

# **Income Tax Update**

**2011**

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- New Tax Acts
- Tax Form Changes
- Recent Significant Developments
- Gross Income - Inclusions and Exclusions
- Gains and Losses
- Retirement Plans and Distributions
- Business and Itemized Deductions
- Credits and Additional Taxes

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Sincerely,

James R. Hasselback

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# 2011 INDIVIDUAL INCOME TAX UPDATE

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## **JAMES R. HASSELBACK**

James R. Hasselback became the Mary Ball Washington Eminent Scholar at the University of West Florida in 2006 after teaching at Florida State University for 27 years. He previously taught at the University of Florida, Texas A&M University, and Eastern Michigan University. A member of the American Accounting Association and the American Taxation Association, he has published over 150 papers in professional and academic journals, including *The Accounting Review*, *The Tax Adviser*, *Financial Management*, *Journal of Real Estate Taxation*, and the *American Business Law Journal*.

Dr. Hasselback has presented papers at numerous national and regional professional meetings, and served as chairman at tax sessions of professional conferences. He regularly presents continuing education seminars for practicing accountants. He is co-author and technical editor on a two-volume introductory taxation series published by CCH Inc. for the past 28 years. Jim has also served as technical editor on several publications by CCH Inc. and Harper-Collins Inc. He is a contributing author on *2008 U.S. Master Accounting Guide*, by CCH Incorporated. Jim is co-author with Irvin Gleim on the *Twentieth-First Edition of Federal Tax Exam Questions and Explanations* and also on the 13th edition of the three volume *EA Review for the IRS Special Enrollment Exam*.

Jim Hasselback compiles the *Accounting Faculty Directory* published by Prentice Hall. The 2011-2012 edition marked the 34th edition. The *Accounting Faculty Directory* may be the most cited reference in the Accounting field. The other Directories in the business field include: a Directory of Management Faculty, a Directory of Finance Faculty, a Directory of Marketing Faculty, a Directory of Economics Faculty, a Directory of Business Law Faculty, and a Directory of Hospitality Faculty. An Engineering Faculty Directory was published in 1992 and 1995. A Computer Science Faculty Directory was published in 1994 and 1996. The Nursing Faculty Directory was published in January 1995.

The American Accounting Association awarded Jim Hasselback the Outstanding Service Award in 2005. He is only the eighth person to receive this award.

Dr. Hasselback taught two courses, Income Tax Planning and Estate Planning, in Florida State University's Certificate in Financial Planning Program through the internet for six years. He taught for several years in the Florida State University's CPA Review Course. He currently prepares online CPE materials for Gleim Publications.

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## 2011 Individual Income Tax Update

### Chapter 1 - New Tax Acts

- A. Written Identity Theft Prevention Program
  - 1. The Federal Trade Commission's Red Flags Rule requires financial institutions and creditors to implement a written Identity Theft Prevention Program to detect the warning signs (or red flags) of identity theft in their day-to-day operations.
  - 2. The definition of creditor is broad, and includes businesses, such as accountants, that provide goods or services, with payment to be received later.
  - 3. Fortunately, the Red Flag Program Clarification Act of 2010 signed by President Obama on 12/18/10 confirms that accountants are not creditors for this purpose.
- B. Claims Settlement Act of 2010 [HR 4783]
  - 1. Expands the government's authority to offset federal tax refunds against unemployment compensation incorrectly paid to a taxpayer.
  - 2. Signed by the President on December 8, 2010.
- C. Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011 [ HR 4]
  - 1. The recent expansions of the 1099 reporting rules are officially repealed. The legislation repeals the requirement that businesses issue 1099 when paying \$600 or more to corporations or for goods. Also repealed is the rule making owners of rental properties file 1099s on payments of \$600 or more for goods and services.
  - 2. President Obama signed the legislation on April 14, 2011.
- D. Airport and Airway Extension Act of 2011, Part IV
  - 1. On August 5, 2011, Congress approved an extension of the FAA budget through September 16, 2011. Congress reinstated the airline excise taxes retroactively. As a result, passengers who purchased tickets before July 23, 2011, were no longer entitled to a refund, the IRS stated in revised FAQs on August 10, 2011.
  - 2. In its revised FAQs, the IRS also announced that if airlines did not collect the tax, the IRS would waive them. The IRS would not make the airlines go back and collect taxes for tickets purchased during the expiration period: July 23, 2011 - August 7, 2011. The IRS waiver applies whether the passengers flew during the expiration period or after Congress reinstated the taxes.

E. American Invents Act - HR 1249

1. Congress has approved a patent reform bill containing provisions that eliminate patents of tax strategies. The bill expressly provides that a strategy for reducing, avoiding, or deferring tax liability cannot be considered a new or non-obvious idea, and therefore, a patent on a tax strategy cannot be obtained.
  - a. Under federal statute, copyright protection for an original work of authorship does not extend to any idea, procedure, process, system, method of operation, concept, principle, or discovery, regardless of the form in which it is described, explained illustrated, or embodied in such work.
  - b. The US Patent and Trademark Office has granted over 150 patents of tax strategies and more than 160 are pending. Existing patents would not be affected by the new law, but applications pending on the date of enactment are within the scope of the provision.
2. A federal district court has dismissed a copyright infringement claim brought by the holders of copyrighted tax strategy planning services. The court found that the holders failed to show, merely because the fact that their materials were registered with the U.S. Copyright Office, that the materials were indeed copyrightable.

F. U.S. Korea Trade Act

1. Preparers of returns with the earned income credit are going to have to file a due diligence checklist along with the returns after 2011 – Form 8867.
2. Increased the penalty from \$100 to \$500 for each failure to satisfy the due diligence requirement.

G. 3% Withholding Repeal and Job Creation Act

1. The bill repeals the 3% withholding on government contractors that was set to begin in 2013.
2. Vow to Hire Heroes
  - a. The bill provides for an expanded Work Opportunity Credit (WOC) of up to \$5,600 for employers that hire veterans who have been looking for employment for more than six months.
  - b. Employers that hire veterans who have been unemployed for more than four weeks but less than six months are eligible for a maximum tax credit of \$2,400.
  - c. A \$9,600 tax credit is available to employers that hire veterans with service-connected disabilities who have been looking for employment for more than six months.
  - d. The credit applies for eligible veterans starting work after November 21, 2011, and before January 1, 2013.
  - e. The credit is 40% of first-year wages.
  - f. Tax exempt groups can take the credit as an offset against payroll taxes.
  - g. Signed by the President on November 21, 2011.

### 3. Form 5884 Directions

- a. Generally, you must request and be issued a certification for each employee from the state employment security agency (SECA). The certification proves that the employee is a member of a targeted group. You must receive the certification by the day the individual begins work or complete Form 8850, Pre-Screening Notice and Certification Request for the Work Opportunity Credit, on or before the day you offer the individual a job.

## H. Changes to Tax Forms

### 1. Form 1099-K

- a. For 2011, credit and debit card companies will begin to issue 1099-K forms on payments to (1) payment card transactions and (2) third-party network transactions.
  - 1) Gross amount means the total dollar amount of total payment transactions for each participating payee without regard to any adjustments for credits, cash equivalents, discount amounts, fees, refunded amounts or any other amounts.
- b. These amounts will be reported on a separate line on Schedule C and Forms 1065, 1120, and 1120S. The IRS is able to match the amounts shown on the 1099-K with what is reported on a return, making discrepancies easier to spot. [TIGTA 2011-40-065; 7-26-2011]
- c. All payments made in settlement of payment card transactions must be reported.
- d. Payments made in settlement of third party network transactions need be reported only if gross payments to a payee exceed \$20,000 and the number of such transactions exceeds 200 with respect to the participating payee.
- e. Under current rules, information reporting for applicable payment card and third party network transactions are due to the IRS by February 28th each year (or March 31st, if filed electronically) for the prior calendar year.
- f. Backup withholding of 28% is required if a payee fails to furnish a correct taxpayer identification number to the payor.
- g. All payments, regardless of any monetary or transactional thresholds, are subject to potential backup withholding.
- h. A payment made by a third party settlement organization (TPSO) is potentially subject to backup withholding only if the payee has received payment from that TPSO in more than 200 transactions within a calendar year. [Notice 2011-42]
- i. The IRS is postponing the effective date for backup withholding for an additional year.
  - 1) Backup withholding will be required on payments made after December 31, 2012. [Notice 2011-88]
- j. Forms 1099-K must include the gross amount of reportable payment transactions, as well as the name, address, and taxpayer identification number (TIN) of the payee.
  - 1) Penalties apply for failing to include all required information or including incorrect information on the Form 2099-K sent to the IRS or to the payee.

- k. The IRS will not impose accuracy-related penalties on payors that file Forms 1099-K provided that the payors make good-faith efforts in filing accurate forms.
    - 1) This relief is only applicable to payments made in the calendar year 2011 and does not apply to payors who simply do not file. [Notice 2011-89]
  - l. For 2011, you are not required to report income received via merchant card or third party networks payers, so enter zero on line 1a and report all income, regardless of how it was earned, on line 1b. [2011 Instructions for Schedule C]
  - m. The IRS issued regs in 2010 that business transactions conducted using payment cards such as credit and debit cards are exempt from the reporting requirements because these transactions will already be covered by reporting requirements on payment card processors.
2. Schedule D
- a. Taxpayers will report capital gains on both Form 8949 and Schedule D for 2011.
  - b. Separate Form for Each Type of Transaction
    - 1) Box (A) Short-term transactions reported on Form 1099-B with basis reported to the IRS.  
  
Box (B) Short-term transactions reported on Form 1099-B but basis not reported to IRS.  
  
Box © Short-term transactions for which you cannot check box A or B.
  - c. Instead of reporting each of your transactions on a separate line of Form 8949, you can report them on an attached statement containing all the same information as Form 8949 and in a similar format. Enter the combined totals from all your attached statements on a Form 8949 with the appropriate box checked. If you have statements from more than one broker, report the totals from each broker on a separate line. [Directions Form 8949]
  - d. Do not enter "available upon request" and summary totals in lieu of reporting the details of each transaction of Form(s) 8949 or attached statements.
  - e. e-Filing
    - 1) If you e-file your return but choose not to include your transactions on the electronic short-term capital gain (or loss) or long-term capital gain (or loss) records, you must attach Form 8949 (or a statement with the same information) for Form 8453 and mail the forms to the IRS.

3. Form 8938 - Foreign Financial Assets
  - a. Filing Form 8938 does not relieve you of the requirement to file Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR), if you are otherwise required to file Form TD F 90-22.1.
  - b. Filing Thresholds
    - 1) Single - \$50,000 at the end of the year or \$100,000 at any time during the year.
    - 2) Married Filing Jointly - \$100,000 at the end of the year or \$200,000 at any time during the year.
4. Schedule E
  - a. Taxpayers will report more data on Schedule E for 2011. Taxpayers will report the type of property rented--a single family home, condo, commercial property, and so forth. Filers will have to list the number of days the property was occupied as well as the number of days used for personal purposes. [TIGTA 2011-30-005]
5. Form 5695
  - a. The IRS will revise Form 5695 so claimants must list the home on which the residential energy-savings improvements are made. Treasury inspectors found that the IRS did not deny credits taken on returns by people who did not own a residence, were under age 18, or were incarcerated.
6. Form 4684
  - a. The IRS will revise Form 4684 to require separate reporting of Ponzi loss write-offs and will open up a special audit project to measure noncompliance in this area.
  - b. Treasury inspectors allowed millions of dollars in erroneous loss write-offs.
7. Self-Employed Health Insurance
  - a. No longer allowed on Schedule SE.
  - b. Still allowed on Form 1040, line 29.
8. Fringe Benefits Treated as Additional Compensation to Owners of S Corporations and Partnerships
  - a. Payments to accident and health plans (§106)
  - b. Health Savings Account contribution (§223)
  - c. Group-term life insurance coverage up to \$50,000 (§79)
  - d. Medical reimbursement plans and disability plans (§105)
  - e. Meals and lodging furnished for the convenience of the employer (§119)
  - f. Adoption assistance program (§137)
  - g. Employment achievement award (§74©)
  - h. Cafeteria plans (§125)
  - i. Qualified transportation benefits (§132(a)(5))
  - j. Moving expense reimbursement (§217)
  - k. Personal use of employer-provided property or services (Reg. 1.61-21)

9. Fringe Benefits Available to Owners of S Corporations and Partnerships if Nondiscrimination Rules are Met
  - a. Dependent care assistance program (§129)
  - b. Educational assistance program (§127)
  - c. Compensation for injury and sickness (§104)
  - d. No additional-cost service (§132(a)(1))
  - e. Qualified employee discount (§132(a)(2))
  - f. Working condition fringe (§132(a)(3))
  - g. De minimis fringe (§132(a)(4))
  - h. On-premise athletic facilities (§132)
  - i. Tuition reduction

## Chapter 2 - Significant Developments

### A. Registered Tax Return Preparer

#### 1. Regulate Practice Before Treasury

- a. Section 330 of title 31 of the United States Code authorizes the Secretary of the Treasury to regulate the practice of representation before the Treasury Department.
- b. The Secretary is authorized, after notice and an opportunity for a proceeding, to censure, suspend, or disbar from practice before the Treasury Department those representatives who are incompetent, disreputable, or who violate regulations prescribed under Section 330 to title 31.
- c. The Secretary also is authorized to impose a monetary penalty against these individuals and the individuals' firms or other entities that employ them
- d. Additionally, the Secretary may seek an injunction against these individuals under section 7408 of the Internal Revenue Code.

#### 2. The Secretary has published regulations governing the practice of representative before the IRS and reprinted the regulations as Treasury Department Circular No. 230.

- a. These regulations authorize the IRS:
  - 1) To act upon application for enrollment to practice before the IRS;
  - 2) To make inquiries with respect to matters under Circular 230;
  - 3) To institute proceedings to impose a monetary penalty or to censure, suspend, or disbar a practitioner from practice before the IRS;
  - 4) To institute proceedings to disqualify appraisers; and
  - 5) To perform other duties necessary to carry out these functions.

