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Supreme Court Sets Limits On Deductions For Investment Advisory Fees By Trusts

◆ *Michael J. Knight, Trustee of William L. Rudkin Testamentary Trust, SCT, January 16, 2008*

The Supreme Court has found that investment advisory fees incurred by trusts are subject to the two-percent floor for miscellaneous deductions. Code Sec. 67(e), the Court found, exempts from the floor only those costs that would uncommonly, unusually or unlikely be incurred by individuals. Chief Justice John Roberts, Jr. delivered the Court's unanimous opinion.

■ **CCH Take Away.** The IRS has issued proposed regs based largely on the Second Circuit Court of Appeals reasoning in this dispute. Because the Supreme Court rejected the Second Circuit's analysis, it is likely that the IRS will re-propose the regs.

■ **Comment.** The decision requires practitioners to inquire with trustees if the costs would not have been incurred by an individual, Carol Cantrell, CPA, JD, co-counsel for the trustee in this case, told CCH. "The Supreme Court says if an individual would commonly incur the costs, he or she would be subject to the two percent floor. Practitioners will have to ask (trustees) to show that the costs would not have been incurred by an individual."

that the deductions exceed two percent of their adjusted gross income (AGI). Investment advisory fees are subject to the two percent floor. The issue in *Rudkin* was whether these fees are also subject to the two percent floor when incurred by a trust.

In 1993, the Court of Appeals for the Sixth Circuit interpreted Code Sec. 67(e) as allowing trusts and estates to fully deduct investment advisory fees in *W.J. O'Neill, Jr., Irrevocable Trust, CA-6, 93-1 USTC ¶50,332*. Several years later, the Federal Circuit in *Mellon Bank N.A. (CA-FC, 2001-2 USTC ¶50,621)* and the Fourth Circuit in *J.H. Scott (CA-4, 2003-1 USTC ¶50,428)* held that Code Sec. 67(e) does not permit the full deduction of investment advisory fees because those fees are commonly incurred outside of the trust context.

In 2006, the Second Circuit held in *Rudkin* that Code Sec. 67(e) permits a full deduction only for those costs that could not have been incurred by an individual. Because investment advisory fees are costs that could be incurred by individuals, the deduction was subject to the two-percent floor, the Second Circuit found.

The trustee appealed to the Supreme Court. During oral argument in November 2007, the trustee argued that the inquiry into deductibility of an expense turns on whether a particular expense of a trust was caused by the fact that the property was held in trust.

Background

Generally, individuals may subtract from their taxable income certain "miscellaneous itemized deductions" but only to the extent

Court's analysis

The Court rejected the "could" test used by the Second Circuit. "This approach

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IRS Clarifies Components Of Intermediary Transaction Tax Shelters

◆ Notice 2008-20

New IRS guidance expands upon the agency's position on intermediary transaction tax shelters (ITTSs). Often performed to allow corporate business owners to avoid built-in gains on assets when selling the company, these prohibited transactions also benefit the corporate acquirer by granting them a stepped-up cost basis in the corporation's assets. Notice 2008-20 lists four new factors the IRS will use to recognize these prohibited shelters. It also reports on two exceptions to participation in an intermediary transaction tax shelter.

■ **CCH Take Away.** ITTSs were classified by the IRS as listed transactions in Notice 2001-16 for purposes of Reg. §1.6011-4 and subject to the reporting requirements of Code Sections 6011, 6111, and 6112. The latest guidance further describes the components of the transaction and warns participants that the IRS will treat them as being involved in such a shelter. While the IRS indicated that Notice 2008-20 should not be interpreted as superseding the original notice, it advises taxpayers who have already filed returns claiming tax

benefits under an ITTS to consult with a tax advisor to ensure that their transactions are disclosed properly and "to take appropriate corrective action."

The transaction

The IRS describes the abusive intermediary transaction tax shelter as generally involving four parties: (1) a Seller, who is looking to sell the stock of (2) a Target corporation, (3) a promoter-controlled Intermediary, and (4) a Buyer who desires to purchase the assets, but not the stock, of the Target. Under a prearranged plan, Seller sells the Target's stock to the Intermediary. Contemporaneous with or shortly after the stock sale, the Intermediary sells the Target's assets to the Buyer. The Buyer ends up with a high basis in the assets for depreciation and the Seller recognizes little gain on the sale of its Target stock.

New guidance

The IRS has received information and comments from taxpayers criticizing its determination of an ITTS by looking for Intermediaries as the sole "red flag" in evaluating a transaction. As a result, this latest round of IRS guidance maintains four necessary components the IRS will

use instead to determine the existence of the shelter over and above simply the presence of intermediaries:

1. The Target corporation owns assets with built-in gain and does not have enough tax benefits to eliminate or offset the gain;
2. At least 50 percent of the Target corporation's stock is disposed of by shareholders in one or more related transactions within a 12 month period;
3. Either within 12 months before or after the date the Seller disposed of at least 50 percent of the value or voting power of the Target stock, all or most of the Target's assets are transferred to one or more Buyers in one or more transactions in which gain is recognized; and
4. All or most of the built-in gain for the Target's assets is offset, avoided, or not paid.

Exceptions

The guidance also provided the method by which IRS will determine whether to except an entity from treatment as a Seller or Buyer. Entities will not be treated as Seller participants if the entity only sells less than five percent of the value or voting power of the Target corporation stock on an

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Supreme Court

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flies in the face of the statutory language," Justice Roberts wrote. "The provision asks whether the costs would not have been incurred if the property was not held in trust, not...whether the costs could have been incurred." If Congress had intended this result, it would have used the word "could" in the statute, and not the word "would."

Unfortunately for the trustee, the Court also found no evidence that Code Sec. 67(e)

establishes a causation test. "The statute... does not establish a causation test but, rather, invites a hypothetical inquiry into the treatment of the property were it held outside a trust," Justice Roberts wrote. The trustee's approach, the Court found, would impermissibly allow every trust-related expense to be fully deductible. Congress likewise did not intend this result.

"The question of whether a trust-related expense is fully deductible turns on a prediction about what would happen if a fact were changed, specifically, if the property

were held by an individual rather than by a trust. In the context of making such a prediction, when there is uncertainty about the answer, the word 'would' is best read as expressing concepts such as custom, habit, natural disposition, or probability," the Court held.

