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2008-2009 Tax Update for the Non Profit Organization

Presented by:
Vern Hoven, CPA, w/Masters in Taxation
www.hoven.com
vern@hoven.com
253-265-1040

Table of Contents

EXEMPT ORGANIZATIONS §501-528

Ten Tips for Keeping You and Your Non Profit out of Trouble

File all federal, state and local reporting forms.	See (1) the revised federal Form 990 with its 16 reporting schedules, (2) the new filing requirements for the 990EZ and (3) the new form 990-N for small charities.
The charity must comply with all federal, state and local laws. This includes employment taxes, sales taxes and local business licenses.	see www.stayexempt.org for IRS info on this topic (FS-2008-13; FS-2008-14). Also know state and local resources.
The charity must comply with requirements for solicitation registration. Some local and some state requirements exist. 38 of 50 states require registration if the organization solicits contributions in their state.	Watch for internet solicitations requiring state registration.
A conflict of interest policy is essential for protecting the charity from unethical or illegal practices (or the appearance of them.) In addition, the revised form 990 asks if the organization has a conflict of interest policy.	See www.IRS.gov for sample language (and the form 1023 package and Cyber Assistant) and have all board and senior staff members sign.
The Board is responsible for reviewing and approving the budget, key financial transactions, executive compensation and benefits.	See §4958 for penalties that can be assessed against Board members for approving excess benefits.
To qualify as a public charity (and avoid the limits imposed on a private foundation), public support must exceed 33 1/3% .	
Review all unrelated business taxable income definitions and reporting requirements. Know rules on gift shops, silent auctions, charity web links to corporate sponsors, etc.	See Form 990T and its instructions. http://www.irs.gov/pub/irs-pdf/f990t.pdf http://www.irs.gov/pub/irs-pdf/i990t.pdf
Make sure that staff and volunteers know the substantiation requirements for charity donations including the "quid pro quo" statement on charity receipts (particularly charity auctions, golf tournaments and celebrity dinners) for benefits received.	See IRS publication 1771, *Charitable Contributions-Substantiation and Disclosure Requirements*. http://www.irs.gov/pub/irs-pdf/p1771.pdf
Make sure that your charity is following good governance policies.	See www.nonprofitpanel.org for *33 Principles for Good Governance and Ethical Practice*

See local law for exceptions and inclusions for charities.	For example, California does not provide for an exemption to sales tax for charity auctions.

E-Postcard Filing for Small Tax-Exempt Organizations (IR-2008-25; Gateway to Form 990-N; Filing Form 990-N (e-Postcard))

Small tax-exempt organizations whose gross receipts are normally $25,000 or less (increasing to $50,000 in 2010) may be required to electronically submit Form 990-N, also known as the e-Postcard. The e-Postcard is due every year by the 15th day of the 5th month after the close of your tax year. For example, if the non-profit's tax year ended on December 31, 2008, the e-Postcard is due May 15, 2009. To file the e-Postcard the taxpayer will leave the IRS site and file the e-Postcard with the IRS's trusted partner, Urban Institute. The form must be completed and filed electronically. There is no paper form.

e-Postcard FAQs. The IRS has established an extensive list of frequently asked questions, with IRS answers, on e-Postcards.

Late filing or failure to file the e-Postcard. If the non-profit does not file an e-Postcard on time, the IRS will send out a reminder notice but the organization will not be assessed a penalty for late filing the e-Postcard. However, an organization that fails to file required e-Postcards (or information returns – Forms 990 or 990-EZ) for three consecutive years will automatically lose its tax-exempt status. The revocation of the organization's tax-exempt status will not take place until the filing due date of the third year.

Public disclosure of e-Postcards. IRS establishes "find and view an organization's filed e-Postcard search." The IRS has launched a disclosure site on its website where the public can view a particular organization's filed e-Postcard.

Newly Designed Form 990 for the 2008 Tax Year (Returns Filed in 2009) (IR 2007-117; IR-2007-204).

A new Form 990, the tax-exempt organization annual information return, will be used for the 2008 tax year (returns filed in 2009). The last time Form 990 was significantly reviewed and updated was more than 25 years ago. Since that time, the number of exempt organizations has grown dramatically. According to the IRS, the new Form 990 reflects the way this growing sector operates. In addition, the new 990 will give both the IRS and the public an improved window into the way tax-exempt organizations operate.

The redesign of Form 990 is based on three guiding principles:

1. Enhancing transparency to provide the IRS and the public with a realistic picture of the organization;
2. Promoting compliance by accurately reflecting the organizations operations so the IRS may efficiently assess the risk of noncompliance; and
3. Minimizing the burden on filing organizations.

The redesigned Form 990 consists of a 11 page core form (current Form 990 has 9 pages) to be completed by each Form 990 filer and a series of 16 schedules designed to require reporting of

information only from those organizations that conduct particular activities.

Form 990-EZ still available for smaller non-profits. The IRS also announced a graduated transition period for smaller organizations. These organizations will be allowed to file the Form 990-EZ instead of the Form 990.

May file 990-EZ for:	*If gross receipts are:*	*If assets are:*
2008 tax year (filed in 2009)	>$25,000 and <$1 million	< $2.5 million
2009 tax year (filed in 2010)	>$25,000 and <$500,000	<$1.25 million
2010 and later tax years	>$50,000 and <$200,000	<$500,000

> **Comment:** Also, starting with the 2010 tax year, the IRS will increase the filing threshold for organizations required to file Form 990-N (the e-postcard) from $25,000 to $50,000.

Highlights of the new form include:

1. A summary page providing the organization's identifying information and a snapshot of the organization's key financial, compensation, governance, and operational information.
2. A portion of the form requiring governance information including the composition of the board, and certain other governance and financial statement practices.
3. Schedules that will focus reporting on certain areas of interest to the public and IRS: fundraising, compensation, hospitals, tax exempt bonds and non-cash charitable contributions.

Major changes from discussion draft (IR 2007-117). Among the major changes the new form made to the discussion draft are the following:

- A revised summary page that:
  - eliminates the ratios, percentages, and other metrics included in the draft, and
  - incorporates a two-year summary of financial information comparing the current and prior years;
- A reordered core form that moves the organization's description of its program service accomplishments to page 2, immediately after the summary;
- A new checklist of schedules that shows which schedules the filing organization must complete;
- More opportunity throughout the form to provide supplemental information;
- Retention of group return filings for organizations with a group exemption ruling;
- Revised governance and compensation sections;
- Modified schedules for hospitals, tax-exempt bonds, non-cash contributions, and supplemental financial statements; and
- Reduced burden throughout the form and schedules, including increased or new reporting thresholds for several of the schedules.

Be Careful About New Schedules Found in 2008 Revised Form 990

Numerous questions ... that must be answered. Preparers of new Form 990 will find many questions have "triggers" requesting more detailed explanations on various schedules. Answering "no" to any of

these questions will, potentially, raise a red flag, converting the new form into an enforcement tool for the IRS. The core of revised Form 990 includes 11 parts with numerous "yes and no" questions. For example, Part IV of the core form alone asks filers to answer 37 questions, with each "yes" potentially requiring the completion of a schedule. The IRS is attempting to discover whether the exempt organizations are furthering their exempt purpose or are actually insider groups serving the interests of insiders.

Proving good governance. In addition, in Section A of Part VI, titled "Governing Body and Management," the IRS may be looking for the directors of non-profits to prove their involvement on entity business. For example, Question 10 asks if a copy of Form 990 was provided to the organization's governing body before it was annually filed. Organizations must describe the process, if any, they used to review Form 990 annually and if this review is delegated, it may but it must describe why. Because of the numerous topics covered by the new Form 990, different board committees may need to review different sections of the tax return.

Public Inspection of Form 990-T Does Not Include Schedules, Attachments (Notice 2008-49 modifying Notice 2007-45)

Under the amended Form 990-T, Exempt Organization Business Income Tax Return public disclosure requirement under §6104, charities must make available for public inspection and copying only those returns filed under §6011 that relate to the organization's unrelated business income tax. Therefore, schedules, attachments, and supporting documents filed with Form 990-T that do not relate to the imposition of unrelated business income tax (UBIT) are not required to be made available for public inspection and copying. Additionally, charities must make Forms 990-T available for public inspection and copying only for the three-year period beginning on the last day prescribed for filing such return. Therefore, Notice 2007-45, which provided that Forms 990-T filed with the IRS after August 17, 2006, must be made available for public inspection and copying by all charities, has been modified.

Inurement to Private Individuals

A non-profit organization will lose its tax-exempt status if any part of the organization's net earnings inure to the benefit of *any person* having a personal and private interest in the activities of the organization (§1.501(a)-1(c)). The term "inurement" does not prohibit payments to stockholders or individuals, but rather applies to payments that are made to shareholders or individuals for purposes other than as reasonable compensation for goods or services.

This inurement prohibition is directed at many types of transactions. Factors emerging repeatedly as indicative of prohibited inurement and private benefit include:

- control by the founder over the entity's funds, assets, and disbursements;
- use of entity moneys for personal expenses;
- payment of salary or rent to the founder without any accompanying evidence or analysis of the reasonableness of the amounts; and
- purported loans to the founder showing a ready private source of credit (see, *Founding Church of Scientology v. U.S.*, 188 Ct. Cl. 490, 412 F2d 1197 (1969); *Church of Eternal Life & Liberty, Inc. v. Comm.*, 86 T.C. 916 (1986); *Church of the Transfiguring Spirit, Inc. v. Comm.*, 76 TC 1 (1981); *Basic Bible Church v. Comm.*, 75 TC 846 (1980); and *Bubbling Well Church of Universal Love, Inc. v. Comm.*, 74 TC 531 (1980)).

The Use of Expert Witnesses (*Beiner, Inc. v. Comm*., TCM 2004-219; *Brewer Quality Homes, Inc. v. Comm*., (CA-5) 2005-1 USTC ¶50,114; Affirming TCM 2003-200)

Expert witnesses becoming more important. In the *Beiner* case, the court stated that they were using a variation of the *Exacto Springs* "independent investor" test but in actuality they relied totally on an expert witness who testified on the "prevailing salary for comparable work" standard. The Tax Court held that Beiner Inc. may deduct all but $180,260 of the officer compensation of $1,087,000 claimed on its 1999 Federal income tax return and all $1,350,000 that it claimed on its 2000 return paid to Robert Lance Beiner, its sole shareholder. The IRS auditor felt only $303,020 and $157,982 was reasonable. So how did this get to court? Beiner, Inc never paid a dividend, did not have a formal compensation plan, and did not have a written employment agreement with Beiner. Beiner, who worked approximately 38 hours per week and had another job, generally was entitled to a fixed salary of $50,000 per month and a huge bonus in December. In December of each subject year, Beiner's accountant met with Beiner to ascertain the bonus to be paid during that year by using a formula that took into account its sales and profit for that year, Beiner's work during that year, and the amount of its profit that it needed to retain at the end of that year for its operation after that year.

So where can one find the "prevailing salary for comparable work?" Hire a salary consulting firm as found in the *Biener* or *Brewer* case! Or go to www.salary.com. They have a wonderful list of average salaries. So does www.roberthalf.com, www.salaryexpert.com, http://www.salaryestimator.com, and www.bls.gov/oes.

