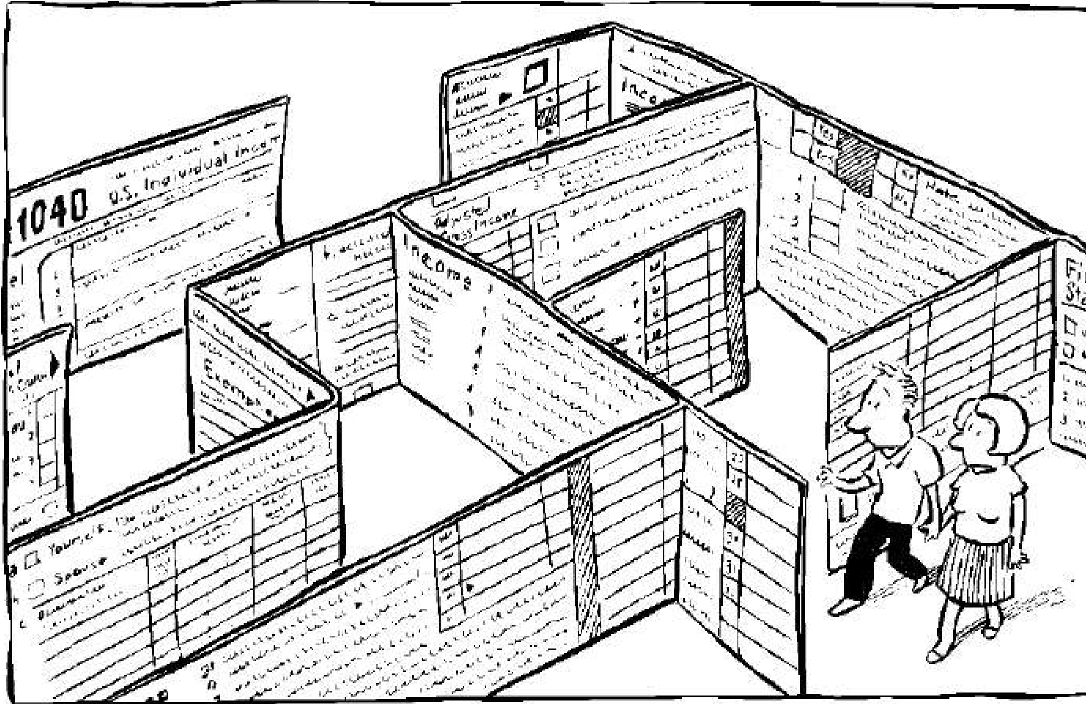
Federal Tax Developments Update (Last Minute Additions)



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The material in this manual is designed for, and intended to serve as an aid to, continuing professional education of CPAs and others in seminar presentations. Due to the certainty of continuing current developments, this material is not appropriate to serve as the sole authority for any opinion or position. It must be supplemented for such purposes by reference to other current authoritative materials.

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I. Introduction

Below are items that have occurred since the manual went to print that may be of interest.

II. Federal Legislation

No final issues covered.

III. Regulations, Rulings, Etc.

We will consider selected ruling and regulatory activity from the IRS as presented below, as well as other IRS releases and commentaries from other parties.

When evaluating these items, be sure to consider the level of authority that each type of release carries with it. For instance, a private letter ruling is not binding on the IRS except for the single taxpayer involved, while a final regulation carries substantial weight and will only be disregarded by the Courts in cases where the Court finds the regulation is clearly not a valid interpretation of the underlying law.

A. Disclosure of Taxpayer Information to Third Parties (Including Overseas Outsourcing) Would Require Revised Consent Under Proposed Regulations

(Proposed Regulations §301.7216-1, 2 and 3, IRS Notice 2005-93, 12/7/05) The IRS proposed revising the regulations under §7216 on the release of taxpayer information to third parties. Under the revised regulations, the IRS would be authorized to provide specific consents to be used by tax preparers in order to disclose return information to third parties. As well, certain disclosures would be allowed without taxpayer consent, while others would required specific taxpayer consent prior to the disclosure.

