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Inside this Issue

<i>House Passes Stimulus Package; IRS Ponders Logistics Of Sending Tens Of Millions Of Rebates</i>	49
<i>Reimbursement Of Costs On Unfinished Cost-Plus Service Contract Not Taxable</i>	50
<i>IRS Describes Adequate Disclosure For 2007 Returns; Updates Charitable Contribution Requirements And Others</i>	51
<i>U.S.-U.K. Treaty Trumps IRS Regs On Interest Expense Of Bank's U.S. Branch</i>	52
<i>Chief Counsel Explains When IRS Should Consider Dual Consolidated Loss Relief Requests</i>	52
<i>Termination Clause Allowing For Payment Of Performance-Based Executive Comp Triggers \$1 Million Deduction Limit</i>	53
<i>Proof Of Gambling Addiction Adequate To Substantiate Slot Machine Losses To Offset Lottery Annuity</i>	53
<i>IRS Loses Attack On Disclaimer Formula In Charitable Lead Annuity Trust As Against Public Policy</i>	54
<i>Fraud Victims Allowed Partial Theft Loss Deduction; IRS's All-Or-Nothing Interpretation Of Regs Rejected</i>	55
<i>Tax Briefs</i>	55
<i>Final Regs Cover Treatment Of Sec. 197 Intangibles And Sec. 338 Reserves In Certain Insurance Company Acquisitions</i>	56
<i>Practitioners Corner: IRS Whistleblower Program Takes Shape Through New Guidance</i>	57
<i>Washington Report</i>	58
<i>Compliance Calendar</i>	60

House Quickly Passes Stimulus Package; IRS Ponders Logistics Of Sending Tens Of Millions Of Rebates

◆ H.R. 5140

A \$150 billion economic stimulus package (H.R. 5140), including rebates for individuals and business incentives, passed the House on January 29 by a wide margin. Bush Administration officials are now lobbying the Senate to pass the package quickly. Meanwhile, the IRS is preparing to issue tens of millions of rebate checks possibly at the same time it is sending 2007 tax refunds.

■ **CCH Take Away.** A Treasury spokesperson told CCH that “technically the rebates are advance payments of the additional money that taxpayers would receive because of the lowering of the 10 percent bracket.” According to a White House explanation, “in 2008, taxes would be cut from 10 percent to zero percent on the first \$6,000 of taxable income for individuals and the first \$12,000 of taxable income for married couples.” Treasury officials have said that rebates will be based on 2007 tax returns.

■ **Comment.** Congress used a similar approach in 2001 to stimulate the economy. The *Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)* created a new 10 percent income tax rate. Taxpayers received the benefit of the new 10 percent rate in the form of advance refunds. Treasury and the IRS sent advance refund checks to nearly 100 million taxpayers during the summer and autumn of 2001.

Rebates

Under H.R. 5140, the rebate amount is equal to the lesser of net income tax liability for 2007 or \$600 (\$1,200 for joint filers). Effectively, that means that no one paying tax above the 10 percent rate bracket will get less than the maximum \$600/\$1,200. In no case, however, would the rebate be less than \$300 (\$600 for joint filers) for taxpayers with either at least \$3,000 in earned income or those with at least \$1 in net income tax liability and gross income of more than \$8,750 (\$17,500 for joint filers). In addition, no one who can be claimed as a dependent or who is a nonresident alien would be entitled to the rebate.

Rebates would phase out for single individuals with adjusted gross incomes (AGI) starting at \$75,000 and for married couples filing jointly with AGI starting at \$150,000. Rebates would phase out at five percent of the amount exceeding the applicable AGI threshold.

■ **Comment.** While the Administration is hoping that taxpayers will spend their checks quickly to pump up the economy, many financial planners are advising uses that will better prepare for a possible recession. “The very first thing a person should do when they receive a rebate is look at their debt and pay whatever debt has the highest interest rate and no tax deductibility,” Susan E.S. Howe, CPA, past president of the Pennsylvania Institute of Certified Public Accountants (PICPA) told CCH. “For most

Continued on page 50

Reimbursement Of Costs On Unfinished Cost-Plus Service Contract Not Taxable, IRS Chief Counsel Determines

◆ TAM 200803017

The IRS Office of Chief Counsel recently concluded that, under the all-events test, a taxpayer does not recognize income on the reimbursement of allowable costs as the costs are incurred on a cost-plus services contract. The taxpayer does not have a fixed right to income under its government contracts until amounts become due and performance is complete.

■ **CCH Take Away.** Under the TAM's conclusion, the taxpayer receives cash-flow and tax benefits: it is reimbursed for its costs, but it does not have to recognize any income until the contract is completed.

Background

An accrual method corporation enters into fixed-price and cost-plus contracts with the U.S. government. Under the former, the government pays a fixed fee for work. Under the latter, the government reimburses the contractor for its costs and agrees to separately negotiate and pay a profit fee for contract work. The taxpayer previously used the percentage of completion method.

Some of the taxpayer's contracts are for providing services. IRS Exam claimed that the taxpayer's unbilled receivables for services on its cost-plus contracts must be included in income, specifically income from reimbursable costs under the contracts. The taxpayer argued that the service income accrues when it completed performance and amounts became due under the contracts. Exam conceded that profit fees on the cost-plus contracts are not income until amounts became due under the contracts.

Under the Federal Acquisition Regulations, a cost-plus contract includes one or more contract fee provisions. Typically, the contract authorizes interim billing and payment of ratable portions of the contract fee while work is being done. The government may terminate a contract for default or for convenience, but will reimburse the contractor its allowable costs (and pay a contract fee in the latter case).

Divisible amounts

Based on the all-events test, the general rule is that prior to a payment being made or due, the right to receive income is fixed only

when full required performance occurs, not when partial performance occurs. IRS Exam argued that the required performance occurred as the taxpayer incurred costs in performing under a cost-reimbursement contract. Chief Counsel determined that performance had not occurred unless the cost portion of the contract was divisible from the rest of the contract.

In Rev. Rul. 79-195, the IRS determined that services were divisible and that a portion of the income may be allocated to each divisible service under the contract. The Chief Counsel distinguished the present case from the revenue ruling by noting that the income accrued in the ruling represented all the income from the portion of the services completed during the year. In the taxpayer's case, there was fee income as well as cost reimbursement income. Because divisibility does not apply to the components of billable amounts, Chief Counsel rejected IRS Exam's position and agreed with the taxpayer that income should not be recognized until performance was complete.

