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2009 National Income Tax Workbook™ Update

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BUSINESS ISSUES

Deductions

*Cavaretta v. Commissioner*
I.R.C. §§162 and 6662

The repayment of fraudulent insurance claims reported as business revenue on prior years’ tax returns is allowed as an I.R.C. § 162 business expense deduction.

Facts

The taxpayer operated a dental practice that served clients of several insurance companies, including Group Health, Inc. (GHI). The taxpayer treated GHI patients at agreed upon rates and then billed GHI, which would send him a check. If the taxpayer overbilled GHI, he was required to repay the difference. If he did not remit this difference, GHI could simply deduct the amount owed from future reimbursement checks.

The taxpayer employed his spouse to maintain the accounting records and handle the billing. From 1995 until 2001, she submitted false claims to GHI. A postal inspector halted the claims submissions and extracted a statement from the spouse admitting to the false claims. The IRS did not dispute that the taxpayer was unaware of his spouse’s enterprise, and also agreed with the taxpayer that the overcharges were included in revenue on the taxpayer’s tax returns.

The spouse pled guilty to one count of healthcare fraud and was sentenced to 18 months in prison followed with two years of supervised release. She agreed to pay GHI $600,000 to settle the claims. The first $230,000 payment was paid through the spouse’s attorney in 2001, followed by payments of $165,833 in 2002 and $55,322 in 2003. The taxpayer deducted these payments as Schedule C (Form 1040) business expenses of his dentistry practice. The deductions generated net operating losses that he carried back to 1996, 1997, and 1998, and the taxpayers received tentative refunds. After auditing the taxpayers’ returns, the IRS changed its mind and sent the taxpayers a notice of deficiency for all three years, claiming that the repayments were not deductible as a business expense and, therefore, not allowable as a loss carryback.

Issue

Whether the repayments for the false claims are deductible business expenses allowable as a loss carryback or nonbusiness restitution

Analysis

The IRS argued that *Stephens v. Commissioner*, 965 F.2d 667 [2d Cir., 1990], labeled restitution payments nondeductible as I.R.C. § 162 business expenses and only sometimes deductible as I.R.C. § 165 losses. In *Stephens*, the Second Circuit carefully distinguished nondeductible punitive from deductible compensatory restitution. The restitution in *Stephens* was for criminal fraud without any connection to a separate business and the taxpayer seeking the deduction was the wrongdoer.

Although it was not clear if the restitution was part of the criminal sentence, the amount of the restitution was intended to make GHI whole and not meant to punish—the $600,000 in payments closely approximates the $550,000 claim plus interest that would have accrued over six years. Thus, the court concluded that the payments were noncriminal, compensatory restitution.

The payments clearly settled a contract claim. The taxpayer credibly testified that he would have lost his business if he had not settled the matter with GHI, which led the court to conclude that the payments were ordinary and necessary to his business. Although the restitution payments resulted from the spouse’s wrongdoing, both the taxpayer and his spouse were obliged to make them. GHI’s final release of claims noted that it released both the taxpayer and his spouse, jointly and severally. Even though the spouse would likely be prohibited from claiming the deduction on their joint tax return, the taxpayer is not similarly barred.

Holding

Repayments of the false insurance claims are deductible business expenses allowable as a loss carryback deduction because the payments were
noncriminal restitution through no wrongdoing by the taxpayer.  
[Cavaretta v. Commissioner, T.C.Memo. 2010-4]

C.C.A. 2009-046-037  
I.R.C. § 199

Costs incurred in the current year for activities that generated gross receipts in years prior to the effective date of I.R.C. § 199 must be deducted from current year domestic production gross receipts.

Facts

Corporation X began 2008 with no inventory, manufactured 1,000 units of Product B, and sold 900 units of Product B. All of Corporation X’s gross receipts qualified as DPGR in 2008. Corporation X uses both a standard cost method and the simplified production method to account for inventory costs under I.R.C. §§ 263A and 471. The 2008 standard cost of one unit of Product B was $20 (materials, $5; labor costs, $5; and overhead expenses including workers’ compensation payments, $10), and the corporation allocated no variances in 2008. Corporation X corporation incurred additional I.R.C. § 263A costs in 2008 of $5,000 ($5 per unit), which included retiree medical expenses and environmental remediation costs.

Employee 1 was involved in Corporation X’s production process until he retired in 2000. In 2008, Corporation X paid $30 of Employee 1’s medical expenses pursuant to an existing retiree medical plan. Employee 2 has been involved in Corporation X’s production process for her entire career and was injured in 2004 while manufacturing Product A. In 2008, Corporation X paid Employee 2 $20 of worker’s compensation payments for her injuries suffered in 2004. Both the retiree medical payment and the workers’ compensation payment were subject to I.R.C. § 263A capitalization for purposes of computing Corporation X’s 2008 taxable income.

Products A and B were manufactured at the same factory. From 2000 through 2004, production activities related to the manufacture of Product A discharged hazardous waste at the factory. As a result, in 2008, Corporation X incurred $400 in environmental remediation costs to clean up the factory and surrounding land. These expenses were also subject to I.R.C. § 263A capitalization for purposes of computing Corporation X’s 2008 taxable income.

Corporation X asserts that pursuant to Treas. Reg. § 1.199-4(b)(2)(ii)(B), the portion of its CGS attributable to environmental remediation, worker’s compensation, and retiree medical benefits expenses incurred in 2008 (2008 Expenses) must be allocated to non-DPGR, because these costs relate to activities generating gross receipts in years prior to the effective date of I.R.C. § 199.

Issue
Whether Treas. Reg. § 1.199-4(b)(2)(ii)(B) requires or permits the taxpayer to allocate some of the cost of goods sold (CGS) to non-domestic production gross receipts (non-DPGR)

Analysis
I.R.C. § 199 allows a deduction equal to a specified percentage of income attributable to domestic production activities, effective for tax years beginning after December 31, 2004. The deduction is generally limited to a percentage of the lesser of the taxpayer’s (a) qualified production activities income (QPAI) or (b) taxable income for the tax year. QPAI is generally the excess of the taxpayer’s DPGR for the tax year over the sum of the CGS allocable to such receipts, and other expenses, losses, and deductions (determined without regard to I.R.C. § 199) properly allocable to these receipts.

Treas. Reg. § 1.199-1(d)(1) provides that a taxpayer must determine the portion of its gross receipts for the tax year that is DPGR and the portion of its gross receipts that is non-DPGR. Factors considered in determining whether the taxpayer's method of allocating gross receipts between DPGR and non-DPGR is reasonable include whether the taxpayer uses the most accurate information available and the accuracy of the method chosen as compared with other possible methods [Treas. Reg. § 1.199-1(d)(2)]. Thus, if a taxpayer has the information readily available and can (without undue burden or expense) specifically identify whether the gross receipts derived from an item are DPGR, then the taxpayer must use that specific identification to determine DPGR.

CGS is determined under the methods of accounting that the taxpayer uses to compute tax-
able income pursuant to I.R.C. §§ 263A, 471, and 472. If I.R.C. § 263A requires a taxpayer to include additional costs in inventory, then these costs must also be included in determining CGS.

CGS allocable to DPGR for a tax year includes the inventory cost and adjusted basis of qualifying production property (QPP) that will generate (or have generated) DPGR notwithstanding that the gross receipts attributable to the disposition of the QPP will be (or have been) included in the gross income for a different tax year. For example, advance payments that are DPGR may be included in gross income under Treas. Reg. § 1.451-5(b)(1)(i) in a different tax year than the related CGS allocable to that DPGR.

A taxpayer must use a reasonable method based on all of the facts and circumstances to allocate CGS between DPGR and non-DPGR [Treas. Reg. § 1.199-4(b)(2)(i)]. Reasonable methods include methods based on gross receipts, number of units sold, number of units produced, or total production costs. Ordinarily, if a taxpayer uses a method to allocate gross receipts between DPGR and non-DPGR, the use of a different method to allocate CGS that is not demonstrably more accurate than the method used to allocate gross receipts is not considered reasonable. However, if a taxpayer has readily available information to specifically identify CGS allocable to DPGR and can specifically identify that amount without undue burden or expense, CGS allocable to DPGR is that amount irrespective of whether the taxpayer uses another allocation method to allocate gross receipts between DPGR and non-DPGR.

Treas. Reg. § 1.199-4(b)(2)(ii) provides that, generally, if a taxpayer recognizes and reports gross receipts on a federal income tax return for one tax year, and incurs CGS related to these gross receipts in a subsequent tax year, then regardless of whether the gross receipts ultimately qualify as DPGR, the taxpayer must allocate the CGS to

- DPGR if the taxpayer identified the related gross receipts as DPGR in the prior tax year; or
- Non-DPGR if the taxpayer identified the related gross receipts as non-DPGR in the prior tax year or if the taxpayer recognized under the taxpayer's methods of accounting those gross receipts in a tax year to which I.R.C. § 199 does not apply.

Taxpayers must capitalize their direct costs and a properly allocable share of their indirect costs to inventory. Treas. Reg. § 1.263A-1(c)(1) provides that to determine these capitalizable costs, taxpayers must allocate or apportion costs to various activities, including production activities (in the case of a manufacturer). After I.R.C. § 263A costs are allocated to production activities, these costs are generally allocated to the items of property produced during the tax year and capitalized to the items that remain on hand at the end of the tax year.

I.R.C. § 1.263A-1(c)(2)(ii) provides that the amount of any cost required to be capitalized under I.R.C. § 263A may not be included in inventory or charged to capital accounts or basis any earlier than the tax year in which it meets the all-events test within the meaning of Treas. Reg. § 1.446-1(c)(1)(ii).

Pension and other related costs are indirect costs must be capitalized, and contributions to employee plans representing past services are capitalized in the same manner as amounts contributed for current service [I.R.C. § 1.263A-1(e)(3)(ii)(C)]. Generally, all other employee benefit expenses, including worker's compensation, payments pursuant to a wage continuation plan under I.R.C. § 105(d) as it existed prior to its repeal in 1983, and benefits provided for employees such as medical treatment, are I.R.C. § 263A capitalized indirect costs [I.R.C. § 1.263A-1(e)(3)(ii)(D)].

Treas. Reg. § 1.263A-2(a)(3)(i) provides that producers generally must capitalize direct and indirect costs properly allocable to property produced under I.R.C. § 263A, without regard to whether those costs are incurred before, during, or after the production period.

Rev. Rul. 2005-42, 2005-2 C.B. 67, holds that environmental remediation costs incurred to clean up land that a taxpayer contaminated with hazardous waste as a result of the taxpayer's manufacturing activities are incurred by reason of production activities and are properly allocable under I.R.C. § 263A to the inventory produced during the tax year the costs are incurred.

For purposes of computing QPAI, CGS is determined using the methods of accounting that the taxpayer uses to compute taxable income. Additional I.R.C. § 263A costs must be included in determining CGS allocable to
DPGR if a taxpayer is required to include such costs in inventory pursuant to I.R.C. § 263A. I.R.C. § 263A and its related regulations require a properly allocable share of indirect costs to be included in the inventory cost of goods produced during the tax year (in the case of a manufacturer). Thus, the 2008 Expenses are properly treated as the cost of producing property in the current tax year, are required to be included in inventory costs under I.R.C. § 263A, and are included in inventory costs under Corporation X’s methods of accounting.

The most reasonable method for allocating CGS under these facts is the specific identification method. All of the units of Product B sold by Corporation X generated DPGR; therefore, the inventory cost of each unit of Product B sold should be allocated to DPGR. The inventory cost of each unit of Product B is $25 ($20 of I.R.C. § 471 costs + $5 of additional I.R.C. § 263A costs). Other reasonable methods described in Treas. Reg. § 1.199-4(b)(2)(i) (allocation based on gross receipts, number of units sold, number of units produced and total production costs) would yield the same result. Treas. Reg. § 1.199-4(b)(2)(ii) does not allow taxpayers to segregate the cost of a unit of inventory into component costs and then allocate those component costs between CGS allocable to DPGR and CGS allocable to non-DPGR, but rather addresses the allocation of CGS determined on the basis of unit costs when gross receipts from the sale of those units are received in a prior year.

**Conclusion**

Treas. Reg. § 1.199-4(b)(2)(ii)(B) does not require or permit taxpayers to allocate part of the CGS of an inventory item to non-DPGR when the gross receipts from the sale of that item are treated as DPGR. Because the costs at issue are properly capitalizable to current year production pursuant to I.R.C. § 263A, they must be included in determining CGS allocable to DPGR for the tax year in which the costs are incurred, and allocated to DPGR using a reasonable method pursuant to Treas. Reg. § 1.199-4(b)(2)(i). Application of a reasonable method results in the entire amount of the costs at issue being allocated to DPGR.

[C.C.A. 2009-46-037 (October 26, 2009)]

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**Ding v. Commissioner**

I.R.C. §§ 195, 262, and 280A

☞ A business expense deduction is disallowed for a failed consulting business that had no clients and generated no income.

**Facts**

The taxpayer was a full-time employee who managed a corporation’s manufacturing operations in Asia. The corporation reimbursed the taxpayer for all of his employee-related international and domestic traveling expenses. In 2003, the taxpayer tried to start a consulting business to match American companies interested in exporting to Asia with Asian companies interested in investing in American companies, hoping to earn income through commissions and finders’ fees.

Because the corporation did not provide the taxpayer with an office, from 1998 to 2003, the taxpayer used a small room of his home as his principal place of business. The corporation did not reimburse the taxpayer for expenses related to his home office. Because of the time zone differences in Asia, the taxpayer would frequently receive or make calls in the evenings and late at night, disturbing his family. To eliminate the disruption, he began remodeling his basement in 2003 and completed the project in 2004. He divided the space in half, using one side as an open conference area used exclusively for occasional meetings with prospects for his consulting activity, and the other side as a self-enclosed main office that he used exclusively for his work as an employee and for his consulting activities.

The taxpayer reported Schedule C (Form 1040) losses of $21,076 for 2003 and $28,347 for 2004 in connection with his attempts to start a consulting business. The taxpayer never generated any income from his consulting business efforts, and he abandoned his efforts at the end of 2004.

The IRS issued a notice of deficiency disallowing the 2004 Schedule C business expenses and stating that the Schedule C expenses should have been reported as a Schedule A (Form 1040) miscellaneous itemized deduction for unreimbursed employee business expenses subject to the 2%-of-AGI floor.
Issue
Whether business expenses are deductible for a failed business that had no clients and generated no income

Analysis
Taxpayers may deduct ordinary and necessary expenses paid in connection with operating a trade or business [I.R.C. § 162(a)]. The business must be functioning as a going concern at the time the taxpayer incurred the expenses. Until that time, expenses related to the activity are I.R.C. § 195 start-up or pre-opening expenses that the taxpayer may elect to amortize over a period of not less than 60 months, beginning with the month in which the active trade or business begins.

To determine whether a taxpayer has become actively engaged in a trade or business, the courts have adopted a facts and circumstances test focusing on whether the taxpayer has satisfied all of the following three factors:

1. Whether the taxpayer undertook the activity intending to earn a profit
2. Whether the taxpayer was regularly and actively involved in the activity
3. Whether the taxpayer’s activity has actually commenced

The taxpayer intended to earn a profit; however, he did not establish that he was regularly and actively engaged in his consulting efforts or that the business actually began in 2003 or 2004. He failed to attract a single client or generate a single dollar in income. Thus, the business expenses reported are not Schedule C (Form 1040) business expenses.

As noted in the notice of deficiency, however, some of the business expenses may qualify as Schedule A (Form 1040) unreimbursed employee business expenses. A taxpayer may deduct expenses related to a home office if he uses the space exclusively on a regular basis as his principal place of business or as a place to meet clients or customers in the normal course of business. A taxpayer who is an employee must also satisfy the additional requirement that the exclusive use is for the convenience of his employer [I.R.C. § 280A(c)].

Because the taxpayer’s employer did not furnish him with an office, the taxpayer had nowhere else to regularly and properly perform his job-related responsibilities. The Tax Court concluded that the taxpayer’s home office was for the convenience of the employer and satisfied the I.R.C. § 280A requirements with respect to the business use of his home for 2004. However, the expenses must be separated between the employee-related expenses and the nondeductible expenses for his startup consulting activities. The taxpayer testified that he split his time in the basement office between his employee functions and his consulting business, but gave no indication that he used the conference area for his employee activities. Applying the Cohan rule, the Tax Court determined that the taxpayer could deduct 25% (50% of the self-enclosed office space and none of the open conference area) of his furniture purchases, 25% of his basement repairs and maintenance expense, and 25% of his basement utility expenses.

Applying the Cohan rule to his other expenses, the Tax Court found that the taxpayer could claim Schedule A (Form 1040) unreimbursed business expense deductions for 25% of the computer and printer expenses, 50% of the fax and telephone expenses, and 70% of the office expenses and supplies. The remaining expenses are nondeductible startup expenses.

Holding
Expenses related to the taxpayer’s failed consulting business are nondeductible. However, the taxpayer may claim his employee-related home office expenses as unreimbursed employee business expenses on Schedule A (Form 1040), subject to the 2%-of-AGI floor.

[Ding v. Commissioner, T.C. Summary Opinion 2009-186]

C.C.A. 2009-43-028
I.R.C. §§ 61 and 7872

☞ Interest paid to the lender by the Small Business Administration under the America’s Recovery Capital Loan Program is not includable in the gross income of the qualified small business borrower.

Facts
The American Recovery and Reinvestment Act of 2009 (ARRA), Pub. L. No. 111-5, § 506, authorizes the Small Business Administration (SBA) to carry out a temporary program to provide loans to help viable small businesses experiencing immediate financial hardship. Under ARRA’s authority, the SBA designed the America’s
Recovery Capital Loan Program (ARC Loan Program), allowing a qualified small business borrower (borrower) to receive a loan from an SBA-approved lender (lender) to make payments on qualifying small business loans. The ARC Loan Program extends through September 30, 2010, or until the appropriated funds run out, whichever comes first.

Under the terms of the ARC Loan Program, a borrower receives a loan of up to $35,000 from a lender (ARC loan) to help make up to 6 months of principal and interest payments on qualifying small business loans. Examples of qualifying small business loans include credit card obligations for the borrower’s business, capital leases for major equipment and vehicles, and notes payable to suppliers or vendors. The proceeds from an ARC loan are disbursed over a 6-month period and repayment of the loan principal is deferred for at least 12 months after the last disbursement of the proceeds. Repayment of an ARC loan may extend up to 5 years; however, the borrower is required to pay the principal over the repayment period.

The terms of an ARC loan require the SBA to pay monthly interest to the lender and provide a 100% guaranty of payment to the lender. The borrower has no obligation to pay any interest on the loan. The SBA and the lender of an ARC loan are prohibited from charging any fees, including points, for ARC loans.

**Issue**

Whether a qualified small business borrower must include in gross income under I.R.C. § 61 interest on a loan that the SBA pays to the lender under the ARC Loan Program

**Analysis**

I.R.C. § 61 defines gross income as all income from whatever source derived. I.R.C. § 7872 defines a below-market loan as any loan on which the interest rate charged is less than the applicable federal rate (AFR). The borrower of a below-market term loan is treated as having received cash from the lender (on the date the loan is made) equal to the excess of the amount loaned over the present value of all payments required under the loan (the imputed transfer) [I.R.C. § 7872(b)]. A below-market term loan is treated as having original issue discount (OID) in an amount equal to the imputed transfer, which is in addition to any other OID on the loan.

I.R.C. § 7872 does not apply to the loans listed in Treas. Reg. § 1.7872-5T(b) because the interest arrangements of those loans do not have a significant effect on the federal tax liability of the borrower or the lender [Treas. Reg. § 1.7872-5T(a)(1)]. However, if one of the principal purposes of the loan transaction structuring is tax avoidance, then the transaction will be recharacterized as a tax avoidance loan [Treas. Reg. 1.7872-5T(a)(2)].

Treas. Reg. § 1.7872-5T(b)(5) provides an exemption for loans that are subsidized by a federal, state, or municipal government (or any agency or instrumentality thereof), and that are made available under a program of general application to the public.

The ARC Loan Program does not impose any obligation on the borrower to pay interest on the ARC loans. Requiring the borrower to include the SBA’s payment of interest to the lender in gross income under I.R.C. § 61 would be inconsistent with the statutory purpose of not imposing any interest obligation on the borrower. The borrower, however, is not entitled to an interest deduction for this loan.

