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GENERAL TAX MATTERS:

☞President's Signature Sets Effective Date of Various Recovery Act Provisions

On Feb. 17, the President signed into law **H.R. 1, the American Recovery and Reinvestment Act of 2009** (the Recovery Act). As this summary outlines below, his signature sets the effective date for numerous Recovery Act provisions with an effective date geared to Feb. 17, 2009 (i.e., the date of enactment), including the more widely applicable provisions listed below.

> **Comment:** With regard to the new Tax Act, the IRS has established a webpage to provide information.

> **Comment:** The Congressional Budget Office has also made available on its website a cost estimate of the conference agreement for H.R. 1, the American Recovery and Reinvestment Act of 2009. CBO estimated the new law would increase federal budget deficits by $185 billion over the remainder of fiscal year 2009, by $399 billion in FY 2010, by $134 billion in FY 2011, and by $787 billion over the period of 2009-2019 (combining both spending and revenue effects). And, according to a new federal government website, $288 billion of the money from the law will go to "tax relief."

Small Businesses May Elect Longer NOL Carryback Period: For NOLs arising in tax years ending or beginning in 2008, the Recovery Act permits "eligible small businesses" to elect to increase the NOL carryback period for an "applicable 2008 NOL" from 2 years to either 3, 4 or 5 years. (**Code §172(b)(1)(H)**) Furthermore, under transition rules, the new law provides that for an NOL from a tax year ending *before* Feb. 17, 2009:

- any election made under **Code §172(b)(3)** to waive the carryback period with respect to such loss may be revoked *before* Apr. 18, 2009 (i.e., the date which is 60 days after the Feb. 17, 2009 enactment date);

- any election to increase the carryback period under **Code §172(b)(1)(H)** is treated as timely made if made *before* Apr. 18, 2009; and

- any application for a tentative carryback adjustment under **Code §6411(a)** with respect to such loss is treated as timely filed if filed *before* Apr. 18, 2009.

> **Comment:** According to the instructions listed above, it is *not* enough to simply answer the question "no" with regard to forgoing the normal 2-year NOL carryback (e.g., on Form 1120, page 2). In addition, the taxpayer is also required to include an election on a return filed before April 18, 2009 indicating which year beyond the normal 2-year carryback period they wish to take an NOL (i.e., 3, 4 or 5 years).

> **Comment:** Once again, accelerating deductions (or, taking bonus depreciation vs. Sec. 179) in 2008 to either create or increase an NOL might make sense, given the taxpayer had profits during the period 2, 3, 4 or 5 years ago, so as to create an immediate cashflow source stemming from a tax refund due to the specially elected NOL carryback.

> **Comment:** This stimulus legislation does *not* currently address extending the net *capital* loss carryback period or the carryback for unused business credits for businesses. And, it only affects the carryback period for NOLs generated for tax years either beginning or ending during 2008.

Reduced Estimated Tax Burden in 2009 for Individuals With Small Businesses: Effective on Feb. 17, 2009, the Recovery Act provides that notwithstanding **Code §6654(d)(1)(C)**, for any tax year beginning in 2009, in computing the amount of the required annual installments of estimated income tax of any qualified individual, the term "required annual payment" means the *lesser* of: (1) 90% of the tax shown on the return for the tax year, or (2) 90% of the tax shown on the return of the individual for the preceding tax year (i.e., instead of the normal "Exception #1" which had required 100% of last year's tax to have been paid). (**Code §6654(d)(1)(D)**) For purposes of this provision, a "qualified individual" means any individual (i.e., apparently, married, single or head of household) if the AGI on the tax return for the preceding tax year is *less than* $500,000 ($250,000 if married filing separately) and the individual certifies that *at least 50%* of the gross income shown on the return for the preceding tax year was income from a "small trade or business."

Exclusion for Qualified Small Business (QSB) Stock Increased to 75% of Gain: For QSB stock acquired *after* Feb. 17, 2009 and before Jan. 1, 2011, the Recovery Act provides that:

- the 50% gain exclusion is increased to 75%, and

- none of the 60% gain exclusion rules for qualified business entity QSB stock apply. (**Code §1202(a)(3)**)

> **Comment:** As a result, under the Recovery Act, the percentage exclusion for QSB stock sold by an individual is increased to 75% for stock acquired *after* Feb. 17, 2009 and *before* Jan. 1, 2011.

Code §382 Limit N/A Where EESA Bail-Out Agreement Requires Ownership Restructuring: For "ownership changes" *after* Feb. 17, 2009, the Recovery Act provides that the **Code §382** limitation does *not* apply to an ownership change (a) occurring under a

restructuring plan required pursuant to a loan agreement or a commitment for a line of credit entered into with the U.S. under the Emergency Economic Stabilization Act of 2008 (EESA), and (b) intended to result in a rationalization of the costs, capitalization, and capacity with regard to the manufacturing workforce of, and suppliers to, the taxpayer and its subsidiaries. (**Code §382(n)(1)**)

> **Comment:** This rule, however, does *not* apply to a subsequent ownership change, unless that ownership change is also described above. (**Code §382(n)(2)**)

Economic Recovery Payment to Recipients of Social Security, SSI, Railroad Retirement and Veterans Disability Compensation Benefits: The Recovery Act provides a one-time payment of $250 to retirees, disabled individuals and SSI recipients receiving benefits from the Social Security Administration, Railroad Retirement beneficiaries, and disabled veterans receiving benefits from the U.S. Department of Veterans Affairs. To be entitled to the $250 payment, the individual must have been eligible for one of the four benefit programs for any month during the three-month period ending with the month which ends before the month that includes the Feb. 17, 2009 date of enactment.

> **Comment:** In other words, to be entitled to the payment, the individual must have been so eligible for at least one of these benefit programs any time during November or December of 2008 or January of 2009.

Refundable Credit for Certain Federal and State Pensioners: Effective Feb. 17, 2009, the Recovery Act provide a one-time refundable tax credit of $250 in 2009 to certain government retirees who are *not* otherwise eligible for Social Security benefits.

New American Opportunity Tax Credit: The Recovery Act enhances the Hope credit for 2009 and 2010 and renames this increased credit the “New American Opportunity Tax Credit.” In connection with these changes, the Recovery Act of 2009 requires the IRS to conduct two studies and submit a report to Congress on their results not later than Feb. 17, 2010. The first is a study on how to coordinate the Hope and Lifetime Learning credits with the Pell grant program. And, the second, a study on requiring students to perform community service as a condition of taking their tuition and related expenses into account for purposes of the Hope and Lifetime Learning credits.

Increased Transit and Vanpool Transportation Fringe Benefits: For months beginning on Mar. 1, 2009 and before Jan. 1, 2011, the Recovery Act *increases* the monthly exclusion for employer-provided transit and vanpool benefits to the *same* level as the exclusion for employer-provided parking. (**Code §132(f)(2)**)

Limited-Time-Only Subsidy for COBRA Continuation Coverage of Unemployed Workers: The Recovery Act provides a 65% subsidy for COBRA continuation premiums for up to 9 months for workers who have been “involuntarily terminated” (i.e., laid off), and for their families. This subsidy also applies to health care continuation coverage if required by states for “small employers.” To qualify for this premium assistance, a worker must be involuntarily terminated between Sept. 1, 2008 and Dec. 31, 2009. The subsidy terminates upon offer of *any* new employer-sponsored health care coverage or Medicare eligibility. Workers who were involuntarily terminated between Sept. 1, 2008 and Feb. 17, 2009, but failed to initially elect COBRA “because it was unaffordable,” must be given an additional 60 days to elect COBRA and receive the subsidy.

Health Coverage Tax Credit (HCTC) Changes: The Recovery Act makes numerous changes to the HCTC including these changes with an effective date geared to the enactment date:

- For coverage months beginning on or after the first day of the first month beginning 60 days after Feb. 17, 2009, and ending Dec. 31, 2010, the Recovery Act increases the amount of the HCTC to 80% of the taxpayer's premiums for “qualified health insurance” of the taxpayer and qualifying family members. (**Code §35(a)**)

- The IRS must make one or more *retroactive* payments on behalf of “certified individuals” equal to 80% of the premiums for coverage of the taxpayer and qualifying family members for qualified health insurance for eligible coverage months occurring *before* the first month for which an advance payment is made on behalf of that individual. (**Code §7527(e)(1)**) However, the amount of the payment must be reduced by the amount of any payment made to the taxpayer under certain national emergency grants. This change applies for coverage months beginning *after* Dec. 31, 2008 and *before* Jan. 1, 2011, but the IRS is *not* required to make any payments until after Aug. 17, 2009 (i.e., the date that is 6 months *after* the Feb. 17, 2009 enactment date).

- For coverage months beginning *after* Feb. 17, 2009, the Recovery Act modifies the definition of an eligible Trade Adjustment Act (TAA) recipient to eliminate the requirement that an individual receiving unemployment compensation be enrolled in training.

- For coverage months beginning *after* Feb. 17, 2009 and *before* Jan. 1, 2011, the Recovery Act provides that qualified health insurance for which the HCTC is allowed includes coverage under an employee benefit plan funded by a **Code §501(c)(9)** voluntary employee benefit plan (VEBA) established under a bankruptcy court order or by an agreement with an authorized representative under 11 U.S.C. §1114. (**Code §35(e)(1)(K)**)

New Temporary Deduction for Sales and Excise Taxes on Car Purchases: For purchases *on or after* Feb. 17, 2009 and *before* Jan. 1, 2010, the Recovery Act provides a deduction for qualified motor

vehicle taxes. Furthermore, it expands the definition of taxes allowed as a deduction to include "qualified motor vehicle taxes" paid or accrued within the tax year. (**Code §164(b)(6)**) Most importantly, the deduction is allowed for AGI, so it is *not* necessary for the taxpayer to itemize their deductions to take advantage of this break (i.e., it will be treated as an addition to the standard deduction for those taxpayers who do *not* itemize). (**Code §63(c)(1)(E)**) However, if the taxpayer does itemize, they may *not* also be claiming a sales tax (i.e., vs. state or local income taxes) deduction on Schedule A.

New Qualified Advanced Energy Manufacturing Project Credit: Generally effective *after* Feb. 17, 2009, the Recovery Act establishes a *new* 30% credit for investment in qualified property used in a "qualified advanced energy manufacturing project." (**Code §48**) Credits are available only for qualified advanced energy manufacturing projects certified by the Secretary of Treasury, in consultation with the Secretary of Energy. In this regard, the Secretary of Treasury must establish a certification program no later than Aug. 16, 2009 (i.e., 180 days *after* the enactment date), and may allocate up to $2.3 billion in credits.

Nonbusiness Homeowners Energy Credit Extended to 2010 and Modified: The Recovery Act extends the **Code §25C** nonbusiness energy tax credit for one year through Dec. 31, 2010 and modifies it. (**Code §25C**) In addition, effective on Feb. 17, 2009, there are revised standards for energy efficient building property (e.g., electric heat pumps, central air conditioners and water heaters), oil furnaces and hot water boilers, and exterior windows, doors, and skylights.

Carbon Dioxide Sequestration Credit Modified: For carbon dioxide captured *after* Feb. 17, 2009, the Recovery Act provides that carbon dioxide used as a tertiary injectant and otherwise eligible for a $10 per metric ton credit must be sequestered by the taxpayer in permanent geological storage to qualify for the credit. (**Code §45Q(a)(2)(C)**)

Plug-in Electric Motor Vehicle Credit Modified: For vehicles bought *after* Feb. 17, 2009 and *before* Jan. 1, 2012, the Recovery Act creates a *new* 10% nonrefundable personal credit for electric drive low-speed vehicles, motorcycles, and three-wheeled vehicles. (**Code §30**) However, for a vehicle acquired *after* Feb. 17, 2009 and *before* Jan. 1, 2010, no **Code §30** credit is allowed if a **Code §30D** credit is also allowed for the vehicle. For property placed in service *after* Feb. 17, 2009 and *before* Jan. 1, 2012, the Recovery Act also creates a *new* 10% credit, up to $4,000, for the cost of converting any motor vehicle into a qualified plug-in electric drive motor vehicle. (**Code §30B(i)**)

New Clean Renewable Energy Bonds (new CREBs) Are Expanded: For bonds issued *after* Feb. 17, 2009, the Recovery Act authorizes the issuance of up to an additional $1.6 billion of new CREBs. (**Code §54C(c)**)

Qualified Energy Conservation Bonds Are Expanded: For bonds issued *after* Feb. 17, 2009, the Recovery Act authorizes the issuance of an additional $2.4 billion of qualified energy conservation bonds (i.e., to bring it up to a $3.2 billion limitation). (**Code §54D(d)**)

Miscellaneous Bond Provisions: A number of other provisions involving tax-favored bonds have an effective date geared to the enactment date, including, for example:

- Industrial development bonds issued *after* Feb. 17, 2009 and *before* Jan. 1, 2011 may finance facilities used to create intangible property. (**Code §144(a)(12)(C)**)

- National limits for recovery zone economic development bonds and recovery zone facility bonds issued *after* Feb. 17, 2009 and *before* Jan. 1, 2011 are allocated among States based on their 2008 employment declines, subject to a minimum allocation. (**Code §1400U-1**)

- For bonds issued Feb. 17, 2009, Indian tribal governments can issue $2 billion of tribal economic development bonds. (**Code §7871(f)**)

- For bonds issued Feb. 17, 2009, qualified school construction bond is a new type of tax credit bond. (**Code §54F**) **(Misc.; 2009 Recovery Act)**

> **Comment:** A number of other highly specialized provisions have an effective date geared to the Feb. 17th date of enactment. For example, effective on Feb. 17, 2009, states can elect grants, instead of tax credits, to finance low-income housing for 2009, but tax credit allocations are reduced.

