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SECTION: ERISA
ALTER EGO TEST FOR WITHDRAWAL LIABILITY REQUIRES SHOWING BOTH COMMON CONTROL AND USE OF SECOND EMPLOYER AS SHAM TO AVOID COLLECTIVE BARGAINING LIABILITY

Citation: Resilient Floor Covering Pension Fund v. M&M Installation, CA9 No. 09-17047, 12/22/10

The Ninth Circuit remanded to the District Court for reconsideration under different grounds whether a non-union employer could be charged a withdrawal liability due to a union pension plan when a union employer owned by the same parties as the non-union employer ceased operations. The Ninth Circuit disagreed with the test used by the District Court to find the non-union employer was the alter ego of the now defunct union employer.

The panel noted that the Ninth Circuit had previously outlined a two-part alter ego test. First, there must be shown to be common ownership, management, operations and labor relations. Neither party disputed this was true in the case of these two employers. The second test is whether the non-union firm is used in a “sham effort to avoid collective bargaining obligations.” The panel complains that the District Court replaced that test with one of whether recognizing the two employers as separate undermines the purposes of ERISA.

However the Court did not find that the second standard could not be satisfied in this case simply because the non-union employer existed first and the union employer was created later to allow the firm to bid on union contracts. The Court found it was possible a double-breasted operation, while not inherently illegal, could be used to avoid payment of a withdrawal liability. Such use would satisfy the second prong of the test.

The Court found there was some evidence that the non-union employer may have engaged in activities that effectively bankrupted the union employer, and that a determination of whether these actions were sufficient to meet the second test would be a matter for consideration of the District Court on remand.

The Court did comment, in an aside, that it was not clear that the alter ego doctrine or veil piercing is consistent with the statutory rule being applied under ERISA when withdrawal liability is at issue. Since neither party disputed that issue in their arguments, the panel accepted the position for this decision, but “suggested” that the District consider whether 29 USC §1392(c) is “intended to be the sole route of redress for evading or avoiding withdrawal liability.”

SECTION: ERISA
ENTITY FOUND TO BE ALTER EGO OF ORGANIZATION IT CONTROLLED, LIABLE FOR PLAN WITHDRAWAL LIABILITY

Citation: The Retirement Plan of the UNITE HERE National Retirement Fund v. Kombassan Holdings, CA2 No. 07-4143-cv, 12/21/10

A Turkish company was held to be the alter ego of a U.S. corporation that incurred withdrawal liability from an employee benefit plan, making the Turkish entity liability for the withdrawal liability of its now defunct related entity. The U.S. entity's shares had been assigned to four other entities when the stock was acquired by the Turkish entity. The assignment was undertaken primarily to get around Turkey's limits on foreign investments by Turkish entities without the Turkish government's approval.

The chairman of the Turkish company was also chairman of each of the four entities to which the shares were assigned, and that company maintained control of the four entities. The President of the U.S. operation looked to the Turkish effective parent as the controlling entity. The Turkish entity numerous times in the U.S. entity's bankruptcy case represented to the bankruptcy court that it had effective control of the U.S. entity.

The Turkish entity argued that the alter ego concept should not apply because the transfers were not undertaken to avoid ERISA liability, but rather for wholly unrelated reasons. As well, the entity was not a successor company formed with the intent of evading the U.S. entity's ERISA liabilities. However, the Second Circuit Court of Appeals held that these issues were not relevant—what was relevant was that the Turkish entity was that it was the actual, if not technically the legal, owner of the enterprise in question and directed its operations.

SECTION: ERISA
INSURER THAT NEGOTIATED PRICE PLANS THAT FAVORED ITS HMO OVER COSTS TO SELF-INSURED PLAN DID NOT VIOLATE ERISA FIDUCIARY DUTY PROVISIONS

Citation: DeLuca v. Blue Cross Blue Shield of Michigan, CA6 No. 08-1085, 12/8/10

The Sixth Circuit Court of Appeals was asked to decide if an insurer had violated the fiduciary duty rules under ERISA in the following circumstance. The insurer administered a self-insured plan for a particular employer. The plan paid care providers rates negotiated by the insurer under the particular type of program the plan elected to be run under—its traditional insurance plan, a PPO plan or an HMO plan. For each plan the insurer would negotiate standard rates with care providers.

In the year in question the insurer, wishing to make its HMO offering more attractive to customers, went to participating providers and negotiated lower reimbursement rates for HMO patients while agreeing to higher reimbursement rates for patients under the other programs, including self-insured programs. These amounts were calculated to be revenue neutral to the providers in general, but allowed the insurer to reduce the cost of the HMO option.

These rates applied to all of the plans which the insurer sold or the self-insured plans it administered. As the self-insured plans paid the rates on the traditional plans, the costs to those plans would go up following this renegotiation.

A beneficiary of the plan brought suit, claiming the insurer violated its fiduciary duty as plan administrator when it negotiated these rates, as it was not acting solely in the best interests of plan participants. A majority of the appellate panel disagreed, finding that the insurer was operating in two separate capacities in this case. In terms of administering the plan, the insurer did have fiduciary responsibilities. However, the rate negotiation was held to be a standard business negotiation and, as such, there was no special responsibility to take into account the higher costs for this particular self-insured plan.

The majority found that although the insurer had agreed generally to establish, arrange and maintain a provider network, it did not find it had agreed to do so separately for the plan in question—rather, it had granted access to its own independent network on its own terms.

The panel also found that if the insurer had to negotiate separately for each plan, the costs to the plan would go up. The insurer was able to negotiate lower rates from suppliers largely because it could use the size of the overall customer base it had—if that base was split up, the lower rates would not be available to such self-insured plans, since the individual plan would not be a large enough group to represent a significant part of the overall market for health care.

A dissenting opinion disagreed with this view, finding that this agreement amounted not to selling a product (access to the network) to the plan, but rather a service (providing such a network). Thus, the dissent argued, the insurer had an obligation not to negotiate in way that benefited its own insurance products and offset that by charging higher costs to the plans it administered. It may be interesting to see if other Circuits agree with the majority here, or if some circuits elect to go with the minority view.

SECTION: ERISA
PARTICIPANT'S SPOUSE'S RELIANCE ON REPRESENTATION OF PLAN FIDUCIARY CANNOT GIVE RISE TO CLAIM UNDER ERISA FOR BREACH OF FIDUCIARY DUTY

Citation: Shook v. Avaya, Inc, CA3 No. 09-4043, 11/2/10`

The Third Circuit Court of Appeals ruled that there could not be an action for breach of fiduciary duty under ERISA when a participant claimed he had been damaged by a misrepresentation that caused he and his wife to decide that she should retire from her job. The case in question involved an employer that had been subject to an acquisition. The key question became how many years of service the participant would have credit for under the plan, and to what extent his service to the predecessor employer would count under the successor employer's plan.

Based on answers the participant had received to inquiries regarding his start date for various benefits the participant had computed his expected retirement benefit. The benefit he computed presumed that he would be able to obtain a full retirement benefits even if he were to be, as it turns out he was, laid off in a force reduction in the near future. Based on that expected benefit, it was decided that his wife could go ahead and retire from her job with a different employer. Unfortunately, the actual benefit he qualified for when he was laid off was substantially less than what he had computed. Even worse, his wife had retired before he had been laid off.

The Court held that the actions of a non-participant (the wife in this case) could not be the source of a claim for breach of fiduciary duty due to detrimental reliance on a fiduciary's representation. Rather, the Court held that it was required to show action on the part of the participant that led to the damages.

The Court noted that the wife's decision to retire had no impact on the participant's benefits, nor did it have any effect on benefits potentially payable to her as a beneficiary of her spouse under the plan. The Court found that this was not a reasonably foreseeable consequence to the fiduciary.

SECTION: ERISA
WHERE INSURER HAD NO DISCRETION UNDER THE PLAN, BURDEN OF PROOF NOT SHIFTED TO INSURER FOR DISPUTE OVER TERMINATION OF DISABILITY BENEFITS

Citation: Muniz v. Amec Construction Management, No. 09-55689, 10/27/10

The Ninth Circuit Court of Appeals sustained a District Court ruling holding an individual did not qualify for disability benefits under the terms of an employer plan, and that the plan was justified in terminating the individual's disability benefits.

The individual in question was diagnosed with HIV in 1989, and stopped working in 1991. He began receiving disability benefits under the plan in 1992. In 2005 his claim came up for periodic review.

After examining medical records submitted by the employee, the insurer determined that he could perform sedentary employment which rendered him no longer disabled under the terms of the plan. Eventually the employee filed an appeal with the United States District Court. The court reviewed the insurer's decision using a de novo standard of review after finding the plan did not grant discretion to the insurer in this area.

An expert appointed by the court to perform this review determined that the employee was no longer disabled under the terms of the plan and the court sustained the denial of benefits.

The employee argued that because he had presented his own physician's statements regarding proof of disability, the burden of proof should have shifted to the insurer to clearly show he was no longer disabled.

The Ninth Circuit declined to follow this result. The Court noted that the employee was citing cases on the burden of proof under situations where the administrator had discretion and the test was for an abuse of discretion. In this case, the administrator did not have discretion and the prior burden decisions did not apply to the District Court's de novo review.

The Court also found that while the fact the employee had previously been paid disability benefits may be relevant to the question of whether he remained disabled, that fact itself did not shift the burden of proof to the plan.

The key factor in this case was the lack of discretion on the part of the plan administrator. Where the plan administrator has discretion under the plan, the Courts have expressed concern that a conflict may exist where the funds to pay the benefit will come from the organization which is exercising the discretion. However, in this case the plan did not grant discretion and the District Court conducted its own independent de novo review of the determination of disability. Thus it appears the Ninth Circuit panel concluded that the risk inherent when there is discretion did not exist here, and therefore no special burden rested upon the plan administrator.

SECTION: 1
ADDITIONAL COST OF LIVING FIGURES FOR 2011, ADJUSTED FOR THE TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010, RELEASED BY THE IRS

Citation: Revenue Procedure 2011-12, 12/23/10

The IRS released an additional set of inflation adjusted figures for 2011. The new release is in addition to adjustments announced in Rev. Proc. 2010-40, 2010-46 I.R.B. 663. These adjustments are primarily required due to the extension of certain provisions contained in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

The new notice contains the tax rate tables for 2011 for all filing statuses, adjusted to reflect the continuation of the 2010 rates contained in the tax act.

The earned income number that is used in computing the refundable child tax credit pursuant to §24(d)(1)(B)(i) remains at $3,000. As well, the maximum HOPE scholarship credit available under §25A(b)(1) remains at $2,500.

A minor adjustment is made in the phase-out levels for the Lifetime Learning Credit, with the adjustments beginning for taxpayers with modified adjusted gross income in excess of $51,000 ($102,000 for married couples filing a joint return). For 2010 the phase-out began at $50,000 and $100,000 respectively.

The limits for the earned income credit for 2011 are as follows:

	Number of Qualifying Children			
Item	**One**	**Two**	**Three or More**	**None**
Earned Income Amount	$9,100	$12,780	$12,780	$6,070
Maximum Amount of Credit	$3,094	$5,112	$5,751	$464
Threshold Phaseout Amount (Single, Surviving Spouse, or Head of Household)	$16,690	$16,690	$16,690	$7,590
Completed Phaseout Amount (Single, Surviving Spouse, or Head of Household)	$36,052	$40,964	$43,998	$13,660
Threshold Phaseout Amount (Married Filing Jointly)	$21,770	$21,770	$21,770	$12,670
Completed Phaseout Amount (Married Filing Jointly)	$41,132	$46,044	$49,078	$18,740

For 2011, the earned income credit will be disallowed under §32(i) for excess investment income if such income exceeds $3,150.

The standard deductions for 2011 will be:

Filing Status	Standard Deduction
Married Individuals Filing Joint Returns and Surviving Spouses	$11,600
Heads of Households	$8,500
Unmarried Individuals (other than Surviving Spouses and Heads of Households)	$5,800
Married Individuals Filing Separate Returns	$5,800

The standard deduction for a person eligible to be claimed as a dependent on another's tax return will be further limited to no more than the greater of $950 or the individual's earned income plus $300. The additional standard deduction for the aged or blind is increased to $1,150, with the amounts increased to $1,450 if the individual is unmarried and not also a surviving spouse.

The qualified transportation fringe monthly limitation for 2011 under §132(f)(2)(B) is set at $230.

The personal exemption for 2011 will be $3,700.

For tax years beginning in 2011, the maximum deduction for interest paid on student loans will be capped at $2,500, with the deduction phasing out as a taxpayer's modified adjusted gross income exceeds $60,000 ($120,000 for married couples filing a joint return). The entire deduction will be phased out for taxpayers with incomes above $75,000 ($150,000 for a married couple filing a joint return).

SECTION: 1
IRS ANNOUNCES COST OF LIVING FIGURES FOR 2011 RETURNS

Citation: Revenue Procedure 2010-40, 10/28/10

The IRS has some released inflation adjusted figures to be used for 2011, while others that are impacted by various expiring provisions of the law are not yet included—presumably to wait and see if Congress takes action to extend a number of the expired benefits to apply to 2011 returns.

For 2011 the amount used to reduce net unearned income reported on a child's tax return for purposes of the kiddie tax is $950.

The alternative minimum tax exemption for child subject to the kiddie tax for 2011 can be no more than the sum of the child's current income for the taxable year plus $6,800.