References: FED ¶(to be reported); TRC STAGES: 9,202.10; ACCTNG: 9,052.

Economic Stimulus

Continued from page 49

people, that would be credit card debt," she explained. After paying down debt, Howe suggested taxpayers consider investing the remainder in savings. "Before you're tempted to spend it, save it."

Child payments

The bill also calls for a \$300 per child payment (alternatively known as a bonus). The \$300 payment would not be capped on the number of children.

Checks

According to Treasury, the IRS will begin sending rebates to qualifying taxpayers 60 days after legislation is enacted. If the Senate passes the bill quickly, 60 days would be right at the end of the 2008 filing season. *H.R. 5140* gives Treasury and the IRS an additional \$250 million to process and administer the checks.

The Joint Committee on Taxation recently questioned if the IRS has the resources to issue rebates and refunds at the same time. According to the Joint Committee, "it is not practical to contemplate distributing cash rebates until the peak filing

season is completed, which in past years has been the very end of May."

■ **Comment.** A Treasury spokesperson told CCH that the government can print a maximum of roughly seven million checks per week in May, climbing to 11 million checks per week in June. "The capacity to issue stimulus checks in May is lower because we will still be issuing millions of normal tax refunds in May, which will occupy part of the check writing capacity." A new report by the Joint Committee on Taxation indicates that Treasury and IRS anticipate using direct deposit to the fullest extent possible. "Direct deposit is a path we have been exploring," the Treasury spokesperson explained.

■ **Comment.** In 2001, the IRS used a distribution schedule based on the last two digits of the taxpayer's Social

Continued on page 51

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 Describes Adequate Disclosure For 2007 Returns; Updates Charitable Contribution Requirements And Others

◆ *Rev. Proc. 2008-14*

Every year, the IRS identifies the circumstances under which disclosure of a position on a return will be deemed adequate disclosure. If a taxpayer follows the guidance in the annual revenue procedure, which this year is Rev. Proc. 2008-14, it is unnecessary to make any additional disclosure of a particular item. The IRS recently updated the annual revenue procedure for 2007 returns, reflecting recent legislation and other developments.

■ **CCH Take Away.** Many practitioners have been waiting for the release of Rev. Proc. 2008-14 in light of the significant changes to the Code Sec. 6694(a) preparer penalty rules and for guidance when a disclosure using Form 8275 or Form 8275-R is not necessary. Code Sec. 6694(a) imposes a penalty on a tax return preparer for filing a return or claim for refund that results in an understatement of liability due to a position of which the preparer knew or should have known, if the preparer did not have a reasonable belief that the position would more likely than not be sustained on the merits and the position was not disclosed in ac-

cordance with Code Sec. 6662(d)(2)(B)(ii). The penalty equals the greater of \$1,000 or 50 percent of the income derived, or to be derived, by the preparer with respect to the return or claim.

Itemized deductions

Rev. Proc. 2008-14 describes when disclosure is considered adequate for various itemized deductions listed on 2007 Form 1040, Schedule A, including medical and dental expenses, taxes, interest expenses, casualty and theft losses, and charitable contributions. The disclosure requirements for charitable contributions have been updated to reflect heightened substantiation requirements in the *Pension Protection Act of 2006 (PPA)*.

For charitable contributions, lines 16-19 must be completed with all of the required information. Rev. Proc. 2008-14 instructs that the amount of the contribution reduced by the value of any substantial benefit (goods or services) provided by the charity in consideration, in whole or in part, must be entered. Entering the value of the contribution unreduced by the value of the benefit received is not adequate disclosure, the IRS cautioned.

If a contribution of \$250 or more is made, a contemporaneous written ac-

knowledgment must be secured from the charity. If contribution of cash of less than \$250 is made, a bank record must reflect the contribution or a written communication must be secured from the charity. If a contribution of property other than cash is made and the amount claimed as a deduction exceeds \$500, taxpayers must attach Form 8283, Noncash Charitable Contributions, to the return. In addition to Form 8283, a contribution of a qualified motor vehicle, boat, or airplane, which has a value of more than \$500, must be substantiated by a contemporaneous written acknowledgment from the charity and it must be attached to the return.

Book/Income tax reporting differences

Rev. Proc. 2008-14 also expands the disclosure requirements relating to differences in book and income tax reporting. Rev. Proc. 2008-14 adds Form 1120-F, Schedule M-3, Net Income (Loss) for Foreign Corporations With Total Assets of \$10 Million or More, to the roster of forms deemed to constitute adequate disclosure for reporting differences in book and income tax reporting.

References: FED ¶46,278; TRC PENALTY: 3,108.15.

Economic Stimulus

Continued from page 50

Security number. For married couples filing jointly, the first Social Security number on the return determined the mailing date for the rebate. It is likely that the IRS will use the same distribution system in 2008.

■ **Comment.** A Treasury spokesperson told CCH that the rebates will be offset by any federal debts the taxpayer may owe, including any unpaid child support.

Rival plan

Senate Finance Committee Chair Max Baucus, D-Montana, unveiled his version of a

stimulus plan on January 28. Baucus' plan would treat Social Security benefits as taxable income and provide for enhanced net operating loss carrybacks. Under the House bill, senior citizens with no taxable income would not receive a rebate. Many Senate democrats also want to extend unemployment insurance and food stamps.

Business incentives

H.R. 5140 also includes two business tax incentives: temporary bonus depreciation and enhanced Code Sec. 179 expensing. Bonus depreciation would reach 50 percent. The Code Sec. 179 expensing amount would reach \$250,000, with an overall investment limit of \$800,000. The bill does not include an extended loss carryback.

■ **Comment.** At press time, the Senate Finance Committee's markup of its stimulus package called for similar amounts of expensing and a five percent bonus depreciation given 25 percent in 2008 and 25 percent in 2009.

■ **Comment.** "Bonus depreciation works very well if you are a successful company and you want to expand," AICPA Vice President – Taxation Thomas Ochenschlager told CCH. "It does not do much good for companies affected by the economic slowdown that are reporting losses. An extended loss carryback would help these companies by giving them an immediate cash infusion."

U.S.-U.K. Tax Treaty Trumps IRS Regs On Interest Expense Of Bank's American Branch

◆ *National Westminster Bank, PLC, CA-FC, January 15, 2008*

A federal appeals court has upheld a lower court decision that the U.S. branch of a British bank was entitled to a \$65 million refund for interest expense. The court held that the terms of the 1975 U.S.-U.K. Tax Treaty overrode Reg. §1.882-5 on the determination of interest expense of the U.S. branch.

