2005 National Income Tax Workbook™

Update

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and
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The Secretary of Agriculture determined that payments under the Conservation Security Program (CSP) are made primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, and providing a habitat for wildlife, and therefore CSP payments can be excluded from income if the other requirements of I.R.C. §126 are met.
The U.S. Department of Agriculture announced that payments under the Conservation Security Program (CSP) are made primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, and providing a habitat for wildlife. That determination is one of the requirements for payments to qualify for exclusion from income under I.R.C. §126 [I.R.C. §126(b)(1)(A)]. The other requirements are the following:

1. The Secretary of Treasury must determine that the program is substantially similar to the conservation programs listed in I.R.C. §126(a)(1) through (8) [I.R.C. §126(a)(9)]. Although the Secretary of Treasury has not made this determination, it is likely the Conservation Security Program is substantially similar to those programs.

2. The payment must be used to pay for a capital improvement [I.R.C. §126(b)(2); Treas. Reg. §16A.126-1(a); Graves v. Commissioner, 89 T.C. 49 (1987)].

3. The improvement for which the payment is made cannot significantly increase the annual income derived from the property [I.R.C. §126(b)(1)(B)]. The regulations [Treas. Reg. §16A.126-1(a)] implement this requirement by limiting the amount that can be excluded to the present value of the greater of the following:
   a. 10% of the average annual income of the affected acreage prior to the improvement, or
   b. $2.50 per affected acre

4. The basis of the improvement does not include the portion of the cost of the improvement that is paid by CSP payments that are excluded from income [I.R.C. §126(e)]. To avoid that exclusion from basis and the recapture rules of I.R.C. §1255, taxpayers can elect to not exclude the payment from income [I.R.C. §126(c)].

Application of the I.R.C. §126 Rules to CSP Payments

CSP payments for stewardship and maintenance of conservation practices that are not for a capital improvement are not eligible for the I.R.C. §126 exclusion. CSP payments that reimburse taxpayers for the cost of capital improvements may be excluded from income under I.R.C. §126 if the other requirements of I.R.C. §126 are met.

Example

Larry Landowner received a $10,000 CSP payment in 2005. The payment was made for the three conservation practices shown in Figure 1.1.

---

**FIGURE 1.1 CSP Payments**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of waterways established in 2005 ($6,000 total cost)</td>
<td>$5,000</td>
</tr>
<tr>
<td>Cost of maintaining waterways and drainage ditches</td>
<td>3,000</td>
</tr>
<tr>
<td>Payment for prior adoption of conservation tillage practices</td>
<td>2,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$10,000</strong></td>
</tr>
</tbody>
</table>

The payments for maintaining waterways and ditches and for the adoption of conservation tillage practices do not qualify for the I.R.C. §126 exclusion because they were not used to pay for a capital improvement. The payment for
the cost of waterways may qualify for exclusion from income under I.R.C. §126 if the CSP is determined to be similar to the conservation programs under I.R.C. §126(a)(1) through (8) and if the waterways do not substantially increase the annual income from the property.

To compute the amount of the CSP payment that is included in income under the formula provided in Treas. Reg. §16A.126-1(c) and illustrated in the examples in Treas. Reg. §16A.126-1(g), the additional facts shown in Figure 1.2 are needed.

**FIGURE 1.2 Additional Facts**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of improvement*</td>
<td>$1,500</td>
</tr>
<tr>
<td>Cost of improvement paid by taxpayer</td>
<td>$1,000</td>
</tr>
<tr>
<td>Affected acres</td>
<td>45</td>
</tr>
<tr>
<td>Present value of $2.50 per acre × 45 acres</td>
<td>$2,250</td>
</tr>
<tr>
<td>Average annual income prior to improvement</td>
<td>$5,625</td>
</tr>
<tr>
<td>Present value of 10% of average annual income</td>
<td>$11,250</td>
</tr>
</tbody>
</table>

*The regulations do not define the term “value of improvement,” but the examples in the regulations imply that it is the increase in the value of the land as a result of the improvement.

The formula provided in Treas. Reg. §16A.126-1(c) results in none of the $5,000 CSP payment for establishing waterways being included in Larry’s income, as shown in Figure 1.3.

**FIGURE 1.3 Amount Included in Gross Income with Exclusion**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of improvement</td>
<td>$6,000</td>
</tr>
<tr>
<td>Non-I.R.C. §126 government payments</td>
<td>(0)</td>
</tr>
<tr>
<td>Compensation for services</td>
<td>(0)</td>
</tr>
<tr>
<td>Current deductions</td>
<td>(0)</td>
</tr>
<tr>
<td>I.R.C. §126 cost</td>
<td>$6,000</td>
</tr>
<tr>
<td>Value of improvement</td>
<td>$1,500</td>
</tr>
<tr>
<td>Multiplier: §126 cost divided by cost of improvement</td>
<td>$11,250</td>
</tr>
<tr>
<td>Value of I.R.C. §126 improvement</td>
<td>$1,500</td>
</tr>
<tr>
<td>Minus taxpayer’s contribution</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Minus excludable portion (greater of $11,250 and $5,625)</td>
<td>(11,250)</td>
</tr>
<tr>
<td>Amount included in gross income</td>
<td>$0</td>
</tr>
</tbody>
</table>

If Larry elected out of the I.R.C. §126 exclusion, he must include $500 of the $5,000 CSP payment for the cost of waterways in income, as shown in Figure 1.4.

**FIGURE 1.4 Amount Included in Gross Income without Exclusion**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of improvement</td>
<td>$6,000</td>
</tr>
<tr>
<td>Non-I.R.C. §126 government payments</td>
<td>(0)</td>
</tr>
<tr>
<td>Compensation for services</td>
<td>(0)</td>
</tr>
<tr>
<td>Current deductions</td>
<td>(0)</td>
</tr>
<tr>
<td>I.R.C. §126 cost</td>
<td>$6,000</td>
</tr>
<tr>
<td>Value of improvement</td>
<td>$1,500</td>
</tr>
<tr>
<td>Multiplier: §126 cost divided by cost of improvement</td>
<td>$11,250</td>
</tr>
<tr>
<td>Value of I.R.C. §126 improvement</td>
<td>$1,500</td>
</tr>
<tr>
<td>Minus taxpayer’s contribution</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Amount included in gross income</td>
<td>$500</td>
</tr>
</tbody>
</table>
New limitations on the deductibility of losses relating to tax-exempt use property were enacted in the American Jobs Creation Act of 2004, P.L. 108-357, which added §470 to the Internal Revenue Code. Under I.R.C. §470(c)(2), tax-exempt use property has the meaning provided under I.R.C. §168(h), with certain modifications. I.R.C. §168(h)(6) provides that if any property that is not otherwise tax-exempt use property is owned by a partnership that has as partners both a tax-exempt entity and a person who is not a tax-exempt entity, and any allocation of partnership items to the tax-exempt entity is not a qualified allocation, an amount equal to the tax-exempt entity’s proportionate share of the property generally is treated as tax-exempt use property. It also provides that similar rules apply to other pass-through entities. I.R.C. §470 generally applies to leases entered into after March 12, 2004.

Notice 2005-29, 2005-13 IRB. 796, provides transition relief to pass-through entities that are treated by I.R.C. §470 as holding tax-exempt use property as a result of the application of §168(h)(6). It states that for taxable years that begin before January 1, 2005, the IRS will not apply I.R.C. §470 to disallow losses associated with property that is treated as tax-exempt use property solely as a result of the application of I.R.C. §168(h)(6).
Abusive transactions involving partnerships and other pass-through entities remain subject to challenge by the IRS under other provisions of the tax law.
[Notice 2006-2, 2006-2 IRB 278]

**BUSINESS ISSUES**

**Employees**

I.R.C. §274(d)

New high-low per diem rates are provided for travel after September 30, 2005.

The high-low per diem rate for travel to a high-cost city increased from $204 to $226, and $58 of that amount is treated as a meal expense. The per diem rate for travel to any other city was increased from $129 to $141, and $45 of that amount is treated as a meal expense.

**Notice 2005-76**
I.R.C. §3402(a)(1)

Because certain nonresident alien (NRA) employees were experiencing overwithholding of income tax on their wages for services performed within the United States, the IRS has reconsidered the requirements for determining the amount of income tax to be withheld under I.R.C. §3402 from the wages of NRA employees. These new rules are designed to provide for withholding that more closely approximates the income tax liability of the NRA.

Beginning with wages paid on or after January 1, 2006, employers are required to calculate income tax withholding under I.R.C. §3402 on wages of NRA employees (except for students and business apprentices from India) using a new procedure. The employer will add an amount to the wages of the NRA employee solely for purposes of calculating the income tax withholding for each payroll period; the specific amount depends on the payroll period. Employers will determine the income tax to be withheld by applying the tables to the sum of the wages.

Law Change—Applicable Date Clarified. The Tax Technical Corrections Act of 2005 provides that in the case of property other than property leased to a tax-exempt entity, only property acquired after March 12, 2004, is treated as tax-exempt use property under I.R.C. §168(h)(6).
paid for the payroll period plus the additional amount. Adding this amount will offset the assumed standard deduction that is incorporated into the tables without requiring income tax to be withheld from wages that will fall below the personal exemption when annualized. The added amount is not income or wages to the employee; it does not affect income, Federal Insurance Contributions Act (FICA) or Federal Unemployment Tax Act (FUTA) tax liability for the employer or the employee, and is not to be reported as income or wages.

The amounts set forth in Figure 1.5 are added purely for purposes of calculating the amount of the income tax withholding on the wages of the NRA employee. These amounts should not be included in any box on the Form W-2, Wage and Tax Statement.

The amount required to be added to the wages of an NRA employee for purposes of calculating income tax withholding is the highest wage amount to which a zero withholding rate applies, as shown in the Table for the Percentage Method of Withholding for a single person (including a head of household) for each payroll period. The tables are published periodically in Publication 15, (Circular E) Employer’s Tax Guide.

For 2006, the amounts required to be added to the wages of an NRA employee for calculating income tax withholding are shown in Figure 1.5.

**FIGURE 1.5** NRA Wage Adjustment for Withholding

<table>
<thead>
<tr>
<th>Payroll period</th>
<th>Add additional</th>
</tr>
</thead>
<tbody>
<tr>
<td>Weekly</td>
<td>$51</td>
</tr>
<tr>
<td>Biweekly</td>
<td>$102</td>
</tr>
<tr>
<td>Semimonthly</td>
<td>$110</td>
</tr>
<tr>
<td>Monthly</td>
<td>$221</td>
</tr>
<tr>
<td>Quarterly</td>
<td>$663</td>
</tr>
<tr>
<td>Semiannually</td>
<td>$1,325</td>
</tr>
<tr>
<td>Annually</td>
<td>$2,650</td>
</tr>
<tr>
<td>Daily or Miscellaneous (each day of the payroll period)</td>
<td>$10.20</td>
</tr>
</tbody>
</table>

Updated tables will be published each year in Publication 15. If intra-year changes in the tables are released, they may appear in other IRS publications.

Thus, in determining the amount of income tax withholding on wages of NRA employees, employers will calculate the amount of wages to be used in applying the applicable income tax withholding tables as follows:

- Employers will add to gross wages (to be included on Form W-2) the additional amount pursuant to the previously described procedure (not included on Form W-2).
- If the employer uses the percentage method, the employer should subtract an amount for withholding allowances for the payroll period, and then apply the percentage method withholding tables to the remainder.
- If the employer uses the wage bracket method, the employer should not subtract an amount for withholding allowance(s), because withholding allowances are reflected in the wage bracket withholding tables. Under the wage bracket method, the employer will apply the wage bracket tables to the sum of the gross wages and the additional amount added pursuant to the chart.

**Example 1.2 Annual Payroll Period**

An NRA employee is receiving wages on an annual payroll period in 2006. The employer is required to add $2,650 to the wages to determine the amount of income tax withholding. Then, if the employer is using the percentage method of withholding, the employer subtracts the applicable amount for withholding allowance(s) and applies the applicable percentage method withholding table for an annual payroll period for single employees. The $2,650 addition is not included on Form W-2. The amount to be added to wages for a payroll period in calculating income tax withholding is the same for each payroll period as long as the employee retains the same payroll period.

Rev. Rul. 2005-74
I.R.C. §61

In one of three situations, an employer’s payment of expenses for selling an employee’s home is taxable compensation to the employee.

Issue
Whether the transactions in the following situations are, for federal tax purposes, a sale of a home by an employee to an employer through the employer’s agent (a relocation management company), followed by a separate sale of that home by the employer to a third-party buyer, or one sale of the home by the employee to the third-party buyer, facilitated by the employer through the relocation management company.

Situation 1
An employer enters into a contract with a relocation management company to provide relocation assistance, including a home purchase program, to employees being relocated to new job sites. Under the contract, the relocation company agrees to act as the employer’s agent in purchasing at fair market value the homes of employees who are being relocated, and then selling the homes to third-party buyers. The employer is liable for all costs incurred by the relocation company in purchasing and selling the homes, and is also liable for any losses incurred by the relocation company on the sale of any home. The employer is entitled to proceeds from the sale of a home in excess of the costs of purchasing the home. In no event will the employer or the relocation company pay an employee any amount representing gain on the subsequent sale of the employee’s home to a third-party buyer. The employer agrees to pay the relocation company a fee for performing these services on its behalf.

Ace is an employee being relocated to another job site. Pursuant to its contract with the employer, the relocation company offers its services under the home purchase program. The purchase price for Ace’s home, determined under an appraisal process, is $500,000. After the settlement date, the relocation company holds itself out as the owner of the home to the general public. It deals with mortgage holders, insurance companies, home maintenance companies, taxing jurisdictions, utility companies, real estate brokers, and other third parties in its own name.

At closing, the relocation company pays Ace the value of the equity in the home ($500,000 purchase price minus any mortgages, liens, or encumbrances assumed), plus any property tax prorations and other customary allocations (such as homeowner association dues). The relocation company pays the settlement costs that are typically imposed on the buyer under local law. Ace, as grantor, transfers the home to the relocation company by executing a deed to the property on which the name of the grantee is left blank (a “blank deed”). The company has the option of inserting its own name as grantee and recording the deed, or inserting the name of a third-party buyer at the time it closes the sale of the home to the third-party buyer.

The company does not insert its name as grantee and does not record the deed. It manages and maintains the property while listing the home for sale through a real estate broker that locates a third-party buyer. The relocation company sells the home to the buyer for $490,000, inserts the buyer’s name in the deed, and conveys legal title to the home to the buyer. Pursuant to the contract between the employer and the relocation company, the employer pays the company’s fee and reimburses it for any costs incurred and for the $10,000 loss on the sale of the home to the third-party buyer.

Situation 2
The facts are the same as in Situation 1, except that the home purchase program also affords an amended value option to employees that are being relocated. In addition to receiving the appraised value offer from the relocation company, an employee who exercises the amended value option may list the home with a real estate broker to market the home to other potential buyers. If the employee exercises the amended value option, the employee must select the broker from a list of qualified brokers maintained by the relocation company. Any listing agreement entered into by the employee must include an exclusion clause that provides that no commission is earned by or due to the broker unless a sale of the home to a third-party buyer closes,
and that a sale of the home to the relocation company terminates the listing agreement without any commission being earned or due.

If a potential third-party buyer makes an offer, the real estate broker refers the offer to the relocation company. If the company determines that the offer is bona fide and exceeds the company’s earlier offer based on the appraisals, the company amends the contract of sale to match the third-party buyer’s offer. If the employee accepts the amended offer by signing the contract of sale, the company then enters into a new listing agreement with a real estate broker, customarily the broker previously selected by the employee, to market the home to a third-party buyer, who may or may not be the same potential buyer who made the previous offer. The employee does not sign any contract, binder, or other document with a third-party buyer, and does not accept any down payment, deposit, or earnest money from a third-party buyer.

The relocation company remits to the employer any proceeds received on the sale of the home to a third-party buyer in excess of the purchase price paid to the employee for the home. In no event does the company or the employer transfer any part of the excess amount to the employee.

If the sale of the home by the relocation company to the third-party buyer does not close, the employee is not obligated under the contract of sale to refund any portion of the purchase price paid to the company. Nothing related to the company’s sale of the home to a third-party buyer affects the employee’s sale of the home to the company.

Chet is an employee being relocated to another job site. In addition to receiving an appraised value offer of $500,000 from the relocation company, Chet exercises the amended value option and lists the home with a qualified real estate broker. As a result of this listing, Chet obtains an offer for $520,000 from a third-party buyer and forwards the offer to the relocation company. The company determines that the $520,000 offer is bona fide and amends its proposed contract of sale to match the offer. Chet accepts the offer by signing the contract of sale at the amended price of $520,000.

The relocation company subsequently pays Chet the value of the equity in the home based on the purchase price of $520,000. Pursuant to the exclusion clause, Chet’s listing agreement with the real estate broker is terminated without any commission being earned or due. The company takes possession of the home and, pursuant to the contract of sale, becomes unconditionally obligated for all maintenance, taxes, insurance, expenses, risks, losses, and costs associated with the home. Chet transfers the home to the relocation company by executing a blank deed to the property. The company leaves the name of the grantee blank and does not record this deed.