#### 3. Prior Circular 230 Rules

- a. Prior to the most recent amendments to Circular 230, an individual tax return preparer generally was not subject to the provisions in Circular 230 unless the tax return preparer was an attorney, certified public accountant, enrolled agent, or other type of practitioner identified in Circular 230.
- b. Before the issuance of these final regulations, any individuals could prepare tax returns and claims for refund without meeting any qualifications or competency standards.
- c. A tax return preparer previously was able to exercise the privilege of limited practice before the IRS.
- d. In June 2009, the IRS launched a review of tax return preparers with the intent to propose a comprehensive set of recommendations to ensure uniform high ethical standards of conduct for all tax return preparers and to increase taxpayer compliance.

4. Those Affected by Circular 230 Amendments
  - a. The amendments to Circular 230 do not affect attorneys or certified public accountants. However, the new rules may affect those employed by an attorney or certified public accountant.
  - b. The new regulations may affect practitioners that are not attorneys or certified public accountants that prepare, or assist in preparing, all or substantially all of a tax return or claim for refund for compensation.
  - c. An individual that only furnishes typing, reproductions, or other mechanical assistance with respect to a tax return or a claim for refund, is not a tax return preparer under Circular 230.
5. New Circular 230 Amendments
  - a. Preparation of a tax return is practice before the IRS.
  - b. Either preparing a document or filing a document may constitute practice before the IRS.
6. Required IRS Designation
  - a. All paid tax preparers that are not Certified Public Accountants, Attorneys, or Enrolled Agents will be required to become Registered Tax Return Preparers (RTRP).
7. The process of becoming a Registered Tax Return Preparer is a three-step process:
  - a. Pass a one-time competency exam,
  - b. Pass a suitability check, and
  - c. Obtain a PTIN (and pay the amount provided in the PTIN User Fee regulations).
8. Initially the IRS is requiring RTRP candidates to complete this process in reverse order.
  - a. The process of becoming a Registered Tax Return Preparer is comparable to the existing process for enrolled agents.
    - 1) These regulations do not change enrolled agents' status as practitioners under Circular 230.

## 9. Obtaining a PTIN

- a. Beginning January 1, 2011, paid tax preparers were required to use a valid Preparer Tax Identification Number (PTIN) on prepared returns.
- b. The process of applying for a PTIN involves:
  - 1) The creation of an account. Creating a new PTIN account can be done using the online PTIN sign-up system.
    - a) This account is different from e-Services.
  - 2) Applying for a PTIN. Complete the one PTIN application. Preparers will need to provide some personal information about the previous year's tax return and professional credentials.
  - 3) Pay the fee. Pay \$64.25 user fee via credit card or direct debit.
    - a) The fee is \$63 for PTIN renewals.
- c. Preparers who obtained their PTINs by creating an online account should renew their PTINs at [www.irs.gov/ptin](http://www.irs.gov/ptin). Preparers who used paper applications to receive their 2011 PTIN will receive an activation code in the mail from the IRS. They can then use that number to create an online account and convert to an electronic renewal for 2012.
  - 1) Individuals can also renew using a paper Form W-12, IRS Paid Preparer Tax Identification Number Application, but that process takes four to six weeks.
- d. After receiving the PTIN, review the welcome letter received to understand future obligations. Keep the PTIN and account information in a safe place for future reference.
- e. PTIN renewal for 2012 became available on October 16, 2011.
- f. Attorneys, CPAs, and enrolled agents must provide the expiration dates for their licenses when they apply or renew their PTINs.
- g. Individuals who obtain a provisional PTIN before April 18, 2012, may prepare for compensation any tax return or claim for refund until December 31, 2013, as long as the individual renews their PTIN, passes a suitability check, and pays the applicable user fee.
  - 1) After April 18, 2012, only attorneys, certified public accountants, enrolled agents, and Registered Tax Return Preparers, or individuals defined in Notice 2011-6 may obtain a PTIN.
- h. The IRS will prescribe by forms instructions, or other appropriate guidance the tax returns and claims for refund registered tax return preparers are permitted to prepare after successfully completing the competency examination.

## 10. Registration Year

- a. The registration year is defined as each calendar year that the registered tax return preparer is authorized to practice before the IRS.

## 11. Compliance and Suitability Checks

- a. As part of the application process, the IRS may conduct a Federal tax compliance check and suitability check.
- b. The tax compliance check will be limited to an inquiry regarding whether the individual has filed all required individual or business tax returns (such as employment tax returns that might have been are required to be filed by the applicant) and whether the individual has failed to pay, or make proper arrangements with the IRS for payment of any Federal tax debts.
- c. The suitability check will be limited to an inquiry regarding whether the individual has engaged in any conduct that would justify suspension or disbarment of any practitioner under the provisions of Circular 230, including whether the applicant has engaged in disreputable conduct.

## 12. Fingerprinting

- a. The IRS Commissioner Doug Shulman said that the IRS is temporarily shelving its controversial plan to fingerprint tax preparers.

## 13. Competency Examination

- a. The competency examination is a timed 2.5 hour exam that will cover the Tax Year 2010 Form 1040 series and its related tax schedules plus a portion of Circular 230. The test is available in English only at this time and generally will be administered in a computer based testing format.
- b. There are 120 questions in a combination of multiple choice and true or false format. Only 100 of the questions will be graded.
- c. Prometric will be administering the test at more than 260 centers nationwide, but the test is not currently available at all locations.
- d. Prior to mid-January 2012, candidates will not received their results for two to six weeks, so the IRS can validate the exam and determine the threshold for passing.
  - 1) After mid-January 2012, candidates will receive their test results immediately upon completion of the test
- e. Test results will be made available only to the candidates and the IRS.
- f. The fee for the competency test is \$116.
  - 1) There is no limit on the number of times the test can be taken, but preparers must pass the test only once.
  - 2) If an individual takes the test more than once, the \$116 fee will apply each time the individual takes the test.
- g. Preparers who need to take the test can schedule an appointment through their online PTIN account at [www.irs.gov/ptin](http://www.irs.gov/ptin). Preparers must pay the \$116 test fee at the time they are scheduling their appointment. Those who do not have an online PTIN account can make test appointments and pay by phone at 855-477-3926.

#### 14. Continuing Education Requirements

- a. Beginning in 2012, Registered Tax Return Preparers must complete 15 hours of continuing education during each registration year, with a minimum of:
  - 1) Three hours of Federal tax law updates,
  - 2) Two hours of tax-related ethics, and
  - 3) 10 hours of Federal tax law topics.
- b. Registered Tax Return Preparers must maintain records with respect to the completing of the continuing education credit hours and self-certify the completion of the continuing education credits at the time of renewal.
- c. The regulations require that a qualifying continuing education course enhance professional knowledge in Federal taxation or Federal tax related matters and be consistent with the Code and effective tax administration.
- d. The final regulations allow enrolled agents and enrolled retirement plan agents to earn six hours of continuing education annually for instruction and preparation.
  - 1) Registered tax return preparers can earn four hours annually.
  - 2) The final regulations remove the ability to receive hours for authoring articles, books, or other publications that was formerly allowed with respect to enrolled agents and enrolled retirement plan agents.

#### 15. Approved Registered Tax Return Preparer

- a. Once an individual is approved as a Registered Tax Return Preparer, the IRS will issue a registration card or certificate.
- b. The card or certificate will be in addition to any notification provided to an individual who obtained a PTIN.
- c. Registered Tax Return Preparers must have both a valid registration card or certificate and a current and valid PTIN number to practice before the IRS.
- d. In describing their designation, Registered Tax Return Preparers may not utilize the term "certified" or imply an employer/employee relationship with the IRS.
- e. Registered Tax Return Preparers are permitted to use the term "designated as a Registered Tax Return Preparer by the Internal Revenue Service."
  - 1) The designation "Registered Tax Return Preparer" is not yet available.
- f. Registered Tax Return Preparers will need to include a clear statement on any paid advertising involving print, television, or radio that "The IRS does not endorse any particular individual tax return preparer. For more information on tax return preparers go to IRS.gov."

## 16. Renewal Process

- a. A Registered Tax Return Preparer must:
  - 1) Annually renew their PTIN and pay a user fee.
  - 2) Complete a minimum of 15 credits of continuing education annually.
  - 3) Retain records of continuing education courses for four years.
- b. A new return preparer office was created to administer PTIN application, competency testing, and continuing education.
  - 1) David Williams, Directory IRS Return Preparer Office
- c. The Office of Professional Responsibility will continue to enforce the Circular 230 provisions relating to practitioner conduct and discipline.

## 17. Representation

- a. Registered Tax Return Preparers may represent taxpayers before revenue agents, customer service representative, or similar officers and employees of the IRS (including the Tax Advocate Service) during an examination if the Registered Tax Return Preparer signed the tax return or claim for refund for the taxable year or period under examination.
  - 1) This is consistent with the limited practice rights previously available to unenrolled return preparers.
- b. Registered Tax Return Preparers are not permitted to represent taxpayers, regardless of the circumstances requiring representation' before appeals officers, revenue officers, Counsel, or similar officers or employees of the IRS or the Treasury Department.
- c. A Registered Tax Return Preparer's authorization to practice does not include the authority to provide tax advice to a client or another person except as necessary to prepare a tax return, claim for refund, or other document intended to be submitted to the IRS.
- d. The Treasury Department and the IRS have concluded that the federally authorized tax practitioner privilege generally does not apply to communications between a taxpayer and a Registered Tax Return Preparer because the advice a registered tax return preparer provided ordinarily is intended to be reflected on a tax return and is not intended to be confidential or privileged.

## 18. Non-Form 1040 Series Preparers

- a. Preparers who do not prepare individual returns for compensation will not be required to complete the initial competency test or become a Registered Tax Return Preparer at this time.
  - 1) The IRS left open the door to requiring testing outside the 1040 universe in the future.
- b. Non-Form 1040 series preparer are individuals who certify that they do not prepare, or assist in the preparation of, any Form 1040 series tax return or claim for refund, except Form 1040-PR or Form 1040-SS, for compensation.
- c. Non-Form 1040 series preparers may:
  - 1) Sign any tax return they prepare or assist in preparing;
  - 2) Represent taxpayers before revenue agents, customer service representatives, or similar officers and employees of the IRS (including the Taxpayer Advocate Service) during an examination if the individual signed the tax return or claim for refund for the taxable year under examination.

## 19. Supervised Preparers

- a. Individuals who are not attorneys, certified public accountants, enrolled agents, enrolled retirement plan agents, enrolled actuaries, or Registered Tax Return Preparers will be eligible to obtain a PTIN and, thus, prepare, or assist in preparing, all or substantially all of a tax return or claim for refund for compensation in certain discrete circumstances. [Notice 2011-6]
  - 1) Section 1.02(1) of Notice 2011-6 permits certain individuals supervised by an attorney, certified public accountant, enrolled agent, enrolled retirement plan agent, or enrolled actuary who signs the return or claim for refund prepared by the individual to obtain a PTIN.
- b. Supervised preparers are individuals who do not sign, and are not required to sign, tax returns as a paid return preparer but are: employed by attorney or CPA firms or employed by other recognized firms that are at least 80% owned by attorneys, CPAs, or EAs; and who are supervised by an attorney, CPA, EA, enrolled retirement plan agent, or enrolled actuary who signs the returns prepared by the supervised preparer as the paid tax return preparer.
- c. These individuals are required to certify in their application to receive a PTIN that they are supervised by an attorney, certified public accountant, enrolled agent, enrolled retirement plan agent, or enrolled actuary who signs the tax return or claim for refund and provide a supervising individual's PTIN or other number if prescribed by the IRS.
  - 1) These individuals may not sign any tax return they prepare or assist in preparing for compensation.
- d. Tax preparers must self-identify whether they are supervised preparers or non-1040 preparers.
- e. Supervised preparers will need to provide a supervisor's PTIN when applying for or renewing their PTINs.

- f. Supervised individuals are not required to become registered tax return preparers in order to obtain a PTIN.
- g. Supervised preparers are exempt from competency testing and continuing education.

#### 20. Student Interns

- a. If an intern does not receive compensation, the intern is not required to obtain a PTIN under the Sec. 1.6109-2 regulations.
- b. If, however, an intern engages in tax return preparation activities that make the intern a tax return preparer for purposes of the Sec. 1.6109-2 regulations and the intern is compensated for these activities, the intern must obtain a PTIN.

#### 21. Special Exceptions

- a. Preparers of 5500 series forms do not have to get preparer numbers. [Notice 2011-6]
- b. Preparers of payroll tax returns only have to obtain a preparer number.

#### 22. Electronic Return Originators

- a. Tax professionals accepted into the electronic file program are called Authorized IRS e-File Providers.
- b. They are the Electronic Return Originators (EROs) who transmit tax return information to the IRS.
- c. They must obtain an electronic filing identification number (EFIN).
- d. Steps to become an Authorized e-File Provider and to obtain an EFIN are:
  - 1) Create an IRS e-Service account;
  - 2) Submit an online application; and
  - 3) Pass a suitability check.
- e. The process to obtain an EFIN may take up to 45 days.
- f. A suitability check may include a credit check, a tax compliance check, a criminal background check, and a check for prior noncompliance with IRS e-file requirements.

## B. Personal Exemptions, Standard Deduction, and Filing Requirements

### 1. Personal Exemption

- a. The personal exemption is \$3,700 for 2011.
- b. Phaseout of personal exemptions is repealed for 2010, 2011, and 2012.

### 2. Standard Deduction and Itemized Deductions

- a. Standard deduction amounts increased for 2011 [Rev. Proc. 2011-12]:

| <u>Filing status</u> . . . . .   | <u>Deduction amount</u> |
|--|-------------------------|
| Married filing jointly . . . . .   | \$ 11,600               |
| Head of household . . . . .  | 8,500                   |
| Single . . . . .   | 5,800                   |
| Married filing separately . . . . .  | 5,800                   |
| Additional-unmarried and aged and/or blind<br>and not a surviving spouse . . . . . | 1,450 each              |
| Additional-married and aged and/or blind . . . . .                                 | 1,150 each              |
| Taxpayer-dependent . . . . .   | 950                     |

- b. Phaseout of itemized deductions is eliminated for 2010, 2011, and 2012.
- c. The additional standard deduction for an allowance of up to \$1,000 of property taxes paid and the addition of casualty losses incurred in presidentially declared disaster areas expired at the end of 2009.
- d. AMT Itemizing
  - 1) When a taxpayer is subject to the AMT there is the possibility that itemizing could be better even when the itemized deductions are less than the standard deduction.
  - 2) Certain itemized deductions are not added back for AMT while the full standard deduction is added back.