☞**New Motor Vehicle Sales Tax Deduction May Require Detailed Planning While Leaving Certain Issues Unanswered**

As discussed above, the **American Recovery and Reinvestment Act of 2009** includes a tax provision designed to generate more automobile purchases. It is a new "for AGI" income tax deduction for sales and excises taxes paid on qualifying 2009 motor vehicle purchases. As a result, taxpayers considering a purchase of a *new* (vs. used) car or other qualifying motor vehicle this year should review the details behind this new temporary deduction.

> **Comment:** This summary covers the details as well as highlighting the various tax planning considerations behind the deduction. However, there are still a number of questions which are discussed below that are left unanswered by the Code provisions and legislative history concerning this new provision.

New Temporary Deduction: For purchases *on or after* Feb. 17, 2009 and *before* Jan. 1, 2010, the

Recovery Act provides a deduction for qualified motor vehicle taxes. Furthermore, it expands the definition of taxes allowed as a deduction to include "qualified motor vehicle taxes" paid or accrued within the tax year. (**Code §164(b)(6)**) Most importantly, the deduction is allowed for AGI, so it is *not* necessary for the taxpayer to itemize their deductions to take advantage of this break (i.e., non-itemizers will treat this as an addition to the standard deduction). (**Code §63(c)(1)(E)**) However, if the taxpayer does itemize, they may *not* also be claiming a sales tax (i.e., vs. state or local income taxes) deduction on Schedule A.

Covered Taxes and Vehicles: "Qualified motor vehicle taxes" are state or local sales or excise taxes imposed on the purchase of a qualified motor vehicle. (**Code §164(b)(6)(A)**) A "qualified motor vehicle" is a (1) passenger automobile, light truck or motorcycle the gross vehicle rating of which is *not* more than 8,500 pounds and (2) a motor home. And, as with the bonus depreciation rules, the original use of the motor vehicle must commence with the taxpayer. (**Code §164(b)(6)(D)**)

> **Comment:** Apparently, Congress did not see fit to extend this special deduction to "heavier" vehicles or trucks (i.e., those whose weight, plus the capacity to carry a load, when added together exceeded 8,500 pounds).

Limitation Based on Vehicle Price: Only taxes on that part of the qualified motor vehicle's purchase price *not* exceeding $49,500 may be deducted. (**Code §164(b)(6)(B)**)

Deduction Allowed for Multiple Vehicle Purchases? One of the questions being asked is whether the deduction can be taken for more than *one* otherwise qualifying vehicles, and if so, in what amount. In this regard, the Code and legislative history are *not* clear on this. However, the law does state that the deduction is allowed for "qualified motor vehicle taxes." And, this term includes "any State or local sales or excise tax imposed on the purchase of a qualified motor vehicle." So, it would initially appear that absent any limiting language in this provision, a taxpayer could argue a deduction could be take for *more than one* vehicle. Nevertheless, the use of "a" as opposed to "any" or "one or more" suggests that the deduction is allowed only with respect to *one* vehicle. And, the dollar limitation seems to confirm this in that it too uses "a" in its language. Specifically, it states that "[t]he amount of any State or local sales or excise tax imposed on the purchase of a qualified motor vehicle...shall *not* exceed the portion of such tax attributable to so much of the purchase price as does *not* exceed $49,500." Conversely one could argue that "a" being an indefinite article should *not* be interpreted as "one." But, if the deduction were available for two (or more vehicles), the $49,500 limitation would produce an anomalous result. Namely, an individual buying two cars each costing $49,500 would be allowed to deduct the taxes on *both* vehicles, whereas another individual buying just one car costing $99,000 could only deduct the tax on the first $49,500. Consequently, the better view seems to be that the deduction is limited to the tax on just *one* qualified motor vehicle subject to the applicable limitations. In any event, the Service will have to clarify this issue.

Deduction Allowed for Multiple Vehicle Purchases Not Exceeding $49,500? How should a taxpayer be treated who purchases two cars but they do *not* cost more than $49,500 in the aggregate? From a policy standpoint, there would be no reason to deny the deduction to such an individual given that he could deduct the taxes on a *single* vehicle costing *not* more than $49,500 (or, on the first $49,500 of the purchase price of a higher costing vehicle). However, again it boils down to whether the Code permits a deduction for *more than one* vehicle. If so, then the limitation would be $49,500 and there would be no issue of splitting the limitation among two or more vehicles.

Would Each Spouse Be Allowed the Deduction? In the case of married taxpayers, would each spouse on a joint return be permitted to deduct the tax on up to $49,500 of the purchase price of his or her own vehicle, whether they file jointly or separately? Once again, we need some additional clarification from the IRS.

Income Limitation: The amount of sales or excise taxes that may be treated as "qualified motor vehicle taxes" is phased out ratably for a taxpayer with modified AGI (MAGI) between $125,000 and $135,00 ($250,000 and $260,000 on a joint return). MAGI is adjusted gross income for the tax year increased by any amount excluded from gross income under **Code §911** (i.e., foreign earned income and foreign housing exclusions), **Code §931** (i.e., exclusion of income derived from American Samoa) or **Code §933** (i.e., exclusion of income from Puerto Rico). (**Code §164(b)(6)(C)**)

Example1: Lisa purchases a car for $25,000 in a locality that imposes a 6% sales tax. Lisa's modified AGI is $130,000. The qualified motor vehicle tax is $1,500. The $49,500 purchase price limitation does *not* apply. However, since Lisa's modified AGI exceeds $125,000 by $5,000, the taxpayer's qualified motor vehicle tax deduction is reduced by $750 ($1,500 x $5,000/$10,000). As a result, Lisa may only claim a $750 qualified motor vehicle tax deduction.

Example 2: Mary purchases a car for $25,000 in a locality that imposes a 6% sales tax. Mary's modified AGI is $135,000. The qualified motor vehicle tax is $1,500. The purchase price limitation does *not* apply. However, since Mary's modified AGI exceeds $125,000 by $10,000 the taxpayer's qualified motor vehicle tax deduction is reduced by $1,500 ($1,500 x $10,000/$10,000). As a result, no deduction is permitted in this instance.

Coordination With Pre-2010 0ptional Sales Tax Deduction for Itemizers: The deduction for qualified motor vehicle taxes is *not* available to a taxpayer who elects to deduct state and local sales and use taxes under **Code §164(b)(5)** (i.e., instead of state

and local *income* taxes as an itemized deduction). (**Code §164(b)(6)(F)**)

Comment: For those taxpayers who itemize their sales tax deductions, this new for AGI deduction is *not* allowed in order to prevent a "double deduction" on the same sales tax dollars. However, for those taxpayers residing in a state with no income taxes (e.g., WA, TX, NV, etc.), there is no other choice except to take all sales taxes on Schedule A (i.e., if they otherwise choose to itemize vs. taking the standard deduction).

Comment: Taxpayers should be careful when comparing the optional sales tax under **Code §164(b)(5)** and the new deduction. For instance, when calculating the optional sales tax deduction under **Code §164(b)(5)(F)**, if the rate of tax on motor vehicles exceeds the general sales tax rate, the deduction is limited to the general rate. Also, there is no dollar limitation under **Code §164(b)(5)** (i.e., with regard to itemizing the actual sales taxes associated with major purchases such as a motor vehicle). As a result, the **Code §164(b)(5)(F)** rule could limit the deduction under **Code §164(b)(5)** where the sales tax rate on an auto purchase is *higher* than the general sales tax rate, especially where the car is modestly priced. But, if the car's cost is well in excess of $49,500, that difference would probably become immaterial and it would therefore be better to take the *unlimited* general sales tax deduction than the Recovery Act's new deduction for those who have a choice.

Comment: In states where there is an income tax, the **Code §164(b)(5)** election (i.e., to itemize *sales* taxes on Schedule A vs. this new for AGI deduction) will normally only be made if the taxpayer has made major purchases such as an new vehicle. As a result, in those states that do have an income tax, the election will probably *not* be made now since the deduction for "qualified motor vehicle taxes" can be made even if income taxes are deductible (and, it's a "for AGI" deduction). For example, if state and local sales taxes are equal to $5,000 including $2,500 on the purchase of a qualified motor vehicle, and state income taxes are $4,000, under pre-Recovery Act law, a taxpayer would elect to deduct sales taxes instead of income taxes so as to get a $1,000 additional deduction (i.e., $5,000 instead of $4,000 on Schedule A). However, under the Recovery Act, a taxpayer would now get a total deduction of $6,500 if he chooses *not* make the election (i.e., $4,000 of income taxes and $2,500 for taxes on the qualified motor vehicle). This assumes there's no MAGI-based phaseout of the deduction.

Impact of AMT: The deduction for qualified motor vehicle taxes is also allowed in computing the AMT. (**Code §56(b)(1)(E)**)

Comment: If a taxpayer would be subject to the AMT *before* itemizing any deduction for state or local income or sales taxes on Schedule A, the taxpayer would never benefit by electing to deduct state or local sales or use taxes instead of income taxes since such a deduction would *not* be allowed in computing the AMT. In addition, the taxpayer would lose the deduction for sales or excise taxes paid on a qualified motor vehicle. In other words, the election would reduce his regular tax, but the AMT would be increased by the *same* amount that the regular tax was reduced.

Comment: In the following examples an assumption is made, solely for purposes of simplification, that allowing the deduction for sales or use taxes on a qualified motor vehicle in computing AMT will *not* affect the amount of the exemption allowed in determining the taxable excess (i.e., alternative minimum taxable income (AMTI) less any exemption amount otherwise allowed) on which the tentative minimum tax is computed.

Example 3: A married couple filing a joint return live in a state that has no state or local income tax. They itemize their deductions and are in a 28% tax bracket for regular income tax purposes and a 26% tax bracket for AMT purposes. In 2009, they pay state sales taxes of $5,000 including taxes of $2,500 on the purchase of a qualified motor vehicle. Before taking into account any deduction for the payment of those taxes, their tentative minimum tax is $26,000 (26% of taxable excess of $100,000) and their regular income tax is $25,500. Accordingly they owe an AMT of $500 ($26,000 less $25,500). The total tax payable will be $26,000 (i.e., regular income tax of $25,500 plus AMT of $500). In effect the total tax is the tentative minimum tax.

Option #1: If they elect to instead deduct their sales taxes as an itemized deduction, their taxable income will be reduced by $5,000 and their regular income tax will be reduced by $1,400 (28% of $5,000) to $24,100. However, their taxable excess will remain at $100,000 since sales taxes are *not* deductible in computing alternative minimum taxable income. As a result, the tentative minimum tax will remain at $26,000, and the AMT will increase to $1,900 ($26,000 less $24,100). The total taxes payable will remain at $26,000 (i.e., regular income tax of $24,100 plus AMT of $1,900).

Option #2: On the other hand, if the taxpayers choose *not* make the election to deduct sales taxes on Schedule A, they will be able to deduct the $2,500 they paid for a qualified motor vehicle against *both* regular income tax and the tentative minimum tax. As a result,

their regular income tax will be reduced by $700 (28% of $2,500) to $24,800), and their tentative minimum tax will be reduced by $650 (26% of $2,500) to $25,350. While their AMT will increase by $50 to $550, the total taxes payable will be reduced by $650 from $26,000 to $25,350 (i.e., regular income tax of $24,800 plus AMT of $550).

Comment: If a taxpayer would *not* be subject to the AMT before taking any deduction for state or local income taxes or state or local sales and use taxes into account, then whether the taxpayer would be better off electing to itemize sales and use taxes instead of taking the "for AGI" deduction for sales or excise taxes paid on a qualified motor vehicle would depend mainly on by how much the regular income tax exceeds the tentative minimum tax. The larger the excess, the more likely it is that the taxpayer will benefit by making the election to take an itemized deduction for any sales and use taxes on Schedule A.

Example 4: Same facts as in **Example 3** (i.e., the couple lives in a state with no income taxes) except that the taxpayers' regular income tax is $27,000 (i.e., $1,000 more than their tentative minimum tax of $26,000). If they choose *not* to make the election to itemize their sales and use taxes, their regular income tax will be reduced by $700 (28% of $2,500 sales tax paid on purchase of qualified motor vehicle) to $26,300. But, this would still be $950 more than the tentative minimum tax of $25,350 ($26,000 reduced by $650). Therefore, no AMT will be owed.

Alternative Option: On the other hand, if they do take an itemized deduction for their sales and use taxes, their regular income tax will be reduced by $1,400 (28% of $5,000) to $25,600. Their tentative minimum tax will remain at $26,000 and they will owe an AMT of $400. Their total tax including the AMT will be $26,000, but this still will be $300 less than the $26,300 of regular income tax they will owe if they do *not* make the election to itemize their sales and use taxes.

Example 5: Same facts as **Example 4** except that the taxpayers' regular income tax is $26,300 (i.e., $300 more than their tentative minimum tax of $26,000). If they do *not* itemize their sales and use taxes, their regular income tax will be reduced by $700 (28% of $2,500 sales tax paid on purchase of qualified motor vehicle) to $25,600. Their tentative minimum tax will be reduced by $650 (26% of $2,500) to $25,350 so no AMT will be owed. And, their total tax will be the regular income tax of $25,600.

