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Supreme Court Rejects Opportunity To Weigh In On Tax Accrual Workpapers Protection

◆ *Textron Inc. et al v. U.S. (Sup Ct. cert denied May 24, 2010)*

In a controversial move, the U.S. Supreme Court has declined to review the decision of the Court of Appeals for the First Circuit that allowed the IRS access to a corporation's tax accrual workpapers. The First Circuit in *Textron Inc. v. U.S.*, 2009-2 *USTC* ¶50,574 had found that the work product privilege did not protect tax accrual workpapers.

■ **CCH Take Away.** "On one level, it is not all that surprising that the Court declined to grant cert given the limited number of cases it agrees to hear," Kevin Kenworthy, member, Miller & Chevalier, Chartered, Washington, D.C., told CCH. "But it is disappointing," Kenworthy added, "because the Court's action leaves unresolved important questions about the scope of the work product privilege. For example, we do not know how the novel standard adopted by the First Circuit in *Textron* can be reconciled, if indeed it can be, with the standards that are applied in other circuits across the country."

Background

The controversy leading to *Textron's* appeal to the Supreme Court began over *Textron's* refusal to turn over its tax-accrual workpapers in response to an IRS summons issued in connection with an investigation of alleged tax shelter activities. A federal district court had held that the workpapers

were protected because they were prepared in anticipation of litigation. In response to an IRS appeal, the First Circuit initially agreed with the lower court. But in a 3-2 en banc rehearing, the First Circuit reversed, narrowly defining the scope of those documents protected because they were prepared "in anticipation of litigation" and distinguishing them from those that had to be prepared because they were needed to fulfill financial reporting requirements.

Future course

In its *Textron* decision, the First Circuit noted that the Fifth Circuit in *El Paso*, 82-2 *USTC* ¶9,354, had also denied protection for work papers in which the analysis was needed for financial reporting purposes. It further noted, however, that "other circuits have not passed on tax audit workpapers and some might take a different view."

■ **Comment.** While other circuits have not yet ruled directly on protection of tax accrual workpapers, the issue is bound to be tested. Some practitioners have commented that the IRS has been quite strategic so far in how and where it presses its summons powers on such matters. The IRS's recent plans to roll out a mandatory disclosure Schedule UTP for reporting uncertain tax positions may also force the issue of what workpapers may be segregated into the protected category of documents prepared "in anticipation of litigation."

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Route to: _____

IRS Unveils Revised Form 941 For *HIRE Act* Payroll Tax Forgiveness

◆ *IR-2010-64*, www.irs.gov

The IRS has revised Form 941, Employer's Quarterly Federal Tax Return, and its instructions to reflect payroll tax forgiveness under the *Hiring Incentives to Restore Employment (HIRE Act)*. Revised Form 941 tracks a draft version posted earlier on the IRS web site.

■ **CCH Take Away.** Payroll tax forgiveness in the *HIRE Act* is applicable to wages that would otherwise be subject to the employer's share of Social Security tax (that is, wages up to the Social Security wage base, which is \$106,800 for 2010) paid to qualified employees from March 19, 2010 through December 31, 2010. "The IRS's online frequently asked questions (FAQs) on the payroll tax exemption leave some questions unanswered," Melissa Labant, CPA, manager, American Institute of Certified Public Accountants (AICPA), explained. For example, an individual may begin employment after February 3, 2010 and immediately receive a paycheck. Only wages paid

after March 18 qualify for the exemption. The question arises if the February wages would reduce the Social Security wage base for that employee, Labant observed. Another question arises when an individual works for one company in January 2010, earns, for example, \$20,000, and then is laid off. The individual is hired by a new employer on April 1, 2010 and earns \$120,000 for the remainder of 2010. Would the second employer only receive a credit for the Social Security tax paid on \$86,800 (\$106,800 - \$20,000) even though the wages paid to the employee exceeded the Social Security wage base?

Payroll tax forgiveness

The *HIRE Act* provides qualified employers with payroll tax forgiveness. Qualified employers are exempt from the employer's 6.2 percent share of Social Security tax on all wages paid to covered employees from March 19, 2010 (the day after the date of enactment of the *HIRE Act*) through December 31, 2010. The covered employee must begin work for the qualified employer after February 3, 2010 and before January 1, 2011.

■ **Planning Note.** Semi-weekly and monthly depositors may reduce deposits during the quarter by the amount of payroll tax forgiveness, the IRS advised.

Form 941

The IRS has revised Form 941 for use beginning with the second calendar quarter of 2010. The *HIRE Act* does not allow employers to claim payroll tax forgiveness in the first calendar quarter of 2010 but provides for a credit in the

second calendar quarter. The second calendar quarter of 2010 ends June 30, 2010 and Form 941 is due by July 31 (August 2, 2010 under the weekend rule).

Line 6a of revised Form 941 asks employers to report the number of covered employees first paid exempt wages/tips this quarter. On line 6b, employers report the total number of covered employees paid exempt wages/tips to which they applied the Social Security exemption in this quarter.

On line 6c, employers enter the amount of exempt wages/tips paid this quarter to all covered employees reported on line 6b. Employers multiply the amount of exempt wages/tips reported on line 6c by .062 and enter the result on line 6d.

March wages

The IRS also explained how qualified employers will claim payroll tax forgiveness for wages paid to covered employees from March 19, 2010 through March 31, 2010. The payroll tax exemption that would be applicable to covered wages paid during the first calendar quarter of 2010 cannot be applied on the first quarter Form 941. Instead, the amount by which the employer's Social Security tax would have been reduced as a result of applying the exemption to wages paid during the first quarter is treated as a payment for the second quarter.

■ **Comment.** The credit for this payment may be claimed only on the second quarter Form 941 (lines 12c-12e) and may only be claimed with respect to wages paid to qualified employees from March 19, 2010 (the day after the date of enactment of the *HIRE Act*) through March 31, 2010.

■ **Comment** The IRS also explained how qualified employers will report the payroll tax exemption on Schedule B, Report of Tax Liability for Semi-weekly Schedule Depositors.