■ **CCH Take Away.** This is “an important issue,” Joan Arnold of Pepper Hamilton LLP told CCH. It has particular significance “for capital intensive industries like banking [and] continues to leave a large mark,” Arnold indicated. “The court used a facts and circumstances test,” she said. “The [Code Sec. 882] reg is not consistent with the treaties we were negotiating. Older treaties are pretty much identical to [this case]. Treasury recently amended the regs to require that the treaty specifically allow [another method]. It’s hard to see how this will stand up,” Arnold, head of the firm’s international tax practice, commented.

■ **Comment.** The Court of Federal Claims issued three summary judgment decisions in favor of the bank, relying on the primacy of the 1975 treaty over the reg. In Notice 2005-53, the IRS indicated that it would amend

Reg. §1.882-5 so that it could be harmonized with the U.S.-U.K. and U.S.-Japan treaties for determining interest expense of a foreign bank. However, the IRS indicated that it still favored the method in the regs.

Background

From 1981-1987, a U.K. bank operated in the U.S. through six permanently established branches (the “U.S. branch”). The U.S. branch claimed deductions for accrued interest expense. The IRS reduced the deductions using the formula in Reg. §1.882-5, which excluded interbranch transactions. The bank filed a refund suit, claiming that the reg violated the 1975 treaty.

The IRS claimed that the reg apportions interest expense of all foreign corporations with permanent establishments in the U.S., and makes no exception for banks. The reg disregards interbranch loans and interest expenses between separate branches of the same foreign corporation.

1975 treaty

The 1975 treaty required that the U.S. branch be taxed as if it were a separate enterprise from the bank. The Claims Court held that the reg’s exclusion of interbranch transactions violated the separate enterprise approach.

The IRS argued that to ensure the use of market rates for interest expense, it could attribute capital to the U.S. branch based on U.S.

regulatory and marketplace requirements for U.S. banks — the “corporate yardstick.” The Claims Court held that the separate enterprise approach did not allow attributing hypothetical capital to the U.S. branch based on requirements that did not apply.

1963 model convention

The appeals court relied on the treaty’s plain language and the 1963 model convention on which the treaty was based. Interbranch transactions are not disregarded but are adjusted to reflect arm’s length terms. The 1963 convention stated that interbranch payments of interest must be allowed in determining profits of a permanent establishment. The 1963 commentary specifically allowed interest payments made by different parts of a bank to each other. The express position of the U.K. in its *amicus* brief to the Claims Court also supported this interpretation and opposed a formula allocation.

The appeals court again looked at the treaty’s plain language and the 1963 commentary regarding the attribution of capital. The analysis of business profits started with the “real facts” of the permanent establishment. Here, the branch was not required to maintain a minimal amount of capital. A formula allocation is allowed only where the permanent establishment does not maintain separate accounts from the main office.

References: 2008-1 USTC ¶50,140; TRC INTLIN: 3,106.30; INTL: 18,102.05.

Chief Counsel Explains When IRS Should Consider Dual Consolidated Loss Relief Requests

◆ *AM 2008-001*

A new Chief Counsel advice memorandum explains when the IRS should consider a reasonable cause request involving a dual consolidated loss (DCL) from a year for which the statute of limitations has expired. The request seeks approval to make an election to use the DCL or to provide a certification that recapture of the DCL was not triggered.

■ **CCH Take Away.** Previously, the DCL rules required taxpayers to obtain consent to make a late election or certification under Reg. §1.9100. The IRS issued revised regs on DCLs in March 2007 (T.D. 9315) that adopted the reasonable cause standard instead.

DCL rules

The DCL rules prevent the use of a corporation’s or separate unit’s loss in both

a foreign country and the U.S. Generally, the loss cannot be used to offset the income of a domestic affiliated corporation unless the taxpayer timely elects not to use the loss to offset income in a foreign country (a domestic use election). The corporation must certify annually for five years that the DCL was not used to offset foreign income. If it was (a triggering event), the income must be recaptured. Failure to timely file a certification is also a triggering event.

Continued on page 53

Termination Clause Allowing For Payment Of Performance-Based Executive Comp Triggers \$1 Million Deduction Limit

◆ LTR 200804004

The IRS has privately ruled that compensation paid to an executive upon attainment of a performance goal under an incentive plan will not be considered performance-based compensation under Code Sec. 162(m)(4)(C) that allows a deduction for more than \$1 million in pay. While payment was actually made on account of performance, the agreement had allowed payment in any event if the executive was terminated “without cause” or left voluntarily “for good reason.”

■ **Comment.** Performance goals can be based on one or more business criteria that apply to the individual, a business unit, or the corporation as a whole. In this time of possible recession, it is also useful that the regs do not require business goals to be based on an increased or positive result under a business criterion and could include, for

example, maintaining the status quo or limiting economic losses, as long as these were measured by reference to a specific business criterion. Unfortunately for the plan under review in this ruling, the regs are not as flexible when it comes to mitigating circumstances for payment of performance pay irrespective of meeting any criteria.

Background

A corporate taxpayer provided a variety of incentive awards under an incentive plan to certain executives. The awards were intended to be qualified performance-based compensation under Code Sec. 162(m)(4)(C). The agreement, however, provided for payment of the incentive awards if the corporation terminated the executive without cause or the executive terminated his or her employment for good reason. That clause

was added under the apparent assumption that it was close enough to be covered under the exception in Reg. §1.162-27(e)(2)(v) that permits payment upon death, disability or a change in ownership or control.

Narrow exception

Performance-based compensation that qualifies for a deduction in amounts over \$1 million must be paid solely on the attainment of pre-established performance goals. The IRS concluded that the compensation paid by the taxpayer to its executive with respect to incentive awards was not payable solely upon attainment of performance goals. Nor did it view a broad termination without cause or leaving for good reason as covering only circumstances involving death, disability or a change in ownership or control, as required under the regs.

References: FED ¶(to be reported); TRC COMPEN: 12,356.10.

Dual Consolidated Losses

Continued from page 52

Facts

The memo discussed three scenarios. All involve a U.S. parent corporation and a foreign subsidiary treated as a separate unit in the foreign country. The IRS did not disallow any DCLs used domestically. The three-year statute of limitations applies. Some of the parent's years are closed; others are still open.

