

Standard Federal Tax Reports *Taxes On Parade*

Vol. 99, Issue No. 4, Report 4

January 26, 2012

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IRS Finalizes Regs On Exclusion From Income For Personal Injury/Sickness Damages

◆ TD 9573

The IRS has issued final regs on the Code Sec. 104(a)(2) exclusion from gross income for amounts received on account of personal physical injuries or physical sickness. The final regs track proposed regs issued in 2009. Like the proposed regs, the final regs do not require that to qualify for exclusion from gross income, damages received from a legal suit, action or settlement agreement must be based upon tort or tort type rights.

■ **CCH Take Away.** In the preamble to the final regs, the IRS justified removing a “tort test” by finding that the case law in *Schleier*, 515 US 323 (1995), and certain revisions adopted by Congress in 1996 provided specific definitions that served to clarify the definition of excluded damages that “eliminated the need to base the section 104(a)(2) exclusion on tort cause of action and remedy concepts.” The final regs reflect the Supreme Court’s decision in *Schleier*, which held that there needs to be a direct link between the personal injury and the recovery, Steven A. Loeb, LLM, of the Law Firm of Fein, Such, Kahn & Shepard, P.C., Parsippany, N.J., told CCH.

■ **Comment.** The IRS declined to clarify certain issues and this leaves practitioners without a roadmap, Robert A. McKenzie, Arnstein & Lehr LLP, Chicago, told CCH.

Background

Code Sec. 61 provides that, except as otherwise provided by the Tax Code, gross income includes all income from whatever source derived. Code Sec. 104(a)(2) provides that gross income does not include the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as a lump sum or as periodic payments) on account of personal physical injuries or physical sickness.

In *Schleier*, 515 U.S. 323 (1995), the Supreme Court held that the statutory “on account of” test excluded only damages directly linked to “personal” injuries or sickness. The Small Business Jobs Protection Act of 1996 (SBJPA) restricted the exclusion provided by Code Sec. 104(a)(2) to amounts received on account of personal physical injuries or physical sickness.

Tort type test nixed

The IRS explained that before *Schleier* and the SBJPA, the tort type rights test was intended to distinguish damages for personal injuries from, for example, damages for breach of contract. However, *Schleier* interpreted the statutory on account of test to exclude only damages directly linked to personal physical injuries or sickness. The SBJPA, the IRS added, provided that only damages for personal physical injuries or physical sickness would be excluded. *Schleier* and the SBJPA eliminated the need to base the Code Sec. 104(a)(2) exclusion on tort cause of action and remedy concepts, the IRS concluded in the final regs.

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IRS Updates Disclosure Guidance For Understatement And Preparer Penalties

◆ *Rev. Proc. 2012-15*

The IRS has updated its guidance describing when disclosure on a taxpayer's income tax return is adequate to reduce a Code Sec. 6662(d) accuracy-related penalty for substantial understatement of income tax and to avoid a Code Sec. 6694(a) preparer penalty. Rev. Proc. 2012-15 makes minor revisions to earlier guidance in Rev. Proc. 2011-13.

■ **CCH Take Away.** "Rev. Proc. 2012-15 is an update of the prior year guidance and makes two basic corrections," Benson Goldstein, senior technical manager, American Institute of Certified Public Accountants (AICPA) told CCH. Rev. Proc. 2012-15 applies to any income tax return filed on 2011 tax forms for a tax year beginning in 2011, and to any income tax return filed on 2011 tax forms in 2012 for short tax years beginning in 2012.

Penalties

Code Sec. 6662(d) imposes an accuracy-related penalty on any portion of an un-

derpayment attributable to a substantial understatement of income tax. Generally, an understatement is substantial if the amount of the understatement exceeds the greater of 10 percent of the amount of tax required to be shown on the return or \$5,000. A corporation, other than an S corp or personal holding company, has a substantial understatement if the amount of the understatement exceeds the lesser of 10 percent of the tax required to be shown on the return for the tax year (or if greater, \$10,000); or \$10 million.

Under Code Sec. 6694(a), a tax return preparer may be liable for a penalty if a return reflects an understatement of liability due to an unreasonable position if the preparer knew or reasonably should have known of the position. Generally, a position is treated as unreasonable unless substantial authority exists for the position or the position was properly disclosed under Code Sec. 6662(d) and had a reasonable basis. The Code Sec. 6694(a) penalty is the greater of \$1,000 or 50 percent of the income derived by the tax return preparer with respect to the return or claim for refund.