### 3. Identity Theft

- a. Taxpayers who provide the IRS with documentation of an identity theft are issued a six-digit Identity Protection PIN (IP PIN) to allow their tax returns to bypass fraudulent return filters placed on their account.
- b. When preparing returns, practitioners should inquire if taxpayers have been issued an IP PIN, and if so, verify it is specific to the tax year for which it is provided since a new number is issued every year as long as there is an identity theft indicator on the taxpayer's account.

#### 4. IRS Letters

- a. The IRS has send more than 21,000 letters to tax return preparers nationwide to "remind them of their obligations to prepare accurate tax returns on behalf of their clients." The letters were send to paid preparers with "large volumes of tax returns with Schedules A, C, or D ... during the most recent filing season having a high percentage of attributes associated with returns typically containing inaccuracies and misinterpretations of tax law.

### C. Gross Income

#### 1. Cancellation of Debt

- a. After his college graduation, a taxpayer fell behind on his student loan. After trying to collect, the lender let him pay off the debt at a \$28,000 discount. This amount is discharge of indebtedness income because there was no dispute that he was liable for the full amount of the debt. [Martin, TC Summ Op. 2011-62]
- b. Taxpayers' home was sold in foreclosure in 1994, and the bank charged off the loan in 1995. However, Form 1099-C was not sent until 2006 and was addressed to a different name at an address that the taxpayer had not used since 1998. The bank could not point to an identifiable event, bank policy, or state law that would justify the discharge of debt in 2006, so the Tax court concluded that there was no cancellation of debt income in 2006. [Dennis Gaffney, TC Summ. Op. 2010-128]
- c. The Tax Court has rejected the government's attempt to tax cancellation of indebtedness income in 2006, concluding that the debt was discharged in 2002. [Kleber, TC Memo 2011-233] The court applied regs, which establish a presumption that a debt is discharged after 36 months if there has been no activity on the debt. The IRS failed to demonstrate any substantiative collection activities from 1999 to 2006 and failed to rebut the presumption that an identifiable event occurred in 2002.
- d. The Seventh Circuit Court upheld a district court's rejection of the son-in-law's claims that a Form 1099-C filed by someone other than a financial entity is necessarily fraudulent. [Calvatia v. Hayes, 107 AFTR 2d 2011-1051 (CA-7)] Although the individual was not required to file a Form 1099-C she was not prohibited from doing so. Additionally, filing a Form 1099-C is not the equivalent of filing a false return as long as the information on the form is accurate.
  - 1) Section 7434 provides that if any person willfully files a fraudulent information return with respect to payments purported to be made to any other person, such person may bring a civil action for damages against the person filing the information return. The types of false information returns for which an injured taxpayer may recover are limited to an enumerated list in Section 6724(d)(1)(A). Returns relating to the cancellation of indebtedness (Form 1099-C) are not enumerated in that list, the Seventh Circuit found.
- e. Owners must be bankrupt or insolvent to exclude income from canceled debts of disregarded entities. [Proposed Reg-154159-09] Some solvent taxpayer claimed they could use the exclusion if their disregarded entities were insolvent. The regulations reject that argument. A disregarded entity is a business that elects not to be taxed as a separate entity, such as a one-member LLC. Instead, income of loss is reported on the owner's return.

- f. IRS Chief Counsel determined that payments to settle allegations of unfair lending practices do not generate cancellation of indebtedness (COI) income to the borrower where the payments are used to adjust the principal amount of the loans in dispute. [CCA 201112008] Chief Counsel used an equitable "no accession to wealth" theory to conclude that the payments did not generate discharge of indebtedness income. The payments were treated the same as rebates or price reduction (on the loans), which merely reduced a borrower's payment obligation and were not taxable. The payments may also be analogous to government payments made to promote the general welfare.

## 2. Disability Payments

- a. Under Sec. 104(a)(1), amounts received under a workers' compensation act or a statute in the nature of a workers' compensation act are excluded from an employee's income. The taxpayer was injured in the line of duty working as a firefighter and was paid from the date of injury through his retirement based on a collective bargaining agreement between the city and the local fire fighters union. The Tax Court agreed with the IRS that the disability payments were taxable because the collective bargaining agreement did not rise to the force and effect of law. [John Bayse, TC Summ. Op. 2010-118]
- b. A police officer injured in the line of duty received disability benefits. He did not meet the qualifications for retirement when his benefits began; he was under age 50 and had not put in 20 years. When he turned 50, his benefit were converted into a pension and he was issued a 1099 showing it as taxable income. Because he received the money solely due to his disability, and not his age or years of service, his benefits are not taxable. [Bakken, TC Summ. Op. 2011-55]
- c. The Tax Court held that a civilian's pension is not tax free when a military-related disability causes retirement from a civilian job. [Robison, TC Memo 2011-59] The exclusion for amounts received for injuries from service in the armed forces is restricted to disability pensions that are paid by the military.
- d. A woman on workers' compensation sought to get Social Security disability benefits. She succeeded, but those benefits were offset by the amount of her workers' compensation. For tax purposes, she is treated as receiving the full amount of Social Security benefits, including the workers' compensation offset. Up to 85% of those benefits are taxable. [Sherar, TC Summ. Op. 2011-44] The tax-free nature of her worker's compensation is lost.

## 3. Embezzled Funds

- a. Funds embezzled by an individuals were gross income to him and his wife, and they were liable for accuracy-related penalties for failure to report that income. The disposition of the funds was irrelevant. [Wood, TC, CCH Dec. 58,724(M)]

## 4. Parsonage Allowance

- a. The Tax Court found that an ordained minister was entitled to exclude compensation received from his ministry and used to purchase his second home. [Driscoll, 135 TC N. 27] The court held the taxpayer had met the requirements for the exclusion under Sec. 107 because he used the home to provide a dwelling for himself and did not use it for any business purpose. The taxpayer owned a principal residence and a second lake home.

- b. A retired minister can exclude a parsonage allowance provided as compensation for past services from his or her gross income. [INFO 2010-0228] The governing body of a religious denomination can also set up a retirement fund that designates a portion of a retired minister's pension as a parsonage allowance as compensation for past services.

#### 5. Combat Zone Pay

- a. Wages of employees of private security firms in combat zones are taxed according to the Tax Court. [Holmes, TC Memo. 2011-26] The income tax exclusion for pay received in a combat zone is available only to those serving in the U.S. military.

#### 6. Housing Allowance

- a. The inflation-adjusted standard cost-allowance on housing expenses for 2011 is \$27,870 for those locations not on the IRS's list of high-cost locations.

Hong Kong, China - \$114,300

$\$92,900 \times 16\% = \$14,864$  Base Amount  $\$40.72$  per day

$\$92,900 \times 30\% = \$27,870$

#### 7. Health Care Professionals

- a. State A has several programs to entice health care professionals to perform services in rural, low-income, or other underserved areas of the State. If the program requires recipients to use the incentive payments to repay student loans, the money is tax free. If the workers can use the funds for any purposes, the payments are taxable wages. Participants in this particular program need not have outstanding student or other types of loans to participate, and the available information indicates that they can spend the incentives as they wish. As presently structured, the programs represent employment incentives or compensation for agreeing to perform services with the State. The amounts paid under these programs are not received under a "State loan repayment or loan forgiveness program" and so are taxable income. [CCA 201104032]

#### 8. Forfeiting Cash Value

- a. A policy holder expected a tax break when most of the cash value in his policy was withheld by the insurer at maturity to cover loans he had taken out against the policy over the years. He reported as income only the net amount of cash he received from the insurer. The Tax Court held that he owes tax on the full amount by which the cash value of the insurance policy exceeds his investment in the policy. [Ledger, TC Memo 2011-183]
- b. A policy owner stopped paying the premiums on a policy. The insurance company terminated the policy and offset its cash value against funds that the owner had borrowed against the policy, plus accrued interest. The Tax Court said that he owes tax on the net amount plus the debt, less what he had invested in the policy. [Brown, TC Memo 2011-83]

## 9. Patent Infringement

- a. An S corporation that supplied sausage to Pizza Hut patented a way to make precooked sausage look and taste as if it were homemade. It sued Pizza Hut for divulging the process to a competitor. The parties settled and the S firm treated the money it received as capital gain from the sale of patent rights. Since the firm retained nearly all the rights to its patent, the proceeds were treated as ordinary income from lost profits and patent infringement. [Freda, CA-7; 8-26-2011]

## 10. Stock Options

- a. A corporate officer who received stock as incentive compensation is taxed on the stock's value at receipt, even though federal securities law barred him from selling the stock for a year. [Gundmundsson, CA-2] Unfortunately, the stock lost almost 80% of its value during the time after accounting irregularities were discovered. Since the officer was vested in the shares immediately upon receipt, the value on that date is used to determine his income.
- b. The taxpayer was granted nonqualified stock options for her services and exercised them at a time when the stock's value far exceeded the exercise price. Soon after, the stock's price began to plummet. She claimed that she was subject to federal rule requiring corporate insiders to wait six months before selling stock or risk forfeiting the profits to the government. This way, she could use the lower value of the stock on the later date to trim her income tax bill from exercising the option. The Court said the six-month period begins on the date the option was granted, not on the vesting date, so her window of potential liability ended before any options were exercised. She is taxed on the difference between the value of the stock on the date of exercise minus what she paid to exercise the option. [Strom, CA-9]

## 11. Vehicle Leasing

- a. The amount taxed for leasing a vehicle to use in your business is about 50% less than in 2010. [Rev. Proc. 2011-21]

## 12. Mortgage Assistance Payments

- a. The IRS says that government-sponsored home mortgage assistance payments are not taxable. [Notice 2011-14] The funds are paid to or on behalf of financially ailing homeowners under federal and state government programs designed to prevent home foreclosures and to stabilize the housing market. Since the payment promote general welfare, they are excluded from income and 1099 forms need not be given to the recipients.

## 13. Government Subsidies to Business

- a. Government subsidies to corporations can be tax free capital contributions. But partnerships and limited liability firms are taxed on them according to the IRS. [LMSB Coordinated Issue Paper LMSB4-1008-051] In a memo to the field, the Revenue Service continues to assert that only corporations can exclude from income government-offered subsidies, grants, and similar payments. The agency has instructed it appeals officers not to concede this issue to taxpayers.

#### 14. State Foster Care Payments

- a. The care recipients must be placed by a state agency in the foster home for the care payments to be tax free. The Tax Court said that the payments received were taxable income where the caregivers were paid by the state to care for their parents, who lived with them. [Alexander, TC Summ. Op. 2011-48] Another problem was that under state law, a house where the individuals being cared for are related to the caregivers is not a qualifying foster home.
- b. Care payments a mother of a disable child receives from a county are taxable. [Harper, TC Summ. Op. 2011-56] The municipality paid her to assist her adult son in all activities of daily living because he could not care for himself. The Tax Court said that because she was paid for providing services, the payments to her are taxed as compensation.

#### 15. Treatment of State and Local Tax Incentives

- a. The IRS determined that a state and local tax (SALT) incentive is not income under Code Sec. 61, is not a contribution of capital under Sec. 118(a), and therefore would not reduce a taxpayer's basis under Sec. 362© ). The IRS also determined that a SALT incentive is not deductible as tax paid under Sc. 164. Finally, the IRS determined that a SALT incentive does not qualify for exclusion to capital by a non-shareholder under Sec. 188(a) even if the incentive would be treated as an item of income. [Appeals Settlement Guidelines, 3-2-2011]

#### 16. Cell Phones

- a. The Notice 2011-72 provides guidance on the treatment of employer- provided cell phones as an excludable fringe benefit.
- b. The Notice provides that when an employer provides an employee with a cell phone primarily for noncompensatory business reasons, the business and personal use of the cell phone is generally nontaxable to the employee.
- c. The IRS will not require recordkeeping of business use in order to receive this tax-free treatment.
- d. Simultaneously with the Notice, the IRS announced in a memo to its examiners a similar administrative approach that applies with respect to arrangements common to small businesses that provide cash allowances and reimbursements for work-related use of personally-owned cell phones.
- e. This treatment does not apply to reimbursements of unusual or excessive expenses or to reimbursements made as a substitute for a portion of the employee's regular wages.

## 17. Tool Reimbursements

- a. The IRS is continuing its scrutiny of employee tool reimbursement plans. The probe covers automobile dealers, car repair firms, and body shops, plus firms involved in aviation, agriculture, telecommunications, and construction.
- b. One such plan is a sham to avoid income and payroll taxes, the Service says. [CCA 201120021] Under the plan, a portion of an employee's regular wages is converted into a tax-free reimbursement for tools used on the job. Once a worker has received an amount equal to his estimated tool costs for the year, his regular pay is increased back to its previous level. No substantiation of tool cost is required, the workers do not have to return any excess tool reimbursements to the employer. According to the IRS, all payments under the plan are income and subject to payroll tax.
- c. Firms can qualify for a reduced tax bill if the Service disallows a tool plan. They can escape liability for income taxes that should have been withheld if they are able to prove that employees reported the payments as income. Of course, employees who do so also typically deduct the identical amount as tool expenses, showing no net income.
- d. In a recent case, a court permitted an employer access to employees' tax returns to demonstrate that the payments were properly reported, so it could reduce what it owed. For privacy purposes, the IRS was told to scrub names and Social Security numbers from the returns. [Creasmen Electronics, DC, NC]

## 18. Whistleblower Award

- a. The Court of Appeals for the Eleventh Circuit found that the recipient of a qui tam award from the government as a whistleblower under the Federal Claims Act is taxable on the award. [Campbell, 2011-2 USTC p50,644, CA-11]. The taxpayer, a whistleblower against his employer-defense contractor, claimed that a \$5.25 million payment net of attorneys fees was excluded from his income. The Eleventh Circuit also imposed a 20% penalty, because the taxpayer did not act in good faith, since he failed to consult a professional tax adviser.

