pay estimated income tax.

Analysis. As to the first issue, the court noted that pensions are listed among the forms of income within the definition of IRC §61(a). Under §402(a), a pension distribution is normally taxed to the distributee. The spouse or former spouse is treated as the distributee with respect to distributions allocated to that spouse pursuant to a QDRO, and such distributions therefore become taxable income to that spouse. In this situation, the spouse receiving the distribution pursuant to the QDRO is also known as an "alternate payee." The court noted that in 2002, the taxpayer received the $168,355 pension distribution as an alternate payee under the QDRO.

For issue 2, the court examined IRC §86 that contains a formula for taxing social security benefits. Although the formula is somewhat complex, a single taxpayer whose modified adjusted gross income plus one-half of his social security benefits exceeds an "adjusted base amount" of $34,000 must include in his gross income 85% of his social security benefits.

For issue 3, the court found that the taxpayer failed to file a federal income tax return for 2002. No evidence was presented to suggest that his failure to file was due to reasonable cause.

In addition, the IRS, pursuant to IRC §6020(b), filed a return for the taxpayer that qualifies as a return for purposes of §6651(a)(2). The taxpayer also failed to pay his entire 2002 tax liability as shown on the return filed by the IRS.

Finally, for issue 4, the taxpayer failed to file a 2002 federal income tax return and made no estimated tax payments for 2002. The taxpayer also failed to file a 2001 federal income tax return. Because the taxpayer did not file a return for 2001, the taxpayer had a required annual payment of estimated tax for 2002.

Holding. The court held that the taxpayer had to include in income the pension distribution made pursuant to the QDRO and part of the social security benefits received during the tax year. Because the taxpayer received a portion of his ex-wife's pension pursuant to the QDRO, he was the distributee or the alternate payee to whom the distribution was taxable pursuant to §402. Accordingly, he had to include the full amount of the pension distribution in income. He also had to include in income 85% of the social security benefits received during the year because his modified adjusted gross income greatly exceeded the statutory adjusted base amount under §86.

Further, the court held the taxpayer liable for additions to tax pursuant to §6651 because he failed to file a return and pay tax for the tax year in question and did not present any evidence that his failure to file or pay tax was due to reasonable cause. Although the taxpayer did not file a return, the IRS filed a return for him and such a return qualified as a return for purposes of the §6651 penalty. The taxpayer was also subject to an addition to tax for underpayment of estimated tax under §6654. He not only failed to file a return for the tax year in question and the preceding tax year, but also failed to make the required estimated tax payments and he did not qualify for any of the §6654 exceptions.

TAX FRAUD

Tax Scheme or Shelter

***U.S. v. Sanders*, Civ. 1:05-CV-2458-JEC (D.Ga., Aug. 27, 2007)**
IRC §§6700, 6701, and 7408

☞ Non-recognized Indian Tribe Found to be Tax Scheme

Facts. The United States sought to stop the defendant from promoting an alleged tax fraud scheme. The defendant, Derrick H. Sanders, referred to himself as Chief Black Hawk, and claimed to be the Grand Master Consul of a group of Native Americans called the Yamassee Native Americans. He insisted that in his official capacity as Grand Master Consul of the Yamassee Native Americans, he entered into a treaty with the State of Georgia. Defendant further alleged that the United States Department of State authenticated the treaty. The treaty purportedly declareed that the Yamassee Native Americans were not subject to federal income taxes because they were non-resident aliens.

The defendant created a website that allowed individuals to become members of the Yamassee Native Americans through an application process. Once a person became a Yamassee, the defendant sent him a packet of five documents that the new Yamassee tribesman used to claim exemption from federal income taxes. The documents included: a letter from the defendant proclaiming the individual a Yamassee Native American with tax exempt status; an "Apostille" that supposedly granted the defendant the authority to issue certifications to other governments; a Declaration of Naturalization as a Yamassee; a homemade W-8BEN form to claim tax exemption; and a Declaration of Tax-Exempt Foreign Status.

Issue. Should the defendant be stopped from promoting his tax-related operations?

