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INSIDE THIS ISSUE

IRS Issues Temporary Regs On Allocation Of Code Sec. 199 Wages In Short Tax Years

TD 9731

Recently issued temporary regs describe the allocation of W-2 wages in short tax years for purposes of the Code Sec. 199 domestic production activities deduction. The temporary regs also address the calculation of W-2 wages when a trade or business is acquired or disposed of.

- ***Take Away.*** Along with TD 9731, the IRS issued proposed regs on the Code Sec. 199 deduction (see the article in this week's newsletter). "As previously promised by Treasury and the IRS, the regulations are wide-ranging and address a variety of issues under Section 199. The impact of the guidance and taxpayer feedback are also likely to be wide-ranging," Andrea Mouw, National Tax Senior Manager, Accounting Methods, Eide Bailly LLP, Minneapolis, told Wolters Kluwer. "The portion of the guidance addressing the computation of the W-2 wage limitation for taxpayers with business transactions and short tax years should be largely beneficial to taxpayers and should reduce concern about the taxpayer's deduction being limited or unavailable in these situations."

Background

The Code Sec. 199 deduction allows qualified taxpayers to deduct an amount equal to the lesser of a percentage of taxable income (adjusted gross income for individuals) or qualified production activities income (QPAI). A taxpayer's Code Sec. 199 deduction cannot exceed one-half (50 percent) of the W-2 wages paid by the taxpayer during the year. Code Sec. 199(b)(2)(A) generally defines W-2 wages as the sum of amounts described in Code Sec. 6051(a)(3) and (8) paid with respect to employment of employees. The *Tax Increase Prevention Act of 2014* provided for the application of Code Sec. 199(b) in cases of a short tax year or where the taxpayer acquires, or disposes of, the major portion of a trade or business, or the major portion of a separate unit of a trade or business during the tax year.

Temporary regs

The temporary regs provide a rule to apply in the case of a short tax year in which there is no calendar year ending within such short tax year (short-taxable-year rule). Wages paid by a taxpayer during the short tax year to employees for employment by such taxpayer are treated as W-2 wages for the short taxable year for purposes of Code Sec. 199(b)(1), the IRS explained. Wages qualifying as W-2 wages of one taxpayer based on the temporary regulations cannot be treated as W-2 wages of another taxpayer, the IRS added.

continued on page 418

Proposed Regs Clarify Code Sec. 199 Domestic Production Activities Deduction

NPRM REG-136459-09

Long-awaited proposed regs on the Code Sec. 199 domestic production activities deduction have been issued to clarify how to determine domestic production gross receipts (DPGR), and provide guidance on materials manufactured, produced, grown, or extracted (MPGE) for purposes of the deduction. The regs reflect recent legislation and court decisions about the deduction.

- ***Take Away.*** "The most significant and unanticipated portion of the guidance is the removal of the benefits and burdens of ownership test to identify the taxpayer entitled to claim the Section 199 deduction for contract manufacturing activities," Andrea Mouw, National Tax Senior Manager, Accounting Methods, Eide Bailly LLP, Minneapolis, told Wolters Kluwer. "The proposed regulations now provide that the taxpayer actually producing the property is entitled to the Section 199 benefit. The new standard will likely be less complex and burdensome to apply and may reduce controversy with the IRS, which would be a benefit to some taxpayers."

Proposed regs

MPGE. For purposes of the Code Sec. 199 deduction, MPGE includes manufacturing, producing, growing, extracting, installing, developing, improving, and creating qualified production property (QPP); making QPP out of scrap, salvage, or junk material as well as from new or raw material by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles; cultivating soil, raising livestock, fishing, and mining minerals.

- ***Comment.*** "The regulations also highlight several activities that the IRS and Treasury do not believe constitute qualifying production activities for Section 199 purposes, such as testing of products, approval and payment of invoices by general contractors and assembling of gift baskets," Mouw noted. "In some cases, the regulations only include an example stating that the activity does not constitute production without providing an explanation of the standards applied in reaching that conclusion. Taxpayers may struggle in implementing these rules without additional guidance regarding why these activities do not constitute production."

Construction. According to the IRS, some taxpayers that only approve or authorize payments claim to be engaged in activities typically performed by a general contractor under Reg. §1.199-3(m)(2)(i). The proposed regs clarify that a taxpayer must engage in construction activities that include more than the approval or authorization of payments or invoices for that taxpayer's activities to be considered as activities typically performed by a general contractor. The proposed regs also revise the definition of substantial renovation.

Oil related activities. In 2008, Congress reduced the Code Sec. 199 deduction for taxpayers with oil related qualified production activities income by three percentage points for tax years beginning after 2009. Under the proposed regs, oil related DPGR generally does not include gross receipts derived from the transportation or distribution of oil.

Films. The *Tax Extenders Act of 2008* expanded the definition of W-2 wages for purposes of the deduction, as applied to a qualified film, to include compensation for services performed in the U.S. by actors, production personnel, directors, and producers. The proposed regs modify the definition of W-2 wages to reflect the 2008 law. The proposed regs also revise the definition of qualified film

continued on page 419

Section 199 Temporary Regs

Continued from page 417

The temporary regs also provide a rule for acquisitions and dispositions if one or more taxpayers may be considered the employer of the employees of the acquired or disposed of trade or business during that calendar year. In that case, the W-2 wages paid during the calendar year to employees of the acquired or disposed of trade or business are allocated between each taxpayer based on the period during which the employees of the acquired or disposed of trade or business were employed by the taxpayer. An acquisition or disposition includes an incorporation, a formation, a liquidation, a reorganization, or a purchase or sale of assets, the IRS explained.

- ***Comment.*** The temporary regs are applicable for tax years beginning on or after August 27, 2015, and expire August 24, 2018. Taxpayers may apply the temporary regs to tax years for which the limitations for assessment of tax has not expired beginning before August 27, 2015.

References: FED ¶47,028; TRC BUSEXP: 6,100.

REFERENCE KEY

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

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Proposed Regs Reflect Reforms To 6707A Penalty For Failing To Disclose Reportable Transactions

NPRM REG-103033-11

The IRS has released proposed regs describing the Code Sec. 6707A penalty for failing to disclose a reportable transaction. The proposed regs reflect changes to the penalty made by the *Small Business Jobs Act of 2010* (SBJA).