Final Regulations on Excess Benefit Transaction Relationship (T.D. 9390)

Final regulations clarify the substantive requirements for tax exemption under §501(c)(3) and the relationship between these requirements and the imposition of §4958 excise taxes on excess benefit transactions. Several examples illustrate the requirement that an organization serve a public rather than a private interest. The purpose of the examples is to illustrate that prohibited private benefit may involve non-economic benefits as well as economic benefits and that prohibited private benefit may arise regardless of whether payments made to private interests are reasonable or excessive. Example 1 in §1.501(c)(3)-1(d)(1)(iii) illustrates that private benefit may involve non-economic benefits. Example 2 illustrates that private benefit is inconsistent with tax-exempt status under §501(c)(3) if it is substantial and not merely incidental to the accomplishment of the organization's exempt purposes. Example 3 illustrates that private benefit may exist even though the transaction is at fair market value. Moreover, these examples are intended to illustrate the principle that private benefit remains an independent basis for revocation even if it does not involve economic benefit or raise fair market value issues. Three new example address reasonable compensation and illustrate the application of the revocation factors to an excess benefit transaction that is neither significant in comparison to the size and scope of the organization's exempt activities nor de minimis. The new rules apply with respect to excess benefit transactions occurring after March 28, 2008.

Unrelated Business Income Tax - UBIT (§513)

The Internal Revenue Code imposes a tax, at the ordinary corporate rate, on income that a tax-exempt organization obtains from "unrelated trade or business ... regularly carried on by it" (§511(a)(1)). §513(c) defines a "trade or business" as "any activity which is carried on for the production of income from the

sale of goods or the performance of services." Furthermore, TR §1.513-1(b) notes that "trade or business" in §513 has the same meaning as it does in §162.

REQUIRED DOCUMENTATION FOR CHARITABLE DEDUCTIONS CHART

	Amount	Required records
CASH	Single cash contribution of less than $250	Cancelled check, bank record, credit card statement or written acknowledgment from the charity. §170(f)(17) ; IR-2006-192
	Single cash contribution of $250 or more	Written acknowledgment from the charity.§170(e)(8)
	Payroll Deduction	Pledge card *and* W-2, paystub, etc. §1.170A-13(c); Notice 2008-16
NONCASH	Non cash contributions less than $250	Written acknowledgment from the charity or other reliable record. §1.170A-13(b)(1)
	Non cash contribution of $250 but not more than $500	Written acknowledgment from the charity. §1.170A-13(b)(3)
	Non cash contribution over $500 but not more than $5,000 §170(e)(12)	Written acknowledgment from the charity and form 8283, part A. §1.170A-13(b)(3)
	Non cash contribution of over $5,000 of similar items	Written acknowledgment from the charity, appraisal and form 8283, part B. §170(f)(11)(C)
	Non cash contribution of more than $500,000	Written acknowledgment from the charity, appraisal and form 8283, part B. Attach appraisal to the return. §170(f)(11)(D)
OTHER GIFT	Non cash contribution of auto, boat or airplane with a value of more than $500	Written acknowledgment from the charity. Attach form 1098-C and form 8283 to return. §170(e)(11)(C); IR-2006-172
	Non cash contribution of publically traded stock	Written acknowledgment from the charity and form 8283, part A. §1.170A-13 (c)(7)(xi)(B)
	Non cash contribution of privately traded stock of more than $5,000	Written acknowledgment from the charity, and form 8283 part B. If the privately traded stock is valued at 10,000 or more, attach an appraisal to the return. §1.170A-13 (c)(2)(ii)(B)(1)
	Non cash contribution of art valued at more than $20,000	Written acknowledgment from the charity, appraisal, form 8283, part B. Appraisal and a photo of the art must be attached to the return. Rev. Proc. 96-15.

The written acknowledgment must be received from the charity before the due date of the return (including extensions) and it must include a statement regarding goods and services received in exchange for the contribution.

CHARITABLE CONTRIBUTIONS §170

Proposed Regulations Clarify Guidelines for Substantiating Cash Charitable Donations (NPRM Reg-140029-07)

Cancelled check or receipt required for all cash contributions. To deduct any charitable donation of money, a taxpayer must have a bank record or a written communication from the charity showing the name of the charity and the date and amount of the contribution. A bank record includes canceled checks, bank or credit union statements, an electronic fund transfer receipt, a scanned image of both sides of a canceled check obtained from a bank website and credit card statements. Bank or credit union statements should show the name of the charity and the date and amount paid. Credit card statements should show the name of the charity and the transaction posting date. A written communication includes electronic mail correspondence (email).

Single document sufficient if received timely. The substantiation requirements for cash contributions may be met with a single document (receipt from charity or a bank record) as long as the documentation contains all of the required information and is obtained by the earlier of the date the donor files the original return for the year of contribution or the extended due date of the donor's tax return for that year.

> **Example**: Al contributes $100 of cash to the Hornet Fund, his college alumni fund, but doesn't receive a receipt. Two years later, Al is audited by the IRS who disallows the Hornet Fund contribution because there is no receipt. Al goes to the treasurer of the Hornet Fund, gets a receipt, and takes it to the IRS auditor. The contribution is still not allowed because the supporting documentation was not timely obtained. **Score another trap for the uninformed taxpayer!**

Donor's unreimbursed expenses require receipt if amount exceeds $250. The charitable donation substantiation requirements of §170(f)(17) do not apply to donors who incur unreimbursed expenses of less than $250 incident to the rendition of services on behalf of a charitable organization. For unreimbursed expenses of $250 or more, taxpayers must have adequate records to substantiate the amount of the expenditure and a statement from the donee organization, which must contain: 1) a description of the services provided by the taxpayer; 2) a statement whether the donee organization provided any goods or services to the donor; and, if goods or services were provided, 3) the value of such goods or services.

> **Note**: Transfers of less than $250 to charitable remainder annuity or unitrusts are also exempt from the documentation requirements of §170(f)(17).

Receipt only required for donations of $250 or more (cancelled check not enough). There has been no change in the requirement that a taxpayer get an acknowledgment from a charity for each deductible donation (either money or property) of $250 or more (§170(f)(8)(A)). The acknowledgment must be obtained by the earlier of the date the return is filed or its due date (§170(f)(8)(C)). The acknowledgment must include the amount of cash and a description of any property other than cash along with certain information about any goods or services provided by the donee (§170(f)(8)(B)). However, one statement containing all of the required information may meet the requirements of both provisions.

> **Tax planning tip**: Contributions are deductible in the year made. Thus, donations charged to a

credit card before the end of the year count for 2008. This is true even if the credit-card bill isn't paid until next year. Also, checks count for 2008 as long as they are mailed this year.

Contemporaneous Receipt Required for Each Charitable Donation Exceeding $250 (*Daniel Gomez v. Comm.*, TCS 2008-93)

Daniel Gomez was a member of the Apostolic Assembly of the Faith In Christ Jesus (Apostolic Assembly), a religious organization. During 2005, he wrote ten checks for a total of $6,100. Each check was over $250. A letter from the Apostolic Assembly, dated January 22, 2008, indicated that Daniel paid a total of $6,552 as tithes during 2005.

Contemporaneous records required. Despite the fact that Daniel made the contributions, §170(f)(8)(A) and Reg. 1.170A-13(f)(1) require a contemporaneous written acknowledgment for contributions of $250 or more in order for a charitable contribution deduction to be allowed. The letter from the Apostolic Assembly was not contemporaneous with the claimed deduction. The letter was dated January 22, 2008, the date of the Court's trial session and was not received by the earlier of the date the petitioner filed his income tax return or the due date of the tax return, which was April 17,2006.

No goods and services provided for the contribution. The letter from the Apostolic Assembly and the 10 canceled checks indicating that they were for tithes were reliable. However, they do not meet the substantiation requirements set forth by the Internal Revenue Code or the Treasury regulations. According to the Code and the Regulations, the required acknowledgment of the charitable contribution not only must include the amount contributed, but also must state whether the charity provided any goods or services in consideration of the contributions and describe and set forth a good faith estimate of the value of those goods or services. See §170(f)(8)(B).

Since the letter was not contemporaneous and it did not include the necessary language, Daniel was entitled to a charity deduction of only $420.50 (checks of $250 or less).

Payroll Deduction to United-Way-Type Organizations Will be Disallowed Unless New, More Stringent, Employer-Provided Recordkeeping Rules Met (Notice 2008-16)

Make sure pledge card *and* evidence of amount is available. Starting in 2007, because of the additional, more stringent, recordkeeping requirements before taxpayers may claim charitable contribution deductions for cash, check, or other monetary gifts, the IRS has provided guidance on how charitable contributions may be made through the Combined Federal Campaign (CFC) or a similar program (e.g., a United Way campaign) by payroll deductions (see §170(f)(17) added by PPA '06). This will be in addition to satisfying the written communication requirements of §170(f)(8) for contributions of $250 or more. In the case of a contribution made by payroll deduction, a "written communication from the donee organization" within the meaning of § 170(f)(17) must include:

1. a pay stub, Form W-2, or other document furnished by the employer that sets forth the amount withheld during a taxable year by the employer for the purpose of payment to a donee organization, ***together with***
2. a pledge card or other document prepared by or at the direction of the donee organization that shows the name of the donee organization.

Make sure employer's written communication states that the non-profit did not provide goods or services. To substantiate a contribution of $250 or more made by payroll deduction, the pledge card or other document prepared by the donee organization also must include a statement to the effect that the organization does not provide goods or services in whole or partial consideration for any contributions made to the organization by payroll deduction.

Rules for Deducting Donation of Clothing and Household Items (IR-2006-172)

Charitable deduction for contributions of clothing and household items may be limited. To be deductible, clothing and household items donated to charity must be in good used condition or better. However, a taxpayer may claim a deduction of more than $500 for any single item, regardless of its condition, if the taxpayer includes a qualified appraisal of the item with the return. Household items include furniture, furnishings, electronics, appliances, and linens. Food, paintings, antiques, and other objects of art, jewelry and gems, and collections are excluded from the provision.

> **Planning Point**: How will the client prove "good condition"? Better start talking now to clients. Maybe they'll need pictures or a more detailed description of the item gifted than they have provided before. In other words, the pink or yellow carbon receipts from Salvation Army or Goodwill that simply say "3 boxes and 4 bags" will not be enough substantiation for a $1,000 or $2,000 (for example) non-cash contribution.

Non-Cash Contribution Requirements Clarified (NPRM Reg-140029-07, §1.170A-16)

To claim a deduction of less than $250, the donor must maintain a receipt that shows the date of the contribution, the name and address of the donee organization, and a detailed description of the property donated. If it is impractical to obtain a receipt (i.e., dropping off canned food at a donee's unattended drop site), the donor may substitute a reliable written record, which is defined as a contemporaneous record containing all of the aforementioned items and the fair market value of the property on the date of the contribution, the method used to determine the fair market value, and, in the case of clothing or household items, the condition of the property (Prop Reg. §1.170A-16(a)).

> **Preparer Note**: The proposed regulations define household items as furniture, furnishings electronics, appliances, linens, and other similar items. Food, paintings, antiques, jewelry, gems and collections are not household items (§1.170A-18(c)).

To claim a deduction of $250 or more, but not more than $500, the donor must maintain a contemporaneous written acknowledgment from the donee organization. This written acknowledgment must provide a description of the property donated, whether or not the donee organization provides any goods or services in consideration of the donation to the donor, and, if so, a description and estimate of the value of any such goods or services that were provided. No other written documentation is required (Prop Reg. §1.170A-16(b)).