The company enters into a new listing agreement with the real estate broker and thereafter enters into a separate sales agreement with the third-party buyer for $520,000. The sales agreement is made in the company’s name. Chet does not sign any contract, binder, or other document with the third-party buyer. The company’s sale of the home to the third-party buyer closes. At closing, the buyer pays $520,000 to the company, the company inserts the buyer’s name on the deed, and the deed is recorded in the third party’s name.

Situation 3
The facts are the same as in Situation 2, except that the employer instead enters into a contract with a different relocation management company to provide relocation assistance to employees being relocated to new job sites. Under the home purchase program provided for in this contract, employees may select an amended value option that has different terms and conditions than the amended value option described in Situation 2. Specifically, the relocation company, acting as the employer’s agent, is not required to offer a higher amended value for an employee’s home, based on an offer from a prospective third-party buyer located by the employee, unless and until the relocation company enters into a sales contract with that third-party buyer. In addition, the employee retains the right to approve or reject any offer or counter-offer made in the course of negotiations between the relocation company and the third-party buyer. Finally, the proceeds representing the higher amended value are distributed to the employee, not to the employer or the relocation company, only if and when the sale to the third-party buyer closes.

Ellen receives an appraised value offer of $500,000 from the relocation company for her
home. She exercises the amended value option and locates a prospective purchaser who offers $510,000 for the home. Ellen informs the relocation company of the $510,000 offer. The company, with Ellen's approval, agrees that it will accept the offer and sell the home to the third-party buyer for $510,000 once it purchases the home from Ellen. The company subsequently closes on the purchase of the home from Ellen for $510,000 and receives a blank deed signed by Ellen. At the closing of the sale of the home to the third-party buyer, the company inserts the buyer’s name on the deed, and it is recorded in the buyer’s name. The company pays Ellen the value of the equity in the home based on the $510,000 sales price.

**Analysis**

Pursuant to a benefits and burdens analysis of the transactions in Situation 1, there are two separate sales of the home. Ace and the relocation company treat the transaction as a sale of the home from Ace to the employer, because the company is acting as the employer’s agent. The employer has the risk of loss due to casualty and is responsible for insuring the home and making any and all necessary repairs to the home.

Any gain on the sale of the home is realized by Ace under I.R.C. §§1001 and 61(a)(3), and none of this amount constitutes taxable compensation to Ace under I.R.C. §61(a)(1). The employer, acting through the relocation company, separately sells the home to the third-party buyer for $490,000.

**Observation—Exclusion of Gain.** Ace may be eligible to exclude all or part of the gain under I.R.C. §121. This ruling focuses only on determining the buyer in each transaction and any employment tax consequences of the transactions.

Applying the benefits and burdens analysis to the transactions in Situation 2, the fact that Chet exercises the amended value option does not alter the conclusion that there are two separate sales of the home. The benefits and burdens of ownership also transfer from Chet to the employer in the sale of the home in Situation 2. Any gain on the sale of the home is realized by Chet under I.R.C. §§1001 and 61(a)(3), and none of this amount constitutes taxable compensation to Chet under I.R.C. §61(a)(1). The employer separately sells the home to the third-party buyer for $520,000.

However, applying the benefits and burdens analysis to the transactions in Situation 3 yields a different result. In Situation 3 the amended value option offered under the contract between the employer and the relocation company acting as the employer’s agent differs significantly from the option described in Situation 2. The sale of Ellen’s home to the relocation company, acting for the employer, at the higher amended price is contingent on the company entering into a contract at that price with the third-party buyer located by Ellen. In addition, Ellen retains the right to approve any offer or counter-offer in any negotiations between the company and the third-party buyer. Therefore, although the employer, through its agent, is burdened with some costs in connection with the transaction, Ellen effectively retains the rights to negotiate the final contract and obtain the benefit of a higher price for the property. See *Amdahl v. Commissioner*, 108 T.C. at 523 [1997] (employer “did not acquire beneficial ownership of the residences of its relocating employees”).

Thus, in Situation 3 the transaction is, for federal tax purposes, one sale of the home from Ellen to the third-party buyer for $510,000, facilitated by the employer through its agent, the relocation company. Any gain on the sale of the home is realized by Ellen under I.R.C. §§1001 and 61(a)(3). Any expenses paid by the employer, directly or through its relocation company agent, with respect to the home, including maintenance costs, taxes, insurance, losses, and other costs associated with the home are considered paid on behalf of Ellen by virtue of Ellen’s employment. Consequently, any such amounts paid by the employer constitute taxable compensation to Ellen under I.R.C. §61(a)(1).

The conclusions in this revenue ruling with respect to Situation 1 and Situation 2 apply to circumstances involving substantially similar relocation service programs. The IRS will follow the Amdahl opinion in circumstances involving relocation service programs that are substantially similar to the programs described in that opinion, and in other circumstances, such as those described in Situation 3, which indicate that the benefits and burdens of ownership of the
employees’ homes are not transferred to the employer. Consistent with the holdings in Situation 1 and Situation 2, the use of a blank deed will not, by itself, cause a program to be treated as substantially similar to the programs described in Amdahl.

**Holdings**

The transactions in Situation 1 and Situation 2 are, for federal tax purposes, sales of a home by an employee to an employer through the employer’s agent, a relocation management company, followed by a separate sale of that home by the employer to a third-party buyer. The transaction in Situation 3 is, for federal tax purposes, one sale of a home by an employee to a third-party buyer, facilitated by the employer through the relocation management company. [Rev. Rul. 2005-74, 2005-51 IRB 1153]

### Health Plans

**Notice 2005-86**

I.R.C. §§125 and 223

 Guidance is provided for employers about amending a cafeteria plan document to enable an employee to become eligible for a health savings account (HSA) during the grace period that allows flexible spending account participants 2½ months after the end of the year to incur qualified expenditures.

### Cafeteria Plans

I.R.C. §125(a) states that, in general, no amount is included in the gross income of a participant in a cafeteria plan solely because the participant may choose among the benefits of the plan. I.R.C. §125(d) defines a cafeteria plan as a written plan under which all participants are employees, and the participants may choose among two or more benefits consisting of cash and qualified benefits. The term qualified benefits means any benefit that is not includable in the gross income of the employee by reason of an express provision of Chapter 1 of the Internal Revenue Code, including employer-provided accident and health coverage under I.R.C. §§106 and 105(b). A high deductible health plan (HDHP), as defined in I.R.C. §223(c)(2)(A), can be employer-provided accident and health coverage. A health flexible spending account (FSA), which pays or reimburses I.R.C. §213(d) medical expenses (other than health insurance or long-term care services or insurance), is also employer-provided accident and health coverage. The term qualified medical expenses as used in this notice means expenses that may be paid or reimbursed under a health FSA.

### Cafeteria Plan Grace Period

Notice 2005-42, 2005-23 IRB 1204, modifies the rule prohibiting deferred compensation under a cafeteria plan (the “use-it-or-lose-it” rule). It permits a cafeteria plan to be amended, at the employer’s option, to provide a grace period immediately following the end of each plan year. An individual who incurs expenses for a qualified benefit during the grace period may be paid or reimbursed for those expenses from the unused benefits or contributions relating to that benefit. The grace period cannot extend beyond the 15th day of the third calendar month after the end of the immediately preceding plan year to which it relates, and may be adopted for a shorter period.

### Interaction between HSAs and Health FSAs

I.R.C. §223(a) allows a deduction for contributions to a health savings account (HSA) for an eligible individual for any month during the taxable year. An eligible individual means, in general, with respect to any month, any individual who is covered under an HDHP on the first day of such month and who is not, while covered under an HDHP, covered under any health plan that is not a high-deductible health plan and that provides coverage for any benefit that is covered under the high-deductible health plan.

A health FSA that reimburses all qualified I.R.C. §213(d) medical expenses without other restrictions is a health plan that constitutes other coverage. Consequently, an individual who is covered by a health FSA that pays or reimburses all qualified medical expenses is not an eligible individual for purposes of making contributions to an HSA. This result is the same even if the individual is covered by a health FSA sponsored by a spouse’s employer.
Options Available to an Employer
An employer may adopt either of the following two options, which will affect participants’ HSA eligibility during the cafeteria plan grace period:

1. General Purpose Health FSA During Grace Period—The employer amends the cafeteria plan document to provide a grace period but takes no other action with respect to the general purpose health FSA. Because a health FSA that pays or reimburses all qualified medical expenses constitutes impermissible other coverage for HSA eligibility purposes, an individual who participated in the health FSA (or a spouse whose medical expenses are eligible for reimbursement under the health FSA) for the immediately preceding cafeteria plan year and who is covered by the grace period, is not eligible to contribute to an HSA until the first day of the first month following the end of the grace period. For example, if the health FSA grace period ends March 15, 2006, an individual who did not elect coverage by a general health FSA or other disqualifying coverage for 2006 is HSA eligible on April 1, 2006, and may contribute 9/12ths of the 2006 HSA contribution limit. The result is the same even if a participant’s health FSA has no unused contributions remaining at the end of the immediately preceding cafeteria plan year.

2. Mandatory Conversion from Health FSA to HSA-compatible Health FSA for All Participants—The employer amends the cafeteria plan document to provide for both a grace period and a mandatory conversion of the general purpose health FSA to a limited purpose or post-deductible FSA (or combined limited purpose and post-deductible health FSA) during the grace period. The amendments do not permit an individual participant to elect between an HSA-compatible FSA or an FSA that is not HSA-compatible. The amendments apply to the entire grace period and to all participants in the health FSA who are covered by the grace period. The amendments must satisfy all other requirements of Notice 2005-42. Coverage of these participants by the HSA-compatible FSA during the grace period does not disqualify participants who are otherwise eligible individuals from contributing to an HSA during the grace period.


FICA Taxes

Notice 2005-85
I.R.C. §3121(x)

☞ The 2006 threshold for domestic wages subject to FICA taxes is $1,500.

The domestic employee coverage threshold amount for 2006 is $1,500. By law, the domestic employee coverage threshold amount for 2006 is equal to the 1995 amount of $1,000 multiplied by the ratio of the national average wage index for 2004 ($35,648.55) to that for 1993 ($23,132.67). If the result is not a multiple of $100, it is rounded to the next lower multiple of $100.
The petitioner had a personal cell phone during 2002 that he also used for business calls. He paid a flat rate, no matter how many phone calls were made on the phone. On his Schedule A, Itemized Deductions, attached to his Form 1040 for 2002, he deducted unreimbursed employee business expenses of $13,980, tax preparation fees of $550, and charitable contributions of $1,755, of which $1,260 was listed as being made by cash or check. The IRS disallowed all of the deductions for lack of substantiation.

The petitioner must show that the business expenses he claimed were incurred primarily for business rather than for personal reasons. To show that an expense was not personal, he must prove that the expense was incurred primarily to benefit his business, for the continuation of his employment, and that there was a proximate relationship between the claimed expense and his business. *Walliser v. Commissioner*, 72 T.C. 433, 437 (1979).

The petitioner’s cell phone was a personal phone that he also used for business calls. The petitioner testified that he paid a flat rate, regardless of phone usage. The personal expense of the phone is nondeductible under I.R.C. §262. He incurred no additional charge for business use.

To the extent he did incur an additional charge for business use, the petitioner’s evidence fails to meet the substantiation requirements of I.R.C. §274(d).

*Ritchie v. Commissioner, T.C. Summary Opinion 2005-181*

**Michael Sklar v. Commissioner**

**Facts**

The petitioners sent their children to Emek Hebrew Academy (Emek) and Yeshiva Rav Isaacsohn Torath Emeth Academy (Yeshiva Rav Isaacsohn), private Orthodox Jewish day schools in the Los Angeles area because they deeply believe that they should provide their children with an Orthodox Jewish education in an Orthodox Jewish environment. They were primarily concerned with the religious component of their children’s education, but they were also interested in the quality of their secular education.

During 1995, Emek and Yeshiva Rav Isaacsohn were exempt from federal income tax under I.R.C. §501(c)(3) and qualified as organizations described in I.R.C. §170(b)(1)(A)(ii) (i.e., an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly conducted).

During 1995, the petitioners paid a total of $27,283 to the schools for tuition, registration and other mandatory fees, and Mishna (after-school Orthodox Jewish education) classes as follows in Figure 1.6.

Practitioner Note—Summary Opinion Is Not Precedent. Pursuant to I.R.C. §7463(b), this opinion may not be treated as precedent for any other case.
The petitioners timely filed their 1995 federal income tax return on October 15, 1996. They deducted $24,421 as a charitable contribution for 1995, including $15,000 that they attributed to the cost of their children’s religious education at Emek and Yeshiva Rav Isacsohn during 1995. That amount ($15,000) is 54.97% (referred to here as 55%) of the total amount of tuition and fees they paid to Emek and Yeshiva Rav Isacsohn during 1995. They did not file a Form 8275 or otherwise describe their payment on their 1995 return. The IRS had the petitioners’ 1994 return under examination when the petitioners filed their 1995 return.

The petitioners filed a petition with the Tax Court challenging the notice of deficiency for 1994. In Sklar v. Commissioner, T.C. Memo 2000-118 (Sklar I), the Tax Court held that they could not deduct as charitable contributions amounts for tuition and fees that they paid for their children’s religious education at Emek and Yeshiva Rav Isacsohn during 1995. That amount ($15,000) was 54.97% (referred to here as 55%) of the total amount of tuition and fees they paid to Emek and Yeshiva Rav Isacsohn during 1995. They did not file a Form 8275 or otherwise describe their payment on their 1995 return. The IRS had the petitioners’ 1994 return under examination when the petitioners filed their 1995 return.

The petitioners filed a petition with the Tax Court challenging the notice of deficiency for 1994. In Sklar v. Commissioner, T.C. Memo 2000-118 (Sklar I), the Tax Court held that they could not deduct as charitable contributions amounts for tuition and fees that they paid for their children’s religious education that year. That decision was affirmed on appeal by the U.S. Court of Appeals for the Ninth Circuit in Sklar v. Commissioner, 282 F.3d 610 (9th Cir. 2002), amending and superseding 279 F.3d 697 (9th Cir. 2002).

### Issues

1. Whether petitioners may deduct as a charitable contribution $15,000 of the $27,283 in tuition and fees they paid in 1995 to Orthodox Jewish day schools for the secular and religious education of their five children, including $175 they paid to one of the schools for Mishna classes. The court held that they may not.

2. Whether petitioners are liable for the accuracy-related penalty for 1995 because they deducted tuition payments for their children’s secular and religious education. The court held that they are not.

### Opinion

Petitioners contend that they may deduct as a charitable contribution $15,000 of the $27,283 they paid to Emek and Yeshiva Rav Isacsohn in 1995. They deducted about 55% of those payments because that was the portion of the school day that each school estimated was devoted to religious studies.

Petitioners must have a charitable intent to be entitled to a deduction under I.R.C. §170 for part of their tuition payments. See Sklar v. Commissioner, supra at 612; see also I.R.C. §170(c); United States v. Am. Bar Endowment, 477 U.S. at 117-118. On the basis of evidence in the record regarding tuition at various Los Angeles area schools the court concluded: (1) Some schools charge more tuition than Emek and Yeshiva Rav Isacsohn, and some charge less; and (2) the amount of tuition the petitioners paid is unremarkable and is not excessive for the substantial benefit they received in exchange (i.e., an education for their children). Thus, the petitioners did not show that any part of their tuition payments was a charitable contribution.

The petitioners contend that, under I.R.C. §§170(f)(8) and 6115 as enacted in 1993, a portion of tuition payments to schools providing a religious and secular education is deductible as a charitable contribution. They argue that if a taxpayer pays $100 to his church and receives in return a book that could be purchased in any bookstore for $20 plus the right to sit in a certain pew at the church, $80 is deductible as a charitable contribution to the church, regardless of whether having the right to sit in that pew is worth $80 or more to the taxpayer, because that right is only an intangible religious benefit. To the extent that the petitioners’ dual payments to the schools exceeded the value of the secular studies they purchased, they argue that those payments are deductible as charitable contributions notwithstanding that they received religious educations for their children worth that excess, because those religious educations are only intangible religious benefits.

The court voiced a belief that if Congress had intended to overturn decades of case law disallowing charitable contribution deductions...

<table>
<thead>
<tr>
<th>Payment</th>
<th>Emek</th>
<th>Yeshiva Rav Isacsohn</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tuition</td>
<td>$16,043</td>
<td>$8,050</td>
</tr>
<tr>
<td>Registration fees</td>
<td>900</td>
<td>400</td>
</tr>
<tr>
<td>Mishna classes</td>
<td>175</td>
<td>0</td>
</tr>
<tr>
<td>Other</td>
<td>1,215</td>
<td>500</td>
</tr>
<tr>
<td>Total</td>
<td>$18,333</td>
<td>$8,950</td>
</tr>
</tbody>
</table>

**FIGURE 1.6**

Payment Emek Yeshiva Rav Isacsohn

- Tuition: $16,043, $8,050
- Registration fees: 900, 400
- Mishna classes: 175, 0
- Other: 1,215, 500
- Total: $18,333, $8,950
for tuition payments to schools providing a religious and secular education, Congress would have made such an intention clear. It did not.