Alternative Option: On the other hand, if they do itemize their sales and use taxes, their regular income tax will be reduced by $1,400 (28% of $5,000) to $24,900. Their tentative minimum tax will remain at $26,000 and they will owe an AMT of $1,100. Their total tax including the AMT will be $26,000, or $400 more than they would owe if they do *not* itemize their sales and use taxes. **(Code §164; Sales Tax)**

☞ Definition of Qualified Leasehold Improvements Expanded to Include Building Owners and New Restaurants

Previously, to satisfy the test for the special 15-year write-off as a "qualified leasehold improvement," the assets involved had to be used by a lessee (or, sublessee) pursuant to a formal lease arrangement. Furthermore, for the lease to be "qualified," it could *not* be between *related* parties. Yet, a common occurrence is in fact where the lessee's business is also owned by the same owners of an LLC which in turn is renting the real estate to the trade or business). On the other hand, businesses which also owned their premises (i.e., the real estate is an asset listed on the business' balance sheet), could *not* qualify for this special 15-year write-off. Another requirement was that the improvements had to be made to a building that had first been placed into service more than 3 years ago. As explained below, this barrier for owners of real estate (at least where it is used in a retail business) has been removed, thereby allowing more leasehold improvements to qualify. However, the restriction pertaining to "related party" leases remains (i.e., they continue *not* to be "qualified" for the 15-year write-off).

Comment: If the new law continues to restrict this write-off for leases between *related* parties, will commercial building owners be tempted to leave the building on their balance sheets thereby making these improvements eligible for a 15-year write-off? Probably, not. Given the litigious nature of our society, valuable real estate is normally kept in a separate entity, such as an LLC, and then rented back to the business so as to keep it out of the grips of a creditor, or as a settlement option for a lawsuit judgment.

Background: Generally, depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the underlying term of the lease (e.g., 39-year commercial real estate). This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service. As a result, if a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement generally is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service. However, as explained below, exceptions exist for certain qualified leasehold improvements and qualified restaurant property.

Comment: This is why it is so important to do a cost segregation study where it could result in as much as 20 to 25% of the property being broken out as 15-year "land improvements," 5-

or 7-year fixtures (or, possibly, wiring dedicated to these types of assets, or machinery or equipment).

Comment: Congress stated that taxpayers should *not* be required to recover the costs of certain leasehold improvements beyond the useful life of the investment. And, the 39-year recovery period for leasehold improvements for property placed in service after December 31, 2007, extends beyond the useful life of many such investments. Although lease terms differ, Congress believes that lease terms for commercial real estate are also typically shorter than the 39-year recovery period. And, in the interests of simplicity and administrative convenience, a uniform period for recovery of leasehold improvements is desirable. Therefore, the 2009 Recovery Tax Act extends the 15-year recovery period for leasehold improvements.

Qualified Leasehold Improvements: "Qualified leasehold improvement property" is any improvement to an interior portion of a building that is nonresidential (i.e., commercial) real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). The improvement normally must be placed in service *more than three years* after the date the building was first placed in service. Qualified leasehold improvement property does *not* include any improvement for which the expenditure is attributable: (1) to the enlargement of the building; (2) any elevator or escalator: (3) any structural component benefitting a common area (e.g., restrooms located in the center core of building and which are used by all of the tenants on that floor); or (4) the internal structural framework of the building. If a lessor makes an improvement that does in fact meet the aforementioned tests as qualified leasehold improvement property, such improvement does *not* continue to qualify as such property to any *subsequent* owner of such improvement. An exception to the rule does apply, however, in the case of death and certain transfers of property that qualify for nonrecognition treatment.

Qualified Retail Improvement Property: This new provision now provides owners of such property a statutory 15-year recovery period and straight-line method (i.e., 150% DB is *not* available for these particular assets) using the half-year convention for "qualified retail improvement property" placed in service *after* December 31, 2008, and before January 1, 2010. The key difference here is that these particular assets do *not* have to be used pursuant to a lease arrangement. For purposes of the provision, qualified retail improvement property means *any* improvement to an interior portion of a building which is nonresidential (i.e., commercial) real property if such portion is: (1) open to the general public and is used in the retail trade or business of selling tangible personal property to the general public, and (2) such improvement is placed in service *more than three years* after the date the building was first placed in service. However, unlike leasehold improvements to restaurant areas, "qualified retail improvement property" does *not* include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building. In other words, these improvements fall under the *same* general rules for 15-year qualified leasehold improvements discussed above, *not* the special rule for "restaurant improvements." For purposes of this provision, retail establishments that qualify for the 15-year recovery period include those primarily engaged in the sale of goods. Examples of these retail establishments include, but are not limited to, grocery stores, clothing stores, hardware stores and convenience stores. However, establishments primarily engaged in providing services, such as professional services, financial services, personal services, health services, and entertainment, do *not* qualify.

Comment: Congress generally intended that businesses defined as a "store retailer" under the current North American Industry Classification System (industry sub-sectors 441 through 453) qualify for the provision, while those in other industry classes do *not* qualify under the provision.

Comment: The reason for this change is that Congress "believes retailers should *not* be treated differently based on whether the building in which they operate is owned or leased." The shorter 15-year recovery period for leasehold improvements under prior law (i.e., before 2008) "provided an unfair competitive advantage for those retailers who leased space" (i.e., because the improvements had to be made under or pursuant to a lease either by the lessee or sublessee). Yet, as many small business retailers own the building in which they operate their business, Congress "believes this new provision will provide relief to small businesses who also make such improvements."

3-Year Rule Dropped for Restaurant Improvements: As mentioned above, the 2009 Recovery Tax Act provides that these special rules for qualified leasehold improvement property and restaurant improvements are *extended for two years* (i.e., through December 31, 2009). But, in addition, the *three-year rule for restaurant property is now repealed* for property placed in service *after* December 31, 2008, and before January 1, 2010. As a result, restaurant improvements made *within the first three years* will also now qualify for the 15-year recovery period. **(Code §168(k)(3); Qualified Leasehold Improvements)**

Comment: Congress also "believes that unlike other commercial buildings, restaurant buildings generally are more specialized structures." Restaurants also "experience considerably more traffic, and remain open

longer than most commercial properties." This daily use "causes rapid deterioration of restaurant properties and forces restaurateurs to constantly repair and upgrade their facilities." As such, restaurant facilities "generally have a shorter life span than other commercial establishments." Therefore, the new law extends the 15year recovery period for improvements made to restaurant buildings, while also applying the 15-year recovery period to *new* restaurants, "to more accurately reflect the true economic life of such properties."

INDIVIDUAL TAXATION:

☞Information on Top 400 Form 1040s for 1992 Through 2006 Available on IRS Website

This tax data has been compiled in four separate tables. **Table 1** contains frequencies, money amounts, and average dollar amounts for the major income deductions and tax credits reported as part of the Form 1040. **Table 2** shows ranges of *marginal* tax rates for the various statutory rates that were in effect. **Table 3** shows the range of *average* tax rates up to 35% and over, computed as total income tax divided by adjusted gross income. The data in these tables are based on the individual returns with the *largest* AGIs reported for each specific year shown and do *not* necessarily reflect the same taxpayers over the 15-year period. **Table 4** presents the number of times an individual return appeared among the 400 largest AGIs for each of the tax years. **(Misc.; Tax Statistics)**

IRS Website Highlights Filing for Nonresident Aliens

This IRS summary (taken from an IRS **International Tax Gap Series Fact Sheet**) provides an overview of the tax filing requirements for nonresident aliens. Aliens (i.e., those who are *not* U.S. citizens) are considered to be a "nonresident alien" unless they meet the "green card test" or the "substantial presence test" for the calendar year. Nonresident aliens are subject to U.S. income tax on their U.S. source income at two different tax rates: (1) one for "effectively connected income," which is derived from operating a business or performing personal services in the U.S., and is taxed at the *same* graduated rates as for a U.S. person; and (2) "fixed or determinable, annual, or periodic income," such as interest or dividends, which is taxed at a *flat* 30% rate unless a tax treaty specifies a lower rate. **(Misc.; Nonresident Aliens)**

> **Comment:** Nonresident aliens file and pay tax due on **Form 1040NR** (U.S. Nonresident Alien Income Tax Return) or **Form 1040NR-EZ** (U.S. Income Tax Return for Certain Nonresident Aliens With No Dependents).

Service Again Promoting Availability of Earned Income Tax Credit (IR 2009-8)

According to IRS statistics, one in four eligible taxpayers fails to claim the EITC each year. And, almost 70% of all EITC returns are prepared by a third party or tax professional. The IRS is now encouraging taxpayers to use the **EITC Assistant**, an interactive tool on the agency Web site at to help determine if the taxpayer is qualified to claim the EITC. "People may be eligible for the EITC for the first time and really should check out their eligibility," said IRS Commissioner Douglas Shulman. "This is a significant credit that can make their lives a little easier," he added. **(Code §43; EITC)**

> **Comment:** The IRS has also published a fact sheet which details the eligibility requirements for the EITC. (**Fact Sheet 2009-9**) In addition, the IRS has updated information on its website entitled **EITC Information for Employers** to make it easier for employers to provide information on the earned income tax credit (EITC) to their workers.

> **Comment:** According to a notice posted to its website, the IRS has implemented "a paid preparer compliance program as part of a multi-prong approach to reduce the number of erroneous earned income tax credit claims. For 2009, this includes an "educational and outreach program" for preparers who are "new" to EITC return preparation, which will include follow-up contacts by mail or phone if there is a high error rate. In addition, the IRS will visit return preparers who file "highly questionable" EITC returns to, in part, discuss possible civil and criminal penalties that could result from filing inaccurate EITC returns.

☞Taxpayer Must Have Business vs. Personal Reason for Tax Home (*Wilbert v. Commr.*, 08-2169 (7th Cir., 1/21/2009))

In *affirming* the Tax Court's decision, the 7th Circuit concluded that an airline mechanic was *not* permitted to deduct travel and lodging expenses incurred while working in other cities after being laid off because he was *not* considered to be"away from home" under **Code §162(a)(2)**. After discussing various tests, the appellate court fell back on the rule "that unless the taxpayer has a *business* rather than a *personal* reason to be living in two places, he cannot deduct his traveling expenses if he decides not to move. Indeed, [taxpayer's] situation is really no different from the . . . construction worker who works at different sites throughout the country, never certain how long each stint will last and reluctant therefore to relocate his home. The construction worker loses, as must [taxpayer]." **(Code §162; Travel Expenses)**

PARTNERSHIP/LLC TAXATION:

☞IRS Addresses FAQs Regarding 2008 Changes to Form 1065

The IRS has made numerous changes to the 2008 version of Form 1065. And, to help practitioners understand them, the IRS has now posted to its website nine frequently asked questions (FAQs) on these changes. This summary provides an overview of the changes, as well as the FAQs meant to address them.

Changes to Form 1065: The first page of the instructions for the 2008 **Form 1065** now list these new items:

(1) Many of the questions on **Schedule B** have been modified and additional questions have been added. Partnerships filing **Schedule M-3** must also complete the questions on the *new* **Schedule C, Additional Information for Schedule M-3 Filers**.

(2) On Form 1065, page 1, **Item G, checkbox (6)** has been added. It is used to indicate a technical termination, and is checked in conjunction with checkbox (1) or checkbox (2).

(3) The automatic extension period for Form 1065 returns that are due to be filed on or after Jan. 1, 2009, has been changed to just 5 months.

(4) The "Where To File" instructions have been revised for certain partnerships whose principal business, office, or agency is located in Tennessee or Georgia.

(5) For business start-up and organizational costs paid or incurred *after* Sept. 8, 2008, a partnership is *automatically* deemed to have made an election to deduct a certain amount of its start-up and organizational costs under **Code §195(b)** and **Code §709(b)**. Therefore, it is no longer necessary to attach a statement to the return to make this election. Nevertheless, a partnership can elect to forgo this deemed election and amortize all such costs (i.e., over 180 months).

(6) Various credits are new for 2008, as detailed on page 1 of the Form 1065 instructions.

(7) A *new* **code G** has been added for box 13 of Schedule K-1 (Form 1065) to report certain charitable contributions for which the adjusted gross income limitation has been suspended.

(8) The AMT on the low-income housing credit have been repealed for credits attributable to buildings placed in service *after* Dec. 31, 2007. As a result, two *new* codes have been added to separately report the post-2007 low-income housing credits on Schedule K-1 that are *not* subject to the alternative minimum tax limitations.

(9) The codes used to report the welfare-to-work credit and the "new markets credit" on Schedule K-1 have changed. These credits are now reported using **code P** in box 15.

(10) One *new* code has been added for box 19 of Schedule K-1 (Form 1065). **Code C** is used to report distributions of **Code §737** property.

(11) Recapture of low-income housing credit. For the disposal of a building (or, an interest therein) occurring *after* July 30, 2008, a partnership is *not* required to establish a bond or pledge eligible U.S. Treasury Securities to avoid recapture of the low-income housing credit "if it is reasonably expected that the building will continue to be operated as a qualified low-income building for the remainder of the building's compliance period."

(12) One *new* code has been added to box 20 of Schedule K-1 (Form 1065). **Code W** is used to report pre-contribution gain or loss.

FAQs on changes to Form 1065: The FAQs relate to *new* information that must be entered on the revised Form 1065, *not* new law changes. The summary below lists the questions and provides abbreviated answers to some of them.

> **Comment:** The IRS website provides more detailed responses to these FAQs.

(1) How may the partners' shares of profit, loss, and capital be reported in cases where the partnership agreement does *not* express such items as percentages? The IRS provides the answer to this question in the form of an example of a "reasonable method" of calculating partners' percentage shares of profit, loss, and capital for purposes of completing Form 1065 Schedule B questions 3 and 4, and for purposes of completing Schedule K-1 item J, for tax years ending on or after Dec. 31, 2008. The method shown by the IRS includes a fairly detailed fact pattern involving a two-person partnership governed by a partnership agreement that requires capital accounts to be maintained in accordance with **Code §704(b)** but that does *not* express the partners' shares of profit, loss, and capital as fixed percentages. Under **Code §704(b)**, a partner's distributive share of income, gain, loss, deduction, or credit is determined in accordance with his interest in the partnership if the partnership agreement does *not* specify the partner's distributive share of these items, or the allocation to a partner of these items under the agreement does *not* have "substantial economic effect."

