

Monthly Tax Update

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INDIVIDUAL TAXATION:

☛ **Key Individual Tax Numbers for 2008**

Based on the inflation index released at the end of August, here are the tax brackets and other key tax numbers for 2008.

Comment: The standard deduction, exemption amount, and individual tax rate brackets are adjusted annually for cost-of-living increases. The adjustments are based on the average Consumer Price Index (CPI) for the 12-month period ending the previous Aug. 31st. The Aug. 2007 CPI has been released by the Labor Department. (U.S. Department of Labor, Consumer Price Index (for all-urban consumers), 9/19/2007). The IRS is required to officially release the 2008 adjustments by Dec. 15, 2007.

Standard Deductions: The basic standard deduction for 2008 will be: Joint return or surviving spouse - \$10,900 (up from \$10,700 in 2007); Single (other than head of household or surviving spouse) - \$5,450 (up from \$5,350 in 2007); Head of household - \$8,000 (up from \$7,850 in 2007); Married filing separate returns - \$5,450 (up from \$5,350 in 2007). For an individual who can be claimed as a dependent on another's return, the basic standard deduction for 2008 will be \$900 (up from \$850 in 2007), or \$300 (same as in 2007), plus the individual's earned income, whichever is *greater*. However, the standard deduction may *not* exceed the regular standard deduction for that individual. For 2008, the additional standard deduction for married taxpayers 65 or over or blind will be \$1,050 (same as in 2007). For a single taxpayer or head of household who is 65 or over or blind the additional standard deduction for 2008 will be \$1,350 (up from \$1,300 in 2007).

Kiddie Tax: The exemption from the kiddie tax for 2008 will be \$1,800 (up from \$1,700 in 2007, or

twice the \$900 minimum standard deduction that the kid is otherwise entitled to). As a result, a parent will be able to elect to include a child's unearned income on the parent's return for 2008 if that income is more than \$900 and less than \$9,000 (up from \$850 and \$8,500 in 2007).

Comment: Remember that this income must consist *solely* of interest, dividends, capital gains distributions coming strictly from mutual funds (i.e., *not* stocks or other capital assets disposed of by the child directly) and Alaskan dividends. Furthermore, no estimated taxes must have been paid on this income in the SSN of the child. Finally, if the child has any *earned* income, this election is *not* available (i.e., then, the child's income would *not* have consisted "solely" of the unearned income sources listed above; keep in mind that the assignment of income doctrine would prevent any earned income from ever being taxed to another taxpayer except the person who had actually performed the services justifying the payment of it).

Comment: Given how easy it normally is to produce a child's return using the tax prep software that we have today, it really doesn't make sense from a tax planning standpoint to make this election thereby increasing a parent's AGI by up to \$9,000 for each child for whom the election is made. Approximately 20 different items on the parent's tax return can be impacted by a higher AGI number and this should be kept in mind when considering the election.

AMT Exemption for Child Under 18: The AMT exemption for 2008 for a child under 18 will be the *lesser* of: 1) \$6,400 (up from \$6,300 in 2007) plus the child's earned income, or 2) \$33,750 (down from \$42,500 in 2007).

Comment: As in past years, Congress will probably maintain at least the level of the AMT exemption amounts (as they have done with other items impacted by AMT when they were about to revert to lower levels). In fact, there might end up being a possible increase over the 2006 amounts.

Personal Exemption Amount: The personal exemption amount for 2008 will rise to \$3,500 (up from \$3,400 in 2007).

Comment: The minimum gross income thresholds for filing will also increase for 2008 since they are based on the basic standard deduction, the additional standard deduction, and the exemption amounts.

Phase-out of Personal Exemption: The phase-out of the personal exemption for 2008 will begin at adjusted gross income of: Joint Return or surviving spouse - \$239,950 (up from \$234,600 in 2007); Head of household of household) - \$199,950 (up from \$195,500 in 2007); Single individual (other than surviving spouse

or head - \$159,950 (up from \$156,400 in 2007); Married filing separately - \$119,975 (up from \$117,300 in 2007).

Comment: For 2008, a taxpayer will lose only 1/3 of the amount he would otherwise lose under the regular phase-out computation. **(Code §151(d)(3)(E))**

Tax Rate Schedules: The tax rate schedules for 2008 will be as follows:

- FOR MARRIED INDIVIDUALS FILING JOINT RETURNS AND SURVIVING SPOUSES: If taxable income is not over \$16,050, 10% of taxable income; over \$16,050 but not over \$65,100, \$1,605.00 plus 15% of the excess over \$16,050; Over \$65,100 but not over \$131,450, \$8,962.50 plus 25% of the excess over \$65,100; Over \$131,450 but not over \$200,300, \$25,550.00 plus 28% of the excess over \$131,450; Over \$200,300 but not over \$357,700, \$44,828.00 plus 33% of the excess over \$200,300; Over \$357,700, \$96,770.00 plus 35% of the excess over \$357,700.

- FOR SINGLE INDIVIDUALS (OTHER THAN HEADS OF HOUSEHOLDS AND SURVIVING SPOUSES): If taxable income is not over \$8,025, 10% of taxable income; Over \$8,025 but not over \$32,550, \$802.50 plus 15% of the excess over \$8,025; Over \$32,550 but not over \$78,850, \$4,481.25 plus 25% of the excess over \$32,550; Over \$78,850 but not over \$164,550, \$16,056.25 plus 28% of the excess over \$78,850; Over \$164,550 but not over \$357,700, \$40,052.25 plus 33% of the excess over \$164,550; Over \$357,700, \$103,791.75 plus 35% of the excess over \$357,700.

- FOR HEADS OF HOUSEHOLDS: If taxable income is not over \$11,450, 10% of taxable income; Over \$11,450 but not over \$43,650, \$1,145.00 plus 15% of the excess over \$11,450; Over \$43,650 but not over \$112,650, \$5,975.00 plus 25% of the excess over \$43,650; Over \$112,650 but not over \$182,400, \$23,225.00 plus 28% of the excess over \$112,650; Over \$182,400 but not over \$357,700, \$42,755.00 plus 33% of the excess over \$182,400; Over \$357,700, \$100,604.00 plus 35% of the excess over \$357,700.

- FOR MARRIED FILING SEPARATE RETURNS: If taxable income is not over \$8,025, 10% of taxable income; Over \$8,025 but not over \$32,550, \$802.50 plus 15% of the excess over \$8,025; Over \$32,550 but not over \$65,725, \$4,481.25 plus 25% of the excess over \$32,550; Over \$65,725 but not over \$100,150, \$12,775.00 plus 28% of the excess over \$65,725; Over \$100,150 but not over \$178,850, \$22,414.00 plus 33% of the excess over \$100,150; Over \$178,850, \$48,385.00 plus 35% of the excess over \$178,850.

- FOR ESTATES AND TRUSTS: If taxable income is not over \$2,200, 15% of taxable income; Over \$2,200 but not over \$5,150, \$330.00 plus 25% of the excess over \$2,200; Over \$5,150 but not over \$7,850,

\$1,067.50 plus 28% of the excess over \$5,150; Over \$7,850 but not over \$10,700, \$1,823.50 plus 33% of the excess over \$7,850; Over \$10,700, \$2,764.00 plus 35% of the excess over \$10,700.

Reduction of Itemized Deductions: The allowable amount of itemized deductions will be reduced if adjusted gross income in 2008 is more than:

- All returns other than married filing separately: \$159,950 (up from \$156,400 in 2007)
- Married filing separately: \$79,975 (up from \$78,200 in 2007)

Comment: Once again, for 2008, a taxpayer will lose only 1/3 of the amount he would otherwise lose under the regular reduction computation. **(Code §68(f))**

Interest Exclusion for Higher Education: The interest on U.S. savings bonds redeemed to pay qualified higher education expenses may be tax-free. But, the exclusion is phased-out for certain higher income individuals. The phase-out level is adjusted annually for cost-of-living increases. The phase-out for 2008 will begin at modified AGI above \$67,100 (\$100,650 on a joint return). For 2007, the corresponding figures are \$65,600 and \$98,400.

Qualified Transportation Fringe Benefits: For 2008, an employee will be able to exclude up to \$220 (up from \$215 in 2007) a month for qualified parking expenses, and up to \$115 a month (up from \$110 in 2007) of the combined value of transit passes and transportation in a commuter highway vehicle.

Refundable Child Credit: For 2008, the child credit is refundable to the extent of the *greater* of: 15% of earned income above \$12,050 (up from \$11,750 in 2007), or for taxpayers with three or more qualifying children, the excess of the taxpayer's social security taxes for the tax year over his earned income credit for the year. **(Code §24(d))**

Earned Income Tax Credit: In 2008, the maximum amount of earned income on which the earned income tax credit will be computed is \$5,720 for taxpayers with no qualifying children, \$8,580 for taxpayers with one qualifying child, and \$12,060 for taxpayers with two or more qualifying children. These amounts are up from \$5,590, \$8,390, and \$11,790 in 2007. In 2008, the phaseout of the allowable earned income tax credit will begin at \$10,160 for joint filers with no qualifying children (\$7,160 for others with no qualifying children), and at \$18,740 for joint filers with one or more qualifying children (\$15,740 for others with one or more qualifying children). These amounts are up from \$9,000, \$7,000, \$17,390 and \$15,390 in 2007.

Comment: Taxpayers are required to use the IRS tables to determine the amount of their earned income credit. While these tables are based on the inflation adjusted figures set out above, because the credit under the tables is the

same for everyone within a \$50 range, there may be slight differences between the credit under the tables and the credit the taxpayer would determine using those inflation adjusted figures.

The amount of disqualified income (i.e., investment income) a taxpayer may have before losing the entire earned income tax credit will increase to \$2,950 in 2008, up from \$2,900 in 2007.

Education Credits: For 2008, the Hope and Lifetime Learning credits phase out ratably for taxpayers with modified AGI of \$48,000 to \$58,000 (\$96,000 to \$116,000 for joint filers). For 2007, these figures are \$47,000 to \$55,700 (\$94,000 to \$114,000 for joint filers). For 2008, the Hope credit will be 100% of up to \$1,200 (up from \$1,100 in 2007) of qualified higher education tuition and related expenses plus 50% of the next \$1,200 (up from \$1,100 in 2007) of such expenses.

Immediate Expensing: The amount that may be expensed under [Code §179](#) in 2008 will be \$128,000 (up from \$125,000 in 2007). For 2008, the expensing limit will be reduced when more than \$510,000 of eligible property is placed in service (up from \$500,000 in 2007).

Adoption Credit: An individual is allowed a credit against income tax (and AMT) for qualified adoption expenses. The total expenses that may be taken as a credit for all tax years with respect to the adoption of a child by the taxpayer will be limited to \$11,650 for 2008 (up from \$11,390 in 2007). For 2008, the credit for the adoption of a special-needs child will be \$11,650 under [Code §23\(a\)\(3\)](#), regardless of the extent to which the taxpayer has qualified adoption expenses (up from \$11,390 in 2007). The credit will begin to phase out at AGI of \$174,730 (up from \$170,820 in 2007). The phaseout will be complete at \$40,000 above the threshold.

Adoption Exclusion: Similar inflation adjustments and phaseout rules apply for purposes of the exclusion for employer-provided adoption assistance. The total amount excludible per child (whether or not he has special needs) will be limited to \$11,650 in 2008 (up from \$11,390 in 2007). Note that the exclusion for the adoption of a child with special needs applies regardless of whether the employee has qualified adoption expenses.

Student Loan Interest Deduction: For 2008, the deduction phases out ratably for taxpayers other than joint filers with modified AGI between \$55,000 and \$70,000 (\$115,000 and \$145,000 for joint filers). For 2007, the corresponding figures are \$55,000 and \$70,000 for taxpayers other than joint filers; \$110,000 and \$140,000 for joint filers.

Comment: Remember that the deduction is \$2,500 per taxpayer. Therefore, when a young couple who both have student loan interest on

their respective tax returns decides to get married, they are only entitled to a total of \$2,500 (not \$5,000) on their joint return.

MAGI Limits for Making Deductible Contributions by Active Plan Participants to Traditional IRAs:

In general, an individual who is *not* an active participant in certain employer-sponsored retirement plans, and whose spouse is also *not* an active participant, may make an annual deductible cash contribution to an IRA up to the *lesser* of: 1) a statutory dollar limit (for 2008, \$5,000, increased to \$6,000 for those age 50 or older), or 2) 100% of the compensation that is includible in his gross income for that year. However, if the individual (or his spouse) is an active plan participant, the deduction phases out over a specified dollar range of MAGI. For taxpayers filing joint returns, the otherwise allowable deductible contribution will be phased out ratably in 2008 for MAGI between \$85,000 and \$105,000 (up from between \$83,000 and \$103,000 in 2007). For 2008, for single taxpayers and heads of household, the otherwise allowable deductible contribution will be phased out ratably for MAGI between \$53,000 and \$63,000 (up from between \$52,000 and \$62,000 in 2007). For married taxpayers filing separate returns, the otherwise allowable deductible contribution will continue to be phased out ratably for contributions between \$0 and \$10,000. For married taxpayers who are *not* active plan participants but whose spouse is such a participant, the otherwise allowable deductible contribution will be phased out ratably for MAGI between \$159,000 and \$169,000 (up from between \$156,000 and \$166,000 in 2007).

MAGI Limits for Making Contributions to Roth IRAs:

Individuals may make *nondeductible* contributions to a Roth IRA, subject to the overall limit on IRA contributions. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with MAGI over certain levels for the tax year. For taxpayers filing joint returns, the otherwise allowable contributions to a Roth IRA will be phased out ratably in 2008 for MAGI between \$159,000 and \$169,000 (up from between \$156,000 and \$166,000 in 2007). For single taxpayers and heads of household it will be phased out ratably for MAGI between \$101,000 and \$116,000 (up from between \$99,000 and \$114,000 in 2007). For married taxpayers filing separate returns, the otherwise allowable contribution will continue to be phased out ratably for contributions between \$0 and \$10,000. **(Misc.; 2008 Tax Numbers)**

Key Health, Charitable, Compliance and Special Entity Tax Numbers for 2008

Based on the inflation adjustments for 2008, here are the key numbers for health, charitable, compliance and special entity items:

Long-term Care Premiums: Amounts paid for insurance that covers qualified long-term care services are treated as medical expenses up to specified dollar limits that vary with the age of the taxpayer as of the close of the tax year. For a taxpayer age 40 or younger, the 2008 limit will be \$310 (up from \$290 in 2007); more

than 40 but not more than 50, \$580 (up from \$550 in 2007); more than 50 but not more than 60, \$1,150 (up from \$1,110 in 2007); more than 60 but not more than 70, \$3,080 (up from \$2,950 in 2007); and more than 70, \$3,850 (up from \$3,680 in 2007).