- ***Take Away.*** After passage of the *American Jobs Creation Act of 2004,* which created the penalty, lawmakers and the IRS discovered that some taxpayers, especially small businesses, were unaware of the disclosure requirements and the penalties were significantly larger than the potential tax savings. In response, the IRS temporarily suspended collection efforts for the penalty in certain cases, and Congress ultimately reformed the penalty in the SBJA.
- ***Comment.*** The IRS issued final regulations (TD 9550) on the Code Sec. 6707A penalty in 2011, but the final regs did not reflect the SBJA.

Background

Code Sec. 6707A imposes a penalty on taxpayers who fail to disclose a reportable transaction. A reportable transaction is any transaction with respect to which information must be included with the taxpayer's return because the IRS has determined, under regulations prescribed under Code Sec. 6011, that the transaction is of the type that has the potential for tax avoidance or evasion.

In 2010, Congress passed the SBJA, which made the penalty proportional (75 percent) to the tax saved; converted the flat rate amounts to a maximum; and added a minimum amount. In the case of a listed transaction, the maximum penalty is $200,000, or $100,000 in the case of a natural person. In the case of any other reportable transaction, the penalty will not exceed $50,000, or $10,000 in the case of a natural person. For all transactions, the minimum penalty is $10,000, or $5,000 in the case of a natural person.

Proposed regs

Returns. A taxpayer's failure to disclose participation in a reportable transaction will trigger a penalty under Code Sec. 6707A regardless of whether the participation is reflected on an original return, an amended return, or an application for tentative refund. The proposed regs streamline the term "return" to include all three.

Decrease in tax. The proposed regs define the decrease in tax generally as the difference between the amount of tax reported on the return as filed and the amount of tax that would be reported on a hypothetical return where the taxpayer did not participate in the reportable transaction. The amount of tax shown on the hypothetical return will reflect adjustments that result mechanically from backing out the reportable transaction, such as tax items affected by an increase in adjusted gross income resulting from non-participation in the reportable transaction, the IRS explained.

A taxpayer, the IRS noted, may use a single disclosure statement to disclose multiple years of participation in a reportable transaction. As a result, the taxpayer's failure to complete and submit the disclosure statement properly will result in no more than one penalty under Code Sec. 6707A. The proposed regs provide, however, that the amount of that penalty will be determined by taking into account the aggregate decrease in tax shown on all of the returns for which disclosure was not provided. The decrease in tax will be determined separately for each year of participation for which only a single disclosure statement was required and the amount of the penalty will be 75 percent of the aggregate decrease in tax in all years for which disclosure was required, subject to the minimum and maximum penalty amount limitations, the IRS explained. Additionally, the IRS explained that the minimum and maximum limits on the amount of the penalty apply separately to each failure to disclose.

For returns with respect to which disclosure is required but on which no tax is required to be shown (for example, returns of pass-through entities), the minimum penalty amount will be imposed for failures to disclose. The partners may have separate disclosure obligations and be subject to separate Code Sec. 6707A penalties if they fail to comply with the disclosure requirements, the IRS noted.

SEC disclosure. Generally, taxpayers liable for a Code Sec. 6707A penalty (among other penalties) must make disclosures to the Securities and Exchange Commission (SEC). The proposed regs clarify when disclosure to the SEC is required to be made by taxpayers.

References: FED ¶49,663; TRC PENALTY: 3,252.10.

Section 199 Proposed Regs

Continued from page 418

in Reg. §1.199-3(k)(1) to include copyrights, trademarks, or other intangibles with respect to films. Additionally, the proposed regs describe the application of the film safe harbor to live or delayed television programs.

- ***Comment.*** The agency reported that some taxpayers have taken the position that film production activities include activities related to the transmission or distribution of films. The regs clarify that film production as distinct from the transmission and distribution of films.
- ***Comment.*** The proposed regs also address the Code Sec. 199 deduction and Puerto Rico; hedging rules in Reg. §1.199-3(i)(3); application of Code Sec. 199 to agricultural and horticultural cooperatives; and how a taxpayer determines its cost of goods sold (CGS) to DPGR.

References: FED ¶49,661; TRC BUSEXP: 6,100.

Proposed Regs Ease Test For Bona Fide Residents Of U.S. Possessions

NPRM REG-109813-11

The IRS has issued proposed regs that ease the test for determining whether an individual is a bona fide resident of a U.S. possession. The localities include the United States Virgin Islands (VI), Guam, Puerto Rico, American Samoa, and the Commonwealth of the Northern Mariana Islands.

- ***Take Away.*** The regs interpret Code Sec. 937, which was adopted in the *American Jobs Creation Act of 2004* to impose consistent rules for determining residents of U.S. possessions. According to the legislative history, a uniform definition of bona fide residence in a U.S. possession would address the problem of U.S. citizens and residents who claimed exemption from U.S. taxes on worldwide income as "residents" of a possession. For example, in Notice 2004-45, the IRS challenged a tax avoidance scheme by individuals who claimed to be residents of the VI and, therefore, to be entitled to significant tax reductions under the VI economic development program.

Background

Under Code Sec. 937, an individual will be considered a bona fide resident of a U.S. possession only if the individual:

- Is physically present in the possession for 183 days during the tax year (presence test);
- Does not have a tax home outside the possession during the tax year (tax home test); and
- Does not have a closer connection to the U.S. or another country than to the possession (closer connection test).

Certain days count as constructive presence, even if the individual is not physically present. Qualified medical visits and days spent in the U.S. during a natural disaster may be counted as physical presence. Final regs adopted in 2006 and amended in 2008 provide several alternatives for persons who do not satisfy the 183-day rule:

- The individual is present in the possession for 549 days over three years (the current year and the previous two years), and is in the possession for at least 60 days during each of the three years;
- The individual is present in the U.S. no more than 90 days during the tax year;
- The individual has no more than $3,000 of U.S. earned income and is present in the possession for more days than in the U.S.; or
- The individual has no "significant connection" to the U.S. during the year.

A significant connection includes a permanent home, a spouse, voter registration, or a minor child in the U.S. The regs currently provide that all relevant factors should be considered to determine if a person has a closer connection to the U.S. or another country than to the possession.

Proposed regs

Commentors asked that days of constructive presence include certain trips for business or personal travel outside the possession. The proposed regs would allow up to 30 days of constructive presence for an individual who is outside of both the U.S. and the relevant possession. Furthermore, taxpayers may rely on the proposed regs for tax years beginning on or after the date the proposed regs are published as final.