Of special interest given recent developments in the outsourcing of income tax return work outside the United States are provisions in Proposed Regulation §301.7216-2(d) that provide that tax preparers may disclose taxpayer information to other preparers "for the purpose of preparing, or assisting in preparing a tax return, or obtaining or providing auxiliary services in connection with the preparation of any tax return so long as the services provided are not substantive determinations or advice affecting a taxpayer's reported tax liability." Such purposes would include sending the data to the other preparer for the purpose of transferring information to a tax return and computing the tax due, as well as for electronic filing.

However, as the example below from the proposed regulations note, that would not apply to preparers located outside the United States and its territories:

> *Example 3.* E, an employee of Firm in State A in the United States, receives tax return information from T for use in preparing T's income tax return. After E enters T's tax return information into Firms' computer, that information is stored on a computer server that is physically located in State A. Firm contracts with Contractor, located in Country F, to prepare its clients' tax returns. FE, an employee of Contractor, uses a computer in Country F and inputs a password to view T's income tax information stored on the computer server in State A to prepare T's tax return. A computer program permits FE to view T's tax return information, but prohibits FE from downloading or printing out T's tax return information from the computer server. Because Firm is disclosing T's tax return information outside of the United States, Firm is required to obtain T's consent under §301.7216-3 prior to the disclosure to FE.

Consents under §301-7216-3 will follow a specified format outline in the proposed Revenue Procedure found in Notice 2005-93 that was released at the same time as the proposed regulations and generally required specific consent from the taxpayer prior to disclosure. As well, the disclosure would be required to be a "stand alone" document and could not normally be combined with other materials (so, for instance, it could be part of an engagement letter). This would mean that firms outsourcing returns outside the United States would have to obtain specific consent from each client prior to sending the information to the outsourcing contractor.

Certain mandatory items would be required to be in each consent. The mandatory language items are noted below:

> (6) Mandatory statements in the consent.
>
> (a) A consent to disclose tax return information must contain the following statement in the following format:
>
> *We generally are not authorized to disclose your tax return information for purposes other than the preparation and filing of your tax return. We may disclose your tax return information to third parties only if you consent to each specific disclosure. Your consent is valid for one year.*
>
> ***Warning****: Once your tax return information is disclosed to a third party per your consent, we have no control over what that third party does with your tax return information. If the third party uses or discloses your tax return information for purposes other than the purpose for which you authorized the disclosure, under Federal tax law, we are not responsible for that subsequent use or disclosure, and Federal tax law may not protect you from that disclosure.*
>
> (b) A consent to use tax return information must contain the following statement in the following format:
>
> *We generally are not authorized to use your tax return information for purposes other than the preparation and filing of your tax return. We may use your tax return information for other purposes only if you consent to each specific use. Your consent is valid for one year.*
>
> (c) All consents must contain the following statement in the following format:
>
> ***If you believe that your rights have been violated***
>
> *If you have any questions or concerns about your rights regarding the use or disclosure of your tax return information, visit www.irs.gov/advocate for more information, or contact the Taxpayer Advocate Service of the Internal Revenue Service at 1-877-777-4778.*
>
> *If you believe we have used or disclosed your information without your permission, you may contact the Treasury Inspector General for Tax Administration at 1-800-366-4484.*
>
> (7) Mandatory statement in any consent to disclosure outside of the United States. If a tax return preparer to whom the tax return information is to be disclosed is located outside of the United States, the taxpayer's consent under §301.7216-3 prior to any disclosure is required. See §301.7216-2(c) and (d). All consents for disclosures of tax return information outside of the United States must contain the following statement in the following format:
>
> *This consent to disclose will result in your tax return information being disclosed to a tax return preparer located outside the United States.*

CPAs should note that violation of §7216 carries with it the potential for *criminal* penalties.