To claim a deduction of more than $500, but not more than $5,000, for the gift of a non cash item (or group of similar items), all of the requirements for donations of $250 to $500 must be met, plus Form 8283 (Noncash Cash Charitable Contributions) must be attached to the return. Form 8283 requires the taxpayer to report information documenting how and when the property was acquired, fair market value on the date of donation, how the fair market value was determined and the property's basis or cost

(§1.170A-13(b)(3)).

To claim a deduction of more than $5,000 (§170(f)(11)(C)) for the gift of a non cash item (or group of similar items), all of the requirements for donations not more than $5,000 must be met, and the taxpayer must obtain a qualified appraisal, as defined in §1.170A-17(a)(1), before the due date of the return (including extensions). The appraisal cannot be obtained more than 60 days before the gift. The appraisal must prepared by a "qualified appraiser" as defined in §1.170A-17(b)(1). The taxpayer must also complete part B of Form 8283 and attach it to the tax return, including the name, address and tax ID number for the donor, donee and qualified appraiser.

> **Preparer point**: When large non cash donations are involved, it will be important to ask the client what specific items were donated. Don't call the contribution simply "household goods." More definition may avoid reaching the $5,000 limit.

Attach appraisal if gift's value exceeds $500,000. If the amount of the non-cash contribution, other than inventory or publicly traded securities, exceeds $500,000, then the donor (whether an individual, partnership or corporation) must attach the qualified appraisal to the donor's tax return. For purposes of the dollar thresholds under this provision, property and all similar items of property donated to one or more donees are treated as one property.

Charitable Distributions from IRAs Extended to December 31, 2009 - §408 (Emergency Economic Stabilization Act of 2008)

An IRA owner, age 70½ or over, can directly transfer tax-free, up to $100,000 per year to an eligible charitable organization. This provides an exclusion from gross income for otherwise taxable IRA distributions from a traditional or a Roth IRA in the case of qualified charitable distributions. Eligible IRA owners can take advantage of this provision, regardless of whether they itemize their deductions.

Some SIMPLE IRA or SEP IRA transfers to a charity may also qualify. Generally transfers can be made from any IRA to a charity. However a restriction applies to transfers from SIMPLE IRAs or SEP IRAs. If the employer has made a contribution to the plan during the year, it does not qualify for the charity transfer. If the employee (account owner) is retired and contributions are no longer being made to the SIMPLE IRA or SEP IRA, then the account qualifies for the §408(d)(8)(A) rollover.

Trustee to charity transfer required. To qualify, the funds must be contributed directly by the IRA trustee to the eligible charity. Amounts so transferred are not taxable and no deduction is available for the amount given to the charity.

Transfers are part of RMD. Transferred amounts are counted in determining whether the owner has met the IRA's required minimum distribution rules. Where individuals have made nondeductible contributions to their traditional IRAs, a special rule treats transferred amounts as coming first from taxable funds, instead of proportionately from taxable and nontaxable funds, as would be the case with regular distributions.

Planning tips for transfers:

1. Non itemizers get full benefit for the contribution and the full benefit of the standard deduction!

2. Since the IRA distribution made to a charity is not included in the client's taxable income, the many AGI related phaseouts are minimized. For example, the client does not experience
   a. a phaseout of itemized deductions,
   b. a 50% charitable contribution base limitation, or
   c. an increase in the amount of social security benefits taxable as he or she would under prior law if the IRA distribution is included in AGI and then the amount paid over to the charity is deducted on his or her schedule A.
3. Clients will have to rethink the source of large charitable contributions during their lifetime. Perhaps the gift from an IRA will be a better choice than the gift of appreciated stock. Since the IRA produces income in respect of a decedent at the death of the account owner, leaving stock rather than the IRA may result in less tax to the beneficiary.
4. Distributions to donor advised funds, private foundations, charitable remainder trusts, and gift annuities do not qualify for this provision.
5. Distributions from a qualified retirement plan do not qualify for this provision.
6. Since the IRA distribution made to a charity is not included in the client's AGI, the Medicare B premium surcharge may be reduced if an IRA transfer is made directly to the charity.
7. The IRS has announced that no Form 1099-R is to be issued for IRA distributions made directly to a charity.

INDEPENDENT CONTRACTOR VERSES EMPLOYEE STATUS

Contract labor and commission expenses *(including commission splits)* are deductible when paid to an independent contractor (IC). Form 1099 must be issued if $600 or more is paid for services to an unincorporated individual or business. The issue involved in both the commission expense and the contract labor deduction is whether the worker is properly an employee (or an IC) of the business.

> **WARNING:** This is one of the major tax audit issues. All IRS agents must examine the tax return for employee salaries disguised as contract labor *(e.g., sales assistants, part-time workers)*.

IRS and State Workforce Agencies to Share Results of Employment Tax Examinations (IR-2007-184; FS-2007-25; Headliner Volume 218, November 13, 2007)

29 state agencies have entered into individual information-sharing agreements, called memorandum of understandings (MOU), with the IRS to share the results of employment tax examinations. The agreements, part of the Questionable Employment Tax Practice (QETP) initiative, provide a centralized, uniform means to exchange data, thereby leveraging IRS/state resources in an attempt to encourage businesses to comply with federal and state employment tax requirements. The IRS may participate in coordinated enforcement efforts, share audit results and work side-by-side on audits. It is hoped that this will also enable the IRS and the states to be more consistent in classifying workers as employees or independent contractors.

> **Comment:** The problem is that the Federal government uses substantially different factors (e.g. the 20 factors at Rev. Rul. 87-41) than states when determining if a worker is an employee or an independent contractor. To make matters worse, the IRS instructs their employees that state factors are *not* to be taken into account at the Federal level. An IRS training guide states "only federal tax treatment as an employee is relevant. Thus, if a business treats workers as employees

for state unemployment or state withholding tax purposes, that is not treatment for purposes of section 530" (IRS Training Material Course 3320-102, page 1-11)

IRS's Common Law Approach on Worker Classification: Three Categories of Evidence (1) Behavioral Control, (2) Financial Control and (3) Parties Views

Most of the difficulty in deciding if a worker is an employee or an independent contractor stems from the fact that an employer's goals conflict with those of the IRS. Conferring independent contractor status upon a worker often benefits the employer, since the employer is not obligated to withhold income taxes, to pay social security and unemployment taxes, or to provide employee benefits. Conversely, classifying workers as employees makes it easier for the IRS to collect the worker's taxes because it shifts much of the collection burden to the employer. The IRS has developed a 20-factor test to assess this degree of control, with factors generally skewed toward concluding that the worker is an employee (see Rev. Rul. 87-41 and Form SS-8). Most of these tests have summarily been rejected by the courts and Congress.

Recognizing the direction the wind is blowing, the IRS's worker classification training manual sets forth three categories of evidence they think are most significant in making a determination of a worker's status under common law (IRS Training Materials [Course 3320-102] titled "Independent Contractor or Employee?", hereafter referred to as ICorE). The IRS training guide moves its focus toward gathering evidence that illustrates "the extent of an employer's behavioral and financial control" over the worker *and* "how the parties view their relationship." Following is an abbreviated synopsis of each factor. With notable exceptions, the old 20 tests of Rev. Rul. 87-41 have been reshuffled into the three categories. Eight of the old factors have been retained, two new factors have been added and seven factors have been de-emphasized.

Does behavioral control over worker exist? Behavioral control focuses on whether the business has the right to direct or control **how** the work is done, e.g., **how** the worker performs the specific task for which he or she is hired. Factors include:

1. ***To what extent are instructions given and taken?*** An employee is generally subject to the business's instructions about when, where, and how to work; an independent contractor is not. Even if no instructions are given, sufficient behavioral control may exist if the employer has the **right to control** how the work results are achieved. Pertinent evidence includes: (1) needing prior approval before proceeding, (2) rendering services personally, and (3) hiring, supervising, and paying assistants.
2. ***What training does the business give the worker?*** Employees may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods. The business's orientation course, safety seminars and voluntary unpaid educational programs are to be disregarded.

Do financial controls over worker exist? These factors illustrate whether there is a right to direct or control how the **business** aspects of the worker's activities are conducted:

3. ***Can the worker realize a profit or incur a loss?*** An independent contractor can make a profit or loss whereas employees can only make a profit. IRS discloses that the worker's dependence on the job is NOT a factor.
4. ***Is the worker's investment significant?*** An independent contractor often has a significant

investment in the equipment or facilities he or she uses in performing services for someone else. However, a significant investment is not required. Pertinent evidence includes: (1) amount of unreimbursed expenses, (2) payment of business and/or travel expenses, (3) furnishing of tools and materials and (4) analysis of lease arrangements between worker and business. The IRS has listed business expenses expected to be found on the taxpayer's business return.

5. ***To what extent does the worker make services available to the general public?*** Pertinent evidence includes: (1) Yellow Page advertising, (2) working for more than one firm, and (3) identifying when advertising not required, e.g., use of word-of-mouth advertising and having long-term contracts.
6. ***How does the business pay the worker?*** An employee is generally paid by the hour, week or month. An independent contractor is generally paid a flat fee or by the job, even though it is common in some professions, such as law and accounting, to pay hourly. The payment of commissions indicate both are possible.

What type of relationship between the parties exist? These factors illustrate how the worker and the business perceive their relationship between each other:

7. ***Does a written contract exist that describes the relationship the parties intend to create?*** This is a new factor generally considered of lesser importance by the IRS (but more important by the courts!) as the *substance*, not the *label*, governs the worker's status. A written contract contains other evidence, e.g., method of compensation, what expenses are unreimbursed, and *how* work is to be performed.
8. ***Does the business provide the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay?:*** Employee benefits are *only* paid to employees! The IRS surprisingly discloses that W-2's do not necessarily indicate employee status, incorporated workers generally will not be recharacterized as the business's employees, and state law determination (or other government or industry imposed regulations) is not a relevant indicator of employer-employee status (IcorE, p 1-11).
9. ***How permanent, on-going, is this relationship?*** Permanent and indefinite relationships indicate an employer-employee relationship whereas, the IRS divulges, long-term and temporary relationships are not important evidence (e.g., independent contractors can have long-lasting relationships).
10. ***To what extent are the services performed by the worker a key aspect of the regular business of the company?*** Is the success of the business dependent, to an appreciable degree, upon the worker's performance? If so, an employer-employee relationship exists. For example, as restaurants need cooks and cashiers and law firms need lawyers, these workers are generally employees. But, even though it is essential for an appliance store to retain good accountants, bookkeeping is NOT the store's regular business and therefore this work can be done equally well by independent contractors or employees.

Factors IRS now considers of lesser importance:

1. Does the client/customer have the right to discharge the worker?
2. Does the worker have the right to terminate the relationship?
3. Can the worker work part time or is full time required?
4. Must the work be performed on the employer's premises?
5. Who sets the hours to be worked?

6. Must the work be performed in an order or sequence?

Factors IRS no longer mentions:

7. Are interim oral or written reports required?

Come to a conclusion - weigh the evidence! Once the relevant evidence in all three categories have been accumulated, each evidence must be weighed before determining the worker's status. It's still a facts and circumstances test!

