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EMPLOYEE FRINGE BENEFITS

IRS Puts Fringe Benefits Under Microscope

Businesses frequently provide fringe benefits to their valued employees and corporate executives as a means of rewarding their loyalty, dedication and hard work. Benefits can range from free employee use of athletic skyboxes, entertainment suites and company-owned aircraft to no-cost or low-cost loans and employer-paid vacations. Most fringe benefits are afforded favored tax treatment, which makes them valuable to companies and employees alike. However, there are often special rules and restrictions that must be met in order to qualify for the tax breaks.

The IRS has found that employers may classify a taxable fringe benefit under expense accounts other than compensation, resulting in a failure to subject the fringe benefit to income and employment taxes. In an effort to stem the abuse that is rampant in this area, the IRS recently released a new audit guide in conjunction with its Market Segment Specialization Program (MSSP) [IRS MSSP audit guide (EXECUTIVE COMPENSATION-

FRINGE BENEFIT AUDIT TECHNIQUES GUIDE, Apr. 13, 2005)]. The new audit guide provides a virtual roadmap for how the IRS will analyze the returns of companies that provide compensation in the form of fringe benefits to corporate executives. Tax professionals and companies will find the audit guide helpful in determining if proposed fringe benefits or those already in place will pass muster in the eyes of the IRS.

In the audit guide, the IRS explains that frequently corporate executives receive fringe benefits not available to other employees and executives in lieu of, or in addition to regular taxable wages. Some of the benefits are subject to taxation and others are not. The IRS's detailed audit guide identifies which benefits are taxable, to what extent they are taxable, and what steps an examiner should follow to uncover abuse.

The IRS instructs examiners to apply the following three-part test to identify if an executive's fringe benefit is taxable:

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1. Identify the fringe benefit and start with the assumption that its value will be taxable as compensation to the employee.
2. Check to see if there are any statutory provisions that exclude the benefit from the executive's gross income.
3. Value any portion of the benefit that is not excludible for inclusion in the executive's gross income. The IRS adds that fringe benefits are generally valued at the amount the employee would have to pay for the benefit in an arm's-length transaction.

After this initial level of inquiry, examiners must determine the following:

- Is the expense deductible by the corporation?
- Is the amount excludible from gross income of the executive?
- Is the executive receiving personal benefit from the corporation?
- Does the benefit exceed the limitation in Code Sec. 162(m)?

The fringe benefits considered in the IRS MSSP audit guide include the following:

Athletic Skyboxes/ Entertainment Suites

In the case of luxury skyboxes leased for more than one event, corporations may claim a deduction not to exceed the sum of the face value of the nonluxury seats in the luxury box. Luxury boxes rented by related parties or individuals are treated as a single lease in determining whether a box is

leased for more than one event. The amount spent for attendance at the event will only be deductible if the expenditures qualify as ordinary and necessary business expenses under Code Sec. 274. Use of the skyboxes is not considered taxable income to the executive unless the executive uses the luxury box personally. Catered events should be examined additionally to ensure that the catering satisfies the requirements of Code Sec. 274.

Awards/Bonuses

Companies often use a variety of methods to provide compensation for services rendered by executives. The audit guide reminds auditors that all payments in whatever form, are payments in the nature of compensation if they arise out of an employment relationship or are associated with the performance of services. Payments in the nature of compensation include wages, salary, bonuses, severance pay, fringe benefits, pension benefits and other deferred compensation. The IRS warns that companies may also provide executives with non-cash awards and bonuses that should be subject to tax. The IRS also instructs auditors to review invoices for the "ship-to" address for large ticket items that appear to be personal in nature but should be taxed as compensation.

Club Memberships

Code Sec. 274(a)(3) provides in general that no deduction is available for club dues paid for membership in a wide variety of clubs including business, athletic, social, luncheon, sport-

ing, airline, hotel, country or golf clubs. The purposes and activities of a club, rather than its name, determine whether it is covered under the disallowance provision. The IRS reminds auditors that corporations may try to deduct club memberships by disguising them as compensation paid to departing executives in severance packages. The value of a club membership distributed to executives upon departure should be taxed as wages, and agents are warned in the audit manual to subject employment contracts and executives' severance agreements to close scrutiny.

Practice Pointer. If classified as a working condition fringe benefit under Code Sec. 132, club dues paid by an employer on behalf of the employee may be excludible from an employee's gross income. To qualify for the exclusion, however, the working condition fringe benefit rules must be satisfied. The cost of the membership dues paid by an employer on behalf of an employee must qualify as an ordinary and necessary business expense to be excluded from the employee's gross income as a working condition fringe benefit [Reg. §1.132-5(s)(2)].

Club dues paid on behalf of employees may be deductible by the employer despite the fact that the expense is completely disallowed under Code Sec. 274(a)(3) if an employer treats the amount paid for membership in any club organized for business, pleasure, recreation or other social purpose as compensation to the employee. Note, however, that in this situation, no amount may be excluded from the employee's gross income as a working condi-

tion fringe benefit [Reg. §1.132-5(s)(1)].

Example. An employer provides an employee with a \$15,000 country club membership. If the employee can substantiate by receipts and logs that the club was used 40 percent for business purposes, then \$6,000 may be a working condition fringe benefit, despite the fact that the expense is completely disallowed as club dues under Code Sec. 274(a)(3). The \$9,000 balance of the dues is taxed to the employee and is deductible by the employer as compensation paid.

The dues disallowance provisions do not apply to dues paid to business leagues, trade associations, chambers of commerce, boards of trade, real estate boards, professional organizations (*e.g.*, bar associations and medical associations), and civic or public service organizations (*e.g.*, Kiwanis, Lions, Rotary and Civitan clubs and similar organizations). However, any dues paid to these organizations will be disallowed if a principal purpose of the organization is to conduct entertainment activities for members or their guests or to provide such individuals with access to entertainment facilities [Reg. §1.274-2(a)(2)(iii)(b)].

Corporate Credit Cards

The IRS is aware that many companies provide corporate credit cards to executives and other employees. Different policies often exist for use of the card by rank and file employees and top-level executives. For example, the higher-ups may be allowed to use the company credit card at will with a monthly statement mailed directly to the corporation and the account paid in full

without even the submission of a business expense report. On the other hand, lower-level executives may be required to submit detailed expense reports in order for their bills to be paid. These discriminatory practices could be signs that the parties are using the corporate credit cards to pay the executive's personal living expenses with company funds. The MSSP audit guide warns auditors to be on the lookout for this abuse. When these expenses are paid on behalf of the employee, they are taxable fringe benefits that should be included in the employee's wages as compensation.

