Income Tax Update

2012

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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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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-Second 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 2012-2013 edition marked the 35th 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 and has developed an RTRP Review Course for Gleim Publications.

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12-20-2012

2012 Individual Income Tax Update

Chapter 1 - New Tax Acts

A. Middle Class Tax Relief and Job Creation Act of 2012

1. On February 17, Congress passed HR 3630, which extends the two-percent payroll tax holiday for an additional 10 months, through the end of 2012. The new law followed on the heels of a temporary two-month extension of the payroll tax holiday through the end of February 2012.

2. The law includes an extension of the unemployment benefits, although they are scaled back in three stages, and a 10-month extension of the Medicare "doc fix" that increased Medicare reimbursements for physicians.

3. The law also reverses prior legislation that accelerated corporate estimated tax payments for certain large corporations from one quarter into the previous quarter.

4. Signed by the President on February 22, 2012.

B. Moving Ahead for Progress in the 21st Century Act (MAP-21)

1. Extends highway excise taxes

2. Provides for pension funding stabilization;

3. Enhances the ability of employers to transfer excess pension assets to fund retiree health benefits;

4. Provides for phased retirement authority for federal employees;

5. Expands the definition of a tobacco manufacturer to include businesses operating roll-your-own cigarette machines;

6. Extends reduced interest rates on federal student loans one more year;

7. Increases insurance premiums paid by plan sponsors to the Pension Benefit Guaranty Corporation; and

8. Extends Leaking Underground Storage Tank trust funding through September 30, 2015.

9. Service S Corporations

    a. Treat as same as partnership for self-employment tax purposes.

        1) Performance of services in the fields of health, law engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial service, brokerage services, or any trade or business where the principal asset of the such trade or business is the reputation or skill of one or more of its employees.

C. Provisions Expired at the End of 2011

1. Credit for certain nonbusiness energy property

2. Increased AMT exemption amount

   a. AMT Exemption Amounts

2011	2012	
$48,450	$33,750	Single
$74,450	$45,000	Married Filing Jointly
$37,225	$22,500	Married Filing Separately

3. Personal tax credit allowed against regular tax and alternative minimum tax

   a. Personal Credits
      1) Child tax credit (up to $1,000 per child)
      2) Hope Scholarship education tax credit (up to $2,500) and Lifetime Learning credit (up to $2,000)
      3) Child and dependent care tax credit
      4) Adoption tax credit
      5) Retirement saver's tax credit
      6) Tax credit for certain energy-saving equipment installed in your residence
      7) Tax credit for elderly and disabled individuals
      8) First-time DC homebuyer tax credit

   b. A report by the Congressional Research Service states that 34 million taxpayers (one-fifth of all taxpayers) will be subject to AMT in 2012 unless Congress raises the AMT exemption amounts.

4. Expansion of adoption credit and adoption assistance programs

5. Tax credit for research and experimentation

6. New markets tax credit

7. Credit for construction of new energy efficient homes

8. Credit for energy efficient appliances

9. Work opportunity tax credit

10. Deduction for certain expenses of elementary and secondary school teachers

11. Parity for exclusion from income for employer-provided mass transit and parking benefits

12. Premiums for mortgage insurance deductible as interest

13. Deduction for State and local general sales taxes

14. 15-year straight-line cost recovery for qualified leasehold improvements, qualified restaurant buildings and improvements, and qualified retail improvement property

15. Additional first-year depreciation for 100% of basis of qualified property

16. Enhanced charitable deduction for contributions of food inventory, book inventories, and computer equipment

17. Increase in expensing to $500,000 and expansion of definition of Section 179

18. Above-the-line deduction for qualified tuition and related expenses

19. Tax-free distributions from IRAs for charitable purposes

20. Special rules for qualified small business stock

21. Basis adjustment of charitable contributions of S corporation stock

22. Reduction in S corporation built-in gain period

Chapter 2 - Significant Developments

A. Personal Exemptions, Standard Deduction, and Filing Requirements

1. Personal Exemption

a. The personal exemption is $3,800 for 2012.

b. Phaseout of personal exemptions is repealed for 2010, 2011, and 2012.

c. Dependency Requirement

1) The Tax Court has upheld the IRS's determination that a married couple residing in Israel were not entitled to dependency exemptions deductions because their children were not U.S. citizens during most of the relevant tax years. [Carlebach, 139 TC No. 1]

2) Under the "citizenship test" set forth in Sec. 152, "dependent" does not include an individual who is not a citizen or national of the United States unless such individual is a resident of the United States or a country contiguous to the United States.

3) The couple lived in Israel with their six children, all of whom were born in Israel. Only the wife was a U.S. citizen.

4) The court found the couple liable for the accuracy-related penalties and additions to tax. The couple failed to show that they acted with reasonable cause and in good faith in claiming the deductions.

5) In another similar case the court ruled consistently. [Stern, TC Memo 2012-204]

d. A noncustodial parent was not entitled to the dependency exemptions for his two sons because his ex-spouse, the custodial parent, did not release her claim to the exemptions through Form 8332, or other valid written declaration. [Walters, TC, CCH Dec. 59,157(M)]

1) Absent the form prescribed for the custodial spouse to release her claim, Code Sec. 152 prevented him from claiming the dependency exemptions regardless of the amount of financial support he provided for his children.

e. The taxpayer and his ex-wife signed a separation agreement fixing their child's primary residence with the mother who promised not to claim the child as a dependent as long as child support was kept current. The ex-wife refused to sign Form 8332 even though child support was current. The Tax Court granted the noncustodial father the dependency exemption even though the separation agreement lacked the parties' Social Security number as required on Form 8332. [Gary Scalone, TC Summ. Op. 2012-40]

1) The tax return was for 2006.

2) Beginning in 2009, a state court order or decree cannot serve as a written declaration and therefore, does not determine the dependency exemption between divorced or separated parents.

2. Standard Deduction and Itemized Deductions

a. Standard deduction amounts increased for 2012 [Rev. Proc. 2011-52]:

Filing status	Deduction amount
Married filing jointly	$ 11,900
Head of household	8,700
Single	5,950
Married filing separately	5,950
Additional-unmarried and aged and/or blind 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. Itemized Deductions Not Phased Out

1) Medical expenses
2) Investment interest
3) Casualty and theft losses
4) Gambling losses
5) Remaining itemized deductions cannot be reduced by more than 80%

e. Additional Standard Deductions Gone

1) 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.

f. 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.

B. Gross Income

1. Olympic Medal Winners

a. Medal winners in the Olympics receive $25,000 for gold, $15,000 for silver, and $10,000 for bronze. The winnings are taxable for Americans. Sec. 61(a) provides that gross income includes income from whatever source derived, unless there is a specific exclusion. Furthermore, the medals themselves could be seen as valuable gifts that are taxable by the U.S. government.

2. Frequent-Flier Miles

a. Citibank is issuing Form 1099s to customers who received miles for opening accounts there. The bank says that if the miles are worth $600 or more, it will issue a Form 1099-MISC because the miles are given as a premium and are taxed as income. In 2002, the IRS threw in the towel on taxing the value of free personal flights received for miles earned on company-paid travel. Since then, the IRS has not asserted that taxpayer owe tax on mileage earned through credit card purchases, either. The Service now says the 2002 ruling does not exempt miles received as a premium from a bank.

3. Damage Awards

a. An arbitrator's award for wrongful termination from employment on account of a disability was not excludable from gross income. The arbitration award made no mention of physical injury and the taxpayer failed to allege such an injury in the complaint or show it at trial. [Neri, TC, CCH Dec. 58,981(M)]

1) However, the taxpayer acted reasonably and in good faith and so was not subject to an accuracy-related penalty.

b. An individual's damages award for wrongful termination under the Family and Medical Leave Act, was wages subject to income and employment tax withholding. The damages were awarded to the individual based on her total wage loss and as compensation for the wages that her employer would have paid to her if she had not been wrongfully terminated. [Cheetham, DC Fla., 2012-1 USTC ¶50,320]

c. The Appeals Court ruled that a jury award in a wrongful termination case is subject to withholding. [Noel v. New York, CA-2] Because the award compensates him for what he would have earned as an employee had he not been discriminated against, it is treated as wages. As a result, the payer was right to withhold income and payroll taxes.

d. The Tax Court held that a portion of a taxpayer's service-connected disability payments was not excludable from income. The portion had been determined by reference to the taxpayer's length of service with his employer. [Sewards, 238 TC No. 15]

1) A law enforcement officer received the larger of a service retirement based on his length of service or a service-connected disability retirement based on his service-connected injuries. The amount that his retirement amount exceeded his service-connected injuries amount was taxable income.

2) The court did not uphold the accuracy-related penalty. The court found that the taxpayer had relied in good faith on advice from a retirement advisor.

e. Worker's compensation paid in lieu of Social Security benefits is taxable, according to the Tax Court. [Moore, TC Memo 2012-249] An injured filer received both worker's compensation and Social Security disability benefit. By law, the worker's compensation payments that she received offset her Social Security disability benefits dollar for dollar. The worker's compensation payments is treated just like other Social Security benefits; up to 85% of the payments can be subject to the income tax.

f. The Tax Court found that a terminated employee who received $100,000 in a wrongful termination settlement was not entitled to exclude the amount from her gross income. [Blackwood, TC Memo 2912-190]

1) The settlement was for the employee's symptoms, which manifested as a result of emotional distress. Emotional distress is not considered a physical injury or sickness for which damages may be excluded from gross income.

2) The court denied imposition of the 20% accuracy related penalty for an understatement attributable to a substantial understatement of tax. The taxpayer had reasonable cause to exclude the settlement payment where she acted on the advice of her counsel, a CPA and attorney.

4. Personal Injury/Sickness Damages

a. The IRS has issued final regs on the Sec. 104(a)(2) exclusion from gross income for amounts received on account of personal physical injuries or physical sickness. [TD 9573]

b. The regs do not require that to qualify for exclusion from gross income, damages received from a legal suit, action, or settlement agreement must be based upon tort or tort type rights.

c. The final regs allow an exclusion for damages for emotional distress, even if not necessarily attributable or related to a physical injury or physical sickness, to the extent that the damages for emotional distress are not in excess of amount paid for medical care related to such emotional distress.

d. Attorney's Fees Deductible From Gross Income

1) Of "unlawful discrimination";

2) Against the Federal government of a violation of subchapter III of chapter 37 of title 31 of the U.S. Code

5. Foster Care Payments

a. The Tax Court has found that state payments made to a married couple's foster care group home operating out of their second home were taxable. [Jonathan Stromme, 138 TC No. 9]

1) Sec. 131 provides that qualified foster care payments are excludable from income when (1) paid by either a state (or political subdivision thereof); and (2) which are paid to the foster care provider for caring for a qualified foster individual in the foster care provider's home.

2) The court concluded that they resided in another home for purposes of the exclusion.

b. The IRS held that Medicaid funds received by a certified family home provider were taxable because the care was provided by a biological parent. [INFO 2012-0030]

   1) Care by a biological parent is not foster care. [PTMA 2010-007]

   2) However, any Supplemental Security Income (SSI) payments received by the son were not taxable to him.

   3) Family caregivers do not owe self-employment tax on the payments unless they are in the business of providing care to others.

6. Whistleblower's Award

   a. The Ninth Circuit Court of Appeals has affirmed a federal district court decision which held that a taxpayer's share of an award under the False Claims Act constituted ordinary income, not capital gain. [Alderson, CA-9, 7-18-2012]

      1) The federal government obtained a $630 million settlement. The taxpayer was awarded $27 million.

7. Cancellation of Debt (COD) Income

   a. Generally taxable income to debtor.

      1) Publication 4681

   b. The Tax Court found that an individual was not insolvent when his credit card debt was forgiven. Therefore, he could not exclude cancellation of debt income from his gross income. [Bernard Shepherd, TC Memo 2012-212]

      1) The taxpayer valued some of his assets (a principal residence and a beach house) several years after the discharge of debt. The determination of insolvency must be based on assets and liabilities immediately before the discharge.

         a) The court stated that a value placed upon property for local taxation purposes is not determinative of fair market value of the property for federal income tax purposes in the absence of evidence of the method used in arriving at that valuation.

      2) The taxpayer also claimed a loan from his pension as a liability, but did not claim the pension asset as an asset. The Tax Court found that the taxpayer had an asset equal to at least the amount that he could withdraw from the pension.

   c. Sec. 108 excludes from income any debt that is discharged in:

      1) Bankruptcy
      2) Insolvency
      3) Qualified Farm Indebtedness
      4) Qualified Real Property Business Indebtedness
      5) Qualified Principal Residence Indebtedness

d. Example:

$250,000 Purchase residence
$220,000 Borrow
$300,000 FMV later
$ 60,000 Borrow on increase in value
$200,000 Decreased in value
$ 80,000 Debt canceled
$ 20,000 Excluded from income
$ 80,000 Included in income (could use insolvency)

8. Human Trafficking Victims Restitution

a. The IRS has issued guidance providing that court-ordered restitution payments from an offender to a victim of human trafficking are not included in the victim's gross income. The full amount of any restitution payments may be excluded, including medical costs, transportation, temporary house, child care, lost income, the value of his or her services or labor, and any other costs suffered as a proximate result of the offense. [Notice 2012-12]

1) Congress passed the Trafficking Victims Protection Act of 2000, which requires courts to order a defendant to pay restitution to a victim for any offense committed under 18.S.S.C. §§1581-1594.

2) Among the offenses set forth is kidnapping any person "with the intent that such other person be sold into involuntary servitude, or held as a slave."

9. Parsonage Allowance

a. The 11th Circuit reversed the Tax Court and ruled that the income exclusion under Sec. 107 for a parsonage allowance did not apply to multiple homes. A divided Tax Court had permitted the parsonage allowance on the minister's principal residence and a second lake home. The appeals court found that the language "a home" used in Sec. 107 "maintains a singular connotation, especially when the context indicates a singular meaning." [Comm. v. Driscoll, 109 AFTR 2d 2012 (CA-11); cert. denied 10-1-2012]

10. Housing Allowance

a. The inflation-adjusted standard cost-allowance on housing expenses for 2012 is $28,530 for those locations not on the IRS's list of high-cost locations. [Notice 2012-19]

Hong Kong, China - $114,300; Tokyo, Japan - $128,000

$95,100 x 16% = $15,216 Base Amount $41.57 per day
$95,100 x 30% = $28,530

11. Employer-Provided Health Insurance

    a. The Patient Protection and Affordable Care Act generally requires employers to disclose the aggregate cost of applicable employer-sponsored coverage on an employee's Form W-2 for tax years beginning on or after January 1, 2011.

    b. Notice 2010-69 made reporting optional for all employers for in 2012 for 2011.

    c. The W-2 reporting requirement does not apply to contributions to HRAs, HSAs, MSAs, and FSAs funded solely by employee pre-tax salary contributions. [Notice 2012-9]

    d. For 2012 Forms W-2, an employer is not subject to reporting for any calendar year if the employer was required to file fewer than 250 Forms W-2 for the preceding calendar year.

    e. The value of the health care coverage will be reported in Box 12 of Form W-2, with Code DD to identify the amount.

    f. The amount reported should include both the portion paid by the employer and the portion paid by the employee.

    g. An employer is not required to issue a Form W-2 to report the value of the health care coverage for retirees or other employees or former employees to whom the employer would not otherwise provide a Form W-2.

    h. Major medical; health FSA value for the plan year in excess of employee cafeteria plan salary reductions for all qualified benefits; and domestic partner coverage included in gross income, are among the types of coverage with the mandatory reporting requirement.

    i. Dental or vision plan not integrated into another medical or health plan and certain other coverage are among the types of coverage with the optional reporting requirements.

12. Fringe Benefit Income

    a. Employer-Provided Vehicles

        1) Sec. 61 provides that an employee who employer has provided a vehicle for personal use must include the value of that personal use in his or her income and wages as a fringe benefit.

        2) There are five IRS-provided valuation methods for personal use of a company car:

            a) Fair market value,
            b) Annual lease value (ALV),
            c) Cents-per-mile,
            d) Commuting value, and
            e) Fleet-average method.

3) Taxpayers with employer-provided automobiles within the designated FMV amounts may apply the 55.5 cents-per-mile for fleet average valuation rule. [Rev. Proc. 2012-13]

   a) The 2012 Rev. Proc. dollar caps only apply to employer-provided for personal use in calendar year 2012.

   b) Vehicles first used for personal purposes in previous years must be the limit designated by the IRS for those years.

4) The maximum 2012 FMV amounts for use of the cents-per-mile valuation rule are:

   a) $15,900 for a passenger automobile (up from $15,300 in 2011), and

   b) $16,700 for a truck or van, including passenger automobiles such as mini-vans and sport utility vehicles, which are built on a truck chassis (up from $16,200 in 2011).

5) Employers maintaining a fleet of at least 20 automobiles can value the FMV of each automobile as equal to the average value of the entire fleet.

   a) The maximum FMV amounts for use of the fleet-average valuation rule in 2012 are $21,200 for a passenger automobile and $21,900 for a truck or van.

b. Local Lodging Expenses

1) The IRS has issued proposed reliance regs allowing an employee to treat local lodging expenses as working condition fringe benefits or accountable plan reimbursements and allowing an employer to treat expenses as deductible business expenses. [NPRM REG-137589-07]

2) In the preamble to the regs, the IRS stated that the following are considered personal, not business-related:

   a) A weekend at a luxury hotel provided by the employer;

   b) Lodging to avoid a long-distance commute;

   c) Lodging because the employee must work overtime;

   d) Housing for a recently-relocated employee; or

   e) Lodging for employee's indefinite personal use.

3) The proposed regs provide a safe harbor for an employee to deduct local lodging expenses if:

a) The lodging is necessary for the individual to participate fully in or be available for a bona fide business meeting, conference, training activity, or other function;

b) The period of lodging does not exceed five calendar days and does not recur more frequently than once per calendar quarter;

c) The employer required the employee to remain at the activity or function overnight; and

d) The lodging is not lavish or extravagant and does not provide significant personal pleasure, recreation, or benefit.

4) The proposed regs do not address the tax treatment of meal costs incurred during local hotel says to facilitate the employer's business. Presumably, the meals would be treated as directly connected to or associated with the business under existing tax rules. If so, the employer-paid meals would qualify as tax-free working condition fringe benefits or tax-free accountable plan reimbursements.

a) 100% Meals Deduction

(1) A taxpayer can deduct 100% of the food, beverage, and entertainment expenses for six for fewer special events held during a calendar year. These events must be held at a particular place of business (such as the taxpayer's business premises, hotel, restaurant, etc.). The food, beverages, and entertainment must be generally available to all employees of the business. This would include events such as a company Christmas party.

5) While the proposed regs are not effective until issued as final regs, the IRS provided that taxpayer can rely on them now, if they are claiming a deduction for expenses incurred during a tax year for which the statute of limitations is still open.

13. Tip Income

a. The IRS has clarified and updated guidance on differentiating between employee tips, to which special FICA rules apply, and distributed service charges, which are treated as wages. [Rev. Rul. 2012-18, Ann. 2012-25]

b. Sections 3102 and 3111 impose FICA taxes on employees and employers. Sec. 3131(q) provides that tips received by an employee during the course of his or her employment are remuneration and are deemed to be paid by the employer for purposes of the employer portion of FICA taxes. The remuneration is deemed to be paid when a written statement including the tip is provided by the employee to the employer. If the employee does not report the tips,they are deemed paid when the IRS makes notice and demand to the employer.

1) Under Sec. 6053(a), employees who receive tips of $20 or more in a calendar month must report to their employers the total amount of tips they receive on or before the tenth day of the following month.

c. In Rev. Rul. 59-252, the IRS provided criteria which indicate when amounts received are tips:

1) The payment must be made free from compulsion;

2) The customer must have the unrestricted right to determine the amount;

3) The payment should not be subject of negotiation or dictated by employer policy; and

4) Generally, the customer has the right to determine who receives the payment.

5) The absence of any of these factors creates a serious doubt as to whether the payment is really a tip and indicates that it is in fact a service charge.

d. The IRS determined in Rev. Rul 59-252 that the payment of a service charge imposed by a banquet hall that is distributed to employees who render services is a service charge and not a tip.

e. In Rev. Rul. 95-7, Question 2, the IRS explained that Sec. 3121(q) does not apply in situations where all tips are required by the employer to be turned over to the employer by the employees, and the employer, in turn, distributes the tips among all the employees. The tips, distributed in these situations are wages when paid by the employer.

f. The IRS clarified that simple characterization of a payment as a tip by the employer is not determinative for employment tax purposes. [Rev. Rul. 2012-18, Q&A 1]

14. Code Sec. 83(b) Election

a. The IRS has provided sample language that employees and independent contractors (service providers) may use to make an election under Code Sec. 83(b) to recognize compensation income on stock (or other property) transferred for the performance of services. The election is available if the service provider's rights in the property are subject to a substantial risk of forfeiture and are not transferable. [Rev. Proc. 2012-29] Effective date of 6-25-2012.

b. To make a valid election, the service provider must file the election statement with the IRS within 30 days of the transfer of the property. An election, which cannot be revoked without IRS consent, cannot be made on an option if the option lacks a readily ascertainable fair market value. The election must identify the property being transferred, the restrictions on the property, the property's value at the time of transfer, the amount paid, and the amount of compensation income (the value minus the amount). A copy of the election must be provided to the employer.

c. If an election is made, the excess of the value of the property (ignoring restrictions that will lapse) over the amount paid by the service provider is income. The basis of the property is increased by the amount of income. No amount is taxable when the property becomes substantially vested.

d. On a subsequent sale of the property, any gain or loss is capital. If, instead, the property is forfeited after making an election, no deduction is available for the amount previously included in income, but the service provider can take a capital loss, equal to the amount paid for the property over the amount realized on the forfeiture.

Section 83(b) Election

The undersigned taxpayer hereby elects, pursuant to § 83(b) of the Internal Revenue Code of 1986, as amended, to include in gross income as compensation for services the excess (if any) of the fair market value of the shares described below over the amount paid for those shares.

1. The name, taxpayer identification number, address of the undersigned, and the taxable year for which this election is being made are:
TAXPAYER'S NAME: ____
TAXPAYER'S SOCIAL SECURITY NUMBER: ____
ADDRESS: ____
TAXABLE YEAR: Calendar Year 20 __

2. The property which is the subject of this election is __________ shares of common stock of __________________________.

3. The property was transferred to the undersigned on [DATE].

4. The property is subject to the following restrictions: [Describe applicable restrictions here.]

5. The fair market value of the property at the time of transfer (determined without regard to any restriction other than a nonlapse restriction as defined in §1.83-3(h) of the Income Tax Regulations) is: $ _______ per share × ________ shares = $ ___________.
6. For the property transferred, the undersigned paid $ ______ per share × _________ shares = $ ______________.

7. The amount to include in gross income is $ ______________. [The result of the amount reported in Item 5 minus the amount reported in Item 6.]

The undersigned taxpayer will file this election with the Internal Revenue Service office with which taxpayer files his or her annual income tax return not later than 30 days after the date of transfer of the property. A copy of the election also will be furnished to the person for whom the services were performed. Additionally, the undersigned will include a copy of the election with his or her income tax return for the taxable year in which the property is transferred. The undersigned is the person performing the services in connection with which the property was transferred.

Dated: ____________________
____
Taxpayer

15. Political Funds for Personal Purposes

    a. The statute of limitations did not bar the IRS from assessing the civil fraud penalty against an Illinois politician who fraudulently understated her income. The politician used political committee funds to purchase a car for her personal use and to invest in a luxury golf course in her own name. She failed to include that amount as income on her return, which caused an understatement of her tax liability. [Loren-Maltese, TC, CCH Dec. 59, 1938(M)]

16. Medical Loss Ratio Rebates

    a. Medical loss ratio (MLR) rebates payable under the Patient Protection and Affordable Care Act may be reportable income.

        1) MLR premium rebates were designed to persuade health insurance companies to spend at least 80% of premiums directly on health care as opposed to advertising, certain administrative cost, and executive salaries. Insurers that do not meet these standards are required to rebate a portion of the premiums to customers.

        2) The U.S. Department of Health and Human Services estimates that nearly 12.8 million Americans will receive a little more than $1.1 billion during August 2012. The average household rebated in $151.

        3) If a tax benefit as previously taken on the premiums now being refunded, the rebate is taxable; otherwise, the premiums are usually tax free to the recipient.

        4) Rebate payments passed along by employers to employees under a cafeteria plan, either as cash or premium reductions, will normally be reflected on each employee's Form W-2 as increased wage income, subject to income tax withholding and employment taxes.

17. Tool Reimbursement Plans

    a. The IRS has provided guidance which clarifies that an arrangement that recharacterizes taxable wages as nontaxable reimbursement or allowances does not satisfy the business connection requirement of the accountable plan rules under Sec. 62(c). [Rev. Rul. 2012-25] In three of the cases the plans were not accountable plans. 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 these plans are income and subject to payroll tax.

b. To be an accountable plan, the reimbursement or allowance arrangement must include all of the following rules.

1) The expenses must have a business connection — that is, the expenses must have paid or incurred deductible expenses while performing services as an employee of the employer.

2) The expenses must be adequately accounted to the employer for these expenses within a reasonable period of time.

3) Any excess reimbursement or allowance must be returned within a reasonable period of time.

C. Passive Income

1. The IRS held that rental income is not passive investment income when significant services are performed and substantial cost are incurred. [PLR 201229007]

a. Passive investment income exceeding 25% of gross receipts for three consecutive years could cause an S corporation election to terminate if it has accumulated earnings and profits.

D. Capital Gains and Losses

1. Selling Unimproved Lots

a. A successful day trader also ran a real estate business, buying 250 lots over an eight-year span. His strategy was to buy the lots at a bargain and make money by reselling them. He did not improve or subdivide any of the parcels, so he claimed they were held for investment. He sold 42 lots over a two-year period and said his profit was capital gains. The Tax Court said that with so many sales, he was dealer in realty, so his profit is ordinary income. [Flood, TC Memo 2012-243]

1) He owes self-employment tax on the profits earned on the real estate venture.

E. Like-Kind Exchanges and Involuntary Conversions

1. Code Section 1045

a. Code Sec. 1045 provides that a non-corporate taxpayer may defer recognition of gain on the sale of qualified small business stock (QSB) held by the taxpayer for more than six months. Any gain not recognized reduces the cost basis of the replacement qualified small business stock. The taxpayer recognizes gain to the extent the amount realized on the sale of the QSB stock exceeds the cost basis of the replacement qualified small business stock.

b. Qualified small business stock under Sec. 1202(c)(2) must have an active business requirement. At last 80% of the assets of the corporation must be used in active conduct of one or more qualified trades or businesses. Excluded from the definition of qualified trade or business are any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial service, brokerage services, or any trade or business where the principal asset of the such trade or business is the reputation or skill of one or more of its employees.

c. The Tax Court found that the couple did not invest at least 80% of the proceeds from the sale of a qualified small business into the active trade or business or a replacement qualified small business. [John P. Owen, TC Memo 2012-21] The couple had effectively deposited a large amount of money into an account rather than use it to operate a jewelry business.

2. Replacement Property as a Residence

   a. The Tax Court found that a married couple who used replacement property in a like-kind exchange as their personal residence nonetheless had investment intent when they acquired the property. [Reesink, TC Memo 2012-118]

   b. The taxpayer and his brother sold an apartment building and each received $700,000. The taxpayer bought a single family home in a different city as investment property. The taxpayer had advertised for renters and had placed fliers in the community inviting persons to visit the property. They moved into the rental property eight months after the exchange. They sold their personal residence almost six months after purchasing the rental property.

   c. The court further found that the couple had not made the purchase of the replacement property contingent on the sale of their principal residence to distinguish from Goolsby, TC Memo 2010-64.

3. Federal Law Determines Like-Kind

   a. IRS Chief Counsel has concluded that federal law, rather than state law, controls the determination of whether exchanged properties are like-kind under Code Sec. 1031. [CCA 201238027]

   b. One state may classify property as real property while another state classifies the same type of property as personal property. Facts and circumstances should be considered to determine whether properties are of the same nature and character.

F. Retirement Plans

1. Early Withdrawal

a. An individual was liable for a 10% additional tax relating to early distributions from a qualified retirement plan because she was 49 years old at the time the distribution was made and no exceptions to the additional tax applied to the distribution. [Randolph, TC, CCH Dec. 59,041(M)]

b. The Seventh Circuit has affirmed a Tax Court decision in a case involving a former law firm employee who, at age 56, had rolled over his pension funds into an individual retirement account (IRA). The taxpayer later took $240,000 of distributions from the IRA before age 59½ without paying the 10% additional tax. The Tax Court found he was liable for both the 10% additional tax and a substantial underpayment penalty. [Kim, CA-7, 5-9-2012]

1) A penalty exception applies to distributions made to a employee who has separated from the employer's service and is at least age 55. He lost that option by rolling the employer's pension amount to an IRA.

c. The Tax Court properly held that a distribution received by an individual from his retirement plan was taxable income and he was liable for failure to report the distribution in the tax year at issue. [Clanton, 2012-2 USTC ¶50,508, CA-6]

1) Contrary to the individual's assertion, Code Sec. 408 does not include any hardship exception and withdrawals from IRAs are generally taxable.

d. An IRA owner was using a special withdrawal rule for persons under age 59 1/2 to avoid the 10% early-payout penalty, taking a series of essentially equal payments for the longer of five years or until she reached 59 1/2. Because of a clerical mistake, an extra distribution was made from the IRA and the bank failed to reverse the payout. In a private ruling, the IRS voided the 10% penalty because the extra withdrawal was not her fault. [PLR 201234029] Otherwise, she would have had to pay the 10% levy on all previous withdrawals.

2. 2010 Roth Conversions

a. 2010 was the first year taxpayers could transfer funds from a traditional individual retirement account (IRA) to a Roth IRA without restriction.

b. Congress provided a special benefit for taxpayer who created Roth accounts in 2010 and made a taxable transfer to the account. Taxpayers could defer reporting the income until 2011 and 2012. The IRS instructed that taxpayers engaging in one of these transactions during 2010 must report half of the taxable amount from the transfer on the 2011 tax return and half of the taxable amount in 2012.

c. If the taxpayer received a taxable distribution in 2010 or 2011, the taxpayer had to fill out Part III or Part IV of the 2011 Form 8606 to determine how much of the transferred amount to report in 2011 and 2012.

3. Roth IRAs

   a. The Tax Court has found in a consolidated case that a married couple's purported service agreement between their construction business and two corporations, owned in turn by two Roth IRAs, was a sham. [Repetto, TC Memo 2012-168]

      1) The taxpayers operated their construction business as an S corporation. In 2003, the taxpayers organized two C corporations, which in turn were owned by two Roth IRAs (one Roth IRA was owned by the husband and the other Roth IRA was owned by the wife). The corporations were organized to provide services, such as facilities support, to the S corporation. The S corporation paid the C corporation for these services.

      2) The Tax Court agreed with the IRS that the purported facilities support agreements were nothing more than mechanisms for transferring value to the Roth IRAs.

4. Distributions from Inherited IRA

   a. Since Sec. 408(d)(3)(C) does not allow rollover treatment for inherited IRAs, a trustee-to-trustee transfer is the only basis upon which a nontaxable transfer of funds can be implemented. [Jankelovits, TC Memo 2008-285]

      1) The distribution check from the IRA was made out to the taxpayer. The Tax Court rejected the taxpayer's argument that her intent was to bring about a trustee-to-trustee transfer. [Charles Beech, TC Summ. Op. 2012-74]

      2) Tax Court Small Cases Division

         a) Tax for one year is $50,000 or less

         b) $60 filing fee

         c) Pro sese -- represent yourself

G. Losses

1. Gambling Losses

   a. The Tax Court held that the limitation of wagering losses in Sec. 165(d) applies to persons in the trade or business of gambling; therefore, they may not deduct wagering losses in excess of wagering gains. However, a gambler's business expenses are not losses from wagering transactions subject to that limitation and are deductible under Sec. 162(a). [R. Mayo, 136 TC 81, CCH Dec. 58,524]

      1) The IRS Chief Counsel has recommended acquiescence. [AOD-2011-06, Fed ¶46,205]

   b. IRS Options

      1) Appeal to higher court

      2) Not appeal but issue nonacquiescence

      3) Acquiesce

2. Passive Losses

a. In an effort to prevent passive limited partners from taking deductions against active income, the IRS issued proposed guidance that would define a limited partner who shall not be treated as "materially participating" in a partnership activity through a two-part test.

1) The test specifies first of all that an interest in "the entity" shall be treated as an interest in a limited partnership as a limited partner if the entity (such as a limited liability company or LLC) is classified as a partnership under federal tax law.

2) Secondly, the holder of the interest would not be treated as "materially participating" in a partnership activity if it did not have the right to manage the entity at all times under state law and the governing partnership agreement.

b. An individual was not entitled to excess expenses deductions attributable to renting the home where he also resided. The expense deductions were properly limited to the gross income derived from the rental activity. Therefore, the Tax Court correctly determined the deficiency for the tax year at issue. [Velasquez, CA-9, 2012-2 USTC ¶50.449]

1) Losses

a) Hobby loss

b) Vacation home

c) Home office

2) Order of Deduction

a) Category #1: Deductions that a taxpayer may take for personal as well as business activities, such as home mortgage interest and taxes, may be taken in full irrespective of hobby income, but must reduce the amount of hobby income remaining available to offset deductions in Categories #2 or 3;

b) Category #2: Deductions that do not result in an adjustment to basis, such as advertising, insurance premiums and wages, may be taken next, to the extent gross income for the activity is more than the deductions from Category #1;

c) Category #3: Business deductions that reduce the basis of property, such as depreciation and amortization, are taken last, but only to the extent gross income for the activity is more than the deductions taken in Categories #1 and 2.

c. Self Rental

1) Income attributable to a couple's rental of a commercial office building to the husband's wholly-owned medical corporation was nonpassive income under the self-rental rule of Reg. 1.469-2(f)(6). [Samarasinghe TC, CCH Dec. 58,925(M)] Therefore it could not be offset against accumulated and unused passive losses.

a) The accuracy-related penalty did not apply because they reasonably relied on the advice of their tax advisor.

2) The self-rental rule is designed to prevent taxpayers with passive losses from setting up a separate leasing business to generate passive income, to offset the losses.

3) Reg. 1.469-2(f)(6) treats rental income from an "item of property" as nonpassive if the property is rented for use in a trade or business in which the taxpayer materially participates.

4) Net rental income from an item of property is converted from passive to nonpassive but not rental loss from an item of property is not so converted. It seems that such an outcome is what Congress intended. So, courts facing this issue have concluded that the self-rental rule is a valid exercise of Treasury's rule-making authority.

a) Example. Rented 3 items to own S corporation. 1st item $4,000 gain, 2nd item $3,000 loss, and 3rd item $3,000 loss. Netted: $2,000 loss not deductible; Per Item: $4,000 income and $6,000 passive loss not deductible.

5) The Tax Court held that each individual tractor or trailer was an "item of property" rather than the entire collection of tractors and trailers owned by the company. [Joseph Veriha, 139 TC No. 3] They leased each tractor and each trailer separately.

d. Cattle Ranch

1) A couple's ownership of an out-of-state cattle ranch was a passive investment. Therefore, their losses were subject to the passive loss limitation under Sec. 469. There was little evidence, other than the couple's assertion, that their activities satisfied the 500-hour test or that they participated in ranch activities on a regular, continuous, and substantial basis. [Eversen, TCM, CCH Dec. 58,921(M)]

e. The Seven Material Participation Tests

Current Year Tests

1) Hourly Safe Harbor
2) Primary Participant
3) Maximum Participant
4) Significant Participation Activity Aggregation

Prior Year Tests

5) Historical Participation
6) Personal Service Activity

Statutory Test

7) Facts and Circumstances

3. Property Sold to Ex-Spouse After Divorce

1) A husband sells property (independent of any divorce agreement) to his ex-wife at a significant loss seven years after the divorce. The loss is probably not subject to the nonrecognition of gain or loss rules of divorce. There is a rebuttable presumption that transfers not made under a divorce or separation instrument -- and which occurred more than six years after the marriage ends -- are not incident to a divorce or related to the cessation of the marriage. If the property transfer was held up because of legal or business problems, or a valuation dispute, it could be considered related to the cessation of marriage even though the transfer takes more than six years.