References: FED ¶46,371;
TRC PAYROLL: 9,060.

Workpapers

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■ **Comment.** "A decision by the Supreme Court in *Textron* would have given the lower courts useful guidance on an issue that arises not just in the specialized context of taxes, but in a range of contexts affecting the business community," Kenworthy observed.

References: FED ¶(to be reported);
TRC IRS: 21,402.35.

Reference Key

FED references are to *Standard Federal Tax Reporter*
USTC references are to *U.S. Tax Cases*
CCH Dec references are to *Tax Court Reports*
TRC references are to *Tax Research Consultant*

IRS Announces Short Window To Access Tax Credits/Grants For Therapeutic Discovery Projects

◆ Notice 2010-45, TG-712

The IRS has announced the application process for taxpayers to obtain investment tax credits or grants for “therapeutic discovery” projects. Taxpayers must submit their application by July 21, 2010. The IRS, in concert with the U.S. Department of Health and Human Services (HHS), will review applications by September 30, 2010 and approve or deny an application by October 29, 2010.

■ **CCH Take Away.** The health care reform package (the *Patient Protection and Affordable Care Act of 2010 and the Health Care and Education Reconciliation Act of 2010*) established the therapeutic discovery program under Code Sec. 48D. The government will certify projects up to a maximum of \$5 million per taxpayer and \$1 billion for all projects. A spokesperson for the Biotechnology Industry Organization, Washington, D.C., praised the guidance, predicting, “it will lead to many small biotechnology companies receiving needed funding to support critical on-going research and development programs.” Unveiling the guidance, Treasury Secretary Timothy Geithner said the program “will help advance research to find life-saving treatments and help U.S. companies lead the way in innovative medical discoveries.”

Qualifying project

Code Sec. 48D requires that a “qualifying project” be designed to (a) prevent or treat disease by developing a drug, (b) diagnose disease by developing molecular diagnostics, or (c) develop a process to advance the delivery of drugs. The IRS will certify the project only if:

- HHS determines that the project is a “qualifying project;”
- HHS determines that the project shows reasonable potential to (a) produce new therapies to treat areas of unmet medical needs or prevent, detect or treat chronic or acute conditions; (b) reduce long-term

health costs; or (c) significantly advance a cure for cancer within 30 years; and

- IRS determines that the project is among those with the “greatest potential” to (a) create and sustain high quality, high-paying U.S. jobs, and (b) advance U.S. competitiveness in the life, biological or medical sciences.
- **Comment.** Practitioners speaking on a recent KPMG web cast stated that job-generating potential is crucial and that applicants must provide specifics about potential jobs and their salaries. The credit is only available to firms with fewer than 250 employees.

Applications

Taxpayers must submit Form 8942, Application for Certification of Qualified Investments Eligible for Credits and Grants Under the Qualifying Therapeutic Discovery Project Program. The IRS will post this form on its web site by June 21, 2010, giving taxpayers at least a month to complete their applications.

Taxpayers must also submit a project information memorandum. HHS will review the memorandum to determine whether the project has reasonable potential to meet the statutory goals.

An applicant may elect on Form 8942 to apply for a grant for 2009 or 2010 instead of investment tax credits. Grants will not be taxable.

Eligible costs

The amount of an award will be based on 50 percent of the “qualified investment” (costs) incurred in a qualifying project in 2009 or 2010. The IRS noted that its certification and allocation of credits/grants is not a determination that the costs described in the application were (or will be) paid or were necessary.

- **Comment.** Practitioners on the KPMG web cast predicted that the IRS will certify a project for all qualified costs (up to the \$5 million limit), rather than certify only a portion of project costs.

Other tax consequences

If a credit is based on the cost of depreciable property, the property’s basis must be reduced by the amount of the credit. A credit will not be allowed for any investment involving bonus depreciation. If the credit is based on a deductible expense, no deduction is allowed for the amount of the credit.

References: FED ¶46,376;
TRC BUSEXP: 51,850.

House Set To Approve Extenders Bill

At press time, the House is expected to approve before its Memorial Day recess the *American Jobs and Closing Tax Loopholes Act of 2010 (H.R. 4213)*. The House bill extends many temporary tax incentives, eligibility for COBRA premium assistance, and other non-tax measures, including unemployment benefits.

- **CCH Take Away.** It is unclear if Senate Democrats will bring the House bill for a vote before Memorial Day. The GOP will not agree to approve the House extenders bill by unanimous consent, citing its cost to the federal budget deficit, setting the stage for what could be a lengthy debate in the Senate.

Extenders. Included in the House bill are individual incentives, such as the state and local sales tax deduction and the higher education tuition deduction, and business incentives, such as the research tax credit. The House bill also extends many energy and charitable incentives.

Carried interest. Under the House bill, a portion of carried interest would be taxed as ordinary income rather than capital gains. The bill provides transition relief.

For more details and analysis, see the *CCH Tax Briefing: American Jobs and Closing Tax Loopholes Act on CCH Intelliconnect and the CCH Tax Research Network*.

Final Regs Require Diversification Of Defined Contribution Plans Holding Publicly-Traded Employer Stock

◆ *T.D. 9484*

The IRS has adopted final regs that give participants in defined contribution plans, including 401(k) plans, the power to divest themselves of their investments in publicly-traded employer stock. Plans must offer employees at least three other investment alternatives that are diversified and that have materially different risk and return characteristics.

■ **CCH Take Away.** After employees of Enron and other bankrupt companies lost their retirement savings invested in employer securities, the *Pension Protection Act of 2006 (PPA)* imposed diversification requirements that enable employees to shift plan investments out of employer stock. Employers started to loosen their diversification rules even before the *PPA* was enacted, Jan Jacobson, senior counsel

for retirement policy at the American Benefits Council, Washington, D.C., told CCH. Since employers complying with the final regs will be eliminating older restrictions on diversification, the IRS will issue further guidance providing that these plan changes will not violate the anti-cutback rule, Jacobson explained.

■ **Comment.** The final regs apply to plan years beginning on or after January 1, 2011, but the underlying diversification requirements have applied since 2007.

