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Five-Minute Tax Briefing®

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Five-Minute Tax Briefing Editor

Highlights

Business Use of Employer-provided Cell Phones: An employee with an employer-provided cell phone receives a nontaxable working condition fringe benefit to the extent he or she uses the phone for business purposes, and the cell phone cost is a deductible business expense for the employer if the substantiation requirements of IRC Sec. 274(d) are met. This notice requests comments from the public on several proposals (including a minimal personal use method, a safe harbor substantiation method, and a statistical sampling method), as well as alternatives that can be used, to simplify the procedures for employers to substantiate an employee's business use of employer-provided cell phones. Notice 2009-46, 2009-23 IRB.

***Cohan* Rule Applies to Research Credit:** The IRS argued that even if *qualified research* occurred for Section 41 credit purposes, taxpayer failed to provide adequate documentation to substantiate the costs associated with the research. Citing *Cohan v. Comm.* [8 AFTR 10552 (2nd Cir. 1930)], the 5th Circuit responded that if the taxpayer can show it conducted *qualified research* activities, the court should estimate the expenses associated with those activities. So, the appellate court remanded (returned) the case to the Texas District Court to, in part, "determine whether any qualified research occurred, and, if so, estimate the expenses related to that research." *McFerrin v. U.S.*, 103 AFTR 2d 2009-XXXX (5th Cir.).

International Tax Law Enforcement: In prepared remarks for a 6/2/09 conference, Commissioner Doug Shulman said that the IRS has "particular interest" in transfer pricing, financial instruments, hybrid structures, and withholding taxes. The Administration's proposed fiscal year 2010 budget will allow the IRS "to make unprecedented investments in people, tools, and overall coverage in the international arena," including nearly 800 new employees devoted to international enforcement. In addition, the IRS has initiated talks to take international cooperation to another level, including joint examinations with other countries.

Return Preparer Initiative: Because there is "virtually no federal oversight over unenrolled preparers, who constitute the majority of tax return preparers today," National Taxpayer Advocate Nina Olson previously recommended that Congress enact an examination, certification, and enforcement program for unenrolled tax return preparers in her most recent annual report to Congress. Following up on this suggestion, Commissioner Doug Shulman announced that by the end of 2009, he will issue a set of recommendations that could include "a new model for the regulation of tax return preparers; service and outreach for return preparers; education and training of return preparers; and enforcement related to return preparer misconduct." News Release IR-2009-57.

Return Preparer Penalty Procedures for Estate and Gift Tax Cases: An IRS Small Business/Self-employed Division memo (SBSE-04-0509-009) provides interim guidance to estate tax attorneys on imposing the Section 6694 and 6695 return preparer penalties. In each examination, the attorney will determine if consideration of return preparer penalties is necessary. The determination and settlement of the estate or gift tax examination will at all times proceed without regard to the return preparer penalty issue.

Sales Tax Deduction for New Car Purchases: Under IRC Sec. 164(b)(6), taxpayers who buy an eligible new vehicle after 2/16/09 and before 1/1/10 can deduct state or local sales or excise taxes paid on the purchase. The IRS says that taxpayers who buy a qualifying vehicle in a state that doesn't have a sales tax can deduct other fees or taxes imposed by the state or local government. To qualify, the fees or taxes must be assessed on the purchase of the vehicle and must be based on the vehicle's sales price or as a per unit fee. News Release IR-2009-60. See NTA-705 in this issue for further discussion of this deduction.

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Other Current Releases

Employment Taxes—FICA Student Exemption: IRC Sec. 3121(b)(10) authorizes a FICA exemption for students employed by and regularly attending classes at a school or university. However, for services performed after 3/31/05, Reg. 31.3121(b)(10)-2 states that medical residents whose normal work schedule is 40 or more hours per week are not eligible for the exemption. In this case, the 8th Circuit reversed a Minnesota District Court decision that invalidated the regulation. After finding that the statute was ambiguous on whether a medical resident working for the school full time is a “student who is enrolled and regularly attending classes,” the 8th Circuit held that the regulation was a permissible interpretation of the statute. Since the medical residents’ worked more than 40 hours per week, their compensation for patient care was subject to FICA taxation. *Mayo Foundation for Medical Education and Research v. U.S.*, 103 AFTR 2d 2009-XXXX (8th Cir.).