I.R.C. § 7872 would not apply to ARC loans. The ARC Loan Program was designed to carry out a temporary program to provide loans to help viable small businesses experiencing immediate financial hardship. As part of the ARC Loan Program, the SBA, rather than the borrower, is obligated to pay the interest on an ARC loan. A purpose of this interest arrangement is to alleviate the financial hardships of small businesses. The interest arrangements of the ARC loans are, therefore, not structured with a principal purpose of tax avoidance. Furthermore, even if the ARC loans were considered below-market loans within the meaning of I.R.C. § 7872(c), the loans would qualify for exemption under Treas. Reg. § 1.7872-5T(b).

**Conclusion**

A qualified small business borrower does not include in gross income under I.R.C. § 61 any interest paid by the SBA to the lender for an ARC loan and, correspondingly, has no interest deduction for this payment.

[C.C.A. 2009-43-028 (September 8, 2009)]
**Foster v. Commissioner**  
I.R.C. §§ 162 and 6001

Business deductions are disallowed without adequate substantiation and failure to show reasonable cause for the lack of substantiation resulted in an accuracy-related penalty assessment.

**Facts**

The taxpayer owns a business relocation company that involves moving heavy equipment and machinery from one site to another and requires large amounts of storage space. Prior to starting his own business, he was a salesperson at several other business relocation companies. He had studied business finance in college for 3 years in the 1970s and had taken a basic accounting course.

The taxpayer hired two unrelated companies to provide contract laborers to staff specific relocation projects, and he hired two project managers to supervise and coordinate the contract laborers. The taxpayer did not use a general ledger, cash expenditures journal, or computer program to keep a track of his income and expenses. He hired an acquaintance to prepare his 2005 tax return. The acquaintance passed away in February 2007, and it was unclear whether the return preparer was a licensed accountant. The taxpayer’s 2005 Schedule C (Form 1040) included deductions for wages ($603,662), contract labor ($8,160), and rental costs ($120,000). He also filed multiple Forms 1099-MISC, Miscellaneous Income, reporting that he paid various independent contractors $645,524. The IRS disallowed his business expense deductions for wages, contract labor, and rental costs.

**Issues**

1. Whether the taxpayer is entitled to business expense deductions for labor costs and rental payments  
2. Whether the taxpayer is liable for the I.R.C. § 6662 accuracy-related penalty

**Analysis**

I.R.C. § 162(a) allows a deduction for all ordinary and necessary business expenses paid or incurred by a taxpayer in carrying on any trade or business. Treas. Reg. § 1.6001-1(a) requires a taxpayer to maintain records sufficient to substantiate the deduction amounts. If a taxpayer establishes that an expense is deductible but is unable to substan-

tiate the precise amount, the court may estimate the amount, bearing heavily against the taxpayer if it chooses [Cohan v. Commissioner, 39 F.2d 540 (2d Cir., 1930)].

The taxpayer lost the original Forms 1099-MISC when his tax return preparer passed away, so he provided reconstituted forms that represent his best recollection of his labor costs for 2005. He also provided a worksheet that listed other invoices and payments for 2005. The court held that the taxpayer’s testimony and submitted documentation were inadequate to meet his burden to substantiate his claimed contract labor expenses. A schedule of expenses is not sufficient to substantiate claimed deductions [Lofstrom v. Commissioner, 125 T.C. 271 (2005) and Cluck v. Commissioner, 105 T.C. 324 (1995)]. The taxpayer, however, credibly testified that he paid his project managers weekly and paid his rental monthly, and was allowed $90,700 in wages deductions for these two employees and $120,000 in rental costs for 2005.

The I.R.C. § 6662 accuracy-related penalty applies to any underpayment of tax that is attributable to negligence or disregard of rules or regulations. The penalty is not imposed if the taxpayer shows reasonable cause for the underpayment and that the taxpayer acted in good faith. The taxpayer demonstrated that he relied on the advice of his tax return preparer but failed to show that his return preparer was a qualified tax advisor. He did not offer any reasonable cause for his inability to substantiate his claimed business deductions given his level of education and prior experience in the business relocation industry.

**Holdings**

1. The taxpayer is allowed a business deduction for his rental costs and a portion of the labor costs based on his credible testimony, while the remaining business deductions are disallowed due to a lack of substantiation.

2. The taxpayer’s failure to show reasonable cause for his inability to substantiate his claimed deductions resulted in an assessment of the accuracy-related penalty on the disallowed deductions.

[Foster v. Commissioner, T.C. Memo. 2009-274]
The Alternative Tip Income Program (ATIP) is a reporting alternative for employers in the food and beverage industry designed to promote compliance by employers and employees with the provisions of the Internal Revenue Code governing tip income, to reduce disputes on audit, and to reduce filing and recordkeeping burdens.

Rev. Proc. 2006-30 established the ATIP as a pilot program available for the three calendar years beginning on or after January 1, 2007. The IRS has determined that the ATIP pilot program should be extended. ATIP will now terminate on December 31, 2011, unless the IRS issues further guidance extending the term. Notwithstanding the foregoing, the Commissioner of Internal Revenue may terminate ATIP at any time. With the exception of this extension, requirements for ATIP as set forth in Rev. Proc. 2006-30 remain unchanged.

This revenue procedure is effective immediately.


Rev. Rul. 2009-39
I.R.C. § 6205

The IRS explains how to correct employment tax reporting errors using the interest-free adjustment and refund claim process.

Issue
How does an employer correct employment tax reporting errors using the interest-free adjustment and refund claim processes under I.R.C. §§ 6205, 6402, 6413, and 6414 and the accompanying regulations in the following situations:

1. an underpayment of Federal Insurance Contributions Act (FICA) tax and income tax withholding (ITW) when the error is not ascertained in the year the wages were paid;
2. an overpayment of ITW when the error is ascertained in the same year the wages were paid;
3. both an overpayment and an underpayment of FICA tax for the same tax period;
4. an underpayment of FICA tax when the employer's filing requirement has changed;
5. an underpayment of FICA tax and ITW resulting from a failure to file an employment tax return because the employer failed to treat any workers as employees;
6. an overpayment of FICA tax on wages paid to a household employee;
7. an overpayment of FICA tax when the error is ascertained close to the expiration of the period of limitations on credit or refund;
8. an underpayment of FICA tax and ITW ascertained in the course of an employment tax examination;
9. an underpayment of FICA tax and ITW ascertained in the course of the appeals process;
10. an underpayment of FICA tax and ITW resulting from the misclassification of employees ascertained in the course of the appeals process.

Underpayments
An employer that has underreported and underpaid FICA tax with respect to any payment of wages can correct the error as an interest-free adjustment by reporting the additional amount due on an adjusted return filed by the due date for filing the employment tax return for the return period in which the error is ascertained. The due date for filing the adjusted return is determined by reference to the type of return (e.g., Form 941 or Form 944) being corrected, without regard to the employer's current filing requirements. The amount of the underpayment must be paid to the IRS by the date the adjusted return is filed. Agreement forms, such as Form 2504, “Agreement and Collection of Additional Tax and Acceptance of Overassessment (Excise or Employment Tax),” which are used in the context of an examination or appeals process, constitute adjusted returns. If an adjustment is reported but the amount of the adjustment is not paid when due, interest will accrue thereafter.

Overpayments
In general, employers may choose to correct employment tax overpayment errors by either making an interest-free adjustment or filing a claim for refund after an error has been ascertained.
The regulations require that an employer certify that it has repaid or reimbursed its employee or obtained the employee's consent to the filing of the refund claim. For refund claims for employee FICA tax overcollected in prior years, the employer must also certify that it has obtained the employee’s written statement confirming that the employee has not made any previous claims (or the claims were rejected) and will not make any future claims for refund or credit of the amount of the overcollection. However, these requirements do not apply to the extent that the taxes were not withheld from the employee, nor do they apply if after having made reasonable efforts the employer cannot locate the employee or the employee will not provide consent, or the employee did not provide the required written statement. If, after the employer’s reasonable efforts to obtain the employee’s consent or secure the required written statement, the employee does not furnish one or the other of them, the employer may claim a refund of the overpaid employer FICA tax. A claim must be filed before the expiration of the period of limitations on credit or refund.

The revenue ruling includes ten situations that illustrate the application of these rules.


### ENERGY CREDITS AND DEDUCTIONS

**P.L.R. 2009-47-027**  
I.R.C. § 48

Manufacturer’s proposed installation of reflective roof surface in connection with a solar generation system constitutes “energy property” under I.R.C. § 48.

**Facts**  
The taxpayer uses a calendar taxable year accounting period, and the accrual method of accounting for maintaining its accounting books and records and filing its federal income tax return. The operation of the taxpayer's manufacturing facilities requires significant amounts of electricity. In order to control its electricity costs and further establish its brand image as an environmentally friendly manufacturer, the taxpayer is considering the purchase of a rooftop photovoltaic solar generation system.

**Ruling Requested**  
The Reflective Roof Surface, when installed in connection with the System, constitutes energy property under I.R.C. § 48.

**Law and Analysis**  
I.R.C. § 48(a)(3)(A)(i) provides that energy property includes equipment that uses solar energy to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat, excepting property used to generate energy for the purposes of heating a swimming pool.

Treas. Reg. § 1.48-9(a)(2) provides that in order to qualify as “energy property” under I.R.C. § 48, property must be depreciable property with an estimated useful life when placed in service of at least 3 years and constructed after certain dates.

Treas. Reg. § 1.48-9(d)(1) provides as follows: Energy property includes solar energy property. The term “solar energy property” includes equipment and materials (and parts related to the functioning of such equipment) that use solar energy directly to (i) generate electricity, (ii) heat or cool a building or structure, or (iii) provide hot water for use within a building or structure.

Generally, those functions are accomplished through the use of equipment such as collectors (to absorb sunlight and create hot liquids or air), storage tanks (to store hot liquids), rockbeds (to store hot air), thermostats (to activate pumps or fans which circulate the hot liquids or air), and heat exchangers (to utilize hot liquids or air to create hot air or water). Property that uses, as an energy source, fuel or energy derived indirectly from solar energy, such as ocean thermal energy, fossil fuel, or wood, is not considered solar energy property.

Treas. Reg. § 1.48-9(d)(2) specifically excludes “passive solar systems” from qualification as “energy property.” A passive solar system is defined as a “system [that] is based on the use of conductive, convective, or radiant energy transfer.”

Treas. Reg. § 1.48-9(d)(3) provides, in part, that solar energy property includes equipment that uses solar energy to generate electricity, and includes storage devices, power conditioning
equipment, transfer equipment, and parts related to the functioning of those items. Such property, however, does not include any equipment that transmits or uses the electricity generated.

The System generates electricity from sunlight. Because of the cylindrical configuration of the photovoltaic cells, a large portion of the aggregate generating surface of the panels is oriented toward the underside of each panel. The design of the panels allows sunlight to shine through the spaces between each cylinder and reflect upon the underside of the panels from the surface on which the panels are installed. By orienting energy-generating surface toward the underside of the panel and allowing sunlight to shine through the spaces between the cylinders, the panels generate electricity using sunlight reflected from the surface on which the panels rest.

When installed upon a highly reflective surface such as the Reflective Roof Surface, the System generates significant amounts of electricity from reflected sunlight. Because the Reflective Roof Surface enables the generation of significant amounts of electricity from reflected sunlight, the Reflective Roof Surface constitutes equipment that uses solar energy to generate electricity when installed in connection with the System. The Reflective Roof Surface also satisfies, when installed in connection with the System, the definition of energy property under Treas. Reg. §§ 1.48-9(d)(1) and 1.48-9(d)(3), because the Reflective Roof Surface is part of the equipment and materials that use solar energy to directly generate electricity.

**Holding**
Accordingly, we conclude that the Reflective Roof Surface, when installed over an existing roof in connection with the System, constitutes energy property under I.R.C. § 48.

[P.L.R. 2009-47-027 (August 11, 2009)]

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**ESTATE AND GIFT TAXES**

**Price v. Commissioner**
I.R.C. § 2503

Gifts of limited interests in a partnership did not qualify for the annual gift tax exclusion because they were not present interests.

**Facts**
The taxpayers gave limited partnership interests to their adult children. The limited partnership agreement included several restrictions.

1. Partners generally cannot withdraw capital contributions
2. Limited partners cannot sell or assign their interest to anyone other than another partner without the written consent of all partners
3. An assignment to anyone other than a partner gave the assignee only the right to the assignor’s share of profits
4. An assignment of a partnership interest gives the partnership and each of the remaining partners the right to buy the interest at fair market value.
5. Partnership profits are to be distributed to the partners “in the discretion of the general partner except as otherwise directed by a majority in interest of all of the partners, both general and limited.”

The taxpayers filed gift tax returns claiming substantial discounts for lack of control and for lack of marketability as well as the annual exclusion. The IRS issued notices of deficiency that denied the annual exclusions because the donees did not receive a present interest.

**Issue**
Whether gifts of interests in the partnership conferred upon the donees the immediate use, possession, or enjoyment of either:

1. the interest in the partnership or
2. the income from the interest in the partnership

**Analysis**
**Interest in the Partnership**
Transfers subject to the contingency of approval (by all partners in the instant cases) cannot support a present interest characterization, and the possibility of making sales in violation thereof, to a transferee who would then have no right to become a member or to participate in the business, can hardly be seen as a sufficient source of substantial economic benefit to qualify the gift as...
a present interest. Moreover, it appears that the donees are not even properly characterized as limited partners in the partnership because the partnership agreement states: “Any assignment made to anyone, not already a partner, shall be effective only to give the assignee the right to receive the share of profits to which his assignor would otherwise be entitled *** and shall not give the assignee the right to become a substituted limited partner.” Because the children were not partners when the partnership was formed, the gifts were effective to give each child only a share of the profits to which the revocable trusts otherwise would have been entitled. Consequently, the donees lack the ability presently to access any substantial economic or financial benefit that might be represented by the ownership units.

But even if it were to be assumed, contrary to the foregoing analysis, that the donees did somehow become substituted limited partners, contingencies stand between the donees and their receipt of economic value for the transferred partnership interests so as to negate finding that the donees have the immediate use, possession, or enjoyment of the transferred property. Unless all partners consented the donees could transfer their partnership interests to only another partner. In addition, any such purchase would be subject to option-to-purchase provisions, which gives the partnership itself or any of the other partners a right to purchase the property according to a complicated valuation process but without providing any time limit for exercising the purchase option with respect to a voluntary transfer.

The taxpayers suggest that if one donee purchased the partnership interest of another donee, the purchaser would gain an “unrestricted and noncontingent right to the immediate use, possession or enjoyment of the partnership interest”, for instance, by being able unilaterally to cause the partnership’s liquidation. As just discussed, the donees were not substituted limited partners in the partnership. Consequently, the donees did not possess anything more than income rights to transfer to each other or anyone else. More fundamentally, a present interest in a donee is not properly founded on additional rights that the donee or some other donee might later acquire.

The taxpayers allude to the possibility of the donees' selling their partnership interests to the general partner. However, the general partner is owned by the taxpayers and its president is the taxpayer, who engineered the gifts of partnership interests to his children in the first instance. If the possibility of a donor’s agreeing to buy back a gift sufficed to establish a present interest in the donee, little would remain of the present interest requirement and its statutory purpose would be subverted if not entirely defeated.

The taxpayers contend that the donees enjoyed a present interest in the transferred property because they were able to use the Schedules K-1 (Form 1065), Partner's Share of Income, Credits, Deductions, Etc., that the partnership issued to them each year as evidence of their own personal assets, thereby enhancing their “financial borrowing ability.” Apart from the taxpayer’s vague and uncorroborated testimony, there is no evidence to support this contention. In any event, whatever benefit the donees might be thought to enjoy in this regard is at best highly contingent and speculative and does not constitute a source of substantial economic benefit, particularly in the light of the restrictions on alienation (including on the ability of a partner to “encumber” a partnership interest) contained in the partnership agreement.

Income From the Interest in the Partnership
To show that the gifts of the partnership interests afforded the donees the right to immediately use, possess, or enjoy the income therefrom, the taxpayers must show that:

1. the partnership would generate income at or near the time of the gifts;
2. some portion of that income would flow steadily to the donees; and
3. the portion of income flowing to the donees can be readily ascertained.

Because the partnership owned real properties generating rents under long-term leases, we believe that the partnership could be expected to generate income at or near the time of the gifts. The record fails to establish, however, that any ascertainable portion of the income would flow steadily to the donees. To the contrary, the record shows that the partnership’s income did not flow steadily to the donees—there were no distributions in 1997 or 2001.

Pursuant to the partnership agreement, profits of the partnership were distributed at the discretion of the general partner, except when otherwise directed by a majority in interest of all the partners, both limited and general. Without
citation of legal authority, the taxpayers contend that the general partner has a “strict fiduciary duty” to make income distributions to the donees. We are not persuaded that such a fiduciary duty, if it exists, establishes a present interest in a transferred limited partnership interest where the limited partner lacks withdrawal rights. Moreover, because (as previously discussed) the donees are not substituted limited partners, there is significant question as to whether under Nebraska law the general partner owes them any duty other than loyalty and due care.

Holding
The taxpayers failed to show that the gifts of partnership interests conferred on the donees an unrestricted and noncontingent right to immediately use, possess, or enjoy either the property itself or income from the property. Therefore the taxpayers are not entitled to exclusions under I.R.C. § 2503(b) for their gifts of partnership interests.

[Price v. Commissioner, T.C. Memo. 2010-2]

ETHICS

News Release 2010-1
I.R.C. § 7803

The IRS announced the results of a six-month study undertaken to enhance return preparers’ competent and ethical service to taxpayers.

New Registration, Testing and Continuing Education Requirements
The IRS issued the results of a landmark six-month study that proposes new registration, testing and continuing education of tax return preparers. With more than 80% of American households using a tax preparer or tax software to help them prepare and file their taxes, higher standards for the tax preparer community will significantly enhance protections and service for taxpayers, increase confidence in the tax system and result in greater compliance with tax laws over the long term. To bring immediate help to taxpayers this filing season, the IRS also announced a sweeping new effort to reach tax return preparers with enforcement and education. As part of the outreach effort, the IRS is providing tips to taxpayers to ensure they are working with a reputable tax return preparer.

Based on the results of the Return Preparer Review released today, the IRS recommends a number of steps that it plans to implement for future filing seasons, including:

■ Requiring all paid tax return preparers who must sign a federal tax return to register with the IRS and obtain a preparer tax identification number (PTIN). These preparers will be subject to a limited tax compliance check to ensure they have filed federal personal, employment and business tax returns and that the tax due on those returns has been paid.
■ Requiring competency tests for all paid tax return preparers except attorneys, certified public accountants (CPAs) and enrolled agents who are active and in good standing with their respective licensing agencies.
■ Requiring ongoing continuing professional education for all paid tax return preparers except attorneys, CPAs, enrolled agents and others who are already subject to continuing education requirements.
■ Extending the ethical rules found in Treasury Department Circular 230—which currently apply only to attorneys, CPAs and enrolled agents who practice before the IRS—to all paid preparers. This expansion would allow the IRS to suspend or otherwise discipline tax return preparers who engage in unethical or disreputable conduct.

First Step: Letters to 10,000 Preparers
The initiatives will take several years to fully implement and will not be in effect for the current 2010 tax season. In the meantime, the IRS is taking immediate action to step up oversight of preparers for the 2010 filing season.

Beginning the first week of January 2010, the IRS is sending letters to approximately 10,000 paid tax return preparers nationwide. These preparers are among those with large volumes of specific tax returns where the IRS typically sees frequent errors. The letters are intended to remind preparers to be vigilant in areas where the errors are frequently found, including Schedule C income and expenses, Schedule A deductions,
the Earned Income Tax Credit and the First Time Homebuyer Credit.

Thousands of the preparers who receive these letters will also be visited by IRS Revenue Agents to discuss their obligations and responsibilities to prepare accurate tax returns. This is part of a broader initiative by the IRS to step up its efforts to ensure paid tax return preparers are assisting clients appropriately. Separately, the IRS will be conducting other compliance and education visits with return preparers on a variety of issues.

In addition, the IRS will more widely use investigative tools during this filing season aimed at determining tax return preparer non-compliance. One of those tools will include visits to return preparers by IRS agents posing as a taxpayer.