Payments Received Under Qualified Long-term Care Insurance: Amounts received under a qualified long-term care insurance contract are generally excludible as amounts received for personal injuries and sickness, subject to a per diem limitation, which will be \$270 in 2008 (up from \$260 in 2007).

Archer MSAs: For Archer medical savings account (MSA) purposes, in 2008, a "high deductible health plan" will be a health plan:

- with an annual deductible of at least \$1,950 and not more than \$2,900 (up from \$1,900 and \$2,850), in the case of self-only coverage, and
- with an annual deductible of at least \$3,850 and not more than \$5,800 (up from \$3,750 and \$5,650), in the case of family coverage, and
- under which the annual out-of-pocket expenses required to be paid (other than for premiums) for covered benefits does not exceed: 1) \$3,850 (up from \$3,750) for self-only coverage, and 2) \$7,050 (up from \$6,900) for family coverage.

HSAs: For calendar year 2007, the limitation on deductions under [Code §223\(b\)\(2\)\(A\)](#) for an individual with *self-only* coverage under a high deductible health plan is \$2,850. For calendar year 2007, the limitation on deductions under [Code §223\(b\)\(2\)\(B\)](#) for an individual with *family* coverage under a high deductible health plan is \$5,650. For calendar year 2008, the limitation on deductions for an individual with *self-only* coverage under a high deductible health plan is \$2,900. For calendar year 2008, the limitation on deductions for an individual with *family* coverage under a high deductible health plan is \$5,800. For those born before 1954, an additional \$900 can be added to these respective amounts. For calendar year 2008, a "high deductible health plan" is defined under [Code §223\(c\)\(2\)\(A\)](#) as a health plan with an annual deductible that is *not* less than \$1,100 for self-only coverage or \$2,200 for family coverage, and the annual out-of-pocket expenses (deductibles, co-payments, and other amounts, but *not* premiums) do *not* exceed \$5,600 for self-only coverage or \$11,200 for family coverage.

Insubstantial Benefit Charitable Contribution Limitation: Certain de minimis benefits provided by a charity to a donor will *not* affect the donor's charitable contribution deductions. Under these rules, charitable contributions will be fully deductible in 2008 if: 1) the donor makes a minimum payment of \$45.50 (\$44.50 in 2007) and receives certain benefits with a cost of *not* more than \$9.10 (\$8.90 in 2007) or 2) the charity mails or otherwise distributes free unordered "low-cost articles" with a cost of not more than \$9.10 (\$8.90 in 2007). In addition, charitable contributions will be fully deductible if the benefit

received by the donor is *not* more than the *lesser* of \$91 (\$89 in 2007) or 2% of the amount of the contribution.

Dues Paid to Agricultural or Horticultural Organizations: Annual dues *not* exceeding \$139 for 2008 (\$136 in 2007) for membership in an agricultural or horticultural organization will *not* be considered unrelated business income despite any benefits or privileges to which members of the organization will be entitled.

Qualified Funeral Trusts: For contracts entered into in 2008, contributions to a qualified funeral trust may *not* exceed \$9,000 (up from \$8,800 in 2007).

Reporting Exemption for Exempt Organizations With Lobbying Expenditures: For 2008, social welfare, agricultural and horticultural organizations are exempt from the requirement that they report to their members the portion of their dues allocable to lobbying if 90% or more of their annual dues are received from persons, families, or entities who pay dues of \$96 or less (up from \$95 for 2007).

Maximum Hourly Fee for Attorneys: The maximum hourly amount allowed by the IRS for reimbursement of attorney's fees to a prevailing party under [Code §7430\(c\)\(1\)](#) will be \$170 an hour for fees incurred in 2008 (same as in 2007).

Mechanics' Lien Priority Over Tax Liens: The holder of a lien for \$6,600 or less for the repair or improvement of a personal residence will have priority over notices of tax liens filed in 2008. This is up from \$6,450 in 2007.

Sales Price Priority Over Tax Liens: A nondealer purchaser of household goods, personal effects, etc. will be protected against a tax lien filed in 2008 if the sales price is *not* over \$1,320. This is up from \$1,290 in 2007.

Property Exempt From Levy: The value of property exempt from levy under [Code §6334\(a\)\(2\)](#) (i.e., fuel, provisions, furniture, and other household personal effects, as well as arms for personal use, livestock, and poultry) may *not* exceed \$7,900 for levies in 2008 (up from \$7,720 for 2007). The value of property exempt from levy under [Code §6334\(a\)\(3\)](#) (i.e., books and tools necessary for the trade, business, or profession of the taxpayer) may *not* exceed \$3,950 for levies issued in 2008 (up from \$3,860 for 2007).

Foreign Earned Income Exclusion: The foreign earned income exclusion amount increases to \$87,600 in 2008 (up from \$85,700 in 2007). (**Misc.; 2008 Tax Numbers**)

CPA's Gambling Activities Did Not Constitute Trade or Business ([Mohammadpour, T.C. Summary Opinion 2007-163](#))

As might have been expected, it continues to be extremely difficult to establish that one's gambling activities equate to the level of being a trade or business (even for a CPA). As a result, his gambling losses were

only deductible as an itemized deduction, and then only to the extent of his winnings (which had to be shown as "Other Income" on page one of Form 1040).

Background: In general, all ordinary and necessary expenses paid or incurred in carrying on a trade or business during the tax year are deductible. ([Code §162\(a\)](#)) The key case in this area was decided by the Supreme Court, in *Commr. v. Groetzinger*, 59 AFTR 2d 87-532, 480 US 23, (S Ct, 1987) which held that a taxpayer may be in the trade or business of gambling where he "engages in the gambling activity with continuity and regularity and with the primary purpose of making a profit." Thus, a "sporadic activity, hobby, or diversion" does *not* qualify. The difference with *Groetzinger* was that the taxpayer pursued his gambling activity full-time, attending the racetrack 6 days a week for 48 weeks (or 288 days) during the tax year and devoting 60 to 80 hours each week to gambling activities. And, almost as important was that he had no other profession or employment during the 48-week period and kept detailed records of his daily winnings and losses.

Facts: Mr. Mohammadpour, a certified public accountant, and his wife filed a joint return for 2003 on which they reported adjusted gross income of \$59,917. They reported \$41,246 of wage income and on a Schedule C, reported \$21,553 of net profit from Mr. Mohammadpour's accounting services business. On a second Schedule C included with their return, they reported \$83,451 of income from Mr. Mohammadpour's gambling activity, which they offset (also on Sched. C) by a similar amount of gambling losses. However, based on taxpayers' Form W-2G, Certain Gambling Winnings, the IRS adjusted the Mohammadpours' 2003 return to show gambling income of \$84,730 (i.e., \$1,279 more than reported). The IRS also determined that the gambling activity did *not* constitute a trade or business. As a result, the gambling losses of \$83,451 had to be claimed as a Schedule A itemized deduction.

Comment: This reclassification of the gambling loss resulted in the disallowance of the Mohammadpours' claimed child tax credit and in a reduction in the amount of otherwise allowable itemized deductions (i.e., because of the phaseout rules). And, the IRS determined there to be a \$1,410 tax deficiency in the return as filed.

Tax Court Decision: The Tax Court agreed that Mr. Mohammadpour "did not demonstrate that his gambling activity was a trade or business" (or, even as a second trade or business to that of his accounting services business). According to the Court, his gambling activity "failed to show the level of continuity or regularity required by *Groetzinger*." Furthermore, he "failed to demonstrate that the primary purpose of his gambling activity was to make a profit." In this regard, the Tax Court took note of the fact that, in contrast to *Groetzinger*, Mohammadpour only dedicated approximately 900 hours to his gambling activity in

2003 (i.e., about 17 hours per week) over 136 days. In addition, while they reported substantial income from the accounting services business, the Mohammadpours reported absolutely no net income from the gambling activity on their return for 2001, 2002, 2003, or 2004 (even though it was supposed to be a business with a profit motive). Mr. Mohammadpour even admitted that they did *not* rely on the gambling for their livelihood for any of these years and failed to keep reliable records of his gambling activity. Finally, partly due to error and partly due to his practice of ignoring bets on which he won less than \$600, he adopted a recordkeeping practices which would only approximate his gambling activity. As a result, his failure to keep records on winning bets of less than \$600 (which made up approximately 10% of all his bets and which were *not* reported to IRS on a Form W-2G) "was inconsistent with Mr. Mohammadpour engaging in his gambling activity with the primary purpose of making a profit." ([Code §165; Gambling Losses](#))

Worker in Community Property State Taxed on Court-Ordered Pension Substitute Payments Made to Ex-Spouse (*Commr. v. Dunkin*, 100 AFTR 2d ¶2007-5225 (9th Cir., 8/31/2007))

The 9th Circuit, *reversing* the Tax Court, has held that a divorced individual who resided in a community property state was taxable on amounts he paid from his wages to his ex-spouse as ordered by a state court. The court had awarded the spouse one-half of the individual's retirement benefits. But, because he had *not* retired, these benefits were *not* yet payable so the court ordered him to make "alternative payments" to the spouse until he retired.

Facts: John Michael Dunkin and his wife were divorced on Aug 19, 1997, at which time he had been employed by the City of Los Angeles for 27 years. As a result of this employment, John was a participant in a defined benefit pension plan (the pension plan). He had been eligible to start receiving pension benefits on May 19, 1989 but kept working and therefore did *not* start to collect his pension. The divorce judgment gave John's wife one-half of the community interest in the pension plan. If John had retired on the date of the divorce, she would have been entitled to receive \$2,072 per month. Because John did *not* retire, the divorce court ordered him to pay his former spouse \$2,072 per month until he retired. Furthermore, the pension board was ordered to make these payments for as long as benefits were payable, even if Julie died in the interim (in which case benefits would flow to her designated beneficiaries). The divorce court also ordered John and his former spouse to prepare a California qualified domestic relations order (QDRO) to be signed by the judge and entered in the court's record providing that the pension plan would pay the former spouse \$2,072 per month when John retired. John paid his former spouse \$25,511 in 2000 as ordered in the divorce judgment and deducted it as alimony on his 2000 Federal income tax return. John then retired on Sept. 22, 2002 and from that point on, the pension board separately paid John and his former spouse their respective shares of his pension. The IRS determined a deficiency of \$8,222 in John's Federal income tax for

2000 since he was *not* allowed to reduce his gross income by the \$25,511 that he was required by California community property law to pay to his former spouse. John challenged this determination in Tax Court and won. The 9th Circuit has now *reversed* the Tax Court decision.

Tax Court Decision: The Tax Court held that John could reduce his gross income by \$25,211 for 2000. The Court reasoned that a taxpayer's earnings in a community property state "are the property of the community." Therefore, they are *not* considered property of the taxpayer providing the services to earn the underlying income. Furthermore, California community property rights do *not* depend on the form of the payments received by the employee spouse or the source of the payments to the former, nonemployee spouse. Thus, it did *not* matter whether John paid his former wife directly from his wages or from retirement benefits. The Court also ruled there was no assignment of income from John to his ex-wife and that [Code §402](#) did *not* apply because a distribution had *not* been made from a qualified trust.

Appeals Court Decision: The 9th Circuit concluded that the wages earned in exchange for John's continued employment in the year 2000 "were clearly income under [Code §61\(a\)\(1\)](#)." In other words, the fact that John owed money to a creditor (i.e., his ex-spouse) did *not* justify excluding any amount of his wages from income. And, because California community property law "did *not* denominate any part of John's post-divorce wages as community property, the 2000 wages were *not* community property, half of which was John's and half Julie's." The 9th Circuit concluded that the Tax Court was wrong when it reasoned that because John's obligation arose out of his duty to make current payments in lieu of Julie's community pension interest, the funds belonged to Julie and *not* John under California community property law and were therefore *not* income to John. In addition, the Court concluded that because John's liability "was *not* conditioned on Julie's survival, the payments did *not* meet the requirements under [Code §71\(b\)](#) for a deduction as alimony." ([Code §71; Alimony](#))

Comment: A dissenting opinion found that there was "a sufficient significant ambiguity under California State law on the treatment of court-ordered current payments in lieu of an ex-spouse's community pension interest that the 9th Circuit should certify the question to the California Supreme Court." The dissent concluded that the majority's decision "imposes an unfair result on a taxpayer who chooses to work past retirement eligibility age, requiring him to pay full income taxes on the part of his salary that he pays over to his former wife as her community interest in his pension benefits." Instead, the payment "should be treated as what it actually was, a distribution of the ex-wife's interest in the pension benefits, that's nontaxable to the husband."

ESTATES, GIFTS & TRUSTS:

☛ Key Transfer Tax Numbers for 2008

Inflation-adjusted 2008 figures for transfer tax and foreign items have been calculated using the CPI for Aug. 2007 (and the preceding 11 months).

Gift Tax Annual Exclusion: For gifts made in 2008, the gift tax annual exclusion will be \$12,000 (same as for gifts made in 2007).

Special Use Valuation Reduction Limit: For estates of decedents dying in 2008, the limit on the decrease in value that can result from the use of special valuation will increase to \$960,000, up from \$940,000 in 2007.

Determining 2% Portion for Interest on Deferred Estate Tax: In determining the part of the estate tax that is deferred on a farm or closely-held business that is subject to interest at a rate of 2% a year, for decedents dying in 2008 the tentative tax will be computed on \$1,280,000 (up from \$1,250,000 in 2007) plus the applicable exclusion amount (\$2 million for 2008, same as in 2007 as set in the statute).

Increased Annual Exclusion for Gifts to Noncitizen Spouses: For gifts made in 2008, the annual exclusion for gifts to noncitizen spouses will be \$128,000 (up from \$125,000 in 2007).