Analysis. The Yamassee Native Americans are not recognized as an Indian tribe by the Bureau of Indian Affairs. The Yamassees do not have a treaty with the United States. Finally, the Yamassees are not listed as a recognized Indian tribe in IRS Revenue Procedure 2002-64.

The IRS notified defendant that the Yamassee were not recognized as a separate sovereign nation and that their "citizens" were not exempt from federal income taxes. After this notification, defendant filed his own homemade W-8BEN form, with an Atlanta address listed. Additionally, 35 other Yamassee tribal members filed the same homemade W-8BEN form, even though the IRS notified the defendant that the Yamassees did not have tax exempt status. Although the tribal territory of the Yamassee is purportedly located at the Mt. Arafat Embassy in Georgia, a majority of the 35 individuals who filed the homemade W-8BENs lived in or around Philadelphia, Pennsylvania.

The IRS first brought suit to prevent the defendant from promoting his alleged tax scheme. Rather than answering the complaint, the defendant challenged the jurisdiction of the Court, stating that he had diplomatic immunity.

The IRS originally filed for a preliminary injunction against defendant, which was granted, and subsequently filed a permanent injunction.

The defendant's reply included a Motion to Dismiss, and a request for financial compensation from the United States in the amount of $11 million dollars.

Holding. The government showed that the individual ignored a preliminary injunction issued against him and continued to publicize fraudulent claims on his website that the "Yamassee Native Americans" were nonresident aliens and exempt from federal taxation due to a treaty with the United States. The court found the permanent injunction was necessary to prevent reoccurrence of the violation, and the individual had violated §6700 and §6701. He had prepared and sold documents claiming an exemption based on his material fraudulent statements and he knew or should have known that the statements were false or fraudulent and that the documents would be used in connection with a material tax matter that would result in an understatement of tax liability. The court granted the IRS's request for a permanent injunction, and ordered that the defendant and his agents, servants, employees, attorneys, and all persons in active concert or participation with him are permanently enjoined under §7408 from promoting the Yamassee Native American tribe as a tax scheme, and engaging in conduct subject to penalty under §6700 and §6701.

Tax Fraud

***U.S. v. Blase*, 06 CR 421, (N.D. Ill. Oct. 24, 2007).**
IRC §7206

☞ Tax Fraud Indictment Against Mayor Valid

Facts. In December, 2005, the Grand Jury returned an eleven-count superseding indictment against defendant Nicholas Blase ("Blase") alleging that Blase misused his official government position for private gain in violation of the federal mail fraud statute and that Blase filed false federal income tax returns for the years 2000 through 2005. Specifically, the indictment alleges that from around 1974 to June 2006 Blase used his position as the Mayor of the Village of Niles, Illinois in a variety of ways to assist Ralph Weiner and Associates (RWA), an insurance broker once located in Niles and later relocated to Wheeling, Illinois, to obtain and keep Niles businesses as customers. In return, RWA allegedly took a percentage of the money it received from these Niles businesses and paid that percentage as a kickback to Blase through S.M.P. Insurance Service, Inc. (SMP), which the indictment alleges was a sham corporation created and maintained for Blase's benefit. The indictment alleges that throughout this scheme, Blase failed to disclose his receipt of these payments to the public and, in fact, took numerous steps to conceal the true nature of his kickback arrangement with RWA. Counts six through eleven charge Blase with willfully and knowingly filing false federal tax returns for the years 2000 to 2005 in violation of IRC §7206 by failing to report as "Other Income" the payments that Blase allegedly received from RWA. Blase has moved to dismiss the indictment in its entirety.

Issue. Does the indictment properly allege that Blase personally received funds from RWA or SMP and thus violate §7206, which prohibits filing materially false *individual* tax returns.

Analysis. To sufficiently plead a violation of §7206, an indictment must allege that the:

1. Defendant made or caused to be made a verified federal income tax return for the year in question;
2. Tax return was false as to a material matter;
3. Defendant signed the return willfully and knowing it was false; and
4. Tax return contained a written declaration that it was made under the penalty of perjury.

