

# Federal Tax Weekly

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## Change In Treatment Of Customer Payments Is Change Of Accounting Method, Requiring IRS Consent

◆ *Rev. Rul. 2008-30*

The IRS has determined that a regulated public utility company that changed its treatment of customer payments had changed its method of accounting and must secure the IRS's consent to make the change. The utility began to treat the payments as taxable fees, rather than as nontaxable contributions to capital under Code Sec. 118.

■ **CCH Take Away.** The ruling gives some insight into the IRS's thinking about a change in accounting method. In relying on principles much broader than those applicable just to utility-type businesses, the IRS views a change in the treatment of one-time customer charges as affecting the timing of income even if lifetime income is not permanently impacted because of offsetting deductions such as depreciation.

■ **Comment.** "There certainly is some controversy whether the analysis in *Saline Sewer* is correct," Glen Mackles of Deloitte & Touche, LLP, in Washington, D.C., told CCH. (In *Saline Sewer Co. v. Commr.*, T.C. Memo. 1992-236, the Tax Court held that a change from excluding customer connection fees from gross income, as nontaxable contributions in aid of construction (CIACs) under Code Sec. 118, to including the customer connection fees in gross income was not a change in method of accounting.)

"It's always good when the IRS clarifies whether something is an accounting method change," Ellen McElroy, partner, Pepper Hamilton LLP, Washington, D.C. told CCH. "With Section 118 that is especially valuable. A lot of companies are looking at 118 since it's a Tier One Issue" [the highest priority audit category for the Large and Mid-Size Business Division], McElroy commented. "IRS is giving [Code Sec. 118] a lot more scrutiny," she said.

### Customer connection fees

A utility that operated sanitary sewer lines and sewerage disposal plants charged a customer connection fee when it built lines to extend its service to new customers. The fees financed the utility's construction of sewer line extensions. The utility initially treated the fees as a CIAC, which are nontaxable under Code Secs. 118(a) and 118(c) as contributions to capital. The utility's basis in the sewer line extensions was zero, as required by Code Sec. 118(c).

■ **Comment.** This denied depreciation for sewerage lines financed by funds excluded from income.

In a subsequent year, the utility concluded that Code Sec. 118(c) did not apply and that the fees must be included in income. The utility capitalized the cost of the extensions and began to claim depreciation annually on the capitalized costs.

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Route to: \_\_\_\_\_

# IRS Creates New Category Of Qualified Nonpersonal Use Vehicles For Emergency Responders

## ◆ NPRM REG-106897-08

More emergency responders who take home clearly marked public safety vehicles would be eligible to treat their vehicles as working condition fringe benefits under proposed regs. The IRS has proposed adding a new category of vehicles — public safety officer vehicles — to the list of qualified nonpersonal use vehicles.

■ **CCH Take Away.** Neil Kossler, CPA, managing member, Kossler Jones & Company, LLC, Fairfax, Va., told CCH that the proposed regulations reflect the realities of public safety officers being “on call” even when they are technically off-duty. “Essentially, the IRS is saying that it will consider every second that a public safety officer is in his or her vehicle to be business miles.”

## Background

Generally, an employee’s use of an employer-provided vehicle results in

taxable income. However, Code Sec. 132(a)(3) allows an exclusion for working condition fringe benefits. A qualified nonpersonal use vehicle can be treated as a working condition fringe benefit. The IRS has identified clearly marked police and fire vehicles as qualified nonpersonal use vehicles.

■ **Comment.** Unmarked vehicles used by law enforcement personnel may also be treated as qualified nonpersonal use vehicles if certain conditions are met. Personal use must be authorized and must be incidental to law enforcement functions, such as being able to report directly from home to a stakeout or surveillance site.

## Expanded scope

Now, the IRS has proposed expanding the category of qualified nonpersonal vehicles to include clearly marked public safety officer vehicles. The proposed regs incorporate the definition of public safety officer in the

*Omnibus Crime Control and Safe Streets Act of 1968.* This law defines public safety officer as an “individual serving a public agency in an official capacity, with or without compensation, as a law enforcement officer, fire fighter, chaplain, or as a member of a rescue squad or ambulance crew.”

## Vehicles

A clearly marked public safety officer vehicle, the IRS explained, is a vehicle owned or leased by a governmental unit, required to be used for commuting by a public safety officer who, when not on a regular shift, is on-call at all times. Any personal use of the vehicle, other than commuting, generally must be prohibited.

Additionally, individuals must be able to readily identify the vehicle as a public safety vehicle. Most commonly, these vehicles would have painted insignia or words identifying them as public safety vehicles.

■ **Comment.** The proposed regs apply to clearly marked public safety officer vehicles. Unmarked

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## Change of Accounting

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### Method of accounting

The IRS noted that under either treatment the taxpayer’s lifetime taxable income would be the same. However, the taxpayer’s change from treating the fees as nontaxable CIACs under Code Sec. 118 to treating the payments as includible in gross income was a change in method of accounting because the timing of taxable income would be different.

■ **Comment.** According to the IRS, Congress viewed the exclusion as a method of accounting when it originally enacted Code Sec. 118. “If a

taxpayer wishes to change its present practice of treating contributions in aid of construction to a practice which is consistent with this provision, such change constitutes a change in method of accounting,” the legislative history of Code Sec. 118 reads.

### Combined effects

The IRS looked at the combined impact of the changes in income, basis and depreciation.

■ **Comment.** The IRS stated that it disagreed with two cases, *Saline Sewer Co., T.C. Memo. 1992-236*, and *Florida Progress Corp., 156 F.Supp.2d 1265 (M.D. Fla. 1999)*, which held the change in payment

treatment as giving rise to permanent changes in lifetime income. The IRS stated that those cases incorrectly failed to look at the effects of depreciation on the improvement constructed with those fees. In Rev. Rul. 2008-30, the IRS announced its nonacquiescence in the holdings on this issue in these cases.

The IRS cited two cases, *Johnson, 108 TC 448 (1997)* and *Rankin, 138 F.3d 1286 (9th Cir. 1998)* that considered both income and offsetting deductions to determine whether there was a permanent effect on taxable income. The IRS concluded that the utility’s lifetime income was the same regardless of whether the customer connection fees were excluded from income or included in income because the treatment of fees as income required the fees to be added to basis and then depreciated. It was the timing of that income that made the difference.