Reporting Foreign Gifts: If the value of the aggregate "foreign gifts" received by a U.S. person (other than an exempt [Code §501\(c\)](#) organization) exceeds a threshold amount, the U.S. person must report each "foreign gift" to the IRS. ([Code §6039F\(a\)](#)) Different reporting thresholds apply for gifts received from: (a) nonresident alien individuals or foreign estates, and (b) foreign partnerships or foreign corporations. For gifts from a nonresident alien individual or foreign estate, reporting is required only if the aggregate amount of gifts from that person exceeds \$100,000 during the tax year. For gifts from foreign corporations and foreign partnerships, the reporting threshold amount will be \$13,561 in 2008 (up from \$13,258 in 2007).

Expatriation Rules: Subject to certain exceptions, a tax avoidance motive is presumed for an expatriate whose average annual net income tax liability for the 5 tax years ending before the date of loss of citizenship or residency exceeds \$139,000 in 2008 (up from \$136,000 in 2007) or whose net worth on that date exceeds \$2 million (not indexed for inflation). (**Misc.; 2008 Tax Numbers**)

☛ SOI Bulletin Indicates Steep Drop-off in Filing of Estate Tax Returns (IR 2007-153)

An article in the recently released summer 2007 issue of the Statistics of Income (SOI) Bulletin shows how recent changes in the estate tax exemption level have "significantly reduced filings of estate tax returns." Specifically, the total number of estate tax returns filed fell by 58% to about 45,000 in 2005 from about 108,000 in 2001. The total amount of assets represented by these

returns fell by 14% to \$185 billion in 2005 from \$216 billion in 2001. Meanwhile, net estate taxes reported on these returns declined by only 8%.

Background: The article notes that the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) "significantly altered the framework of the Federal estate tax." The exemption amount for estates was increased incrementally from \$675,000 for 2001 deaths to \$2 million for deaths in 2006 through 2008. And, the exemption amount will increase to \$3.5 million for 2009 deaths. The highest tax rate on estates was decreased gradually, from 55% for 2001 deaths to 45% for deaths occurring in 2007 through 2009.

Comment: Without Congressional action, the estate tax is repealed for 2010 deaths, only to be reinstated for deaths occurring in 2011 and later with a \$1 million exemption and a top rate of 55%. Most experts believe that Congress will *not* let happen. Moreover, it is unlikely that Congress will permanently repeal the estate tax. The most likely scenario would be a permanent increase in the exemption to somewhere between \$3.5 and \$5 million, perhaps with inflation adjustments.

The article points out that estate tax law is based on the decedent's year of death. The estate tax return is due 9 months from the date of death, although a 6-month extension is commonly allowed. In a small number of cases, longer extensions may be granted. Therefore, several years of death will be represented in the population of estate tax returns filed in a given filing year. In filing years 2001 through 2005, between 68% and 80% of returns were filed for decedents who died in the prior filing year, with a much smaller percentage filed for decedents who died 2 filing years earlier. Only a small fraction of returns filed were for decedents who died 3 or more filing years prior. And, before EGTRRA became law, the estate tax exemption level had changed in relatively small increments since '87, while the estate tax return filing population increased consistently. The larger increases to the exemption level created by EGTRRA, however, have had a significant impact on the number of estates filing estate tax returns. Between 2001 and 2005, the number of estate tax returns filed dropped by more than 58%, from 108,071 in 2001 to 45,070 in 2005. The drop in the number of returns filed tracks closely with the changes in the exemption amount and the filing patterns described above. In 2003, the year after the exemption level increased to \$1 million, the number of returns filed with a gross estate of less than \$1 million dropped to 7,086, an 81% decline from 38,056 in 2002. The relatively few returns with less than \$1 million in gross estate filed during 2003 were for deaths occurring before 2002. A similar drop-off can be seen following the increase in the exemption level to \$1.5 million for 2004 deaths; in 2005, only 4,796 returns were filed with a gross estate between \$1 million and \$1.5 million, an 81% decline from the 25,141 filed in 2004. In contrast, the total number of estate tax returns filed with a gross estate of \$1.5 million or more grew steadily from 2002 through 2005 after a small decline

from 2001 to 2002. Of these returns, those with gross estate of \$20 million or more increased most rapidly, 21%, from 628 in 2001 to 760 in 2005. Returns with gross estate between \$10 million and \$20 million showed the slowest rate of growth, 5.9%, from 1,282 in 2001 to 1,358 in 2005. Despite a significant drop in the number of returns filed between filing years 2001 and 2005, total estate tax liability reported on Form 706 experienced a relatively modest decline during this period, from \$23.5 billion in 2001 to \$21.7 billion in 2005. This is consistent with the relatively small share of all estate tax liability reported by estates with less than \$1.5 million in gross estate in each filing year. In 2001, prior to the effects of EGTRRA, only 11.4% of tax liability was attributable to these estates. In contrast, the share of tax liability reported on estate tax returns by estates with \$20 million or more in gross estate increased significantly between filing years 2001 and 2005. **(Misc.; Estate Tax)**

Real Estate Transferred From Revocable Trust to FLP Added Back to Estate (*Estate of Virginia A. Bigelow*, 100 AFTR 2d ¶ 5271 (9th Cir., 9/14/07))

The 9th Circuit, *affirming* the Tax Court, has held that rental real estate transferred from a decedent's revocable trust to a family limited partnership (FLP) had to be included in her gross estate under **Code §2036(a)** because "she had retained, for her life, the right to the property's rental income and its economic benefit under an implied agreement that the court found to have existed."

Comment: Individuals typically transfer assets to family partnerships in the hope of achieving large estate tax discounts for these assets that would *not* otherwise be available if the assets were retained in outright ownership. These discounts, in turn, could result in substantial estate tax savings. However, in order to achieve the desired result, the hurdle of **Code §2036** generally must be overcome, as it was in the 5th Circuit's decision in *Kimbell v. U.S.*, 93 AFTR 2d 2004-2400 (5th Cir., 5/20/2004). The estate in this instance argued that the transfer to the FLP qualified as a "bona fide sale" under the *Kimbell* analysis. Nevertheless, the Tax Court found that the facts in the current case "were substantially different from those in *Kimbell*."

Facts: Virginia A. Bigelow lived in a home in California (the Sand Point Road property) from '63 until '92. In '91, when it was worth \$1.75 million, she gave a 1/175 undivided interest in it to each of her three children (her son and two daughters, one of whom later died before she did) and transferred her remaining interest in it to a new revocable trust (Trust) that she had then created. She and her son, Franklin, were its trustees (Trustees). He was also executor of her estate and her attorney-in-fact pursuant to a durable power of attorney from '86 until she died on Aug. 8, '97. Virginia suffered a stroke and was hospitalized on Mar. 9, '92. Six weeks after she was released from the hospital, she moved into an assisted-living facility. On Dec. 30, '92, she withdrew a 1.5% interest in the Sand Point Road property from the Trust and gave each of her daughters a .75% interest in

that property. In Jan. '93, the trustees and the children exchanged the Sand Point Road property for another residential property (the Padaro Lane property) and \$125,000 in cash. The trust obtained a \$350,000 bank loan evidenced by a promissory note and secured by a first position deed of trust on the Padaro Lane property. Virginia and Franklin personally guaranteed the performance of the Trust under the purchase money note. In Dec. '93, the Trust obtained a \$100,000 line of credit from a bank secured by a second position deed of trust on the Padaro Lane property. Virginia guaranteed the performance of the Trust under the line of credit. The trust then drew down the full \$100,000 and the funds were given as gifts to Virginia's children and grandchildren. In Dec '94, Trustees and Virginia's three children formed Spindrift Associates, Ltd., a California limited partnership to engage in the business of owning and operating residential real property. "A units" were issued to limited partners in exchange for cash or checks. "B units" were issued to limited partners in exchange for contributions of property. The trust was both the sole general partner and a limited partner. Virginia's three children were limited partners. On Dec. 22, '94, the Trust transferred the Padaro Lane property, then worth \$1,450,000, but *not* the debt secured by it, to the partnership in exchange for 14,500 B units. Virginia, in her capacity as grantor and beneficiary of the Trust, agreed to hold the partnership harmless for the bank loan and line of credit. The partnership agreement allocated 1% of the net operating profits and losses of the partnership to the general partner and 99% to the limited partners. From Apr. 6, '95, to the date of Virginia's death, Franklin transferred funds between the partnership and Trust 40 times. Under his mother's power of attorney, Franklin made various gifts of partnership units to himself, his siblings and his mother's grandchildren. After these various transfers, the Trust owned a 1% general partnership interest and a 45% limited partnership interest when Virginia died. The partnership did *not* make any distributions to partners before Virginia died. But, not long after she died, the Padaro Lane property was sold and final partnership distributions were made to the partners. After the Padaro Lane property was transferred to the partnership, Virginia's monthly expenses exceeded her monthly income until her death but the partnership paid some of her expenses. On the estate tax return, Franklin reported a gross estate of \$175,958 and taxable gifts of \$463,070. Virginia's limited partnership interest was reported at \$135,080. In computing that value, the estate: 1) computed 44% of \$1,475,000 (i.e., the value of the Padaro Lane property), 2) subtracted \$435,070 (i.e., the amount of the bank loan and the line of credit secured by the property), and 3) applied to the remainder a 37% discount for lack of marketability. The general partnership interest was reported at \$19,912, computed by taking 1% of the value of the Padaro Lane property and applying a 35% control premium. Meanwhile, the IRS determined an estate tax deficiency of \$217,480, after concluding that the real property that the Trust transferred to the partnership was includible in Virginia's gross estate under **Code §2036(a)(1)**.

Background: A decedent's gross estate includes transfers under which he retained for life the possession or enjoyment of, or the right to the income from, the transferred property. However, inclusion is *not* required if the transfer was a bona fide sale for full and adequate consideration. (**Code §2036(a)**)

Tax Court Decision: The Tax Court noted that **Code §2036(a)(1)** does *not* apply unless the decedent retains the possession or enjoyment of, or the right to the income from, the transferred property. But, this requirement is considered to have been met if there is an implied agreement among the parties to the transaction at the time of transfer that the transferor may retain the possession or enjoyment of, or the right to the income from, the transferred property. In this instance, Virginia's use of partnership income to replace the income lost because of the transfer of the Padaro Lane property to the partnership showed that there was an implied agreement between Virginia and her children that she would retain the right to the income from the Padaro Lane property. The estate countered that there was no such agreement. Nevertheless, after the transfer of the Padaro Lane property to the partnership, the property continued to secure Virginia's legal obligation to pay the \$350,000 bank loan and the \$100,000 bank line of credit. Thus, she was treated as having retained the economic benefit of ownership of the Padaro Lane property after it was transferred to the partnership. As a result, the Tax Court concluded that there was an implied agreement between Virginia and her children that she would retain for her life the present economic benefit of the Padaro Lane property. The estate contended that the transfer by Trust of the Padaro Lane property to the partnership was a "bona fide and genuine transfer for which Trust received adequate and full consideration" (i.e., 14,500 of the 14,504 limited partnership units (99.97242%)). The Tax Court found that there was no bona fide sale because the transfer "was *not* made in good faith in that the transfer impoverished Virginia, partnership formalities were *not* respected, and the transfer did *not* provide any nontax benefit to Virginia."

Appeals Court Decision: Before the Appeals Court, the estate argued that the Tax Court erred in finding that: 1) an implied agreement existed and 2) the bona fide sale exception did *not* apply. The 9th Circuit rejected both arguments. For numerous reasons spelled out in the opinion, the Appeals Court agreed with the Tax Court's conclusion that there was an implied agreement between Virginia and the Bigelow children that she would retain income and the benefit of using the Padaro Lane property to secure her debt. For example, with respect to the conveyance of the Padaro Lane property to Spindrift, the 9th Circuit noted that the debt that was secured by the property was *not* also transferred. This discrepancy indicated that Spindrift repaid the debt on Virginia's behalf despite no legal obligation to do so. Because Spindrift used funds to make these payments of debt that were derived from income on the property she had purported to transfer to Spindrift, it supported the IRS's position that Virginia retained an interest in the property. The 9th Circuit also agreed that the Tax Court was correct in concluding that the sale exception did *not* apply for the

following reasons: 1) the transfer resulted in the impoverishment of Virginia, who, before the transfer, was able to meet her financial needs but required assistance from the partnership (and, the income that it generated) afterward until her death; 2) the partnership did *not* honor partnership formalities; and (3) the transfer did *not* create a potential non-tax benefit for Virginia. For instance, the 9th Circuit said that the Tax Court did *not* err in rejecting the estate's "proffered non-tax justifications of minimizing liability exposure absent some concrete incident or circumstance that reasonably motivated the family to form a partnership to shield itself from liability where the estate could point to no particular incident that could give rise to a personal injury claim, and no general conditions of the purported business venture that posed inherent risks of litigation." ([Code §2036\(a\)](#); FLPs)

RETIREMENT PLANS & FRINGE BENEFITS:

Code §409A Plans Granted Extra Year for Document Compliance (Notice 2007-78)

The IRS has extended transition relief for complying with the plan document requirements for nonqualified deferred compensation plans under **Code §409A** until Dec. 31, 2008. The Notice also provides guidance and limited relief on certain other issues, and announces it will soon approve a voluntary compliance program under **Code §409A**.

Background: Under **Code §409A**, which was added by the 2004 Jobs Act, all amounts deferred under a nonqualified deferred compensation (NQDC) plan for all tax years are currently includible in income to the extent *not* subject to a substantial risk of forfeiture and *not* previously included in gross income, unless: (a) the plan meets the distribution, acceleration of benefit, and election requirements under **Code §409A**, and (b) is operated in accordance with these requirements. (**Code §409A(a)(1)(A)(i)**) Noncompliance results in inclusion in income for all amounts deferred under the plan by a participant, interest (at the underpayment rate plus one percentage point), and a 20% penalty. (**Code §409A(a)(1)(B)**) In 2007, the IRS issued final regs on the **Code §409A** NQDC plan rules. (**T.D. 9321**) The regs generally apply to tax years beginning on or after Jan. 1, 2008, and require that the material terms of a NQDC plan be in writing. (**Reg. §1.409A-1(c)**)

Notice 2007-78: The relief in **Notice 2007-78** responds to comments that many taxpayers would find it difficult to formally amend existing plans to comply with the final regs by the original Jan. 1, 2008 deadline. In addition, **Notice 2007-78** addresses a number of questions that commentators raised on the application of the final regs to certain types of plans.