In addition, the audit guide instructs auditors to determine whether the corporation has an accountable plan as defined in Code Sec. 62(c). With an accountable plan in place, an employee isn't taxed on an advance, reimbursement or other expense allowance received from an employer or from a third party [Code Sec. 62(a)(2)(A), (c); Reg. §1.62-2(c)(4)]. This means that employees who receive travel allowances or reimbursements under an "accountable plan" need not report the payment as income on their tax return. In contrast, reimbursements provided under something other than an "accountable plan" will be considered taxable wages. The employer must withhold income taxes on the payments and report the reimbursements as income on the employee's Form W-2. The employee must treat the payments as income and claim an offsetting deduction for the actual business-related travel expenses [Reg. §1.62-2(c)(5)]. Note, however, that these expenses will be treat-

ed as a miscellaneous itemized deduction deductible only to the extent their total for the year exceeds two percent of the taxpayer's adjusted gross income. An accountable plan will pass muster if it satisfies the following four key requirements: (1) business connection, (2) substantiation, (3) return of unspent amounts, and (4) timely submission of invoices. An advance that fails to satisfy these conditions is treated as paid under a nonaccountable plan, taxed to the employee, and subject to FICA and income tax withholding [Code Sec. 62(c); Reg. §1.62-2(c)(5)].

Employee Use of Corporate Jets

Code Sec. 274(e) provides that a business' deduction may no longer exceed the amount that the executive takes into income for the entertainment use of the aircraft. Generally, "entertainment use" is considered an amusement or recreational activity, such as traveling to a sporting event or to a vacation destination. In Notice 2005-45 [IRB 2005-24, 1228], the IRS explains how to apply new Code Sec. 274(e), which was enacted to overturn *Sutherland Lumber-Southwest, Inc.* [114 TC 197, Dec. 53,817 (2000), *aff'd*, CA-8, 2001-2 USTC ¶150,503, 255 F3d 495, *acq.*, IRB 2002-6 (Feb. 11, 2002)] and limit the costs that a business may deduct when an executive uses the company's aircraft for entertainment travel. In *Sutherland Lumber-Southwest, Inc.*, the Tax Court held that the amount a taxpayer could deduct for the cost of entertainment-related flights under the Code Sec.

274(e)(2) exception is not limited to the amount included in the income of the employees and corporate officers who took the flights. Rather, the court held that a taxpayer may deduct the full cost of an employee's or officer's non-business flight on the taxpayer's aircraft if the taxpayer includes in the recipient's income the value of the flights calculated under the Department of Transportation's Standard Industry Fare Levels (SIFL) formula under the rules of Reg. §1.61-21. As a result, a deduction greater than the amount included in the recipient's income was allowable. Congress enacted Code Sec. 274(e) to alleviate this imbalance.

Employee Use of Listed Property Such As Computers

Many corporations furnish executives' residences with elaborate home offices equipped with computers, laptops and other expensive electronic equipment. Detailed records must be maintained to show business use of computers that can be taken home or are kept at home by an executive. The IRS reminded examiners to look out for furnishings and equipment that are transferred to departing executives as part of their severance packages and to be sure that the tax consequences of these transfers are not overlooked.

Employer-Provided Transportation Fringe Benefits

The qualified transportation fringe allows employees to escape tax on three types of employer-provided transportation benefits up to a statutory monthly limit: (1) public trans-

sit passes, (2) transportation in commuter highway vehicles, and (3) free parking for employee cars [Code Sec. 132(f); Reg. §1.132-9, Q&A-1]. In 2005, the monthly limitation for transportation in a commuter highway vehicle and any transit pass is \$105. The monthly limitation for qualified parking is \$200. Any amount in excess of the monthly limit is taxable. The exclusion for a qualified transportation fringe is available only to "employees," which could include household employees such as nannies, housekeepers and gardeners [Reg. §1.132-9, Q&A-5]. Self-employed taxpayers do not qualify [Code Sec. 132(f)(5)(E); Reg. §1.132-9, Q&A-24]. Therefore, individuals who are partners, sole proprietors or other independent contractors are not employees for purposes of Code Sec. 132(f). In addition, two-percent shareholders of S corporations are treated as partners for fringe benefits purposes. Thus, an individual who is both a two-percent shareholder of an S corporation and a common law employee of that S corporation is not considered an employee for purposes of Code Sec. 132(f) and is therefore ineligible to take advantage of the transportation fringe benefit exclusion. An employee may receive qualified transportation fringes from more than one employer. Qualified transportation fringes not exceeding the applicable statutory monthly limit are not wages for FICA, FUTA and income tax withholding purposes. Thus, any amount by which an employee elects to reduce compensation is not subject to FICA, FUTA or income tax withholding. Qualified trans-

portation fringes exceeding the applicable statutory monthly limit are wages for FICA, FUTA and income tax withholding purposes and are reported on the employee's Form W-2 [Reg. §1.132-9, Q&A-22].

Employer-Paid Vacations

The value of an employer-paid vacation is generally not excludible because vacation expenses are considered nondeductible personal living expenses. Examiners are encouraged to review the flight logs of corporate aircraft to discover any vacation trips taken by executives and their families, especially their spouses, significant others and friends.

Executive Dining Rooms

Meals provided on the employer's business premises for the convenience of the employer are excludible from the employee's income under Code Sec. 119. The value of meals provided to employees at an employer-operated eating facility will be excludible from gross income as a *de minimis* fringe only if on an annual basis, the revenue from the facility equals or exceeds the direct operating costs of the facility. In addition, the benefit cannot be offered solely for "highly compensated employees," who are defined in 2005 as either being a five-percent owner or receiving more than \$95,000 in pay for the preceding year. In the case of an employer-operated eating facility, the value of the meals will be excludible as a *de minimis* fringe if the following four tests of Reg. §1.132-7(a)(2) are satisfied:

1. The facility is owned or leased by the employer.

2. The facility is operated by the employer.
3. The facility is located on or near the business premises of the employer.
4. The meals furnished at the facility are provided during, or immediately before or after, the employee's workday.