> **Comment:** A partnership can also compute the partners' end-of-tax-year percentages of *capital* by dividing each partner's *positive* capital account balance on the last day of the tax year by the total positive capital account balance on that day, and expressing the result as a percentage. A *negative* capital account balance is reported as zero percent. Likewise, *profit* percentages are determined by computing each partner's share of items that *increased* partnership capital (other than capital contributions). *Loss* percentages are determined by computing each partner's share of items that *decreased* partnership capital (other than distributions).

(2) What is the percentage interest in the partnership that should be reported on Form 1065 Schedule B question 3b in three distinct cases? In **Situation 1**, spouses H and W each owns a 50% interest in the partnership profit, loss, and capital. **Answer:** Report H and W each as owning, directly or indirectly, 100% (i.e., each owns 50% directly and 50% by family

attribution). In **Situation 2**, Parent and Child each owns a 50% interest in the partnership profit, loss, and capital. **Answer:** Report each as owning, directly or indirectly, 100% (50% directly and 50% by attribution). In **Situation 3**, four siblings each owns a 25% interest in the partnership profit, loss, and capital. **Answer:** Report each as owning, directly or indirectly, 100% (25% directly and 75% by family attribution).

> **Comment:** Keep in mind that in **Situation 1**, the H and W can instead elect to file two Schedule Cs instead of Form 1065 to report the results of this jointly-owned trade or business (i.e., vs. the co-ownership of a partnership which holds rental properties reported on Form 8825).

(3) In this instance, a partnership consists of three partners who own differing percentages of the three items named (profit, loss, capital). Form 1065, Schedule B, Question 3b, asks for the *maximum* percentage owned by any partner owning more than 50 percent of *any* of those three items. A partner whose interests in profits, loss, and capital are 60, 20 and 50 percent, respectively, would answer Question 3b by reporting 60 percent (i.e., the *maximum* of the three percentages given).

(4) The fourth question pertains to each partner's percentage of ownership reported on Form 1065, Schedule K-1, Item J. In this example, the partners' interests are *not* set forth as percentages, but are calculated using a complex formula taking into account activity thresholds and targets, which causes profit allocations to vary. For example, three partners end the tax year with capital account balances of $75, $50, and a deficit of $25. The end-of-year capital account reported by the partnership is $100 ($125 in the positive account balances minus the $25 negative account balance). The first partner divides his $75 positive ending capital by the total positive ending capital of $125, for a share of 60 percent. The second partner divides her $50 positive ending capital by $125, for a share of 40 percent. The third partner would receive no net distribution
of capital if the partnership were to liquidate at the end of the year, but would instead have to contribute capital to the partnership. Therefore, for purposes of computing the percentage amounts on Schedule K-1, Item J, this partner's ending positive capital account percentage would be zero. The IRS considers this to be a "reasonable method" of calculating these amounts.

(5) What percentage interests in partnership X are individual partners A and B and entities W, Y, Z, and T considered to own for purposes of answering questions 3a and 3b of Form 1065, Schedule B for tax year 2008? The IRS provides an answer to this question involving complicated facts.

(6) For purposes of the requirement in the Form 1065 Schedule K-1, Item J, instruction at page 24, first paragraph, last sentence referring to "multiple changes in the profit and loss sharing percentage during the year" should the phrase "change" be interpreted as applying only to changes in ownership resulting from sale, purchase, transfer, contribution, or distribution as distinguished from changes which occur because of fluctuations in profit allocations during the year due to formula methods specified in the partnership agreement? The IRS says that the answer to this question is "yes," and the phrase "change" for this purpose does *not* apply to changes that occur because of fluctuations in profit allocations during the year due to formula methods specified in the partnership agreement.

(7) Partnership A wishes to report ownership percentages on tax year 2009 Form 1065 Schedules K-1, Item J, using *a different* reasonable method from the reasonable method that the entity used for tax year 2008. Must Partnership A disclose this change in methods on the 2009 Form 1065? Because, the partnership agreement does *not* express the partners' percentage interests as *fixed* percentages, the IRS answers this question in the affirmative.

(8) Partnership A has over 100 partners. The partnership agreement does *not* express the partners' percentage interests as *fixed* percentages. The partnership wants to send tax year 2008 Form 1065 Schedules K-1 to partners in March 2009 with a *blank* Item J. But, the partnership proposes that it will adopt a "reasonable method" for reporting ownership percentages on Item J *before* the extended due date of the return and include percentages on Item J of the Schedules K-1 included with the Form 1065 that will be filed with the IRS prior to the extended due date. Is it permissible for Partnership A to send 2008 Schedules K-1 to partners with a *blank* Item J? The answer is "no." The tax year 2008 Form 1065 Schedules K-1 sent to partners in 2009 must include a completed Item J and must be consistent with those filed with the Form 1065.

(9) For purposes of answering Schedule B questions 3a and 3b what percentage interest does the Partnership report as being owned by individual partners A and B and revocable grantor trusts T1 and T2 under specified facts? The IRS provides an answer to this questions involving somewhat complicated facts. **(Misc.; Partnership FAQs)**

C CORPORATIONS:

☞1st Circuit Affirms Noncompete Agreement Payment Not Really for Sale of Goodwill (*Muskat v. U.S.*, 103 AFTR 2d ¶2009-418 (1st Cir., 1/29/2009))

The 1st Circuit, affirming a district court, has held that a taxpayer failed to show by "strong proof" that a noncompetition agreement in the sale of his family business was actually intended to be a purchase his personal goodwill. The Court found that the taxpayer's initial treatment of the noncompete agreement payments as ordinary income was correct and rejected his refund claim based on treating it as a capital asset.

> **Comment:** This case is an excellent example

of the importance of carefully reviewing the documents which memorialize an agreement for their tax consequences. Otherwise, both the IRS and the courts will hold taxpayers to the language of the agreements they have made and will reject taxpayer attempts to recast the deal after it has been finalized. Trying to claim that amounts received under a covenant-not-to-compete were really payments for "personal goodwill" is particularly difficult, as the same elements that make up a taxpayer's personal goodwill (i.e., reputation and customer relationships) would make the other party want to enter into a noncompetition agreement with them.

Facts: Irwin Muskat sold his family business, Jac Pac Foods, Ltd. (Jac Pac), to Manchester Acquisition Corporation (MAC), a subsidiary of Corporate Brand Foods America, Inc. (CBFA), which was formed for the purpose of the acquisition (collectively referred to as MAC/CBFA). Muskat had been president, CEO, and a 37% shareholder of Jac Pac. He exercised operational control of the company, maintained involvement in key accounts and had personal relationships with customers and suppliers. The purchase agreement included $15 million allocated for Jac Pac's goodwill. The agreement also required Muskat to execute a mutually satisfactory noncompete agreement, employment agreement (in which Muskat agreed to work for CBFA), and subscription agreement (in which Muskat agreed to invest in CBFA). The term of the noncompete agreement extended for 13 years and provided that MAC/CBFA's obligation to make the payments survived Muskat's death or disability. Initially, Muskat reported the $1,000,000 he received as part of the sale under the noncompete agreement as ordinary income. However, he later determined that it should have been treated as a payment for his personal goodwill, taxed at long-term capital gain rates. He sought a refund of $203,434. The IRS contested the refund, maintaining that the payment was properly taxed as ordinary income.

Background: The sale and purchase of a business often involves the transfer of intangible assets which the parties to the transaction may see as interrelated. These assets are, essentially, the goodwill of the business and the seller's agreement not to compete with the buyer. The transfer of one or both of these assets may also involve an arrangement for the seller's future services. Goodwill (i.e., the expectancy that customers will continue to patronize a certain place of business based on a pre-existing business relationship) is a capital asset. (***International Multifoods Corp.*, 108 TC 25 (1997)**) Conversely, payments to the seller to agree *not* to compete with the new buyer under a noncompete agreement (or, a covenant-not-to- compete) are taxable as ordinary income. (**Rev. Rul. 69-643**) The treatment of a buyer's payment for both goodwill and a noncompete agreement in connection with the purchase of a business is generally governed by Code §197, under which such intangibles must be ratably amortized over a 15-year period.

Deferred Compensation: As clarified in the Preamble to **T.D. 9321** and **Reg. §1.409A-1(d)**, payments for noncompete agreements generally are subject to the complex and sometimes draconian **Code §409A** rules because such payments occur in connection with the performance or nonperformance of services, yet they do *not* involve a substantial risk of forfeiture. As a result, the legally binding right obtained in one year to a payment in a later year under a noncompete agreement is deferred compensation that must meet the distribution, acceleration of benefits, and election requirements under **Code §409A**. Noncompliance results in inclusion in income for all amounts deferred under the plan by a participant, interest (at the underpayment rate plus one percentage point), and a 20% penalty.

Older Deferred Comp Arrangements Grandfathered: Generally, the **Code §409A** rules apply for amounts deferred *after* Dec. 31, 2004, subject to certain grandfather and transition rules. In this instance, Muskat's noncompete agreement was entered into in '98 and lasted for 13 years. As a result, it would *not* be subject to the **Code §409A** rules unless it was "materially modified" after Oct. 3, 2004.

District Court Decision: The district court found that the noncompete payment was includible by Muskat as ordinary income. Muskat failed to show by "strong proof" that, despite the express terms of the agreement, he and MAC/CBFA had intended the $1,000,000 payment to be made for his personal goodwill and *not* for the promises made in the noncompete agreement. In reaching its decision, the district court rejected Muskat's argument that the noncompete agreement's long term and survivability provisions were unusual and showed that it really was a sale of his personal goodwill. The negotiation for the sale of Jac Pac to MAC/CBFA did *not* include any discussion of Muskat's personal goodwill. Neither the noncompete agreement nor any other agreement in the sale transaction mentioned Muskat's "personal goodwill." In fact, the consideration paid under the noncompete agreement was expressly for the covenants-not-to-compete. Muskat appealed the district court's decision, challenging the use of the "strong proof" rule, and questioning whether the weight of the evidence supported the decision. He also contended that the district court unfairly refused to consider his self-employment tax refund claim and objected to the exclusion of certain expert testimony.

1th Circuit Decision: The 1st Circuit upheld the district court's decision, rejecting all of Muskat arguments. It concluded that the use of the "strong proof" rule, which had *not* been superceded by case law or statute, was appropriate. It rejected Muskat's contention that the rule was inapplicable because "he was *not* a party to allocation and the allocation was ambiguous." The "strong proof"rule applied because the parties to the transaction had executed a written instrument allocating money for particular items, and Muskat had thereafter sought to alter the written allocation for tax purposes on the basis that the sums were in reality intended as compensation for another

item. The rule required Muskat to show by "strong proof" that at the time of execution of the instrument the contracting parties actually intended the payments to compensate for something different then indicated. The Court also found that the district court was warranted in concluding that the contracting parties did *not* intend the payment to be compensation for personal goodwill. There was no discussion of Muskat's personal goodwill during negotiations, and none of the transaction documents mentioned it. The absence of any reference to Muskat's separate goodwill, combined with the express reference to Jac Pac's goodwill, "made it extremely unlikely that the contracting parties intended the payments described in the noncompetition agreement to serve as de facto compensation for Muskat's personal goodwill." The Court also rejected Muskat's assertion that the survivability provision and overly lucrative terms for a man of his advanced age indicated that the payments were for something other than refraining from competition. The Court reasoned that proof that a written allocation lacks economic reality does *not*, in and of itself, constitute strong proof that the contracting parties intended some other allocation. With regard to Muskat's self-employment tax refund claim, it was raised for the first time at trial and was *not* mentioned in his administrative refund claim. The Court concluded that because Muskat failed to put the IRS on notice during the administrative phase of the basic nature of his new theory, the district court lacked subject matter jurisdiction over that claim. **(Code §1060; Personal Goodwill)**

ESTATES, TRUSTS & GIFTS:

IRS Modifies Actuarial Valuation Tables in Response to Lower Interest Rates (Notice 2009-18)

This new notice provides supplements to the Code §7520 actuarial tables because the **Code §7520** interest rate recently fell below 2.2%, which was the lowest interest rate under the preexisting tables. The notice also furnishes extensions to the existing tables for interest rates below 2.2%.

Background: The value of annuities (other than commercial annuities), life estates, term interests, remainders and reversions for estate, gift and income tax purposes is determined using tables issued by the IRS under **Code §7520**. The value in a given month under the tables may be higher or lower than the value in an earlier or later month because the interest factor under the tables changes monthly. For charitable transfers, the interest rate for the month of the transfer or for either of the two preceding months may be used. (**Code §7520(a)**) For instance, the **Code §7520** interest rate for February 2009 is 2.0%. (**Rev. Rul. 2009-5**)

IRS Notice: This IRS notice supplements the valuation tables with additional interest rates by providing extensions to the existing tables for interest rates below 2.2%. Specifically, it shows valuation factors under **Table S** (single life remainder factors based on Life Table 90CM for valuations after Apr. 30, '99), **Table B** (remainder factors for terms certain), **Table J** (adjustment factors for term certain annuities payable at the beginning of period), and **Table K** (adjustment factors for annuities payable at the end of period), based on interest rates of 0.2%, 0.4%, 0.6%, 0.8%, 1.0%, 1.2%, 1.4%, 1.6%, 1.8%, and 2.0%.

> **Comment:** From a planning prospective, agreeing to a private annuity with a younger family member when interest rates are lower results in a lower annual payment amount that the younger family member will have to make to the older family member to prevent a gift from arising on the transfer. This is demonstrated in the examples below.

Example1: When the **Code §7520** interest factor is 2.0%, Ellen, age 70, transfers property worth $1 million to her daughter in exchange for a private annuity. The daughter would have to make an annual payment of $86,077.04 to prevent a gift from arising on the transfer. This figure is determined by dividing $1 million by 11.6175, which is the annuity factor which can be determined using the remainder factor for 2.0% for a 70-year old as supplied in **Notice 2009-18**.