Scenario one

The separate unit has a DCL in years 1 and 2. The parent failed to file domestic use elections or certifications. The parent used the year 1 DCL to offset year 1 income, and the year 2 DCL to offset year 2 income. In year 5, the parent requested reasonable cause relief for failing to make the election and annual certifications. Year 1 is closed; years 2-4 are open.

Result-year 1. The field should not accept the relief request for year 1. Although the certification period includes open years, there can be no event triggering recapture of income because no election was filed.

Continued on page 56

Proof Of Gambling Addiction Adequate To Substantiate Slot Machine Losses To Offset Lottery Annuity

The Tax Court has found that a state lottery winner could prove sufficient annual net losses from compulsive slot-machine gambling to offset most, and in some years, all of his annual lottery annuity payout. Even though he kept no log of his gambling activities, he successfully proved his losses to the court's satisfaction through casino-located ATM receipts, casino-issued Forms W-G, net worth summaries, bank statements and expert testimony that he suffered from a pathological gambling addiction.

The court gave significant weight to testimony by a casino gaming industry and math expert with expertise in slot machines. Because the expert had access to casino operations data and regularly performed analysis to determine whether slot machines overpay or underpay gamblers, he used these techniques to show that the likelihood of the taxpayer breaking even or profiting from his reckless gambling was infinitesimal.

■ **Comment.** In contrast, another slots player (in *Myers, TC Summary Opinion 2007-194*) convinced the court that she played so frequently and methodically that she was in a business that could support losses in excess of winnings. Despite conventional wisdom holding that slot machines have some of the worst casino odds, she persuaded the court (at least in a non-precedent setting summary opinion) that she had a plausible “strategy,” consulted experts, won enough to keep playing, showed management skills in other areas and never made playing a social event.

F.M. Gagliardi, TC Memo 2008-10, CCH Dec. 57,311(M); TRC BUSEXP: 30,256.

IRS Loses Attack On Disclaimer Formula In Charitable Lead Annuity Trust As Against Public Policy

◆ *Estate of Christiansen, 130 TC No. 1*

In a decision creating partial victories for both the taxpayer and the IRS, the Tax Court recently denied a decedent's estate a charitable deduction for disclaimed property that passed to a charitable lead annuity trust because the disclaimant, decedent's daughter, retained a contingent remainder interest in the trust. However, a charitable deduction was allowed for the entire value of disclaimed property that passed to the decedent's private foundation, even though the IRS argued that the clause that accomplished the transfer was against public policy.

■ **Comment.** "From a policy standpoint this is a relatively simple technique to allow beneficiaries the choice of benefiting charity while still maintaining a taxwise plan. By disqualifying the disclaimer on a very narrow technicality, if that's even valid, it seems to me the government is further limiting the charitable choices of the taxpayer," Jason Havens of Howard, Mobley & Havens, PLLC, Bluewater Bay, Florida, and co-chair of the charitable planning committee, ABA Section of Real Property, Trust and Estate Law, told CCH.

■ **CCH Take Away.** Despite a partial loss on one disclaimer issue, this decision is good news for use of charitable lead annuity trusts on several counts. First, the issue on which the taxpayer lost had the support of a dissenting opinion, giving hope that another court may find acceptable a disclaimer that includes the disclaimer of a related, yet separate interest. Next, the Tax Court in effect blessed the use of disclaimer clauses in favor of a family's private foundation set up by the decedent. Finally, the Tax Court rejected the IRS's argument that disclaimer clauses of the type used in this case will discourage the IRS from conducting audits and, therefore, should be disregarded.

Disclaimed property

Under the terms of the decedent's will, all property passed to her daughter, with any

property disclaimed by the daughter to pass in part to a charitable lead annuity trust and in part to the decedent's charitable foundation, in which the daughter served as director. The trust was to pay an annuity for 20 years. At the end of 20 years, any remaining trust property was to pass to the daughter, if she survived.

The daughter disclaimed a part of the gross estate, but did not disclaim her contingent remainder interest in the charitable trust to which part of the disclaimed property passed according to the will. The estate claimed charitable deductions for (1) the entire amount that passed to the foundation, including the amount of inheritance disclaimed by the taxpayer, and (2) the value of the property that passed to the charitable trust as a result of the taxpayer's disclaimer.

Charitable trust

The estate could not take a charitable deduction for the disclaimed property transferred to the charitable trust as a result of the daughter's disclaimer because she retained a contingent remainder interest in the trust. To effectively disclaim property, Code Sec. 2518 regs require that the disclaimer be "qualified." A disclaimer is not a qualified disclaimer if the disclaimant retains a right to receive the disclaimed property as an "heir at law, residuary beneficiary, or by other means." Additionally, all or an undivided portion of the property must be transferred.

The Tax Court found that the daughter's remainder interest in the charitable trust and the 20-year annuity were neither "severable property" nor an undivided portion in the property. The daughter could not disclaim the present enjoyment of the property that passed to the trust as a result of her disclaimer, yet retain a remainder interest in the property. The interests were not severable or undivided and therefore a partial failure of the disclaimer occurred.

■ **Comment.** "I think the qualified disclaimer regs would treat this particular disclaimer as qualified. In addition, actuarial principles would value [the daughter's] contingent remainder interest at zero, or close to it. So, she really had no benefit from the disclaimer," Havens said. "I think

that this planning is substantially similar to the Jackie O estate plan, which everyone counted as brilliant. The planning there was almost identical to this, allowing a disclaimer to the Kennedy children to disclaim part or all of their interests to a charitable trust," Havens added.

■ **Comment.** The dissent would have treated the daughter's disclaimer in favor of the trust annuity as a qualifying disclaimer. The dissent argued that the daughter's remainder interest in the trust and the foundation's annuity interest were independent because the foundation could not affect the daughter's contingent remainder interest and the daughter could not affect the annuity.

Private foundation

The estate was entitled to take a charitable deduction for the entire value of the property that passed to the decedent's private foundation, the Tax Court held. The daughter retained no interest in the amount that passed to the foundation and the transfer of property to the foundation was not contingent on any event occurring after the decedent's death. Therefore, the daughter's disclaimer was a qualified disclaimer with respect to the amount that passed outright to the foundation.

Adjustment clause

The court also found that an adjustment clause in the disclaimer, which increased the amount passing to the charitable trust if the value of the estate increased, was not void as against public policy. After the IRS asserted a higher valuation of the estate, to which the parties agreed, the estate claimed an increased charitable deduction for both property going to the trust and foundation. The IRS argued to no avail that such language would discourage IRS examination of estate tax returns because any estate tax deficiency would be offset by an additional charitable deduction.