Income Tax—COBRA Premium Subsidy: The IRS added 19 new questions and answers on its website (see **www.irs.gov/newsroom/article/0,,id=204708,00.html**) related to the COBRA continuation premium subsidy for former employees and their families. The new questions address issues such as involuntary terminations, claiming the payroll tax credit for the subsidy, recordkeeping, and reporting the subsidy on the recipient’s Form W-2 or Form 1040.

Income Tax—Corporate Inversions: IRC Sec. 7874 applies to inversion transactions in which the U.S. parent of a multinational corporate group is replaced by a foreign entity. This enables the group to continue business as before while minimizing U.S. tax on foreign operations. Temporary regulations were issued in 2006 (found in TD 9265) to help determine whether a foreign entity should be treated as a surrogate foreign corporation under IRC Sec. 7874(a)(2)(B). After consideration of comments, Treasury has replaced the 2006 regulations with new temporary regulations (see TD 9453). For example, the new regulations retain the 2006 rules identifying certain acquisitions as constituting indirect acquisitions of properties held by a domestic corporation, but note that the identified transactions don’t represent an exclusive list of transactions constituting indirect acquisitions. Temp. Regs. 1.7874-1T and 1.7874-2T (generally applicable to acquisitions completed on or after 6/9/09).

Income Tax—Dividends from Noncontrolled Corporations: Final and temporary regulations (found in TD 9452) discuss the application of separate foreign tax credit limitations to dividends received from noncontrolled Section 902 corporations following changes by the American Jobs Creation Act of 2004. [**Editor’s Note:** Under the 2004 Act, dividends paid by a noncontrolled Section 902 corporation (10/50 corporation) are treated as income in a separate category based on the separate category of the underlying earnings and profits being distributed (look-through treatment) without regard to when the distributed earnings were accumulated.] The regulations adopt without amendment most of the prior (2006) temporary regulations, and generally apply to acquisitions completed on or after 6/9/09.

Income Tax—Employee Fringe Benefits: In chief counsel advice, the IRS determined that company discounts were not excluded from the employees’ income under IRC Sec. 132(c) as *qualified employee discounts*. Qualified employee discounts include discounts on “qualified

property or services," which are limited by IRC Sec. 132(c)(4) to property or services "offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services." The discounted property in this case was not offered for sale to customers by the same employer for which the employees receiving the discount performed services. CCA 200923029.

Income Tax—Intercompany Transactions: The IRS issued revised guidance on how (1) a taxpayer may obtain IRS consent to treat intercompany transactions on a separate entity basis under Reg. 1.1502-13(e)(3), (2) the taxpayer or the IRS revokes this consent, and (3) to obtain IRS consent to change from separate entity reporting to single entity reporting of intercompany transactions. The new procedures provide a stricter consolidated taxable income test with an additional consolidated taxable liability test compared to previous guidance before the IRS will grant consent. This revenue procedure supersedes Rev. Proc. 97-49 (1997-2 CB 523) and is effective for tax years ending after 7/5/09. Rev. Proc. 2009-31, 2009-27 IRB.

Income Tax—Investment Tax Credit: The IRS explains how to elect to claim the Section 48 investment tax credit instead of the Section 45 production tax credit (generally based on kilowatt hours of electricity produced) for certain renewable energy facilities. This election was authorized by the American Recovery and Reinvestment Act of 2009 and is available for facilities placed in service after 12/31/08. The election is made by filing Form 3468 (Investment Credit) along with an attached statement providing additional taxpayer and property information on a timely filed return for the year the qualified facility is placed in service. Notice 2009-52, 2009-25 IRB.