4. Hobby Losses

   a. The Eighth Circuit held that the Tax Court erred in denying deductions for the taxpayer's operations. [DKD Enterprises v. Comm, 110 AFTR 2d 2012, CA-8]

      1) The mere fact that the cattery expenses vastly exceeded its income is not sufficient to disprove the existence of a genuine profit motive. The rule is clear -- the Tax Court should find the trade or business venture lacked a genuine profit motive only if the courts finds, as a factual matter, the taxpayer lacked a good faith, subjective intention to make a profit and was engaged in the activity for wholly different reasons.

   b. The Tax Court denied the taxpayers automobile deductions of $16,550 for miles traveled in pursuit of their goal of investment in "fixer-upper" homes to ultimately sell for profit. The court held that the activity was not engaged in for profit under Sec. 183 because (1) there was no evidence that taxpayers met with realtors or sellers to see the interior of any homes or that a purchase offer was ever made, (2) taxpayers claimed that most of the miles were logged looking at homes during their daily commute to work, and the homes claimed to have been viewed on weekends were near the husband's mother's home, and (3) taxpayers did not show they had sufficient credit, capital, or sources of income to purchase investment property. [John Wathall, TC Summ. Op. 2012-65]

5. Bad Debt Deduction

   a. The taxpayer loaned money to a distant relative to be used in connection with a real estate project. The debt remained unpaid at the time of debtors death. The taxpayer claimed a bad debt deduction two years after the debtor's death after failing to obtain any of the unpaid balance from the debtor's sons. The Tax Court denied the deduction since it was not claimed, as required under Sec. 166(d), in the year of worthlessness. The note matured six years before the deduction was taken, and although there was evidence the taxpayer pursued collection, he did not how that he made any formal claim against the debtor's estate. [George Saadian, TC Summ. Op. 2012-44]

H. Alimony

1. Divorced taxpayers modified their separation agreement with a requirement that the husband pay a lump-sum amount in full settlement of future obligations to pay alimony and leave a portion of his net estate to his ex-wife, if she survived him. The IRS held that the lump-sum payment violated the Sec. 71(b) requirement that payments not be designated as excludable from income under the divorce or separation instrument and since there were no past-due liabilities, none of the lump-sum amount was deductible by the husband or income to the wife. [PLR 201206005]

2. Post-1986 Alimony Requirements
   a. Payments must be in cash
   b. Payments are not designated as other than alimony
   c. Spouses are not members of the same household
   d. No liability to continue payments after death of transferee spouse
   e. Payments are not treated as child support--child support if amount reduced by event relating to child
   f. Payor obligated to make annual payments of at lest three years if any payment is over $15,000

3. Alimony Recapture Example:
$50,000 First Year Alimony
$30,000 Second Year Alimony
$10,000 Third Year Alimony

$30,000 - $10,000 - $15,000 = $5,000 Recapture from Second Year
$50,000 - ($30,000+$10,000-$5,000)/2 - $15,000 =$17,500 First Year Recapture

Could pay $30,000 each of three years and avoid recapture

Pay $40,000 first year; $32,500 second year; and $17,500 third year

4. A professional baseball player was not allowed alimony deductions for payments under a postnuptial because he was liable to make payments after the spouse's death. [LaPoint, TC, CCH Dec. 59,023(M)]

5. The Tax Court has held that a taxpayer could not exclude her court-ordered share of her ex-husbands' disability pay from her income. The court found no support for the taxpayer's claim that because she "stepped into the shoes of her former husband" and he was injured at the time of his early retirement, she should be taxed in the same manner as her former husband. [Shannon Fernandez, 138 TC No. 20]

   a. The court noted that in all of the years, to our knowledge, the taxpayer's particular issue has not been before the court.

6. Oral Agreement

   a. A couple was not entitled to deduct support payments that were made by the husband to his ex-wife, pursuant to an oral separation agreement, for the months prior to the entry of a judgment of dissolution. [Larivey, TC, CCH Dec. 59,174(M)] They were not liable for the accuracy-related penalty on the underpayment of tax because they reasonably relied on a competent tax professional to prepare their return.

7. Payments After Death of Payee Spouse

   a. To deduct a payment as alimony under Sec. 71(b)(1), one of the requirements is that a taxpayer must have no liability to continue making payments after the death of the payee spouse. In this case, the taxpayers' settlement agreement provided for a $5,000 monthly payments beginning on a specified date and "continuing each month thereafter for sixty months until paid in full." The Tax Court examined Florida law and found it clear that alimony granted in a divorce decree does not terminate upon the death of the payee spouse. [Daniel Rood, TC Memo 2102-122]

I. Moving Expenses

1. The taxpayer was general manager of a restaurant in Arizona and agreed to relocate to one of his employer's other restaurants in California. He transferred his family and belongings and lived in a hotel for approximately a month before moving into an apartment. The taxpayer claimed that his tax home remained in Arizona until he and his family moved into the apartment, and his expenses prior to that time were deductible as travel costs under Sec. 162. The Tax Court denied the deductions because once employment is accepted for an indefinite time away from an old place of employment, the tax home shifts to the location of the new principal place of employment. [Darren Newell, TC Summ. Op. 2012-57]

J. Business Deductions

1. Tangible Property Regulations

a. The IRS issued proposed regulations on the deduction vs. capitalization issue in 2006. These proposed regulations were withdrawn and new one were reissued in 2008. In December 2011, the IRS withdrew the 2008 proposed regulations and reissued a new, third set of proposed regulations, along with a matching set of temporary regulations. The temporary regulations are effective for tax years beginning after December 31, 2011.

1) They affect all businesses in one way or another.

2) The temporary regulations are effective for tax years beginning after December 31, 2013. [Notice 2012-73, issued 11-20-2012]

a) Taxpayers can choose to make them effective for tax years after 12-31-2011.

b) Taxpayers can choose to implement only certain items of the regulations before 2014.

c) Certain portions are effective for amounts paid or incurred in tax years beginning on or after the effective date.

3) They are comprehensive regs on the treatment of payments to "acquire, produce, or improve" tangible property.

b. A change by a taxpayer to conform to the regs will be a change in method of accounting under Sec. 446(e) if the existing method conflicts with the proposed regulations.

1) Because the government will impose a Sec. 481 adjustment, taxpayers will have to look at repairs and capitalized expenses for prior years.

2) Rev. Procs. 2012-19-2012-20 provide for automatic accounting method changes relating to the temporary regulations.

a) No user fee charged.

b) Generally an automatic accounting method change must be filed for the year of change by the due date of the taxpayer's income tax return (including extensions).

c. Improvements must be capitalized, whereas repairs can be deducted.

1) The Tax Code and the regs require capitalization of amounts paid for permanent improvements, betterments, and restoration, as well as payments that add to the property's value, prolong its useful life, or adapt the property to a new use.

d. The regs generally defined a unit of property for real and personal property, other than buildings, as consisting of all the components of the property that are functionally interdependent. Components are functionally interdependent if one component (such as, an airplane) cannot function without the other component (an aircraft engine).

   1) Taxpayers want the unit of property to be as large as possible, so that amount spent on a portion of the property are treated as a repair.

e. The restoration rules in the proposed regs provide an expansive rule allowing taxpayers to deduct, rather than capitalize, amounts paid to replace a major component or substantial structural part of the building.

f. The regs require that improvements (and thus capital expenditures) be determined by considering the effect of the work on eight significant, specifically defined building components, such as heating and air conditioning, plumbing, electrical, and elevators. This approach will require greater amount to be capitalized that previously. However, the temporary regs allow taxpayers to deduct expenditures that had to be capitalized under old law.

g. The temporary regs allow taxpayer to deduct expenditures that had to be capitalized under old law.

h. The retirement of a structural component on an MACRS building is treated as a disposition that results in a loss deduction equal to the adjusted depreciable basis of the structural component.

   1) Taxpayers are allowed to use a reasonable and consistent method to treat components of a structural component as an asset and, therefore, recognize a loss upon the disposition of a portion of a structural component.

   2) Taxpayers that previously retired a structural component which is currently being depreciated will need to change accounting methods to bring the treatment of the structural component into compliance with the new rules.

i. Taxpayers that place multiple items in the same general asset account may now elect to recognize a gain or loss by reference to the adjusted basis when it sells or otherwise disposes of an item with the account.

j. De Minimis Expense

   1) The aggregate cost that may be expenses annually under a taxpayer's expensing policy is subject to a ceiling equal to the greater of:

      a) .1% of gross receipts, or

      b) 2% of total depreciation and amortization reported on the financial statement.

   2) Must have an applicable financial statement and written policy expensing de minimis amounts. Otherwise use Section 179.

k. Materials and Supplies

1) Incidental materials and supplies are deductible in the tax year their cost is paid or incurred. [Temp. Reg. 1.162-3T(a)(2)]

2) The cost of nonincidental materials and supplies are deducted in the year used or consumed. [Temp. Reg. 1.162-3T(a)(1)]

l. A component on a unit of property cannot be deducted as a repair or as a material or supply if a retirement is claimed on the replaced component. [Temp. Reg. 1.263(a)-3t(i)]

m. Uniform Capitalization Rules

1) Section 263A governs the treatment of direct and certain indirect costs of producing property or acquiring property for resale.

n. Cost of Defending Title

1) Amounts paid or incurred to defend or perfect title to real or personal property are capitalized. [Temp. Reg. 1.263-2T(e)]

o. Roof Repair

1) The roof comprises a major component or substantial structural part of the building structure and the replacement costs must be capitalized.

2) The result is the same if only a large portion of the decking, insulation, and membrane of the roof is replaced.

3) If only the waterproof membrane is replaced, the cost does not have to be capitalized.

2. Slot Machine Conversions

a. IRS Chief Counsel has concluded that the costs of making certain changes to slot machines were deductible as repairs and did not have to be capitalized. The changes generally involved a conversion of a slot machine by changing software and video displays to change the particular game or theme of the machine. [CCA 201213023] The IRS also noted that the taxpayer capitalizes its slot conversion costs on its financial statements.

1) The conversions do not materially add value to a slot machine. The conversions do not substantially prolong the useful life of the machines. The conversions do not adapt the machines to a new or different use.

3. New Client

   a. New client has several rental properties and her son has been doing the tax returns. No depreciation taken for 10 years.

   b. "Allowed or Allowable."

   c. 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.

      1) $4,200 user fee.

   d. 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.

      1) 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 180 automatic changes.

         a) From an impermissible method to a permissible method.

      2) 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]

      3) To qualify for the change of accounting method, the taxpayer must own the asset at the beginning of the year of change.

      4) 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]

4. a. Trade or Business Expenses

   b. After retiring from his job, the taxpayer wished to become involved in the rental real estate business. He purchased one duplex property in 207 and began extensive renovations that were not completed until 2009. The property was not rented until sometime in 2010. The taxpayer claimed Schedule C expenses of $61,779 on his 2007 tax return with no gross receipts reported. The Tax Court denied a deductions for the expenses on the 2007 return because a taxpayer is not carrying on a trade or business for purposes of Sec. 162 until the business is functioning as a going concern and performing the activities for which it was organized. [Lawrence McPartland, TC Summ. Op. 2012-88]

5. Cost of Goods Sold Business Expenses

   a. A CPA taxpayer prepared tax returns out of his home and was also involved in various other businesses including insurance sales. His insurance business was reported on Schedule C where he claimed Cost of Goods Sold of $44,542, comprised of amounts paid for rent, referral fees, and record-keeping services. The Tax Court held that the expenses were not deductible as COGS. Gross receipted must equal gross income when the business is primarily engaged in providing services. [Bobby Perry, TC Memo. 2012-237]

6. Pension Contributions

    a. Under Sec. 404(a)(8), a self-employed taxpayer's pension contribution is deductible expense to the extent it does not exceed earned income from the business. However, a self-employed taxpayer's contribution is not an expense attributable to the taxpayer's trade or business. In this case, a self-employed real estate agent claimed her pension contributions on Schedule C, thereby reducing self-employment income. The Tax Court denied the deductions on Schedule C since no statutory authority attributes the contributions to a trade or business. The contributions were deductible on Form 1040, line 28. [Lisa Laflamme, TC Memo 2012-36]

        1) She was not liable for the accuracy-related penalty under Sec. 6662(a) because she had reasonable cause for doing so and she acted in good faith.

7. Health Savings Accounts

    a. An HSA is a tax-exempt trust or custodial account established for paying qualified medical expenses of the account beneficiary. Accounts may be established with banks and insurance companies or with other entities approved by the IRS to hold Individual Retirement Accounts (IRAs) or MSAs.

    b. For 2012, the deductible for self-only coverage must be at least $1,200, with an annual out-of-pocket limit not exceeding $6,050; the deductible for family coverage must be at least $2,400, with an annual out-of-pocket limit not exceeding $12,100. The annual HSA contribution limit in 2012 for individuals with self-only coverage if $3,100; for family coverage, it is $6,250. Individuals who are at least 55 years of age but not yet enrolled in Medicare may contribute an additional $1,000.

8. Medicare Premiums of Self-Employed

    a. The Chief Counsel has advised that a self-employed individual who is an employee under Sec. 401(c)1) can deduct Medicare insurance premiums in computing adjusted gross income. Self-employed individuals include a partner in a partnership, a two-percent shareholder in an S corporation, and a sole proprietor. [CCA 201228037]

    b. Chief Counsel also advised that:

        1) All Medicare Parts, not just Part B, are similar to other health insurance premiums that provide medical care coverage under Sec. 162(l);

        2) A self-employed individual can pay the premiums directly and be reimbursed by the employer, or the premiums may be paid by the employer (the partnership or S corporation), sole proprietors must pay the premium directly;

        3) Medicare premiums can be deducted for coverage of the self-employed individual's spouse, dependent, or child (assuming the child is not age 27); and

        4) Self-employed individuals who failed to deduct Medicare premiums for prior years may file an amended return to claim the deduction.

    c. Chief Counsel noted that the deduction is not allowed to the extent it exceeds the individual's earned income from the trade or business for which the medical plan is established.

d. A deduction also in not allowed if the employer of the individual or the individual's spouse provides a subsidized health plan.

e. The insurance arrangement must comply with Notice 2008-1. If the premiums are paid by the employer, the premium amounts must be included in the gross income of the self-employed individual.

f. The self-employed health insurance deduction is taken on line 29 of Form 1040. It is not an allowed deduction on Schedules C, E, F, or SE.

g. The CCA dispels the notion that a self-employed individual's spouse also had to be self-employed.

9. Unreimbursed Expenses

a. Generally a partner cannot deduct the partnership's expenses on his Form 1040, even if he incurs the expenses in conducting partnership business. However, if the partnership agreement or established partnership practice requires the partner to pay certain partnership expenses out of his own funds, the expenses can be deducted on Schedule C (and as a reduction of SE income on Schedule SE).

b. If the partner is entitled to be reimbursed for the expenses under the partnership agreement or established partnership practice, but fails to obtain reimbursement, he cannot deduct them. [PLR 9316003]

c. The Tax Court found that the taxpayer "was not required to pay without reimbursement any expenses for travel, meals, entertainment, vehicle rental, continuing legal education, professional organizations State bar memberships" and disallowed the expenses. [Paul McLauchlan, TC Memo 2011-289]

1) The Court also agreed with the IRS that McLauchlan "did not act with reasonable cause and in good faith with respect to the underpayment for the years at issue" and was subject to the Section 6662 accuracy-related penalty.

K. Depreciation and Amortization

1. Luxury Automobiles [Rev. Proc. 2012-23]

a. The depreciation for new autos put in use in 2012 increase slightly from 2011. The higher depreciation deduction limits for electric automobiles only applied to vehicles placed in service between January 1, 2002 and December 31, 2006.

Year	Passenger Autos	
	New	Used
First year	$11,160	$3,160
Second year	5,100	5,100
Third year	3,050	3,050
Succeeding years	1,875	1,875

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 build on a truck chassis.

3)

Year	Trucks and Vans	
	New	Used
First year	$11,360	$3,360
Second year	5,300	5,300
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 for 2008 and 2009

a. IRS Chief Counsel has concluded that qualified restaurant property and qualified retail improvement property are eligible for 50% bonus depreciation in both 2008 and 2009. [CCA 201203014]

1) The property must also qualify as qualified leasehold improvement property for bonus depreciation, even if the restaurant or retail property would not qualify by itself.

3. Retention Pond

a. The IRS cost segregation table say a retention pond is a depreciable land improvement. A land improvement is generally 15-year property under the modified accelerated cost recovery system and is depreciated over 15 years using the 150% declining balance method. The pond should qualify for bonus depreciation since it has a recovery period of 20 years or less.

4. Floating Gaming Facility

   a. The IRS Chief Counsel held that the taxpayer's floating gaming facility should be classified as nonresidential real property under Sec. 168(e), with a recovery period of 39 years. [CCA 201225012] The U.S. Coast Guard determined that is was permanently moored or practically incapable of transportation or movement.

5. Retrofitted Buildings

   a. Improvements to buildings are capitalized. The regulations specifically give an example of a retrofitted building improvement designed to protect against earthquakes that must be capitalized.

6. Real Versus Personal Property

   a. The Tax Court agreed with the IRS that many assets in an apartment complex were depreciable as residential property written off over 27.5 years. The court rejected the taxpayer's claims that certain assets could be depreciated as personal property. [AmeriSouth XXXII, LTD., TC Memo 201-67]

   b. The Tax Court viewed what is considered structural components with a residential complex as very broad, leaving little room for the taxpayer to separate out certain items for faster depreciation.

   c. The court found that the water-distribution system, which included water and fire lines, fire hydrants, and trenching and backfill, was an integral par of the plumbing and air conditioning system and depreciable over 27.5 years.

   d. The court found that Reg. 1.48-1(e)(2), specifically lists sinks as structural components. Similarly, interior windows and chair rails were structural components. Built-in shelves in the kitchen and living room in the apartments also were integral parts.

   e. The court did find that duplex outlets, which were four-feet above the ground in the kitchens and intended to accommodate refrigerators, were personal property along with 220-volt outlets in the kitchens because they are used solely for powering stoves.

   f. Venting connected to clothes dryers were personal property while vent hoods above stoves were an integral components of the building.

7. Idle Asset Rule

   a. An asset can be considered placed in service before actual business usage begins, it if is devoted to the taxpayer's business and ready for use should the occasion arise. [Piggly Wiggly Southern, Inc., 59 AFTR 2d 87-394, 803 F2d 1572 (CA-11, 1986)]

8. Section 179

   a. The taxpayer began planting a vineyard in 2005 and capitalized the costs of land preparation, labor, and planting over the next few years until the plants became viable. The vineyard was placed in service in 2009 and the taxpayers claimed a deduction under Sec. 179 for the costs incurred in planting the vines.

   b. Section 179 property means (a) tangible property to which Sec. 168 applies, (2) Sec. 124 property, and (3) property purchased for use in an active trade or business. In Chief Counsel Advise, the IRS determined that the vineyard met all the requirements as qualifying property, and the taxpayer were entitled to expense in 2009 the costs under Sec. 179 (including capital expenditures made to develop the vineyard to an income-producing stage). [CCA 20124024]

L. Business Expenses

1. Temporary Work Sites

   a. A taxpayer failed to persuade the Tax Court that his travel expenses to five temporary work sites were exceptions to the general rule treating the costs of commuting an nondeductible personal expenses. The temporary work sites were not outside the metropolitan area where the taxpayer worked. [Kristopher Saunders, TC Memo 2012-200]

      1) The taxpayer did not report to the employers' Cincinnati office but traveled to five temporary work sites. The temporary worksites ranged from 74 to 96 miles from the taxpayer's residence. The taxpayer deducted $23,000 for unreimbursed employee business expenses, largely attributable to commuting from his residence to the five work sites.

      2) The court observed, in certain cases, a taxpayer may deduct travel expenses between his or her residence and temporary work locations outside of the metropolitan area where the taxpayer lives and normally works.

      3) The court also found that expenses incurred commuting between a taxpayer's residence and a place of business may be deducible if the residence is the taxpayer's principal place of business. However, the taxpayer did not claim that his residence was his principal place of business.

2. Book Writing Expenses

   a. An individual's expenses related to his writing a proposed book were not deductible because he was not in the trade or business of being a book author. Further, he did not establish a business purpose for each of his expenses. [Michael Oros, TC Memo 2012-4]

      1) He was not liable for an accuracy-related penalty because he relied on the advise of his tax advisor in claiming the disallowed deductions.

3. Advertising Expenses

    a. Expenditures for advertising are deductible whether or nor the advertising is effective (even if the advertising misfires and has disastrous results for the company; however, expenditures providing only minimal benefits are not deductible. The deduction depends on whether the expenditure, when authorized, "might reasonably be expected to produce some patronage benefit." [FAA 20115002F]

        1) It is not for the IRS to decide whether an expenditure is the best possible use of company funds, only whether it was ordinary and necessary in the pursuit of business.

4. Medical Marijuana Dispensary

    a. The Tax Court held that Sec. 280E barred a taxpayer from deducting expenses for his state-authorized medical marijuana dispensary. The court found that the taxpayer's dispensary was engage in trafficking in a controlled substance. [Martin Olive, 139 TC No. 2]

        1) Under Code Sec. 280E, a taxpayer may not deduct any amount for a trade or a business where the trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances.

        2) In Californians Helping to Alleviate Med. Problems (CHAMP), Inc., CCH Dec. 56,935, the Tax Court held that medical marijuana is a controlled substance under Code Sec. 280E.

        3) The IRS disallowed all Cost of Goods Sold (COGA) for lack of substantiation. The Tax Court accepted an expert's opinion that average COGS for a medical marijuana dispensary is 75.16%, but adjusted that percentage for inventory given away or personally consumed. The parties agreed that Sec. 280E disallows deductions for the dispensary's expenses, but not for COGS.

5. Deductible Restitution Payments

    a. Under Sec. 165(c)(2), taxpayers who repay embezzled funds are ordinarily entitled to a deduction in the year in which the funds are repaid. In a Private Letter Ruling, the IRS allowed a doctor to deduct restitution payment made to an insurance company in a criminal lawsuit for insurance fraud. In addition, restitution payments made to the state of New Jersey, in exchange for the dismissal of charges in its suit against the taxpayer, were deductible if no contributions from another party (i.e., the other doctor and practices that had been sued) were received and the amounts had been included in gross income in prior years. [PLR 2012400007]

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 2012 is 55.5 cents-per-mile. The standard mileage rate for medical and moving expenses for 2012 is 23 cents-per-mile. The statutorily determined rate for the charitable deduction remains at 14 cents-per-mile for 2012. The depreciation component of the business standard mileage rate is 22 cents-per-mile for 2011. [Rev. Proc. 2012-1]

b. 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. Reimbursement Arrangements

a. Recently-released proposed reliance regs clarify the exception to the 50% meal and entertainment expenses deduction limit under Sec. 274(n) where amounts are paid or incurred under reimbursement or other expense allowance arrangements. [NPRM REG-101812-07]

1) Generally, Sec. 274(n)(1) limits the deduction for meal and entertainment expenses to 50%. Sec, 274(e)(3) provides an exception from the limitation for expenses that a taxpayer pays or incurs in performing services for another person under a reimbursement or other expenses allowance arrangement with the other person.

2) The Sec. 274(e)(3) exception applies if the taxpayer is an employee performing services for an employer and the employee does not treat the reimbursement for the expenses as compensation and wages to the taxpayer. The employee under such an arrangement is not treated as having additional compensation and has no deduction for the expense; the employer bears and deducts the expense and is subject to the deduction limitations.

3) If the employer treats the reimbursement as compensation and wages, the employee may be able to deduct the expense as an employee business expense. In that case, the employee bears the expense and is subject to the deduction limitations. The employer deducts an expense for compensation, which is not subject to the deduction limitations under Sec. 274.

4) The exception applies if the taxpayer performs services for a person other than an employer and the taxpayer accounts to that person. In a reimbursement or other expense allowance arrangement in which a client or customer reimburses the expenses of an independent contractor, the deduction limitations do not apply to the independent contractor to the extent the independent contractor accounts to the client by substantiating the expenses are required by Sec. 274(d). If the independent contractor is subject to the deduction limitations, the limitations do not apply to the client.

5) The proposed reliance regs provide that a reimbursement or other expense allowance arrangement involving persons who are not employees is an arrangement under which an independent contractor receives an advance, allowance, or reimbursement from a client or customer for expenses the independent contract pays or incurs in performing services if either:

a) A written agreement between the parties expressly provides that the client or customer will reimburse the independent contractor for expenses that are subject to the deduction limitations, or

b) A written agreement between the parties expressly identifies the party that is subject the limitations under Reg. 1.274-2(a)-(d and Sec. 274(n).

6) The limitations apply to the independent contractor and not to the client if the independent contractor fails to account to the client.

7) The proposed regs would apply to expenses paid or incurred in tax years beginning on or after the date the regs are finalized. However, taxpayer may apply the regs for tax years beginning before the date the regs are finalized for which the period of limitations under Sec. 6511 has not expired.

N. Itemized Deductions

1. Charitable Contributions

a. Gift of Home to Fire Department

1) Taxpayers purchased lakefront property and donated the home on the property to the local fire department to be burned down in a training exercise. Taxpayers then claimed a $76,000 charitable deduction using an appraiser's before-and-after approach. The 7th Circuit agreed with the Tax Court in finding that the value of the donated property did not exceed the value of the benefit received. Since there was no market for doomed houses as firefighter training sites, the courts looked to the salvage and concluded the home had no substantial value. [Rolfs v. Comm., 109 AFTR 2d 2012 (CA-7)]

2) A fire department that was allowed to burn a taxpayer's house for practice did not receive a property interest, and so the taxpayer was denied a charitable contribution deduction for the value of the house that was burned. Penalties were not imposed. [Patel, TC, CCH Dec. 59,100]

b. Defective Acknowledgments

1) The Tax Court has found that a married couple's charitable contributions were not deductible because the written acknowledgments provided by the church did not meet the substantiation requirement under Sec. 170. The first acknowledgment did not include a statement regarding whether services were provided to taxpayers as consideration for their contribution; the second written statement was not contemporaneous. [Durden, TC Memo 2012-140]

   a) Documentation Requirements

      (1) The name and address of the charity.

      (2) The date of the contribution.

      (3) The amount of cash and/or a description (but not an estimate of value) of any property contributed.

      (4) A list of any significant goods or services received in return for the donation (other than intangible religious benefits) or specifically state that the donor receive no goods or services from the charity.

2) Under Sec. 170(f)(8), for cash donations to a qualified donee organization, taxpayers must receive from that organization a contemporaneous written acknowledgment that states the amount contributed, whether the organization provided any goods or services in consideration of the contribution and if so, a description and good faith estimate of the value of any goods or services the organization provided.

3) Under Sec. 170(f)(8)(C), an acknowledgment is considered to be contemporaneous only if the taxpayer obtains the acknowledgments on or before the earlier of (1) the date on which the taxpayer files a return for the tax year in which the contribution was made, or (2) the due date (including extension) for filing such return.

c. Qualified Appraisal

1) The Tax Court upheld the IRS's disallowance of a charitable contribution deduction because the donor failed to follow the substantiation requirements of Sec. 170. The taxpayer's purported appraisals were not qualified appraisals because he did them himself. [Mohamed, TC Memo, 2012-152]

a) A qualified appraiser can not be the donor, the taxpayer claiming the deduction, or the donee of the property.

b) An independent appraiser valued the properties slightly higher than the self appraisal.

d. Conservation Easement

1) The Tax Court upheld the IRS's disallowance of a married couple's deduction for charitable donation of a historic facade easement on their residence because they did not obtain a qualified appraisal as required under Sec. 170, [Rothman, TC Memo 2012-163]

a) The appraisal did not properly arrive at the value of the charitable contribution easement, but instead took a percentage of the property's value using a range of percentages that the IRS had not challenged.

b) The qualified appraisal must include, among other things, the method of valuation used to determine the fair market value of the contributed property.

c) The Tax Court also found that the firm did not include a specific basis for the valuation in its appraisal of the property.

d) In a reconsideration, the Tax Court denied a charitable deduction because the deduction was not based on a qualified appraisal. The court found that the appraisal failed to satisfy a majority of the reg's requirements for a qualified appraisal. [Rothman, TC Memo 2012-218]

e. Contributions to a Disregarded Entity Owned by a Charity

1) The IRS announced that a contribution to a single-member limited liability company (SMLLC) that is wholly-owned and controlled by a U.S. charity is fully deductible as a charitable contributions to the charity. [Notice 2012-52]

a) Notice 2012-52 allows a charity to accept through an LLC gifts of real estate or other business property to insulate itself from certain liabilities that may be associated with direct ownership.

2. Interest Deduction

a. Qualified Residence Interest

1) IRS Chief Counsel has approved the use of "any reasonable method" by a taxpayer to determine the amount of interest that can be deducted as qualified residence interest. [CCA 201201017]

a) Regs have not been issued.

2) Applies to situations in which the debt exceeds the $1 million or $100,000 statutory limits, reasonable methods include the simplified method and the "exact" method, as described in the regs, and a hybrid method described in Publication 936, Home Mortgage Interest Deduction.

3) The simplified method multiplies the interest paid by a fraction equal to the debt limits divided by the sum of all the secured debts. Under this method, the interest on excess debt is treated as personal, nondeductible, interest.

4) The exact method compares the debt limit to the average balance on each debt. The debt limit is the lesser of the fair market value or the purchase price of the residence, reduced by prior debts.

a) Thus, the interest paid is multiplied by a fraction equal to the debt limit for a particular debt, divided by the average balance of the debt. The interest on excess debt is deductible or nondeductible based on the use of the debt proceeds under interest tracing rules.

5) There is a hybrid method in Publication 936.

6) Taxpayers can also elect to treat debt secured by a qualified residence as not secured by the residence.

a) If an election is made, the entire debt is treated as not secured by the residence.

b. Per Residence Limit

1) The Tax Court has found that two unmarried co-owners cannot each deduct interest on $1.1 million of personal residence indebtedness, because the debt limitations are residence-based, rather than taxpayer-focused. [Sophy, 138 TC No. 8]

c. Married Filing Separately

1) A taxpayer who filed as married filing separately, was limited to a deduction for interest paid on $500,000 of home acquisition indebtedness plus interest paid on $50,000 of home equity indebtedness. [Bronstein, 138 TC No. 21]

a) The plain language of Code Sec. 163(h)(3)(B)(iii) limited the taxpayer's deduction for interest paid on $550,000 of the mortgage indebtedness.

b) The court found the taxpayer liable for the 20% accuracy-related penalty. It viewed the taxpayer has having no substantial authority or reasonable basis on which to base her treatment of the mortgage interest paid.

d. Mortgage Insurance Premiums

1) Mortgage insurance premiums are no longer deductible.

2) For the period January 1, 2007, through December 31, 2011, mortgage premium were treated as interest and deductible.

e. Equitable Owners

1) Deductible interest can generally be claimed only by the taxpayer liable for the debt obligations. However, the legal borrower on a loan does not always make the loan payments. The Tax Court allowed an individual to deduct home mortgage interest, even though he did not legally own the home and was not liable on the mortgage. [Conrad Edosada, TC Summ. Op. 2012-17]

   a) Conrad Edosada's parent bought a home in 2005. However, he and his parents considered this a family home, even though the title and mortgage obligation were in the parents' name. Edosada contributed $70,000 toward the $570,000 down payment and agreed to be responsible for the mortgage payments with the understanding the he would eventually be given a legal interest in the property.

   b) Under Reg. 1.163-1, even if an individual is not directly liable on a home mortgage, he can still deduct interest he paid on the loan, if he is the legal or equitable owner of the property.

   c) Edosada was considered an equitable owner of the home because he had the benefits and burdens of ownership. To make that determination, the court considered whether he:

      (1) Had a right to possess the property and enjoy the use, rents,or profits thereof.

      (2) Had a duty to maintain the property.

      (3) Was responsible for insuring the property.

      (4) Bore the property's risk of loss.

      (5) Was obligated to pay the property's taxes, assessment, or charges.

      (6) Had the right to improve the property without the owner's consent.

      (7) Had the right to obtain legal title at any time by paying the balance of the purchase price.

   d) The court found that Edosada meet three of the seven tests and had sufficient burdens and benefits of ownership.

3. Casualty Losses

   a. Taxpayer failed to establish that an individual's former spouse's use of funds from the couple's joint bank account resulted in a theft loss. [Moragne Est., TC, CCH Dec. 58,846(M)]

   b. The Court of Federal Claims found that a married couple's failure to provide timely proof of their loss to their insurance provider did not preclude them from deduction the loss under Sec. 165(h)(5)(E). [Ambrose, FedCl, 8-3-2012]

      1) According to the insurer, the taxpayer failed to provide a proof of loss with the designated timeframe and the insurer denied their claim. The taxpayers claimed a casualty loss of $168,000 on their tax return. The IRS disallowed the refund determining that the couple did not file a timely insurance claim as required under Sec. 165(h)(5)(E).

      2) The court concluded that requiring a taxpayer to file a timely claim does not mean that she must file with her insurer anything more than what qualifies under the policy as a basic demand for compensation.

4. Miscellaneous Itemized Deductions

   a. Substantiation of Gambling Losses

      1) For taxpayers who are unable to adequately substantiate the amount of a deduction, the court may estimate the amount of expenses "bearing heavily against the taxpayer whose inexactitute is of his or her own making..." [Fortunato Gonzalez, TC Summ. Op. 2012-78]

         a) In this case the taxpayer did not include as income their gambling winnings reported to them on Forms W-2G that totaled $20,700. They attempted to substantiate their gambling losses through general testimony that they lost more than they won, their record of cashed checks they said was used to provide available funds at the casino, and under the theory that all gamblers lose money.

         b) The Tax Court allowed a gambling loss of $15,000 after satisfying itself that at least some of the funds from checks cashed near weekends and holidays were used to engage in gambling activities. The court used its best judgment to reasonable estimate the amount of gambling losses.

   b. Job Search Expenses

      1) The IRS listed these reminders for deducting job search costs: [Summertime Tax Tip 2012-06]

         a) The expenses must be spent on a job search in the same or current occupation;

         b) Outplacement agency fees and amounts spent of preparing and mailing resumes are deductible when paid to look for a job in the present occupation;

         c) Travel expenses may be deductible if the trip is primarily to look for a new job;

d) Expenses are deductible if there was substantial break between the end of the last job and the time a new search began;

e) First time job search expenses are not deductible [Rev. Rul. 75-120]; and

f) Job search expenses are claimed as miscellaneous itemized deductions subject to the two percent of AGI limitation.

O. Credits

1. Work Opportunity Credit (WOTC)

a. The WOTC was enhanced as part of the VOW to Hire Heroes Act, passed by Congress at the end of November 2011. Employers had until June 19, 2012, to complete and file a newly-revised Form 8850, Pre-Screening Notice and Certification for Work Opportunity Tax Credit, to claim credits for veterans hired on or after November 22, 2011, and before May 22, 2012. After May 22, 2012, employer must file Form 8850 within 28 days of the eligible worker's start date. [IR-2012-17, Notice 2012-13]

b. Employers that hire veterans who have been looking for employment for more than six months may be eligible for a maximum $5,600 credit per employer (Returning Heroes Tax Credit); employers that hire veterans who have been looking for employment for less than six months may be eligible for a credit of up to $2,400 per employee. Employers that hire veterans with service-connected disabilities who have been looking for employment for more than six months may be eligible for a credit of up to $9,600 per employee (Wounded Warriors Tax Credit).

c. An individual is a veteran for purposes of the WOTC if he or she served on active duty (not including training) in the U.S. Armed Forces for more than 180 days or was discharged or released from active duty for a service-connected disability, and did not have a period of active duty (no including training) or more than 90 days that ended during the 60-day period ending on the hiring date.

2. Adoption Tax Credit

a. The adoption credit under former Sec. 23 was nonrefundable, but had a five-year carryforward. The tax years 2010 and 2011, the credit was made refundable as designated as Sec. 36C. The IRS indicated that a carryforward credit from a nonrefundable to 2010 or 2011, entitled the taxpayer to a refundable credit in those years. [CCA 201211021]

3. Research Credit

a. The research tax credit expired after December 31, 2011.

b. Since its enactment in mid-1981, the credit has been extended 14 times and significantly modified five times. Although the credit is usually assumed to be a single credit, it actually consists of four discrete credits: (1) a regular credit, (2) an alternative simplified credit (ASC), (3) a basic research credit, and (4) an energy research credit. A taxpayer may claim no more than either of the first two and each of the other two, provided it meets the requirements for each.

P. Employment Taxes

1. The maximum amount of earnings subject to Social Security is $110,100 for 2012, up from $106,800 for 2011.

2. The so-called "nanny tax" threshold will increase to $1,800 for 2012.

3. S Corporation Compensation/Distributions

   a. The Eighth Circuit Court of Appeals has affirmed a federal district court decision holding that a portion of the dividends paid to an employee-owner of an accounting firm was compensation for services. As a result the taxpayer earned additional wages and owed additional Social Security taxes. [Watson P.C., CA-8, 2-21-2012; cert. denied 10-1-12]

   b. The taxpayer was a certified public accountant working for his own professional corporation (P.C.). The P.C. owned 25% of the accounting firm that was an S corporation. His P.C. entered into an employment agreement with the S corporation and he exclusively worked for the accounting firm.

   c. In 2002 and 2003, the P.C. paid the taxpayer $24,000 a year as compensation and paid Social Security taxes on that amount. The P.C. received substantial distributions from the accounting firm, which had gross earnings of $2-3 million each year. After the P.C. paid the taxpayer's salary and other expenses, it distributed the remaining cash to the taxpayer as dividends, amounting to $203,000 in 2002 and $175,000 in 2003.

   d. The court determined (based on the testimony of IRS's expert) that the taxpayer's compensation should have been $91,000 a year. The taxpayer worked 35 to 45 hours per week as a primary earner of the firm.