## D. Capital Gains and Losses

### 1. Musical Work as a Capital Asset

- a. The IRS has issued final regs describing the election to treat the sale of a musical work as a sale of a capital asset. [TD 9415] Effective for sales or exchanges in tax years beginning after May 17, 2006, a taxpayer may elect to treat the sale or exchange of a musical composition or a copyright in a self-created musical work as a sale or exchange of a capital asset. The election may also be made for musical compositions and copyrights having a basis determined by reference to the basis in the hands of the taxpayer who personal efforts created the composition or copyrights.
- b. An election must be made separately for each musical composition (or copyright in a musical work) sold or exchanged during the tax year. An election must be made on or before the due date (including extensions) of the income tax return for the tax year of the sale or exchange. The election is made on Schedule D, Capital Gains and Losses, of the appropriate income tax form.
- c. The final regs provide an automatic extension of six months from the date of the taxpayer's return (excluding extensions) to revoke an election. The taxpayer must file his or her return on a timely basis. With the six-month extension period, the taxpayer must file an amended return that reports the sale or exchange of the musical composition or copyright, but not as a capital asset. If the taxpayer fails to obtain an automatic revocation, the taxpayer may request a letter ruling to revoke the election.

## E. Like-Kind Exchanges and Involuntary Conversions

### 1. Constructive Receipt

- a. A businessman intended to do a tax-deferred exchange of his plane for another one. He sold his plane and used an unrelated intermediary to hold the proceeds in escrow to purchase a replacement. But the escrow agent accidentally wired him the funds. Although he returned the money the next day, the Service argued that his receipt of the sale proceeds caused the exchange to be taxable. The Claim Court disagreed, saying he should not be punished for the agent's mistake. [Morton, Ct. of Fed. Claims]
- b. The Tax Court ruled that the taxpayers had constructive receipt and did not qualify for nonrecognition treatment under Sec. 1031. [Ralph Crandall, TC Summ. Op. 2011-14] As part of the exchange, the parties established two escrow accounts. Neither account limited taxpayers' right to receive, borrow, or otherwise obtain the benefit of the funds nor made any mention of a like-kind exchange.

### 2. Depreciation

- a. The full tax basis of acquired property from like-kind exchanges are eligible for 100% bonus depreciation. Assets with useful lives of 20 years or less, such as machinery and equipment, are eligible for this write-off.

### 3. Long-Term Care Policies

- a. Congress changed the law to permit tax-deferred exchanges of life insurance or annuities for long-term care policies. Long-term care insurance can be offered as part of an annuity contract. The IRS has stated that no tax is due if the insurance premiums are paid with the annuity's cash value. The cash value in annuities and life insurance policies can be used tax free to purchase long-term-care insurance coverage. [Notice 2011-68]

### 4. Inventory

- a. According to the IRS, gain on inventory destroyed in a federal disaster area can be deferred. [PLR 201111004] A hurricane destroyed a firms' inventory and the insurance money exceeded its cost basis in the inventory. The company can defer the tax on the gain by using the proceeds to purchase other business assets -- inventory or noninventory items. The firms used the insurance money to build new stores. The normal rule that requires reinvestment in like-kind assets to defer the gain does not apply here. Replacement property must be purchased within two years after the end of the first tax year in which the condemnation proceeds are received to defer gain. An additional three years is added for property that was located in the 2005 Katrina disaster zone or the areas affected by the 2008 Midwest floods.
- b. Sec. 1033(h)(2) applies to property held for productive use in a trade or business or for investment. If this property is involuntarily converted because of a federally-declared disaster, then any tangible property held for productive use in a trade or business treated as property that is similar or related in service or use to the converted property. Because Sec. 1033(h)(2) does not exclude conversions of inventory, and because Congress did not intend to deny the benefit of the provision to inventory businesses, the IRS concluded that the provision applies to inventory that is involuntarily converted in a federally-declared disaster. Thus, inventory is property held for productive use in a trade or business for purposes of Sec. 1033(h)(2).

### 5. Failed Like-Kind Exchanges

- a. The IRS has unveiled a safe harbor for participants in multiple-party like-kind exchanges under Sec. 1031 that have gone bad because of the default of qualified intermediaries (QIs). [Rev. Proc. 2010-14]

## F. Sale of Residence

1. The pair owned land on which they had their primary home and ran a towing business. The county wanted to put a road through their parcel, and they eventually sold the county an easement for \$131,000. As part of the deal, they had to remove a trailer, vehicles, and other items from the land. The Court found their use of the land to be substantially reduced and concluded that the easement was a sale of a property interest for \$131,000. [Wickersham, TC Memo 2011-178] The part that is allocated to the residential component of their mixed-use property is eligible for the Sec. 121 exclusion.

## G. Retirement Plans

### 1. Contributions to IRAs

- a. Contributions to IRAs cannot be based on interest and dividend income or Social Security benefits, the Tax Court says. [Kobell, TC Memo 2011-66] Contributions must be based on earned income such as wages or Schedule C income. Interest and dividends received in the capacity of security dealer qualify as earned income.

### 2. Wrap Fees

- a. Wrap fees charged to IRA holders are not counted as payments to the IRA if separately paid by the owner. [Ltr. Rul. 201104061] The fee covers investment help, broker commissions, and the like. Although the payment of broker commissions is usually treated as an IRA payment, the rule does not apply to wrap fees because the charge does not vary with the number of trades made. It is based on a percentage of total assets under management.
- b. The wrap fees can be claimed as miscellaneous itemized deductions on Schedule A to the extent the total exceeds 2% of the taxpayer's adjusted gross income.

### 3. Plan Beneficiary

- a. A 401(k) plan provided that if a participant died, the account would go to the spouse unless the spouse agreed to waive his or her rights as a beneficiary. A plan member designated his three adult children as beneficiaries after his first wife passed away. He eventually remarried, but died six weeks later. Both his children and his new spouse claimed the balance left in his 401(k) plan, and a district court awarded it to his wife because a spousal waiver was never executed. [Cajun Industries v. Kidder, DC, La]

### 4. 60-Day Rollover Period for IRA Funds

- a. The IRS refused to waive the 60-day rollover period for redepositing IRA funds. [PLR 201118025] The taxpayer took a distribution and put the funds toward his mother's cash purchase of a new residence. His mother planned to enter into a reverse mortgage and expected to receive a lump sum which she could use to repay the taxpayer. The 60-day rollover period expired before the bank provided the funds to the taxpayer.
  - 1) The IRS cited Rev. Proc. 2003-16, which provides factors it will consider for waiving the 60-day period. The IRS noted that the bank issuing the reverse mortgage did not transact any financial matters relating to an IRA. The taxpayer failed to provide evidence of the impact of any factor outlined in Rev. Proc. 2003-16.

## H. Losses

### 1. Grouping Activities

- a. Beginning with 2011 tax returns, taxpayers will be required to provide tax return disclosures of: (1) activity groupings and regroupings that occur during the tax year, and (2) additions of new activities to existing groupings that occur during the year. [Rev. Proc. 2010-13] The new disclosure requirements are effective for tax years beginning on or after January 25, 2010.
- b. Real Estate Professional
  - 1) Requirements
    - a) More than half of the personal services that you performed in trades or businesses during the year were performed in real property trades or businesses in which you materially participated.
    - b) You performed more than 750 hours of services during the year in real property trades or businesses in which you materially participated.
    - c) You must have materially participated in each rental real estate activity.
  - 2) If you were a real estate professional for the year, any rental real estate activity in which you materially participated is not a passive activity.
- c. Reg. 1.469-4 provides that it is acceptable to group several business or rental activities into a single combined activity because the combined activity constitutes an "appropriate economic unit" for measuring income, gain or loss for PAL purposes.
- d. In general, once the taxpayer groups activities together or treats them as separate activities, the existing treatment cannot be change in subsequent years. The exceptions are when: (1) it is determined that the existing treatment is clearly inappropriate; (2) there is a material change in the facts and circumstances that causes the existing treatment to be clearly inappropriate; or (3) the IRS determines that the taxpayer's existing treatment is inappropriate and was done with a principal purpose of circumventing the PAL rules. In these cases, the taxpayer must regroup activities into appropriate economic units and comply with any applicable requirements to disclose the changes. [Reg. 1.469-4(d)(1), (e)(2), and (f)]
- e. Before Rev. Proc. 2010-13, there were generally no such disclosure requirements.
- f. Activity groupings are important for several reasons:
  - 1) When several activities are grouped together into one combined activity, it is often much easier to meet the material participation standard for the combined activity. If the material participation standard is met for the tax year in question, the combined activity is exempt from the PAL rules.
  - 2) When several activities are grouped together into one combined activity, losses from one or more activities within the grouping can offset income from one or more other activities within the grouping. This happens even if the material participation standard is not met for the combined activity.

- 3) When several activities are grouped together into one combined activity and there are suspended passive losses from the combined activity, it can be harder to "free up" and deduct the suspended passive losses by selling substantially all of the combined activity. Selling prices of the combined activity will generally not be sufficient to allow suspended passive losses to be freed up.
- 4) The new disclosure rules require tax return statements in three specified circumstances, and the statements must include specified information.
  - a) **New Groupings.** The taxpayer must file a written disclosure statement with the original federal income return for the first tax year in which two or more activities are grouped together into a single activity. The statement must list the names, addresses, and employer identification numbers for the activities that are grouped. The statement must also declare that the activities are now being grouped together constitute an appropriate economic unit for measuring gain or loss under Section 469 rules. [Section 4.03 of Rev. Proc. 2010-13]
  - b) **Addition of New Activities to Existing Groups.** For a tax year when the taxpayer adds a new activity to an existing grouping, the taxpayer must file a written disclosure statement with the original return for that year. The statement must list the name, address, and employer identification number for the new activity and list the same information for the activity or activities within the existing grouping to which the new activity is being added. The statement must also declare that the activities that are now being grouped together constitute an appropriate economic unit for measuring gain or loss under the Section 469 rules. [Section 4.03 of Rev. Proc. 2010-13]
  - c) **Regrouping of Activities.** If pursuant to Reg. 1.469-4(e)(2) it is determined that the taxpayer's existing grouping of activities is clearly inappropriate or that a material change in the facts and circumstances has occurred that makes the existing grouping clearly inappropriate, the taxpayer must regroup the activities into one or more appropriate economic units. With the original return for the tax year in which the regrouping occurs, the taxpayer must file a written disclosure statement. The statement must list the name, address, and employer identification number for the activities that are being regrouped and an explanation of why the original grouping was deemed to be clearly inappropriate. If the regrouping results in two or more activities being grouped into a single activity, the statement must declare that the now-combined activities constitute an appropriate economic unit for measuring gain or loss under the Section 469 rules. [Section 4.04 of Rev. Proc. 2010-13]
- 5) Disclosure of activity grouping are not required in the following three circumstances:
  - a) **Preexisting Grouping Remain Unchanged.** No disclosures are required for grouping that existed before January 25, 2010. [Section 4.05 of Rev. Proc. 2010-13]

- 6) Groupings by Partnerships and S Corporations. These pass-through entities must already comply with existing activity grouping disclosure requirements set forth in the instructions to Form 1065 and Form 1120S, respectively. Under these existing requirements, the entity must disclose activity groupings to partners and shareholders by separately stating income or loss amounts for each grouping on attachments to annual Schedules K-1. Similarly, partners and shareholders are not required to disclose on their own returns activity groupings that are simple "passed through" to them by the partnership or S corporation. [Section 4.05 of Rev. Proc. 2010-13]
  - a) The disclosure rules do apply if a partner or shareholder combines "passed-through" partnership or S corporation activities that were not grouped together by the partnership or S corporation, if this is done on the partner's or shareholder's return for a tax year beginning on or after January 25, 2010. Disclosure is required if a partner or shareholder combines "passed-through" partnership or S corporate activities with other activities conducted directly by the partner or shareholder or with other activities conducted through other partnerships or S corporations.
- 7) Certain Rental Real Estate Groupings. The new disclosure rules do not apply to qualifying individuals who have made the so-called real estate professional election under Sec. 469(c)(7)(A) to group all rental real estate activities into a single activity.
- 8) When the taxpayer fails to make a disclosure required by Rev. Proc. 2010-13 that certain activities have been grouped together, each such activity will be treated as a separate activity for PAL purposes. However, a taxpayer's grouping are acceptable if the taxpayer: (1) files all affected federal income tax returns in a manner that is consistent with the desired, but undisclosed, grouping of activities, and (2) makes the required disclosure with the return for the year when the failure to disclose is first discovered. If the IRS discovers the failure before the taxpayer does, the taxpayer must have "reasonable cause" for not disclosing. Otherwise the general rule requiring all activities to be treated as separate activities will apply. [Section 4.07 of Rev. Proc. 2010-13]

## 2. Real Estate Professional

### a. Late Elections

- 1) Real estate professionals with rental losses can make a late election to treat all rentals as a single unit. [Rev. Proc. 2011-34]
- 2) A real property trade or business includes development, construction, acquisition, conversion, rental, leasing, management, or brokerage.
- 3) Ordinarily, the PAL rules apply as if each taxpayer's interest in rental real estate were a separate activity. However, a taxpayer may elect to treat all interests in rental real estate as a single real estate activity, by filing a statement with the taxpayer's original income tax return for the year.
- 4) The election is binding for the year in which it is made and for all future years, unless the taxpayer is not a qualifying taxpayer. The taxpayer can make the election in any year in which the taxpayer qualifies; not just the initial year of qualification. A taxpayer can revoke the election only if there is a material change in the taxpayer's circumstances.