> *Remember that these regulations would apply in addition to the standards that are generally applicable to CPAs under the Code of Professional Conduct. You will be required to adhere the highest applicable standard.*

> *As well, these rules apply to any disclosure to a third party, even if the taxpayer originates the request (such as in support of a mortgage loan application). Generally blanket authorization that mortgage brokers or officers may have obtained will not be adequate to meet the requirements under even the prior regulations.*

The regulations would become effective 30 days after the publication of final regulations in the *Federal Register*. The deadline for comments falls during March of 2006, so it's most likely that these regulations would not become effective until after the April 15 filing deadline, but could very well apply shortly thereafter.

B. Disclosure for Purposes of Reducing the Penalty Under §6662(d)

(Revenue Procedure 2005-75, 12/12/05) The IRS has updated the guidance regarding adequate disclosure in order to reduce the penalty under §6662(d) (substantial understatement of tax) and the preparer penalty under §6694(a), updating Revenue Procedure 2004-73.

The IRS summarized the changes to the procedure in Section 2:

> SEC. 2. CHANGES FROM REV. PROC. 2004-73
>
> .01 Editorial changes have been made in updating Rev. Proc. 2004-73.
>
> .02 Section 1 clarifies that the disregard provisions, and not the negligence provision, of the section 6662 accuracy penalty are subject to an adequate disclosure exception (and that this revenue procedure is not applicable to the exception for the disregard provisions).
>
> .03 Section 3.02 reflects the amendment of section 6662(d)(1)(B) by section 819 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004) (the AJCA of 2004) which revises the threshold for determining whether an understatement is substantial for certain corporations.
>
> .04 Section 3.06 explains the effect of tax law changes effective after December 31, 2005, on the use of this revenue procedure for fiscal year and short year returns.
>
> .05 Section 4.01 has been divided into paragraphs: 4.01, General, and 4.02, Items. The first paragraph provides general guidance relevant to all items in the revenue procedure, and the second paragraph identifies the items for which the entry of an amount on the line of a return is adequate disclosure.
>
> .06 Section 4.01(3) adds a new paragraph cautioning that the entry of an amount on a line will not provide adequate disclosure when an understatement arises from a related party transaction.
>
> .07 Section 4.01(4) adds an example (using Schedule M-3, Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More) for disclosing an item on a line that does not have a preprinted description identifying that item.
>
> .08 Section 4.01(5) adds a new paragraph cautioning that the entry of an amount on a line in conformity with this revenue procedure will not provide adequate disclosure for the section 6662 accuracy-related penalty if the item or position is attributable to a tax shelter or if it does not have a reasonable basis and supporting records. The paragraph also includes limitations on the effectiveness of a disclosure for purposes of the section 6694 return preparer penalty.
>
> .09 Section 4.02(1)(d) reflects the enactment of section 170(f)(12) by section 884 of the AJCA of 2004. Section 170(f)(12) concerns the amount that a donor may deduct for a charitable contribution of a qualified vehicle, boat, or airplane having a value of more than $500.

The updated procedure applies to 2005 tax returns filed on 2005 forms for tax years beginning in 2005, as well as short year returns beginning in 2006 that are filed on the 2005 forms.

C. Estimated Tax Annualization Proposed Regulations Issued for Corporate Taxpayers

(Proposed Regulation §1.6425-2, 12/8/05) The IRS issued proposed regulations that would define various requirements for computing estimated tax payment requirements taking into account various timing issues and development since the old regulations that were issued many years ago.

In the preamble to the proposed regulations, the IRS hints that they see these regulations as closing down "creative" methods of computing the annualization payment amount:

> In addition, the IRS and Treasury Department have become aware of techniques employed by taxpayers, particularly those taxpayers computing their estimated tax payments using an annualization method, that reduce, if not eliminate, estimated tax payments for one or more installments for a taxable year.

The regulations address the application of the economic performance rules under §461(h), the proper method of handling issues under §§404, 419 and 419A, dealing with net operating losses and the proper allocation of depreciation and amortization deductions.