The exception to the substantiation and disclosure requirements in I.R.C. §§170(f)(8) and 6115 for intangible religious benefits applies only where the organization is organized exclusively for religious purposes. The petitioners contend that Emek and Yeshiva Rav Isaacsohn were organized and existed solely for the religious purpose of allowing Jewish parents to fulfill their religious obligation to teach their children Torah, which includes providing a secular education in an Orthodox Jewish environment.

The court disagreed, finding that Emek and Yeshiva Rav Isaacsohn were organized and operated to provide both a secular and a religious education. Both schools were granted exemptions from tax under I.R.C. §501(c)(3), and both schools qualify as charitable organizations described in I.R.C. §170(b)(1)(A)(ii), which pertains to educational organizations. A substantial part of each day was spent on secular studies. The petitioners concede that the education their children received in 1995 at Emek and Yeshiva Rav Isaacsohn met educational requirements imposed by the state of California. Both schools were accredited by nonreligious accrediting agencies based in part on their secular educational programs.

The petitioners contend that Emek and Yeshiva Rav Isaacsohn were organized exclusively as religious organizations because the respondent excused both from filing Form 990, Return of Organization Exempt from Income Tax. The court disagreed, stating that the IRS may relieve any exempt organization from filing a return where the IRS determines that filing is not necessary to the efficient administration of the internal revenue laws. [I.R.C. §6033(a)(2)(B)]

Conclusion
The petitioners are not entitled to a charitable contribution deduction under I.R.C. §170 for any part of the tuition, including the fee for Mishna classes, they paid to Emek or Yeshiva Rav Isaacsohn in 1995.

The petitioners’ 1994 return was being audited when they timely filed their 1995 return pursuant to an extension on October 15, 1996. Petitioners filed their petition in Sklar I on January 27, 1997. Decision was entered in that case on April 5, 2000, and affirmed early in 2002. Thus, when they filed their 1995 return, petitioners knew that the respondent had allowed them to claim similar deductions for 1991–1993, and they knew their 1994 return was being audited; but they did not know they would not prevail on this issue for 1994. Under these circumstances, the court concluded that the petitioners had a reasonable basis for claiming the deductions that were disallowed, and that they believed in good faith that they could deduct the $15,000 for tuition and Mishna payments on their 1995 return.

[Michael Sklar v. Commissioner, 125 T.C. No. 14]

IR-2005-132
I.R.C. §179A

Under current law, the clean-burning fuel deduction is limited to up to $2,000 for certified vehicles first put into service in 2005. This one-time deduction must be taken in the year the vehicle is originally used. The taxpayer must be the original owner. Individuals do not have to itemize deductions on their tax return to claim this deduction. This benefit can be taken as an adjustment to income on the Form 1040.

The deduction for the purchase of a hybrid vehicle expires on December 31, 2005, under §1348 of the Energy Act of 2005. The deduction has been replaced by a tax credit found in I.R.C. §30B, the Alternative Motor Vehicle Credit.

The complete list of vehicle models that have been certified for the clean-burning fuel deduction is as follows:

- Ford Escape Hybrid—model year 2006
- Mercury Mariner Hybrid—model year 2006
- Lexus RX 400h—model year 2006
- Ford Escape Hybrid—model year 2005
- Toyota Prius—model years 2001 through 2005
- Toyota Highlander Hybrid—model year 2006
Some charities have sold donated vehicles at auction and claimed that the sales are to needy individuals at prices significantly below fair market value (FMV). By doing so, these charities have claimed that the sales trigger an exception to the general rule that the deduction allowed to the donor is limited to the proceeds from the charity’s sale.

The IRS’s position is that vehicles sold at auction are not sold at prices significantly below FMV. Therefore, the IRS will not treat vehicles sold at auction as qualifying for the exception for sales to needy individuals at prices below FMV.

If a charity sells a donated vehicle at auction, the IRS will not accept as substantiation an acknowledgment from the charity stating that the vehicle is to be transferred to a needy individual for significantly below FMV (box 5b on IRS Form 1098-C). In such cases, the donor may claim a deduction of more than $500 only to the extent that the gross proceeds from the sale exceed that amount and the donor substantiates the contribution with an acknowledgment from the charity that indicates the gross proceeds from the sale (box 4c on IRS Form 1098-C).

Because the exception for sales to needy individuals does not apply to sales at auction, a charity may be subject to penalties under I.R.C. §§6701 and 6720 if the charity sells a donated vehicle at auction and provides to the donor an acknowledgment that indicates anything other than the deduction may not exceed the gross proceeds from the sale. [IR-2005-145, December 20, 2005]
Procedure

General

Additional disclosure of the items set forth below is unnecessary for purposes of reducing any understatement of income tax under I.R.C. §6662(d) (except as otherwise provided in item 3 below concerning Schedules M-1 and M-3), provided that the forms and attachments are completed in a clear manner and in accordance with their instructions.

The money amounts entered on the forms must be verifiable, and the information on the return must be disclosed in the manner described below. A number is verifiable if, on audit, the taxpayer can demonstrate the origin of the number (even if that number is not ultimately accepted by the IRS) and the taxpayer can show good faith in entering that number on the applicable form.

The disclosure of an amount is not adequate when the understatement arises from a transaction between related parties. If an entry may present a legal issue or controversy because of a related-party transaction, then that transaction and the relationship must be disclosed on Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement.

Where the amount of an item is shown on a line that does not have a preprinted description identifying that item (such as on an unnamed line under an “Other Expense” category) the taxpayer must clearly identify the item by including the description on that line. For example, to disclose a bad debt for a sole proprietorship, the words “bad debt” must be written or typed on the line of Schedule C that shows the amount of the bad debt. Also, for Schedule M-3, Part II, line 26, Other income (loss) items with differences, or Part III, line 35, Other expense/deduction items with differences, the entry must provide descriptive language (for example, “Cost of non-compete agreement deductible not capitalizable”). If space limitations on a form do not allow for an adequate description, the description must be continued on an attachment.

Although a taxpayer may literally meet these disclosure requirements, the disclosure will have no effect for purposes of the I.R.C. §6662 accuracy-related penalty if the item or position on the return (1) does not have a reasonable basis as defined in Treas. Reg. §1.6662-3(b)(3); (2) is attributable to a tax shelter item as defined in I.R.C. §6662(d)(2) and Treas. Reg. §1.6662-4(g); or (3) is not properly substantiated or the taxpayer failed to keep adequate books and records with respect to the item or position. See Treas. Reg. §1.6694-2(c) regarding limitations on the effectiveness of a disclosure regarding the I.R.C. §6694 return preparer penalty.

Items

1. Form 1040, Schedule A, Itemized Deductions:

   a. Medical and Dental Expenses: Complete lines 1 through 4, supplying all required information.

   b. Taxes: Complete lines 5 through 9, supplying all required information. Line 8 must list each type of tax and the amount paid.

   c. Interest Expenses: Complete lines 10 through 14, supplying all required information. This procedure does not apply to (i) amounts disallowed under I.R.C. §163(d) unless Form 4952, Investment Interest Expense Deduction, is completed, or (ii) amounts disallowed under I.R.C. §265 (interest relating to tax-exempt income).

   d. Contributions: Complete lines 15 through 18, supplying all required information. Enter the amount of the contribution reduced by the value of any substantial benefit (goods or services) provided by the donee organization in consideration, in whole, or in part. Entering the value of the contribution unreduced by the value of the benefit received will not constitute adequate disclosure. If a contribution of $250 or more is made, this procedure will not apply unless a contemporaneous written acknowledgment, as required by I.R.C. §170(f)(8), is obtained from the donee organization. If a contribution of property other than cash is made and the amount claimed as a deduction exceeds
$500, attach a properly completed Form 8283, Noncash Charitable Contributions, to the return. In addition to the Form 8283, if a contribution of a qualified motor vehicle, boat, or airplane has a value of more than $500, this procedure will not apply unless a contemporaneous written acknowledgment, as required by I.R.C. §170(f)(12), is obtained from the donee organization and attached to the return. An acknowledgment under I.R.C. §170(f)(8) is not required if an acknowledgment under I.R.C. §170(f)(12) is required.

e. Casualty and Theft Losses: Complete Form 4684, Casualties and Thefts, and attach to the return. Each item or article for which a casualty or theft loss is claimed must be listed on Form 4684.

2. Certain Trade or Business Expenses (including, for purposes of this section, the following six expenses as they relate to the rental of property):

a. Casualty and Theft Losses: Complete Form 4684, Casualties and Thefts, and attach to the return. Each item or article for which a casualty or theft loss is claimed must be listed on Form 4684.

b. Legal Expenses: The amount claimed must be stated. This procedure does not apply, however, to amounts properly characterized as capital expenditures, personal expenses, or nondeductible lobbying or political expenditures, including amounts that are required to be (or that are) amortized over a period of years.

c. Specific Bad Debt Charge-off: The amount written off must be stated.

d. Reasonableness of Officers’ Compensation: Form 1120, Schedule E, Compensation of Officers, must be completed when required by its instructions. The time devoted to business must be expressed as a percentage as opposed to “part” or “as needed.” This procedure does not apply to golden parachute payments, as defined under I.R.C. §280G, and it will not apply to the extent that remuneration paid or incurred exceeds the $1 million-employee-remuneration limitation, if applicable.

e. Repair Expenses: The amount claimed must be stated. This procedure does not apply, however, to any repair expenses properly characterized as capital expenditures or personal expenses.

f. Taxes (other than foreign taxes): The amount claimed must be stated.

3. Differences in book and income tax reporting.

a. Form 1120, Schedule M-1, Reconciliation of Income (Loss) per Return, and

b. Form 1120, Schedule M-3, Net Income (Loss) Reconciliation for Corporations with Total Assets of $10 Million or More: Column (b), Temporary Difference, and Column (c), Permanent Difference, of Part II, (reconciliation of income (loss) items) and Part III (reconciliation of expense/deduction items).

The information provided must be expected to reasonably apprise the IRS of the nature of the potential controversy concerning the tax treatment of the item. If the information provided does not so apprise the IRS, a Form 8275 or Form 8275-R, must be used to adequately disclose the item (see Part II of the instructions for those forms).

Note: An item reported on a line with a preprinted description, shown on an attached schedule, or “itemized” on Schedule M-1 may represent the aggregate amount of several transactions producing that item (for example, a group of similar items, such as amounts paid or incurred for supplies by a taxpayer engaged in business). In some instances, the potentially controversial item may involve a portion of the amount disclosed on the schedule. The IRS will not be reasonably apprised of the potential controversy by the amount disclosed. In these instances, the taxpayer must use Form 8275 or Form 8275-R regarding that portion of the item.

The combining of unlike items, whether on Schedule M-1 or Schedule M-3 (or on an attachment when directed by the instructions), will not constitute an adequate disclosure.

4. Foreign Tax Items:

a. International Boycott Transactions: Transactions disclosed on Form 5713, International Boycott Report, Schedule A,
International Boycott Factor (Section 999(c)(1)); Schedule B, Specifically Attributable Taxes and Income (Section 999(c)(2)); and Schedule C, Tax Effect of the International Boycott Provisions, must be completed when required by their instructions.

b. Treaty-Based Return Position: Transactions and amounts under I.R.C. §6114 or §7701(b) as disclosed on Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b).

5. Other:
   a. Moving Expenses: Complete Form 3903, Moving Expenses, and attach to the return.
   b. Employee Business Expenses: Complete Form 2106, Employee Business Expenses, or Form 2106-EZ, Unreimbursed Employee Business Expenses, and attach to the return. This procedure does not apply to club dues, or to travel expenses for any non-employee accompanying the taxpayer on the trip.
   c. Fuels Credit: Complete Form 4136, Credit for Federal Tax Paid on Fuels, and attach to the return.
   d. Investment Credit: Complete Form 3468, Investment Credit, and attach to the return.

Effective Date
This revenue procedure applies to any return filed on a 2005 tax form for a taxable year beginning in 2005, and to any return filed on a 2005 tax form in 2006 for a short taxable year beginning in 2006.

CCA 200542034
I.R.C. §6695

☞ A return preparer penalty for failing to retain a copy or list of returns prepared should be assessed against an S corporation if its sole shareholder is an employee of the corporation under common-law rules. If the shareholder isn’t an employee, the penalty should be assessed against the shareholder directly.

Facts
An S corporation is in the business of tax return preparation. It has one shareholder and at least one employee. Both the shareholder and an employee have signed returns as the preparer. The shareholder has prepared the majority of the returns that the corporation prepared for clients. About half of the returns the shareholder signed included the name and EIN of the corporation. The shareholder signed the other returns using only her name and social security number.

The IRS conducted an audit of the corporation and summoned returns and bills required to be maintained pursuant to I.R.C. §6107(b) from the shareholder for 2 taxable years. The court ordered her to produce her bills to clients. The shareholder produced records pertaining to approximately 400 returns, which were incomplete in some respects. The IRS’s computer records indicate that the shareholder and S corporation prepared approximately 1,500 returns during the years at issue. The IRS then assessed the penalty under I.R.C. §6695(d) for the remaining approximately 1,100 returns against the shareholder and the S corporation separately.

Issue
Whether the income tax return preparer for purposes of applying the penalty is an S corporation or the sole owner of the S corporation who signed most of the returns.

Conclusion
The penalty under I.R.C. §6695(d) should be assessed against the S corporation if the shareholder is an employee of the S corporation under common-law rules. If the shareholder is not an employee, the penalty should be assessed against the shareholder directly.

Law and Analysis
I.R.C. §6107(b) requires an income tax return preparer to retain a completed copy of the return or claim, or retain, on a list, the name and taxpayer identification number of the taxpayer for whom the return or claim was prepared and to make the copy or list available for inspection upon request by the IRS for a period of 3 years after the close of the return period.

A person who fails to comply with I.R.C. §6107(b) is subject to a penalty of $50 for each
failure, unless it is shown that the failure is due to reasonable cause and not due to willful neglect [I.R.C. §6695(d)]. The maximum penalty imposed on any person with respect to any return period is $25,000.

An income tax return preparer is any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of any return of income tax or any claim for refund of income tax [I.R.C. §7701(a)(36)(A), Treas. Reg. §301.7701-15(a)]. The general rule is that where there is an employment arrangement between two or more income tax return preparers, the person who employs (or engages) one or more other persons to prepare for compensation any return or claim for refund (other than for the person) shall be considered to be the sole income tax return preparer [Treas. Reg. §1.6107-1(c)].

In this case, the S corporation employed at least one employee other than the shareholder to prepare tax returns. Because the corporation employs agents or employees to prepare income tax returns for compensation, the corporation is an income tax return preparer with respect to those returns or claims for refund for purposes of I.R.C. §§6107(b) and 6695(d).

With respect to the returns that the shareholder prepared, the issue of who is subject to the I.R.C. §6695(d) penalty depends upon whether the corporation employed the shareholder. This is determined under the common-law rules applicable in determining the employer-employee relationship. Some cases have held that where a sole shareholder of an S corporation is the “central worker” of the corporation and performs more than minor services for the corporation, the sole shareholder should be treated as an employee.

If facts reveal that there was an employer-employee relationship between the corporation and the shareholder for some or all of the returns the shareholder signed, then with respect to those returns, the penalty under I.R.C. §6695(d) should only be asserted against the corporation. If facts show that there was no employer-employee relationship for some or all of the returns the shareholder signed, then with respect to those returns, the penalty under I.R.C. §6695(d) should only be asserted against the shareholder as the actual preparer. If the S corporation did not employ the shareholder, then the shareholder should be considered the preparer because she prepared the returns for compensation.

The fact that the shareholder signed the majority of the returns does not bear on the test for determining whether the shareholder is an employee.

[CCA 200542034, Release Date: 10/21/2005]

Estate of Robert J. Capehart v. Commissioner
I.R.C. §§6015 and 6662

The Tax Court determined the spouse’s share of a deficiency.

Facts
The parties agree that the joint return filers have a federal income tax deficiency of $8,225 and are liable for a $507 accuracy-related penalty under I.R.C. §6662(a) for 1994. The IRS agrees that the wife is entitled to relief under I.R.C. §6015(c). The issue for decision concerns the computation of the portion of the deficiency allocable to the wife under I.R.C. §6015(d).

Discussion
As a general rule, spouses filing joint federal income tax returns are jointly and severally liable for all taxes due [I.R.C. §6013(d)(3)]. I.R.C. §6015 provides three alternative grounds for granting relief from joint and several liability.

1. I.R.C. §6015(b) provides for traditional relief from joint and several liability for a tax deficiency following the model of former I.R.C. §6013(e).
2. I.R.C. §6015(c) provides for an allocation of liability for a tax deficiency.
3. I.R.C. §6015(f) provides for relief from liability for any unpaid tax or deficiency on equitable grounds, but only if I.R.C. §6015(b) and (c) do not apply.