Court Used Eight of Nine Factors To Determine Truck Driver Was Independent Contractor, Not Employee (*Ronald e. Byers v. Comm.*, TCM 2007-331)

Ronald Byers worked as a truck driver for Edina Couriers, Inc. (ECI), picking up and delivering goods to and from ECI customers in the Minneapolis area. Ronald was paid 70% of the gross amounts ECI billed (before paying truck lease payments). Ronald argued that he was an employee of ECI, that under §3402(a)(1) employers are required to withhold Federal income taxes from employee wages, and that ECI rather than he should be held liable for payment to the IRS of his unpaid Federal income and employment taxes. In deciding whether Ronald was to be treated as an independent contractor or as an employee, the court applied nine factors:

1. **Control over manner of accomplishing work.** The court felt that Ronald controlled the manner in which he scheduled and made pickups and deliveries without control from ECI, which indicated an independent contractor relationship.
2. **Investment in work facilities and tools.** Because Ronald was required either to own or lease his own truck, tools, and other equipment, the court felt he made a significant investment in his truck driving activity, indicating an independent contractor relationship.
3. **Opportunity for profit or loss.** Because Ronald was paid not a fixed wage but a percentage of gross amounts billed to customers, and because the number of deliveries Ronald made depended significantly on his efficiency, Ronald had an opportunity to participate in ECI's profits. Additionally, because he provided and paid for the truck and insurance, among other things, Ronald risked a net loss if his profits did not exceed his expenses. Therefore, this factor indicated an independent contractor relationship.
4. **Termination of the work relationship.** Under their operating agreement, ECI and/or Ronald were to give 30 days' notice before termination, but ECI had a practice of allowing truck drivers to terminate without notice, if the truck drivers so desired. The court regarded this factor as neutral.
5. **Participation in service integral to regular business.** Because truck drivers were an integral part of ECI's regular delivery service, Ronald participated as a truck driver in ECI's regular business and this factor indicated an employment relationship.
6. **Length of the relationship.** Because Ronald performed delivery services for ECI for almost 6 years, he had a long-term relationship with ECI which indicated an employment relationship.
7. **Parties' intent as to type of relationship formed.** The operating agreement clearly stated that both Ronald and ECI agreed Ronald was to be treated as an independent contractor. Because Ronald worked for years under the operating agreement and never objected to the Forms 1099 issued by ECI, the operating agreement did not support Ronald's claim that an employment relationship with ECI was intended. Further, Ronald was treated by ECI as an independent

contractor (i.e., no accrued paid leave, no health or pension benefits, and no wage withholding). This factor indicated an independent contractor relationship.

8. **Substantial costs incurred.** Ronald incurred substantial costs (i.e., 55% of the reported gross earnings) to lease a truck which allowed him to make deliveries to and from ECI customers. This factor indicated an independent contractor relationship.
9. **Special skills required.** Outside of the skills needed to drive trucks, ECI did not require that Ronald have special skills and this factor indicated an employment relationship.

Of the nine factors used by the Eighth Circuit Court of Appeals, five factors indicated an independent contractor relationship, three factors indicated an employee relationship, and one factor was neutral. The court concluded that Ronald was an independent contractor and liable for self-employment taxes for each year at issue.

ACT §530 - RELIEF FROM PAYROLL

Even If Business Classifies Workers Wrong, Act §530 Relief; a Synopsis

Background. In the Revenue Act of 1978 (P.L. 95-600) Congress took note of the controversy that has existed since the late 1960's between taxpayers and the IRS as to whether certain individuals treated as independent contractors should be reclassified as employees. Act §530 was originally intended as a stop-gap measure until Congress could find an acceptable definition of who is an independent contractor (Act §530; extended indefinitely by TEFRA of 1982; Act §530(d) added by TRA of 1986 limiting certain technically skilled workers; Act §530(e) added by SMJPA of 1996 which also broadened the scope).

If certain requirements are met, Act §530 terminates the business's, but not the worker's, employment tax liability, including Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), federal income tax withholding (FIT), Railroad Retirement Tax Act taxes and any interest or penalties attributable to the liability for employment tax (Rev. Proc. 85-189, 1985-1 CB 518).

IRS explains Act §530 in training manual. The IRS's training manual explains to their auditors the requirements that are necessary to qualify for this relief provision (see ICorE).

IRS required to give *up-front* notice - Publication 1976. The IRS is required to inform businesses by IRS Publication 1976 of their potential Act §530 protection as soon as an improper worker classification issue is raised in an audit (Act §530(e)(1)).

IRS must consider Act §530 relief first - that's a change from prior IRS policy! Immediately after delivery of Publication 1976, the IRS auditor ***must*** next determine if the business meets the requirements of Act §530, even before beginning the development of the reclassification issue. If Act §530 is available, the business will not have an employment tax liability with respect to the workers in question (ICorE, p. 1-4 & p. 1-5).

The business must meet two consistency tests to use Act §530. For employers to qualify for the Act §530 safe harbor protection, the business must first meet both consistency requirements:

1. **The reporting consistency: *Forms 1099*** (and any other federal tax returns including information returns) ***were filed*** on the worker(s), and

2. **The substantive consistency**: all workers holding a ***substantially similar position*** in the business (after 12/31/78) have been treated ***the same*** [Act §530(a)(1)&(3)]. This also requires that the business did not treat the worker as an ***employee for any period*** for employment tax purposes.

   Comment: But, common law determination (e.g. is the worker an independent contractor under the common law tests?) is always available to the business even if Act §530 relief is not (*Apollo Drywall, Inc*., 96-1 USTC ¶50,196).

Consistency Test: Reporting Consistency

To be entitled to relief under §530, the taxpayer must not have treated the worker as an employee for any period, and, for periods since 1978, all Federal tax returns, including information returns, must have been filed on a basis consistent with treating such worker as an independent contractor.

> **Example**: Withholding income and employment taxes from a worker's remuneration would not be consistent with treatment as an independent contractor, and the taxpayer must file a Form 1099 (discussed next) with respect to the worker as opposed to a Form W-2 (Rev. Proc. 85-18).

Must File Form 1099 For Each Independent Contractor

Timely filed requirement. The first requirement a business must meet for Act §530 relief is to have *timely filed by the last day of February all required Forms 1099* for the worker "for the period."

Subsequent Form 1099 filings gets Act §530 relief back - for the subsequent period. If a business in a subsequent year files all required returns on a basis consistent with the treatment of the worker as not being an employee, then the business may qualify for Act §530 relief for the subsequent period (Rev. Proc. 85-18, Sec. 3.03(B)).

What if the Worker is Paid Less than $600?

If a business is not "required to file" because the worker did not receive $600 or more, relief will not be denied on the basis that the Form 1099 was not filed (IC or E, page 1-6).

Four Safe Harbors Available if Consistency Rules Met

If the two consistency requirements are met, then the taxpayer shall have available statutory relief from the recharacterization rules via three reasonable basis objective tests and one reasonable basis subjective test. An employer is treated as having a reasonable basis if such treatment was in reasonable reliance on any of the following:

1. ***Any past court case or IRS ruling***: Judicial precedent, published rulings, or technical advice or letter ruling to the employer;

   Comment: These cases and rulings must use Federal common law analysis, not state analysis (*Peno Trucking, Inc. v. Comm.*, TCM 2007-66; *Nu-Look Design, Inc. V. Comm.*, TCM 2004-52).

But, it would seem logical that state-issued cases and rulings could be used under the fourth "any reasonable basis" subjective test discussed below. Peno Trucking never argued this point.

2. ***A past IRS audit*** in which no assessment was made on account of improper treatment of the worker,

3. ***Everyone else treats the worker as an independent contractor***: A long-standing recognized practice of a significant segment of the industry in which the individual worked, or

4. ***Use of any other reasonable basis***: If the business can demonstrate a "reasonable basis" for the nonemployee treatment ***in some other manner***, they can also qualify for the independent contractor treatment. The Committee Report of the House Ways and Means Committee, concerning Report No. 95-1748, states: "generally the bill (Act Section 530) grants relief if a taxpayer had ***any reasonable basis*** for treating workers as other than employees. The committee intends that this reasonable basis requirement be construed liberally in favor of taxpayers (emphasis added)" (also see: ICorE, p.1-32; IRM 4.23.5.2.2.7).

Demonstrating "reasonable basis" using the fourth subjective test. Situations when the IRS or courts have accepted the "any other reasonable basis" safe harbor include:

- Reliance on advice from an accountant or attorney (IRS Training Guide at 1-32; IRM 4.23.5.2.2.7. The IRS (and the courts) often require evidence the accountant reviewed the relevant facts before issuing the advice, even though not required by Act §530[1] (***Winners:*** *Smokey Mountain Secrets, Inc.* 910 F. Supp. 1316. 76 AFTR 2d 95-6974 (DC E. Tenn); *Select Rehab. Inc.* 205 F. Supp. 2d 376, 89 AFTR 2d 2002 (DC Pa.); *North Louisiana Rehabilitation Center, Inc.* 179 F. Supp. 2d 658, 88 AFTR 2d 2001-7057 (DC La.); LTR Ruling 9801001; ***Losers:*** *Edward W. MaAtee*, 66 AFTR 2d 90-5739 (DC Iowa); *Compass Marine Corp. In re.* 146 B.R. 138 (Bankr. E.D. Pa. 1992)).
- Rely on common law rules, which requires a lessor degree of proof (*Critical Care Register Nursing, Inc. v. U.S.,* 776 F. Supp. 1025, 68 AFTR 2d 91-5716 (DC Pa.); *American Institute of Family Relations v. U.S.,* 44 AFTR 2d 79-5043 (DC Calif); but see: *Boles Trucking, Inc. v. U.S.,* 77 F.3d 236, 77 AFTR 2d 96-909 (8th Cir. 1996).
- Letter form Social Security Administration that worker performed services as an independent contractor (LTR 9004040)
- Ruling from State Dental Board that dentists must be an independent contractor (*Queensgate Dental Family Practice, Inc. v. U.S.* 68 AFTR 2d 91-5679 (DC Pa.)).
- Prior state administrative action (e.g., workers' compensation decisions) and other federal determinations (e.g., determinations under the Federal Labor Standards Act (Wage and Hour Division) may constitute a reasonable basis if the state similarly interprets the common law standards (IRM 4.23.5.2.2.7).

Burden of proof is on the IRS if business (1) establishes a *prima facie* case and (2) cooperates with IRS's investigation. Generally, the burden to prove that the business reasonably relied on any of the four safe harbor factors rests with the taxpayer. Starting in 1997, businesses seeking to show reasonable reliance on one of the first three safe harbor factors (i.e., precedent, prior audit or industry practice) will

[1] Therefore, the business should present a prima facie case to the IRS and let the IRS refute the evidence.

only have the burden of establishing a prima facie case (meaning "at first sight; on first view; before further examination") that it was reasonable not to treat a worker as an employee under the safe haven. If the business cooperates with the IRS investigation (including reasonable requests for information relevant to the taxpayer's treatment of the worker as an independent contractor), the burden shifts to the IRS to prove the business wrong (Act §530(e)(4)).

> **Comment**: Act §530(e)(4) basically codified the holding in McClellan v. U.S., 900 F. Supp. 101 (E.D. Mich. 1995).

> **Comment**: Shifting of the burden of proof back to the IRS applies to:

- ♦ the reporting consistency requirement,
- ■ the substantive consistency requirement,
- ■ the judicial safe haven
- ■ the past IRS audit safe haven, and
- ■ the industry practice safe haven, but
- ■ **NOT** the "any other reasonable basis method (ICorE, p. 1-17).

Prima facie case. The IRS more strictly interprets a prima facie case to mean: "that the taxpayer has presented evidence that will allow the taxpayer to prevail unless the government presents other evidence that contradicts and overcomes the taxpayer's evidence" (ICorE, p. 1-18).