Transitional Relief: **Notice 2007-78** instead provides for a Dec. 31, 2008 deadline to adopt documents that comply with **Code §409A**, subject to limited requirements on the timely written designation

of a time and form of payment. A plan's written provisions may fail to meet the requirements of **Code §409A** and its regs, if it either includes a nonconforming provision or fails to include a required provision. **Notice 2007-78** provides that a NQDC plan will *not* violate the requirements of **Code §409A** on or before Dec. 31, 2008, merely because the plan's written provisions fail to meet the requirements of **Code §409A**, its final regs, or other guidance, if: 1) the plan is operated in accordance with either the requirements of **Code §409A**, the final regs, and other guidance; and 2) is amended on or before Dec. 31, 2008 to comply retroactively to Jan. 1, 2008.

Comment: **Notice 2007-78** does *not* alter a taxpayer's duty to demonstrate that any initial deferral election or later deferral election was made in a manner that complied in operation with **Code §409A**, the final regs, and other guidance. Nor does **Notice 2007-78** alter the restrictions on changes in the time and form of payment on or before Dec. 31, 2007, under the transition rules set out in previous guidance.

Notice 2007-78 also includes:

- Guidance and additional relief with regard to employment agreements and cashout features
- IRS's announcement that it plans to issue guidance containing a limited voluntary compliance program that will allow taxpayers to correct certain unintentional operational violations of **Code §409A**
- IRS's caution that the **Code §409A(b)** relief (which prohibits the use of offshore trusts to pay for NQDC) provided in **Notice 2006-33** for certain "grace period assets," which expires Dec. 31, 2007, will *not* be extended. After that date, taxpayers must comply with "a reasonable, good faith interpretation" of **Code §409A** for all assets in arrangements subject to **Code §409A(b)**. ([Code §409A](#); [Deferred Comp](#))

Late IRA Rollover Waiver Denied for Online Error Putting Fund in Non-IRA Account (PLR 200736036)

The IRS has refused to allow a late rollover where funds withdrawn from a 401(k) plan intended to be transferred into an IRA were instead deposited into a non-IRA account mistakenly created by the taxpayer using an online computer tool. The IRS refused to grant the waiver because it concluded that the taxpayer "was solely responsible for the failure to timely deposit the funds into the IRA."

Background: A rollover from a qualified plan (such as a 401(k) plan) in an eligible rollover distribution which the employee then transfers to an eligible retirement plan (such as an IRA) is generally tax-free. (**Code §402(c)(1)**) A distribution must be rolled over within 60 days after receipt to be tax-free, but the IRS may waive the 60-day rollover period "for equitable reasons." A distribution rolled over after the 60-day period generally will be taxed (and also may be subject to a 10% premature withdrawal penalty tax under **Code §72(t)**). The IRS may waive the 60-day rule "if an individual suffers a casualty, disaster, or other event beyond his reasonable control, and *not* waiving the

60-day rule would be against equity or good conscience" (i.e., hardship waiver). (**Code §402(c)(3)**) The IRS will consider several factors in determining whether to waive the 60-day rollover requirement, including the time elapsed since the distribution and the inability to complete the rollover due to: errors committed by a financial institution, death, disability, hospitalization, incarceration, restrictions imposed by a foreign country, postal errors, etc. (i.e., unrelated third parties) (**Rev. Proc. 2003-16**)

Facts: The taxpayer changed jobs and decided to roll over his account balance in the 401(k) plan he had with his previous employer into an IRA. Intending to establish an IRA with Company V to receive his 401(k) distribution, he opened via an online account creation tool, an account with Company V. He believed that he had opened an IRA, but he mistakenly opened a non-IRA account. In withdrawing the balance of the assets in his 401(K), he indicated that he was transferring all the assets into an IRA with Company V. When he received a check payable to Company V, he mailed the funds to it with, he maintained, an IRA deposit slip on which he checked "Direct Rollover" (although Company V indicates that it did *not* receive a copy of the deposit slip.) He was unaware that the funds had *not* been placed into an IRA until he received a Form 1099-INT from Company V some 3 months later, after the 60-day rollover period had expired. Although he bought stock with the funds, he had *not* withdrawn any amounts from the supposed IRA account. The taxpayer maintained that he "did *not* possess the financial knowledge or experience to know that he was placing his assets in a non-IRA account and that if he had been aware that he was *not* effectuating a qualified IRA rollover into an IRA with it, he would *not* have performed the transaction."

IRS Ruling: In denying the taxpayer's request for a waiver of the 60-day rollover period, the IRS reasoned that he had *not* presented any evidence as to how any of the factors listed in **Rev. Proc. 2003-16** affected his ability to timely roll over the funds into an IRA. There was no evidence to indicate that Company V personnel provided any information to him before or immediately after he established his non-IRA account. He contacted Company V approximately 3 months after the funds had been deposited into the account and only after receiving a Form 1099-INT. As a result, the IRS concluded that the taxpayer was solely responsible for failing to timely deposit the funds into an IRA. (**Code §402(c)(3)**; **IRA Rollovers**)

6th Circuit Agrees Cash Balance Plans' Interest Crediting Provisions Did Not Violate Age Discrimination Rules (*Drutis v. Rand McNally & Co.*, 2007 WL 2409762 (6th Cir., 8/27/07))

Following the decisions by the Court of Appeals for the 7th Circuit in **Cooper** and the 3rd Circuit in **Register**, the 6th Circuit held that cash balance plans do *not* discriminate against older workers solely due to operation of their interest-crediting mechanism. Thus, all three appellate-level federal courts that have ruled on this issue have found that cash balance plan

interest-crediting mechanisms are *not* considered to be age discriminatory.

Comment: The cash balance plan at issue was *not* affected by the Pension Protection Act of 2006. The revised rules for cash balance plans in the PPA apply to periods beginning on or after June 29, 2005. So any behavior treated as "discriminatory" under the PPA, but occurring before that date, is *not* covered. The lack of clear guidance for "older" cash balance type plans was one of the many criticisms of the PPA, but the courts appear to be resolving one of the key issues for these plans. (**ERISA § 204(b)(1)(H)(i); Cash Balance Plans**)

Disability Exception to 10% Early Withdrawal Penalty Not Available Where Condition Was Remediable and Not Indefinite (*Steven A. Dykes*, TC Summary Opinion 2007-101)

A taxpayer who took a premature distribution from his retirement plan did *not* qualify for the disability exception to the 10% early distribution penalty under **Code §72(t)**, where his disability "was both remediable and *not* indefinite."

Facts: Steven Dykes, the taxpayer, was diagnosed with hepatitis C, which caused fatigue, and rendered him unable to work for several months while he was undergoing treatment. He later quit his job, in 2003, after trying a graveyard shift with a lighter workload. However, a doctor's report had indicated that Dykes' treatment plan "was making a significant difference in his work performance, and that he was having fewer problems with fatigue and attention." Furthermore, the doctor stated that Dykes "was *not* so impaired as to be unable to engage in any substantial gainful activity." In 2003, at age 50, Dykes received a \$39,000 distribution from his retirement plan. The IRS determined that he owed, for 2003, the 10% penalty on early distributions, but Dykes claimed that he was *not* liable for the penalty since he withdrew the \$39,000 to cover both his daily living costs and medical expenses. The IRS disagreed, and Dykes brought suit in Tax Court.

Background: **Code §72(t)(1)** imposes a 10% penalty for early withdrawal on plan distributions made to those under age 59½, unless a statutory exception applies (e.g., the disability exception under **Code §72(t)(2)(A)(iii)**). The definition of disabled, under **Code §72(m)(7)** and **Reg. §1.72-17A(f)**, requires that the disability "persist for a long and indefinite period, so as to prevent the individual from engaging in substantial gainful activity." And, an impairment which is remediable does *not* constitute a disability. Dykes argued that his illness was "indefinite" because it "was incurable and permanent." The Tax Court found, however, that although his illness was permanent, the condition itself was remediable through medication, and so did *not* constitute a disability. Since his illness was remediable and *not* indefinite, the court held that Dykes was *not* disabled within the meaning of **Code §72(m)(7)**, and thus was *not* eligible for the disability exception under the 10% early withdrawal penalty rules. (**Code §72(t)**; **Early**

Withdrawal Penalty)

Partnership's Use of Vacation Property Treated as Trade or Business Thereby Triggering Pension Withdrawal Liability ([Howard McDougall and Central States, Southeast and Southwest Areas Pension Fund v. Pioneer Ranch Limited Partnership and Robert S. Whiting, 2007 WL 2004094 \(7th Cir., 7/12/07\)](#))

A partnership that used a vacation property for farming and raising cattle had to pay the withdrawal liability owed by a bankrupt company, where both the partnership and the company were under common control, and the partnership's use of the vacation property was found to be a trade or business.

Background: Elaine and Robert Whiting bought property in 1970 to use as a vacation home. They also kept cattle and conducted farming and ranching activities there. In 1993, the Whitings established the Pioneer Ranch Limited Partnership, whose principal purpose was to engage in the business of farming, ranching, and agriculture. The Whitings also owned a trucking company, which, after several years of operation, became bankrupt and ceased doing business. Under a collective bargaining agreement, the trucking company had been required to make pension contributions to the Central States, Southeast and Southwest Areas Pension Fund (the fund), a multi-employer pension fund. The trucking company withdrew from the fund, and was assessed withdrawal liability in the amount of \$3.7 million. After the fund determined that it could *not* collect the withdrawal liability from the trucking company, it sued the partnership and Robert Whiting for the amount owed. A district court granted the fund's motion for summary judgment, concluding that the partnership was responsible for the trucking company's liability under ERISA § 4001(b)(1), which imposes joint and several liability for the withdrawal liability of each trade or business under common control. The partnership then appealed.

Background: Under ERISA § 4001(b)(1), a withdrawal liability can be imposed on an organization other than the one obligated to the fund, if the organization is both: 1) under common control with the obligated organization, and 2) a trade or business. Here, there was no dispute that the Whitings controlled both the trucking company and the partnership. Thus, the only question was whether the partnership constituted a "trade or business."

Appeals Court Decision: To determine whether an enterprise constitutes a "trade or business" (a phrase *not* defined by ERISA), a court must consider whether the activity of the enterprise is: (i) for the primary purpose of producing income or profit, and (ii) continuous and regular. A trade or business does *not* encompass purely personal activities, no matter how continuous or extended the activity may be, nor how profitable. In addition, a sporadic activity, a hobby, or an amusement does *not* qualify. In making its arguments that its use of the ranch did *not* constitute a

trade or business, the partnership contended that the Whitings operated the ranch for purely personal reasons, as a vacation home and retreat, and created the partnership for estate planning purposes. The partnership also emphasized that the Whitings suffered significant losses for nine straight years, and that the ranch's tennis courts, shuffleboard court, and trout pond all demonstrated that the Whitings intended the ranch to be a vacation home, since those things have nothing to do with ranching or farming. The pension fund argued, emphasizing the partnership agreement, which stated that the business purpose of the ranch "was to engage in the business of farming, ranching, and agriculture." The fund also pointed out that the Whitings constructed fences to hold cattle, sold livestock and grains, and employed three people, providing them with health, retirement, and workers' compensation benefits. The fund also highlighted the fact that the Whitings' tax returns claimed business exemptions and deductions for farming expenses each year. Taking into account the arguments on both sides (the underlying facts of which were *not* in dispute), the 7th Circuit said that even if those facts were interpreted differently, a court could reasonably consider the evidence of the Whitings' intent, and conclude that they "had engaged in the activities on the ranch for the primary purpose of income or profit, and simply derived incidental personal benefit from the ranch." Thus, finding no error of law, the 7th Court affirmed the district court's decision that the ranch was a trade or business (and therefore owed the \$3.7 million withdrawal penalty). (**ERISA § 4001(b)(1); Pension Withdrawal Penalty**)

Disability Income Tax-free Where Owner-Shareholder Reimbursed Company for Previously Paid Policy Premiums ([Cotler, TC Memo 2007-283](#))

The Tax Court has held that an attorney who reimbursed his solely owned law firm for his disability insurance premiums could exclude the policy payments he received after he became disabled since the attorney, and not his firm, "bore the economic burden of paying the premiums.

Background: Amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness are generally excluded from income. However, this exclusion does *not* apply to amounts received by an employee to the extent the amounts are: 1) attributable to employer contributions that were *not* includible in the employee's gross income, or 2) are paid by the employer. (**Code §104(a)(3)**)

Facts: Richard Cotler was a practicing attorney who owned and ran a law firm. Beginning in '93, the firm held a long-term group disability insurance policy and wrote the checks to pay the premiums. The portion of the monthly disability premium attributable to Cotler was \$81 per month. In '96, Cotler began experience debilitating headaches that left him unable to focus for long periods and unable to work, and caused his firm to struggle. To keep the firm operational, he began lending the firm money in '96, and by '98 the unpaid loan balance was \$177,770. In either January or February, after the close

of the year, Cotler, in consultation with the firm's CPA, would make adjusting entries to the cash disbursements journal. Cotler would reduce the amount of the insurance expense column by the amount of the disability premium that was attributable to him (i.e., \$81 per month thereby reducing the overall cost of the firm's insurance expenses). The \$81 per month was also subtracted from Cotler's shareholder loan account to the firm to reflect the fact that he personally paid for his disability insurance. At the end of the year, Cotler had a consistent practice of going through the cash disbursements journal and subtracting his personal expenses from the expense columns to ensure that they were *not* deducted on the firm's Form 1120. The CPA also prepared a document entitled "Loan Receivable-Stockholder" reflecting that Cotler's personal expenses were subtracted from his loan account to the firm. Cotler then filed a long-term disability claim in '97, and on the claim application said he had paid 100% of the premiums. The insurance company declared Cotler disabled in '97, waived further premiums on the policy, and began paying him about \$72,000 in annual benefits. Cotler said the disability benefits he received in '97 and '98 were excludible from gross income under **Code Sec. 104(a)(3)**. However, the IRS said the benefits were taxable, arguing that Cotler failed to reimburse his firm for the insurance premiums, and that the bookkeeping entries and the shareholder loan receivable document "did *not* demonstrate that he actually paid the premiums on the disability policy."

Tax Court Decision: The Tax Court held that Cotler did in fact reimburse the firm by subtracting the amounts of the insurance premiums from his loan to the firm. Cotler's law firm was thus "nothing more than a conduit." As a result, Cotler was the one who was actually considered to have paid the premiums on the policy. And, since Cotler bore the economic burden of the disability premiums, the disability payments he received in '97 and '98 were excludible from income under **Code §104(a)(3)**. (**Code §104(a)(3); Disability Premiums**)

EMPLOYMENT TAXES:

IRS Conducts Forum on Foreign Worker Payroll Tax Issues

The IRS recently conducted a nationwide telephone forum on the withholding requirements for foreign workers. The forum was led by Lowell Hancock, who is a Tax Specialist with the IRS's LMSB Foreign Payments and International Information Reporting Office. Below is a summary of some of the major points covered in the symposium.