4. NOL Carryforward and Self-Employment Taxes

   a. The Tax Court affirmed that a taxpayer cannot offset net earnings from self-employment with a net operating loss (NOL) that originated in an earlier tax year. [DeCrescenzo, TC Memo 2012-51]

   b. The court noted that it had previously found that Sec. 1402(a)(4) prohibits a taxpayer from offsetting net earnings from self-employment with an NOL carryforward or carryback.

5. Rules for Reporting Agents to Deposit Employment Taxes

   a. Rev. Rul. 2012-32 modifies and supersedes Rev. Proc. 2007-38. It includes the following changes:

      1) Reporting agents making deposits or payments for clients must do so electronically, regardless of whether the taxpayer would make payments electronically, and must obtain the IRS's permission to act electronically. Electronic submissions by the agent will allow taxpayers enrolled in the EFTPS to view payments and deposits made on their behalf and to verify that payments are being made in a timely manner.

      2) If a taxpayer submits a new authorization to change an agent's authority, the preceding authorization remains in effect except as modified.

3) Authorizing an agent does not relieve a taxpayer of responsibility and liability for reporting and depositing taxes. The agent must inform the taxpayer quarterly of this fact.

4) The reporting agent must provide the IRS with a reporting agent's list of all taxpayers that the agents acts for, and must provide a separate Form 8655 for each taxpayer on the agent's list.

6. Severance Payments

a. According to the 6th Circuit Court of Appeals, severance payments to laid-off employees are not subject to FICA taxes. [Quality Stores, CA-6] Since the tax code requires firms to treat severance pay for paid-off workers as wages solely for purposes of income tax withholding, this indicates that severance pay is not otherwise treated as wages and is exempt form FICA tax. The Revenue Service said severance pay must be tied to the receipt of jobless benefits to be exempt from FICA withholding, but the Court disagreed.

1) In 2008, the IRS won an Appeals Court case on the identical issue. A Supreme Court appeal is likely.

2) Companies should consider filing protective refund claims for FICA tax paid on severance payment made in all open tax years, citing this Appeals Court decision. Use Form 843.

Q. Indoor Tanning Tax

1. Enrollment fees paid by customers as part of a monthly membership program to received a number of tanning sessions at a lower cost are subject to the 10% indoor tanning service tax under Sec. 5000B. [CCA 201226022]

a. Fees paid by customers to "freeze" their membership status while skipping one or more months are also taxable.

R. Method of Accounting

1. Installment Sales

a. Sec. 453 provides that income from an installment sale must be taken into account under the installment method unless a taxpayer elects not to have the installment provisions apply.

b. An election of the installment method may be revoked only with the IRS consent.

c. The IRS allowed the election out of the installment method to be revokes since it was inadvertently made by the taxpayer's accountant who reported total gains from the sale of properties in Year 1, but went undiscovered by the taxpayer until a later year. There was no tax avoidance purpose in the revocation, and the taxable year in which the payment was received was still open. [PLR 201232021]

2. Change of Accounting Method

   a. IRS Chief Counsel determined that a taxpayer incorrectly took deductions for certain expenditures and the IRS properly proposed to change the taxpayer's methods of accounting under Sec. 446 by capitalizing some items that were previously deducted, and deducting other items in a later year. [CCA 2012300024]

      1) The Chief Council concluded that to prevent the taxpayer from deducting the same item twice, the IRS also properly required the taxpayer to include additional amounts in income entirely in the year of change that reflected all items deduction previous years, even if those years are now closed.

      2) Chief Council observed that an examining agent changing a taxpayer's method of accounting will generally make the change to the earliest tax year under examination, or, if later, the first tax year that the method is considered to be impermissible, although an examining agent may defer the year of change to a later year in appropriate circumstances.

         a) The Sec. 481(a) adjustment must be taken into account entirely in the year of change.

         b) A taxpayer that voluntarily makes the change may spread the adjustment over four years.

      3) The adjustments must reflect deductions previously taken in closed years as well as open years.

S. Worker Classification

1. The Tax Court found that an S corporation engaged in masonry subcontracting misclassified its workers as independent contractors. [Atlantic Coast Masonry, Inc., TC Memo 2012-233] Applying the common law worker classification test, the court fund that the majority of factors favored employee status.

   a. Certain employers that have misclassified worker may be eligible for relief under Sec. 530 of the Revenue Act of 1978 if they can show that:

      1) The did not treat the workers as employees;

      2) They consistently treated the individuals as non-employees on all tax returns; and

      3) They had a reasonable basis for not treating the individuals as employees.

   b. Courts seem to be taking the position that if you have not complied with the Form 1099 requirements, you are not likely to receive any relief under the IRS voluntary Classification Settlement Program or the Section 530 safe harbor.

2. The Tax Court held that farm workers engaged by an S corporation were employees and not independent contractors. [Twin Rivers Farm, TC Memo 2012-184] The court found that the S corporation exercise sufficient control over the activities of the workers to treat the workers as employees. As a result, the S corporation was liable for employment taxes on remuneration paid to the workers.

T. Loan or Taxable Income

1. Affirming the Tax Court, the Fifth Circuit Court of Appeals has found that an advance on a life insurance policy to a taxpayer, who was the sole shareholder of a corporation was a taxable distributions and not a bona fide loan. [Todd, CA-5, 8-16-2012]

   a. The Tax Court used a common law test to determine whether a bona fide loan existed. These factors, laid out in Welch, CA-9, 2000-1 USTC ¶50,258, include:

      1) Whether the promise to pay is evidenced by a note or other instrument;

      2) Whether interest was charged;

      3) Whether a fixed schedule for repayments was established;

      4) Whether collateral was given to secure payment;

      5) Whether the borrower had a reasonable prospect of repaying the loan and whether the lender had sufficient funds to advance the loan; and

      6) Whether the parties conducted themselves as if the transactions were a loan.

   b. The Tax Court found that the parties had failed to comply with the terms of the promissory note, the interest rate charged was below-market, there were no payments made by the taxpayer or attempts at collection by the lender, the purported alternative payment method of relying on the death benefit was inadequate because the benefit was contingent, and the parties did not conduct themselves as if the transaction were a loan.

U. Form 941

1. The IRS says that rounding to the nearest dollar is not acceptable on Form 941. Neither the form nor the instructions permit rounding.

V. 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 finals 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.

W. Preparer's e-Filing

1. Applications on Form 8633 for those wanting to enroll in the Services' e-filing will not be accepted after September 30. As of October 1, preparers will have to apply online and create an e-Services account. They will have to pass a suitability check as part of the application process. IRS advises not to wait until year-end to apply, since approval takes up to six weeks.

X. Refund of Taxes

1. An individual who purchased stock that became valueless was not entitled to a refund of the income tax paid when he received the stock. The taxpayer had acquired a beneficial ownership interest in the shares, which were transferable and not subject to a substantial risk of forfeiture. Therefore, the taxpayer was required to recognize gross income in the amount by which the fair market value of the shares exceeded the exercise price paid for them.

2. The Department of Treasury's Financial Management Service, which issues IRS tax refunds, will offset federal and state income taxes, child support, and student loan debt against any tax refunds. Taxpayers will receive a notice if an offset occurs and any disputes should be taken up with the agency listed on the notice. [IRS Tax Tip 2012-59]

Y. Statute of Limitations

1. Overstatement of Basis

   a. Under Sec. 6501(e)(1)(A) the three-year period statute of limitations is extended to six years if a taxpayer omits from gross income an amount properly includible therein which exceeds 25% of the amount of gross income shown on the return.

   b. The Supreme Court has resolved a split among the circuits by concluding that an overstatement of basis does not result in an omission of income for statute of limitations purposes. [Home Concrete & Supply, LLC, Sup. Ct. 4-25-2012]

   c. As a result, the IRS has three years, rather than six, to act against taxpayers that overstate basis.

   d. At the trial court and appellate levels, the taxpayers had the upper hand. In response to a series of losses, the IRS issued unprecedented regulation that would apply the six-year statute of limitation to an overstatement of basis, overturning judicial decision in which the IRS was the losing party-litigant.

   e. The IRS issued regs during the course of the litigation that defined an omission from gross income to include an understatement of basis.

      1) Under Chevron [Chevron, U.S.A., Inc. v. NRDC Sup. Ct., 1984] a two-step process is required before the courts will uphold the regs.

         a) Is the statutory language ambiguous?

         b) If so, are the regs a reasonable interpretation of the statue?

      2) The Brand X [National Cable & Telecommunications Assn. v. Brand X Internet Services, Sup. Ct. (2005)] decision appears to allow regulations to act unless a court has found that the statute is unambiguous.

2. An individual's underpaid income tax were due to fraud on his part. As a result, he could not avail himself of the three-year statute of limitations. Further, he was liable for the 75% fraud penalty. [Scott, TC, CCH Dec. 58,973(M)]

Z. Internal Revenue Service

1. Late Filing of Business Returns

   a. The failure to file penalty under Sec. 6651 does not apply if the taxpayer can show that any delay was due to reasonable cause and not willful neglect. Beginning with 2011 forms, the instructions to Form 1065, Form 1120, and Form 1120S direct taxpayers to wait until they receive a later filing notice from the IRS before sending a reasonable cause explanation instead of attaching it to the late filed return, as instructed in earlier years. Individual taxpayer can still include a reasonable explanation with Form 1040.

2. Late Filing Penalty

   a. Failure to file a timely return may result in a penalty up to 25% of the tax owed under Sec. 6651(a). The executor of an estate retained an attorney to handle the estate's administration, including the filing of returns and payment of taxes. Due to some physical and mental ailments suffered by the attorney that were unknown to the executor, the estate tax return was never filed. The District court refused to accept the failure to file penalty since the attorney's disability did not excuse the executor. Reliance on an agent is not reasonable cause for late filing. [Thomas Freeman v. U.S., 109 AFTR 2d 2012 (DC PA)]

3. Understatement and Preparer Penalties

   a. Under Sec. 6694(a), a tax return preparer may be liable for a penalty if a return reflects an understatement of liability due to an unreasonable position if the preparer knew or reasonably should have known of the position. Generally, a position is treated as unreasonable unless substantial authority exists for the position or the position was property disclosed under Sec. 6662(d) and had a reasonable basis.

      1) The Sec. 6694(a) penalty is the greater of $1,000 or 50% of the income derived by the tax return preparer with respect to the return or claim for refund.

      2) If the position is with respect to a tax shelter, listed transaction, or reportable transaction with significant tax avoidance or evasion purposes, the standard under Sec. 6694(a) is more likely than not rather than substantial authority.

4. Statutory Deadlines

   a. The IRS cannot extend a deadline for making an election when the deadline is prescribed by statute. [PLR 201202005]

      1) The IRS has more discretion to extend a deadline for making an election, such as a Subchapter S election, if the election deadline is prescribed in IRS guidance.

   b. The taxpayer was denied a request to extend the time to elect to carry back net operating losses five years. The firm electronically filed the taxpayers tax returns by the extended due date, but did not make the election for the extended carryback period.

5. FBAR Filing

   a. Form TD F 90-22-1, Report of Foreign Bank and Financial Accounts (FBAR) must be received on or before June 30 of the year following the calendar year being reported.

      1) Most returns are considered timely filed if postmarked by their due date but the FBAR is not timely filed until IRS has received it.

6. Homebuyer Credit Tool

   a. A taxpayer must repay the first-time homebuyer credit if he or she purchased a home in 2008 and claimed the first-time homebuyer credit.

   b. The IRS has introduced a new online tool for taxpayers checking if they must repay their first-time homebuyer credit. Letters will no longer be mailed to taxpayers who have to repay the credit.

AA. Responsible Person Penalty

1. The IRS collects the Sec, 6672 penalty no more than once when there are multiple responsible persons. The penalty is considered collected only after the passage of two years from the date of payment. The court noted that the IRS faces the risk that, if it stops collecting after receiving amounts that equal the trust fund shortage, one assessed person may later prove himself or herself not responsible and therefore be entitled to a refund. [Weber 183 TC No. 18]

   a. Where more than person is held liable for the Sec. 6672 penalty and one of those persons believes he or she is entitled to contribution from others, the taxpayer may bring a separate suit claiming a right of contribution.

   b. In October 2007, the taxpayer filed his 2006 return reporting an overpayment of $47,000. The taxpayer elected to have his overpayment applied to his 2008 estimated tax. The IRS applied the amount to the Sec. 6672 penalty. The IRS has discretion to credit that overpayment to another liability.

   c. The court further found that if the IRS held the taxpayer's money wrongly, the agency held it not as an overpaid 2006 income tax but as an overpaid Sec. 6672 penalty. No regulation permits a taxpayer to elect to have an overpayment of Sec. 6672 penalty to be applied to his or her income tax liability.

BB. S Corporations

1. Roth IRA is Ineligible S Corporation Shareholder

   a. Affirming the Tax Court, the Court of Appeals for the Ninth Circuit has found that a Roth IRA was not an eligible shareholder of an S corporation. [Taproot Administrative Services, Inc., CA-9, 3-21-2012]

      1) The Ninth Circuit noted that if it had ruled in favor of the taxpayer, the outcome would have been that shareholders could employ Roth IRAs to avoid taxation on S corporation profits.

      2) The court relied on Rev. Rul. 92-73 to find that a Roth IRS is not an eligible S corporation shareholder. In Rev. Rul. 92-73, the IRS determined that a trust that qualified as an IRA is not a permitted shareholder of an S corporation.

CC. U.S. Banks to Report Deposit Interest to Nonresident Aliens

1. The IRS has finalized regs that require U.S. banks and other financial institutions to report to the agency interest on deposits paid to a nonresident alien. [TD 9584, Rev. Proc. 2012-24] The requirement applies to payments to residents of any country having a tax information exchange agreement under which the United States will provide information, as well as receive it.

2. The reporting requirements will apply to interest payments made on or after January 1, 2013. Reporting will apply to commercial banks, savings institutions, credit unions, securities brokerages, and insurance companies.

3. Although the regs require reporting, the Tax Code exempts the interest itself from income and is designed to encourage foreigners to deposit funds in the U.S.

    a. Additionally, the Secretary may seek an injunction against these individuals under section 7408 of the Internal Revenue Code.

Chapter 3 - Filing Requirements and Exemptions

A. Standard Deduction

1. Standard deduction amounts increased for 2012 [Rev. Proc. 2011-52]:

Filing status	Deduction amount
Married filing jointly	$ 11,900
Head of household	8,700
Single	5,950
Married filing separately	5,950
Additional-unmarried and aged and/or blind and not a surviving spouse	1,450 each
Additional-married and aged and/or blind	1,150 each
Taxpayer-dependent	950

2. Phaseout of itemized deductions is eliminated for 2010, 2011, and 2012.

3. 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.

Personal Exemptions

4. Personal exemption indexed for inflation in 2012: $3,800. [Rev. Proc. 2012-52]

5. Definition of Child

    a. Simplification by providing a uniform definition of a child throughout the Tax Code, starting in 2005.

    b. Creates a common definition of child for dependency exemption, child credit, earned income tax credit, dependent care credit, and head of household filing status.

    c. A child is a qualifying child of a taxpayer if the child satisfies each of five tests:

        1) The child has the same principal place of abode as the taxpayer for more than one half the taxable year;

            a) Temporary absences due to special circumstances, including absences due to illness, education, business, vacation, or military service, are not treated as absences.

            b) A tie-breaking rule applies if more than one taxpayer claims a child as a qualifying child.

                (1) First, if only one of the individuals claiming the child as a qualifying child is the child's parent, the child is deemed the qualifying child of the parent.

                (2) Second, if both parents claim the child and the parents do not file a joint return, then the child is deemed a qualifying child first with respect to the parent which whom the child resides the longest period of time, and second with respect to the parent with the higher adjusted gross income.

(3) Third, if the child's parents do not claim the child, then the child is deemed a qualifying child with respect to the claimant with the highest adjusted gross income.

2) The child has specified relationship to the taxpayer;

a) The child must be the taxpayer's son, daughter, stepson, stepdaughter, brother, sister, stepbrother, stepsister, or a descendant of any such individual

b) An individual legally adopted by the taxpayer, or an individual who is lawfully placed with the taxpayer for adoption by the taxpayer, is treated as a child of such taxpayer by blood.

c) A foster child who is placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction is treated as the taxpayer' child.

3) The child has not yet attained a specified age.

a) In general, a child must be under age 19 (or 24 in the case of a full-time student) in order to be a qualifying child.

b) In general, no age limit applies with respect to individuals who are totally and permanently disabled at any time during the calendar year.

c) The requirements are retained that a child must be under age 13 for purposes of the dependent care credit, and under age 17 for purposes of the child tax credit.

d) A child attains a given age on the anniversary of the date he or she was born. For example, a child born on 1/1/87 attains age 17 on 1/1/04. [Rev. Rul. 2003-72]

4) A child who provides over half of his or her own support generally is not considered a qualifying child of another taxpayer.

a) A child who provides over one half of his or her own support may constitute a qualifying child of another taxpayer for purposes of the earned income credit.

5) The law retains the requirement that a taxpayer identification number for a child must be provided on the taxpayer's return.

d. The support and gross income tests for determining dependency do not apply to a child who meets the requirements of the uniform definition of qualifying child.

e. Taxpayers generally may claim an individual who does not meet the uniform definition of qualifying child with respect to any taxpayer as a dependent if the dependency requirements (including the gross income and support tests) are satisfied.

f. The law retains the rule that allows a custodial parent to release the claim to a dependency exemption (and, therefore the child credit) to a noncustodial parent.

1) A waiver that applies for the dependency exemption will also apply for the child credit, and the waiver will not apply for purposes of the other provisions.

g. One of the effects of the law is that never-married parents of children can no longer allocate dependency exemptions as divorced or separated parents may do.

6. If a parent may claim a particular qualifying child, no other individual may claim that child.

a. An exception applies if no parent claims the qualifying child, another individual may claim such child if such other individual:

1) Otherwise is eligible to claim the child and

2) Has a higher adjusted gross income for the taxable year than any parent eligible to claim the child.

b. This allows a cohabitation person to claim the child when the parent does not claim the child.

7. Dependency under Sec. 152(a)(9) includes an individual whose principal place of abode is the taxpayer's home and who is a member of the taxpayer's household, but not if the relationship is in violation of local law.

8. Social security numbers are required for newborns born after 1996 as a prerequisite for claiming the dependency exemption and other related items. [Personal Responsibility and Work Opportunity Act]

a. Failure to provide a correct TIN for a dependent will be treated as a mathematical or clerical error.

b. Mathematical or clerical error treatment allows the IRS to assess additional tax without sending the individual a notice of deficiency; thus, the individual may not file a petition with the Tax Court. However, the individual may file within 60 days a request for abatement of the tax due; the IRS must abate the tax and any reassessment of the tax must be made under the regular notice-of-deficiency procedures.

9. Dependent filers are not eligible for child-related tax benefits.

10. Final Regs Issued on Claiming Dependency Exemption for Children of Divorced or Separated Parents [TD 9408]

a. Effective to tax years beginning after July 2, 2008.

b. The custodial parent is the parent with whom the child resides for the greater number of nights during the calendar year. If a child is temporarily absent from a parent's home, the child is viewed as residing with the parent with whom the child usually resides on the night(s). If a child resides with each parent for an equal amount of time during the year, the parent with the higher adjusted gross income for that year is treated as the custodial parent.

 1) A child resides for a night with a parent if the child sleeps:

  a) At the parent's residence (whether or nor the parent is present); or

  b) In the company of the parent when the child does not sleep at the parent's residence (e.g., if the parent and child are on vacation).

 2) The child is not considered to be in the custody of either parent for purposes of Sec. 152(e) when the child reaches the age of majority under state law.

c. A custodial parent may release an exemption claim for a child by signing a written declaration that he or she will not claim the child as a dependent. The noncustodial parent must attach the declaration to his or her return to claim the dependency exemption. An exemption claim can be released for one year, several years, or all future years.

d. A custodial parent who released an exemption claim may revoke the release for future tax years by giving written notice of the revocation to the noncustodial parent. The revoking parent must maintain a copy of the revocation and confirm delivery to the noncustodial parent. The revoking parent must attach a copy the revocation to his or her return for any tax year the parent claims the exemption.

 1) The revocation may be made on an IRS-designated form or by a declaration that accommodates the substance of such form.

e. A state court order or decree cannot serve as a written declaration and therefore, does not determine the dependency exemption between divorced or separated parents.

11. Qualifying Relative [CCA 200812024]

a. Sec. 152(d)(1)(D) provides that an individual is not a qualifying relative of the taxpayer if the individual is otherwise a "qualifying child" of any other taxpayer.

b. An individual is not a qualifying child of any other taxpayer if the individual's parent (or any other person to whom the individual is defined as a qualifying child) is not required to file an income tax return and 1) does not file one, or 2) files one solely to obtain a refund of withheld tax. [Notice 2008-5]

 1) The parent of the child filing a return for the earned income credit will make the child a qualifying child of the parent.

 2) This will allow a taxpayer who co-habitats with another person who has children to qualify to claim these children as dependents, thereby making the taxpayer eligible for a number of other tax breaks.

12. An Internal Legal Memorandum concludes that, apart from a dependency exemption, a taxpayer's qualifying relative does not qualify the taxpayer for the earned income credit, head of household filing status, or the child tax credit. In limited circumstances, it may qualify the taxpayer for the child and dependant care credit. [ILM 200812024]

    a. The earned income credit requires that the dependent be a "qualifying child," not a "qualifying relative," of the taxpayer.

    b. The person meeting the definition of "qualifying relative" must be a relative of the taxpayer to qualify the taxpayer for head of household status. A person meeting the definition of "qualifying relative" under Notice 2008-5 does not qualify the taxpayer for head of household status.

    c. The child tax credit requires that the dependent be a "qualifying child," not a "qualifying relative," of the taxpayer.

    d. A taxpayer who is otherwise claiming an individual as his or her "qualifying relative" may not claim the dependent care credit unless that qualifying relative is also physically or mentally disabled.

13. Principal Residence for Missing Children

    a. Effective for tax years ending after December 21, 2000, a taxpayer's child who is presumed by law enforcement authorities to have been kidnapped by a nonrelative and who qualified as the taxpayer's dependent for the portion of the year prior to the kidnapping will be treated as the taxpayer's dependent for:

        1) The dependency exemption under Code Sec. 151;

        2) The child tax credit under Code Sec. 24;

        3) The determination of eligibility for surviving spouse or head of householder filing status under Code Sec. 2; and

        4) The earned income credit under Code Sec. 32.

    b. The taxpayer will be treated as meeting the principal place of abode requirement for all tax years ending during the period that the child is kidnapped.

        1) This special treatment ends with the first tax year of the taxpayer that begins after the year in which the kidnapped child is determined to be deceased or in which the child would have reached age 18, whichever occurs earlier.

14. Developments

   a. An unmarried individual could claim (1) dependency exemptions for his girlfriend and her children because they were members of his household and he provided more than half their support, (2) head-of-household status because he contributed more than half their rent, and (3) the earned income credit because he supported the children. [*Samuel K. Rasco*, TC Memo 1999-169]

      1) States it is illegal to live together -- Arizona, Florida, Idaho, Illinois, Michigan, Mississippi, Montana, North Carolina, North Dakota, Virginia, West Virginia.

      2) After 1999, the taxpayer will not qualify for the earned income credit because the girlfriend's children no longer qualify as foster children.

      3) An eligible foster child is any child you cared for as your own and who is:

         a) Your brother, sister, stepbrother, stepsister, or

         b) A descendent (such as a child) of your brother, sister, stepbrother, stepsister, or

         c) A child placed with you by an authorized placement agency. [Sec. 32(c)(3)(B)(iii)]

   b. A noncustodial parent lost the dependency exemption for his child even though his ex-wife orally agreed to change the custodial agreement. The oral change was not sufficient. [*Noah*, TC Memo 1998-384]

   c. A parent cannot claim a dependency exemption for a child over 18 who has income more than the personal exemption amount unless the child is a full-time student, in which case the age limit is 24. A full-time student is defined as one who is enrolled full-time for five calendar months during the year. The IRS allowed a dependency exemption for a student who was enrolled in school full-time but did not attend classes in all five months. Registration rather than attendance is the test of "full-time student" status. [Ltr. Rul. 9838027]

   d. The Tax Code says minor children adopted by a taxpayer qualify as the taxpayer's dependents only if placed with the taxpayer by an authorized placement agency recognized by the state. A birth mother privately placed her children with a couple who adopted them, and a state agency approved the adoption. The IRS disallowed the dependency exemptions because the children had not been placed with them by an "authorized placement agency." Finally, 36 years later, the IRS has given in. It now says private adoptions do meet the Tax Code's requirements when permitted by state law. [IRS Action on Decision 2000-001, acquiescing in result in *John A. McLeod*, DC-Alabama, 276 F.Supp 213]

   e. Parents objected to providing their children's social security number (SSN) to the IRS on religious grounds, but offered to apply for an ITIN instead. The Tax Court held against them, finding that there was a compelling government interest for the requirement. The court found that issuing ITINs would be a less effective means of detecting fraud than tracking SSNs. [*Miller*, 114 TC 32 (2000)]

   f. Parents refused to reach a reasonable agreement as to who had custody for the greater period of the year, so neither will get the exemption because neither proved he or she had custody of the child for more days than the other. [Jennifer A. Rogers, TC Summary Opinion 2002-41]

g. The IRS will accept a late-filed Form 8332, even if it is presented during an examination of the taxpayer's return. [Ltr. Rul. 200646014]

B. Filing Status

1. Marital status is determined under local law, according to Rev. Rul. 58-66.

2. Gay couples generally must file as singles even if their "marriage" is recognized under state law (e.g., Massachusetts' same sex marriage laws). [Mueller, TC Memo 2000-132]

3. A legal union between one man and one woman as husband and wife. [The Defense of Marriage Act (P.L. 104-199)]

   a. It defines spouse as a person of the opposite sex who is a husband or wife.

C. Returns of Dependents

1. Individual qualifying as a dependent on another taxpayer's return is not eligible to claim a personal exemption on their own return.

2. Standard deduction for a dependent with unearned income is limited to the greater of $950 or the amount of earned income plus $300, not to exceed $5,950 (for 2012).

3. Net unearned income of a dependent under 19 or a student under 24 at close of tax year is taxed to dependent at the marginal parent's rate.

   a. Net unearned income is unearned income minus the sum of

      1) $950 (first $950 clause)

      2) Greater of (a) $950 of the standard deduction or $950 of itemized deductions or (b) the amount of allowable deductions which are directly connected with the production of unearned income

   b. Dependent is allowed at least $1,900 reduction in unearned income

D. Electronic Filing Signatures

1. The IRS released temporary and proposed regulations that allow income tax return preparers two alternative ways to meet the requirement that a preparer retain a copy of the return or claim manually signed by the taxpayer: [NPRM REG-106386-98, TD 8803]

   a. Retain a photocopy of the manually signed copy of the return or claim for refund, or

   b. Use an electronic storage system to store and produce a copy of the return or claim manually signed by the taxpayer.

      1) An electronic storage system must electronically image hard-copy documents to an electronic storage media while ensuring an accurate and complete transfer of the hard copy. [Rev. Proc. 97-22]

2. Any person who is an income tax return preparer who fails to comply with the requirement to sign the return must pay a penalty of $50 for such failure (up to a maximum of $25,000 per year), unless it is shown that the failure is due to reasonable cause and not willful neglect.

E. Nonresident Alien Filing Requirements and Withholding

1. Nonresident aliens will not be required to file Form 1040NR if the amount of wage income is less than the amount of one personal exemption. [Notice 2005-76]

    a. The exception applies to tax years beginning on or after January 1, 2006. However, taxpayers can rely immediately on Notice 2005-77 until the regs are amended.

2. The IRS has issued new rules for determining the amount that must be withheld from wages earned by nonresident alien individuals in the U.S. The new rules apply to wages paid on or after January 1, 2006. [Notice 2005-76]

    a. The new rules are designed to counteract overwithholding on nonresident aliens that receive a small amount of wages in the U.S.

Chapter 4 - Gross Income - Inclusions and Exclusions

A. Debt Forgiveness

1. Generally, when a debt is forgiven by a creditor, the amount of the debt forgiveness is taxable income to the debtor. Sec. 108 excludes from income any debt that is discharged in:

2. Excludable from income:

    a. Bankruptcy

    b. Insolvency

    c. Qualified Farm Indebtedness

    d. Qualified Real Property Business Indebtedness

    e. Qualified Principal Residence Indebtedness

3. Mortgage Forgiveness Debt Relief Act (H.R. 3648)

    a. Permanently exclude discharges of up to $2 million of indebtedness, which is secured by a principal residence and which is incurred in the acquisition, construction, or substantial improvement of the principal residence.

        1) Relief is retroactive to January 1, 2007.

            a) Extended through 2012 by Emergency Economic Stabilization Act of 2008.

        2) The amount excluded from gross income reduces the basis of the residence, but not below zero.

        3) Principal residence has the same meaning as when used in section 121.

4. Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

    a. The qualified principal residence indebtedness exclusion is taken by attaching Form 982 to the federal tax return and checking the box on line 1e.

    b. The bankruptcy exclusion is taken by attaching Form 982 and checking the box on line 1e.

    c. The insolvency exclusion is taken by attaching Form 982 and checking the box on line 1b.

    d. Homeowners who continue to own their home after debt forgiveness under the principal residence exclusion must reduce their basis by the amount of the debt forgiveness and enter the reduction on Form 982, line 10b.

5. Loss on Personal Residence

   a. There are no deductions available for taking a loss on the sale of one's primary residence. When the net sales price of the homeowner's home is less than his or her tax basis, the loss incurred on the sale is considered a nondeductible personal expense for federal income tax purposes. [Reg. 1.165-9(a)]

   b. If a lender refuses to discharge the remaining debt, the homeowner is obligated to pay off the loan and there is no tax break or write-off for doing so.

   c. A borrower's "canceled debt" may be taxable as ordinary income. When borrowers are insolvent or involved in bankruptcy proceeding, discharged debt is not taxable.

   d. If property is foreclosed and sold at auction for more than the home's tax basis, the sale produces taxable capital gain. Gain from a foreclosure of an individual's principal residence may be excluded under Sec. 121.

   e. Example. Homeowner paid $500,000 for a home that he sells for a net sales price of $425,000, but he has a mortgage of $510,000 on the property. For tax purposes, he has incurred a nondeductible $75,000 loss on the sale ($425,000 sales price - $500,000 basis). If the lender forgives the remaining $85,000 unpaid balance, the homeowner has taxable income that must be reported on his federal income tax return and which may not be offset by the $75,000 loss.

   f. Example. Three years ago, taxpayer purchased a home for $500,000 with a $425,000 mortgage. Last year, when the home was worth $700,000, the taxpayer refinanced with a $600,000 mortgage. The mortgage lender sells the home for $525,000 and walks away from the mortgage. The taxpayer realizes $25,000 capital gain ($525,000 selling price minus $500,000 basis) that is covered by the Sec. 121 exclusion. The taxpayer also has $75,000 debt forgiveness that is taxed as ordinary income.

   g. When a bank or other creditor forgives part or all of a borrower's unpaid mortgage balance, the lender is required to report the canceled debt amount to the IRS on Form 1099-C (Cancellation of Debt), if the amount forgiven is $600 or more.

6. Developments

   a. Exempt Assets

      1) The IRS has ruled that, in determining insolvency, assets exempt from the claims of creditors under state law are included as assets. In the particular case, if assets exempt from the claims of creditors were not counted in determining insolvency, then the taxpayer would have been insolvent. However, the exempt assets were included and, as a result, the taxpayers were not insolvent and had debt discharge income. The IRS maintained that excluding exempt assets for purposes of making a determination of solvency could allow taxpayers who are economically solvent to defer tax liability, even if the taxpayer has the ability to pay taxes. [TAM 199935002]

      2) Taxpayers whose liabilities exceed their assets do not have income from forgiven debts until the amount waived is more than their insolvency. Homes or other assets that are exempted from creditors by state law cannot be excluded when making the calculation, the Tax Court decides. They count as assets of the debtor. [Quartemont, TC Summ. Op. 2007-19]

b. Sec. 61(a)(12) provides that gross income includes income from discharge of indebtedness. Section 6050P requires certain financial entities to report discharge of indebtedness of $600 or more during any calendar year. Under Reg. 1.6050P-1(a) discharge of indebtedness must be reported if one of eight identifiable events occurs. The regulations make it clear that if one of the identifiable events has occurred a discharge of indebtedness is deemed to have occurred solely for purposes of the reporting requirements whether or not an actual discharge of indebtedness has occurred.

c. Discharge of indebtedness does not include contested late payment fees and finance charges, but only the amount of the undisputed charges and cash advances, less payments already made. [George W. Earnshaw, TC Memo 2002-191] The Tax Court reached the same conclusion as a prior appellate court decision to which the Earnshaw decision is appealable. [Preslar, 167 F.3d 1323 (CA-10, 1999)] Discharge of indebtedness income results when amounts owned that are not in dispute are forgiven, whatever the events may be that precipitate the reduction of the debt.

d. A taxpayer who reports income from a discharge of indebtedness but who later repays the debt may file a claim for refund for the year the income was reported. [Ltr. Rul. 200234030; CAF-104744-022] The three-year limitation on filing for a refund applies.

e. The regulations make it clear that if one of the identifiable events has occurred, a discharge of indebtedness is deemed to have occurred "solely for purposes of the reporting requirements" whether or not an actual discharge of indebtedness has occurred.

f. A person defaulted on his home mortgage at a point where he owned more on the mortgage than the home was worth. Although he got out from under the mortgage, he received "discharge of indebtedness income" in the amount by which the balance of the mortgage exceeded the value of the home. [*Jerry Myers Johnson*, TC Memo 1999-162]

g. Some creditors issue 1099s to debtors reporting their unpaid debts as income to the IRS. The Tax Code does not require creditors to issue such 1099s when they write off debts, but neither does it prevent them from doing so. The IRS has no authority to prevent the issuance of the 1099s, or to stop the use of this tactic. [FSA 1998-78]

7. Forgiven Credit Card Debt Resulted in Income

a. Taxpayer used his credit card to pay hospital bills and receive cash advances during periods of unemployment. The bank agreed to accept $4,592 as a full settlement of the account balance of $21,270. The bank issued a Form 1099-C reporting $16,678 of discharge of debt income. The taxpayer did not report the income on the tax return because it was a retroactive reduction of the rate of interest charged by the bank and thus a reduction of the purchase price of the loan under Sec. 108(e)(5). The Tax Court rejected that argument. [Payne, TC Memo 2008-66]

8. Insolvency Exception

    a. A married couple that was forgiven the debt on a home lost in foreclosure was insolvent at the time of foreclosure and the debt was substantially excluded from their gross income. [Keith TC Summ. Op. 2007-214] Immediately preceding the foreclosure of a mortgage on their home, the Keiths' had assets totaling $133,715 and liabilities totaling $155,505, including $22,035 excess loan on their residence. They had income of $245 ($22,035 - ($155,505 - $133,715)).

    b. The insolvency computation includes the entire balance of retirement savings, without any reduction for taxes that would be paid on distribution. [Pub. 4681]

9. Loan Forgiveness Programs for Law Students

    a. Loan forgiveness programs for law students is tax free when it is granted under law school programs to reduce the outstanding debt of graduates who take low paying public service jobs, such as public defenders or prosecutors. [Rev. Rul. 2008-34]

        1) The IRS rejected any implicit agreement with the Tax Court's footnote in Moloney [TCS 2008-53], which commented that the student-loan exclusion under Sec. 108(f) may be limited to nursing, medicine, and teaching.

10. Loan Forgiveness on Terminated Auto Leases

    a. The IRS privately rules that soldiers who terminate auto leases when they are deployed do not owe income tax on the forgiven debt or on early termination fees waived by car leasing companies. [CCA 200825045] By law, lessor are barred from charging the fee if the soldier voiding the lease is deployed for at least 180 days.

11. Taxable nonbusiness debt-forgiveness must be reported on Form 1040 or Form 1040NR, line 21.

B. Damage Awards

1. The Supreme Court has held that contingent fees paid to attorneys as part of settlements of employment-related lawsuits must be included in gross income. [Banks and Banaitis, 125 S.Ct. 826, 1-24-05]

   a. Most taxpayers are limited to deducting attorneys' fees as itemized miscellaneous deductions subject to the 2% AGI limitation.

   b. The decision perpetuates the more serious alternative minimum tax disadvantage since miscellaneous itemized deductions are disallowed for AMT purposes.

   c. The Court characterized the relationship as one between principal and agent, as the client retains control over the underlying claim. In agency relationships, all income collected by the agent is attributable to the principal.

   d. Even state laws purporting to give attorneys an ownership interest in their fees are insufficient to convert the relationship from one of agency to a partnership.

2. The case considered by the Supreme Court involved only a straight contingency fee -- where the lawyer received a percentage of the plaintiff's award. There are other kinds of fee agreements that the Court specifically said it did not consider.

   a. Statutory fee shifting is a possibility in many cases under both federal and state law. With this, instead of the plaintiff receiving a general award from which the lawyer is paid, the judge assesses the cost of legal fee directly against the losing defendant and directs their payment to the plaintiff's lawyer. Because they are not awarded to the plaintiff personally, they very arguably are not taxable to the plaintiff.