References: CCH Dec. 57,301; TRC ESTGIFT: 45,066.20.

Fraud Victims Allowed Partial Theft Loss Deduction; IRS's All-Or-Nothing Interpretation Of Regs Rejected

◆ *A.E. Johnson, FedCl, January 9, 2008*

While a married couple still had not unravelled the entirety of a fraud scheme involving the purchases of gems that bilked them out of over \$78 million, the Court of Federal Claims found that they did not need to wait for total resolution to get at least a partial loss deduction. The court found that they were entitled to Code Sec. 165 theft loss deductions during a tax year they had settled or successfully litigated some of their claims against the perpetrator of the scheme, even though there were still pending actions.

Fraud litigation

The taxpayers had been involved in litigation since 1998 to recover the over \$78 million lost in a jewelry scheme. In that year, they successfully sued the mastermind of the fraud, but discovered that he only had a little over \$45 million in net assets from which to collect because he had allegedly laundered funds and assigned others to foreign accounts.

In 2001, a criminal court entered a final judgment to reimburse victims of the fraud. During that year, the taxpayers also brought a civil case against the promoter of the scheme and added 56 new third-party defendants and later impleaded several other parties to collect the remaining loss.

The taxpayers argued that they were entitled to loss deductions under Code Sec. 165 after their settlement of the original civil case in 1998. In the alternative, they argued they were allowed the deduction for 2001 due to settlement of remaining claims, judgments awarded, or their abandonment. The IRS countered that, because the taxpayers were still pursuing claims for reimbursement of their losses, they could not ascertain the total amount they would recover with reasonable certainty until 2005, when they had completely abandoned all efforts to recover the loss.

Loss deductions allowed

While the court denied the taxpayers a deduction in 1998 on the grounds that it was too early in the process, it did allow

the taxpayers a theft loss deduction in 2001. It reasoned that many of the taxpayers' claims had been settled, adjudicated, or abandoned; with the remaining claims seeking fixed identifiable amounts.

Reasonable certainty

The court rejected the IRS's interpretation of Reg. §1.165-1(d)(2). That reg states "no portion of the loss with respect to which reimbursement may be received is sustained...until it can be ascertained with reasonable certainty whether or not such reimbursement will be received." The IRS read this to mean that no portion of the taxpayer's entire losses could be deducted until it was reasonably certain as to whether the entire amount was recoverable. The court disagreed with this interpretation, finding that the taxpayers were "not required to wait until the total amount of recovery from every source was established to take a theft loss deduction for a portion of their loss."

References: 2008-1 USTC ¶50,142; TRC BUSEXP: 30,110.05.

Tax Briefs

Jurisdiction

An individual whose previous Tax Court petition was dismissed for lack of jurisdiction could not raise the same underlying tax liability at a later Collection Due Process (CDP) hearing. Moreover, he refused to participate in a telephone hearing and failed to provide the documents the settlement officer requested. Thus, the settlement officer reasonably concluded that the levy could proceed.

Shere, TC, CCH Dec. 57,309(M), FED ¶47,922(M); TRC IRS: 51,056.

Tax Crimes

A federal district court properly convicted and sentenced an individual for filing false individual income tax returns because he failed

to report income diverted from his company to pay off his gambling debts. The district court did not abuse its discretion when it did not admit expert evidence that the court found was irrelevant, lacked probative value and would have confused the jury.

Hayez, CA-4, 2008-1 USTC ¶50,137; TRC IRS: 66,058.210.

The sentence imposed on a luxury car salesman convicted of tax evasion was affirmed because it was reasonable. The individual's attempts to seek a below-guidelines sentence because of his purported gambling addiction were properly rejected by the trial court.

Tahzib, CA-7, 2008-1 USTC ¶50,145; TRC IRS: 66,462.

Summons

A wife's petition to quash IRS third-party administrative summonses served on banks and mortgage companies seeking information regarding her husband's finances was properly dismissed for lack of standing. In addition, the summonses were properly enforced because the couple failed to rebut the IRS's "prima facie" case for enforcement.

Stewart, CA-9, 2008-1 USTC ¶50,143; TRC IRS: 21,106.

Income

An individual could not exclude from income amounts earned for services per-

Continued on page 56

Tax Briefs

Continued from page 55

formed in Antarctica because Antarctica is not a foreign country.

*Yamasaki, TC, CCH Dec. 57,308(M),
FED ¶47,921(M); TRC EXPAT: 12,100.*

Frivolous Arguments

Sanctions were imposed on an individual for raising frivolous arguments on appeal. Even though the Tax Court had previously warned the individual about the potential consequences of maintaining an appeal based on frivolous arguments, the individual nonetheless maintained that the IRS was required to notify him of his obligation to maintain financial records.

*Perkins, CA-11, 2008-1 USTC ¶50,144;
TRC LITIG: 3,152.*

Default Judgment

Default judgment entered against an individual was not set aside. His statute of limitations defense to the assessment of taxes was barred by *res judicata* because that defense could have been raised in the prior proceedings.

*Johnson, DC Pa., 2008-1 USTC ¶50,139;
TRC LITIG: 3,052.*

Liens and Levies

An individual's complaint against his employer and the IRS for fraud and theft was dismissed for failure to state a cause of action. The employer was obligated to forward the taxpayer's wages to the government when served with the levy notice. Moreover, his request to enjoin his employer from complying with the IRS notice of levy was also denied.

*Dickinson, DC Ohio, 2008-1 USTC ¶50,136;
TRC IRS: 51,064.25.*

Deficiencies and Penalties

A taxpayer was liable for additions to tax for failure to pay tax and failure to pay estimated taxes. Despite admitting to relying on tax protestor arguments, no penalty for instituting frivolous proceedings was imposed.

*Phillips, TC, CCH Dec. 57,310(M),
FED ¶47,924(M); TRC PENALTY: 3,050.*

Bankruptcy

A CPA's tax liabilities were nondischargeable in bankruptcy because he willfully attempted to evade the payment of such taxes. His claim that he believed his tax obligations were discharged in a prior bankruptcy was implausible because he included the taxes as outstanding liabilities in his subsequent bankruptcy petition.

*In re Zimmerman, CA-11, 2008-1 USTC
¶50,146; TRC IRS: 57,158.*

Dual Consolidated Losses

Continued from page 53

Result-year 2. The field should accept the relief request for year 2. The IRS may still disallow the DCL and assess any additional tax.