Immigration Law: Hancock said that some basic knowledge of U.S. immigration law is required to: (a) correctly classify a foreign worker as a resident or nonresident alien, (b) determine whether an alien is subject to FICA tax, and (c) properly interpret various tax treaties. Under immigration law, aliens are classified as immigrants, non-immigrants, and

undocumented (illegal aliens). An immigrant is an alien who has been granted the right by the U.S. Citizenship and Immigration Service (USCIS) to reside permanently and to work without restrictions in the United States. A non-immigrant is an alien who has been granted the right by USCIS to reside temporarily in the United States. Such workers usually arrive in the U.S. on a non-immigrant visa. The visa they arrive on corresponds to their "non-immigrant status." For example, a student who arrives in the U.S. on an F-1 visa is considered to be in F-1 non-immigrant status.

Resident vs. Nonresident Aliens: Resident aliens are subject to federal employment taxes in the *same* manner as U.S. citizens (i.e., on their worldwide income). Foreign workers who meet the "green card" test or the "substantial presence test" are treated as resident aliens. Individuals who are *not* U.S. citizens and who do *not* qualify as resident aliens are classified as nonresident aliens. Nonresident aliens are generally subject to federal employment taxes on their U.S. source income. Furthermore, nonresident aliens are subject to the following special withholding rules: 1) They are *not* permitted to write "exempt" on line 7 of Form W-4; 2) They may claim only "single" filing status on line 3 of Form W-4, even if they are married; and 3) With certain exceptions, they may *not* claim more than one personal exemption on Form W-4.

Form W-4: Failure of nonresident aliens to file Form W-4, or file an invalid W-4, will have federal income taxes withheld at the rates pertaining to single status, zero exemptions. Hancock cited federal regulations and said that a Form W-4 submitted without a Social Security Number is still valid, as long as everything else on the Form W-4 meets IRS requirements. Nonresident aliens are required to write "nonresident alien" or "NRA" above the dotted line on line 6 (additional withholding) of Form W-4. An employer can allow its nonresident aliens to complete Form W-4 on a secured Web site, as long as the workers can electronically write in the above information. Otherwise, the W-4 must be completed on paper. At this time, the IRS is considering creating a new W-4 form specifically for nonresident aliens.

Wages Paid After 12/31/05: Effective for wages paid after Dec. 31, 2005, an additional amount must be added to the wages of most nonresident alien employees for purposes of computing federal income tax withholding. The additional amount is required because nonresident aliens are *not* allowed to claim the standard deduction and the federal withholding tables automatically have this amount built into them. Without the addback, withholding would be understated. The addition to wages is only for purposes of computing withholding. It is *not* added to any box of the employee's Form W-2.

Taxpayer Identification Numbers: Nonresident aliens who receive wages must furnish their employer with an individual taxpayer identification number (ITIN) or Social Security Number (SSN). The IRS issues an ITIN to alien workers who *cannot* receive an SSN. Workers apply for an ITIN on Form W-7, Application for IRS

Individual Taxpayer Identification Number. The IRS and the Social Security Administration will accept a Form W-2 that only has an ITIN. The agencies accept ITINs because it makes it easier to find the worker's previous Forms W-2.

Tax Treaties: Some nonresident aliens are eligible for exemptions from federal income tax withholding on wages because of tax treaties. Nonresident aliens must give their employer Form 8233, Exemption From Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual, to claim exemption under a tax treaty. Some states do *not* honor these treaties. Therefore, wages reported for federal and state purposes may be different. ([Code §3402](#); **Withholding Taxes**)

Comment: The following IRS publications provide further information on foreign worker payroll tax issues: [Pub. #15, Circular E, Employer's Tax Guide](#); [Pub. #515, Withholding of Tax on Nonresident Aliens and Foreign Entities](#); [Pub. #519, U.S. Tax Guide for Aliens](#); and [Pub. #901, U.S. Tax Treaties](#).

IRS Issues Guidance on Changes to FICA Tip Credit (IR 2007-155)

The IRS reminds employers of two changes under the Small Business and Work Opportunity Tax Act of 2007 to the **Code §45B** credit for the portion of employer Social Security paid for employee cash tips. Effective in 2007, increases in the federal minimum wage will no longer reduce the **Code §45B** credit, and the credit can be used by the employer to offset AMT.

Background on Computation of Credit: The credit under **Code §45B** (i.e., FICA tip credit) allows employers in the food and beverage industry to claim a credit for the Social Security and Medicare taxes the employers pay on their employees' tip income. The credit, claimed on Form 8846 (Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips), equals the Social Security and Medicare taxes the employer paid on the tips received by the employees. However, no credit is given for tips used to meet the federal minimum wage rate. ([Code §45B](#))

Credit Not Affected by Minimum Wage Increases: For tips received for services performed after Dec. 31, 2006, **IR 2007-155** reminds taxpayers that the 2007 Small Business Act provides that employers determine their **Code §45B** credit using the minimum wage in effect on Jan. 1, 2007, even if the minimum wage increases. (**Code §45B(b)(1)**) Thus, in 2007, when the federal minimum wage increases to \$5.85 from \$5.15 per hour, employers will still use the \$5.15 rate to determine their credit to compute their allowable credit.

Comment: In effect, **Code §45B(b)(1)** freezes the FICA tip credit so that it will *not* be affected

by any minimum wage increases after Jan. 1, 2007.

Credit Limitation Based on Tax Liability:

Generally, general business credits *cannot* exceed the excess of a taxpayer's income tax liability over the tentative minimum tax (or, if greater, 25% of the regular tax liability in excess of \$25,000). (**Code §38(c)**) Credits in excess of the limitation can be carried back one year and forward for up to 20 years. The tentative minimum tax is an amount equal to specified rates of tax imposed on the excess of the alternative minimum taxable income (AMTI) over an exemption amount. To the extent the tentative minimum tax exceeds the regular tax, a taxpayer is subject to the alternative minimum tax (AMT). ([Code §55\(b\)](#))

Credit Can Offset AMT: For **Code §45B** credits determined in tax years beginning after Dec. 31, 2006 and to carrybacks of those credits, **IR 2007-155** reminds taxpayers that the 2007 Small Business Act allows employers to use the **Code §45B** credit to offset 100% of AMT liability. Previously, the credit could only be used against the regular tax. Specifically, the 2007 Small Business Act adds the **Code §45B** credits to the list of "specified credits" under **Code §38(c)(4)(B)**, and treats the tentative minimum tax as being zero for purposes of determining the tax liability limitation with respect to the **Code §45B** credit. And, as a specified credit, the **Code §38(c)** limitation based on a taxpayer's tax liability is also applied separately to the credit. ([Code §38\(c\)\(4\)\(B\)](#))

Comment: The 2007 Small Business Act also provides similar AMT treatment for the work opportunity tax credit under **Code §51**.

Comment: A taxpayer with a **Code §45B** tip credit determined in 2007, that is *not* fully used against the taxpayer's regular tax liability or AMT liability in 2007, can carry back any unused credits to use against the taxpayer's regular tax liability or AMT liability in 2006. ([Code §45B](#); **Tip Credit**)

ADMINISTRATIVE & PROCEDURAL MATTERS:

TIGTA Audit Critical of How Federal Tax Information Shared With State Agencies (Audit Report No. 2007-20-134)

Management oversight of the IRS program to safeguard the confidentiality of taxpayer data shared with state agencies was strongly criticized in a new Treasury Inspector General for Tax Administration (TIGTA) audit. The audit was a follow-up to a September 2005 audit which found computer security deficiencies at state tax agencies. In response, the IRS was expected to take actions to correct those deficiencies as it continues to share taxpayers' personal and financial data with state agencies involved in tax administration. As detailed in the audit, the IRS has a Safeguard Review program that is intended to ensure the states provide adequate security over the information to prevent unauthorized disclosure. "Without an effective Safeguard Review program, the

IRS has little assurance the information provided to the states is adequately protected and funds are prudently spent on contractor support,” TIGTA said. During the course of the latest audit, auditors “became very concerned at the lack of management attention being directed to the Safeguard Review program.” Consequently, auditors also turned their attention to the administration of a five-year contract with a firm to supplement the Safeguard Review staff in conducting more reviews. “Controls over the contract were insufficient to ensure the federal government receives the services for which it contracted, on time, and in accordance with specifications.” (Misc.; Taxpayer Data)

TIGTA Audit Lists Ways for Improving Information Reporting Compliance (Audit Report No. 2007-30-159)

The Treasury Inspector General for Tax Administration (TIGTA) has issued a new audit report which says that tax law changes are necessary to reduce the volume of mismatched names and employee identification numbers reported on Form 1099-MISC, Miscellaneous Income, and Form W-2, Wage and Tax Statement. The IRS annually receives millions of miscellaneous income and wage statements with mismatched names and identification numbers. As a result, it is unable to use this information in determining if the recipients filed tax returns and/or reported the income reflected on the statements. These mismatches consequently create opportunities for the income recipients to avoid the scrutiny of the IRS through underreporting income and not filing tax returns. TIGTA believes that the mismatched names and identification numbers could undermine strategies to reduce the tax gap (i.e., the difference between what is paid in taxes and what should be paid, according to the tax laws) because the success of information reporting is largely dependent on the accuracy of the names and identification numbers reported on the documents. TIGTA recommends tax law changes that would allow the IRS to verify employee identification numbers for employers and require employers to: 1) use the IRS identification number matching system to verify the accuracy of identification numbers for the employees they hire and 2) withhold taxes at the maximum tax rates on those employees whose identification numbers do *not* match IRS records. The IRS agrees with TIGTA's first recommendation. The IRS identification number (TIN) matching system is part of a suite of IRS Internet-based pre-filing e-services that allow "authorized payers" the opportunity to match 1099 payee information against IRS records prior to filing information returns. An "authorized payer" is one who has filed information returns with the IRS in at least one of the two past tax years. But, at this point in time, the IRS has no plans to act on TIGTA's second recommendation. IRS management noted, among other things, that the additional cost of manually perfecting mismatched names and identification numbers on miscellaneous income and wage statements might exceed the monetary benefits. TIGTA also recommends that the Director of the IRS, Examination, Small Business/Self-Employed Division,

use IRS automated data systems to research, resolve, and investigate high-dollar miscellaneous income and wage statements with mismatched names and identification numbers. ([Code §6050I](#); Form 1099-Misc)

TIGTA Audit Examines Tax Impact of Abusive Hobby Loss Deductions by High-Income Taxpayers (Audit Report No. 2007-30-173)

This new Treasury Inspector General for Tax Administration (TIGTA) audit has found that actions must be taken to prevent taxpayers from continually deducting losses in potentially not-for-profit (i.e., hobby) activities to reduce their tax liabilities. The audit focused on IRS efforts to address noncompliant, high-income Small Business/Self-Employed Division taxpayers who claim business losses using Schedule C for activities considered to be not-for-profit. For purposes of the audit, TIGTA categorized taxpayers with total income sources of \$100,000 or greater to be “high-income taxpayers.” In general, if a taxpayer has hobby income and expenses, the expense deduction should be limited to the hobby income amount. About 1.5 million taxpayers, many with significant income from other sources, filed Form 1040 Schedules C showing no profits, only losses, over four consecutive tax years running from 2002 to 2005. And, about 73% of these taxpayers were assisted by tax practitioners. By claiming these losses, almost 80% of the 1.5 million taxpayers “potentially avoided” paying \$2.8 billion in taxes in 2005. However, an actual examination of books and records would be necessary to determine whether there was tax avoidance or abuse. **Code §183**, known as the “hobby loss” provision, and a related Treasury regulation, are problematic since they do *not* provide specific criteria for the IRS to use to determine whether a Schedule C loss is a legitimate business expense without conducting a full examination. **Code §183** “makes it difficult for IRS to efficiently administer tax law that ensures taxpayers are *not* deducting not-for-profit losses to reduce their taxes on other incomes year after year.” ([Code §183](#); **Hobby Losses**)

IRS Releases Fact Sheet on Construction Industry and the Tax Gap (Fact Sheet 2007-22)

The failure to report business income from construction activities and the under-reporting of such income add to the tax gap, the IRS stated in its 15th fact sheet on the subject. As described by IRS, the tax gap is the difference between the amount of taxes that should be paid in a given year and the amount actually paid voluntarily and in a timely way. According to the fact sheet, contractors, subcontractors and workers must pay taxes on income received for all work, including side jobs and work that is paid for with cash. This includes work done in exchange for credit on a bill as well as work that is done in exchange for goods or services in a barter exchange. The fact sheet discusses the possible use of different accounting methods, such as the cash method and the accrual method. It also includes a list of common business expenses deductible in the year incurred, and expenses for business assets that are expected to last more than a year and must be capitalized and depreciated over their useful lives.

Sole Proprietorship Profits Increased by 9% in 2005 Over 2004 (IR 2007-153)

Profits from all non-farm sole proprietorships amounted to \$269.9 billion in 2005, an increase of 9% from tax year 2004, according to an article in the summer 2007 issue of the [Statistics of Income Bulletin](#). After adjusting for inflation, profits rose by 5.5% in 2005, making it the biggest year-to-year increase since '98. The data was taken from 21.5 million individual income tax returns that reported non-farm sole proprietorship activity in 2006. The real estate and rental leasing sector had a 19.4% gain in profits, transportation and warehousing was second with a 15.5% gain in profits and retail trade was third with a 14.6% increase. However, these sector-specific figures were *not* adjusted for inflation. (**Misc.; Schedule C Statistics**)

Two 2008 GM Vehicles Certified for Hybrid Motor Vehicle Credit (IR 2007-156)

In [IR 2007-156](#), the IRS acknowledged the certification of the 2008 Chevrolet Malibu Hybrid and 2008 Saturn Aura Hybrid for the **Code §30B** hybrid motor vehicle credit, both with a credit amount of \$1,300. (**Code §30B; Hybrid Credit**)

Comment: Based on GM's most recent sales report, buyers of qualified vehicles sold by GM may continue to claim the full **Code §30B** alternative motor vehicle credit otherwise allowed at least through Dec. 31, 2007. ([IR 2007-150](#))

IRS Release Addresses FAQs Concerning Taxpayers Who Lose Their Homes Through Foreclosure (IR 2007-159)

The IRS has announced that it has a new frequently asked questions (FAQs) section on its website devoted to taxpayers who lose their homes due to foreclosure. It also reassured homeowners that while mortgage workouts and foreclosures can have tax consequences, special relief provisions were in place to "reduce or eliminate the tax bite for financially strapped taxpayers who lose their homes."

