Chapter 1: Compliance Target Areas

Corrections were made to this workbook through January of 2014. No subsequent modifications were made.

As tax law evolves, there are always a few areas that develop into higher-priority focal points for IRS enforcement. These change over time and it is essential for the tax return preparer to know what they are, the relevant rules and guidance, and what is required for compliance. IRS actions such as form and instruction changes, increased litigation, new proposed regulations, and other trends or signals provide some indications about the specific areas to which the tax practitioner must be most attentive.

This chapter covers some of the most relevant compliance areas for the tax return preparer to become familiar with in 2013 and early 2014. This is based on the IRS's recent actions.

OFFICE OF PROFESSIONAL RESPONSIBILITY

TAX PRACTITIONER DISCIPLINE

Circular 230, §10.51, provides the IRS with the ability to sanction tax practitioners for incompetence and disreputable conduct. One of the forms of conduct that may constitute incompetence and disreputable conduct is the following.

> *Willfully failing to make a Federal tax return in violation of the Federal tax laws, or willfully evading, attempting to evade, or participating in any way in evading or attempting to evade any assessment or payment of any Federal tax.*[1]

Disciplinary Sanctions

Periodically, the IRS publishes disciplinary sanction information in the Internal Revenue Bulletin (IRB). During the 2012 calendar year, six IRBs contained information regarding disciplinary sanctions of tax practitioners. A list of the six IRBs follows, along with the number of specific references to sanctions invoked under §10.51 of Circular 230 for the tax practitioner's failure to file tax returns. This table shows an increase in sanctions in this area.

Disciplinary Violation Reference	Date	Number of Sanctions Noted Specifically for Failure to File
2012-7 IRB 374	Feb. 13, 2012	2
2012-23 IRB 983	Jun. 4, 2012	0
2012-27 IRB 12	Jul. 2, 2012	0
2012-35 IRB 326	Aug. 27, 2012	0
2012-47 IRB 558	Nov. 19, 2012	2
2012-49 IRB 665	Dec. 3, 2012	11

1. Circular 230, §10.51(a)(6).

Circular 230, §10.82, "Expedited Suspension," authorizes the immediate suspension of a practitioner who, within five years prior to receiving an IRS notice pursuant to §10.82, has:

- Had a CPA or attorney license suspended or revoked by a licensing authority;
- Been convicted of a federal tax crime or any crime involving dishonesty or a breach of trust;
- Been convicted of any felony that involved conduct that renders the practitioner unfit for practice before the IRS;
- Violated conditions placed on practice before the IRS as a result of IRS disciplinary action; or
- Been sanctioned by a court for using delay tactics, advancing frivolous or groundless arguments, or failing to pursue administrative remedies in connection with an action regarding the tax liability of the practitioner or another person.[2]

Proposed Changes to Circular 230

In October 2012, the IRS proposed changes to several rules in Circular 230, including §10.82.[3] To the list of items that provide the IRS with grounds for immediate suspension, the IRS proposed adding the circumstance in which the tax practitioner has demonstrated a **pattern of willful disreputable conduct** evidenced by one of the following.

- Failing to file an **annual** federal tax return during four of the five tax years immediately preceding the institution of a §10.82 proceeding and remaining noncompliant with any of the practitioner's federal tax filing obligations at the time the §10.82 notice of suspension is issued
- Failing to file a return required **more frequently than annually** during five of the seven tax periods immediately preceding the institution of a §10.82 proceeding and remaining noncompliant with any of the practitioner's federal tax filing obligations at the time the notice of suspension is issued under §10.82(f)

The proposed changes extend the expedited disciplinary provision to practitioners who willfully failed to comply with federal tax filing obligations.

In the preamble to the proposed changes, the IRS noted that:

- Provisions to extend §10.82 expedited suspension against practitioners who do not comply with filing requirements have been proposed since 2006, and
- The IRS "continues, however, to encounter practitioners who demonstrate they are unfit to practice by repeatedly failing to comply with their own tax obligations."

The proposed provisions do not provide the use of expedited suspension proceedings for the tax practitioner's failure to pay federal tax obligations. This is because a failure to pay federal tax liabilities may exist due to circumstances beyond the tax practitioner's control.

2. Circular 230, §10.82(b).
3. REG 138367-06, 2012-40 IRB 426.

COMPETENCY REQUIREMENTS

Tax practitioners should be aware of recent developments with respect to competency rules in Circular 230.

Proposed changes to Circular 230 include the elimination of the rules regarding covered opinions and the removal of existing §10.35, "Requirements for Covered Opinions." However, the changes proposed would create a new §10.35, "Competence." This addresses the absence of a specific competence requirement and definition of competence in the current version of Circular 230. The proposed §10.35 indicates the following.

- A practitioner must possess the necessary competence to engage in practice before the IRS.
- Competent practice requires the knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged.[4]

Although §10.51 provides for the sanction of a practitioner for incompetency, the proposed §10.35 provides the corresponding definition of competence that previously did not exist.

> **Note.** For more information about the proposed changes to Circular 230, see the 2013 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 5: Ethics.

DOCUMENTATION OF CHARITABLE DONATIONS

Charitable donations are only deductible if given to a §501(c)(3) organization.

Adequate documentation of charitable contributions in excess of $250 has been the subject of substantial recent litigation between taxpayers and the IRS. The following table outlines some of the Tax Court cases that have involved this issue.

Case Name	Citation	Date
Randall A. and Kelly C. Schrimsher v. Comm'r	TC Memo 2011-71	Mar. 28, 2011
Aaron Kirman v. Comm'r	TC Memo 2011-128	Jun. 8, 2011
E. Bruce and Denise Agness DiDonato v. Comm'r	TC Memo 2011-153	Jun. 29, 2011
Judith Gaerttner and Keith Williams v. Comm'r	TC Memo 2012-43	Feb. 14, 2012
Loren Dunlap and Nancy Dunlap, et al. v. Comm'r	TC Memo 2012-126	May 1, 2012
David and Veronda Durden v. Comm'r	TC Memo 2012-140	May 17, 2012
Joseph Mohamed, Sr. and Shirley Mohamed v. Comm'r	TC Memo 2012-152	May 29, 2012
Gayle O. Averyt and Margaret Averyt, et al. v. Comm'r	TC Memo 2012-198	Jul. 16, 2012
RP Golf, LLC, SB Golf, LLC, Tax Matters Partner v. Comm'r	TC Memo 2012-282	Oct. 3, 2012
Charles R. Irby and Irene Irby v. Comm'r	139 TC No. 14	Oct. 25, 2012

Tax practitioners should be particularly aware of the Tax Court's stance in the *Durden* case (cited in the preceding table). In *Durden*, the taxpayers conceded that their charitable contribution documentation did not meet all of the requirements outlined in the Code[5] but argued that they substantially complied with documentation that met some, but not all, of those requirements. The Tax Court rejected the notion that only substantial compliance was sufficient to meet the documentation requirements necessary to deduct a charitable contribution over $250. Instead, the Tax Court's holding indicates that **full compliance** with the requirements is necessary.

Given the nature and degree of tax litigation involving these documentation requirements, the tax practitioner must be aware of the applicable rules and ensure that they are adhered to for claimed charitable contributions.

4. Ibid.

5. As stated in IRC §170(f)(8).

DOCUMENTATION RULES

The type of substantiation required from the taxpayer in order to claim a deduction for a charitable contribution depends on the nature of the contribution (cash or noncash) and the amount of the contribution.

Substantiation Requirements

Generally, in order to claim a deduction for a cash donation that is **less than $250,** the taxpayer must have a bank record or a written communication from the donee that includes the following information.

- The donee's name
- The date of the contribution
- The amount contributed[6]

Additionally, regulatory guidance indicates that a receipt from the donee or a canceled check satisfies this requirement.[7] In the absence of a receipt or canceled check, the taxpayer can use another type of **reliable written record** to substantiate the contribution.

> **Note.** The reliability of a written record is determined by all the facts and circumstances. The factors considered include:
>
> - The contemporaneous nature of the record, and
> - The regularity of the taxpayer's recordkeeping procedures.[8]
>
> This facts-and-circumstances analysis applies whenever the taxpayer's own **reliable written record** may suffice as substantiation for a charitable donation.

For cash and noncash[9] donations of **$250 or more,** the taxpayer must substantiate the contribution with a **contemporaneous written acknowledgement** of the donation from the donee that indicates:

- The donee's name
- The date of the contribution
- The amount of cash and a description of any noncash property contributed
- Whether the donee provided the taxpayer with any goods or services in exchange for the amount contributed
- If the donee provided any goods and services other than intangible religious benefits, a description and good faith estimate of the value of those goods and services
- If the donee provides any intangible religious benefits, a statement to that effect[10]

The written acknowledgement is **contemporaneous** if the taxpayer obtains it on or before the **earlier** of:

- The date the taxpayer files the return on which the charitable deduction claim is made, or
- The due date (including extensions) of the return.[11]

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6. IRC §170(f)(7).
7. Treas. Reg. §1.170A-13(a)(1).
8. Treas. Reg. §1.170A-13(a)(2).
9. Treas. Reg. §1.170A-13(f).
10. IRC §170(f)(8).
11. Treas. Reg. §1.170A-13(f)(3).

Example 1. During 2012, Todd made several charitable contributions to his church (which is a §501(c)(3) organization eligible to receive tax deductible contributions). Each of these individual contributions was over $250. Todd made a total of $25,000 in contributions for 2012 and claimed this amount on his Schedule A. His return was filed April 7, 2013. In June 2013, the IRS disallowed the $25,000 contribution because Todd did not have a written acknowledgement from the church. However, he contacted the church to obtain one before the end of June 2013.

The church issued Todd a letter dated July 2, 2013, duly acknowledging his contributions of $25,000. As required, the letter also specifically indicated that the church did not provide Todd with any goods or services in exchange for the amount contributed, other than intangible religious benefits. However, the church's letter did not meet the substantiation requirements under Treas. Reg. §1.170A-13(f). Even though the letter contained the required statements regarding provision of goods or services to the donee and intangible religious benefits, the letter did not meet the "contemporaneous" requirement of Treas. Reg. §1.170A-13(f)(3). In order for the letter to be contemporaneous, Todd had to obtain it on or before his actual filing date or the due date of his return (including extensions). Thus, in order to meet the requirement, Todd had to obtain the letter on or before April 7, 2013.

