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Working Families Tax Relief Act of 2004: Summary of Selected Provisions

— by Neil E. Harl* and Roger A. McEowen**

On October 4, 2004, the President signed H.R. 1308, *The Working Families Tax Relief Act of* 2004, into law. **Pub. L. No. 108-311, 108th Cong., 2d Sess. (2004).** This legislation has also come to be known as the "tax extenders" bill. **See H.R. Rep. No. 108-696, 108th Cong., 2d Sess. (2004).**

Child tax credit

The legislation extends the $1,000 child tax credit through December 31, 2009. **Act Sec. 101(a), amending I.R.C. § 24(a).** The credit was scheduled to drop to $700 in 2005-2008 and $800 in 2009, reverting to $500 after 2010 under the "sunset" provisions of The Economic Growth and Tax Relief Reconciliation Act of 2001. **Pub. L. No. 107-16, Sec. 901.** The bill also accelerates to 2004 the increase in the refundability of the child tax credit to 15 percent of the taxpayer's earned income in excess of $10,750 (with indexing) as discussed below. **Act Sec. 102, amending I.R.C. § 24(d)(1)(B)(i).**

Marriage penalty relief

The Act specifies that the basic standard deduction is to be 200 percent of the dollar amount in effect for single returns for 2005 through 2010 for those filing joint returns and surviving spouses ($4400 in the case of a head of household and $3,000 in any other case). **Act Sec. 101(b), amending I.R.C. § 63(c)(2).**

Moreover, the legislation eliminates the marriage penalty in the 15 percent bracket beginning in 2004. The size of the 15 percent tax bracket is increased to twice the size of the corresponding rate bracket for single returns. Therefore, the size of the 15 percent rate bracket for joint returns is twice the size of the corresponding rate bracket for single returns for taxable years 2004-2010. The provision is one of several subject to the JGTRRA "sunset" provision after 2010. **Act Sec. 101(c), amending I.R.C. § 1(f)(8).**

The provision is effective for taxable years beginning after December 31, 2003. **Act Sec. 101(c), amending I.R.C. § 1(f)(8).**

Ten percent tax bracket

The 2004 legislation continues the 10 percent tax bracket with the initial bracket amount set at $14,000 for 2004 and later years through 2010 for joint return filers ($7,000 for single individuals, $10,000 for heads of households). **Act Sec. 101(d), amending I.R.C. § 1(i)(1)(B)(i).**

Refundability of child tax credit

The Act amends the Code by striking "(10 percent in the case of taxable years before

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January 1, 2005)" which leaves the amount by which the aggregate amount of credits allowed would increase in 2004 and later years if the limitation were increased by the greater of 15 percent of so much of the taxpayer's earned income as exceeds $10,000 or, in the case of a taxpayer with three or more qualifying children, the excess (if any) of the taxpayer's social security taxes over the earned income credit. **Act Sec. 102, amending I.R.C. § 24(d)(1)(B)(i).**

The provision relating to refundability of the child tax credit is effective for taxable years beginning after December 31, 2003. **Act Sec. 102(b).**

Alternative minimum tax relief

Effective through 2005, the Act continues the alternative minimum tax exemption amount of $58,000 for those filing a joint return or surviving spouses and $40,250 for others. **Act Sec. 103(a), amending I.R.C. § 55(d)(1)(A), (B).**

"Earned income" includes combat pay

The legislation includes combat zone compensation in earned income for purposes of the earned income credit. **Act Sec. 104(b), amending I.R.C. § 32(c)(2)(B).** The earned income credit election is effective for taxable years ending after the date of enactment and before January 1, 2006. **Act Sec. 104(b), (c).**

The 2004 legislation makes a similar change in the rules for refundability of the child tax credit. Combat pay otherwise excluded under I.R.C. § 112 is treated as earned income which is taken into account in computing taxable income for purposes of figuring the refundable portion of the child credit. **Act Sec. 104(a), amending I.R.C. § 24(d)(1).** The provision relating to refundability of the child tax credit is effective for taxable years beginning after December 31, 2003. **Act Sec. 102(b).**

Uniform definition of "child"

The 2004 Act establishes a uniform definition of "child" for purposes of the dependency exemption, the child tax credit, the earned income credit, the dependent care credit and head-of-household filing status.