However, an individual could not use the 30-day rule if the number of days that the individual is present in the U.S. equals or exceeds the number of days present in the possession during the tax year. The 30-day rule also could not be applied to satisfy the 60-day requirement under the 549-day test.

References: FED ¶49,662; TRC INTL: 24,300.

Penalties for Missing, Incorrect TINs On Forms 1098-T Filed By Educational Institutions To Be Waived

The IRS has announced on its website that it will waive penalties for colleges, universities and other educational institutions that filed Form 1098-T, Tuition Statement, with incorrect or missing taxpayer identification numbers (TIN) for tax years 2012, 2013 and 2014.

- ***Comment.*** Wolters Kluwer asked the IRS if official guidance will be forthcoming but did not receive a response by press time.

Background. Code Sec. 6050S generally requires colleges and universities to report to the IRS, and to students, certain information on enrollment, tuition and related expenses, and scholarships related to claims for education deductions or credits on Form 1098-T. The higher education institution identifies the student by name, address and TIN.

Trade Act. Included in the trade legislation is a technical amendment to Code Sec. 6050S. The penalty for failure to furnish a correct payee statement will not be imposed on an educational institution that fails to include a TIN if the educational institution certifies that it properly requested the TIN but was unable to collect it from the student. This provision applies to returns required to be made, and statements required to be furnished, after December 31, 2015.

IRS action. The IRS explained that it is not assessing penalties for incorrect or missing TINs for tax years 2013 and 2014. Additionally, educational institutions that were assessed penalties for missing TINs for tax year 2012 are being contacted by the agency.

www.irs.gov; TRC FILEBUS: 9,370.15.

IRS Provides Guidance On Funding Rules For Pension Plans Of Groups Of Cooperatives And Charities

Notice 2015-58

The IRS has issued guidance on certain funding rules for defined benefit (DB) pension plans under the *Cooperative and Small Employer Charity Pension Flexibility Act* (CSEC Act) passed by Congress in 2014. In addition to the funding rules, the guidance addresses the notice and Schedule SB reporting requirements for plans subject to Code Sec. 433, as enacted in the CSEC Act.

- ***Take Away.*** The CSEC Act and the guidance apply to certain DB plans maintained by groups of cooperatives and related entities and by groups of charities. Code Sec. 433 provides minimum funding rules for CSEC plans beginning for plan years beginning on or after January 1, 2014. Notice 2015-58 provides rules on the funding standard account and funding bases for a plan year to which Code Sec. 412 applies before 2014 and Code Sec. 433 applies for 2014 and after.

Code Sec. 430

Code Sec. 430, as enacted by the *Pension Protection Act of 2006* (PPA), specifies minimum funding requirements for single-employer DB plans (including multi-employer plans). Plans with funding shortfalls are supposed to meet the funding targets by amortizing the shortfall base in level installments over seven years.

The PPA delayed the effective date for the Code Sec. 430 minimum funding rules until January 1, 2017, for plans maintained by more than one employer that is a rural cooperative organization and related entity. Until Code Sec. 430 applies, Code Sec. 412 funding rules apply, as in effect prior to the PPA. In 2010, the delayed funding date was expanded to include "eligible charity plans" of employers described in Code Sec. 501(c)(3).

CSEC plans

The funding rules in the CSEC Act apply to CSEC plans, which generally are the cooperative and charity groups described in the PPA. However, some CSEC plans are not eligible charity plans and vice versa. In addition some rules in the CSEC Act apply only to eligible charity plans, while others apply to all multiple-employer plans.

A plan opting out of Code Sec. 433 can elect extended amortization funding relief under Code Sec. 430. CSEC provides several elections out of Code Sec. 433 for eligible charity plans and for CSEC plans:

- A CSEC plan can elect not to be a CSEC plan, beginning on or after January 1, 2014. Code Sec. 433 will not apply to a plan making this election.
- If Code Sec. 433 does not apply to an eligible charity plan, the plan can elect not to be an eligible charity plan for plan years beginning after December 31, 2014, so that Code Sec. 430 applies, including extended amortization rules under the PPA.
- A plan can elect not be an eligible charity plan, for plan years beginning after December 31, 2007, so that Code Sec. 430 applies beginning with the 2008 plan year.

References: FED ¶46,392; TRC RETIRE: 30,650.

Eighth Circuit Upholds Denial Of Principal Residence Exclusion After Taxpayer Reacquired Property

DeBough v. Shulman, CA-8, August 28, 2015

The Eighth Circuit Court of Appeals has affirmed a Tax Court decision that rejected the taxpayer's claim of the principal residence exclusion for gain from the reacquisition of property on default. The court agreed that Code Sec. 1038 did not allow the taxpayer to claim the principal residence exclusion under Code Sec. 121 because the taxpayer did not resell the property within one year after the reacquisition.

- ***Take Away.*** The interaction of Code Sec. 121 and 1038 involved an issue of first impression. The court determined that the taxpayer's interpretation of Code Sec. 1038 would render the one-year sale provision superfluous and was incorrect.

Background

The taxpayer sold his principal residence on the installment basis in 2006 for over $1 million. He excluded $500,000 in gain under Code Sec. 121, leaving taxable gain of $157,800. The taxpayer received $505,000 in installment payments and reported $57,000 as taxable installment sale gain for 2006-2008.

In 2009, the buyers defaulted and the taxpayer reacquired the property. The taxpayer kept the $505,000 previously received as liquidated damages. The taxpayer did not resell the property.

Court's analysis

Under Code Sec. 1038(a), a taxpayer may disregard gain from the reacquisition of property, except to the extent that the money received exceeds gain previously reported. The IRS claimed that under Code Sec. 1038, the taxpayer must recognize $448,000 in gain, the excess of the money received on the sale ($505,000), minus the gain previously reported ($57,000).

Code Sec. 1038(e) allows a taxpayer who reacquires a principal residence to continue to apply the principal residence exclusion ($500,000 for a married seller) if the seller reacquires the property and re-

continued on page 424

IRS Reports Slight Decrease In Individual Income For 2013

IR-2015-104, IR-2015-105

The IRS Statistics of Income Division has issued its 2013 Individual Income Tax Returns Complete Report finding that although the number of tax returns filed by individual U.S. taxpayers increased by nearly 1.7 percent between 2012 and 2013, the adjusted gross income less deficit reported decreased by 0.1 percent during this period. The IRS also issued its *2015 Summer Statistics of Income (SOI) Bulletin* featuring reports on higher-income tax returns and foreign-controlled domestic corporations for Tax Year (TY) 2012.