■ **Comment.** If the position is with respect to a tax shelter, listed transaction or reportable transaction with significant tax avoidance or evasion purposes, the standard under Code Sec. 6694(a) is more likely than not rather than substantial authority.

Rev. Proc. 2012-15

The IRS explained that Rev. Proc. 2012-15 makes a correction to the reference in Rev. Proc. 2011-13 to Schedule M-3 (Form 1120). For Part III, line 37, Other expense/deduction items, the entry must provide descriptive language. If additional space is needed for the description, taxpayers should continue the description on an attachment, the IRS instructed.

■ **Comment.** Rev. Proc. 2011-13 indicated Part III, line 35 and not Part III, line 37.

Rev. Proc. 2012-15 also updates Rev. Proc. 2011-13 to include a reference to the employee-remuneration limitations under amended Code Sec. 162(m).

*References: FED ¶46,251;
TRC IRS: 6,156.05.*

Exclusion

Continued from page 1

Other issues

The IRS reported that one commentator recommended that the final regs address whether a claimant has constructive receipt or the current economic benefit of a damage award that is set aside for the claimant's benefit in a trust or fund, such as a qualified settlement fund described in Reg. §1.468B-1. The IRS determined that the recommendation was outside the scope of the regs.

The IRS was also asked to define in the final regs certain personal injuries and describe the circumstances in which emotional distress is attributable to physical injuries. Again, the IRS declined to do so, explaining that the recommendation was outside the scope of the regs.

■ **Comment.** The final regs allow an exclusion under Code Sec. 104(a)(2) for damages for emotional distress, even not necessarily attributable or related to a physical injury or physical sickness, to the extent that the

damages for emotional distress are not in excess of amount paid for medical care related to such emotional distress, Loeb noted.

Effective date

The final regs apply to damages paid under a written binding agreement, court decree or mediation award entered into or issued after September 13, 1995, and received after January 23, 2012. The IRS advised that taxpayers may apply the final regs to amounts paid under a written binding agreement, court decree, or mediation award entered into or issued after September 13, 1995, and received after August 20, 1996, and if otherwise eligible may file a claim for refund for a tax year for which the period of limitation on credit or refund under Code Sec. 6511 has not expired.

*References: FED ¶47,010;
TRC INDIV: 33,402.5.*

STANDARD FEDERAL TAX REPORTS (USPS 518000) (ISSN 0162-3494), TOP Edition published weekly, except for the week of Christmas by CCH, a Wolters Kluwer business, 4025 W. Peterson Ave., Chicago, Illinois 60646-6085. Subscription rate \$3,855 per year. Taxes on Parade sold separately, subscription rate \$235 per year for the TOP Edition. Periodicals postage paid at Chicago, Illinois, and at additional mailing offices. **POSTMASTER:** SEND ADDRESS CHANGES TO STANDARD FEDERAL TAX REPORTS, 4025 W. PETERSON AVE., CHICAGO, IL 60646-6085. Printed in U.S.A. All rights reserved. ©2012 CCH. All Rights Reserved.

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 Regs To Require Withholding On Dividend Equivalents

◆ TD 9572, NPRM REG-120282-10

The IRS has issued temporary and proposed regs to require income tax withholding on dividend equivalents. The rules implement Code Sec. 871(m), enacted March 18, 2010, in the *Hiring Incentives to Restore Employment Act*.

■ **CCH Take Away.** “In the absence of regulatory relief, every NPC [notional principal contract] would have become a specified NPC by default with respect to payments made after March 18, 2012, pursuant to section 871(m)(3)(B),” Michael J. Miller, partner, Roberts & Holland LLP, New York, told CCH. “The new regulations provide two forms of relief from this disastrous result. First, the temporary regulations extend the currently applicable statutory definition of a specified NPC, as set forth in section 871(m)(3)(A), through December 31, 2012. This transitional relief is extremely helpful. Second, for payments made on or after January 1, 2013, the proposed regulations follow the format of section 871(m)(3)(A) by setting forth an enumerated list of circumstances in which an NPC will be a specified NPC. There are some material changes, but the proposed regulations would preserve the current (favorable) treatment of many common equity swaps.”