Loans

The IRS warns that companies often make no-cost or low-cost loans or extend credit to executives without observance of typical loan requirements. Sometimes, the loans are actually disguised compensation that should be subject to tax. Taxpayers must be able to show the following to prove the existence of a *bona fide* tax-free loan: (1) existence of a promissory note; (2) cash payments according to a specified repayment schedule; (3) interest is charged; and (4) security for the loan. The IRS warns auditors to review loans to executives to determine if they are *bona fide* and to determine if the terms are being followed. Auditors should ask the following questions:

- Is there a written document detailing the terms of the loan, payment over a certain number of years or is payment on demand?
- Is the interest rate at market or at a below market rate of interest?
- Is the loan listed on the company's balance sheet as a receivable?
- Are the terms of the loan being followed? For example, red flags should be raised if all or part of the loan is forgiven if the executive remains with

the company for a certain number of years.

Code Sec. 7872 provides that below-market loans directly or indirectly between an employer and an employee are in reality compensation-related loans and the employer may be treated as transferring the foregone interest to the employee as additional compensation and the employee may be treated as paying taxable interest back to the employer. There is a *de minimis* exception from the application of the imputed interest rules if loans between the parties in aggregate do not exceed \$10,000 unless one of the principal purposes of the loan is tax avoidance.

The Sarbanes-Oxley Act of 2002 [P.L. 107-204], which became effective on July 30, 2002, bans personal loans to officers and executives of public companies. Personal loans outstanding on July 30, 2002, are not prohibited, provided there is no material modification or renewal of the loan on or after July 30, 2002. The IRS warns examiners to be alert for unusual loan forgiveness terms, repayment methods and repayment dates. These may be attempts to disguise compensation.

Outplacement Services

Corporations frequently offer extensive outplacement services solely for the benefit of top-level executives. The MSSP audit guide explains that outplacement services provided solely for executives are not excludible from gross income. In order for the services to be considered a tax-free fringe benefit, they must be offered to all classes of employees. However, the IRS provided

in Rev. Rul. 92-69 [1992-2 CB 51] that the level of service afforded the executives can differ greatly from that provided to lower-level employees. To be tax-free, the outplacement services must also meet the requirements of a working condition fringe benefit as outlined in Code Sec. 132.

Qualified Employee Discounts

Employees may exclude from gross income certain discounts received when they purchase their employer's goods and services [Code Sec. 132(c)(4)]. In the audit manual, the IRS warns that the discount is not available to discounts on real property or discounts on personal property of a kind commonly held for investment (such as stocks and bonds) and that special rules must be followed if the employee is highly compensated. The IRS also alerts auditors to abuses that have occurred when former officers are retained on a contractual basis by the corporation upon retirement and continue to receive discounts despite Reg. §1.132-1(b)(1), which does not allow company discounts for directors and independent contractors. In addition, employee discounts must be provided on a nondiscriminatory basis.

Spousal/Dependent Life Insurance

Group term life insurance premiums paid to insure the lives of a spouse or dependent of an executive are included in the gross income of the executive [Reg. §61-21(b)(1)]. Employers' attempts to classify such payments as a *de minimis* fringe benefit have been rejected by the IRS. Note, however, that

premiums paid by the employer for up to \$50,000 of group term life insurance for the employee are not taxable to the employee [Code Sec. 79(a)].

Spouse or Dependent Travel

No deduction is available for travel expenses paid or incurred for a spouse, dependent or other individual accompanying the executive on business travel unless (1) the spouse, dependent or other individual is an employee of the taxpayer, (2) the travel of the spouse, dependent or other individual is for

a *bona fide* business purpose, and (3) such expenses would otherwise be deductible by the spouse, dependent or other individual. The amount will be deductible as a working condition fringe if it can be shown that the spouse's presence has a *bona fide* business purpose. If the spouse's travel is not excludible as a working condition fringe, then the employee must include the value of the spouse's travel in gross income.

For further discussion of fringe benefits, see FTC Chapter 4. ■

TAX CREDITS

IRS Provides Foreign Adoption Safe Harbor

Code Sec. 23 provides that taxpayers may claim an adoption tax credit for qualified adoption expenses paid or incurred by an individual in connection with the adoption of an eligible child. Under Code Sec. 23(d)(2), an eligible child is an individual who has not attained age 18 or who is physically or mentally incapable of caring for himself. Code Sec. 23(d)(1)(C) provides that a stepchild is not an eligible child.

A special timing rule applies when a taxpayer adopts a child who is not a citizen or resident of the United States at the time the adoption proceedings commence. In the case of a foreign adoption, Code Sec. 23(e) provides that (1) the adoption tax credit is allowed only if the adoption becomes final, and (2) qualified adoption expenses paid or incurred in any year

before the year in which the adoption becomes final are treated as paid or incurred in the year in which the adoption becomes final. Rules similar to these apply under Code Sec. 137(e) for purposes of the exclusion for employer-provided adoption assistance.

In Rev. Proc. 2005-31 [IRB 2005-26, 1374], the IRS provides a safe harbor for determining the finality of a foreign adoption for purposes of the adoption expenses credit. This revenue procedure applies to taxpayers who claim the adoption credit or exclusion for qualified adoption expenses paid or incurred in connection with the adoption of a foreign-born child. Rev. Proc. 2005-31 does not apply to the adoption of a child who is a citizen or resident of the United States at the time the adoption process commences.

In an earlier release, Notice 2003-15 [IRB 2003-9, 540], the IRS issued a proposed procedure that established certain safe harbors for determining the finality of the adoption of a foreign-born child who had received an “immediate relative” or IR visa from the State Department.

When Is Foreign Adoption Considered Final?

Rev. Proc. 2005-31 modifies and supercedes Notice 2003-15 by providing that for purposes of the adoption credit and the exclusion for employer-provided assistance for qualified adoption expenses, the IRS will treat an adoption of a foreign-born child as final if:

- a competent authority of a foreign-sending country has entered a decree of adoption with respect to the foreign-born child or has authorized the child to leave the foreign-sending country under a guardianship or legal custody arrangement; and
- the child receives an IR visa from the Department of State.