■ **Comment.** The Supreme Court's decision does not otherwise change existing law that requires advisory fees that represent advice on tax-exempt income not to be deducted at all. In addition, fees that represent brokerage commissions on specific trades, whether from a "full service" or a "discount" broker, may fully offset that amount of capital gains recognized on those trades.

References: 2008-1 USTC ¶50,132; TRC ESTTRUST: 12,054.

Reference Key

FED references are to *Standard Federal Tax Reporter*
 USTC references are to *U.S. Tax Cases*
 CCH Dec references are to *Tax Court Reports*
 TRC references are to *Tax Research Consultant*

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IRS Ramps Up Audits Of High-Income Individuals

◆ *IRS Fiscal Year 2007 Enforcement and Services Results, IRS Enforcement and Service Tables FY 2007, IRS Enforcement Revenue and Individual Audit Chart*

One out of 11 millionaires faced an audit in 2007, the IRS recently reported. The IRS touted a significant uptick in audits of very wealthy individuals in its FY 2007 roundup of enforcement activities posted on its web site. For the first time since 1998, total audit coverage was higher than one percent of all individual returns. At the same time, audits of S corps and partnerships increased but audits of large corporations fell from the prior year.

■ **CCH Take Away.** The increase in audits of wealthy individuals in 2007 came after a critical report by the Treasury Inspector General for Tax Administration (TIGTA) (*White Examinations of High-Income Taxpayers Have Increased; The Impact on Compliance May Be Limited, 2006-30-105*) in 2006. TIGTA discovered that increased audit coverage was “due largely to an increase in correspondence examinations, which limit the tax issues the IRS can address in comparison with face-to-face examinations.” The trend identified by TIGTA appears to be continuing. One million of the 1.38 million individual returns selected for audit in 2007 were correspondence audits.

■ **Comment.** The IRS is under great pressure from Congress to show results in closing the \$300 billion tax

gap, the difference between what taxpayers owe and what they pay. The agency reported that enforcement and examination revenue totaled more than \$55 billion in 2007, up from roughly \$45 billion in 2006.

All audits

Audits of all individuals across all income levels increased in 2007. The IRS reported that the total number of individual returns audited in 2007 was 1.38 million compared to 1.29 million in 2006, an increase of seven percent.

Overall audit coverage continued to climb since 1998. It was 1.03 percent in 2007 compared to 0.98 percent in 2006.

High-income individuals

The IRS considers high-income individuals to be those who file a Form 1040 with

Total Positive Income (TPI) of \$100,000 or more. Generally, TPI is calculated by using only positive income values from specific income fields on the tax return and treats losses as zero.

■ **Example.** Abby files a return showing wages of \$90,000, interest of \$12,000, and a \$25,000 loss from an interest in a partnership. Abby's return would have a TPI totaling \$102,000 and be considered a high-income tax return by the IRS.

Millionaires. Audits of individuals with incomes of \$1 million or more increased 84 percent from 2006 to 2007. More than 30,000 millionaires were audited in 2007 compared to 17,000 in 2006.

■ **Comment.** More than one-half of the audits of millionaires were correspondence audits.

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Tax Shelter

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established securities market. Entities also will not be considered Buyer participants if the only Target corporation assets they acquire consist of a less than five percent interest in a class of securities traded on an established securities market or assets that are not securities and not used in a trade or business.

*References: FED ¶46,273;
FILEBUS: 9,450.05.*

White House Calls For Quick Tax Rebates As Economic Stimulus

President Bush has called for creation of a \$150 billion economic stimulus package aimed at infusing cash quickly into the hands of individuals and spurring business investment with temporary tax relief, free of tax increases. The president is expected at press time to propose tax rebates of up to \$800 for individuals and \$1,600 for married couples; amounts equal to their taxable income at the 10-percent marginal rate. For businesses, the proposal could double the \$125,000 expensing limit on equipment.

■ **Comment.** The 2001 economic stimulus package, which also relied on rebates, produced a total \$35.5 billion in refunds to 84.1 million qualifying taxpayers according to a 2002 Government Accountability Office report; costing \$104 million and creating many administrative problems. Taxpayers were confused by a line on the 2002 Form 1040, intended for taxpayers who did not receive rebate checks during the previous year or received incorrect amounts. The confusion caused a “large number” of math errors, according to a 2002 House Ways and Means Oversight Subcommittee memorandum.

Congressional reaction. Congressional Democrats agreed with the President that any economic stimulus package should be targeted, timely, and temporary. House Majority Leader Steny Hoyer, D-Md. assured the public that the House “pay-as-you-go” budget rules would allow deficit spending to stimulate the economy. However, Democrats would use tax relief as a foundation for further social programs. Additionally, Sen. Charles Schumer, D-N.Y. warned that any attempt to extend the 2001 and 2003 tax cuts in the president's package would prevent passage in the Senate.

■ **Comment.** Congress and the White House appear to want to get the rebates into taxpayers' hands as quickly as possible. The tax rebates could come at the same time as the IRS is issuing tens of millions of regular tax refunds during the filing season, placing a great strain on the agency's resources. CCH asked the IRS what plans it is making for the rebates. An IRS spokesperson said that since no legislation has been passed, the agency could not comment at this time.

Final Regs Explain How Consolidated Group Members Treat Items Of Liquidating Corporation

◆ T.D. 9376

The IRS recently issued final regs under Code Sec. 1502 that explain how members of a consolidated group succeed to the items (attributes) of a liquidating corporation when they acquire the corporation's assets in a Code Sec. 332 complete liquidation. The final regs will apply to transactions occurring after April 14, 2008.

The regs indicate that members of the group succeed to the items described in Code Sec. 381(c), including net operating loss carryovers, earnings and profits (E&P), capital loss carryovers, methods of accounting, methods of computing depreciation, and certain liabilities.

■ **Comment.** The final regs provide guidance under Reg. §1.1502-80 primarily for the allocation of Code Sec. 381(c) items, Devon Bodoh of Dewey & LeBoeuf LLP told CCH. The final regs had no surprises and were generally well received, Bodoh said. These allocations involve easier questions than the treatment of intercompany items, which the final regs do not address, he said. People were surprised that the IRS withdrew the proposed regs on this subject. There are problems with the existing regs on intercompany items, but the IRS indicated it was going to study the issues further because it apparently was not sure that the regs clearly reflected income, he said.