Example 2. Assume the same facts as **Example 1,** except that $3,000 of the $25,000 in contributions is composed of individual contributions in amounts less than $250. Todd can claim this $3,000 of charitable contributions because the sum of all contributions that are each less than $250 is not subject to the requirement for a contemporaneous written acknowledgement. In order to adequately substantiate these contributions of less than $250, Todd only needs to furnish the IRS with a canceled check or other reliable written record of each contribution. The check or other reliable written record must contain the name of the donee as well as the date and amount of the contribution. The remaining $22,000 of charitable contributions (composed of individual contributions of $250 or more) is not deductible given the absence of a contemporaneous written acknowledgement.

Note. Preparers should encourage their clients to provide documentation in a timely manner to ensure that their contribution deduction is substantiated. If the client requires further documentation from the donee, the client must obtain it **before** submitting a timely-filed return (including extensions).

Further Requirements for Noncash Donations

Generally, for noncash contributions valued at $500 or less, the taxpayer must be able to substantiate all noncash contribution deduction claims with a receipt that indicates the following information.

- The donee's name
- The date and location of the contribution
- A description of the property consisting of detail that is reasonably sufficient under the circumstances[12]

Although an indication of the contributed property's fair market value (FMV) on the receipt may be a factor in establishing the receipt's sufficiency, such an FMV statement is not necessary. Moreover, a letter or other document from the donee serves as the necessary receipt if it includes:

- An acknowledgement that the contribution was received,
- The date of the contribution, and
- A description of the property consisting of detail that is reasonably sufficient under the circumstances.[13]

12. Treas. Reg. §1.170A-13(b)(1).

13. Treas. Reg. §1.170A-13(b)(1)(iii).

Valuation. The Salvation Army provides a helpful valuation guide that lists appropriate values for items that are commonly donated. The Salvation Army provides a value range for each type of donated item and suggests that the donor select a value within the range for the item donated based on the age and quality of that item. The table on the following page is taken from the Salvation Army's Valuation Guide.[14]

> **Note.** Additional information and values for donated items may be found on the Salvation Army website at **www.salvationarmyusa.org/usn/www_usn_2.nsf/0/D477340FFA28755C8525743D0049D1EF?Opendocument.**

[14] *Valuation Guide for Salvation Army Donations*. The Salvation Army. [www.salvationarmyusa.org/usn/www_usn_2.nsf/0/D477340FFA28755C8525743D0049D1EF?Opendocument] Accessed on Feb. 14, 2013.

Item	Low	High	Item	Low	High
Appliances					
Air conditioner	$ 20.00	$ 90.00	Microwave	$10.00	$ 50.00
Dryer	45.00	90.00	Refrigerator (working)	75.00	250.00
Electric stove	75.00	150.00	T.V. (color, working)	75.00	225.00
Gas stove	50.00	125.00	Washing machine	40.00	150.00
Heater	7.50	22.00			
Furniture					
Bed (full, queen, king)	50.00	170.00	Hi riser	35.00	75.00
Bed (single)	35.00	100.00	High chair	10.00	50.00
Bedroom set (complete)	250.00	1000.00	Kitchen cabinet	25.00	75.00
Carriage	5.00	100.00	Kitchen chair	2.50	10.00
Chair (upholstered)	25.00	100.00	Kitchen set	35.00	170.00
Chest	25.00	95.00	Mattress (double)	12.50	75.00
China cabinet	85.00	300.00	Mattress (single)	15.00	35.00
Clothes closet	15.00	50.00	Playpen	3.75	30.00
Coffee table	15.00	65.00	Rugs	20.00	90.00
Crib (with mattress)	25.00	100.00	Secretary	50.00	140.00
Desk	25.00	140.00	Sleeper sofa (with mattress)	85.00	300.00
Dining room set (complete)	150.00	900.00	Sofa	35.00	200.00
Dresser with mirror	20.00	100.00	Trunk	5.00	70.00
End table	10.00	50.00	Wardrobe	20.00	100.00
Folding bed	20.00	60.00			
Household Goods					
Bakeware	1.00	3.00	Kitchen utensils	0.50	1.50
Bedspread/quilt	3.00	24.00	Lamp	5.00	75.00
Blanket	3.00	15.00	Mixer/blender	5.00	20.00
Chair/sofa cover	15.00	35.00	Picture/painting	5.00	200.00
Coffeemaker	4.00	15.00	Pillow	2.00	8.00
Curtains	1.50	12.00	Plate	0.50	3.00
Drapes	6.50	40.00	Pot/pan	1.00	3.00
Fireplace set	20.00	80.00	Sheets	2.00	8.00
Floor lamp	6.00	50.00	Throw rug	1.50	12.00
Glass/cup	0.50	1.50	Towels	0.50	4.00
Griddle	4.00	12.00			
Miscellaneous					
Answering machine	10.00	30.00	Ice skates	3.00	15.00
Bicycle	5.00	80.00	Luggage	5.00	15.00
Board game	1.00	3.00	Mower	25.00	100.00
Book (paperback)	0.75	1.50	Mower (riding)	100.00	300.00
Book (hardback)	1.00	3.00	Radio	7.50	50.00
CD	2.00	5.00	Roller blades	3.00	15.00
Computer monitor	5.00	50.00	Sewing machine	15.00	85.00
Computer printer	5.00	150.00	Stereo	15.00	75.00
Computer system	100.00	400.00	Stuffed animal	0.50	1.00
Copier	40.00	200.00	Tennis racket	2.00	5.00
DVD	2.00	5.00	Typewriter	5.00	25.00
DVD player/VCR	8.00	15.00	Umbrella	2.00	6.00
Edger	5.00	25.00	Vacuum cleaner	15.00	65.00
Golf clubs	2.00	25.00			

Recordkeeping Requirement if Receipt Cannot Be Obtained. IRS guidance indicates that a receipt to substantiate a noncash contribution is not necessary if the contribution is made under circumstances that make it impractical to obtain one. In such cases, the taxpayer must maintain **reliable written records** of each donated item. To substantiate donations without a receipt, the taxpayer's written records must include the following **four components** of information.

- The name and address of the donee
- The date and location of the contribution
- A description of the property in detail that is reasonable under the circumstances
- The FMV of the property at the time the contribution is made and the method used to determine the FMV amount (If an appraisal is used, a signed copy must be retained.)[15]

> **Note.** In connection with the donation of certain types of property, a record of the property's cost basis is also necessary. See IRC §170(e) and Treas. Reg. §1.170A-13(b)(2)(E) for additional guidance. Donations of partial interests in property are also addressed in Treas. Reg. §1.170A-13(b)(2)(F) and (G).

Noncash Donations in Excess of $500. Charitable deductions for noncash contributions in excess of $500 must be substantiated by the taxpayer by maintaining a written record that generally includes the previously mentioned **four components** of information as well as the following.

- How the taxpayer acquired the property donated
- The adjusted cost basis in the property immediately before the donation if the property was held for less than one year before the donation[16]

Example 3. During each month of the 2013 tax year, Sierra gave various household goods to a local charity, Metropolitan Homeless Aid (MHA). She always leaves her donated goods in the local MHA dropbox, which is located down the street from her home. Because she uses the dropbox, it is not practical to obtain a receipt.

Although Sierra kept no record of her donations, she made a brief list of the goods she donated immediately before tax preparation season and indicated a reasonable amount at the bottom of the list for the total value of the donated goods for 2013. No other information was included on the list that she provided to her tax return preparer. Because use of the dropbox made it impractical to obtain receipts, Sierra's own reliable written record of each donated item is acceptable if it contains all of the four components of required information. If Sierra's list does not contain the four components of information necessary, her tax return preparer should not claim a deduction for the amount indicated on Sierra's list.

Example 4. Assume the same facts as **Example 3,** except that each time Sierra drops off a donation of goods at the MHA dropbox, she records a detailed description of the goods, along with a value for each item. The values she generally uses reflect the amount of money that the item would sell for if she were to sell them at a garage sale or on the Internet. She enters this information into a logbook that she keeps in her car. If the item donated has a serial number, model number, or other distinguishing description, Sierra includes this in her logbook entry. She gives this logbook to her tax return preparer, along with her other tax information. Sierra's logbook contains the four components of information with respect to her donations under circumstances in which it is impractical to obtain a receipt. A deduction for those donations may be claimed.

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15. Treas. Reg. §1.170A-13(b)(2).
16. Treas. Reg. §1.170A-13(b)(3).

Noncash Donations in Excess of $5,000. If the noncash donation is in excess of $5,000, the taxpayer must substantiate the donation with a written record containing the **four components** of information mentioned earlier, as well as:

- Obtaining a signed written qualified appraisal that is submitted with the tax return, and
- Maintaining a **reliable written record** of the contribution.[17]

> **Note.** For details on the requirements for the appraisal, see Treas. Reg. §1.170A-13(c)(3).

> **Observation.** Although this section provides an overview of the basic substantiation rules for charitable donations, the tax practitioner should review and become familiar with the additional rules contained in Treas. Reg. §1.170A-13. In addition, IRS Pub. 1771, *Charitable Contributions–Substantiation and Disclosure Requirements,* and IRS Pub. 526, *Charitable Contributions,* provide helpful information.

EARNED INCOME CREDIT DUE DILIGENCE

On December 20, 2011, the IRS issued final regulations regarding the due diligence requirements for tax return preparers in connection with determining a taxpayer's eligibility for the earned income credit (EIC) and the amount of the EIC.[18] These new regulations were published in the Internal Revenue Bulletin in March 2012.[19] The changes made by the IRS included important revisions to the 2012 version of Form 8867, *Paid Preparer's Earned Income Credit Checklist.* In addition, IRC §6695(g) was amended to increase the applicable penalty from $100 to $500 for each tax return preparer failure to adhere to the due diligence rules associated with determinations of taxpayer EIC eligibility and amounts.[20]

TAX RETURN PREPARER'S DUE DILIGENCE REQUIREMENTS

With respect to a tax return on which the EIC is claimed, the EIC due diligence requirements are imposed only on the preparer. A "tax return preparer" is defined as any person who:

- Prepares all or a **substantial portion** of that return for compensation, or
- Employs another person or persons to prepare all or a substantial portion of that return for compensation.[21]

In addition, a **signing tax return preparer** is the person with primary responsibility for accurately preparing a return. A **nonsigning tax return preparer** is a person who prepares all, or a **substantial portion**, of a return that is signed by another person.