- 5) The new procedure is in lieu of applying for a letter ruling. Accordingly, the taxpayer does not have to pay user fees to obtain permission for a late election. Taxpayers not eligible for the shortcut procedures can still apply for a letter ruling, provided the three-years statute of limitations on assessment has not expired.
  - 6) To obtain relief under the new procedures from an otherwise untimely election, representations must be made that the taxpayer:
    - a) Failed to make the election solely because the election would not have been timely.
    - b) Filed return consistently with having made an election and aggregating the taxpayer's activities, and did not file any returns inconsistent with the requested aggregation of activities.
    - c) Timely filed each return that would have been affected by a timely election. A return is timely if filed within six months after its due date, excluding extensions.
    - d) Has reasonable cause for not making a timely election.
  - 7) The taxpayer must attach the statement to an amended return for the most recent tax year, explain the reason for the failure to file a timely election, and identify the year for which it is making a late election. The IRS will notify the taxpayer that it has received a completed application for relief that satisfies the requirements of Rev. Proc. 2011-34. The taxpayer may then treat all interests in rental real estate as a single rental real estate activity for the year for which the election was made.
- b. Short-Term Rentals
- 1) Taxpayers must materially participate in short-term rentals in order to deduct their losses. Short-term rentals are where the average rental period is seven days or less. [Jende, TC Summ. Op. 2011-82] Applies to the active-participation requirement for the \$25,000 exception. Short-term rentals are not considered rental property.
  - 2) The active participation test does not apply in the case of short-term rentals. The taxpayers must put in at least 100 or more hours a year on each unit and their participation must be more than anyone else's. Or they must work over 500 hours on each rental.
  - 3) The Tax Court has held that time spent by real estate professionals who have short-term rentals will not count in determining whether the taxpayer spent 750 or more hours a year materially participating in real estate activities. [Bailey, TC Summ. Op. 2011-22] It does not matter that the taxpayer materially participated in the short-term rentals. The taxpayer spent more than 1,003 hours during the year managing rental properties, 324 of the hours were spent running short-term rental property.
- c. The IRS gave a couple with multiple rental properties additional time to elect to treat the units as one entity. [PLR 201117011]

### 3. Business Bad Debt

- a. A venture capitalist's \$3.6 million bad loan to a business associate is deductible business bad debt. [Dagres, 136 TC No. 12] The capitalist loaned money to a businessman who had given him several leads on companies that he would then invest in and help operate. Unfortunately, the tipster defaulted. The Service treated the loan as a nonbusiness bad debt, deductible as a short-term capital loss. The Tax Court said the loan was related to his business, because the dominant motivation for making the loan was to protect or enhance his business, not to protect his investments. The loss is fully deductible, without regard to the \$3,000 annual limit on capital losses.

### 4. Gambling Expenses

- a. The Tax Court affirmed that the taxpayer's wagering costs were limited to the amount of his wagering gains under Sec. 165(d). However, the Court held that Sec. 165 loss limitations did not apply to the taxpayer's business expenses from his professional gambling. [Mayo, 136 TC No. 4 (2011)] The Court chose not to follow the decision in Offutt that held that losses from wagering transactions included both losses from wagers and more general expenses incurred in the conduct of a gambling business. [16 TC 1214 (1951)] Related expenses such as meals, lodging, and transportation are not treated as wagering losses. These costs can offset self-employment tax, and if large enough can even create a net operating loss to offset prior years' income.

### 5. Trading Losses

- a. The Tax Court has found that an individual was an investor, not a trader, and could not deduct investment losses as ordinary losses. Instead the taxpayer was limited to a \$3,000 deduction for capital losses. [van der Lee, TC Memo 2011-234] An individual had substantial experience as a trader for various investment banks. In 2002 he started trading for his own account. He engaged in nearly 200 transactions during the year. He claimed ordinary losses of almost \$1.4 million from his investment activities, plus another \$92,000 in expenses. The court found that despite his training the individual was an investor because he held stocks for asset appreciation rather than short-term price variations. The taxpayer did not trade with sufficient frequency to be a trader, and his total number of trades was not substantial.

## I. Alimony

1. A taxpayer paid his ex-wife \$50,000 so she could qualify to refinance the mortgage to get his name off the loan. Since the payment was not required by the court order, it is not alimony. [Grosjean, TC Summ. Op. 2011-75]
2. Attorney's fees paid in a divorce were not deductible because they failed to meet the "ends-on-death" criteria of Section 71 [Dan Nicolas, TC Summ Op. 2011-9] The judgment order did not state whether the obligation would continue if his ex-wife died. Oregon state law was ambiguous on this point. This allowed the court to read the divorce instrument and make its own determination based on the language of the document.

## J. Business Deductions

### 1. Health Insurance

- a. By offering family coverage for all employees, a taxpayer can receive health insurance coverage under the spouse's policy. The entire cost of the medical plan can be deducted as a business expense, an Appeals Court says, as long as the spouse is a bona fide employee. [Shellito, CA-10] In this case, a farmer hired his wife and paid her \$100 a month plus health insurance. The business expense deduction reduces the farmer's income tax and SECA tax bills.

## K. Depreciation and Amortization

### 1. Luxury Automobiles [Rev. Proc. 2011-12]

- a. The depreciation for new autos put in use in 2011 does not change from 2010. The higher depreciation deduction limits for electric automobiles only applied to vehicles placed in service between January 1, 2002 and December 31, 2006.

| <u>Year</u>      | <u>Passenger Autos</u> |         |
|------------------|------------------------|---------|
|                  | New                    | Used    |
| First year       | \$11,060               | \$3,060 |
| Second year      | 4,900                  | 4,900   |
| Third year       | 2,950                  | 2,950   |
| Succeeding years | 1,775                  | 1,775   |

- 1) The method of calculating the price inflation amount for trucks and vans placed in service in or after 2003 uses a "new trucks" component, resulting in somewhat higher depreciation deductions for trucks and vans.
- 2) The term "trucks and vans" refers to passenger automobiles that are built on a truck chassis, including minivans and sport utility vehicles (SUVs) that are built on a truck chassis.

| 3) <u>Year</u>   | Trucks and Vans |         |
|------------------|-----------------|---------|
|                  | New             | Used    |
| First year       | \$11,260        | \$3,260 |
| Second year      | 5,200           | 5,200   |
| Third year       | 3,150           | 3,150   |
| Succeeding years | 1,875           | 1,875   |

- b. If business use fall below 50% in a year after a heavy SUV is placed in service, the excess of the depreciation taken over straight-line depreciation is taxed as income. [Birdsall, TC Summ. Op. 2008-55] The recapture period lasts for five years.

### 2. Bonus Depreciation

- a. The 2010 Tax Relief Act retroactively increased bonus depreciation for new assets placed in service after September 8, 2010 and through 2011 from 50% to 100%. The Congressional Committee Report explaining this legislation indicated that the increase to 100% was effective for assets placed in service after September 8, 2010.

b. Qualifying Property

- 1) New equipment
- 2) Software
- 3) Qualified leasehold improvement property
- 4) Placed in service by year-end

c. Self-Constructed Property

- 1) According to Rev. Proc. 2011-26, the IRS interprets the September 8, 2010, effective date for transitioning from 50% to 100% bonus depreciation to mean that to qualify for the 100%, the asset must be both acquired and placed in service after September 8, 2010. An asset is placed in service when it is available for service, whether or not actually utilized in the business. In the case of a purchased asset, the property is acquired when the taxpayer pays or incurs the cost of the property.
- 2) Self-constructed property is acquired when the taxpayer begins constructing, manufacturing, or producing the property. Self-constructed property includes arrangements under a written contract with another party to construct the property. [Reg. 1.168(k)-1(b)(4)(iii)] Rev. Proc. 2011-26 defines the beginning of construction as when physical work of a significant nature begins.
- 3) Thus, construction that began before September 9, 2010, will not qualify for the 100% bonus depreciation.
- 4) There is a safe harbor within the regulations, stating that physical work of a significant nature is not considered to begin until the taxpayer incurs more than 10% of the total cost of the property (excluding the cost of any land any preliminary activities such as planning or designing, securing financing, exploring or researching). [Reg. 1.168(k)-1(b)(4)(iii)(B)]
- 5) Taxpayers have the ability to elect 100% bonus depreciation on a component of a larger constructed asset, where the large asset is ineligible because significant construction began before September 9, 2010, but the component is constructed after September 8, 2010. The guidance states that a component is "any part...of the larger self-constructed property, which may or may not be the same as the asset for depreciation purposes or the same as the unit of property for purposes of other Code sections."
- 6) Taxpayers must elect to claim 100% bonus depreciation on eligible components that are carved out of a larger 50% bonus depreciation property. The election must be made by the extended due date of the federal tax return for the year in which the larger self-constructed property was placed in service. The election statement must indicate that the taxpayer is "making the election for all or some components described in section 3.02(2)(b) of Rev. Proc. 2011-26."

- 7) A taxpayer who claimed 100% bonus depreciation when only 50% was allowable will need to correct the error by one of the following methods:
  - a) Filing an Amended 2010 Return. The additional taxes plus interest resulting from correcting the overstated depreciation will have to be paid at the time the amended return is filed.
  - b) Requesting an Automatic Accounting Method Change. The disallowed depreciation can be taken into income ratably over four years rather than being recognized all in 2010. There is no interest charge if the correction is made in this manner. Attach a copy of Form 3115 to a timely filed return. A copy of Form 3115 must also be filed with the IRS in Ogden, Utah. This is Change No. 7 per the Form 3115 instructions.
- d. New Client
  - 1) New client has several rental properties and her son has been doing the tax returns. No depreciation taken for 10 years.
  - 2) "Allowed or Allowable."
  - 3) Permission to change accounting method is obtained by filing Form 3115 (Application for Change in Accounting Method) and taking a Code Sec. 481 adjustment to income.
    - a) \$3,800 user fee.
  - 4) Some changes in depreciation method, although granted automatically, still require filing of Form 3115. The automatic change procedures generally are easier to follow and allow taxpayer to avoid the user fee that normally must be paid.
  - 5) Form 3115 must be filed after the beginning of the year of change and not later than the due date (including extensions) of the taxpayer return for the year of change. #7 of 149 automatic changes.
    - a) From an impermissible method to a permissible method.
  - 6) The IRS has reduced the four-year spread for negative adjustments to a single year, effective for tax years ending on or after December 31, 2001. [Rev. Proc. 2002-19]
  - 7) To qualify for the change of accounting method, the taxpayer must own the asset at the beginning of the year of change.
  - 8) Form 3115 can be filed within the statute of limitations for disposed assets. The change in accounting method is instituted for the year the asset is disposed. {Rev. Proc. 2004-11}
- e. The interaction between the statutory language for the 100% bonus depreciation deduction and the luxury vehicle limits has created a technical anomaly unintended by Congress. The IRS developed a special safe harbor method of accounting to correct the problem. Under Rev. Proc. 2011-26, taxpayers will no longer be denied further deductions until the vehicle's five-year recovery period ends. The safe harbor method is adopted simply by using it and taking depreciation accordingly on the return for the tax year after the year first placed in service.

- f. New heavy SUVs put in service in 2011 can write off 100% of the cost thanks to 100% bonus depreciation. SUVs must have loaded gross vehicle weight over 6,000 pounds to qualify for this break. The \$25,000 ceiling on expensing SUVs does not apply if bonus depreciation is taken. Used SUVs do not get bonus depreciation. New pickup trucks with loaded weights over 6,000 pounds can be fully written off. Used heavy pickup trucks can be fully written off if the cargo bed is at least six feet in length.

### 3. Section 179

- a. Increases the maximum deduction to \$500,000; phaseout begins at \$2 million.
  - 1) Available for 2010 and 2011.
- b. Generally, the Section 179 deduction for any year is limited to the taxpayer's business taxable income. [Sec. 179(b)(3)] Amounts not deducted due to this taxable income limit are generally carried forward indefinitely. But a special rule applies to unused Section 179 deductions related to qualified real property that are disallowed because of the taxable income limit. These disallowed deductions can only be carried over to a tax year that begins in 2011. Therefore, there is no carryover for disallowed deductions from qualified real property placed in service in the 2011 tax year. Disallowed deductions remaining at the end of the 2011 tax year are treated as if no Section 179 expensing election had been made for them. Amounts not deducted as of the end of the 2011 tax year are depreciated under the normal rules for real property.
- c. The full amount of the member's share of Section 179 expense reduces the member's outside basis even though the member cannot claim the full amount of the Section 179 deduction on the tax return. [Rev. Rul. 89-7]
- d. Qualified Real Property
  - 1) Temporarily expands the definition of qualified Sec. 179 property to include qualified real property, which is defined as:
    - a) Qualified leasehold improvement property,
    - b) Qualified restaurant property, and
    - c) Qualified retail improvement property.
  - 2) Taxpayers are limited to expensing up to \$250,000 of the total cost of these properties. Limitations apply to the carryover of qualified real property deductions.
- e. Qualified Leasehold Improvement Property
  - 1) The improvement must be to the interior portion of a building;
  - 2) The building must be nonresidential real property;
  - 3) The improvement must be made pursuant to or under a lease by either the lessee (or sublessee) or the lessor to property that will be occupied exclusively by the lessee (or sub-lessee); and
  - 4) The improvement must be placed in service more than three years after the date the building was first placed in service.
  - 5) Leases between related taxpayers do not qualify.

- f. Qualified Restaurant Property
    - 1) Qualified restaurant property includes a new building as well as a used building placed in service after 2008.
    - 2) The restaurant must use more than half of the building's square footage.
    - 3) Applicable to all improvements attached to the building,
  - g. Qualified Retail Improvement Property
    - 1) The property must be an improvement to an interior portion of a building that is nonresidential real property.
    - 2) The interior portion of the building must be open to the general public and used in the retail trade or business of selling tangible personal property to the general public.
    - 3) The improvement must be placed in service more than three years after the building was first placed in service.
    - 4) Businesses primarily engaged in providing services, such as professional services, health services, and entertainment services will not qualify.
      - a) Examples of qualifying businesses are grocery, hardware, convenience, and clothing stores.
  - h. Neither restaurant property nor retail improvement property qualify for bonus depreciation. Leasehold improvements qualify for bonus depreciation.
  - i. The real property is still Sec. 1250 property for depreciation recapture of Sec. 179.
  - j. 15-Year Depreciation
    - 1) Leasehold improvement property
    - 2) Restaurant property
    - 3) Retail improvement property
4. Residential Real Estate
- a. A building with commercial and residential sections can be one structure for tax purposes. [LTR 201103006] The components must be on one tract of land or contiguous tracts, and they must be operated and managed as an integrated unit. The depreciation for the entire complex depends on the source of its income. If at least 80% of the gross rental income is derived from rentals of dwelling units, including income from the parking garage, then the building is residential real estate that can be depreciated over 27 ½ years. Otherwise, the owners of the structure are required to depreciate it over a 39-year period as commercial real estate.
5. Available for Use
- a. The Tax Court has concluded that a taxpayer cannot take depreciation deductions under Sec. 179 for an airplane that it owned but never used in its business. The court indicated that the plane was not ready and available for business use because there was no pilot to fly it. [Douglas, TC Memo 2011-214]

## L. Business Expenses

### 1. Deductible Repairs vs. Capitalized Expenses

- a. The IRS has released an Audit Technique Guide (ATG) that addresses whether an expense should be a currently deductible repair or is required to be capitalized under current law. [LB&J-4-0910-023]
- b. Costs are currently deductible as repairs expense under Sec. 162 if they are incidental in nature, and neither materially add to the value of the property nor appreciably prolong its useful life. On the other hand, costs must generally be capitalized under Sec. 263 if they are permanent improvements or betterments that increase the property's value, restore its value or use, substantially prolong its useful life, or adapt it to a new or different use.
- c. A key issue in the capitalization versus repairs determination is the unit of property (UOP); the smaller the UOP, the more likely it will be that expenses undertaken with the UOP will be capitalized.