Covered plans

The diversification requirement applies to any defined contribution plan that holds “publicly-traded” employer securities (i.e. securities that are readily tradable on an established securities market, including a foreign

exchange). The requirements also apply to a plan holding employer securities that are not publicly traded, if the employer or a member of the employer’s controlled group has issued publicly-traded stock.

The diversification requirement does not apply to an employee stock ownership plan (ESOP) that is separate from any of the employer’s other plans and does not hold contributions under Code Sections 401(k) or 401(m). A one-participant plan is also excepted.

Indirect investments

A plan is not treated as holding employer securities if the plan invests in a fund, such as a mutual fund, that holds the securities, provided (1) the securities are no more than 10 percent of the fund’s assets and (2) the investment is independent of the employer. This exclusion also applies to a

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Final Regs Include Clearly Marked Public Safety Vehicles As Qualified Non-Personal Use Vehicles

◆ *T.D. 9483*

Recently issued final regs include clearly marked public safety officer vehicles in the category of Code Sec. 274(i) qualified non-personal use vehicles. The final regs generally track proposed regs issued in 2008.

Vehicles

Under prior rules, a clearly marked vehicle provided to federal, state and local government workers who respond to emergency situations did not satisfy the current substantiation regs under Code Sec. 274 governing qualified non-personal use vehicles if the workers were not employed by either the fire or police department. The proposed regs covered clearly marked public safety officer vehicles driven by emergency responders not employed by a fire or police department. The finalized regs continue this treatment.

The final regs also offer guidance on determining when a vehicle is a clearly marked public safety officer vehicle. Clearly marked

public safety officer vehicles are:

- Owned or leased by a government unit or agency;
- Used for commuting by the employee who, when not on a regular shift, is on call at all times;
- Prohibited from personal use outside of responding to an emergency; and
- Marked with a painted insignia or words, making it readily apparent that it is a public safety officer vehicle.

Rejected expansion

Several commentators on the proposed regs asked the agency to remove certain requirements for a qualified non-personal use public safety officer vehicle. These included the on-call status for employees and the clear marking requirements. However, the IRS declined to follow these suggestions. The agency explained that, if an employee was not on-call at all times, personal use of the vehicle could be more than de minimis. If the rules did not require that the vehicle have clear markings, the vehicle could function

easily as a personal use vehicle and would not be readily distinguishable from vehicles routinely used for personal purposes.

■ **Comment.** A marking on a license plate is not a clear marking for purposes of the final regs.

Public safety officers

Other commentators asked the IRS to include specific types of workers under the definition of a public safety officer. The agency responded that Code Sec. 402(l)(4)(C) defines the term “public safety officer” in reference to the *Public Safety Officer’s Benefits Act (PSOBA)*.

■ **Comment.** An individual’s job title is not determinative of his or her status as a public safety officer. Instead the determination is made based on the facts and circumstances of the individual’s employment, including training, legal authority and legal responsibility, the IRS explained.

References: FED ¶47,014;

TRC BUSEXP: 24,862.

IRS Sets Out Regulatory Scheme For Withholding On Substitute Dividend Payments

◆ Notice 2010-46

The IRS has set out a proposed regulatory regime to ensure adequate withholding of U.S. taxes on substitute dividend payments. The regime would apply to payments made on loans of U.S. securities (stock or debt) between a foreign lender and a foreign borrower.

■ **CCH Take Away.** Participants in these transactions have claimed that a series of securities lending transactions (SLTs) on the identical securities could generate excessive withholding, above the 30 percent limit on U.S. dividends paid to a foreign taxpayer. The IRS issued Notice 97-66 to prevent over-withholding. Some taxpayers subsequently claimed that no tax was due. To prevent tax avoidance, Congress enacted Code Sec. 871(l) in the *Hiring Incentives to Restore Employment (HIRE) Act*.

Code Sec. 871(l)

Code Sec. 871(l) treats certain dividend equivalent payments as U.S.-source dividends. Code Sec. 871(l) applies to payments made on or after September 14, 2010 (180 days after enactment of the *HIRE Act*). The IRS intends to withdraw Notice 97-66

effective for payments made on or after September 14, 2010. Prior to September 14, 2010, taxpayers may continue to rely on Notice 97-66 with modifications.

Beginning May 20, 2010 (the effective date of Notice 2010-46), a withholding agent or foreign lender may not rely on Notice 97-66 if the agent or lender knows (or has reason to know) that an SLT has a principal purpose of avoiding part or all of the withholding tax otherwise due. The IRS indicated that no inference should be drawn about the validity of a transaction entered into before May 20, 2010; the IRS may challenge transactions under existing law.

Proposed regs

The IRS intends to issue regs under Code Sec. 871(l) to ensure that the appropriate amount of tax is paid and reported. The IRS expects that the regs will apply to transactions entered into on or after January 1, 2012.

The regs will coordinate the tax imposed under Code Sec. 871(l) with the withholding and reporting obligations for U.S.-source payments. The regs will adopt a document-based system under which withholding agents can reduce withholding by an amount shown to be withheld on another substitute payment or dividend for identical securities.

Withholding

The regs will exempt financial institutions from withholding if they assume responsibility and liability for withholding, reporting, depositing and paying U.S. taxes on the substitute dividends. A withholding agent that pays a substitute dividend to an institution that is a Qualified Securities Lender will not be required to withhold tax.

■ **Comment.** The IRS predicted that this system will relieve most instances of excess taxation. In other situations, a credit-forward system will give credit for tax withheld on a prior substitute dividend.

Under an anti-abuse rule, an agent or lender must withhold at the 30 percent rate if the agent or lender knows that an SLT has a principal purpose of avoiding withholding tax.

Transition period

Until the IRS issues regs, Notice 2010-46 provides transition rules for withholding agents, to avoid over-withholding for the period beginning September 14, 2010. The transition rules also include an anti-abuse rule that requires withholding for transactions with a principal purpose of avoiding the withholding tax.

References: FED ¶46,375;
TRC INTL: 3,558.25.