Finality Safe Harbor for Children Receiving IR2, IR3 or IR4 Visa

The IRS will not challenge a taxpayer’s treatment of the adoption of a child who receives an IR2, IR3 or IR4 (if the child was adopted in a simple adoption) visa as final in:

- the tax year in which the competent authority enters a decree of adoption; or
- the tax year in which a home state court enters a decree of re-adoption or the home state otherwise recognizes the

decree of the foreign-sending country, if that year is one of the next two tax years after the year in which the competent authority enters the decree.

Children Who Receive an IR4 Visa (Guardianship or Legal Custody)

The IRS will not challenge a taxpayer’s treatment of the adoption of a child who was subject to a guardianship or legal custody arrangement and who receives an IR4 visa as final in the tax year in which a home state court enters a decree of adoption.

Key Definitions

- **IR2 visa.** An IR2 visa is a visa issued to a foreign-born child who is not an orphan, who was adopted in the foreign-sending country while under the age of 16 years and who has been in the legal custody of, and has resided with the adoptive parent for at least two years.
- **IR3 visa.** An IR3 visa is a visa issued to an orphan after a full and final adoption of the orphan has occurred in the foreign-sending country. An IR3 visa is issued if (1) the competent authority of the foreign-sending country severs the parental rights of the biological or any previous adoptive parents and establishes a parent-child relationship between the orphan and the adoptive parent or parents, and (2) the adoptive parent or parents see the orphan before or during the adoption proceeding.
- **IR4 visa.** An IR4 visa is a visa issued to an orphan if (1) a simple adoption occurs in the foreign-sending country, or (2)

the competent authority of the foreign-sending country grants legal guardianship or custody either to the prospective adoptive parent or parents or to an individual or agency acting on behalf of the prospective adoptive parent or parents.

- **Re-adoption expenses.** Otherwise qualified expenses paid or incurred in connection with a re-adoption satisfy the requirement that expenses be “reasonable and necessary” for purposes of determining whether the expenses are qualified adoption expenses.
- **Full and final adoption.** An adoption of an orphan in which the competent authority of the foreign-sending country enters a decree of adoption establishing a parent-child relationship under the laws of the foreign-sending country and both adoptive parents (in adoptions by two parents) or the sole adoptive parent (in adoptions by one parent) see the orphan before or during the adoption proceeding.
- **Simple adoption.** An adoption of an orphan in which the competent authority of the foreign-sending country enters a decree of adoption establishing a parent-child relationship under the laws of the foreign-sending country, in which one or both of the adoptive parents do not see the orphan before or during the adoption proceeding.

Rev. Proc. 2005-31 is effective for qualified adoption expenses paid or incurred after June 15, 2005. However, the IRS will not challenge the time of finality of adoptions by taxpayers

who apply this revenue procedure or Notice 2003-15 to qualified adoption expenses paid or incurred on or before June 15, 2005, if the period of limitation has not expired.

Taxpayers may rely on either Notice 2003-15 or newly released Rev. Proc. 2005-31 to determine when the adoption of a foreign-born child is final

for purposes of claiming the adoption expenses credit or the exclusion for employer-provided adoption assistance. Note that this procedure does not apply to adoptions the finality of which are determined by the Intercountry Adoption Act of 2000 or the Hague Convention on Protection of Children and Co-operation in respect of

Intercountry Adoption.

Finally, the procedure clarifies that otherwise qualified expenses paid or incurred in connection with a home state re-adoption are considered ordinary and necessary expenses for purposes of Code Sec. 23.

For further discussion, see *FTC* ¶2404. ■

ESTATE AND TRUST TAXATION

Tax Court Forces Circuit Split by Holding Trust Investment Advice Subject to Two-Percent Floor

In a recent case, *Rudkin Testamentary Trust* [124 TC No. 19, Dec. 56,073 (2005)], the Tax Court concluded that a testamentary trust could not deduct in full the cost of fees incurred for investment management advice. Instead, the fees were subject to the two-percent floor for miscellaneous itemized deductions under Code Sec. 67. The trustee argued that the exception for trusts and estates under Code Sec. 67(e) applied because the costs were required by his fiduciary duties and, therefore, would not have been incurred if the property were held outside the trust. The Tax Court, however, held that the exception only applies to costs that are unique to the administration of a trust and not customarily incurred outside of a trust. The court relied on *Mellon Bank* [CA-FC, 2001-2 USTC ¶50,621, 265 F3d 1275] and *J.H. Scott* [CA-4, 2003-1 USTC ¶50,428, 328 F3d 132] in reaching its decision.

Facts

In 1967, the William L. Rudkin Testamentary Trust was established under the will of Henry A. Rudkin whose family was involved in the founding of Pepperidge Farm, a food products company. Pepperidge Farm was sold to Campbell Soup Company in the 1960s, and the trust was initially funded primarily with proceeds from that sale. The will of Henry A. Rudkin provided that income and principal of the trust should be applied for the benefit of Henry A. Rudkin's son, William L. Rudkin, and the son's spouse, descendants and spouses of descendants. The trustee and other fiduciaries of Henry A. Rudkin's estate had broad authority to manage the property, including the authority to invest and reinvest the funds of the trust in such manner as they may deem advisable and to employ agents, experts and counsel to assist them in connection with the administration and management of the trust funds. The trustee engaged an outside

firm to provide investment management advice and the firm was paid approximately \$22,000 for services rendered in 2000.

Tax Return Treatment

On the Form 1041, *U.S. Income Tax Return for Estates and Trusts*, filed by the Rudkin Testamentary Trust for 2000, the trust reported total income of \$624,816. The Form 1041 also reflected, among other things, a deduction of \$22,241 on line 15a for "Other deductions *not* subject to the 2% floor," further described on an attached statement as "INVESTMENT MANAGEMENT FEES." No deduction was claimed on line 15b for "Allowable miscellaneous itemized deductions subject to the 2% floor."

IRS Challenge

The IRS determined a federal income tax deficiency in the amount of \$4,448 with respect to the deduction in 2000 of investment advisory fees paid by the trust. The IRS took the posi-

tion that the fees are deductible only to the extent that they exceed two percent of the trust's adjusted gross income pursuant to Code Sec. 67(a). The IRS therefore disallowed the deduction of \$22,241 in investment fees and instead permitted a deduction of \$9,780, the amount by which \$22,241 exceeded two percent of the taxpayer's adjusted gross income.