> **Comment: Notice 2009-18** does *not* include annuity factors. It includes remainder factors for ages ranging from 0 to 109 for interest rates ranging from 0.2% to 2.0%. However, as explained in **Reg. §20.2031-7(d)(2)(iv)**, an annuity factor can be mathematically derived by subtracting the remainder factor (that corresponds to the interest rate and age involved) from 1.0000 and multiplying the result by the interest rate expressed as a decimal number.

Example 2: Based on the facts in **Example 1** above, the remainder factor from **Notice 2009-18** for a 70-year old is .76765. Subtracting .76765 from 1.000000 yields .23235. Dividing .23235 by .02 equals 11.6175.

Example 3: By way of comparison, had a transfer like the one in **Example 1** occurred when the interest factor was 6.2% as it was for August 2007, the annual payment to prevent a gift would have been $119,323.20. **(Code §7520; Actuarial Tables)**

RETIREMENT PLANS & FRINGE BENEFITS:

Recharacterization of Roth RA Allowed After Deadline for Filing Return (PLR 200903105)

A taxpayer was permitted to recharacterize her Roth IRA as a traditional IRA even though the due date for filing her tax return has already passed. When she had originally filed her unextended return, her AGI was less than the $100,000 threshold. However, she subsequently received additional income that made her exceed the $100,000 modified AGI limit.

> **Comment:** An interesting fact was that while the additional income was received prior to the

October 15th extension date, neither the taxpayer nor the IRA custodian was aware that the date for the recharacterization was the *same* as the date for the extension of filing the tax return.

Facts: In this instance, the taxpayer maintained both the Roth and regular IRAs with her financial institution as the custodian. During the tax year at issue, she successfully converted traditional IRA funds to a Roth IRA and was aware that such conversions could take place only during tax years in which her modified AGI did *not* exceed $100,000. At the time of the conversion, the taxpayer and her husband, with whom she filed a joint return, had earned income that was substantially less than $100,000. However, the couple filed an extension on their federal income tax return due to *not* having received several K-1 forms. After the last K-1 forms were received, the couple's return was completed. It then showed a modified AGI in excess of $100,000, thereby making the taxpayer ineligible to convert her traditional IRA to a Roth IRA during that tax year. As a result, the couple timely filed the return by the October 15 extended deadline without including the IRA conversion. Prior to filing the return, the taxpayer contacted the IRA custodian several times indicating that there would be no way for the couple to reduce their modified AGI below $100,000. The custodian suggested that the taxpayers wait until their tax return was finished prior to making a final decision on whether to recharacterize the Roth IRA as a traditional IRA. Neither the taxpayer or the custodian was aware that October 15 also was the deadline for completion of the Roth IRA recharacterization for the tax year. Therefore, no effort was made by either party to assure that recharacterization was completed by the extended return due date. It was only after the October 15 deadline did the custodian become aware of the deadline, and so it denied the taxpayers' request to recharacterize the IRA for the year. Given the circumstances, the taxpayer requested a ruling that she be granted time to recharacterize her Roth IRA to a traditional IRA despite the fact that the October 15 deadline had passed.

IRS Ruling: The IRS granted the relief under **Reg. §301.9100-1**, finding that the taxpayer acted reasonably and in good faith with respect to making the election to recharacterize her failed conversion as a traditional IRA. It also noted that the grant of an extension only defers the payment of tax on the IRA distributions, thus the governments interest was *not* prejudiced, as the tax year at issue was *not* closed. **(Code §408A; Roth IRAs)**

Final Regs Provide Guidance on 401(k) Automatic Contribution Arrangements (T.D. 9447)

The IRS has issued final regs for 401(k) and other eligible plans that include an automatic contribution arrangement. The regs incorporate comments received by the IRS on the proposed reliance regs, as well as changes made by the Worker, Retiree, and Employer Recovery Act of 2008.

Comment: The regs are generally effective for plan years beginning on or after Jan. 1, 2008.

Background: Section 902 of the Pension Protection Act of 2006 amended a number of Code sections to facilitate automatic contribution arrangements (i.e., "automatic enrollment") in qualified cash or deferred arrangements (CODAs) under **Code §401(k)**, as well as in similar arrangements under **Code §403(b)** and **Code §457(b)**. WRERA added SARSEPs under **Code §408(k)(6)** and SIMPLE IRAs under **Code §408(p)** to this list.

Automatic Enrollment: An automatic contribution arrangement is a CODA which provides that, in the absence of an affirmative election by an eligible employee, a default election applies under which the employee is treated as having made an election to have a specified contribution made on his behalf under the plan. Contributions to 401(k) plans must meet the actual deferral percentage (ADP) nondiscrimination test for elective contributions, and the actual contribution percentage (ACP) nondiscrimination test for matching contributions. **Code §401(k)(13)** and **Code §401(m)(12)**, added by PPA, effective for plan years beginning on or after Jan. 1, 2008, provide a design-based nondiscrimination test safe harbor for a CODA that provides for automatic contributions at a specified level of contributions and meets certain contribution, notice, and other requirements. A CODA that satisfies these requirements, referred to as a qualified automatic contribution arrangement (QACA), is treated as satisfying the ADP and ACP tests. PPA also made other changes to facilitate automatic enrollment including:

- **Code §414(w)**, which provides limited relief from the plan distribution restrictions applicable to CODAs for an eligible automatic contribution arrangement (EACA). Under this rule, an employee may elect to receive a distribution equal to the amount of elective contributions (and attributable earnings) made for the employee beginning with the first payroll period to which the EACA applied to the employee and ending with the effective date of the election. The amount of the distribution is includible in gross income for the tax year in which the distribution is made, but is *not* subject to the 10% additional income tax under **Code §72(t)**.

- **Code §411(a)(3)(G)** was amended to provide that a matching contribution will *not* be treated as forfeitable merely because it is withdrawn under an automatic contribution arrangement that satisfies the **Code §414(w)** requirements.

- **Code §4979** (i.e., excise tax on excess plan contributions) was amended to lengthen the 2½-month correction period for excess contributions and excess aggregate contributions under an EACA to six months.

Nondiscrimination Safe Harbor: Under **Code §401(k)(13)(C)(iii)**, a QACA must meet an increasing series of minimum default contribution percentages. The final regs clarify that the minimum percentage for the initial period is based on when the employee first

has contributions made under the default election. The final regs provide guidance on the application of the minimum percentage requirement in the case of a rehired employee. Specifically, they provide that the minimum percentages are determined without regard to whether an employee has continued to be eligible to make contributions under the plan. As a result, the minimum percentage generally is determined based on the number of years since the date the employee first had default contributions made under the QACA.

Duration of Automatic Enrollment Period: The final regs permit plans to limit the duration of an affirmative election. (**Reg. §1.401(k)-3(j)(2)(ii)**)

Default Percentage: To allow employers to provide for increases in the default percentage to coincide with salary increases or performance evaluations, the final regs modify the uniformity requirement applicable to QACAs so that the default percentage may vary based on the portions of years since the date of an employee's first default contribution. (**Reg. §1.401(k)-3(j)(2)(iii)**)

Notice Requirement: In response to commentators' concerns over meeting the notice requirement for employees who are eligible to participate in a plan immediately upon hire, the final regs provide that if it is *not* practicable for the notice to be provided on or before the date specified in the plan that an employee becomes eligible, the notice will nonetheless be treated as provided timely if it is provided "as soon as practicable" after that date and the employee is permitted to elect to defer from all types of compensation that may be deferred under the plan beginning on that date. (**Reg. §1.401(k)-3(k)(4)**)

Hardship Withdrawals: The final regs clarify that safe harbor nonelective and matching contributions under a QACA are subject to the *same* hardship withdrawal provisions as those made under other plans. (**Preamble to T.D. 9447**)

Withdrawal of Automatic Contributions: The final regs provide that the employees who must be subject to the automatic enrollment provisions under an EACA are only those employees who are specified in the plan as being covered employees under the EACA. (**Reg. §1.414(w)-1(b)**) However, for a plan year beginning on or after Jan. 1, 2010, the final regs provide that a plan that contains an EACA is entitled to the extended 6-month period for correcting excess contributions and excess aggregate contributions without incurring a **Code §4979** excise tax, only if all eligible non-highly compensated employees (NHCEs) and eligible highly compensated employees (HCEs) are covered employees under the EACA for the entire plan year (or the portion of the plan year that the employees are eligible employees). (**Reg. §54.4979-1(c)**) An employee must withdraw default elective contributions from an EACA within the 90-day period starting after the date the compensation would otherwise have been included in the employee's gross income. Under the final regs, a plan may set an earlier deadline (but not less than 30 days) for the election to withdraw default elective contributions. The final regs also provide that the date of the first default elective contribution must take into account any default elective contributions made under any EACA under the plan. The final regs clarify that the permissible withdrawal distribution must be made in accordance with the plan's ordinary timing procedures for processing distributions and making distributions. Plans may charge a fee for the permissible withdrawal distribution but it cannot be higher than the fee that applies to any other distributions of cash. (**Reg. §1.414(w)-1(c)**)

Effective Date: The final regs relating to QACAs (i.e., the nondiscrimination safe harbor rules) apply to plan years beginning on or after Jan. 1, 2008. However, for plan years beginning on or after Jan. 1, 2010, compensation for purposes of determining default contributions means safe harbor compensation as defined in **Reg. §1.401(k)-3(b)(2)**. Meanwhile, the EACA (i.e., permissible withdrawal), regs apply for plan years beginning on or after Jan. 1, 2010. For plan years that began in 2008, a plan must be operated in accordance with a good faith interpretation of **Code §414(w)**. For this purpose, a plan that operates in accordance with the proposed regs or final regs under **Reg. §1.414(w)-1** will be treated as operating in accordance with a good faith interpretation of **Code §414(w)**. (**Preamble to T.D. 9447**) **(Misc.; Retirement Plans)**

EMPLOYMENT TAXES:

☞Revised Form 941 Reflects Changes Made by Economic Stimulus Package

The IRS has issued a 2009 version of Form 941, Employer's Quarterly Tax Return, that takes into account the new federal legislation in the economic stimulus package on COBRA continuation coverage. The form should be used beginning with the first quarter return due on April 30th.

COBRA Continuation Coverage: Included in **H.R. 1, the American Recovery and Reinvestment Act of 2009**, is a provision that provides a 65% subsidy for COBRA continuation premiums for up to 9 months to workers who have been involuntarily terminated (i.e., laid off) between Sept. 1, 2008 and Dec. 31, 2009. The person to whom premiums are payable (e.g., an employer) may be reimbursed for the difference between the full premium and the amount paid by the worker. Employers who are entitled to the reimbursement are allowed to take a refundable credit on Form 941 to reduce their quarterly employment tax liability. Alternatively, they can apply to the IRS to receive the money back.

> **Comment:** The IRS has announced on its website that employers can delay starting subsidy payments until May, so ex-employees would still have to pay the full premium for March and April. But the employer is required, within 60 days of receiving those payments, to reimburse workers or give them credits toward future premium payments. The delay is

intended to allow businesses time to prepare for this new provision, which was effective March 1st. Also, employers will report premiums they paid on newly-revised Form 941. The form is also used to take a credit on payroll taxes if a firm does *not* reduce its tax deposits. The number of ex-workers receiving the subsidies must also be reported on the 941. Keep in mind that under the Service's rules, ex-employees must first pay their 35% share of the premium *before* employers can be reimbursed for their insurance payments.

Form 941 Changes: The following lines have been added to Form 941:

- Line 12a: COBRA premium assistance payments. The form instructions note that employers should only report the COBRA premium assistance payments that they made on behalf of workers. This amount should be 65% of eligible workers' total COBRA premium payments. Employers should *not* include on this line any amounts that they received from the workers.

- Line 12b: Number of individuals provided COBRA premium assistance reported on line 12a. The balance due (or overpayment) on the return is now determined by subtracting: (1) the sum of the total tax deposits and the amount reported on line 12a, from (2) the total tax liability.

- Schedule B of Form 941, Report of Tax Liability for Semiweekly Schedule Depositors: It has also been revised, but there are no changes to the way that semiweekly depositors record their tax liabilities on Schedule B. Tax liabilities on Schedule B should still equal line 10 of Form 941. Line 10 is an employer's tax liability for the quarter before consideration of the refundable COBRA credit. The revised Form 941 and Schedule B also take into account changes in the employment tax return correction process. **(Code §3401; Form 941)**

IRS Issues New Versions of Pubs Dealing With Tip Reporting and Clergy Members (IRS Pubs. 517 & 531)

The IRS has issued new versions of **Pub. 517, Social Security and Other Information for Members of the Clergy and Religious Workers**, and **Pub. 531, Reporting Tip Income**. The publications were issued to help employees prepare their 2008 personal income tax returns, but they also contain useful information for employers as well.

IRS Pub. 517: This publication includes a chart (Table 1) on whether ministers, members of a religious order who have taken (or not taken) a vow of poverty, Christian Science practitioners, church employees, and members of a recognized religious sect are subject to FICA tax. If these individuals are *not* subject to FICA tax, they should file **Form 4029**, Application for Exemption From Social Security and Medicare Taxes and Waiver of Benefits, with the IRS. An employer is advised *not* to report wages paid to these individuals as Social and Medicare wages if the individual has provided the employer with an approved Form 4029. Employers completing a **Form W-2** for an employee with an approved Form 4029 should enter "Form 4029" in box 14, Other. They should *not* make any entries in boxes 3, 4, 5, or 6 of Form W-2. Employers should also *not* include exempt wages for an employee with an approved Form 4029 on Forms 941, 943, and 944. Instead, **Form 941** filers are advised to check the box on line 4 and enter "Form 4029" in the empty space below the check box for Form 941. **Form 943** filers should enter "Form 4029" to the right of the wage entry spaces on lines 2 and 4 of Form 943. **Form 944** filers should check the box on line 3, and enter "Form 4029" in the empty space below the check box.