First, the statute makes dependents ineligible to have dependents and provides that an individual is not treated as a dependent of a taxpayer if the individual has made a joint return with the individual's spouse. Moreover, the term "dependent" does not include an individual who is not a citizen or national of the United States unless the individual is a resident of the United States or a country contiguous to the United States (Canada or Mexico). **Act Sec. 201, amending I.R.C. § 152.**

A "qualifying child" is defined as an individual who–

- Bears a relationship to the taxpayer as a child of the taxpayer or a descendant of such a child or a brother, sister, stepbrother or stepsister of the taxpayer or of any such relative;
- Has the same principal place of abode as the taxpayer for more than one-half of the taxable year;
- Meets the age requirements (has not attained the age of 19 as of the close of the calendar year in which the taxable year of the taxpayer begins, is a student who has not attained the age of 24 as of the close of the calendar year or is permanently and totally disabled of any age), and
- Who has not provided over one-half of the individual's own support for the calendar year in which the taxable year of the taxpayer begins. **Act Sec. 201, amending I.R.C. § 152.**

Where two or more taxpayers claim a qualifying child, the individual is to be treated as the qualifying child of the taxpayer who is-

- A parent of the individual, or
- The taxpayer (who is not a parent) with the highest adjusted gross income for the taxable year. **Act Sec. 201, amending I.R.C. § 152(c)(4)(A).**

If more than one parent claims a child, and the parents do not file a joint return, the child is treated as the qualifying child of the parent with whom the child resided for the longest period of time during the taxable year or, if the child resides with both parents for the same amount of time during the taxable year, the parent with the highest adjusted gross income. **Act Sec. 201, amending I.R.C. § 152(c)(4)(B).**

"Qualifying relative"

The term "qualifying relative" means, under the Act, an individual who is any of the following with respect to the taxpayer–

- A child or descendant of a child,
- A brother, sister, stepbrother or stepsister,
- Father, mother or ancestor of either,
- Stepfather or stepmother,
- Son or daughter of a brother or sister of the taxpayer,
- Brother or sister of the father or mother of the taxpayer,
- Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law,
- An individual (other than a spouse) who has the same principal place of abode as the taxpayer and is a member of the taxpayer's household during the taxable year.

A qualifying relative must also-

- Have gross income for the calendar year in which the taxable year begins of less than the exemption amount (generally $2000).
- Be receiving over one-half of the individual's support from the taxpayer for the calendar year in which the taxable year begins (over one-half of the support is treated as received from the taxpayer if no one person contributed over one-half of the support, over one-half of the support was received from two or more persons, each of whom but for the fact that any such person did not alone contribute over one-half of the support, would have been entitled to claim the individual as a dependent, the taxpayer contributed over 10 percent of the support and each person contributing more than 10 percent of the support files a written declaration that the person will not claim the individual as a dependent), and
- Not be a qualifying child of the taxpayer or of any other taxpayer for any taxable year beginning in the calendar year in which the taxable year begins. **Act Sec. 201, amending I.R.C. § 152(d).**

For divorced parents, if a child receives more than one-half of the child's support during the calendar from the child's parents who are divorced or legally separated under a decree of divorce or separate maintenance, who are separated under a written separation agreement or who live apart at all times during the last six months of the calendar year, and the child is in the custody of one or both of the child's parents for more than one-half of the year, the child is treated as being the qualifying child (or qualifying relative) of the non custodial parent for a calendar year if specified requirements are met. Those requirements are met if a decree of divorce or separate maintenance or written separation agreement between the parents provides that the non custodial parent is entitled to a dependency deduction for a personal exemption, or the custodial parent will sign a written declaration that such parent will not claim the child as a dependent, or the non custodial parent provides at least $600 for the support of the child during the calendar year. **Act Sec. 201, amending I.R.C. § 152(e).**

Research credit

The Act extends the research tax credit through the end of the calendar year 2005. **Act Sec. 301(a), amending I.R.C. § 41(h)(1)(B).** The amendment applies to amounts paid or incurred after June 30, 2004.

Work opportunity credit and welfare-to-work credit

The Act extends the work opportunity and welfare-to-work credits to the end of calendar year 2005. **Act Sec. 303(a), amending I.R.C. § 51(c)(4).** The amendment applies to individuals who begin work for the employer after December 31, 2003. **Act Sec. 303(b).**

School teacher expenses

The Act extends the deduction (of up to $250) for expenses incurred by a K-12 school teacher for materials used in the classroom through 2005. **Act Sec. 307(a), amending I.R.C. § 62(a)(2)(D).**