*References: FED ¶46,458;  
TRC ACCTNG: 21,054.*

### 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*

# IRS Issues Guidance On HSA Contributions To Reflect 2006 Tax Act Changes

## ◆ Notice 2008-52

The IRS has issued guidance on contributions to Health Savings Accounts (HSAs) to reflect taxpayer-friendly changes made by the *Tax Relief and Health Care Act of 2006 (TRHCA)*. Under the *TRHCA*, contributions to HSAs are no longer limited to the annual deductible under a high deductible health plan (HDHP). The IRS included 15 examples explaining the operation of the guidance.

■ **CCH Take Away.** The changes made by the *TRHCA* have been criticized for enhancing the ability of an HSA to shelter income from taxation. Eventual distributions of the funds, along with the income it earns, will be tax-free so long as the money is used for qualified medical expenses or after the taxpayer dies, becomes disabled or reaches the age of 65. Americans have an estimated \$1 billion invested in HSAs. According to the Government Accountability Office (GAO), the number of individuals covered by HSA-eligible plans rose from approximately 480,000 in 2004 to an estimated 6.1 million in 2008.

■ **Comment.** At the same time, the IRS has also issued guidance (Notice 2008-51) on HSA distributions.

## Monthly contribution limits

Under Code Secs. 223(b)(1) and 223(b)(2), as modified by the *TRHCA*, the maximum annual contribution to an HSA is the sum of the contribution limits determined separately for each month, based on eligibility and health plan coverage on the first day of the month. The IRS explained that for this purpose, the monthly limit is one-half of the indexed amount provided under Code Sec. 223(b)(2)(A) for self-only coverage (which is \$2,900 for 2008) and under Code Sec. 223(b)(2)(B) for family coverage (which is \$5,800 for 2008).

Additionally, the maximum HSA contribution is increased by a "catch-up" amount for individuals age 55 or older as of the last

day of the calendar year and who are not enrolled in Medicare. The catch-up contribution, the IRS explained, is also computed on a monthly basis. For 2008, the catch-up amount is \$900 for eligible taxpayers.

## Full contribution rule

The guidance also tracks the full contribution rule in the *TRHCA*. To make a full contribution for the year under new Code Sec. 223(b)(8), a taxpayer must be an eligible individual on the first day of the last month of his or her tax year (which is December 1 for calendar year taxpayers). The eligible individual is also treated as enrolled in the same HDHP coverage as he or she has on the first day of the last month of the year.

The full contribution rule, the IRS explained, applies without regard to whether

the individual was an eligible individual for the entire year, had HDHP coverage for the entire year, or had disqualifying non-HDHP coverage for part of the year. However, a testing period applies for purposes of the full contribution rule. The testing period begins on the first day of the last month of the tax year and ends on the last day of the 12th month following that month (December 1 of the current year to December 31 of the following year for calendar year taxpayers).

■ **Comment.** Under Code Sec. 223(b)(8)(B), if an individual contributes under the full contribution rule (but does not remain an eligible individual during the testing period, which begins with the last month of the tax year and ends on the last day

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## Vehicles

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public safety officer vehicles are not treated as qualified nonpersonal use vehicles under the proposed regs.

■ **Caution.** A marking on a license plate, by itself, does not make a vehicle a clearly marked public safety officer vehicle.

*References: FED ¶49,805; TRC BUSEXP: 24,862.*

## Senate Approves Farm Bill On Re-Vote; Military Tax Relief Act Awaits President's Signature

The Senate voted 77-15 on June 5 to approve, for the second time, the \$289 billion *Food, Conservation, and Energy Act of 2008 (H.R. 6124)*. The measure will be sent again to the White House for another expected veto. Congress initially overrode President Bush's veto of the *Food, Conservation, and Energy Security Act of 2008 (P.L. 110-234)*, but the enrolling clerk made an error that omitted the trade title from that bill. The president is expected to veto the bill again, requiring both the House and Senate to hold a second veto override vote, which is expected to pass.

■ **CCH Take Away.** Congress is passing the entire *Farm Bill* again, rather than just the missing Title, just in case any judicial challenge would be lodged against the validity of the law based on parliamentary considerations. Technically, Section 4(a) of the new *H.R. 6124* repeals the "old" *Farm Act* enacted on May 22. Nevertheless, the new bill retains May 22 as the effective date for "date of enactment" provisions.

Meanwhile, the *Heroes Earnings Assistance and Relief Tax Act (H.R. 6081)*, the so-called *Military Tax Relief Act* finally was received by the White House on June 9 and, at press time, awaits President Bush's expected signature. The legislation was approved by Congress on May 22 but subject to an enrollment delay at the Capitol Hill staff level.

# IRS Explains Tests And Procedures For One-Time IRA-To-HSA Transfers

## ◆ Notice 2008-51

New guidance explains one-time transfers from a traditional IRA or a Roth IRA to a Health Savings Account (HSA) as authorized by the *Tax Relief and Health Care Act of 2006 (TRHCA)*. The guidance describes the tax treatment of these qualified HSA funding distributions, transfer procedures and testing period rules.

■ **Comment.** Under *TRHCA*, contributions to HSAs are no longer limited to the annual deductible under a high deductible health plan (HDHP). The IRS simultaneously released guidance on this new treatment in Notice 2008-52.

## Qualified HSA funding distribution

The *TRHCA* allows eligible taxpayers to make one-time transfers from a traditional IRA or a Roth IRA to an HSA. These distributions are generally excluded from gross income and are not subject to the early withdrawal penalty. The amount contributed to the HSA through a qualified HSA funding distribution is not allowed as a deduction and counts against the taxpayer's maximum annual HSA contribution for the tax year of the distribution. Additionally, testing period rules apply.

■ **Caution.** A qualified HSA funding distribution may not be made from an ongoing SIMPLE IRA or an SEP IRA. A SEP IRA or SIMPLE IRA is treated as ongoing if an employer contribution is made for the plan year ending with or within the IRA owner's taxable year in which the qualified HSA funding distribution would be made.