The regulations would be effective thirty days after the publication of final regulations in the *Federal Register*.

D. Payors Temporarily Exempted from Reporting and Withholding Requirements on Certain §409A Matters

(IRS Notice 2005-94, 12/8/05) Until further guidance is issued, the IRS has removed the requirements that payors report and/or withhold tax on certain items subject to §409A. The exception is not a blanket exemption for all nonqualified deferred compensation—those items required to be reported under prior law per §3121(v)(2) and Regulation §31.3121(v)(2)-1 will still need to be reported. However, additional reporting under §409A will not be required until the IRS issues further guidance. As well, the IRS has indicated that they will not penalize service recipients under §§ 6651(a)(1) and (2), 6654, and 6662 who fail to report income until such time as the IRS has issued guidance on reporting.

At that time, the IRS indicates that employers may be required to issue corrected reports and service recipients who have taxable income will be given a period during which they may report such income to take advantage of the waiver of penalties under this notice. However, the service recipients will be required to pay the appropriate amount of interest for the period of nonpayment.

The IRS issued this guidance primarily because the final regulations under §409A have not yet been adopted, so we cannot be sure exactly what needs to be reported and what may be considered taxable income. For that reason, they have also provided the exemption from penalties. However, since the IRS will expect both employers and recipients to eventually report in accordance with the final guidance, potentially affected taxpayers will need to monitor future developments in this area.

IV. Court Cases

Remember when looking at cases that they are the application of the law to specific set of facts. CPAs sometimes do not give enough weight to the importance of the exact facts that existed when a decision was rendered, and so want to apply the result of a case broadly. You need to carefully evaluate the facts your client's exact situation presents when evaluating the applicability of a particular court decision. Even if the legal analysis contained in the decision is accepted entirely as representing the appropriate interpretation of the law, the fact that person X with fact set Y

obtained result Z does not mean your client will obtain that same result unless you can establish there is no relevant difference in your client's situation.

As well, you must also consider the precedential value of the particular case in your situation. A published decision of the Circuit Court of Appeals that would have jurisdiction over your client's case[1] should be given far more weight than a single Tax Court Memorandum decision that was subject to appeal in a different circuit.

A. Charity Found to Have Paid Compensation to Run Bingo Games and Loses Its §501(c)(3) Status

(South Community Association, TC Memorandum 2005-285, 12/14/05) The Tax Court found that a charity was paying individuals to conduct its Bingo games, despite affidavits from individuals to the contrary and the testimony of six individuals for the taxpayer. The court found far more believable the testimony of three former game workers put forward by the government and held, in any event, that service performed by individuals the entity had reported making payments to were sufficiently related to the Bingo games to fail the requirements of §513(a) that " in which substantially all the work in carrying on such trade or business is performed for the organization without compensation" and sustained the IRS's revocation of the organization's exempt status since the IRS found it was not being operated primarily for a charitable purpose, but rather primarily existed to run a gambling business.

The IRS alleged that the organization paid individuals working in the bingo operation $65 a night in cash and did not report these payments as compensation. The charity alleged that it had not paid the workers, but the court did not find such testimony credible, noting that the evidence in support of that contention all seemed to come from sources that had a vested interest in supporting the exempt status of the organization for their own personal benefit (such as continued employment). The charity had received no public support during the period in question and although it had made contributions to educational causes, it also received its supplies from a for profit organization controlled by the individual that founded the charity.

B. IRS Loses For Third Time on Telephone Excise Tax

(National Railroad Passenger Corporation, Court of Appeals for the District of Columbia, Case No. 04-5421, 2005-2 USTC ¶70,247, 12/9/05) The IRS racked up yet another loss on the issue of whether the telephone excise tax under §4252 applies to long distance charges that vary solely by time and not by distance. Amtrak sued for a refund of taxes paid for long distance services relying, as had the taxpayers in *American Bankers Insurance* (CA11, 408 F.3d 1328) and *OfficeMax* (CA6, 2005-2 USTC ¶70,246) on the fact that the literal language of the statute appears to apply the tax only to long distance charges that vary by time *and* distance.