The exclusion under Section 135 for income from United States savings bonds for taxpayers to pay qualified higher education expenses will begin to phase out for modified adjusted gross income above $106,650 for those filing joint returns and $71,100 for those filing under other filing statuses. The exclusion will be completely phased out for those filing joint returns with modified adjusted gross income above $136,650 or for those with $86,100 or more of modified adjusted gross income that have other filing statuses.

The limitations in 2011 for amounts deductible for long-term care premiums are set at $340 for those age 40 or less, $640 for individuals more than age 40 but not more than age 50, $1,270 for those more than age 50 but not more than age 60, $3,390 for those more than age 60 but not more than age 70, and $4,240 for those older than age 70.

For Archer Medical Savings Accounts the amounts defined for a high deductible health plan are set at annual deductibles of not less than $2050 and not more than $3050 for self-only coverage. For such coverage annual out-of-pocket expenses required to be paid cannot exceed $4,100. For those with family coverage, a annual deductible can be not less than $4100 and not more than $6150. The maximum out-of-pocket expenses to be paid for covered benefits cannot exceed $7,500.

The foreign earned income exclusion for 2011 will be $92,900.

The annual exclusion for gifts remains at $13,000 for gifts of a present interest to any person in 2011.

The Revenue Procedure goes on to provide a number of other inflation adjusted items effective for 2011.

SECTION: 45R
IRS RELEASES EXPANDED GUIDANCE ON SMALL EMPLOYER HEALTH CARE CREDIT, INCLUDING DETAILS OF UNIFORMITY TEST

Citation: Notice 2010-82, 12/3/10

The IRS clarified that, generally, for a nonprofit organization to qualify for the small business health care credit, the organization must be both an organization described in §501(c) and exempt from tax under §501(a)—just meeting one criteria will not be adequate. However a farmer's cooperative under §521 subject to tax under §1381 will be eligible if it otherwise meets the requirements of being a small employer

The notice also points out there is no requirement that the employer be engaged in a trade or business to qualify for the credit. Specifically, a household employer can qualify for this credit.

An employer located outside the United States (including one in a United States territory) with income effectively connected with a US trade or business can only claim the credit if it pays premiums for coverage issued in and regulated by one of the 50 states or the District of Columbia. A similar rule applies for a tax-exempt organization located outside the United States.

Even though spouses aren't specifically included in the definition of excluded family members of owners under §45R, the notice points out they are excluded by attribution rules in other sections. Thus employee-spouses of sole proprietors, a greater than 2% shareholder of an S corporation, or a greater than 5% partner of a partnership or corporation are excluded from consideration for the credit.

While employees of an employee leasing organization are counted in determining an employer's FTEs and average annual wages, any premiums paid by the leasing organization are not attributed back to the employer for purposes of claiming the credit.

All employees must be counted for §45R purposes, including those covered under a collective bargaining agreement, those who have terminated employment and those who do not enroll in the employer's plan (even if the reason for doing so is because they have coverage elsewhere).

A minister that is treated as being self-employed for Social Security and Medicare purposes will not necessarily be treated as self-employed for purposes of the §45R test. Rather, the common law standard will be applied to the minister and if the minister would be a common law employee of the organization will be treated as an employee for purposes of the §45R credit, counting in the calculation of FTEs and premiums eligible for the credit. However, since the minister had no FICA wages under §3121(a), no wages will be counted in computing the employer's average annual wages.

This notice clarifies a matter that was not clear in the earlier notice—an employer can use different methods of computing the hours worked for employees for different classifications of workers, and does not have to use one method for all employees. The employer can also change methods used each tax year.

Payments made to an HRA or an HSA account by an employer are not eligible for the credit, because those are part of a self-insurance plan and insurance issued under state regulatory supervision (the latter being a requirement for creditable payments under §45R).

The notice provides additional clarifications for multiemployer welfare benefit plans and church welfare benefit plans.

The notice give guidance and a number of examples of application of the uniformity rules for years beginning after December 31, 2009 and prior to 2014, though for years beginning in 2010 an employer can use either these rules or the transition rules in Notice 2010-44.

The guidance is relatively employer friendly with regard to uniformity. The rules start out by defining a few terms. A plan is defined as a single benefits package. Such a package can be divided into tiers, where a tier involves only how many individuals are covered (self-only, self plus one and family). That benefits package is still considered a single plan.

If an employer offers different benefit packages, each package is considered a separate plan under these rules. Each plan can, as noted above, have its own subset of tiers.

If an insurer charges an employer the same rate for each employee or a single premium to cover all employees in the group, then it is referred to as having "composite billing." If an insurer varies the premium per employee under the same health plan by their age or other factors is using a "list" billing.

The employer computed composite rate is an average rate computed adding the premiums for all employees eligible to participate in that tier (whether or not they do) and dividing by that number of employees. For a plan where the same premium is charged by the insurer for each employee in the group, the number will be that rate. In the case of list billing, each employee's actual premium that is (or would be charged) for the tier of coverage being tested is computed and that is used to arrive at the average.

An employer that offers only a single benefit package can satisfy the uniformity requirement in various manners. The simplest is that the employer can simply pay for each employee who participates the same amount that is equal to at least 50% of the employer computed average composite rate under the self-only option, regardless of which tier of coverage the employee selects. Alternatively, an employer can satisfy this test separately for each tier—meaning the employer can pay a greater amount for those with self plus one or family coverage, but if the employer does so that amount will need to be greater than 50% of each tier's composite billing rate.

For list billing plans, the employer can, rather than using the composite billing rate (though that option is always open), pay a fixed percentage of at least 50% of the actual billed amount for each employee if they had elected self-only coverage. Again, the employer can elect to either use only the self-only amount or, alternatively, separately satisfy the test for each tier of coverage. If the employer uses the employer computed composite billing amount option noted in the earlier paragraph, it must make contributions towards the premium so that each employee pays a uniform amount for coverage (meaning the employer picks up the variance in premium).

If an employer offers more than one plan (benefits package), then it can either satisfy the tests for each plan separately or designate one plan as a reference plan and provide the contribution that would be required under the reference plan, allowing the employee to apply the employer's contribution either to the reference plan or to whatever plan the employee selects from those made available. A plan may only be designated a reference plan if the self-only composite rate for the reference plan is at least 66% of the rate for each non-reference plan.

The IRS gives a number of specific examples of the application of these rules in the notice. The notice also points out that §45R does not mandate a coverage requirement, but that §105(h), as referenced by §10101(d) of the Patient Protection and Affordable Care Act, may impose such a requirement on a health plan.

The notice makes clear that if an employer has employees in multiple states, it must apply the actual state limit for the state in which the employee lives on the premiums. The cap depends only on the coverage the employee elects, and how the employer decided to satisfy the uniformity rule does not impact the amount used—so an employer satisfying uniformity by using an equal payment at the self-only rate would still be able to claim the credit for an employee electing family coverage by using the "other coverage" limit.

SECTION: 62
IRS OUTLINES FAILURES OF CLAIMED ACCOUNTABLE REIMBURSEMENT PLAN

Citation: CCM 201120021, 5/20/11

In a Chief Counsel Memorandum the IRS gave a more detailed on its views on how compensation packages can and cannot be structured to come under the accountable plan rules of §62(c), allowing amounts designated for expense reimbursements to be excluded from the employee's income and from the application of payroll taxes. The memorandum addresses a plan that fails to meet the requirements, but describes the flaws that are fatal to the plan.

The plan in question is one of a type that had been marketed heavily to certain businesses in the early 2000's. The "tool plan" involved a program where a portion of an employee's wages would be designated as reimbursement for tools the employee was expected to use on the job. In this specific plan an inventory of tools owned by the employee was taken. If the employee had receipts for the acquisition of the tools, those receipts were used to value the tools, otherwise some other method was used to estimate the values. This tool inventory was then used to establish the reimbursement and a portion of the employee's wages was now redesignated as reimbursement of the tools under an accountable plan, excluded from wages.

The tools did not have to be acquired while an employee of the employer, nor did the employee have to turn the tools in to the employer if he/she left employment. As well, the employee would end up with the same cash in pocket no matter what happened—there was no possibility the employee could end up worse off under this program.

The IRS found this program violated two key requirements. First, under Reg. §1.62-2(d)(1) the expenses must be paid or incurred in connection with the employer's business. The fact that the tools could have been purchased prior to the commencement of employment violated the business connection test. The memorandum held that the mere fact the expense would be deductible to the employee as a business expense was not sufficient to meet this test.

As well, the memorandum cited Example 1 of Reg. §1.62-2(j) to point out that, to be an excludable reimbursement, the payment must be structured to be paid only when expenses are incurred or are reasonably expected to be incurred. In the example, on the days an employee traveled away from home $50 of his $200 daily wage would be designated as reimbursements. On days he did not travel, he would receive a full $200 designated as wages. Because he would receive the same $200 regardless of whether expenses were incurred, the plan was found to fail to qualify as an excludable reimbursement.

However, the memorandum makes it clear that an employer can negotiate a reimbursement arrangement with an employee as part of a compensation agreement, specifically noting "an employer may prospectively alter its
compensation structure to include reimbursement of substantiated expenses under an accountable plan..." It would be fine for an employee and employer to agree for the following year that an employee's salary would be reduced from $80,000 to $75,000, with $5,000 available for expense reimbursement. However the employee would need to account for $5,000 of expenses incurred in that year, and would either only be reimbursed if the expenses were incurred, or be required to repay any shortfall to the employer.

SECTION: 72
TAXPAYER FAILS TO SHOW SHE WAS DISABLED UNDER TAX LAW DEFINTION, SUBJECT TO §71(T)(1) 10% ADDITION TO TAX

Citation: Stipe v. Commissioner, TC Memo. 2011-92, 4/25/11

Kathleen Stipe argued that she should not be subject to the 10% additional tax on a premature distribution from a retirement plan under IRC §72(t)(1) because she was disabled. While Katherine's major problem was a failure to provided evidence to back up her assertion, the case does outline the requirements to receive relief under this provision.

First, the case notes that to receive relief the taxpayer must meet the definition of disabled found at IRC §72(m)(7). The provision reads: "In determining whether a taxpayer is a trader, nonexclusive factors to consider are: (1) The taxpayer's intent, (2) the nature of the income to be derived from the activity, and (3) the frequency, extent, and regularity of the taxpayer's securities transactions."

While Kathleen claimed a doctor had declared her permanently disabled, she did not provide the doctor's certification or any other evidence regarding her disability. Thus she was not found to exempt from the 10% premature distribution addition to tax.

Potentially surprising to some advisers, however, may be the statement in the opinion regarding qualifying, citing the case of Kopty v. Commissioner (TC Memo 2007-343) that "a taxpayer who is disabled for Social Security or employment purposes is not necessarily disabled within the meaning of section 72(m)(7)."

Advisers counseling a client that may qualify for disability treatment should review the requirements for documentation found in Reg. §1.72-17A(f) as a failure to provide the required information, as Kathleen discovered, is fatal to a claim to be exempt under the disability exception.

SECTION: 83
CORPORATE INSIDER MUST SHOW OBJECTIVELY REASONABLE POSSIBILITY OF SUCCESSFUL SECTION 16(B) CLAIM TO DEFER TAXATION AT OPTION EXERCISE

Citation: Strom v. United States, CA9, Docket Nos. 09-35175, 09-35197, 4/6/11

The general rule holds that when an employee receives employer stock options that do not have a readily ascertainable fair market value, income is recognized when the options are exercised pursuant to §83. However, that recognition may be delayed under the provisions of §83(c)(3) if the exercise of the options could subject that person to a suit under section 16(b) of the Securities Act of 1934.

Section 16(b) of the Securities Act of 1934 can apply when a corporate insider sells stock at a profit within six months of purchase. The taxpayer in this case claimed that she had a right to defer recognition on the exercise of any options in this case until she was more than six months past the date any options had vested. She argued that a suit could be brought under such an interpretation of Section 16(b) and that §83(c)(3) would act to defer taxation until such a risk of suit went away.

The Ninth Circuit ruled that §83(c)(3) did not apply to any possible suit. Rather, the panel held, the taxpayer must face an objectively reasonable chance of a successful lawsuit against her. The panel noted that the SEC's regulations interpreted the date of grant of the specific shares as the date of purchase (and thus the date from which the six months would run) and did not differentiate between vested and unvested positions. The panel found such a holding objectively reasonable, being in line with the general goal of the provision to prevent unfair enrichment by using short term price swings.

In the case of her options, the taxpayer's underlying cost was set when the option was granted. Any gain she realized would be measured against the value at the grant date. Thus there did not appear to be an objectively reasonably chance of a successful suit against her. Thus §83(c)(3) would not apply to the exercise of any options that had been granted more than six months prior to the exercise date.

SECTION: 106
IRS ALLOWS USE OF FSA OR HRA DEBIT CARDS TO PURCHASE PRESCRIBED OVER-THE-COUNTER MEDICINES AND DRUGS FROM VENDORS MEETING SPECIFIC REQUIREMENTS

Citation: IRS Notice 2011-5, 12/23/10

The IRS modified the guidance originally published in Notice 2010-59 regarding the use of FSA and HRA debit cards for use for the purchase of over-the-counter medicines. The original notice prohibited such use entirely after January 15, 2011.

The guidance is modified to indicate that reimbursement is allowed for a drug that is a prescribed drug (determined without regard to whether such drug is available without a prescription) or is insulin.