- ***Take Away.*** Reported salaries and wages increased by 2.8 percent from 2012 to 2013. A decrease in total reported adjusted gross income was partly attributable to a decrease in reported investment income, which coincided with the effective date of the net investment income tax, the Additional Medicare tax, and the increase in the top capital gains tax rate and the top marginal income tax rate.

Individual income

As the U.S. economy improved, 2.3 million more individual tax returns reported income from salaries and wages increased than had in 2012. Overall income from salaries and wages increased from 2012 to 2013 by a total of $174 billion. Notably the number of tax returns reporting income between $75,000 and $200,000 increased from 2012 to 2013 by more than 935,000, which figure accounts for nearly 40 percent of the increased number of returns reporting salaries and wages for 2013. At the same time, unemployment income decreased by more than 27 percent, from $71 billion in 2012 to just under $52 billion for 2013. Capital gains distributions also increased by 180 percent as mutual funds paid out large distributions resulting from several large stock sell offs during 2013.

Reported individual investment income from ordinary and qualified dividends and net capital gain less loss, however, decreased from 2012 to 2013 by 17.4, 22.7, and 22.1 percent, respectively. One reason for this decrease is likely that many tax filers accelerated investment income into 2012 to avoid tax bracket increases, as well as the net investment income tax, that became effective in 2013. Also likely indicative of an improving economy, the number of returns paying an early withdrawal penalty on retirement savings decreased by more than 10 percent from 2012 to 2013 and the amount of early withdrawal penalties owed decreased by more than 50 percent, from $456 million to $221 million.

SOI Bulletin

In the new SOI Bulletin, the IRS highlighted that, for TY 2012, nearly 5.3 million individual income tax returns reported adjusted gross income (AGI) of at least $200,000. This represented an increase of just under 12 percent from the number of returns reporting income for 2011.

The IRS also reported that, for TY 2012, foreign-controlled domestic corporations (FCDCs) accounted for 1.4 percent of all U.S. corporate returns, but made up 16.1 percent of total corporate receipts and 14.5 percent of total assets.

Reference: TRC IRS: 9,402.

District Court Finds Oil/Gas Property Managers Were Partners; Subsequent Sale Generated Capital Gains

Stewart, DC-Texas, August 20, 2015

A federal district court has rejected the IRS's argument that taxpayers' income was a commission rather than a return from an investment. The court agreed with the partners that the income should be taxed as capital gains.

- ***Take Away.*** The court looked to *Haley, 53-1 USTC ¶9350 (CA-5, 1953)* for guidance. In Haley, the Fifth Circuit explained that the term partnership under the Tax Code is not limited to the common law meaning of partnership but is broader in its scope and includes groups not commonly called partnerships.

Background

The taxpayer and four other individuals organized a limited partnership. The partnership managed the operation of oil and gas wells. The oil and gas wells were owned by another entity, which had to approve expenses, but the partnership fully controlled the operations of the wells. The owner of the wells loaned $6 million to the partnership without recourse for working capital. When the assets were sold, the partnership had a 20 percent interest in the sale revenue after the owner recouped its expenses, its investment, 10 percent return on its investment, and the loan. The sale generated some $20 million for the partnership.

The partnership initially treated the income as ordinary income. The partnership later filed an amended return treating the income as long-term capital gains. The taxpayer received a $1.3 million refund. The IRS subsequently determined that the earnings should be taxed as ordinary income and sued for the return of the refund.

Court's analysis

The court found that the taxpayers and the other partners in the partnership had an ownership interest in the operation. While the owner of the wells contributed financing, the partners contributed their expertise and energy. The owner of the wells relied on their management skills. The work and expertise of the partners increased the value of the wells, which was reflected in the sale

continued on page 424

TAX BRIEFS

Internal Revenue Service

The IRS has issued a fact sheet covering the basic information about business taxes needed by anyone who is self-employed. The fact sheet provides an overview of subjects such as: obtaining an Employer Identification Number (EIN), filing tax returns; business expenses, business use of a home; self-employment taxes; estimated tax payments; recordkeeping; and making electronic tax payments through IRS Direct Pay or the Electronic Federal Tax Payment System (EFTPS).

FS-2015-22, FED ¶46,389; TRC INDIV: 63,500

Jurisdiction

A pro se individual's damages action for wrongful levy brought against several individuals, a bank and a law firm was dismissed for lack of subject matter jurisdiction. An action under Code Sec. 7433 can only be brought against the U.S. and not against individual IRS agents or nongovernmental entities. Further, the individual was precluded from pursuing a *Bivens* action against the IRS agents because Code Sec. 7433 provides the exclusive remedy for unauthorized collection actions.

Buczek, DC N.Y., 2015-2 USTC ¶50,452; TRC IRS: 45,114

Two debtors were barred from relitigating their tax liability because the issue had been litigated in a prior civil enforcement action against them for violations of securities laws with respect to offshore trusts. During the securities enforcement action, the court determined that the best measure of the debtors' ill-gotten gains was a calculation of the federal income taxes avoided by the securities' fraud.

In re S.E. Wyly, BC-DC Tex., 2015-2 USTC ¶50,451; TRC IRS: 57,056.10

Income

An individual was not entitled to exclude her foreign earned income for the tax year at issue because she failed to make a timely election under Reg §1.911-7(a)(2). The taxpayer's argument that Reg §1.911-7(a)(2) was invalid because the additional timing requirement the rule imposed is absent from the statute was rejected. The statute authorizes the IRS to impose a deadline for filing the election and the deadlines contained in the regulation are not unreasonable or arbitrary and were within the specific authority granted to the IRS by Congress to prescribe regulations necessary and appropriate to carry out the purposes of the statute.

McDonald, TC, Dec. 60,391(M), FED ¶48,101(M); TRC EXPAT: 12,108

A noncustodial parent was not entitled to claim dependent exemptions for his two children since he failed to obtain a signed Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents, or any other document signed by the custodial parent stating that she would not claim the children as her dependents.