Legal Background

Trustees who lack expertise in money management often seek professional advice to aid them in fulfilling their fiduciary duties and directing the investment of trust assets. Whether or not those trust investment advice fees are fully deductible depends on whether the trust's outside investment expenses are unique to the administration of the trust. If the expenses are normal expenses that would be incurred by any taxpayer, the fees are deductible only to the extent that they exceed two percent of the taxpayer's adjusted gross income (AGI). This dichotomy is established in Code Sec. 67(e), which provides that individuals are allowed to deduct "miscellaneous itemized deductions" only if all such deductions exceed two percent of the taxpayer's AGI [Code Sec. 67(a)]. This is referred to as the "two-percent-of-AGI floor." Two exceptions allow full above-the-line deductions without regard to the two-percent-of-AGI floor as follows:

1. If the claimed expenditures are "paid or incurred in connection with the administration of the estate or trust and which would not have

been incurred if the property were not held in such trust or estate." This exception means that a trust's management expenses will be fully deductible and not subject to the two-percent floor if they are trust-related expenses that are unique to the administration of a trust and would not customarily be incurred outside of the trust context. The language in Code Sec. 67(e)(1) serves as a filter, allowing a full deduction only for trust-related administrative expenses that are unique to the administration of a trust and not customarily incurred outside of the trust context. The focus is not on the relationship between the trust and the costs, but on the type of costs, and whether those costs would have been incurred if the assets were not held in trust.

2. Items deductible under Code Sec. 642(b) (trust/estate personal exemption), Code Sec. 651 (distribution deduction for trusts distributing current income only) and Code Sec. 661 (distribution deduction for estates and trusts accumulating income or distributing corpus).

The first exception listed above has spawned numerous lawsuits regarding the deductibility of a trust's investment advice expenses. In *Scott*, the Fourth Circuit followed the Federal Circuit and held that a trust's deductions for investment advice were subject to the two-percent floor for miscellaneous deductions. This decision, which follows the Federal Circuit in *Mellon Bank*, is at odds

with the Sixth Circuit's decision in *W.J. O'Neill, Jr. Irrevocable Trust* [CA-6, 93-1 USTC ¶50,332, 994 F2d 302]. In *Mellon Bank*, the Court of Appeals for the Federal Circuit decided that investment-advice fees were miscellaneous expenses subject to the two-percent-of-AGI floor because the expenses were commonly incurred outside the administration of trusts and were therefore not unique trust-related expenses.

Court's Analysis and Conclusion

Against this backdrop, the taxpayer contends that the investment management fees in dispute are properly deductible under the exception set forth in Code Sec. 67(e)(1). The trustee maintains that the fees were paid in connection with administration of the trust and would not have been incurred if the property was not held in trust. In reaching this conclusion, the trustee relies largely on the fiduciary duties imposed on trustees. According to the trustee, while an individual may make a voluntary and personal choice to seek investment advice, fiduciary duties render such professional advice a necessary and "involuntary" component of trust administration.

In contrast, the IRS argues that the Code Sec. 67(e)(1) exception does not apply to the expenses at issue. The IRS does not dispute the expenditures were made in connection with the administration of the trust. However, the IRS alleges that because investment advisory fees are commonly incurred by individual investors outside the context of trust administration,

the fees fail to satisfy the requirement that they would not have been incurred if the assets were not held in trust. It is also the IRS's view that neither state law nor the governing trust instrument imposed a legal obligation on the fiduciary to obtain professional investment management services.

The Tax Court noted that there is a split in authority on the issue and that the Second Circuit, to which the appeal of the case would lie, has not yet decided the issue. The Sixth, Fourth and Federal Circuits have addressed the issue. The court agreed with the reasoning applied by the Federal Circuit and Fourth Circuit courts. Both circuits rejected the notion that a trust expense incurred as a result of a fiduciary duty was one that was not subject to the two-percent floor. Such an interpretation, noted the circuit courts, would render the limitation's purpose meaningless. Based on the other courts' interpretation, the Tax Court found that it correctly interpreted the applicability of the two-percent limitation in its 1992 *O'Neill* decision. In that decision, it held that only those costs which are unique to the administration of a trust may be deducted without being subject to the two-percent floor. Therefore, the court in *Rudkin* held that investment advisory fees are not unique to administering the trust and are limited by the floor pursuant to Code Sec. 67(a).

Practice Pointer. Until the oft-contested issue is resolved once and for all in the U.S. Supreme Court or by legislators with some sort of statutory reform, the law

in the state where the trust was created will determine whether the fees paid by a trust for investment advice are deductible in full or subject to the two-percent-of-AGI floor ("the floor"). For example, trusts located in the Sixth Circuit (Kentucky, Michigan, Ohio and Tennessee) must follow the *O'Neill* decision and may deduct the fees in full without regard to the floor. Trusts created in any other states, however, are governed by the decisions in the Court of

Federal Claims and the Fourth Circuit and will have their investment advice deductions limited by the floor. To date, the Second Circuit has not addressed the issue. It remains to be seen what the Second Circuit will say if the taxpayers in *Rudkin* decide to appeal this case to the appellate court. We will keep you posted.

For further discussion, see *FTC ¶3511 and Estate & Gift Tax Handbook ¶915.* ■

WEALTH TRANSFER TAXES

Beneficiary's Disclaimer of IRA Principal Valid

In Rev. Rul. 2005-36 [IRB 2005-26, 1368], the IRS concluded that a beneficiary's disclaimer of an interest in a decedent's individual retirement account (IRA) is a qualified disclaimer under CodeSec.2518 (if all other requirements are satisfied) although the disclaimant received the required minimum distribution (RMD) from the IRA for the year of the decedent's death. A qualified disclaimer may be made with respect to all, or a portion of, the balance of the IRA, except for the income attributable to the RMD. Specifically, a qualified disclaimer can be made if, when the disclaimer is made, the beneficiary entitled to receive the disclaimed amount is paid the disclaimed amount and the income attributable to such amount or the disclaimed amounts is segregated in a separate fund.

Facts

Decedent dies in 2004 and at the time of his death, owns an IRA. Decedent's "required beginning date" occurred prior to

2004, and Decedent was therefore receiving annual distributions from the IRA prior to the time of death. However, at the time of death, Decedent had not received his RMD for 2004.