Comment: This release was issued the same day as the publication of a letter to the Treasury Secretary from Senator Chuck Grassley (R-IA), ranking member of the Senate Finance Committee, joined by Senators Gordon Smith (R-OR) and Pat Roberts (R-KS), urging that the IRS, in effect, "get creative" in providing relief to homeowners who default on their home loans and wind up with debt forgiveness income on top of their other woes. One solution Grassley offered was for the IRS to act under its authority to compromise a tax liability under **Code §7122**. This relief is mentioned in [IR 2007-159](#), but this point in time, it is *not* mentioned in the IRS's online FAQs. However, the House Ways and Means Committee has passed a new bill which would add an exclusion under **Code §108** for COD income resulting from foreclosures (although

taxpayers would still have to reduced any tax attributes under [Code §1017](#)).

Background: Gross income generally includes "all income from whatever source derived." (**Code §61(a)**) This includes income from the cancellation of debt (COD income). (**Code §61(a)(12)**) Under **Code §1001(a)**, gain realized from a sale of property equals the excess of the amount realized over the taxpayer's adjusted basis in the property. The amount realized from the sale or other disposition of property also includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. Where the debt is recourse, the amount realized is the property's fair market value (FMV). Additionally, the debtor also realizes COD income to the extent the debt discharged exceeds the property's FMV. (**Reg. §1.1001-2(a)(1)**, **Reg. §1.1001-2(a)(2)**, **Reg. §1.1001-2(c)**, **Ex. 8**) A debtor is treated as having sold or exchanged property when he transfers it to his creditor in discharge of his debt. This applies whether the property is transferred as a result of agreement between the parties or as a result of a foreclosure proceeding. (**Rev. Rul 90-16**) Thus, if a home mortgage is recourse (and virtually all will be in this category), the actual or deemed sale of the property may generate a gain or loss and discharge of debt income. However, the discharged debt may be excluded from income under **Code §108(a)(1)(B)** if the taxpayer is insolvent. And, where a home is lost due to foreclosure, the IRS's FAQs say the COD income equals the excess of the total amount of debt immediately before the foreclosure less the FMV of the property from box 7 of Form 1099-C (Cancellation of Debt).

Comment: Determining exactly what the FMV of the property is may not be an easy task. If the taxpayer surrenders his property to the bank in exchange for cancellation of debt in a foreclosure sale, the FMV will be the sale price. However, if the transfer is in lieu of foreclosure and the bank sells the home shortly thereafter, the taxpayer will have to find out what the actual selling price of the property. One of the FAQs suggests that taxpayers who do *not* agree with the information on a Form 1099-C to contact the lender and get it to issue a corrected form if the information on it is incorrect.

Gain from Foreclosure: Where a home is lost due to foreclosure, the IRS's FAQs state that the taxpayer will be considered to have gain to the extent that the home's FMV exceeds his adjusted basis. However, this gain may be excluded under **Code §121** if a 2-out-of-5-year ownership and use rules are met (and, it does *not* exceed the \$250/500,000 caps).

Comment: Gain on a home sale may also be partially or completely protected by the pro rata exclusion under **Code §121(c)** (i.e., where the 2-out-of-5-year ownership and use rule is *not* met) but where the sale is made due to a change in employment, health, or "unforeseen circumstances." In its FAQs, IRS does *not* address whether it would treat the foreclosure of

a home as an “unforeseen circumstance.”

Example: A borrower bought a home in August 2005 and lived in it until it was taken through foreclosure in September 2007. The original purchase price was \$170,000, the home is worth \$200,000 at foreclosure, and the mortgage debt canceled at foreclosure is \$220,000. The borrower would have \$20,000 of COD income and \$30,000 of home sale gain (which might be eligible for the **Code §121** exclusion).

Comment: The COD income may be excluded under the insolvency provisions outlined in **Code §108**. For example, if the borrower was insolvent at the time of foreclosure (e.g., his total liabilities were \$250,000 and his total assets were only \$230,000), the \$20,000 of cancelled debt would be excluded. (“Questions and Answers on Home Foreclosure and Debt Cancellation,” FAQ 5) Of course, any tax attributes that the borrower might have would be reduced pursuant to **Code §1017**.

Loss on Home Sale: If by chance the taxpayer’s adjusted basis in the home exceeded the FMV of the foreclosed home, he would then have a personal loss on the sale of the home that is *not* deductible. (“Questions and Answers on Home Foreclosure and Debt Cancellation,” FAQ 4)

Nonrecourse Loan: In today’s lending world, it is rare for a home mortgage to be nonrecourse (i.e., where the borrower is *not* personally liable for repayment). But, if that was the case and a homeowner whose home is foreclosed was fortunate enough to have one of these mortgages, he will *not* be treated as having any COD income for tax purposes. However, he may still have gain from the deemed sale of his residence. (“Questions and Answers on Home Foreclosure and Debt Cancellation,” FAQs 2 and 3) (**Code §108; Home Foreclosures**)

Comment: Without getting into specifics, the IRS reminds borrowers who end up owing additional tax and are unable to pay it in full to use the installment agreement form, normally included with the notice, to set up a payment agreement with IRS. (“Questions and Answers on Home Foreclosure and Debt Cancellation,” FAQ 7)

IRS Implements New System for Getting EIN Instantly (IR 2007-161)

The IRS has announced that taxpayers can now request an Employer Identification Number (EIN) through a Web-based system that instantly processes requests and generates identification numbers in real time.

Comment: This is a significant improvement for taxpayers. In the past, taxpayers were told to file an application for an EIN four to five weeks before the number was needed.

Application Process: A taxpayer would access the Internet EIN system through www.irs.gov and enter the required information. If the information passes the automatic validity checks, the IRS will issue a permanent EIN to the taxpayer. But, if the information does *not* pass the validity checks, it is rejected. The taxpayer then has an opportunity to correct the information and resubmit the application. The Internet EIN application is interactive and asks questions tailored to the type of entity the taxpayer is establishing. According to the IRS, this is similar to popular tax processing software packages on the market. And, the system provides help screens throughout the application process which means taxpayers will no longer have to print the EIN instructions and separately search for answers while requesting an EIN. When the EIN application process is complete, a taxpayer has the option to view, print and save his or her confirmation notice, as opposed to waiting for the IRS to mail it. Third parties authorized by the taxpayer can also be provided with the EIN, but the third party is *not* permitted to view, print or save the confirmation notice. Instead, the confirmation notice is mailed to the taxpayer. Finally, an EIN assigned through Internet submission is immediately recognized by the IRS’ systems. Therefore, taxpayers can begin using the EIN immediately for most business purposes. (**Code §6109; EINs**)

2007 Housing Allowances Increased for Taxpayers Working Abroad in High-Cost Areas (Notice 2007-77)

The IRS has announced increases for the maximum housing cost exclusion for U.S. citizens and residents working abroad in specified high-cost locations. The increases are made based on geographic differences in foreign housing costs relative to U.S. housing costs.

Background: A qualified individual may elect to exclude from U.S. gross income his foreign earned income and housing cost amount. (**Code §911(a)**) Under **Code §911(c)(1)**, the maximum excludible housing cost amount is calculated by way of a complex formula. The excludible housing cost amount is the excess, if any, of 1) the individual’s allowable housing expenses for the year (i.e., the housing expense limitation) over 2) a base amount. For 2007, a taxpayer’s allowable housing expenses, assuming he is eligible for entire year, generally *cannot* exceed \$25,710. Then, subtracting the base amount of \$13,712, this would yield a generally applicable maximum housing amount exclusion of \$11,998.

Comment: The IRS may issue regs or other guidance providing for the adjustment of the maximum allowable housing expense limitation on the basis of geographic differences in housing costs relative to housing costs in the U.S. (**Code §911(c)(2)(B)**)

Increases for High-Cost Areas: Notice 2007-77 makes adjustments for housing costs during 2007 in high-cost foreign areas. Specifically, it contains a table that 1) identifies locations within countries with high housing costs relative to U.S. housing costs, and 2) provides an adjusted annual maximum and daily housing expense limitation for a qualified individual incurring

housing expenses in one or more specified high cost localities in 2007 to use (i.e., instead of the otherwise applicable annual housing expense limitation of \$25,710, or the prorated daily amount) in determining his housing expenses. As a result, a qualified individual incurring housing expenses in one or more of the high cost localities identified in the table for the year 2007 may use the adjusted limit provided in the table (in lieu of \$25,710 or the prorated daily amount) in determining his housing cost amount on Form 2555, Foreign Earned Income. ([Code §911](#); **Foreign Housing Exclusion**)

Example: A U.S. taxpayer is posted to Paris, France, for all of 2007. His maximum housing cost exclusion is \$73,488 (\$87,200 full year limit on housing expense in Paris - \$13,712 base amount).

Comment: Many, but not all, of the maximum housing expense limitations for specified high cost localities are higher for 2007 than they were for 2006. For example, for 2007 the maximum housing expense limitation for Toronto, Canada, is \$46,000; it was \$41,500 for 2006. On the other hand, for Vienna, Austria, the maximum housing expense limitation remains unchanged at \$28,824.

SIFL Rates Released for Second Half of 2007 (Rev. Rul. 2007-55)

The IRS has announced the cents-per-mile rates and terminal charges in effect for the second half of 2007 used in valuing noncommercial flights on employer-provided aircraft the value of which is taxed as a fringe benefit. Under **Reg. §1.61-21(g)(5)**, the value of noncommercial flights on employer-provided aircraft that is subject to taxation as a fringe benefit is determined by multiplying the standard industry fare level (SIFL) cents-per-mile rates applicable for the period during which the flight was taken by the appropriate aircraft multiple provided in **Reg. §1.61-21(g)(7)** and then adding the applicable terminal charge. For the second half of 2007, the terminal charge fell to \$37.91 from \$37.92 for the first half of 2007. The SIFL mileage rates are \$0.2074 per mile up to 500 miles, down from \$0.2075 for the first half of 2007; \$0.1581 per mile from 501 to 1,500 miles, down from \$0.1582 for the first half of 2007; and \$0.1520 per mile over 1,500 miles, down from \$0.1521 for the first half of 2007. (**Reg. §1.61-21(g)**; **SIFL**)

Proposed Regs Would Toughen Return Prep Standards to Reflect Changes Made by Small Business Tax Act (Preamble to Prop Reg 09/24/2007; Prop Reg § 10.34)

The IRS has issued proposed regs that would modify the Circular 230 tax return preparation standards to reflect changes made to the “first-tier” return preparer penalty by the Small Business and Work Opportunity Act of 2007. The changes would be effective when the regs are finalized, but *not* earlier than Jan. 1, 2008.

Comment: Don't be misled that, since the effective date cannot be earlier than 1/1/08,

these new standards will not affect the preparation of '07 tax returns. They will indeed be the what the IRS will be using to judge positions taken by clients and condoned by preparers when these returns are chosen for audit and subjected to review by Service personnel.

Background: Effective for returns prepared after May 25, 2007, the Small Business Act broadened and toughened the return rules for preparers. As part of this overhaul, the “first-tier” return preparer penalty of **Code §6694(a)** was revised to provide that a tax return preparer who prepares a return or refund claim for which any part of a tax liability understatement is due to an “unreasonable position” must pay a penalty for each return or claim equal to the greater of: 1) \$1,000 or 2) 50% of the income derived (or to be derived) by the tax return preparer for preparing the return or claim. A position is deemed to be “unreasonable” if: the tax return preparer knew (or, “reasonably should have known”) of the position; there was *not* a “reasonable belief” that the position would “more likely than not” be sustained on its merits; *and* the position was *not* disclosed as provided in **Code §6662(d)(2)(B)(ii)**, or there was no reasonable basis for the position. (**Code §6694(a)(2)**) However, there's no penalty if it is shown that there is a “reasonable cause” for the understatement and the tax return preparer “acted in good faith.” (**Code §6694(a)(3)**) The Small Business Act also broadened the scope of the preparer rules and toughened the “second tier” willful or reckless conduct penalty.

Comment: The bottom line might be that a Form 8275 should be used more often, especially where the client is insistent is taking a position that might be hard to sustained if audited (and, we as the preparer, have otherwise agreed to sign the tax return)

Comment: Earlier this year, in **Notice 2007-54**, the IRS announced that effective generally for original and amended returns and refund claims due before Jan. 1, 2008, the standards carried in the *prior* law and regs will apply in determining whether IRS will impose the “first tier” return preparer penalty under **Code §6694(a)**. But, once again, only for returns due *before* 1/1/08. So, this upcoming busy season's returns would be subject to the new standards.