The court found that counts six through eleven alleged that for the years 2000 to 2005 Blase filed signed federal tax returns and failed to report the kickbacks from RWA as "Other Income." The indictment further alleges that Blase verified those tax returns by written declarations that they were made under penalties of perjury, that Blase did not believe those returns to be true and correct as to every material matter, and that Blase knew that his income was substantially in excess of that reported for those years. Although Blase correctly asserts that the indictment does not allege that RWA paid Blase directly, the indictment does allege that RWA transferred money to SMP, which Blase allegedly constructively controlled, and that Blase then used that money to pay the salaries of his paralegals for their work at Blase's law firm. Those allegations are sufficient to allege that Blase received individual income that he failed to report on his federal tax returns for the years 2000 to 2005.

Holding. The court held that the indictment was sufficient because the allegations contained in the indictment adequately apprised him of the charges against him. The indictment sufficiently alleged that he made material misstatements to conceal his kickback arrangement from the public, signed his tax returns under penalties of perjury, did not believe those returns were correct, and knew that his income was substantially in excess of that reported.

Tax Fraud Sentencing

***Contreras v. U.S.*, No. 05-6692-cr, (2nd Cir. 2007)**
IRC §7206

☞ Sentence for Aiding and Abetting Fraudulent Returns Reasonable

Facts. Carlos Contreras was convicted by a jury of tax fraud. He was sentenced to 60 months' imprisonment for one count of conspiracy to defraud the government in violation of 18 USC §286, and 24 months on 17 counts of aiding and abetting the filing of fraudulent income tax returns in violation §7206, to run concurrently.

Issue. Did the evidence presented establish his culpability, and was the jury instructed properly as to that level of culpability?

Analysis. The evidence established the individual prepared fraudulent tax returns for his clients and also instructed and supervised the preparation of fraudulent returns by his employees. The trial court did not err in refusing to instruct the jury that he held an absolute right to rely in good faith on the information provided by his clients. The court properly instructed the jury as to the correct legal standard of review, and also instructed the jury regarding good faith. Further, in determining sentencing, the trial court properly considered the pre-sentence report, the amount of loss, the severity of the crime, the necessity for deterrence and the defendant's statement. The sentence imposed was less than the minimum contained in the applicable Guidelines range and was reasonable.

Holding. The 2nd Circuit upheld the conviction and sentence for aiding and abetting the filing of fraudulent tax returns.

TRAVEL AND TRANSPORTATION EXPENSE

2008 Per Diem Rates

Revenue Procedure 2007-63, 2007-42 IRB 809
IRC §§62, 162 and 274

☞ Per Diem Rates for Travel After October 1, 2007 Announced and Transportation Worker Meal Deductible Percentage Increased

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

Analysis and Conclusion. Instead of reimbursing employees' actual substantiated expenses for away-from-home lodging and meals and incidental expenses (M&IE), an employer can reimburse them at a rate that doesn't exceed the per-diem rate paid by the federal government to its workers on travel status. The rate varies with the locality of travel. If employees provide simplified substantiation (time, place and business purpose), the per-diem reimbursement isn't subject to income- or payroll-tax withholding and isn't reported on the employee's Form W-2. For 2007, transportation workers may deduct 75% of their food, beverage, and entertainment expenses. Beginning in 2008, they may deduct 80%.

Beginning October 1, 2007, the "standard" rate for all locations within CONUS (continental U.S.) not specifically listed on the GSA's list of domestic per diem rates (found at **www.gsa.gov/perdiem**) will be $109 (up from $99), as a result of an increase in the standard lodging rate from $60 to $70. A number of changes have been made to the GSA's listing of locations and per diems, with rates ranging from a low of $109 in places like Muskegon, MI, all the way up to $381, in Vail, CO.

Auto Mileage Allowance

Revenue Procedure 2007-70, 2007-50 IRB
IRC §§61, 62, 162, 170, 213, 217, 274, and 1016

☞ IRS Announces the 2008 Optional Standard Mileage Rates

Background. The IRS released the 2008 optional standard mileage rates to be used by employees, self-employed individuals, and other taxpayers to compute deductible costs of operating an automobile (including vans, pickups and panel trucks) for business, medical, moving and charitable purposes.