Even Though Waterproofing Business Gave Each Worker Form 1099 and Was Consistent, Business Didn't Show Any "Reasonable Basis" (*Juan Ramirez v. Comm.*, TCM 2007-346; also see: *Peno Trucking, Inc. v. Comm.*, 6th Circuit, No. 07-1869, 10/03/2008; Appeals court, reversing the Tax Court, found it was reasonable that the trucking company treated the truckers as independent contractors as Peno Trucking (1) issued Form 1099's to all truckers, (2) consistently treated the truckers as independent contractors, and (3) used state rulings and court decisions as evidence.)

Must provide evidence to use any of the safe harbor factors. From 1999 through 2003, Juan Ramirez operated a California waterproofing business as a sole proprietorship called J. R. Waterproofing, waterproofing decks, shower stalls, and stairways. Juan's brother, nephew and brother-in-law worked for him. Juan's accountant filed Forms 1099-MISC, reporting nonemployee compensation payments made to his three workers in 2003. The IRS conceded that Juan met the first two requirements of Revenue Act §530(a)(1), i.e., Juan had never treated any of his workers as employees for Federal employment tax purposes, and he has timely filed all required returns for the periods in issue and for prior periods on a basis consistent with his treatment of the workers as independent contractors. However, the IRS argued that Juan did not have a reasonable basis for treating his workers as independent contractors instead of employees, and thus fails the third element of the Revenue Act §530(a)(1) test.

The court properly pointed out that Revenue Act §530(a)(2) set forth three statutory safe harbors for purposes of establishing reasonable basis and that reasonable reliance upon ***any*** of these three circumstances is deemed sufficient to establish the requisite reasonable basis.

> **Comment:** But the court failed to enumerated the fourth subjective reasonable basis test, i.e., that relief is to be granted if a taxpayer has ***any reasonable basis*** for treating workers as other than employees and that Congress intended that his subjective test be ***construed liberally in***

favor of taxpayers.

Business loses Act §530 relief for lack of evidence. Juan presented no court cases or rulings, no evidence of a prior tax audit, and no evidence of a long-standing practice of independent contractor treatment in the waterproofing industry. The court chose not to examine the "any other reasonable basis" test, probably for the same reason. The court concluded, therefore, that the safe havens of Revenue Act §530(a)(2) were inapplicable.

Business also lost under common law factors as business controlled "what to do" and "how to do it." What about under the common law tests? Nope, Juan controlled each job site, delegated responsibilities, and directed each of his worker's actions to varying degrees based on the individual worker's respective experience. Juan also provided all materials for each job and reimbursed his workers for expenses on the job. Therefore, the court concluded that there was a lack of an opportunity for profit or loss on the part of the workers. The court concluded that Juan's workers were employees for the year at issue.

> **Comment:** Juan represented himself in Tax Court, and fulfilled the adage "He who represents himself has a lousy lawyer and has a fool for a client."

New Form 8919 - IRS Asks Workers to Identify Employers Who Misclassify (IR-2007-203)

Want to cut worker/independent-contractor's SE tax in half? IRS blesses new option! Instead of reporting compensation on the employee/worker's W-2, some businesses treat the worker as an independent contractor to save on payroll taxes (i.e., 7.65% FICA tax) and report the compensation on Form 1099-MISC. The worker then reports this amount on Schedule C, resulting in the worker paying self-employment (SE) taxes at a 15.3% rate on the net earnings. Some workers complain they should have been treated as employees instead of an independent contractors and therefore should only be required to contribute 7.65% FICA instead of the 15.3% SE tax. Starting with the 2007 tax year, the IRS allows the worker to file Form 8919, Uncollected Social Security and Medicare Tax on Wages, instead of filing Schedule SE (Form 1040), Self-Employment Tax, if they meet at least one of seven criteria (e.g., reason codes) as enumerated below. Previously, misclassified workers were required to file Form 4137, Social Security and Medicare Tax on Unreported Tip Income, for this purpose, a form that will still be used by certain tipped employees to report social security and Medicare taxes on allocated tips and tips not reported to their employers.

> **Example:** The 2008 FICA wage base is $102,000. The self-employed's maximum SE tax is $15,606 whereas the employee's maximum FICA tax is half that, resulting in an annual $7,803 savings! This option can create a substantial tax savings for the qualified worker.

> **Comment:** By filing Form 8919, the worker's social security and Medicare taxes will be credited to the worker's social security record. In other words, the worker will get the same credit as if filing as self-employed ... at half the cost.

Four requirements to file Form 8919. The worker may file Form 8919 if **all** of the following apply:

- The worker performed services for a firm[2];
- The firm did not withhold the worker's share of social security and Medicare taxes from the worker's pay;
- The worker's pay from the firm was ***not*** for services as an independent contractor; and
- One or more of the reasons listed below under ***reason codes*** apply to the worker.

Reason codes. When treated by the employer as an independent contractor, the worker should indicate on Form 8919 one of six reasons why they determine they should have been treated as an employee. If none of the first six reason codes apply, but the worker still believes they should have been treated as an employee, the worker should enter reason code G, and file Form SS-8 on or before filing the worker's tax return.

A. Worker filed Form SS-8[3] and received a determination letter stating that the worker was an employee of the firm.
B. The worker was designated as a "section 530 employee[4]" by the employer or by the IRS prior to January 1, 1997.
C. The worker received other correspondence from the IRS stating the worker was an employee.
D. The worker was previously treated as an employee by the firm and was performing services in a substantially similar capacity and under substantially similar direction and control. (The worker must also enter reason code G.)
E. Any co-workers, performing substantially similar services under substantially similar direction and control, were treated as employees. (The worker must also enter reason code G.)
F. Any co-workers, performing substantially similar services under substantially similar direction and control, filed Form SS-8 for the firm and received a determination that they were employees. (The worker must also enter reason code G.)
G. The worker filed Form SS-8 with the IRS and has not received a reply.

Caution. Risk of filing Form 8919 may result in job loss! Along with the reason code, the worker must list the firm's name and the firm's federal identification number. If the worker enters reason codes D, E, F, or G, the worker or the firm that paid the worker may be contacted by the IRS for additional information. Additionally, the use of these reason codes is not a guarantee that the IRS will agree with the worker's status determination. If the IRS does not agree that the worker is an employee, the worker will probably be billed for the additional tax, penalties, and interest resulting from the change to this worker status.

TRUST FUND RECOVERY PENALTY - 100% PENALTY §6672

Penalty for Failure to Pay Trust Fund Taxes

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[2] The term "firm" means any individual, business enterprise, company, non-profit organization, state, or other entity for which the worker performed services.

[3] Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding.

[4] A section 530 employee is one who was determined to be an employee by the IRS, but whose employer has been granted relief from payment of employment taxes under Section 530 of the Revenue Act of 1978.

Responsible persons are personally liable for corporate payroll tax! While entrepreneurs may name many, the number one reason a taxpayer incorporates his or her business is to avoid personal liability for business actions. Personal liability can creep out to the taxpayer regardless of his or her care in structuring the corporate shield if financial troubles in the corporation lead the company to "borrow" payroll trust fund amounts. Under §6672, the IRS can hold "responsible persons" personally liable for taxes withheld from employees but not deposited with the government. The liability equals 100% of the undeposited trust fund taxes (withheld FICA and federal income taxes).

> "Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or attempts in any manner to evade or defeat any such tax or payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over" (§6672).

Exceptions for volunteers and tax-exempt organizations. The IRS may not impose the trust fund recovery penalty on volunteers, unpaid members of a board of trustees, or directors of a tax-exempt organization to the extent that such members serve solely in an honorary capacity, do not participate in the day-to-day or financial operations of the organization, and do not have actual knowledge of the failure to pay the trust fund taxes for which the penalty is imposed. However, the relief does not apply if it results in no other person being liable for the penalty and, thus, cannot operate to eliminate all responsible persons from liability for the penalty (§6672(e)).

Liability under §6672 requires:

1. a *responsible* person - one who had a duty to collect and pay over the taxes. The following have been held to be responsible: board members, corporate officers, managers, payroll check signers, payroll report signers.

2. the responsible person must have acted willfully in failing to pay and collect the taxes. "Willful" can be nothing more than knowing the liability exists and paying another creditor.

The burden of proof is on the taxpayer. The taxpayer must show that he or she is not a responsible person or did not act willfully in failing to collect and pay over the taxes.

The 100% penalty is not necessarily imposed on the most responsible person. The IRS can assess the same dollar penalty against several people it considers responsible for failing to pay over taxes without ever determining who was actually at fault. However, the IRS cannot collect more than 100% of the liability. The IRS can choose to collect from one of several responsible persons, ignoring the others. Indeed, it can collect from an individual without first pursuing collection actions against the corporation. The courts have given the IRS great latitude in performing its job of collecting delinquent trust fund taxes.

The 100% penalty does not include *pre-assessment interest or penalties* due from the corporation on its delinquent payroll taxes. Interest and penalties accrue to the individual once the individual has been assessed the penalty tax.

Preliminary notice required. Congress thought it necessary to add to the law a provision requiring the

government to notify such "responsible persons" that the penalty is going to be assessed at least 60 days before the notice and demand for the penalty. This preliminary notice must now be issued or the government cannot assess the penalty.

The statute of limitations on the assessment shall not expire before the later of:

1. The date 90 days after the date on which such notice was mailed, or
2. If there is a timely protest of the proposed assessment, 30 days after the IRS makes a final administrative determination on the protest (§6672(b), for assessments made after June 30, 1996).

> **Note**: The IRS does not need to send the notice if the collection of the tax is in jeopardy.

Disclosure required of IRS attempts to recover taxes from another. Previous, the IRS could not disclose information as to other persons they had determined to be liable for the Sec. 6672 penalty. The IRS is now authorized to disclose this information upon the written request by a person that they have determined to be liable for the trust fund recovery penalty under Sec. 6672.

The IRS must disclose in writing:

1. The name of any other person whom they have determined to be liable for such penalty, and
2. Whether they have attempted to collect such penalty from such other person, the general nature of such collection activities, and the amount collected, if any (§6103(e)(9) effective on July 30, 1996).

Federal right of contribution where more than one person is liable for the penalty for failure to collect and pay over tax. Under the bill, if more than one person is liable for the penalty under Sec. 6672, each person who paid such penalty shall be entitled to recover from other persons who are liable for such penalty an amount equal to the excess of the amount paid by them over such person's proportionate share of the penalty. This proceeding is a "federal cause of action" separate from any IRS collection activities relating to the penalty (§6672(d), for **penalties assessed after July 30, 1996**).

> **Note**: Any claim for such a recovery may be made only in a separate action involving such persons.

IRS Wins Following §6672 100% Penalty Cases for Numerous Reasons

1. Texas CPA/Controller responsible party - fined $158,500. CPA Saraleigh E. Looney, the controller of NetTec Operating Corporation (NexTec) was assessed $158,500 of §6672 penalties for NexTec's failure to pay employment tax for one quarter in 2002. It did not matter that the IRS's assessment was made after she filed for bankruptcy. Her liability under §6672 was not a penalty; therefore, the challenged assessment was an "assessment of tax" expressly exempted from the automatic stay provisions of the Bankruptcy Code. CPA Looney did not disprove her status as a responsible person or that she willfully failed to pay the corporation's employment withholding taxes. Nor did she offer any evidence substantiating her contention that she was unaware that the corporation owed withholding taxes (*Saraleigh E. Looney v. U.S.*, U.S. District Court, So. Dist. Texas, Houston Div.; Civ. H-06-1166, February 26, 2008, 2008-1 USTC ¶50,204).