During this effort, the IRS will continue to work closely with the Department of Justice to pursue civil or criminal action as appropriate.

Steps Taxpayers Can Take Now to Find a Preparer
Most tax return preparers are professional, honest and provide excellent service to their clients. The IRS offered the following points for taxpayers to keep in mind when selecting a tax return preparer:

- Be wary of tax preparers who claim they can obtain larger refunds than others.
- Avoid tax preparers who base their fees on a percentage of the refund.
- Use a reputable tax professional who signs the tax return and provides a copy.
- Consider whether the individual or firm will be around months or years after the return has been filed to answer questions about the preparation of the tax return.
- Check the person’s credentials. Only attorneys, CPAs and enrolled agents can represent taxpayers before the IRS in all matters, including audits, collection and appeals. Other return preparers may represent taxpayers only for audits of returns they actually prepared.
- Find out if the return preparer is affiliated with a professional organization that provides its members with continuing education and other resources and holds them to a code of ethics.

[News Release 2010-1 (January 4, 2010)]

**FINANCIAL DISTRESS**

T.D. 9469
I.R.C. § 108

Final regulations explain the allocation of excess losses and deductions of an S corporation after a reduction of tax attributes resulting from a discharge of indebtedness.

**Allocation of Excess Losses and Deductions After an I.R.C. § 108(b) Tax Attribute Reduction**

I.R.C. § 108 provides special rules for an S corporation that has cancellation of debt (COD) income. I.R.C. § 108(d)(7)(A) provides, in part, that the rules under I.R.C. § 108(a) for the exclusion of COD income and under I.R.C. § 108(b) for the reduction of tax attributes are applied at the corporate level, including by not taking into account under I.R.C. § 1366(a) any amount excluded under I.R.C. § 108(a). Therefore, if an S corporation excludes COD income from its gross income under I.R.C. § 108(a), the amount excluded is applied to reduce the S corporation’s tax attributes under I.R.C. § 108(b)(2). Under I.R.C. § 108(b)(4)(A), the reduction of tax attributes occurs after the S corporation’s items of income, loss, deduction and credit for the taxable year of the discharge pass through to its shareholders under I.R.C. § 1366(a). Under I.R.C. § 1366(d)(1), the aggregate amount of losses and deductions a shareholder can take into account under I.R.C. § 1366(a) cannot exceed the shareholder’s adjusted basis in the shareholder’s stock in the S corporation and the shareholder’s adjusted basis of any indebtedness of the S corporation to the shareholder. For purposes of the tax attribute reduction rule under I.R.C. § 108(b)(2), I.R.C. § 108(d)(7)(B) provides that any loss or deduction that is disallowed for the taxable year of the discharge under I.R.C. § 1366(d)(1) is treated as a net operating loss of the S corporation (deemed NOL).

I.R.C. § 1371(b)(1) states that no carryforward, and no carryback, arising for a taxable year for which a corporation is a C corporation may be
carried to a taxable year for which such corporation is an S corporation. This prohibition applies to tax attribute carryovers described in I.R.C. § 108(b)(2). For example, I.R.C. § 108(b)(2)(A) describes a net operating loss tax attribute as “any net operating loss for the taxable year of discharge and any net operating loss carryover to such taxable year.” Accordingly, I.R.C. § 1371(b)(1) prohibits an S corporation from using a C Year NOL as an S corporation tax attribute for purposes of I.R.C. § 108(b)(2). The same analysis applies to capital losses and business credits that arose in a C corporation taxable year.

One commentator suggested that the final regulations clarify how the allocation rules in Treas. Reg. § 1.108-7(d)(2) of the proposed regulations apply when an S corporation, with the consent of all affected shareholders, makes an election under I.R.C. § 1377(a)(2) (a terminating election). Regardless of whether a terminating election is made, all disallowed losses and deductions of a shareholder under I.R.C. § 1366(d)(1), including disallowed losses and deductions of a terminating shareholder, are treated as an S corporation’s deemed NOL. The impact of a terminating election on the allocation of the COD income, however, may result in a different allocation of the S corporation’s excess deemed NOL among the shareholders. Therefore, the final regulations add an example to clarify how the allocation rules apply when a terminating election is made.

I.R.C. § 108(d)(7)(B) provides that a deemed NOL is any loss or deduction that is disallowed for the taxable year of the discharge under I.R.C. § 1366(d)(1). I.R.C. § 1366(d)(1) specifically provides for the disallowance of losses due only to lack of basis. Therefore, a deemed NOL does not include losses suspended under I.R.C. §§ 465 or 469.

I.R.C. § 108(d)(7)(B) provides that any loss or deduction that is disallowed for the taxable year of the discharge under I.R.C. § 1366(d)(1) is treated as a deemed NOL of the S corporation. Accordingly, I.R.C. § 108(d)(7)(B) applies to any shareholder, including an ESOP shareholder, that has disallowed losses and deductions for the taxable year of the discharge under I.R.C. § 1366(d)(1).

Nondeductible, noncapital expenses that reduce basis under I.R.C. § 1367(a)(2)(D), including any that are carried over as a result of the elective ordering rule in Treas. Reg. § 1.1367-1(g), are not losses and deductions that can be taken into account by a shareholder under I.R.C. § 1366(a) and therefore are not included as disallowed losses and deductions under I.R.C. § 1366(d)(1) for purposes of I.R.C. § 108(d)(7)(B).

In some situations, an S corporation shareholder may have a different taxable year than the S corporation. The basis adjustments under I.R.C. § 1367 are determined as of the close of the S corporation’s taxable year. See Treas. Reg. §§ 1.1367-1(d)(1) and 1.1367-2(d)(1). Therefore, a shareholder’s disallowed losses and deductions under I.R.C. § 1366(d)(1) are determined for purposes of I.R.C. § 108(d)(7) as of the close of the S corporation’s taxable year.

Finally, one commentator recommended that the final regulations provide that all shareholders share tax attribute reductions in proportion to their ownership interests in the S corporation in all situations. The preamble to the proposed regulations noted that shareholders may be disproportionately impacted where the shareholders’ respective disallowed losses or deductions are disproportionate to their respective interests. However, the disproportionate impact that occurs in certain situations is a result of the statutory provisions of I.R.C. § 108. Therefore, the final regulations do not adopt this recommendation. In certain situations, an S corporation may eliminate or mitigate inequitable results by making an election under I.R.C. § 108(b)(5) to reduce the basis of its depreciable property before reducing its net operating loss.

**Character of Excess Deemed NOL Allocated to a Shareholder**

The proposed regulations provide an ordering approach for determining the character of the amount of the S corporation’s excess deemed NOL that is allocated to a shareholder. The approach in the proposed regulations is generally consistent with the ordering rules of I.R.C. § 108(b)(2) in that ordinary losses are reduced before capital losses. One commentator recommended that the final regulations adopt an approach that is consistent with the method for determining the character of a shareholder’s losses and deductions under I.R.C. § 1366(d). Under this approach, the S corporation’s excess deemed NOL that is allocated to a shareholder consists of a proportionate amount of each item of the shareholder’s loss or deduction that is disallowed for the taxable year of the discharge under
I.R.C. § 1366(d)(1). After considering this comment, the IRS and Treasury have decided to adopt this approach in the final regulations.

**Information Sharing Requirements**

The proposed regulations require a shareholder of an S corporation that excludes COD income from its gross income in a taxable year to report to the S corporation the amount of the shareholder's losses and deductions that are disallowed for the taxable year of the discharge under I.R.C. § 1366(d)(1) (shareholder-information reporting requirement). The proposed regulations also require the S corporation to report to its shareholders the amount of any excess deemed NOL that is allocated to a shareholder (S corporation information reporting requirement). Commentators recommended changes to the shareholder-information reporting requirement to minimize dependence on information furnished by shareholders who provide (intentionally or unintentionally) incorrect information or on shareholders who fail to furnish this information. One commentator explained that as a practical matter, an S corporation often maintains records for its shareholders and may possess all the requisite information to determine the amount of a shareholder’s suspended loss under I.R.C. § 1366(d). Another commentator requested that the final regulations provide consequences for shareholders who do not comply with the shareholder-information reporting requirement or who provide incorrect information.

After considering these comments, the final regulations modify the shareholder-information reporting requirement to alleviate the dependence on shareholders who fail to furnish information or who provide incorrect information. The final regulations provide that in certain situations, the S corporation may rely on its own books and records as well as other information available to the S corporation to determine the amount of a shareholder’s suspended loss under I.R.C. § 1366(d). Another commentator requested that the final regulations provide consequences for shareholders who do not comply with the shareholder-information reporting requirement or who provide incorrect information.

After considering these comments, the final regulations modify the shareholder-information reporting requirement to alleviate the dependence on shareholders who fail to furnish information or who provide incorrect information. The final regulations provide that in certain situations, the S corporation may rely on its own books and records as well as other information available to the S corporation to determine the amount of a shareholder’s suspended loss under I.R.C. § 1366(d)(1), provided that the S corporation knows that the amount reported by the shareholder is inaccurate, or the information, as provided, appears to be incomplete or incorrect. The final regulations do not adopt any special rules to provide for consequences to shareholders who either fail to report this information to the S corporation or report incorrect information to the S corporation. However, the IRS and Treasury note that I.R.C. § 6037(c) requires that a shareholder of an S corporation, on the shareholder’s return, treat a “subchapter S item” in a manner consistent with the S corporation return. The IRS and Treasury believe that the S corporation’s excess deemed NOL that is allocated to a shareholder is a “subchapter S item” for purposes of I.R.C. § 6037(c) and that the consequences of failure to comply with I.R.C. § 6037(c) are sufficient to encourage shareholders to cooperate with the S corporation in order to avoid inconsistencies between the S corporation’s return and the shareholder’s return.

**Effective Date**

The final regulations apply to discharges of indebtedness occurring on or after October 30, 2009.

[T.D. 9469 (October 30, 2009)]

**P.L.R. 2009-53-005**

I.R.C. § 108

☞ Indebtedness collateralized by an ownership interest in an entity owning real property is “secured by such real property” within the meaning of I.R.C. § 108(c)(3)(A).

**Facts**

The taxpayer is a domestic limited liability company that, for federal income tax purposes is classified as a partnership and, through a series of disregarded entities, owns an interest in another LLC that owns rental property. The taxpayer acquired a loan to renovate and rehabilitate the rental property through another related LLC. The loan is secured by the taxpayer’s interest in the LLC that owns the rental property. The taxpayer anticipates that future refinancing will result in a discharge of some of the debt.

**Issue**

Whether indebtedness collateralized by an ownership interest in an entity owning real property is “secured by such real property” within the meaning of I.R.C. § 108(c)(3)(A).

**Law and Analysis**

Under I.R.C. § 61(a)(12), gross income includes income from the discharge of indebtedness. I.R.C. § 108, however, excludes discharge of indebtedness income from gross income under certain circumstances, including income from the discharge of Qualified Real Property Business Indebtedness (QRPBI). I.R.C. § 108(a)(1)(D).
I.R.C. § 108(c)(3) sets forth the criteria for a debt to be QRPI. First, the debt must have been incurred or assumed “in connection with” real property used in a trade or business. Whether the “in connection with” requirement is satisfied is determined as of the time the debt was incurred or assumed. Second, at the time the debt is forgiven, it must be secured by the real property used in the trade or business. Third, the debt must have been incurred or assumed prior to 1993, or, if incurred or assumed after 1992, the debt must be qualified acquisition indebtedness as defined in I.R.C. § 108(c)(4). Qualified acquisition indebtedness is defined as indebtedness “incurred or assumed to acquire, construct, reconstruct or substantially improve” business real property. Finally, the taxpayer must elect to exclude the discharge of indebtedness income and reduce the basis of depreciable property.

Under I.R.C. § 108(c)(2)(A), the amount excluded is limited to the difference between the principal amount of the debt and the fair market value of the property at the time of discharge (less the amount of any senior, qualified debt).

“In connection with” Requirement
With respect to the ownership and management of the rental property, the taxpayer represents the following:

1. that through its managing member, the taxpayer has been actively engaged in the acquisition of the rental property and in the renovation and conversion project on a continuous basis;
2. a management company controlled by an individual who is an indirect owner of the taxpayer provides the day-to-day management of the operation and maintenance of the rental property; and
3. the taxpayer supervises the management activities.

The taxpayer further represents that the rental property is used in a trade or business. Based on the taxpayer’s representations, the IRS concluded that the debt meets the first requirement for QRPI status—it was incurred in connection with real property used in a trade or business.

Secured by the Real Property
The legislative history, as well as the statutory provision limiting relief to the amount by which the debt exceeds the value of the security, indicate that Congress intended for the exclusion to apply when debt secured by real property becomes undersecured due to a decline in the property’s value. Under these circumstances, rather than requiring a taxpayer to report discharge of indebtedness income when the debt is modified, the Code allows a taxpayer to reduce the basis of depreciable property (and take smaller depreciation deductions). The taxpayer’s circumstances in this case are those contemplated by Congress. The debt is junior debt that has become undersecured due to declining property value and which the parties wish to renegotiate.

Neither the statute nor the legislative history contains any explanation of or definition for the term “secured by such real property.” Mortgages are the most common mechanism by which lenders take a secured interest in real estate. But the legislative history of the Omnibus Budget Reconciliation Act of 1993 does not state that indebtedness is secured by real property only when that security is a mortgage. The fact that Congress used the more general term “secured by” rather than limiting the I.R.C. § 108 security interest to mortgages is indicative of its intent to include a broader range of security interests.

Economically, the debt is secured by real property. Upon default, the creditor acquires control of the rental property. The transaction was so structured to limit cost associated with the financing, to prevent delays in foreclosure of the pledged real property for the senior mortgage debt holder and to facilitate remarketing or securitization of the senior debt and related bonds. Any foreclosure on the debt will produce a transfer of all of the equity interest in the rental property. The only difference between this structure and that of a mortgage or deed of trust is the method of foreclosure.

For federal income tax purposes, the taxpayer owns the real property at issue and incurred the debt at issue. It would be incongruent to give significance to disregarded LLCs for purposes of determining whether the debt is secured by the real property and disregard them for all other purposes. The taxpayer’s debt is secured by the rental property.

Qualified Acquisition Indebtedness
Not all of the indebtedness was incurred to acquire, construct, reconstruct or substantially improve the property. For example, some of the indebtedness was incurred for the purpose of
making distributions to owners. Such indebtedness is not qualified acquisition indebtedness within the meaning of I.R.C. § 108(c)(4). The flush language of I.R.C. § 108(c)(3) supports the notion that debt can qualify under I.R.C. § 108(c) in part. The fact that a portion of a single debt does not meet the requirements of the statute does not disqualify the entire debt.

[P.L.R. 2009-53-005 (January 4, 2010)]

McCormick v. Commissioner
I.R.C. §§ 61 and 6201

[Facts]
The taxpayers challenged the $8,042.10 payoff amount that CitiFinancial Services claimed was due on a loan by asserting that a $492.44 insurance refund should have been credited to the loan. The taxpayers accepted an offer to settle for $7,500 and paid that amount.

The taxpayers challenged the alleged $2,875 account balance on a Chase Manhattan Bank credit card. Chase accepted their offer to pay the $1,000 “actually owed” and sent a Form 1099-C Cancellation of Debt, for the $1,875 difference.

[Issue]
Whether the taxpayers must recognize cancellation of debt income as reported on Forms 1099-C, Cancellation of Debt

[Discussion]
I.R.C. § 61(a)(12) includes in the general definition of gross income “income from discharge of indebtedness”. There must be evidence of a dispute; a settlement standing alone does not prove that a good-faith dispute existed.

In a fax sent to CitiFinancial the taxpayer argued that the loan payoff amount of $8,042.10 should be reduced by a $492.44 insurance refund. Aside from the insurance refund, the taxpayers do not argue that the payoff amount was incorrect.

In a letter sent to Chase the taxpayer argued that the outstanding balance should be $1,000 rather than the $2,875 claimed by the bank. Bank records reflected that the account had been disputed from at least 2002.

The preponderance of the evidence supports a conclusion that a bona fide dispute existed regarding the $492.44 insurance refund on the CitiFinancial debt and the balance of the Chase account over $1,000.

To determine the amount of cancellation of indebtedness income properly attributed to the taxpayers, we must determine the amount of the CitiFinancial and Chase debt that was definite and liquidated.

In this case, respondent may not rely on the Forms 1099-C submitted by CitiFinancial and Chase as evidence of the amount of debt that was definite and liquidated. I.R.C. § 6201(d) provides that in any court proceeding, if a taxpayer asserts a reasonable dispute with respect to any item of income reported on an information return and has fully cooperated, the Commissioner shall have the burden of producing reasonable and probative information concerning the deficiency in addition to the information return. The taxpayers have asserted reasonable disputes with respect to the amounts reported by CitiFinancial and Chase. Respondent has failed to produce reasonable and probative information independent of the third-party information returns.

The taxpayers did not dispute the CitiFinancial claimed payoff amount of $8,042.10, less the disputed insurance refund of $492.44, a total of $7,549.66. That amount is decreased by the settlement payment of $7,500. The court concluded that the amount of the taxpayers’ cancellation of indebtedness income from CitiFinancial is $49.66.

The taxpayers had an uncontested and liquidated outstanding balance of $1,000 with Chase. Because they paid $1,000 to settle the account, they have no cancellation of indebtedness income from Chase.

[McCormick v. Commissioner, T.C. Memo. 2009-239]


**INDIVIDUAL TAXPAYER ISSUES**

## Income

**Barr v. Commissioner**  
I.R.C. §§ 61 and 72

☞ Surrender of a life insurance policy, with proceeds applied to repay a loan, results in ordinary income. The taxpayer, an attorney, was negligent in failing to report the income.

### Facts

The taxpayer, a bankruptcy lawyer who was admitted to practice before the U.S. Tax Court, owned a whole life policy with his mother as the insured. Premiums were paid for 8 or 9 years; subsequent premiums were paid using accumulated dividends on the policy and loans against its cash value. In September 2005, a statement listed the net investment in the policy as $225,390, its total cash value as $361,353, the indebtedness as $354,399, and the built-in taxable gain as $135,963. A month later, the insurance company notified the taxpayer that the policy was in overloan and both the overloan amount ($1,541) and the premium due at that time ($2,286) must be paid to keep the policy in force.

The taxpayer decided the policy was no longer necessary and he surrendered it effective December 20, 2005. In 2005 he received and cashed an $11,648 check from the insurance company. In January 2006, he received a Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., showing a 2005 gross distribution and taxable amount of $135,963 (the $361,353 cash value plus a $4,694 terminal dividend, less $354,399 withheld to repay the outstanding policy loan balance). He timely filed his 2005 tax return but did not report the distribution. The IRS issued a notice of deficiency.

### Issues

1. Whether the surrender of a life insurance policy results in ordinary income or capital gain

2. Whether the taxpayer is liable for the I.R.C. § 6662(a) penalty

### Analysis

Amounts received upon the surrender of a life insurance contract that are not received as an annuity are specifically included in gross income to the extent that they exceed the investment in the contract [I.R.C. § 72(e)(5)(A), (C)]. The satisfaction of the loans had the effect of a pro tanto payment of the policy proceeds to the taxpayer and constituted income to him at that time. Thus, he constructively received the policy’s cash value without reduction for outstanding loans.

To recognize a capital gain or loss, a taxpayer must have engaged in a sale or exchange of a capital asset. Surrender of an insurance policy is not a sale or exchange of a capital asset and does not result in capital gain [Hellman v. Commissioner, 33 B.T.A. 901 (1936)].

A taxpayer may be liable for a 20% penalty on the portion of an underpayment of tax attributable to a substantial understatement of income tax or due to negligence or disregard of rules or regulations [I.R.C. § 6662(b)]. Negligence is strongly indicated where a taxpayer fails to include on an income tax return an amount of income shown on an information return. The accuracy-related penalty is not imposed with respect to any portion of the underpayment as to which the taxpayer acted with reasonable cause and in good faith [I.R.C. § 6664(c)(1)]. The decision as to whether a taxpayer acted with reasonable cause and in good faith depends upon all the pertinent facts and circumstances.