Electricity from alternative means

The 2004 legislation extends tax credits (at a rate of 1.8 cents per kilowatt hour) for producing electricity from alternative means, such as wind and biomass, through the end of calendar year 2005. **Act Sec. 313, amending I.R.C. § 45(c)(3).** The amendment applies to facilities placed in service after December 31, 2003. **Act Sec. 313(b).**

Nonrefundable personal credit allowed against alternative minimum tax liability

The Act allows nonrefundable personal credits to offset alternative minimum tax in tax years 2004 and 2005. **Act Sec. 312(a), amending I.R.C. § 26(a)(2).**

Phase-out of credit for qualified electric vehicles

The 2004 legislation eliminates the phase-out of credit for qualified electric vehicles for 2004 and 2005. Thus, the credit will not be reduced by 75 percent until 2006. **Act Sec. 318(a), amending I.R.C. § 30(b)(2).** The amendment applies to eligible vehicles placed in service after December 31, 2003. **Act Sec. 318(b).**

The Act also eliminates the phase-out for clean-fuel vehicle property for 2004 and 2005. For otherwise eligible vehicles placed in service after 2005, the limit allowable is reduced by 75 percent. **Act Sec. 319(a), amending I.R.C. § 179A(b)(1).**

Environmental remediation costs

The Act extends through 2005 the deduction of “qualified environmental expenditures.” **Act Sec. 308, amending I.R.C. § 198(h).**

Disclosures relating to terrorist activities

In what has become a controversial provision in tax circles, the Act allows the disclosure of taxpayer identity to law enforcement agencies investigating terrorism. **Act Sec. 320, amending I.R.C. §§ 6103(i)(3)(C)(iv), 6103(i)(7)(E) (effective on date of enactment).**

Capital gains and AMT

In a technical correction to the 1997 Act, the maximum amount of adjusted net capital gain eligible for the 5 percent rate under AMT under the correction is the excess of the maximum amount of taxable income that may be taxed at a rate less than 25 percent under the regular tax (for example $56,800 for a joint return in 2003) over the taxable income reduced by the adjusted net capital gain. **Act Sec. 406(d), effective as if included in the 97 Act. Act Sec. 406(h)**.

The Conference Committee Report, H.R. Rep. No. 108-696, 108th Cong., 2d Sess. (2004), provides an example —

For example, assume that a married couple with no dependents in 2003 has $32,100 of salary,$82,000 of long-term capital gain from the sale of stock, $73,000 of itemized deductions consisting entirely of state and local taxes and allowable miscellaneous itemized deductions. For purposes of the regular tax, the taxable income is $35,000 ($32,100 plus $82,000 minus $73,000 minus $6,100 deduction for personal exemptions). For purposes of the alternative minimum tax, the taxable excess is $56,100 ($32,100 plus $82,000 less the $58,000 exemption amount).

Under the law before the amendment, the amount taxed under the regular tax at 5 percent is $35,000 (the lesser of (i) taxable income ($35,000), (ii) adjusted net capital gain ($82,000), or (iii) the excess of the maximum taxed at the 10 and 15 percent rates ($56,800 in 2003) over the ordinary taxable income (zero)) The regular tax would be $1,750. Under the law before the amendment, $35,000 is taxed at 5 percent in computing the alternative minimum tax (the lesser of (i) the amount of adjusted net capital gain which is taxed at 5 percent under the regular tax ($35,000) or (ii) the taxable excess ($56,100)). The remaining $21,100 of taxable excess would be taxed at 15 percent, for a total minimum tax of $4,915.

Under the provision, in computing the alternative minimum tax, $56,100 is taxed at 5 percent (the lesser of (i) the taxable excess ($56,100), (ii) the adjusted net capital gain ($82,000), or (iii) the excess of the maximum amount taxed at the 10 and 15 percent rates under the regular tax ($56,800) over the ordinary taxable income (zero)). The tentative minimum tax under the amendment would be $2,805.

BANKRUPTCY

GENERAL

EXEMPTIONS.

TOOLS OF THE TRADE. Prior to filing for bankruptcy, the debtors, husband and wife, raised game birds for sale as part of their farming operation. The debtor were forced to sell all the birds prior to filing for bankruptcy but intended to restart the business after bankruptcy. The debtors filed for Chapter 13 and claimed farm equipment, including equipment used in raising the birds, as exempt under the Kansas tools of the trade exemption, Kan. Stat. § 60-2304(e). The court found that, although the debtors earned more money from nonfarm employment, the farm operation was a business for federal income tax purposes and operated with the intent to make a profit. The debtors' Schedule F did show a small profit from the bird sales, although the other farm operations showed a loss in the previous and current tax years. The court discussed the holding in *Jenkins v. McNall, 27 Kan. 532 (1882)*, that the exemption was restricted to tools in the debtor's principal business and could not be spread among several businesses. The court rejected this restriction because it was not expressly provided by the exemption statute and because the spreading of the exemption among several businesses was still limited by the maximum exemption amount of $7,500. Thus, the court held that the debtor would be allowed the tools of the trade exemption for the farm equipment and the bird raising equipment up to the exemption amount. ***In re*** **Thompson, 311 B.R. 822 (D. Kan. 2004)**.