Allocation of items

Each group member receiving a distribution from the liquidating corporation that could be used to offset income or tax liabilities of the group or a member must receive an allocation of items to the extent the items would have been reflected in investment adjustments to the member's stock in the liquidating corporation. This rule applies provided that any stock owned by nonmembers is redeemed beforehand and the items are then taken into account.

A distributee member succeeds to the entire deferred deduction or deferred income of assets or business operations it receives if the item did not affect the income or loss of the liquidating corporation.

80-percent distributee

Under Code Sec. 337(a), the liquidating corporation does not recognize gain or loss when it distributes property to an 80-percent stockholder. Otherwise, the liquidating corporation must recognize gain or loss on the distribution as if the property were sold to the group member for its fair market value. Thus, a complete liquidation may be tax-free to the recipients but taxable partially or wholly to the liquidating corporation.

■ **Comment.** Code Sec. 332 does not apply to determine whether a non-80-percent group member has taxable income when it assumes an obligation related to deferred income, because the income is not recognized with respect to the stock of the liquidating corporation.

Credits; E&P

The proposed regs allocated the liquidating corporation's credits based on the carryover items attributable to the ac-

tivities that gave rise to the credits. After comments that this was unclear, the final regs now provide that each distributee will receive credits based proportionately on the value of the liquidating corporation's stock that it holds.

Earnings and profits or a deficit in E&P will be allocated to distributees (after a portion is allocated to non-member distributees) as investment adjustments under Reg. §1.1502-32(c).

Other items

A consolidated group member that owns 80 percent of the liquidating corporation and receives a distribution succeeds to the corporation's items in accordance with Code Sec. 381(a) and other applicable principles. A non-80-percent member succeeds to the items to the extent it would have if it had purchased in a taxable transaction the assets or business of the liquidating corporation that it received in the liquidation and assumed the same liabilities.

Other items of the liquidating corporation include the amount of any consolidated tax determined under Reg. §1.1502-21.

*References: FED ¶47,013;
TRC CCORP: 45,352.35, CONSOL:
29,201.20.*

High Income Audits

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Other high-income individuals. The IRS also audited more individuals with incomes above \$200,000 in 2007 than in 2006. Audits of individuals with incomes over \$200,000 reached 113,105 returns, reflecting an increase of nearly 30 percent from 2006. The higher audit numbers were also reflected in audits of individuals with incomes of \$100,000 or more. The IRS audited 293,188 of these returns in 2007, up nearly 14 percent from 2006.

Businesses

On the business side, the IRS took special interest in two popular business entities:

S corps and partnerships. Audits of both entities were up in 2007 compared to 2006. Audits of S corp returns (taxpayers filing Form 1120-S) and partnership returns (taxpayers filing Form 1065) increased by roughly 25 percent. The coverage rate for S corps and partnerships was approximately 0.45 percent in 2007.

While audit statistics for S corps and partnerships were up, the number of large corporation returns (corporations with assets of \$10 million or higher) examined fell in 2007. The IRS examined 9,644 large corporation returns in 2007 down from 10,591 in 2006. The coverage rate fell slightly from 18.6 percent in 2006 to 16.8 percent in 2007.

*References: FED ¶(to be reported);
TRC IRS: 6,050.*

Proposed Regs On 529 Tuition Plans Take Aim At Gift And Estate Tax “Abuses”

◆ NPRM REG-127127-05

The IRS will issue proposed regs to address the potential for abuse of Code Sec. 529 qualified tuition programs (QTPs), the agency recently announced. The rules will apply estate, gift and generation-skipping transfer tax provisions to Code Sec. 529 accounts.

■ **CCH Take Away.** QTPs provide a valuable tax benefit. Although contributions are not deductible, earnings grow tax-free and may be distributed tax-free if used for qualified higher education expenses. David Pearlman, chair of the College Savings Foundation Legal and Regulatory Committee, told CCH that \$120 billion has been invested in QTPs: \$100 billion in savings plans and \$20 billion in prepaid tuition plans. CSF members manage savings plans with \$50 billion. Pearlman said that the CSF has had extensive discussions with Treasury and understands its concerns, but does not want the regs to be draconian and affect the way that plans do business. “We don’t see signs of abuse,” Pearlman said.

■ **Comment.** Fred Oliphant and Maria Jones of Miller & Chevalier Chartered told CCH they “wonder how much abuse is really going on.” States will not want the IRS to interfere with plan administration, Jones said.

Regulatory history

The IRS issued proposed regs in 1998 and additional guidance in Notices 2001-55 and 2001-81, restricting investment directions and specifying recordkeeping. This guidance will be incorporated in the new regs.

■ **Comment.** Taxpayers have been able to rely on portions of the 1998 proposed regs, but they predate many of the statutory changes to Code Sec. 529, Pearlman said.

“Current law regarding the transfer tax treatment of section 529 accounts is unclear and in some situations imposes tax in a manner inconsistent with generally applicable transfer tax provisions,” the

IRS indicated. The *Pension Protection Act of 2006* directed the IRS to issue regs to prevent abuses of Code Sec. 529.

Anti-abuse rule

The proposed regs will likely include a general anti-abuse rule for accounts used to evade transfer taxes or for other purposes contrary to Code Sec. 529. The anti-abuse rule will deny favorable transfer tax treatment if contributions are not made or used to pay qualified higher education expenses of the account’s designated beneficiary. The regs will focus on the source of the funds, the actual contributor, and the ultimate recipient of the funds.

■ **Comment.** “You have to understand that there is a basic disconnect [in 529 plans],” Oliphant told CCH. The contributor is treated as making a completed gift to the account beneficiary, but the account owner, who may also be the contributor [such as a parent], retains control over the money, he said. “They’ve tried to allow some flexibility for transfers within the family,” Jones added.

While new rules will apply prospectively, the anti-abuse regs may apply retroactively.

The IRS also may impose more specific limits if abuses continue. These could include limits on when the account owner (AO) can withdraw funds, limits on changing the designated beneficiary, and limits on changing the AO.

■ **Comment.** The AO is the person with control over the account.