Under the revised rules, the cards may continue to be used to purchase prescribed over-the-counter medicines if all of the following conditions are satisfied:

1. prior to purchase, (i) the prescription for the over-the-counter medicine or drug is presented (in any format) to the pharmacist; (ii) the over-the-counter medicine or drug is dispensed by the pharmacist in accordance with applicable law and regulations pertaining to the practice of pharmacy; and (iii) an Rx number is assigned;
2. the pharmacy or other vendor retains a record of the Rx number, the name of the purchaser (or the name of the person for whom the prescription applies), and the date and amount of the purchase in a manner that meets IRS recordkeeping requirements;
3. all of these records are available to the employer or its agent upon request;
4. the debit card system will not accept a charge for an over-the-counter medicine or drug unless an Rx number has been assigned; and
5. the requirements of previously issued Prop. Treas. Reg. § 1.125-6, Rev. Rul. 2003-43, 2003-1 C.B. 935; Notice 2006-69, 2006-2 C.B. 107; Notice 2007-2, 2007-1 C.B. 254; and Notice 2008-104, 2008-2 C.B. 1298 are followed.

The cards can also be used to purchase over-the-counter medicine or drugs that have been prescribed after January 15, 2011 at pharmacies for which 90% of the store's gross receipts for the prior tax year consisted of items which qualify for medical care under §213(d) even if they do not have an inventory information system in place.

For purchases at all others merchants not meeting either of the two above requirements, FSA or HRA debit cards may not be used to purchase over-the-counter medicines or drugs after January 15, 2011.

SECTION: 107
MINISTER ALLOWED HOUSING ALLOWANCE EXCLUSION FROM INCOME ON MORE THAN ONE RESIDENCE

Citation: Driscoll v. Commissioner, 135 TC No. 27, 12/14/10

The minister in the case before the Tax Court had received a housing allowance from a §501(c)(3) organization that was used by him to pay for both a first and second residence. The IRS argued that, since §107(2) of the IRC, which provides for the exclusion of housing allowances to ministers, only talks about payments for "a home" that the payments related to the second residence could not be excluded from income.

The Tax Court did not agree. First, the Court found that the IRS was effectively asking it to insert the word "one" between "a home" in that portion of the Code, something the Court did not find necessary to do. Second, the Tax Court pointed out that §7701(m)(1) of the Internal Revenue Code effectively brings in the general rule of 1 USC 1 that provides that, unless the context indicates otherwise, it should be assumed that when Congress uses a singular term it will include the plural.

The IRS agreed that the second residence was used as a home, and that the payments in question went to the expenses of that home. As such, the Tax Court allowed the taxpayer's position that the payments related to the second residence were excludable from income.

SECTION: 132
IRS DELAYS EFFECTIVE DATE OF DEBIT CARD AND SMARTCARD REVENUE PROCEDURE USED FOR TRANSPORTATION BENEFIT

Citation: Notice 2010-94, 12/16/10

The IRS has once again delayed the effective date of Revenue Ruling 2006-57 which outlined requirements for the use of smartcards and debit cards for providing a qualified transportation fringe benefit. The ruling listed requirements that had to be met that limited the use of such cards to acquiring only a transportation benefit. If that requirement was not met, such cards could only be used if it was part of an accountable plan that would require employees to document qualified use.

The rules were first scheduled to go into effect on January 1, 2008. However, it has been delayed three times before as the due date for compliance approached. Again the IRS has delayed the effective date because transit systems have indicated they have not been able to modify their systems to meet these requirements. The new effective date, barring yet another IRS delay, is for benefits provided on or after January 1, 2012. However, employers and employees may continue to rely on the ruling for transactions prior to the effective date.

SECTION: 162
IRS CLARIFIES EMPLOYER'S PROVISION OF OR REIMBURSEMENT OF EMPLOYEES FOR CELL PHONES FOLLOWING REMOVAL OF PHONES FROM LISTED PROPERTY CATEGORY

Citation: Notice 2011-72 and SBSE Memorandum SBSE-04-0911-083, 9/14/11

In Notice 2011-72 and SBSE Memorandum SBSE-04-0911-083 the IRS gave guidance on how to handle cellular telephones provided to employees or payments to reimburse employees for business use of their personal cellular telephone. The Small Business Jobs Act of 2010 removed cellular phones from items treated as "listed property" which imposed detailed specific recordkeeping requirements to claim a business deduction. The changes were effective for taxable years beginning after December 31, 2009.

In the Notice, the IRS indicated that if the employer can demonstrate a legitimate, non-compensatory business reason for the employee to have the telephone, the IRS would treat the provision of the phone as a working condition fringe under IRC §132(d). The IRS also ruled that in such a case any personal use of the phone by the employee would be deemed to be a deminimus nontaxable fringe benefit under §132(a)(4).

The memorandum issued to IRS agents to clarify the application of these rules described that similar tests would be used for purposes of treating a reimbursement to the employee as being paid under an accountable plan. The memorandum goes on to give examples of what would and would not be legitimate non-compensatory business reasons for the employee to be provided a phone or be reimbursed for business use of the phone.

SECTION: 162
TAXPAYERS EACH HAD DIFFERENT TAX HOMES, AND NEITHER WAS WHERE THEIR RESIDENCE WAS

Citation: Baker v. Commissioner, TC Summary Opinion 2011-95, 7/19/11

The location of the tax home for taxpayers is crucial for taxpayers who attempt to claim deductions for work related travel expenses away from home. While Jac and Cynthia Baker had a residence in Seattle, Washington, he was a tug master based in Hawaii while she was a flight attendant based in New York.

The Tax Court found that Seattle was neither of the Baker's tax homes and therefore travel costs to and from Seattle were nondeductible under IRC §162. The choice for the couple to live away from their tax homes in New York and Hawaii, while perfectly reasonable, was a personal decision that rendered the travel expenses into nondeductible expenses.

However the taxpayers were not assessed penalty. The court the taxpayers had relied in good faith on their long time CPA who was aware of the situation and prepared returns claiming the expenses, triggering the reasonable cause exception to a penalty under IRC §6662.

SECTION: 162
TAX COURT DISALLOWS DEDUCTIONS PAID FOR MANAGEMENT FEES TO RELATED ENTITY, NO SERVICES SHOWN PERFORMED

Citation: Weekend Warrior Trailers, Inc. v. Commissioner, TC Memo 2011-105, 5/19/11

The taxpayer in the case in question created a complex web to siphon profits from his profitable enterprise to a controlled entities, allegedly for performing management services. This related company had the vast majority of its shares eventually transferred to an ESOP it established which would, if this worked, serve to shelter the management fees being drained off as this management entity had elected S status.

The Tax Court found the entity to effectively be a sham, disallowing all deductions for management fees paid by the profitable corporation as not being "necessary" under IRC §162. The court found no evidence of services rendered for the supposed "management services" for which large payments were made. The Court also found the ESOP to be questionable, noting that it was terminated as soon as the law changed to render it no longer useful for a pure shelter.

It certainly didn't help matters that the owner was more than somewhat informal in his dealings with the entities. He would take money when he "needed it" and would then create a record afterwards to justify the payment.

SECTION: 162
CPA AND CONSULTING FIRM DENIED DEDUCTION FOR PAYMENTS MADE TO RELATED ENTITIES

Citation: Mulcahy, Pauritsch, Salvador & Co., Ltd., T.C. Memo 2011-74, 3/31/2011

When payments are made to related entities, often to accomplish various tax planning objectives, care must be taken to show that the payments are reasonable payments for services actually rendered or products actually transferred. A failure to do this properly can lead to a disallowance of a deduction for the payments made.

In the case at hand a CPA firm operating as a C corporation made various payments for consulting fees and interest to other entities controlled by its three officers and shareholders. The case does not describe what the firm believed it was achieving with these entities, but then the Tax Court did not terribly care about that matter.

Rather the Court found no evidence that these entities had actually performed any services—at least none that the firm could document at trial. Thus the Court denied the payments under IRC §162, holding that the payments were unreasonable compensation for the services performed. It didn't help matters that the firm conceded the amounts paid each year for these services was set primarily at an amount to eliminate the C corporation's profits.

The officers received modest W2s from the accounting firm for their services, with over $800,000 per year being paid to the related entity for the "services" and "interest" payments.

The Tax Court also, not surprisingly, held the Company to the form it had structured. Since it claimed the payments were not to the officers for their services, but rather to the entities for services the Court did not offer to reclassify the payments as officer salaries.

SECTION: 223
HSA LIMITS SET FOR 2012

Citation: Revenue Procedure 2011-32, 5/13/11

Revenue Procedure 2011-32 contains the inflation adjusted limits applicable to Health Savings Accounts for 2012.

For 2012 the maximum deductible contribution under IRC §223(b)(2)(A) to an HSA for an individual with qualifying self-only coverage is $3,100, while the limit under IRC §223(b)(2)(B) for an individual with qualifying family coverage is $6,250.

The minimum deductibles for high deductible health plans will be unchanged from their 2011 levels, set at $1,200 for self-only coverage and $2,400 for family coverage. The out-of-pocket expense caps will be $6,050 for self-only coverage and $12,100 for family coverage.

SECTION: 274
IRS PUBLISHES REVISED PER DIEM PROCEDURES, REVERSES DECISION TO ELIMINATE HIGH-LOW METHOD

Citation: Revenue Procedure 2011-47 and Notice 2011-81, 9/30/11

The IRS has modified the method it will use to publish per diem guidance, creating a general Revenue Procedure 2011-47 to be supplemented by annual notices (Notice 2011-81 being the first such notice) that will provide the special per diem rates and the list of high cost localities.

The special rates that will be published in the annual notice are:

1. Special transportation industry meals and incidentals rates
2. Rate for incidental expenses only deductions and
3. Rates and lists of high-cost localities for purposes of the high-low substantiation method.

The Revenue Procedure also announced that the IRS would not eliminate the use of the high-low substantiation method, something the IRS had announced earlier in 2011 with Announcement 2011-42. The IRS indicated that they had received comments following the release of that announcements from taxpayers that used the high-low method, leading the IRS to conclude the method should be retained.

The revised procedure clarifies, in Section 3.04, that partners and volunteers who receive reimbursements from payors may use the per diem methods provided in the procedure to substantiate their expenses. As well, Section 5 provides that taxpayers may now use the high-low substantiation method in lieu of meal and incidental expenses only per diem substantiation method for travel within the continental United States.

The CONUS rates to be used for travel within the continental United States are the applicable General Services Administration rates. These rates can be found at www.gsa.gov. The easiest way to get to the specific page on the GSA's site that contains an interactive map of rates is generally to use a comprehensive internet search engine (such as Google or Bing) and search for "CONUS per diem rates."

The rates for non-foreign localities outside the continental United States, such as Alaska, Hawaii, Puerto Rico, the Northern Mariana Islands, and the possessions of the United States, are maintained by the Department of Defense and can be found at www.defensetravel.dod.mil. The rates foreign locations are published by the U.S. State Department and can be found at www.state.gov.

If an employer elects to use a per diem rate rather than require specific substantiation for expenses incurred in travel away from home, the amount deemed substantiated is the lesser of the per diem allowance actually paid for the day or the applicable federal per diem rate. If the employer reimburses lodging based on actual receipts but provides a meals and incidentals per diem, then the amount deemed substantiated will be limited to the lower of the applicable federal meals & incidental rate or the amount actually paid. Similar rules apply if the employer provides a per diem only for incidental expenses, but reimburses meals and lodging based on receipts. Per Notice 2011-81, that rate is set at $5 per day for the fiscal year beginning October 1, 2011.

The Revenue Procedure describes the special rules applicable to the transportation industry and a definition of the transportation industry. Per Notice 2011-81, the special meals & incidentals rate is set at $59 for any locality of travel in the continental United States (CONUS) and $65 for any locality of travel outside the continental United States (OCONUS). These rates became effective October 1, 2011.

For the final three months of the year, an employer can use either the rates in effect for the first nine months of 2011, or use the updated rates as of October 1 that are published due to the start of a new federal government fiscal year.

Section 5 of the Revenue Procedure describes the application of the simplied high-low substantiation method, the method rescued from its announced termination by this Revenue Procedure. Under that method one rate is used for the high cost localities ($242 effective October 1, 2011 per Notice 2011-81) and a separate rate is used for all other localities ($163 effective October 1, 2011). These apply within the continental United States only. The high-low meal rates are set by Notice 2011-81 beginning October 1, 2011 at $65 for high cost localities and $52 for all other localities.

Notice 2011-81 contains the comprehensive list of high cost localities. Note that many such localities are high cost only for a portion of the year. As well, the notice removed from the list of high cost localities the following locations: Phoenix/Scottsdale, Arizona; South Lake Tahoe, California; Silverthorne/Breckenridge, Colorado; Riverhead/Ronkonkoma/Melville, New York; and Stowe, Vermont."

If an employer elects to use the simplified high-low cost method, it must use this method for all amounts paid to that employee for travel within the continental United States during the year.

SECTION: 274
IRS ANNOUNCES DUAL STANDARD MILEAGE RATES FOR 2011

Citation: Revenue Procedure 2010-51, Notice 2010-88, Announcement 2011-40, 6/23/11

The IRS issued its annual Revenue Procedure for use of the standard mileage method, but this year did not include the mileage amounts in the ruling. Rather, the IRS announced that for 2011 and later years, the actual amounts will now be issued in a notice and the Revenue Procedure will only be issued should any other matter related to such mileage rate usage change.