### 2. Worthless Goodwill

- a. The IRS Chief Counsel determined that a dealer may not deduct purportedly worthless goodwill allocated to terminated franchise rights. [FAA 20111101F, 3-23-2011] Taxpayer purchased assets of another auto dealer and booked goodwill for the franchise rights to sell and service W, X, Y1, Y2, and Z autos. Later, taxpayer was notified that the manufacturer was terminating its franchise to sell W and Y2 products. Even if the goodwill associated with the franchises became worthless when the manufacturer terminated the franchise agreements with the dealer, Sec. 197(f)(1) prohibits a deduction for worthless amortizable Sec. 197 intangibles, including goodwill, where other amortizable Sec. 197 intangible purchased as part of the same transaction or series of transactions remain. Instead, the amount of any worthless amortizable Sec. 197 intangible is included in the basis of the remaining amortizable Sec. 197 intangibles.

### 3. Home Office

- a. The taxpayer operated his computer software and marketing consulting business from a home with more than 7,200 square feet. The Tax Court allowed deductions for the library, garage, and living room, even though visitors "walked through" the living room on the way to other rooms. This was considered de minimis personal use. The court also allowed deductions for two bedrooms and a maid's room used exclusively for staging and preparing projects. But occasional personal use of a breakfast room and minimal personal use of a dining room and adjoining areas cost the taxpayer deductions in other parts of the house. [Rayden, TC Memo 2011-1]
- b. The Tax Court allowed a home office deduction for the area attributable to the bedroom, but not the hallway and the bathroom since the taxpayer's children and personal guests occasionally used the bathroom. [Luis Bulas, TC Memo 2011-201]

#### 4. Caregiver Expenses

- a. Taxpayer, a self-employed contractor, claimed a business deduction for amounts paid to a caregiver who looked after his wife with Alzheimer's and also performed clerical work for the taxpayer's business. Taxpayer maintained that a caregiver had to be employed for him to work. The IRS disallowed the amount attributable to care giving services as personal and family expenses under Sec. 262, and the Tax Court agreed the expenses were not deductible as business expenses but were entitled to medical expense deduction. [Joseph Kuntz III, TC Memo 2011-52] While the taxpayer may have qualified for a dependent care credit under Sec. 21, the credit was not claimed.

#### 5. Design/Development Costs

- a. IRS Chief Counsel has concluded that a taxpayer must capitalize its design and development costs and allocate them to a long-term contract. [CCA 201111006] The taxpayer cannot deduct the costs until it receives a purchase order to provide the customer with a manufactured item.
- b. Sec. 460(c)(1) sets forth the general rule that in the case of a long-term contract, all costs, including research and experimental costs, that directly benefit the taxpayer's long-term contract activities shall be allocated to the contract.
- c. Chief Counsel also noted that bidding and other pre-contract costs have to be capitalized, even though bidding is a non-long-term contract activity.

#### 6. Theft Loss

- a. The boyfriend of a business owner worked for her firm. Although she knew he was stealing money from the business, she remained silent because he was verbally and physically abusing her. He even threatened to kill her and her kids. The Tax Court allowed the theft loss as a tax deduction. [TC Memo 2011-73]

#### 7. Business Acquisition Fees

- a. The IRS released an irrevocable safe harbor election for allocating success-based fees paid in business acquisitions or reorganizations. Payers can elect to immediately deduct 70% of the fees and capitalize the remaining 30%. [Rev. Proc. 2011-29]
- b. Reg. 1.263(a)-(5) generally requires amount paid to facilitate a business accession or reorganization to be capitalized. An amount is paid to facilitate a transaction if the amount is paid in the process of investigating or otherwise pursuing the transaction. Under Reg. 1.263(a)-5(f), an amount contingent on the successful closing of a transaction (success-based fee) is presumed to facilitate the transaction.
- c. Under the safe harbor, the IRS will not challenge a taxpayer's allocation of a success-based fee between activities that facilitate an acquisition or reorganization if the taxpayer:
  - 1) Treats 70% of the amount of the success-based fee as an amount that does not facilitate the transaction;
  - 2) Capitalizes the remaining 30% as an amount that does facilitate the transaction; and

- 3) Attaches a statement to its original federal income tax return for the taxable year the success-based fee is paid or incurred, stating that the taxpayer is electing the safe harbor, identifying the transaction, and stated the success-based fee amount that are deducted and capitalized.
  - d. The safe harbor election does not constitute a change in method of accounting for success-based fees, and a Sec. 481(a) adjustment is not permitted or required.
  - e. The 70/30 rule can be applied to fees paid in tax years ending after April 7, 2011.
8. Unreimbursed Expenses
  - a. Any expenses that an employer would have reimbursed are not deductible according to the Tax Court. [DeWerff, TC Summ. Op. 2011-29] A taxpayer listed many business expenses on her tax return, such as parking fees and travel, that appeared to be reimbursable under the policy of her employer. She never asked her employer to cover the expenses and that failure cost her the deduction.
9. Self-Employed Health Insurance Deduction
  - a. Self-employed individuals can deduct Medicare Part B premiums as part of their above-the-line deduction for health insurance. The deduction also applies to Part D premiums for prescription drugs. The spouse's Part B and D premiums do not count unless the spouse is self-employed. The deduction applies to 2% owners of S corporations only if the firm paid the premiums or reimbursed the owner.
    - 1) Publication 535 states that self-employed taxpayers can amend prior year returns to deduct Medicare premiums as part of their tax deduction for health insurance. Prior instructions stated that the amounts were not deductible.
10. Adjunct Professor
  - a. The Tax Court has concluded that an adjunct professor of economics who taught online courses was an employee, not an independent contractor. As a result, the individual had to deduct business expenses as miscellaneous itemized deductions on Schedule A, rather than as self-employment expenses on Schedule C. [Schramm, TC Memo 2011-212]
  - b. In another case the taxpayer was considered an independent contractor. [Donald T. Robinsion, TC Memo. 2011-99] The Tax Court ruled that Temple University exercised little control over how the taxpayer completed his work. The taxpayer had no office at Temple, he could market his services to others, and Temple did not provide him with any employee benefits.

## M. Travel and Entertainment

### 1. Per Diem Rate for Fiscal-Year 2011

- a. The simplified "high-low" per diems have decreased to \$233 for high-cost localities and \$160 for all other localities. [Rev. Proc. 2010-39]
- b. The amounts are \$168 for lodging and \$65 for meals and incidental expenses for the high-cost areas and \$108 for lodging and \$52 for meals and incidental expenses for other localities.
- c. Taxpayers in the transportation industry may treat \$59 as the federal meals and incidental expenses rate for all localities within the CONUS, and \$65 as the meals and incidental expense rate for all localities outside of CONUS.
- d. The revised rates apply to per diem allowances paid for travel on or after October 1, 2010.

### 2. Per Diem Rate for Fiscal-Year 2012

- a. The simplified "high-low" per diems have risen to \$242 for high-cost localities and \$163 for all other localities, up from \$233 and \$160 respectively. [Rev. Proc. 2011-47]
- b. The amounts are \$177 for lodging and \$65 for meals and incidental expenses for the high-cost areas and \$111 for lodging and \$52 for meals and incidental expenses for other localities.
- c. Taxpayers in the transportation industry may treat \$59 as the federal meals and incidental expenses rate for all localities within the CONUS, and \$65 as the meals and incidental expense rate for all localities outside of CONUS.
- d. The revised rates apply to per diem allowances paid for travel on or after October 1, 2011.

### 3. Mileage Rates

- a. The business standard mileage reimbursement rate for the first half of 2011 will be 51 cents-per-mile. The standard mileage rate for medical and moving expenses for 2011 will be 19 cents-per-mile. The statutorily determined rate for the charitable deduction remains at 14 cents-per-mile for 2011. The depreciation component of the business standard mileage rate will be 22 cents-per-mile for 2011. [Rev. Proc. 2010-51, Notice 2010-88]
- b. The business standard mileage rate rises to 55.5 cents-per-mile and the medical/moving standard mileage rate to 23.5 cents-per-mile for the second half of 2011. [IR-2011-69, Ann. 2011-40]
- c. Taxpayers may use the standard mileage rate method for calculating deductible expenses of automobiles used for hire, such as taxicabs, for transportation expenses paid or incurred on or after January 1, 2011. [Rev. Proc. 2010-51]

#### 4. Tax Home

- a. Taxpayer with no principal place of work may be able to treat their personal residence as their tax home if they incur duplicate living expenses while traveling for business, have personal and historical connections to the home, and have a business justification for maintaining the home. [Gary Lysen, TC Memo 2011-226] The Tax Court found that a contract laborer's tax home was his personal residence and his unreimbursed employee business expenses were deductible to the extent he was able to substantiate the deductions. The taxpayer was a member of a laborer's union that contacted him regularly about temporary jobs in several states. The court found it an adequate business justification that taxpayer would continue to use his union to obtain work in his state of residence as well as other locations, and reasonable to maintain a house in the city where he has lived since childhood.

#### N. Itemized Deductions

##### 1. Medical Expenses

###### a. Payment of Somewhat Else's Expenses

- 1) A taxpayer was entitled to deduct medical expenses and real estate taxes that her mother paid on her behalf. [Judith Lang, TC Memo. 2010-286] Although the mother paid the creditors directly, the substance-over-form doctrine treated the mother as transferring the funds to the taxpayer, who then transferred them to the creditors. Moreover, there was no risk of double deductions because the mother did not claim and was not entitled to either deduction. She could not deduct the medical expenses because the taxpayer was not her dependent, and she could not deduct the taxes because they were imposed on the taxpayer. Finally, although the payment of the medical expenses directly to the providers was exempt from any gift tax even though it exceeded the applicable exclusion amount, that fact was irrelevant in determining the income tax consequences of the payment.

- b. The Tax Court has concluded that amounts paid for long-term care of an elderly woman with dementia were deductible under Sec. 7702B©. The patient received long-term care services that were properly provided under a doctor's plan of care, even though the caregivers were not licensed healthcare providers. [Estate of Baral, 137 TC No. 1]

###### c. Over-the-Counter Drugs

- 1) Beginning 2011, the Patient Protection and Affordable Care Act allows the cost of over-the-counter medicines and drugs to be reimbursed under a health FSA or HRA only if purchased with a prescription.
- 2) Flexible spending account debit cards can be used for doctor-prescribed over-the-counter drugs. [Notice 2011-5] These flex plan or health reimbursement arrangement debit cards can be used at drugstores, pharmacies, and at mail-order or Web-based vendors. Individuals are required to present a prescription for the product to the pharmacist, who must assign a prescription number to it.

d. Lactation Supplies Qualify for Medical Expense Deduction

- 1) The IRS has announced that breast pumps and certain supplies that held lactation quality as "medical care" under Sec. 213(d). [Announcement 2011-14] The IRS also indicated that amounts reimbursed for these expenses under flexible spending arrangement, Archer medical savings accounts, health reimbursement arrangements, or health savings accounts will be excludable from taxpayer's income.

2. Charitable Contributions

a. Contemporaneous Acknowledgment

- 1) IRS Chief Counsel determined that a taxpayer could not satisfy the contemporaneous written acknowledgment requirement of a contribution to a charity by reference to the charity's Form 990, Return of Organization Exempt from Taxation. [CCA 201120022] The Chief Counsel explained that the IRS has not identified Form 990 or any other form for charities, which would serve to satisfy the requirement for a contemporaneous written acknowledgment.
- 2) A taxpayer substantiates a qualified contribution by a contemporaneous written acknowledgment of the contribution by the charity. The contemporaneous written acknowledgment must contain, among other things, the amount of cash and a description any property other than cash contributed and a description and good faith estimate of the value of any goods or services provided in consideration for the contribution. The taxpayer has the responsibility to obtain the acknowledgment from the charity.
- 3) To be contemporaneous, an acknowledgment must be obtained no later than the date the taxpayer files a return for the year that the gift was made, or by the due date or extended due date if the return is filed after either of those dates.
- 4) The Omnibus Budget Reconciliation Act of 1993 provided that charities do not have to substantiate donations if, under the regs, they report directly to the IRS the information required in a contemporaneous written acknowledgment. However, Chief Counsel found that the IRS has not issued regs nor identified any forms for charities to use for this purpose.

b. State Tax Credits

- 1) The IRS say that the receipt of a state tax credit does not reduce a charitable deduction. [PLR 201105010] Donors who contribute to four special state programs are given a transferable credit that they can either sell or use against their state taxes. The receipt of a state tax benefit for a charitable donation is not a return benefit that reduces the amount of the deduction. But recipients who elect to sell their credits are required to report the sales proceeds as taxable income.
- 2) A couple gave a conservation easement to a charity. In return, they received tax credits from the state of Colorado that they could either sell or use against their state taxes. They sold some of the tax credits weeks after receiving them. The IRS said the sales proceeds were taxed as ordinary income, but the Court disagreed. In its view, the credits are capital assets in which the couple had no basis. The gain is short term since the credits were not held for more than a year. [Tempel, 13 TC No. 15]