      1) Taxpayers were members of a class action litigation against a brokerage firm. The settlement went to the members of the class action lawsuit and the fees were awarded directly to the plaintiffs' law firm by the court. This procedure is referred to as the "common fund theory of recovery." The tax result is that the taxpayers do not have to include their portion of the court-awarded attorney fees in their gross income. [Ltr. Rul. 200316040] This tax result applies to "opt-out" class action lawsuits which are common in security violations proceedings.

   b. It is possible to write a settlement agreement to reflect terms of statutory fee shifting. The Supreme Court stated that its ruling did not consider this opinion -- so the question of whether this will work is still open.

   c. Another strategy is to design a negotiated settlement that is a structured settlement. This spreads the receipt of the settlement amount over a period of years. This will lessen the AMT impact and legal fees becoming nondeductible.

3. Damages compensating an injured person for personal injuries are excludable from gross income. These damages often are excludable even when measured by the amount of wages that could have been earned but for the injuries. Effective for amounts received after August 20, 1996, the exclusion does not apply to nonphysical personal injuries such as age discrimination, injury to reputation, and emotional distress in some cases.

4. Punitive damages are taxable as ordinary income, regardless of the underlying physical or nonphysical injury. [IRC Sec. 104(a)]

5. Emotional distress (including physical symptoms such as insomnia, headaches, and stomach disorders) is not considered a physical injury or physical sickness. [Conference Committee Report, 1996 Tax Act]

6. Emotional Damages Fail to Qualify as "Physical Injury"

    a. No part of a settlement payment that a taxpayer received as the result of an age discrimination suit was excludable from income since it was not considered to be a "physical injury" as required under the law. [Pettit, TC Memo 2008-87]

    b. The taxpayer was not liable for an accuracy-related penalty for failing to include the entire amount in income because he relied in good faith upon the advice of the accounting firm that prepared his return.

7. Damages received for sexual harassment are taxable according to the Tax Court. But there is a limited exception: Damages for treating emotional trauma from the harassment are tax free. The victim must be able to document the costs and must not have deducted them in a previous year. [Sanford, TC Memo 2008-158]

8. A settlement agreement said that $500,000 was tax-free damages for personal injury, but the IRS taxed it. The Court stated that the damages clearly compensated for both personal injury, such as illness from stress, and economic harm but with any credible allocation. So they were treated as paid 50% for each. [Damian Gerard, TC Memo 2003-320]

9. If the payment of damages to "alleged victims of sexual abuse" represent damages for physical injury or sickness (other than punitive damages) or reimbursement for medical expenses incurred to treat emotional distress, the damages can be excluded from income. If the payment represents damages solely for emotional distress or other nonphysical injuries of sickness, the award cannot be excluded from income. [INFO 2004-0068]

10. The Tax Court held that $120,000 of the $200,000 that NBA player Dennis Rodman paid taxpayer for kicking him during a 1-15-97 Chicago Bulls basketball game was excludable from income as payment for "his claimed physical injuries relating to the incident." The remaining $80,000, which was attributable to taxpayer's agreement not to defame Mr. Rodman was includible. [Eugene Amos, TC Memo 2003-329]

11. A terminated worker won a suit over the size of a lump-sum payout he received from the retirement plan maintained by his former employer. The IRS says that attorney fees paid can be netted against the taxable recovery. Although this relief is normally associated with awards for employment discrimination, a claim for pension benefits under federal law also qualified for this favorable income tax treatment. [Ltr. Rul. 200550004]

12. The entire amount of an individual's settlement of his claims against the District of Columbia was included in income. The taxpayer suffered physical symptoms related to emotional trauma, therefore, the settlement did not qualify for exclusion under Sec. 104. [Goode, TC, CCH Dec. 56,454(M)]

13. In 1993, the taxpayer's employer abruptly terminated his employment after 24 years. The taxpayer reached a settlement with his employer based on what he believed was a wrongful termination under which he would receive $331,968 (over six times the normal severance payment). The district court found $280,000 to be tax free. The Sixth Circuit stated that to be excludable the taxpayer needed to show the following four discrete elements:

    a. There was an underlying claim sounding in tort;
    b. The claim existed at the time of the settlement;
    c. The claim encompassed personal injuries;
    d. The agreement was executed "in lieu" of the prosecution of the tort claim and "on account of" the personal injury rendering it a settlement rather than a severance agreement.

    The court felt that the taxpayer had not met the fourth element. The taxpayer had not established a causal connection between the employer's payment and injuries caused by the employer. [*Greer v U.S.*, 2000-1 USTC ¶50,300, CA-6]

    e. Practice Tip. When advising a client on negotiating and documenting a termination of employment from which the client will be receiving a settlement payment, an agreement must be drafted that addresses each of the four elements set forth in the *Greer* case to establish that the entire payment (or that an allocated portion of the payment) is excludable from income. It must be shown that the payment is being made on account of a personal physical injury -- rather than just any personal injury to accommodate the SBJPA amendment to Sec. 104(a)(2). Specific physical injuries must be mentioned along with supporting medical costs for which the payment is being made in the nature of reimbursement. The settlement agreement must spell out the employer's tortuous action, that the tort had occurred before the settlement was made, that the client's claim encompassed personal physical injuries, and most importantly that the settlement agreement is being entered into in lieu of the client's prosecution of his or her tort claim.

14. Defamation Claim

    a. Payments received by a talent agent to settle a defamation claim were not excludable from income because they were received after Sec. 104 was amended to preclude their exclusion. Payments received under a structured settlement are taxed in the year they are received, not on the date of settlement. [Polone, 2007-2 USTC p50,729, CA-9]

C. Nonqualified Deferred Compensation

1. The 2004 Jobs Act drastically changed the rules for nonqualified deferred compensation arrangements. Congress enacted complex new rules about when taxpayers may defer compensation. Congress acted to terminate what it saw as abuses in nonqualified compensation arrangements.

2. There are significant tax consequences if an arrangement fails to satisfy the requirements of Sec. 409A.

    a. All amounts must be included in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income.

    b. The amount included in gross income is also subject to an interest rate equal to the underpayment rate plus one percentage point and an additional income tax of 20 percent of the compensation included in gross income.

3. Sec. 409A is generally effective for amounts deferred after December 31, 2004. If the deferred compensation plan is materially modified after October 3, 2004, Sec. 409A applies to amounts deferred in tax years beginning before January 1, 2005.

D. Transfer of Partnership Interest for Services

1. The Treasury and the IRS have issued proposed regs on the tax consequences of transferring a partnership interest in exchange for services. The regs treat the transfer as taxable to the service provider under Sec. 83. [Notice 2005-43; NPRM REG-105346-03]

2. The proposed regs treat both profits interest and capital interests as property under Sec. 83.

   a. The individual who receives the partnership interest for services is treated as a partner at the time the interest is "substantially vested" under Sec. 83, that is, no longer subject to a substantial risk of forfeiture.

   b. If the interest is subject to a substantial risk of forfeiture, the service provider can elect under Sec. 83(b) to treat the interest as substantially vested and the individual will be treated as a partner at the time of the election.

3. Under safe harbor rules, the fair market value of the partnership interest would equal the liquidation value of the interest.

   a. A service provider receiving a profits interest has no income and the partnership will have no deduction, the same as under current law.

4. The new regs and the safe harbor in Notice 2005-43 revoke Rev. Proc. 93-27 and 2001-43, which held that the receipt of a profits interest is not taxable to the service provider.

E. Partner Must Report Undistributed Income Held in Escrow

1. The U.S. Circuit Court of Appeals held that income must be reported in the year the partnership earns the income, regardless of whether the partner actually receives his or her distributive share. It further held that the rule that a partner must recognize undistributed partnership income trumps any claim of right argument for a delay of income recognition when the income is held in escrow because of a dispute among the partners over proper allocation. [Burke, CA-1, May 4, 2007]

2. The court held that self-imposed restrictions on the distribution of a partner's share of partnership income do not legally defer a partner's recognition of that income for federal income tax purposes. The escrow account did not succeed in deferring recognition.

F. Employer-Sponsored Disability Plans

1. If an employer-sponsored disability plan allows, participating employees can elect at the start of any plan year to switch employer's contribution from pre-tax to after-tax dollars. The IRS determined that employees selecting the after-tax option thereafter could exclude their benefit payments from their incomes. [Rev. Rul. 2004-55]

   a. Disability policy paid with pre-tax dollars for 7 years. Employee pays the premiums for the next 3 years with after-tax dollars. Employee then becomes disabled. Under prior rules 70% of disability payments received would be taxable.

2. Employees must elect before or after-tax treatment at the start of the plan year. An election would be irrevocable for the plan year but could be changed the next year.

3. The IRS noted that the amended plan is a new plan for purposes of computing employer and employee contributions.

4. Benefits attributable solely to after-tax employee contributions would be excluded from an employee's gross income. Benefits attributable solely to pre-tax employer contributions would be included in an employee's gross income.

G. Disability Benefits

1. Payments made under a workmen's compensation act as compensation for personal injuries are excludable, unless they are determined by reference to age or length of service, in which case they are includible as retirement or pension benefits.

2. Work-related disability payments can become includible in income if the payments are converted to retirement payments.

3. A policeman was granted a disability pension. Under the plan, he received 75% of his base salary until the date on which he would have completed 25 years of service. At that time, the benefits would be reduced to the retirement benefit he would have received had he retired after having worked the full 25 years. His pension was reduced to 50% of his former base salary in 1991 pursuant to the plan. The IRS and the Tax Court determined that his disability pension was income because the amount was determined by reference to his length of service. The Ninth Circuit determined that the taxpayer qualified only for disability benefits and the benefits were not determined by reference to his age or his length of service, and the reduction in payments on the 25-anniversary of his hiring did not convert his disability pension into a retirement pension. [*Picard v Commr*, 99-01 USTC ¶50,218, CA-9]

H. Accelerated Death Benefits

1. Accelerated death benefits for terminally ill and chronically ill individuals excludable (with dollar limit on exclusion for chronically ill) *after* 1996 (Health Insurance Portability and Accountability Act).

2. The excludable amount for a chronically ill individual is capped at $310 per day (2012) ($113,460 for year), adjusted for inflation. [Notice 2012-1]

3. To meet the criteria as terminally ill for tax purposes, a taxpayer must have proper physician's certification that the taxpayer has less than two years to live.

    a. People deemed chronically ill must be certified as being unable to perform at least two activities of daily living for at least 90 days due to a loss of functional capacity. [Notice 97-31]

    b. Activities of daily living include eating, toileting, transferring, bathing, dressing, and continence.

    c. Form 1099-LTC, Long-Term Care Benefits and Accelerated Death Benefits, used to report benefits paid to individuals.

I. Flexible Spending Accounts

1. The IRS has relaxed the "use-it-or-lose-it" rule for flexible spending accounts (FSAs). Employers can give employees an additional 2 ½ month "grace period" into the next year to use the funds in their FSAs. [Notice 2005-42]

2. The rule applies to a participant who has unused contributions for a particular benefit, such as health expenses, at the end of the 12-month plan year and who incurs expenses for the same benefit during the grace period. The employee may be reimbursed for those expenses from the unused contributions as if the expenses had been incurred in the immediately preceding 12-month period.

3. During the grace period, a cafeteria plan may not permit unused benefits or contributions to be cashed out or converted to another benefit. Unused contributions relating to a particular benefit may only be used to pay or reimburse expenses incurred for that particular benefit.

4. Employers can adopt a grace period for the current cafeteria plan year, or for future years, by amending their plan documents before the end of the plan year.

5. If, due to the additional 2 ½ month grace period, the employer does not know at the time Form W-2 must be sent the tax year amount actually reimbursed to the employee from the account, the employer may continue to make a reasonable estimate by determining the amount the employee elected to use in the account plus any matching funds the employer may furnish. [Notice 2005-61]

J. Health Reimbursement Arrangements

1. The IRS has ruled that money provided by employers to employees to cover out-of-pocket medical expenses through a health reimbursement arrangement (HRA) is not subject to tax. And, unspent funds may be rolled over from one year to the next. [Rev. Rul. 2002-41, 2002-28 IRB 75, IRS Notice 2002-45, 2002-28 IRB 93]

    a. HRAs are not subject to the highly complicated rules that apply to flexible spending accounts (FSAs), which are often available under cafeteria plans.

    b. The IRS requires HRAs to be funded solely by employer contributions. HRAs cannot be funded through a salary reduction agreement signed by an employee.

    c. Can be used to reimburse for health insurance premiums.

2. An HRA cannot be used in conjunction with a cafeteria plan.

3. The HRA contribution is not subject to employment taxes.

4. Unspent Fund Carryover

    a. Unspent funds may be rolled over from one year to the next.

    b. An employer may restrict the amount of the carryover.

5. Reimbursements from HRAs must be substantiated.

    a. Employees can be given debit cards to spend on their health care. [Rev. Rul. 2003-43] This means that the employer and employees will not have to shuffle paper for each reimbursement claim.

6. If the HRA provides for payments or other benefits irrespective of medical expenses, all amounts provided under the HRA become taxable, including previous medical reimbursements.

7. Employees cannot have the right to receive cash or any benefits other than the reimbursement of medical expenses from the HRA. If any employee has such a right, either currently or in the future, such as at retirement, then all reimbursements to all employees (including reimbursements made in prior years) from the HRA are included in gross income, even if they are reimbursements of medical expenses.

8. The IRS has ruled that a Health Reimbursement Arrangement (HRA) that makes any payments in cash or benefits for unused reimbursement amounts will generate taxable income to the employee for all payments, whether or not any medical expenses were incurred. [Rev. Rul. 2005-24]

    a. When a plan authorizes a payment that is not eligible for exclusion from gross income, it is the plan that fails, not merely the payment.

    b. Three plans not satisfying the requirements for tax-favored treatment:

        1) An employee may receive a cash payment equal to the unused reimbursement amount at the end of each year or upon termination of employment.

        2) An unused reimbursement amounts are paid in the form of a death benefit.

        3) Any unused reimbursement amounts are forfeited; however, the employee may receive an amount equal to any forfeited amounts either in cash or in contributions to one of several retirement plans.

9. Health Reimbursement Plans

    a. The IRS issued a ruling making it clear that the benefits of a health reimbursement arrangement (HRA) maintained by an employer are taxable to each employee if the HRA can pay benefits to non-family members of the employee. This treatment applies to all amounts paid by the HRA, even if the payment for medical expenses can be received by the employee, or the employee's spouse or dependents. [Rev. Rul. 2006-36]

10. HRA accounts can not be used to pay for long-term care or long-term-care insurance.

11. HRA funds are generally not portable unless the employer permits, subject to the COBRA provisions.

12. As a group health plan, HRAs are subject to the COBRA (Consolidated Omnibus Budget Reconciliation Act of 1986) continuation coverage requirements. If an employee elects COBRA continuation coverage, not only must the unused funds in the HRA be available to the former employees, but HRA contributions must continue to be made in amounts similar to the amount for non-COBRA employees. If an employee does not elect COBRA continuation coverage, the HRA may continue to reimburse the employee for medical expenses until the HRA is exhausted.

13. IRS rules permit HRA accounts to be used for retirees and retiree's survivors.

14. Example. The employer provides each employee with health insurance that has a $3,400 deductible. In addition, each employee receives an HRA account with a credit of $2,000 per year. That $2,000 can be used for medical expenses throughout the year. If more than $2,000 is spent, the employee is responsible for the next $1,400. Once the $3,400 deductible has been reached, the insurance kicks in.

15. Since this is an unfunded account, it is subject to ERISA.

    a. This means that for the plan to be legal, it must have specific plan documentation and provide summary plan descriptions to employees.

    b. Special nondiscrimination rules apply and if there are 100 or more participants, Form 5500 must be filed.

16. It would appear that 2% shareholders are not eligible for the HRA benefit. It would probably fall in the same category as health insurance premiums.

17. Self-employed individuals are not considered employees. Thus, self-employed individuals cannot cover themselves with an HRA, but they can cover their employees, including their own spouse, if their spouse is a valid employee.

18. The IRS has given approval to a new system that takes into account both the employee's wages and the number of exemptions on the W4. Employees with high wages and large number of exemptions receive a greater employer contribution toward health care costs. [Ltr. Rul. 200329014 - July 18, 2003]

19. After 2010, health reimbursement arrangements cannot reimburse the cost of over-the-counter drugs, including aspirin, antacids, and allergy medications. [Health Care Act of 2010]

20. Medical expense reimbursement plans cannot apply retroactively. In December, a firm set up a plan to reimburse employees for medical expenses incurred during the year, even for costs arising before the plan was adopted. Payments for medical expenses incurred before the plan was set up are taxable, the IRS says. Only subsequent costs are reimbursable. [Rev. Rul. 2002-58]

K. Employee Tool Reimbursements

1. An employee tool reimbursement plan did not qualify as an Accountable Plan and reimbursement were included in income. [Rev. Rul. 2005-52]

2. Each technician received an hourly wage for services, as well as a "tool allowance." The tool allowance was meant to cover the expenses incurred from buying, maintaining, and replacing a technician's tools. The tool allowance was an hourly rate, derived from an amalgam of survey data from a national survey of average tool expenses.

   a. The employer did not require the technicians to return any overage from the actual tool costs incurred.

3. Under Reg. 1.62-2, to qualify as an accountable plan, an employer that reimburses it employees must show:

   a. The reimbursed expenses must be allowable as a deduction and must be paid or incurred in connection with performing services as an employee of the reimbursing employer;
   b. All reimbursed expenses must be individually and adequately accounted for to the reimbursing employer within a reasonable time; and
   c. Any amounts paid to the employee in excess of the actual expenses must be returned to the reimbursing employer within a reasonable time.

4. The plan did not require exact substantiation of costs incurred and did not require employees to return amounts in excess of substantiated expenses.

5. In 2002, the IRS worked with the pipeline industry to resolve exactly this issue under the Industry Issue Resolution (IIR) Program. The IRS agreed that it was unduly burdensome on the pipeline industry to conform to the standards and a deemed-substantiation deal was worked out.

   a. The IRS indicated that it now is willing to examine tool reimbursements in the auto repair industry under the IIR program.

6. The IRS is expanding its examination of tool reimbursement plans. The Service decided to act after it discovered widespread marketing of these plans. The IRS believes that many tool reimbursement plans are just shams that are designed to make a portion of the workers' pay tax fee and save payroll taxes for employers. Unless employees are required to substantiate tool expenses and return any excess to their employers, payments made under the plan are taxed as wages and subject to employment taxes. [Coordinated Issue - Motor Vehicle Industry; July 2, 2008]

L. Stock Options

1. The IRS has ruled that an employee must recognize income on the exercise of a nonstatutory option more than six months after the grant date even if the stock obtained through exercise of the option is subject to restrictions under Rule 10b-5 of the Securities Exchange Act of 1934 and other contractual provisions. [Rev. Rul. 2005-48]

2. The Tax Court has held that a taxpayer received income from the exercise of nonstatutory stock options, even though he paid for the shares with borrowed funds, which were not repaid and the value of the shares declined during the restricted period. [Hillen, TC Memo 2005-226]

3. Income from Nonqualified Options

   a. Taxpayer exercised her options for $316,000, plus $616,000 to cover withholding. To pay for the stock, she borrowed $932,000. She represented that she was the owner of the stock and that there were no restrictions on transfer. The stock was worth $2.4 million when she exercised the options. The taxpayer repaid the loan when the stock was worth only $337,000.

   b. The taxpayer argued that her options were incentive stock options, and, therefore, were not taxable on exercise under Sec. 422. The Tax Court found that the options failed many of the ISO requirements. [Moore, TC Memo, 2007-123]

   c. The fact that she paid for the stock with borrowed funds was irrelevant; she paid cash and became the owner of the stock. Her right in the shares was not subject to a substantial risk of forfeiture because she was not required to perform any additional services to retain the stock. The potential violation of insider trading rules had the taxpayer sold her stock to a third-party upon receiving it was not a substantial risk of forfeiture.

4. Section 83 Stock

   a. Putting new restrictions of vested options will not trigger a refund of tax paid initially on the options. [Rev. Rul. 2007-49] Even if the limitations cause the shares to become invested for a period of time, that risk of forfeiture does not let an employee get money back. But if the shares are forfeited because of the new conditions are not met, the amount of income the originally reported is a capital loss.

M. Property Tax Rebate

1. The 2008 Act created an income tax exclusion for qualified state or local tax benefits and qualified reimbursement payments granted to members of qualified volunteer emergency response organizations for tax years 2008 through 2010.

   a. A "qualified state or local tax benefit" is any reduction or rebate of state or local income, real property, or personal property taxes on account of services preformed by individuals as member of a qualified volunteer emergency response organization.

   b. The amount of these payments is limited to $30 multiplied by the number of months during the year that the taxpayer performs such service.

   c. The amount taken into account by a taxpayer in determining itemized deductions (e.g., taxes, charitable contributions, miscellaneous itemized deductions) is reduced by the amount of any qualified state or local tax benefit.

   d. Any qualified State or local tax benefit and any qualified reimbursement payment excluded from gross income on account of services performed by individuals as members of a qualified volunteer emergency response organization is not subject to social security tax, unemployment tax, or withholding.

2. A taxpayer who receives a refund of state taxes must include the amount in income if it was deducted on a prior year's return. The tax benefit rule applies. [CCA 200504027]

   a. If the rebate is for two or more years, the rebate must be prorated over the years.

   b. A rebate that occurs in the current year for the current year's taxes reduces the allowable deduction for the taxpayer who itemizes in the current year.

3. Property Tax Rebate for Volunteers

    a. The school district offered property tax rebates for "volunteers." The amount of tax relief is taxed as income because the rebates are received in exchange for services they provide. Payroll taxes are due on the abatements. [INFO 2005-0130 Letter to Tim Holden; CCA 200227003; CCA 200025050]

4. Commission Rebates

    a. Commissions rebated to home buyers are tax free. [Ltr. Rul. 200721013] Many real estate agents representing buyers agree to give back a portion of their commission when a home is purchased. For tax purposes, the IRS says the rebate the home buyer receives is a nontaxable purchase price reduction. No Form 1099 reporting is required.

5. Energy Conservation Subsidies

    a. The IRS says that homeowners do not owe tax on energy conservation subsidies. [Ltr. Rul. 200717010] This applies to aid that public utilities give individuals to help offset costs of energy-saving home improvements, such as solar-powered units. Form 1099s need not be issued.

        1) The rule is different for businesses. Conservation subsidies paid to businesses are taxable, and 1099s must be filed if payments exceed $600.

6. Driveway Repaid Reimbursement from a City

    a. Driveway repair reimbursements from a city are tax free. [Ltr. Rul. 200722005] A city's program covers 50% of the cost (100% for seniors) of fixing the portion of a homeowner's driveway that is within an easement granted to the city. The work is controlled by the city, all driveway repairs must be authorized, and they are not paid for until city inspectors approve the work done.

N. Employer's Holiday Gift Coupons are Taxable

1. Gift certificates, such as the taxpayer's coupons, are the equivalent of cash. Like cash, they have a readily ascertainable value. Similarly, it is not unreasonable or administratively impracticable to account for them. [TAM 200437030]

O. Interest Income

1. Banks and other financial institutions often hand out inexpensive gifts, such as flashlights, tote bags, or mouse pads, to attract new deposits or induce customers to add to their existing accounts. Under a recent IRS revenue procedure, a noncash gift is a de minimis premium, and thus taxfree, if it does not have a value of more than $10 for a deposit of less than $5,000, or $20 for a deposit of $5,000 or more. The value is based on the cost to the financial institution of the premium. The financial institution that hands out such a gift is not required to treat it as interest for information-reporting purposes. The rule is effective for premiums provided after 1999. [Rev. Proc. 2000-30, 2000-28 IRB 113]

P. Series EE Bonds

1. May defer income until cashed or report accrued income each year.

    a. Interest must be reported at maturity even if not cashed at that time.

    b. May change from cash method to accrual method by reporting all income up to point of change in method.

2. Series EE Bonds Used for Higher Education Expenses

    a. Interest exempt from taxation if certain requirements are met.

    b. The bonds must be issued after 1989.

    c. The bonds must be issued in taxpayer's name or in the taxpayer and spouse's names as co-owners.

    d. Taxpayer must be at least 24 years old before the bond's issue date.

    e. If the taxpayer is married, a joint return must be filed in year of redemption.

    f. The bonds must be use to pay tuition and fees for taxpayer, spouse, or dependent.

    g. For 2012, benefit phases out for adjusted gross income in the year of redemption between $72,850 and $87,850 for single taxpayers and between $109,250 and $139,250 for married filing jointly.

3. The Tax Court ruled that a taxpayer had $10,255 in unreported interest income from the redemption of U.S. savings bonds. The taxpayer produced no evidence that a Code Sec. 454 election had been made. [Landers, TC Memo 2003-300]

    a. Sec. 454 allows taxpayers to elect to pay tax on certain bond interest at the time it accrues.

    b. Under Sec. 454, a taxpayer owning non-interest-bearing bonds issued at a discount and redeemable for fixed amounts that increase at stated intervals, or owning Series E bonds, can elect to treat the increase as income received in that particular year.

Q. Relocation Payments

1. Relocation payments made by local jurisdictions in Presidentially declared disaster areas to flood victims to defray the costs of moving from their damaged homes are in the nature of welfare payments (i.e., tax free). [Rev. Rul. 98-19, 1998-15 IRB 5]

2. State aid to low-income homeowners who were the victims of a casualty is a tax-free benefit in the nature of welfare benefits. [TAM 200020050]

R. Tobacco Quota Holders

1. Payments to tobacco quota holders under the Tobacco Transition Payment Program (TTPP) will be taxed at the capital gains rate. [Notice 2005-57, modifying Notice 2005-51]

    a. Beginning with the 2005 tobacco crop, there will be no planting restrictions and no price support loans.

    b. Payments start in 2005 and end in 2014.

        1) Quota holders will receive $7 per pound.

        2) Producers will receive up to $3 per pound.

2. Quota holders are the landowners of the farm where a tobacco quota was assigned.

3. Adjusted basis is determined differently depending on how the holder acquired the quota:

    a. The basis of a purchased quota is the price the holder paid for it.

    b. If the quota is derived from an original grant by the federal government, the basis is zero.

    c. The basis of an inherited quota is generally the FMV of the quota at the time of the decedent's death.

4. The basis of a tobacco quota is not subject to adjustment through amortization, depletion, or depreciation. However, if an owner improperly has deducted any amount for these purposes, the owner must reduce the basis by the amount deducted before determining gain or loss.

5. Whether gain or loss is ordinary or capital depends on how the holder used the quota.

    a. If the quota holder used the quota in the business of farming, and held the quota for more than one year, receipt of TTPP payments could be treated as a Sec. 1231 transaction. Gain would be treated as long-term capital gain and loss would be treated as ordinary income.

    b. If the quota was held for investment purposes, or for the production of income, but not used in a trade or business, any gain or loss is capital gain or loss.

6. A quota holder may postpone reporting gain or loss by entering into a Sec. 1031 like-kind exchange.

7. A tobacco quota is considered an interest in land, and farm income averaging is not available for gain or loss arising from the sale or other disposition of land.

8. Tobacco Quota Holders

    a. The gain reported on Form 1099-S can be reported on the installment method over the 10-year payment period. The U.S. Department of Agriculture reports the proceeds from the sale, including payments in later years, to the quota holder on Form 1099-S in the year in which the sale takes place. [Notice 2005-57]

S. Scholarships and Fellowships

1. Newsboy who earned a $5,000 scholarship for delivering newspapers for three years could not treat it as a tax-free scholarship. He was required to perform services (i.e., deliver newspapers) as a condition of receipt. [*Godfrey*, TC Memo 1998-51]

T. Employee Benefits

1. The 2012 monthly parking fringe benefit exclusion is $240 per month; the exclusions for commuter highway vehicles and monthly transit passes is $125. [Rev. Proc. 2011-52]

   a. After 1997, employees have a choice between the parking and the cash equivalent without loss of exclusion. [Taxpayer Relief Act of 1997]

   b. Nondiscrimination rules do not apply to parking and transportation benefits

   c. The exclusion is not available to self-employed persons, including independent contractors, partners, and 2% shareholders of S corporations. However, the de minimis fringe benefit rule for transit passes continues to apply to them -- tokens for fares worth $21 or less.

2. The IRS issued proposed regs on the income tax exclusion for "qualified transportation" fringe benefits. Qualified transportation fringe benefits are the following benefits provided by the employer:

   a. Transportation in a commuter highway vehicle if the transportation is in connection with travel between the employee's residence and the place of employment;
   b. Transit passes; and
   c. Qualified parking

   There are two categories of qualified transportation fringe benefits. The first category is transportation in a commuter highway vehicle and transit passes. The second category is qualified parking. The proposed regs explain that there are no substantiation requirements with respect to mass transit passes provided directly by the employer to its employees. However, the employer may impose its own substantiation requirements.

   The proposed regs provided that the salary reduction election for any month in a year may not exceed the aggregate monthly maximum for the year. The salary reduction election must be made before the employee is currently able to receive the taxable compensation that he or she is agreeing to reduce. Employers can offer employees qualified transportation fringe benefits as one of the benefits under a Section 125 cafeteria plan. An employee may receive benefits from each category provided the applicable statutory monthly limit for that category is not exceeded. The amount by which the value of qualified transportation fringe benefits provided by an employer to an employee exceeds the applicable statutory monthly limit is included in the employee's wages for income and employment tax purposes. [NPRM REG-113572-99]

3. Bicycle Commuting

   a. Employers can exclude up to $20 per month in employer-provided transportation fringe benefits paid to employees who commute by bicycle.

   b. Effective for tax years beginning after December 31, 2008.

4. Salary reduction plans for commuting costs are tax favored. Employees can agree to reduce their salaries by as much as $240 (2012) a month for parking and up to $125 per month for bus and train passes. Workers save taxes because their income is lower. Employers benefit too because they owe less Social Security and Medicare taxes on reduced pay. Amounts remaining in accounts at year end can be carried over and used to pay for commuting expenses in the following year. However, unused set-asides cannot be refunded to workers who terminate employment. [Info 2002-0003]

5. A new ruling concludes that if the employer has already paid for parking, additional reimbursements of parking expenses are not excludable from income and are treated as wages under the employment tax rules. [Rev. Rul. 2004-98]

    a. Put a halt to abusive fringe benefit arrangements where employers reimburse employees twice for the same parking expenses and attempt to exclude both reimbursements from the employees' income.

U. Personal Use Employer-Provided Vehicles

1. For 2012, the cents-per-mile method can be used for passenger automobiles with a fair market value of $15,900 or less on the day they were first made available to employees. The cents-per-mile method can only be used for trucks and vans with a FMV of $16,700 or less. [Rev. Proc. 2012-13]

    a. For vehicles that are more expensive, the IRS' annual lease value tables must be used.

    b. Trucks and vans are defined as passenger automobiles built on a truck chassis, including minivans and SUVs that are built on a truck chassis.

2. Employers that have 20 or more qualifying vehicles may use the fleet average valuation rule to calculate the annual lease values of the vehicles. The FMV of each vehicle can be treated as equal to the fleet-average value.

    a. For 2012, this approach may only be used for passenger automobiles with a FMV of $21,100 or less. The limit for trucks and vans is $21,900.

3. For vehicles initially leased for 2012 and costing more than $18,500, the IRS imputes varying amounts of income annually to users. [Rev. Proc. 2011-21]

4. The vehicle-value limit is applied when the employee first used the vehicle for personal use. Once the maximum value is exceeded in the first year, it is not revalued at the start of each subsequent year with a new inflation-adjusted value. A business might consider first using the vehicle exclusively for business for a few months, then giving the "used" vehicle to an employee for personal use.

V. Reimbursements for Travel and Entertainment

1. Finalized regulations (1999) clarify that reimbursements of employee's travel and entertainment expenses that are not fully deductible by their employees do not constitute taxable compensation.

2. Reimbursements for travel expenses of business associates, club dues, and spousal travel paid by exempt organizations are also not taxable compensation.

W. Foreign Income Exclusion

1. The exclusion for foreign earned income increases to $95,100 for 2012.

X. Sec. 911 Housing Exclusion

1. The new base housing amount is set at 16% (computed on a daily basis) of the foreign earned income exclusion limitation, multiplied by the number of days of foreign residence or presence in that year.

2. Reasonable foreign housing expenses over the base amount may be excluded from gross income. The exclusion amount is limited to 30% of the maximum amount of a taxpayer's foreign earned income exclusion.

3. Any income over the exclusion will be subject to the tax rate applicable had the taxpayer not elected the exclusion.

4. The IRS has carved out a list of over 200 high-cost foreign cities in over 50 countries from application of the relatively low foreign housing exclusion amount.

   a. The list is based upon the location in which the individual lives, rather than where his or her office may be located.

   b. The IRS plans to update its list each year.

Y. Group-Term Life Insurance

1. Under IRC Sec. 79, an employer must report gross income to an employee for the value of group-term life insurance in excess of $50,000 of coverage. Key employees in discriminatory group-term plans are not eligible for the exclusion. The amount to be included in income is based on a table provided in Reg. 1.79-3(d)(2).

2. New rates are in effect as of July 1, 1999, to calculate the economic benefit of the group-term life insurance. The new rates are significantly lower than the old rates, resulting in less taxable income to the employee. For purposes of this table, the age of the employee is based on the attained age on the last day of the employee's tax year. The new rates are as follows:

	Monthly Cost per $1,000	
Age	After 6-99	Before 7-99
Under 25	$.05	--
25-29	.06	.08
30-34	.08	.09
35-39	.09	.11
40-44	.10	.17
45-49	.15	.29
50-54	.23	.48
55-59	.43	.75
60-64	.66	1.17
65-69	1.27	2.18
70 and over	2.06	3.76

   a. The new rates are lower in all age categories than the old rates, with a new age bracket for employees under age 25. The preexisting rates had been used since 1983.

Z. Employer-Provided Adoption Assistance

1. Employer-provided adoption assistance is excludable up to $12,650 for 2012.

2. The exclusion phases out for those with modified adjusted gross income over $189,710 for 2012.

3. The excluded amounts are subject to FICA and FUTA employment taxes.

4. The exclusion applies to adoption fees, court costs, attorney's fees, traveling expenses, and other expenses directly related to a legal adoption.

5. No exclusion can be claimed for expenses for which the taxpayer claims an adoption credit and no credit can be taken for any amounts reimbursed by an employer.

AA. New Proposed Regulations Providing Guidance on Cafeteria Plans [REG-142695-05]

1. Prepaid orthodontist charges can be reimbursed up front even if the treatment lasts into the following year.

2. Newly employed workers are allowed to make retroactive election as long as they do so within 30 days of their hiring date.

3. Workers who quit can tap unused funds to pay dependent care costs that are incurred after leaving their jobs.

4. Workers who do not have health insurance can buy it with their set-asides.

5. However, unused amounts not spent by December 31 (or March 15 if the plan elects) are lost.

BB. Lottery Winnings

1. The Sixth Circuit held that the economic benefit rule did not cause $8.8 million in lottery winnings to be included in income in the year of the drawing, rather than in the subsequent year when the winning ticket was finally verified and paid. The court said that the economic benefit doctrine requires a taxpayer to include in gross income items that have not yet been paid whenever the financial benefits are (a) fixed, (2) located in an irrevocable fund, and (3) not subject to the payor's debtors. According to the court, the taxpayer's lottery award did not satisfy any of these elements. [*Thomas*, 85 AFTR2d 2000-1886 (CA-6, 2000)] The tax rates increased from 31% in 1991 to 39.6% in 1992.

2. Under 1998 legislation, winners of lotteries and similar prizes are allowed a 60-day window after notification of an award to elect either a cash settlement or an installment payout without risk of constructive receipt attack from the IRS. [Sec. 451(h)]

3. The IRS has ruled that a taxpayer who sold the rights to receive future annual installments from lottery winnings was taxable on the amounts as ordinary income rather than as capital gains. The sale of the rights did not represent payment for an increase in the value of income-producing property, but rather merely represented a substitute for future ordinary income. [TAM 199945008]

4. A federal district court also concluded a lump-sum payment obtained in consideration of an assignment of a right to get future lottery payments was ordinary income. There was an assignment of an established, noncontingent right to get future payments of ordinary income. [Maginnis, DC Ore., 2002-2 USTC ¶50,494] The Ninth Circuit found that the taxpayer did not make any underlying investment of capital in return for the lottery right. Purchase of a lottery ticket is no more an underlying investment in capital than is a bet on a roulette wheel. In addition, sale of the lottery right did not reflect an accumulation in value over cost to any underlying asset. [Maginnis, 2004-1 USTC ¶50,149, CA-9]

5. The Tax Court held that the right to receive future lottery payments is not a capital asset, but a right to receive future ordinary income. Thus, a lump sum received on assigning such right is also ordinary income. [Davis, 119 TC 1, 2002]

6. Mary Boehme, who in 1991 won $1.5 million in the Colorado State Lottery, payable in 25 annual installments. In 1996 she assigned her rights to receive the next 12 annual lottery payments, a total of $664,000, in exchange for a $400,000 lump-sum payment. On Schedule D of a joint return, they reported a $264,000 long-term capital loss, treating the $664,000 value of assigned payments as Mary's "basis" in the lottery installments and the $400,000 lump sum as the "sales price." The Tax Court agreed with the IRS that the $400,000 was ordinary income. [Peter U. and Mary M. Boehme, TC Memo 2003-81]

CC. Claim of Right Doctrine

1. The Tax Court ruled that the claim of right doctrine did not require the taxpayer to take into income the credit balances remaining at the end of the tax year for that year because the taxpayer and the customers had established a sufficient consensual recognition of the taxpayer's obligation to return the credit balances. [*Smarthealth Inc.*, TC Memo 2001-145]

    a. The court based its conclusion on the facts that (1) overpayments were the result of customer and not taxpayer conduct and (2) customers had at their disposal all of the information necessary to determine that they had in fact overpaid.