Under I.R.C. §6015(c)(3), if spouses who filed a joint return are no longer married or are legally separated, the requesting spouse may elect to limit his or her liability to the portion of
the deficiency allocated to him or her as provided in I.R.C. §6015(d).

The parties agree that the Form 4797 loss and the theft loss are “erroneous items” that are attributable equally to each spouse. If they had filed separate returns, each would have reported one-half of the losses on their respective separate returns. The erroneous items giving rise to the deficiency totaled $42,565.

Because all erroneous items giving rise to the deficiency for 1994 are attributed equally to each spouse, under the general rule, the wife would be liable for one-half of the deficiency ($4,112.50). See I.R.C. §6015(d)(1), (3)(A); Treas. Reg. §1.6015-3(d)(4)(i)(A).

The excess of the amount of the deduction from the erroneous items attributed to an individual over his or her share of income reported on the joint return may give rise to a tax benefit to the individual’s spouse by offsetting the income reported on the joint return that the spouse would have reported had he or she filed a separate return. Consequently, the excess is allocated to the individual’s spouse to the extent it reduces the spouse’s share of income reported on the joint return. However, I.R.C. §6015(d)(3)(B) provides that an item attributable to one spouse must be allocated to the other spouse “to the extent the item gave rise to a tax benefit on the joint return” to the other spouse. In essence, it provides for a reallocation to the extent one spouse received a tax benefit on a joint return and the other spouse did not.

The wife’s erroneous items ($21,282.50) thus are first allocated to her to the extent of the $14,204 of income reported on the joint return that she would have reported on a separate return. The $7,078.50 excess of petitioner’s erroneous items over her share of the income reported on the joint return is then allocated to her spouse.

The portion of the deficiency allocable to petitioner can be algebraically expressed as follows:

\[
X = \frac{\text{deficiency} \times \text{net amount of erroneous items allocable to the spouse}}{\text{net amount of all erroneous items}}
\]

where X is the portion of the deficiency allocable to petitioner. Thus, $2,744.69 is the portion of the $8,225 deficiency allocable to petitioner, computed as follows:

\[
2,744.69 = \frac{8,225 \times 14,204}{42,565}
\]

The wife asserts that her liability should be limited to $2,134, the amount she would have paid on taxable income of $14,204 had she filed a separate return. Her theory assumes that erroneous items cannot be allocated in a way that would result in a spouse’s owing more tax than if separate returns had been filed. Neither the statute nor the regulations provide for such a limitation.

**Conclusion**

Pursuant to I.R.C. §6015(c), the wife remains jointly and severally liable for $2,745 of the deficiency and $116 of the accuracy-related penalty under I.R.C. §6662.

[*Estate of Robert J. Capehart v. Commissioner*, 125 T.C. No. 10]

**Procedure**

**IR-2005-144**

I.R.C. §7528

- The IRS announced increases in selected user fees for 2006.

The Office of Management and Budget has directed federal agencies to charge user fees reflecting the full cost of goods or services “that convey special benefits to recipients beyond those accruing to the general public.” The new IRS user structure will more accurately reflect the costs of processing various applications, ruling requests and opinion letters. The fee increases affect a limited population of taxpayers and tax-exempt entities with technical questions or procedural issues.

The revised user fees will be effective February 1, 2006, except as noted. Among the changes:

- The fee for IRS Chief Counsel private letter rulings will increase from $7,500 to $10,000. However, taxpayers earning less than $250,000 can request a private letter ruling.
for a reduced fee of $625, while a fee of $2,500 will apply to requests from taxpayers earning from $250,000 to $1 million.

- The fee for requests for changes in accounting methods for businesses will increase from $1,500 to $2,500.

- For corporate taxpayers, the cost of a pre-filing agreement will increase from the previous three-tiered structure, which was capped at $10,000, to a new flat fee of $50,000. Also, Advance Pricing Agreements, which previously cost from $5,000 to $25,000, will now cost from $22,500 to $50,000.

- For employee plans, fees for opinion letters on prototype IRAs, SEPs, SIMPLE IRAs, and Roth IRAs, which were previously $125 to $2,570, will now range from $200 to $4,500. Fees for exempt organizations rulings, which previously cost $155 to $2,570, will now range from $275 to $8,700.

Some other user fees in the exempt organizations and employee plans area will increase July 1. This includes user fees for exempt organization applications and requests for group exemption letters, which currently range from $150 to $500 and will increase to $300 to $900.


[IR-2005-144, December 19, 2005]

TD 9239
I.R.C. §§6011 and 6302

☞ New Form 944 replaces Form 941 for eligible employers and is filed only once a year.

The IRS issued temporary and proposed regulations that may significantly reduce the tax-filing burden for nearly 950,000 small business owners. Beginning January 1, 2006, certain employment tax filers will be able to file the new Form 944, Employer’s Annual Federal Tax Return, once a year rather than filing Form 941, Employer’s Quarterly Federal Tax Return, four times a year.

Eligible employers are those with estimated annual employment tax liability of $1,000 or less. The IRS will begin mailing notification letters between February 1 and February 15, 2006, to eligible small employers for calendar year 2006. Employers who do not receive a letter and believe they are eligible to file the new Form 944 can call the IRS at (800) 829-0115 to find out if they qualify. Taxpayers should contact the IRS by April 1, 2006.

New employers who expect to owe $1,000 or less in total annual employment tax (approximately $4,000 or less in annual wages) also are eligible to file Form 944. These employers can indicate their estimated tax amount when applying for their EIN (Employer’s Identification Number) on Form SS-4. The IRS will notify the employer to file either Form 944 or Form 941 in the same notice indicating the taxpayer’s new EIN.

The new Form 944 and instructions will be available on the IRS Web site at www.IRS.gov by January 31, 2006.
[TD 9239; REG-148568-04, published January 3, 2006]

Sorrentino v. IRS
I.R.C. §§7502 and 7422

☞ A taxpayer must make a threshold showing of proper and timely mailing to invoke the rebuttable presumption of the common-law mailbox rule.

On October 3, 2005, the U.S. Supreme Court declined to review the 10th Circuit Court of Appeals’ holding in this case, reversing a U.S. District Court (Colorado) opinion. The 10th Circuit’s holding is summarized below.

Facts
The IRS granted Rolly and Joann Sorrentino a 4-month extension of time until August 15, 1995, to file their 1994 Form 1040 income tax return. The taxpayers, apparently awaiting an IRPOL report from the IRS, maintain they mailed their 1994 return to the IRS via regular U.S. Postal
Service mail in early March 1998, 2½ years after its due date. On their return, the taxpayers claimed a refund of $8,551 based on excess wage withholding during the 1994 taxable year. The IRS maintained it had no record of receiving the taxpayers’ 1994 return until October 1998, and it disallowed the refund claim as untimely.

Analysis
The district court had held that the taxpayers were entitled to a rebuttable presumption that they timely filed their refund claim for the 1994 tax year upon proof that they properly mailed their 1994 tax return in time for it to be delivered to the IRS before their August 15, 1998, deadline for filing a refund claim.

Mr. Sorrentino testified that he properly mailed the 1994 return in early March 1998, which provided more than ample time in the ordinary course of the mail for the return to reach the IRS before the August 15 deadline. His account of an early March mailing is supported by the March 1 signature date on the photocopied return the IRS acknowledges receiving and by Mr. Sorrentino’s testimony that he followed up on the status of the return before the October 2, 1998, filing date asserted by the IRS.

The court explained that the common-law mailbox rule is well settled that if a letter properly directed is proved to have been either put into the post office or delivered to the postman, it is presumed, from the known course of business in the post office department, that it reached its destination at the regular time, and was received by the person to whom it was addressed. The court also stated that it did not believe that in enacting I.R.C. §7502, Congress intended to foreclose application of a presumption of delivery in those cases in which the postmark requirements of the section can be conclusively established.

But it noted that the only evidence the taxpayer presented was his own self-supporting testimony at trial. The couple, who have a history of filing belated returns, offered no independent proof of a postmark or any evidence of mailing apart from Mr. Sorrentino’s testimony. The court stated they bore the burden of making a meaningful evidentiary showing of “proper and timely” mailing before invoking the mailbox rule presumption.

Allegations of mailing are easy to make and hard to disprove, the court explained. Because the taxpayer, not the IRS, controls the mailing of a tax return, the taxpayer, not the IRS, has access to any evidence demonstrating the return has been mailed. The taxpayer is in the best position with the clock running to protect himself by procuring independent evidence of postmark and/or mailing, whether by mail receipt, corroborating testimony, or otherwise. This is especially true where a refund or credit is involved because no canceled check will exist to verify receipt.

In their respective depositions, the taxpayers stated they signed and dated their 1994 joint return on March 1, 1998. This was not found particularly probative of “proper and timely” mailing. Importantly, Mrs. Sorrentino offered no proof—she did not mail the return or see Mr. Sorrentino prepare the return for mailing or take the return to the post office. Mr. Sorrentino could not recall the specific date he mailed the return, but stated he mailed it to the IRS, postage affixed, sometime during the first five days of March 1998. He did not use certified or registered mail and he did not see any postal worker stamp a postmark on the envelope. Mr. Sorrentino further stated that in September 1998, over 6 months after mailing his return, he contacted the IRS to inquire on the status of the refund. When informed the IRS had no record of receiving the return, he faxed the IRS a copy of the return that was stamped “Received 10-2-98, IRS, Austin Texas.” This testimony, without corroborating evidence, is insufficient to raise a presumption the IRS received the taxpayers’ 1994 tax return prior to October 2, 1998.

Holding
The appellate court reversed the judgment of the district court and remanded the case with instructions to dismiss the taxpayers’ refund suit for want of subject matter jurisdiction. [Sorrentino v. Commissioner, 383 F.3d 1187 (10th Cir. 2004)]
IRS Issues

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TD 9229
I.R.C. §6081

Taxpayers can file a single request for an automatic 6-month extension to file certain tax returns.

Rationale for Change
Currently, most taxpayers other than corporations can receive a full 6-month extension of time to file their income tax returns, but to obtain the full 6-month extension they must file one application for an initial extension of time and then file a second application to obtain an extension for the balance of the 6 months. Requiring taxpayers to file two different forms to obtain the full 6-month extension creates an unnecessary burden on taxpayers and the IRS, and it can cause unnecessary confusion.

To reduce the complexity of the current extension process, and to provide cost savings and other benefits to taxpayers and the IRS, these temporary regulations simplify the extension process by allowing certain taxpayers to file a single request for an automatic 6-month extension of time to file certain returns. Because the extension is automatic, these taxpayers do not need to sign the extension request or provide an explanation of the reasons for requesting an extension.

An automatic extension under the temporary regulations does not extend the time for payment of tax. Accordingly, taxpayers must make a proper estimate of any tax due. While no payment of tax is required in order to obtain the extension, failure to pay any tax as of the original due date of the return may subject the taxpayer to penalties and interest.

Individual Taxpayers
The temporary regulations provide an automatic 6-month extension to taxpayers who must file an individual income tax return if they submit a timely, completed application for extension on Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return. Taxpayers do not have to sign the request or explain why an extension is needed in order to receive the automatic 6-month extension of time to file.

Corporate Taxpayers
These temporary regulations do not change the rules regarding filing extensions for corporate income tax returns. Currently, corporations may obtain an automatic 6-month extension of time to file their income tax returns by submitting Form 7004, Application for Automatic Extension of Time to File Corporation Income Tax Return. Corporations do not have to sign the extension request or give a reason for their request.

Although these regulations do not change the rules regarding filing extensions for corporations, they do change the title and appearance of Form 7004. Taxpayers filing certain other types of returns will now also use Form 7004 to request an automatic 6-month extension of time to file. The new Form 7004 will be titled Application for Automatic 6-Month Extension of Time to File Certain Business Income Tax, Information, and Other Returns and will apply to a larger number of returns than the prior form.

Partnership, REMIC, and Certain Trust Taxpayers
Prior regulations required partnerships, real estate mortgage investment conduits (REMICs), and certain trusts to request 3-month automatic extensions of time to file by submitting Form 8736, Application for Automatic Extension of Time to File U.S. Return for a Partnership, REMIC, or for Certain Trusts. These entities could then file a second request for an additional 3-month extension of time to file on Form 8800, Application for Additional Extension of Time to
File U.S. Return for a Partnership, REMIC, or for Certain Trusts.

To promote simplified extension procedures, the temporary regulations allow these taxpayers to file an automatic 6-month extension of time to file on one application, the new Form 7004. These taxpayers do not have to sign the Form 7004 or provide an explanation for their request in order to receive the automatic 6-month extension. Forms 8736 and 8800 have been obsoleted by these regulations.

Pass-through Entities

The 6-month automatic extension of time to file set forth in these temporary regulations applies to returns of pass-through entities, such as Form 1065 for partnerships. The Treasury Department and the IRS recognize that because the 6-month automatic extension is available for returns of pass-through entities, some taxpayers may not receive information returns from the pass-through entities that they need in order to complete their own income tax returns before those returns are due. This filing anomaly existed under prior regulations when the pass-through entity received an extension of time to file to a date on or after the extended due date for the pass-through interest holder, but the automatic 6-month extension in these regulations may cause this to happen with more frequency.

Because of this filing anomaly, the availability of a 6-month extension of time to file for pass-through entities may result in taxpayers filing an increased number of amended income tax returns. Therefore, it may be appropriate for pass-through entities to have a shorter extension period than their partners or shareholders. The Treasury Department and the IRS request comments on whether a shorter extension of time to file for pass-through entities might reduce overall taxpayer burden.

The Treasury Department and the IRS encourage pass-through entities that request an extension of time to file to minimize the impact that such extension might have on their partners’ or members’ ability to timely file (with an extension) their own tax returns.

Transition Rule

These temporary regulations are effective for applications for an automatic extension of time to file certain returns filed after December 31, 2005. Therefore, the temporary regulations apply to applications for extension of time to file tax year 2005 returns. In addition, these temporary regulations apply to applications for extension of time to file tax year 2004 returns for certain fiscal year taxpayers because these returns are due after December 31, 2005. Although these fiscal-year taxpayers should continue to use the tax year 2004 extension forms, the IRS will grant a 6-month extension of time to file if an extension request made on one of these forms would otherwise qualify under these temporary regulations, except for use of the specified form.

Certain Employee Plan Returns

These temporary regulations also allow administrators and sponsors of employee benefit plans subject to the Employee Retirement Income Security Act of 1974 (ERISA) to report information concerning the plans and direct filing entities to use a new version of Form 5558, Application for Extension of Time To File Certain Employee Plan Returns, for an automatic 2½-month extension of time to file. Under these regulations, Form 5558 no longer requires taxpayers to provide a signature or an explanation of the need for the extension of time to file.

Gift Tax Returns

Under I.R.C. §6075(b)(2), individuals who make a transfer by gift and who request an automatic extension of time to file the individual’s income tax return are deemed to have an extension of time to file the return required by I.R.C. §6019. The temporary regulations also allow donors who do not request an extension of time to file an income tax return to request an automatic 6-month extension of time to file Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, by filing a new version of Form 8892, Payment of Gift/GST Tax and/or Application for Extension of Time to File Form 709. Under these regulations, Form 8892 no longer requires a signature or an explanation of the need for the extension of time to file.

[TD 9229, November 4, 2005]
Tax Forms and Publications

The following forms and publications for claiming various Katrina-related tax benefits will be issued by the IRS. As of January 4, 2005, final versions were not yet posted on the IRS Web site.

Publication 4492, Information for Taxpayers Affected by Hurricanes Katrina, Rita, and Wilma

Form 5884-A, Hurricane Katrina Employee Retention Credit

Form 8914, Exemption Amount for Taxpayers Housing Individuals Displaced by Hurricane Katrina

Form 8915, Qualified Hurricane Katrina Retirement Plan Distributions and Repayments

Notice 2005-92

§§101 and 103 of the Katrina Emergency Tax Relief Act of 2005 (KETRA)

A qualified individual is an individual whose principal place of abode on August 28, 2005, is located in the Hurricane Katrina disaster area as defined in §2(1) of KETRA and who has sustained an economic loss by reason of Hurricane Katrina. The term “Hurricane Katrina disaster area” as set forth in §2(1) means the entire states of Louisiana, Mississippi, Alabama, and Florida.

A Katrina distribution is any distribution from an eligible retirement plan made on or after August 25, 2005, and before January 1, 2007, to a qualified individual. Section 101(b) of KETRA limits the amount of distributions that can be treated as Katrina distributions to no more than $100,000.