Substantial Portion of Return

A person's work performed on a return constitutes a substantial portion of that return if the person knows (or should reasonably know) that the amount of tax attributable to that work is a substantial portion of the overall tax required to be shown on the return.[22] Therefore, a single entry on a return may constitute a substantial portion of that return's preparation. Factors to consider in determining whether work on a particular item shown on a return constitutes a substantial portion of the return include the following.[23]

- The size and complexity of the item relative to the taxpayer's gross income
- The amount of understatement attributable to the item compared to the taxpayer's reported tax liability for the year

17. Treas. Reg. §1.170A-13(c)(2).
18. See TD 9570, 76 FR 78816.
19. REG 140280-09, 2011-45 IRB 709.
20. See IRC §6695(g) as amended by the United States-Korea Free Trade Agreement Implementation Act, PL 112-41 (Oct. 21, 2011).
21. Treas. Reg. §301.7701-15(a).
22. Treas. Reg. §301.7701-15(b)(3).
23. Ibid.

De Minimis Rule. The work performed by a **nonsigning preparer** does not constitute a "substantial portion" of the return if the entry, schedule, or other part of a return involves amounts of gross income, amounts of deductions, or amounts on which tax credits are based that are:

- Less than $10,000, or
- Less than $400,000 and also less than 20% of the taxpayer's adjusted gross income (AGI).[24]

However, if work was performed on more than one schedule, entry, or portion of the return, amounts from all of those portions are aggregated in applying this rule.

> **Note.** This de minimis rule only applies to **nonsigning preparers.** Further details can be found in Treas. Reg. §301.7701-15(b)(3).

EIC Due Diligence Requirements

The regulations impose several due diligence requirements on tax return preparers as follows.

- Complete and submit Form 8867, *Paid Preparer's Earned Income Credit Checklist.*
- Compute the credit and complete the EIC worksheet.
- Comply with the knowledge requirement.
- Retain copies of the completed Form 8867 and the EIC computation.

Completion and Submission of Form 8867. Completing Form 8867 is an EIC due diligence requirement.[25] It is not necessary for the tax return preparer to use the Form 8867 checklist to interview clients.[26] However, the tax return preparer must complete this form as part of the process of obtaining the necessary information, details, and documentation from the taxpayer who substantiates eligibility for the EIC and the EIC amount claimed on a return.

Beginning with tax returns for the 2012 tax year, a signing tax return preparer must submit Form 8867 with the taxpayer's return. A preparer who completes Form 8867 for another signing preparer meets the due diligence requirement by providing the completed Form 8867 to the signing preparer for inclusion with the return.[27]

Verification of Taxpayer Information. The EIC due diligence regulations state that the tax return preparer must not know, or have reason to know, that any information used in determining the eligibility for the EIC, or the EIC amount is incorrect. Furthermore, the regulations mirror Circular 230 requirements by indicating that the preparer cannot ignore the implications of information furnished by the taxpayer or known by the preparer. The regulations also reflect Circular 230 requirements by indicating that the preparer must make reasonable inquiries if the information provided by the taxpayer appears incorrect, inconsistent, or incomplete. In addition, the inquiries made by the preparer and the taxpayer's responses must be contemporaneously documented.

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24. Ibid.
25. Treas.Reg. §1.6695-2(b)(1).
26. *Consequences of Filing EITC Returns Incorrectly.* Jul. 10, 2012. [www.eitc.irs.gov/rptoolkit/dd/consequences] Accessed on Jan. 18, 2013.
27. Treas. Reg. §1.6695-2(b).

Example 5. Melissa has prepared the joint tax return for Oliver and Gabriella for several years. Oliver and Gabriella have a 23-year-old daughter, Sabrina, who lives with them. Melissa knows that in order to qualify for the EIC for 2013, Oliver and Gabriella must meet the following requirements.

- Their AGI must be less than $43,210 for jointly filing taxpayers with one qualifying child.
- Their investment income must be $3,300 or less for the year.
- Sabrina must have lived with Oliver and Gabriella for more than half the year and, generally, Sabrina must not have filed a joint return.

Because Sabrina is over age 19 at the end of 2013 but is under age 24, she must be a full-time student for some part of each of any five calendar months during the tax year in order to be a qualifying child under EIC rules.

Melissa meets with Oliver and Gabriella to review their tax information and obtain all of the necessary details in connection with the preparation of their 2013 tax return. During their appointment, Melissa congratulates Oliver and Gabriella on Sabrina's graduation from the local university's business school program in March 2013. Oliver and Gabriella also mention that Sabrina was married in October of 2013.

As Melissa completes Form 8867 during her meeting with Oliver and Gabriella, she explains to them that even though their AGI and investment income are just below EIC thresholds (which initially indicates they might qualify), the changes in Sabrina's situation may disqualify them for the EIC for 2013. Included with tax information for Oliver and Gabriella is a Form 1098-T, *Tuition Statement*, showing a tuition amount substantially lower than the amount shown in previous years. Melissa explains to Oliver and Gabriella that if Sabrina was not a full-time student for at least some part of any five months of the year, she is not a qualifying child under the EIC rules. This could disqualify them for the EIC for 2013. Oliver indicates that after her graduation date, Sabrina was still doing some coursework. However, he was uncertain whether the extra coursework was correspondence courses or a co-op training program.

Melissa explains that correspondence or Internet courses do not qualify under EIC rules, but co-op training does qualify. Oliver immediately answers that it was a co-op course Sabrina had taken for five months.

Melissa indicates to Oliver and Gabriella that Sabrina must have lived with them long enough during 2013 to qualify for the EIC. Also, if Sabrina is filing a joint return with her husband for the 2013 tax year, that will also disqualify Sabrina as a qualifying child. This would eliminate the EIC for Oliver and Gabriella. Oliver states that Sabrina lived with them all year and indicated he was certain that Sabrina and her husband would not file jointly. After Oliver and Gabriella leave her office, Melissa continues to review their tax information and finds a copy of an invoice addressed to Sabrina for moving expenses dated March 19, 2013.

Melissa must exercise due diligence by making reasonable inquiries if the taxpayer's information appears incorrect, inconsistent, or incomplete.[28] This requires her to contact Oliver and Gabriella to obtain further details about Sabrina's coursework to determine whether that coursework qualifies Sabrina as a student under the EIC rules. Melissa must also make additional inquiries about whether Sabrina lived at home for more than half the year. Under §10.34(d) of Circular 230, Melissa may rely in good faith upon the information furnished by Oliver and Gabriella without verification but may not ignore the implications of the information provided.

Under EIC due diligence rules, Melissa must also document the inquiries she makes of Oliver and Gabriella and document their responses. The revised Form 8867, *Paid Preparer's Earned Income Credit Checklist,* requires Melissa to indicate the particular documents she relies on to substantiate that Oliver and Gabriella qualify for the EIC for 2013.

Note. Due diligence requirements dictate that Melissa should not complete the return if she is not comfortable with the answers or credibility of the client.[29] If Melissa decides the answers are credible, she should ask Oliver and Gabriella to sign the Form 8867 as evidence that the answers were obtained from the taxpayers.

28. Circular 230, §10.34(d).

29. *Consequences of Filing EITC Returns Incorrectly.* Feb. 2, 2012. [www.eitc.irs.gov/rptoolkit/faqs/duediligence] Accessed on Feb. 12, 2013.

Failure to Claim Expenses. A taxpayer may not wish to claim some business expenses in order to inflate taxable income to qualify for a higher EIC. However, Rev. Rul. 56-407[30] holds that every taxpayer generally must claim all allowable deductions, including depreciation, when computing net earnings from self-employment.

Example 6. Corrine has been preparing tax returns for three years. Corrine meets with a new client, Lauren, to discuss the preparation of her 2013 tax return. Lauren indicates to Corrine that she earns income from doing yard work for three homes in her neighborhood. After further discussion, Corrine learns that Lauren has two young children of her own. Lauren mentions that she has earned $15,000 from babysitting and indicates that she does not have any expenses.

Due diligence requires Corrine to make additional inquiries of Lauren. It is not likely that Lauren's business earned exactly $15,000. In addition, is it unlikely that Lauren had no business expenses. Corrine must document her additional inquiries and Lauren's responses. If Corrine is not comfortable with Lauren's responses or with Lauren's credibility, Corrine should not prepare the return.

Retention of Records. EIC due diligence requires the tax return preparer to retain the following records for each tax return on which the EIC is claimed.

1. A copy of the completed Form 8867
2. A copy of the EIC worksheet
3. A record of how and when the information used to complete Form 8867 and the EIC worksheet was obtained, including:
   - **a.** The identity of the person who furnished the information, and
   - **b.** Copies of documents furnished by the taxpayer upon which the preparer relied[31]

These documents must be retained for a period of **three years** from the latest of the following dates.

- The due date of the return (excluding any extensions)
- The date on which a signing preparer either electronically filed the return or presented the return to the taxpayer for signature in the event the return is not electronically filed
- The date on which the nonsigning preparer presented to the signing preparer that portion of the return for which the nonsigning preparer is responsible[32]

Observation. The tax return preparer must retain a record of any document used that affects or supports the determination of the taxpayer's eligibility for the EIC or the amount of the EIC. Examples of some of the records the preparer must retain to meet the EIC due diligence requirements include income documents other than Forms W-2, income and expense documents supporting Schedules C or F amounts, interest income statements, social security cards, guardianship records, and court documents.[33]

30. Rev. Rul. 56-407, 1956-2 CB 564.
31. Treas. Reg. §1.6695-2(b)(4)(i).
32. Treas. Reg. §1.6695-2(b)(4)(ii).
33. *Consequences of Filing EITC Returns Incorrectly.* Oct. 7, 2012. [www.EITC.irs.gov/rptoolkit/dd/consequences] Accessed on Jan. 18, 2013.