2. Shareholder liable for $264,579 of unpaid employment taxes (Charles B. Erwin v. U.S. ,(C N.C.) 1:06CV59, March 18, 2008. In 1994,Charles Erwin, along with three other investors, developed and operated five Golden Corral restaurant franchises in the Cleveland, Ohio area under the name of GC Affordable Dining, Inc. (GCAD). GCAD was never as successful as the investors envisioned and GCAD was out of business by 2001. In 1998, they hired Buddy Light Accounting & Tax Services to prepare payroll and monitor accounts payable. Cash-flow problems started and Buddy Light didn't communicate clearly that GCAD was not paying their payroll tax. This was discovered in 1999, Buddy Light was fired and Erwin's own management company took over GCAD accounting functions, including payroll and withholding tax matters. The court found Erwin liable for the trust fund recovery penalty assessed against him in connection with the corporation's unpaid withholding taxes. He was just too involved in the day-to-day operations not to be a "responsible person" and he acted willfully because he had reason to know that the taxes were not being paid and failed to exercise his authority to ensure their payment. Despite knowledge of the tax deficiencies, he regularly directed that payments be made to creditors other than the IRS.

3. Board chairman of exempt hospital liable for $409,000 of unpaid employment taxes (*Stephen K. Verret v. U.S.*, (DC Texas) CIV. 1:06-CV-636, February 14, 2008). As the Board Chairman of Community Healthcare Foundation, a tax-exempt hospital in Grove, Texas, Stephen Verret was not entitled to a refund of the trust fund recovery penalty. Stephen was determined to a responsible person because he actively participated in the day-to-day management of the hospital, had authority to sign checks and to hire and fire employees. In addition, he was held to be acting willfully because he had reason to know that the taxes were not being paid and failed to exercise his authority to ensure their payment. Stephen did not qualify for exemption from the penalty under §6672(e) because he clearly played an active role in the hospital's management, and therefore, did not serve solely in an honorary capacity as Chairman of the Board.

4. President and CEO penalized $233,000 for unpaid employment taxes. James Tornes was the president, director, CEO and majority owner of Electric Motor Sales, an Ohio corporation in the business of selling and servicing small electric motors in the Marietta, Ohio, area and also providing electrical contracting work on commercial construction projects. The IRS assessed Tornes for unpaid trust fund recovery penalties in the total amount of $233,253 by reason of Tornes' willful failure to collect, truthfully account for, or pay the federal income and FICA taxes withheld from the wages of the employees of Electric Motor Sales. The court determined Tornes was a "responsible person" because he had complete authority over every aspect of the corporation's finances, including the sole authority to hire and fire employees, take out loans, and sign contracts and checks. As he withhold income and FICA taxes from wages and didn't submit them to the government, he also acted willfully because he was aware of the tax debt, yet authorized and made payments to other creditors **(*U.S. v. James C. Tornes*, 2008-2 USTC ¶50,431, U.S. District Court, So. Dist. Ohio, East. Div.; 2:07-cv-49, May 8, 2008)**

PER DIEM ARRANGEMENTS -YEAR 2008 - 2009 UPDATE

Per Diem Arrangements - Background

This section sets forth the fiscal year 2008-9 per diem options available for (1) employee reimbursements and deductions and (2) self-employed deductions.

Any available per diem method is optional (it is not mandatory) for employees *and* self-employed

individuals to use in computing the deductible costs of business lodging, meals and incidental expenses paid or incurred while traveling away from home, i.e., they may always use actual allowable expenses if they maintain adequate records (or other sufficient evidence) [Rev. Proc. 2007-63; Sec.1].

The requirements to use the per diem option. An employee receiving a fixed allowance (e.g., reimbursement varies in proportion with miles driven or days away from home) will be allowed a deemed above-the-line deduction by not including the payments in W-2 income only if the following requirements are met:

1. **"Adequate accounting" to the employer required**. The employee must timely substantiate to the employer "the elements necessary to determine the amount of the allowance (e.g., the number of miles driven ***or*** the number of days away from home, AND the time, place and business purpose of the travel)" [Rev. Proc. 2007-63; Sec. 7.01]. The per diem must be paid with respect to ordinary and necessary business expenses incurred, or which the payor reasonably anticipates will be incurred, by an employee for lodging, meal, and incidental expenses or for meal and incidental expenses for travel away from home in connection with the performance of services as an employee of the employer (Rev. Proc. 2007-63, Sec. 3.01).

   Major Misunderstanding! The per diem option does not relieve the employee of properly verifying to the employer the time, place, and business purpose of each expense (Form 2106 instructions, page 2)! If the employee does not timely substantiate to the employer, the per diem becomes taxable income and expenses are not deductible on Form 2106 (*B.J. Baugh*, TCM 1996-70).

2. **Per diem cannot be more than the IRS-specified rates**. The employee may only receive a per diem amount at or below the "IRS-specified rates" (e.g., year 2008's 50.5/58.5-cents-per-mile, or the 2008-9 applicable Federal per diem allowance for meals of $39 to $64 and lodging of $70 to $317), or "a flat rate or stated schedule" (e.g., trucking industries 2008's $52 meal per diem or based on miles driven and airline industries meal per diem based on hours flown) that is reasonably calculated not to exceed the amount of the anticipated expenses (Rev. Proc. 2007-63; Sec. 3.01(3); Sec. 3.03(1); Sec. 4.04(3)).

   Penalty: Excess per diem creates W-2 income.

3. **Must return any per diem not substantiated**. The employee must be required to return any portion of such an allowance which relates to days, miles, or travel not substantiated.

   Example: Drake, Inc. provides President Deb an advance mileage allowance of $109, based on an anticipated 100 business miles at $.505 per mile and 100 business miles at $58.5 per mile, and Deb only substantiates 60 miles for each half of the year, 120 business miles total. Deb MUST be required to (and actually) return $43.60 relating to the 80 unsubstantiated business miles.

Per Diem Rates Updated Oct. 1, not Jan. 1 (2007-8: Rev. Proc. 2007-63; 2006-7: Rev. Proc. 2006-41)

"Hi-low" & "meal only" per diem rates will also change; transportation per diem is $52 for 2007-8. Rev. Proc. 2007-63 provides a simplified high-low substantiation method for use by employers in

substantiating the amount of employees' lodging, meal and incidental expenses (M&IE) and special M&IE rates for the transportation industry ($52 per day for CONUS locality of travel in 2007 and 2008; Rev. Proc. 2007-63, Sec. 4.04(3)). When the rates for these optional ("special rate") methods are updated in the next per diem revenue procedure (due out every September), the IRS will permit taxpayers using the optional methods for travel in the calendar year to use either the updated special rates or the current special rates for the last three months of the calendar year. However, such taxpayers may not use the GSA rates instead of the special rates for that period, for the same consistency reasons.

> **Comment**: The auto per diem (e.g., 50.5¢/58.5¢ per mile) rules will continue to be effective, and updated, only on a calendar basis, not the October fiscal year basis

2008 - 2009 Federal per Diem Rates (www.gsa.gov; Rev. Proc. 2007-63, Rev Proc. 2008-59)

$39 minimum meal rate, $109 minimum standard CONUS rate. Effective October 1, 2008, the 2008-9 fiscal year M&IE (meal and incidental expense) federal per diem rates vary: $39/$44/$49/$54/$59/$64 M&IE rates. Therefore, the standard CONUS rates for all destinations not specifically listed is $109 (e.g, $70 lodging plus $39 M&IE). The highest 2008-9 FY lodging and meal rate is $424 in Manhattan, New York. This meal and incidental expense rate does not include laundry, cleaning and pressing (Rev. Proc. 2007-63; Sec. 3.02(3)& (b))

Self-employed. Self-employed individuals can use the meal and incidental rate to substantiate travel meals but must have actual receipts for lodging.

Five available per diem *employee reimbursement options*. To make life easier, a payor (the employer, its agents or a third party) may pay a per diem allowance in lieu of reimbursing actual expenses for lodging, meals and incidental expenses (called M&IE expenses) incurred or to be incurred by an employee for travel away from home. But the amount of the per diem allowance that can be paid to an employee is limited to five options:

Option 1. **Reimbursement of automobile mileage at 50.5¢ (Jan. - June) or 58.5¢ (July - Dec.) per mile (or less).**

Option 2. **Reimbursement of meals and lodging at the federal per diem rate (or less) which vary from $109 to $424,** depending on the city of destination (see following example).

Option 3. **Reimbursement of meals and lodging at a $237/152 high/low amount, depending on the city of destination** (Rev. Proc. 2007-63, Sec. 5.02; see Sec. 5.03 for list of high-cost localities; effective October 1, 2007. Effective October 1, 2008, these amounts are increased to $256/158 (Rev. Proc. 2008-59).

Option 4. **Reimbursement of meals and incidental expenses only at the federal M&IE per diem rate of $39/$44/$49/$54/$59/$64 (or less), depending on the city of destination** (see middle column of federal per diem rates).

Option 5. **Reimbursement of incidental expenses only at a $3 per day rate.**

> **Note**: There is no lodging-only per diem option (Rev. Proc. 2007-63, Sec. 1).

Two available per diem *employee expensing* elections.

Option 1. **Deducting automobile mileage at 50.5¢/58,5¢ per mile or less**.

Option 2. **Meals only**: As long as the employee is not reimbursed meals, the employee may deduct travel away from home meals on his or her personal return (e.g., Form 2106) at the federal M&IE per diem rate of $39/$44/$49/$54/$59/$64 or less, depending on the city of destination (see middle column of federal per diem rates) (Rev. Proc. 2007-63; Sec. 7.06). This amount is subject to the 50% (or 25% for transportation workers) disallowance of §274(n); e.g., only $19.50 of the $39 meal allowance is actually deductible for nontransportation employees.

Two per diem *expensing* options available for the self-employed.

Option 1. **Deducting automobile mileage at 50.5¢/58.5¢ per mile or less**.

Option 2. **Meals only**: As long as the self-employed is not reimbursed meals, the self-employed may deduct travel away from home meals on his or her personal return (e.g., Schedule C) at the federal M&IE per diem rate of $39/$44/$49/$54/$59/$64 or less, depending on the city of destination (see middle column of federal per diem rates) (Rev. Proc. 2007-63; Sec. 7.07). As with employees, this amount is subject to the 50% (or 20% for transportation workers) disallowance of §274(n); e.g., only $19.50 of the $39 meal allowance is actually deductible for the nontransportation self-employed.

Comment: In other words, the self-employed **cannot** use either the federal lodging and meals rate (e.g., $109 to $424) or the high/low method ($152/$237). Although self-employeds may use government per diem rates to substantiate meals and incidental expenses, they must separately substantiate actual lodging expenses.

Reimbursing Combined Lodging, Meals and Incidental Expenses; the "Standard" System

Reimbursing the same (or less) amount as the government employee gets! If an employer pays a per diem allowance in lieu of reimbursing actual expenses for lodging, meal, and incidental expenses incurred or to be incurred by an employee for travel away from home, the expense deemed substantiated is the smaller of the employers per diem allowance ***or*** the standard IRS-specified rate, which is the Federal per diem travel allowance for the locality of the overnight travel (Rev. Proc. 2007-63; Sec. 4.01).