Under the *TRHCA*, a qualified HSA funding distribution from the IRA or Roth IRA must be less than or equal to the IRA or Roth IRA account owner's maximum annual HSA contribution for the year in which the owner decides to make the one-time distribution. The maximum annual HSA contribution is based on both age and type of HDHP coverage (self-only or family HDHP coverage).

■ **Example.** Adam, age 58, has a traditional IRA. Adam has fam-

ily HDHP coverage at the time of the distribution. Adam is allowed a qualified HSA funding distribution of \$5,800 plus a \$900 catch-up contribution for 2008.

## Limitations

Generally, an individual may only make one qualified HSA funding distribution during his or her lifetime. However, the IRS guidance provides that an individual who has self-only HDHP coverage, and later within the taxable year switches to family HDHP coverage, may take a second qualified HSA funding distribution in that tax year. A qualified HSA funding distribution must be less than or equal to the IRA or Roth IRA account owner's maximum annual HSA contribution.

■ **Caution.** Both distributions count against the individual's maximum HSA contribution for the tax year in which they are made.

## Transfer procedures

A qualified HSA funding distribution must be a direct transfer from a single IRA or Roth IRA to an HSA. The IRS also explained that a check from an IRA made payable to an HSA trustee – delivered by the IRA owner to the HSA trustee – would be considered a direct payment by the IRA trustee to the HSA.

■ **Planning Note.** While a maximum distribution is allowed from either a traditional IRA or a Roth IRA, the traditional IRA is subject to full tax treatment (plus a 10 percent penalty) on nonqualified early withdrawals, while an early Roth IRA distribution would only incur tax on earnings. As a result, use of traditional IRA assets for the one-time HSA distribution is generally the better choice. Furthermore, under the IRA to HSA distribution rules, basis is used last rather than pro-rata.

## Testing period rules

An individual must remain an "eligible individual," as defined in Code Sec. 223(c)(1), during the testing period in

order to escape the payment of income tax and a 10 percent additional tax on the amount of the qualified HSA funding distribution. The individual must remain an eligible individual beginning in the month in which the qualified HSA funding distribution is made to the HSA through the last day of the 12th month following that month.

## Impermissible uses

If an individual does not use an HSA distribution for qualified medical expenses, as defined in Code Sec. 223(d)(2), the amount is included in gross income and generally subject to an additional 10 percent tax under Code Sec. 223(f)(4). This inclusion in gross income occurs regardless of whether the amount contributed to the HSA under the qualified HSA funding distribution is included in the account beneficiary's income and is subject to additional tax under Code Sec. 408(d)(9)(D).

References: FED ¶46,456;  
TRC INDIV: 42,452.

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## HSA Contributions

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of the 12th month following that month), the contributions that are attributable to the months preceding the month in which the taxpayer became an eligible individual and, thus, could not have been made but for the full contribution rule, are included in gross income and subject to an additional 10 percent penalty tax. There is an exception for death and disability.

■ **Planning Note.** A taxpayer is not required to keep the same level of HDHP coverage during the testing period to remain an eligible individual during the testing period. An individual may change from family coverage to self-only coverage during the testing period and not be subject to the income inclusion and additional tax provisions.

References: FED ¶46,457;  
TRC INDIV: 42,450.

## IRS Adds New Functionality Features To Online Payment Agreement Application

◆ *IR-2008-77*

The IRS has added new features to enhance its interactive Online Payment Agreement application available on [www.irs.gov](http://www.irs.gov). The IRS's Online Payment Agreement application option provides taxpayers who have filed all required tax returns a simplified way to resolve their tax liabilities.

■ **Comment.** The IRS's online payment agreement option allows individual taxpayers who have an outstanding income tax liability of \$25,000 or less in combined tax, interest and penalties to self-qualify, apply for a payment agreement and receive immediate notification as to approval. To be

eligible, taxpayers must have first filed all required tax returns and be current on all estimated tax payments, if applicable.

### New functions

The enhancements to the system now provide taxpayers the opportunity to revise their payment amounts and payment due dates on existing agreements. Other enhancements permit taxpayers to change an existing regular installment agreement into either (1) a direct debit installment agreement or (2) a payroll deduction installment agreement. Additionally, taxpayers may change existing extensions to regular or direct debit installment agreements.

For practitioners, a new enhancement allows those with valid authorizations to use, for authentication purposes, the signature data from their approved Form 2848, Power of Attorney and Declaration of Representative, or the caller ID, when requesting agreements for clients.

■ **Comment.** Taxpayers are no longer required to submit a paper Form 13844, Application For Reduced User Fee For Installment Agreements, to request a reduced user fee, the IRS also announced. User fee calculations for taxpayers entering into installment agreements are now automatically determined by the IRS.

*References: FED ¶46,461;  
TRC FILEIND: 21,154.40.*

## Tax Court Proposes New Rules For Electronic Service, Whistleblower Claims

◆ *U.S. Tax Court Notice of Proposed Amendments to Rules*

The U.S. Tax Court recently proposed amendments to its Rules of Practice and Procedure to encompass electronic service of filings. The proposed amendments also clarify how whistleblowers can file for judicial review of their IRS reward.

### Electronic service

The Tax Court has proposed expanding service of filings to include electronic means. However, written consent must be obtained from the person served, which could be provided by electronic means. Litigants would be able to use the Tax Court's electronic transmission services for service.

■ **CCH Take Away.** Scott Knott and Gregory Lynam, partners with The Ferraro Law Firm, Washington, D.C., told CCH that while the plaintiffs' bar welcomes the proposed rules, there are some unanswered questions. "We believe the scope of the relevant information goes beyond administrative filings to everything that is relevant to the tax paid

and what information was used by the IRS to determine that tax," Knott explained. Lynam noted that the Tax Court intends to treat whistleblower claims as it does many other proceedings and will not limit its review to the administrative record.

■ **Comment.** In some courts, an attorney's registration as a user of the court's electronic case filing system constitutes consent to accept service electronically.

Transmission by electronic means, the proposed rules note, would be complete when the sender performs the last act to transmit a document electronically (that is, when the sender hits the "send" button on his or her email program). However, transmission would not be deemed complete if the email bounces back to the sender.