Diversification

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common trust fund or pooled investment fund, an investment fund managed by an investment manager for a multiemployer plan, and any other fund designated by the IRS.

Covered employees

If a participant's elective deferrals or employee contributions are invested in employer securities, the participant, an alternate payee, or a beneficiary of a deceased participant may elect to divest the employer securities and reinvest the same amount in other investments. For employer nonelective contributions invested in employer securities, the participant must have three years of service to shift investments.

Permitted restrictions

A plan cannot impose restrictions on investments in employer securities that differ from restrictions imposed on other plan investments. The final regs clarify when different rules are permissible.

■ **Comment.** The American Benefits Council asked the IRS to permit variations in investment restrictions in specific circumstances, Jacobson commented. In response, the IRS made significant changes to the proposed regs in this area. For example, a transitional rule for leveraged ESOPs allows them to continue making allocations of employer securities acquired with a loan before 2007.

The final regs allow investments into or out of a stable value fund, such as a money market fund, more frequently than a fund

with employer securities. A plan also may continue to provide for transfers out of a "qualified default investment alternative" (QDIA) within the first 90 days.

■ **Comment.** Employers may use a QDIA if the participant did not make an investment election, but the participant must be able to shift the investment within the first 90 days, Jacobson explained.

Plans may also impose reasonable restrictions that limit short-term trading in employer securities.

■ **Comment.** This rule allows plans to impose restrictions designed to prevent participants from engaging in market-timing trades, Jacobson said.

References: FED ¶47,015;
TRC RETIRE: 3,214.40.

No Mark-To-Market Loss For Foreign Currency Options

◆ *Summitt, 134 TC No. 12*

In a case of first impression, the Tax Court has found that an S corp did not recognize a loss under Code Sec. 1256 mark-to-market rules from its assignment of a major foreign currency call option to a charity. In summary judgment, the court held that a foreign currency call option was

not a foreign currency contract as defined in Code Sections 1256(b)(2) and 1256(g)(2).

■ **CCH Take Away.** The taxpayer pointed to the language of Code Sec. 1256(b)(2) that refers to “any foreign currency contract” and an option by definition is a unilateral contract. Thus, the taxpayer argued that any loss on

the assignment should be recognized under the Code Sec. 1256 mark-to-market rules. The court found no support in the legislative history for the taxpayer’s position.

Background

The taxpayer was a 10 percent shareholder of an S corp that, in 2002, paid premiums to acquire two major foreign currency options (reciprocal put and call options that exactly offset each other) and received premiums for selling two minor written foreign currency options. Thereafter, the S corp assigned the major and minor foreign currency call options to a charity.

Court’s analysis

The court found no evidence of any legislative intent to include foreign currency options as Code Sec. 1256 contracts and no regs have been issued bringing foreign currency options with the definition of a foreign currency contract. The court rejected the taxpayer’s assertion that the legal distinction between a forward and an option is insignificant. Code Sec. 1256(g)(1) refers to a contract that requires delivery of the foreign currency, not to a contract in which delivery is left to the holder’s discretion.

A forward foreign currency contract is a bilateral contract between seller and buyer obligating the seller at time of signing to settle his obligation to perform by delivering the currency or making a cash settlement. On the other hand, the court distinguished, a foreign currency option is a unilateral contract that does not require delivery or settlement unless and until the option is exercised by the holder. In such case an obligation to settlement may never arise if the holder does not exercise its rights under the option.

The court further found that the addition of other option contracts to Code Sec. 1256 by Congress does not evidence any intent to include all major foreign currency options.

■ **Comment.** The court did not rule on the issue of the income tax treatment of the assignment of the minor foreign currency call option because it found genuine issues of material fact required a trial.

References: FED ¶46,367;
TRC DEPR: 3,504.

June 2010 AFRs Issued

The IRS has released the short-term, mid-term, and long-term applicable interest rates for June, 2010.

Applicable Federal Rates (AFR) for June 2010

Period for Compounding

Short-Term	Annual	Semiannual	Quarterly	Monthly
AFR	0.74%	0.74%	0.74%	0.74%
110% AFR	0.81%	0.81%	0.81%	0.81%
120% AFR	0.89%	0.89%	0.89%	0.89%
130% AFR	0.96%	0.96%	0.96%	0.96%

Mid-Term

AFR	2.72%	2.70%	2.69%	2.68%
110% AFR	2.99%	2.97%	2.96%	2.95%
120% AFR	3.27%	3.24%	3.23%	3.22%
130% AFR	3.54%	3.51%	3.49%	3.48%
150% AFR	4.09%	4.05%	4.03%	4.02%
175% AFR	4.79%	4.73%	4.70%	4.68%

Long-Term

AFR	4.30%	4.25%	4.23%	4.21%
110% AFR	4.73%	4.68%	4.65%	4.64%
120% AFR	5.17%	5.10%	5.07%	5.05%
130% AFR	5.61%	5.53%	5.49%	5.47%

Adjusted AFRs for June 2010

Period for Compounding	Annual	Semiannual	Quarterly	Monthly
Short-term adjusted AFR	0.76%	0.76%	0.76%	0.76%
Mid-term adjusted AFR	2.08%	2.07%	2.06%	2.06%
Long-term adjusted AFR	4.01%	3.97%	3.95%	3.94%

The IRC §382 adjusted federal long-term rate is 4.01%; the long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months) is 4.01%; the Code Sec. 42(b)(2) appropriate percentages for the 70% and 30% present value low-income housing credit are 7.81% and 3.35%, respectively, however, the appropriate percentage for non-federally subsidized new buildings placed in service after July 30, 2008 and before December 31, 2013 shall not be less than 9% ; and the Code Sec. 7520 AFR for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest is 3.2%.

ReRul. 2010-15, FED ¶46,372; TRC ACCTNG: 36,162.05.

Tax Briefs



Tax Crimes

An indictment charging an individual with signing false personal income tax returns and making false claims for tax refunds was not duplicitous. Even though the offenses arose out of the same transaction, the statutory provisions under which the charges were levied, gave rise to two offenses and required proof of different elements. The jury was also properly instructed with respect to the elements of the charged offenses.