The taxpayer, an experienced attorney admitted to practice before the Tax Court, did not offer any authority for not reporting the income from the surrender of the policy on his return. Negligence does not require a bad intent or a willful act. The taxpayer knew, or should have known, that because he was the owner and beneficiary of the policy, any proceeds paid out or gain recognized would be taxable to him. His failure to report income shown on Form 1099-R was
not on account of reasonable cause and good faith.

**Holdings**

1. The surrender of the life insurance policy did not constitute the sale or exchange of a capital asset, and the taxpayer recognized $135,963 of ordinary income in 2005 from the surrender of the life insurance policy.

2. He is also liable for the accuracy-related penalty.

[**Barr v. Commissioner, T.C. Memo. 2009-250**]

**McGowan v. Commissioner**

I.R.C. §§ 72 and 108

Termination of a life insurance policy, with proceeds applied to repay a loan, does not result in excludable cancellation of debt income.

**Facts**

The taxpayers filed a joint return for 2004. In 1986, the wife purchased a single-premium variable life insurance policy (insurance policy) on her own life for $500,000. Upon her death, the policy would pay the beneficiary a benefit based on the return on investments made by the insurer and a guaranteed amount. The policy permitted her to borrow money at 5.25% with the policy’s value as collateral. By 1992 she had borrowed amounts totaling $536,500. Interest due was added to the outstanding loans if it was not paid annually. Her November 2003 monthly statement indicated that the net cash surrender value had been diminished by the loans to $2,782.

On March 1, 2004, the insurer issued a notice warning the insured that her outstanding debt exceeded the policy’s cash value and the policy would be terminated within 31 days if she did not make a $108,313 payment. That notice also stated that cancellation of the policy would be a taxable event, requiring her to recognize $562,746 of income plus interest that was still accruing. On March 30, 2004, the insurer sent a letter informing her that the policy was cancelled along with a Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance, Contracts, etc., that reported a $565,224 gain.

The couple did not treat the income as taxable on their 2004 income tax return, and the IRS issued a notice of deficiency.

**Issues**

1. Whether income from termination of a variable life insurance policy is income from the discharge of indebtedness

2. If it is income from the discharge of indebtedness, whether it should be excluded from gross income pursuant to I.R.C. § 108(g)

**Analysis**

Neither party disputed that the couple received income as a result of the termination of the variable life insurance policy or that they intended to report the income on their 2004 joint return. The dispute concerned the kind of income they received. The couple argued that their income arose from the discharge of a $1,065,224 debt.

A discharge of indebtedness occurs when “the debtor is no longer legally required to satisfy his debt either in part or in full” [**Caton v. Commissioner, T.C. Memo. 1995-80**]. The policy loans were not discharged: they were extinguished after the insurer applied the cash value of the insurance policy towards the debt. The deemed distribution from the insurance policy falls within the purview of I.R.C. § 72(e)(1), which mandates that a taxpayer include in gross income any amount that is received under an annuity, endowment, or life insurance contract that is not received as an annuity.

The $565,224 difference between the policyholder’s $500,000 investment in the contract and the policy’s $1,065,224 cash value on the date of cancellation was attributable to the previously untaxed inside buildup. It must now be recognized as income although it was applied to satisfy the policy loans, which had not previously been included in income.

**Holdings**

1. The income from termination of the life insurance policy is not income from cancellation of indebtedness.

2. The exclusion issue is moot because the income did not arise from cancellation of indebtedness.

[**McGowan v. Commissioner, T.C. Memo. 2009-285**]
**Wells v. Commissioner**
I.R.C. § 104

A settlement paid to a terminated employee for emotional distress is not excludable from income.

**Facts**
After an altercation with her supervisor at a state agency, the taxpayer filed a discrimination and retaliation complaint with the agency’s equal employment opportunity office. She then began taking leave and seeing a therapist to deal with the stress caused by the altercation. The agency terminated her employment when her leave was exhausted 10½ months later. From the date of the complaint until her termination, she was on leave for about 8 of the 10½ months.

She then filed a suit alleging employment discrimination based on gender, stating that the stress caused by the altercation and the agency’s perceived inaction in response to her complaint caused her to take leave. She asserted that when her leave was exhausted, her employment was terminated and she “was given no opportunity to return to her position.”

A summary judgment initially granted to the employer was reversed by an appellate court, which remanded the case for trial. The parties subsequently entered into a settlement agreement and requested dismissal of the suit. The settlement agreement stated that $175,000 was to be paid to the former employee “as damages for her emotional distress due to depression and other claims, not as wages or back pay,” and that it “shall constitute a full and final settlement of all claims [petitioner] asserted or might assert” against the defendants. The agreement also stated that a Form 1099-MISC, Miscellaneous Income, would be issued.

The taxpayer did not report the $175,000 as income on her 2005 income tax return and the IRS issued a notice of deficiency.

**Issue**
Whether a settlement payment received for emotional distress is excludable from income

**Analysis**
Damages (other than punitive damages) received on account of personal physical injuries or physical sickness may generally be excluded from gross income [I.R.C. § 104(a)(2)]. Under the statute as amended in 1996, damages for emotional distress resulting from nonphysical injury are not excludable from gross income, except for an amount of damages not in excess of the amount paid for medical care to treat the emotional distress. Money paid for emotional distress not attributable to physical injury or physical sickness is income, including amounts paid in such circumstances for physical symptoms of emotional distress.

When damages are received pursuant to a settlement agreement, the nature of the claim that is the basis for settlement controls whether the amount is excludable. If a settlement agreement lacks express language explaining the claims the amount was paid to settle, the court looks at the payer’s intent, based on all the facts and circumstances of the case, including the complaint that was filed and the details surrounding the litigation.

**Holding**
The payment is not excludable from the taxpayer’s gross income except to the extent of any amount she paid for medical care to treat her emotional distress.

[Wells v. Commissioner, T.C. Memo. 2010-5]

**P.L.R. 2009-46-006**
I.R.C. § 1033

Sale of escheated stock and return of the proceeds to the taxpayer was an involuntary conversion.

**Facts**
The taxpayer is a family limited partnership holding investments for the benefit of the partners. Because the original trustee for the taxpayer died, an escrow agent who held stock for the taxpayer could not locate the taxpayer and therefore transferred the stock to the state in accordance with the state’s unclaimed property law. The state sold the stock and retained control of the cash proceeds. When the taxpayer later became aware of the unclaimed property, it placed a claim with the state and received the proceeds from the sale of the stock.

**Issue**
Whether the taking of stock by the state pursuant to the state's unclaimed property law qualifies as an involuntary conversion under I.R.C. § 1033 because it is “the destruction, theft, seizure, requisition or condemnation or threat or imminence thereof.”
**Law and Analysis**

**Seizure**

I.R.C. § 1033 provides no definition of the term “seizure.” The provisions found in I.R.C. § 1033 extend back to the Revenue Act of 1921. Neither the legislative history to that act or to subsequent acts amending I.R.C. § 1033 or its predecessor provisions sets forth guidance regarding the specific meaning of the term “seizure.”

Upon the sale of stock by the state, its law required the commissioner to deposit the proceeds into the state’s general fund. It follows that money deposited in the general fund is expended for state purposes. Moreover, state was not required to pay the taxpayer interest on the proceeds from the sale of the taxpayer’s seized stock nor was the taxpayer entitled to any earnings the state derived from such proceeds. Regardless of whether a seizure occurred prior to the state’s sale of the stock, once the state sold the stock the proceeds were held for public use and there was a completed seizure of the taxpayer’s property within the meaning of I.R.C. § 1033(a).

**Involuntary Conversion into Money**

I.R.C. § 1033 defers only gains resulting from compulsory or involuntary conversions. The conversion into money or other property must occur from circumstances beyond the taxpayer’s control. Thus, in an extreme example, a taxpayer who, in an attempt to obtain insurance proceeds, commits arson by voluntarily paying a third party to burn down the taxpayer’s building is not entitled to the benefits of I.R.C. § 1033. Rev. Rul. 82-74, 1982-1 C.B. 110.

The taxpayer represents that it did not intentionally fail to exercise ownership rights with regard to its stock for the purpose of having such stock transferred to and sold by the commissioner pursuant to the state’s unclaimed property law. Assuming this representation to be true, the taxpayer should not be precluded from the tax benefits of I.R.C. § 1033 because of the requirement that conversion be involuntary.

The taxpayer’s trustee represents that to the best of his knowledge he did not receive a letter or other notification informing of the pending transfer of stock prior to its transfer to the state. The trustee also represents that he did not receive any notice from the state that it had taken custody of the taxpayer’s stock prior to its sale by the state, nor did the state notify him that it was going to sell such stock prior to its sale. Under such circumstances an argument still might be advanced that the trustee was negligent in not taking notice of the state’s escheat provisions and in failing to take action to prevent the escheat of the taxpayer’s stock. We find these arguments unnecessary to address in the context of ruling on this matter because negligence on the trustee’s part, even if it were proved, would not preclude the application of I.R.C. § 1033 to any gain from the sale of the taxpayer’s stock by the state. Consequently, we find the involuntary element of the statute met.

**Replacement Period**

I.R.C. § 1033(a)(2)(B)(i) generally requires a taxpayer to purchase qualifying replacement property by the close of the period ending 2 years after the close of the first taxable year in which any part of the gain upon the conversion is realized.

The taxpayer realized gain at the time it had unrestricted access to the money into which that property had been converted. Therefore, the date the state yielded its interest in the cash money proceeds of the sold property, should be considered as the beginning of the 2-year replacement period.

**Qualified Replacement Property**

Generally, replacement property does not qualify as “similar or related in service or use” unless its physical characteristics and end uses are similar to those of the converted property. When an investor owns property that is involuntarily converted, however, the inquiry shifts primarily to the similarity in the relationship of the services or uses which the converted and replacement properties have to the owner-investor.

When an investor’s property is involuntarily converted, the investor is entitled to consider the manner in which the converted property was held in determining whether the proposed replacement property will be similar or related in service or use. The IRS generally does not distinguish among various types of equity securities for purposes of I.R.C. § 1033. Rev. Rul. 66-355, 1966-2 C.B. 302, holds that a taxpayer can replace common stock that was involuntarily converted with common stock, preferred stock, or mutual fund shares and treat the replacement property as similar or related in service or use within the meaning of I.R.C. § 1033. Foreign
stock is not outside the scope of the nonrecognition provisions of I.R.C. § 1033.

The taxpayer owned the stock for investment purposes. The risks to and activities required of the taxpayer with respect to the stock are comparable to the risks of investing in other publicly traded common and preferred stock and stock in publicly traded mutual funds. An investment in debt instruments, however, would not be similar or related in service or use to converted capital stock for purposes of I.R.C. § 1033.

**Conclusion and Ruling**

The taxpayer is entitled to avail itself of the nonrecognition provisions of I.R.C. § 1033 by replacing the “escheated” seized stock in issue sold by the state and involuntarily converted into money with qualified replacement property within the authorized 2-year replacement period, which began to run when the proceeds of the state’s sale were made available to the taxpayer.

[P.L.R. 2009-46-006 (July 29, 2009)]

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**INVESTMENT ISSUES**

**Fisher v. United States**

I.R.C. §§ 61, 354, 1001, 1011, and 1012

☞ A 2008 decision that a policyholder was not required to recognize income from a life insurance company demutualization was affirmed by the Federal Circuit Court of Appeals.

The following facts and analysis are summarized from the 2008 U.S. Court of Federal Claims opinion in Fisher v. United States, 102 A.F.T.R. 2d (RIA) ¶ 2008-5608 (Fed. Cl., 2008). The appellate court affirmed the decision without further commentary.

**Facts**

Prior to 2000, Sun Life Assurance Company (Sun Life) was a mutual life insurance and financial services company. Once a mutual company pays its claims and operating expenses, the profits belong to the policyholders. Typically, some of those profits are returned to the policyholders as dividends, which reduce premium payments, while the remainder is retained as surplus, often accumulating from year to year.

In 1999, Sun Life proposed a plan to its policyholders to demutualize. The policyholders would retain their insurance coverage at premiums that would be unaffected by the demutualization, but would receive shares of stock in a new holding company, Sun Life of Canada Holding Corp. (Financial Services), which would become the corporate parent of Sun Life. Those shares were to be exchanged for the ownership rights possessed by the participating policyholders, with approximately 20% of the shares being allocated to compensate for the loss of voting control and the remaining 80% of the shares being allocated to compensate for the loss of other ownership rights, including the right to receive a liquidating distribution.

Eligible policyholders were not required to take stock in exchange for their shares. They could elect to sell the shares issued in connection with a planned initial public offering (the **cash election**). A policyholder who made this election received an amount determined by multiplying the number of Financial Services Shares sold by the initial share price at which the share were sold in the initial public offering.

The demutualization plan was approved by the eligible policyholders and in early March 2000, Sun Life began its initial public offerings and received various regulatory approvals to proceed with the demutualization.

On May 19, 2000, in response to a request from the company, the IRS issued P.L.R. 2000-20-048 (February 2, 2000), which dealt with tax aspects of the demutualization. The IRS noted that ownership rights “cannot be obtained by any purchase separate from an insurance contract issued by [Sun Life].” It ruled that, under I.R.C. § 354(a)(1), “No gain or loss will be recognized by the eligible policyholders on the deemed exchange of their ownership rights solely for company stock.” It further opined that the “basis of the company stock deemed received by the eligible policyholders in the exchange will be the same as the basis of the ownership rights surrendered in exchange for such company stock,” that is, zero.

The IRS did not rule on the tax treatment to be afforded the cash received in lieu of shares exchanged for ownership rights.

When the demutualization took effect, the policyholder (trustee for a trust) received 3,892

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shares of Financial Services stock in exchange for its voting and liquidation rights. The cash surrender value of the taxpayer’s policy was $185,173, and the total policy premiums paid were $194,344. Opting for the cash election, the policyholder permitted Sun Life to sell the shares on the open market for $31,759. The policyholder reported the proceeds, unreduced by any basis adjustment, on a federal income tax return for 2000 and paid the resulting tax of $5,725. On February 11, 2004, he filed a timely claim seeking a refund of the money, and, upon the denial of that claim, filed suit.

Analysis

I.R.C. § 61(a)(3) provides that gross income includes gains derived from dealings in property. I.R.C. § 1001(a) states that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis for determining gain as provided in I.R.C. § 1011. When a taxpayer transfers only a portion of an asset, the basis generally must be apportioned between the portions disposed of and retained [Treas. Reg. § 1.61-6(a)]. The regulations presume these values are obtainable, stating that “only in rare and extraordinary cases will property be considered to have no fair market value” [Treas. Reg. § 1.1001-1(a)].

The open transaction doctrine is traced to Burnet v. Logan, 283 U.S. 404 (1931). In that case, the taxpayer sold stock of a closely held corporation that owned stock in a second corporation that owned a mine lease. She and the other shareholders exchanged the stock for cash and a stream of annual payments corresponding to the amount of iron ore extracted from the mine. The IRS argued that at the time of the sale the right to receive the mining royalties could be estimated based upon the amount of reserves at the mine, and that the transaction should be taxed based upon the value of that estimate. The U.S. Supreme Court demurred, holding that the shareholder was entitled to recoup her capital investment in the stock before paying income tax based on the supposed market value of the mineral payments. It reasoned that when the profit, if any, was actually realized, the taxpayer would be required to respond. The promise of future payments was in no proper sense equivalent to cash and had no ascertainable fair market value (FMV). Because the transaction was not a closed one, the shareholder could recover her capital investment before there was any taxable profit based on conjecture.

All the experts in the Fisher case subscribed to the same basic definition of FMV: essentially, the “price at which the property would change hands between a willing buyer and a willing seller, neither being under a compulsion to buy or to sell and both having reasonable knowledge of the relevant facts.” However, the experts parted company in deciding whether the nature of the ownership rights made them impossible or impractical to value or simply valueless. The taxpayer’s valuation expert opined that traditional methods could not be used to value the ownership rights because those rights were not separable or alienable. He concluded that, prior to the demutualization, an FMV of ownership rights separate from the policy itself was not determinable. The IRS’s experts also recognized that the ownership rights could not be purchased or sold separately from the purchase of an insurance policy, but they set the value of the ownership rights at zero because Sun Life had not incurred any costs in establishing those rights—prior to the demutualization, Sun Life had neither associated any cost with the ownership rights on its books nor accounted for the rights in pricing its policies.

Several factors have proven pivotal in deciding whether a rational basis exists for determining an asset’s FMV. The first focuses on the asset’s marketability, both in terms of whether it is separately sellable or alienable and, if so, whether an established or private market exists in which to effectuate that sale. A second factor focuses on whether there are any proxies that may be used to estimate the needed value (for example, recent sales or exchanges of assets comparable to the one being valued). The absence of such comparables provides further indication that the value of the asset cannot rationally be ascertained. Finally, an asset is more likely to be deemed insusceptible of valuation if its value is contingent upon facts and circumstances not possible to foretell with anything like fair certainty. If an expert lacks any rational basis upon which to value an asset, that ought to be strong indication that the asset is insusceptible of valuation.

Unless the Code specifies otherwise, an appraiser must take an asset as he finds it: the definition of fair market value anticipates a hypothetical sale not a hypothetical asset. Here, a critical feature that cannot be ignored is the fact the own-
ership rights were indivisible from the insurance policy.

“Open transaction” principles apply where costs are not identifiable to a particular asset, but instead represent investment in the business as a whole. The fact that no specific costs were allocated by Sun Life to the ownership rights merely reflects that those rights related to values associated with the business as a whole—the rights to vote for the entire board, to receive proceeds from the company’s liquidation, and to receive distributions in the case of a demutualization.

**Holding**
The appellate court affirmed the claims court’s decision that the policyholder did not realize any income on the sale of the stock and, therefore was entitled to the requested refund.


**Rosser v. Commissioner**
I.R.C. §§ 61, 162, and 179

There was no fixed and identifiable event that established a deductible loss from investments during the years at issue.

**Facts**
During 2004 the taxpayers made investments with Webb Group Financial Services (Webb Group). As early as May 2005 the Webb Group investors were notified that their investments might be in some financial jeopardy but a class action had been filed. On April 16, 2006, a receiver was appointed in the Superior Court of Forsyth County, North Carolina. On May 22, 2006, the court entered an order authorizing the receiver to make some payments of attorney’s fees and distributions. On or about June 15, 2006, the taxpayers filed proofs of claim with the receiver. The taxpayers received distribution form the Receiver’s Trust Account on January 10, 2007, and final net payments on or about September 29, 2008. The payments partially reimbursed the taxpayers for their losses through the Webb Group.

**Issue**
Whether the taxpayers sustained a deductible loss in 2005

**Opinion**
The taxpayers allege that a loss was incurred in 2005 with respect to investments they placed through the Webb Group.

I.R.C. § 165 allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. See also Treas. Reg. § 1.165-1(a). A loss is not sustained during the taxable year if there is a reasonable prospect of recovery. Treas. Reg. § 1.165-1(d)(2). Filing a lawsuit may indicate a reasonable prospect for reimbursement. To be allowable, a loss must be evidenced by closed and completed transactions that are fixed by identifiable events. Treas. Reg. § 1.165-1(d)(1).

No loss could be determined in 2004 or 2005. The stipulated documents show that the Webb Group investors were informed that a class action would be filed and that a substantial recovery was anticipated. On May 23, 2006, the taxpayers were informed that a written settlement agreement had been approved that would return a significant portion of the investors’ principal investment. On January 10, 2007, the taxpayers received partial payments on their investments made through Webb Group Financial Services. Finally the litigation ended, and on September 29, 2008, the taxpayers received final settlement checks.

The stipulated documents and taxpayers’ testimony shows that there was no fixed and identifiable event that established a deductible loss for the taxpayers during the years at issue and that there was during those years a significant prospect of recovery of the Webb Group loss through both litigation and the settlement agreement, which were concluded after the years at issue. Accordingly, the taxpayers are not entitled to a deduction in 2005 for a loss regarding their investments with the Webb Group.

*Rosser v. Commissioner*, T.C. Memo. 2010-6
The Making Work Pay Tax Credit is a refundable tax credit of up to $400 for individuals ($800 for married taxpayers filing joint returns). Taxpayers who are subject to withholding generally received a benefit of the credit in advance through withholding changes. The reduced withholding may cause some taxpayers to have too little tax withheld and a small balance due. Those likely to be affected are married couples with two incomes, individuals with multiple jobs, dependents, pensioners, social security recipients who also work, and workers without valid social security numbers. An estimated tax penalty may be imposed if the total tax on the return exceeds the tax withheld by $1,000 or more. The general requirement for prepayment of the tax is that the total paid through withholding and quarterly estimated tax payments must cover 90% of the tax on the return or 100% of the prior year’s tax (110% for higher income taxpayers).