In the Continental United States (CONUS)- $109 to $424 for FY 2008-2009. The Federal travel rates applicable to CONUS are published annually by the General Services Administration. Different rates (ranging in 2008-2009 from $109 to $424) are published for approximately 400 different locations in CONUS, and all other CONUS locations are subject to the lowest rate (of $109 in 2008-9). Therefore employers are required to keep track of all these continuously changing per diem rates - for no other reason than to determine whether their per diem rate actually paid exceeds the federal rate applicable for that locality, on the date of the employee's travel. This is serious now! (Rev. Proc. 2007-63, Sec. 3.02(1); Sec. 4.01).

Per diem rates now on the Internet. These per diem rates are available on the internet. Access ***domestic*** per diem rates at: "www.gsa.gov" and click on "Per Diem Rates" under "Featured Topics." You can access ***foreign*** per diem rates at: "http://aoprals.state.gov/web920/per_diem.asp." Converting foreign dollars to U.S. dollars for expense purposes can be done at

"http://www.oanda.com/convert/classic." Per diems also can be found in Publication 1542[5] which can be obtained (1) by calling the IRS's toll-free telephone number, 1-800-TAX-FORM (1-800-829-3676); (2) through FedWorld on the Internet; or (3) by directly accessing the Internal Revenue Information Services bulletin board at (703) 321-8020.

Outside the Continental United States. These travel rates are established by the Secretary of Defense, and can be found on the Internet at www.dtic.mil/perdiem/opdrform.html or reprinted by various tax services [Rev. Proc. 2007-63; Sec. 3.02(1)].

DISALLOWANCE OF CERTAIN ENTERTAINMENT, ETC., EXPENSES §274

Substantiation of Listed Property

Automobile expenses, home computers, cellular phones - items which must be substantiated before reimbursing listed property expenses:

1. **Amount:**

   a. **Expenditures** - The amount of each separate expenditure with respect to an item of listed property, such as the cost of acquisition, the cost of capital improvements, lease payments, the cost of maintenance and repairs or other expenditures, or uses.

   b. **Uses** - The amount of each business-investment use (as defined in Reg. §1.280F-6T(d)(3)) based on the appropriate measure ***(e.g., mileage for automobiles, minutes of use of home computers and cellular phones)*** and the total use of the listed property for the taxable year.

2. **Time** - The date of each expenditure or use.

3. **Business or Investment Purpose -** The business purpose for each expenditure or use (Reg.§1.274-5T(b)(6)).

   Warning: The monthly cellular telephone bill will not, by itself, meet this proper substantiation rule as the bill does not provide evidence whether each expenditure is for business or personal use. Unless the taxpayer so indicates, the *entire* cellular telephone bill could be considered W-2 to the employee(s) and no business expense deduction would be allowed for the employee or independent contractor (*George & Gwendolyn Moss v. Comm.,* TCS 2004-56).

Car Mileage Deductible Without Contemporaneous Written Log (*Gary L. Larson v. Comm.*, TCM 2008-187; also see: *Bamidele Arike Kolapo v. Comm.*, TCS 2007-142, mileage and cell phone expenses denied as logs created after notification of audit; Juvy Lyn Andrade Te Eng Fo v. Comm., TCS 2008-25, the cost of cell phone was nondeductible for lack of substantiation; *Timothy A. And*

[5] Publication 1542 is no longer publicly available in a printed format. Paper copies will be available by request only. Electronic editions are available on the IRS web site, generally updated every October.

***Emma Valdivieso Runels, et al. v. Comm.*, TCS 2008-10, lack of records; *James A. & Joan H. Soholt v. Comm.*, TCS 2007-49, flat-fee cell phone bill deduction denied for lack of cell log, but laptop expenses permitted without time log; yet see: *Duyet Minh Nguyen V .Comm.*, TCS 2007-80, flat-fee cell phone bill deduction allowed without cell log under Cohan rule)**

Taxpayer's testimony and non-contemporaneous records good enough. Gary Larson worked as a manufacturer's representative and was regularly required to travel extensively throughout Wisconsin, Minnesota, North Dakota, South Dakota, and Iowa. Gary kept small hand-held mileage logs in his vehicles and he recorded his business trips and related mileage each day. He then used the daily logs to prepare weekly "rough charts" to summarize the information on his daily logs. The problem was, Gary was unable to produce either the daily or weekly logs when he was audited and the IRS denied his auto expense deduction, arguing that he did not meet the substantiation requirements of §274(d). Gary testified that he consistently transferred the data (i.e., date, destination, business purpose, mileage and odometer readings) from his daily and weekly logs to a monthly log, which he did produce at trial. The court pointed out that the IRS regulations state that in the absence of adequate records to substantiate an expense, a taxpayer may alternatively establish an expense by his or her own statement, ***whether written or oral,*** and by other corroborative evidence (§1.274-5T(c)(3)). The court ruled the monthly log, in conjunction with Gary's corroborating testimony, satisfied the substantiation requirements of §274(d) and Gary was allowed to deduct his business auto expenses, using the standard mileage deduction.

But, Gary learns you can't have it both ways. On his original returns, Gary deducted the standard mileage rate for his business miles and also deducted actual auto expenses such as lease payments, repairs, insurance, etc. The court explained to Gary that you can't have it both ways and denied the actual expense deductions. No wonder the IRS didn't believe anything Gary told them!

Bill Introduced to Exclude Cell Phones from Listed Property Category (S.B. 2668)

Recently, the Internal Revenue Service reminded field examiners of the substantiation rules for cell phones as listed property. The current rule requires employers to maintain expensive and detailed logs, and employers caught without cell phone logs could face tax penalties. Senator Kerry (D-MA) and Senator Ensign (R-NV) have introduced a bill to remove cell phones from listed property under §280F. Nothing passed, but at least two Senators have this recordkeeping problem on their radar screen.

Well-known CA Criminal Attorney Not Entitled to Deductions Due to Lack of Substantiation (*Barry L. Morris v. Comm.*, TCM 2008-65)

Barry, you need more than your mouth ... you need books and records! Barry L. Morris, a famous criminal attorney in Hayward, CA represented himself in Tax Court and still lost all deductions in excess of those agreed to by the IRS. He showed no evidence that his alimony payments were not for property settlement or child support. He also lost numerous Schedule C deductions for lack of records other than his verbal testimony, which didn't impress the court. "(N)o evidence has been admitted that would tend to support any of the claimed business expense deductions that were not conceded by (Barry). To make matters worse, (his) testimony was plagued by memory lapses and confessions of error with respect to some of his claimed deductions. The Court therefore conclude(d) that (Barry) has failed to demonstrate entitlement to deductions for any business expenses in excess of those conceded by (the IRS)."

BUSINESS/PERSONAL EXPENSES

When an automobile is used for both personal and business purposes, the taxpayer must allocate the expenses based on the total annual mileage driven. Therefore the portion of interest, tax, or casualty loss allocable to business use is treated as a business deduction.

> **Tax planning**: Sadly, for employees, this business auto expense must be deducted as a Form 2106 miscellaneous itemized deduction (with the exception for interest and taxes) that is subject to the 2% AGI limitation.

Commuting Is Non-deductible

As a general rule, daily transportation expenses (whether by car, air, bus, taxi, etc.) paid or incurred by a taxpayer in going between the taxpayer's residence and one or more regular places of business or employment (commonly called commuting) are *nondeductible* personal expenses (§262) unless they are otherwise deductible, e.g., taxes or interest (§1.162-2(e) & §1.262-1(b)(5)).

What happens if taxpayer chooses to work while commuting to office? These costs are still personal commuting expenses. The IRS states "you cannot deduct commuting expenses even if you work during the commuting trip. Additionally, the use of the car to display material that advertises the taxpayer's business does ***not*** change the use of the car from personal use to business use" (Pub. 463, part 4). Therefore, mileage by tax preparers going by the post office to pick-up or drop-off business mail on the way to work would not qualify.

Construction Worker Denied Deduction for Commuting Expenses (*Roger A. Green v. Comm.*, TCS 2008-80; also see: Juvy Lyn Andrade Te Eng Fo v. Comm., TCS 2008-25, MD's daily drive from home to medical center a non-deductible commute. Note: IRS received state (Minnesota) tax auditor's report and automatically prepared IRS deficiency notice!)

220 mile daily drive to/from work not deductible if a personal commute. Roger Green was hired by a construction company in Martinsburg, West Virginia, which was approximately 110 miles from his home in Keyser, West Virginia. Most of the construction sites Roger worked at were located in the general vicinity of Martinsburg. Because Roger was caring for his ailing mother, he chose not to move closer to his job location. On his tax return, Roger deducted the cost of his daily trip to Martinsburg and back. The court ruled Roger's travel costs were personal commuting expenses and not deductible.

But Some "Home-Client-Home" Commuting Expenses May Be Deductible

The taxpayer *is* permitted to deduct the costs of commuting in several situations, detailed below.

Commuting Chart

IS "COMMUTING" DEDUCTIBLE		
FROM	**TO**	**TAX RESULT**
Regular (or second) work location	Another regular (or second) work location	Deductible (Rev. Rul. 55-109)
	Residence	Not deductible (§1.262-1(b)(5)

Residence	Regular work location	Not deductible (§1.262-1(b)(5)
	Second work location	Not deductible (§1.262-1(b)(5)
	Temporary work location/ INSIDE city	If regular work location exists - deductible (Rev. Rul. 99-7)
		If no regular work location, it's a non-deductible commute (Rev. Rul. 99-7)
	Temporary work location/OUTSIDE city	Deductible. No regular work location necessary (Rev. Rul. 99-7)
Residence is "principal place of business", e.g., office-in-home	Regular or second work location; all temporary work locations inside or outside of city	Deductible (Rev. Rul. 94-47)
Residence is "regular place of business" e.g., non-deductible office-in-home	Regular work or second work location and all temporary work locations	Not deductible (Rev. Rul. 94-47); But see *Walker* (101 TC 537 (1993)) which disagrees if home office is a "regular place of business," even though not a "principal place of business."

Driving to Temporary Work Location *May* Be Deductible.

The drive from the taxpayer's residence to a temporary work location[6] inside the taxpayer's metropolitan area may be deductible if a regular work location exists (Rev. Rul. 99-7). Also, the drive from the taxpayer's residence to a temporary work location outside the taxpayer's metropolitan area is always deductible, even without a regular work location (Rev. Rul. 99-7). So how expansive is the taxpayer's metropolitan area? The 32 mile drive by a West Virginia sheet metal worker was deemed inside the taxpayer's metropolitan area and therefore the mileage was deemed a nondeductible commute (*Daniel P. Marple v. Comm.,* TCS 2007-76). Yet, the 35 mile drive by a Wisconsin boilermaker was deemed outside the taxpayer's metropolitan area and therefore the mileage was deductible (*C. L. Wheir v. Comm.,* TCS 2004-117).

100 Mile Average Daily "Commute" to Temporary Worksites Deductible (*Estate of David B. Lease, Deceased and Kathy Lease v. Comm.*, TCS 2008-11))

David Lease, a millwright whose jobs were assigned by his local union hiring hall in Cumberland, Maryland, drove an average of 900 miles per month to and from work assignments; he worked 112 days and drove an average of almost 100 miles per workday. His work assignments expanded from within 50 miles of his home to as much as 250 miles from his home. He would generally not spend the night at the work location but would return home, leaving as early as 3:30 or 4:00 a.m. and returning home at 7 or 8 p.m. Each of the jobs accepted outside of his principal place of employment were short in duration, and his travel was both temporary and forseeably terminable. David properly substantiated the travel expenses in a travel log. The court determined that the amount claimed, which was based on the standard mileage deduction, was allowed as the travel was outside of his usual and principal place of employment and was both temporary and forseeably terminable. Therefore, the court ruled that this daily transportation was outside of his metropolitan area where he normally worked.