*Boyd, CA-10, 2010-1 USTC ¶50,419;
TRC IRS: 66,060.*

The acquittal of two individuals on charges of wire fraud in a prior proceeding did not collaterally estop the government from prosecuting them for tax evasion. The acquittal only established that they did not engage in a scheme to defraud their company; not that they did not receive corporate funds for personal use. The case was remanded to determine whether the conspiracy charged in the indictment and the conspiracy for which two individuals were prosecuted in a prior criminal proceeding were the same offense.

*Rigas, CA-3, 2010-1 USTC ¶50,412;
TRC IRS: 66,060.10.*

Disaster Relief

The IRS has extended return-filing and payment deadlines for victims of severe storms, flooding and tornadoes which began May 1, 2010. Alcorn, Benton, Lafayette, Tippah, and Tishomingo counties in Mississippi have been declared federal disaster areas. Affected taxpayers include those residing or having businesses in the disaster areas. Qualifying taxpayers have until June 30, 2010, to file returns (including 2010 individual tax returns), pay taxes (including estimated tax payments), and perform certain other time-sensitive acts otherwise due between May 1, 2010, and June 30, 2010.

*Mississippi Disaster Relief Notice,
FED ¶46,370; TRC FILEIND: 15,204.25.*

Income

Married taxpayers were collaterally estopped from relitigating the deductibility of an uncollected personal injury judgment as a net operating loss carryforward and the exclusion of Social Security disability payments from gross income. Pension income was also includible in income. Medical expense deductions that were either personal expenses or unsubstantiated were disallowed.

*Green, TC, CCH Dec. 58,220(M),
FED ¶48,051(M); TRC PENALTY: 6,000.*

Deductions

Married taxpayers were denied various deductions on their return for failing to keep records and proving that they are entitled to deductions. Specifically, the taxpayers failed to substantiate their charitable deduction relating to contributions of household items and cash. They failed to substantiate their deduction of expenses related to the business use of their passenger automobile or cellular telephone. They also failed to prove the amounts claimed as capital losses on their return and on their Schedule A.

Ramirez, TC, Dec. 58,219(M),

FED ¶48,050(M); TRC INDIV: 51,454.

FOIA

Exemptions asserted by the IRS in response to a corporation's requests under the *Freedom of Information Act (FOIA)* were properly claimed, and the documents did not have to be disclosed. The IRS was entitled to assert the deliberative process privilege, even though not previously invoked because it was merely an additional basis for asserting a previously claimed exemption. Several documents were not withheld due to the possibility of public criticism of the IRS, but rather because disclosure may have confused issues and misled the public.

*FPL Group, Inc., DC D.C., 2010-1 USTC
¶50,417; TRC IRS: 9,502.15.*

Liens and Levies

The IRS was not required to refile a lien to maintain its perfected status when the

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Over- And Underpayment Interest Rates Remain Unchanged For Third Quarter 2010

The IRS has announced that the interest rates on tax overpayments and underpayments for the calendar quarter starting July 1, 2010 will not change from the second calendar quarter of 2010. Quarterly interest rates will stay at:

- 4 percent for non-corporate overpayments and underpayments;
- 3 percent for corporate overpayments;
- 6 percent for large corporate underpayments; and
- 1.5 percent for corporate overpayments exceeding \$10,000.

■ **Comment.** For individuals, overpayment and underpayment interest rates are computed by adding three percentage points to the federal short term interest rate. For corporations, in general, three percentage points are added to the federal short term interest rate to determine the underpayment rate while two percentage points are added to the federal short term interest rate to determine the overpayment interest rate. The interest rate for large corporate underpayments is determined by adding five percentage points to the federal short term interest rate, while the interest rate on a corporate overpayment portion of tax which exceeds \$10,000 for a taxable period is determined by adding 0.5 percentage points to the federal short term interest rate.

*IR-2010-65, Rev. Rul. 2010-14, FED ¶¶46,373, 46,374;
TRC ACCTNG: 33,204.15.*

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debtor couple, who owned the property on which the lien was assessed, moved to a different county. Under state (Arkansas) law, the lien was properly filed in the county where the debtors resided at the time of filing.

In re C.J. Krummel, BC-DC Ark., 2010-1 USTC ¶50,420; TRC IRS: 48,150.

An individual was not entitled to a jury trial in the government's action to foreclose tax liens on real property owned by him. The individual failed to establish unfairness or injustice on account of the denial of the jury trial. Moreover, the Seventh Amendment provides no right to a jury trial in an action to foreclose a tax lien on real property.

O'Callaghan, DC Fla., 2010-1 USTC ¶50,416; TRC IRS: 45,160.

Tax assessments against an individual were reduced to judgment and a tax lien on his interest in real property, which was nominally held by his mother, was foreclosed. Although the mother held legal title, the individual held equitable title to the property. The federal tax lien had priority over a state commission's tax lien because it became choate before the state tax lien.

Criner, DC Okla., 2010-1 USTC ¶50,414; TRC IRS: 48,106.

A successor corporation was a mere continuation of its predecessor corporation under state (Michigan) law; therefore, the successor and the sole owner and president of both of the corporations were liable for the predecessor corporation's unpaid employment tax obligations. Property transferred from the predecessor to the successor corporation was subject to IRS tax liens.

Stramaglia, CA-6, 2010-1 USTC ¶50,410; TRC IRS: 51,060.30.

The government was required to comply with the procedural requirements of state (New York) lien law in its action under that law to recover unpaid employment taxes and enforce a right created by state statute. The state lien law is not

a tax statute and does not conflict with Code Sec. 7402; therefore, it was not preempted by the Supremacy Clause of the U.S. Constitution.

Interworks Systems, Inc. v. Merchant Financial Corp., CA-2, 2010-1 USTC ¶50,411; TRC LITIG: 9,250.

Collection Due Process

The IRS abused its discretion in deciding to proceed with levy absent evidence of the taxpayers' deficiency notice, acceptance of audit changes, or waiver of restrictions on assessment.