If an estimated tax penalty results at least in part from the changes in the 2009 withholding tables, the IRS will waive the portion of the penalty due to the withholding table changes. Form 2210 must be filed to request the waiver.

- If the estimated tax penalty is due entirely to the changes in the withholding tables, complete only page 1 of Form 2210, checking box A in part II. No penalty calculation is required.
- If only part of the underpayment results from the withholding table changes, check Box B in Part II and complete Form 2210 through line 16 of Part III (short method) or through line 30 of Part IV (regular method) without regard to the waiver. Enter the amount of the penalty that is to be waived in parentheses on the dotted line next to line 17 (short method) or line 31 (regular method). Subtract the waiver amount from the total penalty figured without regard to the waiver and enter the remainder on line 17 (short method) or line 31 (regular method). Attach an explanatory statement to the return.

[Instructions to Form 2210]

A revised Form 5405 reflects major changes in the homebuyer credit that were made in November 2009 by the Worker, Homeownership, and Business Assistance Act of 2009, Pub. L. No. 111-92. The new law extended the credit to a broader range of home purchasers and added new documentation requirements to deter fraud and ensure taxpayers properly claim the credit.

Taxpayers claiming the credit must file a paper return because of added documentation requirements. In addition to Form 5405, eligible homebuyers must include one of the following documents to receive the credit:

- A copy of the settlement statement showing all parties’ names and signatures, the property’s address, sales price, and date of purchase. Normally, this is the properly executed Form HUD-1, Settlement Statement.
- Mobile home purchasers who are unable to get a settlement statement should attach a copy of the executed retail sales contract showing all parties’ names and signatures, the property’s address, purchase price, and date of purchase.
- For a newly constructed home where a settlement statement is not available, the documentation is a copy of the certificate of occupancy showing the owner’s name, the property address, and the date of the certificate.

A long-time resident of the same main home may claim the homebuyer credit for the purchase
of a new principal residence. To qualify, eligible taxpayers must show that they lived in their old homes for a 5-consecutive-year period during the 8-year period ending on the purchase date of the new home. The IRS encourages homebuyers claiming this part of the credit to avoid refund delays by attaching documentation covering the 5-consecutive-year period, such as

- Form 1098, Mortgage Interest Statement, or substitute mortgage interest statements
- Property tax records, or
- Homeowner’s insurance records.

The IRS expects to start processing 2009 tax returns claiming the homebuyer credit in mid-February. Normally, it takes 4 to 8 weeks to receive a refund claimed on a complete and accurate paper return where all required documents are attached. For those homebuyers filing early, the IRS expects the first refunds based on the homebuyer credit will be issued toward the end of March.

[IR-News Rel. 2010-3 (January 15, 2010)]

**Notice 2009-93**
I.R.C. §§ 6041, 6109, and 6724

☞ A pilot program allows filers of information returns to truncate an individual payee’s nine-digit identifying number on paper payee statements for calendar years 2009 and 2010.

**Background**

An information return is a return, statement, form, or other document that must be filed with the IRS to report certain payments or distributions to a payee or amounts received from a payee in a calendar year. A filer is any person required to file an information return. A payee is any person who is required to receive a copy of the information set forth on an information return by the filer of the return. Generally, filers are required to furnish payee statements to payees on or before January 31st (in some instances on or before February 15th) of the year following the calendar year for which the information return is made. Filers may be subject to penalties for failure to file correct information returns or furnish correct payee statements.

Regulations, forms, or instructions to forms typically require that the payee statement include the payee’s identifying number. Individual identifying numbers are nine-digit numbers taking the form 000-00-0000. A person’s identifying number is sensitive personal information. A risk exists that this information could be misappropriated from a payee statement and misused in various ways, such as to facilitate identity theft. In an effort to minimize this risk, this notice creates a pilot program allowing truncation of individual identifying numbers on certain paper payee statements.

**Scope**

This notice only applies to paper payee statements in the Form 1098 series, Form 1099 series, and Form 5498 series. Substitute and composite substitute statements that meet the requirements of this notice are also included. (See Rev. Proc. 2008-36, 2008-33 I.R.B. 340, reprinted as Publication 1179, General Rules and Specifications for Substitute Forms 1096, 1098, 1099, 5498, W-2G, and 1042-S. This notice does not apply to any information return filed with the IRS, any payee statement furnished electronically, or any payee statement not in the Form 1098 series, Form 1099 series, or Form 5498 series.

**Requirements**

A filer that satisfies the requirements set forth in this notice is authorized to truncate identifying numbers for individuals on paper payee statements for the calendar years 2009 and 2010. The IRS will treat a filer as having satisfied any requirement in Treasury and IRS guidance to include a payee’s identifying number on a payee statement if the following requirements are met:

1. The identifying number is a social security number, IRS individual taxpayer identification number, or IRS adoption taxpayer identification number.

2. The identifying number is truncated by replacing the first five digits of the nine-digit number with asterisks or Xs (for example, a social security number 123-45-6789 would appear on the paper payee statement as ***-**-6789 or XXX-XX-6789).

3. The truncated identifying number appears on a paper payee statement (including substitute and composite substitute statements) in the Form 1098 series, Form 1099 series, or Form 5498 series for calendar year 2009 or 2010.

**Facts**

No taxpayer-specific facts were provided. The IRS’s Ogden campus submitted general questions about calculating the assessment and refund/credit statute of limitations periods for employment taxes reported on Form 941, Employer’s Quarterly Federal Tax Return.

**Issues**

1. Whether a year’s Forms 941 may be aggregated and treated as a single return (rather than as four separate returns) for calculating the period of limitations for assessment (POLA) under I.R.C. § 6501(a) and the period of limitations for refunds and credits (POLRC) under I.R.C. § 6511(a)

2. Whether an overpayment of employment tax in one quarter can be moved to another quarter if the POLRC has expired for the quarter in which the overpayment occurred

**Analysis**

The analysis reviews the two tax law issues and applies them to two examples.

**Issue 1: Aggregation of Returns**

Form 941 is a quarterly filed return used to report an employer’s social security tax, Medicare tax, and income tax withholding obligations. Each Form 941 is a separate return and could have a different filing date for purposes of determining the limitations period for assessment or for claiming a refund or credit. Under I.R.C. § 6501(a), a 3-year POLA begins running on the date that the relevant return is filed. A return of employment tax filed prior to April 15th of the succeeding calendar year is deemed to be filed on April 15th of the succeeding calendar year. The filing date of an employment tax return filed after April 15th of the succeeding calendar year is the date the return is actually filed.

If all the quarterly employment tax returns for a calendar year are timely filed, the POLA with respect to each return is the same and is measured from April 15 of the succeeding calendar year. However, if a quarterly return is filed after April 15 of the succeeding calendar year, the POLA with respect to that return is measured from the date the Form 941 is actually filed. Because the POLA could vary for the tax reportable on each of the quarterly Forms 941, the Forms 941 should not be aggregated and treated as a single return for purposes of determining the POLA.

The same principles prohibit quarterly Forms 941 from being aggregated for POLRC purposes. Under I.R.C. § 6511(a), the period within which to file a refund claim ends either 3 years after the date the employment tax return is filed or 2 years from the time the tax was paid, whichever is later, or, if no return was filed, within 2 years from the time the employment tax is paid. I.R.C. § 6513(c)(1) states that a return of employment tax filed prior to April 15th of the succeeding calendar year is deemed to be filed on April 15th of that year. An employment tax return filed after April 15th of the succeeding calendar year is considered filed on the date the return is actually filed. I.R.C. § 6513(c)(2) provides that if a tax with respect to remuneration or other amount paid during any period ending with or within a calendar year is paid before April 15 of the succeeding calendar year, the tax shall be considered paid on April 15 of that year.

Because the limitations period for filing a refund claim may vary depending upon the filing date of each quarterly Form 941, the quarterly Forms 941 should not be aggregated and treated as a single return for purposes of determining the POLRC.

**Issue 2: Application of Credit**

Within the applicable I.R.C. § 6511 period of limitations, the IRS may credit the amount of an overpayment against any tax liability of the person who made the overpayment and, subject to certain offsets, refund any balance to the person [I.R.C. § 6402]. I.R.C. § 6413 allows an overpayment of employment tax to be adjusted without interest within the applicable period of limitations on credit or refund. Consequently, an overpayment of employment taxes in one quarter may be credited to another quarter or refunded to the taxpayer subject to the applicable POLRC. Thus, a credit for an overpayment of employment taxes can be applied to another quarter only...
if the POLRC remains open for the quarter in which the overpayment occurred.

**Example 1: Form 941 Not Filed**

An employer makes a timely deposit of tax for the first quarter of 2004, does not file a Form 941 for that quarter of 2004, and timely files Form 941 for the last three quarters of the year. Prior to expiration of the POLRC for the fourth quarter of 2004, the IRS adjusts the liability for the fourth quarter so that the total of the second, third and fourth quarter liabilities agree with the taxes reported on the corresponding Forms W-2, which results in a fourth quarter underpayment. Employer requests in January 2009 that the deposits from the first quarter of 2004 be treated as an overpayment and applied to satisfy the fourth quarter underpayment.

Because a return was not filed, it is not clear that there is any overpayment to be applied from the first quarter. Absent the filing of a return, the POLRC expired on April 15, 2007, so that the employer cannot successfully claim a credit in January 2009 for any overpayment that might exist. Had the employer timely filed a Form 941 for the first quarter of 2004, the deemed filing date would be April 15, 2005, and the POLRC would have expired on April 15, 2008. The employer would still not be entitled to a credit for a first quarter overpayment because the credit was not requested until January 2009, after the POLRC would have expired.

**Example 2: Late-Filed Form 941**

An employer timely deposits taxes for all quarters of 2005 and timely files Forms 941 for the third and fourth quarters of 2005 but does not file Forms 941 for the first and second quarters of 2005. The employer receives a letter from the IRS on May 1, 2009, informing it that it has payments on quarters where no return has been filed and asking that it file the missing returns. On May 15, 2009, the employer files the missing returns for first and second quarters of 2005 and determines that deposits made in 2005 for the first quarter of 2005 were in excess of its first quarter liability and that deposits made in 2005 for the second quarter were insufficient to cover its second quarter liability. When the employer files the missing returns, the employer requests that the overpayment from the first quarter be applied to the second quarter underpayment.

The POLRC expires on the later of the end of the 3-year period from the time the return is filed or the 2-year period from the time the tax is paid. In this example, the POLRC begins to run from May 15, 2009. Therefore, the POLRC expires on May 15, 2012, 3 years from the May 15, 2009 actual filing date.

However, the employer is not entitled to the credit, even though the claim for the credit is made within the POLRC. I.R.C. § 6511(b)(2)(A) states that if a claim for a refund is filed within the 3-year period from the filing date of the return, the amount of the credit or refund is limited to the amount paid within the 3-year period immediately preceding the filing of the claim (plus the period of any extension of time for filing the return). Because the Forms 941 were filed on May 15, 2009, the employer’s claim for credit is limited to payments made on or after May 15, 2006. The 2005 tax deposits, which were timely made, are deemed to have been paid on April 15, 2006, and fall outside this look-back period. Thus, the first quarter credit overpayment cannot be applied to satisfy the second quarter underpayment.

If there had been an underpayment in the first quarter, rather than an overpayment, the IRS could assess the underpayment on May 15, 2009. The POLA expires 3 years from the date a Form 941 is filed or deemed to be filed. Because the employer did not file its Form 941 for the first quarter of 2005 before April 15, 2006, the POLA is calculated from the date the employer actually filed the Form 941 (May 15, 2009). The POLA expires 3 years after that date, on May 15, 2012.

**Conclusions**

1. In calculating the POLA and the POLRC, quarterly Forms 941 should not be aggregated and treated as a single return for a taxable year because the limitations periods may vary depending on the date each quarterly Form 941 is filed.

2. An overpayment of employment tax in one quarter cannot be moved to another quarter if the POLRC has expired for the quarter containing the overpayment.

[C.C.A. 2009-50-012 (September 24, 2009)]
Cavoto v. Hayes
I.R.C. § 6050P

# RULINGS AND CASES

Issuance of Form 1099-C for a legitimate bad debt by a person who is not required to file the form is not fraudulent.

Facts
Mary Lou Hayes filed a Form 1099-C, Cancellation of Debt, information return with her 2006 federal income taxes, in which she reported her cancellation of unpaid debts allegedly owed to her by her former son-in-law, Robert F. Cavoto. While he was married to Hayes’s daughter, Hayes allowed the couple to have their own charge cards issued on Hayes’s American Express account, which the couple used for business and personal expenses.

The case arises from a disagreement concerning $30,238 in charges made to that account. Hayes claims that in late 2002, at Cavoto’s request, Hayes made payments to American Express with the understanding that Cavoto would pay her back. She repeatedly tried to collect the debt to no avail. On or around December 8, 2006, she concluded that the debt was uncollectable and cancelled it.

Cavoto denied that there was ever any loan agreement in place; disputed that the charges in question are imputable to him, rather than to Hayes’s daughter; insisted that he paid for all charges to the account for which he was ever personally responsible; maintained that Hayes reported her “cancellation” of his alleged debt in order to take an additional income tax deduction for 2006; and generally disputed all of Hayes’s material allegations. He filed a suit claiming that Hayes’s Form 1099C filing was fraudulent and actionable under I.R.C. § 7434 because Hayes was not an “applicable entity” under I.R.C. § 6050P and was therefore prohibited from filing a Form 1099-C.

Issue
Whether a nonapplicable entity commits actionable fraud simply by filing a Form 1099-C

Analysis
Form 1099-C is an information return on which a taxpayer reports the amount of a discharged debt and identifies the debtor. The filing of this information return is governed by I.R.C. § 6050P, which provides, in relevant part, that “[a]ny applicable entity which discharges (in whole or in part) the indebtedness of any person during any calendar year shall make a return . . . .” An applicable entity is a governmental agency, a financial institution, or other organization in the business of lending money.

Hayes conceded that she is not an applicable entity and that I.R.C. § 6050P does not require her to file a Form 1099-C. She argues only that it does not forbid her from doing so.

Cavoto argued that “the plain language of 6050P . . . is intended to restrict or limit” the filing of a Form 1099-C to applicable entities. The court opined that “on the contrary, the plain language does not forbid anyone from filing an information return; it merely says that applicable entities shall—that is, must—file a Form 1099-C when discharging a debt of at least $600. It simply does not follow that only applicable entities may file a Form 1099-C.”

Holding
The filing of a Form 1099-C by someone other than an applicable entity is not fraudulent or actionable per se under I.R.C. § 7434. The court emphasized the narrow scope of its holding; whether Hayes filed an erroneous or fraudulent return is for a jury to decide.

[Cavoto v. Hayes, 104 A.F.T.R.2d (RIA) ¶ 2009-6962 (D-N. Ill., 2009)]
The Energy Improvement and Extension Act of 2008, Pub. L. No. 110-343, amended I.R.C. § 6045(b) to change the deadline for furnishing certain information statements to customers from January 31 to February 15. The statements are Form 1099-B, Proceeds From Broker and Barter Exchange Transactions; Form 1099-S, Proceeds From Real Estate Transactions; and, for reporting payments to attorneys or substitute payments by brokers in lieu of dividends or interest, Form 1099-MISC, Miscellaneous Income. On February 2, 2009, the IRS published Notice 2009-11, 2009-5 I.R.B. 420, which provided that brokers had until February 17, 2009, to report all 2008 items that they customarily reported to recipients on composite statements. Notice 2009-11 applied to calendar year 2008 items only.

This notice provides that certain reporting entities that are required to furnish information statements under I.R.C. § 6045 have until February 16, 2010, to report several items they would otherwise be required to report by February 1, 2010. The additional time provided by this notice applies to the following forms if the requirements of this notice are met: Form 1099-DIV, Dividends and Distributions; Form 1099-INT, Interest Income; Form 1099-MISC, Miscellaneous Income; Form 1099-OID, Original Issue Discount; Form 1099-PATR, Taxable Distributions Received From Cooperatives; Form 1099-Q, Payments From Qualified Education Programs (Under I.R.C. §§ 529 and 530); Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.; and Form 5498, IRA Contribution Information.

The additional time applies only to items that a reporting entity must report to the recipient based on the same relationship between the reporting entity and the recipient as the items required by I.R.C. § 6045 (for example, broker, payer, or real estate settlement agent to customer), and not as a result of any other relationship between the parties, such as debtor to creditor or employer to employee. If a customer has a brokerage account for which a Form 1099-B would be required to be furnished if a sale occurred during the year, the additional time applies to other items the broker must report to the customer based on the broker-customer relationship, regardless of whether there is an obligation to furnish a 2009 Form 1099-B to that customer.

This notice modifies the 2009 General Instructions for Forms 1099, 1098, 3921, 3922, 5498, and W-2G and applies to the reporting of items from calendar year 2009 only. Notice 2009-11 is amplified.

[Notice 2010-9, 2010-3 I.R.B. 298]

IR-News Rel. 2010-3
I.R.C. §§ 6011, 6201, 6213, 6402, and more

Nine taxpayer notices have been reviewed and revised for clarity, effectiveness and efficiency. These notices account for about 2 million pieces of correspondence with individuals, businesses and exempt organizations.

“In the past, our notices often looked more like legal documents and not an effort to communicate clearly. The differences between the old and new notices are like night and day. They show the potential of our ongoing effort in this area,” IRS Commissioner Doug Shulman said.

The new format includes a plain language explanation of the nature of the correspondence, clearly states what action the taxpayer must take and presents a consistent, clean design. The new format also guides taxpayers to pages on the Web site www.irs.gov where they can find accurate and relevant information quickly and easily. Samples of the redesigned notices can be accessed at www.irs.gov/notices.

[IR-News. Rel. 2010-3 (January 11, 2010)]

T.D. 9466 and REG–108045–08
I.R.C. §§ 6229 and 6501

Temporary and proposed regulations specify that an overstatement of basis is an omission from gross income for the 6-year period that is applicable for assessing tax when more than 25% of the taxpayer’s gross income is omitted from the return.

Background
I.R.C. § 6501(e) provides that a taxpayer omits from gross income an includible amount that
exceeds 25% of the amount of gross income stated in the return, the tax may be assessed at any time within 6 years after the return was filed. I.R.C. § 6229(c)(2) provides that if a partnership omits from gross income an includible amount that exceeds 25% of the amount of gross income stated in its return, the minimum period for assessing tax attributable to its partnership items is extended to 6 years.

An omission from gross income is not further defined in I.R.C. § 6229(c) as it is in I.R.C. § 6501(e)(1)(A). But the courts have noted that I.R.C. § 6229(c) merely serves to extend the I.R.C. § 6501 period for each separate partner to a minimum expiration date computed from the date the partnership return is filed or due to be filed, whichever is later. In extending each partner’s I.R.C. § 6501 period under I.R.C. § 6229, Congress is presumed to give the language in I.R.C. § 6229, which is identical to language in I.R.C. § 6501, identical meaning.

For instance, in Son of Boss transactions described in Notice 2000-44, 2000-2 C.B. 255, gross income can be generated by the partnership when it sells an inflated basis asset or directly by the partner if the asset is first distributed to the partner before being sold. Thus, I.R.C. § 6501(e)(1)(A) defines an omission from gross income both for purposes of I.R.C. § 6501 and for any extension of I.R.C. § 6501 under I.R.C. § 6229.

**Definition of Gross Income**

I.R.C. § 6501(e)(1)(A)(i) provides that, in the case of a trade or business, the term gross income means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services.

Temporary regulations in T.D. 9466 clarify that, outside of the trade or business context, gross income for purposes of I.R.C. §§ 6501(e)(1)(A) and 6229(c)(2) has the same meaning as gross income as defined in I.R.C. § 61(a). Under I.R.C. § 61(a), gross income includes “gains derived from dealings in property.” The regulations under I.R.C. § 61(a) further explain that gain equals “the excess of the amount realized over the unrecovered cost or other basis for the property sold or exchanged.” Accordingly, outside the context of a trade or business, any basis overstatement that leads to an understatement of gross income under I.R.C. § 61(a) constitutes an omission from gross income for purposes of I.R.C. §§ 6501(e)(1)(A) and 6229(c)(2).