Qualified Hurricane Katrina Distributions

A qualified individual may designate a distribution described above as a Katrina distribution. This designation may be made with respect to any distribution that would meet the requirements of a Katrina distribution without regard to whether the distribution was on account of Hurricane Katrina. Thus, periodic payments and required minimum distributions received by a qualified individual from an eligible retirement plan on or after August 25, 2005, and before January 1, 2007, are permitted to be treated as Katrina distributions. Similarly, any distribution received by a qualified individual as a beneficiary can be treated as a Katrina distribution. In addition, a reduction or offset of a participant’s account balance in order to repay a plan loan, as described in Q&A-9(b) of Treas. Reg. §1.402(c)-2, is permitted to be treated as a Katrina distribution.

However, any amount described in Q&A-4 of Treas. Reg. §1.402(c)-2 is not permitted to be treated as a Katrina distribution. Thus, the following amounts are not Katrina distributions: corrective distributions of excess contributions under I.R.C. §415, excess elective deferrals under I.R.C. §402(g), excess contributions under I.R.C. §401(k), excess aggregate contributions under I.R.C. §401(m), loans that are treated as deemed distributions pursuant to I.R.C. §72(p), dividends paid on applicable employer securities under I.R.C. §404(k), and the costs of current life insurance protection.
The definition of a Katrina distribution does not limit the designation of a Katrina distribution to amounts withdrawn solely to meet a need arising from Hurricane Katrina. Thus, even though a qualified individual is required to have sustained an economic loss, Katrina distributions are permitted without regard to the qualified individual’s need, and the amount of the distribution is not required to correspond to the amount of the economic loss suffered by the qualified individual.

An employer retirement plan is also permitted to treat the plan distribution as a Katrina distribution. It is possible that a qualified individual’s designation of a Katrina distribution may be different from the employer retirement plan’s treatment of the distribution. This different treatment could occur, for example, if a qualified individual has more than one plan distribution that meets the requirements of a Katrina distribution. This different treatment could also occur if a qualified individual has distributions from more than one eligible retirement plan.

Subject to certain exceptions, distributions from an eligible retirement plan that satisfy the requirements of a Katrina distribution may be included in income ratably over 3 years and are not subject to the 10% additional tax under I.R.C. §72(t). However, only a Katrina distribution that is eligible for tax-free rollover treatment under I.R.C. §402(c) is permitted to be reconverted to an eligible retirement plan, and such reconversion will be treated as having been made in a direct rollover to that eligible retirement plan. Thus, periodic payments and required minimum distributions are not permitted to be reconverted to an eligible retirement plan even though those distributions are permitted to be treated as Katrina distributions. In the case of a distribution from an IRA, only a Katrina distribution that is eligible for rollover treatment under I.R.C. §408(d)(3) is permitted to be reconverted to an eligible retirement plan. Thus, required minimum distributions are not permitted to be reconverted to an eligible retirement plan. Any Katrina distribution (whether from an employer retirement plan or an IRA) paid to a qualified individual as a beneficiary of an employee or IRA owner (other than the surviving spouse of the employee or IRA owner) cannot be reconverted.

In general, a distribution from an employer retirement plan made on account of hardship is not an eligible rollover distribution. However, a Katrina distribution that satisfies the requirements of this notice is not treated as made on account of hardship for purposes of this notice and, thus, any portion of the distribution is permitted to be reconverted to an eligible retirement plan.

An individual’s principal place of abode is where the individual lives unless temporarily absent due to special circumstances. A temporary absence from the household due to special circumstances, such as illness, education, business, vacation, or military service, will not change an individual’s principal place of abode. See Treas. Reg. §§1.2-2, 1.152-1(b), and 1.152-2(a)(2)(ii) for information relating to a temporary absence from a principal place of abode. If an individual’s principal place of abode was in the Hurricane Katrina disaster area immediately before August 28, 2005, and the individual evacuated because of Hurricane Katrina, the individual’s principal place of abode will be considered to be in the Hurricane Katrina disaster area on August 28, 2005.

Guidance for Employer Retirement Plans
Katrina distributions are generally treated as satisfying certain plan distribution restrictions. Thus, an employer is permitted to expand the distribution options under its plan to allow an amount attributable to an elective, qualified non-elective, or qualified matching contribution under a qualified cash or deferred arrangement to be distributed as a Katrina distribution even though the distribution is before an otherwise permitted distributable event, such as severance from employment, disability, or attainment of age 59 1/2. Otherwise, the requirements for when plan distributions are permitted to be made from employer retirement plans are not changed. For example, a qualified plan that is a pension plan is not permitted to make in-service distributions merely because the distribution, if made, would qualify as a Katrina distribution. In addition, a pension plan is not permitted to make a distribution under a distribution form that is not a qualified joint and survivor annuity without spousal consent merely because the dis-
distribution, if made, could be treated as a Katrina distribution.

If a distribution is treated as a Katrina distribution by an employer retirement plan, the rules for eligible rollover distributions under I.R.C. §§401(a)(31), 402(f), and 3405 are not applicable with respect to the distribution. Thus, the plan is not required to offer the qualified individual a direct rollover with respect to the distribution. In addition, the plan administrator does not have to provide an I.R.C. §402(f) notice. Finally, the plan administrator or payor of the Katrina distributions is not required to withhold an amount equal to 20% of the distribution, as is usually required under I.R.C. §3405(c)(1). A Katrina distribution is subject to the voluntary withholding requirements of I.R.C. §3405(b) and Temp. Treas. Reg. §35.3405-1T.

The total amount of distributions treated by an employer as Katrina distributions under its retirement plans with respect to a qualified individual is not permitted to exceed $100,000. For purposes of this rule, the term employer means the employer maintaining the plan and those employers required to be aggregated with the employer under I.R.C. §414(b), (c), (m), or (o). However, a plan will not fail to satisfy eligibility requirements merely because a qualified individual’s total Katrina distributions exceed $100,000, taking into account distributions from IRAs or other eligible retirement plans maintained by unrelated employers.

The IRS will issue guidance in the future relating to plan amendments for KETRA. An employer retirement plan will not be treated as failing to operate in accordance with its terms merely because the plan implements the provisions of §§101 and 103 of KETRA if the plan sponsor amends its plan by the applicable dates. For employer retirement plans other than a governmental plan, the date by which any plan amendment to reflect KETRA is required to be made will not be earlier than the last day of the first plan year beginning on or after January 1, 2007. For governmental plans under I.R.C. §414(d), the date by which any plan amendment to reflect KETRA is required to be made will not be earlier than the last day of the first plan year beginning on or after January 1, 2009.

Recontributions of Katrina Distributions

An eligible retirement plan must report the payment of a Katrina distribution to a qualified individual on Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. This reporting is required even if the qualified individual reconverted the Katrina distribution to the same eligible retirement plan in the same year. If a payor is treating the payment as a Katrina distribution and no other appropriate code applies, the payor is permitted to use distribution code 2 (early distribution, exception applies) in box 7 of Form 1099-R. However, a payor is also permitted to use distribution code 1 (early distribution, no known exception) in box 7 of Form 1099-R.

In general, a qualified individual who receives a Katrina distribution that is eligible for tax-free rollover treatment is permitted to reconvert, at any time in a 3-year period, any portion of the distribution to an eligible retirement plan that is permitted to accept eligible rollover contributions. The relief in Q&A-14 of Treas. Reg. §1.401(a)(31)-1 applies to an employer retirement plan accepting reconverted Katrina distributions. A plan administrator accepting the reconverted Katrina distribution must reasonably conclude that the reconverted distribution is eligible for direct rollover treatment under §101(c) of KETRA and that the reconverted distribution is made in accordance with the rules of this notice. A plan administrator may rely on the reasonable representations of a qualified individual with respect to the individual’s principal place of abode on August 28, 2005, and whether the individual suffered an economic loss by reason of Hurricane Katrina, unless the plan administrator has actual knowledge to the contrary.

Individuals Receiving Katrina Distributions

A qualified individual receiving a Katrina distribution is entitled to favorable tax treatment with respect to the distribution. Qualified individuals will use Form 8915, Qualified Hurricane Katrina Retirement Plan Distributions and Repayments, to report any reconverted distribution made during the taxable year and to determine the amount of the Katrina distribution includible in income for the taxable year. A qualified individual is permitted to designate a qualifying distribution as a Katrina
distribution provided the total amount treated by the individual as Katrina distributions does not exceed $100,000.

There are two methods for a qualified individual to include in income the taxable portion of a Katrina distribution. First, a qualified individual who receives a Katrina distribution is permitted to include the taxable portion of the amount of the distribution in income ratably over a 3-year period that begins in the year of the distribution. Second, a qualified individual is permitted to elect out of the 3-year ratable income inclusion and include the entire amount of the taxable portion of the Katrina distribution in income in the year of the distribution. All Katrina distributions received in a taxable year must be treated consistently (either all distributions are included in income over a 3-year period or all distributions are included in income in the current year). If a qualified individual uses the 3-year ratable income inclusion method, the method cannot be changed after the timely filing of the individual’s tax return (including extensions) for the year of the distribution.

**Recontribution Reporting**

If a Katrina distribution is eligible for tax-free rollover treatment, a qualified individual is permitted, at any time in the 3-year period beginning the day after the date of a Katrina distribution, to recontribute any portion of the distribution, but not in excess of the amount of the taxable portion of the Katrina distribution in income in the year of the distribution. All Katrina distributions received in a taxable year must be treated consistently (either all distributions are included in income over a 3-year period or all distributions are included in income in the current year). If a qualified individual includes a Katrina distribution in gross income in the year of the distribution and recontributes the distribution to an eligible retirement plan after the timely filing of the individual’s tax return for the year of the distribution, the individual will need to file an amended tax return. The qualified individual will need to file a revised Form 8915 with his or her amended return to report the amount of the recontribution and should reduce his or her gross income by the amount of the recontribution, but not to exceed the amount of the Katrina distribution.

If a qualified individual includes a Katrina distribution ratably over a 3-year period and the individual recontributes any portion of the Katrina distribution to an eligible retirement plan at any date before the timely filing of the individual’s tax, the amount of the recontribution will reduce the ratable portion of the Katrina distribution that is includible in gross income for the tax year of the filed return.

If a qualified individual using the 3-year ratable income inclusion method recontributes an amount of a Katrina distribution for a taxable year that exceeds the amount which is otherwise includible in gross income for the tax year of the filed return, the excess amount of the recontribution is permitted to be carried forward to reduce the amount of the Katrina distribution that is includible in gross income in the next taxable year. Alternatively, the qualified individual is permitted to carry back the excess amount of the recontribution to a prior taxable year or years in which the individual included income attributable to a Katrina distribution. The individual will need to file an amended return for the prior taxable year or years to report the amount of the recontribution on Form 8915 and reduce his or her gross income by the excess amount of the recontribution.

**Other Rules**

If a qualified individual dies before the full taxable amount of the Katrina distribution has been included in gross income, then the remainder must be included in gross income for the taxable year that includes the individual’s death.

In the case of an individual receiving substantially equal periodic payments from an eligible retirement plan, the receipt of a Katrina distribution from that plan will not be treated as a change in substantially equal payments as described in I.R.C. §72(t)(4) merely because of the Katrina distribution.
Plan Loans
Special rules apply to a loan made from a qualified employer plan (as defined in Treas. Reg. §1.72(p)-1, Q&A-2) to a qualified individual on or after September 24, 2005 (the day after the date of enactment of KETRA) and before January 1, 2007. KETRA §103(a) changes the limits under I.R.C. §72(p)(2)(A), increasing the $50,000 aggregate limit to $100,000 and changing the 50% limit on the aggregate amount of loans to 100% of the employee’s vested accrued benefit.

If a qualified individual has an outstanding loan from a qualified employer plan on or after August 25, 2005, KETRA provides that if the due date for any repayment with respect to the loan occurs during the period beginning on August 25, 2005, and ending on December 31, 2006, the due date shall be delayed for 1 year. In addition, any subsequent repayments shall be appropriately adjusted to reflect the delay and any interest accruing for such delay, and the period of delay shall be disregarded in determining the 5-year period and the term of the loan under I.R.C. §72(p)(2)(B) and (C). Thus, an employer is permitted to choose to allow this delay in loan repayments under its plan with respect to a qualified individual, and, as a result, there will not be a deemed distribution to the individual under I.R.C. §72(p).

This notice provides that a safe harbor under a qualified employer plan will be treated as satisfying the requirements of I.R.C. §72(p) if a qualified individual’s obligation to repay a plan loan is suspended under the plan for any period beginning not earlier than August 25, 2005, and ending not later than December 31, 2006 (suspension period). The loan repayments must resume upon the end of the suspension period, and the term of the loan may be extended by the duration of such suspension period. If a qualified employer plan suspends loan repayments during the suspension period, the suspension will not cause the loan to be deemed distributed even if, due solely to the suspension, the term of the loan is extended beyond 5 years. Interest accruing during the suspension period must be added to the remaining principal of the loan. A plan satisfies these rules if the loan is repaid thereafter by amortization in substantially level installments over the remaining period of the loan. If an employer, under its plan, chooses to permit a suspension period that is less than the suspension period described above, the employer is permitted to extend subsequently the suspension period, but not beyond December 31, 2006. [Notice 2005-92, 2005-51 IRB 1165]
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GULF OPPORTUNITY ZONE ACT OF 2005 (GOZA)  Public Law 109-135, enacted December 22, 2005, amends the Internal Revenue Code to establish tax benefits for a Gulf Opportunity Zone (GO Zone) in the Hurricane Katrina disaster area. It also extends certain tax benefits already available to businesses and individuals in the Hurricane Katrina disaster area to victims of hurricanes Rita and Wilma. In addition, the legislation includes technical corrections to 10 laws enacted from 1987 through 2005.
Charitable Contributions  
Act §201; New I.R.C. §1400S  
Effective retroactively to September 24, 2005

KETRA allows an individual to deduct qualified contributions up to 100% of adjusted gross income (AGI) and corporations to deduct qualified corporate contributions up to 100% of taxable income. Qualified contributions are cash contributions made during the period beginning August 28, 2005, and ending December 31, 2005, to a qualified charitable organization. Qualified contributions by a corporation must be made for relief efforts related to Hurricane Katrina. Contributions of noncash property, such as securities, are not qualified contributions. Qualified contributions also do not include a contribution to a segregated fund or account if the donor (or any person appointed or designated by the donor) has, or reasonably expects to have, advisory privileges with respect to distributions or investments because of the donor’s status as a donor.

GOZA codifies the KETRA provisions and extends the definition of qualified contributions in the case of corporations to include contributions made on or after September 23, 2005, for relief efforts related to Hurricane Rita and Hurricane Wilma.

Low-Income Housing Eligibility  
Act §101; New I.R.C. §1400M  
Effective for tax years ending on or after August 28, 2005

For tenancy beginning during a 6-month period starting on the date when an individual was displaced by Hurricane Katrina, operators of qualified low-income residential rental projects may rely on statements made by prospective tenants who were displaced by reason of Hurricane Katrina for determining whether an individual satisfies the income limitations for qualified low-income residential rental projects.

Education Credits  
Act §102; New I.R.C. §1400O  
Effective for taxable years beginning during 2005 and 2006

Prior Law

The Hope credit is a nonrefundable credit of up to $1,500 per student per year for qualified tuition and related expenses paid for the first 2 years of a student’s postsecondary education in a degree or certificate program. The Hope credit rate is 100% of the first $1,000 of qualified tuition and related expenses and 50% of the next $1,000 of qualified tuition and related expenses.

The lifetime learning credit is equal to 20% of qualified tuition and related expenses incurred during the taxable year. Up to $10,000 of qualified tuition and related expenses per taxpayer return are eligible for the credit, so that the maximum credit per taxpayer return is $2,000. A taxpayer may claim the lifetime learning credit for an unlimited number of taxable years.

The maximum amount of the lifetime Learning credit does not vary based on the number of students in the taxpayer’s family—that is, the Hope credit is computed on a per student basis, whereas the lifetime learning credit is computed on a family-wide basis.

Explanation of Provisions

GOZA temporarily expands the Hope and lifetime learning credits for students attending (enrolled and paying tuition at) an eligible education institution located in the GO Zone.

- The Hope credit is increased to 100% of the first $2,000 in qualified tuition and related expenses and 50% of the next $2,000 of qualified tuition and related expenses, for a maximum credit of $3,000 per student.
- The lifetime learning credit rate is increased from 20% to 40%.
GOZA expands the definition of qualified expenses to mean qualified higher education expenses under the rules relating to qualified tuition programs, including certain room and board expenses for at least half-time students.

**Planning Pointer—Location of School.** This benefit also is available to families throughout the nation. The key is that the student must enroll at a higher education institution located in the GO Zone.

**Combat Pay**

Act §302; I.R.C. §32  
Effective for 2006

Under prior law, combat pay that is otherwise excluded from gross income under I.R.C. §112 is treated as earned income for calculating the refundable portion of the child tax credit. In addition, for tax years ending before 2006, a taxpayer may elect to treat nontaxable combat pay as earned income for purposes of the earned income credit.

GOZA extends the earned income credit election for 1 year, through December 31, 2006.