Previously, in most years the Revenue Procedure had few changes aside from changing the mileage amount, so the IRS has decided to issue a short (four page) Notice rather than a full Revenue Procedure. The only other change reported other than changing where the mileage numbers would now be reported over the prior Revenue Procedure 2009-54 was to allow the use of the mileage method for vehicles for hire, such as taxicabs, if the taxpayer otherwise meets the requirements. However, the prohibition of the use of such a method on a fleet of five or more vehicles remains.

Initially the the standard mileage rates for 2011 were to be:

- Business use: 51 cents per mile
- Charitable use: 14 cents per mile
- Medical care and moving: 19 cents per mile

For automobiles used for business purposes, the portion of the standard mileage rate treated as depreciation will be 22 cents per mile for 2011.

However due to public outcry following a spike in gasoline prices, the IRS announced a mid-year modification to the standard rates. The above rates will apply for mileage incurred prior to July 1, 2011. For mileage from July 1, 2011 through the end of the year, Announcement 2011-40 provided the rates will be as follows:

- Business use: 55.5 cents per mile
- Charitable use: 14 cents per mile
- Medical care and moving: 23.5 cents per mile

For automobiles used for business purposes, the portion of the standard mileage rate treated as depreciation will continue to be 22 cents per mile for the last half of 2011.

SECTION: 401
ESOP DETERMINED TO FAIL TO QUALIFY AS A QUALIFIED PLAN FROM INCEPTION DUE TO DOCUMENT AND OPERATIONAL FAILURES

Citation: Michael C. Hollen, D.D.S., P.C. v. Commissioner, TC Memo 2011-2, 1/4/11

Qualified plans require careful adherence to specific requirements in order to maintain qualified status. The plan in this case failed on numerous counts and, as such, was held not to be a qualified plan dating all the way back to the plan's first year of October 31, 1987 through the current date.

In this case the plan in question was an ESOP maintained by one dentist professional corporation. The plan had 15 participants and/or beneficiaries as of its year ended December 31, 2002.

The first problem the Court addressed was the plan's failure to adopt plan amendments required by the Small Business Job Protection Act of 1996 and the IRS Restructuring and Reform Act of 1998. Such plan amendments were required to be effective as of various effective dates ranging from December 12, 1994 to January 1, 199.. Under Revenue Procedure 2001-55 the plan had until February 28, 2002 to make these amendments under the remedial amendment period.

The plan did adopt amendments well before that final date, adopting them on January 1, 2001. However the amendments did not contain language adopting the required retroactive effective dates, but rather were effective only beginning as of the adoption date. Thus the plan was not qualified since the amendments did not cover the entire remedial amendment period—so at this point the plan would have ceased to be qualified as of December 12, 1994. But the problems were to go back further than that.

The plan document properly required that plan benefits vest over a six year period, but the plan in operation did not follow that vesting schedule. The Court noted four employees that were shown with 0% vested benefits that were required to have currently some level of vested benefits ranging from 20% to 80%, one employee with a reflected vesting of 40% that should have been fully vested and one employee with vesting per the plan records of 20% that actually had no vested benefits. Thus, as the plan did not comply with vesting requirements under §411(a)(2)(B)(iii) and also failed to be operated in accordance with its own requirement, it was again found to fail qualification.

Yet another problem involved the plan's appraisal by a certified public accountant the plan engaged for 2001-2003. The CPA in question failed to sign the declarations that he held himself out to be an appraiser and required by Reg. §1.170A-13(c)(5)(i), one of the requirements to be a "qualified appraiser." As well, Reg. §1.170A-13(c)(ii)(F) and (5)(i)(B) require the appraiser to list his or her background, experience, education and membership in professional organizations, and that was also missing from the appraisals for the year in question. Thus, yet again the plan is found to not to be a qualified plan.

Finally, and probably the item that was truly fatal to the dentist's plan, there was a large dividend paid to the plan on its stock in 1989 of which the doctor was the principal beneficiary. The IRS treated the amount of that dividend allocated to the doctor as being, in effect, a disguised allocation to the dentist's account far in excess of the §415 limit of $30,000 in effect for the year in question. While generally dividend distributions on stock held by an ESOP are not treated as annual additions for §415 purposes, if the transfer is truly an attempt at an "end run" around the annual addition limits, the IRS has authority under Reg. §1.415(b)(2)(i) to reclassify the amounts as annual additions. The Court found the IRS did not abuse its discretion in this case, holding that the large distribution which was used to pay the loan the ESOP used to acquire the stock amounted to a wealth transfer primarily to the dentist.

Thus the plan failed to qualify at that point, and as the plan never took action to correct the failure, it remained disqualified through the dates involved in this case.

Finally, even though the issues noted did not affect years prior to 1989, the Court found the plan was not qualified prior to that point because there was no plan document presented for those earlier years.

The Court noted in the opinion that the taxpayer had failed to take advantage of the opportunity that the IRS had offered to correct these problems via the closing agreement program.

SECTION: 401
IRS ADDRESSES ITS CONCERNS WITH ROBS IN NEWSLETTER TO EMPLOYERS

Citation: Retirement News for Employers, Fall 2010, 12/9/10

The IRS, in its Retirement News for Employers Publication, has given notice to employers that it is looking at ROBS promoted transactions. The guidance is similar to that provided in an internal memorandum issued a few years back by the IRS, but this time the notice indicates the IRS actions they are taking to identify such plans.

A ROBS is a “Rollover as Business Startup” program, where an individual receiving an eligible rollover distribution from an employer plan wishes to use those funds to start a business. That person has a new business entity established that sponsors a retirement plan, with the single individual as the only employee. The employee then rolls his/her distribution into the plan. The plan allows for directed investments, and the employee directs the plan to use the rollover to buy stock or other equity interests in the new enterprise, receiving the ownership of the new employer.

The IRS initially cautions that the underlying businesses of most ROBS that it studied in its project failed, creating significant personal financial problems.

The IRS believes many of these plans violate a number of different applicable IRC and ERISA provisions, rendering them no longer qualified. The IRS specifically finds the following items to be troublesome:

1. Immediately after the plan buys the stock, the plan is amended to remove this direction option for any other participant, insuring only the one person would ever be able to benefit under this provision of the plan
2. The plan is amended to prevent other employees from becoming participants in the plan
3. Fees paid to the promoter may violate prohibited transaction rules
4. The value being paid for the new stock is not adequately supported
5. Failing to issue a 1099R when the assets are rolled into the ROBS from a plan where the employee can exert influence.

The IRS notes that such plans do not qualify for an exemption from filing Form 5500 as a one participant plan when assets are below a certain level, as under a ROBS the plan owns the sponsor’s stock or other equity interests, thus failing the requirements to be treated as plan covering only the owner and spouse. A filing will, therefore, always be required.

The IRS points out that promoters often file for a determination letter on the plan, and the employee may believe that indicates the entire arrangement has the IRS’s blessing. However, such a letter gives a very limited level of assurance, concentrating on the terms of the plan and not on the operation of the plan (including the acquisition of the new employer stock that is crucial to this program).

The IRS is using a compliance check program to find these programs that looks for plans that received a determination letter but did not file a series 5500 form. Plans so identified have letters sent to their sponsors asking for various information related to the issues the IRS has noticed in ROBS plans.

SECTION: 401
IRS ANNOUNCES PENSION PLAN LIMITATIONS FOR 2011

Citation: IRS News Release IR–2010–108, 10/28/10

The IRS announced cost-of-living adjustments that will be in place for pension plans and other plan related items for tax year 2011. Most of the items are not changed for 2011 or have very small adjustments.

Elective deferrals for employees in 401(k), 403(b), and 457(b) plans remain at $16,500. Catch-up contribution limits for those age 50 and over also remain unchanged at $5,500.

The phase-outs for IRA contribution deductions for those covered by employer-sponsored retirement plan are unchanged from 2010. The limits for single individuals and those filing head of household remain between $56,000 and $66,000. For married couples, the income phase-out range is from $90,000 to $110,000 up slightly from the range of $89,000 to $109,000 in 2010. If the IRA contribution is for the spouse who is not an active participant in the plan, but the other spouse is an active participant, the deduction phases out between $169,000 and $179,000. In 2010 the reduction was phased out between $167,000 and $177,000.

The phase-out range for Roth IRAs also increased slightly from 2010. For a married couple filing jointly the ability to make a Roth IRA contribution is phased out between $167,000 and $177,000. For those filing either single status or head of household, the phase-out range will be between $107,000 and $122,000 for 2011. As always, for married individuals filing separate returns, the phase-out range remains between $0 and $10,000.

The Section 415 limitations for both defined benefit and defined contribution plans remain unchanged for 2011. For defined benefit plans the limit on the annual benefit remains at $195,000. For defined contribution plans the maximum amount of allocation allowed to a single participant in the plan remains at $49,000.

Annual compensation limits remain unchanged at $245,000. As well, the dollar limitation for the definition of the key employee in a top-heavy plan remains unchanged at $160,000. The dollar amount for definition of a highly compensated employee under Section 414(q)(1)(B) remains at $110,000.

Compensation to be considered for participation in a simplified employee pension plan (SEP) remains at $550 for 2011. The limits on deferrals to SIMPLE retirement accounts remains at $11,500.

SECTION: 402
IRS DECLINES TO WAIVE WRERA AIRLINE EMPLOYEE ROTH ROLLOVER TIME LIMIT, ARGUES THE AGENCY LACKS THE AUTHORITY TO DO SO

Citation: PLR 201051027, 12/27/10

Prior to the addition of §402(c)(B) to the Internal Revenue Code, the IRS took the position it had no authority to waive the 60-day period for rolling a distribution from a qualified employer sponsored retirement plan to an IRA. The IRS returned to that position when a taxpayer attempted to get permission to make a late rollover to a Roth IRA of an amount received as a qualified airline employee of an amount received pursuant to an order of a federal bankruptcy court by the airline to offset the termination of the airlines' retirement plan.

Section 125 of the Worker, Retiree and Employee Recovery Act of 2008 (WRERA) allowed for such amounts to be rolled into a Roth IRA by such employees, but such a rollover had to take place no later than the later of 180 days after the enactment of WRERA or receipt of the distribution.

The taxpayer received a notice from the airline regarding his option to roll the balance into a Roth IRA and the deadline date that was applicable. However the taxpayer was extremely ill at the time, and was not able to review the notice until after the expiration of the deadline date.

The IRS ruled that while WRERA Section 125 provided that these distributions take on the character of a qualified rollover contribution, it did not actually make it into a §402 rollover contribution. As such, the IRS found that §402(c)(B) did not grant it the authority to extend the due date for this rollover, and there was no relief provision in WRERA itself granting the IRS such authority. The IRS declined to grant relief, arguing that no authority existed allowing it do so in this case.

SECTION: 402A
IN-PLAN ROTH IRA GUIDANCE ISSUED IN Q&A FORMAT BY IRS

Citation: Notice 2010-84, 11/26/10

The IRS released, in question and answer format, information on the in-plan Roth rollover options that were made available by the Small Business Jobs Act of 2010 for distributions made after September 27, 2010. Note that a plan must normally be amended first to allow for such a distribution option—plans are not mandated to offer Roth accounts nor, if they do offer such accounts, allow for in-plan rollovers. However, the notice does provide for retroactive amendments to be made for this purpose so long as the plan is amended prior to December 31, 2011.

The notice points out that such rollovers can only be made for amounts that would otherwise be an eligible rollover distribution under §402(c)(4) and that the amounts must be vested. For taxpayers who have not had a severance of employment, that would mean that the participant would have to have reached age 59 ½, has died, become disabled or received a qualified reservist distribution as defined at §72(t)(2)(G)(iii).

An in-plan Roth direct rollover is not treated as a distribution for purposes of plan loans, spousal consent, distribution rights under §411(d)(6)(B)(ii) and for calculating if the participants' total accounts exceed $5,000 for purposes of §411(a)(11).

The plan can add new distribution triggers that are limited to in-plan Roth conversions (for instance, allowing in service conversions after a participant reaches age 59 ½), but cannot remove any pre-existing distribution rights. So if the plan previously allowed for in-service distributions to participants, that plan could not now limit such rollovers to in-plan IRA rollovers—doing so would violate IRC §411(d)(6).

If a plan offers in-plan Roth rollover options, it must include a description of such options in the notice provided to employees receiving an eligible rollover distribution.

The notice provides that, unlike Roth IRAs, there is no provision to undo the in-plan rollover if the taxpayer has a change of heart shortly after making the conversion. A Roth IRA conversion can be undone up until the extended due date of the individual's tax return, perhaps due to the fact that the value of the underlying investments have dropped—that option is not available for the in-plan distribution.

In-plan Roth rollover distributions are not subject to the 20% withholding requirements on actual cash distributions of amounts eligible for rollover.

The rollover itself is taxed in the same manner as a Roth IRA conversion, including being able to use the special 2010 election to defer taxation of a 2010 conversion to 2011 and 2012.

If the participant is deceased, only a surviving spouse or an alternate payee who is a spouse or former spouse can made the election for an in-plan Roth rollover.