LIABILITY OF THE FIRM

If a tax return preparer who is subject to an EIC due diligence penalty is employed by a firm, the firm is also subject to the penalty under the following conditions.

- One or more principal officers or management members either participated in the failure to exercise EIC due diligence or knew of the failure to exercise due diligence before the return was filed.
- The firm did not establish reasonable, appropriate procedures to ensure EIC due diligence compliance.
- The firm disregarded its EIC compliance procedures willfully, recklessly, or through gross indifference.[34]

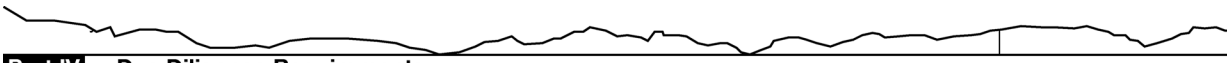
> **Note.** Firm liability may result from a principal officer or manager who ignores facts that would lead a person of reasonable prudence and competence to investigate an employee's compliance.[35]

Firms can take the following steps to prevent liability for EIC due diligence penalties.

- Review current procedures to ensure they address all EIC due diligence requirements.
- Review EIC due diligence procedures with employees and conduct periodic employee training and testing.
- Perform quality control checks to ensure employees asked taxpayers appropriate questions and retained the necessary documents.[36]

FORM 8867 PART IV

As previously mentioned, Form 8867 was revised for 2012 and subsequent tax years. Part IV of Form 8867 follows.



Part IV	Due Diligence Requirements	
20	Did you complete Form 8867 based on current information provided by the taxpayer or reasonably obtained by you?	☐ Yes ☐ No
21	Did you complete the EIC worksheet found in the Form 1040, 1040A, or 1040EZ instructions (or your own worksheet that provides the same information as the 1040, 1040A, or 1040EZ worksheet)?	☐ Yes ☐ No
22	If any qualifying child was not the taxpayer's son or daughter, did you ask why the parents were not claiming the child and document the answer?	☐ Yes ☐ No ☐ Does not apply
23	If the answer to question 13a is "Yes" (indicating that the child lived for more than half the year with someone else who could claim the child for the EIC), did you explain the tiebreaker rules and possible consequences of another person claiming your client's qualifying child?	☐ Yes ☐ No ☐ Does not apply
24	Did you ask this taxpayer any additional questions that are necessary to meet your knowledge requirement? See the instructions before answering	☐ Yes ☐ No ☐ Does not apply
	To comply with the EIC knowledge requirement, you must not know or have reason to know that any information used to determine the taxpayer's eligibility for, and the amount of, the EIC is incorrect. You may not ignore the implications of information furnished to or known by you, and you must make reasonable inquiries if the information furnished appears to be incorrect, inconsistent, or incomplete. At the time you make these inquiries, you must document in your files the inquiries you made and the taxpayer's responses.	
25	Did you document the additional questions you asked and your client's answers?	☐ Yes ☐ No ☐ Does not apply

Form **8867** (2012)

34. Treas. Reg. §1.6695-2(c).

35. Treas. Reg. §1.6695-2(c)(3).

36. *Consequences of Filing EITC Returns Incorrectly.* Jul. 10, 2012. [www.eitc.irs.gov/rptoolkit/dd/consequences] Accessed on Jan. 18, 2013.

26 Which documents below, if any, did you rely on to determine EIC eligibility for the qualifying child(ren) listed on Schedule EIC? Check all that apply. **Keep a copy of any documents you relied on.** See the instructions before answering. If there is no qualifying child, check box a. If there is no disabled child, check box o.

Residency of Qualifying Child(ren)

- ☐ **a** No qualifying child
- ☐ **b** School records or statement
- ☐ **c** Landlord or property management statement
- ☐ **d** Health care provider statement
- ☐ **e** Medical records
- ☐ **f** Child care provider records
- ☐ **g** Placement agency statement
- ☐ **h** Social service records or statement
- ☐ **i** Place of worship statement
- ☐ **j** Indian tribal official statement
- ☐ **k** Employer statement
- ☐ **l** Other (specify) ▼
- ☐ **m** Did not rely on any documents, but made notes in file
- ☐ **n** Did not rely on any documents

Disability of Qualifying Child(ren)

- ☐ **o** No disabled child
- ☐ **p** Doctor statement
- ☐ **q** Other health care provider statement
- ☐ **r** Social services agency or program statement
- ☐ **s** Other (specify) ▼
- ☐ **t** Did not rely on any documents, but made notes in file
- ☐ **u** Did not rely on any documents

27 If a Schedule C is included with this return, which documents or other information, if any, did you rely on to confirm the existence of the business and to figure the amount of Schedule C income and expenses reported on the return? Check all that apply. **Keep a copy of any documents you relied on.** See the instructions before answering. If there is no Schedule C, check box a.

Documents or Other Information

- ☐ **a** No Schedule C
- ☐ **b** Business license
- ☐ **c** Forms 1099
- ☐ **d** Records of gross receipts provided by taxpayer
- ☐ **e** Taxpayer summary of income
- ☐ **f** Records of expenses provided by taxpayer
- ☐ **g** Taxpayer summary of expenses
- ☐ **h** Bank statements
- ☐ **i** Reconstruction of income and expenses
- ☐ **j** Other (specify) ▼
- ☐ **k** Did not rely on any documents, but made notes in file
- ☐ **l** Did not rely on any documents

▶ You have complied with all the due diligence requirements if you:

1. Completed the actions described on lines 20 and 21 and checked **"Yes"** on those lines,
2. Completed the actions described on lines 22, 23, 24, and 25 (if they apply) and checked **"Yes"** (or **"Does not apply"**) on those lines,
3. Submit Form 8867 in the manner required, **and**
4. Keep all five of the following records for 3 years from the latest of the dates specified in the instructions under *Document Retention*:
   a. Form 8867, Paid Preparer's Earned Income Credit Checklist,
   b. The EIC worksheet(s) or your own worksheet(s),
   c. Copies of any taxpayer documents you relied on to determine eligibility for or amount of EIC,
   d. A record of how, when, and from whom the information used to prepare the form and worksheet(s) was obtained, and
   e. A record of any additional questions you asked and your client's answers.

▶ If you checked **"No"** on line 20, 21, 22, 23, 24, or 25, you have not complied with all the due diligence requirements and may have to pay a $500 penalty for each failure to comply.

TAXPAYER ISSUES WITH EIC CLAIMS

Most problematic EIC claims are treated as math or clerical errors, however a taxpayer who **negligently** claims the EIC in a tax year may be banned by the IRS from claiming the EIC for the **next two tax years.**[37] A negligent claim exists if the taxpayer recklessly, carelessly, or intentionally disregards EIC rules.

Taxpayers subject to the 2-year ban receive a CP 79A letter from the IRS if they attempt to make an EIC claim during the ban period. A sample of this IRS letter follows.

Why We Denied Your EIC Claim

We recently denied all or part of the Earned Income Credit (EIC) claimed on your individual income tax return for the tax period shown above. We did this for one of the two following reasons, as indicated in the notice we previously sent to you:

- You did not verify that you were entitled to the credit you claimed.
- We made adjustments to your income and/or expenses that reduces the credit in part or in full.

Why We assessed the Two Year Ban

We determined that your EIC claim was due to reckless or intentional disregard of the EIC rules and regulations. For this reason, the law does not allow you to claim the EIC for the next 2 years.

When and How You Can Claim EIC In The Future

The next year that you may be able to claim EIC is . Please make sure that you qualify for EIC by reviewing Publication 596 Earned Income Credit before you claim it again. If you claim EIC due to reckless or intentional disregard of the EIC rules or regulations again, you could be assessed a penalty and be subject to another Two Year Ban.

To claim the EIC with a qualifying child or children, after the 2-year ban, you must attach a completed Form 8862, Information to Claim Earned Income Credit After Disallowance , to your return. After we receive your return with Form 8862, we will likely ask you for documents to support your EIC claim. This will delay your refund. If we need documentation, we will send you a letter requesting it — please do not attach it to your return.

To claim the EIC for taxpayers without a qualifying child, after the 2-year ban, see the Form 8862 instructions to determine if it is required.

You'll be able to get Form 8862 and Publication 596 at most locations where tax forms are available, from the IRS web site, www.irs.gov, or you can call the IRS at ***{appropriate #}***. You'll also be able to send Form 8862 electronically if you file your federal income tax return electronically.

If you have any questions about this letter, please call the number shown above. If you prefer, you may write to us at the address shown at the top of this letter.

A taxpayer who makes a **fraudulent** claim may be precluded from claiming the EIC for a period of **10 years.**[38] A fraudulent EIC claim exists if the taxpayer intentionally makes an inappropriate claim for the EIC.

Observation. Despite the substantial revision of the due diligence section of Form 8867, there is no question on the form that specifically addresses whether a taxpayer has been banned from making an EIC claim. It may be prudent for the tax return preparer to ask the taxpayer this additional question to prevent the EIC from being disallowed for the year.

37. Ibid.

38. IRC §32(k).

Form 8862

Taxpayers who have been subject to either the 2-year ban or the 10-year ban must generally file Form 8862, *Information To Claim Earned Income Credit After Disallowance,* with their return for the first year in which they are again eligible to make an EIC claim. Form 8862 is not filed during the ban period.

> **Note.** The ban period begins after the tax year in which there was a final determination that the taxpayer was negligent or fraudulent.[39]

Form 8862 follows.

[39] IRC §32(k)(1)(B).