- 3) A married couple made three bargain sales of real property to conservation organizations, transferring conservation easement in the sales. Two sales gave rise to state easement conservation easement credit of \$260,000. The taxpayers sold \$231,000 of credit for \$175,000. They reported this sale as a long-term capital gain, by tacking on the holding period for the land to the holding period for the credits. The Tax Court found that the tax credits were capital assets because they were not noncapital assets under Sec. 1231 and were not a substitute for ordinary income, because the credit did not represent a right to income. However, the gain from the sale of the credits was short-term. The credits arose on account of a grant from the state and were not part of the taxpayers' real property rights. Thus, the taxpayer could not tack on the holding period from the real property. [McNeil, TC Memo 2011-109]

c. Conservation Easement

- 1) Pursuant to a written agreement, the taxpayer granted an easement allegedly worth \$700,000 to a qualified charity for "ten dollars, plus other goods and valuable consideration." The Tax Court denied his write-off because he failed to substantiate the donation with a contemporaneous written acknowledgment from the donee saying no goods or services were given in exchange for his donation. [Schrimsher, TC Memo 2011-71]
- 2) The donor's expert said a conservation easement cut a property's value by \$3 million, but that was based on putting in a condo development barred by local zoning rules. IRS' expert said the value was \$42,000, and the Tax Court agreed. [Boltar, 136 TC No. 14]
- 3) The Tax Court denied a facade easement on mortgaged property. No write-off is allowed unless the donee has a guaranteed right to the easement's value. The mortgage provided that if the building was destroyed, the bank could get all insurance proceeds until the mortgage was satisfied. There is no deduction because there is a chance the donee might not recover the value of its easement. The donor was allowed to write off the cash contributed to administer and monitor the conservation easement. [Kaufman, 136 TC No. 13]

3. Interest Deduction

a. Investment Interest Expense

- 1) Taxpayer elected on their original Form 1040 to treat a certain amount of net capital gain as investment income to offset investment interest expense. An IRS examination of the taxpayer's return increased capital gain and investment interest expense so that the expense exceeded the capital gain originally elected to serve as an offset. The IRS granted the taxpayer's request to modify the dollar amount of the election following the audit results, holding that the request was reasonable and in good faith under Reg. 301.9011-3. [PLR 201110002]
- 2) A couple borrowed almost \$1.6 million to buy a house. The loan was secured by the home and publicly traded stock they owned. The IRS said that they could deduct interest on \$1.1 million as mortgage interest, but the couple argued that the interest on the balance of the loan was deductible investment interest because the loan was partially secured by stock. Since the entire loan proceeds were used to buy the home, all the interest on the loan is treated as mortgage interest, subject to the \$1.1 million limit on mortgage debt. [Ellington, TC Memo 2011-193]

#### 4. Casualty Losses

- a. A married couple was denied a casualty loss deduction for the payment the husband made to settle a wrongful death claim stemming from an automobile accident. [Pang, TC Memo. 2011-55, 3-10-2011] A car struck a pedestrian, who later died. The driver's insurance company paid the pedestrian's estate \$160,000, the maximum under the policy, and the driver paid in \$250,000 more to settle the estate's claim. The couple failed to demonstrate that the claimed casualty loss was attributable to physical damage to their property. The settlement payment was not a "casualty loss" within the meaning of Sec. 165(c)(3).

#### 5. Miscellaneous Itemized Deductions

##### a. Business Clothing Deduction

- 1) According to the Tax Court, a television new anchor cannot deduct the cost of her business clothing that she wore only on TV. [Anierta Hamper, TC Summ. Op. 2011-17] She felt the clothes were too conservative to be suitable for everyday wear. The Court also denied write-off she took for the cost of makeup, manicures, contact lenses, new magazines, tooth whitening, cable TV, and a gym membership. It does not matter that her employer required her to maintain a professional appearance and to keep abreast of breaking new events. They are nondeductible personal expenses.
- 2) The test for determining whether the cost of clothing is deductible is whether it is (1) required or essential in taxpayer's employment, (2) unsuitable for general or personal wear, and (3) in fact not so worn.

#### O. Credits

##### 1. Work Opportunity Credit

- a. The U.S. Court of Appeals for the Federal Circuit upheld a finding from the Federal Claim Court that a taxpayer was not entitled to claim the Work Opportunity Credit for employees who were denied certification under that program by the appropriate state employment security agencies. [Manor Care, CA-FS 1-21-2011] The court was not swayed by the taxpayer's arguments that applications for certification were sufficient to earn the credits or that unclear guidance to state agencies concerning certain targeted group eligibility requirements entitled the taxpayer to claim the credits.

##### 2. Employee Retention Credit

- a. Firms that hired unemployed workers in 2010 can claim a 2011 credit if they retain these employees. The credit is 6.2% of each qualified worker's 2011 wages, but is capped at \$1,000 for workers making over \$16,129. The credit is available if the workers remain employed for 52 consecutive weeks, as long as their pay in the last 26 weeks of the period is at least 80% of their wages for the first 26 weeks. Form 5884-B is used to claim the employee retention credit.

##### 3. Earned Income Credit Preparers

- a. Preparers of returns with the earned income credit are going to have to file a due diligence checklist along with the returns.

## P. Employment Taxes

### 1. Employment Taxes on Medical Residents

- a. The Supreme Court unanimously decided that IRS regulations imposing FICA tax on the pay of medical residents are valid. [Mayo Foundation for Medical Education] Students whose employment by a school is incidental to their studies are exempt from FICA taxes. Effective April 1, 2005, the IRS changed its regulations to impose FICA on the pay of students who worked at least 40 hours a week, specifically targeting medical residents. In the Court's view, that is a reasonable interpretation of the law.
- b. Section 3121(b)(10) authorizes a FICA exemption for students employed by and regularly attending classes at a school or university. However, Reg. 31.3121(b)(1)-2 states that medical residents normally working 40 or more hours per week are not eligible for the exemption. In a unanimous decision, the Supreme Court found that Congress had not directly addressed the FICA taxation of medical residents, since Sec. 3121(b)(10) does not define "student" or otherwise determine whether medical residents are subject to FICA. The regulation was a permissible interpretation of the statute because focusing on the hours spent working and those spend studying is a sensible way to distinguish between workers who study and students who work. Since the medical residents worked more than 40 hours per week, their compensation for patient care was subject to FICA taxation.

### 2. LLP Self-Employment Taxes

- a. The Tax Court found that the distributive shares of a limited liability partnerships were subject to self-employment tax. [Renkemeyer , Campbell & Weaver, LLP, 136 TC No. 7 (2011)] The partnership was converted to a limited liability partnership. The three partners each held one percent of their interest as a general partners, and 32 percent of their interest as a limited liability partner. The court concluded that the partners were liable for self-employment taxes on their entire share of partnership income.
- b. The court found the Congress intended Sec. 1402(a)(13) to ensure that individuals who merely invest in a partnership and who were not actively participating in the partnership's business operations would not receive credit toward Social Security coverage. Congress did not intent to exclude partners who performed services in their capacity as partners from liability for self-employment taxes.

### 3. Disregarded Entity

- a. Sole proprietors or husband-wife partnerships can hire their under age 18 children and their pay is free of FICA tax. [TD 9554] The IRS says this exemption also applies to a one-person LLC that elects to be disregarded for tax purposes. Even though the LLC is treated as a separate entity from the owner for payroll tax deposit purposes, the child's wages remain exempt from FICA tax.
- b. The IRS cannot take an LLC's assets for taxes owed by its sole member. [CCA 201116019] Even if a one-member LLC is disregarded from its owner for federal tax purposes, that status does not apply for tax collection purposes because the member has no ownership interest in the LLC's assets under state law. The IRS can tap a merchant's credit card reserve account according to a memo that was sent to field agents. The Service cannot force a distribution from the account. It must wait for a payout to be made, and another payee may have priority over the IRS. [PMTA 2010-064]

- c. Taxpayers only get nine months to claim that the IRS wrongfully seized funds. Otherwise, the IRS is barred from returning the money, even if the tax levy was erroneous.
4. Third-party payments received by an off-duty policeman are subject to SECA tax. It does not matter that he has to wear his police uniform and monitor his police radio when he is working off duty, or that all jobs must be approved by the sheriff's office. He is still treated as an independent contractor for tax purposes for his off-duty work. The payers all paid him directly and issued 1099 forms to him. He therefore is liable for self-employment taxes. [Ladue, TC Summ. Op. 2011-41]

#### Q. Excise Taxes

##### 1. Free Tanning Services Not Subject to Excise Tax

- a. IRS Chief Counsel has determined that the new indoor tanning services excise tax does not apply to tanning services provided at no-charge when individuals redeem customer reward points. [CCA 201128024] No amount is paid when services are provided for free through the redemption of points.

#### R. Trust Fund Taxes

1. Schools must withhold FICA taxes on grant payments to postdoctoral fellow, according to the IRS. [PLR 201117026] The payments are not tax-free stipends for living costs but are akin to wages paid to employees of the university. Grant recipients are hired once the school get funding for a project and they work on particular research areas under the supervision of faculty members. They are treated as school employees.

The rule is different for National Research Service grants. No FICA is due on those, the IRS says, because the school does not have direct control over that research.

2. A federal district court has concluded that a taxpayer charged with a felony for willful failure to pay over trust fund taxes was not absolved of criminal liability by making the payments before her trial. [Quinn, DC Kan., 2011-1 USTC ¶150,210] Her crime of "willful failure to pay" did not disappear just because she eventually make the payments. A subsequent payment does not negate the failure to pay, although it is relevant to the issue of willfulness.

#### S. Mandatory Preparer E-Filing Final Regs

1. The IRS has issued final regulations on the e-file mandate required under the Worker, Homeownership and Business Assistance Act of 2009. TD 9518, Notice 2011-26, 27, Rev. Proc. 2011-25] The final regs largely track proposed regs published in December 2010.
2. The final regs also reaffirm, without change, the proposed transition rule that applies e-filing to 100 or more return for 2011 and more than 10 returns for 2012. For taxpayers who do not want to file electronically, the regs affirm the requirement that the preparer obtain a signed and dated statement, in accordance with Rev. Proc. 2011-25, for each individual tax return filed by a taxpayer, where the taxpayer chose not to file electronically. The final regs require one signature, instead of two, where joint filers choose to file a return on paper. [Reg. 301.6011-7(a)(4)(ii)]

3. Solely for calendar year 2011, a specified tax return preparer may mail an individual income tax return in paper format to the IRS, but only if the specified tax return preparer obtains a hand-signed and dated statement containing the taxpayer's choice to have the individual income tax return filed in paper format and have the preparer mail it to the IRS. [Notice 2011-27]
4. If hand-signed (by either spouse if a joint return) and dated by the taxpayer on or before the date the return is mailed, the IRS will consider the following language acceptable:
  - a. "I do not want to have my income tax return electronically filed, and I choose to have my return filed on paper forms. I have asked my tax return preparer to mail my paper return on the IRS on my behalf."
5. Notice 2011-26 specifies administrative exemptions to e-filing for tax return preparers otherwise required to file electronically:
  - a. Rejected returns after a good faith attempt to resolve the reject condition or code;
  - b. Preparer's e-file software package does not support one or more forms or schedules that are part of the return;
  - c. Returns currently not electronically filed include Form 1040-NR, Form 1041-QFT, Form 990-T and all amended individual income tax returns, such as Form 1040X;
  - d. Required documentation or attachments the IRS is unable to accept electronically.
6. Some return can be filed electronically and the attachments mailed to the IRS using a transmittal Form 8453. In those cases, the associated return is not covered by the e-file exemption.

#### T. Change of Accounting Method

1. The Tax Court has upheld the IRS's denial of a taxpayer's application to change its accounting method and has rejected the taxpayer's attempt to change its accounting method without the agency's consent. [Lattice Semiconductor Corp., TC Memo 2011-100]
2. The court noted that a taxpayer must obtain IRS consent to change its accounting method and cannot unilaterally make a change. The IRS has wide discretion to grant or deny consent. If a taxpayer changes its method without IRS consent, the IRS can require the taxpayer to return to its old method of accounting.

#### U. Government Withholding

1. The IRS has issued long-awaited final regs that explain when governmental entities must withhold three percent on payments they make to contractors providing property or services. [TD 9524] The final regs delay the effective date of the withholding requirement until payments made after December 31, 2012. The regs will generally only apply to payments of \$10,000 or more.
2. Governments must report withholding to the IRS on Form 945, Annual Return of Withheld Income Tax and follow the deposit rules for that form. Governments must use Form 1099-MISC, Miscellaneous Income, to report payments and withholding to payees.

3. Sec. 3402(t) requires the federal government, states, the District of Columbia, and every political subdivision and instrumentality of a state government to withhold three percent of any payment made to any person providing property or services to the government.
4. Withholding applies to political subdivisions and instrumentalities of a state only if they make annual payments of property or services of \$100 million or more.
5. The final regs exclude from withholding:
  - a. Payments to other government entities, foreign governments, tax-exempt organization, and Indian tribal governments;
  - b. Payments to passthrough organizations 80% owned by these entities;
  - c. Payments to nonresident alien individuals and foreign corporations;
  - d. Interest payments;
  - e. Payment for real property (including the purchase or lease of real property, but not for construction);
  - f. Payments subject to other withholding;
  - g. Payments for a classified or confidential contract;
  - h. Payment of public assistance or welfare where eligibility is based on need or income (but not if based solely on age, such as Medicare);
  - i. Payments to a government employee for services as an employee;
  - j. Grants;
  - k. Loan guarantees; and
  - l. Debt repayments and stock and bond purchases.