DD. Social Security Benefits

1. Up to 85% of Social Security benefits are taxable.

2. No Social Security benefits are taxable if provisional income is less than $32,000 on a joint return ($25,000 for single and $0 for married filing separately unless they lived apart for the entire year).

3. The Senior Citizens Freedom to Work Act of 2000 repealed the social security earnings limit as it applies to beneficiaries age 65 through 69. Taxpayers can earn up to $14,640 in 2012) before $1 is withheld from benefits for every $2 earned. If full retirement is reached during 2012 (age 66), $1 will be withheld for every $3 earned over $38,880 until the month the taxpayer turns age 66. After reaching full retirement age, taxpayers can receive the full benefit amount no matter how much they earn.

4. Developments

    a. A taxpayer whose wife refused to file a joint return had to pay on his Social Security benefits. He lost the use of the $25,000 base amount because he lived with his wife part of the year. [*Clark*, TC Memo 1998-281]

b. The Tax Court has held that a taxpayer and spouse, who maintained separate bedrooms but lived in the same house, did not "live apart" for purposes of determining the taxability of social security benefits. In order to have a workable rule, the Tax Court insists that living apart can only mean living in separate residences. [*McAdams v. Comm*, 118 TC 373 (2002)]

c. Gambling winnings can increase the taxable portion of Social Security benefits because gambling losses can only be deducted as itemized deductions. [Klingaman, TC Sum. Op., 2005-36]

EE. Qualified Retirement Planning Services

1. Employer-provided qualified retirement planning services are excludable from employees' gross wages after 2001.

2. Qualified employer plans include:
   a. Plans that are qualified under 401(a), including trusts exempt from tax under Code Sec. 501(a);
   b. Annuity plans;
   c. Governmental plans;
   d. 403(b) annuity contracts
   e. Simplified employee pensions (SEPs);
   f. SIMPLE retirement accounts; and
   g. Certain employee-only funded trusts established prior to June 25, 1959.

3. Qualified retirement planning services are defined as any retirement planning advice or information provided to an employee and spouse by an employer maintaining a qualified employer plan.

4. The exclusion applies to highly compensated employees only if qualified retirement planning services are available on substantially the same terms to all employees of the group who normally receive information and education about the plan.

5. The provision is not meant to include related services, such as tax preparation, accounting, legal, or brokerage services.

6. Payments made to eligible foster care providers are excludable from gross income. [(Code Sec. 131(a)]

7. Payments must be made (1) by state or local governmental agencies, regardless of the qualified foster individual's age at the time of the placement or (2) by tax-exempt placement agencies licensed by state or local governments, but the qualified foster care individual must be under age 19 at the time of the placement.

8. Amounts are not excludable to the extent that they are made for more than five qualified foster individuals. No limitation applies to foster care recipients under age 19.

FF. Cafeteria Plans

1. Also referred to as "Flexible Spending Accounts" or "Section 125 Plans."

2. A cafeteria plan is a written plan maintained by an employer for the benefit of its employees. The plan must allow employees to choose between two or more benefits consisting of cash (or a taxable benefit which is treated as cash) and certain "qualified benefits".

3. Employer contributions to the cafeteria plan are usually made pursuant to salary reduction agreements between the employer and the employee in which the employee agrees to contribute a portion of his or her salary on a pre-tax basis to pay for the qualified benefits. Salary reduction contributions are not actually or constructively received by the participant. Therefore, those contributions are not considered wages for federal income tax purposes. In addition, those sums generally are not subject to FICA and FUTA. A salary reduction agreement is sufficient to satisfy the "cash" requirement of a cafeteria plan. Thus, a cafeteria plan need only offer a choice between one qualified benefit and salary reduction.

   a. The redirected amounts go into separate spending account.

   b. Although there are no federal limits on how much may be set aside, employers may set limits.

   c. When payments are made, they are converted to pretax deductions. They no longer show up on employee W-2s and become pretax income.

      1) Certain cafeteria plan benefits are subject to Social Security and Medicare taxes, but not to unemployment or income tax withholding: (1) group-term life insurance that exceeds $50,000 and (2) adoption-assistance benefits.

4. No more than 25% of the plan's benefits can be paid on behalf of key employees.

   a. If the 25% ceiling is exceeded, any benefits received by the highly compensated group from a discriminatory plan become taxable income to them.

5. Partners, limited liability company members, sole proprietors, and those owning more than 2% of an S corporation cannot participate in cafeteria plans.

GG. Disaster Relief Payments

1. President Bush signed a bill giving tax-free status to grants used to protect homes and other structures from natural disasters. The change is retroactive, so homeowners who paid tax on grants in prior years can seek refunds. [H.R. 1134, 4-15-05]

   a. The bill was triggered by an IRS ruling last year that some $500-million a year given out under federal disaster mitigation programs is taxable, possibly retroactively. Included in the ruling was a hodgepodge of grants: money used to retrofit home with tornado safe rooms or hurricane straps, money to rebuild flood-prone homes on stilts or higher ground and grants to move homeowners whose properties are particularly susceptible to flooding.

2. State Disaster Loss Grants

   a. The IRS has ruled that a grant received by a qualifying business under a state's program to reimburse losses incurred for disaster damage is not excludable from gross income. [Rev. Rul. 2005-46]

   b. Such a grant did not qualify as (1) a general welfare payment, (2) a qualified disaster relief payment, (3) a gift, or (4) a tax-free contribution to capital in the case of a payment to a corporation.

   c. Any gain realized on account of such inclusion can be deferred under the Sec. 1033 nonrecognition rules.

HH. S Corporations

1. Cancellation-of-debt income that is excluded from an S corporation's income can no longer be taken into account as income by the shareholders and, thus, cannot increase the basis of any shareholder's stock.

2. The legislation overturns the result in the Supreme Court decision in *Gitlitz v. Commissioner* (531 US 206, SCt, 2001) but does not apply retroactively to reverse the *Gitlitz* decision itself.

3. The provision applies to discharges of indebtedness after October 11, 2001.

4. The amendment shall not apply to any discharge of indebtedness before March 1, 2002, pursuant to a plan of reorganization filed with the bankruptcy court on or before October 11, 2001.

II. The Military Family Tax Relief Act of 2003 (MFTRA)

1. The military death benefit is increased from $6,000 to $12,000 and the entire amount is tax-free. The benefit is retroactive to September 10, 2001.

2. Home Sale Exclusion

   a. Military and foreign service personnel called to active duty may elect to suspend for a maximum of 10 years testing for the required two years of ownership and use under the "the five-year rule" for excluding gain from the sale of their home.

   b. A call to a military tour of duty will be considered a qualifying trigger for a partial exclusion.

      1) The taxpayer must be at least 50 miles away from home on extended duty.

      2) Retroactive to May 6, 1997 and taxpayers have one year to file amended returns for closed years.

3. Members of National Guard and Reserve units traveling at least 100 miles away from home and overnight may deduct their travel expenses above-the-line.

4. Appointments to the nation's service academies are not scholarships, allowing withdrawals from 529 plans and Coverdell Education Savings Accounts.

JJ. Combat Zone

1. A member of the military can exclude from his or her gross income compensation received for active service in the Armed Forces of the United States in a combat zone. In order to be excludable from gross income, the payments must represent compensation for active service in a combat zone. The regs provide that the time and place of payment are irrelevant in determining whether the member can exclude the compensation. Rather, the time and place of entitlement to the compensation determines whether the compensation is excludable.

2. A military member who accepted an early separation from service offer, which included a special separation payment, while serving in a combat zone, was not entitled to exclude the separation payment from his income because the payment did not fall within the definition of "compensation received for active service in a combat zone."

3. The Department of Defense Financial Management Regulations provide that the career status bonus is considered to be excludable combat zone compensation if the effective date of the election falls within a month in which the member is service in a combat zone. [INFO 2007-0042]

4. Severance pay received by a member of the Navy on active duty was deemed taxable instead of tax-free for active service in a combat zone. [*Waterman*, CA-4, 6-3-99]

KK. Parsonage Exclusion for Ministers

1. Gross income of a minister does not include the rental value of a home furnished as part of compensation, or a rental allowance paid to a minister as part of compensation to the extent the allowance is used to rent or provide a home. [Sec. 107]

   a. The IRS has interpreted this statutory language to allow the exclusion for the smaller of: [Rev. Rul. 71-280, 1971-2 CB 92, IRS Pub. 517]

      1) The actual expenditures of the minister for the home,

      2) The amount designated with the employer as a rental allowance, or

      3) The fair rental value of the residence, furnishings, utilities, and garage.

2. The Tax Court held that a housing allowance paid to an ordained minister may exceed the actual fair rental value of his residence and still be properly excluded from gross income. Instead of providing a parsonage, the congregation gave the taxpayer a housing allowance, and all the compensation he received was characterized by the church's trustees as a housing allowance -- $77,663 in 1993, $86,175 in 1994, and $82,278 in 1995.

3. Clergy Housing Clarification Act of 2002

   a. The act amends Sec. 107(2) so that the housing allowance exclusion would not exceed the fair rental value of the home, including furnishings and appurtenances, such as a garage, plus the cost of utilities. In narrowing the language of the exclusion to make it more specific, Congress protected it from constitutional challenge.

4. Ministers report wages in Box 1 of Form W-2 and the parsonage allowance in Box 14.

    a. Ministers must allocate a portion of the expenses of operating the ministry to the tax-free income. Unreimbursed business expenses of a common-law employee are taken on Form 2106, after being reduced because of nontaxable income. These expenses are taken as an itemized deduction on Schedule A, subject to the 2% AGI limitation.

    b. The self-employment income is reduced by any Form 2106 expenses, including the disallowed portion of the 2106 expenses because of the nontaxable income, plus any Schedule C expenses disallowed because of the tax-free income.

LL. Stock Options

1. Rev. Rul. 2004-60 addresses FICA and FUTA tax liability when nonstatutory stock options and deferred compensation rights are transferred to an ex-spouse under a divorce. While transfer to a former spouse does not trigger the immediate payment of payroll taxes on the options or the deferred compensation, eventual FICA and FUTA liability generally cannot be avoided.

2. In Rev. Rul. 2002-22, the IRS announced that nonstatutory stock options retain their same character when they are transferred in a divorce. They also are included in the income of the nonemployee spouse.

3. Options do not lose their FICA and FUTA liability after transfer in a divorce. If the nonemployee spouse exercises the options, FICA and FUTA taxes attach. Options, when exercised, are considered FICA and FUTA wages of the employee spouse. The nonemployee spouse is liable for income tax withholding.

    a. Employers should report Social Security and Medicare wages, and FICA taxes withholding, on Form W-2 for the employee spouse. Employers may take into account other wages previously paid to the employee spouse in the calendar year to determine if the payments are excepted under the maximum Social Security and FUTA wage base exceptions.

    b. Income from the option to the nonemployee spouse is reported on Form 1099-MISC. Income should be reported in Box 3, Other income. Income tax withheld should be reported in Box 4, federal income tax withheld.

        1) Employers may use the supplemental flat wage rate, currently 25%, to calculate the amount of income tax.

        2) The amount included in the gross income of the nonemployee spouse is not reduced by FICA withholding from the payments.

MM. Deferral of Advance Payments

1. Rev. Proc. 2004-34 provides accrual method taxpayers with a limited one-year deferral beyond the tax year of receipt for some advance payments. These include advance payments for:

    a. Services;
    b. Sales of goods;
    c. Use of intellectual property;
    d. Occupancy or use of property if occupancy or use is ancillary to the provision of services;
    e. Sale, lease, or license of computer software;
    f. Guaranty or warranty contracts ancillary to the above items;
    g. Subscriptions;
    h. Some memberships; and
    i. Combinations of the above items.

2. "Advance payment" generally does not include: [Announcement 2004-48]
    a. Rent;
    b. Insurance premiums;
    c. Debt instruments, letters of credit, and other payments with respect to financial instruments;
    d. Service warranty contract payments;
    e. Warrant and guaranty contracts where a third party is the primary obligor;
    f. Payments subject to Sections 871(a), 881, 1441, 1442; and
    g. Payments in property to which Sec. 83 applies.

3. Final regs allow the IRS to provide deferral rules for the use of intellectual property and computer software. [TC 9135]

    a. They allow the IRS to issue additional procedures in the future to fine-tune deferral rules for the use of intellectual property and computer software to keep up with advancing technologies.

    b. Rev. Proc. 2004-34 defines "intellectual property" as copyrights, patents, trademarks, service marks, trade names, and similar intangible property rights, such as franchise rights and arena naming rights.

NN. Trade Discounts Reduce Inventory Costs

1. In Westpac Pacific Food v. Comm., 451 F.3d 970 (2006), the Ninth Circuit Court of Appeals examined the treatment of upfront cash payments by a wholesaler to a grocery store chain. The chain agreed to buy a minimum quantity of inventory during the term of the contract and was required to return a pro rata portion of the cash advance if the minimum purchase was not made. The court rejected the IRS's argument that the payments were income when received and concluded they were advance trade discounts. The payments were like security deposits because they might have to be repaid.

2. The IRS has agreed to an appeal court holding that cash payments were advance trade discounts that do not have to be taken into income. Instead, the payment reduced the cost of inventory and did not affect income until the inventory was sold. [Rev. Proc. 2007-53]

3. Affirming the Tax Court, the 3rd Circuit held that $1.5 million a retail store received from a supplier under a supply agreement was income and not a loan. While the taxpayer signed a promissory note to repay the $1.5 million over six years, the $250,000 due each year was forgiven if the taxpayer met the supply requirement for the previous year by buying a specified amount of products. In rejecting the taxpayer's argument that it had an unconditional obligation to repay, the majority opinion noted that the taxpayer, not the supplier "was in control over whether the obligation would be triggered." The majority opinion also distinguished Westpac Pacific Foods. [Karns Prime & Fancy Foods Ltd. v. Comm., 100 AFTR 2d 2007-5267 (CA-3)]

OO. Other Developments

1. The IRS will not assert that a taxpayer owes tax because of the receipt of frequent flyer miles earned as the result of business or official government travel. [Announcement 2002-18] Other promotional benefits, similar to frequent flyer miles, will also be excludable from income. These include promotions for free or discounted travel, travel-related services, or both. If the promotional benefits are converted to cash, however, they must be included in the taxpayer's income.

2. A mutual fund company, as an incentive, awards an investor with 1 point in an airline frequent flyer program for every new dollar invested in the mutual fund. The IRS ruled that the mutual fund must inform the investor of the fair market value of the airline points, and the investor must adjust the basis in the shares downward by the market value of the points, consistent with purchase price adjustment rules. [Ltr. Rul. 199920031]

   a. It is well established that if, as part of a transaction involving a purchase of property, the purchaser receives other consideration, either from the seller of the property or from a third party, as an inducement to the purchase, the fair market value of the other consideration received is treated as a rebate that adjusts the purchase price of the property. For example, a rebate paid by an automobile manufacturer to a customer reduced the customer's basis in the auto under Rev. Rul. 76-96, 1976-1 CB 23.

3. A tax-exempt fund sought to amend its family health plan to include health coverage for employees' same-sex domestic partners. In a private letter ruling, the IRS stated that the partners, although not considered spouses, could be considered dependents. For determining the tax treatment of health benefits, partners are dependents if they receive more than half of their support from the employee; are part of the employee's household; and are not in violation of local law by engaging in the relationship. [Ltr. Rul. 9850011]

   a. 11 states have laws against nonmarital cohabitation.

4. Employer-provided health coverage for an employee's domestic partner is not excludable from the employee's income because the partner is not a "spouse" under state law. [Ltr. Ruls. 9603011, 9717018, and 9850011]

5. The IRS has issued final regulations under IRC §125 increasing the number and type of events that may permit an employee to change coverage elections under a cafeteria plan. Birth, adoption, effective loss of a body function or part, and death have been added to the list of events that can trigger a mid-year change in elections of group-term life insurance and disability coverage.

   The new regs also allow an employee to change his or her elections if the cost of benefits increases either due to a change in the total cost of the plan or due to an increase in the share of the cost borne by the employee. Midyear elections are also now authorized when coverage under the benefit option plan is significantly improved or a new benefit package is offered under the plan.

   An employee wishing to change elections because a domestic relations order requires another party to provide accident or health coverage for the employee's child must demonstrate that other coverage has in fact been obtained. Similarly, an employee who wants to decrease or drop coverage because of marriage or a change in employment status will be permitted to do so if he or she certifies to the employer that coverage under the spouse's plan has been or will be obtained.

6. Salary Overpayments

   a. Salary overpayments are taxable in the year of receipt. If the employee repays the excess in the same year, the employer reports only the net salary on Form W-2. If the repayment is in a later year, the total salary payment goes on the first year's W-2 and the employee gets an itemized deduction the year repayment is made. The write-off is a miscellaneous itemized deduction that is fully deductible. [INFO 2005-0146]

7. Personal Injury Awards

   a. Interest added to a personal injury award is taxable. The interest was paid to compensate the taxpayer for the payment delay, not for the injury itself. [Chamberlain, CA-5]

8. Complimentary Tickets

   a. Complimentary tickets are taxable fringe benefits to players. Payroll taxes must be withheld as well. Major League Baseball and the NBA have instructed their teams to tax the value of free tickets that the players negotiated to receive as part of their contracts.

9. Chemical Contamination Damages

   a. The recovery for damages from chemical contamination of a home are tax free to the extent of the homeowner's basis in the house. The taxpayers received payments because a corporation's pollution reduced the value of their residences. [INFO 2005-13]

   b. Any damages in excess of basis are taxed as capital gain. Up to $500,000 of that profit can be excluded on principal residences.

   c. On rental units, the gain can be excluded by buying other rental property.

10. Faulty Home Construction Damages

    a. Payments made by the developer for faulty home construction are tax free to the extent of homeowner's basis. [Ltr. Rul. 100513011]

11. Respite Care Payments

    a. Payments by states to providers of respite care are taxed. [INFO 2005-0065]

        1) Respite caregivers step in and take over for foster care providers who go away on vacation or otherwise need to have a break from their daily responsibilities.

        2) Only payments for foster care are eligible for tax-free treatment.

12. Disability Plans

    a. The employer can amend its disability plan to give employees the option of paying the premiums with after-tax funds. The premiums are taxable to employees and are subject to payroll taxes. Any future disability benefits received are tax free. [PLR-160587-04]

13. Home-Makeovers

    a. The value of the home improvements is taxable to the winners of home-makeover TV shows. Even if the arrangement is structured as a rental of a house for fewer than 15 days, the income tax exclusion for such short-term rentals does not apply to the home improvements. [INFO 2006-0012]

        1) Producers of the television program Extreme Makeover: Home Edition, pay applicants $50,000 to rent their homes for 10 days. The producers advise the applicants that the home improvements are non-taxable under Sec. 280A(g).

        2) Under Reg. 1.740-1, prizes and awards includible in gross income include, but are not limited to, amounts received from radio and television giveaway shows. To the extent that the value of the improvement constitutes a prize or an award, it cannot also be considered rent, and therefore could not qualify for the exclusion from gross income under Sec. 280A(g) of the Code.

14. Grants to Homeowners

    a. The IRS approved a special Florida program that provides free home inspections and grants of up to 50% of the cost of implementing recommendations to make the residences more resistant to hurricane-force winds. The grants are limited to owners of home that have insured values of $300,000 or less. In the IRS's view, the grants paid to these homeowners are akin to general welfare payments. [Ltr. Rul. 200808012]

15. State Payments to Defray Costs of In-Home Care

    a. A state's payments to defer costs of in-home care are tax free. [Ltr. Rul. 200810005]

    b. The state paid caregivers for low-income individuals over the age of 60 who otherwise would have been sent to nursing homes. The aid is nontaxable because it is akin to welfare, even though the caregivers themselves may not necessarily be low-income taxpayers. The state is not required to file Form 1099s.

16. Merchandise Won by Customers

    a. A store promised to rebate the purchase price of merchandise purchased during a certain period if a particular event happened. The event happened and the store rebated the purchase price. The rebate is treated as a purchase price adjustment, and not income. [Ltr. Rul. 200816027] The store did not need to issue Form 1099s.

17. Sec. 409 and Teachers

    a. Teachers who elect to be paid over a 12-month period will not trigger a penalty tax on the pay they deferred. [Notice 2008-62] By electing to be paid over a 12-month period instead of over the shorter school year, teachers effectively defer a portion of their compensation to the following tax year.

18. Nonpersonal Use Vehicles for Emergency Responders

    a. Emergency responders who take home clearly marked public safety vehicles would be eligible to treat their vehicles as working condition fringe benefits under proposed regs. [NPRM REG-106897-08] Any personal use of the vehicle, other than commuting, generally must be prohibited.

    b. A marking on a license plate, by itself, does not make a vehicle a clearly marked public safety vehicle.

19. Savings Bond Interest

    a. A mother left her entire estate to her son. The mother's income was so low that she did not need to file a tax return. A few years later, after all of the estate had been distributed to him, the some discovered that his mother had a safe-deposit box with savings bonds. The Tax Court ruled that the interest on late-found savings bonds is taxed to the heir since the mother had not elected to pay income tax on the interest each year as it accrued. [Cronk, TC Summ. Op. 2005-174]

        1) The heir missed a chance to save taxes. Once he found the bonds, he could have asked the IRS to approve a retroactive filing extension for his mother's final income tax return, even though the filing deadline had long since passed. The IRS will do so if the request is in good faith. This way, interest on the bonds would have been taxed at her lower rate.

20. Gambling Winnings

    a. After receiving three installments of a jackpot, she sold her rights to the remaining annual payments for $7.1 million. The company that bought her out gave her a 1099-B listing sales proceeds of $7.1 million, so she reported the payment on her 1040 as capital gain. The sales proceeds are ordinary income, the Tax Court says, not capital gain. The amount she received is a substitute for payouts that would have been taxed as ordinary income. [Prebola, TC Memo 2005-61]

21. Annuity Checks

    a. Annuity checks sent through the mail generally are included in income in the year received, unless the amounts are made available to the taxpayer in an earlier year. Unless the taxpayer has access to or control over the check in the first year, no constructive receipt of the check occurs in the firs year and the taxpayer should recognize income in the second year when he or she receives the check. If the taxpayer has the option of receiving payments by direct deposit, there may be constructive receipt when the direct deposit would have been made. [INFO 2006-0005]

22. Employer Fuel Reimbursements

    a. When an employer pays an employee both a mileage reimbursement and the amount of fuel purchased on a company credit card, the amount of fuel purchased by each employee is additional wages to the employee, as is the excess of any mileage reimbursement over the standard mileage rate. In addition, the payments for fuel by the employer are subject to payroll taxes. [INFO 2005-0218]

23. Hybrid Vehicle Cash Incentives

    a. Employers that offer rebates or cash incentives to encourage employees to purchase hybrid cars must include the amounts on the employee's year-end Form W-2. The incentives are taxable compensation just like other forms of compensation. [IR-2006-112]

        1) They are also subject to income tax withholding and employment taxes.

24. Refunds of State Income Taxes

    a. Refunds of tax income taxes are tax free for filers who deducted state sales taxes. A state income tax refund is taxed only is the recipient deducted income taxes on Schedule A.

    b. A state income tax refund is taxable only to the extent the deduction for state income taxes is more than the available sales tax write-off.

    c. Assume that taxpayer could have deducted $5,000 in sales taxes but instead elected to deduct $6,000 state income taxes. A refund of state income taxes of $2,500 would only be taxable to the extent of $1,000.

25. Constructive Receipt

    a. The co-owners of an S firm did not get along so one of the owners exercised his right under the shareholder agreement to buy out the other at a set price. An arbitrator ruled that the proposed buyout was valid. The seller put the $41 million is a separate account while he unsuccessfully fought the buyout in the court for three years. The Tax Court ruled that the sale proceeds are taxable upon receipt. [Hightower, TC Memo 2005-274]

        1) He could have taken the proceeds at any time.

26. Cancellation of Debt

    a. Married taxpayers properly valued their assets for purposes of determining whether they were insolvent and, thus, could exclude cancellation of debt income. Discharged debt that exceeded their negative net worth was included in their income as ordinary income, not capital gain. [Davenport, DC Okla, 2006-1 USTC p50,167]

27. Options

    a. A software designer received income when he exercised his options through a margin account. The Tax Court rejected the taxpayer's argument the, under Sec. 83 principles, the exercise of an option through a margin account should be treated as the grant of another option to buy the shares, and, therefore, the income should be taxed only when the shares are sold to pay off the margin account. [Facq, TC Memo 2006-11]

28. Payment for Wife's Infidelity

    a. A police officer discovered his wife was having an affair with her doctor. He told the doctor he knew of the affair and was going to sue him. The doctor apologized and paid him $25,000. The doctor's accountant sent the cop a Form 1099 showing the payment as income. The Tax Court ruled that the payment was not a tax-free gift but taxable income. [Peebles, TC Summ. Op. 2006-61]

29. Adoption Assistance

    a. Adoption assistance provided by a charity is tax free. The aid is treated as a nontaxable gift and is exempt form 1099 reporting if given directly to the individual. [INFO 2006-0027]

30. Travel Expenses are Wages

    a. The taxpayer, an airline pilot after years of working domestic routes, was assigned to work in Anchorage, Alaska but resided in Bemidji, Minnesota. His employer provided him with transportation between Minnesota and Alaska. The U.S. Court of Appeals affirmed the decision of a district court in concluding that travel, lodging, and per diem expenses were wages because they constituted personal expenses paid for the taxpayer to commute from his home in Minnesota to work in Alaska. [Jordan, CA-9, June 21, 2007]

31. A mark-to-market deemed sale rule, under which the property of certain U.S. citizens who relinquish their U.S. citizenship and certain long-term U.S. residents who terminate their U.S. residency is treated as sold on the day before the expatriation date for its fair market value. [Sec. 877A(a)(1)] In addition, a transfer tax is imposed on certain transfers to U.S. person from covered expatriates, or from their estates.

32. Credit Card Cash Rewards

    a. According to the IRS, credit card cash rewards are not taxable income. A rebate received from the party to whom the buyer directly or indirectly paid the purchase price for an item is a reduction in the purchase price of the item; it is not an accession to wealth and is not includible in the buyer's gross income. [Rev. Rul. 76-96; Rev. Rul 84-41]

Chapter 5 - Education Benefits

A. Education Provisions

Ed Savings Accts	Student Loan Interest	529 Plans	Early IRA Withdrawal
Tuition	Tuition	Tuition	Tuition
Fees	Fees	Fees	Fees
Books	Books	Books	Books
Supplies	Supplies	Supplies	Supplies
Equipment	Equipment	Equipment	Equipment
Room & Board	Room & Board	Room & Board	Room & Board
		Computer Equipment & Tech	

Scholarship	Employer Provided
Tuition	Tuition
Fees	Fees
Books	Books
Supplies	Supplies
Equipment	Equipment

Higher Ed Deduction	Education Credits	Savings Bonds
Tuition	Tuition	Tuition
Fees	Fees	Fees

B. American Opportunity Tax Credit and Lifetime Learning Credit

1. After 1997 two new tax credits may be elected by low- and middle-income individuals for tuition expenses incurred by students pursing college or graduate degrees or vocational training.

2. The American Opportunity Tax Credit phases out for 2012 for AGI between $80,000 and $90,000 for singles; $160,000 and $180,000 on a joint return. The lifetime learning credit phases out for AGI between $52,000 and $62,000 for singles and $104,000 and $124,000 on a joint return. Married taxpayers must file a joint return. These numbers are now indexed for inflation. [Rev. Proc. 2011-52]

3. Married individuals must file a joint return.

4. We no longer have to worry about claiming either of the credits on a timely filed original return as stated in the proposed regulations. The IRS has come to the belated conclusion that taxpayers should be permitted to claim higher education credits on an original or an amended return. [Notice 99-32]

   a. The education credit is not irrevocable once made. A taxpayer may switch education elections up to the time that filing an amended return expires.

5. Tuition and fees are qualified expenses only if they are required to be paid as a condition to enroll or attend courses. Qualified "related expenses" include books, supplies and equipment, but only if those fees must be paid to the eligible institution. Nonacademic fees (fees not used directly for academic courses) are qualified fees if they must be paid to enroll or attend courses.

    a. Example: A student's course requires a textbook, which can be purchased anywhere. Even if the student purchases the textbook from the college's bookstore, the cost is not qualified because the student was not required to purchase it from the college.

    b. Qualified education expenses do not include medical expenses and other charges in student health fees, even if payment is a condition of enrollment.

6. American Opportunity Tax Credit provides a maximum partially refundable tax credit of $2,500 per student for each of the first four years of post-secondary education.

    a. $2,500 per year (100% of the first $2,000 of qualified expenses; 25% of next $2,000 of qualified expenses).

    b. Must be enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential.

    c. Applies for first four years of higher education.

        1) For each eligible student, the American Opportunity Tax Credit may be claimed for no more than four taxable years. [Reg. 1.25A-3©]

        2) The regs state that college credits based on proficiency tests do not count in determining whether you have completed the first four years of post-secondary education for the American Opportunity Tax Credit. [Reg. 1.25A-3(d)(iii)]

        3) As of the beginning of the taxable year, the student has not completed the first four years of postsecondary education at an eligible educational institution. [Reg. 1.25A-3(d)(iii)]

    d. Applies for taxpayer, spouse, and dependents.

    e. The American Opportunity Tax Credit cannot be claimed for a student who has been convicted of a federal or state felony offense consisting of the possession or distribution of a controlled substance.

    f. An exception allows a parent or student to claim a for payments of qualified tuition and related expenses made during the calendar year to cover an academic period that begins in January, February, or March of the following taxable year. [Notice 97-60, 1997-46 IRB 8, A19]

7. Lifetime Learning Credit

   a. Allows a credit of 20% of qualified tuition expenses paid by the taxpayer for any year the American Opportunity Tax Credit is not claimed.

      1) Maximum of $10,000 of qualified tuition and fees paid for taxpayer, spouse, and/or dependent ($5,000 of qualified expenses before 2003).

   b. Credit is figured on a per-taxpayer basis.

   c. Credit applies for any number of years of higher education.

   d. The regs say that courses involving sports, games, or hobbies, and non-credit courses can qualify for the Lifetime Learning credit, if they are taken to acquire or improve job skills. [Reg. §1.25A-2(d)(5)]

   e. There is no degree seeking requirement or number of credits required.

   f. Fees attributable to "advanced placement" courses or courses that are otherwise allowed to later apply toward college credit are not deductible if they are taught in the high school. College courses taken while attending high school may qualify only if the student meets the qualifications for claiming the credit and enrollment for the courses are at an "accredited post-secondary educational institution."

8. Only one credit is available in the same year for the expenses of any one student.

9. Source of the funds used to pay education expenses do not matter -- savings, gift, or loan.

10. No credit can be claimed for any amounts covered by educational assistance that is excludable from gross income, such as employer-provided educational assistance, tax-free scholarships and fellowships, excludable interest from higher education savings bonds, and excludable distributions from education IRAs.

11. Payments of qualified tuition and fees by a third person are treated as payments made by the student. The expenses that are deemed paid by the student are also treated as paid by the taxpayer who claims the student as a dependent. [Reg. 1.25A-5(a)] The expenses that are deemed paid by the student are treated as paid by the taxpayer who claims the student as a dependent for purposes of claiming the higher education tax credit on that taxpayer's return. [Reg. 1.25A-5(b)] This allows a custodial parent claiming the personal exemption for a child to take the higher education credit when the noncustodial parent pays the tuition directly to the child's college.

    a. Example: Michael, a divorced non-custodial parent, pays tuition directly to his child's college. Michael's ex-wife is eligible to claim the child as a dependent on her return. The child is treated as having paid the tuition, and the custodial parent may be treated as having paid those expenses, and thus qualify for the higher education credit.

12. If a taxpayer is eligible to claim a student as a dependent, but does not, the student may claim the higher education credit on his or her own return. [Reg. 1.25A-1(g)] If the parent's income is high enough where the child's personal exemption is being phased out or the education credit has phased out, it may be worthwhile for the parent not to claim the exemption to allow the child to claim the higher education credit. The tax savings on the child's return from the credit may more than offset the loss of the personal exemption on the parent's return. [Also see IRS Legal Memorandum 200236001]

13. The regs also tell how to handle refunds of tuition for which the higher education credits have been claimed. [Reg. 1.25A-5(f)]

    a. If the payment and refund take place in the same tax year, the qualifying expenses for that year are figured by adding all expenses paid for in the tax year, and subtracting any refund received from the school during the same year.

    b. If a refund of expenses paid in the preceding tax year is received before the return is filed for that year, the amount of expenses for the earlier year is reduced by the refunded amount.

    c. If a tuition refund is received after the return for that year is filed, the tax for the year of receipt is increased by a recapture amount. That amount is the difference between the credit claimed in the earlier year and the redetermined credit, figured by reducing the expenses for which a credit was claimed in the earlier year by the amount refunded, and then computing the credit using the redetermined amount of expenses and the relevant facts and circumstances of that earlier tax year, such as modified AGI.

    d. If tax-free education assistance is received for an earlier year, the assistance received is treated in the same way as a tuition refund would be.

    e. Comment -- Often, the amount spent on qualified tuition and related expenses will far exceed the amount that is used to compute the higher education tax credit. Where this is the case, a tuition refund will not reduce the credit that may be claimed.

14. Education Credit Developments

    a. Prepaid tuition is normally creditable in the year paid. Neither the American Opportunity Tax Credit nor the lifetime learning credit can be claimed in the year for which the tuition applies. [Patel, TC Summ. Op. 2006-40]

        1) The same rules apply for the $3,000 and $4,000 tuition deduction claimed for AGI.

    b. In an information letter addressed to Senator Richard Lugar, the IRS noted that amounts paid to enable children to participate in a high school choir would not qualify for the Sec. 25A American Opportunity Tax Credit or lifetime learning credit. These credits are available only for tuition and related expenses at a college, university, or other postsecondary education institution. [INFO 2006-0064]

        1) A Coverdell education savings account can be used to pay tuition, fees, etc. incurred to enroll a child in or attend an elementary or secondary school.

C. Qualified Tuition Programs

1. Code Sec. 529 provides that a qualified tuition program is exempt from all federal income taxation, except that imposed by Code Sec. 511, which relates to the tax on the unrelated business income of a charitable organization.

2. The term "qualified tuition program" is generally defined as a program established and maintained by a State or agency or instrumentality thereof under which a person (1) may purchase, in cash, tuition credits or certificates on behalf of a "designated beneficiary" which entitle the beneficiary to the waiver or payment of "qualified higher education expenses" of the beneficiary, or (2) may make cash contributions to an account established solely for meeting the qualified higher education expenses of the designated beneficiary of that account.

3. The term "qualified higher education expenses" means the tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution.

   a. A 10% penalty will apply if a qualified tuition program withdrawal is not used to pay qualified higher education expenses for a reason other than the death or disability of the designated beneficiary or to the extent that the distribution exceeds amounts not covered by scholarships.

      1) The penalty does not apply to any payment or distribution before 2004 that is includible in gross income but used for qualified higher education expenses of the designated beneficiary.

   b. Distributions from qualified tuition programs, including both in-kind distributions such as a waiver of tuition and cash distributions, are excludable from gross income to the extent that the distribution is used to pay for qualified higher education expenses for tax year beginning after 2001.

      1) The exclusion from gross income is extended to qualified tuition programs established and maintained by an entity other than a state for distributions made in tax years beginning after 2003.

   c. The 10 percent additional tax will not apply to the portion of the distribution from a Coverdell education savings account and qualified tuition programs that are used to pay qualified higher education expenses, but for which the taxpayer elects to claim the education credits under Code Sec. 25A.

      1) Example. Marilyn Smart establishes a 529 plan for her daughter, Susan. A $7,000 distribution is made from the account during the year. Qualified education expenses for the year are $7,000, $4,000 of which is used to claim the American Opportunity Tax Credit. Qualified education expenses of $7,000 are reduced by $4,000. Thus, aggregate distributions of $7,000 exceed qualified education expenses of $3,000 by $4,000. Although $4,000 of the distribution will be included in income, the 10-percent additional tax will not be imposed.

   d. Under the coordination rules, qualified expenses are first reduced for scholarships or fellowships grants excludable from gross income and any other tax-free education benefits. Expenses are then reduced for amounts taken into account in determining the education credits. Where a student receives distributions from both an education IRA and a qualified tuition program that together exceeds these reduced expenses, the expenses must be allocated between the distributions.

e. The transfer of credits or other amounts from one qualified tuition program for the benefit of a designated beneficiary to another qualified tuition program for the benefit of the same beneficiary is not considered a distribution.