Situation 1. Under the terms of the IRA beneficiary designation, Decedent's Spouse is the sole beneficiary of the IRA with A, the child of Decedent and Spouse, named the beneficiary in the event Spouse predeceases Decedent. Three months after Decedent's death, the IRA custodian pays Spouse the RMD for 2004. Seven months after Decedent's death, Spouse validly disclaims the entire IRA account balance plus the income earned after the date of death. As a result of the disclaimer, Spouse is treated as predeceasing Decedent with respect to the disclaimed property and A, as successor beneficiary, is paid the amount disclaimed, plus that portion of IRA income earned between the date of death and the date of the disclaimer.

Situation 2. The facts are the same as in Situation 1, except

that, instead of disclaiming the entire IRA balance, Spouse validly disclaims 30 percent of Spouse's interest in the principal and income of the balance of the IRA account remaining after the 2004 RMD and after reduction for the pre-disclaimer income attributable to the RMD. As soon as the disclaimer is made, A is paid 30 percent of the excess of the remaining account balance.

Situation 3. The facts are the same as in Situation 1, except that A is named the sole beneficiary of the IRA after Decedent's death. Spouse is named the beneficiary in the event A predeceases Decedent. The 2004 RMD is paid to A three months after Decedent's death. Seven months after Decedent's death, A disclaims the entire remaining balance of the IRA account except for the income attributable to the RMD. As soon as the disclaimer is made, the balance of the IRA account is distributed to Spouse as successor beneficiary.

Background

Under Code Sec. 2518(a), if a person makes a qualified disclaimer with respect to any interest in property, then for estate, gift and generation-skipping transfer tax purposes, the disclaimed interest will be treated as if the interest had never been transferred to the disclaimant. Instead, the interest will be considered as having passed directly from the decedent to the person entitled to receive the property as a result of the disclaimer. The term "qualified disclaimer" means an irrevocable and unqualified refusal by a person to accept an interest in property, but only if:

- the refusal is in writing;
- the writing is received by the transferor of the interest, his or her legal representative, or the holder of the legal title to the property to which the interest relates, no later than nine months after the later of (1) the date on which the transfer creating the interest in the person is made, or (2) the day on which the person attains the age of 21;
- the person has not accepted the interest or any of its benefits; and
- as a result of the refusal, the interest passes without any direction on the part of the person making the disclaimer and passes either (1) to the spouse of the decedent, or (2) to a person other than the person making the disclaimer.

A qualified disclaimer cannot be made with respect to an interest in property if the disclaimant has accepted the interest or any of its benefits, expressly or impliedly, prior to making the disclaimer [Reg. §25.2518-2(d)(1)]. Acceptance is manifested by an affirmative act that is consistent with ownership of the interest in the property. Acts indicative of acceptance include using the property or the interest in the property; accepting dividends, interest or rents from the property; and directing others to act with respect to the property or interest in the property. However, a disclaimant is not considered to have accepted the property merely because, under applicable local law, title to the property vests immediately on the decedent's death in the disclaimant.

Reg. §25.2518-3 provides rules regarding the circumstances

under which an individual may make a qualified disclaimer of less than the individual's entire interest in property and may accept the balance of the property. Reg. §25.2518-3(b) provides that a disclaimer of an undivided portion of a separate interest in property that meets the other requirements of a qualified disclaimer is a qualified disclaimer. Under the regulations, each interest in property that is separately created by the transferor is treated as a separate interest in property. An undivided portion of a disclaimant's separate interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the disclaimant in the property and must extend over the entire term of the disclaimant's interest in the property and in other property into which the property is converted.

IRS Analysis and Conclusion

The IRS concluded in Rev. Rul. 2005-36, that a beneficiary's disclaimer of an interest in a decedent's IRA is a qualified disclaimer under Code Sec. 2518 (if all other requirements are satisfied) even though the disclaimant received the RMD from the IRA for the year of the decedent's death. A qualified disclaimer may be made with respect to all, or a portion of, the balance of the IRA, except for the income attributable to the RMD. Specifically, a qualified disclaimer can be made if, when the disclaimer is made, the beneficiary entitled to receive the disclaimed amount is paid the disclaimed amount and the income attributable to such amount or the disclaimed amounts are segregated in a separate fund.

In the three similar factual situations, the decedent died prior to receiving the year-of-death RMD, which was paid to the disclaimant and then the IRA balance was disclaimed in whole or in part and paid to the beneficiary designated if the disclaimant predeceased the decedent. In accordance with Reg. §25.2518-3(c), because the disclaimant received the RMD before the disclaimer, that distribution is treated as coming from the principal of the IRA. The disclaimant's receipt of the RMD does not prevent a disclaimer of the remaining balance of the

IRA if no benefit from the disclaimed amount is accepted by the disclaimant before or after the disclaimer. Thus, the income attributable to the RMD cannot be disclaimed. Consequently, despite receiving the RMD for the year of the decedent's death, the disclaimant is not precluded from disclaiming the remaining IRA balance, in whole or in part, except for the income attributable to the RMD.

Therefore, in Situation 1, Spouse's disclaimer constitutes a qualified disclaimer. In Situation 2, Spouse's disclaimer of 30 percent of Spouse's entire

interest in the principal and income of the balance of the IRA account remaining after the 2004 RMD and after reduction for the pre-disclaimer income attributable to that amount, constitutes a qualified disclaimer to the extent of the remaining IRA account balance after reduction for the of income. In Situation 3, A's disclaimer of the entire principal and income balance of the IRA remaining after the payment of the 2004 RMD constitutes a qualified disclaimer.

For further discussion, see FTC ¶3935. ■

INDIVIDUAL TAXPAYER DEDUCTIONS

Toyota Highlander Hybrid Certified for Clean-Fuel Deduction

The IRS has announced that the 2006 Toyota Highlander Hybrid is eligible for the clean-burning fuel deduction. As a result, individuals who buy the hybrid vehicle during 2005 may claim up to a \$2,000 deduction on Form 1040. Under the Working Families Tax Relief Act of 2004 [P.L. 108-311], the clean-burning fuel deduction is limited to up to \$2,000 for certified vehicles first put into service in 2005 and \$500 for vehicles placed in service in 2006. No deduction will be allowed after 2006.

Federal law allows individuals to claim a deduction for the incremental cost of buying a motor vehicle that is propelled by a clean-burning fuel. By combining an electric motor with a gasoline-powered

engine, these hybrid vehicles obtain greater fuel efficiency and produce fewer emissions than similar vehicles powered solely by conventional gasoline-powered engines.