FEDERAL TAX

DISCHARGE. The debtor failed to file and to pay income taxes for 1992 through 1996 and the IRS made assessments based on substitute returns for those tax years. In 1999 the debtor filed returns for all the years and, based on those returns, the IRS abated some of the taxes and interest previously assessed. The debtor sought the discharge of the remaining taxes because the returns for the taxes were filed more than three years before the bankruptcy filing. The IRS argued that the debtor's returns did not qualify as returns for purposes of Section 523 because the returns were filed after the IRS constructed substitute returns and made assessments. The court disagreed with the IRS that the mere filing of returns after the construction of substitute returns was sufficient to render the taxes nondischargeable. The court noted that the IRS had accepted the debtor's returns and changed the taxes and interest owed based on those returns. The court held that the taxes were dischargeable. **Colson v. United States, 311 B.R. 765 (Bankr. N.D. Iowa 2004)**.

The debtors had filed four almost successive bankruptcy filings which left the IRS with only seven months between the cases in which to assess the taxes owed from pre-bankruptcy tax years. The debtors sought the discharge of those taxes because the taxes were due more than three years before the current bankruptcy filing. The IRS argued that the intervening bankruptcy filing tolled the three year period of Section 507(a)(8)(A)(i) so that much of the three years remained at the time of the current bankruptcy filing. The court, against much acknowledged precedent, ruled that I.R.C. § 108(c) had no express provision for the tolling of the three year period by previous bankruptcy filings. However, the court ruled that equitable principles could allow for tolling of the period and allowed the parties additional time to gather evidence and arguments on the issue of whether equitable principles favored tolling the three year period as to the debtors. ***In re*** **Tarullo, 312 B.R. 209 (Bankr. N.D. N.Y. 2004)**.

The debtors, husband and wife, operated a farm from 1953 to 1999 on land purchased from the husband's parents. The debtors transferred one parcel to the wife. In 1999 when the debtors experienced financial difficulties, the wife transferred her parcel back to the husband and the husband transferred the 10 acre homestead parcel to the wife in exchange. The husband then sold the farmland at auction and paid most of the loans for the farm operation. The homestead portion of the loan was refinanced. The debtors continued their farming operation using land leased from third parties. In order to shield the wife from liability for the capital gains from the sale of the farmland, the debtors filed their federal income tax return using the status "married filing separately." All of these arrangements were made with the advice of lawyers and accountants with the intent to protect the homestead from liability for the taxes on the land sale. The taxes remained owing at the time of the bankruptcy filing, more than three years after the taxes were due. The IRS sought to have the taxes declared nondischargeable under two bankruptcy provisions- (1) Section 727(a)(2)(A) for intent to defraud a creditor within one year before the bankruptcy filing, and (2) Section 523(a)(1)(C) for a fraudulent return or attempt to evade payment of tax. The court held that Section 727(a)(2)(A) did not apply because the transfers occurred more than one year before the bankruptcy filing. The court acknowledged that concealment of assets can be a continuing action, but noted that, although title was transferred to the wife, the husband continued to live and work on the property and had several equitable interests in the property as spouse of the title holder. The court also held that Section 523(a)(1)(C) did not apply because the debtors made the transfers with the intent to save the homestead and reasonably relied on the advice of professionals to structure their transfer and file their returns to accomplish that intent. The court noted that the debtors did not have any equity in the homestead, even after the transfer, the debtors paid more for the homestead than it was worth, but the debtors were able to maintain a homestead of sufficient size to continue their farming operation, none of which would have been possible if the debtors had sold all of the land at the auction and filed a joint tax return. The court held that the taxes were dischargeable. ***In re*** **Petersen, 312 B.R. 385 (Bankr. N.D. Iowa 2004)**.

FEDERAL AGRICULTURAL PROGRAMS

KARNAL BUNT. The APHIS has adopted as final regulations removing Arizona and Texas from the list of regulated areas because of Karnal bunt disease in wheat. **69 Fed. Reg. 57632 (Sept. 27, 2004)**.