   1) The rollover treatment does not apply to more than one transfer within any 12-month period with respect to the same beneficiary.

f. Contributors are permitted to change their selection once a year or when beneficiary designations are changed. [Notice 2001-55, 2001-39 IRB 299]

g. The definition of family is extended to include first cousins of the original beneficiary for purposes of tax-free rollovers and changes of designated beneficiaries.

h. The dollar amount limitation on room and board distribution is removed. The new definition of room and board costs is the same definition of room and board costs used to calculate a student's cost of attendance for federal financial aid programs under 20 U.S. C. §108711:

   1) For students living at home with parents -- an amount determined by the institution;

   2) For students residing in housing owned or operated by the school -- as a standard allowance based on the amount most of the school's residents are normally charged for room and board; and

   3) For all other students -- as the amount of expenses reasonably incurred by the student for room and board.

   4) For qualified tuition distributions to students residing in housing owed and operated by an eligible educational institution -- if the actual room and board expenses charged by an eligible institution exceed that allowed under 20 U.S.C §80711, the allowance is the actual amount charged to the student by the institution for room and board.

i. The definition of qualified higher education expenses is expanded to include expenses of a special needs beneficiary that are necessary in connection with the beneficiary's enrollment or attendance at an eligible institution.

4. No amount is includible in the gross income of a beneficiary of, or contributor to, a qualified State tuition program with respect to any distribution or earnings under such program, except that:

   a. Amounts distributed for educational benefits provided to a beneficiary will be included in the beneficiary's gross income under the annuity rules of Code Sec. 72 to the extent that such amount, or the value of the education benefits, exceeds the contributions made on behalf of the beneficiary, and

   b. Amounts distributed to a contributor will be included in the contributor's gross income to the extent that such amounts exceed the contributions made by that person (subject to 10% penalty).

      1) Parents do not lose control of money meant to be used for college. There is no risk the child can use the money for some other purpose.

   c. Undergraduate and graduate school costs are eligible.

5. Most state-run savings plans are open to any U.S. resident, and all allow you to use your money to pay expenses at any accredited college in the U.S.

6. With 529 plans, the account owner contributing more than the $13,000 annual exclusion amount in one year can consider the contribution made ratably over a five-year period.

7. The amount held in the Sec. 529 plan is not included in the grantor's estate.

8. Utah offers three investment choices in addition to a state run investment pool that invests in fixed-income securities: (1) a standard age-based portfolio that is invested 75% in stocks and 25% in bonds by the time the beneficiary reaches age 7; (2) a more-aggressive plan that does not reach that mix until age 16; and a 100% equity portfolio. All three invest in Vanguard funds.

9. The definition of a qualified tuition program has been expanded to include private institutions after 2003.

10. http://www.savingforcollege.com

D. Coverdell Education Savings Accounts

1. The 1997 Act creates a new tax favored education individual retirement account to help taxpayers save for education expenses.

    a. These accounts were formerly known as Education IRAs.

2. The maximum annual contribution to an Education Savings Account is increased to $2,000 from $500 after 2001.

3. The modified adjusted gross income amounts used to determine the contribution limit phase-out range for married taxpayer filing jointly are increased to twice the amounts applicable for single filers after 2001.

    a. The contribution limit is phased out for joint filers with modified adjusted gross income amounts at or above $190,000 and less than $220,000.

    b. Contributions made by entities, such as corporations or tax-exempt organizations are not subject to the phase-out rules.

4. Earnings on contributions will be distributed tax free provided that they are used to pay the beneficiary's qualified education expenses.

5. Distributions of income are included in income and subject to a 10% penalty to the extent they exceed higher education expenses.

6. No contributions allowed after the beneficiary reaches age 18.

7. Earnings not used for education purposes are subject to tax when the beneficiary reaches age 30.

    a. The balance remaining in an education IRA must be distributed within 30 days after a beneficiary reaches age 30.

        1) Education IRAs may be rolled over tax free to another beneficiary.

            a) Family members include sons, daughters, brothers, sisters, nephews, nieces, certain in-laws, and the spouses of those relations.

    b. Education IRA balances must be distributed within 30 days after the death of a beneficiary.

        1) The earnings portion of the distribution is includible in the beneficiary's gross income.

        2) The education IRA should designate another child as a beneficiary in case of death.

8. After 2001 the accounts may be used for elementary and secondary education.

    a. The school may be either a public, private, or religious school.

    b. Qualified elementary and secondary education expenses include:

        1) Academic tutoring;

        2) The purchase of computer technology or equipment or Internet access or related services; and

        3) Expenses for room and board, uniforms, transportation, and supplementary items and services, such as extended day programs, as required or provided by the school.

9. The definition of room and board is the same as qualified tuition programs.

10. Contributions to a qualified tuition program under Code Sec. 529(b) are qualified education expenses that can be paid from an Education Savings Account.

11. After 2001 contributions to an Education Savings Account can continue past the date when a special needs beneficiary reaches age 18. Similarly, the 30-year age limit used to determine when the remaining balances in an Education Savings Account must be distributed and if rollover contributions can be received and beneficiaries changed can be waived for a beneficiary with special needs.

12. The time for making contributions to an Education Savings Account is extended to the original due date of the tax return for tax years after 2001.

13. The 10% penalty tax, as well as the 6% excise tax on excess contributions, will not be imposed on certain distributions of excess contributions that are made by May 30th following the tax year of the contribution.

    a. The distribution must be accompanied by the net earnings on the excess contribution.

14. After 2001 a beneficiary is no longer required to waive the tax-free treatment for distributions from an Education Savings Account in order for the education credits to be claimed in the same tax year.

    a. The taxpayer must elect not to claim the education credits for qualified tuition and related expenses paid during the tax year.

15. The 6% excise tax is repealed for contributions made during the same tax year to both a beneficiary's education Savings Account and a qualified tuition plan.

16. Under the coordination rules, qualified expenses are first reduced for scholarships or fellowship grants excludable from gross income and any other tax-free educational benefits. Expenses are then reduced for amounts taken into account in determining the education credit. When a student receives distributions from both an education IRA and a qualified tuition program that together exceed these remaining expenses, the expenses, must be allocated between the distributions.

E. Educational Savings Bonds

1. Exclusion for interest on U.S. savings bonds used for higher education: 2012 phase-out ranges from $109,250 to $139,250 for married filing jointly and surviving spouses; $72,850 to $87,850 for all others. [Rev. Proc. 2011-52]

F. Exclusion for Employer-Provided Educational Assistance

1. The $5,250 exclusion has been made permanent. [2001 Tax Act]

2. The exclusion applies to graduate courses after 2001. [2001 Tax Act]

3. The exclusion includes payments for tuition, fees, books, supplies, and equipment but does not include payments for meals, lodging, or transportation.

4. Employer reimbursement or payment for education related to employment is excludable as a working condition fringe under Sec. 132(a)(3).

5. Section 127 programs cannot discriminate in favor of highly compensated employees or their dependents.

    a. Programs cannot provide more than 5% of the benefits to employees who are more-than-5% shareholders, more than 5% owners, or dependents of such shareholders or owners. [Sec. 127(b)(2) and (3)]

G. Special Scholarship Programs

1. Amounts received by degree candidates at qualified educational organizations from the National Health Services Corps Scholarship Program or the Armed Forces Scholarship Program for tuition, fees, books, supplies, and equipment required in the student's course of instruction are excluded from the recipient's gross income.

2. Although there is a future service obligation connected to these qualified scholarships, tax-free treatment is permitted for amounts received in tax years after 2001.

3. Tax-free treatment does not apply to amounts received that are intended to cover regular living expenses, such as room and board.

H. Deduction for Higher Education Expenses

1. A new above-the-line deduction for qualified tuition and related expenses is available to individual taxpayers after 2001 and before 2013.

   a. For 2002 and 2003, the deduction was limited to $3,000 and is only available to taxpayers with adjusted gross income not exceeding $65,000; $130,000 for joint filers.

   b. For 2004-2012, the maximum amount deductible increased to $4,000.

      1) Taxpayers whose income exceeds that limit but does not exceed $80,000 ($160,000 for joint filers) may deduct up to $2,000 in qualified expenses.

   c. Married individuals filing separately are not allowed to take the deduction.

   d. A taxpayer that is a nonresident alien for any part of the tax year is allowed to take the deduction only if the taxpayer is treated as a resident alien.

   e. A deduction is allowed for tuition and related fees required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or any dependent for a year when the taxpayer is entitled to deduct a dependency exemption. The expenditures must be at an eligible educational institution for courses of instruction.

   f. Adjusted gross income is determined without regard to the exclusions from income for foreign earned income and foreign housing costs and income of residents of Guam, American Samoa, the Northern Mariana Island, and Puerto Rico. However, taxable social security benefits, the exclusion for certain savings bond interest used to pay higher education expenses, the exclusion for employer-provided adoption assistance, the deduction for retirement savings and student loan interest payments, and the disallowance of passive activity losses are taken into account in calculating adjusted gross income.

   g. Taxpayers cannot use their education expenses to claim a double benefit. If an expense is deductible under any other provision, it is not deductible under the Higher Education Expense Deduction.

      1) If the taxpayer or any other person takes a American Opportunity Tax Credit or Lifetime Learning Credit with respect to a student, the qualified tuition and related expenses of that student for the year are not deductible.

      2) A taxpayer must reduce the total amount of qualified tuition and related expenses by the amount excluded for (1) distributions from a qualified tuition plan, (2) distributions from an education IRA, or (3) interest on U.S. Savings bonds used to pay for higher education. The amount excluded does not include the portion of such a distribution that represents a return of contribution to the plan.

   h. An individual who can be claimed as a dependent by another taxpayer cannot take a deduction for qualified tuition and related expenses.

   i. The name and taxpayer identification number of the student for whom qualified tuition and related expenses were paid must be included on the taxpayer's return.

   j. The definition of qualified tuition and related expenses is the same as is used for purposes of the American Opportunity Tax Credit and Lifetime Learning Credits.

k. Example. Married couple with $75,000 AGI. $3,000 in education expenses.
$3,000 x 25% = $750 benefit from deduction
$3,000 x 20% = $600 benefit from credit

l. The deduction is allowed for expenses paid during a tax year, in connection with enrollment during the year or in connection with an academic term beginning during the year or the first three months of the following year.

m. The deduction for higher education expenses applies to payments made in tax years after 2001.

I. Deduction for Student Loan Interest

1. Beginning in 1998, individuals were allowed to deduct interest paid during the tax year on any qualified education loan. The deduction is taken from gross income.

   a. The maximum deductible amount of interest rose to $2,500 after 2000.

2. A qualified education loan is any debt incurred to pay the qualified higher education expenses of the taxpayer, the taxpayer's spouse, or any individuals who were the taxpayer's dependent at the time the debt was incurred.

   a. The expenses must be attributable to a period during which the student was attending an eligible educational institutional at least half-time.

   b. Includes interest on loans used not only for tuition and fees but also on room and board.

   c. The debt must be incurred by the taxpayer solely to pay higher education expenses.

      1) A loan does not have to be made or guaranteed under a federal education loan program to be a qualified education loan. [Reg. 1.221-1(f)(3)(iv)]

      2) Revolving lines of credit generally are not qualified education loans, unless the borrower uses the line of credit only to pay qualified higher education expenses.

      3) Example: A loan is not a qualified education loan where part of the proceeds is used to pay for improvements to a residence and part is used to pay qualified higher education expenses.

   d. Regulations provide that loans made under any employer plan or borrowed from a related party are not qualified education loans. [Reg. 1.221-1(e)(3)(iii)]

      1) Example: Elaine's grandmother loans her $15,000 at 9% interest towards her college expenses. When Elaine begins to pay interest on the loan, it will not be deductible because the loan was from a relative.

3. Qualified higher education expenses generally include the costs of tuition, fees, room and board, and related expenses such as books and supplies. However, such expenses must be reduced by the amount excludable from income such as (1) employer-provided educational assistance; (2) amounts received from U.S. savings bonds where the bonds are used to pay higher education costs; (3) amounts distributed from education individual retirement accounts; and (4) qualified scholarships, educational assistance allowances, and other excludable payments for education expenses that do not constitute a gift or inheritance.

4. The tuition expenses must be incurred within a reasonable period of time before or after the debt is incurred in order for a loan to be a qualified education loan. Usually this determination will be made on a facts and circumstances basis, but the proposed regs provide some certainty in this area. Loan proceeds are treated as used for qualified education expenses within a reasonable time if:
   a. The loan is part of a federal post-secondary education loan program, or
   b. The qualified higher education expenses relate to a particular academic period, and the loan proceeds are disbursed during the period that begins 60 days before the start of that academic period and ends 60 days after it ends. [Reg. 1.221-1(f)(3)(ii)]

5. The regs do not require a borrower to trace the proceeds of an education loan to the payment of tuition expenses.

   a. Example: The Simpsons pay their son's tuition from their savings, and later deposit the proceeds of an education loan back into their savings account. The mere fact that the loan proceeds were not used directly to pay tuition will not render the interest paid on the loan nondeductible.

6. Loan origination fees on higher education loans, but not fees for services, are deductible as education loan interest. So is capitalized interest--interest that accrues before repayment begins and is added to the loan principal. A loan repayment is considered first to be an interest payment to the extent of accrued but unpaid interest, next as repayment of loan original fees or capitalized interest until those amounts are fully paid, and, finally, as principal payments. [Reg. 1.221-1(h)(2)]

   a. Example: Morgan's education loan accrues while he is in school, but he does not have to make any loan payments until after graduation, at which time all the accrued interest will be added to the loan principal. Morgan may include as interest, all principal payments that are treated as payments of capitalized interest.

7. The amount of interest deduction is phased out for taxpayers at moderate income levels.

   a. The interest deduction phases out for single taxpayers between $50,000 and $65,000 of modified adjusted gross income and between $100,000 and $130,000 for joint filers. Married taxpayers who file separate returns are ineligible for the deduction.

      1) The income levels are <u>not</u> indexed for inflation.

   b. Taxpayers considered married for tax purposes must file a joint return to qualify for the interest deduction.

8. The deduction is not allowed for any year which the taxpayer is a dependent on another person's tax return.

9. There is no requirement as to when the loan was incurred, but only interest paid after 1997 is eligible for the above-the-line deduction.

10. The student loan interest may be deducted only by a taxpayer who is legally obligated to pay the interest.

    a. Voluntary payments of interest are deductible after 2001.

11. Certain third party payments of interest are treated as first paid to the taxpayer and then paid by the taxpayer to the lender. [Reg. 1.221-1(b)(4)(I)]

Chapter 6 - Gains & Losses

A. Basis [Code Secs. 1011-1023]

1. Generally basis is determined by the cost of the property [Code Sec. 1012]

2. Basis of an asset received for services is the FMV of the asset

3. Basis of property acquired by inheritance is estate tax value (on the date of death or alternate valuation date) [Code Sec. 1014]

4. Basis of property acquired by gift [Code Sec. 1015]

    a. Where value of property at least equals donor's basis at time of gift, donee's basis is donor's basis, plus all or part of gift tax

        1) Gift tax adjustment for property received after 1976 is amount of gift tax that bears the same ratio to the amount of the gift tax paid as the net appreciation in the gift bears to the amount of the gift (but no more than the gift tax paid)

    b. Where value of property on date of the gift is less than the donor's basis, then donor's basis is used for figuring gain on a transfer by the donee; fair market value of the property is used for figuring loss on the transfer by the donee

5. The Tax Court has upheld the principal that a taxpayer who did not prove his basis or holding period in stock he sold had a zero basis and short-term capital gain on the sale of the stock. [Lenihan, TC Memo 2006-259]

B. Holding period [Code Sec. 1222]

1. Holding period for long-term capital gain or loss: more than one year

2. Holding period for short-term capital gain or loss: one year or less

3. Property acquired by inheritance: automatic long-term holding period

4. Property acquired by gift:

    a. Donee adds donor's holding period

    b. However, the holding period begins at the date of the gift if the FMV is less than the basis at the time of the gift and the asset is sold at a loss

5. Include the holding period of previous asset or owner when there is a substituted basis (transaction that established basis of property)

C. Dividend Income of Individuals Taxed at Capital Gains Rates

1. The top federal tax rate for dividends received by an individual is reduced by the new law to 15 percent (5 percent for those whose incomes fall in the 10- or 15-percent rate brackets). These are the same rates applicable to capital gains. The reduced rates apply to eligible dividends received from January 1, 2003, through December 31, 2012. [Sec. 1(h)(11)]

    a. Form 1099-DIV was revised to include a new box for qualified dividends.

2. Interest earned on savings accounts, certificates of deposits, and government bonds is still subject to federal income tax at ordinary tax rates. The new low tax rates apply only to stock dividends. Investments in tax-deferred retirement vehicles such as regular IRAs, 401(k)s and deferred annuities receive no benefit from the rate reduction. Distributions from these accounts will be taxed at ordinary income tax rates even if the funds represent dividends paid on stocks held in the account.

3. Corporate dividends passed through to investors by a mutual fund or other regulated investment company, partnership, real estate investment trust, or held by a common trust fund are eligible for the reduced rate assuming the distribution would otherwise be classified as qualified dividend income.

4. Payments on hybrid preferred stock are technically not dividends and are ineligible for the reduced dividend rate. The preferred stock is actually reported as debt by the corporation issuer and pays interest that is deducted by the corporation.

5. Proceeds from a disposition of stock received as a nontaxable stock dividend, other than a redemption, may be eligible for the reduced dividend tax rate. [Sec. 306(a)(1)(D)]

   a. The dividend rate will apply to the extent that proceeds from a preferred stock bailout is viewed as a dividend substitute.

6. The new rate applies to tax years beginning after December 31, 2002.

7. Qualified Dividends [Notice 2003-71, 2003-43 IRB 922]

   a. Dividends paid to an individual shareholder from either a domestic corporation or a "qualified foreign corporation."

   b. Qualified foreign corporation includes:

      1) Certain foreign corporations that are eligible for benefits of a comprehensive income tax treaty with the United States [Sec. 1(h)(11)(C)(I)];

      2) Incorporated in a possession of the United States; or

      3) A foreign corporation qualifies if the stock is readily tradable on an established securities market in the United States. [Sec. 1(h)(11)(C)(ii)]

         a) An American depository receipt in respect of such stock qualifies.

   c. Foreign corporations not qualifying:

      1) Foreign personal holding company under Sec. 552;
      2) Foreign investment company under Sec. 1246(b); or
      3) Passive foreign investment company under Sec. 1297.

   d. Treasury and the IRS are continuing to consider, for future years, the treatment of dividends with respect to stock listed only in a manner that does not meet this definition, such as on the OTC Bulletin Board or on the electronic pink sheets.

   e. Any foreign tax credit allowed, with respect to dividends eligible for the reduced tax rates, will be scaled back under rules similar to those imposed by Sec. 904(b)(2)(B) (relating to certain capital gains). [Sec. 1(h)(11)(C)(iv)]

8. Dividends paid by a real estate investment trust (REIT) are not generally eligible for the reduced dividend rate. These sums largely represent rents and other income that are passed through to shareholders as dividends deductible to the REIT, rather than corporate earnings subject to the corporate income tax.

    a. REIT distributions will qualify for the reduced dividend rate to the extent they represent qualified corporate dividends.

9. Investment in tax-deferred retirement vehicles such as regular IRAs, 401(k)s, and deferred annuities receive no benefit from the rate reduction. Distributions from these accounts will be taxed as ordinary income tax rates even if the funds represent dividends paid on stocks held in the account.

    a. It probably makes sense to hold taxable bonds, certificates of deposit, and other instruments producing ordinary income within retirement accounts. Since dividends on most REITs do not qualify for special dividend treatment, they may also be held in tax-deferred accounts. Hold stocks, specially dividend-paying stock and stock mutual funds, in personal investment portfolios.

10. Short-sellers borrow shares to trade and "makes payments in lieu of dividends" to owners of the borrowed shares. These payments are not actually dividends and they do not qualify for the 15% rate. These shares are often borrowed through brokers from margin accounts without the owner knowing it.

    a. The IRS will not enforce this new rule in 2003 unless people know they are lending shares to short sellers. But the rules will be enforced for all in 2004.

11. To qualify for dividend treatment, the taxpayer must own the stock for at least 60 days during the 120-day period before and after the ex-dividend date.

12. If an individual receives a dividend that exceeds 10% of the shareholder's basis in the stock, then any loss on the sale of the stock to the extent of the dividends will be treated as a long-term capital loss. [Sec.1(h)(11)(D)(ii)]

13. If dividends are taxed at capital gains rates, then such income generally is not treated as investment income in computing the investment interest deduction limit.

    a. A taxpayer may choose to have the dividend income included in investment income by not applying the capital gains rates to such income.

    b. The election is required to be made on or before the due date of the tax return for the tax year in which the net capital gains or dividends are recognized.

c. Example: $40,000 Investment Interest Expense and $65,000 LTCG and Dividend Income; convert $40,000 to ordinary income.

$40,000	$40,000 Ordinary Income	
x 15%	-40,000 Investment Interest	
$ 6,000	$ -0-	Save $6,000 in taxes

Expect $5,000 investment income each of next several years; 35% tax rate.

Savings	1	2	3	4
$750	$1,750			
$750		$1,750		
$750			$1,750	
$750				$1,750

14. Dividends are taxed at capital gains rates but may not be used to offset capital losses.

15. The special tax rates for long-term capital gains and dividend income applies for both regular income tax purposes and for the alternative minimum tax.

D. 100% Basis Step-Up for Pre-1977 Joint Tenancy

1. Husband and wife jointly purchased property in 1952; wife in 1989 inherited property from husband; she could step up entire basis in property since property was pre-1977 property. [*Patten*, CA-4, 97-1 USTC ¶60,279]

   a. The IRS has also lost similar cases in the Tax Court [*Hahn*, 110 TC 140 (1998)] and in the Sixth Circuit. [*Gallenstein*, CA-6, 92-2 USTC ¶60,114]

   b. The Service will no longer litigate that Section 2040(b)(1) applies to joint interests created before January 1, 1977, where the deceased joint tenant died after December 31, 1981. [CC-2001-08; Oct. 15, 2001]

2. Example. A jointly owned vacation home that was originally acquired by a couple for $50,000 is worth $200,000 when one spouse dies.

   If the house was purchased after 1976, the surviving spouse's basis in the house becomes $125,000--an original basis of $25,000 for the spouse's own half interest, plus stepped-up basis of $100,000 for the inherited half interest. Thus, a sale of the house for $200,000 will produce a $75,000 taxable gain.

   If the house was purchased before 1977, the surviving spouse obtains a stepped up basis of $200,000 for the entire interest in the house. If the property is sold for $200,000, no taxable gain results.

E. Capital Gains and Losses

1. Maximum Capital Gains Rates after May 5 2003

   a. After May 5, 2003, long-term capital gains are taxed at a 15% maximum tax rate.

   b. The rate is 5% for individuals in the 10 and 15 percent tax brackets (0% for 2008 through 2012).

      1) Example: George, a single taxpayer has only $10,000 of wages and a $2,500 long-term capital gain. Since his total income is within the 10% and 15% brackets, the $10,000 will be taxed at 10% and 15% and the long-term capital gain will be taxed at 0%.

   c. Assets held one year or less are considered to be held short-term and subject to ordinary income tax rates.

2. The capital gains rates apply to both the regular income tax and the Alternative Minimum Tax.

   a. Prior to 1997, there was no special tax rate applicable to long-term capital gains for purposes of the Alternative Minimum Tax.

   b. Capital gains are not a preference or adjustment for alternative minimum tax purposes.

3. When a short sale is closed out at a loss, the transaction is completed on the delivery date. If the short sale is closed at a gain, the transaction is closed when the stock is purchased. [Rev. Rul. 2002-44, 2002-28 IRB 84]

   a. Example. Taxpayer sells short 100 shares of stock during the year. On December 31, Year 1, the taxpayer purchases 100 shares and delivers the stock on January 4, Year 2, to close out the stock position. If the transaction results in a loss, the transaction is completed on January 4, Year 2. If the transaction results in a gain, the transaction is completed on December 31, Year 1.

4. Inherited property disposed of within one year of the decedent's death will be considered to have been held for more than one year. [Sec. 1223(11)]

   a. Example: Mary purchases a piece of land on February 1, 2012, for $80,000. She dies on April 2, 2012, when the land was worth $95,000. Joan receives the land as an inheritance on May 5, 2012. Joan sells the land for $100,000 on June 1, 2012. Joan would have a $5,000 long-term capital gain taxed at a maximum rate of 15%.

5. Gains on the sale of collectibles held more than one year and Section 1202 gains from small business stock under Section 1202 are subject to a maximum 28 percent tax rate.

   a. Remember, however, that 50 percent of Section 1202 gains are excludable from income; thus, the effective tax rate on Section 1202 stock is 14 percent.

b. Collectibles: works of art, rugs, antiques, metals, gems, stamps, coins, and alcoholic beverages.

1) U.S. minted gold and silver coins acquired after 1986, and any coin issued under the laws of any state acquired after November 10, 1988, are not collectibles.

2) Certain platinum coins and certain gold, silver, or platinum or palladium bullion is permitted after 1997.

6. Unrecaptured Section 1250 Gain

a. Unrecaptured Section 1250 gain is subject to a maximum 25% tax rate.

1) Unrecaptured Section 1250 gain is the amount of long-term capital gain (not otherwise treated as ordinary income) that would be treated as ordinary income if the asset had been a Section 1245 asset.

2) For Section 1250 property sold after July 28, 1997, only gain on property held long-term qualifies for the 25 percent rate.

3) Unrecaptured Section 1250 Gain Example: Taxpayer purchases a building for $390,000. After taking $50,000 in depreciation, taxpayer sells the building for $490,000 in December. Since the building was depreciated using the straight-line method, there would be no depreciation recapture taxed at ordinary income rates. Taxpayer would have $50,000 "Unrecaptured Section 1250 Gain" taxed at 25%. Taxpayer would have $100,000 gain taxed at 15%.

4) The imposition of a 25% capital gain rate applicable to prior depreciation on buildings has not negated the existing IRC §1250 ordinary income recapture rules. Accordingly, sales of certain pre-1987 buildings may still give rise to an ordinary income element if accelerated depreciation was applied to those buildings when placed in service.

5) Unrecaptured Section 1250 gain for any tax year will not exceed the net Section 1231 gain for that tax year. [Code Sec. 1(h)(7)(B)]

a) Example: Taxpayer purchases building for $390,000 and takes $50,000 in depreciation. Sells asset for $400,000. Sells another Section 1231 asset at a $25,000 loss. $35,000 Net Section 1231 Gain. $35,000 Unrecaptured Section 1231 Gain

6) Any capital gain dividends distributed by a real estate investment trust (REIT) will be subject to the 25% rate.

7) A partnership interest is treated as a capital asset. Gain or loss is capital gain or loss, except as provided in Sec. 751 (unrealized receivables and appreciated inventory).

a) Gain is allocated to collectives and unrecaptured Sec. 1250 property using the principles of Sec. 751.

b) The Sec. 751 principles apply to collectibles and unrecaptured Sec. 1250 property.

8) Gain from the sale of S corporation stock held more than one year generally results in long-term capital gain taxed at 15%.

9) When a taxpayer sells or exchanges an interest in a partnership, S corporation, or a trust that holds collectibles, the gain attributable to unrealized appreciation must be treated as gain taxed at 28%. [TD 8902; Reg. 1.1(h)-1

10) A partner who sells or exchanges a partnership interest must notify the partnership within 30 days of the transfer. The partnership must file Form 8308 with the IRS for the calendar year in which the transfer took place.

11) If a partnership is passing a Section 1231 gain through to the partners, a copy of the partnership Form 4797 should be included with the K-1 to the partnership (Form 1065, Form K, Line 6).

b. Installment Sales

1) The IRS has issued final regulations holding that a taxpayer is required to take any 25% gain into account before the 15% (or 5%) rate gain on any installment sale. The regulations apply to installment payments properly taken into account after August 23, 1999. [Reg. 1.453-12, TD 8836, 1999-37 IRB 411]

   a) Example: In August 2003, the taxpayer sold real property for $50,000 to be paid in 5 equal annual installments. The basis was $25,000, reduced by $15,000 straight-line depreciation. Thus, the gain on each $10,000 installment payment is $8,000. Of the $8,000 gain, the full $8,000 will be 25% Section 1250 gain in 2003. In 2004, $7,000 of the gain will be taxed at 25% and $3,000 at 15%. Thereafter in 2005, 2006, and 2007, all gain will be taxed at 15%.

2) In the case of installment sales originating before May 7, 1997, the regulations make the favorable assumption that any gain reported prior to May 7, 1997, is considered as if the 25% gain had been taken into account before the 20% gain. [Reg. 1.453-12(b)]

   a) Example: Assume from the previous example that the sale took place in 1995. The gain taxed at 25% will be considered to have been covered by the 1996 and 1997 reported gains.

3) If the amount of unrecaptured Section 1250 gain in an installment payment that is properly taken into account after May 6, 1997, and on or before August 23, 1999, is less than the amount that would have been taken into account under these rules, the lesser amount is used to determine the amount of unrecaptured Section 1250 gain that remains to be taken into account. [Reg. 1.453-12(c)

   a) Example: Assume the sale took place early in 1999 and the taxpayer pro rated the $8,000 gain in 1999 between $5,000 at the 25% rate and $3,000 at the 20% rate. The remaining $10,000 of the 25% gain must be reported first before the 20% gain in 2000. Thus, the entire $8,000 gain in 2000 would be reported at the 25% rate. The first $2,000 of gain in 2001 would be reported at the 25% rate.

c. On partially tax deferred exchanges boot is taxed first as ordinary income, second as Unrecaptured Section 1250 Gain at 25%, and finally at the 15% rate. Unrecaptured depreciation carries over to the replacement asset.

d. Recaptured Section 1231 Losses

1) IRC §1231(a) generally provides that, when gains from the sale or exchange of property used in a trade or business exceed losses from such property, the gains and losses are treated as a long-term capital gains and losses. Conversely, when Section 1231 losses exceed Section 1231 gains, the gains and losses are treated as ordinary.

2) The capital nature of a net Section 1231 gain is subject to an exception: a net Section 1231 gain is treated as ordinary to the extent of the taxpayer's non-recaptured net Section 1231 losses for the preceding five years. [IRC § 1231©]

3) The regulations provide that in a year in which any installment capital gain is characterized as ordinary income because of current or prior unrecaptured Section 1231 losses, the gain is treated as consisting of 25% gain first, before the 15% gain, for purposes of determining how much 25% gain remains to be taken into account in later installment payments. [Reg. 1.453-12(d)]

7. Capital Gains and Losses Netting [Notice 97-59; Ann 97-100]

a. Within each group, gains and losses are netted to arrive at a net gain or loss.

b. A net loss from the 28% group is used
1) To reduce gain from the 25% group
2) Then to reduce net gain from the 15% group

c. A net loss from the 15% group is used
1) To reduce net gains from the 28% group
2) Then to reduce gain from the 25% group

d. Short-term capital losses are applied
1) To reduce short-term capital gains
2) Then to reduce net long-term gains from the 28% group
3) Then to reduce gain from the 25% group
4) Finally to reduce net gain from the 15% group

e. Short-term capital gains are applied to reduce net losses from either the 15% or 28% groups.

8. Long-term gains and losses are netted before any netting with short-term gains and losses.

9. The individual's 28% group includes the amount of long-term capital loss carried over from an earlier year. [Code Sec. 1(h)(5)(A)]

a. Thus if an individual has an unused loss from the 15% category and an unused loss from the 28% category, both losses will be placed in the 28% category for the following year.

F. Capital Gains and Losses Developments

1. Sales by a widow of residential lots she had owned with her deceased husband were considered as sales in the ordinary course of business. The losses were deductible as ordinary losses. [*Handcock*, TC Memo 1999-336]

2. Short Sales

   a. Borrowing stock from one broker to satisfy a short sale obligation to another broker generally does not close the short sale. The short sale will not close until the taxpayer satisfies his or her obligation to the second broker. [Rev. Rul. 2004-15]

3. The IRS wants to put an end to the recent rumor that innocent investors holding shares in the likes of Enron and WorldCom might be able to take an ordinary theft loss for those stock losses. Losses as a result of misconduct by corporate executives are not theft losses under state law and therefore are not deductible theft losses for federal income tax purposes. [Notice 2004-27]

   a. Being "robbed" on a stock investment because of dishonest corporate employees or board members is not a theft loss under the tax law. Rather, it gives rise only to a deductible capital loss and then only when the stock is sold or becomes totally worthless.

   b. In cases involving stock purchased on the open market, courts have consistently disallowed theft loss deductions related to a decline in the value of the stock attributable to corporate officers' misrepresenting the financial condition of the corporation. [*Paine v. Comm.*, 523 F.2d 1053, CA-5 (1975); *MTS International Inc. v. Comm.*, 169 F.3d 1081, CA-6 (1999)]

4. Self-Created Musical Works

   a. Taxpayers are allowed to treat the sale or exchange of self-created musical compositions or copyrights as the sale or exchange of a capital asset.

5. Electing Capital Gain Treatment for Self-Created Musical Works [TD 9379]

   a. The IRS has issued a temporary regulation on the time and manner for making an election Sec. 1221(b)(3) to treat gain or loss from the sale or exchange of certain musical compositions or copyrights in musical works as gain or loss from the sale or exchange of a capital asset.

   b. The taxpayer must make a separate election for each musical composition or copyright in a musical work sold or exchanged during the tax year. The election is made on Schedule D of the appropriate tax form (e.g., Form 1040; Form 1065; Form 1120; or Form 1120S). The taxpayer must make the election on or before the due date (including extensions) of his or her return for the tax year of the sale or exchange. [Reg. 1.1221-3T(b)]

   c. An election to elect capital gains treatment is revocable with the IRS's consent. To request that consent, a taxpayer must submit a request for a letter ruling. Alternatively, an automatic 6-month extension from the due date of the taxpayer return (excluding extensions) will be granted to revoke an election if the taxpayer timely filed his return and, within the 6-month extension period, file an amended return that treats the sale or exchange as the sale or exchange of property that is not a capital asset. [Reg. 1.1221-3T©]

6. Final Regs Clarify Treatment of Loss from Abandoned Securities [TD 9386]

    a. The IRS has issued final regs that provide guidance on the availability and character of a loss deduction from abandoned securities under Sec. 165.

    b. If any security that is a capital asset becomes worthless during the tax year, the loss is treated as from the sale or exchange of a capital asset on the last day of the tax year.

        1) A number of practitioners had asserted that without a "sale or exchange" a taxpayer might be able to claim an ordinary loss for the abandoned securities.

7. Demutualized Insurance Companies

    a. A federal court has refuted IRS' claims that such stock has no basis. The court accepted the claim of policy owners that they have no gain on the stock until the proceeds from the sale exceed their basis in the policy. [Fisher, Ct. Fed. Cl.]

8. Selling Depreciable Assets to a Related Firm

    a. Gain on the sale is taxed as ordinary income. For this purpose, actual or constructive ownership of 50% or more of the buyer is sufficient to trigger ordinary-income treatment of the profit made by the seller. It does not matter if the buyer is a partnership, C corporation, or an S corporation.

        1) The IRS ruled that sales of oil and gas reserves are not affected by this rule, because depletion is claimed on those assets, not depreciation. The same rule also applied to other mineral deposits. [Ltr. Rul. 200602018]

9. Relocating Workers

    a. The IRS is limiting employer deductions of home-sale losses in cases where an outside relocation firms issued to assist with the sale. If title to the home passes to the employer or to the relocation company, the company must treat any loss on the sale as a capital loss. If the worker keeps title, the employer can write off the reimbursement to a relocation firm for the home's decline in value. [Rev. Rul. 2005-74]

        1) Any amounts paid by the employer constitute taxable compensation to the employee.

10. Day Traders Losses Are Capital Losses

    a. Taxpayer was a physician who also engaged in the day trading of securities, buying and selling securities on his own account on the same day or within a few days to profit from short-term fluctuations in the market price. After noting that taxpayer and the IRS had stipulated that taxpayer was a trader and not a dealer with regard to this activity, the Tax Court stated that the "courts have consistently held, in keeping with the definition of a capital asset under Sec. 112, that the character of gains or losses from a taxpayer's buying and selling securities on his own account is capital and not ordinary, even though the taxpayer may be engaged in a trade or business with regard to such trading activity." Therefore, taxpayer's losses were capital losses, not ordinary losses. [Shabrooz Jamie, TC Memo 2007-22]

        1) Doctor lost $2.5 million over three years.

11. Broker Settlement

    a. The IRS has determined that an amount received by an investor in settlement of a dispute over a brokerage account was taxable as long-term capital gain in the year of its receipt. [Ltr. Rul. 200724012]

    b. The taxpayers established a taxable investment account with a stockbroker. The taxpayer sustained a loss when the account was terminated and treated it as a long-term capital loss in Year 1, which carried forward to Year 3. In Year 3, the taxpayers signed a settlement agreement under which the stockbroker paid them a settlement amount.

    c. The IRS determined that the carryover of prior capital losses and the settlement paid in Year 3 were each integrally related and, under the tax benefit rule, should be treated as parts of the same transactions. Therefore, it ruled that the settlement was a long-term capital gain, not ordinary income.