Form **8862**
(Rev. December 2012)
Department of the Treasury
Internal Revenue Service

Information To Claim Earned Income Credit After Disallowance

▶ Attach to your tax return.
▶ Information about Form 8862 and its instructions is at *www.irs.gov/form8862.*

OMB No. 1545-0074

Attachment Sequence No. **43A**

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

Before you begin:
- ✓ See your tax return instructions or **Pub. 596,** Earned Income Credit (EIC), for the year for which you are filing this form to make sure you can take the earned income credit (EIC) **and** to find out who is a qualifying child.
- ✓ If you have a qualifying child, complete **Schedule EIC** before you fill in this form.
- ✓ **Do not** file this form if you are taking the EIC without a qualifying child **and** the only reason your EIC was reduced or disallowed in the earlier year was because it was determined that a child listed on **Schedule EIC** was not your qualifying child.

Part I All Filers

1 Enter the year for which you are filing this form (for example, 2012) . . . . . ▶ ☐☐☐☐

2 If the **only** reason your EIC was reduced or disallowed in the earlier year was because you incorrectly reported your earned income or investment income, check "Yes." Otherwise, check "No" . . . . ▶ ☐ **Yes** ☐ **No**

Caution. If you checked "Yes," **stop. Do not** fill in the rest of this form. But you must attach it to your tax return to take the EIC. If you checked "No," continue.

3 Could you (or your spouse if filing jointly) be claimed as a qualifying child of another taxpayer for the year shown on line 1? See the instructions before answering . . . . . ▶ ☐ **Yes** ☐ **No**

Caution. If you checked "Yes," **stop.** You cannot take the EIC. If you checked "No," continue.

Part II Filers With a Qualifying Child or Children

Note. Child 1, **Child 2,** and **Child 3** are the same children you listed as Child 1, Child 2, and Child 3 on **Schedule EIC** for the year shown on line 1 above.

4 Enter the **number of days** each child lived with you in the United States during the year shown on line 1 above:

a **Child 1** ▶ ☐☐☐ b **Child 2** ▶ ☐☐☐ c **Child 3** ▶ ☐☐☐

Caution. If you entered less than **183** (184 if the year on line 1 is a leap year) for any child, you cannot take the EIC based on that child, unless the special rule for a child who was born or died during the year shown on line 1 applies. See the instructions.

5 If your child was born or died during the year shown on line 1, enter the month and day the child was born and/or died. Otherwise, skip this line.

a **Child 1** ▶ **(1)** Month and day of birth (MM/DD) ▶ ☐☐/☐☐ **(2)** Month and day of death (MM/DD) ▶ ☐☐/☐☐
b **Child 2** ▶ **(1)** Month and day of birth (MM/DD) ▶ ☐☐/☐☐ **(2)** Month and day of death (MM/DD) ▶ ☐☐/☐☐
c **Child 3** ▶ **(1)** Month and day of birth (MM/DD) ▶ ☐☐/☐☐ **(2)** Month and day of death (MM/DD) ▶ ☐☐/☐☐

6 Enter the address where you and the child lived together during the year shown on line 1. If you lived with the child at more than one address during the year, attach a list of the addresses where you lived:

a **Child 1** ▶ Number and street _____
City or town, state, and ZIP code _____

b **Child 2** ▶ **If same as shown for child 1, check this box.** ▶ ☐ Otherwise, enter below:
Number and street _____
City or town, state, and ZIP code _____

c **Child 3** ▶ **If same as shown for child 1, check this box.** ▶ ☐ **Or if same as shown for child 2 (and this is different from address shown for child 1), check this box.** ▶ ☐ Otherwise, enter below:
Number and street _____
City or town, state, and ZIP code _____

7 Did any other person (except your spouse, if filing jointly, and your dependents under age 19) live with child 1, child 2, or child 3 for more than half the year shown on line 1? . . . . . ▶ ☐ **Yes** ☐ **No**

If "Yes," enter that person's name and relationship to the child below. If more than one other person lived with the child for more than half the year, attach a list of each person's name and relationship to the child:

a **Other person living with child 1:** Name _____
Relationship to child 1 _____

b **Other person living with child 2:** **If same as shown for child 1, check this box.** ▶ ☐ Otherwise, enter below:
Name _____
Relationship to child 2 _____

c **Other person living with child 3:** **If same as shown for child 1, check this box.** ▶ ☐ **Or if same as shown for child 2 (and this is different from the person living with child 1), check this box.** ▶ ☐
Otherwise, enter below:
Name _____
Relationship to child 3 _____

Caution. The IRS may ask you to provide additional information to verify your eligibility to claim the EIC.

Form 8862 (Rev. 12-2012) Page 2

Part III Filers Without a Qualifying Child

8 Enter the **number of days** during the year shown on line 1 that you lived in the United States . . . ▶ ☐☐☐

Caution. If you entered less than **183 (184 if the year on line 1 is a leap year)**, **stop.** You cannot take the EIC. See the instructions.

9 If married filing a joint return, enter the **number of days** during the year shown on line 1 that your spouse lived in the United States . . . . . ▶ ☐☐☐

Caution. If you entered less than **183 (184 if the year on line 1 is a leap year)**, **stop.** You cannot take the EIC. See the instructions.

Form **8862** (Rev. 12-2012)

S CORPORATIONS AND BASIS ISSUES

The 2012 IRS Nationwide Tax Forum included a seminar entitled "Documenting S Corporation Shareholder Basis as Protection against an IRS Audit."[40] The description of the seminar indicates that the "failure to keep proper shareholder basis records for S corporation shareholders is the single most cited problem by leading IRS auditors."[41] The proper documentation of an S corporation shareholder's basis and the improper claiming of passthrough losses in excess of basis are two areas of increasing IRS concern. It also appears that shareholder basis is a frequent topic of IRS litigation.

IRC §1366(d)(1) indicates that the amount of losses and deductions taken into account by a shareholder in a tax year cannot exceed the sum of that shareholder's stock basis and debt basis for the year. During 2012, the Tax Court heard **four** cases regarding §1366(d)(1) issues.

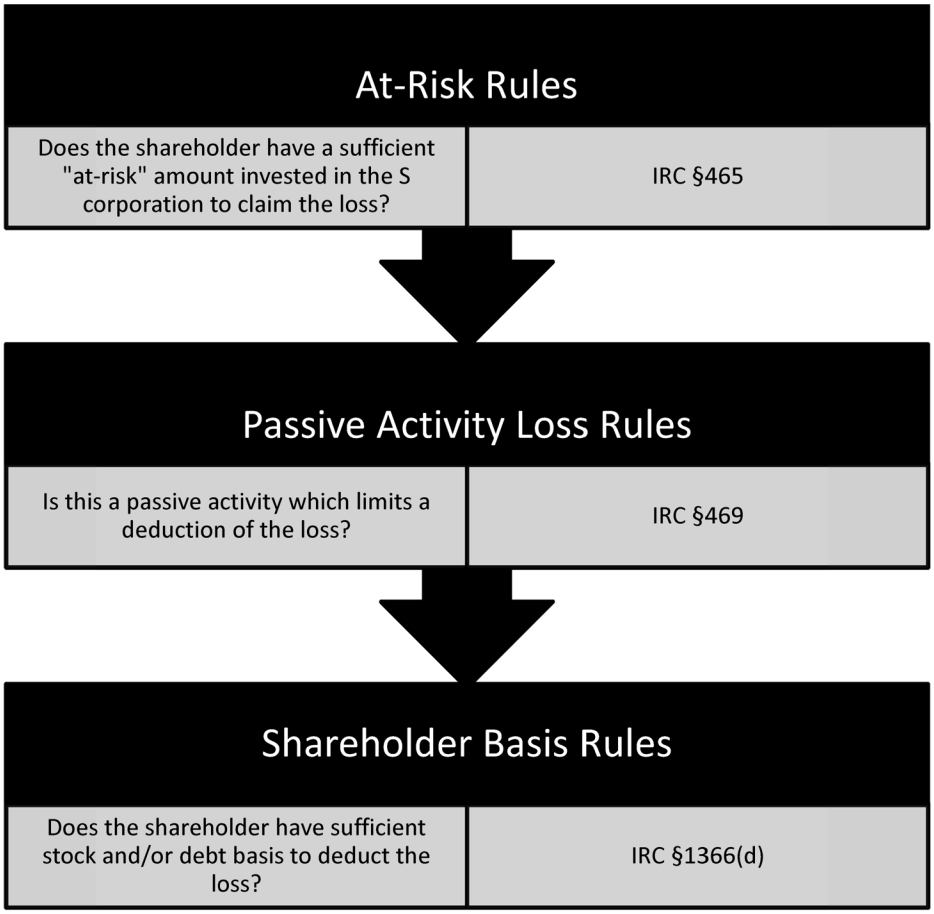
Case Name	Citation	Date
Yolanda Welch v. Comm'r *John Welch v. Comm'r*	TC Memo 2012-179	Jun. 28, 2012
James Maguire and Joy Maguire v. Comm'r *Marc Maguire and Pamela Maguire v. Comm'r*	TC Memo 2012-160	Jun. 6, 2012
Michael Gigliobianco and Mary Gigliobianco v. Comm'r	TC Memo 2012-276	Sep. 27, 2012
Marc S. Barnes and Anne M. Barnes v. Comm'r	U.S. Court of Appeals, D.C. Circuit; No. 12-1284	Apr. 5, 2013

Note. A summary of the *Barnes* case is included in the 2013 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 5: Rulings and Cases.

It is essential for tax practitioners to be aware of the basis limitations with respect to the deduction of passthrough losses from an S corporation. Generally, there are three sets of rules that may serve as a limit on the amount of loss that can be deducted by the S corporation shareholder. The diagram on the following page illustrates these rules.

40. *IRS Nationwide Tax Forum 2012.* [www.irstaxforum.com/seminar] Accessed on Jan. 25, 2013.

41. Ibid.



Note. For a detailed discussion regarding the at-risk rules, the passive activity loss rules, and the shareholder basis rules, see the 2012 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: S Corporation. The Code sections and the guidance provided by the applicable regulations are discussed. Detailed examples and calculations are also provided. Further information can also be found at **www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/S-Corporation-Stock-and-Debt-Basis.**

Observation. Effective January 1, 2013, a 3.8% Medicare tax applies to net investment income under IRC §1411(c)(1). This generally includes forms of income received by an S corporation owner that are not from a trade or business or that are from a trade or business in which the owner is a not a material participant under IRC §469 and Temp. Treas. Reg. §1.469-5T. The new Medicare tax may therefore place the passive activity losses for S corporation shareholders under increased IRS scrutiny.