SUGAR. The CCC has announced the establishment and adjustments to the sugar overall allotment quantity for the 2003 crop year (FY 2004), which runs from October 1, 2003 through September 30, 2004. CCC set the 2003 crop overall allotment quantity (OAQ) of domestic sugar to 8.550 million short tons raw value (STRV) on August 13, 2003. On September 30, 2003, CCC allocated only 96.5 percent of this amount, resulting in a beet sugar sector allotment of 4.484 million STRV and a cane sugar sector allotment of 3.766 million STRV. At that time, CCC also announced the allotments to cane-producing states and allocations to cane and beet sugar processors and set the proportionate share requirement on Louisiana cane sugar producers for the 2003 crop at 84.2 percent. On April 9, 2004, CCC officially reduced the OAQ to 8.250 million STRV. **69 Fed. Reg. 58121 (Sept. 29, 2004)**.

FEDERAL ESTATE AND GIFT TAXATION

ALTERNATE VALUATION DATE. The decedent's executor hired an attorney to prepare the estate's Form 706 and the attorney erroneously determined that the estate was not eligible for the election to value estate property on the alternate valuation date. Upon review of the Form 706, the attorney determined that the election was available and filed within one year after the original Form 706 a supplemental Form 706 with the valuation of estate property reduced to its value on the alternate valuation date. The estate sought an extension of time to file the election. The IRS granted the extension. **Ltr. Rul. 200438014, May 25, 2004**.

MARITAL DEDUCTION. The decedent and spouse had created an intervivos revocable trust. On the decedent's death, the decedent's interest in the trust passed to a marital trust for the benefit of the spouse, with a remainder to a charity. The decedent's estate made a QTIP election for the marital trust. The spouse sought a judicial split of the trust under the same terms as the original trust and assigned all interest in one of the split trusts to the charity. The IRS ruled that the split of the marital trust did not affect the QTIP election, the assignment of the trust to the charity was a taxable gift and the assignment was eligible for the charitable deduction. **Ltr. Rul. 200438028, May 12, 2004**.

PENALTIES. The decedent died in 1998 and the main beneficiary of the estate was named as executor. The executor obtained two extensions to file and pay the estate tax of over $4 million but was refused a third extension. The executor failed to timely file and pay the estate tax and sought an offer in compromise for about one-half of the tax owed, which was denied by the IRS. The executor then tried to sell several real properties owned by the estate at greatly inflated prices. During this time, the estate made substantial inheritance tax payments to four states and failed to collect accounts receivable, particularly a substantial loan to the executor's son. The court upheld assessment of an addition to tax under I.R.C. § 6651(a)(2) for failure to timely file and pay the estate tax. The court held that the taxpayer failed to substantiate any reasonable cause for failing to pay the tax. The court noted that (1) the estate made substantial payments to the states, (2) did not attempt to collect accounts receivable, (3) did not take reasonable steps to sell estate property at reasonable prices, and (4) made no attempt to acquire loans to make the tax payments. **Estate of Hartsell v. Comm'r, T.C. Memo. 2004-211**.

SPECIAL USE VALUATION. The decedent had transferred farmland to an heir before death and filed a gift tax return for the transfer. Based on advice from an attorney and CPA, the executor did not include the transferred property in the gross estate and did not elect special use valuation for the property on the timely-filed federal estate tax return. After the due date for the return, the executor discovered that the property should have been included in the gross estate and applied for an extension of time to elect special use valuation for the property. The IRS granted the extension. **Ltr. Rul. 200438036, May 10, 2004**.

FEDERAL INCOME TAXATION

CORPORATIONS.

DEFINITION. The IRS has announced guidance on the classification of certain European business entities for U.S. tax purposes by updating the list of entities that are classified as "per se" corporations for U.S. tax purposes to include Societas Europaea (SE), a new type of public limited liability company in the European Union, as well as public limited liability companies formed under the laws of Estonia, Latvia, Liechtenstein, Lithuania and Slovenia. **Notice 2004-68, I.R.B. 2004-41.**