Abuses addressed

Potential abuses the regs will likely address include:

- A change in beneficiaries without triggering tax, or treatment of the account as a retirement account. The regs would treat the change as a deemed transfer to the AO, followed by a contribution (gift) to the new beneficiary.
- Contributions to multiple accounts with the same AO, with funds withdrawn for the AO’s benefit. The contributor claims no gift tax on the contributions. The anti-abuse rules would apply.

■ A change in the AO, or designating the AO as the beneficiary, that avoids income tax. The regs would treat the change as a taxable distribution to the original AO.

■ **Comment.** “None of the rules sound unreasonable, but it may be hard to monitor these plans,” Jones said. “A person may not even know [his or her] action is abusive.”

Problematic transactions

Other transactions are not abusive but raise transfer tax issues:

- Contributors, including Uniform Gift to Minors Accounts, designate themselves as the beneficiary. A change of beneficiary will be treated as a deemed distribution to the contributor, followed by a contribution to a Code Sec. 529 account for the new beneficiary.
- Treatment of the account of a deceased beneficiary - generally, the account will not be included in the beneficiary’s estate unless the AO distributes the entire account within six months of the beneficiary’s death.
- **Comment.** There are additional wrinkles, Jones said. A grandparent may contribute to an account for the benefit of a grandchild, owned by the parent. “Nobody’s ever really thought about whether there’s a contribution to the parent,” Jones said.

Administrative issues

The regs will discuss how to make the election to treat contributions as made over a five-year period, how to recognize a loss in an account, how to match distributions with the payment of education expenses, and the requirements for recordkeeping and reporting.

■ **Comment.** Oliphant and Jones thought the requirement to make a distribution shortly after incurring expenses could unnecessarily limit legitimate distributions. Oliphant thought that sponsors of plans would not object to the substantive limits, but might be upset with additional reporting requirements.

References: FED ¶46,274;
TRC INDIV: 60,204.05.

Corporation Entitled To Deduction For Redeeming Stock To Satisfy ESOP Distribution Obligations

◆ *General Mills Inc., DC Minn., January 14, 2008*

A district court has found that a corporation was entitled to a tax deduction for using the proceeds from a stock redemption to satisfy cash distributions made by an employee stock ownership plan (ESOP) trust to terminated employees. The court also rejected the

IRS's argument that the taxpayer would receive a double deduction.

■ **CCH Take Away.** It was essential for the taxpayer, as would be the case for any taxpayer in this situation, to distinguish that it was not seeking a deduction for the transaction in which it redeemed stock from the trust, but sought a deduction for

expenditures incurred in the transaction in which the trust used part of the redemption proceeds to fulfill the taxpayer's cash obligation. Given these parameters, this case, if upheld on any appeal, represents a win-win for corporations sponsoring ESOPs in similar situations.

Background

The taxpayer, a corporation, maintained employee retirement plans with ESOP components. ESOP assets were held in a trust. Upon an employee's termination, the trust was required to distribute the value of his or her vested ESOP account. The employee could elect to receive either shares of the corporation's common stock or the cash equivalent. The taxpayer could, but was not required to, use proceeds from the redemption of its common stock to satisfy the trust's cash distribution obligation. The taxpayer redeemed shares of its common stock held by the trust ("redemptive dividends"), which then used some of the proceeds to satisfy part of its cash distribution obligation ("cash distribution redemptive dividends").

The taxpayer sought to deduct the cash distribution redemption dividends under Code Sec. 404(k). The IRS countered that even if they were deductible under Code Sec. 404(k), they would be disallowed by Code Sec. 162(k). The taxpayer filed suit in federal district court.

Code Sec. 404(k)

Code Sec. 404(k) allows a corporation to take a deduction for the amount of any applicable dividend paid in cash on applicable employer securities. Code Sec. 162(k) disallows a corporation from taking an otherwise allowable deduction for amounts it paid or incurred "in connection with" reacquiring its own stock, such as in a redemption.

Court's analysis

The court agreed with the taxpayer that the cash distribution redemptive dividends were deductible under Code Sec. 404(k). The dividends paid from the taxpayer's stock redemption were the equivalent of

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February 2008 AFRs Issued

The IRS has released the short-term, mid-term, and long-term applicable interest rates for February 2008.

Applicable Federal Rates (AFR) for February 2008

<u>Short-Term</u>	<u>Annual</u>	<u>Semiannual</u>	<u>Quarterly</u>	<u>Monthly</u>
AFR	3.11%	3.09%	3.08%	3.07%
110% AFR	3.43%	3.40%	3.39%	3.38%
120% AFR	3.74%	3.71%	3.69%	3.68%
130% AFR	4.06%	4.02%	4.00%	3.99%
<u>Mid-Term</u>				
AFR	3.51%	3.48%	3.46%	3.46%
110% AFR	3.87%	3.83%	3.81%	3.80%
120% AFR	4.22%	4.18%	4.16%	4.14%
130% AFR	4.57%	4.52%	4.49%	4.48%
150% AFR	5.29%	5.22%	5.19%	5.16%
175% AFR	6.18%	6.09%	6.04%	6.01%
<u>Long-Term</u>				
AFR	4.46%	4.41%	4.39%	4.37%
110% AFR	4.91%	4.85%	4.82%	4.80%
120% AFR	5.36%	5.29%	5.26%	5.23%
130% AFR	5.81%	5.73%	5.69%	5.66%

Adjusted AFRs for February 2008

	<u>Annual</u>	<u>Semiannual</u>	<u>Quarterly</u>	<u>Monthly</u>
Short-term adjusted AFR	2.84%	2.82%	2.81%	2.80%
Mid-term adjusted AFR	3.36%	3.33%	3.32%	3.31%
Long-term adjusted AFR	4.23%	4.19%	4.17%	4.15%

The IRC §382 adjusted federal long-term rate is 4.23%; the long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months) is 4.34%; the IRC §42(b)(2) appropriate percentages for the 70% and 30% present value low-income housing credit are 7.92% and 3.40%, respectively; and the IRC §7520 AFR for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest is 4.2%.

Rev. Rul. 2008-9, FED ¶46,275; ACCTNG: 36,162.05.

Tax Briefs



Tax Court

The U.S. Tax Court has announced that it has adopted amendments to its Rules of Practice and Procedure regarding privacy and public access to electronic case files. The court has also adopted various conforming and miscellaneous amendments to its rules and forms. The amendments are generally effective as of March 1, 2008.