Stapleton, II, TC, Dec. 60,394(M), FED ¶48,104(M);TRC FILEIND: 6,154

Deductions

Married individuals, who formed a private biotechnology company, were not entitled to their claimed business expense deductions because they were unsubstantiated, lacked business purpose and were not ordinary and necessary for their trade or business. The taxpayers were required to include in income a state (Maryland) tax refund they received under the tax benefit rule and were liable for the negligence penalty.

Chen, TC, Dec. 60,389(M), FED ¶48,099(M); TRC BUSEXP: 3,100

Partnerships

A partnership's motion to dismiss a partnership-level proceeding for lack of jurisdiction because the final partnership administrative adjustment (FPAA) the IRS issued was invalid was denied. The mailing of a FPAA less than 120 days after beginning proceedings rendered the FPAA untimely but not invalid. The IRS was not required to request substantiation of claimed credits from the taxpayer, nor to allow it to participate in a hearing. Finally, the IRS was shown to have made a proper determination specific to the taxpayer.

Green Gas Delaware Statutory Trust, TC, Dec. 60,390(M), FED ¶48,100(M); TRC PART: 60,154

Liens and Levies

A bank was not entitled to declaratory relief correcting the legal description of a mortgaged property because federal tax liens had priority over the bank's inchoate mortgage. The bank's mortgage was inchoate under state (Idaho) law because the legal description of the property was incorrect.

Beal Bank, DC Ida., 2015-2 USTC ¶50,446; TRC IRS: 48,150

IRS settlement officers (SOs) did not abuse their discretion in sustaining lien and levy actions against married individuals. The penalty for promoting an abusive tax shelter scheme was properly imposed and calculated. Collateral estoppel precluded the taxpayers from challenging imposition of the penalty. The Tax Court had jurisdiction to consider the penalty issue due to an IRS concession. The year listed on the penalty notice was irrelevant to the notice's validity.

Gardner, TC, Dec. 60,392, FED ¶48,102; TRC PENALTY: 3,256

Refund Claims

The government of Guam and its officers were properly required to pay valid refunds within six months of the refund claim and prohibited from operating an "expedited" refund program that violated the Equal Protection Clause of the Fourteenth Amendment.

R.M.O. Paeste v. Government of Guam, CA-9, 2015-2 USTC ¶50,450;

Collection Due Process

An IRS settlement officer (SO) did not abuse his discretion in denying a married couple's installment agreement because the taxpayers were unable to obtain loans to satisfy their unpaid income tax liabilities and failed to provide any valid collection alternatives. The taxpayers did not qualify for an installment agreement because the

continued on page 424

Tax Briefs

Continued from page 423

balance due could be satisfied by liquidating assets, which they refused to do.

Tillery, TC, Dec. 60,393(M), FED ¶48,103(M); TRC IRS: 45,112.15

An IRS Settlement officer (SO) did not abuse her discretion when she refused to withdraw a Notice of Federal Tax Lien (NFTL) filed against an individual because the issue was never raised at the Collection Due Process (CDP) hearing. In addition, he individual failed to present or offer any evidence that he was adversely affected or denied employment because of the NFTL and mere speculation about the effect of a lien on finding gainful employment was not enough to require its withdrawal.

Schumacher, TC, Dec. 60,388(M), FED ¶48,098(M); TRC LITIG: 6,456.25

Principal Residence

Continued from page 421

sells it within one year. The resale is treated as part of the original sale.

The taxpayer claimed that nothing in Code Sec. 1038 requires the taxpayer to recognize gain that was previously excluded. The court disagreed. Congress explicitly addressed the question in Code Sec. 1038(e) and the IRS's position was consistent with it.

References: 2015-2 ustc ¶50,455; TRC REAL: 6,156.35.

Partners

Continued from page 422

price. Therefore, the profits were long-term capital gains, the court concluded.

The court further rejected the IRS's argument that the partnership did not seek a formal adjustment, and, as a result the original return controlled. The original return had reported the income as ordinary income. The IRS could not recharacterize the taxpayer's income as ordinary income without first adjusting the partnership's return, the court found.

References: 2015-2 USTC ¶50,443; TRC PART: 60,500.

Penalties

In a case of first impression, a merchant bank's claim for refund of tax-shelter registration penalties was dismissed for lack of jurisdiction because it failed to satisfy the full-payment rule. The bank's claim that it was not required to pay the penalty in full before filing suit because the penalty was divisible and, therefore, the court had jurisdiction since it paid the penalty and interest for one transaction was rejected.

Diversified Group, Inc., CA-FC, 2015-2 USTC ¶50,453; TRC PENALTY: 3,252

The administrator of a regional employers assurance leagues voluntary employees' benefit association (REAL VEBA) was liable for the tax shelter promoter penalty. The administrator was liable under Code Sec. 6700 because it made statements about the lawful nature of the REAL VEBA that it knew or should have known were false or fraudulent.

Penn-Mont Benefit Services, DC Pa., 2015-2 USTC ¶50,449;

Anti-Injunction Act

An individual's action against his railroad employer seeking to enjoin it from withholding taxes from his wages or complying with an IRS levy was dismissed for lack of jurisdiction. Despite his insistence that he only sought injunctive relief against his employer, his request amounted to an action to enjoin the government from collecting taxes and, therefore, was barred by the Anti-Injunction Act.

Lewis v. BNSF Railway Company, DC Ill., 2015-2 USTC ¶50,445; TRC IRS: 45,152

FOIA

The IRS properly withheld documents nonresponsive to an organization's Freedom of Information Act (FOIA) request. The 40 pages of records the IRS withheld consisted entirely of return information and, therefore, the records were not responsive to the FOIA request.

Judicial Watch, Inc., DC D.C., 2015-2 USTC ¶50,447; TRC IRS: 9,502

Bankruptcy

A bankruptcy court's order discharging a Chapter 13 debtor's tax liabilities for the two tax years at issue was vacated and remanded. The bankruptcy court's conclusion that the debtor's tax liabilities were discharged rested on a fact that was genuinely in dispute; therefore, summary judgment in favor of the debtor was not proper based on the record.

In re Kemendo, DC Tex., 2015-2 USTC ¶50,448; TRC IRS: 57,158

Taxpayer's Qui Tam Award Not Entitled To Capital Gains Treatment

A qui tam relator's award was not entitled to capital gains treatment, the Court of Appeals for the Seventh Circuit has found. Affirming the Tax Court, the Seventh Circuit found that the taxpayer did not invest in a capital asset.