This one-time deduction may only be claimed in the year that the vehicle is originally put in service for either personal or business use. The taxpayer claiming the deduction must be the original owner of the car. Individuals need not itemize deductions on Form 1040 to claim this deduction because the benefit is claimed as an adjustment to income on Form 1040.

Planning Pointer.

Taxpayers should purchase their 2006 Toyota Highlander Hybrid vehicles prior to December 31, 2005, because taxpayers may claim a clean-burning fuel deduction of up to \$2,000 for certified

vehicles first put into service in 2005. The deduction is worth only \$500 for vehicles placed in service in 2006 and no deduction is allowed after 2006.

The IRS has certified the following additional vehicles for the clean-burning fuel deduction:

- Lexus RX 400h—Model Year 2006
- Ford Escape Hybrid—Model Year 2005
- Toyota Prius—Model Years 2001–2005
- Honda Insight—Model Years 2000–2005
- Honda Civic Hybrid—Model Years 2003–2005
- Honda Accord Hybrid—Model Year 2005

For further discussion, see FTC ¶1949. ■

Easement Donations Were Qualified Conservation Contributions

In *C.F. Glass* [124 TC No. 16, Dec. 56,037 (2005)], the Tax Court held that a couple's charitable contributions of conservation easements on undeveloped lakefront property to a nonprofit nature conservancy were qualified conservation contributions under Code Sec. 170(h)(1) because the contributions satisfied the "conservation purposes test" of Code Sec. 170(h)(4). Under the test, the couple must have a conservation purpose for their contribution. The court found that Reg. §1.170A-14(d)(3)(i), which contemplates contributions "to protect a significant relatively natural habitat in which a fish, wildlife, or plant community, or similar ecosystem, normally lives," was satisfied because the couple presented credible evidence that the donated easement would protect and preserve the bald eagles' habitat and communities of threatened plant species on the land.

The court also concluded that the couple's contributions satisfied the "exclusively for conservation purposes" requirement of Code Sec. 170(h)(5) because the couple gratuitously surrendered their property rights in perpetuity to the organization.

Facts

The taxpayers own approximately 10 acres of land that includes a high undeveloped bluff on 460 feet of shoreline. The bluff is home to both bald eagles and endangered plant species including the Lake Huron tansy and

pitcher's thistle. The taxpayers contributed two conservation easements covering two stretches of the Lake Michigan shoreline bluff owned by the couple in perpetuity to the Lake Traverse Conservancy (LTC) trust. Each easement was contributed to restrict development along the bluff and protect its natural state, and each was accompanied by a small cash contribution to the trust. The easements effectively preclude them or any subsequent owner of the property from ever developing or disturbing the natural state of much of the bluff. The LTC is a tax-exempt, nonprofit organization, dedicated to preserving land and wilderness in northern Michigan for conservation as well as recreational and educational purposes.

Tax Return Position

On their federal income tax returns, the taxpayers deducted the value of the donated easements claiming that the contributions were qualified conservation contributions under Code Sec. 170(h)(1).

IRS Challenge

The IRS challenged the deductions, claiming that the conservation easements were not qualified conservation contributions under Code Sec. 170(h)(1) because they were not "exclusively for conservation purposes."

Legal Background

A taxpayer may claim a charitable deduction for a contribution

of a partial interest in real property if it is a "qualified conservation contribution." To qualify for the deduction, the taxpayer must prove that:

- the real property contributed is a "qualified real property interest,"
- the contributee is a "qualified organization," and
- the contribution is "exclusively for conservation purposes" [Code Sec. 170(h)(1); Reg. §1.170A-14(a)].

As to the first of the three requirements, an interest in real property is a "qualified real property interest" if the interest is the donor's entire interest in that real property (other than a qualified mineral interest), a remainder interest or a restriction granted in perpetuity on the use which may be made of the real property [Code Sec. 170(h)(2)]. A restriction granted in perpetuity on the use which may be made of the real property must be legally enforceable to limit any use of the real property that is inconsistent with the conservation purpose of the contribution. This requirement may be met by recording the restriction in the land records of the jurisdiction in which the real property is located [Reg. §1.170A-14(g)(1)].

As to the second of the three requirements, a contributee is a "qualified organization" if the organization is committed to protecting the conservation pur-

poses of the contribution and has the resources necessary to enforce the restrictions granted in perpetuity [Reg. §1.170A-14(c)(1)].

As to the third of the three requirements, which is the one at issue in this case, a contribution is made exclusively for conservation purposes if it:

- preserves land for outdoor recreation by, or the education of, the general public;
- protects a relatively natural habitat of fish, wildlife or plants, or similar ecosystem;
- preserves open space for the scenic enjoyment of the general public or pursuant to a federal, state or local governmental conservation policy, and this preservation will yield a significant public benefit; or
- preserves a historically important land area or a certified historic structure [Code Sec. 170(h)(4)(A); *see also* Reg. §1.170A-14(d)(1)].

Under the statute, each of these four prongs is a conservation purpose in and of itself, and a taxpayer's satisfaction of one of these prongs suffices to establish the requisite conservation purpose. Code Sec. 170(h)(5)(A) generally provides that a contribution of a qualified real property interest may be exclusively for conservation purposes only if it is protected in perpetuity.

The IRS concedes that the taxpayers in this case have satisfied the first and second requirements in this case. Therefore, the conservation easements are "qualified real property interests" and the contributee is a "qualified organization" under Code Sec. 170(h)(3).

As to the third requirement, the IRS challenges the taxpayers' assertion that the conservation easements protect a relatively natural habitat of wildlife or plants for purposes of Code Sec. 170(h)(4)(A)(ii). The IRS also challenges the taxpayers' assertion that the conservation easements preserve open space in the manner required by Code Sec. 170(h)(4)(A)(iii). The taxpayers will prevail on this issue if (1) they establish either of those conservation purposes as to the contributions, and (2) they meet the requirement in Code Sec. 170(h)(5) that the contributions be exclusively for at least one of those conservation purposes.