[6] Employment at a work location is temporary if it realistically is expected to last for 1 year or less when work commences, and stays temporary until the date the taxpayer realizes it will extend past 1 year (Rev. Rul. 99-7).

The Away from Home Requirement

Taxpayers are allowed a deduction for reasonable and necessary expenses while traveling away from home for business. Deductible expenses include, but are not limited to, transportation costs, meals, lodging and incidental expenses. Whether travel expenses are deductible or not largely depends on if the taxpayer is "away from home," which means the taxpayer must first determine the location of his or her tax home. In order for traveling expenses to be deductible,

1. they must be ordinary and necessary,
2. they must be incurred **while away from home**, and
3. they must be incurred in the pursuit of a trade or business.

The taxpayer is traveling away from home if:

1. The taxpayer's duties require him or her to be away from the general area of their tax home substantially longer than an ordinary day's work, and
2. The taxpayer needs to get sleep or rest to meet the demands of their work while away from home (See §162(a)(2); Rev. Rul. 60-189; Rev. Rul. 83-82; *Comm. v. Flowers* 46-1 USTC ¶9127; Pub 463, p.2).

The "away from home" requirement is often where we find problems during a tax audit, and, to make things worse, a source of judicial conflict.

Minimum Period of Time Needed to Be Away:

The "overnight" or "sleep or rest" rule: A taxpayer is not "away" unless his work requires him to be away from the general area of his tax home for a period substantially longer than an ordinary workday and it is reasonable for him to need sleep or rest (Rev. Rul. 75-170; Rev. Rul. 75-432).

Need not be 24 hours for lodging: Travel expenses may be deductible even though the taxpayer is away from his home for a period of less than 24 hours (Rev. Rul. 75-432; *K. Waters,* 12 TC 414, Dec. 16,873).

Meals only deductible if taxpayer away "overnight": A stricter "overnight" test is applied to determine the deductibility of business meals. The costs of meals on one-day business trips away from home are not deductible if the trips are not overnight trips (*H.O Correll*, (Sup. Ct.) 68-1 USTC 9101, 389 U.S. 299).

> **Example:** George M. drives from his home in Buena Park to a speech in Los Angeles and returns **the same day**. Therefore the automobile costs, but **not the meals**, would be deductible. And if George is reimbursed for the meals, this amount must be added to his taxable income!

The Away from Home Requirements Compel Answering Two Questions:

1. Where is the taxpayer's home for tax purposes?
2. What is the period the taxpayer needs to be away?

Where Is the Home Required to Be Away From? - Three Tests Used to Determine Tax Home

It's generally the taxpayer's place of business (Test 1). Generally, a taxpayer's "home" is considered to be located:

1. at the taxpayer's regular **place of business** (it includes the **entire city or general area** according to the IRS in Pub. 463, p. 3), regardless of where the family home is maintained, **or**
2. at the taxpayer's principal place of business (e.g., a salesperson servicing a well-established route) if the taxpayer has more than one regular place of business, regardless of where the family home is maintained, **or**
3. if the taxpayer has no regular or principal place of business (e.g., construction workers), then at the taxpayer's **regular place of abode** in a real and substantial sense (Rev. Rul. 73-529; Rev. Rul. 60-189; may need spouse and children, see Rev. Rul. 71-247, 1971-1 CB 54).

   Example: This means that Alex Rodriguez cannot choose to live on the weekends with his family in Florida, work and live in New York during the week, and deduct the New York meals or apartment. New York is his "home" in spite of where his family lives as that is where he works.

The taxpayer is only allowed a travel-away-from-home deduction if the absence from the home is temporary, not indefinite,or permanent. If employment at a work location is realistically expected to last (and does in fact last) for 1 year or less, the employment is temporary in the absence of facts and circumstances indicating otherwise. If employment at a work location is realistically expected to last for more than 1 year or there is no realistic expectation that the employment will last for 1 year or less, the employment is not temporary, regardless of whether it actually exceeds 1 year. If employment at a work location initially is realistically expected to last for 1 year or less, but at some later date the employment is realistically expected to exceed 1 year, that employment will be treated as temporary (in the absence of facts and circumstances indicating otherwise) until the date that the taxpayer's realistic expectation changes, and will be treated as not temporary after that date (Rev. Rul. 99-7).

Oh Where, Oh Where, Can My Tax Home Be? (*Paul and Anita Tucker v. Comm.*, TCS 2008-78)

Airline pilot and IRS dispute which of three locations was the tax home. Paul Tucker is a pilot for Southwest Airlines. When not traveling on business, he lives with his wife and children in Birmingham, Alabama. While his flight assignments normally originate and end in Chicago (his home airport), Tucker is supervised by the Southwest Operations Center located in Dallas, Texas.

Tucker contends that supervisor's location, not the location of his residence or work, should control determination of tax home. Tucker routinely traveled between his Birmingham residence and Chicago for his flight assignments. Due to the timing of flights, he sometimes spent the night in Chicago either before or after his regular flight schedule. He rented an apartment in Chicago for this purpose. Occasionally (2-3 times in 2002), Tucker traveled to Dallas to meet with his supervisors. He argued that because he was supervised from Dallas that his tax home should be Dallas, and, accordingly, all travel expenses incurred to travel to Chicago, including his apartment rent, should qualify as travel away from home and be fully tax deductible. The court concluded that while the location of an employee's supervision or supervisor might be instructive, it is hardly determinative to establish a tax home. Tucker's tax home was Chicago and none of his Chicago related travel costs were deductible.

Merchant Sailor's Tax Home is Where His Family Lives Making Travel to Out-of-Town Union

Hall Deductible (*Raymond J. Zbylut v. Comm.*, TCM 2008-44)

Raymond Zbylut was employed as a merchant sailor at various times in 2002 by American Ship Management, L.L.C. (American Ship), and by Matson Navigation Co. (Matson Navigation). Raymond took trips to San Francisco and Honolulu to seek work in 2002. The IRS argued that travel to San Francisco and Honolulu were non-deductible commuting expenses as he was free to choose the locations of his personal residence and he chose to live far from his various places of work. The court felt that the IRS was implicitly arguing that the union hall, rather than his personal residence in Nebraska, should be considered Raymond's tax home. To obtain maritime jobs required Raymond to be physically present at the union hall when the job opportunities were announced. He was not allowed to simply phone his union hall to see what new jobs were currently available. He incurred expenses traveling to union halls in San Francisco and Honolulu in order to seek temporary employment. Raymond was not a permanent or indefinite employee of American Ship, Matson Navigation, or any other company. He served only in temporary positions on various vessels and then returned to his home in Nebraska for vacations and during periods of unemployment. The court felt that the travel to the union hall was a business-related travel away from home rather than a commute.

Meals and Lodging Expenses For More Than One Year Not Deductible as Travel Expenses (*Joseph Cornelius v. Comm.*, TCS 2008-42; also see: *Michael L. & Ann Burski v. Comm.*, TCS 2007-212, traveling between home in Pennsylvania and working in Virginia for 16 years not temporary)

Taxpayer blew the one-year rule. In February 2002, Joe Cornelius was offered employment on an "as needed basis" with Princeton Information Systems (PI). He was assigned to work in Boulder, Colorado, for a client of PI (the Colorado assignment). The Colorado assignment started on March 4, 2002, and continued through April 2003. Joe stayed in a hotel for the first 2 weeks of the Colorado assignment; afterwards he lived in a rented condominium apartment. He maintained his apartment in Austin until June 2002. When the Colorado assignment terminated in April 2003, another began almost immediately. This second assignment was for a client of PI in Basking Ridge, New Jersey (the New Jersey assignment). As before, Joe was hired on an "as needed basis" by PI in connection with this assignment. He lived and worked in New Jersey from April 2003 through July 2005 although in June 2004 his employment status changed. While living and working in New Jersey, Joe stayed for the first 6 months at a Summerfield Suites and thereafter in a shared rented apartment. On each Schedule A Joe claimed substantial expenses for travel, meals and lodging, both in Colorado and New Jersey.

As each assignment ended up lasting more than one year, Joe could not deduct his living expenses as travel expenses. The assignments were not considered to be temporary and each location was considered his tax home during the applicable work periods.

Multiple Work Locations (Test 2)

When there are multiple areas of business activity or places of regular employment, **the principal place of business** is treated as the tax home for the travel expense deduction (so choose one). In determining the principal place, the taxpayer should consider (1) the time spent on business activity in each area, (2) the amount of business activity in each area, and (3) the amount of the resulting financial return in each area.

Three Tests to Determine Abode Location If No Regular or Principal Place of Work (Test 3)

As said previously, **if** there is no regular or main place of work (test one and two), then the tax home will be where the taxpayer regularly lives (test three), but the tests used to determine if the taxpayer has a "regular home" are:

1. The taxpayer must have worked in his or her home area before the temporary job, and continue to maintain work contacts during the absence, such as seeking job, taking leave of absence, maintaining second job, etc. (e.g., you have part of a business in the area of your main home and use that home for lodging while doing business there.)
2. Have duplicate living expenses (e.g., you have living expenses at your main home that you duplicate because your business requires you to be away from that home), AND
3. Taxpayer's spouse or children live at the claimed home, if you continue to use the home for lodging (e.g., you have not left the area in which both your traditional place of lodging and your main home are located; you have a member or members of your family living at your main home; or you often use that home for lodging, Pub 463, p.3) [Rev. Rul. 73-529, 1973-2 CB 37].

Consequences if not meeting all three criteria: Assuming that the job is expected to last less than one year, meeting all three criteria means the IRS will recognize the home; meeting two out of three tests requires the taxpayer to additionally use the facts and circumstances test; meeting only one of the three tests requires the IRS to determine the taxpayer an "itinerant", and therefore the tax home will be wherever the taxpayer happens to work (i.e., no travel deductions).

No Work Location (the "Turtle" Rule - for Itinerant Workers)

If the taxpayer has **no** permanent place of **business (test one) or residence (test two and three),** the courts have consistently denied the taxpayer's deduction for meals and lodging, since there is no "home" to be away from (e.g., construction workers, salesmen, some speakers.) They are considered to be "itinerants" whose "home" is located wherever they happen to be working, and thus are never "away from home" for travel expense deduction purposes (Rev. Rul 60-189; Rev. Rul. 73-529; *George H. James v. US,* 62-2 USTC ¶9735; *Robert H. Castor v. Comm.,* TC Memo 1991-307).

Electrician Determined Not to Have A Tax Home; Business Travel Deductions Denied (*Eric D. Walker & Lynn Walker v. Comm.*, TCS 2008-41)

Lived in Florida and worked in New Jersey. Eric D. Walker was a union electrician and member of Local 613 of the International Brotherhood of Electrical Workers (IBEW) located in Atlanta, Georgia. Eric neither worked nor lived in the Atlanta area during 2002. Eric considered his residence to be Florida but spent 216 days either working or looking for work in New Jersey, staying either at a YMCA or in a rented house. The court determined that Eric had neither a principal permanent place of residence nor a principal place of employment during the period to which the deductions for meals and lodging expenses related, and therefore he was not considered to have a tax home for that period. Because the deductions for meals and lodging expenses related to a period for which Eric had no tax home, he was not entitled to those deductions.