Marlow, TC, CCH Dec. 58,225(M), FED ¶48,056(M); TRC IRS: 27,208.

Deficiencies and Penalties

The president and sole shareholder of two corporations was liable for the trust fund recovery penalty assessed against him in connection with the corporations' unpaid withholding taxes. An IRS employee's opinion that the individual did not act willfully was not determinative. A sale of real property owned jointly by the individual and his ex-wife was ordered in order to satisfy the individual's tax debt.

Steeley, DC Fla., 2010-1 USTC ¶50,415; TRC IRS: 45,158.

An individual who was a responsible person liable for a trust fund recovery penalty assessed against him was properly denied a refund of the penalty. The government proved that the IRS's assessment was timely, and the individual failed to rebut the government's evidence.

Stein, CA-2, 2010-1 USTC ¶50,413; TRC IRS: 27,212.

Bankruptcy

Income taxes generated on gains realized from a debtor couple's post-petition sale of farm assets were stripped of their priority and were not required to be paid in full through their Chapter 12 plan. Treating post-petition taxes as administrative expenses and stripping claims for their payment of priority status meets the remedial purpose of Chapter 12 by providing relief to family farmers.

In re Ficken, BAP-10, 2010-1 USTC ¶50,409; TRC IRS: 57,104.

Innocent Spouse

An ex-husband's distributive share of income from two passthrough entities was includible on the joint income tax return for the divorced couple even though only a portion of the income was distributed to the ex-husband. The ex-wife was granted innocent spouse relief for the undistributed unreported income because she did not know the exact amount of the reportable income from the two entities and she made extensive efforts to ascertain those amounts.

Jones, TC, CCH Dec. 58,224(M), FED ¶48,055(M); TRC INDIV: 18,058.

A spouse who had some knowledge of accounting and had prepared most of the joint tax returns at issue was not entitled to innocent spouse relief from joint income tax liabilities. The spouse did not qualify for relief under Code Sec. 6015(b) because her involvement in preparing the returns and access to her husband's business records gave her reason to know of the tax understatements arising from disallowed Schedule C expenses related to the husband's construction business. No relief under Code Sec. 6015(c) applied because she had actual knowledge of what substantiation was available for the disallowed deductions. Finally, equitable relief under Code Sec. 6015(f) did not apply because she knew of the tax understatements when she signed the returns, which weighed heavily against relief.

Demattos, TC, CCH Dec. 58,221(M), FED ¶48,052(M); TRC INDIV: 18,050.

Tax Shelters

A taxpayer's Son of BOSS transactions were ruled invalid under the economic substance, sham transaction, and step-transaction doctrines. As a result, the IRS did not erroneously issue final notices of partnership administrative adjustment regarding them. The taxpayer entered into a Son of BOSS tax shelter transaction by investing in two limited liability companies that purchased offsetting digital, European-style, interest-rate options.

Fidelity International Currency Advisor A Fund, LLC, DC Mass., 2010-1 USTC ¶50,418; TRC SALES 3,154.

Practitioners' Corner

Sample Client Letter On New Code Sec. 45R Small Employer Health Insurance Tax Credit

The health care reform package (the Patient Protection and Affordable Care Act of 2010 and the Health Care Reform and Reconciliation Act of 2010) created a new tax credit for small employers: the Code Sec. 45R small employer health insurance tax credit, which is available immediately for qualified employers. Practitioners can send or email the following letter to clients to inform them about the benefits of the new credit.

Re: Small Employer Health Insurance Tax Credit

Dear Client:

The new health insurance reform package (the *Patient Protection and Affordable Care Act of 2010 and the Health Care and Education Reconciliation Act of 2010*) includes an immediate tax break for qualified small businesses: the Code Sec. 45R small employer health insurance tax credit. Qualified small employers, including nonprofit employers, may reduce the cost of providing health insurance to their employees this year. However, the credit is complex and there are important limitations, especially when calculating the number of employees and other provisions. Do not let the complexity of the credit discourage you from exploring its benefits. This letter provides a high-level description of the credit; please contact our office so we can explain in detail how the credit may help cut your health insurance costs.

Small employers

The small business health insurance tax credit is targeted to employers that have no more than 25 full-time equivalent (FTE) employees paying wages averaging less than \$50,000 for each employee per year. According to the U.S. Department of Health and Human Services

(HHS), a qualified small business can choose to start offering health insurance coverage to employees in 2010 and be eligible for the credit. HHS has also indicated that the credit is retroactive to January 1, 2010.

wages of \$23,000 for each employee in 2010. The manufacturer pays \$72,000 in health care premiums for its employees. Assuming that the manufacturer meets all the other requirements, its credit for 2010 is \$25,200 (35 percent x \$72,000).

“The new health insurance reform package... includes an immediate tax break for qualified small businesses.”

Employers with 10 or fewer full-time employees (FTEs) paying average annual wages of not more than \$25,000 may be eligible for a maximum credit of 35 percent for tax years beginning in 2010 through 2013. The maximum credit for tax-exempt employers is 25 percent for tax years beginning in 2010 through 2013. For tax years beginning in 2014 through 2015, the maximum credit climbs to 50 percent of qualified premium costs paid by for-profit employers (35 percent for tax-exempt employers). However, an employer may claim the credit after 2013 only if it offers one or more qualified health plans through a state insurance exchange. The health care reform package requires states to create insurance exchanges by January 1, 2014.

The credit is subject to phase-out rules. The credit is reduced by 6.667 percent for each FTE in excess of 10 employees. The credit is also reduced by four percent for each \$1,000 that average annual compensation paid to the employees exceeds \$25,000. This means that the credit completely phases out if an employer has 25 or more FTEs and pays \$50,000 or more in average annual wages.