IRS Pub.531: This publication includes information on "allocated tips." These are tips that an employer assigned to an employee in addition to the tips the employee reported themselves to the employer for the year. An employer can only use a tip rate lower than 8% (but not lower than 2%) to figure allocated tips if the IRS first approves the lower rate. The publication advises employees that their regular pay may *not* be enough for their employer to withhold all the taxes they owe on their regular pay plus their reported tips. If this happens, employees may give their employer money until the close of the calendar year to pay the rest of the taxes. If employees do *not* give their employer enough money for taxes, the employer is instructed to apply their regular pay and any money that they give for taxes, in the following order: (1) All taxes on the employee's regular pay; (2) Social Security and Medicare taxes, or railroad retirement tax, on their reported tips; (3) Federal, state, and local income taxes on their reported tips. Any taxes that remain unpaid can be collected by the employer from the next paycheck. **(Code §3401; Clergy; Allocated Tips)**

Service Needs To Do More to Identify Misclassified Workers (Audit Report No. 2009-30-035)

The Treasury Inspector General for Tax Administration (TIGTA) has issued an audit report that evaluates the effectiveness of IRS actions with respect to identifying misclassified workers. The report notes that the "misclassification of employees as independent contractors is a nationwide issue affecting millions of workers that continues to grow and contribute to the tax gap." Workers are frequently misclassified for a variety of reasons, either intentionally to save costs, or unintentionally because of a lack of knowledge. Some independent contractor misclassifications occur because certain employers are protected from potentially large employment tax assessments by Section 530 of the Revenue Act of 1978. The report notes that the IRS' interest in this issue *is* not to reclassify workers from independent contractors to employees. Instead, it is to ensure that employers are making the proper determinations and that workers are being treated appropriately. The report states that while the IRS has done a great deal to educate employers about proper classification of workers, much more needs to be done. For example, studies of the impact of misclassification on the tax gap are more than twenty years old. Therefore, it is difficult for the IRS to estimate the size of the problem today, or the overall

effectiveness that its actions to date are having. The most recent IRS estimate of the tax gap is $345 billion, with an estimated $1.6 billion resulting from worker misclassification. However, the $1.6 billion figure is based on 1984 data, and is likely to be a great deal higher now. TIGTA recommends that the IRS develop an agency-wide employment tax program to coordinate the decision-making process and efforts among its business divisions. The report also recommends that the IRS Deputy Commissioner for Services and Enforcement (DCSE) conduct a formal compliance study to measure the current impact of worker misclassification on the tax gap. (**Code §3121; Employee Classification)**

> **Comment:** The IRS concurred with the findings in the audit report. DCSE will coordinate an agency-wide employment tax program. The Director of Specialty Programs for the IRS Small Business/Self-Employed Division will coordinate a study in fiscal year 2009 on worker classification and other employment tax issues. The planning for this project has already begun.

☞**Withholding Tables Updated for New Making Work Pay Credit (IR 2009-13)**

The IRS has released new withholding tables that reflect the impact of the new Making Work Pay credit recently enacted by the **American Recovery and Reinvestment Act of 2009**. These new tables will result in more take-home pay for millions of American workers.

> **Comment:** Unmarried taxpayers will take home about $400 more in pay and joint returns will see $800 more.

Background: The Recovery Act provides eligible individuals with a *refundable* income tax credit for tax years beginning in 2009 and 2010. (**Code §36A**) The credit is the *lesser* of (1) 6.2% of an individual's earned income or (2) $400 ($800 for a joint return). (**Code §36A(a)**) For these purposes, the earned income definition is the same as for the earned income tax credit with two modifications: (a) it does *not* include net earnings from self-employment which are *not* taken into account in computing taxable income; but (b) it does include combat pay excluded from gross income under **Code §112**. (**Code §36A(d)(2)**)

Eligible Individual: An eligible individual is any individual other than: (1) a nonresident alien; (2) an individual with respect to whom another may claim a dependency deduction for a tax year beginning in a calendar year in which the eligible individual's tax year begins; and (3) an estate or trust. (**Code §36A(d)(1)(A)**) However, an individual is *not* eligible if he does *not* include his social security number on the return. For joint filers, this requirement is met if the social security number of one of the spouses is included on the return. (**Code §36A(d)(1)(B)**)

Phaseout: The credit is phased out at a rate of 2% of the eligible individual's modified adjusted gross income (defined as AGI increased by any foreign income or income from Puerto Rico or American Samoa excluded under **Code §911**, **Code §931** or **Code §933**) above $75,000 ($150,000 for a joint return). (**Code §36A(b)**) As a result, the credit phases out completely at modified AGI of $95,000 ($190,000 on a joint return).

Reduction for Other Payments: The credit is reduced by any payment received by the taxpayer under Recovery Act §2201 or any credit allowed to the taxpayer under Recovery Act §2202 (i.e., recovery payments under the Veterans Administration, Railroad Retirement Board, and the Social Security Administration and a credit for certain government workers). (**Code §36A(c)**)

New Withholding Tables: In **IR 2009-13**, the IRS announced the release of new withholding tables that incorporate the new Making Work Pay credit. These tables are available online in **Notice 1039 (Rev Feb. 2009)**. The new withholding tables, along with other instructions related to the new tax law, will later be incorporated in new IRS **Pub. 15-T, New Wage Withholding and Advance Earned Income Credit Payment Tables (For Wages Paid Through December 2009)**, which will be soon posted on IRS's website and mailed to more than 9 million employers in mid-March.

> **Comment:** The IRS asks that employers start using these new tables as soon as possible but not later than April 1st.

IRS Notice 1039: Notice 1039 contains the early release copies of the new income tax withholding and advance earned income credit payment tables. These tables, which are effective immediately, replace the corresponding tables previously included in **Pub. 15 (Circular E), Employer's Tax Guide**. These tables will be published in **Pub. 15-T**, which should be used by employers in conjunction with the information in **Pub. 15**. Agricultural employers who use **Pub. 51 (Circular A), Agricultural Employer's Tax Guide**, should also use these tables in lieu of the corresponding tables **Pub. 51**, and use **Pub. 15-T** in conjunction with the information in **Pub. 51**. Updated tables are also included for **Pub. 15-A, Employer's Supplemental Tax Guide**.

> **Comment:** Self-employed individuals, who are *not* subject to wage withholding, can receive the credit in advance by reducing the amount of their estimated tax payments.

Making Work Pay Credit: The IRS notes that because the credit is *refundable*, most low-income workers will also qualify for the full credit. Though all eligible taxpayers will need to claim the credit when they file their 2009 income tax return next year, the benefit will generally be spread out over the paychecks they receive beginning as soon as their employers implement the revised withholding based on the new tables and continuing until the end of the year. Many higher-income taxpayers will see little or no change in

their take-home pay because of the phaseout provisions. Since employers and payroll companies will effectuate the payment of the Making Work Pay credit through the new withholding tables, taxpayers typically will *not* need to take any additional action. Furthermore, employees will *not* need to fill out a *new* **Form W-4**, Employee's Withholding Allowance Certificate, to get the Making Work Pay credit reflected in their take-home pay.

> **Comment:** The IRS advises that individuals and couples with multiple jobs may nevertheless want to submit revised Form W-4 forms to ensure that enough withholding is held to cover the tax for the combined income. IRS **Pub. 919** provides additional guidance for tax withholding. In other words, where an employee has worked for two or more employers it's *not* unusual to find that more than the maximum social security tax has been withheld from their wages, with the result that the excess may be claimed as a credit against his income tax on his return. Conversely, multiple employers under the new withholding tables, particularly where the combined income will be subject to the Making Work Pay's phaseout provisions, can result in underwithholding.

> **Comment:** This was a much less expensive alternative to separate, special rebate checks being mailed to eligible individuals from the IRS, as was the case in last year's Economic Stimulus payments.

☞**General Manager Liable for Trust Fund Recovery Penalty** (***Smith v. U.S.*, No. 07-4210 (10th Cir., 2/17/2009)**)

Affirming a Utah District Court, the 10th Circuit held that the general manager of a printing company that failed to pay its employment taxes was liable for the **Code §6672** penalty. Responding to taxpayer's argument that he "was simply doing what he was told by the owner and had no power over creditor priority," the appellate court noted that taxpayer was aware during the quarters at issue that the payroll taxes were *not* being paid, and, in fact, he paid other creditors instead of paying the payroll taxes. Furthermore, the fact that the owner had more control over creditor payment than taxpayer "[was] *not* determinative; significant control is all that is required." **(Code §6672; Trust Fund Penalty)**

ADMINISTRATIVE & PROCEDURAL MATTERS:

☞**IRS Revises Form SS-4**

The IRS has issued a January 2009 version of **Form SS-4**, Application for Employer Identification Number. The form was last revised in July 2007. The form instructions note that, beginning with wages paid in 2009, IRS regulations require "disregarded entities" to pay their own employment taxes and file their own tax reports. These entities include single-member limited liability companies (SMLLCs) and qualified sub-chapter S subsidiaries (QSUBs). And, they will need to apply for an employer identification number (EIN) if they have *not* done so already. Page two of Form SS-4 includes a table to assist applicants in determining if they need to apply for an EIN, and the lines that they need to complete on the form. A foreign person seeking to avoid withholding on portfolio assets, or to claim tax treaty benefits, will need an EIN to complete the forms in the W-8 series (Certificate of Foreign Status), other than Form W-8ECI, Certificate of Foreign Person's Claim That Income Is Effectively Connected With the Conduct of a Trade or Business in the United States. A withholding agent, broker, fiduciary, manager, tenant, or spouse who is required to file **Form 1042**, Foreign Persons U.S. Source Income Subject to Withholding, to report taxes on non-wage income paid to an alien, will also need to apply for an EIN. **(Code §6109; EIN)**

> **Comment:** Most taxpayers may apply for an EIN on the IRS website. But, applicants who are *not* located within the U.S., or U.S. possessions, are *not* permitted to apply for an EIN online.

Service Releases New SIFL Rates

The Standard Industry Fare Level formula, or SIFL formula, may be used in certain instances to determine the value of a noncommercial flight for employment tax purposes. The SIFL rates for the first half of 2009 (January 1 through June 30) have now been issued. The terminal charge has increased to $45.41 (up from $42.26). The rate for the first 500 miles of travel is now 24.84¢ per mile (previously, 23.12¢ per mile). The rate for miles 501 to 1,500 is now 18.94¢ per mile (previously, 17.63¢ per mile). The rate for miles traveled over 1,500 is now 18.21¢ per mile (previously, 16.95¢ per mile). **(Code §62; SIFL Rates)**

Revised Form 8903 & Instructions Highlight Many Recent Changes for Sec. 199 Deduction

On its website, the IRS has issued **Form 8903** (Domestic Production Activities Deduction) for 2008, and its Instructions. They reflect a number of changes introduced by recent legislation as well as recent regs. This summary highlights what is new for 2008 filers of Form 8903 (as well as another change going into effect 2009).

Background: Taxpayers may claim a domestic production activities deduction (DPAD) on Form 8903 generally equal to 6% (for tax years beginning in 2007-2009, 9% for later years) of the *lesser* of: (1) the taxpayer's qualified production activities income (QPAI) for the tax year or (2) taxable income (modified adjusted gross income, for individual taxpayers) without regard to this deduction, for the tax year. (**Code §199(a)**; **Reg. §1.199-1(a)**) The deduction as computed above is limited to 50% of the W-2 wages of the employer for the tax year. W-2 wages are the sum of the aggregate amounts that must be included on the employees' Forms W-2 under **Code §6051(a)(3)** (i.e., wages subject to withholding) and **Code §6051(a)(8)** (elective deferrals), that are made by the taxpayer during the calendar year that ends in the tax year. (**Code §199(b); Reg. §1.199-1(a)**) The **Code §199**

DPAD is available only if, among other conditions, the taxpayer has domestic production gross receipts from: (1) any sale, exchange or other disposition, or any lease, rental or license, of qualifying production property manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the U.S.; (2) any sale, exchange, etc., of qualified films produced by the taxpayer; (3) any sale, exchange or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the U.S.; (4) construction activities performed in the U.S.; or (5) engineering or architectural services performed in the U.S. for construction projects located in the U.S. The DPAD for partnerships and S corporations is determined at the partner or shareholder level. Partners or shareholders are treated as having W-2 wages equal to their allocable share of the entity's DPGR-related W-2 wages for the tax year. (**Code §199(d)(1)(A), Reg. §1.199-5**) The DPAD is available for a number of domestic activities, including qualified films.

DPAD Allocation to EAG Members: An expanded affiliated group (EAG) allocates its DPAD among its members based on the ratio of each member's QPAI to the EAG's total QPAI. If a member has *negative* QPAI, that member's QPAI is treated as zero for purposes of the allocation. For tax years beginning *before* Mar. 7, 2008, a corporation may elect to apply the **Code §199** closing of the books method. Under this method, a corporation's taxable income or loss, QPAI, and Form W-2 wages for the period during which the corporation was an EAG member are figured by treating the corporation's tax year as two separate tax years. The first tax year is treated as ending on the close of the day on which the corporation's status as a member of the EAG changes. The second tax year is treated as beginning on the day after the corporation's status as a member of the EAG changes. However, under **Reg. §1.199-8(i)(9)**, the closing of the books method for **Code §199** purposes is not available for tax years beginning on or after Mar. 7, 2008.