SECTION: 402
SON WHO RECEIVED 401(K) DISTRIBUTION AFTER MOTHER PLEAD GUILTY TO KILLING FATHER/PARTICIPANT WAS PROPERLY TAXABLE ON DISTRIBUTION

Citation: D.N. (a minor) v. United States, CA9 No. 10-35037, 11/22/10

Murder and retirement accounts have been a recurrent theme this year in tax cases and rulings, and we have a new one from the Ninth Circuit Court of Appeals. In this case the son of the deceased argued that he should not have to pay income taxes on the distribution he eventually received from the 401(k) account of his father. The account named this individual's mother as the beneficiary of the account, but she was not allowed to receive the distribution under Oregon's slayer statute after she pled guilty to manslaughter with regard to her husband's death.

The legal representative of the son (who is a minor) argued that this situation was similar to cases, such the 1991 Tax Court case of Darby v. Commissioner, where an individual had benefits transferred to his former spouse under a divorce decree where no QDRO was issued. The representative argued that the son's mother had used her interest in the plan as a bargaining chip in obtaining her eventual plea bargain, giving up her claim on the plan as part of the agreement to plead guilty to the lesser charge of manslaughter rather than first degree murder.

The Ninth Circuit found this case clearly distinguishable from the issue in Darby. The Court noted that when the child's mother was identified as a suspect in the death of the participant, the plan administrator withheld distribution pending resolution of the criminal matter. The mother never had a right to take a distribution from the plan, and merely using her potential right to get the funds if she was acquitted as a bargaining chip in negotiations on a plea bargain did not change that fact.

As such, the Son was the true distributee of the funds and therefore liable for the tax.

SECTION: 403
EMPLOYEE ORGANIZATION WAS NOT SPONSOR OF ERISA PLAN, ARRANGEMENT WAS A MARKETING ARRANGEMENT

Citation: Daniels Hall v. National Education Association, CA9 No. 08-35531, 12/20/10

Members of the National Education Association (NEA) brought suit against the organization under ERISA, arguing that the organization violated its fiduciary duties under ERISA due to a program it entered into with insurance companies that allowed them to use the NEA's trademarked name and endorsement to market §403(b) annuities. The members allege that the program, under which the NEA received funds for the use of its name and trademarks, promoted annuities that had higher than average fees and that the NEA was under a fiduciary obligation to take such fees into consideration when selecting parties to partner with.

However, the Ninth Circuit Court of Appeals did not agree, finding that the NEA could not be a sponsor of an ERISA plan. The Court considered three theories under which it could be argued that the NEA was the sponsor of an employee benefit plan under ERISA.

It found the "Valuebuilder" program under which the NEA endorsed and promoted the annuities was not an ERISA plan, but rather a marketing arrangement. The court also found that the governmental school districts that included these annuities in their selection of acceptable §403(b) arrangements were specifically exempted from coverage under ERISA as governmental plans. The court found that true even though the districts themselves did not fund the plans, but all funds to acquire the annuities came from the employee's deferrals. The Court noted that, under §403(b), for the employees to obtain the tax beneficial treatment of their deferrals, the deferrals had to be funded via a program established by the governmental agency.

The Ninth Circuit disagreed with Seventh Circuit's view in Otto v. Variable Annuity Life Insurance that a governmental plan meeting the ERISA §2530.3-2(f) safe harbor becomes an ERISA plan. This panel agreed with the Department of Labor's argument that if a plan is determined to be a governmental plan, under the statute it is no longer a relevant question whether it fell under the safe harbor. The statutory exemption serves the shield the arrangement from ERISA.

Finally, the Court noted that the annuities themselves were not established or maintained by the NEA.

The Court notes that the plaintiffs are not without recourse, but they have brought their suit under the wrong area of law—trying, in the Court's view, to fit a square peg into a round hole. Since the program is not covered by ERISA, the proper area of inquiry would be in the area of securities law and whether the NEA or the insurance carried violated obligations to the purchasers of the annuities under those laws.

SECTION: 408
FINANCIAL INSTITUTION'S FAILURE TO PROVIDE ADVICE TO CLIENT DUE TO TERMINATION OF BROKER FOUND VALID REASON FOR IRS TO GRANT LATE IRA ROLLOVER RELIEF

Citation: PLR 201142031, 10/21/11

In PLR 201142031, the IRS decided that doing nothing could, effectively, amount to an error on the part of a financial institution pursuant to Rev. Proc. 2003-16, and granted a taxpayer relief from the 60 day requirement to complete a rollover of her IRA.

Following a rapid decline in the value of her IRA investments due to a market, a taxpayer instructed her financial institution to liquidate that account. The taxpayer’s broker with the financial institution was not at work at that time, and the paperwork to close out the account was prepared by the broker’s assistant, another employee of the institution. Not following normal procedures at the financial institution, the assistant forwarded the forms directly to the customer.

The taxpayer signed the forms which provided that the account would be paid out in cash to her rather than rolled into another IRA account. The forms were forwarded back to the assistant who sent the forms on for processing.

The taxpayer’s broker returned to the financial institution on the same date a check was issued to the taxpayer. However, the broker’s employment with the institution was terminated when he returned and, by the terms of his employment agreement, he was prohibited from contacting any of his former clients. Thus he could not advise the taxpayer about the need to deposit these funds back into an IRA account.

The taxpayer, deprived of the normal advice of her broker, deposited the check into a non-IRA account. The error was not noticed until the taxpayer’s accountant in the following year informed the taxpayer about the implications of the Form 1099R that she received and the consequences of not having redeposited the funds into an IRA account.

The taxpayer immediately withdrew the funds from the non-IRA account and transferred them to an IRA account. The taxpayer then filed the request with the IRS to waive the 60 day period.

The IRS found that the fact that the taxpayer did not receive the advice she expected to receive from financial institution amounted to a failure on the part of the financial institution, and that such failure justified the granting of the relief requested.

Note that even if your client has the identical situation, the IRS is not bound to grant relief by this ruling since a letter ruling binds the IRS only with regard to the taxpayer that requested the ruling. As well, in this case the law requires that the IRS must grant relief for the taxpayer to be excused, so there is no option not to ask for relief if the taxpayer wants to be able to complete a rollover and not pay tax on the distribution.

However, this ruling does illustrate that the IRS can more generous than you might expect in granting such relief. Certainly the nature of some of the relief that has been granted suggests that inquiring of the National Office regarding whether your client's case might qualify for relief may prove fruitful. Normally the attorneys in the National Office that handle these matters will informally discuss the chances of receiving relief under your facts before you go through the formalities of the application for a ruling and the client pays a user fee.

SECTION: 408
INDIVIDUAL STATUTORILY TREATED AS SELF-EMPLOYED NOT ALLOWED TO DEDUCT CONTRIBUTION TO SIMPLIFIED EMPLOYE PENSION (SEP)

Citation: Rosenfeld v. Commissioner, TC Memo 2011-110, 5/23/11

Merely having self-employment income is not, by itself, sufficient to allow a taxpayer to fund a simplified employee pension plan (SEP), a fact pointed out by the Tax Court to Michael Rosenfeld. Mr. Rosenfeld had a contract to provide services to the British Consulate General. Under IRC §3121(b)(11) the income was treated as self-employment income and Mr. Rosenfeld funded a simplified employee pension plan based on this amount plus his net earnings from his regular business activities.

The IRS challenged Mr. Rosenfeld, noting that he met the common law standard to be treated as an employee of the British Consulate even though the income had to be treated as self-employment income. Mr. Rosenfeld contested both points, arguing first that he did not meet the common-law employee test and second, even if he did meet that test, the fact that §3121(b)(11) treated such income as self-employment income would allow him to make a SEP contribution.

The Tax Court considered the common-law employment criteria as described in Reg. §31.3121(d)-1(c)(2) and concluded that all factors were either neutral or went against Mr. Rosenfeld's position, thus he was an employee. The Court then went on to consider Mr. Rosenfeld's argument that since he had to treat the income as self-employment income pursuant to §3121(b)(11) he would still be allowed to fund a SEP based on this income.

The Court found against Mr. Rosenfeld. The Court pointed out that in order to qualify as an "owner-employee" who could be the sponsor of a SEP, Mr. Rosenfeld had to meet the test of §401(c)(3) which requires that an owner-employee to own the entire interest in an unincorporated business. As the British Consulate was the "owner" of the business in which Mr. Rosenfeld operated as a common-law employee, he was not eligible to sponsor a SEP a and make a contribution based on that income.

This same "not the employer" problem more commonly arises when a partner in a partnership attempts to fund a SEP based solely on his/her own share of self-employment income passed out from the partnership. In the partnership case, it is the partnership that is treated as the employer and must be the sponsor of the plan.

SECTION: 408
TAXPAYER THAT "BORROWED" FROM IRA TO MAKE SHORT TERM LOAN TO ELDERLY MOTHER PENDING COMPLETION OF REVERSE MORTGAGE NOT ALLOWED LATE ROLLOVER RELIEF

Citation: PLR 201118025, 5/6/11

Clients may have heard the claim that you can "borrow" funds from your IRA for up to 60 days each year. While the basic tenets of this claim are correct, taxpayers must understand that when they do such a thing the IRS will not generally be willing to consider granting relief should the funds not end up back in the IRA account. In the ruling in question the taxpayer took funds from his IRA to help his elderly mother complete a reverse mortgage. The taxpayer had been assured by the bank that was going to handle the reverse mortgage that the reverse mortgage would be funded well within the sixty day window.

Unfortunately, due to numerous hitches and delays the mortgage was not funded within the 60 day period. The taxpayer requested relief to make a late rollover pursuant to IRC §408(d)(3)(I). However the IRS declined to grant such relief, noting that the taxpayer did not have any of the factors specifically mentioned in Rev. Proc. 2003-16 as justifying the grant of relief. The IRS noted in its ruling that the taxpayer had made a "short term loan" and "assumed the risk" that the funds might be available timely.

Generally the IRS insists on the taxpayer being able to point specifically to a Rev. Proc. 2003-16 factor in order to obtain relief. In this case any applicable error was not made by the financial institution in which he was trying to deposit the IRA funds, the IRS concluded that there was no Rev. Proc. 2003-16 factor involved.

SECTION: 408
TAXPAYER GRANTED LATE ROLLOVER RELIEF WHERE TAXING AGENCY FAILED TO RELEASE FUNDS TIMELY TO CUSTODIAN

Citation: PLR 201043044, 10/29/10

In an interesting ruling on rollovers, the IRS allows a taxpayer the right to roll over and amount distributed from an IRA late in the following circumstance. The taxpayer had a pending tax assessment from a taxing agency. Even though the taxpayer had filed an appeal, the taxing agency began collection activities. In order to retain his employment, the taxpayer had his IRA custodian transferred to the taxing agency the amount of tax in dispute.

The taxpayer was eventually successful in his administrative appeal and was due to be refunded the amount transferred. He requested that the agency transfer the amount directly to his IRA account. However the agency delayed, and the amount was transferred to the IRA custodian a few days after the end of the 60 day.

The IRS ruled in this case that the taxpayer was delayed in making his IRA rollover due to the mistake of the taxing agency, apparently treating that agency as a financial institution. Under Revenue Procedure 2003-16, an error on the part of a financial institution is one of the criteria that justifies allowing a late rollover.

Many may have assumed that the use of the funds to pay a potential tax liability would have been a problem for the IRS and that the mere fact it took the taxing agency a while to issue the check would not have been seen as a financial institution error. However, the IRS was rather generous in his view in this particular case.

SECTION: 409A
IRS ANALYZES REQUESTS FOR DISTRIBUTIONS TO DETERMINE IF THEY WERE UNFORESEEABLE EMERGENCIES

Citation: Revenue Ruling 2010-27, 11/8/10

The IRS has issued guidance on what constitutes an unforeseeable emergency for purposes of distributions from 457 and 409A plans. In both cases distributions are allowed for events meeting the test, but are not allowed for other events. The ruling posits three separate fact patterns to which the IRS applies the appropriate standard.

In the first case the taxpayer asks for a distribution for an unforeseeable emergency for the cost of repairing his residence after significant water damage occurred from a water leak discovered in the basement of his principal residence. In the second case, the taxpayer asked for a distribution to pay for the expenses of a funeral for his non-dependent son who died unexpectedly. The IRS ruled that in both cases, the taxpayer met the requirements for an emergency distribution, even though these events are not specifically spelled out in the regulations or model amendment.

In the third case, the taxpayer asked for a distribution to pay accumulated credit card debt. The IRS ruled that this event did not qualify, as it did not meet the requirements for being an unforeseeable event, nor was it an emergency circumstance that arose as a result of the events beyond the taxpayer's control.

SECTION: 415
IRS ANNOUNCES 2012 QUALIFIED PLAN INFLATION ADJUSTED LIMITS

Citation: IRS News Release IR-2011-103, 10/20/11

The IRS announced the inflation adjusted limitations imposed on qualified plans for 2012. Generally the limits received modest increases, though some remained unchanged.