■ **Comment.** A document has been received by the party on which it is served as long as the party has the ability to retrieve it, the proposed rules note. A party cannot defeat service by choosing not to access email.

### Whistleblowers

Individuals who report violations of federal tax laws to the IRS may be entitled to a reward. Under the *Tax Relief and Health Care Act of 2006 (TRHCA)*, if the IRS proceeds with any administrative or judicial action based on a whistleblower's tip, the informant shall receive a reward based on the amount recovered in some cases.

To be eligible for an award under the *TRHCA*, the tax, penalties, interest, additions to tax, and additional amounts in dispute must exceed, in the aggregate, \$2 million and, if the allegedly noncompliant person is an individual, the individual's gross income must exceed \$200,000 for any tax year at issue in a claim. Rewards in these cases are between 15 and 30 percent of the amount recovered.

■ **Caution.** If the whistleblower planned and initiated the actions that led to the underpayment of tax, or to the violation of federal tax laws, the IRS may reduce the award. If the whistleblower is convicted of criminal conduct arising

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# IRS Audit Technique Guide Questions Prepackaged Research Credit Claim Studies

## ◆ *Research Credit Claims Audit Technique Guide (LMSB-04-0508-030)*

A new IRS audit technique guide (ATG) on audits of Code Sec. 41 research credit claims describes how an auditor can more efficiently examine research credit claims supported by prepackaged research credit claims studies. The IRS reported that it issued the ATG because some taxpayers are purportedly making claims during audits but failing to substantiate their expenses for qualified research activities.

■ **CCH Take Away.** The IRS's Large and Mid-Size Business Division (LMSB) has identified research credit claims as a Tier One examination issue that significantly impacts one or more industries. LMSB is particularly concerned about research credit claims raised at the end of an audit cycle that require additional audit resources. The ATG indicates that prepackaged studies are the most common approach used by taxpayers to make a research credit claim.

■ **Comment.** "This release represents the first audit techniques guide issued by the IRS in connection with a 'Tier One' issue," Tony Mondoro of Ernst & Young, LLP told CCH in an e-mail. The IRS conducts extensive audit activity of research credit claims, Mondoro indicated. A recent study by E&Y shows that research credit claims reached a record high of \$6.6 billion and that a record 18,000 corporations submitted research credit claims in 2005, the most recent year for which data is available. The credit expired at the end of 2007, but Congress is expected to extend it in 2008 legislation (*H.R. 6049*). E&Y recommends that its clients maintain proper documentation for 2008.

### Potential problems – nexus

The ATG emphasizes that the taxpayer must demonstrate a nexus between qualified research expenses (QRE) and specific research projects. Code Sec. 41

requires the taxpayer to identify the QRE by business component. Project-based accounting describes research costs and generally establishes the required nexus to qualified activities.

Cost-center accounting may not demonstrate the nexus, the ATG indicates. Most research claim studies use a combined or hybrid approach. These studies typically fail to establish the connection between accounting records and the research activities. These studies fail to establish nexus and are not "auditable," the ATG comments.

A common problem is claiming expenses using W-2 wages of employees or cost centers, multiplied by a "qualified percentage" applied to the individual's or total wages. The percentage, often based on a manager's estimate, may not be supported by measurable records. "Estimates are not sufficient to support a claim," the ATG explains.

### Substantiation

A taxpayer is required to keep records to support the credit under Code Sec. 6001, the ATG indicates. Information to support the claim should be contemporaneous, the ATG instructs.

The Tax Court laid out the requirements for proper substantiation in *Eustace, T.C. Memo. 2001-66*, a typical research credit claim involving a prepackaged submission by an accounting firm. The tax manager listed salaries of employees he thought qualified for the credit. Six employees testified at trial about their activities.

The latest Audit Technique Guide highlighted the fact that the Tax Court rejected the list of salaries supplemented by testimony as "unreliable, inaccurate, incomplete, and wholly insufficient." The evidence did not demonstrate that the salaries were paid for qualified research activities. The court also declined to make an allocation of salaries to activities. The taxpayer was required to tie salaries to qualified activities at the subcomponent level.

## Whistleblowers

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from his or her role in planning and initiating the action, no reward will be paid.

TRHCA whistleblowers may appeal to the Tax Court if they are displeased with the size of their award. An appeal must be filed within 30 days. The Tax Court may assign review of a whistleblower award to a special trial judge.

■ **Comment.** Congress also authorized a reduced award amount of up to 10 percent in cases based principally on disclosure of specific allegations resulting from, among other things, government investigations and news media reports. Additionally, the IRS also may pay a reward, in its discretion, if the \$2 million/\$200,000 thresholds are

not met. These awards are capped at 15 percent up to \$10 million. Whistleblowers cannot appeal these rewards to the Tax Court.

The proposed amendments would add a new title to the Tax Court's rules: Title XXXIII (Whistleblower Award Actions). The proposed title addresses commencement of a whistleblower award action, request for place of trial and the IRS's answer to the plaintiff's complaint.

■ **Comment.** Paul Scott of Paul D. Scott, P.C. San Francisco, California, expressed concern about the absence of any special provisions in the proposed rules addressing the confidentiality of whistleblowers. "Confidentiality is an integral part of preserving their anonymity," Scott told CCH.

*References: FED ¶46,455;  
TRC LITIG: 6,058.*

*References: FED ¶(to be reported);  
TRC BUSEXP: 54,120.*

## IRS Denies FICA Tax Refund On Unpaid Benefits Under Terminated Deferred Comp Plan

◆ CCA 200823001

IRS Chief Counsel has determined that retired taxpayers were not entitled to a refund of *Federal Insurance Contributions Act (FICA)* taxes paid by their employer on their behalf on the reasonably ascertainable value of nonqualified deferred compensation plan benefits. The fact that a portion of the valued benefits would never be distributed to such employees due to the plan's termination did not create the right to a refund.

### Background

An employer established a nonqualified unfunded deferred compensation plan to supplement the taxpayers current compensation in the future after retirement. The taxpayers were issued letters at retirement in which the employer specifically informed the taxpayers of the present value of their accrued plan benefits and the *FICA* taxes owed on such plan benefits

that were paid by the plan on the taxpayers' behalf, to be reimbursed as benefits were paid out.