Business Mileage Rate

The standard mileage rate for business mileage will be 50.5 cents per mile, an increase of two cents over the 2007 rate. When the standard business mileage rate of 50.5 cents is used for automobiles owned by the taxpayer, depreciation will be considered to have been allowed at a rate of 21 cents per mile. Such depreciation reduces the taxpayer's basis in the automobile.

The standard business mileage rate may not be used for automobiles used for hire (e.g., taxicabs), or when five or more automobiles are owned or leased and used simultaneously by the taxpayer (e.g., fleet operations). Rules providing for substantiation of an employee's ordinary and necessary expenses for local travel or transportation away from home are also provided. Such expenses will be deemed substantiated when the employer, its agent or a third-party provider provides a mileage allowance under a reimbursement or other expense allowance arrangement.

Medical and Moving Mileage Rate

The standard mileage rate for medical and moving expenses has been decreased to 19 cents per mile from 20 cents per mile in 2007.

Charitable Mileage Rate

The standard mileage rate for charitable purposes remains at 14 cents per mile.

WITHHOLDING TAXES

Early Retirement Payments

***University of Pittsburgh v. U.S.* (3rd Cir. 2007)**
IRC §3102, §3121, and §3401

☞ Early Retirement Payments Taxable FICA Wages

Facts. Under early retirement plans offered by the University of Pittsburgh (University), payments to tenured employees were based on the employee's salary at the time of retirement, as well as length of service. Tenured employees had to relinquish their tenure rights in order to participate.

The University initially paid FICA tax on the payments but later sought a refund, contending that since the payments were in exchange for tenure rights, rather than for services, they weren't subject to FICA. The IRS denied the refund.

Issue. Whether retirement payments are within the FICA definition of wages.

Analysis. Two Circuit Courts have come to opposite conclusions on the treatment of this type of payment.

The 6th Circuit held that payments paid to tenured teachers under an early severance plan were FICA wages. It found that the payments easily fit within the definition of FICA wages. The eligibility requirement for qualifying for a payment (that a teacher serve a minimum number of years) indicated that the payments were for services performed rather than for the relinquishment of tenure rights. The court concluded that the payments were in exchange for the teachers' early retirement, and, as such, were essentially severance payments, subject to FICA.[15]

However, the 8th Circuit held that early retirement payments made by a university to tenured faculty members in exchange for their agreement to waive all tenure and employment rights were payments for the purchase of the faculty members' tenure rights. As such, they were not wages for FICA purposes.[16]

Holding. The 3rd Circuit, reversing the district court, concluded that the relinquishment of tenure rights — although a condition precedent to any payment — didn't alter the payments' character as compensation for services. It reasoned that payment eligibility under the plans was linked to past services at the University, not the relinquishment of tenure. Eligibility for both tenured and nontenured employees participating in the early retirement plan was based on the employee's age and years of service. As the plans themselves made clear, the payments were viewed as compensation for service to the University. The Court reasoned that to the extent the payments were a reward for service, they qualified as wages and were subject to FICA.

The Court concluded that even if the payments were in part to secure the relinquishment of tenure rights, their main purpose was to provide for employees' early retirement. In this regard, they were indistinguishable from severance payments, which are generally taxed as wages.[17]

The Court also rejected the University's suggestion that because tenure was wholly discretionary and afforded new rights to the recipient, it was necessarily the start of a new employment relationship. The Court found that the University's tenure award was contingent on past performance and more like a promotion than an entirely new contract. The fact that tenure was awarded on a very limited, discretionary basis did not change this fact.

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15. *Appoloni v. U.S.*, 450 F3d 185, (6th Cir. 2006) *cert. denied*.