**Contrary Court Decisions**

Relying on the Supreme Court’s opinion in Colony v. Commissioner, 357 U.S. 28 (1958), which dealt with an omission from gross income in the context of a trade or business, the U.S. Courts of Appeals for the Ninth Circuit and the Federal Circuit recently construed I.R.C. § 6501(e)(1)(A) in cases outside the trade or business context contrary to this interpretation in the temporary regulations. Those courts held that an omission does not occur by an overstatement of basis [Bakersfield Energy Partners v. Commissioner, 568 F.3d 767 (9th Cir., 2009); Salman Ranch Ltd. v. United States, 573 F.3d 1362 (Fed. Cir., 2009)].

**History of Code Section**

The Treasury Department and the IRS disagree with these courts that the Supreme Court’s reading of the predecessor to I.R.C. § 6501(e) in Colony applies to I.R.C. §§ 6501(e)(1)(A) and 6229(c)(2). When Congress enacted the 1954 Internal Revenue Code, it was aware of the disagreement among the courts that existed at the time regarding the proper scope of section 275(c) of the 1939 Internal Revenue Code. The changes that Congress enacted as part of the 1954 Internal Revenue Code predated the Supreme Court’s opinion in Colony and were intended to resolve the matter for the future. Therefore, by amending the Internal Revenue Code, including the addition of a special definition of gross income with respect to a trade or business, Congress effectively limited what ultimately became the holding in Colony to cases subject to section 275(c) of the 1939 Internal Revenue Code.

Moreover, under section 6501(e)(1)(A) of the 1954 Internal Revenue Code, which remains in effect under the 1986 Internal Revenue Code, the definition of “gross income” in I.R.C. § 61 applies outside of the trade or business context. In this regard, the Treasury Department and the IRS agree with the opinions in Home Concrete & Supply, LLC v. United States, 599 F.Supp.2d 678 (E.D.-N.C., 2008) (overstatement of basis can constitute an omission from gross income for purposes of the 6-year period of limitations) and Brandon Ridge Partners v. United States, 100 A.F.T.R.2d (RIA) ¶ 5347, 5351 (M.D.-Fla., 2007).
Effect of Regulations
Consistent with the Ninth Circuit’s suggestion in Bakersfield, these temporary regulations clarify an “omission from gross income” under I.R.C. §§ 6501(e)(1)(A) and 6229(c)(2). The reasonable interpretation provided in these temporary regulations is entitled to deference even if the agency’s interpretation may run contrary to the opinions in Bakersfield and Salman Ranch.

Because these temporary regulations are a clarification of the period of limitations provided in I.R.C. §§ 6501(e)(1)(A) and 6229(c)(2) and are consistent with the secretary’s application of those provisions both with respect to a trade or business (that is, gross income means gross receipts), as well as outside of the trade or business context (the I.R.C. § 61 definition of gross income), they are applicable to all cases with respect to which the period for assessing tax under the applicable provisions has not expired before September 24, 2009.

Effect of Disclosure
I.R.C. § 6501(e)(1)(A)(ii) provides that an amount omitted from gross income does not include any amount disclosed on the return, or in a statement attached to the return, in a manner adequate to apprise the IRS of the nature and amount of the item. This adequate disclosure exception to the 6-year statute of limitations applies to omissions from gross income resulting from basis overstatements (as provided for in these temporary regulations) in the same manner as it applies to other omissions from gross income.

Accordingly, taxpayers who adequately disclose the nature and amount of the omissions from gross income resulting from dealings in property will not be subject to the extended 6-year statute of limitations. [T.D. 9466, 2009-43 I.R.B. 551; REG–108045–08, 2009-43 I.R.B. 557]

T.D. 9473
I.R.C. § 6159

Final regulations make few changes to the temporary regulations regarding installment agreements for payments of federal taxes.

Proposed Regulations Adopted
On March 5, 2007, a notice of proposed rulemaking (REG-100841-97, 2007-1 C.B. 763 [72 FR 9712]) was published in the Federal Register. The proposed regulations reflected current IRS administrative practice. No public hearing was requested or held. After consideration of the comments received, the proposed regulations are adopted as revised by this Treasury decision.

The final regulations adopt certain recommendations contained in the comments by clarifying two provisions of the proposed regulations.

1. The taxpayer may submit a request to modify or terminate the installment agreement, and such a request will not suspend the statute of limitations on collection. The taxpayer must comply with the existing installment agreement while the request is being considered.

2. The IRS may terminate an installment agreement if the taxpayer provides materially incomplete or inaccurate information in response to an IRS request for a financial update. [T.D. 9473, 2009-52 I.R.B. 945]
**Vinatieri v. Commissioner**  
I.R.C. §§ 6330 and 6343

A levy that creates an economic hardship must be released regardless of the taxpayer’s noncompliance in filing required returns.

**Facts**

The IRS issued a notice of intent to levy to collect unpaid federal income taxes for 2002. The taxpayer timely requested a due process hearing under I.R.C. § 6330. Petitioner told the settlement officer that she has pulmonary fibrosis and is dying. Because of her health she can only find part-time employment.

She submitted Form 433-A, Collection Information Statement for Wage Earners and Self-Employed Individuals, indicating she had monthly income of $800, expenses of $800, $14 cash on hand, and owned a 1996 Toyota Corolla sedan with 243,000 miles and a value of $300. If her wages are levied on, she will be unable to pay her reasonable basic living expenses. If her car is levied on, she will be unable to work.

The settlement officer could not find a record that the taxpayer had filed a return for 2005. The taxpayer explained to the settlement officer that the payroll company responsible for completing her 2005 Form W-2, Wage and Tax Statement, was no longer in business. She had attempted to get the tax information from the IRS, but the IRS had no information regarding her income for 2005.

The settlement officer stated in her log that the taxpayer meets the Internal Revenue Manual (IRM) criteria to have her account reported as currently not collectible because of hardship. However, the IRS Appeals Office issued a notice of determination to proceed with levy, stating that the taxpayer was not entitled to collection alternatives because she had not filed her 2005 federal income tax return.

The taxpayer timely petitioned for review of that determination under I.R.C. § 6330(d).

**Issues**

1. Whether a levy that creates an economic hardship must be released regardless of the taxpayer’s noncompliance with filing required returns
2. Whether a levy on the taxpayer’s wages or car would create an economic hardship that would require release of the levy

**Analysis**

I.R.C. § 6343(a)(1)(D) requires the IRS to release a levy upon all or part of a taxpayer’s property or rights to property if it determines that the levy is creating an economic hardship due to the financial condition of the taxpayer. A levy creates an economic hardship and must be released “if satisfaction of the levy in whole or in part will cause an individual taxpayer to be unable to pay his or her reasonable basic living expenses.”

I.R.C. § 6330(a) provides that no levy may be made on any property or right to property unless the IRS has provided 30 days’ notice to the taxpayer of the right to an administrative hearing before the levy is carried out. If the taxpayer makes a timely request for an administrative hearing, the hearing is conducted by the IRS Appeals Office before an impartial officer.

A taxpayer may petition the Tax Court to review the determination made by the Appeals Office. If the underlying tax liability is not at issue, the court reviews the Appeals Office’s determinations for abuse of discretion. An abuse of discretion occurs if the Appeals Office exercises its discretion “arbitrarily, capriciously, or without sound basis in fact or law.”

The IRS argued that there is no abuse of discretion if a settlement officer rejects collection alternatives because the taxpayer was not in compliance with the filing requirements for all required tax returns. The court that in prior cases it generally has found the IRS policy requiring individuals seeking collection alternatives to be current with filing their returns to be reasonable, but taxpayers in the cited cases had sufficient income to meet basic living expenses.

Neither I.R.C. § 6343 nor the regulations condition a release of a levy that is creating an economic hardship on the taxpayer’s compliance with filing and payment requirements. The purpose of I.R.C. § 6330 is to “afford taxpayers adequate notice of collection activity and a meaningful hearing before the IRS deprives them of their property” [S. Rept. 105-174, 1998-3 C.B. 537, 603].

A determination in a hardship case to proceed with a levy that must immediately be released is unreasonable and undermines public confidence that tax laws are being administered fairly. In a I.R.C. § 6330 pre-levy hearing, if the taxpayer has provided information that establishes the proposed levy will create an economic hardship, the hearing officer has discretion to order a release of the proposed levy.
hardship, the settlement officer cannot go forward with the levy and must consider an alternative.

**Holdings**

1. When a taxpayer establishes that a proposed levy would create an economic hardship, it is unreasonable for the settlement officer to determine to proceed with the levy.

2. A levy on this taxpayer’s wages or car would cause her to be unable to pay her reasonable basic living expenses, creating an economic hardship that requires release of the levy.

[Vinatieri v. Commissioner, 133 T.C. No. 16 (2009)]

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### NET OPERATING LOSSES

**Rev. Proc. 2009-52**  
I.R.C. § 172

The IRS explained the procedure for electing the 3, 4, or 5 year carryback of a 2008 or 2009 applicable NOL.

This revenue procedure prescribes when and how to elect under I.R.C. § 172(b)(1)(H) to carry back an applicable NOL for a period of 3, 4, or 5 years for

1. taxpayers that have not claimed a deduction for an applicable NOL
2. taxpayers that previously claimed a deduction for an applicable NOL, and
3. taxpayers that previously filed an election under I.R.C. §§ 172(b)(3) or 810(b)(3) to forgo the NOL carryback period.

**Background**

Taxpayers can carry an NOL for any taxable year back to each of the 2 years preceding the taxable year of the NOL or elect to relinquish the carryback period. The American Recovery and Reinvestment Tax Act of 2009, Div. B of Pub. L. No. 111-5, (February 17, 2009) (ARRA), amended I.R.C. § 172(b)(1)(H) to allow an eligible small business (ESB) to elect to carry back a 2008 applicable NOL for a period of 3, 4, or 5 years (the ARRA election). I.R.C. § 172(b)(1)(H)(i), as amended by the Worker, Homeownership, and Business Assistance (WHBA) Act of 2009 (Pub. L. 111-92, November 6, 2009), permits a taxpayer to elect to carry back its applicable NOL to 3, 4, or 5 years preceding the taxable year of the applicable NOL. This election is not limited to an ESB. The term “applicable net operating loss” means the taxpayer’s NOL for a taxable year ending after December 31, 2007, and beginning before January 1, 2010.

A taxpayer must make the election in a manner prescribed by the Secretary by the due date (including extensions) for filing the return for the taxpayer’s last taxable year beginning in 2009. The election is irrevocable and, in general, may be made for only one taxable year. However, a taxpayer that made or makes an ARRA election may also make an election under the WHBA Act for another taxable year.

The amount of an NOL that a taxpayer elects to carry back to the 5th taxable year preceding the taxable year of the loss to 50% of the taxpayer’s taxable income for the carryback taxable year. The taxable income for the carryback taxable year is computed without regard to the NOL for the loss year or any taxable year thereafter. The excess of the amount of the loss over 50% of the taxable income, as determined under I.R.C. § 172(b)(2), for the carryback taxable year is carried to later taxable years. For the carryback of an alternative tax NOL to the 5th taxable year preceding the taxable year of the loss, the 50% limitation is applied separately based on the alternative minimum taxable income. The I.R.C. § 172(b)(1)(H)(iv) limitation does not apply to an NOL carryback under the ARRA election.

A taxpayer that has elected to forgo a carryback for a loss for a taxable year ending before the date of enactment of the WHBA Act (November 6, 2009) may revoke that election before the due date (including extensions) for filing the return for the taxpayer’s last taxable year beginning in 2009.

**Application**

A taxpayer may make the election by attaching a statement to the taxpayer’s federal income tax return or amended return for the taxable year in which the applicable NOL arises. The election statement must state that the taxpayer is electing to apply I.R.C. §§ 172(b)(1)(H) or 810(b)(4) under Rev. Proc. 2009-52, and that the taxpayer is not a TARP recipient nor, in 2008 or 2009, an affiliate.
of a TARP recipient. The statement must specify the length of the NOL carryback period the taxpayer elects (3, 4, or 5 years).

A taxpayer must file the election statement with the taxpayer’s original or amended federal income tax return for the taxable year of the applicable NOL on or before the due date (including extensions) for filing the return for the taxpayer’s last taxable year beginning in 2009. The taxpayer must attach a copy of the election statement to the taxpayer’s claim for tentative carryback adjustment (Form 1045, Application for Tentative Refund; or Form 1139, Corporation Application for Tentative Refund) or amended return applying the applicable NOL to the carryback year. The due date for timely filing a claim for tentative carryback adjustment on Form 1045 or 1139 for a taxpayer that makes the election is extended to the due date (including extensions) for filing the return for the taxpayer’s last taxable year beginning in 2009.

Alternatively, a taxpayer may make the election by attaching an election statement to the appropriate form the taxpayer files applying the NOL carryback period the taxpayer elects. The election statement must state that the taxpayer is electing to apply I.R.C. §§ 172(b)(1)(H) or § 810(b)(4) under Rev. Proc. 2009-52, and that the taxpayer is not a TARP recipient nor, in 2008 or 2009, an affiliate of a TARP recipient. The statement must specify the length of the NOL carryback period the taxpayer elects (3, 4, or 5 years). The appropriate form is

1. For corporations, Form 1139 or Form 1120X, Amended U.S. Corporation Income Tax Return;
2. For individuals, Form 1045 or Form 1040X, Amended U.S. Individual Income Tax Return;
3. For estates or trusts, Form 1045 or amended Form 1041, U.S. Income Tax Return for Estates and Trusts.
4. For tax exempt organizations with unrelated business income, Form 1139 or amended Form 990-T, Exempt Organization Business Income Tax Return (and proxy tax under I.R.C. § 6033(e)).

When using an appropriate form to make the election, the taxpayer must file the form on or before the due date (including extensions) for filing the return for the taxpayer’s last taxable year beginning in 2009. The taxpayer’s time for claiming a tentative carryback adjustment on Form 1045 or 1139 also is extended to this date.

A taxpayer that previously filed an application for a tentative carryback adjustment (whether or not the I.R.S. has acted upon the application) or an amended return (except to the extent that the application or claim was for an applicable NOL for which an ESB made an ARRA election) may make the election under the WHBA Act by following the procedures discussed above. The taxpayer’s election statement must state that the election amends a previous carryback application or claim.

A taxpayer that previously elected under to forgo the carryback period for an applicable NOL for a taxable year ending before November 6, 2009, may revoke that election and make the election under the WHBA Act by following the above procedures. The election statement must state that the election amends a previous carryback application or claim. The taxpayer’s election statement must state that the election amends a previous carryback application or claim.

A taxpayer that previously elected under to forgo the carryback period for an applicable NOL for a taxable year ending before November 6, 2009, may revoke that election and make the election under the WHBA Act by following the above procedures. The election statement must state that the election amends a previous carryback application or claim. The taxpayer’s election statement must state that the election amends a previous carryback application or claim.

Effective Date
This revenue procedure is effective for NOLs arising in taxable years ending after December 31, 2007.

NEW LEGISLATION

Pub. L. No. 111-118 (H.R. 3326)
I.R.C. § 139C

☞ The COBRA premium subsidy period for unemployed workers can be up to 15 months and the eligibility extends to employees terminated through February 28, 2010.

Background
I.R.C. § 139C provides a 65% premium subsidy to “assistance eligible individuals.” Under prior law, qualified beneficiaries were those eligible for COBRA continuation coverage because of the covered employee’s involuntary termination or reduction of hours of employment at any time from September 1, 2008 through December 31, 2009. The subsidy was permitted for a maximum of 9 months per beneficiary.

A qualifying individual pays 35% of the amount he would have to pay for COBRA continuation coverage if he were not eligible for the subsidy. The person to whom the premiums are payable—generally the employer—pays the other 65% of the COBRA continuation premium, and the federal government reimburses that person for the 65% of premium advance through a refundable payroll tax credit.

Explanation of Change
The COBRA premium subsidy period now terminates no later than the date that is 15 months after the first day of the first month for which the premium reduction applies to the individual. Additionally, the eligibility period based on termination of employment now extends through February 28, 2010.


Pub. L. No. 111-126 (H.R. 4462)
I.R.C. § 170

☞ Donors may accelerate to 2009 the income tax benefits of cash charitable contributions for the relief of victims of the earthquake in Haiti if the contributions are made before March 1, 2010.

Background
Taxpayers may claim an income tax deduction for qualifying charitable contributions made during the tax year. For calendar tax years, the tax benefit of a charitable contribution made in January or February is not realized until the following calendar year when the tax return is filed.

A donor who claims a charitable deduction for a charitable contribution of money, regardless of amount, must maintain as a record of the contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution.

An additional substantiation requirement applies for charitable contributions with a value of $250 or more—no charitable deduction is allowed unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgment of the contribution by the donee organization.

Explanation of Change
Taxpayers may treat charitable contributions of cash made after January 11, 2010, and before March 1, 2010, as contributions made on December 31, 2009, if such contributions are made for the purpose of providing relief to victims in areas affected by the earthquake in Haiti that occurred on January 12, 2010. The provision thus gives calendar-year taxpayers who make cash charitable contributions for Haitian earthquake-relief after January 11, 2010, and before March 1, 2010, the opportunity to accelerate their tax benefit by taking a deduction on their 2009 tax return.

The recordkeeping requirement for monetary contributions eligible for the accelerated income tax benefits is simplified for some contributions. A telephone bill will satisfy the recordkeeping requirement if it shows the name of the donee organization, the date of the contribution, and the amount of the contribution. If a charitable contribution is made by text message and chargeable to a telephone or wireless account, a bill from the telecommunications company containing the relevant information will satisfy the recordkeeping requirement.

Modified rules relate to the ability of a tax return preparer to use tax return information without taxpayer consent for the following purposes:

- Compiling, maintaining and using lists for solicitation of tax return business under Treas. Reg. § 301.7216-2(n)
- Disclosing and using statistical compilations of data described in Treas. Reg. §301.7216-1(b)(3)(i)(B) under §301.7216-2(o)
- Disclosing and using tax return information for the purpose of performing conflict reviews under §301.7216-2(p)

These modifications expand the ability of tax return preparers to disclose or use certain limited tax return information under specific and limited circumstances in a manner that is expected to benefit taxpayers, tax return preparers, and the general public. In the notice of proposed rulemaking, the Treasury Department and the IRS request comments on the proposed rules from all interested parties.

**Background**

On January 7, 2008, the Treasury Department and the IRS issued final regulations under I.R.C. § 7216 (T.D. 9375, 2008-1 C.B. 344) applicable to disclosures or uses of tax return information occurring on or after January 1, 2009. The Treasury Department and the IRS subsequently issued Notice 2009-13, 2009-6 I.R.B. 447, to provide interim guidance relating to the ability of a tax return preparer to disclose and use statistical compilations of anonymous tax return information in support of a tax return preparer’s tax return preparation business. These temporary regulations modify the rules under Treas. Reg. §§ 301.7216-2(n), 301.7216-2(o), and 301.7216-2(p), and supersede the interim guidance provided by Notice 2009-13.

Some commentators recommended that the prohibition on disclosing cells containing data from fewer than 25 tax returns be modified to allow for the disclosure of cells containing data from 10 or more tax returns. These commentators indicated that removal of all taxpayer-identifying information provides sufficient taxpayer protection and implied that it may not be feasible for tax return preparers who operate small tax return preparation businesses to always produce a statistical compilation that meets the 25 tax return threshold. This recommendation was adopted, and the temporary regulations now permit the disclosure of cells containing data from 10 or more tax returns.

One commentator recommended that the term **tax return preparation business** should include “bona fide research or public policy discussions (i) concerning state or federal taxation or (ii) utilizing data acquired during the tax return preparation process.” The commentator was concerned that the interim guidance would inhibit tax return preparers from cooperating with scholars or sharing anonymous data with bona fide academic researchers studying consumer financial behavior. The temporary regulations now clarify that a **tax return preparer is allowed to disclose an anonymous statistical compilation for bona fide research or public policy discussions concerning state or federal taxation or requiring data acquired during the tax return preparation process.**

**Treas. Reg. § 301.7216-2(n)**

The amendment provides a limited expansion of the information tax return preparers may, without taxpayer consent, use and include in lists for solicitation of tax return business. Lists for solicitation of tax return business may not be used to solicit non-tax return preparation services. The meanings of the phrases **tax information** and **in conjunction with the sale or other disposition of the compiler’s tax return business** are clarified.