Prior to the taxpayers receiving all of their benefits under the plan, the employer filed for bankruptcy and was allowed to terminate the plan. Consequently, the taxpayers' monthly benefits under the plan ceased on the plan's termination date. The taxpayers filed claims for refund based on the difference between the *FICA* taxes paid on their original plan benefit and the *FICA* taxes that would have been assessed on the actual benefit received by them.

### FICA

Relying on the legislative history relevant to Code Sec. 3121(v)(2), Chief Counsel determined that nonqualified deferred compensation is subject to *FICA* taxes based upon the later of when the employee has performed the services or when the employee's right to the compensation is not

subject to a substantial risk of forfeiture. The fact that the employee later receives less than the amount originally deferred as a result of an employer's bankruptcy does not give rise to a refund of the *FICA* taxes paid on amounts deferred, according to Chief Counsel.

■ **Comment.** Chief Counsel also addressed the limitations period for refund claims. For example, the limitations period for the taxpayers' claims for refund of *FICA* taxes in this case would have begun on April 15 of the year following the year in which the taxpayer retired and the employer filed the *FICA* tax return and remitted the appropriate *FICA* taxes to the IRS with respect to the reasonable ascertainable value of nonqualified deferred compensation plan benefits.

*References: FED ¶(to be reported); TRC COMPEN: 18,416.*

## IRS Agent Must Follow Strict Procedure Before Assessing Employment Tax For Worker Misclassification

◆ CCA 200822026

Chief Counsel has determined that while IRS revenue agents have the authority under Code Sec. 6020 to prepare employment tax returns to correct worker classification, an assessment of employment taxes so reported under Code Sec. 7436 cannot move forward until strict procedural steps have been taken. Chief Counsel also has determined, however, that such procedural missteps are not permanently fatal if the agent takes corrective measures and reassesses as if the abated assessment had not occurred.

■ **Comment.** Under pressure from Congress to close the tax gap, the IRS has been working diligently to increase compliance with employment tax rules. The latest advice memo indicates both that some agents may have become "overly-aggressive" in routing out worker

misclassification and that Chief Counsel's Office is willing to put some brakes on them.

### Procedures

Notice 2002-5 describes the procedures that must be followed prior to an assessment of employment taxes. The taxpayer will receive a Notice of Determination of Worker Classification (NDWC). The mailing of the NDWC suspends the period of limitations for assessment of taxes attributable to the worker classification issues for a 90-day period. During this time, the taxpayer can file a petition with the Tax Court and preclude the IRS from assessing the taxes identified in the NDWC prior to the expiration of the 90 days.

If the IRS erroneously makes an assessment of taxes attributable to the worker classification issues without first either issuing a NDWC or obtaining a waiver of restrictions

on assessment from the taxpayer, the taxpayer is entitled to an automatic abatement of the assessment.

### SFRs

Under Code Sec. 6020, if a taxpayer fails to make a required return, an IRS agent is authorized to make a Substitute for Return (SFR) from his or her own knowledge and from such information as can be obtained through testimony or otherwise.

Chief Counsel determined that because the agent failed to meet the procedure requirements, an assessment of employment taxes based on the SFR was improper. However, Chief Counsel concluded that the government was not required to concede the case. Once procedural defects are corrected and the requirements are satisfied, employment taxes may be assessed.

*References: FED ¶(to be reported); TRC IRS: 27,206.30.*

# Tax Briefs



## Forms

The IRS has released specifications for filing 2008 Forms 1098, 1099, 5498 and W-2G electronically through the IRS FIRE System. The IRS Enterprise Computing Center—Martinsburg (IRS/ECC-MTB) no longer accepts any form of magnetic media. Magnetic media tape cartridge files for tax years prior to 2008 must be received by December 1, 2008, in order to be processed. After December 1, 2008, electronic filing will be the only acceptable method of filing information returns with ECC-MTB.

*Rev. Proc. 2008-30, FED ¶46,459;  
TRC FILEBUS: 12,302.*

## Jurisdiction

A federal district court lacked subject matter jurisdiction over a married couple's request to review an IRS decision letter issued following an equivalent hearing. The couple was also denied injunctive relief and a church did not state a claim for wrongful levy.

*Gardner, CA-9, 2008-1 USTC ¶50,366;  
TRC IRS: 51,056.25.*

A federal district court lacked subject matter jurisdiction over a couple's refund claims because they failed to file their administrative claim within the Code Sec. 6511(a) limitations period.

*Chenyao, DC N.J., 2008-1 USTC ¶50,364;  
TRC IRS: 36,052.05.*

## Tax Evasion

An individual was properly convicted and sentenced for tax evasion. The government was not required to prove that the individual owed a "substantial" amount of tax and the individual did not qualify for a downward departure based on diminished capacity.

*Heath, CA-6, 2008-1 USTC ¶50,360;  
TRC IRS: 66,102.*

Substantial evidence existed to establish that a married couple willfully attempted to evade the payment of taxes and that their conduct resulted in a substantial tax

deficiency. The base offense level was properly determined.

*Harned, CA-4, 2008-1 USTC ¶50,359;  
TRC IRS: 66,100.*

An individual was properly convicted for tax evasion and for failure to file an income tax return. The government was not required to obtain a civil or administrative determination to establish a substantial tax deficiency before proceeding to criminally prosecute for tax evasion.

*Ellett, CA-2, 2008-1 USTC ¶50,362;  
TRC IRS: 66,154.*

## Summons

An IRS agent's declaration established the government's *prima facie* case for enforcement of a summons issued to an individual and the individual failed to rebut the agent's statements.

*DePolo, DC Texas, 2008-1 USTC ¶50,365;  
TRC IRS: 21,300.*

## Trade or Business Activity

A doctor's gambling activity did not rise to the level of a trade or business activity as contemplated by Code Sec. 162(a). In addition, the doctor conceded application of the accuracy-related penalty under Code Sec. 6662(a).