16. *North Dakota State University v. U.S.*, 255 F3d 599 (8th Cir. 2001)

17. See Rev. Rul. 75-44, 1975-1 CB 15.

Responsible Person

***Van Dijk v. Lloyd and Lee,* No. 05-07-0109 (Del. 2007)**

IRC §6672

☞ Majority Stockholder Entitled to Recover Taxes from Partners

Facts. On May 31, 2003, Van Dijk, his wife, Nancy C. Van Dijk, James B. Lee, Patricia C. Lee (Lee), and Donald H. Lloyd, Jr. (Lloyd) formed a corporation known as Biztec, Inc. (Biztec) for the purpose of selling computer equipment, software and hardware. Pursuant to a stock agreement executed on the same day, Van Dijk held 52% of the stock of the corporation and Lee and Lloyd each held 24% of the stock.

Lee and Lloyd operated the business of the corporation in Delaware, and Van Dijk was the "silent partner" of the corporation. Lee and Lloyd were to pay the business expenses of the corporation, as well as the federal withholding taxes. Lee operated the financial end of the business and signed most of the checks. The business was not profitable and in April 2004, the corporation went out of business. After Biztec ceased to do business, Van Dijk met with Lee and Lloyd and observed a number of unopened notices from the IRS. These notices were dated in 2003 and related to the assessment of delinquent withholding taxes due from Biztec. After the dissolution of the corporation Van Dijk collected some of the accounts receivables and he paid unsecured creditors prior to paying the delinquent taxes to the IRS. On August 30, 2004, Van Dijk received a notice of delinquent taxes due from Biztec during the period ending June 30, 2003, as well as a notice of delinquent taxes due from Biztec for the period ending December 31, 2003. Van Dijk paid $3,630 in taxes to the IRS on November 1, 2004, and on December 13, 2005, a tax lien was assessed against Biztec in the amount of $7,085. On July 25, 2005, Van Dijk filed a civil action, pursuant to IRC §6672(d) in the Court of Common Pleas, State of Delaware, against Lee and Lloyd for the amount that he was required to pay to the IRS.

Issue. Whether Van Dijk is solely responsible for unpaid withholding taxes.

Analysis. This is a civil action for contribution brought under §6672. Civil actions can be filed in state courts under federal statutes, and §6672 is used frequently for collection of taxes owed by defunct corporations. The IRS may attempt to collect the taxes from a responsible person. Several factors have been used by the courts to determine whether an individual is a responsible person including whether the person:

1. Is an officer or member of the board of directors;
2. Owns substantial amount of stock in the company;
3. Manages the day-to-day operations of the business;
4. Has authority to hire and fire employees;
5. Makes decisions as to disbursement of funds and payment of creditors; and
6. Possesses authority to sign company checks.

The IRS told Van Dijk that he was a responsible party as president of the corporation and majority stockholder. The IRS's ability to assess does not preclude other courts from determining that other defendants are responsible parties.[18] In this case, Lee and Lloyd ran the day-to-day business of the corporation. Both of them were entrusted with the responsibility of paying the federal withholding taxes. Each of them had the power to write checks and pay the bills of the corporation. Therefore, the court determined that Lee and Lloyd were responsible persons under §6672.

Both Lee and Lloyd were aware that withholding taxes were due the government, and that those taxes were not paid to the federal government. Additionally, the unopened notices from the IRS indicated that both defendants intentionally ignored notices from the IRS. Under these circumstances, the court concluded the defendants conduct was willful.

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18. *Aardema v. Fitch*, 684 N.E.2d 884, 888 (Ill. App. 1997)

IRC §6672 authorizes a right of contribution for an amount equal to the excess of the amount paid by such person over the person's proportionate share of the penalty. Proportional share does not mean equally distributing the burden. IRC §6672 does not preclude an analysis of the relative culpability of the responsible parties.

Holding. Because the defendants managed the day-by-day operations of the corporation, the court determined that they were primarily culpable. Van Dijk bears some culpability because of his failure to promptly pay the delinquent taxes when he was aware the taxes were delinquent. The court assessed the degree of responsibility 20% to Van Dijk and 80% to Lee and Lloyd. The court held that Van Dijk has paid $3,630 in taxes and is entitled to recover 80% of that amount from the defendants. The taxpayer is entitled to recover from Lee and Lloyd the sum of $2,904.