■ **Comment.** The temporary regs implement the more narrow statutory withholding requirement through December 31, 2012; the proposed regs provide a broader withholding requirement that would not be effective until January 1, 2013.

Background

Nonresident alien individuals and foreign corporations are subject to 30 percent U.S. income tax withholding on U.S.-source income, under Code Secs. 871 and 881 (assuming it is not effectively connected income). This rate may be reduced or eliminated by treaty.

■ **Comment.** Current IRS regs provide that substitute interest and dividend payments are treated

as having the same source and character as the income for which they substitute.

New law

Code Sec. 871(m) is aimed at transactions where substitute dividends paid to a foreign person are contingent on the payment of U.S.-source dividends. Under Code Sec. 871(m)(2), this “dividend equivalent” includes:

- A substitute dividend made under a securities lending agreement or sale-repurchase agreement;
- A payment made under a “specified” notional principal contract (NPC) that is contingent on a U.S. source dividend payment; and
- Any other payment that the IRS determines is “substantially similar” to a substitute dividend or payment on a specified NPC.

■ **Comment.** An NPC is a financial instrument where a party and a counterparty each agree to pay an

amount to the other party, based on the product of a specified index and a “notional” or deemed amount of principal, without an actual investment of principal.

Specified NPC

Under Code Sec. 871(m)(3)(A), an NPC is a specified NPC only if at least one of four criteria are met. Under Code Sec. 871(m)(3)(B), a specified NPC also includes payments made on any NPC after two years from the date of enactment (March 18, 2012), unless the IRS determines that the contract does not have the potential for tax avoidance.

New regs

The temporary regs extend the Code Sec. 871(m)(3)(A) definition of a specified NPC through December 31, 2012. Thus, Code Sec. 871(m)(3)(B) (the default rule that would have phased in after two years) will not apply.

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IRS Touts Electronic Return Filing As Season Gets Underway

◆ IR-2012-7, IR-2012-8, www.irs.gov

The IRS is reminding taxpayers that e-filing helps to ensure accurate tax returns result in fast refunds (in as few as 10 days for e-filers using direct deposit). The 2012 electronic tax return filing season opened on January 17 for e-filed returns

■ **CCH Take Away.** Last year more than 112 million, or 77 percent, of all individual federal tax returns were e-filed. Apart from faster refunds and greater accuracy, taxpayers are attracted to e-filing by its user-friendliness. Most e-file programs automatically calculate adjusted gross income, itemized deductions, tax liability, refunds, and other items; and many provide the option for taxpayers to simultaneously file their state tax returns.

IRS Free File

Taxpayers with adjusted gross income of less than \$57,000 are eligible to file their

returns with tax software offered through private companies in the IRS Free File program. Taxpayers should visit www.irs.gov/freefile to determine their eligibility.

Other requirements

E-filers must acquire an electronic PIN from the IRS by visiting the IRS website or by using the self-select PIN method on the return. Taxpayers use the PIN to electronically sign their returns right before they file them.

Taxpayers who received a letter from the IRS providing them with an Identity Theft Protection PIN (IP PIN) must enter that IP PIN number when prompted by the e-filing software. Taxpayers who received an IP PIN and do not enter it may find their electronically filed return rejected, the IRS cautioned.

References: FED ¶¶46,249, 46,250; TRC FILEBUS: 15,056.

Tax Court Rejects Couple's Purported Assignment Of Income To Personal Services Corporation

◆ *Owen, TC Memo 2012-21*

The Tax Court has rejected a married couple's purported attempt to defer recognition of income from the sale of qualified small business stock by making a Code Sec. 1045 election. The court found that the couple did not invest at least 80 percent of the proceeds from the sale of a qualified small business into the active trade or business of a replacement qualified small business.

■ **CCH Take Away.** The Code Sec. 1045 election is similar to the like-kind exchange rules under Code Sec. 1031, but without the requirement that the taxpayer place property with an intermediary and without the prohibition of receiving cash from the transaction.

Background

The couple organized a personal services corporation in 1995. The couple were the only shareholders in the corporation. The husband and a third-party subsequently organized insurance companies, which sold prepaid legal service policies. In

2002, the husband sold his interest in the insurance companies.