For more information about the new Medicare tax, see the 2013 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 2: Affordable Care Act Update.

RECENT DEVELOPMENTS WITH DEBT BASIS

In June 2012, the IRS issued proposed regulations regarding debt basis.[42] In the proposed regulation, the IRS states:

> *The frequency of disputes between S corporation shareholders and the government regarding whether certain loan transactions . . . create shareholder basis . . . demonstrates the complexity of and uncertainty about this issue for both shareholders and the government.*[43]

Generally, indebtedness of an S corporation shareholder to the corporation only increases debt basis if the debt runs directly to the shareholder[44] and constitutes an **actual economic outlay.**[45]

In a **back-to-back loan transaction,** the S corporation shareholder borrows from a related person or entity and subsequently loans the proceeds to the S corporation in an attempt to increase debt basis so that a loss may be deducted. The proposed regulations indicate that such back-to-back loan transactions and other loan transactions qualify to increase debt basis if the loan is a bona fide debt. General tax principles determine whether a debt is bona fide. These principles have largely been developed by case law. The following cases are referred to in the proposed regulation to provide guidance.

Mixon v. U.S.[46] involved a determination of whether amounts contributed to a bank by its officers constituted debt or equity. The court noted that all the facts and circumstances are looked at in determining whether a loan arrangement constitutes a bona fide debt. However, the court cited 13 particular factors that it has emphasized in 5th Circuit cases in which it determined whether advances of funds to a corporation are equity or a bona fide debt. These factors are the following.

1. The type of certificate or document used in the transaction
2. The presence or absence of a fixed maturity date
3. The source of the advanced funds
4. The right to enforce the payment of principal and interest
5. Whether the shareholder's voting power or participation expanded as a result of the advance
6. The status provided to the advance in relationship to other corporate creditors
7. The intent of the parties involved
8. Whether the corporation was thinly or adequately capitalized
9. Whether advances are made in proportion to existing stock ownership
10. The source of interest payments made to the shareholder
11. The ability of the corporation to obtain loans from outside lending institutions
12. The extent that the advanced funds are used to acquire capital assets
13. Failure of the corporation debtor to timely pay or seek postponement

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42. See REG 134042-07, Federal Register Vol. 77, No. 113 (Jun. 12, 2012).
43. Ibid.
44. Ibid.
45. *Maloof v. Comm'r*, 456 F.3d 645 (6th Cir. 2006).
46. *Mixon v. U.S.,* 464 F.2d 394 (5th Cir. 1972).

For further guidance on what constitutes a bona fide debt for debt basis purposes, the proposed regulation also cites *Knetsch v. U.S.,*[47] in which a taxpayer's loan arrangement with an insurance company that was entered into in order to generate interest deductions was deemed a "sham." The loan was not considered a bona fide debt because no actual taxpayer indebtedness was created by the arrangement.

Furthermore, the proposed regulation refers to *Geftman v. Comm'r,*[48] which focused on the objective attributes and economic realities of the debt transaction in order to determine whether the debt was bona fide. Under the proposed regulation, the presence of a bona fide debt satisfies the "actual economic outlay" requirement and provides the shareholder with additional debt basis.

> **Note.** Taxpayers claiming a loss from S corporation activity have the burden of substantiating the amount of stock and/or debt basis to support that loss deduction.[49]

The proposed regulation indicates that merely **guaranteeing** an S corporation debt does not provide additional basis. However, the shareholder is entitled to additional debt basis to the extent of any actual payments made on the loan as guarantor.

A loan made directly to the S corporation from another entity related to the shareholder may provide additional debt basis if the debt arrangement constitutes bona fide debt that creates an actual debtor/creditor relationship between the shareholder and the S corporation.

Example 7. Claire owns Claire's Salon and Spa, Ltd., which is an S corporation. In early 2012, a $20,000 loan is obtained from the local bank. The loan is in the name of Claire's Salon and Spa, Ltd. In order to obtain the loan, the bank required Claire to sign as guarantor, which she did.

The monthly payment is $1,000, which includes interest. The S corporation made the required scheduled payments through December 2012. However, the business began struggling in January 2013. As a result, cash flow within the corporation was not sufficient to continue to make the monthly payments. Claire, as guarantor, personally continued to make the 12 monthly payments for 2013.

Because the $20,000 loan was originated in the name of the corporation, Claire cannot adjust her debt basis upward by this amount. There is no debtor/creditor relationship between Claire and the S corporation and Claire's role as guarantor is not sufficient to create a bona fide debt arrangement between her and the corporation. However, Claire is entitled to increase her debt basis at the end of 2013 for the $12,000 of loan payments she was required to make as guarantor. It is important that Claire maintain adequate records of the payments she made in order to substantiate the increase to her debt basis.

Example 8. Assume the same facts as **Example 7,** except the loan originated in Claire's name and Claire subsequently loans the proceeds to Claire's Salon and Spa, Ltd., in 2012. If the loan from Claire to the S corporation is a bona fide debt arrangement, Claire can increase her debt basis by $20,000 at the end of 2012. It is essential that the loan arrangement between Claire and the S corporation be appropriately documented so that its status as a bona fide debt may be substantiated.

Example 9. Merton is sole shareholder of Merton's Boat Bazaar, Incorporated (MBB). He is also sole shareholder of Merton's Marine Supply Corporation (MMS). MBB and MMS are S corporations.

In 2013, MMS needs money. Merton borrows $100,000 from MBB and loans the proceeds to MMS. If the loan arrangement between Merton and MMS is a bona fide debt arrangement, Merton is entitled to increase his debt basis at the end of 2013 by the $100,000 loan.

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47. *Knetsch v. U.S.,* 364 U.S. 361 (1960).

48. *Geftman v. Comm'r,* 154 F.3d 61 (1998).

49. IRC §6001; *Hradesky v. Comm'r*, 65 TC 87 (1975).

S CORPORATIONS AND REASONABLE COMPENSATION

To prevent abusive avoidance of FICA tax, the IRS requires S corporation owners to pay themselves a reasonable salary each year.[50] The IRS first addressed this issue in 1974,[51] and since that time the IRS has successfully litigated this issue. Accordingly, substantial legal precedent has been established.[52]

Courts have upheld the IRS's ability to recharacterize distribution amounts (such as dividends) as wage compensation in order to ensure the business owner reports a reasonable amount as wage compensation for the tax year.

In IRS Fact Sheet 2008-25, *Wage Compensation for S Corporation Officers*, the IRS provides some guidance on how to determine the amount of wage compensation that is reasonable for a taxpayer. In making the determination, the IRS notes that the courts have taken into account all facts and circumstances of each case. Some of the specific factors considered by the courts include the following.

- The training and experience of the taxpayer
- The taxpayer's duties and responsibilities
- The time and effort the taxpayer devotes to the business endeavor
- The dividend history
- The payments made to nonshareholder employees
- The timing and manner of paying bonuses to key people in the business
- The amount of comparable pay for similar services that the taxpayer provides
- The existence of any compensation agreements
- Whether there is any formula that determines compensation

Comparable compensation information may be found from sources such as the U.S. Department of Labor, employment agencies and placement offices, union administrations, and professional associations.

> **Note.** It is important to document the sources of information used to justify the wage compensation amount paid to an S corporation business owner.

Additional IRS Guidance

The IRS has indicated that the key to establishing the amount of reasonable compensation is to consider the activity engaged in by the shareholder-employee with respect to the S corporation. In this regard, looking at the source of gross receipts is relevant. For purposes of this inquiry, there are three major sources of gross receipts.

1. Services provided by the shareholder-employee
2. Services provided by nonshareholder employees
3. Capital and equipment[53]

50. Rev. Rul. 74-44, 1974-1 CB 287.

51. Ibid.

52. See, e.g., *Radtke v. U.S.*, 712 F.Supp. 143 (E.D. Wis. 1989), *aff'd* 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting v. U.S.*, 918 F.2d 90 (9th Cir. 1990); *Veterinary Surgical Consultants, P.C. v. Comm'r*, TC Memo 2003-48, *aff'd* 90 Fed.Appx. 669; *Joseph M. Grey v. Comm'r*, 119 TC 121 (Dec. 2002), *aff'd* 93 Fed.Appx. 473; *Nu-Look Design, Inc. v. Comm'r*, 85 TCM 927, *aff'd* 356 F.3d 290 (Jan. 2004).

53. *S Corporation Compensation and Medical Insurance Issues.* Dec. 6, 2012. [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/S-Corporation-Compensation-and-Medical-Insurance-Issues] Accessed on Jan. 30, 2013.

If most of the gross receipts and profits are associated with the services of shareholders, then most of the profits should be allocated as compensation.[54] Gross receipts or profits associated with nonshareholder employees or associated with capital and equipment should not be allocated as wage compensation for shareholder-employees. However, shareholders should receive wage compensation for their administrative work related to income associated with nonshareholder employees or capital and equipment.

Social security tax applies to the taxpayer's earned income up to a maximum of **$113,700** for 2013. There is no social security tax on earned income above this amount. There is no upper limit on the amount of income subject to the 2.9% Medicare tax.

The social security and Medicare tax rates for 2013 follow.

Social security tax	12.4%
Medicare tax	2.9%
Total	15.3%

On earned income above certain thresholds, an additional Medicare tax rate of 0.9% on earned income applies only to the employee portion. This Medicare tax on earned income became effective January 1, 2013, and the applicable income threshold amounts are based on filing status, as follows.

Filing Status	Income Threshold for 0.9% Medicare Tax
Single	$200,000
HoH	200,000
MFJ	250,000
Qualifying widow(er)	250,000
MFS	125,000

Note. The new 0.9% Medicare tax on earned income, which includes self-employment (SE) income, creates additional incentives to use an S corporation to avoid tax. This makes reasonable compensation advice to taxpayers even more important for 2013 onward.