The Federal Circuit agreed with the holding of the United States District Court that the literal language of the statute clearly does not apply to a charge solely computed with regard to time and the Court of Appeals, like the Sixth Circuit, notes that the IRS's own Revenue Ruling the government cites in support of imposing the tax concedes that the language of the statute is such that the tax would not apply. For that reason, the court concludes the ruling cannot be afforded any special deference on this matter.

Now that the IRS is 0 for 3 at the Court of Appeals level, it will be interesting to see if they finally concede the issue or whether they will continue to try and find a Circuit that will agree with their position.

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1 In Ohio, the relevant Circuit for a resident of the state normally would be the Sixth Circuit Court of Appeals—so a Sixth Circuit opinion would carry special weight. But if your client is located outside Kentucky, Michigan, Ohio or Tennessee (say in the neighboring states of Indiana, Pennsylvania or West Virginia), or it is decided the appropriate venue for the case is the US Court of Claims, a different circuit would apply.

C. Payments Received from Father-in-Law's Corporation Were Compensation and Not Gifts

(Hajek, TC Summary 2005-179, 12/6/05) T was the general manager of a tool and die business owned by his father-in-law. In addition to his regular salary from the corporation, T receive additional weekly payments from the corporation that came from funds advanced to the corporation by the shareholder, T's father-in-law. The corporation was experiencing financial problems and this payment system was suggested by the corporation's accountant as a method of avoiding payroll taxes by treating these payments as gifts from the corporation to the son-in-law and to compensate the son for the fact that his salary was below what was in line with the services rendered. In 2001, the corporation finally ceased doing business.

The funds were kept in a separate bank account and the accountant apparently reasoned that since the funds came from the father-in-law and were kept separate that the gift treatment would be accorded to these funds. However, the court held:

> The amounts petitioner received from his employer represented payments for his services. Those amounts represented compensation for services rendered. The moneys came from corporate funds. Those amounts are includable in gross income including that portion of the payments that came out of the amounts advanced to the corporation by Mr. Marchisset. None of the payments can even be remotely connected to a situation that could be considered as being "excluded by law" under section 1.61-2(a)(1), Income Tax Regs., or as a gift under section 102(a). All the moneys paid to petitioner came out of the corporate bank account, and there was no written agreement that would have characterized those payments as anything but compensation for services rendered.

The court therefore held that the payments were taxable income to the son-in-law.

> *There were a number of bad facts in this case. Clearly, a major problem was the fact that the funds were advanced to and paid from the corporation specifically to "make up" for the fact that the son-in-law was undercompensated and this was the shareholder's method of retaining the manager in the position. Any one of those facts likely would have been enough to sink the treatment of these payments as gifts.*
>
> *Remember that intent is what determines if a payment is a gift under §102, and not the label that may be placed on the transaction. In this case, the motivation was not the "detached and disinterested generosity" standard that the court noted for a gift, but rather was clearly aimed at retaining the services of the manager.*

D. Tenure Buy-Out Payments Are Not FICA Wages

On October 18, 2005, the U.S. District Court for the Western District of Pennsylvania issued its opinion in *University of Pittsburgh v. United States* (Docket No. 04-1616) where it followed the holding in the *North Dakota State University* case and held that payments to tenured faculty members where they accepted early retirement in exchange for giving up their tenure rights were not FICA wages, based on the concept that this was a payment for a contractual property interest rather than compensation. The court cites Revenue Ruling 58-301 in support of its position, not commenting on the IRS's change of heart on that ruling in Revenue Ruling 2004-110 (which, to be fair, was not published until well after the year being litigated).

However, the court held that payments to librarians who did not possess tenure, but merely an expectation of continued employment, were subject to FICA. In that case, the court did not find that the librarians had a protected property interest and agreed with the IRS that such payments constituted wages.