A tax return preparer may compile and maintain a list for solicitation of tax return business consisting solely of the names, addresses, e-mail addresses, and phone numbers of taxpayers whose tax returns the preparer has prepared or processed. A tax return preparer may use this list to contact the taxpayers on the list to offer tax information or additional tax return preparation services to such taxpayers. A transfer of the list is
limited to transfers occurring in conjunction with the sale or other disposition of the compiler’s tax return preparation business.

The amendment adds e-mail addresses to the short list of information allowed to be included in the lists. It also expands the information that may be compiled and maintained in a list for solicitation of tax return business to include the taxpayer entity classification or type, including individual status, and taxpayer income tax return form number (for example, Form 1040, U.S. Individual Income Tax Return, or Form 1120, U.S. Corporation Income Tax Return).

The phrase tax information is replaced with the phrase tax information and general business or economic information or analysis for educational purposes. It is contemplated that tax information includes explanations of current developments in tax law.

The phrase in conjunction with the sale or other disposition of the compiler’s tax return preparation business is clarified to include due diligence performed in contemplation of a sale or other disposition of a tax return preparation business. Tax return information made available to a potential purchaser for due diligence purposes constitutes a disclosure of that information and not a transfer of that information.

The amendment also clarifies that a person who is a tax return preparer solely because he provides auxiliary services to another tax return preparer may not use the tax return information he receives from such other tax return preparer to compile and maintain a list of taxpayers for his own use. For example, a software company could market tax return preparation software to taxpayers directly and to tax return preparers. In connection with auxiliary services provided to tax return preparers, the software provider may receive information regarding the clients of the tax return preparers. In such circumstances, the software provider could not use the tax return information it received from tax return preparers in the performance of auxiliary services to compile a list to market its software directly to the clients of the tax return preparers.

**Treas. Reg. § 301.7216-2(o)**

The amendment provides additional exceptions to the general rule that a tax return preparer may not disclose or use statistical compilations of tax return information without taxpayer consent. Disclosure of statistical compilations is prohibited unless the disclosure is made to comply with financial accounting or regulatory reporting requirements or occurs in conjunction with the sale or other disposition of the compiler’s tax return preparation business. The amendment allows a tax return preparer to disclose statistical compilations of tax return information without taxpayer consent for additional limited purposes, with certain additional requirements.

Anonymous statistical data disclosed within the constraints provided by temporary regulations can be used by tax return preparers for marketing purposes and to assist taxpayers in making informed choices about tax return preparers. The availability of anonymous statistical data can be useful from a public policy perspective, as the use and availability of such data can assist lawmakers, academics, non-profits, and other agencies in the facilitation of sound tax policy analysis and decisions. In addition, volunteer tax return preparers who provide free tax return preparation services to low- and moderate-income taxpayers and families would be able to demonstrate the impact of their efforts in order to obtain and administer funding necessary for their continued operation.

In the context of marketing or advertising, the temporary regulations prohibit the use or disclosure of statistical compilations that identify dollar amounts of refunds, credits, or deductions associated with tax returns, whether or not the data are statistical, averaged, aggregated, or anonymous. The IRS will continue to rely on all existing enforcement powers to address concerns regarding advertising and marketing claims by tax return preparers.

Any disclosure of a statistical compilation, other than to satisfy reporting requirements or in conjunction with the disposition of a tax return business, must be anonymous as to taxpayer identity, meaning that it must be in a form which cannot be associated with, or otherwise identify, directly or indirectly, a particular taxpayer. Thus, the disclosure of statistical compilations with cells containing data from fewer than 10 tax returns is prohibited.

A tax return preparer is authorized to make statistical disclosures in conjunction with bona fide research or public policy discussions concerning state or federal taxation or requiring data acquired during the tax return preparation process, and to provide tax information to the public regarding tax return preparation services. I.R.C.
§ 501(c) organizations whose program services include the free preparation of tax returns may disclose statistical compilations to comply with reporting requirements in connection with the receipt of grants or to facilitate solicitation of grants. Lawful recipients of statistical compilations may disclose or use such tax return information, subject to the provisions of Treas. Reg. § 301.7216-2T(o).

*Treas. Reg. § 301.7216-2(p)*
The amendment clarifies that tax return preparers may use and disclose tax return information to the extent necessary to accomplish a conflict-of-interest review undertaken to comply with the requirements established by any federal, state, or local law, agency, board, or commission, or by a professional association ethics committee or board, to identify, evaluate, and monitor actual or potential legal and ethical conflicts of interest that may arise when a tax return preparer or tax return preparation business is employed or acquired by another tax return preparer or tax return preparation business, or when a tax return preparer is considering engaging a new client.

Temporary regulations add an exception to the written consent rules to allow disclosures of tax return information by a tax return preparer without taxpayer consent for the purpose of conducting conflict reviews, but only to the extent necessary to accomplish the reviews. For example, if the tax return preparer only needs to disclose the names of taxpayers, and nothing more, to allow the conflict review to be completed, then the tax return preparer shall not disclose any tax return information other than the taxpayers’ names.

The regulations contemplate that the information necessary to accomplish a conflict review shall be disclosed to and used by only those persons permitted to be involved in the conflict review as described in the applicable law or regulations or as authorized by the relevant agency, board, commission, or professional association. The regulations also contemplate that, in order for tax return preparers to fulfill the required conflict reviews, circumstances may require the preparer to disclose the information necessary to perform a conflict review outside of the United States or a territory or possession of the United States. If disclosure outside of the United States is required to conduct a conflict review, the disclosure is authorized by these regulations provided the disclosing and receiving tax return preparers have procedures in place that are consistent with good business practices and designed to maintain the confidentiality of the disclosed information. The regulations also include specific restrictions on the further use and disclosure of information disclosed under this exception.


*Rev. Rul. 2010-4*
I.R.C. §§ 6713 and 7216

This ruling provides guidance on whether a tax return preparer is liable for criminal and civil penalties when the preparer discloses or uses tax return information in communicating with taxpayers and in certain other circumstances.

**Issues**

1. Is a tax return preparer liable for penalties under I.R.C. §§ 6713 and 7216 when the tax return preparer uses tax return information to contact taxpayers to inform them of changes in tax law that could affect the taxpayers’ income tax liability reported in tax returns previously prepared or processed by the tax return preparer?

2. Is a tax return preparer, who is lawfully engaged in the practice of law or accounting, liable for the penalties when the tax return preparer uses tax return information of taxpayers whose tax returns the tax return preparer has prepared or processed to determine which taxpayers’ future income tax return filing obligations may be affected by a prospective change in a tax rule or regulation and to contact the potentially affected taxpayers for whom the tax return preparer reasonably expects to provide accounting services in the next year to notify them of the changed rule or regulation, explain how the change may affect them, and advise them with regard to actions they may take in response to the change?

3. Is a tax return preparer liable for the penalties when the tax return preparer discloses tax return information contained in the list permitted to be maintained by the tax return preparer under Treas. Reg. § 301.7216-2(n) to a third-party service provider that creates, publishes, or distributes, by mail or e-mail, newsletters, bulletins, or similar communications
to taxpayers whose tax returns the tax return preparers have prepared or processed containing tax information and general business and economic information or analysis for educational purposes or for purposes of soliciting additional tax return preparation services for the tax return preparer?

**Facts**
Tax Return Preparers A, B, C, D, and E prepared individual and corporate income tax returns for 2008 and several other past years and expect to prepare 2009 income tax returns in the upcoming 2010 filing season.

Prompted by legislation passed by the Congress in 2009 authorizing net operating losses (NOLs) for 2008 to be carried back up to 5 years, Tax Return Preparer A reviews income tax returns and other tax return information of taxpayers whose income tax returns A has prepared or processed, even if A has not been engaged to prepare the taxpayers’ most recent returns, to determine which taxpayer clients may be able to benefit from the expanded carryback rules. Following this review, A contacts the affected taxpayers to inform them of the change, advise them with regard to whether an amended return or returns can be filed for years affected by the change, and offer A’s tax return preparation services with regard to preparing and filing the amended returns. A then prepares and files amended returns for some of the taxpayers.

Also in 2009, the IRS issues a temporary regulation interpreting the manner that a tax credit is to be calculated in future tax years. Tax Return Preparer B, who is lawfully engaged in the practice of accountancy, is prompted by this temporary regulation to review the income tax returns of the taxpayers whose income tax returns B has prepared or processed, even if B has not been engaged to prepare the taxpayers’ most recent returns, to determine who among B’s clients may be affected by the revised credit calculation for tax year 2009. Following this review, B contacts those taxpayers to notify them of the change, explain how it may affect them, and suggest actions that the taxpayers may take to properly report the credit on their 2009 returns. B only contacts those taxpayers for whom B reasonably expects to provide accounting services with respect to the 2009 tax year, including taxpayers for whom B prepared an income tax return in previous years and who have not specifically informed B that they do not wish to be contacted by B or will not be using B’s income tax return preparation services in the upcoming filing season.

Tax Return Preparer C engages Third-party Service Provider X to publish both paper and electronic monthly newsletters containing educational tax information, tax tips, tax law updates, and direct solicitation for C’s tax return preparation business. C discloses to X the names and mailing addresses of taxpayers whose tax returns C has prepared or processed who have not provided C with an e-mail address, and X prints those addresses onto the paper newsletters it publishes for C. X provides C with the completed newsletters in paper and electronic format, and C then distributes them to C’s tax return preparation clients, using a list that contains the tax return information authorized by Treas. Reg. § 301.7216-2(n), including taxpayer names, addresses and e-mail addresses.

Tax Return Preparer D has in the past periodically published and delivered to D’s tax return preparation clients newsletters containing general educational tax information, tax tips, tax law updates, and direct solicitations for D’s tax return preparation business. Due to growth experienced by D’s tax return preparation business, D begins to outsource all aspects of this client communication activity to Third-party Service Provider X so that D may focus primarily on the business of tax return preparation. D discloses to X tax return information consisting solely of the names, addresses, and e-mail addresses of taxpayers whose income tax returns D has prepared or processed, and X then creates and distributes the newsletters to these taxpayers as directed by D.

Twice a month Tax Return Preparer E publishes her own newsletter containing general educational tax information, tax tips, tax law updates, and direct solicitations of E’s tax return preparation business. After publication, E sends the newsletters to Third-Party Service Provider X, and X then distributes the newsletters to taxpayers whose income tax returns E has prepared or processed, as instructed by E. To allow X to distribute the newsletters, E provides X with the names, addresses, and e-mail addresses of E’s tax return preparation clients.

Tax Return Preparers C, D, and E each have procedures in place that are consistent with good business practices and are designed to maintain the confidentiality of the disclosed tax return
information. By following these procedures, each concludes that X has sufficient data confidentiality procedures in place to protect the disclosed tax return information.

Third-party Service Provider X, located in the United States, is in the business of creating, publishing, and distributing newsletters, bulletins, advertisements, and similar communications. X does not provide substantive determinations or advice affecting the tax liability reported by taxpayers. X provides its services to tax professionals, including income tax return preparers. X creates, customizes, prints, and publishes newsletters containing general educational tax law updates it has aggregated from various sources, information on general filing requirements, general educational business or economic information and analysis, and tax compliance tips. X may also include in these communications any specific updates or solicitations submitted by its tax professional clients. X will also distribute these communications to taxpayers by mail or e-mail as directed by its clients.

Analysis

Issue 1
A change in the tax law that affects previously filed tax returns may require a tax return preparer to review taxpayer clients’ income tax return information to determine which of those clients may be affected by the change. Taxpayers who engage a tax return preparer can reasonably expect that their tax return preparer will advise them regarding a change in tax law that affects them and whether the change supports the filing of amended returns or other actions by the taxpayer related to any affected returns. A tax return preparer who performs this type of review in response to a change in tax law will contact the affected taxpayers to advise the taxpayers about the change in tax law and on a course of action to be taken, and can use a variety of mechanisms to do so (including direct contact, newsletters, e-mail, and other forms of communication).

I.R.C. § 7216 does not prohibit the use of tax return information when the use is for the purpose of preparing a tax return, which is defined as “any return (or amended return) of income tax imposed by chapter 1 of the Internal Revenue Code.” Treas. Reg. § 301.7216-1(b)(1) specifically includes amended returns in the definition of tax return. Accordingly, A’s use of client tax return information to identify affected taxpayers, inform them regarding the change in tax law, advise whether it would be appropriate for them to file amended income tax returns, and assist in the preparation and filing of any amended returns is permitted under I.R.C. § 7216, because those uses are for the purpose of preparing a tax return as defined in the regulations.

Issue 2
Treas. Reg. § 301.7216-2(h)(1)(i) allows a tax return preparer who is lawfully engaged in the practice of law or accountancy to use tax return information “for the purpose of providing other legal or accounting services to the taxpayer,” consistent with applicable legal and ethical responsibilities. “Other legal or accounting services” that are consistent with applicable legal or ethical responsibilities can include advice related to current and future income tax compliance. Taxpayers who engage a tax return preparer lawfully engaged in the practice of law or accountancy can reasonably expect that the tax return preparer will advise them regarding changes in tax rules and regulations that might affect a tax return being prepared or future income tax return filing obligations.

Accordingly, B, who is lawfully engaged in the practice of accountancy, may use tax return information of taxpayers whose tax returns B has prepared or processed, regardless of whether B prepared or processed the most recent tax returns for a taxpayer, to determine whether the taxpayers may be affected by the temporary regulations issued by the IRS, and to contact the potentially affected taxpayers in order to explain the regulations and to advise them regarding their response to the regulations. B’s use of tax return information permitted by Treas. Reg. § 301.7216-2(h)(1)(i) because it is for the purpose of providing other accounting services to taxpayers. B does not, however, use the tax return information of those taxpayers who have specifically informed B that they do not wish to be contacted by B or will not be using B’s income tax preparation services in the upcoming filing season.

Issue 3
Third-party service providers that create, publish, or distribute tax-focused newsletters, bulletins, or similar publication or communication services typically hold themselves out to tax return preparers and other tax professionals as
persons who perform services that are auxiliary to tax return preparation. These service providers also may monitor current tax events and have access to a broad range of knowledgeable tax and business professionals; they are able to provide current and relevant information to a tax return preparer’s clients while allowing the tax return preparer to focus on the business of tax return preparation.

X holds itself out as providing services that are auxiliary to tax return preparation. X’s services are provided in connection with the preparation of tax returns by C, D, and E because the services are intended to offer additional tax information and tax preparation services to the preparers’ clients. Treas. Reg. § 301.7216-2(n) specifically allows a tax return preparer to offer such information and additional services to clients. Because it provides services in connection with the preparation of tax returns by C, D, and E, and because C, D, and E have procedures in place that are consistent with good business practices and designed to maintain the confidentiality of the disclosed tax return information and, by following these procedures, they conclusively determined that X has sufficient data confidentiality procedures in place, X qualifies as both an auxiliary service provider and a tax return preparer under Treas. Reg. § 301.7216-1(b)(2)(i)(B).

C, D, and E may disclose to an auxiliary service provider, without taxpayer consent, tax return information to the extent necessary to obtain auxiliary services in connection with the preparation of any tax return under Treas. Reg. § 301.7216-2(d)(1), provided the service provider is located in the United States and the services provided are not substantive determinations or advice affecting the tax liability reported by taxpayers. X is located in the United States and does not provide substantive determinations or advice affecting the tax liability reported by taxpayers.

As directed by C, D, and E, X may use the names and mailing or e-mail addresses disclosed to it to contact the taxpayers for the purpose of creating, publishing, or distributing newsletters, or similar bulletins or communications, containing tax information and general business or economic information and analysis for educational purposes. The newsletters may include tax law developments, information on filing requirements, and tax compliance tips, together with solicitations for additional tax return preparation services by C, D, or E, under Treas. Reg. § 301.7216-2(n). The disclosure to X does not constitute a transfer under Treas. Reg. § 301.7216-2(n) but rather a disclosure to an auxiliary service provider pursuant to Treas. Reg. § 301.7216-2(d)(1).

X, however, is prohibited from the further use or disclosure of the tax return information provided to it by C, D, and E for purposes other than those related to the provision of the auxiliary services provided to C, D and E or as otherwise expressly permitted under I.R.C. §§ 7216 and 6713.

Holdings

1. Tax Return Preparer A is not liable for penalties under I.R.C. §§ 6713 and 7216 when A uses tax return information to contact taxpayers to inform them of a change in tax law that could affect the income tax liability on the taxpayers’ returns that were previously prepared or processed by A.

2. Tax Return Preparer B, who is lawfully engaged in the practice of accountancy, is not liable for the penalties when B uses tax return information of taxpayers whose tax returns B has prepared or processed to determine who might be affected by the temporary regulation and to contact the potentially affected taxpayers for whom B reasonably expects to provide accounting services in the next year to notify them of the changed regulation, explain how the change may affect them, and advise them with regard to actions they may take in response to the change.

3. Tax Return Preparers C, D, and E are not liable for the penalties when they disclose tax return information limited to the information listed in Treas. Reg. § 301.7216-2(n) to Third-party Service Provider X, which holds itself out as providing services that include creation, publication, and distribution of newsletters, bulletins, or similar communications to taxpayers whose tax returns the tax return preparers have prepared or processed containing tax information and general business and economic information or analysis for educational purposes or for purposes of soliciting additional tax return preparation services for the tax return preparer.

[Rev. Rul. 2010-4, 2010-4 I.R.B. 309]
Rev. Rul. 2010-5
I.R.C. §§ 6713 and 7216

This ruling provides guidance on whether a tax return preparer is liable for criminal and civil penalties when the preparer discloses or uses tax return information in connection with professional liability insurance.

Issues

1. Is a tax return preparer liable for penalties under I.R.C. §§ 6713 and 7216 when the preparer discloses to a professional liability insurance carrier tax return information required by the insurance carrier to obtain or maintain professional liability insurance coverage?

2. Is a tax return preparer liable for the penalties when the preparer discloses to the preparer’s professional liability insurance carrier tax return information required by the insurance carrier to promptly and accurately report a claim or a potential claim against the tax return preparer, or to aid in the investigation of a claim or potential claim against the tax return preparer?

3. Is a tax return preparer liable for the penalties when the preparer discloses tax return information to the preparer’s professional liability insurance carrier in order to secure legal representation under the terms of the insurance policy or to an unrelated attorney for the purpose of evaluating a claim or potential claim against the tax return preparer?

Facts

Tax Return Preparer A prepared income tax returns during the 2009 filing season and expects to prepare income tax returns in the 2010 filing season. During 2010, A expects to disclose to insurance agents or other insurance company representatives tax return information required to obtain or maintain professional liability insurance coverage, including information necessary to obtain price quotes from the insurance companies. The disclosed information would include a list of client names and descriptions of the services A provided to those clients.

A also expects to disclose to its professional liability insurance carrier tax return information required by the terms of the insurance policy to promptly and accurately report, and to aid in the investigation of, a claim or potential claim against A, including client names, descriptions of services A provided to the named clients, a description of the claim or potential claim of professional negligence, misconduct, or fraud, and, when necessary, copies of tax returns relevant to the claim or potential claim.

Finally, A expects to disclose to its professional liability insurance carrier tax return information required by the terms of the insurance policy to obtain legal representation provided by the insurance carrier under the terms of the insurance policy related to a claim or potential claim of professional negligence, misconduct, or fraud, or to an unrelated attorney for the purpose of evaluating a claim or potential claim of professional negligence, misconduct, or fraud.

All of the professional liability insurance carriers contacted by A, including their agents and representatives, are located within the United States or its territories or possessions, and all hold themselves out as providing professional liability insurance with respect to potential claims arising in connection with the preparation of tax returns. None of the insurance carriers provide substantive determinations or advice affecting the tax liability reported by taxpayers or the preparation of tax returns. The professional liability insurance carrier that issued the policy purchased by A is one these insurance carriers.