*Merkin, TC, CCH Dec. 57,459(M),  
FED ¶48,073(M); TRC INDIV: 6,266.*

## Deductions

An individual failed to introduce any credible evidence to substantiate his claimed theft loss deduction. The burden of proving entitlement to the claimed deduction did not shift to the government.

*Geiger, CA-11, 2008-1 USTC ¶50,358;  
TRC BUSEXP: 30,104.*

## Wrongful Disclosure

An individual's Code Sec. 7431 complaint alleging wrongful disclosure of return information by the IRS was dismissed. Letters sent to third parties by criminal investigation agents contained only a detailed

description of certain checks, which did not constitute return information.

*Cryer, DC La., 2008-1 USTC ¶50,361;  
TRC IRS: 9,252.10.*

## Liens and Levies

An individual's claims seeking removal and cancellation of notices of federal tax lien, reimbursement of social security benefits garnished by the IRS and a judgment declaring that his future social security benefits were exempt from IRS collection were frivolous.

*Acevedo, DC Mo., 2008-1 USTC ¶50,355;  
TRC IRS: 51,052.*

## Deficiencies and Penalties

An individual was liable for a deficiency and penalties for his failure to file a tax return and to pay tax. Disability payments were includible in income because they were not otherwise excludable.

*Connors, CA-2, 2008-1 USTC ¶50,356;  
TRC LITIG: 3,200.*

The Tax Court has found that the IRS failed to prove that a married couple fraudulently evaded federal taxation. The purported evidence of fraud failed to reach the threshold of the clear and convincing standard.

*Gagliardi, FedCl., 2008-1 USTC ¶50,363;  
TRC PENALTY: 6,054.05.*

## Refund Claims

The Court of Federal Claims lacked subject matter jurisdiction over a corporation's claim for refund of communications excise tax under Code Sec. 4251 because the claim was filed 10 years after the date the corporation paid the tax. The argument that neither Code Sec. 6511 nor any other statute of limitations applied to its claim because no return had been required with respect to the tax at issue was rejected.

*Radioshack Corporation, FedCl.,  
2008-1 USTC 50,357; TRC EXCISE: 9,056.*

# Practitioners' Corner

## Latest SOI Bulletin Indicates Dramatic Jump In Itemized Deductions

The IRS's just-released Spring 2008 issue of its Statistics of Income (SOI) Bulletin (IR-2008-72) indicates a big jump in the dollar amount of individual itemized deductions for tax year 2006. While the percentage of taxpayers not itemizing deductions had been steadily increasing as the dollar amount of the standard deduction rose each year, reaching 63.3 percent in 2005, that trend slipped in 2006 according to the latest statistics. The statistics indicate two basic reasons for this trend:

- (1) While more individuals at the lower end of the income scale continue to take the standard deduction in increasing numbers, more taxpayers at the upper end are now benefiting from itemized deductions because the phase-out of itemized deductions for upper-income taxpayers is itself being phased out (elimination of the "Pease limitation"); and
- (2) While the "mortgage meltdown" is now grabbing the headlines, the run up in housing values also increased the average size of the mortgage interest deduction.

Close runner-ups to the increase in the size of the interest deduction are the spike in the amount of charitable deductions taken for non-cash contributions and the overall jump in income reported by taxpayers.

### Itemized deductions

At the same time as the adjusted gross income (AGI) of individual taxpayers increased on average by 8.4 percent in tax year 2006 from 2005, the average total itemized deduction in 2006 rose 6.3 percent to \$24,122. The IRS pointed out that the largest increase in an itemized deduction took place for interest paid, which represented 37 percent of the total itemized deductions reported. Amounts of that deduction rose by 15.4 percent.

The IRS also reported that deductions for student loan interest payments grew by a large 21.9 percent to \$6.2 billion. However, deductions for tuition and fees fell 11.9 percent to \$9.6 billion for Tax Year (TY) 2006.

■ **Caution.** The above-the-line higher education tuition deduction expired at the end of 2007. It is likely that Congress will extend

■ **Comment.** Pease does not apply to certain deductions, such as the deduction for medical expenses and casualty and theft losses. Pease also does not apply under the AMT.

■ **Planning Note.** For tax years beginning in 2008, the inflation-adjusted threshold amount of AGI, above which the amount of otherwise allowable itemized deductions

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*"The IRS's just-released Spring 2008 issue of its Statistics of Income (SOI) Bulletin (IR-2008-72) indicates a big jump in the dollar amount of individual itemized deductions for tax year 2006."*

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it one or two years. The student loan interest deduction is separate and distinct from the higher education tuition deduction. The student loan interest deduction remains available but is subject to income phase-outs.

### Phase-out of phase-out

Under the Pease limitation, higher income taxpayers lost some of their itemized deductions when their incomes exceeded certain thresholds. However, the *Economic Growth and Tax Relief Act of 2001 (EGTRRA)* repeals the itemized deduction limitation in stages between 2006 and 2009. In 2006 and 2007, only two-thirds of the itemized deduction limitation applied. In 2008 and 2009, only one-third of the itemized deduction limitation applies. After 2010, the itemized deduction limitation disappears completely. However, because *EGTRRA* is temporary, it returns in full effect after *EGTRRA* sunsets in 2011.

is reduced, is \$159,950 for married taxpayers filing jointly, single taxpayers and heads of households, and \$79,975 for married taxpayers filing separately.

■ **Planning Note.** Because of *EGTRRA*, itemized deductions for higher income individuals greatly increased in 2006 because it was the first year of *EGTRRA*'s phase-out of Pease. The IRS reported a 21.1 percent decline in previously disallowed deductions by higher income taxpayers.

### Average itemized deductions

The following chart shows the average amount of an itemized deduction for each range of adjusted gross incomes and the percentage within each range claiming the deduction:

*Continued on page 287*

# Washington Report

by the CCH Washington News Bureau



## Farm Bill II and Military Bill almost official

A second *Farm Bill*, which includes missing non-tax Title III, has cleared Congress and has been sent to the White House for another anticipated veto before returning to Congress for an expected veto override. Meanwhile, the *Military Tax Relief Bill* has finally been received by the White House and awaits the president's anticipated signature at press time. See page 279 of this issue for details.