Income Tax—Nonbusiness Energy Property Credit: The Energy Improvement and Extension Act of 2008 reinstated and modified the Section 25C nonbusiness energy property credit for property placed in service during 2009. A new notice provides procedures that manufacturers can follow to certify property as *qualified nonbusiness energy property* under IRC Sec. 25C and guidance on taxpayers' reliance on a certification. This notice also discusses changes made to the credit by the Energy Improvement and Extension Act of 2008 and the American Recovery and Reinvestment Tax Act of 2009, as well as transition rules for certain nonbusiness energy property acquired before 6/1/09 or placed in service after 12/31/08. Notice 2009-53, 2009-25 IRB.

Income Tax—Plug-in Electric Vehicle Credit: The IRS issued interim guidance for vehicle manufacturers (or the domestic distributor of a foreign manufacturer) to certify to the IRS (1) that a particular make, model, and model year meets the requirements to claim the Section 30D credit, and (2) the allowable credit for that vehicle. [**Editor's Note:** This notice applies to the credit as originally enacted in the Energy Improvement and Extension Act of 2008. Future guidance will address amendments made to IRC Sec. 30D by the American Recovery and Reinvestment Act of 2009, which apply to vehicles acquired after 12/31/09.] Purchasers can rely on the manufacturer's certification as long as the vehicle is purchased in 2009 for original use by the taxpayer in the U.S. Notice 2009-54, 2009-26 IRB.

Income Tax—Recovery Zone Bonds: This notice provides interim guidance on Recovery Zone Economic Development Bonds and Recovery Zone Facility Bonds authorized by IRC Secs. 1400U-2 and 1400U-3. In general, these bonds provide tax incentives for state and local governments to "promote job creation and economic recovery that is targeted to areas particularly affected by employment declines." This notice also provides guidance on the maximum amount of bonds that can be issued by each state, county, and large municipality before 1/1/11 under IRC Sec. 1400U-1. Notice 2009-50, 2009-26 IRB.

Income Tax—Related Party Loss in LLC Conversion: In chief counsel advice, the IRS concluded that when a parent company's wholly owned subsidiary distributes all of its membership interests in a disregarded entity to the parent company and has a deferred loss under IRC Sec. 267(f), the loss can be taken into account upon the parent's subsequent conversion to an LLC under the state's formless conversion statute. CCA 200924043.

Income Tax—Reporting Insurance Proceeds from Destroyed Crops: Under IRC Sec. 451(d), a cash basis farmer can defer the receipt of crop insurance from the year the crops are destroyed to the next year unless, under the farmer's normal business practice, income from the crop would have been reported in any tax year following the tax year of the crop's destruction. Unfortunately, this deferral was not available to taxpayers whose 2001 sugar beet crop was destroyed, but who had historically reported 65% of the sugar beet income in the year of the harvest and the remaining 35% the following year. Rev. Rul. 74-145 (1974-1 CB 113) established the *substantial portion test* allowing deferral when the farmer customarily

defers more than 50% of the income from the damaged crop. Since this ruling reasonably reflected Congress's intent in enacting IRC Sec. 451(d), the 8th Circuit affirmed the Tax Court's holding that deferral was not available. *Nelson v. Comm.*, 103 AFTR 2d 2009-XXXX (8th Cir.).

Income Tax—Sale of Excess Real Estate: Taxpayers bought 14.4 acres of undeveloped property to build their dream home. Thereafter, they decided to subdivide the property and sell the excess lots. Because their only prior experience was the sale of personal residences, they hired a consultant to create a subdivision layout and obtain a zoning change to subdivide and develop the property. They sold the lots by word of mouth, disposing of one lot in 2000, three lots in 2004, and one lot in 2005, 2007, and 2008. In finding that the excess lots were held for investment purposes and the proceeds were capital gains and losses, the Tax Court noted that (1) the total number of lots sold was small, and the 5th Circuit, to which this case is appealable, has held that substantiality and frequency of sales are among the most important factors; (2) taxpayers devoted little time to the sale of the excess lots; (3) the lots were sold primarily to friends and relatives; and (4) taxpayers had other, full-time jobs and devoted little time to the sale of the excess lots. *Bruce Rice*, TC Memo 2009-142 (Tax Ct.).