DISASTER LOSSES. On September 10, 2004, the President determined that certain areas in North Carolina were eligible for assistance under the Disaster Relief and Emergency Assistance Act (42 USC 5121) as a result of tropical storm Frances, which began on September 7, 2004. **FEMA-1546-DR**. On September 15, 2004, the President determined that certain areas in South Carolina were eligible for assistance under the Act as a result of tropical storm Gaston, which began on August 28, 2004. **FEMA-1547-DR**. On September 15, 2004, the President determined that certain areas in Louisiana were eligible for assistance under the Act as a result of hurricane Ivan, which began on September 13, 2004. **FEMA-1548-DR**. On September 15, 2004, the President determined that certain areas in Alabama were eligible for assistance under the Act as a result of hurricane Ivan, which began on September 13, 2004. **FEMA-1549-DR**. On September 15, 2004, the President determined that certain areas in Mississippi were eligible for assistance under the Act as a result of hurricane Ivan, which began on September 13, 2004. **FEMA-1550-DR**. On September 16, 2004, the President determined that certain areas in Florida were eligible for assistance under the Act as a result of hurricane Ivan, which began on September 13, 2004. **FEMA-1551-**

DR. On September 17, 2004, the President determined that certain areas in Puerto Rico were eligible for assistance under the Act as a result of tropical storm Jeanne, which began on September 14, 2004. **FEMA-1552-DR**. On September 18, 2004, the President determined that certain areas in North Carolina were eligible for assistance under the Act as a result of hurricane Ivan, which began on September 16, 2004. **FEMA-1553-DR**. On September 18, 2004, the President determined that certain areas in Georgia were eligible for assistance under the Act as a result of hurricane Ivan, which began on September 14, 2004. **FEMA-1554-DR**. On September 19, 2004, the President determined that certain areas in Pennsylvania were eligible for assistance under the Act as a result of tropical depression Frances, which began on September 8, 2004. **FEMA-1555-DR**. On September 19, 2004, the President determined that certain areas in Ohio were eligible for assistance under the Act as a result of severe storms and flooding, which began on September 8, 2004. **FEMA-1556-DR**. On September 19, 2004, the President determined that certain areas in Pennsylvania were eligible for assistance under the Act as a result of tropical depression Ivan, which began on September 17, 2004. **FEMA-1557-DR**. On September 20, 2004, the President determined that certain areas in West Virginia were eligible for assistance under the Act as a result of severe storms and flooding, which began on September 16, 2004. **FEMA-1558-DR**. On September 23, 2004, the President determined that certain areas in Vermont were eligible for assistance under the Act as a result of severe storms and flooding, which began on August 12, 2004. **FEMA-1559-DR**. On September 24, 2004, the President determined that certain areas in Georgia were eligible for assistance under the Act as a result of tropical storm Frances, which began on September 3, 2004. **FEMA-1560-DR**. On September 26, 2004, the President determined that certain areas in Florida were eligible for assistance under the Act as a result of hurricane Jeanne, which began on September 13, 2004. **FEMA-1549-DR**. Accordingly, taxpayers in the affected areas who sustained losses may deduct them on their 2003 federal income tax returns.

The IRS has announced extensions and penalty waivers for business and individual taxpayers affected by hurricane Ivan and with tax payments or reports due from September 13 to December 20, 2004. **IR-2004-118**.

EMPLOYEE EXPENSES. The IRS has announced its annual update of the simplified per diem rates that employers (or their agents or third parties) can use to reimburse employees for lodging, meals and incidental expenses incurred on or after October 1, 2004 during business travel away from home without the need to produce receipts. **Rev. Proc. 2004-60, I.R.B. 2004-41**.

The taxpayer's employees' wages were reduced by the value of employer-provided parking. The employer then "reimbursed" the employees for the cost of the parking. The IRS ruled that the reimbursement amounts were included in the employees' income and were subject to withholding and social security tax. The IRS also ruled that this ruling would apply to any similar system of charging employees for an employer-provided benefit and a later reimbursement for the charge. **Rev. Rul. 2004-98, I.R.B. 2004-41**.

HOBBY LOSSES. The taxpayer was the income beneficiary of three trusts which provided most of the taxpayer's income. The taxpayer engaged in breeding and raising horses, primarily through a manager. The court held that the taxpayer did not operate the horse breeding and racing activity with the intent to make a profit because (1) the taxpayer did not attempt to make any changes in the operation of the activity to make it profitable; (2) the taxpayer failed to demonstrate that the taxpayer devoted any significant amount of time to the activity, the court noting that the taxpayer rarely visited the horses; (3) the taxpayer failed to provide any evidence that the horses' value did or would appreciate at least as much as losses incurred by the activity; (4) the taxpayer had no history of any profitable business activity; (5) the activity never was profitable; and (6) the losses offset substantial income from the trusts. **Freed v. Comm'r, T.C. Memo. 2004-215**.