Tax Court Press Release, FED ¶46,272; TRC LITIG: 6,100.

Jurisdiction

An individual's complaint seeking injunctive relief from tax liens placed on his property was properly removed from state court. The court lacked jurisdiction under the *Anti-Injunction Act* over his complaint because he sought to restrain the assessment and collection of taxes and failed to show that any exceptions to the Act applied.

Beale, CA-3, 2008-1 USTC ¶50,129; TRC IRS: 27,218.

Tax Crimes

Sentence imposed on an individual for filing false, fictitious and fraudulent income tax returns was reasonable. The individual's criminal history and utilization of family members in the commission of his offense weighed against a downward departure or variance of his sentence based on exceptional family circumstances. Also, application of a sentence enhancement was proper because the individual willfully impeded the government's investigation.

Carter, CA-6, 2008-1 USTC ¶50,124; TRC IRS: 66,462.20.

A federal district court properly sentenced an individual after he pleaded guilty to failure to collect and pay over taxes. The court took account of and weighed the relevant sentencing factors and considered and rejected the individual's arguments regarding mitigating

circumstances and unwarranted sentence disparity before applying the advisory guidelines imprisonment range.

Wetzel, CA-8, 2008-1 USTC ¶50,128; TRC IRS: 66,462.05.

Deductions

Unsubstantiated casualty and theft losses claimed in connection with the burning of the taxpayer's home, alleged illegal foreclosure of his land, and the government's alleged theft of computer equipment and installed self-developed software were denied.

Lockett, TC, CCH Dec. 57,306(M), FED ¶47,919(M); TRC INDIV: 54,104.

Statute of Limitations

A partnership was granted certification for an interlocutory appeal regarding whether the extended six-year statute of limitations contained in Code Sec. 6501(e)(1)(A) or, alternatively, in Code Sec. 6229(c)(2) applied to an Final Partnership Administrative Adjustment issued by the IRS more than three years after the partnership filed its return.

Salman Ranch Ltd., FedCl, 2008-1 USTC ¶50,135; TRC IRS: 30,152.

Claims Against IRS

An individual was not entitled to damages under Code Sec. 7431 for allegedly unlaw-

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Frequent Flier Miles Purchased By Business To Provide Mileage Awards Subject To Excise Tax

In a heavily redacted private letter ruling (PLR), the IRS has held that, in certain circumstances, the price paid for frequent flier miles is considered an amount paid for the right to provide mileage awards for, or other reductions in the cost of, passenger air transportation. As such, frequent flier miles are subject to an air transportation excise tax under Code Sec. 4261(e)(3).

Frequent flier miles. The taxpayer (presumably a credit-card business) offered two types of products to its customers to earn "points" redeemable for air travel. The use of one product entitled customers to redeem their points for frequent flier miles from a number of airlines from which the taxpayer had contracted to purchase frequent flier miles. The second product offered frequent flier miles from a specific airline at a specified cost per mile.

■ **Comment.** In LTR 9920031, the IRS ruled that the receipt of miles as an inducement to purchase property or services should be treated as a rebate, which reduces the cost basis of the property and are excluded from gross income. Thus, frequent flier miles received as an inducement are not subject to income tax. In LTR 9547001, the IRS held that miles are not included in an employee's gross income for tax purposes unless his or her employer reimburses the employee in cash for the fair market value of frequent flier miles accumulated on business trips.

Excise tax. Under Code Sec. 4261(e)(3)(A), amounts paid to, and the value of other benefits provided to, an air carrier for the right to provide mileage awards for, or other reductions in the cost of, passenger air transportation are subject to the excise tax imposed by Code Sec. 4261(a). However, not all amounts paid to provide mileage awards and other reductions in the cost of such air transportation may be subject to tax under Code Sec. 4261(a). Regs under Code Sec. 4261 provide that, if a payment covers charges for transportation services and nontransportation services, such as charges for meals and hotel accommodations, the nontransportation service charges may be excluded in computing the excise tax owed. However, the charges must be separable, or the tax must be computed on the full amount of the payment.

TAM 200803018, FED ¶(to be reported); TRC EXCISE 9,102.40.

Tax Briefs

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ful disclosures of his confidential tax return information through the filing of notices of federal tax liens because Code Sec. 7433 provides the exclusive remedy for such alleged disclosures made in connection with tax-collection activity.

Marsoun, DC D.C., 2008-1 USTC ¶50,127; TRC IRS: 9,150.

An individual was permanently enjoined from filing UCC financing statements or other such documents against government employees and those she had already filed were declared null and void.

Perkins, DC Calif., 2008-1 USTC ¶50,133; TRC IRS: 45,156.

UCC financing statements containing false representations that the IRS and certain employees were indebted to an individual were declared null, void and without legal effect, and the individual was permanently enjoined from filing similar documents in the future. The government was also awarded attorney's fees for initiating its action to expunge the individual's bad faith filing.

Roy, DC Calif., 2008-1 USTC ¶50,134; TRC IRS: 45,156.

Liens and Levies

An attorney was not entitled to recover fees from funds that were payable to the client under a settlement agreement because the funds were subject to a federal tax lien and the attorney could not claim superpriority status because he failed to prove the existence of a lien or a contract enforceable under state (Texas) law.

Betancourt, CA-5, 2008-1 USTC ¶50,123; TRC IRS: 48,160.40.

The government sufficiently pleaded facts to support its claim that it was entitled to reduce to judgment several tax liens assessed against an individual and satisfy those liens through foreclosure of a property that belonged to a land trust; therefore, the individual's motion to dismiss was denied.

Gaumer, DC Ohio, 2008-1 USTC ¶50,130; TRC IRS: 48,100.

Refund Claims

An individual's refund claim under Code Sec. 7422 was dismissed because she failed to prosecute her claim. Further, the government was entitled to summary judgment on its Code Sec. 7405 erroneous refund claim. It submitted evidence of duplicate checks erroneously issued to the individual and endorsed by her.

Chocallo, DC Pa., 2008-1 USTC ¶50,125; TRC IRS: 45,162.