Let's look at an example of how the credit works in 2010. A small manufacturer employs nine individuals with average annual

Employees

To determine eligibility for the credit, employers have to calculate their number of FTEs. The number of an employer's FTEs is determined by dividing the total hours of service (but not more than 2,080 hours for any employee) by 2,080. The result, if not a whole number, is rounded to the next lowest whole number. Lawmakers selected 2,080 hours because 2,080 hours comprise the number of hours in a 52-week assuming a 40-hour work week. Any hours beyond 2,080, such as overtime hours, are not taken into account when calculating FTEs.

Average annual wages

Employers also need to calculate average annual wages. The amount of average annual wages is determined by first dividing the total wages paid by the employer to employees during the employer's tax year by the number of the employer's FTEs for the year. The result is then rounded down to the nearest \$1,000 (if not otherwise a multiple of \$1,000).

Hours of service

Employers also must determine the number of hours of service performed by employ-

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Washington Report

by the CCH Washington News Bureau



House takes up extenders; financial reform progresses

The *American Jobs and Closing Tax Loopholes Act of 2010 (H.R. 4213)* is expected to go to the House floor before Memorial Day. The measure includes a host of individual, business, energy, and charitable extenders as well as COBRA premium assistance and a package of pension funding relief measures. A preliminary report by the Joint Committee on Taxation, estimates that the bill includes \$7.8 billion in infrastructure incentives, \$31.9 billion for extending expiring tax incentives and \$5.6 billion in pension provisions. The cost of these incentives would be partially offset by changes to the international tax rules and the taxation of carried interest. See the article on page 243 for more information.

On May 20, the Senate passed a comprehensive financial regulatory reform package. Attempts to attach tax provisions to the bill were defeated. The House and Senate bills must now be reconciled in conference.

Oil tax breaks targeted

On May 24, Sen. Robert Menendez, D-N.J., Sen. Bill Nelson, D-Fla., and Sen. Jeff Merkley, D-Oregon, introduced the *Close Big Oil Tax Loopholes Act*. Among other things, the bill would repeal expensing of intangible drilling costs, repeal exemption of passive loss limits for interests in oil and gas properties, and repeal the domestic manufacturing deduction for oil and gas production. Some of the provisions track recommendations by President Obama in his Fiscal Year (FY) 2011 federal budget.

Ways and Means considers internet gambling tax

House Ways and Means committee members grappled with the idea of passing legislation to tax online gambling activities during a hearing on the issue May 19. Rep. Jim McDermott, D-Wash., and House Financial Services Chair Barney Frank, D-Mass., tes-

tified in favor of passing legislation taxing internet gambling winnings. McDermott's bill, the *Internet Gambling Regulation and Tax Enforcement Bill (H.R. 2268)*, would require licensed gambling operators to provide winning and loss statements to the IRS as well as to the gamblers on Form 1099-IG. Gamblers would then have to report their winnings when filing their income taxes.

Bill would pull back U.S. tax benefits for foreign multinationals

On May 18, House Ways and Means Committee member Lloyd Doggett, D-Tex., unveiled the *International Tax Competitiveness Act of 2010 (H.R. 5328)* to pull back U.S. tax benefits for foreign multinational corporations. The bill would, among other things, treat such companies as domestic corporations for tax purposes if they are primarily managed and controlled in the U.S. repeal the lookthrough treatment for royalties received from controlled foreign corporations (CFCs), repeal special rules for interest and dividends received from persons meeting the 80 percent foreign business requirements, and require companies to account for certain income derived from U.S. intangibles under Subpart F.

IRS updates 401(k) compliance study web page

The IRS recently updated its 401(k) compliance study page on its web site. Approximately 1,200 plans have been selected to receive a compliance check questionnaire. The project, the IRS explained, is designed to be a comprehensive look into 401(k) plans to determine potential compliance issues, gain a better understanding of the reasons for noncompliance and determine any potential plan operational issues. The 1,200 plans were chosen at random from 401(k) plans that filed a Form 5500 for the 2007 plan year.

Elizabeth Dold, principal, The Groom Law Group, Washington, D.C., identified for CCH

some action steps plans should take if they receive a questionnaire. "The plan should organize an internal team to be responsible for the response; (2) coordinate with its third party administrator to provide as much assistance as possible; (3) prior to submission, provide a copy of the checklist for attorney review and identification of any required corrective action to maintain tax-qualified status of the plan (EPCRS) and to ensure that submission will not trigger an audit due to inadequate responses; and (4) retain a copy of the checklist with the plan records."

Additional security needed for tax professionals on IRS web site, TIGTA finds

The IRS should improve security measures for its online portal used by tax preparers submitting and retrieving tax-related information and e-filing returns, according to the Treasury Inspector General for Tax Administration (TIGTA) ("Additional Security Is Needed for Access to the Registered User Portal"). The IRS's Registered User Portal (RUP) is the entry point for web access to the IRS's e-Services set of applications. According to TIGTA, additional controls are needed to protect taxpayer information even though the IRS has implemented some required security controls.

IRS must address IRA noncompliance, TIGTA cautions

The IRS must develop a broad strategy to address growing noncompliance with individual retirement account (IRA) contribution and distribution requirements, the Treasury Inspector General for Tax Administration (TIGTA) recently cautioned. According to TIGTA, nearly 300,000 individuals made excess IRA contributions in 2006 and 2007, resulting in an estimated \$235 million in unreported excise taxes over five years. TIGTA predicts the problem is likely to grow since the number of individuals age 65 and older is expected to double over the next 20 years.

IRS Plans Help For Small Tax-Exempts That Missed May 17 Filing Deadline

◆ www.irs.gov

The IRS intends to help small tax-exempt organizations maintain their exempt status even if they are subject to automatic revocation, IRS Commissioner Douglas Shulman has announced. May 17, 2010 was the deadline for all exempt organizations to file returns with the IRS for three consecutive years or have their exempt status automatically revoked.

■ **CCH Take Away.** Churches, integrated church auxiliaries and conventions or associations of churches along with organizations that are included in a group return are excluded from the filing requirement, Daniel Romano, CPA, partner-in-charge, National NFP Tax Practice, Grant Thornton, LLP. “These subsidiaries (for example, chapters of a national organization) must make sure they are included in the group return. If they are not listed, they have a separate filing requirement.”