As to the first assertion, Reg. §1.170A-14(d)(3)(i) provides that a qualified real property interest will meet the conservation purposes test, and thus satisfy the third requirement, if that interest is contributed "to protect a significant relatively natural habitat in which a fish, wildlife or plant community, or similar ecosystem, normally lives. For this purpose, Reg. §1.170A-14(d)(3)(ii) lists as examples of significant habitats and ecosystems:

- Habitats for rare, endangered or threatened species of animals, fish or plants
- Natural areas that represent high quality examples of a terrestrial or aquatic community, such as islands that are undeveloped or not intensely developed where the coastal ecosystem is relatively intact
- Natural areas that are included in, or that contribute to, the ecological viability of a local, state or national park, nature preserve, wildlife ref-

uge, wilderness area or other similar conservation area

Reg. §1.170A-14(d)(3)(iii) explains that a contribution of a qualified real property interest that meets this significant habitat or ecosystem test is deductible even if the public's right to access that property is restricted. A contribution is "considered to be made for conservation purposes if it will operate to protect or enhance the viability of an area or environment in which a fish, wildlife, or plant community normally lives or occurs."

The Tax Court concluded that both Lake Huron tansy and pitcher's thistle were threatened species worthy of special attention toward the goal of preservation and that LTC, the largest membership-supported nonprofit organization in northern Michigan, agreed through the conservation easements to preserve those species by giving them that special attention.

The encumbered shoreline fits those definitions of "habitat" and "community." In its natural undeveloped state, it is a "relatively natural habitat" for a community of Lake Huron tansy, of pitcher's thistle and of bald eagles, among other species of plants and wildlife. Each of the conservation easements will therefore protect and preserve significant natural habitats by limiting the development or use of the encumbered shoreline. The Tax Court was convinced that the taxpayers' contributions of the conservation easements operate to protect or enhance the viability of an area or environment in which a wildlife community and a plant community normally live

or occur. Both portions of encumbered shoreline also have natural values that make them possible places to create or promote the habitat of Lake Huron tansy as well as the habitat of bald eagles. The court held that the taxpayers proved that their contributions of the conservation easements were for a conservation purpose under Code Sec. 170(h)(4), specifically, Code Sec. 170(h)(4)(A)(ii).

The court then turned to the question of whether the contributions satisfied the “exclusively for conservation purposes” requirement of Code Sec. 170(h)(5). The court read that term to place a focus on the contributee’s holding of a qualified real property interest and, more specifically, to require that the contributee hold such an interest in perpetuity exclusively for one or more of the conservation purposes listed in Code Sec. 170(h)(4). The Tax Court concluded that the taxpayers’ contributions satisfied

the “exclusively for conservation purposes” requirement of Code Sec. 170(h)(5) because LTC was a legitimate, longstanding nature conservancy dealing at arm’s length with the taxpayers, and agreed (and had the commitment and financial resources) to enforce the preservation-related restrictions. LTC’s holding of the conservation easements also was directly related to its tax-exempt purposes. The court noted that the taxpayers gratuitously surrendered valuable property rights in the encumbered shoreline, that those restrictions were legally enforceable to limit in perpetuity any inconsistent use of the encumbered shoreline, and that any subsequent holder of the conservation easements must be an entity fully committed to carrying out the contributions’ charitable purposes.

The court concluded that the taxpayers’ contributions of the conservation easements were

qualified conservation contributions under Code Sec. 170(h)(1) because they protected a relatively natural habitat of wildlife and plants and were exclusively for conservation purposes.

Practice Pointer. The IRS has targeted the contribution of conservation easements as an area frequently abused by creative taxpayers. Consequently, the IRS frequently employs aggressive tactics and untenable arguments when auditing returns where this deduction appears. Environmental lovers should rejoice over the taxpayer’s victory in this case, which clearly sends a message to the IRS. The Tax Court intends to preserve Congressional intent exhibited in Code Sec. 170(h), which was enacted to encourage preservation of our country’s natural resources through the contribution of conservation easements.

For further discussion, see FTC ¶1918. ■

Tax Calendar: August 2005

August 1

- **Social Security, Medicare and withheld income tax.** File Form 941 for the second quarter of 2005. Deposit any undeposited tax (if tax liability is less than \$2,500, pay it in full with a timely filed return). If the tax for the quarter is deposited in full and on time, file the return by August 10 to file the return [sense?].
- **Federal unemployment tax.** Deposit the tax owed through June if more than \$500.
- **All employers.** Employers who maintain an employee benefit plan, such as a pension, profit-sharing or stock bonus plan, file Form 5500 or 5500-EZ for calendar year 2004. Fiscal year plans must file by the last day of the seventh month after the close of the plan year.
- **Form 720 taxes.** File Form 720 for the second quarter of 2005. Attach Form 6627 to Form

720 to report ozone-depleting chemicals’ floor stocks tax.

- **Wagering tax.** File Form 730 and pay the tax on wagers accepted during June.
- **Heavy highway vehicle use tax.** File Form 2290 or Form 2290-EZ and pay the tax for vehicles first used in June.

August 10

- **Employees who work for tips.** Employees who work for tips and received \$20 or more in tips in July must report tip income to employer on Form 4070.
- **Social Security, Medicare and withheld income tax.** File Form 941 for the second quarter of 2005. This due date applies only if you deposited the tax for the quarter in full and on time.

- **Communications and air transportation taxes under the alternative method.** Deposit the tax included in amounts billed or tickets sold during the first 15 days of July.

August 12

- **Regular method taxes.** Deposit the tax for the last 16 days of July.

August 15

- **Individuals.** Last day for individual taxpayers to file a 2004 federal income tax return on Form 1040, 1040A or 1040EZ and pay any tax, interest and penalties due if the calendar-year individual obtained an automatic four-month filing extension. Last day to file Form 2688 to request an additional two-month extension.
- **Social Security, Medicare and withheld income tax.** If the monthly deposit rule applies, deposit the tax for payments in July.

- **Nonpayroll withholding.** If the monthly deposit rule applies, deposit the tax for payments in July.

August 25

- **Communications and air transportation taxes under the alternative method.** Deposit the tax included in amounts billed or tickets sold during the last 16 days of July.

August 29

- **Regular method taxes.** Deposit the tax for the first 15 days of August.

August 31

- **Heavy highway vehicle use tax.** File Form 2290 or Form 2290-EZ and pay the tax (or the first installment) for vehicles first used in July.
- **Wagering tax.** File Form 730 and pay the tax on wagers accepted during July.

For the complete tax calendar, see FTC ¶301. ■

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