Offer-in-Compromise

The IRS Appeals Office did not abuse its discretion by rejecting a married couple's offer-in-compromise where the taxpayers had underreported their income for several tax years due to claimed losses and credits from Hoyt partnership tax shelter investments. The court found that the taxpayers did not show that payment of more than they offered would render them unable to meet their basic living expenses in retirement.

Bergevin, TC, CCH Dec. 57,307(M), FED ¶47,920(M); TRC IRS: 33,400.

Bankruptcy

The IRS had the right to offset a married couple's prepetition tax overpayment against the couple's tax liabilities that had been discharged in bankruptcy. The IRS's set-off rights existed at the time of filing of the bankruptcy petition; thus, the discharge did not affect these rights.

In re Emery, BC-DC Ky., 2008-1 USTC ¶50,126; TRC IRS: 33,302.

Insurance

The IRS has alerted life insurance companies to federal income tax issues that may arise as a result of the adoption of proposed actuarial guideline VACARVM and/or a proposed principles-based approach for calculating statutory reserves for life insurance.

Notice 2008-18, FED 46,268.

The IRS has requested comments on proposed guidance that would address when a cell of a protected cell company (PCC) is treated as an insurance company for federal income tax purposes and some of the consequences of the treatment of a cell as an insurance company.

Notice 2008-19, FED 46,271.

The arrangement between one cell of a protected cell company (PCC) and that cell's sole insured shareholder was not an insurance contract, the IRS determined. The arrangement lacked the requisite risk shifting and risk distribution because any claim payment to the sole shareholder would be paid out of that shareholder's premium payments.

Rev. Rul. 2008-8, FED 46,270.

ESOP Distributions

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dividends, paid in cash, for "employer securities" (i.e. the taxpayer's common stock), and thus satisfied the criteria for deduction under Code Sec. 404(k).

The court rejected the IRS' argument that the three separate transactions should be treated as a whole transaction. Under this view, the taxpayer would be seen as seeking deductions for the second and third transactions. The court found that the transactions were appropriately treated as separate transactions and a deduction under Code Sec. 404(k) was not a double deduction.

■ **Comment.** In 2006, the IRS issued final regs (T.D. 9282) under Code Sec. 404(k) disallowing a deduction for amounts paid to reacquire stock because it would entitle corporations to claim a double deduction – an initial deduction for the value of the stock first contributed to an ESOP and second deduction in the future for the amount paid by a corporation to redeem the same stock.

The court disagreed with the government's assertion that the deductions were nonetheless prohibited by Code Sec. 162(k). Although the cash distribution redemptive dividends arose out of the same general circumstances as the redemptive dividends, the cash distribution redemptive dividends were not "paid in connection with" the redemptive dividends. The taxpayer had the option, but not duty, to redeem stock held by the trust in order to satisfy the trust's cash distribution obligations. Likewise, the trust was not required to use the proceeds from the redemption to satisfy the trust's cash distribution obligations. Thus, the cash distribution redemptive dividends were not expenditures "necessary and incident" to the redemptive dividends.

Practitioners' Corner

Return Preparer Penalties: Interim Standards For Disclosure Create Client Communications Challenges

The Small Business and Work Opportunity Tax Act of 2007 (2007 Small Business Tax Act) changed the realistic possibility of success standard for return preparers in Code Sec. 6694(a) for undisclosed, non-abusive items, to more-likely-than-not. The new law also significantly increased the penalties for violating Code Sec. 6694, setting a minimum penalty of \$1,000 and a maximum of 50 percent of fees earned. Effective starting in 2008, the new preparer standard ("more-likely-than-not") for avoiding a preparer penalty is higher than the taxpayer standard ("substantial authority") for avoiding the negligence penalty under Code Sec. 6662, creating a potential conflict of interest between the taxpayer and the preparer that has been a flash point of controversy.

While legislation may be introduced that will resolve the conflict of interest, the IRS already has provided some relief. Notice 2008-13, discussed in the January 10 issue of this newsletter, provides interim guidance that allows a preparer to escape the penalty not by disclosing a particular position to the IRS but instead choosing to discuss the conflict with the taxpayer and follow up with a contemporaneous written memo placed in the taxpayer's file. Treasury and IRS officials have indicated that they plan to move forward with a complete overhaul of the preparer penalty regs notwithstanding the proposed legislation.

Notice 2008-13 requires a specific discussion between taxpayer and preparer for each position taken on the return that is between the "substantial authority" and "more-likely-than-not" standards. A sample memorandum is presented, below, to assist in fulfilling that option.

For those clients who have seen the controversy mentioned in the media and for those clients for whom the practitioner

anticipates having a specific discussion on a particular return position before filing their returns, a general client letter is also presented, below, for immediate use.

Re: New Standards for Tax Return Preparers

Dear Client:

The Tax Code can pose some dilemmas for preparers and taxpayers. An underpayment of tax can be subject to an

the position would more-likely-than not be sustained on its merits. Otherwise, certain disclosures must be made or the risk of stiff penalties faced. The change is much more than semantics. Realistic possibility had been traditionally and broadly understood to mean a one-in-three likelihood of success. "More-likely-than-not" sets a higher threshold. It is generally understood to mean a greater than 50 percent likelihood of success.

"With all the press lately about these new preparer penalties it's easy to lose sight of the overriding principle that a taxpayer should take every tax deduction and credit to which he or she is entitled."

accuracy-related penalty for negligence. Any substantial understatement of income tax can be subject to the same penalty even if it is not negligent. Duplication of these penalties is not allowed under the law. Neither penalty applies if the transaction is adequately disclosed and is not frivolous. However, disclosing the transaction may alert the IRS.

Traditionally, if a tax return preparer reported an undisclosed item that caused an understatement and that had no realistic possibility of being sustained on the merits, and the preparer knew this, or should have known it, the preparer was subject to a penalty unless the item was disclosed and was not frivolous. In May 2007, Congress made some important revisions to this rule you should know about. It changed the "realistic possibility" standard to "more-likely-than-not."

Starting for returns filed on or after January 1, 2008, the preparer must have a reasonable belief that the tax treatment of

Although Congress changed the preparer standard, it did not change the taxpayer standard. The taxpayer standard for an undisclosed, nonfrivolous item is "substantial authority." This standard is generally considered not as high as "more-likely-than-not" but higher than a "realistic possibility." If you sense that this is splitting hairs, it is ... for most issues. Only on a very few issues will you find some courts or expert authority going one way and others going another to be able to make such a fine distinction on the odds of success.