Type	2012 Amounts	2011 Amounts
Maximum annual benefit-DB Plan	$ 200,000	$ 195,000

(§415)		
Contribution limit DC Plan (§415)	50,000	49,000
Annual Compensation Limit (§404(l))	250,000	245,000
Catch up Contributions to Employer Plan	5,500	5,500
Elective Deferrals (§402(g))	17,000	16,500
Highly Compensated Employee (§414(q))	115,000	110,000
Key Employee Compensation (§416(i))	165,000	160,000
SIMPLE Deferral Limitation (§408(p))	11,500	11,500
SEP Compensation Limit (§408(k))	550	550
Roth IRA Maximum Contribution Phaseout Begins:		
Married filing joint	173,000	169,000
Other except married filing separate	110,000	107,000

SECTION: 419A
TAXPAYER FOUND NOT TO HAVE LEGITIMATE LOAN FROM BENEFIT PLAN, AMOUNT TREATED AS TAXABLE DISTRIBUTION

Citation: Todd v. Commissioner, TC Memo 2011-123, 6/6/11

A neurosurgeon enrolled his corporation in the American Workers Master Contract Group to negotiate with his employees who “joined” the National Production Workers Union Local 707. The reason for this union organizing by the 100% owner of the company was not some strange sympathy with union activism by the owner, but rather to attempt to create a §419A qualified plan that avoided the limitations imposed on small plans.

The stated purpose of the program was to "provide eligible employees with a death benefit," but loans were permitted. However the real purpose was to allow the doctor to deduct premiums on a universal life policy and withdraw cash, purportedly tax free.

Interestingly enough in this case the IRS did not attack the reality of this collective bargain arrangement, but rather simply went after $400,000 the doctor took out as a loan from the plan.

The Tax Court found the $400,000 “loan” was really a taxable distribution after analyzing the transaction to determin if there was a bona fide loan. The Court noted that the plan’s requirements for a loan were not followed, documentation was completed well after the fact, the fact that the plan charged the doctor a significantly lower interest rate than the insurance company was charging, the doctor never made the scheduled payments on the note, there was not adequate collateral for the loan and the parties simply failed to conduct themselves in a manner to suggest the loan was real.

After the dust settled, the physician's tax increased by $165,000, and he incurred a penalty of $33,000.

Unfortunately in the 1990s and 2000s many such programs were promoted to small business clients, using either the "collective bargaining program" found here or attempting to structure a 10 or more employer plan that claimed not to segregate the assets of each employer but which, the client was assured, really did so. The IRS has been almost universally successful in challenging these arrangements.

SECTION: 419A
CONVERSION OF MULTIPLE EMPLOYER §419A PLAN TO SINGLE EMPLOYER ARRANGEMENT TRIGGERED IMMEDIATE INCOME RECOGNITION

Citation: Cadwell v. Commissioner, 136 TC No. 2, 1/3/11

The Tax Court took a look at the impact of a conversion of an employee benefit plan from a purported multiple employer plan to a single employer plan, specifically looking at the amount that must be treated as income (if any) by the employee in the situation. In this case, the individual was treated as an employee of his spouse's S corporation, a corporation that held an interest in a limited partnership.

The corporation had adopted a multiple employer plan that purportedly complied with the requirements of §419A(f)(6). The transaction was of a type that the IRS had identified as a listed transaction in Notice 95-34. Following the passage of the American Jobs Creation Act of 2004, where failing to include disclosure information related to listed transactions subjected the taxpayers to significant penalties, the plan was converted by its sponsor (a benefits consulting firm) into separate plans for each employer. The sponsor noted in its letter to the employers participating in the plan that this action was being taken specifically due the possibility that the transaction was a listed transaction subject to substantial penalties.

The IRS contended that in the year of the conversion of the plan the taxpayer had $102,039 of unreported income, consisting of $70,529 in fund value of the insurance policy, $18,000 of excess contributions to the plan and the cost of term insurance on the taxpayer's life for the year of $13,510. The Tax Court found first that following the conversion of the plan to a single employer there was no longer a substantial risk of forfeiture, as the conversion eliminated the chance that other employer's claims under the multi-employer plan could cause the assets to be used to pay those claims. The court found the taxpayer, as the sole listed officer of the corporation, had the right to terminate the plan at any time, thus eliminating the risk of forfeiture. The court determined its prior decision in Booth v. Commissioner was not applicable as the court held that deferred compensation was not an issue in this case, unlike Booth.

The Court also found the purported vesting restrictions were illusory under the facts of this case, since the taxpayer could terminate the plan at will and have the plan assets distributed to the corporation and any power to enforce restrictions against the taxpayer was in the hands of his spouse and children. As the employer was designated as the plan administrator and taxpayer controlled the employer completely, the taxpayer had no real restrictions on his access to the asset.

The fact that the employer never claimed a deduction for premiums paid to the plan also did not remove it from taxation, as the Court held that IRC §402(b)(1) does not condition inclusion in income on an employer level deduction being claimed. In accordance with Rev. Proc. 2005-25 the cash surrender value is ignored in computing the fair market value of the policy to determine the amount taxable to the taxpayer upon the conversion.

The Court also concluded that excess contributions to the plan and the value of the year's death benefit were also taxable to the taxpayer, since the taxpayer's relied on the same defense based on the illusory risk of forfeiture to argue against inclusion of either of these items in income.

SECTION: 501
MEMBERS OF §501(D) ORGANIZATION FOUND TO BE EMPLOYEES EVEN THOUGH PAID NO WAGES

Citation: Stahl v. Commissioner, CA9 No. 10-35006, 11/29/10

The Ninth Circuit ruled that an members of a §501(d) organization were actually employees of the organization, and that the income reported by the members should be reduced by the amounts paid by the organization for medical and meals that would be properly deductible as excludable fringe benefits.

A §501(d) organization is a bit of a unique entity, being a religious and apostolic organization. These organizations, in the words of the court, "maintain a common treasury and do not pay income tax" but rather the individual members pay personal income tax on their share of the entity's income, making them a flow through style tax entity. If the payments of medical and meals are allowed at the entity level, then the individual's tax burden is lessened.

Under the tenets of the group's Hutterite tradition, the members do not own individual property, such property being held by the organization. As such, the entity did not pay wages to the members, as they would be required to contribute them immediately back to the organization. The IRS argued that such individuals were clearly not employees of the organization and, therefore, no employee benefits should be allowed as a deduction.

While the District Court that originally heard the case agreed, the Ninth Circuit did not. The Court of Appeals applied the Supreme Court's definition of an employee as found in the 1992 case of Nationwide Mutual Ins. Co. v. Darden. The Court disagreed with the trial court's view that no business was conducted, noting the mere existence of other, social reasons for organizing did not detract from the fact that the group ran a large, and fairly successful, farming operation. The Court also found the District Court had erroneously found no right to discharge individuals, noting that the organization provided for expulsion and the appellate panel did not find that such an option could not be use for poor performance of a job.

The Court noted the lack of payment of actual salaries was a factor in favor of the government's position, but found valid reasons for such nonpayment of salaries (the fact that the amount would simply be repaid). The failure to pay payroll taxes on the net earnings was noted by the Court, but it pointed out that the mere fact such tax might have been due and wasn't paid would be a matter for the IRS to raise a payroll tax claim, and does not impact the finding of whether these individuals were employees. Overall, the panel concluded, these individuals appear to be employees of the organization.

The Court remanded the case back to the District Court to deal with the factual issue of exactly which expenses would qualify for deduction since other requirements are imposed by the law before a deduction would be allowed.

The decision leaves open the question of whether the nonpayment of wages would have been fatal outside of the unique nature of a §501(d) organization, as well as whether members of other passthroughs (such as partnerships) might end up in an employment relationship—simply put, those issues were not before the Court. Rather, the case illustrates that sometimes things aren't quite as simple as they might appear (or as the IRS wishes them to appear).

SECTION: 1362
CORPORATION ACQUIRED BY PARENT ADOPTION ESOP ALLOWED EARLY RE-ELECTION OF S STATUS AND QSUB ELECTION, SUBJECT TO CONDITIONS

Citation: PLR 201047007, 11/26/10

The IRS dealt with the question of granting permission for a corporation to re-elect S status and make a Qualifying S Corporation Subsidiary election in the following situation. In order, the following events took place:

- Corporation Y (eventually the parent corporation) adopted an employee stock ownership plan (ESOP).
- Corporation X (to be the subsidiary) terminated its S election.
- Corporation Y acquired 100% of the shares of Corporation X.
- The ESOP acquired 100% of the shares of Corporation Y.
- Corporation Y filed an election to be an S corporation.

Corporation X now wishes to elect S status and make a QSUB election. The problem is that less than five years have elapsed since the original S election was revoked, thus the corporation is still within the five year waiting period before a new S election can be made without IRS consent under §1362(g). So the corporation asked for permission to make that election.

The IRS granted permission to make the election, but the former shareholders of Y (the parent) had to represent that no election to defer gain on the sale of the stock to the ESOP under §1042 would be made, and Corporation Y represented that it would not consent to any such election under §§4978 or 4979A.

SECTION: 1402
REGISTERED DOMESTIC PARTNERS AND SAME SEX SPOSUES IN COMMUNITY PROPERTY STATES MUST EACH PAY SELF-EMPLOYMENT TAX ON HALF OF COMMUNITY TRADE OR BUSINESSS INCOME

Citation: IRS Information Letter 2011-0066, 9/30/11

In a letter to a United States Senator, the IRS clarified the agency's view of the tax treatment of self-employment income of registered domestic partners and same sex married couples in community property states. In 2010 the IRS ruled in Chief Counsel Advice 201021050 that California registered domestic partners and same sex married couples had to each report ½ of community income, since California law provided that community property law applies to individuals holding either status.

Generally state law determines property rights, and property rights determine federal taxation of items of income. While under the Defense of Marriage Act the IRS does not respect same sex married couples as being married for purposes of filing status, the law did not contain any provisions overriding state law for property purposes.

The ruling notes that if trade or business income is community income under the applicable state law for these individuals, then each must report half of that income on their individual returns, which is consistent with the treatment in community property states for married couples that file a joint return.

However, IRC §1402(a)(5) provides that community property laws are not respected for determining the self-employment income of spouses for purposes of the self-employment tax. Thus, while a married couple splits the income for regular income tax purposes, the spouse performing the services generally picks up the entire self-employment income. Because the self-employment tax, unlike the income tax, is effectively regressive (there is a FICA maximum that kicks in, eliminating the FICA portion of the tax once income exceeds the limit each year), this rule, when it makes a difference, generally works to the tax benefit of the couple

However, the IRS notes that the provision specifically applies this rule to spouses. Registered domestic partners are not considered married under state law, and therefore the rule does not apply. While same-sex married couples may be considered married under state law, the Defense of Marriage Act holds them to be not married for purposes of the tax law, thus for federal purposes they are also not spouses. Thus, the prohibition on the application of community property rules to self-employment income for self-employment tax purposes does not apply to either class of individuals in the IRS's view.

SECTION: 1402
SHERIFF'S DUTY OWED SELF-EMPLOYMENT TAX FOR OFF-DUTY WORK, EVEN THOUGH SUBJECT TO PREAPPROVAL BY EMPLOYER

Citation: LaDue v. Commissioner, TC Summary Opinion 2011-41, 4/5/11

Some rules that advisers believe they "just know" aren't truly rules at all. One of the best examples of that is the belief that payments for services received by an individual as part of his/her trade or business must be subject to either self-employment tax (amounts paid to a taxpayer for services by someone who does not have an employment relationship with the individual) or FICA/Medicare taxes (for amounts paid by an employer of the individual).

New car salespeople often find themselves educating their tax adviser in this area. In that industry salesmen are often paid an incentive directly by the car manufacturer if they achieve certain goals when selling cars at the dealership. The payment is not subject to FICA or Medicare because it is not paid by the taxpayer's employer (a requirement for FICA taxation). But the payment, reported on Form 1099MISC, is also not subject to self-employment tax because 1402(c)(2) provides that self-employment tax does not apply to amounts paid as compensation paid to an employee. If this sounds too good to be true, you just need to read IRS Publication 3204, an IRS flyer that confirms the above tax treatment.

However not many situations fall into this crack, and the taxpayer before the Tax Court found he was not one either. The taxpayer was a deputy sheriff in Florida who performed off-duty security services for other entities.

The taxpayer was required to have such off-duty work approved by his employer prior to working for those entities, and those entities paid his employer an administrative fee. However, the Court noted that the services performed were for the third party and not the taxpayer's employer, who received at best only an incidental benefit from having the officer seen in uniform at these locations. While his employer had to approve any work, it did not rise to the level of the employer being able to hire and fire individuals at will for this work. Finally, payments were from the third party.

Taken as a whole, these facts in the Court's view supported the view that the taxpayer was truly self-employed and not acting as an employee when performing this off-duty work. Thus, §1402(c)(2) did not serve to shield the deputy from self-employment tax.

SECTION: 1402
LLP MEMBERS OF LAW FIRM ARE NOT LIMITED PARTNERS, SUBJECT TO SELF-EMPLOYMENT TAX

Citation: Renkemeyer, Campbell & Weaver, LLP v. Commissioner, 136 TC No. 7, 2/9/11

The Tax Court was asked by the IRS to rule on the applicability of the self-employment tax in the case of a limited liability partnership, a ruling that should have similar implications for limited liability companies and similar entities that elect to be taxed as partnerships under the check the box regulations. What the Tax Court ruled was not as severe as some may have worried might have been the case given prior rulings in cases like Norwood v. Commissioner (TC Memo 2000-84), but certainly does not give much comfort to anyone who was trying to take the position that an LLP or LLC member who is active in the entity was "like" a limited partner.