Analysis

Issue 1: Obtaining and Maintaining Professional Liability Insurance

Insurance companies offer professional liability coverage to tax return preparers to insure against potential claims arising from the tax return preparers’ negligence, misconduct, or fraud in connection with the preparation or processing of tax returns. A professional liability insurance carrier provides auxiliary services in connection with the preparation of tax returns because it provides liability coverage for claims or potential claims that relate directly to the tax returns prepared or processed by the tax return preparers it insures.

In the course of obtaining professional liability insurance, various insurance companies may routinely offer, and tax return preparers may routinely receive, price quotes for such coverage in the ordinary course of their tax return preparation businesses. The tax return information required to be disclosed to an insurance provider in order to obtain and maintain insurance cover-
age (including obtaining a price quote) might include a list of client names and descriptions of the services provided to those clients by the tax return preparer.

The professional liability insurance policy purchased by A is an auxiliary service provided in connection with the preparation of tax returns, and the insurance carriers are tax return preparers within the meaning of Treas. Reg. § 301.7216-1(b)(2)(i)(B) and (iii). Under Treas. Reg. § 301.7216-2(d)(1), A may disclose to these insurance carriers, without taxpayer consent, the tax return information required to obtain and maintain the auxiliary services provided by the insurance carriers, including the information necessary to obtain price quotes from various professional liability insurance carriers.

Disclosure by a tax return preparer of tax return information beyond that necessary to obtain or maintain insurance coverage would constitute a violation of I.R.C. §§ 6713 and 7216 and would result in the tax return preparer’s liability for penalties. The insurance carriers who receive a list of client names or any other tax return information from A are prohibited from the further use or disclosure of the tax return information for purposes other than those related to the provision of the auxiliary services to A or as otherwise expressly permitted under I.R.C. §§ 6713 and 7216.

Issue 2: Reporting and Investigating Claims
Services provided by a professional liability insurance carrier include investigation and management of claims or potential claims arising in connection with the preparation of tax returns by the covered tax return preparer. To request coverage for a claim or potential claim, a tax return preparer is required to promptly and accurately report claims or potential claims to its professional liability insurance carrier. To properly evaluate all claims or potential claims, aid in claim investigation and management, and process the payment of valid claims, a professional liability insurance carrier may require the tax return preparer to disclose additional information, such as client names, descriptions of the services provided to the named clients containing tax return information, tax return information describing the circumstances of the claim or potential claim, and copies of tax returns relevant to a claim or potential claim.

Disclosure of tax return information in connection with these communications is required to allow A to obtain the auxiliary services provided by its professional liability insurance carrier, and is permitted without taxpayer consent under Treas. Reg. § 301.7216-2(d)(1), provided the information is necessary to obtain those services. Disclosure by a tax return preparer of tax return information beyond that necessary to obtain the auxiliary services would constitute a violation of I.R.C. §§ 6713 and 7216 and would result in the tax return preparer’s liability for penalties.

Issue 3: Obtaining Legal Advice or Representation
A typical benefit provided to a tax return preparer by the terms of a professional liability insurance policy issued in connection with the preparation of tax returns includes the selection and engagement, by the insurance carrier, of an attorney to represent the preparer during the pendency of a claim investigation or litigation related to a claim, with the cost of the attorney paid for by the insurance carrier. When A seeks to have the professional liability insurance carrier provide this legal representation under the terms of the professional liability insurance policy, A does so for the purpose of obtaining auxiliary services in connection with the preparation of a tax return and may disclose relevant tax return information, without taxpayer consent, to the insurance carrier as an auxiliary services provider under Treas. Reg. § 301.7216-2(d)(1).

Disclosure by a tax return preparer of tax return information beyond the scope of the legal representation constitutes a violation of I.R.C. §§ 6713 and 7216 and would result in the tax return preparer’s liability for penalties. After the professional liability insurance carrier selects an attorney to represent A in relation to the claim or potential claim, A may disclose to that attorney tax return information related to the claim or potential claim without taxpayer consent under Treas. Reg. § 301.7216-2(g)(1).

When a tax return preparer seeks legal advice or representation in relation to any claim or potential claim of negligence, misconduct, or fraud from an attorney who is not a representative of the professional liability insurance carrier, the tax return preparer may disclose tax return information to that attorney without taxpayer consent under Treas. Reg. § 301.7216-2(g)(1).
Holdings
1. Tax Return Preparer A is not liable for penalties under I.R.C. §§ 6713 and 7216 when A discloses to a professional liability insurance carrier tax return information required by the insurance carrier to obtain or maintain professional liability insurance coverage, including obtaining price quotes for such insurance coverage.
2. Tax Return Preparer A is not liable for the penalties when A discloses to A's professional liability insurance carrier tax return information relevant to a claim or potential claim of professional negligence, misconduct, or fraud that is required by the insurance carrier to promptly and accurately report the claim or potential claim against A or to aid in the investigation of that claim or potential claim.
3. Tax Return Preparer A is not liable for the penalties when A discloses to its professional liability insurance carrier tax return information required by the insurance carrier in order to secure legal representation relating to a professional liability claim, or tax return information relevant to a claim or potential claim of professional negligence, misconduct, or fraud to the attorney selected by the insurance carrier or to an unrelated attorney for the purpose of evaluating a claim or potential claim against A.

[Rev. Rul. 2010-5, 2010-4 I.R.B. 312]

United States v. Wasson
I.R.C. § 7606

A trust scheme promoter was found guilty on fraud charges.

Facts
The evidence presented at trial showed that the Aegis Company (Aegis) was founded sometime in the 1990s in Palos Hills, Illinois. The defendant, Brian K. Wasson, was a representative of Aegis. Beginning in 1994, Aegis and its representatives devised, organized, promoted and sold various financial instruments, known as domestic and foreign trusts, to federal taxpayers in exchange for substantial fees. There was no change in the taxpayers’ control over their assets and income after setting up the so-called trusts. The purpose of marketing the trusts was to assist the taxpayers in concealing assets and income from the IRS, resulting in the reduction of the income tax paid to the IRS.

In approximately 1997, Wasson and an associate established a business known as Midwest Alternative Planning (Midwest) in Danville, Illinois. Through Midwest, they promoted the Aegis system to various taxpayers. Wasson eventually became a member of an Aegis advisory body known as the Aegis Fortress Advisory Group.

The evidence showed that Aegis and its representatives caused taxpayers to assign and transfer some or all of their income and assets to the trusts, then omit or deduct the amount of the assignments and transfers from their individual tax returns. The taxpayers would then falsely claim that the trusts had actually earned the income for a particular tax year. This resulted in substantially reducing or eliminating any tax liability for the individual taxpayer.

In addition, Aegis and its representatives further caused taxpayers to assign and transfer the income and assets from trusts to additional trusts and entities and then claim false deductions from income on the tax returns for those entities, which substantially reduced or eliminated tax liability for those entities, sometimes filing no federal income tax return for the entities whatsoever. Aegis and its representatives assisted taxpayers in carrying out this paper scheme, while at the same time assisting taxpayers in maintaining complete access to and control of their assets and income.

The most egregious example of the use of the Aegis system presented during the trial was the testimony of David Kindred. Kindred testified that he is a medical doctor specializing in obstetrics and gynecology. He has been in solo practice in Morton, Illinois, since 1994. Kindred testified that Wasson visited him at his home in 1996. He stated that in December 1996 he paid Aegis $45,000 for the trust system. Midwest received $20,200 of this amount as a commission. Kindred also paid annual management fees in the amount of $6,000 to Midwest. Kindred testified that Wasson accepted the management fees.

Based upon Kindred's testimony and the documents introduced into evidence, the government showed that Kindred, who earned as much as $1,000,000 per year from his medical practice, paid almost nothing in taxes for the tax years 1996, 1997, 1998, 1999, and 2000. Astoundingly, in 1997, Kindred received an earned income credit of $754. Kindred testified that Midwest
representatives prepared his income tax returns for the 1996–2000 tax years.

He also testified that in 1998 he received a letter from Merrill Lynch which indicated that it would not open an account for his Aegis trust because those types of trust could be used to illegally shelter assets from the IRS and were the subject of an ongoing IRS investigation. Kindred faxed the Merrill Lynch letter to Midwest. On June 16, 1998, Wasson faxed a copy of the letter to another Midwest representative with a cover letter in which Wasson said, “I need to know how you wish to proceed with this matter.”

The evidence showed that Kindred did come to the attention of the IRS and Kindred received his first IRS audit letter in May 2001. Kindred testified that Wasson was involved in responding to the IRS. Kindred testified that Wasson never told him to cooperate with the IRS. Kindred testified that he has paid some back taxes and penalties to the IRS. Kindred testified that Wasson never told him to cooperate with the IRS. Kindred testified that he is currently trying to claim the $1,000,000 as a business loss with the IRS.

The government also presented evidence from numerous other witnesses regarding their involvement with the Aegis system and with the IRS. Some were in the custody of the Federal Bureau of Prisons following guilty pleas to charges of conspiring to impede, impair, obstruct and defeat the IRS in the ascertainment, computation, assessment and collection of income taxes.

In March 2000, the IRS executed search warrants on various locations including the offices of Aegis. The evidence also showed that, when Wasson’s clients received audit notices from the IRS, he directed them to send frivolous correspondence to the IRS, challenging the IRS’s authority. This was sometimes referred to as the Aegis audit arsenal.

**Issue**

Whether the evidence presented at trial was sufficient to prove a conspiracy, that the promoter acted willfully, or that the tax returns were false or fraudulent

**Analysis**

Wasson argued that if a defendant in a tax case believed that he is following the tax laws, the reasonableness of the belief, or rather the unreasonableness of the belief, is not the issue for the trier of fact as long as the defendant sincerely believes he is following the law. He also argued that the government failed to establish that he knew that the Aegis trust system was in fact illegal. He contended that his sincere belief that the tax code allowed for the deductions taken by his Aegis clients meant that the court should find him not guilty on all counts, including the conspiracy count.

Wasson argued that the evidence of statements made during Aegis seminars does not show the existence of a conspiracy because the seminars were videotaped and not kept secret in any way. He noted that he has never claimed to be a tax lawyer or accountant and he sincerely believed that the deductions he counseled were legitimate. He pointed out that the Aegis directors at the seminars quoted chapter and verse on code and law to their audience and also noted that other professionals he dealt with did not tell him of any misgivings about the system.

He also argued that, although he sometimes supplied numbers for tax returns, this fact alone was insufficient to prove, beyond a reasonable doubt, that he caused anyone to file falsely.

There are three elements required to prove a conspiracy to defraud the IRS in violation of 18 U.S.C. § 371:

1. An agreement to accomplish an illegal objective against the United States
2. One or more overt acts in furtherance of the illegal purpose
3. The intent to commit the substantive offense, i.e., to defraud the United States

The court concluded that the government presented overwhelming evidence that Wasson did not have a good-faith belief that his actions were in accord with the tax statutes. It concluded that the evidence regarding the “audit arsenal” he encouraged his clients to use when dealing with audit requests showed that he did not believe the Aegis system was legal. Instead of encouraging clients to cooperate with the IRS, he encouraged them to question the authority of the IRS and, in some cases, to claim to not be citizens of the United States.

**Holding**

The government proved, beyond a reasonable doubt, that there was an agreement to accomplish
an illegal objective against the United States, that there were many overt acts in furtherance of this illegal purpose and that the defendant had the intent to defraud the United States.


**TAX RATES AND USEFUL TABLES**

**Rev. Proc. 2010-10**
I.R.C. § 61

The maximum value of employer-provided vehicles for use of the vehicle cents-per-mile and the fleet-average valuation rule are updated for 2010.

The maximum value of employer-provided vehicles first made available to employees for personal use in calendar year 2010 using the vehicle cents-per-mile valuation rule provided under Treas. Reg. § 1.61-21(e) is $15,300 for a passenger automobile and $16,000 for a truck or van. The maximum value of employer-provided vehicles first made available to employees for personal use in calendar year 2010 for which the fleet-average valuation rule provided under Treas. Reg. § 1.61-21(d) is $20,300 for a passenger automobile and $21,000 for a truck or van.

**Background**

If an employer provides an employee with a vehicle that is available to the employee for personal use, the value of the personal use must generally be included in the employee’s income and wages. If the employer-provided vehicle meets the requirements of Treas. Reg. § 1.61-21(e)(1), generally the value of the personal use may be determined under the vehicle cents-per-mile. However, the value of the personal use may not be determined under the vehicle cents-per-mile valuation rule for a calendar year if the fair market value (FMV) of the passenger automobile on the first date the passenger automobile is made available to the employee exceeds a specified dollar limit.

If employer-provided vehicles are available to employees for personal use for an entire year, generally the value of the personal use may be determined under the automobile lease valuation (Annual Lease Value) rule of Treas. Reg. § 1.61-21(d). An employer with a fleet of 20 or more automobiles may use a fleet-average value for purposes of calculating the Annual Lease Values of the automobiles in the employer’s fleet. The fleet-average value is the average of the FMVs of all the automobiles in the fleet. However, the value of the personal use may not be determined under the fleet-average valuation rule for a calendar year if the FMV of the automobile on the first date the passenger automobile is made available to the employee exceeds a specified dollar limit.

The maximum passenger automobile values for applying the vehicle cents-per-mile and the fleet-average value rules reflect the automobile price inflation adjustment of I.R.C. § 280F(d)(7). The method of calculating this price inflation amount for automobiles other than trucks and vans uses the new car component of the CPI automobile component. When calculating this price inflation adjustment for trucks and vans, the new trucks component of the CPI is used. This results in somewhat higher maximum values for trucks and vans. For purposes of this revenue procedure, the term trucks and vans refers to passenger automobiles that are built on a truck chassis, including minivans and sport utility vehicles (SUVs) that are built on a truck chassis.

**2010 FMV Limitations**

An employer providing a passenger automobile for the first time in calendar year 2010 for the personal use of any employee may determine the value of the personal use by using the vehicle cents-per-mile valuation rule in Treas. Reg. § 1.61-21(e) of the regulations if its FMV on the date it is first made available does not exceed $15,300 for a passenger automobile other than a truck or van, or $16,000 for a truck or van. If the FMV exceeds this amount, the employer may determine the value of the personal use under the general valuation rules of Treas. Reg. § 1.61-21(b) or under the lease valuation rule of Treas. Reg. § 1.61-21(d) or the commuting valuation rule of Treas. Reg. § 1.61-21(f) if the applicable requirements are met.

An employer with a fleet of 20 or more automobiles providing an automobile for the first time in calendar year 2010 for the personal use of
any employee for an entire year may not determine the value of the personal use by using the fleet-average valuation rule if the vehicle’s FMV on the date it is first made available exceeds $20,300 for a passenger automobile other than a truck or van, or $21,000 for a truck or van. If all other applicable requirements are met, an employer with a fleet of 20 or more vehicles consisting of passenger automobiles other than trucks or vans as well as trucks and vans may use the fleet-average valuation rule as long as none of the vehicles exceed their respective maximum allowable values. If the FMV of any passenger automobile in the fleet exceeds these amounts, the employer may determine the value of the personal use using the commuting valuation rule or the general valuation rules or determine the Annual Lease Value of the automobile separately under the automobile lease valuation rule of Treas. Reg. § 1.61-21(d)(2) if the applicable requirements are met.

[Rev. Proc. 2010-10, 2010-3 I.R.B. 300]
## UPDATES AND CORRECTIONS

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**Chapter 15. Tax Rates and Useful Tables**

### Standard Mileage Rates for 2010

- **Business:** 50.0¢
- **Charity work:** 14.0¢
- **Medical:** 16.5¢

### Update

- **October 2009**
  - Short-term AFR: 0.75% 0.75% 0.75% 0.75%
  - Mid-term AFR: 2.66% 2.64% 2.63% 2.63%
  - Long-term AFR: 4.10% 4.06% 4.04% 4.03%
  
  [Rev.Rul. 2009-33, 2009-40 I.R.B. 447, Table 1]

- **November 2009**
  - Short-term AFR: 0.71% 0.71% 0.71% 0.71%
  - Mid-term AFR: 2.59% 2.57% 2.56% 2.56%
  - Long-term AFR: 4.01% 3.97% 3.95% 3.94%
  
  [Rev.Rul. 2009-35, 2009-44 I.R.B. 568, Table 1]

- **December 2009**
  - Short-term AFR: 0.69% 0.69% 0.69% 0.69%
  - Mid-term AFR: 2.64% 2.62% 2.61% 2.61%
  - Long-term AFR: 4.17% 4.13% 4.11% 4.09%
  
  [Rev.Rul. 2009-38, 2009-49 I.R.B. 736, Table 1]
### January 2010 Period for Compounding

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[Rev.Rul. 2010-1, 2010-2 I.R.B. 248, Table 1]

### February 2010 Period for Compounding

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[Rev.Rul. 2010-6, 2010-6 I.R.B., Table 1]

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647 First table, last row I.R.C. § 7520 rate

**October 2009** 3.2% Rev. Rul. 2009-33, 2009-40 I.R.B. 447, Table 5
**November 2009** 3.2% Rev. Rul. 2009-35, 2009-44 I.R.B 568, Table 5
**January 2010** 3.0% Rev. Rul. 2010-1, 2010-2 I.R.B. 248, Table 5
**February 2010** 3.4% Rev. Rul. 2010-6, 2010-6 I.R.B., Table 5

650 **Retirement Plan Contribution Limits.** The TBA items in the 2010 row are as follows:

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<th>401(k); 403(b); &amp; SARSEP</th>
<th>Defined-Contribution Plan &amp; SEP</th>
<th>Defined-Benefit Plan</th>
<th>Compensation Limit</th>
<th>Stock Bonus and Profit Sharing</th>
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650 **Age 50 Catch-Up Contribution Limit.** The TBA items are as follows:

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<td>2010</td>
<td>$2,500</td>
<td>$5,500</td>
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652 First table, Social Security Information.: The TBA items in the 2010 column are as follows

- **OASDI Tax maximum earnings** $106,800
- **Earnings Ceiling for Social Security** Below full retirement age (FRA) $14,160
- Monthly maximum earnings before FRA for full benefits $3,140
- **Earnings Required to Earn One Quarter of Social Security Coverage** $1,120
- Domestic employee wage threshold $1,700

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**Updates** 57
CORRECTIONS

Chapter 2. Net Operating Losses
32 Example 2.4, second sentence. “$67,550” should be “$67,150” and “$59,900” should be “$59,500.”
33 Figure 2.3. The theft loss deduction should be “($50,000 – $500 floor) (49,500).” The taxable income should be “(67,150).” The NOL should be “($59,500).” First line of text after Figure 2.3. “$49,900” should be “$49,500.”

Chapter 3. International Issues
85 Example 3.8 heading. Delete “Nondeductible.”

Chapter 4. Individual Taxpayer Issues
119 Second column, last sentence before Issue 2. Delete “and the education credits” at the end of the sentence and insert “and” before “dependent-care tax benefits.” The custodial parent does not retain the right to the education credit. It goes with the child’s exemption deduction [I.R.C. § 25A(f)(1)(iii)].
124 Figure 2.4, First line, last column. “$77,000” should be “$72,000.”
151 Retirement Savings Credit, first line. “credit of up to $2,000 for qualified retirement savings contributions” should be “credit equal to a percentage of up to $2,000 of qualified savings contributions.”

Chapter 5. Business Issues
180 Form 4562 at the bottom of the page. $77 of amortized logo costs should be reported on line 42 and included in the line 44 total as follows.

Chapter 8. Retirement
322 Second column, Answer 2, 5th line. “($5,000 × 0.037)” should be “($5,000 × 0.370).”

Chapter 12. Business Entity Issues
470 First column, 6th line under “Timely Trust Election.” “EBST” should be “ESBT.”

Chapter 13. New Legislation
493 Second column, Transportation Fringe Benefits. Effective date, “December 2009” should be “December 2010.”
Chapter 14. Rulings and Cases
560  First column, summary box for T.A.M. 2009-11-009. In the last line, “surviving” should be “deceased.”

Chapter 15. Tax Rates and Useful Tables
629  Table 14, lines 2 and 3. In three places, “$45,500” should be “$45,550.”
636  First table, line 3, second column. The maximum for MFS is $12,500, not $12,000.
639  Second table, line 2, last column. Beginning MAGI for phaseout for MFJ and QW for 2010 is $105,100, not $105,000.
642  Medicare Deductibles. The Part A Deductible for 2009 should be $1,068, not $1,024.