Scenario two

The separate unit has a DCL in year 1 and filed a timely domestic use election. The parent used the DCL to offset domestic income in year 1. The parent did not file timely certifications in years 2-5 and did not recapture the DCL in year 2. In year 6, the parent requests relief for failing to file certifications. Years 1-2 are closed; years 3-5 are open.

Result. The IRS field should not accept the relief request. Recapture was triggered in year 2 when the parent failed to file a timely certification. Although the certification period includes open years, there can be no additional triggering events in the open years because the election terminated in year 2.

Scenario three

The separate unit has a DCL in year 2 but fails to file a timely election or certifications. The parent used the DCL to offset domestic income for year 2. The parent has a net operating loss

(NOL) incurred in year 1 and carried forward to year 6. The year 1 NOL exceeds the year 2 DCL. In year 6, the parent requests relief for not filing the election and certifications for the year 2 DCL. Year 2 is closed; years 3-5 are open.

Result. The field should accept the relief request for the year 2 DCL. Because year 2 is closed, and no election was made, there can be no triggering event resulting in recapture income. However, the IRS may effectively disallow the domestic

use of the year 2 DCL by recomputing and reducing the NOL carryforward available in subsequent open years. The NOL carryforward would be reduced by disallowing the DCL and using the NOL to offset year 2 income in a subsequent year. Because disallowing the DCL would affect tax liability in an open year, the request should be considered.

*References: FED ¶(to be reported);
TRC CCORP: 45,264.*

Final Regs Cover Treatment Of Sec. 197 Intangibles And Sec. 338 Reserves In Certain Insurance Company Acquisitions

The IRS has published final regs that set forth rules applying to Code Sec. 197 intangibles resulting from an assumption reinsurance transaction and Code Sec. 338 reserve increases after a deemed asset sale that results from a section 338 election. The final regs apply to insurance companies and are effective January 23, 2008.

Code Sec. 197(f)(5) determines the basis of an amortizable intangible for insurance or annuity contracts acquired in an assumption reinsurance transaction. The basis of such intangible is the excess, if any, of the amount paid or incurred by the acquirer (reinsurer) under the assumption reinsurance transaction; over the amount, if any, required to be capitalized under Code Sec. 848 in connection with such transaction.

The regs also provide guidance on the effect of a Code Sec. 338 election on an insurance company's election under Code Sec. 846(e) to use its historical loss payment pattern to discount certain unpaid losses.

T.D. 9377, FED ¶47,014; TRC CCORP: 30,208.

Practitioners' Corner

IRS Whistleblower Program Takes Shape Through New Guidance

In 2006, Congress passed the *Tax Relief and Health Care Act of 2006* (2006 Tax Relief Act), which significantly strengthened the IRS's longstanding whistleblower informant program. Not only did the legislation create a Whistleblower Office within the IRS, it also substantially increased the monetary incentive for informants to report alleged violations of the tax laws and offered an enhanced mechanism through which whistleblowers could enforce an award.

The IRS has been busy issuing guidance on the reformed whistleblower program, its operations and procedures. Recently, it issued interim guidance on Whistleblower Office operations, the filing of claims and administration of the reward program, as well as privacy issues. This Practitioners' Corner highlights the development of the IRS Whistleblower Office.

■ **Comment.** "Prior to the whistleblower legislation, the IRS had discretion in terms of the award an informant whistleblower was entitled to receive. If the individual felt that his or her efforts weren't satisfactorily compensated, there was really no opportunity to judicially challenge the amount of the award. Now it's statutory that the informant who provides information that substantially contributes to a recovery must receive an award," Donald Rocen, former IRS deputy chief counsel, told CCH (*To read a full transcript of the interview with Donald Rocen see the January 2008 issue of TAXES magazine*).

Guidance strengthens Whistleblower Office

Under Code Sec. 7623, the IRS had been authorized in its discretion to pay awards to certain whistleblowers from the proceeds of amounts collected as a result of information provided by informants. *The*

2006 Tax Relief Act expanded the scope of Code Sec. 7623, creating the IRS Whistleblower Office, providing for increased award payments and conferring upon the

report information relating to alleged non-compliance. The guidance also clarifies that existing regs issued under Code Sec. 7623(a), which grants the IRS the authority to pay

"The whistleblower provisions themselves could lead to behavior that might incentivize employees to report innocent mistakes to the IRS rather than bringing them to the attention of their employers." - Former IRS Deputy Chief Counsel Donald Rocen

Tax Court jurisdiction to hear appeals of certain award determinations made by the IRS's Whistleblower Office. The Act also added Code Sec. 7623(b), which sets forth the threshold requirements for filing a claim with the Whistleblower Office.

■ **Comment.** "While the IRS has always had an informant program, legislative changes are now in place that offer a real financial incentive for folks to come forward to the extent that they see compliance issues and, if the information significantly contributes to a recovery of tax, interest and possible penalties, to participate in that recovery. It's [the whistleblower legislation] modeled after the *False Claims Act* proceedings that have been rather successful over the last several years...As a result, Code Sec. 7623 was modified to import the *False Claims Act* concepts into the Internal Revenue Code," Rocen explained.

Filing requirements

In late December 2007, the IRS issued interim guidance (Notice 2008-4, IRB 2008-2) regarding the filing of claims with the Whistleblower Office under Code Sec. 7623. The guidance addresses a host of threshold filing requirements and outlines how informants are to

awards, do not apply to the award program authorized by Code Sec. 7623(b).

Under Code Sec. 7623(b), as amended by Section 406 of the *2006 Tax Relief Act*, the amount of the award available to an informant must fall between 15 and 30 percent of the total amount recovered by the IRS. Within the IRS's structure, the Whistleblower Office will make the determination of whether the award should be paid under the statutory guidelines and, if so, the amount to be paid within the 15 to 30 percent of the collected proceeds. Under certain circumstances the IRS can limit an award to 10 percent. For example, if a whistleblower's allegations of wrongdoing have resulted principally from judicial or administrative proceedings, government hearings, audits, or the media, the IRS has the discretion to cap the claimant's award at ten percent.

■ **Comment.** "Given the potential for recovery and the fact that people might see this as an opportunity to participate in substantial awards, companies may need to be a little more vigilant," Rocen said.