12. Abandonment of Stock or Security

    a. Under newly issued proposed regulations, the abandonment of a security that is a capital asset is treated as a capital loss on the last day of the tax year. Taxpayers need not relinquish legal title to establish an abandonment, but must permanently surrender and relinquish all rights in the security and receive no consideration in exchange for the security in order to abandon the security. [Prop. Reg. 1.165-5(l)]

    b. Some taxpayers have argued that the abandonment of a security is not subject to the capital loss characterization rule.

13. Termination payments made by an insurance company to an insurance agent when he retired were taxed as ordinary income and not as long-term capital gain since there was so "sale or exchange" of a capital asset. [Trantina v. U.S. (CA-9, 1-9-08]

    a. The agreement obligated Trantina to perform certain services for which he was compensated through commission payments. Furthermore, Charles only became entitled to the termination payments after he complied with the conditions to return State Farm's property and to comply with a noncompete agreement.

    b. The IRS has been unanimously successful in determining that these State Farm termination payments are ordinary income.

    c. Given the new stiffer preparer penalties along with new "more likely than not" standard would a practitioner even sign off on a return that took this position.

G. Section 1202 Stock

1. Taxpayers may exclude 50 percent of the gain from the sale or exchange of qualified small business stock (QSB stock). The stock must have been issued after August 10, 1993, and held for more than 5 years.

2. Qualified small business stock must be that of a domestic C corporation with aggregate gross assets not exceeding $50 million.

3. The aggregate annual gain which a taxpayer may qualify under Section 1202 is limited to the greater of $10 million or 10 times the adjusted tax basis of qualified stock disposed of by the taxpayer during the year.

4. The corporation must have at least 80%, by value, of its assets used in the active conduct of a qualified business. A qualified business is any business other than the performance of personal services, banking, financing and leasing, any farming business, any extractive industry, and hospitality businesses such as hotels and restaurants.

5. Section 1202 stock qualifying for the 50% exclusion is taxed at the 28% rate.

6. An Alternative Minimum Tax (AMT) preference is equal to 7% of the excluded gain. Since this is an exclusion preference, there is no Minimum Tax Credit allowed.

7. Individuals are allowed to rollover capital gains from the sale of Section 1202 stock if other small business stock is purchased within 60 days after the date of sale.

    a. The small business stock being sold must have been held for more than six months and the sale must have taken place after August 5, 1997.

    b. The normal rules of nontaxable exchange apply to the gain being deferred, the basis of the small business stock acquired, and the holding period for the acquired stock.

    c. Qualified small business (QSB) stock held through passthrough entities qualifies for the rollover rules. [Rev. Proc. 98-48, 1998-38 IRB 7]

        1) A passthrough entity may make the election if the entity sells QSB stock held more than six months and purchases replacement QSB stock during the 60-day period beginning on the date of sale. The benefit of deferral will flow through to the taxpayers (other than C corporations) that held interests in the entity during the entire period in which the entity held the QSB stock.

        2) If a passthrough entity sells QSB stock held for more than six months, an individual who has held an interest in the entity during the entire period in which the entity held the QSB stock and who purchases replacement QSB stock during the 60-day period beginning on the date of the sale of the QSB stock may make the rollover election with respect to the individual's share of any gain on the sale that the entity does not defer under §1045.

    d. If a person has more than one sale of QSB stock in a tax year that qualifies for the rollover election, the person may make the rollover election for any one or more of those sales.

e. Report the entire gain from the sale of Qualified Small Business stock on Schedule D, writing "section 1045 rollover" directly below the line on which the gain is reported, and entering the gain deferred under §1045 on the same line as the gain, as a loss. [Rev. Proc. 98-48, 1998-38 IRB 7]

H. Rollover of Publicly Traded Stock into SSBIC (Sec. 1044)

1. Taxpayers may elect to defer the recognition of gain on the sale of publicly traded stock where the proceeds are invested within 60 days in any common stock or partnership interest in a specialized small business investment company

2. Taxpayers may elect to defer the recognition of gain on the sale of specialized small business stock where the proceeds are invested within 60 days in any common stock or partnership interest in a specialized small business investment company

3. Specialized small business investment company is any partnership or corporation which is licensed by the Small Business Administration

4. Publicly traded securities are those traded on an established securities market

5. Maximum yearly deferral is smaller of (1) $50,000 or (2) $500,000 reduced by previous gains deferred under Sec. 1044

I. Section 1244 Stock

1. Individual taxpayers are allowed ordinary loss deductions for losses from the sale or exchange, or from worthlessness of certain small business stock. The maximum deduction for any taxable year is limited to $50,000. On a joint return, the limit is $100,000 whether the stock is owned by one spouse or both spouses.

2. Eligibility rules for Sec. 1244 stock

a. The stock must be issued originally to an individual or a partnership.

b. The stock must be issued in exchange for money or other property.

c. The stock must not be convertible into other securities of the corporation.

d. The aggregate amount of money and other property received by the corporation for stock must not exceed $1,000,000 at the time of stock issuance.

e. For the 5 tax years ending before the date of the loss, more than 50% of the corporation's gross receipts must be from sources other than royalties, rents, dividends, interests, annuities, and sales or exchange of stock or securities.

3. Finalized amendment to Reg. §1.1244(e)-(1)(b) removes the requirement that an information statement be filed with a taxpayer's income tax return in order for the taxpayer to claim an ordinary loss with respect to Section 1244 stock.

a. Taxpayers must maintain sufficient records to establish their entitlement to the loss and their satisfaction of the other statutory requirements.

4. Developments

    a. An attorney who received stock in a computer software business in exchange for legal services was not allowed to claim an ordinary Sec. 1244 loss, because the stock was received in exchange for services rather than for money or property. [*Boyko*, TC Memo 1998-67]
    b. Individuals who invested in a corporation were limited to a capital loss rather than an ordinary Sec. 1244 loss because the corporation did not issue stock to them. [*Willis Starnes v U.S.*, N.D., Tx 99-1 USTC 50,132, 11-20-98]

J. Section 1031 Like-Kind Exchanges

1. Under Section 1031, real estate held for business or investment use may be exchanged for other real estate held for either business or investment use. However, inventory and other property held for resale is ineligible. The Tax Court found that a real estate developer was ineligible for Section 1031 treatment. The developer had exchanged various tracts of land, but the Tax Court found that the original intent was to develop the tracts for sale as houses, and there was not sufficient evidence of a later conversion to holding the property for investment purposes. [*Baker Enterprises*, TC Memo 1998-302]

2. The IRS has issued proposed regulations regarding the taxability of interest income earned on escrow accounts maintained in Section 1031 like-kind exchanges. [Prop. Reg. 1.468B; REG-209619-93, 2-1-99]

    a. In general, the proposed regulations treat the assets of a qualified escrow account or qualified trust established in connection with a Section 1031 exchange as owned by the party that transfers the exchanged property.

    b. However, if the transferor or the third party intermediary has all of the beneficial use and enjoyment of the escrow account, then the assets of the escrow or trust are treated as owned by the transferee or qualified intermediary, and the income earned on the assets is taxable to the transferee or qualified intermediary.

3. LLCs in Like-Kind Exchange

    a. An individual owns real estate that a local government will acquire through condemnation. He proposes to receive the condemnation proceeds tax free by reinvesting them in replacement real estate. But he wants to acquire the replacement property through two LLCs that he has formed to own and manage it. The IRS has ruled that the individual will be the sole owner of the LLCs, and they will be treated as sole proprietorships for tax purposes. So their use will not keep the individual from being deemed to have acquired the replacement properties personally. [Ltr. Rul. 199945038]

    b. The IRS determined that the actions of three wholly-owned limited liability companies (LLCs) were attributable to their owner under the disregarded-entity regs for purposes of qualifying an exchange for Sec. 1031 like-kind treatment. [Ltr. Rul. 200732012]

4. Like-Kind Guidance for Exchange of Residences

   a. In Rev. Proc. 2005-14, the IRS details when an exchange will qualify for like-kind treatment and the home sale exclusion.

      1) The rules apply to an exchange of the residence for property used for investment or in a trade or business. Both the residence exchanged and the property acquired must be used in a trade or business or for investment.

      2) The exclusion for gain on a primary home is applied first.

      3) The exclusion does not apply to gain attributable to the depreciation deductions taken after May 6, 1997. However, the like-kind exchange provisions of Sec. 1031 may apply to defer the recapture gain.

      4) Any gain excluded under Sec. 121 is treated as gain recognized by the taxpayer. Thus, the basis of the replacement business property is increased by any gain attributable to the relinquished business property that is excluded under Sec. 121.

   b. Example: Sonya Smyth purchased a house for $210,000 that was used as her principal residence for four years. For the next two years, she rents the house to tenants and claims depreciation of $15,000. At the end of the two years she exchanges the house for $10,000 cash and a townhouse with a fair market value of $460,000 that she intends to rent to tenants. Sonya realizes a gain of $275,000 ($470,000 selling price - $195,000 basis ($210,000 - $15,000 depreciation)).

      Sonya meets the requirements of Sec. 121 and Sec. 1031. Section 121 does not require the property to be the taxpayer's principal residence on the sale or exchange date. Sonya owned and used the house as her principal residence for at least two years during the 5-year period prior to the exchange, to qualify for Sec. 121. Since the house is investment property at the time of the exchange, she may defer gain under Sec. 1031.

      Sonya applies Sec. 121 to exclude $250,000 of the $275,000 gain before applying the nonrecognition rules of Sec. 1031. She may defer the remaining gain of $25,000, including $15,000 gain attributable to depreciation, under Sec. 1031. Although Sonya receives $10,000 of cash (boot) in the exchange, she is not required to recognize gain because the boot is taken into account for purposes of Sec. 1031 only to the extent the boot exceeds the amount of excluded gain.

      Sonya's basis in the replacement property is $435,000, which is equal to the basis of the relinquished property at the time of the exchange ($195,000) increased by the gain excluded under Sec. 121 ($250,000), and reduced by the cash she receives ($10,000).

5. Transfer of Realty for Development Rights Qualified as Like-Kind Exchange

   a. A taxpayer's exchange of a parcel of real property for development rights was considered a like-kind exchange which qualified for tax-deferred treatment. [Ltr. Rul. 200805012] The development rights permitted the corporation to develop its other property with greater floor space than would otherwise have been allowed without the development rights.

   b. The state law generally defines an interest in real property to include development rights. The IRS focused on three factors: First, under the various ordinances, the development rights are as-of-right and not discretionary and, as such, appear to be analogous to perpetual rights. Second, the development rights must be verified by filings with the city and may require recording of certain easements a condition of the transfer. And third, the development rights are subject to city and state transfer taxes in the same manner as real property.

6. Like-Kind Exchange of Residence Allowed

   a. The IRS has provided taxpayers with a safe harbor under which a dwelling unit will qualify as property held "for productive use in a trade or business" or "for investment" for Sec. 1031 purposes "even though they occasionally use the dwelling unit for personal purposes." [Rev. Proc. 2008-16]

   b. The IRS will not challenge whether a dwelling unit qualifies under Sec. 1031 as property "held for productive use in a trade or business" or "for investment" if:

      1) The taxpayer owns both properties for the "qualifying use period" and

         a) Qualifying use -- for the relinquished property, at least 24 months immediately before the exchange; for the replacement property, at least 24 months immediately after the exchange.

      2) Within the qualifying use period, in each of the two 12-month periods immediately preceding and after the exchange, (I) the taxpayer rents the dwelling unit to another person(s) at a fair rental for 14 day or more, and (ii) the period of the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

   c. Personal use is deemed to have occurred on any day on which a taxpayer is treated as having used the dwelling unit for personal purposes under Sec. 280A(d)(2).

   d. Rev. Proc. 2008-16 is effective for exchanges of dwelling units after March 9, 2008.

7. Like-Kind Treatment Allowed for Acquisition of Partnership Interest

   a. The IRS agreed that where the monies being held by a qualified intermediary in an escrow account were used to acquire all of the partners' interest in a partnership that held nothing but a parcel of real estate, it could be treated as the acquisition of "qualified replacement property." [Ltr. Rul. 200807005] Because the taxpayer received the whole partnership, it was treated for tax purposes as if it got all of the partnership's underlying assets.

8. Related Party Exchange

   a. A trust and an S corporation were related parties under Sec. 1031(f)(3). The trust transferred Building 1 to a buyer and will acquire Building 2, owned by the S corp, as replacement property in a like-kind exchange. The S corp will also exchange Building 2 for other like-kind property. The S corp and the trust will use a qualified intermediary to facilitate their exchanges.

      Both parties would own like-kind property to the one exchanged and there would be no "cashing out" by either party. The IRS concluded that as long as the parties did not dispose of the properties received in the exchange for two years from the date of receipt of the property, the transaction would qualify for nonrecognition treatment. [Ltr. Rul. 200615005]

   b. A trust and an S corporation were related parties under Sec. 1031(f)(3). The trust transferred Building 1 to a buyer and will acquire Building 2, owned by the S corp, as replacement property in a like-kind exchange. The S corp will also exchange Building 2 for other like-kind property. The S corp and the trust will use a qualified intermediary to facilitate their exchanges.

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9. Timber Land Exchanges

   a. The exchange of old timberland for reproduction timberland is a like-kind exchange under Sec. 1031. Removal of timber would not trigger recognition of gain under Sec. 1031 because the taxpayer will still own the underlying land. [Ltr. Rul. 200541037]

10. Qualified Intermediary Related Party Exchange

   a. The use of a qualified intermediary in a like-kind exchange failed to avoid the related-party rule in a like-kind exchange. [Teruya Brothers, Ltd. & Subsidiaries, 124 TC No. 4]

      1) Under Sec. 1031(f)(1), the nonrecognition of gain in a like-kind exchange between related parties is lost if either party disposes of the property within two years of the exchange.

         a) A disposition will be ignored if it can be proved not to have tax avoidance as one of its principal purposes.

      2) The Court found that the qualified intermediary was employed for no other reason than to avoid paying tax on the transaction; that is, tax avoidance in the form of avoiding the related-party rules.

   b. IRS regulations say an attorney who performed services for the seller in the two years before an exchange cannot be a qualified intermediary.

      1) Work in connection with prior exchanges is disregarded under this rule.

11. Partial Interests

    a. Partial interests in realty can be acquired in like-kind exchanges. Sellers can receive a fractional share of other real estate in exchange for their property and defer tax on gain. [PLR-134191-04]

    b. Limitations:

        1) No more than 35 co-owners are allowed.

        2) Key events, such as hiring a manager or selling the realty, require unanimous approval, although owners who disagree with these moves can be bought out.

        3) Profits or losses must be shared proportionately.

    c. In final regulations the IRS has stated that sellers will not have to report the earnings on escrow accounts if the exchange proceeds are $2 million or less, the funds are held for six months or less, and the earnings are kept by the intermediary as part of the fee. [TD 9413]

    d. There is imputed interest for other sellers. The amount of interest is assumed paid to the seller and then paid to the intermediary as part of the intermediary's fee.

    e. The IRS devised a special rate that is the lower of the short-term annual federal rate (AFR) or the investment rate on a 12-week Treasury bill made on the date of the deemed loan.

    f. The regs will apply to transfer of relinquished property and to facilitator loans issued on or after October 8, 2008.

        1) For transfers before that date, the IRS will not challenge a reasonable, consistent method of taxing the earnings.

12. Escrow Agent's Bankruptcy

    a. Gain on the property transferred will be taxed if the bankrupt escrow intermediary firm fails to acquire the replacement property and transfer it to the seller within 180 days of the original sale. [INFO 2008-0021] Although the seller is not at fault for missing the deadline, the IRS cannot extend the 180-day period.

    b. The seller can claim a loss for the sales proceeds forfeited because of the intermediary's bankruptcy. However, the deduction cannot be taken until the amount of the loss is fixed; typically the year when the bankruptcy case is closed.

13. Like-Kind Disaster Extension

    a. The IRS will allow a blanket automatic 120-day extension for meeting Sec. 1031 like-kind exchange deadlines due to a presidentially-declared disaster. A similar extension is available for taxpayers affected by a terrorist or military action or serving in a combat zone. [Notice 2005-3]

        1) The extension applies to all acts that are performed on or after January 26, 2004.

        2) The postponement only applies if the relinquished property or qualified indicia of ownership were transferred on or before the date of the declared disaster.

        3) The disaster must affect the exchange in any one of the following ways:

            a) The replacement or relinquished property is located in a disaster area;

            b) The principal place of business of any party to the transaction is located in a disaster area;

            c) A party to the transaction in connection with the exchange is damaged or lost;

            d) A lender withdraws from the transaction due to the disaster; or

            e) A title company is unable to provide title insurance policy to close the transaction due to the disaster.

14. Product Classification System for Like-Kind Exchanges

    a. The IRS replaced the Standard Industrial Classification (SIC) system with the North American Industry Classification (NAIC) system for determining when properties are like-kind properties. [TD 9202]

    b. In 1997, the Department of Commerce replaced the SIC system with the NAIC system. Now, the IRS is following the Commerce Department's lead.

    c. NAIC uses six digit codes rather than the SIC's four digit codes. Properties within the same product class under the four-digit SIC system generally will be of the same product class under the six-digit NAIC system.

15. Like-Kind Exchange of Intangibles

    a. Exchanges of intangible assets rarely qualify for tax deferral. Strict rules apply to these swaps, the Service privately rules. For patents, the underlying assets must relate to the same product or to the same asset class for gain on the exchange to be deferred. In addition, the patents must be used in the U.S. If a foreign patent is involved in the exchange, the swap is taxed, according to the IRS. [TAM 200602034]

16. Vacation Homes

    a. The Tax Court has ruled that a couple who sold their vacation and home and purchased another using an escrow agent were not entitled to exclude the gain from the sale of the first home under Sec. 1031 because the properties were not held primarily for use in a trade or business or for investment. [Moore, TC Memo 2007-134]

    b. The evidence established that the couple and their children used the property as a vacation retreat, did not rent it out or claim depreciation or investment interest expenses on it, and stopped maintaining the first property when they no longer used it for personal purposes.

17. Developments

    a. A businessman purchased some vacant land so he could move his shop there. He received an offer to buy his current building and then deeded the land he bought to the potential buyer, who was required to put a new structure on the site and then swap the finished property for the seller's old building. The seller financed all construction and was at risk for cost overruns. The transaction was a sale for tax purposes according to the Tax Court. [*DeCleene*, 115 TC No. 34] An intermediary should have been used to hold title to the land until the transfer was ready.

    b. Replacement property must be identified within 45 days of the initial transfer and acquired with the lesser of 180 days of that date, or the due date of the return including extension, if sooner. Such exchanges are reported on Form 8824. The replacement period cannot be extended, even when the failure is beyond the seller's control. [*Knight*, TC Memo 1998-107]

    c. Effective on or after September 15, 2000, the IRS has issued a safe harbor procedure under which taxpayers may enter into reverse like-kind exchanges (Reverse Starker) -- the replacement property is acquired prior to the property being sold. Three requirements must be met to qualify: [Rev. Proc. 2000-37, 2000-40 IRB 308]

        1) The intermediary or "Exchange Accommodation Titleholder" (EAT) must be an independent party.

        2) The EAT must take legal ownership of the property with the clear intent of entering into a Sec. 1031 exchange.

        3) No later than five business days after the transfer of the replacement property, the taxpayer and the EAT must enter into a written agreement to facilitate the Sec. 1031 exchange.

        4) The 45 and 180 day requirements must be met.

        5) The combined period that the relinquished property and the replacement property are held in a Qualified Exchange Accommodation Arrangement may not exceed 180 days.

d. SUV Exchanged for an Auto

1) The IRS has ruled that an exchange of a business SUV or an auto is a tax-free exchange. Even though a sports-utility vehicle is different from a passenger automobile, it is still a like-kind asset. The differences between a car and an SUV are differences in grade or quality; they are not differences in nature or character. [Ltr. Rul. 200450005]

e. Construction Exchange

1) Constructing a building on another site the taxpayer owns does not defer the gain on the insurance proceeds received for the original property. The newly constructed building is not treated as being of a like kind to the realty that was subject to a casualty loss. [INFO 2006-0028; Rev. Rul. 67-255]

f. Like-Kind Exchange of Intangibles

1) Exchanges of intangible assets rarely qualify for tax deferral. Strict rules apply to these swaps, the Service privately rules. For patents, the underlying assets must relate to the same product or to the same asset class for gain on the exchange to be deferred. In addition, the patents must be used in the U.S. If a foreign patent is involved in the exchange, the swap is taxed, according to the IRS. [TAM 200602034]

g. Mining Properties

1) Taxpayer exchanged operating gold mines, including realty, for operating coal mines. The coal mines were subject to supply contracts obligating the mine owner to provide electric utilities with coal, while the gold mines were not subject to any such contracts. Since the coal supply contracts were covenants running with and appurtenant to the mine under New Mexico law, the Tax Court held that the coal supply contracts were like-kind property and were not taxable as part of the exchange. [Peabody Natural Resources Co., 126 TC No. 14]

h. Intellectual Property Rights

1) The IRS concluded that amounts received to settle claims for copyright infringement and misappropriation of trade secrets could not be deferred under Sec. 1033 as proceeds of an involuntary conversion. The payments were to compensate the taxpayer for lost profits and to prevent unjust enrichment. The taxpayer did not prove that any part of the settlement represented "a recovery of an investment of capital with respect to involuntarily converted property that it could reestablish by purchasing replacement property." [TAM 200625032]

i. Intellectual Property Rights

1) The IRS concluded that amounts received to settle claims for copyright infringement and misappropriation of trade secrets could not be deferred under Sec. 1033 as proceeds of an involuntary conversion. The payments were to compensate the taxpayer for lost profits and to prevent unjust enrichment. The taxpayer did not prove that any part of the settlement represented "a recovery of an investment of capital with respect to involuntarily converted property that it could reestablish by purchasing replacement property." [TAM 200625032]

j. For exchanges completed after May 22, 2008, the rule barring exchanges of stocks from the Section 1031 nonrecognition rule does not apply to shares in a mutual ditch, reservoir, or irrigation company if certain conditions are met. [Sec. 1031(l)]

k. Annuities

1) The IRS has affirmed that there is no way to escape tax when an annuity is cashed-out. The cash proceeds received cannot be rolled over to another annuity on a tax-deferred basis because the nontaxable exchange rules apply only to the direct exchange of one annuity contract for another. [Ltr. Rul. 200622020]

2) A taxpayer cannot use amounts distributed from one annuity contract to purchase a second annuity contract and qualify for nonrecognition treatment under Sec. 1035. [Rev. Rul. 2007-24]

a) The life insurance company issued a nonqualified annuity contract to a taxpayer. Later the insurance company issued a check directly to the taxpayer which the taxpayer endorsed to a second insurance company as consideration for a new annuity contract.

b) The IRS determined that there was no exchange in this case.

c) Unlike the 60-day IRA rollover period, there is no statutory grace period for exchanges that involve a direct cash distribution to the insured.

d) However, in Greene the policyholder surrendered an annuity policy and used the proceeds to purchase an equivalent policy with another insurer. The court held that the transaction was a nontaxable exchange. [Greene, 85 TC 1024]

l. Mining Properties

1) Taxpayer exchanged operating gold mines, including realty, for operating coal mines. The coal mines were subject to supply contracts obligating the mine owner to provide electric utilities with coal, while the gold mines were not subject to any such contracts. Since the coal supply contracts were covenants running with and appurtenant to the mine under New Mexico law, the Tax Court held that the coal supply contracts were like-kind property and were not taxable as part of the exchange. [Peabody Natural Resources Co., 126 TC No. 14]

m. Stock Sold by State

1) Using its authority under an unclaimed property law, the elderly investor's state took control of stock that he had forgotten about and sold the shares. He filed a claim and recovered the proceeds. The IRS said the stock sale was an involuntary conversion, so he can defer gain if he buys other stock or mutual funds within two years after the year that the sale occurred. [Ltr. Rul. 200714002]

18. 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]

b. The safe harbor for reporting gain or loss is available to taxpayer that initiated deferred like-kind exchanges but failed to complete the exchange due to a QI's default on its obligation to timely acquire and transfer replacement property when its assets are suddenly frozen in bankruptcy or receivership.

c. The taxpayer will not be deemed to be in actual or constructive receipt of any of the exchange proceeds until the QI emerges from bankruptcy or receivership and, then, will recognize gain only as required under the safe harbor gross profit method.

d. The safe harbor applies to taxpayers that:

1) Transferred relinquished property to a QI in accordance with the regs;

2) Properly identified replacement property within the identification period (unless the QI default occurs during that period);

3) Did not complete the like-kind exchange solely because of a QI default involving a bankruptcy or a receivership; and

4) Did not, without regard to any actual or constructive receipt by the QI, have actual or constructive receipt of the proceeds from the disposition of the relinquished property or any property of the QI prior to the time the QI entered bankruptcy or receivership.

e. A qualified taxpayer may report gain realized on the disposition of the relinquished property as the taxpayer receives payments attributable to the relinquished property using the safe harbor gross profit ratio method in Rev. Proc. 2010-14.

f. Under the safe harbor gross profit method, the portion of any payment attributable to the relinquished property that is recognized as gain is determined by multiplying the payment by a fraction, the numerator of which is the taxpayer's gross profit and the denominator of which is the taxpayer's contract price. Gross profit and contract price have the same definitions as installment sales.

g. Example. A owns investment property (Property 1) with a fair market value of $150,000 and adjusted basis of $50,000. On May 1, Year 1, A transfers Property 1 to QI and IQ transfers the property to a third party for $150,000. On June 1, Year 1, A identified Property 2 as like-kind replacement property. On June 15, Year 1, QI notifies A that it has filed for bankruptcy protection and cannot acquire replacement property nor return the money. On July 1, Year, QI exits from bankruptcy and under court order pays $130,000 in full satisfaction of QI's obligation on August 4, Year 2.

A recognizes gain in Year 2. A's selling price is $130,000, as is A's contract price because there is no satisfied or assumed indebtedness. A's gross profit is $80,000 (the selling price ($130,000) minus the adjusted basis ($50,000). A's gross profit ration is 80/130 (the gross profit over the contract price). Therefore, A must recognize gain in Year 2 of $80,000 (the payment attributable to the relinquished property ($130,000) multiplied by A's gross profit ratio ($80,000/$130,000).

h. a) Rev. Proc. 2010-14 is effective for taxpayers whose like-kind exchanges failed due to a QI default on or after January 1, 2009.

Chapter 7 - Sale of Residence Exclusion

A. Basic Rules

1. After May 6, 1997, taxpayers may exclude up to $250,000 ($500,000 on joint return) of the gain on the sale of a principal residence; under prior law, the maximum exclusion was $125,000 and available only to taxpayers over age 55. [Sec. 121]

    a. Under prior rules taxpayers could rollover a gain on a prior residence by reinvesting within 24 months at a higher price under Sec. 1034.

    b. Example: Married taxpayers purchased a residence for $100,000. Years later they sell the residence for $1,000,000. They purchase a replacement residence for $1,200,000. They will have a taxable gain of $400,000 ($1,000,000 selling price minus $100,000 basis and minus $500,000 exclusion). Under prior law of Sec. 1034 they could have deferred the entire gain by rolling over the proceeds into a replacement residence.

2. Taxpayers must meet three criteria to be eligible for the exclusion.

    a. The taxpayer must have owned the home for at least two of the five years prior to sale.

        1) One of five years for a move to a nursing home due to incapacity.

    b. The taxpayer must have occupied the home as the principal residence for at least two of the five years before sale.

    c. The taxpayer must not have used the gain exclusion within the last two years.

    d. An individual may elect to suspend for a maximum of 10 years, the homesale exclusion's five-year test period for ownership and use during certain absences due to member of the uniformed services, Foreign, service, intelligence community, and volunteer service in the Peace Corps. [Sec. 121(d)(12)]

        1) The extended duty can take place at a duty station located within or outside the U.S. [Sec. 121(d)(9)]

3. Requirements for $500,000 gain exclusion [Sec. 121(b)(2)]

    a. Husband and wife make a joint return for the tax year of the sale or exchange of the residence.

    b. Either spouse owns the property for two of the previous five years.

    c. Both spouses use the property as their principal residence for two of the previous five years.

    d. Neither spouse is ineligible because of another sale or exchange within two years of the sale.

4. After death of a spouse, the surviving spouse is able to use the $500,000 exclusion for two years after the spouse's death.

5. Taxpayers may use the new exclusion once every two years; under prior law the $125,000 exclusion was available only once in a lifetime.

6. If taxpayers jointly own a principal residence but file separate returns, each taxpayer may exclude from gross income up to $250,000 of gain that is attributable to each taxpayer's interest in the property, if the requirements of section 121 have otherwise been met. [Reg. 1.121-2(a)(2)]

7. Each unmarried taxpayer who jointly owns a principal residence may be eligible to exclude from gross income up to $250,000 of gain that is attributable to each taxpayer's interest in the property.

    a. During the year, married Taxpayers H and W each sell a residence that each had separately owned and used as a principal residence before their marriage. Each spouse meets the ownership and use tests for his or her respective residence. Neither spouse meets the use requirement for the other spouse's residence. H and W file a joint return for the year of the sales. The gain realized from the sale of H's residence is $200,000. The gain realized from the sale of W's residence is $300,000. Because the ownership and use requirements are met for each residence by each respective spouse, H and W are each eligible to exclude up to $250,000 of gain from the sale of their individual residences. However, W may not use H's unused exclusion to exclude gain in excess of her limitation amount. Therefore, H and W must recognize $50,000 of the gain realized on the sale of W's residence. [Reg. 1.121-2(a)(4) Example 3]

B. Principal Residence

1. A property used by the taxpayer as the taxpayer's residence may include a houseboat, a house trailer, or the house or apartment that the taxpayer is entitled to occupy as tenant-stockholder in a cooperative housing corporation. Property used by the taxpayer s the taxpayer's residence does not include personal property that is not a fixture under local law. [Reg. 1.121-1(b)]

2. In the case of a taxpayer using more than one property as a residence, whether the property is used by the taxpayer as the taxpayer's principal residence depends upon all the facts and circumstances.

3. If a taxpayer alternates between two properties, using each as a residence for successive periods of time, the property that the taxpayer uses the majority of the time during the year ordinarily will be considered the taxpayer's principal residence. [Reg. 1.121-1(b)(2)]

    a. Example. From 1999 through 2004, the taxpayer lives in New York for 7 months. The taxpayer lives in Florida for 5 months. Only the time in New York counts as the principal residence. [Reg. 1.212-1(b)(4) Example 1]

4. However, this test is not dispositive. The final regulations also include a nonexclusive list of factors that are relevant in identifying a property as a taxpayer's principal residence.

    a. In addition to the taxpayer's use of the property, relevant factors in determining a taxpayer's principal residence, include, but are not limited to --
        The taxpayer’s place of employment;
        The principal place of abode of the taxpayer's family members
        The address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card;
        The taxpayer's mailing address for bills and correspondence;
        The location of the taxpayer's banks; and
        The location of religious organizations and recreational clubs with which the taxpayer is affiliated. [Reg. 1.121-1(b)(2)]

C. Ownership and Use Requirements

1. The requirements of ownership and use for periods aggregating 2 years or more may be satisfied by establishing ownership and use for 24 full months or for 730 days (365 x 2). The requirements of ownership and use may be satisfied during noncurrent periods if both the ownership and use tests are met during the 5-year period ending on the date of the sale or exchange. [Reg. 1.121-1(c)(1)

2. In establishing whether a taxpayer has satisfied the 2-year use requirement, occupancy of the residence is required. However, short temporary absences, such as for vacation or other seasonal absence (although accompanied with rental of the residence), are counted as periods of use. [Reg. 1.121-1(c)(2)(I)]

3. A one-year sabbatical is not considered to be a short temporary absence. [Reg. 1.121-1(c)(4) Example 4]

4. Two 2-month summer vacations in successive summers are short temporary absences and are counted as periods of use in determining whether the residence was used for the requisite period. [Reg. 1.121-1(c)(4) Example 5]

5. Example. Taxpayer C lives in a townhouse he rents from 1993 through 1996. On January 18, 1997, he purchases the townhouse. On February 1, 1998, C moves into his daughter's home. On May 25, 2000, while still living in his daughters' home, C sells his townhouse. The Sec. 121 exclusion will apply to gain from the sale because C owned the townhouse for at least 2 years out of the 5 years preceding the sale (from January 19, 1997 until May 25, 2000) and he used the townhouse as his principal residence for at least 2 years during the 5-year period preceding the sale (from May 25, 1995 until February 1, 1998). [Reg. 1.121-1(c)(4)]

6. If a taxpayer has become physically or mentally incapable of self-care and the taxpayer sell or exchanges property that the taxpayer owned and used as the taxpayer's principal residence for periods aggregating at least 1 year during the 5-year period in which the taxpayer owns the property and resides any facility (including a nursing home) licensed by a State or political subdivision to care for an individual in the taxpayer's condition. [Reg. 1.121-1(c)(2)(ii)]

D. Partial Interests

1. A taxpayer may exclude gain from the sale or exchange of partial interest (other than interests remaining after the sale or exchange of a remained interest) in the taxpayer's principal residence if the interest sold or exchanged includes the interest in the dwelling unit. [Reg. 1.121-4(e)(1)(I)]

2. Only one maximum limitation amount of $250,000 ($500,000 for certain joint returns) applies to the combined sales or exchanges of partial interests. The sales or exchanges of partial interests in the same principal residence are treated as one sale or exchange. [Reg. 1.121-4(e)(1)(ii)(A)]

3. In applying the maximum limitation amount to sales or exchanges that occur in different taxable years, a taxpayer may exclude gain from the first sale or exchange of a partial interest up to the taxpayer’s full maximum limitation amount and may exclude gain from the sale or exchange of any other partial interest in the same principal residence to the extent of any remaining maximum limitation amount, and each spouse is treated as excluding one-half of the gain from a sale or exchange. [Reg. 1.121-4(e)(1)(ii)(A)]

4. Each sale or exchange of a partial interest is disregarded with respect to other sales or exchanges of partial interests in the same principal residence for purposes of applying the one sale or exchange every two years rule. Partial sales are taken into account as of the date of sale or exchange in applying the two-year rule of the sale or exchange of any other principal residence. [Reg. 1.121-4(e)(1)(ii)(B)]

5. A taxpayer may elect to apply the section 121 exclusion to the gain from the sale or exchange of a remainder interest in the taxpayer's principal residence. [Reg. 1.121-4(e)(2)(I)]

6. The section 121 exclusion will not apply to a sale or exchange to any person that bears a relationship to the taxpayer that is described in section 267(b) or 707(b). [Reg. 1.121-4(e)(2)(ii)(B)]

7. If a taxpayer elects to exclude gain from the sale or exchange of a remainder interest in the taxpayer's principal residence, the section 121 exclusion will not apply to a sale or exchange any other interest in the residence that is sold or exchanged separately. [Reg. 1.121-4(e)(2)(ii)]

E. Partial Exclusion

1. Partial exclusion for less than two years by reason of:

   a. Change of employment,

   b. Health, or

   c. Other unforeseen circumstances.

2. On September 9, 2002, the IRS published Notice 2002-60 (2002-36 IRB 482), which provides that certain taxpayers affected by the September 11, 2001, terrorists may claim a reduced maximum exclusion for a sale or exchange of the taxpayer's principal residence by reason of unforeseen circumstances.