## V. Statute of Limitations

### 1. Six-Year Statute

- a. The IRS issued regs adopting an expansive definition of an omission from gross income that triggers a six-year statute of limitations. [TD 9511] The regs treat an overstatement of basis on the sale of an asset as an omission from gross income.
- b. A 1958 Supreme Court decision held that the six-year limitation period applies only where a taxpayer omits some income it received or accrued.
- c. The IRS agrees that in the trade or business context, an omission from gross income requires an understatement of income received or accrued from the sale of goods or services.
- d. However, the IRS, in the final regs, maintains that in cases outside the trade-or-business context, an omission from gross income results from an overstatement of basis is used to determine gain from the sale of an asset.
- e. According to IRS chief counsel advice, the original return governs when determining whether the 25% threshold was exceeded. An amended return showing additional income will not operate to preclude the application of Sec. 6501(e). [CCA 201118020]

2. In Reversing the Tax Court, The Court of Appeals for the Seventh Circuit determined that an overstatement of basis is an omission of gross income for purposes of the six-year period of limitations.[Beard, CA-7, 1-1-2011] Sec. 6501(e)(1)(B)(ii) demonstrates that the six-year statute of limitations is intended to apply when there is either a complete omission of an item of income of the requisite amount or a misstatement of an item of income when the IRS is at a disadvantage in detecting the error. According to the Court, Congress intended to enact the longer six-year period to allow the IRS time to detect such omissions.
  - a. The Fourth Circuit and the Fifth Circuit, recently ruled in favor of taxpayers, joining the Ninth and Federal Circuit. In both Home Concrete (CA-4) and Burks (CA-5), the appellate courts reversed federal district courts that had approved the six-year limitations period.
  - b. The circuit courts are split as to whether an overstatement of basis is an omission of gross income for purposes of the Sec. 6501(e) six-year limitations period.
3. NOL Statute of Limitations
  - a. A claim for refund of an overpayment must be filed within the later of three years from when the return was filed or two years from when the tax was paid. [Sec. 6511(d)] The limitation period for a claim relating to an overpayment attributable to a NOL carryback is the period ending three years after the due date of the return (plus extensions) for the tax year of the NOL. [Sec. 6511(d)(2)] There is no limitation period for a claim for refund from an NOL carryback that, if allowed, would not result in an overpayment but would simply reduce the taxpayer's outstanding tax liability [CCA 201049035]
4. Overstated Inventory
  - a. In Tax Court, a business owner claimed she overstated her ending inventory for a tax year, which meant her cost of goods sold was higher. That lowered her income. The Court agreed with her. As a result, her beginning inventory for the next tax years was also inflated, meaning she owned more tax for that year. Even though year was closed because the three-year statute of limitations had run, the Court allowed the IRS to reopen the year to prevent an unjust tax break. [Anthony, TC Summ. Op. 2011-50]

## W. Internal Revenue Service

1. Filing Extensions for Pass-Through Entities
  - a. The IRS finalized regs that continue to provide automatic five-month extensions of time to file most partnership, estate, and trust returns. [TD 9531] The due dates for filing returns are set by statute and the agency cannot change them without authorization from Congress.
2. Allocate Refunds for Return Preparation
  - a. The IRS is not ready to pursue the concept of having taxpayers direct a portion of their tax refund to practitioners to pay for return preparation. [David R. Williams, director, IRS Return Preparer Office, June 29, 2011] Williams said that the agency is not going to pursue the concept "at this time."

### 3. Sale of Seized Property

- a. The Ninth Circuit Court of Appeals found that the IRS had to give credit to taxpayers for the decline in value of stock that the IRS seized but then failed to sell in "a timely manner." [Zapara, CA-9, July 18, 2011] Based on Sec. 6335(f), the Ninth Circuit concluded that the IRS should have sold the stock within 60 days after the taxpayer requested the sale.

### 4. Innocent Spouse Relief

- a. In Notice 2011-70, the IRS abandoned the controversial two-year limitations for requesting equitable innocent spouse relief.
- b. The IRS Restructuring and Reform Act of 1998 did not specify a limitations period for equitable innocent spouse relief. However, the IRS imposed one by regulation. A taxpayer requesting equitable relief must file Form 8857, Request for Innocent Spouse Relief, or similar statement, with the IRS no later than two years from the date of the first collection activity against the requesting spouse. [IR-2011-80, Notice 2011-70]
- c. Under transition rules, taxpayers may request equitable innocent spouse relief without regard to when the first collection activity was taken. The requests must be filed within the limitations period on collection.
- d. The IRS instructed taxpayers whose requests for equitable innocent spouse relief were denied as untimely and were not litigated to reapply by filing a new Form 8857. The IRS will treat the original Form 8857 as a claim for refund for purposes of the Code Sec. 6511 limitations period.
- e. Under the innocent spouse rules, an individual may avoid liability for unpaid tax and penalties, despite having signed a joint return, if the following requirements are met:
  - 1) You filed a joint return which has an understatement of tax.
  - 2) The understatement of tax is due to erroneous items of your spouse.
  - 3) You establish that at the time the joint return was signed, you did not know (or have reason to know) there was an understatement of tax.
  - 4) Taking into account all of the facts and circumstances, it would be unfair to hold you liable for the understatement.
- f. Timely Filed Rule Not Applicable to Amended Returns
  - 1) The IRS Chief Counsel has concluded that the timely-mailing-as-timely-filing rule under Section 7502 does not apply to amended returns. [CCA 201052003] Chief Counsel found that an amended corporate return that was mailed on and received after the date that the statute of limitations for assessment expired was untimely. Sec. 7502 applies only to returns "required to be filed." The rule did not apply to the corporations' amended return, Form 1120X, because the statute does not require the filing of an amended return.
  - 2) This ruling empowers the IRS to issue guidance. It is going to be tough to challenge Treasury regs.

## 5. Tax Return Filed Under Stolen SSN

- a. Because of their status, undocumented aliens who are in the United States illegally do not have a Social Security Number (SSN), so they provide a stolen or misappropriated SSN to their employer, and use the stolen or misappropriated SSN to file a tax return reporting the earnings and income tax withheld. The IRS concluded that the use of another person's SSN does not by itself invalidate the tax return. If the return otherwise meets the established criteria for a valid return, it will start the statute of limitations for assessment. [PMTA 2011-009]

## 6. Audited Companies and Electronic Records

- a. The IRS is now requiring companies being audited to turn over exact copies of the electronic records kept in their business software programs. The IRS says its request for complete software files is part of its efforts to modernize.
- b. According to IRS guidance, examiners are only supposed to review data relevant to the year or years under examination. However, they can make an exception when reviewing the transactions for the month prior to and the month after the tax year or the tax periods before and after the ones under examination.

## 7. Returns Altered by Preparer

- a. The IRS, in program manager technical advice (PMTA) has determined that a return preparer's fraud nullified returns he prepared for clients. [PMTA 2011013] The taxpayer signed returns which they believed to be correct but were subsequently altered by the preparer to generate large refunds of which they were unaware. However, taxpayers could not double-dip and claim second refunds when they filed their true returns. The returns they signed, under penalty of perjury, were never filed with the IRS. Therefore, the returns that were filed with the IRS were unknown and unverified by the taxpayers and were null. The IRS instructed affected taxpayers to file new returns. Taxpayers should not file amended returns because no original return had been filed.
- b. The preparer (a CPA) prepared and electronically filed approximately 700 individual returns. Without the knowledge and consent of the taxpayer, the preparer increased the amounts of charitable contributions reported on Schedule A. The return presented to the taxpayer did not reflect the inflated charitable contribution. The preparer also established RAL accounts of which the taxpayer were unaware. The RALS were based on the inflated refunds. The bank servicing the RALS took the taxpayer refunds, deducted its fees and transferred the remainder of the refunds to the preparer's personal account.

## 8. Withheld Income Taxes

- a. An IRS agent attempted to deny the credit for withheld taxes shown on a worker's W-2 because the employer did not deposit them. The workers still can claim a credit for the withheld income taxes when they file. The IRS' recourse is to go after the person or persons responsible for the shortfall. [CCA 201102225]

## 9. Timely Filed

- a. The IRS has issued new regulations for treating mailing as timely filed. [TD 9543] The timely use of private services such as DHL or Federal Express will be evidence of timely delivery. The following services offered by the United State Postal System do not qualify as timely filed: Priority Mail, Certificate of Mailing, Express Mail Receipt, Delivery Confirmation Receipt, and Signature Confirmation. Section 7502 does not authorize the Treasury Department or the IRS to adopt a rule that would permit USPS services in addition to certified and registered mail to establish prima facie evidence of delivery. Absent actual delivery, first class mail with additional services provides nothing to establish proof of delivery.

## 10. Federal Tax Liens

- a. Taxpayers must ask the IRS to withdraw a tax lien once the tax liability is fully paid. A withdrawal of a federal tax lien is more beneficial than a release because a withdrawal expunges the lien immediately from the debtor's records and it is as if the lien had never been filed. Use Form 12277 to request a withdrawal. Taxpayers can ask for a lien withdrawal even if they have not fully repaid the debt, as long as the amount currently owed the IRS does not exceed \$25,000. The taxpayer also must agree to pay off the rest via monthly debts from the bank account. The IRS will not withdraw the lien until at least three consecutive debits have been made.

## 11. Qualified Amended Return

- a. A taxpayer can avoid an underpayment and a 20% accuracy-related penalty by filing a qualified amended return (QAR). A QAR treats additional tax reported on an amended return as if it were reported on the original return. [Bergmann, 137 TC No. 10]
- b. A QAR is an amended return filed before certain terminating events. The Tax Court noted that the period for taxpayers to file a QAR will have terminated when the IRS contacted the firm about a promoter investigation.

## X. Employee Classification

1. Cave was the sole shareholder and president of the firm. In this capacity he: selected the associate attorneys who would work for the firm; hired law clerks to provide legal services; hired the support staff, including an investigator, receptionist, and several secretaries; set the hours for the support staff; determined whether workers would receive bonuses and the amounts; approved the payroll; decided whether to make advance payments or reimburse workers for work-related expenses. The firm treated Cave as an independent contractor, not an employee. The Tax Court determined that Cave was an employee. An officer of a corporation who performs substantial services for a corporation and is compensated for those services is an employee for employment tax purposes. The management services that Cave performed were fundamental to the operation. [Donald G. Cave A Professional Law Corp., TC Memo 2011-48]

## 2. Misclassified Workers Are Not Eligible Retroactively for Employee Benefits

- a. After the IRS reclassified two women as employees, they claimed they were entitled to benefits under the firm's 401(d) and cafeteria plans for the period they worked as contractors. The District Court disagreed, finding that the plan administrator did not intentionally misclassify the workers as part of a scheme to deny them benefits. The plans specified that anyone reclassified as an employee by a court or the IRS would not receive benefits. [Kalkasma v. Konica Minolta Business Solutions, DC NJ]
- b. An independent contractor who is reclassified as an employee is penalized for contributing to a SEP. As an employee, he cannot contribute to a SEP and is deemed to have made an excess contribution that is subject to a 10% penalty. [Rosenfeld, TC Memo 2011-110]

## 3. Penalty Relief

- a. The Tax Court has held that if a worker misclassification is unintentional, the penalty for not withholding income tax is slashed to only 1.5% of wages, and the penalty for the employee's share of FICA tax is one-fifth of the regular rate. In this case, a direct sales company correctly treated its outside sales force as contractors, but it also classified its officers and office workers that way with no valid basis. As a result, the full penalties apply. [D&R Financial Services, TC Memo 2011-252]

## 4. Offset

- a. The extra payroll tax owed by firms from improperly classifying employees as independent contractors is offset in part the amount of self-employment tax reported on the workers' returns. The employers remain subject to the penalty for failing to deposit the required FICA taxes. [Western Management, Fed. Cl.; 1-19-2011]

## Y. Relying on Tax Adviser Advice

1. The Tax Court defined a promoter as "an adviser who participated in structuring the transaction or is otherwise related to, has an interest in, or profits from the transaction." [106 Ltd, 136 TC No. 3, (2011)]
  - a. A tax adviser is not a promoter when he or she (1) has a long-term relationship with the client, (2) does not give unsolicited advice regarding the tax shelter, (3) advises only within his or her field or expertise, (4) follows his or her regular course of conduct in rendering the advice, and (5) has no stake in the transaction besides normal billings at regular hourly rates.
2. The Tax Court classified the attorney and accountants as promoters and ruled it was unreasonable for the taxpayer to rely on them. [106 LTD, David Palmlund, Tax Matters Partner, 136 TC No. 3, 2011]
3. Three factors determine whether a taxpayer relied on professional advice:
  - a. Whether the adviser was a competent professional with sufficient expertise to justify the reliance;
  - b. Whether the taxpayer provided the adviser with necessary and accurate information; and
  - c. Whether the taxpayer actually relied in good faith on the adviser's judgment.

## Z. Estate Tax Deduction

### 1. Palimony Claim

- a. The Ninth Circuit Court of Appeals allowed an estate to deduct a palimony claim against it. [Shapiro, CA-9] Although they never married, a couple lived together for more than 20 years. When they broke up, she filed a palimony suit. He died while the case was pending. The estate later settled for \$1 million. The Appeals Court said his estate could deduct the value of her claim as of his death and set the case back for the lower court to determine its value.

### 2. Deducting Claims Against the Estate

- a. The rules on deducting claims against estates have changed. Claims over \$500,000 are deducted only when they are paid. Smaller claims can still be deducted on Form 706 before they are paid. This rule applies to estates of people who died after October 19, 2009. If a claim is not settled until after the three-year period for amending the 706 lapses, the executor can file a protective refund claim that is finalized when the claim is paid.

### 3. Protective Claims

- a. The IRS has explained how estates can file protective claims for a refund of estate taxes, based on a potential deduction for an unpaid claim or expense.[Rev. Proc. 2011-48] A taxpayer that files a protective claim will be entitled to a refund when the amount of the claim is established and paid.
- b. A Section 2053 protective claim for refund may be filed before the expiration of the period of limitations under Sec. 6511(a) for filing a refund claim.
- c. The IRS will refund overpaid estate taxes where the amount deductible is established after the period of limitation, but only if a protective claim is filed.
- d. The protective claim must identify the outstanding claim and the reasons delaying its payment. When the claim is resolved, the estate must notify the IRS within a reasonable period of the amount deductible.
- e. The protective claim must describe in detail the claim or expense, including its exact basis, the ground on which the refund is claimed, and the reasons and contingencies delaying payment of the claim. A claim that is adequately identified will be deemed to include related and ancillary expenses, such as attorney's fees.
- f. The IRS provided two methods for filing a protective claim:
  - 1) Schedule(s) PC with Form 706; or
  - 2) Form 843 (Claim for Refund) if Form 706 was previously filed.

- g. Estates that have already filed a protective claim may replace the initial filing, to comply with Rev. Proc. 2011-48.
- h. The estate must notify the IRS within 90 days after the claim is paid or the amount becomes certain, whichever is later. For a claim involving multiple payments, the 90-day period begins with the final payment. The estate may provide notice by filing a supplemental Form 706 or a Form 843, with appropriate notations.
- i. When an estate files a protective claim, the IRS will not suspend its examination of Form 7706 and will not delay issuing a closing letter. When the estate notifies the IRS that the protective claim has been resolved, the IRS will limit its review of Form 706 to the deduction.