**Suspension of Interest**

Act §303; I.R.C. §6404  
Generally effective as if included in the American Jobs Creation Act of 2004, except that the restart of the 18-month period is effective for documents provided on or after December 22, 2005

**Prior Law**

The Internal Revenue Code suspends the accrual of certain penalties and interest starting 18 months after the filing of an individual tax return if the IRS has not sent a notice specifically stating the taxpayer’s liability and the basis for the liability within the specified period. If the return is filed before the due date, it is treated as filed on the due date. Interest and penalties resume 21 days after the IRS sends the required notice to the taxpayer. The provision does not apply where a taxpayer has self-assessed the tax. The suspension applies only to taxpayers who file a timely tax return. It applies only to individuals and does not apply to the failure to pay penalty, in the case of fraud, or with respect to criminal penalties.

The suspension of interest does not apply to interest accruing after October 3, 2004, with respect to underpayments resulting from listed transactions or undisclosed reportable transactions.

On October 27, 2005, the IRS announced a settlement initiative for 21 identified transactions (Announcement 2005-80). Participants in the settlement are required to pay 100% of the taxes owed, plus interest and, depending on the transaction, either a quarter or a half of the penalty the IRS will otherwise seek. The penalty relief will be granted for transactions disclosed to the IRS or where the taxpayer got a tax opinion from an independent tax advisor. Transaction costs paid by the taxpayer, including professional and promoter fees, will be allowed. The application deadline for the settlement initiative is January 23, 2006.

**Explanation of Provision**

GOZA extends the interest suspension exception for listed transactions and undisclosed reportable transactions to interest accruing on or before October 3, 2004. However, taxpayers will remain eligible for the prior-law suspension of interest in three circumstances:

- The year in which the underpayment occurred is barred by the statute of limitations or by a closing agreement as of December 14, 2005.
- The IRS determines that the taxpayer acted reasonably and in good faith with respect to the transaction.
- The taxpayer is participating in the IRS settlement initiative (previously described) as of January 23, 2006. A taxpayer’s eligibility under this rule is revoked if the taxpayer ceases to participate in the settlement initiative or the Treasury determines that a settlement agreement will not be reached within a reasonable period of time.

The special rule applies on a transaction-by-transaction basis. Thus, participation in the settlement initiative with respect to an individual transaction qualifies the taxpayer for the prior-law suspension of interest only with respect to
interest and penalties on underpayments resulting from that transaction.

GOZA also provides that if a taxpayer files an amended return or other signed written document showing that the taxpayer owes an additional amount of tax for the taxable year, the 18-month period is measured from the latest date on which the documents were provided.

**Gulf Coast Recovery Bonds**

**Act §301**

Effective December 22, 2005

GOZA expresses the sense of Congress that the Treasury Department should designate one or more series of U.S. savings bonds or savings certificates as Gulf Coast Recovery bonds in response to hurricanes Katrina, Rita, and Wilma.

**Undercover Operations**

**Act §304; I.R.C. §7608**

Effective December 22, 2005

IRS undercover operations are exempt from certain statutory restrictions controlling the use of government funds, thus permitting the IRS to use proceeds from an undercover operation to pay additional expenses incurred in the undercover operation. The IRS is required to conduct a detailed financial audit of these undercover operations and to provide an annual audit report to the Congress. The exemption expires December 31, 2005.

GOZA extends for 1 year, through December 31, 2006, the authority of the IRS to use proceeds from undercover operations to pay additional expenses incurred in conducting undercover operations.

**Disclosure**

**Act §305; I.R.C. §6103**

Effective for disclosures after December 31, 2005

Three disclosure programs were extended for one year:

1. The IRS may disclose taxpayer identity information and signatures to a state to carry out a combined federal and state employment tax-reporting program. The federal disclosure restrictions, safeguard requirements, and criminal penalties for unauthorized disclosure and unauthorized inspection do not apply to disclosures or inspections made pursuant to this authority. The authority for this program was scheduled to expire December 31, 2005. GOZA extends for 1 year, through December 31, 2006, the prior-law authority for the combined employment tax-reporting program.

2. The IRS may disclose returns and return information for purposes of investigating terrorist incidents, threats, or activities, and for analyzing intelligence concerning terrorist incidents, threats, or activities. The term “terrorist incident, threat, or activity” is statutorily defined to mean an incident, threat, or activity involving an act of domestic terrorism or international terrorism, as both of those terms are defined in the USA Patriot Act. In general, returns and taxpayer return information must be obtained pursuant to an ex parte court order. Other return information generally is available upon a written request meeting specific requirements. The IRS also is permitted to make limited disclosures of such information on its own initiative to the appropriate federal law enforcement agency. The authority for these disclosures was scheduled to expire December 31, 2005. GOZA extends for 1 year, through December 31, 2006, the prior-law terrorist activity disclosure provisions.

3. The IRS may disclose to the Department of Education (but not to contractors thereof) a taxpayer’s filing status, adjusted gross income, and identity information (i.e., name, mailing address, taxpayer identifying number) to establish an appropriate repayment amount for an income-contingent student loan repayment program. This disclosure authority also was scheduled to expire after December 31, 2005. GOZA extends for 1 year, through December 31, 2006, the prior-law authority to disclose return information for purposes of the income-contingent loan repayment.
GOZA includes 22 pages of amendments to 10 prior tax bills and the Internal Revenue Code. This section excerpts only a few of these corrections. Except as otherwise provided, GOZA’s technical and clerical corrections take effect as if included in the original legislation to which each amendment relates.

Domestic Production Deduction
Act §403; I.R.C. §199
Effective for tax years beginning after December 31, 2004

Explanation of Provisions

1. The American Jobs Creation Act of 2004 provided a Form W-2 wage limitation on the allowable amount of the domestic production activities deduction, but it did not specify whether the employees must be the common-law employees of the taxpayer. GOZA clarifies that a taxpayer may take into account only wages that are paid to the common-law employees of the taxpayer and that are reported on a Form W-2 filed with the Social Security Administration no later than 60 days after the extended due date for the Form W-2.

2. In computing qualified production activities income, the domestic production activities deduction itself is not an allocable deduction.

3. The term “domestic production gross receipts,” as it relates to construction performed in the United States and engineering or architectural services performed in the United States for construction projects in the United States, refers only to gross receipts derived from the construction of real property by a taxpayer engaged in the active conduct of a construction trade or business, or from engineering or architectural services performed with respect to real property by a taxpayer engaged in the active conduct of an engineering or architectural services trade or business. It does not include gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of land.

4. Gross receipts derived from certain contracts (or subcontracts) to manufacture or produce property for the federal government are derived from the sale of such property and, therefore, are domestic production gross receipts.

5. For purposes of determining the domestic production gross receipts of a partnership and its partners, if all of the interests in the capital and profits of the partnership are owned by members of the same expanded affiliated group at all times during the taxable year of the partnership, then the partnership and all members of that expanded affiliated group are treated as a single taxpayer during such period. The treatment of the partners and the partnership as a single taxpayer under this rule is only for the purpose of determining domestic production gross receipts.

6. With respect to the domestic production activities of a partnership or S corporation, the deduction is determined at the partner or shareholder level. In performing the calculation, each partner or shareholder generally will take into account his or her allocable share of the components of the calculation (including domestic production gross receipts; the cost of goods sold allocable to such receipts; and other expenses, losses, or deductions allocable to such receipts) from the partnership or S corporation as well as any items relating to the partner or shareholder’s own qualified production activities, if any.

7. In applying the effective date of the I.R.C. §199 deduction, items arising from a taxable year of a partnership, S corporation, estate, or trust beginning before 2005 are not taken into account when determining the deduction at the shareholder, partner, or similar level, or when applying the wage limitation with respect to such entities.
8. A patron who receives certain payments from an agricultural or horticultural cooperative that are attributable to qualified production activities income is allowed a deduction equal to the portion of the deduction allowed to the cooperative that is attributable to such income. The patron’s deduction is allowed in the year that the payment attributable to qualified production activities income is received. The cooperative’s taxable income is not reduced under I.R.C. §1382 by the portion of the payment that does not exceed the portion deductible by the patron.

9. Agricultural or horticultural marketing cooperatives are treated as having manufactured, produced, grown, or extracted any qualifying production property marketed by the organization that its patrons have manufactured, produced, grown, or extracted. For purposes of the I.R.C. §199 deduction, an agricultural or horticultural cooperative is a cooperative engaged in the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural products, or in the marketing of agricultural or horticultural products.

10. GOZA clarifies the definition of an expanded affiliated group so that a corporation eligible for the deduction with respect to income of a subsidiary must own more than 50%, rather than 50% or more, of the subsidiary’s stock by vote and value.

11. The deduction under I.R.C. §199 is the same in computing alternative minimum taxable income (AMTI) as in computing the regular tax, except that in the case of a corporation, the taxable income limitation is the corporation’s AMTI.


13. The manufacturing deduction is not taken into account in computing any net operating loss or the amount of any net operating loss carryback or carryover. Thus, the deduction cannot create, or increase, the amount of a net operating loss deduction. The manufacturing deduction also is not taken into account in determining the amount of the alternative tax net operating loss deduction.

14. GOZA coordinates the computation of adjusted taxable income of a corporation for purposes of computing a corporation’s limitation on the deduction for interest on certain indebtedness with the deduction under I.R.C. §199. It also coordinates the computation of taxable income for purposes of computing a corporation’s charitable contribution deduction and a taxpayer’s deduction for percentage depletion with respect to oil and gas wells with the deduction under I.R.C. §199.

S Corporations
Act §403, 411, 413; I.R.C. §§1361, 1367, 1371
GOZA repeals the election requirement for a family to be treated as one shareholder for determining the number of shareholders for purposes of subchapter S. It also provides that the determination of whether a common ancestor is more that six generations removed from the youngest generation of shareholders is made at the latest of the following dates:

- The date the subchapter S election is made
- The date a family member first holds stock in the S corporation, or
- October 22, 2004

The estate of a family member also is treated as a member of the family for purposes of determining the number of shareholders, and the provision relating to certain adopted individuals and foster children is conformed to the Working Families Tax Relief Act of 2004.

The 2004 Jobs Act provision for the transfer of suspended S corporation losses incident to divorce is effective for transfers after December 31, 2004.

GOZA also clarifies the adjustment of earnings and profits and stock basis when the LIFO (last in, first out) recapture tax applies. The LIFO recapture amount is included in the income of a corporation that becomes an S corporation for its last taxable year that it was a C corporation. Any increase in tax by reason of this inclusion is payable in four equal annual installments. The technical correction provides that the rules relating to the prohibition on adjustments of earnings and profits of an S corporation and the requirement to reduce the basis
of stock of the S corporation by reason of nonde-
deductible expenses do not apply to the LIFO tax. No inference is intended as to the treatment of other corporate taxes.

Additionally, GOZA provides that an S cor-
poration and a qualified subchapter S subsidiary are recognized as separate entities for purposes of filing information returns.

Other Provisions

Income Averaging
Act §403; I.R.C. §55
GOZA clarifies that in computing the regular tax for purposes of determining the alternative mini-
mum tax of a farmer or fisherman using income averaging, the foreign tax credit does not need to be recomputed.

Reforestation Expenditures
Act §403; I.R.C. §194
GOZA clarifies that the amortization provision for reforestation expenditures applies to both trusts and estates, but the deduction applies just to estates (and not to trusts). In addition, GOZA expands I.R.C. §1245 to provide recapture rules for the I.R.C. §194 expensing provisions.

Sales Tax Deduction
Act §403; I.R.C. §164
GOZA clarifies that the itemized deduction for state and local sales taxes does not apply in cal-
culating alternative minimum taxable income.

Sale of Residence
Act §403; I.R.C. §121
The exclusion of gain on the sale or exchange of a principal residence is denied to a taxpayer who acquired the residence within the prior 5 years in an I.R.C. §1031 transaction in which gain was not recognized. GOZA clarifies that the denial also applies during the 5-year period for a sale by a subsequent owner whose basis in the resi-
dence is determined with reference to its basis in the hands of the prior owner.

Tax-Exempt Use Property
Act §403; I.R.C. §470
The Jobs Creation Act of 2004 established rules to limit deductions that are allocable to tax-
exempt use property (I.R.C. §470), which generally define “tax-exempt use property” by refer-
ence to the definition provided in I.R.C. §168(h). I.R.C. §168(h) generally provides that tax-
exempt use property includes tangible property that is leased to a tax-exempt entity, as well as certain property owned by a partnership that both has a tax-exempt partner and provides for certain special allocations.

GOZA clarifies that the deduction limitation rules apply without regard to whether the tax-
exempt use property is treated as such by reason of a lease or otherwise (for example, because the property is owned by a partnership that has a tax-exempt partner and provides for special allo-
cations). If property is treated as tax-exempt use property other than by reason of a lease, GOZA clarifies that the deduction limitation rules generally are effective for property acquired after March 12, 2004.

Nonqualified Deferred Compensation
Act §403; I.R.C. §§26, 409A
GOZA clarifies that the additional tax and inter-
est assessed under the nonqualified deferred compensation provisions are not treated as pay-
ments of regular tax for alternative minimum tax purposes. It also clarifies that the rule providing that certain additional deferrals must be for a period of not less than 5 years is not limited to the first payment for which deferral is made.

Uniform Definition of Child
Act §404; I.R.C. §§152, 21, 223
Conforming amendments are made to provisions for health savings accounts, the dependent care credit, and dependent care assistance programs that allow an individual to qualify as a dependent for these limited purposes without regard to whether the individual has gross income that exceeds an otherwise applicable gross income limitation or is married and files a joint return. An individual who is treated as a dependent under these provisions is not subject to the general rule that a dependent is treated as having no depen-
dents for the applicable tax year.

In addition, GOZA amends I.R.C. §152(e) to again require a written declaration by a divorced or legally separated custodial parent to waive his or her right to claim a child as a dependent for purposes of the dependency exemption deduc-
tion and child credit (but not with respect to other child-related tax benefits). By means of the waiver, the noncustodial parent is granted the right to claim the child as a dependent for these purposes. The provision clarifies that the waiver rules under the uniform definition of qualifying child operate as under prior law.

Practitioner Note—Practitioner Note—Change from 2005 Workbook. An observation in the 2005 National Income Tax Workbook, on page 505, stated that there was no special child tax credit rule for divorced or separated parent. GOZA clarifies that releasing the child’s exemption deduction also releases the child tax credit. GOZA also retroactively removes the Working Families Tax Relief Act provision that would have allowed a post-1984 divorce decree or other court order that was not signed by the custodial parent to be used in lieu of Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents. The prior law rules for a custodial parent’s release of the exemption are restored. The pre-1985 decree rule for a noncustodial parent paying at least $600 in support is also still in effect.

Practitioner Note—Disaster Areas. Lists of counties and parishes included in each disaster area can be found on the Federal Emergency Management Agency (FEMA) website at http://www.fema.gov/.

Small Timber Producers
Act §101; New I.R.C. §1400N
GOZA doubles the $10,000 expensing limit under I.R.C. §194 for reforestation expenditures paid or incurred by qualified small timber producers (those whose aggregate holdings of qualified timber property do not exceed 500 acres at any time during the taxable year). The additional deduction applies during the following periods:

- On or after August 28, 2005, and before January 1, 2008, with respect to qualified timber property any portion of which is located in the GO Zone
- On or after September 23, 2005, and before January 1, 2008, with respect to qualified timber property any portion of which is located in the Rita GO Zone and no portion of which is located in the Gulf Opportunity Zone
- On or after October 23, 2005, and before January 1, 2008, with respect to qualified timber property any portion of which is located in the Wilma GO Zone

The increased deduction is limited to the amount of reforestation expenditures paid or incurred during the relevant portion of the taxable year.

Provisions for Taxpayers Affected by Hurricanes Katrina, Rita, or Wilma

Definitions of “Gulf Opportunity Zone,” “Rita GO Zone,” and “Wilma GO Zone”
Act §101; New I.R.C. §1400M
Effective for tax years ending on or after August 28, 2005

Explanation of Provisions
New I.R.C. §1400M creates three economic opportunity zones:
- The Gulf Opportunity Zone (GO Zone) is the portion of the Hurricane Katrina disaster area that was determined to warrant individual or individual and public assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.
- The Rita GO Zone is the portion of the Hurricane Rita disaster area that was determined to warrant individual or individual and public assistance.
- The Wilma GO Zone is the portion of the Hurricane Wilma disaster area that was determined to warrant individual or individual and public assistance.

Many of the tax benefits created by GOZA through new I.R.C. §§1400N, 1400O, and 1400P are limited to the GO Zone (Katrina).
Example 2.1 Timing of Expenditures
Douglas Fir incurred $20,000 of reforestation expenditures in June 2005 and $5,000 of reforestation expenditures in October 2005 in the GO Zone. He may expense $15,000 of the costs ($10,000 of the June amount, plus the $5,000 of expenditures paid or incurred during October) under I.R.C. §194(b) and can amortize the remaining $10,000 over 84 months under I.R.C. §194(a).

If Douglas had incurred $5,000 of reforestation expenditures in June 2005 and $20,000 of reforestation expenditures in October 2005, he would be permitted to expense $20,000 of the expenditures, and could amortize the remaining $5,000.