The couple structured the sale and related transactions intending to defer recognition of the income under Code Sec. 1045. The couple purported to assign the income to their personal service corporation, which they claimed to operate as a jewelry business. The IRS disagreed with the couple's purported treatment and the couple sought relief in the Tax Court.

Court's analysis

The court first noted that a fundamental principle of tax law is that income is taxed to the person who earns it. Attempts to subvert this fundamental principle by diverting income away from its true earner to another entity by means of contractual arrangements, however cleverly drafted, are not recognized as dispositive for federal income tax purposes, regardless of whether such arrangements are otherwise valid under state law.

Code Sec. 1045 provides that a non-corporate taxpayer may defer recognition of gain on the sale of qualified small business

stock held by the taxpayer for more than six months. Any gain not recognized reduces the cost basis of the replacement qualified small business stock. The taxpayer recognizes gain to the extent the amount realized on the sale of the QSB stock exceeds the cost basis of the replacement qualified small business stock.

Qualified small business stock under Code Sec. 1202(c)(2) must have an active business requirement, the Court noted. At least 80 percent of the assets of the corporation must be used in active conduct of one or more qualified trades or businesses. Excluded from the definition of qualified trade or business are any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees.

The court found that the insurance activities qualified as a small business. Their principal asset was its training and organizational structure rather than the person of the husband.

However, the couple's personal services corporation failed to meet the active business requirement of Code Sec. 1202(c)(2). The court found that the couple's personal service corporation used less than 80 percent of the assets in an active trade or business. The personal service corporation, the court found, used merely eight percent of the assets in an active trade or business to acquire jewelry for its inventory. Indeed, this trend continued for more than two years, the court found.

Penalty

The court further found that the couple had not acted in good faith with respect to the purported Code Sec. 1045 transaction. According to the court, the couple had effectively deposited a large amount of money into an account rather than use it to operate a jewelry business. The court upheld the Code Sec. 6662(a) accuracy-related penalty.

References: CCH Dec. 58,923(M); TRC INDIV: 27,202.

Dividend Equivalents

Continued from page 3

The IRS adopted the temporary regs, extending the statutory definition of a specified NPC, to give taxpayers and withholding agents time to modify their systems and other operating procedures to comply with the proposed rules.

■ **Comment.** The IRS may challenge transactions under applicable judicial doctrines if the transactions are designed to avoid these rules.

Proposed regs

The proposed regs would adopt the same definition of a dividend equivalent as the temporary regs and the statute. However, a payment is not a dividend equivalent if it is based on an estimate of an expected dividend without reference to or adjustment for the actual dividend. A payment includes

any gross amount used in computing the net amount transferred to or from a taxpayer.

■ **Comment.** "The proposed regulations would also expand the class of dividend equivalents to include" gross-up payments by a short party to satisfy a long-party's tax liability on a dividend equivalent; and payments based on a dividend from U.S. sources made pursuant to an equity-linked instrument other than an NPC, Miller said.

The proposed regs describe an NPC as a specified NPC if any of seven criteria apply. These criteria include: the underlying security is not regularly traded on a qualified exchange, or the NPC's term is less than 90 days.

■ **Comment.** "The proposed regulations confirm that dividend equivalents will be treated as dividends for treaty purposes," Miller noted.

References: FED ¶¶47,009, 49,517; TRC INTL: 3558.25.

Reversing Claims Court, Federal Circuit Finds IRS Not Required To Disclose Third Party Information

◆ *In re United States, Fed. Cir., No. 992, January 20, 2012*

In a case of first impression, the Court of Appeals for the Federal Circuit has found that the Federal Claims Court erred when it compelled the IRS to disclose third party information under Code Sec. 6103(h)(4)(B). Adopting the taxpayer's argument would be contrary to Congress' intent and would make the release of information of a third party the norm rather than the exception, the court held.

■ **CCH Take Away.** The Federal Circuit noted that the decision resolves a split within the Federal Claims Court. In *Shell Petroleum, Inc., 47 Fed. Cl. 812 (2000)*, the court construed Code Sec. 6103(h)(4)(B) to allow discovery of tax treatment of similarly situated third parties. In *Vons Cos, Inc., 51 Fed. Cl. 1 (2001)*, the court construed Code Sec. 6103(h)(4)(B) to deny discovery for similarly situated third parties.