Changes for Qualified Films: Among the tax provisions included with the Emergency Economic Stabilization Act of 2008, were the following changes for qualified films under **Code §199**, all effective for tax years beginning after Dec. 31, 2007:

- Form W-2 wages for **Code §199** purposes include compensation for services performed in the U.S. by actors, production personnel, directors, and producers to produce a qualified film. (**Code §199(b)(2)(D)**)

- A qualified film includes the copyrights, trademarks, or other intangibles related to the film. Also, a **Code §199** deduction may be claimed for the production of a qualified film regardless of the methods and means by which the film is distributed. (**Code §199(c)(6)**) For example, the distribution of a qualified film via the Internet (whether the film is viewed online or downloaded or whether or not there is a fee charged) is considered a disposition of the film for purposes of determining DPGR.

- New rules apply to S corporations, partnerships, S corporation shareholders, and partners engaged in film production. First, each partner who owns at least a 20% capital interest or an S shareholder who owns at least a 20% stock interest, either directly or indirectly, in the entity is treated as having engaged directly in any film produced by the partnership or S corporation. (**Code §199(d)(1)(A)(iv)(I)**) Additionally, a partnership or S corporation is treated as having engaged directly in any film produced by any partner who owns at least a 20% capital interest or S shareholder who owns at least a 20% stock interest, either directly or indirectly, in the partnership or S corporation. (**Code §199(d)(1)(A)(iv)(II)**)

DPAD Extension for Puerto Rico: Prior to **P.L. 110-343**, for the first two tax years of the taxpayer beginning after Dec. 31, 2005, and before Jan. 1, 2008, a taxpayer could treat Puerto Rico as part of the U.S. for **Code §199** purposes, but only if all of its gross receipts from sources within Puerto Rico were currently taxable for U.S. Federal income tax purposes. **P.L. 110-343**, *retroactively* extended the rule allowing Puerto Rico to be treated as part of the U.S. for **Code §199** purposes so that it applies for the first four tax years beginning after Dec. 31, 2005, and before Jan. 1, 2010. (**Code §199(d)(8)(C)**)

Reduced DPAD for Oil and Gas: For tax years beginning *after* 2009, **P.L. 110-343**, reduced the otherwise allowable DPAD of taxpayers with oil-related qualified production activities income for tax years beginning after 2009 by 3% of the least of the taxpayer's: (1) oil-related qualified production activities income for the tax year; (2) QPAI for the tax year; or (3) taxable income (determined without regard to the DPAD). (**Code §199(d)(9)(A)**) **(Code §199; DPAD)**

IRS Examiners Could Better Scrutinize All Open Tax Periods During Audits (Audit Report No. 2009-30-034)

IRS Examination function employees do *not* always appropriately inspect and examine prior and/or subsequent year tax returns when warranted, the Treasury Inspector General for Tax Administration (TIGTA) stated in a new audit. Auditors reviewed 68 statistical sample cases and found that 13 (or 21%) of the cases warranted scrutiny of additional returns but none were selected for examination. In 26 (or 38%) of the 68 cases, "there was no evidence that examiners inspected either the prior or subsequent year return to identify similar issues to the years under examination or if large, unusual, or questionable items existed that would warrant examination." Factors that might be considered include the comparative size of an expense, if the nature of the item is significant, the beneficial effect of the manner in which an item is reported, and missing items on the return. "When examiners do not make the proper decision to select returns for examination, taxpayers are not provided equitable treatment, and the examination is not as effective for improving taxpayer compliance on future tax returns." The audit also found that Compliance function tax examiners are currently unable to assess subsequent year tax returns and select them for audit.

As a result, the IRS "could be missing an opportunity to conduct examinations more efficiently and consistently from year to year." **(Misc.; IRS Audits)**

> **Comment:** This assessment was based on a review of 68 additional cases which revealed that in 31 (or 46%) of those cases the *same* issues adjusted on the tax year return under examination were present on the subsequent year return.

Excludible Payments Not Subject to Back-Up Withholding (CCA 200906051)

Payments of $600 or more which are excludible from income, such as damages received on account of physical personal injuries or physical sickness under **Code §104(a)(2)**, are *not* reportable as payments to others in the course of a trade or business required to be reported on information returns (Form 1099). Therefore, the backup withholding rules do *not* apply. **(Code §3406; Back-up Withholding)**

9th Circuit Affirms Costs of Selling Manufactured Homes Not Currently Deductible Marketing Expenses (*LOAD, Inc.; COAD, Inc. v. U.S.*, No. 07-72564 (9th Cir., 2/2/2009))

The 9th Circuit has *affirmed* the Tax Court's holding that the costs of a seller of manufactured homes for placing the homes on retail sales lots so that local independent salespersons could sell them were includible in inventory under **Code §263A**. Therefore, they were *not* currently deductible under **Code §162**.

Background: Under the uniform capitalization rules (UNICAP), direct costs and indirect costs properly allocable to inventory in a taxpayer's hands must be included in inventory costs. (**Code §263A(a)**) Generally, indirect costs allocable to inventory acquired for resale are *not* currently deductible. Regs under **Code §263A** expressly include transportation, rent, taxes, and repair and maintenance costs relating to property held for resale as examples of indirect costs to be included in inventory. (**Reg. §1.263A-1(e)(3)(ii)**) However, there is an exception from the inventory requirement for marketing, selling, advertising, and distribution costs for property held for resale. (**Reg. §1.263A-1(e)(3)(iii)(A)**) Normally, costs associated with storing property held for resale generally must be included in inventory. (**Reg. §1.263A-1(e)(3)(ii)(H)**) But, storage costs relating to inventory that are incurred at an on-site storage facility are specifically excepted from inclusion in inventory. (**Reg. §1.263A-1(e)(3)(iii)(I)**) An on-site storage facility is a storage facility that is physically attached to and that is an integral part of a retail sales facility (i.e., the location at which merchandise is sold "exclusively to retail customers in on-site sales"). (**Reg. §1.263A-3(c)(5)(ii)**)

Facts: Associated Dealers, Inc. (ADI), along with LOAD, Inc. and 18 other related corporations (including COAD, Inc.) that are either ADI subsidiaries or sister corporations, sell manufactured homes which they buy from the manufacturers. ADI buys model manufactured homes and places them on retail sales lots that it leases to attract public attention and provide an opportunity for interested retail customers to inspect the homes. ADI sells its manufactured homes through independent salespersons. Putting the homes on the lots, which are generally located in prominent, high traffic areas, allows these salespersons to show the homes to customers. After meeting and negotiating with the independent salespersons, 90% of ADI's retail customers custom order homes and 10% buy the homes right off the sales lots. Under written contracts, the manufactured homes are sold by the manufacturers to ADI, by ADI to the independent salespersons, and by the independent salespersons to the retail customers. In some cases, if a customer's homesite is *not* ready for delivery, the completed manufactured home may be delivered to one of ADI's nearby sales lots until it is ready either a few days or months later. On its return for the year in issue, ADI deducted as ordinary and necessary business expenses $243,350 in sales lot lease payments and $22,387 in miscellaneous expenses related to the model homes (including $16,184 for shipping them to the sales lots, $3,423 for delinquent State taxes, $2,500 for repairs, and $280 for cleaning). On audit, the IRS determined that these costs were *not* currently deductible but instead had to be included in inventory costs.

9th Circuit Decision: The 9th Circuit *affirmed* the Tax Court's holding that ADI could *not* recharacterize the costs as deductible marketing, selling, or distribution costs, excepted from inventory under **Reg. §1.263A-1(e)(3)(iii)(A)**. The regs specifically require these expenses (i.e., $243,350 lot lease payments, $16,684 transportation costs, $3,423 State taxes, $2,500 repair expenses, and $280 maintenance costs) to be included in inventory. The Court agreed that none of these expenses were "marketing or distribution expenses." Therefore, none were currently deductible as ordinary and necessary business expenses. The "inventory exception" for on-site storage costs was inapplicable to ADI. **Reg. §1.263A-3(c)(5)(ii)(B)** expressly states that to be excepted, on-site storage costs must relate to property sold by a taxpayer "exclusively" to retail customers. Although ADI participated in the sale of the manufactured homes to the retail customers, it did *not* sell the manufactured homes exclusively to the retail customers. ADI's sale and title transfer to the independent salespersons who sold the homes to the retail customers could *not* be ignored. **(Code §263A; Uniform Capitalization)**

Collection Due Process Hearing Procedures Clarified (*James Baber*, TC Memo 2009-30 (2/9/2009))

In requesting a Collection Due Process (CDP) hearing after a Notice of Federal Tax lien has been filed, the taxpayer may demand a hearing before an Appeals Officer who has had no prior involvement with the taxpayer's case. In this case, the IRS sent taxpayer a Notice of Determination concerning a Notice of Federal Tax Lien filed to collect unpaid taxes for 1994 through 1997. The Tax Court held that taxpayer was entitled to a new CDP hearing because the Appeals Officer who

handled the first hearing had been involved with a prior offer in compromise for the same tax liabilities. **(Code §6323; IRS Liens)**

Tax Court Not Bound by Administrative Findings Regarding Innocent Spouse Relief (*Commr. v. Neal*, No. 06-14357 (11th Cir., 2/10/2009))

The issue in this case, whether the Tax Court at trial can consider evidence *not* included in the administrative record in determining if the taxpayer is entitled to equitable innocent spouse relief under **Code §6015(f)**, has divided the 14 members of the Tax Court: 12 judges have concluded the Tax Court's determination of equitable relief is made in a trial de novo and is *not* confined to the administrative record, while two members would limit the scope of review to the administrative record. Here, the 11th Circuit *affirmed* that the Tax Court did *not* err in refusing to limit its consideration to the administrative record. Furthermore, it did *not* abuse its discretion in determining that the taxpayer was entitled to equitable relief. **(Code §6015; Innocent Spouse)**

☞**Widow Entitled to Partial Equitable Spousal Relief (*Martinez*, TC Summ. 2008-165 (12/29/2008))**

The Tax Court held that a widow was entitled to equitable spousal relief for two of four tax years, even though she had knowledge of her and her husband's tax liabilities, because she took steps to address their tax problems and made significant payments under an installment agreement.

Facts: The taxpayer married her husband in 1971 and they remained married until his death on 4/2/01. From 1985 onward, the taxpayer's husband struggled with serious health issues resulting in him ceasing work in July 1995. The taxpayer was working as a secretary during this time. The couples' bank account was in her name, but her husband decided which bills to pay and when to pay them. The taxpayer did *not* review monthly banking statements, did *not* balance the checkbook, and did *not* pick up or open the mail. The taxpayer's husband would prepare their tax returns, show her a preliminary draft, and have her sign a blank original that he would complete and mail. In 1988, the taxpayer and her husband had a balance due for their federal income tax that the IRS collected by levy in 1994. In 1992, they earned equivalent wages and had equivalent withholdings, but began drawing money from the taxpayer's retirement account. By 1995, they were experiencing significant problems as the taxpayer's husband stopped working, and the couple began withdrawing larger amounts of money from their retirement plans. Their tax preparer included the withdrawals in their gross income and reported a 10% additional tax for these premature distributions from their retirement plans. In 1996, the taxpayer and her family moved from southern to northern California. Shortly after the move, the taxpayer learned that her husband had *not* filed their 1992 and 1995 tax returns. The couple hired a regional law firm that specialized in taxes to prepare the delinquent returns. By 1998 or 1999, the couple had no financial resources other than the taxpayer's paycheck, as they had exhausted their retirement accounts and emptied their after-tax investments and savings. The taxpayer's salary was in the low- to mid-thirty thousands. Shortly before her husband's death, the taxpayer discovered shoe boxes filled with unopened letters from the IRS and the tax returns that she signed but her husband had *not* mailed. The taxpayer re-engaged the law firm that prepared the prior delinquent returns. The firm determined that the couple had outstanding balances for each year during 1992-2000 except for 1996, where a refund was due. The total amount due was $48,684. The firm prepared an offer-in-compromise of $1,000 to settle the entire debt, which was submitted to the IRS during the summer of 2001. The IRS indicated that it was going to reject the offer, so the taxpayer decided to enter into an installment agreement with the IRS, under which she agreed to pay $775 per month to resolve the entire debt. The taxpayer began making installment payments in May 2002 and continued until November 2005, when she ceased because the IRS had stopped sending her monthly payment coupons. In total, the taxpayer paid approximately $35,650 in installment payments. The IRS applied the couple's 1996 refund to the 1993 underpayment, and applied the installment payments in a "seemingly haphazard manner" that resulted in full payment of the balances owing for 1993, 1994, 1997, and 2000, while leaving balances due on 1992, 1995, 1998, and 1999. The taxpayer retained a national tax preparation firm to help her prepare her 2004 return. After reviewing her records, the firm suggested that she apply for innocent spouse relief. The taxpayer completed an application, including a **Form 12510**, Questionnaire for Requesting Spouse, which had a worksheet for monthly income and expenses. The taxpayer reported a monthly net income of $2,636 and expenses of $2,480 (including the $775 monthly installment payment), leaving her a surplus of $156 per month. The IRS denied the taxpayer's request for innocent spouse relief. The taxpayer timely appealed the denial to the IRS' Office of Appeals, where the Appeals officer determined that the taxpayer was in tax compliance and satisfied the threshold requirements for relief on the portion of the liability attributable to her deceased husband. Nevertheless, the Appeals officer rejected the taxpayer's request for relief, because:

(1) The taxpayer had reason to know of the underpayment.

(2) In 1999 and 2000 nearly all of the underpayments were attributable to her earnings (the officer did *not* have the 1998 return for review).

(3) Paying the debt would *not* cause the taxpayer economic hardship, because she reported a monthly surplus on her worksheet.

(4) The taxpayer's husband did *not* abuse her.

(5) The taxpayer had no health problems.