Filing requirement

Generally, exempt organizations with gross receipts greater than \$500,000 or total assets greater than \$1.25 million file Form 990. Exempt organizations with gross receipts of less than \$500,000 and total assets of less than \$1.25 million may file Form 990-EZ or Form 990. Private foundations, regardless of financial activity, file Form 990-PF.

Form 990-series returns are due on the 15th day of the fifth month after an exempt organization’s fiscal year ends. For exempt organizations that use the calendar year as their fiscal year, May 15, 2010 was the deadline for those exempt organizations. In 2010, May 15 fell on a Saturday. Consequently, the deadline was moved to Monday, May 17, 2010.

Under the *Pension Protection Act of 2006 (PPA)*, any exempt organization that fails to file for three consecutive years automatically loses its exempt status. Exempt organizations not required to file an annual return or notice are not subject to automatic revocation.

Small organizations

The *PPA* also imposed filing requirement on exempt organizations that formerly had no obligation to file an annual return because their gross receipts are normally not more than \$25,000. The IRS developed Form 990-N, Electronic Notice (e-Postcard) for Tax-Exempt Organizations Not Required to File Form 990 or 990-EZ. Small organizations that failed to file Form 990-N for three consecutive years had their exempt status automatically revoked as of May 17, 2010.

Help for small organizations

Shulman reported that many small exempt organizations did not file Form 990-N by the deadline. Shulman said in a statement that the IRS will do what it can to help small organizations “keep their critical tax-exempt status intact.” Shulman also urged small exempt organizations to file Form 990-N even though the May 17, 2010 deadline has passed.

Reference: TRC EXEMPT: 12,252.

Practitioners’ Corner

Continued from page 249

ees. The IRS has provided three methods that employers may use to calculate the total number of hours of service that must be taken into account for an employee for the year. The three methods are: (1) Actual hours of service; (2) Days-worked equivalency; or (3) Weeks-worked equivalency. The days-worked equivalency is based on an eight-hour work day and the week-worked equivalency is based on a 40-hour work week.

Here’s an example. Alicia worked 48 weeks, took three weeks of vacation and one week of unpaid leave. Alicia’s employer uses the weeks-worked equivalency method to calculate the total number of hours of service. Using this method, Alicia would be credited with 2,040 hours of service (51 weeks x 40 hours per week).

Additional requirements

Congress imposed some important limita-

tions on the credit. Employers must exclude certain individuals from the calculation of FTEs and average annual wages. Certain family members of these individuals are also excluded from the calculation of FTEs and average annual wages. Please contact our office for more details about who is excluded from these calculations.

Additionally, the credit applies only to premiums paid by the employer under a qualifying plan. An employer’s contribution is also linked to the average cost of health insurance in its state or part of a state. Because the credit is effective for 2010 but was not enacted until March 23, 2010, some employers currently offering coverage may not meet all of the requirements for a qualifying arrangement. The IRS has provided transition relief.

The credit also impacts an employer’s deduction for the cost of health insurance premiums paid on behalf of employees. The amount of premiums that an employer may deduct is reduced by the amount of the small employer health care tax credit.

Additionally, the IRS has advised that the credit will generally not be reduced by a state health insurance credit that the employer may claim.

Claiming the credit

The credit is a general business credit and qualified for-profit employers will claim it on their annual income tax return. The IRS has indicated it will issue guidance on how tax-exempt employers will claim the credit.

The IRS has posted general information about the credit on its web site, sent postcards about the credit to more than four million small businesses nationwide, and issued formal guidance. Additional guidance is expected as employers start taking advantage of the credit and new questions arise. Our office will keep you posted of developments.

Please contact our office if you have any questions about the Code Sec. 45R small employer health insurance tax credit.

Sincerely yours,

Compliance Calendar

■ **June 3**

Employers deposit Social Security, Medicare, and withheld income tax for May 26, 27, and 28.

■ **June 4**

Employers deposit Social Security, Medicare, and withheld income tax for May 29, 30, and 31 and June 1.

■ **June 9**

Employers deposit Social Security, Medicare, and withheld income tax for June 2, 3, and 4.

■ **June 10**

Employees who received \$20 or more in tips during May report them to their employers.

■ **June 11**

Employers deposit Social Security, Medicare, and withheld income tax for June 5, 6, 7, and 8.

■ **June 15**

U.S. citizens or resident aliens living and working or on military duty outside the U.S. and Puerto Rico file Form 1040, U.S. Individual Income Tax Return and pay an tax or interest due.

Monthly depositors must deposit Social Security, Medicare, and withheld income tax for May.

Individuals pay the second installment of 2010 estimated tax.

Corporations pay the second installment of estimated income tax for 2010.

Monthly Quizzer

The following questions (with answers at the bottom of the column) will help you review some of the more important developments in *CCH Federal Tax Weekly* during the past month.

Q To calculate the small employer health insurance tax credit, employers must determine:

- (a) Employees taken into account and number of service hours performed
- (b) Average annual wages paid per full-time equivalent (FTE) employees
- (c) Amount of qualifying premiums paid
- (d) All of the above

Q Under current law, eligibility for COBRA premium assistance will end after May 31, 2010. True or False?

Q The U.S. Supreme Court has agreed to hear the controversial tax accrual workpaper case of *Textron, Inc.* True or False?

Q The IRS has issued regs on the extended income exclusion for employer-provided health insurance for children under age 27 applicable to:

- (a) Plans or plan issuers that do not offer dependent coverage of children
- (b) Group health plans
- (c) Health insurance companies that do not issue policies to either groups or individuals
- (d) None of the above

Answers:

- Q1.** (d), See Issue #20, page 229.
- Q2.** True, See Issue #18, page 206.
- Q3.** False, See Issue #21, page 241.
- Q4.** (b), See Issue #19, page 218.

TRC Text Reference Table

The cross references at the end of the articles in *CCH Federal Tax Weekly (FTW)* are text references to *CCH Tax Research Consultant (TRC)*. The following is a table of TRC text references to developments reported in FTW since the last release of *New Developments*.

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