GOZA also treats net operating losses incurred by qualified small timber producers as farm losses for purposes of the 5-year NOL carryback period. The loss must be attributable to qualified timber property at least partly located in the GO Zone, the Rita GO Zone, or the Wilma GO Zone.

The provision applies to the income and loss that is allocable to the portion of the taxpayer’s taxable year that meets the following standards:

- On or after August 28, 2005, for qualified timber property any portion of which is located in the GO Zone
- On or after September 23, 2005, for qualified timber property any portion of which is located in the Rita GO Zone and no portion of which is located in the GO Zone
- On or after October 23, 2005, for qualified timber property any portion of which is located in the Wilma Zone

In all three zones, the qualifying period ends on December 31, 2006.

The GOZA timber provisions do not apply to corporations with stock that is publicly traded on an established securities market or to real estate investment trusts.

Low-Income Housing Credit
Act §101; New I.R.C. 1400N
The state low-income housing credit ceiling is increased for each of the states within the GO Zone for calendar years 2006, 2007, and 2008; the increase is $18 times the number of state residents within the GO Zone. In addition, the Florida and Texas housing credit ceiling amounts are increased by $3,500,000 per state for calendar year 2006 only.

“Difficult development areas” for the credit include all three zones (the GO Zone, the Rita GO Zone, and the Wilma GO Zone). Property placed in service in calendar years 2006, 2007, and 2008 thus is eligible for the enhanced high-cost area credit that increases the 70% and 30% credits to 91% and 39%, respectively.

Area gross median income determinations are relaxed for nonmetropolitan areas of the GO zone. If property is placed in service during 2006, 2007, and 2008, the income-targeting rules will be applied by replacing the area median gross income standard with a national nonmetropolitan median gross income standard.

Bonus Depreciation Extension
Act §105; I.R.C. §168(k)
Effective for property placed in service on or after August 28, 2005

Explanation of Provisions
Generally, first-year bonus depreciation was available only for property placed in service before January 1, 2005. A 1-year extension of the placed-in-service date (to January 1, 2006) was provided for certain long-production period property with a recovery period of 10 years or longer and for certain transportation property. Qualifying long-production period property must be subject to I.R.C. §263A and have an estimated production period exceeding 2 years or an estimated production period exceeding 1 year and a cost exceeding $1 million. Transportation property is tangible personal property used in the trade or business of transporting persons or property. In addition, certain noncommercial aircraft can qualify for the extended placed-in-service date. Qualifying aircraft are eligible for the additional first-year depreciation deduction if they are placed in service before January 1, 2006.

GOZA provides IRS authority to further extend the placed-in-service date (beyond December 31, 2005), on a case-by-case basis, for certain property eligible for the December 31, 2005, placed-in-service date under prior law. The authority extends only to property placed in
service or manufactured in the GO Zone, the Rita GO Zone, or the Wilma GO Zone. In addition, the authority extends only to circumstances in which the taxpayer was unable to meet the December 31, 2005, deadline as a result of Hurricanes Katrina, Rita, and/or Wilma. The extension should be only for the additional time required as a result of the hurricane(s) and in no case should extend beyond December 31, 2006.

**Explanation of Provisions**
GOZA excludes from an employee’s income the value of in-kind lodging provided to a qualified employee (and the employee’s spouse or dependents) by or on behalf of a qualified employer for up to 6 months. The exclusion cannot exceed $600 for any month. It does not apply for purposes of social security and Medicare taxes or unemployment tax.

GOZA also provides to a qualified employer a temporary credit of 30% of the value of lodging excluded from the income of a qualified employee. The amount taken as a credit is not deductible by the employer.

A qualified employee is an individual who on August 28, 2005, had a principal residence in the GO Zone and who performs substantially all of his or her employment services in the GO Zone for the qualified employer furnishing the lodging. A qualified employer is any employer with a trade or business located in the GO Zone.

**Mortgage Revenue Bonds**
Act §201; New I.R.C. §1400T
Effective for financing provided before January 1, 2011

**Explanation of Provisions**
Residences located in the GO Zone, the Rita GO Zone, or the Wilma GO Zone are treated as targeted area residences for purposes of I.R.C. §143. The first-time homebuyer rule is waived. Special purchase and income rules for residences located in the specified areas that are financed with qualified mortgage bonds require that 100% of the mortgages be made to mortgagors whose family income is 140% or less of the applicable median family income. In addition, GOZA increases the limit from $15,000 to $150,000 on a qualified home-improvement loan for a residence located in the specified disaster areas.

**Gulf Opportunity (GO) Zone Tax Benefits**
Act §101; New I.R.C. §1400N
Effective for tax years ending on or after August 28, 2005

**Special Depreciation Allowance**
An additional first-year depreciation deduction is allowed equal to 50% of the adjusted basis of qualified GO Zone property placed in service on or before December 31, 2007 (December 31, 2008, in the case of nonresidential real property and residential rental property). The additional deduction is allowed for both regular tax and alternative minimum tax. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

To qualify for the additional first-year depreciation deduction, the property must meet all of the following requirements:

- It must be property to which the general rules of the Modified Accelerated Cost Recovery System (MACRS) apply. This excludes property that is required to be depreciated under the alternative depreciation system.
It must have an applicable recovery period of 20 years or less, or be computer software (other than computer software covered by I.R.C. §197), water utility property as defined in I.R.C. §168(e)(5), certain leasehold improvement property, or certain nonresidential real property and residential rental property.

Substantially all of the use of such property must be in the GO Zone and in the active conduct of a trade or business by the taxpayer in the GO Zone.

The original use of the property in the GO Zone must commence with the taxpayer on or after August 28, 2005. (Used property may constitute qualified property so long as it has not previously been used within the GO Zone. Additional capital expenditures incurred to recondition or rebuild property originally used by the taxpayer in the GO Zone also will satisfy the original use requirement.)

The property must be acquired by purchase on or after August 28, 2005, and generally must be placed in service on or before December 31, 2007. Qualifying nonresidential real property and residential rental property must be placed in service on or before December 31, 2008. Property does not qualify if a binding written contract for its acquisition was in effect before August 28, 2005. However, property is not precluded from qualifying merely because a binding written contract to acquire a component of the property was in effect prior to August 28, 2005.

Property does not qualify if any portion of it is financed with the proceeds of a tax-exempt obligation under I.R.C. §103. Recapture rules apply if the property ceases to be qualified GO Zone property.

I.R.C. §179 Expensing
GOZA increases the limit that a taxpayer may elect to deduct under I.R.C. §179 by the lesser of $100,000 or the cost of qualified I.R.C. §179 GO Zone property acquired on or after August 28, 2005, and placed in service on or before December 31, 2007. This results in a maximum deductible amount of $200,000 before indexing the prior-law portion for inflation. The $100,000 additional amount for the cost of GO Zone property is not indexed for inflation.

Planning Pointer—2005 Limits. The general limit for I.R.C. §179 expensing is $105,000 for 2005. Thus, the limit for taxpayers expensing qualified GO Zone property is $205,000, because the additional $100,000 amount is not adjusted for inflation.

In addition, the dollar cap for reducing the maximum deduction does not begin until the total cost of qualified I.R.C. §179 GO Zone property exceeds $1,020,000. The general $420,000 dollar cap for 2005 is increased by the lesser of $600,000 or the cost of qualified I.R.C. §179 GO Zone property placed in service during the taxable year. The $600,000 additional amount is not indexed.

Qualified I.R.C. §179 GO Zone property is I.R.C. §179 property that also meets the requirements to qualify for GO Zone bonus depreciation. Recapture rules apply if the property ceases to be qualified I.R.C. §179 GO Zone property.

The increased I.R.C. §179 amounts provided in GOZA are coordinated with prior-law expensing rules for enterprise zone businesses in empowerment zones and for renewal communities. Qualified I.R.C. §179 GO Zone property is not treated as qualified enterprise/empowerment zone property or as qualified renewal property unless the taxpayer elects not to take the property into account for GO Zone expensing. Thus, a taxpayer acquiring property that could qualify under more than one expanded I.R.C. §179 expensing provision may elect the additional expensing allowed by either provision, but not both, with respect to the same property.

Demolition and Clean-up Costs
I.R.C. §280B requires the cost of demolition of a structure to be capitalized into the taxpayer’s basis in the land on which the structure is located. The treatment of the cost of removing debris depends on the nature of the costs incurred. Debris removal after a storm may constitute an ordinary and necessary business expense that is deductible in the year it is paid or incurred. In other cases, debris removal may be a part of replacing property that was damaged,
so that the costs must be capitalized and added to the taxpayer’s basis in the property (Rev. Rul. 71-161, 1971-1 CB 76).

GOZA provides a deduction for 50% of any qualified GO Zone clean-up costs paid or incurred on or after August 28, 2005, and before January 1, 2008. A qualified GO Zone clean-up cost is an amount paid or incurred for demolition of a structure or removal of debris from real property located in the GO Zone to the extent that the amount would otherwise be capitalized. The qualifying property must be held for use in a trade or business, for the production of income, or as inventory.

Environmental Remediation
Certain expenditures incurred in connection with abatement or control of hazardous substances at a qualified contaminated site are deductible under I.R.C. §198. A qualified contaminated site generally is any property held for use in a trade or business, for the production of income, or as inventory at a brownfields site (one on which there has been a release or disposal of certain hazardous substances as certified by the appropriate state environmental agency). The brownfields deduction generally expired December 31, 2005. GOZA extends the expensing provision through December 31, 2007, for qualified contaminated sites located in the GO Zone. In addition, petroleum products are treated as hazardous substances.

Rehabilitation Credit
Existing law provides a 20% credit for qualified rehabilitation expenditures with respect to a certified historic structure and a 10% credit for qualified rehabilitation expenditures with respect to a qualified rehabilitated building. GOZA increases the certified historic structure credit from 20% to 26% and the qualified rehabilitated building credit from 10% to 13% with respect to property located in the GO Zone, for expenditures incurred on or after August 28, 2005, and before January 1, 2009.

Net Operating Losses
GOZA provides a special 5-year carryback period for NOLs to the extent of certain specified amounts related to Hurricane Katrina or the GO Zone. The amount eligible for the 5-year carryback is limited to the aggregate amount of the following five deductions:

1. Qualified Gulf Opportunity Zone casualty losses
2. Certain employee moving expenses paid by an employer
3. Certain temporary housing expenses for employees incurred by an employer
4. Depreciation deductions with respect to qualified GO Zone property for the taxable year the property is placed in service
5. Deductions for certain repair expenses resulting from Hurricane Katrina, including removal of mold and contaminants.

The provision applies for losses paid or incurred after August 27, 2005, and before January 1, 2008. An irrevocable election not to apply the 5-year carryback may be made with respect to any taxable year. The disaster loss rules of I.R.C. §165(i) do not apply to losses taken into account under this provision. That includes the election to treat a disaster loss as incurred in the preceding year.

Eligible GO Zone casualty losses for the NOL deduction are limited to losses with respect to property used in a trade or business and losses with respect to capital assets held for more than 1 year in connection with either a trade or business or a transaction entered into for profit.

In addition, the rule limiting an NOL deduction to 90% of alternative minimum taxable income (AMTI) will not apply to any NOL to which the 5-year carryback period applies under GOZA. A taxpayer may apply such NOL carrybacks to offset up to 100% of AMTI.

Public Utility NOLs
Taxpayers may treat a GO Zone public utility casualty loss as a specified liability loss to which the 10-year carryback period applies. Public utility property means property used predominantly in a rate-regulated trade or business of the furnishing or sale of electrical energy, water, or sewage disposal services; gas or steam through a local distribution system; telephone services or certain other communication services; or transportation of gas or steam by pipeline. A taxpayer cannot make the election to treat a disaster loss
as incurred in the prior year to the extent it is treated as a specified liability loss.

Public Utility Disaster Losses
Taxpayers who incurred casualty losses attributable to Hurricane Katrina with respect to public utility property located in the GO Zone may elect to treat the loss as incurred in the fifth taxable year (rather than the first taxable year) immediately preceding the year in which the loss occurred. If the application of this provision results in the creation or increase of an NOL for the year in which the casualty loss is taken into account, the NOL may be carried back or carried forward.

GOZA provides that the statute of limitations with respect to such a claim cannot expire earlier than 1 year after the date of enactment (December 22, 2005). A taxpayer making the election is not entitled to interest with respect to any overpayment attributable to the loss.

Public utility property is property used predominantly in the trade or business of furnishing electrical energy, water, or sewage disposal services; gas or steam through a local distribution system; telephone services, or other communication services if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962; or transportation of gas or steam by pipeline. It is eligible regardless of whether the taxpayer’s rates are established or approved by any regulatory body.

Exclusions
GOZA’s provisions relating to additional first-year depreciation, increased expensing under I.R.C. §179, and the 5-year carryback of NOLs do not apply to certain otherwise qualified property. Specifically, they do not apply with respect to any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises. The provisions also do not apply with respect to any gambling or animal-racing property.

Personal property treated as gambling or animal-racing property is any equipment, furniture, software, or other property used directly in connection with gambling, the racing of animals, or the on-site viewing of such racing.

Gambling or animal-racing real property is the portion of any real property (determined by square footage) that is dedicated to gambling, the racing of animals, or the on-site viewing of such racing. A de minimis exception applies if the dedicated portion is less than 100 square feet.

Tax-Exempt Bond Financing
Qualified private activity bonds may be issued by the states of Alabama, Louisiana, or Mississippi, or any political subdivision thereof to finance construction and rehabilitation of residential and nonresidential property located in the GO Zone. Gulf Opportunity Zone bonds must be issued after December 22, 2005, and before January 1, 2011. Each state’s limit is $2,500 per person residing in the GO Zone. Depending on the purpose for which the bonds are issued, Gulf Opportunity Zone bonds are treated as either exempt facility bonds or qualified mortgage bonds.

Qualified project costs include acquisition, construction, reconstruction, and renovation of nonresidential real property, qualified residential rental projects, and public utility property. A project is a qualified residential rental project if 20% or more of the residential units in the project are occupied by individuals whose income is 60% or less of area median gross income, or if 40% or more of the residential units in such project are occupied by individuals whose income is 70% or less of area median gross income.

All residences located in the GO Zone are treated as targeted area residences for qualified mortgage bonds. The first-time homebuyer rule is waived, and the purchase and income rules for targeted area residences apply to all residences financed with bonds issued under the provision. Thus, 100% of the mortgages must be made to mortgagors whose family income is 140% or less of the applicable median family income. In addition, the amount of a qualified home-improvement loan that may be financed with bond proceeds provision is increased from $15,000 to $150,000.

GOZA also permits an additional advance refunding of certain governmental and qualified I.R.C. §501(c)(3) bonds issued by the states of Alabama, Louisiana, or Mississippi, or by any political subdivision of those states, and one advance refunding of certain exempt facility
bonds for airports, docks, or wharves issued by those government entities, notwithstanding the general prohibition on advance refunding of such bonds. The advance refunding authority applies only to bonds issued by the states of Alabama, Louisiana, or Mississippi, or their political subdivisions, that were outstanding on August 28, 2005, and could not be advance refunded under Internal Revenue Code restrictions in effect on that date.

**Tax Credit Bonds**

As an alternative to traditional tax-exempt bonds, state and local governments may issue tax-credit bonds. Rather than receiving interest payments, a taxpayer holding a tax-credit bond on an allowance date is entitled to a federal income tax credit. Generally, the credit amount is includible in gross income (as if it were a taxable interest payment on the bond), and the credit may be claimed against regular income tax and alternative minimum tax liability.

GOZA creates a new category of tax-credit bonds that may be issued in calendar year 2006 by the states of Louisiana, Mississippi, and Alabama. The amount of the credit will be determined by multiplying the bond’s credit rate by the face amount on the holder’s bond. Gulf Tax Credit bonds must be a general obligation of the issuing state. The maximum maturity on Gulf Tax Credit bonds is 2 years.

**New Markets Credit**

I.R.C. §45D provides a new markets tax credit over a 7-year period for qualified equity investments made to acquire a capital interest in a qualified community development entity (CDE). GOZA allows an additional allocation of the new markets tax credit in an amount equal to $300 million for 2005 and 2006, and $400 million for 2007, to be allocated among qualified CDEs for investments within the GO Zone. A qualified CDE must have as a significant mission the recovery and redevelopment of the GO Zone.

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### Provisions for Taxpayers Affected by Hurricanes Rita or Wilma

#### Retirement Funds

**Act §201; New I.R.C. §1400Q**

Generally effective December 22, 2005

**Tax-Favored Withdrawals**

A qualified Hurricane Katrina distribution is a distribution from an eligible retirement plan made on or after August 25, 2005, and before January 1, 2007, to an individual whose principal place of abode on August 28, 2005, was located in the Hurricane Katrina disaster area and who sustained an economic loss by reason of Hurricane Katrina.