Background

The taxpayer manufactured products in Mexico and sold the products in the U.S. The IRS determined that the taxpayer was liable for more than \$9 million in excise taxes under Code Sec. 4681(a)(2), along with penalties and interest for allegedly using ozone-depleting chemicals (ODCs) in the manufacturing of its products. The taxpayer paid part of the excise tax assessments and filed for a refund in the Federal Claims Court.

The IRS had contracted with a federally-funded research center to test if ODCs were being used by the taxpayer and other manufacturers. The taxpayer sought to discover information on the research center's testing of commercial products during the IRS's audit of other taxpayers. The IRS refused to provide the information on confidential-ity grounds.

Claims Court's decision

The Federal Claims Court found that the information was return information under Code Sec. 6103 and generally barred from disclosure. However, the Federal Claims Court found the IRS was authorized to disclose the information under Code Sec. 6103(h)(4)(B). The IRS appealed to the Federal Circuit.

Federal Circuit's analysis

In a per curiam opinion, the Federal Circuit found that Code Sec. 6103(h)(4)(B) allows disclosure of tax information on a tax return in a judicial or administrative proceeding pertaining to tax administration if the treatment of an item reflected on such return is directly related to the resolution of an issue in the proceeding. According to the Federal Circuit, the legislative history of Code Sec. 6103(h)(4)(B) described an "item test" which allows disclosure where the treatment of an item reflected on the third party's return is or may be relevant to the resolution of an issue of the taxpayer's liability

under the Tax Code. The legislative history further indicated that there must be a direct relationship to the resolution of an issue of the taxpayer's liability.

The Federal Circuit found that the treatment of an item on a third party's return is not related to the resolution of a taxpayer's issue where the only link between the third party and taxpayer is the same tax treatment for a similar item of liability, income, deduction, or credit. Therefore, the taxpayer's argument failed to satisfy the directly related requirement.

The Federal Circuit further found that Congress did not intend for the courts to focus on the relevance of the "return information" sought to the issue in the proceeding as opposed to the relevance of the treatment of the item on the return being sought to the issue in the proceeding. Wherever Congress intended to permit disclosure of information based on relevance, it has indicated that clearly, the court held.

Reference: TRC IRS: 9,206.10.

Restitution Payments To Human Trafficking Victims Excluded From Income

The IRS has issued guidance providing that court-ordered restitution payments from an offender to a victim of human trafficking under 18 U.S.C. § 1593 are not included in the victim's gross income. The full amount of any restitution payments may be excluded, including medical costs, transportation, temporary house, child care, lost income, the value of his or her services or labor, and any other costs suffered as a proximate result of the offense.

As part of an international initiative to combat the trafficking of persons, Congress passed the *Trafficking Victims Protection Act of 2000*, which requires courts to order a defendant to pay restitution to a victim for any offense committed under 18 U.S.C. §§ 1581-1594. Among the offenses set forth is kidnapping any person "with the intent that such other person be sold into involuntary servitude, or held as a slave."

■ **Comment.** The U.S. Department of State's *Trafficking in Persons Report 2011* stated that in fiscal year (FY) 2010, federal law enforcement obtained 141 convictions in 103 human trafficking prosecutions (32 labor trafficking and 71 sex trafficking) brought under the *Trafficking Victims Protection Act*.

Notice 2012-12, FED ¶46,252; TRC INDIV: 33,402.

Fifty Percent Bonus Depreciation Available In 2008 And 2009 For Restaurant Property and Retail Improvement Property

◆ CCA 201203014

IRS Chief Counsel has concluded that qualified restaurant property and qualified retail improvement property are eligible for 50-percent bonus depreciation in both 2008 and 2009. Moreover, taxpayers are not required to take any special steps to claim bonus depreciation for these items.

■ **CCH Take Away.** The key factor, Chief Counsel determined, was that property that also is qualified leasehold improvement property qualifies for bonus depreciation, even if the restaurant or retail property would not qualify by itself.

Improvements

Qualified leasehold improvement property is an improvement to an interior portion of a nonresidential building, if made under a lease by the lessee or the lessor of that portion.

Qualified restaurant property is a building or a building improvement, if more than 50 percent of the square footage is devoted to on-premises preparation and consumption of prepared meals. Qualified restaurant property is not qualified property under Code Sec. 168(k) (for bonus depreciation).