Background. The taxpayer filed a qui tam complaint against his employer alleging that the employer had defrauded the federal government. The employer eventually entered into a settlement. The taxpayer received an award of nearly $7 million from the government, which issued a Form 1099-MISC, Miscellaneous Income. The taxpayer reported the award, less attorney's fees, as capital gains.

- ***Comment.*** According to the taxpayer, he had sold information to the government, creating a contractual right to a share in the recovery. The IRS countered that the taxpayer's statutory obligation to provide all information to the government did not constitute a sale or exchange.

Court's analysis. The court found that treating a qui tam award as a capital gain would contravene the long-recognized rule that a capital gain generally involves a "realization of appreciation in value accrued over a substantial period of time of an initial investment of capital." In this case, the taxpayer did not make an investment in an asset. Rather, he invested time and effort to uncover his employer's fraudulent activities. The taxpayer's work, the court concluded, was not an investment in capital.

Patrick; 2015-2 USTC ¶50,454; TRC INDIV: 6,354.10.

Lawmakers Return From August Recess; Tax Bills High On Agenda

When Congress returns to work after Labor Day, lawmakers will have an array of tax bills to consider, and many lawmakers are eager to take-up a handful of these tax-related measures as a means to bolster employers' hiring of new employees and increase economic output. At the top of the list, and a must do, is passing legislation to renew approximately 50 tax incentives, known as extenders. Tax changes may also appear in a multi-year highway and transportation funding bill and/or as stand-alone legislation before year-end 2015.

- ***Comment.*** "We're hoping lawmakers turn to the tax extender provisions a little more quickly this Fall, but based on recent history, we could be waiting until December," Dustin Stamper, director, Washington National Tax Office, Grant Thornton, LLP, told Wolters Kluwer. "Either way, it should be exciting to see Rep. Paul Ryan (chair of the House Ways and Means Committee) take a stab at international reform on the next extension of highway funding in October."

Tax extenders

Congress passed a one-year extension of the tax extenders in the *Tax Increase Prevention Act of 2014.* Just before the August recess, the Senate Finance Committee (SFC) marked up legislation, the Tax Relief Extension Act of 2015 (Sen. 1946), to extend many of the extenders for two years (retroactive to January 1, 2015 and through 2016).

- ***Comment.*** "I want to note that this year marked the first time in 20 years that a new Congress began with the tax extenders already expired. In other words, we began this Congress with a built-in disadvantage when it comes to tax policy," SFC Chair Orrin Hatch, R-Utah, said in his opening statement at the markup.

The House, however, has not taken up an extenders package. Rather, the House, and particularly the House Ways and Means Committee, has voted on several extenders in stand-alone bills. One drawback to this approach might be cost. The cost of stand-alone legislation could prove too much for lawmakers to swallow in a time of budget deficits. House Ways and Means Chair Paul Ryan, R-Wisc. has appeared to favor this approach, at least so far in 2015.

"At the top of the list, and a must do, is passing legislation to renew approximately 50 tax incentives, known as extenders."

Widely viewed as one of the most significant tax extenders is the research tax credit, and lawmakers, including Ryan and Hatch, have called for making the research credit permanent. The House on May 20 approved legislation, the American Research and Competitiveness Bill of 2015 (HR 880), to simplify and make permanent the research tax credit. Hatch followed the lead of the House by proposing an amendment to his tax extender mark to make the research tax credit permanent, but withdrew it during the mark-up, saying it would be addressed at a later time.

- ***Comment.*** Considering how important the research tax credit is to businesses, there remains the possibility that the Senate could take-up the House bill before the end of the year as a stand-alone bill.

The SFC bill would potentially significantly expand the Work Opportunity Tax Credit (WOTC) beyond its traditional base of generally well-defined target groups. Under the SFC bill, eligible employers who hire long-term unemployed individuals would qualify for the WOTC. The SFC bill generally defines the term unemployed individuals as individuals who are certified by a local agency as being unemployed for 27 weeks or more.

- ***Comment.*** The most recent expansion of the WOTC was the inclusion of qualified veterans. The *VOW to Hire Heroes Act* added five subcategories of qualified veterans for WOTC purposes. In addition, the WOTC continues to cover the traditional target groups, such as qualified TANF families, qualified ex-felons, and qualified summer youth employees.

The SFC bill also extends a number of temporary tax incentives for individuals. These include the state and local sales tax deduction, higher education tuition deduction, Code Sec. 25C residential energy property incentive, and more.

Highway bill

Lawmakers in both chambers also appear to be on course to pass a multi-year highway funding bill with revenue for highway and transportation development and maintenance. And like tax extenders, it has been done on a seemingly ad hoc basis for a short-term. However, in July, the Senate approved a multi-year highway funding bill, the Developing a Reliable and Innovative Vision for the Economy (Drive) Act (Sen. 1647), The House plans to produce its own long-term highway funding bill sometime in late September or early October, at which point House and Senate leaders have said they will go to conference in order to reconcile their respective multi-year bills.

Some revenue raisers for a multi-year highway bill were used in the short-term

continued on page 427

WASHINGTON REPORT *by the Wolters Kluwer Washington News Bureau*

Koskinen briefs lawmakers about stolen identity refund fraud

At an August 26 field hearing of the Senate Budget Committee, lawmakers heard about efforts to curb identity theft and stolen identity refund fraud. IRS Commissioner John Koskinen reported that the agency has some 3,000 employees working on identity theft cases and has trained more than 35,000 employees to assist victims of identity theft. Koskinen also highlighted the agency's criminal enforcement activities. "Over the past few years, approximately 2,000 individuals have been convicted on federal charges related to refund fraud involving identity theft. More than 400 special agents from the IRS's Criminal Investigation (CI) division continue to conduct tax-related identity theft investigations, with the number of active cases now totaling approximately 1,700," Koskinen said. "Cyber criminals are using increasingly sophisticated means to steal personal information from a variety of sources, and gain access to even more sensitive data than in the past," Koskinen said. "A good illustration of this problem is the unauthorized attempts to gain access to our Get Transcript application earlier this year."

Koskinen added that the IRS is working identity theft cases more quickly. "Individuals who become identity theft victims in 2015 can expect to have their situations resolved in less than 120 days, far more quickly than in previous years, when cases could take over 300 days to resolve. While this marks a significant improvement, we are continuing to work to find ways to shorten this time and ease the burden identity theft places on its victims."