The Katrina Emergency Tax Relief Act of 2005 (KETRA, P.L. 109-73) provides the following tax benefits for a qualified Hurricane Katrina distribution from a qualified retirement or annuity plan, a 403(b) annuity, or an IRA:

- It is not subject to the 10% early withdrawal tax.
- Income attributable to a qualified distribution may be included in income ratably over 3 years.
- The distribution may be recontributed to an eligible retirement plan as a rollover within 3 years.
- A qualified Hurricane Katrina distribution is a permissible distribution from an employer plan regardless of whether a distribution would otherwise be permissible.
- Qualified distributions are not subject to 20% mandatory income tax withholding.

The total amount of qualified Hurricane Katrina distributions that an individual can receive from all plans, annuities, or IRAs is $100,000.

GOZA codifies and expands the premature distribution penalty relief provided under KETRA to any qualified hurricane distribution, which includes distributions relating to Hurricanes Rita and Wilma.
A qualified hurricane distribution includes the following distributions:

- A distribution that meets the definition of qualified Hurricane Katrina distribution under KETRA
- A distribution from an eligible retirement plan made on or after September 23, 2005, and before January 1, 2007, to an individual whose principal place of abode on September 23, 2005, is located in the Hurricane Rita disaster area and who has sustained an economic loss by reason of Hurricane Rita
- A distribution from an eligible retirement plan made on or after October 23, 2005, and before January 1, 2007, to an individual whose principal place of abode on October 23, 2005, is located in the Hurricane Wilma disaster area and who has sustained an economic loss by reason of Hurricane Wilma

Withdrawals for Home Purchases

KETRA generally provides that an extension of the recontributions period for certain retirement plan distributions from an employer plan, annuity, or IRA. The extension applies to a hardship distribution from a 401(k) plan or 403(b) annuity, or a qualified first-time homebuyer distribution from an IRA, that was received after February 28, 2005, and before August 29, 2005, if it was to be used to purchase or construct a principal residence in the Hurricane Katrina disaster area, but the residence is not purchased or constructed on account of Hurricane Katrina. Any portion of a qualified distribution may be recontributed to a plan, annuity, or IRA to which a rollover is permitted during the period beginning on August 25, 2005, and ending on February 28, 2006. The recontributed amount is treated as a rollover.

GOZA codifies the KETRA provision and expands it to qualified Hurricane Rita distributions and to qualified Hurricane Wilma distributions.

- A qualified Hurricane Rita distribution is a distribution received after February 28, 2005, and before September 24, 2005, that was to be used to purchase or construct a principal residence in the Hurricane Rita disaster area, but the residence is not pur-

Plan Loans

KETRA provides special rules for loans from a qualified employer plan to a qualified individual made after September 23, 2005, and before January 1, 2007. (A qualified individual is an individual whose principal place of abode on August 28, 2005, is located in the Hurricane Katrina disaster area and who sustained an economic loss by reason of Hurricane Katrina.)

A plan loan is excluded from income to the extent (when added to the outstanding balance of all other loans to the participant from all plans maintained by the employer) it does not exceed the lesser of the following:

1. $100,000, reduced by the excess of the highest outstanding balance of loans from such plans during the 1-year period ending on the day before the date the loan is made over the outstanding balance of loans from the plan on the date the loan is made.
2. The greater of $10,000 or the participant’s accrued benefit under the plan.

Due dates for payments on outstanding loans are deferred for 1 year if the due date occurs during the period beginning on August 25, 2005, and ending on December 31, 2006. Subsequent repayments will be adjusted to reflect the delay in the due date and any interest accruing during...
the delay. The deferral period is disregarded in complying with the requirements that a plan loan be repaid within 5 years and that level amortization payments be made.

GOZA codifies the KETRA rules and expands them to qualified employer plan loans made to a qualified Hurricane Rita or Hurricane Wilma individual on or after December 22, 2005, and before January 1, 2007.

- A qualified Hurricane Rita individual includes an individual whose principal place of abode on September 23, 2005, is located in a Hurricane Rita disaster area and who sustained an economic loss by reason of Hurricane Rita. A qualified Hurricane Rita individual with an outstanding loan on or after September 23, 2005, qualifies for a 1-year repayment deferral if the due date for the repayment occurs during the period beginning on September 23, 2005, and ending on December 31, 2006.

- A qualified Hurricane Wilma individual includes an individual whose principal place of abode on October 23, 2005, is located in a Hurricane Wilma disaster area and who sustained an economic loss by reason of Hurricane Wilma. A qualified Hurricane Wilma individual with an outstanding loan on or after October 23, 2005, qualifies for a 1-year repayment deferral if the due date for the repayment occurs during the period beginning on October 23, 2005, and ending on December 31, 2006.

**Plan Amendments**

KETRA permits certain plan amendments to be retroactively effective if they are made on or before the last day of the first plan year beginning on or after January 1, 2007, or on a later date as provided by the Treasury Department.

GOZA codifies the KETRA provision and expands an employer’s ability to make retroactive plan amendments for changes made pursuant to new I.R.C. §1400Q.

**Employee Retention Credit**

Act §201; New I.R.C. §1400R

Effective retroactively to disaster dates

**Explanation of Provision**

KETRA provided an income tax credit of 40% of qualified retention wages (up to a maximum of $6,000 in wages per employee) paid by an eligible small employer to an eligible employee.

- An eligible small employer is one that conducted an active trade or business on August 28, 2005, in the core disaster area that was inoperable on any day after August 28, 2005, and before January 1, 2006, as a result of damage sustained by reason of Hurricane Katrina, employing an average of no more than 200 employees on business days during the taxable year.

- An eligible employee is an employee whose principal place of employment on August 28, 2005, was in a core disaster area.

- Qualified retention wages are wages paid or incurred on any day after August 28, 2005, and before January 1, 2006, during the period beginning when the trade or business first became inoperable and ending when the trade or business resumed significant operations at the employee’s principal place of employment. Retention wages may qualify without regard to whether the employee performs no services, performs services at a different place of employment than the principal place of employment, or performs services at the principal place of employment before significant operations have resumed.

GOZA codifies the Katrina employee retention credit and eliminates the provision that restricted the credit to employers of not more than 200 employees. It also extends the retention credit to employers affected by Hurricanes Rita and Wilma and located in the Rita GO Zone and Wilma GO Zone, respectively. The reference dates for employers affected by Hurricane Rita and Hurricane Wilma that are comparable to the August 28, 2005, date for employers affected by Hurricane Katrina, are September 23, 2005, and October 23, 2005, respectively.
Additional Relief Provisions for Taxpayers Affected by Hurricanes Rita and Wilma

Act §201; New I.R.C. §1400S
Effective retroactively to September 24, 2005

Personal Casualty Losses
Under prior law, personal casualty or theft losses are deductible only if they exceed $100 per casualty or theft, and aggregate net casualty and theft losses are deductible only to the extent they exceed 10% of an individual taxpayer’s adjusted gross income.

Under KETRA, the two limitations on personal casualty or theft losses do not apply to the extent those losses arise in the Hurricane Katrina disaster area on or after August 25, 2005, and are attributable to Hurricane Katrina.

GOZA codifies the Katrina Emergency Tax Relief Act of 2005 rule for Katrina casualty losses and expands it to include losses that arise in the Hurricane Rita disaster area and are attributable to Hurricane Rita.

The expansion of the provision applies to losses related to Hurricane Rita arising on or after September 23, 2005, and to losses related to Hurricane Wilma arising on or after October 23, 2005.

Postponed Deadlines (I.R.C. §7508A)
GOZA provides that administrative relief from required tax actions (such as filing tax returns, paying taxes, or filing a claim for credit or refund of tax) shall not end earlier than February 28, 2006, for taxpayers determined to be affected by the presidentially declared disasters relating to Hurricanes Katrina, Rita, or Wilma.

Earned Income Determination
Qualified individuals affected by Hurricane Katrina may elect to calculate their earned income credit and refundable child credit for the tax year that includes August 25, 2005, using their earned income from the prior tax year. They may make the election only if their earned income for the 2005 tax year is less than their earned income for the preceding year. Qualifying individuals are those who had their principal place of abode in the Hurricane Katrina core disaster area on August 25, 2005, and those who were not in the core disaster area but lived in the Hurricane Katrina disaster area and were displaced from their homes.

In the case of a joint return, a Katrina election may be made if either spouse is a qualified individual. In such cases, the earned income for the preceding year is the sum of the earned income attributable to each spouse for the preceding year. Any Katrina election applies with respect to both the earned income credit and refundable child credit. For administrative purposes, an incorrect use of a Katrina election is treated as a mathematical or clerical error.

GOZA codifies the Katrina election and expands it to permit qualified individuals affected by Hurricane Rita and Hurricane Wilma to make similar elections. A Rita election or Wilma election is the same as a Katrina election, except that the reference dates are September 23, 2005, for Rita and October 23, 2005, for Wilma.

Dependency Status
For tax years beginning in 2005 and 2006, the IRS may apply federal tax laws to ensure that taxpayers do not lose a deduction or credit or experience a change of filing status by reason of temporary relocations caused by Hurricane Katrina. Adjustments may include the application of residency requirements relating to dependency. Adjustments made using this authority must insure that an individual is not taken into account by more than one taxpayer with respect to the same tax benefit.

GOZA codifies the adjustment authority with respect to Hurricane Katrina and expands it to include taxpayers affected by Hurricane Rita and Hurricane Wilma.
Observation—Wages Not Limited to Wages Paid for DPGR. Note that wages for purposes of the wage limitation are not limited to wages paid for producing products that generate domestic production gross receipts. For example, wages paid by a sole proprietor to employees who prepare meals for retail sale at a restaurant count as Form W-2 wages for purposes of the limit on the I.R.C. §199 deduction based on gross revenue from wholesale sales of food by the same taxpayer, even though the receipts from the retail sale of food at the restaurant are not included in domestic production gross receipts.
EARNED INCOME CREDIT RATES, INCOME RANGES, AND PHASEOUTS FOR 2006

Earned Income or AGI Range for Taxpayers Not Filing as Married Filing Jointly (for 2006)

<table>
<thead>
<tr>
<th>Qualifying Children</th>
<th>Credit Rate (%)</th>
<th>Maximum Credit</th>
<th>Phaseout</th>
<th>Phaseout Rate (%)</th>
<th>Maximum Credit</th>
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<tbody>
<tr>
<td>None</td>
<td>7.65</td>
<td>$ 5,380–6,739</td>
<td>$ 6,740–12,120</td>
<td>7.65</td>
<td>$412</td>
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<tr>
<td>One</td>
<td>34.00</td>
<td>8,080–14,809</td>
<td>14,810–32,001</td>
<td>15.98</td>
<td>2,747</td>
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<tr>
<td>Two or more</td>
<td>40.00</td>
<td>11,340–14,809</td>
<td>14,810–36,348</td>
<td>21.06</td>
<td>4,536</td>
</tr>
</tbody>
</table>

Earned Income or AGI Range for Married Filing Jointly (for 2006)

<table>
<thead>
<tr>
<th>Qualifying Children</th>
<th>Credit Rate (%)</th>
<th>Maximum Credit</th>
<th>Phaseout</th>
<th>Phaseout Rate (%)</th>
<th>Maximum Credit</th>
</tr>
</thead>
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<td>15.98</td>
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<td>40.00</td>
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<td>16,810–38,348</td>
<td>21.06</td>
<td>4,536</td>
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</tbody>
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### INTEREST RATES FOR NONCORPORATE OVERPAYMENTS AND UNDERPAYMENTS OF TAX

<table>
<thead>
<tr>
<th>Jan. 1, 2006–Mar. 31, 2006s</th>
<th>Overpayments</th>
<th>Underpayments</th>
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</thead>
<tbody>
<tr>
<td>7%</td>
<td>7%</td>
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### APPLICABLE FEDERAL RATES FOR NOVEMBER 2005 THROUGH JANUARY 2006

#### NOVEMBER 2005

<table>
<thead>
<tr>
<th>PERIOD FOR COMPOUNDING</th>
<th>Annual</th>
<th>Semiannual</th>
<th>Quarterly</th>
<th>Monthly</th>
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<tbody>
<tr>
<td>Short-term AFR</td>
<td>4.04%</td>
<td>4.00%</td>
<td>3.98%</td>
<td>3.97%</td>
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<tr>
<td>Mid-term AFR</td>
<td>4.23%</td>
<td>4.19%</td>
<td>4.17%</td>
<td>4.15%</td>
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<tr>
<td>Long-term AFR</td>
<td>4.57%</td>
<td>4.52%</td>
<td>4.49%</td>
<td>4.48%</td>
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</table>


#### DECEMBER 2005

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<tr>
<th>PERIOD FOR COMPOUNDING</th>
<th>Annual</th>
<th>Semiannual</th>
<th>Quarterly</th>
<th>Monthly</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term AFR</td>
<td>4.34%</td>
<td>4.29%</td>
<td>4.27%</td>
<td>4.25%</td>
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<tr>
<td>Mid-term AFR</td>
<td>4.52%</td>
<td>4.47%</td>
<td>4.45%</td>
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<td>Long-term AFR</td>
<td>4.79%</td>
<td>4.73%</td>
<td>4.70%</td>
<td>4.68%</td>
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### JANUARY 2005
**PERIOD FOR COMPOUNDING**

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<thead>
<tr>
<th></th>
<th>Annual</th>
<th>Semiannual</th>
<th>Quarterly</th>
<th>Monthly</th>
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</thead>
<tbody>
<tr>
<td>Short-term AFR</td>
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<td>4.33%</td>
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<tr>
<td>Mid-term AFR</td>
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<td>4.43%</td>
<td>4.41%</td>
<td>4.39%</td>
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<tr>
<td>Long-term AFR</td>
<td>4.73%</td>
<td>4.68%</td>
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<td>4.64%</td>
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</table>


**Page 673**

### OTHER RATES FOR VEHICLES

<table>
<thead>
<tr>
<th>Auto Standard Mileage Rate</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business</td>
<td>36¢</td>
<td>37.5¢</td>
<td>44.5¢</td>
<td></td>
</tr>
<tr>
<td>Business prior to 9/1/05</td>
<td></td>
<td></td>
<td>40.5¢</td>
<td></td>
</tr>
<tr>
<td>Business after 8/31/05</td>
<td></td>
<td></td>
<td>48.5¢</td>
<td></td>
</tr>
<tr>
<td>Charity work</td>
<td>14¢</td>
<td>14¢</td>
<td>14¢</td>
<td>14¢</td>
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<tr>
<td>Katrina charity work prior to 9/1/2005</td>
<td></td>
<td></td>
<td>29¢</td>
<td></td>
</tr>
<tr>
<td>Katrina, Rita, or Wilma charity work after 8/31/2005</td>
<td></td>
<td></td>
<td>34¢</td>
<td>32¢</td>
</tr>
<tr>
<td>Medical/moving</td>
<td>12¢</td>
<td>14¢</td>
<td></td>
<td>18¢</td>
</tr>
<tr>
<td>Medical/moving prior to 9/1/05</td>
<td></td>
<td></td>
<td>15¢</td>
<td></td>
</tr>
<tr>
<td>Medical/moving after 8/31/05</td>
<td></td>
<td></td>
<td>22¢</td>
<td></td>
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</table>


<table>
<thead>
<tr>
<th>Qualified Transportation Fringe Monthly Limit</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
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<tbody>
<tr>
<td>Vehicle/transit pass limit</td>
<td>$100</td>
<td>$100</td>
<td>$105</td>
<td>$105</td>
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<tr>
<td>Qualified parking limit</td>
<td>190</td>
<td>195</td>
<td>200</td>
<td>$205</td>
</tr>
</tbody>
</table>

Page 50
First column, second paragraph. Replace the last sentence with the following: “Good will or going concern value that is purchased from a related party that owned the good will or going concern value on August 10, 1993, cannot be amortized by the buyer [I.R.C. §197(f)(9) and Treas. Reg. §1.197-2(h)]. Therefore, I.R.C. §1239 does not recharacterize the gain realized on the sale to the related party as ordinary income.”

Page 100
Second column, end of penultimate paragraph, “John R. Kennedy” should be “John F. Kennedy.”

Page 127
Form 8801, line 19 “46,099” should be “0.”

Page 149
Figure 5.12, second column, third line under Distribution, “$130,000” should be “$300,000.”

Pages 165–176
The 2006 Forms 1099 should be 2005 Forms 1099.

Page 165
Figure 6.1, after CORRECTED, “March 11, 2005” should be “March 11, 2006.”

Page 257
Figure 9.10, in box 12a after the code L, “1840.00” should be “8160.00.”

Page 391
First column, first line, “deducted” should be “included in income.”

Page 509
Example 18.8, last equation, “$142” should be “$152.”

Page 523
Figure 18.3, first column (“Item”), second line, “Farm income” should be “Construction business income.”

Page 582
Example 21.13, last sentence, “2006” should be “2005” in two places.

Page 590
Last paragraph, first sentence, “Form 4864” should be “Form 4684.”
Land Grant University
Tax Education Foundation, Inc.
PO Box 946
College Station TX 77841-0946

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