IRA. In the taxpayer's divorce proceedings the taxpayer's spouse was ordered to transfer one-half of the spouse's IRA to the taxpayer. The spouse ordered the distribution of one-half of the funds in the IRA to an IRA opened by the taxpayer. Within the same tax year, the taxpayer withdrew the funds from the new IRA. The taxpayer was not older than 59 years old at that time. The taxpayer did not include the withdrawn funds in income, arguing that the original transfer was taxable to the spouse; therefore, the funds had a tax basis equal to the amount of the funds and were nontaxable when distributed to the taxpayer. The court held that the divorce decree specifically ordered the transfer of one-half of the IRA; therefore, the transfer was not taxable as a transfer incident to a divorce. The court held that the distribution to the taxpayer was taxable income and was subject to the 10 percent penalty for early withdrawal. The taxpayer was also assessed an accuracy-related penalty for failure to have a reasonable basis for not including the distribution in income. **Cohen v. Comm'r, T.C. Memo. 2004-227**.

LIKE-KIND EXCHANGES. The taxpayer, a partnership, wanted to sell real property with improvements, personal property and leases and acquire similar property owned by a related partnership. The partnerships entered into an agreement with a qualified intermediary who would find a buyer for the taxpayer's property and replacement property for the second partnership's property. After the exchange, the taxpayer would receive the other partnership's property, a buyer would receive the taxpayer's property and the other partnership would receive replacement property. The IRS ruled that the exchanges qualified for tax-deferred exchange treatment under I.R.C. 1031. **Ltr. Rul. 200440002, June 14, 2004**.

PASSIVE ACTIVITY LOSSES. The taxpayers, husband and wife, owned two types of rental real estate properties. The taxpayers were employed full-time as a machinist and a nurse and both worked more than 40 hours per week. The first properties were hotel rooms in established chain hotels. Although the rooms were owned by the taxpayers, the rooms were managed by and appeared to the public as part of the hotels. The other properties were condominiums managed by third party property managers. Although the taxpayers occasionally visited the properties, most of their activities were centered around reviewing reports and accounts about the properties and studying information about the rental industry. The court held that such activities were investment activities and did not count for purposes of the hour requirements in tests one, three and four of the regulations. Moreover, in one project the taxpayer lost under the facts and circumstances test because a paid manager was involved. The court held that such participation did not amount to material participation in either activity, resulting in the losses from the activities to be characterized as passive losses subject to the limitations of I.R.C. § 469. The taxpayers' argument that rentals were from "rental real estate activities" and thus were deductible up to $25,000 was rejected because the taxpayers' adjusted gross incomes were above the top end of the phase-out range. **Lapid v. Comm'r, T.C. Memo. 2004-222**.

The taxpayers, husband and wife, owned two commercial properties. The first property was rented to a S corporation owned by the taxpayers and used for manufacturing. The second property was rented to an S corporation owned by the taxpayers and used as a restaurant. The manufacturing company paid the rent and the taxpayers realized net income from that lease. The restaurant, however, did not pay the rent and the taxpayers realized a net loss from that lease. The taxpayers reported both rentals as one activity on Schedule E and netted the losses against the income. The taxpayers materially participated in the business of both corporations. The court held that, under Treas. Reg. § 1.469-2(f)(6), the self-rental income from the manufacturing corporation was characterized as nonpassive income but the loss from the restaurant rental was passive loss; therefore, the nonpassive income could not be offset against the passive loss. The court acknowledged that the two activities could be treated as one, but that the self-rental income and loss still had to be separately characterized. **Carlos v. Comm'r, 123 T.C. No. 16 (2004)**.

PENSION PLANS. For plans beginning in September 2004 for purposes of determining the full funding limitation under I.R.C. § 412(c)(7), the corporate bond weighted average is 6.21 percent with the permissible range of 5.59 to 6.21 percent (90 to 100 percent permissible range). The 30-year Treasury securities rate for this period is 5.14 percent, the 90 percent to 105 percent permissible range is 4.62 percent to 5.39 percent, and the 90 percent to 110 percent permissible range is 4.62 percent to 5.65 percent. **Notice 2004-69, I.R.B. 2004-41**.

RETURNS. The IRS has announced that the maximum business deductions allowed to be reported using Form 1040, Schedule C-EZ has been increased from $2,500 to $5,000. **IR-2004-119**.