Nevertheless, because these situations sometimes arise and because the preparer and taxpayer standards are different, there could be potential conflicts between preparers and their clients ... a matter being taken very seriously. No one wants the IRS to assess a penalty. Preparers and clients have to work more closely than ever before to avoid any penalties.

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Washington Report

by the CCH Washington News Bureau



Economic stimulus

The White House recently called for tax legislation to avoid what many are calling an economic recession. A bipartisan economic stimulus package, including tax rebates, is expected to be unveiled at press time. Some members of Congress agree with the goals, but not necessarily the rebate proposals the president has put forth. *See page 39 for details.*

Treasury to issue more return preparer rules

Anita Soucy of Treasury's Office of Tax Legislative Counsel recently indicated that the government will issue regs in 2008 on the revised return preparer standards under Code Sec. 6694. The regulations will take a further look at non-signing return preparers. Whether a taxpayer could subject a non-signing preparer to penalties is a central issue that Treasury continues to grapple with. A non-signing preparer may lack control over the taxpayer, she said. Although legislation has been introduced to reconcile the taxpayer standards under Code Sec. 6662 and the preparer standards under Code Sec. 6694, "we're not waiting for legislation," Soucy stated during a January 15 webcast presented by the Tax Governance Institute.

IRS phone forum emphasizes preparer due diligence

The IRS recently held a national phone forum to discuss earned income tax credit (EITC) due diligence for practitioners under Code Sec. 6695(g) and Reg. §1.6695-2. "Over 70 percent of EITC claimants use paid tax preparers" and preparers have a significant impact on the error and participation rates of the EITC, Lynne Morrison, senior program analyst, IRS Earned Income Tax Credit Office, said. Morrison discussed several issues with respect to the credit including participation rate, erroneous payments, Form 8867, tax software, due diligence visits, and additional guidance.

Intangibles are not like-kind assets, IRS officials reiterate

IRS officials have clarified that goodwill, subscriber lists and other intangible assets are never like-kind assets and, no matter what the circumstances, cannot be exchanged tax-free under Code Sec. 1031. Peter Baumgarten of the Chief Counsel's Income Tax and Accounting Division (IT&A) stated that he had never heard of a modern definition of goodwill, but that the historic definition is broad and he expects it to continue. He conceded the use of separate valuation and identification under Code Sec. 197 but he said those regs do not speak to like-kind exchanges.

Baumgarten commented that goodwill exchanges from one company to another are not like-kind. Steve Toomey, senior counsel with IT&A, similarly stated that one company's trademark is not like-kind to any other business's trademark. Donna Crisalli, a senior technical reviewer in IT&A, conceded there is a "paucity of guidance" in this area. She added that practitioners can always put in a request for published guidance.

IRS re-releases excess per diem payment guidance

A recently released Field Examination Operations memorandum from the IRS Small Business and Self-Employed Division (SBSE-04-0108-003) repeats previous guidance concerning excess employer travel reimbursements. Rev. Rul. 2006-56 declared that an employer's routine payment of travel reimbursements exceeding federal per diem rates without including them in the employee's wages and failure to track excess allowances were both evidence of a pattern of abuse by the employer. As a result, all travel reimbursement payments would be taxable wages under a non-accountable plan. However, an IRS memorandum (SBSE-04-1106-049), which expired in November 2007, relaxed the agency's enforcement of Rev. Rul.

2006-56 by prohibiting taxation of all travel reimbursements under a non-accountable plan "absent egregious circumstances or evidence of intentional compliance." This relaxed treatment has been extended until January 14, 2009.

TIGTA uncovers management issues within IRS return delinquency program

The Treasury Inspector General For Tax Administration (TIGTA) recently audited the IRS Return Delinquency Program, a division of the agency identifying taxpayers who have not filed a tax return by the return due date. The division uses a computer program to identify returns as delinquent when the filing requirement exists on a taxpayer's record and no return has been posted to that record. Examiners must review the responses to the return delinquency notices, perform case research, and follow appropriate case resolution procedures to determine the taxpayer's filing liability.

In its examination, TIGTA sampled 150 return delinquency correspondence cases and found that examiners' actions on 24 percent of them were incorrect, incomplete, or not timely. This was cause for concern because taxpayers may be unnecessarily burdened with additional notices requesting returns which they were not liable for filing. IRS explained that this problem occurred because many of the examiners at the location sampled had recently shifted from examining individual return delinquencies to that of businesses.

TIGTA also found a serious systematic problem with the computer program's failure to note when filers of Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return had failed to file a corresponding Form 941, Employer's Quarterly Federal Tax Return. According to the IRS, this was because the program did not cross-reference both forms to identify when a related return was due but not filed.

Practitioners' Corner

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At year-end 2007, the IRS issued some long-awaited guidance about the “more-likely-than-not standard.” The rules emphasize the importance to preparers of understanding the legal basis for positions taken on tax returns, the requirement for taxpayers to disclose certain positions and the need for preparers to advise taxpayers on the various penalties that can apply when a position is taken on a return may not be supported by existing law. Our office is committed to each and every one of these principles.

For purposes of determining whether a preparer has a reasonable belief that the position would more-likely-than-not be sustained on the merits, the IRS rules permit a preparer to rely in good faith, without verification, upon information furnished by the taxpayer, another advisor, preparer, or other third party. However, the preparer may not ignore the implications of information furnished to him or her or actually known to him or her. The preparer must make reasonable inquiries if the information furnished by another preparer or third party appears to be incorrect or incomplete.

The new rules also include interim penalty guidance provisions. A preparer is deemed to meet the requirements of the heightened standards with respect to a position for which there is a reasonable basis but for which the preparer does not have a reasonable belief that the position would more-likely-than-not be sustained on the merits, if the preparer takes certain precautionary steps. One way is to disclose the position on a completed and filed Form 8275, Disclosure Statement, attached to the return. Another permits a preparer to advise the taxpayer of the difference between the penalty standards applicable to the taxpayer and the penalty standards applicable to the preparer along with contemporaneously documenting that the advice was provided.