Eligibility requirements

To claim an award under Code Sec. 7623(b), the tax, penalties, interest, additions to tax,

Continued on page 59

Washington Report

by the CCH Washington News Bureau



House passes stimulus bill

A \$150 billion economic stimulus package with tax rebates for individuals and incentives for businesses has passed in the House. Rebates would reach as much as \$600 for single taxpayers and \$1,200 for married couples. *For more details see page 49 in this week's issue and continuing coverage on the CCH Tax Research Network.*

FASB considers clarifications to FIN 48 deferral for private companies

The Financial Accounting Standards Board (FASB) met on January 23 to examine as part of its agenda the desirability of imposing FIN 48, Accounting for Uncertainty in Income Taxes, on private companies. FIN 48, which is generally effective for fiscal years beginning after December 15, 2006, clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and establishes rules for recognizing and measuring tax positions taken on an income tax return. The effective date has been proposed to be postponed for private companies under an FASB Staff Position (FSP) for nonpublic entities issued in November 2007, subject to a 30 day comment period.

The FSP would allow nonpublic enterprises to defer the effective date for FIN 48 to years beginning after December 15, 2007, if the nonpublic enterprise had not adopted FIN 48 provisions for financial statements or financial information issued to third parties prior to the effective date of the FSP. Staff members recommended that the board modify the FSP to indicate that nonpublic enterprises would be eligible for the deferral unless they issued a full set of annual financial statements incorporating the recognition, measurement and disposal requirements of interpretation 48.

The one-year deferral under the FSP, as currently drafted, applies to periods beginning after December 15, 2007. That language would require the application of FIN 48 to interim financial statements during 2008; a deadline that might come too

early for some companies. An amendment to the FSP would change the effective date to the end of a fiscal year that ends after December 15, 2007. Several board members voiced frustration that the amendment would lengthen application of FIN 48 for a second time. Nevertheless, the consensus of the board was to approve the amendment and change the language to "annual periods beginning after" December 15, 2007.

GAO investigates offshore tax enforcement

The Government Accountability Office (GAO) recently uncovered problems with the Qualified Intermediary (QI) program, which addresses tax evasion via foreign accounts. GAO found that the program, which monitors funds flowing through approved foreign banks and other financial intermediaries, is working in some respects, but the IRS does not know enough about many program participants and the agency needs to audit more aggressively to ensure compliance.

GAO found that U.S. withholding agents are not required to verify the foreign status of self-certified taxpayers in the QI program. Additionally, QI auditors are not required to follow up on indications of fraud or illegal acts, and owners of offshore corporations can shield their identity from IRS scrutiny; GAO identified \$19 billion flowing to countries that could not be identified and \$7 billion flowing to individuals that could not be identified. Foreign corporations received \$200 billion of the \$300 billion examined by GAO.

GAO recommended that the IRS enhance external reviews of QIs; require electronic filing of forms in QI contracts whenever possible; measure U.S. withholding agents' reliance on self-certified documentation and use of that data in compliance activities; and determine why certain jurisdictions and recipients receiving U.S. dollars cannot be identified.

SFC leaders seek information on college endowments

The leaders of the Senate Finance Committee recently wrote to 136 colleges and universities with endowments of \$500 million or more asking them if their endowment payment policies reflect best practices. Senators Max Baucus, D-Montana, SFC chair, and Charles Grassley, R-Iowa, ranking member, noted that a recent study by the National Association of College and University Business Officers (NACUBO) revealed double-digit endowment growth at many colleges and universities.

The lawmakers requested detailed information about the total cost of tuition and the types of tuition assistance the institutions offer to lower-income students. They also requested that the colleges and universities describe how their endowments are managed, year-by-year net growth and payouts from their endowments.

Baucus and Grassley have encouraged colleges and universities to give more help to lower income students. "We need to engage America's colleges and universities to come together to address the fact that college tuition for young Americans and their families is increasing at a faster rate than inflation," Baucus said in a statement. "Tuition has gone up, college presidents' salaries have gone up, and endowments continue to go up and up. We need to start seeing tuition relief for families go up just as fast," Grassley added.

Bill would accelerate phase-in of Code Sec. 199 deduction

Legislation was recently introduced in the House to accelerate the phase-in of the Code Sec. 199 domestic production activities deduction (manufacturing deduction). The deduction has been under-utilized, according to many lawmakers, who have also criticized its lengthy phase-in period. H.R. 5101, introduced by Rep. Donald Manzullo, R-Ill., would accelerate the phase-in of the deduction by two years, making the full nine percent deduction effective for tax years beginning after December 31, 2007.

Practitioners' Corner

Continued from page 57

and other additional amounts in dispute must exceed \$2 million. In addition, the taxpayer against whom the charges are made also must have gross income that exceeds \$200,000 for each taxable year at issue.

If the threshold requirements of Code Sec. 7623(b) are not met, claims submitted under this provision are processed under Code Sec. 7623(a). Code Sec. 7623(a) authorizes, but does not mandate, the IRS to pay for information relating to violations of the tax law that results in the government's recovery of tax.

To make a claim, an informant must first file new Form 211, Application for Award for Original Information, which requires a claimant to provide information such as an estimate of the tax owed, facts related to the claim, an explanation of how the informant obtained the information, and documentation to substantiate the claim.

Award determinations

Ultimately, the decision whether, and to what extent, an award will be paid rests with the Whistleblower Office, subject to Tax Court review. IRS guidance provides that awards will be paid in proportion to the value of information furnished with respect to the proceeds collected, including penalties, interest, additions to tax, and additional amounts. The information provided by the whistleblower must "substantially" contribute to the IRS's recovery of the tax. A factor the IRS considers significant is whether the information provided resulted in IRS administrative action or judicial action.

The IRS explains in Notice 2008-4 that in the case of a large entity where the entity's tax return is subject to annual examination by the IRS, an administrative action can include "the creation of a new issue under the Audit Plan or a change in the way information about an issue is collected or analyzed, which would not otherwise have occurred without the information provided by the claimant. In other cases, an administrative action may also include initiating an examination of the person which would not otherwise have occurred without information provided by the claimant."

Ineligible claimants

Certain individuals are ineligible to receive an award. For example, the IRS will not process

claims under Code Sec. 7623(b) submitted by Treasury employees, employees of any federal, state or local government acting within the scope of their duties as such, individuals who obtained the information while acting in an official capacity as a member of a State body or commission, individuals claiming anonymity or using an alias, or corporations, partnerships and other non-natural persons.