Income Tax—Section 409A Consequences of Treasury Purchases: Most of the financial institutions and other entities whose stock or other equity interests were or will be bought by the Treasury Dept. under the Emergency Economic Stabilization Act of 2008 (EESA) sponsor nonqualified deferred compensation plans subject to IRC Sec. 409A. Questions have arisen about whether Treasury's equity acquisitions constitute a *change-in-control event*, and so are a permissible Section 409A payment event. The IRS has decided that a Treasury equity acquisition under EESA is not a change-in-control event, so a nonqualified deferred compensation plan will fail to meet the requirements of IRC Sec. 409A(a) if a payment is made on account of a Treasury EESA acquisition. However, a plan will not fail to meet these requirements because it doesn't make a payment on account of a Treasury EESA acquisition. Notice 2009-49, 2009-25 IRB.

IRS Announces Early Registration Discount for Tax Forums: The IRS invites practitioners to make their reservations early for one of the six Tax Forums to be held throughout the country. This year, 40 seminars and three workshops are being offered at the three-day event. The cost is $206 per person per city for pre-registration, which ends two weeks prior to the start of each forum, and $335 thereafter. The pre-registration deadline and forum dates for each location are as follows: (1) Las Vegas: June 23 and July 7–9, (2) San Diego: June 30 and July 14–16, (3) Orlando: July 21 and August 4–6, (4) New York City: August 11 and August 25–27, (5) Dallas: August 25 and Sept. 8–10, and (6) Atlanta: Sept. 8 and Sept. 22–24. News Release IR-2009-59.

IRS Issues Spring 2009 Income Bulletin: The IRS published the Spring 2009 issue of the Statistics of Income (SOI) Bulletin, which provides information on high-income individual tax returns filed for the 2006 tax year along with some preliminary information for 2007 year filings. The 4,064,883 returns with more than $200,000 in AGI represented about 3% of all returns filed for 2006. Since 1977, only the 2001 and 2002 tax years reflected a decrease in the number of returns reporting incomes of $200,000 or more. The 2007 preliminary data also shows an 8.6% increase in the AMT. Furthermore, in 2006, about 335,000 U.S. taxpayers living abroad reported approximately $36.7 billion in foreign-earned income and claimed nearly $18.4 billion in exclusions from income. The bulletin is available at **www.irs.gov** under the *Tax Stats* heading. News Release IR-2009-56.

IRS Publishes VITA Application Packages: In a notice published in the 6/1/09 Federal Register (4830-01P), the IRS announced the availability of application packages for the 2010 Community Volunteer Income Tax Assistance (VITA) Matching Grant Program. The deadline for submitting an application to the IRS is 7/17/09. Electronic copies of the application package can be obtained by visiting **www.irs.gov** (key word search "VITA Grant") or by sending an email to *Grant.Program.Office@irs.gov*. However, applications must be submitted by mail.

Procedure—Foreign Bank and Financial Accounts: The IRS is temporarily suspending the reporting requirement for foreign bank accounts [Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR)] due on 6/30/09 for persons who are not U.S. citizens, residents, or domestic entities. Responding to confusion about the definition of a *United States person* in the revised Form TD F 90-22.1 (10/08), the IRS stated that the definition of a *United States person* in the instructions for the prior version (7/00) of the FBAR can be used to determine whether there is an obligation to file the FBAR due on 6/30/09. IRS Ann. 2009-51, 2009-25 IRB.

Procedure—Notice of Deficiency for Partnership Items: Taxpayers (husband and wife) claimed losses from a partnership they identified as M. M was actually the husband's single member LLC that was disregarded for federal tax purposes. The losses stemmed from M's ownership in a multimember LLC taxed as a partnership that was subject to the TEFRA audit rules. The LLC's return did not indicate that M was a disregarded LLC or the husband (not M) was actually the LLC's member. The Tax Court held that the IRS's Notice of Deficiency disallowing taxpayers' losses was not issued prematurely, and the items set forth in the notice were *affected items* that required a determination at the partner level. *Alex Meruelo*, 132 TC No. 18 (Tax Ct.).