Koskinen also urged lawmakers to give the IRS express authority to regulate unenrolled preparers (as the agency did under the now defunct Registered Tax Return Preparer (RTRP) program). "Requiring all paid preparers to keep up with changes in the Tax Code would help promote high quality services from tax return preparers, improve voluntary compliance, and foster taxpayer confidence in the fairness of the tax system. It would allow the IRS to focus resources on the truly fraudulent returns," Koskinen predicted.

IRS telephone impersonation scams continue to spread

Treasury Inspector General for Tax Administration (TIGTA) J. Russell George testified at a Senate Budget Committee field hearing on August 26 about IRS telephone impersonation scams. George reported that telephone impersonation scams are one of TIGTA's top priorities. "It is a surprisingly effective and fast way to steal taxpayers' money, and in this fast-paced electronic environment, the money can be gone before the victims realize that they have been scammed. The hundreds of thousands of complaints we have received about this scam makes it the largest, most pervasive impersonation scam in the history of our agency. It has claimed thousands of victims with reported losses totaling over $21.5 million to date," George said.

To date, TIGTA has received almost 650,000 reports of these calls. "We continue to receive between 9,000 and 12,000 such reports each week. As of August 10, 2015, over 4,200 individuals have been victimized by this scam."

Senate's IRS appropriations bill includes EIC reforms

The Senate Appropriations Committee, in its proposed fiscal year (FY) 2016 budget for the IRS, has raised concerns about abuse of the earned income tax credit (EIC). The FY 2016 appropriations proposal would direct the IRS to ensure that the same EIC eligibility questions are asked of taxpayers whether they are preparing their returns with a paid tax preparer or via do-it-yourself methods such as paper forms, preparation software, or online preparation tools. Questions that appear on Form 8867 would be included on the Schedule EIC. Under the Senate proposal, the changes would take effect for returns filed after January 1, 2016.

Lawmakers ask Lew about BEPS project

Senate Finance Committee Chair Orrin Hatch, R-Utah, and House Ways and Means Committee Chairman Paul Ryan, R-Wis., recently outlined concerns regarding the country-by-country (CbC) reporting requirements that are being considered by the Treasury Department and called on Secretary Jack Lew to respond to their previous request for information on the Base Erosion and Profit Shifting (BEPS) project that is being developed by the Organisation for Economic Co-operation and Development (OECD).

"Rather than expend additional administrative resources on the CbC regulatory project, we encourage Treasury to focus in the near term on preparing and providing the legal memorandum and other documentation requested in our June 9 letter to you," Hatch and Ryan wrote in a letter dated August 27, 2015. "In addition, we ask that Treasury officials consider the results of the GAO analysis of the BEPS project and recommendations before moving forward with any CbC-related guidance."

TIGTA reviews IRS's ACA information sharing and reporting project

In a new report, the Treasury Inspector General for Tax Administration (TIGTA) reviewed the IRS's Affordable Care Act Information Sharing and Reporting Project. The overall objective of the audit was to determine that the IRS sufficiently identified and mitigated risks and had properly managed requirements testing. TIGTA found that, while the project was deployed by the IRS on time, lapses occurred in risk and requirements management.

TIGTA made five recommendations, which the IRS accepted. While the IRS highlighted its established guidance on tracking and controlling requirements and requirements traceability, TIGTA indicated the guidance in the current version of the Internal Revenue Manual needed to be more specific.

Continued from page 425

bill passed in July (the Surface Transportation Act), such as new compliance measures. Possible revenue raisers for a multi-year highway bill include excluding from gross income certain clean coal power grants to noncorporate taxpayers, revoking or denying U.S. passports to individuals with seriously delinquent tax debts, and treating certain persons as employers with respect to motion picture projects. International tax reforms could be put forward in the House (discussed below).

International taxation

Lawmakers could move on some form of tax reform legislation that would partially address international taxation. Earlier this year, the SFC looked at several proposals, such as moving to a hybrid, territorial-like system, innovation boxes, base erosion, and deemed repatriation.

- ***Comment.*** The concept of innovation boxes is now gaining more interest in Congress. Reps. Charles W. Boustany, R-La., and Richard Neal, D-Mass., on July 29 released a discussion draft of innovation box legislation—a lower tax rate on income derived from intellectual property—designed to attract and retain research and development investment and intellectual property in the U.S. "What's driving U.S. tax reform is international taxation and we know that our tax code has become very outdated relative to our foreign counterparts causing U.S. based companies to lose their competitive edge in worldwide business markets," Boustany said.

Small businesses

A bipartisan group of lawmakers has introduced companion legislation in both chambers, the Small Business Healthcare Relief Bill (HR 2911; Sen 1697), that would roll back penalties on small businesses providing health coverage arrangements that run afoul of market reforms under the Affordable Care Act. The legislation was introduced by SFC member Sen. Charles Grassley, R-Iowa, and Sen. Heidi Heitkamp, D-N.D., and House Ways and Means member Charles Boustany, R-La., and Rep. Mike Thompson, D-Calif.

- ***Comment.*** In Rev. Rul. 61-146, the IRS determined that, under certain conditions, if an employer reimburses an employee's substantiated premiums for non-employer sponsored hospital and medical insurance, the payments are excluded from the employee's gross income. This exclusion also applies if the employer pays the premiums directly to the insurance company. In Notice 2013-54, the IRS described these arrangements as employer payment plans, which are considered to be group health plans subject to the ACA's market reforms. Excise taxes under Code Sec. 4980D apply for failure to comply with the ACA's market reforms. The excise tax reaches $100 per affected individual per day. Limited transition relief under Notice 2015-17 from the penalties for qualified small businesses expired after June 30, 2015.
- ***Comment.*** "Our bipartisan bill would make a needed fix to restore the ability for small businesses, which sometimes can't afford to provide health benefits for employees, to help their workers purchase coverage using HRAs," Heitkamp said in a statement.

IRS budget

Grassley and Sen. John Thune, R-S.D., have introduced the Taxpayer Bill of Rights Enhancement Bill of 2015 (Sen 1578), which they predicted would improve customer service at the IRS, create new taxpayer protections and update and strengthen existing taxpayer protections. For fiscal year (FY) 2016, House appropriators recently provided $2.2 billion, $75-million above current levels, for taxpayer services, intended to improve the rate that IRS answers telephone calls and correspondence from taxpayers.