Similar rules apply to qualified retail improvement property (defined as property open to the general public and used to sell tangible personal property to the public at retail).

Bonus depreciation

Chief Counsel noted that to be eligible for 50 percent additional first-year (bonus) depreciation under Code Sec. 168(k), property must have a recovery period of 20 years or less, or must be qualified leasehold improvement property. Qualified restaurant property and qualified retail improvement property placed in service after December 31, 2008, are not eligible for 50 percent bonus depreciation. Although both types of improvements are not eligible for bonus depreciation under Code Sec. 168(k), they are eligible for bonus depreciation if they are also qualified leasehold improvement property.

In some cases, qualified restaurant property placed in service after 2008 also is qualified leasehold improvement

property, and is therefore eligible for 50 percent bonus depreciation. Furthermore, qualified restaurant property placed in service after October 22, 2004 and before January 1, 2012 is classified as 15-year property, and consequently meets one of the requirements in Code Sec. 168(k) for bonus depreciation.

Similarly, in some cases, qualified retail improvement property placed in service in 2008 or after 2008 also is qualified leasehold improvement property. Both the Joint Committee on Taxation's Bluebook and Rev. Proc. 2011-26 provide that this property is therefore eligible for bonus depreciation.

Reference: TRC DEPR: 3,600.

AFRs Issued For February

Rev. Rul. 2012-7

The IRS has released the short-term, mid-term, and long-term applicable interest rates for February 2012.

Applicable Federal Rates (AFR) for February 2012

	Annual	Semiannual	Quarterly	Monthly
Short-Term				
AFR	.19%	.19%	.19%	.19%
110% AFR	.21%	.21%	.21%	.21%
120% AFR	.23%	.23%	.23%	.23%
130% AFR	.25%	.25%	.25%	.25%
Mid-Term				
AFR	1.12%	1.12%	1.12%	1.12%
110% AFR	1.23%	1.23%	1.23%	1.23%
120% AFR	1.34%	1.34%	1.34%	1.34%
130% AFR	1.47%	1.46%	1.46%	1.46%
150% AFR	1.69%	1.68%	1.68%	1.67%
175% AFR	1.97%	1.96%	1.96%	1.95%
Long-Term				
AFR	2.58%	2.56%	2.55%	2.55%
110% AFR	2.84%	2.82%	2.81%	2.80%
120% AFR	3.09%	3.07%	3.06%	3.05%
130% AFR	3.36%	3.33%	3.32%	3.31%

Adjusted AFRs for February 2012

	Annual	Semiannual	Quarterly	Monthly
Short-term adjusted AFR	.35%	.35%	.35%	.35%
Mid-term adjusted AFR	1.24%	1.24%	1.24%	1.24%
Long-term adjusted AFR	3.26%	3.23%	3.22%	3.21%

The Code Sec. 382 adjusted federal long-term rate is 3.26%; the long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months) is 3.55%; the Code Sec. 42(b)(2) appropriate percentages for the 70% and 30% present value low-income housing credit are 7.42% and 3.18%, respectively, however, the appropriate percentage for non-federally subsidized new buildings placed in service after July 30, 2008, and before December 31, 2013, shall not be less than 9%; and the Code Sec. 7520 AFR for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest is 1.4%.

References: FED ¶46,253; TRC ACCTNG: 36,162.05.

IRS Reiterates Absolute Deadline For Making NOL Carryback Election

◆ LTR 201202005

In a private letter ruling, the IRS has denied a taxpayer's request for an extension of time to elect to carry back net operating losses (NOLs) five years. The IRS determined that it could not extend the deadline to make the election because the deadline was prescribed by statute.

■ **CCH Take Away.** Generally, a taxpayer can only carry back NOLs for two years, but Congress, in Code Sec. 172(b)(1)(H), temporarily allowed taxpayers to select a three, four, or five-year carryback period for losses in tax years ending after 2007 and beginning before 2010. This gave taxpayers more opportunities to carry back NOLs and file for a refund for prior years. Here, taxpayers intended to make the election, but their accountants failed to do so, and the statutory deadline was absolute.

■ **Comment.** The IRS has more discretion to extend a deadline for making an election, such as a Subchapter S election, if the election deadline is prescribed in IRS guidance.