A major tax planning strategy associated with the use of an S corporation involves the maximization of distributions and corresponding minimization of wage compensation. Unlike wage compensation, which is subject to FICA, and SE income, which is subject to SE tax, S corporation distributions are not subject to either FICA or SE tax. Use of distributions can amount to a substantial savings in FICA tax for the business owner operating an S corporation.

54. Ibid.

Example 10. Triglyph Architects, Inc., is an S corporation solely owned by Bryan, an architect. For 2013, Triglyph has $150,000 of net earnings. Bryan's FICA tax liability depends on how much of the $150,000 of S corporation earnings is characterized as wage compensation to him. Any distribution amount is not a wage and is not subject to FICA tax, nor is it subject to SE tax.[55] The following table calculates Bryan's FICA tax liability if 100% of the earnings are characterized as wage compensation. In addition, similar comparative calculations are shown for a 50/50 characterization of wage and distribution amounts and for a 30/70 wage and distribution characterization.

	100% Wages		50% Wages 50% Distribution		30% Wages 70% Distribution	
Total S corporation earnings	$150,000		$150,000		$150,000	
Wage amount	150,000		75,000		45,000	
Amount of wages subject to social security tax	113,700		75,000		45,000	
Social security tax (12.4%)		$14,099		$ 9,300		$5,580
Amount subject to Medicare tax	150,000		75,000		45,000	
Medicare tax (2.9%)		4,350		2,175		1,305
Total FICA tax liability		$18,449		$11,475		$6,885

The *Watson* Case

In a major 8th Circuit case in 2012,[56] the Court of Appeals affirmed a lower court ruling that upheld the IRS's recharacterization of S corporation distribution income as wage compensation. In this case, the taxpayer was a CPA with 20 years of experience, a business degree, and a master's degree in taxation. After nine years of experience with a large accounting firm, the taxpayer, Mr. Watson, became a 25% partner in LWBE, an accounting firm. Four years later, he formed an S corporation that became the 25% shareholder in his place. Mr. Watson acted as employee of his own S corporation in the course of performing accounting services for LWBE. For the 2002 and 2003 tax years, Mr. Watson received the following amounts.

	2002	2003
Wages	$ 24,000	$ 24,000
Distribution	203,651	175,470

Recognizing Mr. Watson's education, 20 years of experience, his 35 to 45 hours of weekly work for the firm, and the firm's $2 million and $3 million of gross income in 2002 and 2003, respectively, the court agreed with the IRS that Mr. Watson's $24,000 of wage compensation was unreasonably low and should be adjusted upward.

The IRS provided expert witness testimony that relied on several accounting compensation studies, including survey material from the AICPA. The expert witness concluded that the reasonable compensation amount for Mr. Watson was $91,044 for each of the two tax years involved. Mr. Watson's counterargument was that it was intended that his compensation be $24,000 annually from the S corporation with the remaining amounts distributed based on the firm's success. However, the court found Mr. Watson's position unpersuasive given his experience, education, and career success.

55. Rev. Rul. 59-221, 1959-1 CB 225.

56. *David E. Watson, PC v. U.S.*, 757 F.Supp. 2d 877 (S.D. Iowa 2010), *aff'd* 668 F.3d 1008 (8th Cir. 2012).

The court adjusted Mr. Watson's compensation upward to $91,044 for 2002 and for 2003. This resulted in additional FICA tax, along with penalties and interest.

Observation. Unlike income from a partnership, S corporation income is not considered SE income. This has been a concern for both the Treasury Inspector General for Tax Administration and the Government Accountability Office. Both entities have issued reports commenting on these concerns.[57]

ECONOMIC SUBSTANCE DOCTRINE

A substantial part of a tax practice may involve tax planning. Although tax planning takes on many forms for various types of taxpayers, tax minimization is always the main objective. This raises the question, "Is tax minimization the same as tax avoidance?" Tax avoidance is the focal point of the economic substance doctrine. Tax practitioners must therefore be aware of this doctrine because it is an area of tax law that:

- Appears to be the subject of increased IRS attention and litigation, and
- Was codified in early 2010.

Note. For background information about the economic substance doctrine, see the 2008 *University of Illinois Federal Tax Workbook,* Chapter 10: Small Business Issues. This can be found at **www.taxschool.illinois.edu/taxbookarchive.**

CODIFICATION OF THE DOCTRINE

The economic substance doctrine is a judicially created doctrine that slowly evolved through court litigation. Under this doctrine, the taxpayer is denied the tax benefits from a transaction if it has no economic substance or purpose beyond the tax benefits obtained. Without sufficient economic substance, the IRS may recharacterize the transaction in a manner that reflects its true nature. The doctrine evolved in the courts as a 2-prong test under which the taxpayer's transaction was measured. Most courts agreed that the taxpayer could retain the tax benefits of the transaction under the following conditions.

1. The transaction had objective economic substance.
2. The transaction had a subjective nontax business purpose.

However, courts disagreed on whether **both** of the above factors were necessary or if **only one** of them was sufficient.

The 2nd Circuit, 4th Circuit, and D.C. Courts of Appeals typically required **either** of the prongs to be satisfied in order for the taxpayer's transaction to meet the test and the taxpayer to retain the tax advantages of that transaction. However, the 1st, 7th, 8th, and 11th Circuits made the taxpayer's case more difficult by requiring **both** prongs of the test to be met. In a key case,[58] the Federal Circuit seemed to entirely ignore both of the two approaches and developed its own economic substance doctrine test using a number of rules that it distilled from prior cases.

Perhaps this inconsistency in the courts was a contributing factor in the codification of the economic substance doctrine. The doctrine was codified by the Health Care and Education Reconciliation Act of 2010[59] and is now found at IRC §7701(o). This same legislation also made amendments to the penalty provisions in the Code (e.g., §§6662, 6662A, 6664, and 6676) that may be implicated if the taxpayer's transaction does not meet the test.

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57. *Actions Needed to Address Noncompliance with S Corporation Tax Rules,* GAO-10-195, Dec. 15, 2009; *Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations,* Treasury Inspector General for Tax Administration Reference Number 2005-30-080, May 20, 2005.

58. *Coltec v. U.S.*, 454 F.3d 1340 (Fed. Cir. 2006).

59. PL 111-152, Health Care and Education Reconciliation Act of 2010 (Mar. 30, 2010).

IRC §7701(o) states that a taxpayer's transaction has economic substance if **both** of the following prongs are met.

1. The transaction changes the taxpayer's economic position in a meaningful way (apart from the federal income tax effects).
2. The taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction.[60]

The taxpayer may rely on profit potential to justify a transaction. However, under the codified rules, the profit potential of a transaction is only taken into account if the expected pretax profit is substantial compared to the tax benefits. Expected pretax profits and tax benefits are measured on a present value basis for purposes of this rule.[61]

Furthermore, according to the statute, a financial accounting benefit is not considered a substantial nontax purpose if the "origin of such financial accounting benefit is a reduction of federal income tax."[62]

Note. For purposes of the economic substance doctrine, a "transaction" may consist of a series of transactions.[63]

Observation. A substantial number of economic substance doctrine cases involve IRS efforts to combat sophisticated tax shelters or schemes, but some cases involve simpler taxpayer transactions engaged in for tax avoidance purposes.

INCREASED LITIGATION

The following tables summarize the tax cases from 2009 through 2012 involving the economic substance doctrine. Generally, this summary reflects cases in which the IRS made an economic substance doctrine argument and/or the court considered the issue using an economic substance doctrine analysis in a way that was determinative to the outcome of the case.

Note. In an effort to determine the number of cases litigated each year, this summary consists primarily of cases at the lower court level at which the economic substance doctrine argument was first made by the IRS. In order to prevent counting the same case more than once, this summary does not include subsequent appeals or higher court decisions that may exist for some of the cases cited.