Appeals

The *2006 Tax Relief Act* also conferred upon the Tax Court the jurisdiction to hear appeals of certain award determinations made by the Whistleblower Office. Code Sec. 7623(b)(4) provides that an award must be appealed within 30 days of the determination. Code Sec. 7623(b)(5) limits appeals to actions in which the tax, penalties, interest, and additions to tax in dispute exceed \$2 million, and, in case of claims against an individual, where the individual's gross income exceeds \$200,000. The court's jurisdiction only extends to the review of award determinations pertaining to information provided by a whistleblower on or after December 26, 2006.

Privacy and disclosure concerns

To address privacy concerns, the IRS has recently released interim rules regarding a new system that will allow the IRS to maintain records relevant to its determination as to a claimant's eligibility for an award, including its amount. The records system covers individual claimants who have filed for an award, their representatives and the taxpayers and third parties alleged to have been noncompliant and about whom information is received.

The records will also include claimant identity information, allegation information, claim information, and information relating to any civil or criminal investigation that has been initiated (or extended) as a result of the information received by the Whistleblower Office. The records will also cover any other information relevant to the office's award determination and to appeals of award determinations. The new records system, entitled "Treasury/IRS 42.005 – Whistleblower Office Records," is proposed to be effective February 19, 2008.

The system is also sensitive to disclosure issues, specifically the disclosure of returns and return information. In the IRS's Notice of Proposed New Privacy Act

System of Records, the Service maintains that in accordance with Code Sec. 6103, which governs the disclosure of returns and return information, disclosure may only be made to certain agencies and persons. "While the legislation embraced the established model for *Federal Claims Act* proceedings and applied it to tax whistleblowers, I think there are issues that need to be worked out, especially because of disclosure restrictions in the case of taxpayer information," said Rocen. The new system of records will become effective February 19, 2008.

Balancing act

Given the potential for a lucrative recovery, Whistleblower Office personnel will undoubtedly have to sift through stacks of claims from disgruntled employees, ex-spouses and unscrupulous individuals with a grudge motivated by the increased awards and prospect of a large recovery (which is nevertheless taxable to the claimant). According to Rocen, "given the way the statute is worded, even innocent mistakes that are brought to the attention of the IRS could, under the statutory scheme, lead to a recovery. Uncovering intentional wrongdoing is to everyone's benefit. However, the whistleblower provisions themselves could lead to behavior that might incentivize employees to report innocent mistakes to the IRS rather than bringing them to the attention of their employers so that they might be corrected. I think there should be a balance."

Since the new whistleblower awards are aimed at fairly large organizations due to the minimum \$2 million that needs to be at issue to trigger the new provision, most small and even mid-sized businesses are spared dealing with these rules, at least until they might be expanded in the future. Larger businesses, however, might do well to work with their legal departments, human resources administrators and consultants at this time to structure a formal internal system of whistle-blowing within the company. Such a system might aim to discourage employees from going directly to the IRS by empowering them and creating as one of their job responsibilities the oversight that mandates reporting "up the internal chain of command" any matters that otherwise might become the subject of new Code Sec. 7623(b).

Compliance Calendar

■ February 1

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

■ February 6

Employers deposit Social Security, Medicare, and withheld income tax for January 30, 31, and February 1.

■ February 8

Employers deposit Social Security, Medicare, and withheld income tax for February 2, 3, 4, and 5.

■ February 11

Employees who received \$20 or more in tips during January report them to their employers.

Monthly Quizzer

The following questions (with answers at the bottom of the column) will help you review some of the more important developments in *CCH Federal Tax Weekly* during the past month.

Q In Rev. Proc. 2008-3, the IRS describes the areas in which it will not issue advance rulings or determination letter, which includes all of the following except:

- (a) Whether a transfer is a gift
- (b) The qualified status of pension plans
- (c) Single yields on qualified mortgage bonds
- (d) Charitable contributions involving limited partnership interests

Q The 2007 AMT patch gives taxpayers higher exemption amounts and allows them to use most nonrefundable personal credits to offset AMT liability for the 2007 tax year. **True or False?**

Q More than _____ individuals with incomes over \$1 million were audited in 2007.

- (a) 10,000
- (b) 20,000
- (c) 30,000
- (d) 40,000

Q The National Taxpayer Advocate's just-released annual report ranks dealing with the impact of year-end legislation as the #1 problem for taxpayers. **True or False?**

Answers:

Q1. (b), See Issue #2, page 18.

Q2. True, See Issue #1, page 1.

Q3. (c), See Issue #4, page 39.

Q4. True, See Issue #3, page 33.

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 9,052	50	FILEIND 18,056.04	29	IRS 45,162	44
ACCTNG 12,208	19	INDIV 6,050	19	IRS 45,204	32
ACCTNG 27,464	28	INDIV 6,202	19	IRS 48,100	44
ACCTNG 36,162.05	42	INDIV 48,152.10	20	IRS 48,150	32
BUSEXP 6,154	19	INDIV 51,454	27	IRS 48,160.40	44
BUSEXP 21,500	42	INDIV 54,104	43	IRS 51,056	56
BUSEXP 30,110.05	55	INDIV 57,708	19	IRS 51,056.25	32
BUSEXP 30,256	55	INDIV 60,204.05	41	IRS 51,064.25	56
BUSEXP 54,222	31	INTL 18,102.05	52	IRS 51,158.15	32
CCORP 30,208	56	IRS 3,058	32	IRS 57,158	56
CCORP 36,204	43	IRS 6,050	39	IRS 66,058.210	56
CCORP 45,264	52	IRS 9,150	43	IRS 66,100	31
COMPEN 12,206	29	IRS 9,254	19	IRS 66,204	31
COMPEN 12,356.10	53	IRS 21,106	56	IRS 66,462	56
CONSOL 29,201.20	40	IRS 21,116	31	IRS 66,462.05	43
DEPR 3,504	18	IRS 21,402	30	IRS 66,462.20	43
ESTGIFT 45,066.20	54	IRS 27,218	43	LITIG 3,052	56
ESTTRUST 12,054	37	IRS 30,152	43	LITIG 3,152	56
EXCISE 9,102.40	44	IRS 33,302	44	LITIG 6,100	43
EXEMPT 12,156	19	IRS 33,400	44	PENALTY 3,108.15	19
EXEMPT 12,054	30	IRS 36,052.05	32	PENALTY 3,050	56
EXPAT 21,100	30	IRS 42,120	19	REAL 6,060	27
FILEBUS 9,450.05	38	IRS 45,152.10	32	RETIRE 15,304.05	31
FILEIND 18,050	25	IRS 45,156	43		