Procedure—Qualified Offers: Under the Section 7430 qualified offer rule, a taxpayer who meets the applicable net worth requirements and has exhausted administrative remedies can recover reasonable administrative and litigation costs from the IRS if the taxpayer's liability pursuant to a court judgment is no more than the amount stated in the offer. This chief counsel notice updates the procedures for taxpayers to follow when making a settlement offer that purports to satisfy the Section 7430 requirements. The notice covers issues that frequently occur in evaluating whether offers are qualified offers, such as whether the offer was made during the *qualified offer period*, or whether a taxpayer is eligible to receive fees if the qualified offer is accepted or the offer is determined not to be a qualified offer. CC-2009-016.

Procedure—Statute of Limitations: The IRS has an extended six-year period to assess tax under IRC Sec. 6501(e) when the taxpayer omits gross income in an amount exceeding 25% of the gross income reported on the income tax return. The issue in this case was whether this extended limitations period applied when the taxpayer overstated its basis in an asset and thereby lowered the gross income reported in its return. Affirming the Tax Court, the 9th Circuit held that a taxpayer's overstatement of basis does not omit from gross income "an amount properly includible therein" for Section 6501(e) purposes. Accordingly, the IRS had only three years to assess the tax deficiency, which it failed to do. *Bakersfield Energy Partners v. Comm.*, 103 AFTR 2d 2009-XXXX (9th Cir.).

Procedure—Tax Court Jurisdiction in Partnership Proceeding: In a consolidated appeal concerning the tax liabilities of investors in cattle partnerships operated by Walter Hoyt, the 9th Circuit affirmed a Tax Court decision that the IRS didn't abuse its discretion in rejecting the partners' offers in compromise. The 9th Circuit also held that the Tax Court could decide whether the partnership transactions were tax motivated for underpayment interest purposes based on the record in the partnership-level proceedings. Since the appellate court was "as well situated as the Tax Court to undertake this review," it concluded that the record of the partnership-level proceedings shows that the partnerships' transactions were tax motivated. *Keller v. Comm.*, 103 AFTR 2d 2009-XXXX (9th Cir.).

Procedure—Tax Practitioner Privilege: IRC Sec. 7525(a) authorizes a limited privilege, equivalent to the attorney-client privilege, for tax advice between a taxpayer and a Federally Authorized Tax Practitioner (FATP). This case involved "Estate Planning Meeting Minutes" that documented communications from clients, including a limited partnership, to their attorneys for legal advice or to a FATP for tax advice. The Tax Court held that the partnership doesn't have to give the IRS the minutes because they were protected from disclosure by the Section 7525(a) privilege, subject to the IRS's right to show that the privilege doesn't apply. To do that, the IRS must show that the minutes involve the promotion of corporate tax shelters, and so come within the Section 7525(b) exception to the FATP privilege. *Countryside Limited Partnership*, 132 TC No. 17 (Tax Ct.).

Procedure—Tax Practitioner Privilege: The IRS issued a summons to a CPA firm seeking all documents related to tax planning, tax research, or tax analysis, by or for the taxpayer in connection with its 2001–2003 tax returns. Taxpayer asked an Illinois District Court to quash the summons, arguing that it was overbroad and many documents were protected by the Section 7525 Federally Authorized Tax Practitioner privilege. The IRS countered that the documents came within the Section 7525(b)(2) "promotion of a tax shelter" exception. In finding that the IRS met its burden to overcome the privilege (which is "relatively light"), the 7th Circuit noted that the word "promotion" limits the exception to written communications "encouraging participation in a tax shelter, rather than documents that merely inform a company about such schemes, assess such plans in a neutral fashion, or evaluate the soft spots in tax shelters that a company has used in the past." *Valero Energy Corp. v. U.S.*, 103 AFTR 2d 2009-XXXX (7th Cir.).