60. IRC §7701(o)(1).
61. IRC §7701(o)(2).
62. IRC §7701(o)(4).
63. IRC §7701(o)(5)(D).

Case Name	Citation	Date
2009 Cases		
Michael Scott Ioane and Shelly Jean Olson-Ioane v. Comm'r	TC Memo 2009-68	Mar. 26, 2009
New Phoenix Sunrise Corporation and Subsidiaries v. Comm'r	132 TC 161	Apr. 9, 2009
James T. and Tiffany A. Manning v. Comm'r	TC Memo 2009-157	Jun. 30, 2009
Michael and Marion Balice v. Comm'r	TC Memo 2009-196	Sep. 2, 2009
Country Pine Finance, LLC v. Comm'r	TC Memo 2009-251	Nov. 5, 2009
Palm Canyon X Investments, LLC v. Comm'r	TC Memo 2009-288	Dec. 15, 2009
2010 Cases		
Jade Trading, LLC v. U.S.	598 F.3d 1372	Mar. 23, 2010
Douglas D. and Brenda D. Child v. Comm'r	TC Memo 2010-58	Mar. 25, 2010
Lizzie W. and Albert L. Calloway v. Comm'r	135 TC No. 3	Jul. 8, 2010
Canal Corporation and Subsidiaries v. Comm'r	135 TC No. 9	Aug. 5, 2010
Michael V. Domulewicz and Mary Ann Domulewicz v. Comm'r	TC Memo 2010-177	Aug. 5, 2010
George C. Huff v. Comm'r	135 TC No. 10	Aug. 17, 2010
Fidelity International Currency Advisor A Fund v. U.S.	747 F. Supp. 2d 49	Oct. 18, 2010
Philip S. Glover v. Comm'r	TC Memo 2010-228	Oct. 20, 2010
Flextronics America, LLC v. Comm'r	TC Memo 2010-245	Nov. 8, 2010
Ronald B. and Helen J. Sundrup, et al. v. Comm'r	TC Memo 2010-249	Nov. 16, 2010
2011 Cases		
Historic Boardwalk Hall, LLC v. Comm'r	136 TC No. 1	Jan. 3, 2011
Energy Research and Generation, Inc. v. Comm'r	TC Memo 2011-45	Feb. 24. 2011
Mark and Lucy Kerman v. Comm'r	TC Memo 2011-54	Mar. 8, 2011
Weekend Warrior Trailers, Inc. et al. v. Comm'r	TC Memo 2011-105	May 19, 2011
Wilfredo Emilio Rodriguez, a Minor, Steven W. Conner, Guardian v. Comm'r	TC Memo 2011-122	Jun. 2, 2011
Thomas Investment Partners Ltd., et al. v. U.S.	444 Fed. Appx. 190	Jul. 20, 2011
Superior Trading, LLC v. Comm'r	137 TC No. 6	Sep. 1, 2011
Ravakat, LLC v. Comm'r	TC Memo 2011-225	Sept. 20, 2011
Perry W. Browning v. Comm'r [a]	TC Memo 2011-261	Nov. 3, 2011
Ray Feldman, Transferee, et al. v. Comm'r	TC Memo 2011-297	Dec. 27, 2011
Randall J. and Karen G. Thompson v. Comm'r	137 TC No. 17	Dec. 27, 2011
2012 Cases		
Ashley M. Walker, et al. v. Comm'r	TC Memo 2012-5	Jan. 9, 2012
Scott A. and Audrey R. Blum v. Comm'r	TC Memo 2012-16	Jan. 17, 2012
Tigers Eye Trading, LLC v. Comm'r	138 TC No. 6	Feb. 13, 2012
Norma L. Slone, Transferee, et al. v. Comm'r [b]	TC Memo 2012-57	Mar. 1, 2012
Neal D. Crispin v. Comm'r	TC Memo 2012-70	Mar. 14, 2012
John Paul Reddam v. Comm'r	TC Memo 2012-106	Apr. 11, 2012
Superior Trading, LLC v. Comm'r	TC Memo 2012-110	Apr. 17, 2012
Hewlett Packard Company and Consolidated Subsidiaries v. Comm'r [c]	TC Memo 2012-135	May 14, 2012
Ironbridge Corp. and Subsidiaries v. Comm'r	TC Memo 2012-158	Jun. 5, 2012
SAS Investment Partners v. Comm'r	TC Memo 2012-159	Jun. 6, 2012
Logene L. Foster and Agnes M. Foster v. Comm'r	TC Memo 2012-207	Jul. 23, 2012
Gerdau Macsteel, Inc. and Affiliated Subsidiaries v. Comm'r	139 TC No. 5	Aug. 30, 2012
BLAK Investments v. Comm'r	TC Memo 2012-273	Sep. 25, 2012
Donald J. Kipnis v. Comm'r	TC Memo 2012-306	Nov. 1, 2012
Rawls Trading, LP v. Comm'r [d]	TC Memo 2012-340	Dec. 5, 2012

[a] In *Browning,* the IRS made several arguments including an economic substance argument. The Tax Court did not reach the economic substance argument because the issues were decided on the basis of other IRS arguments.

[b] In *Slone,* the IRS attempted to use the economic substance doctrine argument against the taxpayer but introduced this argument too late in the case for consideration by the Tax Court.

[c] In *Hewlett Packard,* the IRS made an economic substance doctrine argument and other arguments. The Tax Court addressed other arguments to determine the case and did not consider the economic substance argument.

[d] One item noted in *Rawls* was the IRS recharacterization of final partnership administrative adjustments (FPAA) under the economic substance doctrine.

The IRS has updated both its webpage[64] and its guidance for examiners[65] in connection with the economic substance doctrine. In addition, the Internal Revenue Manual specifically provides examiners with substantial guidance on the subject of the economic substance doctrine and its application.[66]

PENALTIES FOR TRANSACTIONS LACKING ECONOMIC SUBSTANCE

The applicable penalty for a transaction lacking economic substance for which the taxpayer claimed disallowed tax benefits depends upon whether the transaction was adequately disclosed.

> **Note.** Details on what constitutes "adequate disclosure" may be found in Treas. Reg. §1.6662-4 and Rev. Rul. 2012-15. Generally, the taxpayer must disclose all relevant facts about the tax treatment of the transaction on Form 8275, *Disclosure Statement,* or Form 8275-R, *Regulation Disclosure Statement,* as appropriate.[67]

For transactions lacking economic substance that were adequately disclosed and for which there is an underpayment because the IRS disallowed claimed tax benefits, the penalty is 20% of the amount of the underpayment.[68] For transactions lacking economic substance that were not adequately disclosed by the taxpayer, the penalty is 40% of the underpayment amount resulting from the disallowance of tax benefits claimed by the taxpayer.[69] **The reasonable cause exception applicable to other types of penalties does not apply to a transaction lacking economic substance.**[70]

IRS GIFT TAX RETURN INITIATIVE

Tax practitioners who complete personal returns for taxpayers should be aware of an evolving IRS initiative regarding **gift tax return** compliance. In particular, this initiative may affect interfamily gifts of real estate that have been made without filing the required gift tax return.

Although land records are generally made available to the public and are typically easily accessible from online sources, the IRS has asked state and county agencies to provide compiled records to the IRS for investigatory purposes.[71] Interfamily land transfers made for little or no consideration usually form a small percentage of the overall number of land records, but states with property tax exemptions on interfamily transfers frequently require the filing of a special form to claim the exemption. This exemption form database may be used to provide the list of interfamily transactions the IRS is targeting in its gift tax initiative.

Several states apparently complied with IRS requests for land transfer records, but California did not, due to disclosure concerns.[72] Accordingly, in December 2011, the IRS filed a petition in California federal court requesting permission to file a "John Doe" summons. A John Doe summons is controversial because it does not identify particular noncompliant taxpayers but instead requests the land transfer records by bringing the gift tax issue to court as a general tax compliance issue that needs to be addressed.

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64. *Codification of Economic Substance Doctrine and Related Penalties*. Sep. 14, 2010. [www.irs.gov/Businesses/Codification-of-Economic-Substance-Doctrine-and-Related-Penalties] Accessed on Feb. 8, 2013.

65. *Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties*. Jul. 15, 2011. [www.irs.gov/Businesses/Guidance-for-Examiners-and-Managers-on-the-Codified-Economic-Substance-Doctrine-and-Related-Penalties] Accessed on Feb. 8, 2013.

66. See IRM Exhibit 4.46-4.6 and IRM 4.46.4.5.9.

67. Treas. Reg. §1.6662-4(f)(1).

68. IRC §6662(b)(6).

69. IRC §6662(i)(1).

70. IRC §6664(c)(2).

71. *The New Gift Tax Audits: IRS Identifies Non-Filers Using State Property Records*. Ungerman, Josh. Oct. 19, 2011. Forbes.com. [www.forbes.com/sites/irswatch/2011/10/19/the-new-gift-tax-audits-irs-identifies-non-filers-using-state-property-records] Accessed on Feb. 18, 2013.

72. Ibid.

The federal court in California granted the IRS's petition to file the John Doe summons and ordered enforcement. The California Board of Equalization (CBOE) was ordered to turn over land transfer records to the IRS. These records consist of interfamily transfers of real estate by landowners who made these transfers between 2005 and 2010 for little or no consideration. The IRS is interested in investigating those transfers for which the taxpayer failed to file Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return,* in connection with the transfer.

After learning of an estimated 60% to 90% noncompliance rate in various states, the IRS Estate and Gift Tax Program concluded that this was a major noncompliance issue and launched a compliance program to investigate taxpayers who made interfamily property transfers for little or no consideration.[73]

In a declaration filed with the court, Josephine Bonaffini, Federal/State Coordinator of the IRS Estate and Gift Tax Program, stated:

> *Based on information received from examinations across the country and information voluntarily disclosed by other states, the IRS has determined that taxpayers who transfer real property to a related party for little or no consideration frequently fail to file Form 709 and report this transfer, despite the fact that they are required to do so by the internal revenue laws. Thus, the IRS has a reasonable basis to believe that a significant portion of the California taxpayers who have transferred property to their children or grandchildren . . . have failed to report these transfers to the IRS.*[74]

Accordingly, the CBOE must turn over the requested records to the IRS to facilitate further IRS investigation of this issue with respect to California taxpayers.

A review of IRS examinations of gift tax returns indicates a steady increase in gift tax return audits. The following table summarizes the relevant data in connection with the examination of gift tax returns from 2008 through 2011.[75]

Tax Year	Total Number of Gift Tax Returns Filed	Total Number of Gift Tax Returns Examined	Percentage of Gift Tax Returns Examined
2008	255,123	1,071	0.4
2009	257,010	1,569	0.6
2010	238,851	1,777	0.7
2011	226,241	2,623	1.2

Under IRC §6501(c)(3), if the taxpayer fails to file a return, the tax may be assessed at any time or a court proceeding can be commenced for collection of the tax without assessment at any time. This provision applies to several types of returns, including Form 709. The taxpayer therefore cannot simply wait for a limitations period to expire for an unfiled Form 709 because there is no limitations period in connection with an unfiled return.

Moreover, taxpayers may be subject to criminal charges for a willful failure to file a return, including a gift tax return.[76]

> **Observation.** In addition to the questions the tax practitioner asks the taxpayer in connection with obtaining necessary personal tax return information, it may be prudent to ask the taxpayer about any gifting activity for the year to ensure that the appropriate gift tax returns are filed. This will prevent the gifting transactions from being overlooked. Appropriate gift tax returns should be filed if necessary for gifts made in previous years, too. Given the increased audit activity associated with gift tax returns that have been filed, it is essential that gifts are bona fide and documented thoroughly.

73. Ibid.

74. *IRS Asks Court to Release Property Tax Records to Catch Gift Tax Nonfilers.* March 28, 2011. Bloomberg BNA. [www.bnasoftware.com/News/Tax_News/Articles/IRS_Asks_Court_to_Release_Property_Tax_Records_to_Catch_Gift_Tax_Nonfilers.asp] Accessed on Feb. 18, 2013.

75. IRS *Databook*, 2008, 2009, 2010, 2011.

76. IRC §7203; *The New Gift Tax Audits: IRS Identifies Non-Filers Using State Property Records.* Ungerman, Josh. Oct. 19, 2011. Forbes.com. [www.forbes.com/sites/irswatch/2011/10/19/the-new-gift-tax-audits-irs-identifies-non-filers-using-state-property-records] Accessed on Feb. 18, 2013.