The case involved a law firm that was organized as an LLP. The IRS had two problems with the entity. The first was that the entity attempted to allocate a large portion of its income to an S corporation that was owned by an ESOP, an issue that proved even more problematical when the firm could not produce a partnership agreement for the year in question that had a special allocation to the ESOP nor any evidence of the economic reality of the allocation. The IRS and the Tax Court rejected that allocation, and instead forced an allocation based on the profits and loss interests. That ruling wasn't terribly unique nor, frankly, surprising.

However there was another issue that got brought into court to go with the first one. The partnership had taken the position that none of its income was self-employment income, arguing that the members of the LLP were "like" limited partnership interests since a) they were called limited partnership interests in the entity's documents (even though the entity was not a limited partnership under Kansas law) and b) they had limited liability. However, the Tax Court pointed out that traditionally a limited partner was barred from participating in management, while LLP members could participate without risking their liability protection—so what we had certainly is not "just like" a limited partnership interest.

The Tax Court noted that §1402(a)(13) was enacted prior to the existence of entities such as LLPs and had no definition of what was a limited partnership interest in the statute. The Court did not take the position outlined in the Norwood case that a limited partnership interest for §1402(a)(13) purposes had to be a limited partnership interest under state law (a position that would make all LLP members subject to self-employment tax on business income of an LLP), but rather attempted to determine what Congress's intent was in enacting the bill.

The Court concluded, looking at the legislative history, that Congress was concerned with whether a partner merely was a passive investor, wanting to avoid giving the latter group credit towards Social Security coverage. The Court concluded that since the income of law firm arose not from the attorneys' investment in the law firm (which was minimal) but from the attorneys' services performed on behalf of the law firm, they were subject to self-employment tax on the income of the partnership.

The case would suggest that a service partner in a service partnership is going to be subject to self-employment tax on all earnings passing out of an LLP or LLC. The case didn't deal with what would happen if there are services but capital is also a material factor in producing income, but to this author it would seem likely that the Court would look primarily at whether the person was "actively participating" in the entity and come up with an "all or nothing" treatment for self-employment taxes absent a true second class of ownership interests that were truly just investment interests.

While the opinion did not apply the 1997 proposed regulations, its reasoning seems largely in line with the holdings of those regulations as applied to LLCs and LLPs, which look largely to the factors that the opinion looked at, though in a more mechanical fashion. What the case does make clear is that merely arguing an LLC or LLP member is "like" a limited partner for self-employment tax purposes based solely on limited liability is not going to pass muster at the Tax Court.

SECTION: 1402
CORPORATIONS FORMED TO ATTEMPT TO AVOID SELF-EMPLOYMENT TAXES FOUND TO BE SHAMS, LLC WAS DISREGARDED ENTITY

Citation: Robucci v. Commissioner, TC Memo 2011-19, 1/24/11

A taxpayer discovered that tax advice to reduce his self-employment tax was "too good to be true" and was held liable for both the tax and negligence penalties. The case in question involved what had previously been an unincorporated practice of a psychiatrist who went to see a local CPA that specialized in entity selection. The CPA advised the doctor to form two corporations and a new limited liability company. The practice became part of the LLC, one of the corporations was given an interest in the practice (thus, it was claimed, creating a partnership entity for tax purposes) while the other became a management company.

The corporate member was granted a 5% interest in the practice, while the doctor received a 10% "general" interest and an 85% "limited" interest in the practice. He treated only distributions on the general interest as being subject to self-employment taxes. The IRS protested that the corporations were shams, and that the entity was therefore an LLC with one owner, making it by default a disregarded entity.

The Tax Court agreed, pointing out that the doctor wasn't able to clearly explain what those other entities were supposed to do or their business purpose, the corporations had no employees, there was no transfer of the intangible assets to the LLC (the CPA had argued for limited interests based on the value of the doctor's goodwill) and neither entity had an employment agreement with the doctor. The court did not find believable the stated business reasons offered for the arrangement, finding that there was no evidence it provided better protection against liabilities nor that it helped the entity provide medical benefits under state law.

The Court also found that the doctor could not rely upon the CPA, as the deal simply looked too good to be true and he should have noticed that there appeared to be no real reason, aside from tax reduction, in forming this entity.

SECTION: 3101
IRS ANNOUNCES VOLUNTARY CLASSIFICATION SETTLEMENT PROGRAM FOR CERTAIN PAYROLL TAX EXPOSURES DUE TO MISCLASSIFICATION

Citation: Announcement 2011-64, 9/21/11

The IRS has announced a program to enable taxpayers that believe they may be at risk of the IRS reclassifying independent contractors or other individuals as employees to voluntarily begin treating them as employees. The program, labeled the "Voluntary Classification Settlement Program" (VCSP) will give a qualified employer protect from IRS examinations reclassifying individuals as employees for prior year, but requires the employer to pay a limited federal payroll tax liability for the immediately prior year and to agree to a six year statute of limitations on the assessment of payroll taxes for the first three years after it enters the program.

To qualify for the program the employer must have consistently treated the individuals in question as nonemployees and filed all required Forms 1099s for the individuals for the prior three years. The taxpayer cannot currently be under examination by the IRS for any reason, nor can the taxpayer be under audit concerning worker classification by the U.S. Department of Labor or any state government agency. If a taxpayer was previously audited by the IRS or DOL on a classification issue, it will only be eligible if the taxpayer has complied with the results of that audit.

An employer entering the program agrees to treat the individuals as employees for future tax periods. As well, the employer will pay 10% of the amount that would have been due on compensation to workers for the most recent tax year, computed under the reduced rates of IRC §3509 for any withholding not made. Under §3509 that liability would have equaled a federal withholding tax liability of 1.5% of the wages paid and 20% of the FICA and Medicare taxes that should have been withheld from the employee.

The tax liability is computed on Form 8952 (the form used to apply to enter the program) using a specified percentage based on the overall liability. Before the 20% reduction, the initial assessment for that prior year will be 10.68% for compensation paid to workers at or below the social security wage base on 2010 compensation (10.28% for 2011 compensation) and 3.24% on classes of workers at or above the social security wage base on 2010 or 2011 compensation. This preliminary tax (the amount that would have due had an examination concluded these individuals were employees for that period) is then reduced by 90%. No penalty or interest will be assessed.

The Form 8952 must be filed no earlier than 60 days before the date on which the employer proposes to begin treating the individuals as employees. The Form 8952 must be executed by the taxpayer under penalties of perjury. This particular form cannot be executed by an individual holding a power of attorney, but must be executed by the taxpayer. However an individual holding a power of attorney can represent the taxpayer in this matter otherwise.

The IRS will review the application and contact the taxpayer once it has verified the taxpayer's eligibility. The IRS retains discretion on whether to accept the application. If the application is accepted, the IRS and the taxpayer will enter into a closing agreement on terms of the VCSP program and the taxpayer must simultaneously make full and complete payment of the amount due.

While not stated in the announcement, it is possible the IRS is offering this program as a predecessor to becoming more active in the employee classification arena in examinations. Advisers should consider advising clients with potential exposure in this area regarding the program. However advisers should point out to clients that while the IRS may have agreed to take only the payment due, the program does not resolve classification issues with other federal agencies (such as the DOL) or state agencies. Similarly, it would appear that the program would not offer protection on the question of qualification of any qualified plan that may have excluded employees from participation.

For these reasons, an employer considering entering this program should consider the advisability of seeking legal counsel skilled in the employment law arena regarding any other exposures that might exist, including whether participation in this program might be seen as an admission of employee status for other purposes.

SECTION: 3121
SOCIAL SECURITY WAGE BASE FOR 2012

Citation: Social Security Administration News Release, 10/19/11

The Social Security Administration announced in an October 19, 2011 news release that the maximum amount of earnings subject to Social Security tax in 2012 will increase from $106,800 that was taxable in 2011 to $110,100 for wages paid in 2012.

SECTION: 3121
SERVICE PROVIDERS WORKING AT SPA HELD NOT TO BE EMPLOYEES

Citation: Cheryl Mayfield Therapy Center v. Commissioner, TC Memo 2010-239, 10/28/10

In what the court found was a close case, the Tax Court found that massage therapists, cosmetologists and nail technicians that worked on the premises of a spa were independent contractors and not employees of the spa. The individuals paid a booth rent of approximately $80 as a base rent or, if higher, 25% of the service provider's gross revenues earned.

The Tax Court discussed a number of Revenue Rulings that had dealt with the question of employment status of individuals in similar industries, including Revenue Ruling 73-592, Revenue Ruling 57-110, Revenue Ruling 73-591, Revenue Ruling 73-574 and Revenue Ruling 70-488. The Court noted that the existence of a fixed rental component generally argued for independent contractor treatment. While the spa was not consistent, normally the rent charged was based on the $80 minimum or, if higher, 25% of gross receipts.

Also in the spa's favor was the fact that all compensation was on a straight and mission basis, no business or travel expenses of the service providers was paid for by the spa and many of the service providers made significant investments to outfit and decorate their room. These factors meant the service providers both had a risk of loss and an opportunity to profit by working longer hours.

The spa did not tell the service providers how to provide the services to their clients, the service providers were all licensed professionals, set their own hours and although they provided their schedules in advance, the service providers could change the schedules as they please.

Arguing against the treatment of the service providers as independent contractors were certain factors the Tax Court pointed out. The services given were integrated directly into the spa's operation, the services were provided almost exclusively on the spa's premises, some basic training was provided and the service providers did not generally offer their services to the public outside of the spa.

Ultimately the Tax Court decided that, although it was a close case, these individuals were properly treated as independent contractors.

SECTION: 3122
FEDERAL AGENCIES CAN BE TREATED AS EITHER ONE OR TWO EMPLOYERS FOR FICA WITHHOLDING PURPOSES

Citation: Chief Counsel Email 201042031, 10/22/10

Individuals that work for two employers and have social security taxes withheld for the year on wages in excess of the annual social security wage base are allowed to claim a credit on their tax return for the excess. However, generally if the amount is paid by a single employer that happens to over withhold, the employee does not get the credit.

An IRS email discusses a special treatment accorded the federal government for this purpose, effectively noting that two federal agencies can be treated as either one or two employers for this purpose. Under §3122 the agencies can either coordinate to limit the deduction (and thus be treated as a single employer) or they cannot coordinate and the employee can treat the two agencies as two separate employers.

The email goes on to note that agencies that had not coordinated in the year in question could request a refund of employer FICA, but that to do so after the fact would require obtaining employee's consent to seek a refund on the employee's behalf.

SECTION: 3406
TAX COURT HAS NO JURISDICTION OVER BACKUP WITHHOLDING ON CONTRACTORS, BUT STATUTE OF LIMITATIONS ON THAT TAX SUSPENDED DURING PERIOD EMPLOYER COULD CHALLENGE IRS CLAIM INDIVIDUALS WERE EMPLOYEES

Citation: CCA 201049027, 12/10/10

If the IRS comes across a business that has paid individuals for services whom the IRS believes are employees, but for whom identification numbers were not obtained and 1099s not filed, what is the status of the potential claim for the IRS for backup withholding from the independent contractors under §3406? The Chief Counsel's office was asked to rule on a couple of issues that arise from that situation.

First, does the Tax Court, which has jurisdiction over the determination of whether the individuals are employees, also have jurisdiction over the question of whether, should the individuals be found not to be employees, there is backup withholding due under §3406. The advice concludes that the Tax Court's jurisdiction is strictly limited to the question of whether the individuals are employees, and it has no jurisdiction over the tax that could be due for backup withholding on independent contractors under §3406 should the case be resolved, by decision, concession or settlement to treat the individuals as not employees.

Second, does the IRS filing a notice to the employer that the individuals were employees suspend the statute of limitations on assessing the backup withholding tax under §3406 if the taxpayer had filed Form 945? The advice concludes that the statue is suspended, even though the Tax Court has no direct jurisdiction, because the taxpayer's right to appeal the finding that the individuals were employees to the Tax Court suspends the IRS's right to assess the backup withholding tax until the right to appeal the employment status goes away.

Thus, the IRS concludes, the suspension of the statute would apply to the backup withholding liability as well. So if the taxpayer prevails in his/her claim the individuals were not employees, the advice holds that the IRS could still assess backup withholding on the payments to these individuals as independent contractors.

SECTION: 3501
COVERAGE THRESHOLD FOR DOMESTIC EMPLOYEES INCREASES FOR 2012

Citation: Social Security Administration News Release, 10/20/11

The Social Security Administration on coverage threshold for domestic employees is to increase in 2012 from $1,700 to $1,800.

SECTION: 4973
FAILURE TO ATTACH FORM 5329 TO TAX RETURN FOUND TO CAUSE STAUTE OF LIMITATIONS ON EXCISE TAX ON OVERCONTRIBUTIONS TO ROTH IRA TO NEVER START RUNNING

Citation: Paschall v. Commissioner, 137 TC No. 2, 7/5/11

A taxpayer that participated in a marketed "Roth IRA Stuffer" tax shelter found the taxpayer's failure to include a Form 5329 with his return to report excise tax on overcontribution to an IRA meant the statute never began to run on assessing the excise tax. The shelter attempted to transfer significant regular IRA assets and non-IRA assets into a Roth IRA, transforming income in that account into tax free earnings.

In the case the IRS found that excess amounts had been contributed, and sought to collect the excise tax on overcontributions.

The taxpayer asserted that the Form 5329 was not a separate tax return, and that by filing the Form 1040 to which the Form 5329 would have been attached that the statute of limitations had run on assessment. The Tax Court agreed with the IRS that, in fact, the Form 5329 represented a separate tax return.