Proposed Revisions to Circular 230: The IRS has determined that the professional standards under §10.34 of Circular 230 should conform with the civil penalty standards for return preparers. As a result, the proposed regs would amend these standards for tax return preparation to reflect changes to **Code §6694(a)** made by the Small Business Act. Under the proposed regs, a tax professional would *not* be permitted to sign a tax return as a preparer unless the practitioner had a “reasonable belief” that the tax treatment of each position on the return would “more likely than not be sustained on its merits,” or there was a “reasonable basis” for each position *and* each position was adequately disclosed to the IRS (i.e., sometimes on Form 8275, and other times,

simply by the way it is presently on a particular form or schedule). In addition, a practitioner would *not* be allowed to advise a client to take a position on a tax return, or prepare the portion of a tax return on which a position was taken, unless: 1) the practitioner had a reasonable belief that the position satisfies the more likely than not standard; or 2) the position had a reasonable basis and is adequately disclosed to the IRS (**Prop. Reg. § 10.34(a)**) Nevertheless, the “more likely than not” standard would be treated as being met if the practitioner analyzes the pertinent facts and authorities (carried under the **Reg. §1.6662-4(d)(3)(iii)** substantial underpayment penalty rules), and based on that analysis “reasonably concludes, in good faith, that there is a greater than 50% likelihood that the tax treatment will be upheld if the IRS challenges it.” (**Prop. Reg. §10.34(e)(1)**) And, the “reasonable basis” standard would be treated as being met if it is “reasonably based on one or more of the authorities described in **Reg. §1.6662-4(d)(3)(iii)**.” “Reasonable basis” is a relatively high standard of tax reporting, that is, significantly higher than “not frivolous” or “not patently improper.” Thus, the reasonable basis standard would *not* be satisfied by a return position that is “merely arguable or that is merely a colorable claim.” The possibility that a tax return will *not* be audited, that an issue will *not* be raised on audit, or that an issue will be settled could *not* be taken into account. (**Prop. Reg. §10.34(e)(2)**)

Comment: The standards in the proposed regs “reflect a growing convergence between the tax rules and the financial accounting rules.” Under the Financial Accounting Standards Board’s (FASB) FIN 48, which is effective for fiscal years beginning after Dec. 15, 2006, tax benefits (e.g., deductions, credits) from uncertain tax positions that reduce an enterprise’s current or future income tax liability are reported in its financial statements only to the extent each benefit is recognized and measured under a two-step approach. Under the first step of this approach, the enterprise must evaluate each tax position to assess whether, based on the “technical merits” (i.e., based on the relevant tax law authorities), it is more-likely-than-not (a likelihood of more than 50%) that the position would be sustained upon examination (including related appeals or litigation processes) by a tax authority that has full knowledge of all relevant information.

Effective Date: To apply §10.34 of Circular 230 consistently with the transitional relief under **Notice 2007-54**, the changes are proposed to apply to returns filed or advice provided on or after the date that the regs are finalized, but no earlier than Jan. 1, 2008. (**Code §6694; Preparer Penalties**)

Comment: Other Circular 230 changes are being proposed. As discussed below, final regs were issued on 9/26/07 which modify the Circular 230 standards with respect to documents, affidavits, and other papers, but

reserving on tax return preparation standards due to the Small Business Act changes.

Final Circular 230 Regs Focus on Contingent Fees, Disciplinary Proceedings, Sanctions, and Procedural Matters (T.D. 9359)

The IRS has issued final regs on the rules governing practice before it (i.e., commonly known as the Circular 230 rules). The regs cover contingent fees, publicity of disciplinary proceedings, sanctions, eligibility to practice, enrollment, limited practice, conflicts of interest, and standards for tax returns and documents.

Final Regs: The final regs generally follow proposed regs issued in early February of 2006, with numerous modifications. Some of the key areas in the final regs, which are generally effective Sept. 26, 2007, are summarized below.

Contingent Fees: For arrangements entered into after Mar. 26, 2008 (an exception to the regs’ general Sept. 26, 2007 effective date), the final regs adopt the provisions in the proposed regs on contingent fees with several modifications. They allow a practitioner to charge a contingent fee for services rendered in connection with an IRS examination of or challenge to: 1) an original tax return, or 2) an amended return or claim for refund or credit where it was filed within 120 days of the taxpayer receiving a written notice of the examination or challenge to the original tax return. The final regs also adopt the provision in the proposed regs which allows a practitioner to charge a contingent fee for services rendered in connection with any judicial proceeding arising under the Code. (**Reg. §10.27**)

Publicity of Disciplinary Proceedings: The final regs adopt the proposed regs’ provisions on the publicity of disciplinary proceedings with modifications. (**Reg. §10.72(d)**) To provide greater transparency to the disciplinary process, the final regs provide that reports and decisions of the Administrative Law Judge and appellate authority will be available for public inspection within 30 days after the agency’s decision becomes final, subject to procedures to protect the identities of any third-party taxpayers. In light of the concerns raised by commentators that premature public disclosure could potentially tarnish practitioners’ reputations, the final regs require that disclosure of the disciplinary decision be delayed until *after* the decision becomes final.

Sanctions: The final regs adopt the provision in **Prop Reg §10.50** authorizing the imposition of a monetary penalty in addition to, or in lieu of, any other sanction in accordance with changes made by the Jobs Act. The regs also contain conforming amendments to other provisions relating to sanctions, including the Pension Protection Act of 2006. Under the regs, the IRS, after providing due notice and opportunity for hearing, may disqualify an appraiser who violates Circular 230 with or without the assessment of a **Code §6701** penalty against the appraiser.

Conflicting Interests: The final regs adopt the conflict of interest provisions in the proposed regs with

modifications. Under the final regs, a practitioner is required to obtain consent to the representation from each affected client in writing in order to represent the conflicting interests. The written consent may vary in form. The practitioner may prepare a letter to the client outlining the conflict, as well as the possible implications of the conflict, and submit the letter to the client for the client to countersign. The final regs allow the confirmation to be made within a reasonable period after the informed consent, but not later than 30 days. Unlike under the American Bar Association model rule 1.7, where clients can provide informed consent verbally if the consent is contemporaneously documented in writing, this approach will *not* satisfy the final reg unless the confirmatory letter is countersigned by the client. In this regard, the IRS stated that the purpose of the regs is *not* "to sanction minor technical violations when there is little or no injury to a client, the public, or tax administration." (Reg. §10.29)

Preparer Penalties and Standards of Conduct: The Small Business and Work Opportunity Tax Act of 2007 extended the application of the income tax return preparer penalties to *all* tax return preparers, altered the standards of conduct that must be met to avoid imposition of the penalties for preparing a return that reflects an understatement of liability, and increased applicable penalties. However, these changes are *not* reflected in the final regs. (Reg. §10.34(a)) Instead, they are covered in proposed regs simultaneously issued by the IRS (which are discussed in the article above).

Practice Before the IRS: The final regs, consistent with changes made by the American Jobs Creation Act of 2004, provide that the term "practice before the IRS" would include "rendering written advice with respect to any entity, transaction, plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion." As a result, this would include "all matters connected with a presentation to the IRS relating to a taxpayer's rights, privileges, or liabilities under laws or regs administered by the IRS." (Reg. §10.2(a)(4)) The regs also clarify that an attorney or CPA is *not* required to file a Form 2848, Power of Attorney and Declaration of Representative, with the IRS before rendering written advice covered under Reg. §10.35 or Reg. §10.37. However, any other practice continues to require the attorney or CPA to first file a Form 2848. (Reg. §10.3(a), Reg. §10.3(b)) Under the final regs, the practice of enrolled retirement plan agents is allowed, but limit to representation of issues arising under: 1) Employee Plans Determination Letter program; 2) Employee Plans Compliance Resolution System; and 3) Employee Plans Master and Prototype and Volume Submitter program. Enrolled retirement plan agents are also allowed to represent taxpayers generally with respect to IRS forms under the 5300 and 5500 series, which are filed by retirement plans and plan sponsors, but *not* with respect to actuarial forms or schedules. (Reg. §10.3(e))

Enrollment Procedures: The final regs

generally adopt the proposed regs' procedures on enrollment and enrollment renewal for enrolled agents. However, the regs also include the new category of enrolled retirement plan agents and reflect previous final regs which established user fees for enrollment and renewal. (Reg. §10.4, Reg. §10.5, Reg. §10.6)

Limited Practice Before the IRS: The final regs do *not* adopt the provisions on limited practice in Prop Reg §10.7. Under the final regs, an enrolled return preparer who prepared the taxpayer's return for the year under examination may continue to negotiate with IRS on behalf of that taxpayer during an examination or bind that taxpayer to a position during an examination. But, he may still *not* represent a taxpayer before any other IRS office (including Collection or Appeals); execute closing agreements, claims for refund, or waivers; or otherwise represent taxpayers before the IRS unless authorized by Reg. §10.7(c)(1)(i) through Reg. §10.7(c)(1)(vii). (Misc.; Circular 230)

Small Case Procedures Unavailable Even Where Taxpayer Disputed Under \$50,000 ([Leahy, 129 TC No. 8 \(2007\)](#))

The Tax Court has determined that its small case procedures could *not* be used where the taxpayers were disputing less than \$50,000 of the more than \$50,000 total that the IRS had determined was owed.

Facts: The Leahys filed a petition under [Code §6330\(d\)](#) in connection with a hearing before a levy, challenging the IRS's determination concerning collection of their unpaid income tax for the years '96 through 2000. As part of that process, they requested that their case be conducted under the "small tax case procedures" authorized by [Code §7463\(f\)\(2\)](#), for "an appeal under [Code § 6330\(d\)\(1\)\(A\)](#) to the Tax Court of a determination in which the unpaid tax does *not* exceed \$50,000." (Note: [Code §6330\(d\)\(1\)\(A\)](#) has since been changed but it was in effect at the time of this case) On the date that the IRS issued the notice of determination, the total amount of unpaid tax exceeded \$50,000. Nevertheless, the Leahys contended that because they were disputing *less* than \$50,000 of the underlying tax liability, their case should proceed under the small tax case procedures of [Code §7463\(f\)\(2\)](#).

Tax Court Decision: The Tax Court concluded that, for a case to qualify for the small tax case procedures under [Code §7463\(f\)\(2\)](#), the total amount of "unpaid tax" (which includes interest and penalties), calculated as of the date of the notice of determination, *cannot* exceed \$50,000. As a result, "the amount of the underlying tax liability in dispute is irrelevant." Thus, the case was *not* eligible to be conducted under the small tax case procedures. ([Code §7463](#); **Small Tax Case Procedures**)

Levied Upon and Escrowed Funds Not Considered "Tax Payments" Which Stopped Accrual of Interest on IRS Assessment ([LaRosa's International Fuel Co., 100 AFTR 2d ¶2007-5275 \(Fed Cir. Appeals Ct., 9/18/2007\)](#))

The Court of Appeals for the Federal Circuit, *affirming*

the decision of the Court of Federal Claims, has held that neither the IRS's levies on taxpayers' funds, nor their placement in an escrow account, should be considered a "payment" of the taxpayers' tax liabilities so as to stop the accrual of interest under [Code §6601\(a\)](#).

Facts: In '85, the IRS made jeopardy assessments against LaRosa's International Fuel Co. (LaRosa Fuel), a company that supplied coal to utility companies, and its shareholder Joseph LaRosa. As part of this process, the IRS served levy notices on financial institutions holding their liquid assets and other property. In January of '86, the taxpayers entered into an agreement with the IRS in which their liquid assets were placed in an escrow account pending final resolution of their tax liabilities. The IRS then issued notices of deficiencies to them, based on the tax liabilities described in the jeopardy assessments. The taxpayers challenged the deficiencies in the Tax Court where they settled their tax liabilities (including taxes, penalties, and underpayment interest) in stipulated decisions, but reserved the right to challenge interest claimed to be due by the IRS on the deficiencies. The taxpayers then filed refund claims with the IRS claiming they paid excessive interest on their former tax liabilities because the IRS had assessed interest after the levies and while their assets remained in escrow. The IRS denied the refund, and the taxpayers sought relief in the Court of Federal Claims, which found against them. They then appealed that decision to the Court of Appeals for the Federal Circuit where they argued that from December of '85 when the IRS made jeopardy assessments and served levy notices, it had actual or constructive possession of their assets. Furthermore, the seizure of their assets by levy and the escrowing of the funds amounted to payment of their tax deficiencies. So, as of that point in time, they asserted that there was no longer any unpaid taxes still owing. And, the IRS should have credited the full value of the levied assets against their tax assessments, stopping the accrual of underpayment interest against them under [Code §6601\(a\)](#) resulting in a refund of the interest they paid from the date of the levies until the date of the payment that settled the Tax Court litigation. On the other hand, the IRS argued that a tax is only considered paid when funds are actually applied to satisfy a tax assessment. Therefore, underpayment interest did *not* stop accruing at the time of the levies on the taxpayers' assets because the IRS "did *not* realize funds from the levies and did *not* apply the taxpayers' funds to satisfy the jeopardy assessments." This was also the case for the funds being held in escrow.

Appeals Court Decision: The Federal Circuit concluded that the taxpayers were *not* entitled to a refund of underpayment interest since the levies on their assets and the escrowing of their funds did *not* constitute an actual payment of their tax liabilities so as to stop underpayment interest from accruing. Although the IRS has the power to seize and sell property and apply the sale proceeds from to an outstanding tax liability, the levy and seizure provisions under [Code](#)

[§6331](#) and [Code §6332](#) are "only provisional remedies" that do *not* serve to determine the IRS's rights to the seized property. In other words, they "merely bring the property into its legal custody." Ownership of the property is considered to have been actually transferred "only when the property is sold to a bona fide purchaser at a tax sale." Under [Code §6331](#), the IRS can attach its interest to property by means of a lien, but in doing so "it gets nothing more than a secured interest." And, because the IRS does *not* actually take ownership of property when it levies, but only has a security interest, its levy was *not* a payment of the taxpayers' tax liabilities. In *Rosenman v. U.S.*, [33 AFTR 314 \(S Ct 1945\)](#), the Supreme Court determined that a remittance was *not* "a payment of tax but a deposit in the nature of a cash bond." Relying on *Rosenman*, the Court concluded that the deposit of the taxpayers' funds in the escrow account was *not* a payment of their tax liabilities. Furthermore, the escrow agreement "explicitly stated that placement of the funds in the account did *not* constitute the payment of taxes." Instead, "it was the mutual intent of both the taxpayers and the IRS to use the escrow account to avoid the seizure and sale of the taxpayers' property, namely actions that would have resulted in the payment of the tax liabilities at issue." ([Code §6601; Underpayment Interest](#))

FROM CONSULTING CALLS:

☛ Tax Planning Strategies for Retirement Plans Holding Depreciated Securities

The stock market's recent erratic behavior does *not* have an immediate tax impact on taxpayers who hold stocks and/or mutual funds in their traditional IRAs or Roth IRAs since any losses as well as gains are *not* recognized within either type of IRA. However, there are some tax strategies for owners of traditional or Roth IRAs to consider as the stock market sorts itself out, whether they are still in their working years, or are retired and taking required minimum distributions (RMDs) from their accounts.

Converting Traditional IRA to Roth IRA: A taxpayer may convert his traditional IRA to a Roth IRA if, for the conversion year, 1) his modified AGI (*not* counting the taxable amount of the conversion) does *not* exceed \$100,000, and 2) he is *not* a married individual filing a separate return (unless he lived apart from his spouse during the *entire* withdrawal year). Furthermore, the distribution from the traditional IRA is a regular payout for income tax purposes, and the income resulting from the distribution is included on the return for the tax year in which funds are transferred or withdrawn. However, the 10% premature distribution penalty does *not* apply. ([Code §408A\(d\)\(3\)\(A\)](#))

Comment: One of the main benefits of this strategy is that a market decline gives taxpayers a chance to convert a traditional IRA to a Roth IRA at a much lower tax cost than would have been possible when stock market values were high.