## Stimulus payments hit half-way mark

Treasury and the IRS are expected to soon announce that more than one-half of the estimated 130 million economic stimulus payments have been distributed. A Treasury spokesperson told CCH that the government is unable to track where recipients are cashing/spending their checks. One of the nation's largest retailers, however, reported on June 5 that it has cashed \$350 million in economic stimulus payments so far.

## FY 2009 budget blueprint passes

The House and Senate this past week passed a nonbinding budget conference report (*S. Con. Res. 70*) for fiscal year (FY) 2009 that lays out spending priorities for Congress and calls for \$340 billion in tax relief over five years, including extensions of marriage penalty relief, the child tax credit and the 10 percent tax bracket. While predicting a budget surplus by 2012, the conference report also allows for estate tax reform and an AMT patch. The conference report also calls for property tax relief, energy and education tax relief and extenders.

## SFC examines small business entities

Senate Finance Committee Chairman Max Baucus, D-Montana, on June 5 held the

third in a series of tax reform hearings, questioning a panel of business tax experts on what they perceive to be the most constructive forms of business organization for tax purposes and whether certain modifications of the Tax Code might better serve the economy and the American small business community. Panelists noted that most domestic businesses organize as sole proprietorships, partnerships, S-corps, or limited liability companies (LLCs) in order to take advantage of the flow-through taxation regime.

Baucus also asked what role small businesses play in unpaid payroll taxes, which constitute part of the \$345 billion tax gap. One recommendation was to clarify the payroll tax requirements for business owners of a pass-through entity, as well as to modify Schedule C in an effort to limit opportunities for noncompliance.

## Confusion over reg slowdown

On May 9, White House Chief of Staff Joshua B. Bolten directed all federal executive departments and agencies to finalize regulations before November 1, 2008. A senior Treasury official said on June 4 that the memorandum does not apply to current guidance projects.

Treasury and the IRS work frequently with the Department of Labor's Employee Benefits Security Administration (EBSA) and the Pension Benefit Guaranty Corporation (PBGC) on joint guidance projects. A PBGC spokesperson told CCH on June 6 that the White House memorandum applies to the PBGC. CCH also asked Treasury for an explanation of how it will coordinate remaining 2008 joint guidance projects with the PBGC, and also the EBSA, in light of the conflicting application of the memorandum but did not receive a response by press time.

## GAO investigates RALs

The Government Accountability Office (GAO) was recently asked by the House Ways and Means Committee to investigate how refund anticipation loans (RALs) are marketed and the types of information tax preparers disclose to potential RAL applicants. GAO found that RALs are marketed by tax preparers that operate in a wide variety of businesses, ranging from major retail stores to automobile dealers and shoe stores. Of the 40 tax preparers called or visited by GAO investigators posing as taxpayers, 37 offered RALs: 13 tax preparers offered year-round tax preparation in their own stand-alone offices and 27 were only open during the tax season, operating at tables or desks within existing businesses that offered other products and services. GAO also found that annual percentage rates on RALs ranged from 36 percent to over 500 percent.

## IRS EP Unit cuts no-change rate

The IRS Employee Plans (EP) unit has reduced its no-change audit rate from 70 percent to 35 percent over the past year, EP Director Michael Julianelle said on June 4 at a meeting of the Profit Sharing Council of America in Washington, D.C. Lawmakers on Capitol Hill have frequently criticized the large number of no-change audits as a waste of the agency's resources. Julianelle explained that EP personnel are mining the agency's extensive data, gleaned from plan filings and examinations, to reduce the no-change audit rate. Roughly 400 EP revenue agents will conduct 8,500 examinations in 2008, Julianelle predicted. He admitted without further explanation, however, that the examinations come at a time when the EP is confronting some "staffing challenges."

## IRS Proposes Declaratory Judgment Procedures For Adverse Gift Tax Valuations

### ◆ NPRM REG-143716-04

Proposed regs would provide taxpayers with a procedure for pursuing a declaratory judgment in the Tax Court to contest an adverse gift valuation by the IRS. Before using the declaratory judgment procedures, however, the regs make it clear that taxpayers must first exhaust all administrative remedies with the IRS.

■ **CCH Take Away.** Without the declaratory judgment procedures, a donor would not be able to petition the Tax Court to contest the IRS's determination or, without an overpayment of tax, file a refund claim or sue for a refund in federal district court. Valuation in gift tax matters continues to be a flash point for estate planners.

### Requirements

The proposed regs describe the various requirements that taxpayers must meet before being able to use the declaratory judgment

procedures under Code Sec. 7477. However, the proposed procedures apply only after donors have exhausted all administrative remedies with the IRS.

■ **Shown on return.** The transfer generally must be shown or disclosed on a federal gift tax return or a statement attached to a return.

■ **Actual controversy.** Code Sec. 7477 requires an actual controversy with respect to a determination by the IRS of the value of the disclosed transfer. Generally, the IRS must propose adjustments with which the donor disagrees.

■ **Comment.** This notification of adjustments is made when the IRS sends a notice of determination of value (Letter 3569) to the taxpayer. IRS Appeals usually issues Letter 3569. However, because Code Sec. 7477 requires that the Tax Court rather than the IRS determine if a donor has exhausted all administrative remedies, the donor generally

will be sent a Letter 3569 in those situations where the donor does not respond to a preliminary notice of determination or does not request consideration by Appeals.

■ **Timeliness.** The taxpayer must file a petition for a declaratory judgment with the Tax Court before the 91st day after the IRS mails Letter 3569.

■ **IRS remedies.** Taxpayers seeking declaratory relief must first exhaust all administrative remedies with the IRS. The IRS explained that it will consider a donor to have exhausted all administrative remedies if, before filing a Tax Court petition, the donor timely requests consideration by Appeals and participates fully in the Appeals process. However, if a donor does not respond to a preliminary notice of determination or does not participate in the Appeals process, the IRS will consider the donor not to have exhausted administrative remedies.

References: FINH ¶41,135;  
TRC ESTGIFT: 36,000.