The IRS has issued proposed regulations that, other than direct proof of actual delivery, a registered or certified mail receipt is the only prima facie evidence of delivery of documents that have a filing deadline prescribed by the internal revenue laws. The IRS also requested comment and information about treating documentation from other delivery services which could also be treated as evidence of delivery. **69 Fed. Reg. 56277 (Sept. 20, 2004), amending Treas. Reg. § 301.7502-1**.

The IRS has announced that tax professionals in several states who file tax returns and payments for clients will be affected by a workload redistribution among the IRS processing centers. Tax year 2004 filings from Connecticut without payments should be sent to the IRS center in Kansas City, Missouri, while filings from Connecticut with payments will be sent to the IRS center in St. Louis, Missouri. Returns from Virginia without payments are to be sent to the IRS center in Fresno, California, while returns from Arizona, Utah and Virginia with payments will be sent to the IRS center in San Francisco, California. The announcement provides a complete list of addresses tax professionals should use when filing returns for their clients, as well as reminders that the zip codes for the addresses vary depending on which form is being filed and whether or not a payment is enclosed. **IR-2004-120**.

The taxpayer filed a Form 1040 using zeros filled in for all items except tax withheld, total tax payments, amount overpaid and amount to be refunded. The taxpayer attached the W-2 forms and the return was signed and dated but had "N.Y.O.B." in the space for the taxpayer's phone number. The IRS did not process the return and sent a notice of deficiency based on the taxpayer's W-2 forms, plus additions to tax for failure to file a return. The court held that the taxpayer's return was not an honest and reasonable effort to comply with the filing requirements; therefore, the assessment of the addition to tax was proper. **Halcott v. Comm'r, T.C. Memo. 2004-214**.

S CORPORATIONS

DISTRIBUTIVE SHARE. The taxpayer was a shareholder in an S corporation. In one tax year, the S corporation reported a net operating loss and the taxpayer reported the taxpayer's share of the loss on the taxpayer's individual tax return. The S corporation's return was audited and the loss reduced because of a change in how two loans were reported. The court held that the decrease of the S corporation allowable losses also decreased the allowable losses that the taxpayer could deduct. **Brady v. Comm'r, T.C. Summary Op. 2004-131**.

PASSIVE INVESTMENT INCOME. The taxpayer was an S corporation which owned commercial and residential rental properties. The taxpayer was responsible for all property maintenance and the administration of the leasing of the properties. The taxpayer had six employees, including a maintenance manager, contract manager and on-site property managers. The IRS ruled that the rental income from the properties was not passive investment income to the taxpayer. **Ltr. Rul. 200438002, May 4, 2004**.

UNDERPAYMENT OF TAX. In *Estate of Smith v. Comm'r, 123 T.C. 15 (2004)* the IRS was prohibited from assessing interest on underpayment of tax after the IRS and taxpayer agreed to a Rule 155 computation of overpayment of tax by the taxpayer which was incorporated in a final decision of the court. The decision had resulted in an overpayment of tax although the taxpayer had not paid all of the taxes assessed. The IRS, in a Chief Counsel Notice, has announced that any interest on underpayment of tax is to be included in the Rule 155 calculation as part of a court case. **CC-2004-035**.

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STATE REGULATION OF AGRICULTURE

HOG CONFINEMENT OPERATION. The defendant county in Iowa adopted an ordinance which prohibited "the emission of objectionable odorous air contaminants or toxic air emissions from confinement structures, manure storage and treatment, waste disposal modalities, land application, and/or carcass disposal to degrade air quality." The ordinance also required livestock operations to meet indoor air quality standards for several chemicals and to install underground water quality monitoring wells. The plaintiffs were people in the county who objected to the ordinance as invalid as unconstitutional. The trial court held that the ordinance was void as unconstitutional and preempted by state law. The appellate court first ruled that the ordinance was allowed as a valid exercise of home rule powers, so long as the ordinance did not conflict with state law or the state constitution. The court held that Iowa Code § 331.304A(2) prohibited counties from adopting legislation "regulating a condition or activity occurring on land used for the production, care, feeding, or housing of animals unless the regulation of the production, care, feeding, or housing of animals is expressly authorized by state law." The county argued that the ordinance did not regulate the production of animals but merely regulated air quality as a public health ordinance. The court disagreed, noting that the ordinance specifically mentions animal production waste as one of the activities regulated. The court held that, because the ordinance regulates, directly and indirectly, the operation of livestock confinement facilities and because the Iowa statute prohibits such local regulation, the ordinance was void as preempted by statute. **Worth County Friends of Agriculture v. Worth County, Iowa, 2004 Iowa Sup. LEXIS 274 (Iowa Oct. 6, 2004)**.