The Court noted that, under the Supreme Court's decision in Commissioner v. Lane-Wells Co., 321 U.S. 219, a taxpayer that files one return when another is actually required doesn't start the statute of limitations running unless the return that was filed had sufficient information to apprise the IRS of the existence of a potential liability for the other tax.

In this case there was no indication on the Forms 1040 filed by Mr. Paschall that a potential excise tax that would have been reported on the Form 5329 was possible. Having not apprised the IRS of the potential issue, the taxpayer could not claim the IRS was barred by the statute of limitations on assessing the tax.

SECTION: 6051
IRS INTERIM GUIDANCE EXPLAINS HEALTH CARE COST REPORTING ON W-2S, EXEMPTS CERTAIN SMALL EMPLOYERS

Citation: Notice 2011-28, 5/9/11

The IRS issued additional interim guidance regarding the reporting of employer provided health coverage, an information reporting requirement added by the Patient Protection and Affordable Care Act of 2010. The IRS had already delayed mandatory reporting until the 2012 calendar year W-2s pursuant to Notice 2010-69.

The aggregate reportable cost is to be shown on Form W-2 in box 12, using code DD. Until further guidance is issued, employers that were required to issue less than 250 Forms W-2 for the preceding calendar year will not be required to report the cost of coverage, though the employer can elect to do so.

Entities may apply any reasonable method, so long as it is applied consistently, to report the cost of coverage for employees that terminate employment during the year. As well, if the employee requests to receive a Form W-2 before the end of the year pursuant to §31.6051-1(d)(1)(i) no amount will be required to be reported for the cost of coverage paid.

If the only item the employer has to report to the individual would be employer sponsored heathcare coverage (such as to a retiree or other former employee) no W-2 will be required to be issued.

Coverages to be included in the employer sponsored coverage includes any coverage that would be excludable from income under §106 if paid by the employer (even if the employee actually pays for it) except for coverage for long term care, coverage for on-site medical clinics, separate contracts whose benefits are limited for treatment of the mouth or the eye (dental and vision coverage) or any coverage described in § 9832(c)(3) the payment for which is not
excludable from gross income and for which a deduction under § 162(l) is not
allowable. As well, contributions to MSAs, HSAs, and HRAs are not included in the reported amount. Employee deferrals to FSAs under a cafeteria plan are also excludable.

Self-insured plans that are not subject to federal continuation coverage are not included in the reported costs, but those that are subject to those rules must be included

All premiums paid due to the employment relationship (such as for an individual's spouse and/or a child under age 27) must be included in the amount reported.

The notice contains methods to be used when an employer charges an employee a composite rate, as well as information on calculations when the reportable cost for a period changes during the year or when an employee commences, ceases or terminates coverage during the year.

SECTION: 6051
IRS WILL NOT PENALIZE EMPLOYERS FOR FAILING TO REPORT COST OF EMPLOYER PAID HEALTH CARE ON 2011 FORMS W-2

Citation: Notice 2010-69, 10/12/10

The IRS has announced relief from the requirement for employers to report premiums paid on behalf of employees as an information line on 2011 Forms W-2. The IRS indicated that the relief was being granted to give employers time to modify their information reporting systems to be able to obtain the necessary information for payment of medical premiums for each employee.

The guidance technically doesn't repeal the requirement, but merely notes that the IRS will not impose any penalties on employers that fail to report the amounts paid as required by §6051(a)(14) paid for employer provided coverage for each employee.

The notice goes on to note that the IRS expects to issue guidance on the reporting requirements under this provision by the end of 2010.

SECTION: 6330
STANDARDS OUTLINED FOR DETERMINING EXISTENCE OF PREDECESSOR FOR PURPOSES OF EMPLOYMENT TAX COLLECTION DUE PROCESS HEARING RIGHTS

Citation: Program Manager Technical Assistance, PMTA 2011-011, 5/13/11

Under §6330(f) the IRS can levy employment tax liabilities on a taxpayer without granting the taxpayer a collections due process (CDP) hearing if the levy relates to a disqualified employment tax levy. Such a levy is one for payroll taxes on a taxpayer if the taxpayer or a predecessor of the taxpayer had previously requested a CDP hearing under §6330 for unpaid employment taxes arising in the two-year period prior to the beginning of the period covered by the levy. A Program Manager Technical Assistance memo outlined the test to be used to determine if there is a predecessor employer.

The PMTA notes that no single factor is determinative, and tax avoidance does not have to be a factor to find an entity is a predecessor. Rather, the IRS is consider the following factors:

"1. The taxpayer has substantially the same owner(s) or shareholder(s) and the same officer(s) as the prior
business.

2. The same individual(s) are actively involved in running the taxpayer that were actively involved in running
the prior business, regardless of whether they are officially listed as the owners/shareholders/officers.

3. There is no evidence that the taxpayer's owner(s) or shareholder(s), if different than before, acquired the
business in an arms-length transaction for fair market value.

4. The taxpayer provides substantially the same product(s), service(s), or function(s) as the prior business.

5. The taxpayer has substantially the same customers as the prior business.

6. The taxpayer has substantially the same assets as the prior business

7. The taxpayer has the same location/telephone number/fax number, etc. as the prior business."

However, the PMTA notes that if there has been a genuine change in control of the business the prior business will not be found to a predecessor. The PMTA defines a change of control as existing if both the business was acquired from its prior owners in an arms-length transaction at fair market value and the previous ownership have ceased all involvement with the business.

The PMTA gives three examples, reproduced below, of the application of these standards:

"EXAMPLE #1:

Company A, in the business of selling equipment, was owned by Individual X. After Company A failed to pay employment taxes for several quarters in Year 1, the Service sent Company A a CDP notice. Company A requested a CDP hearing. After the CDP hearing, Individual X formed Company B, which also sold equipment. Company B used the same supervisors, sold the same equipment, was in the same location, and had the same phone number as Company A. Company A is a predecessor of Company B

EXAMPLE #2:

Company C, in the business of storage, was owned by Individual W. After Company C failed to pay employment taxes for several quarters in Year 1, the Service sent a CDP notice to Company C. Company C requested a CDP hearing. After the CDP hearing, Individual W sold the assets of Company C to Individual Y for fair market value in an arm's length transaction. Individual Y used these assets to form Company D, which also engaged in the storage business and used the same employees and maintained the same customers, location, and phone number as Company C. Individual W was not involved in the operation of Company D. Company C is not a predecessor of Company D.

EXAMPLE #3:

Company E, in the business of providing childcare, was owned by Individual G. After Company E failed to pay employment taxes for several quarters in Year 1, the Service sent a CDP notice to Company E. Company E requested a CDP hearing. After the CDP hearing, Individual G's daughter, Individual H, formed Company F, which also provided childcare. Individual G was actively involved in running Company F. Company F used the same supervisors, cared for the same children, was in the same location, and had the same phone number as Company E. Company E is a predecessor of Company F."

SECTION: 6672
MINISTER LIABLE FOR UNPAID TRUST FUND TAXES DESPITE DELEGATING PAYROLL TAX MATTERS TO FINANCIAL ADMINISTRATOR

Citation: In re Vaugn, U.S. Bankruptcy Court, E.D. North Carolina, 2011-2 U.S.T.C. ¶50,681, 10/17/11

In the case of *In re Vaughn,* (U.S. Bankruptcy Court, E.D. North Carolina, 2011-2 U.S.T.C. ¶50,681) a minister was found to be a responsible person for unpaid payroll taxes of her ministry.

The minister in question, while in the position of Chief Apostle and CEO of the organization, was informed in 1999 that there were unpaid payroll taxes. After discovering this, she hired a financial administrator and put her in charge of all financial matters, including resolving the issue with the IRS. The organization entered into an installment agreement with the IRS to cover the unpaid payroll taxes.

While the organization did pay off the installment agreement, its financial difficulties did not end there. It later failed to pay additional payroll taxes. The minister had her own problems. Her husband became ill, and she and her husband moved from Michigan (where the ministry was located) to North Carolina. However, she remained the Chief Apostle and CEO and continued to draw salary from the organization.

In 2003 she was eventually informed by the financial administrator that the ministry was totally broke, and that "everyone" was owed money with none to be found. At that point, the minister wrote a memo directing that no payments were to be made to anyone but the minister at the church and herself without her approval. That included paying staff, at which point most of the staff, including the financial administrator resigned.

The minister argued first that she was not a responsible person, since she was not aware of the later unpaid taxes and the financial administrator was in charge of paying the taxes at that point. The court disagreed, noting that once she was on notice that there were unpaid taxes, she failed to assure that all available funds were used to pay that liability and, more to the point, she failed to follow up to insure that taxes had continued to be paid timely, something that in fact was not happening.

The Court noted that she clearly had the authority to direct payments, pointing to authority granted to the Chief Apostle in the bylaws of the organization and the memorandum she had written controlling payments when she discovered the organization was out of funds.

The Court also found she acted willfully. Even though she may not have been aware of the specific payments that were not made, being aware that payments had been missed in the past and having the authority to control such payments imposed on her a responsibility to insure that payments were being made—a responsibility she failed to carry out. That failure to act is treated as a willful act sufficient to trigger responsibility.

The minister in this case very likely was only focused on the spiritual, non-business matters of the organization. But her authority to act in financial matters and her knowledge of the payroll tax problems exposed her to the liability that was imposed upon her by the Court. While she believed that by hiring a financial administrator and delegating authority to her she had fulfilled her responsibility, the fact was that her position required her to supervise the work of that person with regard to payroll taxes.

Clients who are not financially savvy but who hold high positions in organizations (including religious ones) should be made aware of the dangers to their personal finances if they find that trust fund taxes have gone unpaid. As this case illustrates, one you have knowledge of the problem and an authority to act, simple delegation is no longer a complete option to avoid liability.

SECTION: 7123
IRS EXTENDS MEDIATION AND ARBITRATION TEST PROGRAM FOR OIC AND TRUST FUND CASES

Citation: Announcement 2011-6, 12/30/10

The IRS has extended the test of mediation and arbitration procedures on certain offer in compromise (OIC) and trust fund recovery penalty cases (TFRP) for an additional two years, through December 31, 2012. The program is still only available for taxpayers whose appeals are located at the

1. Atlanta, Georgia
2. Chicago, Illinois
3. Cincinnati, Ohio
4. Houston, Texas
5. Indianapolis, Indiana
6. Louisville, Kentucky
7. Phoenix, Arizona
8. San Francisco, California

The notice reserves to the IRS the right to expand the program to other cities. The IRS's announced plan is to use this testing period to determine necessary adjustments to the mediation and arbitration program, as well as to consider whether to make the arbitration component permanent.

The notice contains scope limitations on the entire program, as well as limitations applicable to only the OIC or TFRP program.

The notice lists the following issues as generally appropriate for mediation or arbitration in OIC cases:

1. The value of assets, including those held by a third party.
2. The value of dissipated assets and what amount should be included in the overall determination of reasonable collection potential.
3. A taxpayer's proportionate interest in jointly held assets.
4. Projections of future income based on calculations other than current income.
5. The calculation of a taxpayer's future ability to pay when living expenses are shared with a non-liable person.
6. Other factual determinations, such as whether a taxpayer's contributions into a retirement savings account are discretionary or mandatory as a condition of employment.

For TFRP cases, the notice lists the following issues as generally appropriate for mediation:

1. Whether a person was required to collect, truthfully account for, and pay over income, employment, or excise taxes.
2. Whether a responsible person willfully failed to collect or truthfully account for and pay over such tax, or willfully attempted in any manner to evade or defeat the payment of such tax.
3. Whether a taxpayer sufficiently designated a payment to the trust fund portion of the unpaid tax.
4. Whether the taxpayer provided sufficient corporate payroll records to establish that a corporate tax deposit was in the amount required by Treas. Reg. § 31.6302-1(c) and therefore was considered a designated payment to be applied to both the trust fund and non-trust fund portions of the employment taxes associated with that specific payroll.

Separately, the notice lists the following issues as generally appropriate for arbitration in a TFRP case:

1. Specific factual determinations concerning whether a person was required to collect, account for, and pay over income, employment, or excise taxes. Common factors include whether the taxpayer: was an officer, director, or shareholder of the corporation; had the authority to sign checks; exercised significant control over the corporation's financial affairs; had the authority to determine which creditors would be paid; was involved in payroll disbursements; had control over the voting stock of the corporation; was involved in making federal tax deposits; and had the ability to hire and fire employees.
2. Specific factual determinations concerning whether a responsible person willfully failed to collect or truthfully account for and pay over such tax, or willfully attempted in any manner to evade or defeat the payment of such tax. Common factors to be determined include: when the taxpayer became aware of the failure to pay over the withheld tax; whether the taxpayer had knowledge of payments to other creditors, including employees, after becoming aware of the failure to pay over the withheld tax; whether there were unencumbered funds available to satisfy pre-existing employment tax liabilities; and whether the taxpayer failed to use unencumbered funds to satisfy preexisting tax liabilities after becoming aware of such liabilities.
3. A factual determination of the amount designated by the taxpayer as a payment to the trust fund portion of the unpaid tax.
4. A factual determination whether the taxpayer provided sufficient corporate payroll records to establish that a corporate tax deposit was in the amount required by Treas. Reg. § 31.6302-1(c) and therefore was considered a designated payment to be applied to both the trust fund and non-trust fund portions of the employment taxes associated with that specific payroll.