But, the officer did *not* take into account, or find relevant, the dollar amount and percentage of the overall debt that the taxpayer paid through installment payments. More significantly, two years after the

taxpayer's initial submission of Form 12510, the taxpayer submitted a *new* form that showed a monthly cash-flow shortfall of $322, *without provision* for the repayment of outstanding taxes. The record showed that the taxpayer's financial condition worsened due, in part, to the financial arrangement she had with her new husband, who had limited income.

Background: **Code §6015** provides relief from joint and several liability on a joint return. If a taxpayer does *not* qualify for innocent spouse relief under **Code §§6015(b)** or **6015(c)**, the taxpayer may seek an equitable remedy under **Code §6015(f)**. Because the taxpayer did *not* qualify for relief under **Code §§6015(b)** or **6015(c)**, her sole avenue of relief was provided by **Code §6015(f)**.

Tax Court Decision: The Tax Court began its review by examining **Rev. Proc. 2003-61**, which outlined the new review process IRS employees were to follow when determining whether a spouse qualifies for equitable relief. The process begins with *seven* "threshold criteria" that must be satisfied before equitable relief will be considered. The court found that the taxpayer met the threshold requirements of Sec.4.01 of the procedure on the portion of the liability that was attributable to her deceased husband for 1992 and 1995, but because the attribution factor was elevated to a threshold fact under the new process, the court could *not* consider relief for 1998 and 1999 as the liability for those years was her own. Since the taxpayer satisfied the threshold requirements, the court then considered whether her circumstances satisfy all three elements of Sec. 4.02: marital status, knowledge or reason to know, and economic hardship. The court found that the taxpayer satisfied the first element, but failed to satisfy at least one of the other factors. For requesting spouses who fail to qualify under Sec. 4.02, the procedure provides a list of nonexclusive factors that are considered in determining whether to grant full or partial equitable relief. The Tax Court then weighed the factors in reaching its decision:

(1) Marital status: The taxpayer's husband died before she requested relief, so this factor *favored relief*.

(2) Economic hardship: The court said that the Appeals officer properly relied on the taxpayer's Form 12510 in determining that she would *not* suffer economic hardship if denied relief, because her worksheet showed a monthly surplus after paying basic living expenses and the installment payment and the taxpayer corroborated the determination. The court stated that normally its inquiry would stop there, but because **Code §6015(f)** required that the court take into account "all facts and circumstances," it considered the taxpayer's *new* Form 12510, which showed a monthly deficit of $322. The court found that the taxpayer, who already had a modest lifestyle, suffered a diminution in her financial circumstances. Considering the combination of age, education, and work situation, the court found that the taxpayer "was in a precarious financial circumstance" and said that the economic hardship factor was *neutral*.

(3) Knowledge or reason to know: The relevant standard applied when a couple accurately reported, but did *not* pay, balances due is whether the taxpayer requesting relief did *not* know and had no reason to know that her spouse would *not* pay the income tax liability. The court found that it was improbable that the taxpayer lacked knowledge. Specifically, sometime after the taxpayer's husband became ill, the taxpayer assumed sufficient responsibility over their delinquent tax filings so as to encourage him to seek help from a law firm. Furthermore, the court noted that the main reason for the balances due for 1992 through 2000 was that the taxpayer had her employer withhold too little tax from her paycheck, adding that only the taxpayer, and *not* her husband, could have filed the withholding certificate with her employer. Because the court found that the taxpayer knew or had reason to, it found that this factor *strongly disfavored relief*.

(4) Legal obligation: This factor was inapplicable because the taxpayer and her deceased husband did *not* divorce.

(5) Significant benefit: The court found that during and after her marriage, the taxpayer did *not* receive jewelry, luxury cars, or designer clothes, nor did she receive or otherwise own a home. Instead, the taxpayer drained her savings and retirement assets trying to support her family and help her dying husband. As a result, the court found that this factor *significantly favored relief*.

(6) Compliance with federal tax laws: Since her husband's death, the taxpayer was in compliance with federal tax laws, making this factor *neutral* or in *favor of relief*.

(7) Abuse: Because the court found that the taxpayer was *not* abused, this factor was *neutral*.

(8) Mental health: The court believed that the taxpayer "was under great mental strain dealing with her dying husband" while supporting her family solely on her modest wages and found that this factor *strongly favored relief*.

(9) Other factors: First, with respect to the 1995 tax return, the taxpayer's tax preparer included a 10% additional tax on premature retirement plan distributions. But, the court believed that the taxpayer's husband was a good candidate for relief under **Code §72(t)(2)(A)(iii)**, which provides an exception to the additional tax if the distribution was attributable to the employee's being disabled. The court added that if the original 1995 balance was reduced by removing the 10% additional tax attributable to the taxpayer's deceased husband, the IRS's application of the taxpayer's payments would have paid the *entire* remaining liability. Second, the court noted that the taxpayer paid $35,650 or 73% of the entire liability for 1992 through 2000, including a portion attributable to her deceased husband, which was more than her share of the liabilities for the 1992 and 1995 tax years. Third, the court noted that the 1992 and 1995 liabilities were old, particularly the 1992 liability where, oddly, the

IRS applied less of the payments. Finally, the court review of the conference report accompanying the enactment of **Code §6015** showed that the conferees intended to expand the circumstances in which innocent spouse relief could be made available. The court therefore concluded that the other factors *strongly favored relief*.

In summary, the court found that one factor strongly disfavored relief, three or four factors were neutral, and four or five factors favored or strongly favored relief. Balancing the equities, the court held that for 1992 and 1995 the factors in favor of relief outweighed the factors disfavoring relief, with no single factor being determinative. The court denied relief for years 1998 and 1999 because the taxpayer's request for relief failed the threshold test of attribution.

Sec. 179 Deduction Denied Where Substantiation of Business Use Lacking (*S. Singh v. Commr.*, Dec. 57,739(M) , TC Memo. 2009-36 (2/12/2009))

A married couple was denied a Sec. 179 deduction for the purchase of a sport utility vehicle (SUV) where the couple failed to substantiate that the vehicle was used more than 50% in the husband's business.

Facts: In 2004, the taxpayer ran a trucking business, organized as an S corporation, in which he was the sole shareholder. The taxpayer was also the sole operator of his tractor trailer for the company. During the year, the taxpayer contracted with a transport company, located in Plymouth, Ohio, to deliver goods. He drove a route through Ohio twice a week, and during layovers, he would return to the transport company's facility in Plymouth. At the transport company facility, the taxpayer left a used 2001 BMW SUV in the parking lot for the duration of his deliveries. He purchased the vehicle on May 7, 2004, for $30,200. After making his deliveries, the taxpayer would drive his SUV to his brother's home in Michigan, where he frequently stayed. The taxpayer sought to take a deduction for the 2004 tax year under **Code §179** for the full purchase price of his SUV, $30,200.

> **Comment:** Note that the current $25,000 Sec. 179 limit on "heavy" SUVs only applies to such vehicles placed into service *after* 10/22/2004.

Background: Generally, a taxpayer bears the burden of proving his entitlement to a deduction, and is required to maintain records sufficient to enable the IRS to determine the correct tax liability. The taxpayer can take a depreciation deduction for property used in a trade or business, or alternatively, the taxpayer can expense the cost of property purchased for use in business under **Code §179**. If the property is used for both business and personal purposes, the portion attributable to business use can be expensed, but only if the property was used predominantly (i.e., more than 50%) for business purposes. Otherwise, no deduction under **Code §179** is allowed. In addition, the substantiation requirements for a **Code §179** deduction are more stringent than such requirements generally. Specifically, under **Code §274(d)**, the taxpayer must substantiate the amount, time, place and business purpose of the claimed expenditures and must provide adequate records or sufficient evidence to corroborate his own statement.

Tax Court Decision: In this instance, the taxpayer did *not* maintain a mileage log showing how many total miles were driven. Moreover, the SUV was driven primarily between the transport company's building and the place where the taxpayer spent his weekly layovers, and the costs of commuting to and from work are personal expenses which do *not* qualify as deductible business expenses. The taxpayer failed to provide evidence showing the total mileage driven, or the business mileage driven, and the remaining record contained no evidence of that nature. As a result, the taxpayer also failed to satisfy the predominant use requirement. Therefore, the taxpayer did *not* satisfy the substantiation requirements of **Code§274(d)**, and his claim of an expense deduction under **Code §179** was rejected. **(Code §179; Immediate Expensing)**

FROM CONSULTING CALLS:

☞**Properly Claiming an NOL Carryback**

Individuals: Individuals can apply for an NOL refund in two ways: (1) by filing **Form 1040X**, Amended U.S. Individual Income Tax Return, or (2) by filing **Form 1045**, Application for Tentative Refund. (**Reg. §§301.6402-3(a)(2)** and **1.6411-1**) But, the quickest method to obtain a refund is to file Form 1045, because the IRS generally acts upon this form within 90 days.

Form 1045: If Form 1045 is used, it can be filed on or after the date on which the return for the NOL year is filed. However, it must be filed no later than *one year* after the end of the NOL year. For example, a calendar-year taxpayer with an NOL for 2008 must file Form 1045 by December 31, 2009, to obtain a refund for the loss carried back to a previous tax year. A *separate* Form 1045 must be filed for each year involving an NOL adjustment and should be filed separately from the taxpayer's income tax return for the year of the loss. Nevertheless, the individual should attach the first two pages of Form 1040 and all other forms and schedules from the tax year which a carryback results.

Form 1040X: If Form 1040X is instead used, it must be filed *within three years* of the due date (including extensions) for filing the return for the year in which the NOL arose. For example, a calendar-year taxpayer who incurred an NOL in 2007 has until April 15, 2011, to file a claim for refund of taxes paid in the first carryback year.

C Corporations: Like individuals, a corporation can apply for an NOL refund in two ways: by filing **Form 1120X**, Amended U.S. Corporate Income Tax Return, or **Form 1139**, Corporate Application for Tentative Refund. Form 1139 should generally be used if a refund is desired, because the

IRS will generally act upon it in 90 days. Other filing requirements are similar to the procedures for individuals except that a corporation can use just *one* Form 1139 to file for up to *three* years of NOL adjustments.

Form 1139: The amount on Form 1139 should match the IRS's records. If the corporation has *not* yet filed its Form 1120 for the loss year, it can still claim a refund by filing an "original return," followed by a superseding return, so that it can
accelerate the filing of the Form 1139. But, the "original return" must have sufficient information for the IRS to respond. Otherwise, it can reject the return and deny the refund until a complete Form 1120 is filed.

> **Comment:** The IRS may need to contact the corporation for more information before it provides a refund through the Form 1139 route. Therefore, the IRS recommends that the corporation attach **Form 2848** if it wants to designate an attorney or representative for the IRS to contact.

Forgoing the NOL Carryback: Even though the proposed legislation would lengthen the carryback period, a taxpayer must remember that under current law it can elect to waive the carryback period and use only the 20-year carryforward period (i.e., by indicating the rejection of the carryback option on page 2 of Form 1120). Once made, the waiver is generally irrevocable. A taxpayer might want to forgo the NOL carryback for several reasons:

(1) The taxpayer has been able to claim tax credits based upon available income in the prior years;

(2) Income may be taxed at a higher rate in a later year;

(3) The taxpayer generally may want to retain the NOL to use in a future year; or the NOL, by reducing an individual's income, may diminish the allowable individual retirement account contribution or itemized deductions.

> **Comment:** On the other hand, using the NOL in a prior tax year could benefit the individual by reducing the AGI threshold and increasing the itemized medical deduction (or, any other tax benefit which might otherwise be subject to AGI phaseout rules).

> **Comment:** A taxpayer who wishes to waive the entire carryback period must attach a statement to the tax return for the year of the loss. The statement must be attached to a timely filed tax return (including extensions) and indicate that the taxpayer is waiving the entire carryback period. (**Code §172(b)(3)**) Or, the statement may instead be attached to an amended return filed within six months of the due date of the original return (excluding extensions). If an amended return is filed, "Filed pursuant to **Reg. §301.9100-2**" should be written on the election statement. And, the amended return should be filed at the same address as the original return. The amended return option is only available if the original return was timely filed without making the election.

> **Comment:** Eligible small businesses who wishes to utilize the special 3-, 4-, or 5-year carryback provision made available in the 2009 Recovery Tax Act must attach an election to their return to increase the carryback period under **Code §172(b)(1)(H).** More importantly, this election will be treated as timely made if filed *before* Apr. 18, 2009 (i.e., within 60 days of the 2/17/2009 enactment date of the new law).

☞Online Payment Agreements Handy Where Clients Lack Funds to Pay Taxes

Taxpayers are permitted to apply for an **Online Payment Agreement (OPA)** for a monthly payment agreement if they unable to pay their taxes in full.

Background: A taxpayer with $25,000 or less in combined tax, penalties, and interest can use the OPA application to allow the them or their authorized representative (Power of Attorney) to qualify, apply for an installment agreement, and receive immediate notification of approval. If the IRS grants online approval, then the taxpayer will be notified within 10 days,

Two Options Offered: The OPA allows the taxpayer two ways to pay when *not* otherwise submitting their taxes in full. The taxpayer can be granted a short-term extension of time to pay of up to 120 days. There is no fee for an the short-term extension. But, if the taxpayer cannot pay in full within 120 days, then they may make a request to make monthly installments. To be eligible for monthly installments, the taxpayer must have filed all of their tax returns that are due. In addition, a user fee must be added to the amount of taxes owed. Generally, the user fee will be $105 unless the fee is deducted directly from the taxpayer's bank account, in which case it is $52. Eligible individuals with income at or below certain levels who apply and qualify, may pay a reduced user fee of $43. **(Code §7122; Online Payment Agreement)**

Yours very truly,
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