Background

Taxpayers relied on a public accounting firm for preparing their federal tax returns. The firm recommended that taxpayers make an election to carry back their NOLs five years; taxpayers agreed and instructed the firm to take the necessary steps.

Taxpayers obtained an automatic six-month extension to file their returns for the tax year of the NOLs. The firm electronically filed their tax returns by the extended due date, but did not make the election for the extended carryback period. The firm subsequently discovered it had not make the election. Taxpayers applied to the IRS for relief on April 11, 2011.

Election deadline

Code Sec. 172(b)(1)(H)(iii) requires that the election for an extended NOL carryback period must be made by the due date (including extensions) for the taxpayer to file its return for the last taxable year beginning in 2009.

Under IRS regs, a taxpayer cannot extend the due date of a statutory election beyond the extended due date of the return on which the election should have been made.

IRS analysis

The IRS concluded that taxpayers' request for an extension of time was untimely. The election was a statutory election. The taxpayer needed to take corrective action within six months after the unextended due date of their return for 2009. Taxpayers failed to do so, and were not entitled to an extra extension of time.

Reference: TRC NOL: 12,103.

Tax Briefs

Internal Revenue Service

The IRS's motion to compel a law firm to produce a letter addressed to an individual was denied because the letter was protected from disclosure by the attorney-client privilege and the work-product doctrine. The letter was addressed to the individual who did not waive the privilege by affirmatively placing the advice of counsel at issue or by disclosing other privileged communications because he was not a party to the litigation and the privilege cannot be waived by a third party.

Kearney Partners Fund, LLC, DC N.J., 2012-1
ustc ¶50,146; TRC IRS: 9,306.

Jurisdiction

An individual's claim that his employer wrongfully complied with an IRS levy by withholding his wages was properly dismissed for lack of subject matter jurisdiction and for failure to state a claim

upon which relief could be granted. The individual sought damages for the IRS's unauthorized collection of taxes; however, he failed to exhaust his administrative remedies prior to filing suit.

Zuckman, CA-2, 2012-1
ustc ¶50,156; TRC IRS: 45,104.

The U.S. Court of Federal Claims lacked subject matter jurisdiction in a partnership proceeding to impose gross valuation misstatement, negligence and substantial understatement penalties on the partnership because the understatement was generated by overstatement of the partners' outside basis, which was not a partnership item.

Jade Trading, LLC, CA-FC, 2012-1
ustc ¶50,151; TRC PART: 9,102.

A petition filed by a corporate partner for redetermination of a partner-level defi-

ciency was dismissed for lack of jurisdiction because the IRS's notice of deficiency was invalid. The notice was issued before a decision in the related partnership-level proceeding was final.

Bausch & Lomb, Inc., TC, CCH Dec.
58,917(M), FED ¶47,931(M); TRC LITIG: 6,106.05.

Income

Income attributable to a couple's rental of a commercial office building to the husband's wholly-owned medical corporation was nonpassive income under the self-rental rule of Reg. §1.469-2(f)(6). Therefore, it could not be offset against accumulated and unused passive losses. Although the couple was negligent in treating the rental income they received from the medical corporation as passive income, the accuracy-related

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penalty did not apply because the reasonably relied on the advice of their tax advisor in doing so.

*Samarasinghe, TC, CCH Dec. 58,925(M),
FED ¶47,939(M); TRC BUSEXP: 33,506.*

Deductions

A married couple's horse activities did not have a profit objective. Therefore, they were not entitled to deduct their losses from the activity.

*Bronson, TC, CCH Dec. 58,919(M),
FED ¶47,933(M); TRC BUSEXP: 15,150.*

A married couple's claimed capital loss deductions were properly disallowed because the losses were generated by offshore portfolio investment strategy (OPIS) transactions that lacked economic substance and had no purpose other than tax avoidance.

*Blum, TC, CCH Dec. 58,918(M),
FED ¶47,932(M); TRC SALES: 3,168.*

A couple's ownership of an out-of-state cattle ranch was a passive investment. Therefore, their losses were subject to the passive loss limitation under Code Sec. 469. There was little evidence, other than the couple's assertion, that their activities satisfied the 500-hour test or that they participated in ranch activities on a regular, continuous and substantial basis.