## Practitioners' Corner

Continued from page 287

### Average Itemized Deductions Data

AGI Size:	\$0-15K	\$15-30K	\$30-50K	\$50-100K	\$100-200K	+\$200K
Medical	\$7,719	\$6,720	\$5,791	\$6,354	\$9,302	\$29,509
% of Itemizers	63.8%	45.4%	28.8%	17.6%	7.6%	2.3%
Taxes	\$2,693	\$2,837	\$3,665	\$5,815	\$10,445	\$39,234
% of Itemizers	95.1%	97.0%	98.5%	99.6%	99.9%	99.9%
State & Local Taxes	\$721	\$994	\$1,671	\$3,100	\$6,139	\$30,597
% of Itemizers	83.8%	89.5%	93.9%	96.8%	98.2%	99.0%
Income Taxes	\$1,003	\$1,157	\$1,857	\$3,451	\$6,852	\$35,529
% of Itemizers	31.3%	51.6%	69.2%	77.6%	81.7%	82.5%
General Sales Taxes	\$552	\$772	\$1,149	\$1,680	\$2,605	\$5,900
% of Itemizers	52.5%	37.9%	24.7%	19.2%	16.5%	16.5%
Interest Paid	\$8,761	\$8,362	\$8,451	\$9,813	\$12,892	\$23,274
% of Itemizers	64.3%	67.3%	77.4%	85.7%	87.5%	82.9%
Charitable Contributions	\$1,373	\$1,897	\$2,123	\$2,673	\$3,860	\$18,539
% of Itemizers	62.8%	70.8%	77.9%	86.3%	92.7%	95.1%
Total Itemized Deductions	\$14,569	\$14,506	\$15,290	\$19,319	\$27,280	\$73,995
% of Returns	5.0%	15.6%	35.7%	63.5%	88.1%	94.7%

### High income individuals

As required by the *Tax Reform Act of 1976*, the IRS also reported its annual data on individuals reporting \$200,000 or more in adjusted gross income (AGI). That amount has not been adjusted for inflation since 1976. Nevertheless, the IRS reported that, for tax year 2005, more than 3.5 million individual income tax returns were filed with an AGI of \$200,000 or more; 2.654 percent of all returns filed for the year. More than 7,000 of these returns, or 0.207 percent, reported no U.S. income tax liability. Over 4,000, or 0.118 percent reported no worldwide income tax liability.

For TY 2006 more than four million individual income tax returns were filed with an AGI of \$200,000 or more; 3 percent of all returns filed for the year. Their total tax liability was \$557 billion.

# Compliance Calendar

## ■ June 13

Employers deposit Social Security, Medicare, and withheld income tax for June 7, 8, 9, and 10.

## ■ June 16

Individuals living and working outside the U.S. and Puerto Rico file Form 1040 and pay any tax due. File Form 4868, to obtain a four-month extension of time to file.

Individuals pay the second installment of 2008 estimated income tax.

Corporations deposit the second installment of estimated income tax for 2008.

Monthly depositors deposit Social Security, Medicare and withheld income tax for May.

## ■ June 18

Employers deposit Social Security, Medicare, and withheld income tax for June 11, 12, and 13.

## ■ June 20

Employers deposit Social Security, Medicare, and withheld income tax for June 14, 15, 16, and 17.

# From the Helpline

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

**Q** Is a U.S. national living abroad who sold her principal residence in Europe entitled to the Code Sec. 121 exclusion?

**A** Code Sec. 121 concerns an exclusion from income for proceeds from the sale of the taxpayer's principal residence. While there are rules regarding the length of time the residence was owned and occupied, neither the statute or regulations limit the location of the residence. Note, however, that Code Sec 121(e) specifically denies the exclusion to any individual who was an expatriate as defined under Code Sec. 877(a)(1). *See TRC REAL: 15,154.*

**Q** Are exempt organizations required to recognize capital gain income on the sale of debt-financed property to the extent of the debt-financing?

**A** Income from the sale of debt-financed property (to the extent of the debt-financing) is taxed as unrelated business income. Under Code Sec. 511, unrelated business income is taxed at the ordinary income rates applicable under Code Sec. 11 (*i.e.* the corporate income tax rates). *See TRC EXEMPT: 18,000.*

**Q** The Joint Committee on Taxation (JCT) recently reviewed Code Sec.892 and indicated that it intends to issue regs or change an aspect of the current Code Sec. 892 law. Is there any further news on this situation?

**A** In March, Senators Baucus and Grassley sent a letter to the JCT requesting that it conduct a study of various issues involving Code Sec. 892. The letter is attached. CCH has contacted the JCT; they said that the study is not yet completed but, when it is, they will not be publishing their report. However, the JCT also said that Baucus or Grassley may decide to release it to the public.

# 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 9,056	259	IRS 3,152.10	271	IRS 51,060.05	257
ACCTNG 33,204.15	271	IRS 6,252.15	267	IRS 51,062.05	272
ACCTNG 36,162.05	259	IRS 9,052.05	272	IRS 51,158.20	260
BUSEXP 24,102	247	IRS 9,252.10	284	IRS 66,100	284
BUSEXP 24,862	278	IRS 12,380	271	IRS 66,102	284
BUSEXP 30,104	284	IRS 21,054	257	IRS 66,154	284
BUSEXP 54,150	282	IRS 21,108	260	LITIG 3,200	284
BUSEXP 54,500	271	IRS 21,108	271	LITIG 6,100	281
CCORP: 3,254.102	277	IRS 21,300	284	LITIG 6,612.15	272
CCORP: 6,058.35	260	IRS 21,350	260	LITIG 6,654	272
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FILEBUS: 12,302	284	IRS 36,052.05	284	PENALTY 3,106	260
FILEBUS: 12,306	267	IRS 45,052	270	PENALTY 3,108.15	259
FILEIND: 18,100	260	IRS 45,158	247	PENALTY 3,256	271
FILEIND: 21,154.40	281	IRS 45,158	260	PENALTY 3,260	271
INDIV 6,266	284	IRS 48,100	257	PENALTY 6,054.05	284
INDIV 18,058	256	IRS 48,210.15	271	RIC: 9,060.05	247
INDIV 42,454	279	IRS 51,052	284	SALES 24,452	269
INDIV 42,462	280	IRS 51,056	272	SALES 45,360.15	272
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INTL 30,082	255	IRS 51,056.25	260		
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