If we believe that you have a strong enough position under the “substantial authority” standard to support an item on your return but it may not be strong enough to pass the “more-likely-than-not” test, we will tell you and prepare the con-

temporaneous documentation required to dispense with filing Form 8275 or similar disclosure statement with the IRS. We just want to make it clear at this time that we are looking after your best interests and will never compromise the integrity that our responsibilities require.

With all the press lately about these new preparer penalties it's easy to lose sight of the overriding principle that a taxpayer should take every tax deduction and credit to which he or she is entitled. Simply to back down because of the possibility of an IRS audit is never advisable.

Keep in mind, too, that the new IRS rules are only temporary; they represent only the IRS' first attempt at setting down the details for a workable process. There may be significant changes in the future but, for now, they apply to this tax return season. We will keep you posted of all developments in this important area. If you have any questions, please contact our office anytime and we will be glad to discuss the interim rules in more detail.

Client notification to specific line-item position

*Notice 2008-13 allows, in lieu of disclosure on a return, a specific discussion between taxpayer and preparer for each position taken on the return that is between the “substantial authority” and “more-likely-than-not” standards. The following sample memorandum is presented to assist in fulfilling that option. **Practitioners should be advised that each situation is different and, therefore, the sample memorandum may require modification.***

Re: Position taken on your Form _____, line _____

Dear Client:

This memorandum is to follow up on our discussion concerning the position that is being taken on your 2007 income tax return, line [x], with respect to a \$ _____ deduction [credit, offset, income amount, etc.] for _____.

The tax law sometimes is not black and white and opinions vary, even among experts, on whether a position taken with respect to a particular line on a tax return is the correct one. Different degrees of certainty require different responses under new IRS and Internal Revenue Code rules.

In our best judgment, the position taken on line x is backed by “substantial authority.” A position taken with “substantial authority” removes the risk of you being assessed a so-called “negligence” penalty of up to 20 percent for this item should the IRS challenge it.

Despite having a reasonable basis under the tax law, however, the position taken on line X remains aggressive enough to be considered to have no greater than a 50 percent likelihood of success if challenged by the IRS. The new law requires, in the event of such a 50-50 likelihood position, that the return preparer either disclose this position to the IRS or discuss the difference in applicable penalty standards. Otherwise, the preparer may be liable for a substantial penalty. We are choosing the alternative with the least impact to you – explaining to you the difference in applicable penalty standards.

Basically, your standard for avoiding a penalty on any item on your return is the “substantial authority” standard, which is generally accepted as meaning about a 40-percent chance of success of being sustained. My standard as your preparer is higher. It is the “more likely than not” standard, which requires that the position have more than a 50-50 chance of success or it must be disclosed to you or to the IRS.

Our first obligation is to you, our client. We will continue to recommend that you take every deduction, credit or other position on your return that is most favorable to you and supportable by the substantial-authority standard. The only downside for you is that the IRS would demand the additional amount of tax that you would have paid in the first place, plus market-rate interest. The upside is that you save substantial tax dollars if the IRS never makes a challenge or fails on the merits of its argument.

The blanket new return-preparer requirement primarily was enacted to protect both taxpayers and the IRS from a relatively small group of unscrupulous and careless return preparers. The difference in penalty standards between taxpayers and preparers has caused a great deal of controversy and may be revised in 2008 or beyond. For now, however, we must live with it and the additional paperwork that it requires. Thank you.

Compliance Calendar

■ January 25

Employers deposit Social Security, Medicare, and withheld income tax for January 19, 20, 21, and 22.

■ January 30

Employers deposit Social Security, Medicare, and withheld income tax for January 23, 24, and 25.

■ January 31

Individuals file an income tax return and pay any tax due, if they did not pay the last installment of estimated tax by January 15.

Businesses give annual information statements to recipients of certain payments made during 2007.

Employers give employees copies of Form W-2 for 2007.

Employers file Form 945 to report income tax withheld for 2007 on all nonpayroll items. Deposit any undeposited tax (if more than \$2,500).

Employers file Form 940 to report federal unemployment tax for 2007. Deposit any undeposited tax (if more than \$500).

Certain small employers file Form 944 to report Social Security, Medicare, and withheld income tax for 2007. Deposit any undeposited tax (if more than \$2,500).

■ February 1

Employers deposit Social Security, Medicare, and withheld income tax for January 26, 27, 28, and 29.

From the Helpline

The following questions have been answered recently by our "CCH Federal Tax Service" Helpline (1-800-449-8114).

Q What are the tax consequences to both the volunteer and the exempt organization for gifts to volunteers; for example, gift cards?

A While tax-free working condition fringe benefit rules apply to bona fide volunteers, a gift certificate that is readily convertible into cash is not excluded under this umbrella. If redeemable only for merchandise, a \$25 rule generally applies. Generally, volunteers would not be considered employees subject to employment taxes in any event. From the perspective of the organization, two basic issues may be involved: private inurement and excess benefit transactions. Under Code Sec. 501(c)(4), none of the net earnings may inure to (or benefit) any persons having a personal and private interest in the activities of the organization, thus ruling out gift certificates given to those volunteers. The prohibition on excess benefit transactions, on the other hand, refers to economic benefits conferred on any disqualified person when the value of the benefit conferred exceeds the value of what the person provides to the organization (such as the services performed by a volunteer). See *TRC EXEMPT: 100 and 6,056.05*.

Q Does an employer have to withhold on taxable distributions of deferred compensation.

A Yes. See *TRC COMPEN: 15,064 and Notice 2007-89*.

Q How is an accidental IRA distribution remedied when real estate is held within the IRA?

A Qualifying for a rollover under the 60-day rule can often remedy an accidental distribution. That rollover rule is discussed in *TRC RETIRE: 66,702*. Rolling over non cash property is discussed in *TRC RETIRE: 42,462.10*.

TRC Text Reference Table

The cross references at the end of the articles in *CCH Federal Tax Weekly (FTW)* are text references to *CCH Tax Research Consultant (TRC)*. The following is a table of TRC text references to developments reported in *FTW* since the last release of *New Developments*.

ACCTNG 12,208	19	INDIV 57,708	19	IRS 48,150	32
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ACCTNG 36,162.05	42	INTL 18,050	19	IRS 51,056	18
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INDIV 6,202	19	IRS 45,156	43	RETIRE 3,214.40	19
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