*Iversen, TCM, CCHDec. 58,921(M);
TRC REAL: 6,056.10.*

Liens and Levies

The government's subpoena of certain corporations' financial records during litigation about the validity and priority of federal tax liens was not a levy action prohibited by Code Sec. 6330. Therefore, the subpoena was not required to be quashed while the corporations' Collection Due Process (CDP) hearing was pending.

*Benistar Admin. Services, Inc., DC N.Y.,
2012-1 USTC ¶50,154; Benistar Admin
Services, Inc., DC N.Y., 2012-1 USTC ¶50,155;
TRC IRS: 21,054.*

An IRS Appeals officer's determination to sustain a levy against the in-house account

and office manager of a single-owner professional legal services corporation to collect the trust fund recovery penalty was not an abuse of discretion.

*Perrin, TC, CCH Dec. 58,924(M),
FED ¶47,938(M); TRC IRS: 51,056.25.*

The government was entitled to reduce to judgment an individual's unpaid federal income tax liabilities, foreclose federal tax liens and sell his real property. The government could foreclose its tax liens and sell the property even though the individual made the property his homestead because the tax lien attached to the individual's interest in the property and Code Sec. 7403 allows the government to foreclose the liens and sell the property to satisfy the individual's tax liability.

*Poteet, DC N.M., 2012-1 USTC ¶50,149;
TRC IRS: 45,158.*

A bank's mortgage on a delinquent taxpayer's property had priority over a subsequently filed federal tax lien. Absent any provision to the contrary, the priority of federal tax liens is determined by the common-law principle of first in time is first in right.

*HSBC Bank USA, NA v. Jones, Jr., DC Ill.,
2012-1 USTC ¶50,148; TRC IRS: 48,158.10.*

Refund Claims

An individual claim for a refund of the Earned Income Tax Credit (EIC) was dismissed as untimely because she sought to recover overpayments that were deemed to have been paid more than three years before she filed her refund claims.

*Cooper-Igwebuike, DC Ark., 2012-1 USTC
¶50,157; TRC IRS: 36,052.05.*

An individual's claims for a refund of taxes and damages for an IRS agent's alleged breach of regulations and statutes pertaining to refunds were dismissed. The individual was not a resident of the judicial district in which she filed her action and, therefore, her refund claim was dismissed for improper venue. Her other claims were dismissed because she failed to state a cause of action upon which relief could be granted.

*Telford, DC Tex., 2012-1 USTC ¶50,150;
TRC IRS: 45,114.*

Collection Due Process

An IRS Appeals officer's determination to sustain a proposed levy against an individual who raised only frivolous issues in his Collection Due Process (CDP) hearing request was proper. The individual could not contest the underlying tax liabilities at his CDP hearing because he failed to contest notices of deficiency the IRS sent to his last known address and the individual refused to participate in a telephone hearing to discuss collection alternatives.

*Rivas, TC, CCH Dec. 58,922(M),
FED ¶47,936(M); TRC IRS: 51,056.*

Deficiencies and Penalties

The Tax Court properly sustained the IRS's deficiency and penalty determinations based on substitute returns against an individual. The individual's claim that the Tax Court judge was biased towards her was without merit because a judge's comments on lack of evidence and adverse rulings do not constitute bias.

*Brookshire, CA-11, 2012-1 USTC ¶50,153;
TRC LITIG: 6,054.*

The IRS properly imposed penalties for negligence and substantial understatement of income tax on two partnerships whose claimed losses were disallowed because they were generated by transactions lacking economic substance. However, the penalty for gross valuation overstatement was not proper because the underpayment was not attributable to the valuation overstatement, but to the improper deduction.

*Woods, DC Tex., 2012-1 USTC ¶50,147;
TRC PART: 60,552.*

Bankruptcy

A debtor's pre-petition tax liabilities for the three tax years at issue were not dischargeable in bankruptcy because he failed to timely file tax returns for those years.

*In re Hernandez, BC-DC Tex., 2012-1 USTC
¶50,152; TRC FILEIND: 18,102.*

Tax Accounting

A corporation and its subsidiaries were bound by asset allocation agreements they had entered into with the sellers of property they acquired.

*Peco Foods, Inc., TC, CCH Dec. 58,920(M),
FED ¶47,934(M); TRC SALES: 33,062.*