More tax bills

There is also a stack of small, potentially do-able tax measures that have been introduced in Congress in 2015. House Ways and Means Committee ranking member Sander Levin, D-Mich., have introduced legislation, the Equal Dignity for Married Taxpayers Bill, to clarify equal treatment for all married couples under the Tax Code. SFC ranking member Ron Wyden introduced an identical measure in the Senate.

Parents looking for means to send their children to college received a potential boost as the SFC in April approved a bipartisan bill to improve and extend Code Sec. 529 college plans. The bill would change the way that Code Sec. 529 education savings accounts currently operate. The full House approved a similar measure (HR 529) on February 25. The legislation would make three changes to current law. It would allow the purchase of a computer to be considered a qualified expense. It would also remove distribution aggregation requirements. A third provision provides tax and penalty relief in instances where a student may have to withdraw from school for illness or other reasons.

A group of lawmakers in March introduced a series of bills aimed at cutting taxes for the middle class. Specifically, the Senate and House Democrats introduced legislation to extend beyond 2017 the Earned Income Tax Credit (EIC) and to expand the child tax credit, the American Opportunity Tax Credit (AOTC) and the child and dependent care tax credit, plus create a new worker tax cut. The Working Families Tax Relief Bill would expand EIC for workers without children, making it easier for those who qualify to claim the EIC.

On the excise tax front, legislation has been introduced to help distillers of spirits and craft brewers, mainly due to heavy lobbying by organizations that act on their behalf. SFC ranking member Wyden has introduced legislation, the Craft Beverage Modernization and Tax Reform Bill (Sen 1562), which would, among other provisions, reduce excise taxes for brewers. In the House, Reps. Todd Young, R-Ind., and John Yarmuth, D-Ky., have introduced a bill to cut federal excise taxes for all distillers. Distilled spirits products are one of the most highly taxed consumer products in the U.S., with more than half of the purchase price of a typical bottle of spirits going to taxes and fees. The Distillery Innovation and Excise Tax Reform Bill of 2015 (HR 2520) would cut the current tax rate of $13.50 per proof gallon to $2.70 per proof gallon on the first 100,000 gallons for all distillers.

COMPLIANCE CALENDAR

■ September 4

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

■ September 10

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

Employees report tips of $20 or more earned during August.

■ September 11

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

■ September 15

Corporations deposit the third installment of estimated tax for 2015.

Individuals make the third installment of 2015 estimated tax.

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

Corporations and S corporations with 6-month extensions file 2014 Forms 1120 and 1120S and pay tax due.

Partnerships with 5-month extensions file 2014 Form 1065.

■ September 16

Employers deposit Social Security, Medicare, and withheld income tax for September 9, 10, and 11.

■ September 18

Employers deposit Social Security, Medicare, and withheld income tax for September 12, 13, 14, and 15.

TRC TEXT REFERENCE TABLE

The cross references at the end of the articles in Wolters Kluwer Federal Tax Weekly (FTW) are text references to 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.

ACCTNG 21,302.10	373	HEALTH 6,106	406	IRS 48,058	408
ACCTNG 33,100	362	HEALTH 9,302	375	LITIG 3,104.35	385
ACCTNG 36,162.05	410	INDIV 6,364.10	424	PART 9,050	381
BUSEXP 6,100	417	INDIV 6,368	394	PART 24,112.10	371
BUSEXP 18,200	398	INDIV 21,206.05	409	PART 24,112.10	371
BUSEXP 18,808	388	INDIV 36,054	399	PART 27,050	357
BUSEXP 31,100	386	INDIV 48,400	383	PART 60,500	422
COMPEN 3,050	408	INTL 15,052.05	362	PAYROLL 6,106	409
COMPEN 36,354	386	INTL 15,052.05	372	PENALTY 3,252.10	419
CONSOL 41,200	361	INTL 15,210	395	PENALTY 3,304	407
ESTGIFT 36,252	412	INTL 15,306.05	395	PENALTY 18,100	420
ESTGIFT 45,204	374	INTL 24,300	420	REAL 6,156.33	421
ESTGIFT 45,208	397	INTL 30,308.30	363	RETIRE 30,556	376
EXCISE 24,310	398	IRS 3,200	387	RETIRE 30,650	421
FARM 9,050	373	IRS 9,402	422	RETIRE 51,050	359
FILEBUS 9,108	384	IRS 18,054	385	RETIRE 60,312	407
FILEBUS 9,158	411	IRS 21,414	361	RETIRE 78,052.10	350
FILEBUS 9,206	410	IRS 24,054	397	SALES 6,156	405
FILEBUS 9,458.05	358	IRS 33,150	360	SALES 39,000	383
FILEBUS 15,104.25	393	IRS 36,106	396	SCORP 352.35	363

CONFERENCES

September 17: Wolters Kluwer presents a webinar, "Transfers Creating or Terminating Disregarded Entity Status," designed for practitioners who need to understand how to deal with the tax issues facing the creation or termination of disregarded entity status. To register, visit *www.krm.com/cch* or call (800) 775-7654.

September 17–19: The American Bar Association (ABA) Section of Taxation presents its 2015 Joint Fall CLE Meeting in Chicago. The program will discuss recent developments relating to employee benefits, exempt organizations, and business taxation. Visit *www.americanbar.org* to register.

September 24: The New York State Society of CPAs (NYSSCPA) presents a health care conference in New York. Visit *www.nysscpa.org* to register.

October 18–21: The Tax Executives Institute hosts its 70th Annual Conference in Dallas. Industry experts will discuss tax administration, corporate tax planning, international tax transactions, and more. To register, visit *www.tei.org* or call (202) 638-5601.

October 25–30: New York University presents its 74th Institute on Federal Taxation in New York and again in San Francisco on November 15-20. The six-day conference will address all major areas of taxation, including expert discussion of the latest technical, legislative, and planning developments. To register, call (212) 992-3320 or visit *www.scps.nyu.edu*.

November 2–3: The AICPA hosts its National Tax Conference in Washington, D.C. Visit *www.aicpa.org* for more details.

November 12-13: ALI-CLE presents Tax Exempt Organizations 2015 in Washington, D.C. For more information, visit *www.ali-cle.org*.

November 23-24: The California Society of CPAs hosts a tax update and planning conference in San Francisco. *Visit www.calcpa.org for details.*