Recharacterizing Conversion to Roth IRA: A taxpayer who converted from a traditional IRA invested in stocks to a Roth IRA earlier this year, when the market was heading up to its all-time high will wind up with an artificially high tax bill if the market does *not* recover quickly and no action is taken. Fortunately, the taxpayer can treat the conversion as if it had never been made by recharacterizing it. This involves transferring the converted amount (plus earnings, or minus losses) from the Roth IRA back to a traditional IRA via a trustee-to-trustee transfer.

Example: In early July of this year, Joe converted a traditional IRA invested in a stock fund to a Roth IRA invested in the same stock fund. At that time, the regular IRA had a \$50,000 balance, all of it attributable to deductible contributions and their earnings. Joe's Roth IRA currently is worth only \$40,000. To avoid paying tax on \$10,000 of what will be evaporated income unless the market makes a very strong recovery, Joe can instead recharacterize the Roth IRA as a traditional IRA.

Timing Considerations: The easiest way to make a recharacterization is to do so by the due date (plus extensions) of the taxpayer's return for the affected year, and reflect it on that year's return. As a result, a taxpayer who made a traditional-IRA-to-Roth-IRA conversion earlier this year has a long time to consider what move to make as the 2007 return is *not* due until Apr. 15, 2008 (or, Oct. 15, 2008 with an automatic filing extension). But, even with all of this time, some taxpayers might timely file their 2007 returns without recharacterizing a 2007 conversion. Nevertheless, they will still be able to effect the recharacterization as late as Oct. 15, 2008. But, they will have to do so on an amended return for 2007 bearing the notation "Filed pursuant to Reg. §301.9100-2". (Ann. 99-104; Instructions to Form 8606 (2006))

Reconverting a Traditional IRA to Roth IRA: A person who converted an amount from a traditional IRA to a Roth IRA may *not* only transfer the amount back to a traditional IRA in a recharacterization, but may later reconvert that amount from the traditional IRA back into to a Roth IRA. (Reg. §1.408A-5, Q&A 9(a))

Timing Considerations: The reconversion *cannot* be made before the *later* of: 1) the beginning of the tax year following the tax year in which the amount was converted to a Roth IRA or, 2) the end of the 30-day period beginning on the day on which the IRA owner transfers the amount from the Roth IRA back to a traditional IRA by way of a recharacterization. This timing rule applies regardless of whether the recharacterization occurs during the tax year in which the amount was converted to a Roth IRA or the following tax year. (Reg. §1.408A-5 Q&A 9(a)(1))

Comment: Determining when to recharacterize a Roth IRA as a traditional IRA and then reconvert depends on how the IRA owner views the stock

market. For example, an owner who expects the market to remain low for a while but does *not* expect it to get much lower should recharacterize the Roth IRA now, and then reconvert as soon as eligible if the market is still low.

Effect of Market Decline on Traditional IRA Owners Currently Receiving RMDs: Taxpayers must start taking required minimum distributions (RMDs) from their traditional IRAs by April 1st following the year in which they attain age 70½. However, these taxpayers are *not* permitted to otherwise reduce their RMDs for 2007 to account for a drop in their IRAs' market value this year since each year's RMD is generally determined by applying a life-expectancy table factor to the IRA account balance as of the end of the *previous* year. (Reg. §1.401(a)(9)-5, Q&A 3)

Example: Mary, who attains age 73 in 2007, has a traditional IRA that was worth \$500,000 on Dec. 31, 2006. Her RMD for this year is \$20,243 (i.e., \$500,000/24.7, the uniform life expectancy table factor in Reg. §1.401(a)(9)-9, Q&A 2, for a 73-year-old). She must withdraw that amount during 2007 even if her IRA currently is worth much less than \$500,000. And, if she does *not* withdraw the minimum amount, she could face a penalty under Code §4974 equal to 50% of the excess of the amount that should have been withdrawn over the amount that actually is withdrawn.

However, the amount of each RMD is calculated *separately* for each IRA. Nevertheless, once this calculation is made, the RMD amounts for the separate IRAs may be totaled and the aggregated RMD amount may then be paid out from any one or more of the IRA accounts. (Reg. §1.408-8, Q&A 9)

Example: Larry has two separate traditional IRAs. The RMD from IRA-A is \$6,000 and the RMD from IRA-B is \$4,000. Larry may take his total \$10,000 RMD from *either* IRA-A or IRA-B, or take distributions from both as long as the total IRA payout for the year is at least \$10,000. (Misc.; Retirement Accounts)

Comment: This rule gives flexibility to owners of multiple IRAs. For example, if an IRA is invested in stocks or mutual funds shares whose price currently is depressed, the minimum distribution can be made from another IRA invested in a money-market fund to avoid selling at a market low and losing future appreciation potential. However, keep in mind that many financial institutions automatically place each year's RMD in a *separate* non-IRA account. This procedure avoids the risk of penalties for insufficient distributions. A taxpayer who wants to take his RMD from another IRA should notify the trustees or custodians of the IRAs from which he does *not* want to withdraw, otherwise, an amount might be automatically withdrawn from those IRAs.

Comment: The rule permitting amounts in traditional IRAs to be aggregated for RMD purposes applies only to IRAs that an individual

holds as an owner. It does *not* apply to IRAs that an individual holds as a beneficiary. IRAs held by a person as a beneficiary of the same decedent may be aggregated, but *cannot* be aggregated with amounts held in IRAs that the individual holds as the IRA owner or as the beneficiary of another decedent. And, no traditional IRA can be aggregated with a qualified retirement plan account or a Roth IRA to determine payouts. (Reg. §1.408-8, Q&A 9)

☞ Tax Planning Tips to Maximize Tax Benefits From Child and Dependent Care Expenses

Working parents with smaller children are painfully aware of what it actually costs to take care of them while they are at work. Nevertheless, they may *not* be aware of some tax strategies that can maximize the tax breaks available for such care. This summary presents some planning tips that can maximize a client's tax benefits from child and dependent care expenses, with a special focus on year-end planning possibilities.

Background: A taxpayer may claim a tax credit for employment-related expenses he pays for the care of one or more qualifying individuals. The credit is 35% of employment-related expenses incurred by taxpayers with an AGI of \$15,000 or less, and decreases by 1% for each \$2,000 (or, fraction of that amount) of AGI over \$15,000, but *not* below 20%. (Code §21(a)(1), Code §21(a)(2), Reg. §1.21-1(a))

Qualifying Individual: A qualifying individual is someone who: 1) is under the age of 13 and for whom the taxpayer is entitled to a dependency exemption as defined in Code §152(a)(1) (Code §21(b)(1)(A)); 2) is the taxpayer's dependent who is physically or mentally incapable of caring for himself or herself; and 3) who has the *same* principal place of abode as the taxpayer for *more than half* of the tax year. For these purposes, a "dependent" is defined in Code §152, determined without the gross income test for qualifying relatives, the rule that a joint return filer *cannot* be a dependent, and the rule that a dependent is ineligible to have dependents (Code §21(b)(1)(B)); or is the taxpayer's spouse, if the spouse is physically or mentally incapable of caring for himself or herself and has the same principal place of abode as the taxpayer for more than half of the tax year. (Code §21(b)(1)(C)) Furthermore, an individual may qualify as a qualifying individual for only part of the tax year. This is because the status of an individual as a qualifying individual is determined on a daily basis. (Reg. §1.21-1(c)(3))

Credit Amounts: The maximum amount of employment-related expenses that may be used to compute the credit is \$3,000 for expenses incurred for *one* qualifying individual, or \$6,000, for expenses incurred for *two or more* qualifying individuals, at any time during the tax year. And, creditable expenses *cannot* exceed the earned income of the taxpayer or his spouse, whichever is *lower* (a special rule applies to spouses who are students or incapable of self-care). In this regard, an employer may offer employees the

option to reduce salary by making excludible contributions up to \$5,000 (\$2,500 for married-filing separately taxpayers) to a flexible spending account (FSA) that is used to pay for employment-related expenses for the care of a child or dependent. (Code §129(a)(2), Prop. Reg. §1.125-1(a)(3)(F)) However, amounts excluded under this rule reduce, dollar-for-dollar, the applicable dollar limit on employment related expenses for purposes of the Code §21 credit. (Code §21(c); Reg. §1.21-2(a)(3)) A taxpayer may take into account the *total* amount of employment-related expenses that do *not* exceed the annual dollar limit although the amount of employment-related expenses attributable to just one of the qualifying individuals is otherwise disproportionate to the total employment-related expenses. For example, a taxpayer with expenses in 2007 of \$4,000 for one qualifying individual and \$1,500 for a second qualifying individual may take into account the full \$5,500. (Reg. §1.21-2(a)(4))

Qualifying Expenses: Tuition for kindergarten and for schooling above the level of kindergarten does *not* qualify as employment-related expenses. (Reg. §1.21-1(d)(5)) Day camp expenses may qualify as employment-related expenses but neither overnight camp nor summer school qualifies. (Reg. §1.21-1(d)(7)) Household services may qualify as employment-related expenses if such services include work performed for the care of a qualifying individual. (Reg. §1.21-1(c)(3))

Comment: The employment-related expenses for one individual often exceed \$3,000. Therefore, where there is a second qualifying individual, and where it's appropriate to do so, pay a small amount of expenses for him or her to increase the maximum amount of expenses allowed from \$3,000 to \$6,000.

Example: Rhonda has two daughters who are 3 years old and 12 years old, respectively. Her AGI is \$65,000. For 2007, Rhonda will pay \$7,000 of child care expenses for the 3-year old and thus far has no expenses for the 12-year old. As a result, she will be entitled to a federal child care credit of \$600 ($\$3,000 \times .20$). However, if before year-end the 12-year-old is sick one day and Rhonda pays a child care provider \$80 to watch that child while she is at work, she will wind up paying child care expenses for more than one child during 2007. Therefore, her child care credit for 2007 will *double* from \$600 to \$1,200 (20% of the \$6,000 maximum amount of employment-related expenses that may be used to compute the credit for two or more qualifying individuals). The tax savings could be even more if the taxpayer lives in a state that has a child and dependent care credit. For example, on our facts, if Rhonda lived in Delaware, this strategy would double her state child care credit from \$300 to \$600.

Comment: Under Reg. §1.121-4(a), Rhonda can even pay one of her parents the \$80 to watch the 12-year-old as long as the parent is *not* her dependent.

Comment: The expenses must be incurred before Robin's daughter turns 13 years old. That's because, beginning with the day that she turns 13, she will no longer be a qualifying individual for purposes of the credit.

Form 2441: No credit can be claimed unless the taxpayer reports on his or her IRS Form 2441 (Child and Dependent Care Expenses) (or Schedule 2 of Form 1040A) the name, address and taxpayer identification number of the dependent care provider (but a tax-exempt provider does *not* have to provide a TIN), and how much that provider was paid.

Comment: Another set of circumstances where the above strategy can apply is where a spouse or a older-than-age-12 dependent has a temporary medical condition rendering him incapable of self-care.

Example: John and Mary are married and have one child for whom they have incurred \$6,000 of child care expenses. Both are employed. Because they have paid expenses for only one qualifying individual, they are limited to \$3,000 in computing their child and dependent care credit. In late November of 2007, John has surgery and is unable to care for himself for three days. Mary has a choice of forgoing three days of work to care for John or hiring a housekeeper for \$300. If Mary hires a housekeeper for \$300 to care for John and Mary works during that period, the expenses qualify as employment-related expenses. As a result, John and Mary can claim child and dependent care expenses of \$6,000 for purposes of the credit because there are two qualifying individuals for whom expenses have been paid.

Comment: A taxpayer who has already incurred more than \$3,000/\$6,000 for the tax year but who does *not* expect to do so next year should consider deferring payment for child care services until next year.

Example: Ellen has 2 children for whom she will pay a total of \$8,000 in child care expenses from January through November of 2007. She is scheduled to pay an additional \$800 in the first week of Dec. 2007 for Dec. 2007 child care. In 2007, she anticipates her expenses will be reduced to \$5,000 for the 2 children because one of those children will be entering public school. If Ellen is permitted to postpone the payment for December child care until the first week of 2008, she can qualify for an additional \$160 credit in 2008, and she will *not* reduce her 2007 credit.

Comment: There are instances where a single provider offers both a day camp and a school. Because expenses for day camp are deductible as employment-related expenses and expenses for school for kindergarten and above are *not* deductible, a taxpayer paying for both types of services should ask the provider to *separately* bill the amounts for the summer months as expenses for day camp.

Example: A elementary school operates a day care center that includes a kindergarten. During June, July and August, the school becomes a camp that does *not* offer any classes. The expenses paid for June, July and August qualify as employment-related expenses.

Comment: Taxpayers eligible to participate in a dependent care FSA through their employment and are either in a high tax bracket and/or have only one dependent and more than \$3,000 of employment-related expenses, should use the FSA to pay for child care expenses. For these taxpayers, the FSA almost always provides greater federal tax savings than does the credit. Additionally, participating in a dependent care FSA can also save on FICA taxes, because excludible dependent care benefits are excluded from FICA wages.

Example: Becky files as head of household, has AGI of \$70,000, and is in the 25% federal tax bracket. She has one dependent for whom she pays \$5,000 in child care expenses. If she claims the credit, she can save a maximum of \$600 in federal taxes ($\$3,000 \times .20$). If she had established an FSA, she could save \$1,633 ($(\$5,000 \times .25 \text{ federal tax}) + (\$5,000 \times .0765 \text{ for FICA})$). As a result, her federal savings of \$1,633 from the FSA would be \$1,033 more than what she would save by claiming a federal credit. (**Code §21; Child Care Credit**)

Yours very truly,

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LLC MANUALS: For those of you who might be interested, the second edition of the workbook "LLCs Taxed as Partnerships" (2007 - 2nd Edition) is now available. It was co-authored with Gary Hoff and the University of Illinois Tax School. Only a limited number of copies are available and each manual includes a Problem Set with Solution which tracks the life cycle of an LLC through formation, operation and termination issues. The cost is only \$169 (which includes shipping and handling). If you are interested, contact me at TaxesProf@msn.com.