3. Change of Employment

   a. The change in place of employment occurs during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence; and the individual's new place of employment is at least 50 miles farther from the residence sold or exchanged than was the former place of employment. [Reg. 1.121-3T(c)(2)]

   b. Employment includes the commencement of employment with a new employer, the continuation of employment with the same employer, and the commencement or continuation of self-employment. [Reg. 1.121-3T(c)(3)]

4. Health

   a. A sale or exchange is by reason of health if the primary reason for the sale or exchange is obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury of a qualified individual, or to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness, or injury. A sale or exchange that is merely beneficial to the general health or well-being of the individual is not a sale or exchange by reason of health. [Reg. 1.121-3T(d)(1)]

b. The primary reason for the sale or exchange is deemed to be health if a physician recommends a change of residence for reasons of heath. [Reg. 1.121-3T(d)(2)

c. Qualified Individual

1) The taxpayer;

2) The taxpayer's spouse;

3) A co-owner of the residence;

4) A person whose principal place of abode is in the same household as the taxpayer; or

5) A medical dependent of a person above or a descendant of the taxpayer's grandparent. [Reg. 1.121-3T(d)(2)]

5. Unforeseen Circumstances

a. A sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale is the occurrence of an event that the taxpayer does not anticipate before purchasing and occupying the residence. [Reg. 1.121-3(e)(1)]

b. Unforeseen Circumstances Safe Harbor Events

1) Involuntary conversion of the residence

2) A natural or man-made disaster or act of war or terrorism resulting in a casualty to the residence [Reg. 1.121-3(e)(2)]

c. In the case of a qualified individual:

1) Death,
2) The cessation of employment as a result of which the individual is eligible for unemployment compensation,
3) A change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household,
4) Divorce or legal separation under a decree of divorce of separate maintenance, and
5) Multiple births resulting from the same pregnancy. [Reg. 1.121-3(e)(2)(iii)]

d. A taxpayer who does not qualify for a safe harbor may demonstrate that the primary reason for the sale or exchange is unforeseen circumstances, under a facts and circumstances test.

e. Relevant Factors
   1) The sale or exchange and the circumstances giving rise to the sale or exchange are proximate in time;
   2) The suitability of the property as the taxpayer's principal residence materially changes;
   3) The taxpayer's financial ability to maintain the property materially changes;
   4) The taxpayer uses the property as the taxpayer's residence during the period of the taxpayer's ownership of the property;
   5) The circumstances giving rise to the sale or exchange are not reasonably foreseeable when the taxpayer begins using the property as the taxpayer's principal residence; and
   6) The circumstances giving rise to the sale or exchange occur during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence.

f. For taxpayers filing jointly, if either spouse fails to meet the requirements, the maximum limitation amount to be claimed by the couple is the sum of each spouse's limitation amount determined on a separate basis as if they had not been married. For this purpose, each spouse is treated as owning the property during the period that either spouse owned the property. [Reg. 1.121-2(a)(3)(ii)]

g. Partial Exclusion Formula

$$\frac{\text{Shorter of Own Days, Use Days, or Between Sales Days}}{730 \text{ days}} \times \$250{,}000 \text{ or } \$500{,}000$$

h. Example. Husband owns and uses house for the 2-year period. Marries wife and after one-year the house is sold due to wife’s change of employment. Maximum exclusion is $375,000 -- $250,000 for the husband and $125,000 for the wife ($250,000 x 12/24) [Reg. 1.121-3(g)(2) Example 2(iii)]

i. Military or foreign service personnel serving on qualified official extended duty may elect to suspend the running of the five-year period for up to 10 years for testing for ownership and principal residence status of at least two years.

6. Partial Exclusion Developments

   a. The IRS allowed a partial exclusion for taxpayers in a senior-only community who had to sell their home after circumstances forced their child and grandchild to live with them. [Ltr. Rul. 200601023]

   b. A couple from out of state was allowed a partial exclusion when they did not realize their new home was in a high-crime area. They sold after their neighbors assaulted them. [Ltr. Rul. 200601009]

   c. The IRS determined that an adoption qualified as an unforeseen circumstance allowing the taxpayers to claim a partial home sale exclusion. The taxpayer had sold their home, which they had occupied for less than two years, to rent a larger home so they would have room for an adopted child. [Ltr. Rul. 200613009]

d. A taxpayer who had to vacate his home because of fear for his personal safety and the safety of his family is eligible for a reduced home sale exclusion. The sale was by reason of unforseen circumstances. The taxpayer, a police officer, arrested an alleged drug dealer in a highly publicized anti-drug sting. Soon after, the police department learned that the drug dealer's associates had discovered the taxpayer's address and planned to kill him. The taxpayer subsequently sold the house. [Ltr. Rul. 200615011]

e. A taxpayer who had to vacate his home because of fear for his personal safety and the safety of his family is eligible for a reduced home sale exclusion. The sale was by reason of unforseen circumstances. The taxpayer, a police officer, arrested an alleged drug dealer in a highly publicized anti-drug sting. Soon after, the police department learned that the drug dealer's associates had discovered the taxpayer's address and planned to kill him. The taxpayer subsequently sold the house. [Ltr. Rul. 200615011]

f. The taxpayers, a newly married couple each with children from previous marriages, purchase a new home. They needed more space for their blended family of two adults and five children. One of the spouses had held his or her home for less than two years before the sale. The IRS determined that the couple's marriage and the resulting larger family constituted unforeseen circumstances, making the spouse eligible for a reduced exclusion. [Ltr. Rul. 200725018]

g. The IRS permitted the taxpayer to claim a reduced maximum exclusion under Sec. 121 because she sold her home within two years due to school bus bullying. [Ltr. Rul. 200820016] One of the taxpayer's daughters was subjected to unruly behavior, verbal abuse, and sexual assault while riding in the school bus. The child subsequently suffered from persistent fear, and her school performance deteriorated dramatically. The taxpayer tried to work with the school personnel to resolve the problems, but finally choose to sell the residence and more the daughter away from the problems.

F. Special Rules for Deceased or Divorced Spouses

1. A taxpayer is treated as owning and using property as the taxpayer's principal residence during any period that the taxpayer's deceased spouse owned and used the property as a principal residence if:

   a. The taxpayer’s spouse is deceased on the date of the sale or exchange of the property; and

   b. The taxpayer has not remarried at the time of the sale or exchange of the property. [Reg. 1.121-4(a)]

2. The $500,000 exclusion is only available to surviving spouses for sales within two years of death of the other spouse.

3. Basis of Asset Acquired from Decedent

   a. Decedent sole owner -- FMV date of death

   b. Jointly owned, nonspouse -- proportion decedent paid stepped up

   c. Jointly owned with spouse -- one half stepped up

d. Pre-1977 spouse rule -- proportion paid by each

1) Husband and wife jointly purchased property in 1952; wife in 1989 inherited property from husband; she could step up entire basis in property since property was pre-1977 property. [*Patten*, CA-4, 97-1 USTC ¶60,279]

2) The IRS has also lost similar cases in the Tax Court [*Hahn*, 110 TC 140 (1998), acq.] and in the Sixth Circuit. [*Gallenstein*, CA-6, 92-2 USTC ¶60,114]

3) Action on Decision -- The Service will no longer litigate that section 2040(b)(1) applies to joint interests created before January 1, 1977, where the deceased joint tenant died after December 31, 1981. [CC-2001-08; Oct. 15, 2001]

e. If a taxpayer obtains property from a spouse or former spouse in a transaction described in section 1041(a), the period that the taxpayer owns the property will include the period that the spouse or former spouse owned the property. [Reg. 1.121-4(b)(1)]

f. A taxpayer is treated as using property as the taxpayer's principal residence for any period that the taxpayer has an ownership interest in the property and the taxpayer's spouse or former spouse is granted use of the property under a divorce or separation instrument, provided that the spouse or former spouse uses the property as his or her principal residence. [Reg. 1.121-4(b)(2)]

G. Involuntary Conversion

1. For purposes of section 121, the destruction, theft, seizure, requisition, or condemnation of property is treated as a sale of the property. [Reg. 1.121-4(d)(1)]

2. In applying section 1033, the amount realized from the sale or exchange of property used as the taxpayer's principal residence is treated as being the amount determined without regard to section 121, reduced by the amount of gain excluded from the taxpayer's gross income under section 121. [Reg. 1.121-4(d)(2)]

3. If the basis of the property acquired as a result of an involuntary conversion is determined (in whole or in part) under section 1033(b), then for purposes of satisfying the requirements of section 121, the taxpayer will be treated as owning and using the acquired property as the taxpayer's principal residence during any of time that the taxpayer owned and used the converted property as the taxpayer's principal residence. [Reg. 1.121-4(d)(3)]

H. Depreciation

1. The Tax Court held that a residence that qualifies for the principal residence provisions may also qualify as property held for the production of income and therefore qualify for the depreciation deduction. [*Bolaris v. Comm.*, 776 F2d 1428 (CA-9, 1985)]

2. The exclusion does not apply, and gain is recognized, to the extent of any depreciation allowable with respect to the rental or business use of a principal residence after May 6, 1997. [Section 121(d)(6)]

3. Example. Purchased residence on February 19, 1996, for $234,000. 20% business use for home office. Ceased using home office on December 31, 2002. Sold residence for $300,000 on June 3, 2009.

   $300,000 Selling Price
   -225,750 Basis ($234,000 - $8,250 Depreciation)
   $ 73,050 Gain on Sale

   $ 6,781 Gain Reported ($81 Depreciation for May 1997 + 67 months @ $100 per month)

4. The gain recognized is unrecaptured section 1250 gain within the meaning of section 1(h).

I. Property Used in Part as a Principal Residence

1. Former Proposed Regulations -- Home Office

   Purchased residence on February 19, 1996, for $234,000. 20% business use for home office. Ceased using home office on December 31, 2003. Sold residence for $300,000 on June 3, 2005.

   $300,000 Selling Price
   -224,550 Basis ($234,000 - $9,450 Depreciation)
   $ 75,450 Gain on Sale

   $ 7,981 Gain Reported ($81 Depreciation for May 1997 + 79 months @ $100 per month)

   a. Former Proposed Regulations

Residence	1231	
$240,000	$60,000	
-187,200	-37,350	($46,800 - $9,450)
$ 52,800	$22,650	
	$ 9,450	@ 25%
	$13,200	@ 15%

   b. Former Publication 523 -- Selling Your Home -- Example of allocating the gain after home office use on p. 15

2. Final Regulations

   a. Under the final regulations, no allocation of gain is required if both the residential and non-residential portions of the property are within the same dwelling unit. However, Sec. 121 will not apply to the gain to the extent of any post-May 6, 1997, depreciation adjustments. [Reg. 1.121-1(e)(1)]

b. Section 121 will not apply to the gain allocable to any portion of property sold or exchanged with respect to which a taxpayer does not satisfy the use requirement if the non-residential portion is separate from the dwelling unit. [Reg. 1.121-1(e)(1)]

1) The taxpayer had separate dwelling units where he converted a basement level into a separate apartment. [Reg. 1.121-1(e)(4) Example 3]

2) For purposes of determining the amount of gain allocable to the residential and non-residential portions of the property, the taxpayer must allocate the basis and the amount realized between the residential and the non-residential portions of the property using the same method of allocation that the taxpayer used to determine depreciation adjustments if applicable. [Reg. 1.121-1(e)(3)]

3) If the depreciation for periods after May 6, 1997, attributable to the non-residential portion of the property exceeds the gain allocable to the non-residential portion of the property, the excess will not reduce the Sec. 121 exclusion applicable to gain allocable to the residential portion of the property.

J. Reduced Home Sale Exclusion

1. Gain from the sale of a principal residence will no longer be excluded from gross income under Sec. 121 for period that the home was not used as the principal residence.

2. This new income inclusion rule applies to home sales after December 31, 2008.

3. Under a transition rule, the inclusion is based only on nonqualified use period that begin on or after January 1, 2009.

4. Any portion of the five-year period ending on the date the property is sold that is after the last date that the property is used as the principal residence of the taxpayer or the taxpayer's spouse is not considered a period of non-qualified use.

a. Ownership for purposes of the new ratio includes the period during which vacant land may be owned before the residence is built.

5. Periods of temporary absence from the taxpayer's principal residence that do not exceed two years in total because of a change of employment, health conditions, or other unforeseen circumstances are not considered non-qualifying use.

6. The new law determines excluded appreciation on a pro-rata basis.

a. The amount of gain allocated to periods of nonqualified use is the amount of gain multiplied by a fraction, the numerator or which is the aggregate period of nonqualified use during which the property was owned by the taxpayer and the denominator of which is the period the taxpayer owned the property.

b. "Nonqualified use" for the computation does not include any use prior to 2009.

7. Depreciation allowed or allowable after May 6, 1997, is not excluded from income and it is not included when calculating the amount of gain allocated to non-qualified use.

8. Example. Assume that an individual buys a property on January 1, 2009, for $400,000, and uses it as rental property for two years claiming $20,000 of depreciation deductions. On January 1, 2011, the taxpayer converts the property to his principal residence. On January 1, 2013, the taxpayer move out, and the taxpayer sells the property for $700,000 on January 1, 2014. The period 2009-2010 is non-qualifying use. The year 2013, after moving out, is treated as qualifying use. As under present law, $20,000 gain attributable to the depreciation deductions is included in income. Of the remaining $300,000 gain, 40% of the gain (2 years divided by 5 years), or $120,000, is allocated to nonqualified use and is not eligible for the exclusion. Since the remaining gain of $180,000 is less than the maximum gain of $250,000 that may be excluded, gain of $180,000 is excluded from gross income.

9. Example. The Smiths have owned their vacation home since January 1, 1987, when they bought it for $150,000. On January 1, 2010, they move into their vacation property and make it their principal residence. They live there until January 1, 2012, when it is sold for $450,000. Of the $300,000 gain, only the 12 months between January 1, 2009, and January 1, 2010 are considered period of nonqualified use. As a result only 1 year of their 25 years of ownership is attributable to non-qualified use so that, of the $300,000 gain, $12,000 is recognized gain. The remaining $288,000 of the gain is completely covered by the $500,000 home sale exclusion if the Smiths file a joint return for 2012 to report the sale.

K. Vacant Land

1. The sale or exchange of vacant land is not a sale or exchange of the taxpayer's principal residence unless --
   a. The vacant land is adjacent to land containing the dwelling unit of the taxpayer's principal residence;
   b. The taxpayer owned and used the vacant land as part of the taxpayer's principal residence;
   c. The taxpayer sells or exchanges the dwelling unit in a sale or exchange that meets the requirements of section 121 within two years before or two years after the date of the sale or exchange of the vacant land; and
   d. The requirements of section 121 have otherwise been met with respect to the vacant land. [Reg. 1.121-1(b)(3)(I)]

2. Sales or exchanges of the dwelling unit and vacant land are treated as one sale or exchange. Only one maximum limitation amount of $250,000 ($500,000 for certain joint returns) applies to the combined sales or exchanges of the vacant land and dwelling unit. [Reg. 1.121-1(b)(3)(ii)(A)]

3. In applying the maximum limitation amount to sales or exchanges that occur in different taxable years, gain from the sale or exchange of the dwelling unit, up to the maximum limitation amount is excluded first. Each spouse is treated as excluding one-half of the gain from a sale or exchange. [Reg. 1.121-1(b)(3)(ii)(A)]

4. Sales or exchange of the dwelling unit and adjacent vacant land in separate transactions are disregarded in applying the rule restricting the application of Sec. 121 to only one sale or exchange every two years. [Reg. 1.121-1(b)(3)(ii)(B)]

5. Each transaction is taken into account as of the date of sale or exchange in applying the two-year rule of the sale or exchange of any other principal residence. [Reg. 1.121-1(b)(3)(ii)(B)]

6. If the sale or exchange of a dwelling unit occurs in a later taxable year than the sale or exchange of the vacant land and after the date prescribed by law (including extensions) for the filing of the return for the taxable year of the sale or exchange of the vacant land, any gain from the sale or exchange of the vacant land must be treated as taxable on the taxpayer's return for the taxable year of the sale or exchange of the vacant land. [Reg. 1.121-1(b)(3)(ii)©]

7. If the taxpayer has reported gain from the sale or exchange of the vacant land as taxable, after satisfying the requirements, the taxpayer may claim the Sec. 121 exclusion with regard to the sale or exchange of the vacant land by filing an amended return. [Reg. 1.121-1(b)(3)(ii)©]

8. Example. In 1998 Taxpayer D buys a house and 1 acre that he uses as his principal residence. In 1999 D buy 29 acres adjacent to his house and uses the vacant land as part of his principal residence. In 2003 D sells the house and 1 acre and the 29 acres in two separate transactions. D sells the house and 1 acre at a loss of $25,000. D realizes $270,000 of gain from the sale of the 29 acres. D may exclude the $245,000 gain from the two sales. [Reg. 1.121-1(b)(3)(ii)© Example 4]

9. Gain on the sale of a lot adjacent to one's principal residence is eligible for the $250,000/$500,000 exclusion. To qualify for the exclusion, the land must be adjacent to the lot that contains the primary home and be used as part of the home. The land must be sold within two years before or after the home is sold since only that part of the exclusion remaining after calculating the gain on the residence can be applied to offset the gain from the sale of adjacent land.

   a. Since the family partnership owned the adjacent lot, it did not qualify for the Sec. 121 exclusion. [Farah, TC Memo 2007-369]

10. Acreage as Part of Residence

Bennett, 8 AFTR2d 5593 (DC Ga 1961)	All 65 acres considered part of personal residence
Richards, TCM 1993-422 part of personal residence	28 of 158 acres considered
OZ Roy, TCM 195-23	All 100 acres considered part of personal residence
Schlicher, TCM 1997-37	43 of 51 acres considered part of personal residence

L. Residence Held in Trust

1. The IRS has ruled that a principal residence which is transferred to a revocable grantor trust, and in which the taxpayer continues to reside, retains its eligibility for the Section 121 principal residence gain exclusion. [Ltr. Rul. 199912026]

2. The grantor trust rules provide that when the grantor is treated as the owner of any portion of a trust, there will then be included in computing the taxable income and credits of the grantor those items of income, deduction, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account in computing taxable income and credits against the tax of an individual. Since under the terms of the trust, the taxpayer has retained the power to revest in himself the title to the corpus of the trust, the taxpayer is considered the owner of the entire trust, including the residence, under IRC §§ 671 and 676(a).

3. Because the grantor is treated as the owner of the entire trust, the trust will be treated for federal income tax purposes as if made by the grantor.

4. Final Regulations -- If a residence is held by a trust, a taxpayer is treated as the owner of the trust or a portion of the trust that includes the residence under Sec. 671 through 679. The regulations provide similar treatment for certain single-owner entities. [Reg. 1.121-1(c)(3)]

M. Bankruptcy Estates

1. The taxpayer's principal residence was sold by the trustee in bankruptcy. The trustee asserted that the estate's liability for income taxes for the sale of the debtor's property is zero due to the use of the new Sec. 121 home-sale exclusion for $250,000/$500,000 of the gain from the sale of a principal residence. The court granted the exclusion and noted that the preponderance of more recent decisions allows the use of the exclusion by the bankruptcy trustee. [Johnson v IRS, DC Md, 7-21-99]

    a. The prior law elective $125,000 one-time exclusion of gain on the sale of a residence that was available to taxpayers, if age 55 or older, before May 7, 1997, was generally held not available to bankruptcy estates.

2. The Bankruptcy Court sided with the trustee and held that the trustee is entitled to the exclusion if the debtor could claim it on a sale. In this case the taxpayer wanted to prevent the bankruptcy trustee from applying the tax free rules for the sale of the principal residence. If the bankruptcy trustee would not qualify for the exclusion, the tax on the sale would wipe out the equity available to creditors, and in that case, the trustee would have to release the residence back to the debtor's possession. [In re Popa, 218 BC-DC Ill 420 (1998)

3. The IRS acquiesced in the case of *Internal Revenue Service v. Waldschmidt* (In re Bradley), 222 B.R. 313 (M.D. Tenn. 1998). The IRS issued AOD CC-1999-009 (August 30, 1999) and Chief Counsel Notice (35)000-162 (August 10, 1999).

4. The regulations provide that the bankruptcy estate of an individual in a chapter 7 or 11 bankruptcy case under title 11 of the United States Code succeeds to and takes into account the individual's Sec. 121 exclusion if the individual satisfies the requirements of Sec. 121.

5. The IRS will not challenge a position taken prior to the effective date of these regulations than a bankruptcy estate may use the Sec. 121 exclusion if the debtor would otherwise satisfy the Sec. 121 requirements.

N. Reporting Requirements

1. Sales of principal residences with a gross sales price of $250,000 or less ($500,000 or less in the case of married sellers) are excepted from the real estate transaction reporting requirement provided certain requirements are met; to be eligible for the exception, the person who would otherwise be required to file the Form 1099 must obtain written assurances from the seller of the real estate; the written assurances must provide that:

   a. The residence is the seller's principal residence,

   b. No financing of the seller is federally subsidized indebtedness, and

   c. The full amount of gain on the sale or exchange is excludable from gross income.

2. According to Form 1040 instructions, a residence sale is nonreportable if four conditions are satisfied:

   a. No part of the home was used for business or rental purposes.

   b. The taxpayer (or spouse if filing a joint return) owned and lived in the home as the principal residence for at least 2 years within the 5-year period ending on the date of sale.

   c. The taxpayer (and spouse if filing a joint return) have not sold or exchanged another principal residence after May 6, 1997.

   d. The selling price of the residence is not over $250,000 ($500,000 if married filing a joint return and both taxpayers have resided in the home for periods adding up to at least 2 years within the 5 year period ending on the date of sale).

3. If the taxpayer does not meet the nonreporting requirements, Schedule D is to be utilized for the reporting. Publication 523 indicates that the transaction should be reported on line 1 or line 8 of Schedule D, depending on how long the home was held. If the taxpayer qualifies for a gain exclusion, it should be shown as a loss on the line directly below the line on which the gain is reported, with the notation "Section 121 exclusion." [IRS Pub. 523, Selling Your Home, p. 15]

O. Applying Regulations Retroactively

1. Taxpayers may elect to apply the provisions of the final regulations for any years for which the period of limitation has not expired. [Reg. 1.121-4(j)]

2. A taxpayer may make the election by filing a return for the taxable year of the sale or exchange that does not include the gain from the sale or exchange of the taxpayer's principal residence in the taxpayer's gross income. [Reg. 1.121-4(j)]

3. Taxpayers who have filed a return for the taxable year of the sale or exchange may elect to apply the provision of the final regulations for any years for which the period of limitation under Sec. 6511 has not expired by filing an amended return. [Reg. 1.121-4(j)]

4. A taxpayer may make or revoke either election at any time before the expiration of a three-year period beginning on the last day prescribed by law (determined without regard to extensions) for the filing of the return for the taxable year in which the sale or exchange occurred. [Reg. 1.121-4(g)]

5. As long as the home is owned and used as a principal residence two out of the five years prior to sale date, it retains its personal residence character and does not switch to taxable rental property.

P. Developments

1. A couple transferred their home to a limited partnership that they owned, which also owned several rental properties. They then asked the IRS is they could take a tax exclusion for the gain that would result if the partnership sold the home. The home was not used by the partnership to generate income or for any business purpose. Moreover, the couple retained full ownership of the home at all times, directly or indirectly, and used it solely as their residence. So they would be treated as the owners of the home and would be able to exclude any gain on its sale from income. [Ltr. Rul. 200004022]

   a. The IRS has revoked this ruling. Partners are no longer treated as owners of the home for tax purposes for the time when partnership has title to the house.

2. Principal Residence Like-Kind Exchange Property

   a. The exclusion for gain on the sale or exchange of a principal residence does not apply if the principal residence was acquired in a like-kind exchange within the prior five years.

   b. Applies to sales or exchanges after Oct. 22, 2004.

      1) Like-kind exchanges prior to Oct. 23, 2004, trigger the five-year holding period. [INFO 2005-0001] Such swaps are not grandfathered.

3. Settlement Proceeds

   a. Taxpayer sold his residence at a loss due to "unforseen excessive noise from a nearby airport." He sued the sellers, their real estate agent, and his own real estate agent for their failure to disclose the airport noise before the sale. The IRS ruled that the settlement proceeds are characterized by reference to the sale transaction and are treated as proceeds from the sale of a principal residence held more than one year. [Ltr. Rul. 200702032]

   b. The IRS also allowed a Sec. 121 reduced maximum exclusion due to the unforseen circumstances.

4. Exempt Sale of Residence Information Reporting

   a. A new revenue procedure amends guidance on the proper certification paperwork that home buyers need from their sellers to exempt them from information reporting on the sale directly to the IRS. [Rev. Proc. 2007-12]

   b. During the five-year period ending on the date of the sale or exchange of the residence, the seller did not acquire the residence in an exchange to which Sec. 1031 applied; and

   c. In cases where the seller's basis in the residence is determined by reference to the basis in the hands of a person who acquired the residence in an exchange to which Sec. 1031 applied, the exchange to which Sec. 1031 applied occurred more than five years prior to the date of the seller's sale or exchange of the residence.

d. A sample certification form that real estate reporting persons may use to obtain the appropriate assurances from sellers is provided in the Rev. Proc.

e. Effective for all sales or exchanges of a principal residence occurring after January 22, 2007.

f. A real estate reporting person who relies on a certification will not be liable for the penalties under Sec. 6721 for failure to file an information return, or under Sec. 6722 for failure to furnish a payee statement to the seller, unless the real estate reporting person has actual knowledge that any assurance is incorrect.

5. Complete Destruction of Residence Required for Sec. 121

a. A taxpayer's residence must be completely destroyed by a natural disaster for the home sale exclusion rules of Sec. 121 to apply to any gain realized from insurance proceeds. [CCA 200734021]

b. Sec. 1033 provides for the deferral of gain from an involuntary conversion if the proceeds are reinvested in property "similar or related in service or use" to the converted property. Sec. 121 exclusion effectively increases the basis to the extent of reconstruction.

c. It was irrelevant that the taxpayer choose to rebuild on the same piece of land.

d. Example. The fair market value of the property before the damage was $250,000. The adjusted basis was $170,000. Taxpayer received $359,000 in insurance and other proceeds which was spent in rebuilding. The taxpayer's gain was $189,000 ($359,000 proceeds - $170,000 basis) which is excludable under Sec. 121. The basis of the new residence is $359,000.

1) If Sec. 1033 had been used, the basis of the new residence would be $170,000.

Chapter 8 - Retirement Plans and Distributions

A. Deductible IRAs

1. Not all individuals may make deductible contributions to Individual Retirement Accounts. If the individual is an active participant in a qualified plan, the individual's deductible IRA contribution may be limited or eliminated.

2. Adjusted gross income phaseout limits applicable to deductible IRA contributions by individuals who are active participants in employer-sponsored retirement plans:

Year	Singles	Joint Return
1998	$30,000 - $40,000	$50,000 - $60,000
1999	31,000 - 41,000	51,000 - 61,000
2000	32,000 - 42,000	52,000 - 62,000
2001	33,000 - 43,000	53,000 - 63,000
2002	34,000 - 44,000	54,000 - 64,000
2003	40,000 - 50,000	60,000 - 70,000
2004	45,000 - 55,000	65,000 - 75,000
2005	50,000 - 60,000	70,000 - 80,000
2006	50,000 - 60,000	75,000 - 85,000
2007	52,000 - 62,000	83,000 - 103,000
2008	53,000 - 63,000	85,000 - 105,000
2009	55,000 - 65,000	89,000 - 109,000
2010	56,000 - 66,000	89,000 - 109,000
2011	56,000 - 66,000	90,000 - 110,000
2012	58,000 - 68,000	92,000 - 112,000

For married taxpayers filing separate returns, the applicable dollar amount is zero with complete phase-out at AGI of $10,000

3. Increased Contributions to IRAs

   a. In order to induce more individuals into savings for their retirement, the maximum annual contributions to traditional individual retirement arrangements and to Roth IRAs was increased until it reaches $5,000 in 2008 with inflation adjustments thereafter.

      1) $2,000 for 2001
      $3,000 for 2002 through 2004
      $4,000 for 2005 through 2007

$5,000 for 2008 and thereafter

b. For individuals age 50 and over, additional catch-up contributions will be able to be made for tax years beginning in 2002 and after.

1)

For Tax Years	Contribution limit for taxpayers under age 50	Contribution limit for taxpayers age 50 and over
2002	$3,000	$3,500
2003	3,000	3,500
2004	3,000	3,500
2005	4,000	4,500
2006	4,000	5,000
2007	4,000	5,000
2008-2012	5,000	6,000

4. Spousal IRAs

a. The maximum deductible contribution to an individual retirement account (IRA) has been increased for married individuals who file a joint return where one of the spouses has no compensation. For tax years beginning after 2004, the maximum deductible amount is $4,000 ($5,000 after 2007) for each spouse if the combined compensation of both spouses is at least equal to the contributed amount.

b. Example. During 2012, Michael Smith is employed and earns $30,000. Ellen, his wife, is a full-time homemaker. They are joint filers. Each may contribute $5,000 to a deductible IRA (for a total of $10,000). Prior to 2008, the total amount the couple could contribute was limited to $8,000.

5. After 1997, an individual will not be considered an active participant in an employer-sponsored plan merely because the individual's spouse is an active participant for any part of a plan year.

a. The maximum deductible IRA contribution for an individual who is not an active participant, but whose spouse is, will be phased out at adjusted gross incomes between $173,000 and $183,000 (2012).

6. Example 1: Janet and Bob have a combined AGI of $125,000. Janet is an active participant in an employer-sponsored plan. Bob is not. Bob can make a deductible contribution; Janet cannot.

Example 2: Bob and Janet have a combined AGI of $200,000. Neither can make a deductible contribution because at least one is an active participant and their combined incomes are more than $183,000.

7. Distributions from retirement funds prior to age 59½ are subject to a 10% penalty unless one of the following exceptions applies:

    a. Over age 59½.

    b. Payment on account of death.

    c. Payable on account of disability

    d. Over age 55 if from employer plan and separated from service.

    e. Annuitized payments.

    f. Distributions from IRAs after 1996 will not be subject to the 10% additional tax on early withdrawals if the amounts are used to pay medical expenses in excess of 7.5% of adjusted gross income.

        1) Taxpayers do not have to itemize in order to use this exemption.

    g. The 10% tax will not apply to IRA distributions that are used by certain unemployed, formerly unemployed, or self-employed individuals to pay health insurance premiums.

        1) To escape the 10% tax, the individual must have received unemployment compensation for 12 consecutive weeks under federal or state law and the distributions must be made during any year in which the unemployment compensation is paid or during the next tax year.

            a) Taxpayers can take money from an IRA to pay health insurance for up to 60 days after finding a new job. [IRC Sec. 72(t)(2)(D)(ii)]

        2) Self-employed can rely on this exception if they would have been treated as unemployed had they been employees instead of self-employed.

    h. After 1997, the 10% penalty on early withdrawals will not apply to distributions from an IRA for qualified first-time home buyers.

        1) Qualified first-time homebuyer distributions are withdrawals from an IRA of up to $10,000 during the individual's lifetime that are used within 120 days of withdrawal to buy, build, or rebuild a "first" home that is the principal residence of the individual, his or her spouse, or any child, grandchild, or ancestor of the individual or spouse; in order to be considered a first-time homebuyer, the individual (and spouse, if married) must not have had an ownership interest in a principal residence during a two-year period ending on the date that the new home is acquired.

i. After 1997, the 10% penalty on early withdrawals will not apply to distributions from an IRA for higher education expenses

1) Higher-education expenses include tuition, fees, books, supplies, room and board, and equipment expenses.

2) A married couple was subject to the 10% additional tax for an early distribution from an IRA, despite the funds being used to repay education expenses that would otherwise not be subject to the penalty. [Lodder-Beckert, TC Memo 2005-162]

a) The taxpayer withdrew funds from the IRA to cover three years of education expenses paid by credit cards. The Court ruled that only the education expenses incurred in the year of withdrawal were qualified education expenses exempt from the penalty.

b) The Tax Court reaffirmed that distributions from an IRA, to be free of the penalty, must be used "for the taxable year." The expense must be incurred and the distribution used for the same tax year.

c) Distributions for other qualified expenses, such as medical expenses in Sec. 72(t)(2)(B) and distributions for the purchase of a first-home under Sec. 72(t)(2)(F), also must be made in the year in which the expense was incurred to avoid the tax penalty.

j. After 1999, the 10% tax on early withdrawals from employer-sponsored retirement plans or IRAs will not apply to distributions made on account of an IRS levy on a taxpayer's qualified retirement plan or IRA.

k. Distributions incident to a divorce under a QDRO.

8. *After* 1996, individuals over age 70½ who continue to work can delay distributions until retirement. [Small Business Job Protection Act]

a. This delay provision does not apply to 5% owners and IRA holders.

9. Investments in certain platinum coins and in certain gold, silver, or platinum or palladium bullion is permitted after 1997. [Taxpayer Relief Act of 1997]

10. Contributions to Keogh plans and other personal retirement accounts must be funded by 8½ months after year-end. That is September 15, even when a tax return is extended to October 15. [*Philip M. Wenger, CPA,* TC Memo 2000-156]

B. Nondeductible IRAs

1. Individuals are allowed to make nondeductible contributions to traditional IRAs.

2. The earnings are not taxed as they are earned by the IRA.

3. The earnings are includible in income when withdrawn.

4. If a taxpayer makes a contribution to an IRA that is nondeductible, a Form 8606 must be filed with the return.

    a. The penalty for not filing Form 8606 is $50--unless the failure to file was due to reasonable cause.

    b. Consider filing an amended tax return for open years where the Form 8606 was not filed.

    c. If the Form 8606 is not filed, all withdrawals made from the IRA may be taxed, even though tax was paid on the nondeductible contributions.

C. Roth IRAs

1. After 1997, a Tax-Free IRA (referred to as the Roth IRA) is available.

    a. Contributions to the Roth IRA are nondeductible but income can be accumulated tax-free.

    b. To be treated as a Roth IRA, the account must be designated as such when it is established.

    c. Roth IRAs are subject to income limits; the maximum yearly contribution that can be made to a Roth IRA is phased out for single taxpayers with adjusted gross income between $105,000 and $120,000, for joint filers with adjusted gross income between $166,000 and $176,000, and between $0 and $10,000 for married filing separately.

        1) A married individual who has lived apart from his or her spouse for the entire year and who files separately is treated as not married. [Reg. 1.408A-3, A-3(b)]

2. The contribution amount is the same as a deductible IRA and the total contribution between deductible and nondeductible IRAs cannot exceed $5,000 per taxpayer.

3. Unlike deductible IRAs, individuals are allowed to make contributions to the Roth IRA after reaching age 70½.

4. 6% Excise Tax on Excess Contributions

    a. Any contribution in excess of the contribution limit is subject to an annual 6% excise tax unless it is distributed to the taxpayer (with allocable net income) by the tax return due date (including extensions) for the year of the contribution.

    b. Any aggregate excess contributions not distributed are reduced as a deemed Roth IRA contribution for each subsequent year to the extent that traditional contributions are not made. [Reg. 1.408A-3, Q-7]

5. Qualified distributions from a Roth IRA are not included in the taxpayer's gross income and are not subject to the additional 10% early withdrawal tax.

    a. To be a qualified distribution, the distribution must satisfy a five-year holding period and must meet one of four additional requirements; to satisfy the five-year holding period, the Roth IRA distribution may not be made before the end of the five-tax-year period beginning with the first tax year for which the individual made a contribution to the Roth IRA.

    b. The five-year holding period begins to run with the tax year to which the contribution relates, not the year in which the contribution is actually made; thus, a contribution made in April 2000, designated as a 1999 contribution, may be withdrawn tax free in 2004, if otherwise a qualified distribution.

6. Taxpayers must meet one of four other requirements for a tax-free distribution; the distribution must be:

    a. Made on or after the date on which the individual attains age 59½,

    b. Made to a beneficiary (or the individual's estate) on or after the individual's death,

    c. Attributable to the individual being disabled, or

    d. A distribution to pay for "qualified first-time homebuyer expenses."

7. Distributions are treated as made in the following order (determined as of the end of a tax year and exhausting each category before moving to the following category):

    a. From regular (annual) Roth IRA contributions

    b. From converted Roth IRA contributions, on a first-in first-out basis

    c. From earnings on deposits

    d. Thus, no portion of a distribution is treated as attributable to earnings, or includible in gross income, until the total of all distributions from the Roth IRA exceeds the amount of contributions; nonqualified distributions are included in income after recovery of contribution and subject to the 10% early withdrawal penalty.

8. Distributions from one Roth IRA can be rolled over or "converted" tax free to another Roth IRA.

9. Amounts in an ordinary IRA can be rolled into a Roth IRA, but only if:

    a. Requirement for the rollover:

        1) The taxpayer's adjusted gross income for the tax year does not exceed $100,000 and

        2) The taxpayer is not married filing separately

    b. Income must be reported on an ordinary IRA rolled into a Roth IRA.

        1) Income from the Roth conversion is not included in the $100,000 AGI limitation.

        2) The income is included in all other income tax computations.

        3) The Tax Court has held that the Roth conversion income is counted when figuring taxes due on Social Security.

            a) Planning: Make a Roth conversion before taking Social Security benefits.

    c. If a taxpayer has both deductible and nondeductible IRAs and only a portion of the IRAs are converted to a Roth IRA, any amount rolled into a Roth IRA will be considered to have been drawn proportionately from both the deductible and nondeductible IRAs and will be taxed accordingly.

    d. For conversions made by means of a distribution and rollover contribution, the $100,000 limit applies to the year in which the distribution from the non-Roth IRA is made.

        1) Example: A taxpayer withdrew $60,000 from a traditional IRA in December 2011, and rolled over the amount into a Roth IRA in January 2012. The $100,000 modified AGI limit applies for 2011, not for 2012. In addition, the conversion is subject to tax for the 2011 tax year.

    e. Effective for 2005, minimum required distributions from a traditional IRA do not count toward the $100,000 income limit for converting a traditional IRA to a Roth IRA.

    f. The 1998 law permits a transfer from a traditional IRA to a Roth IRA to be rescinded, right up until the time you file your tax return--including extensions.

        1) This is helpful if it is discovered that a taxpayer had exceeded the $100,000 adjusted gross income limit.

    g. Effective January 1, 2000, an IRA owner who converts an amount from a traditional IRA to a Roth IRA during any post-1999 tax year and then transfers that amount back to a traditional IRA through a recharacterization may not then reconvert that amount back again into a Roth IRA before the start of the year following the tax year in which the amount was originally converted to a Roth IRA or, if later, the end of the 30-day period beginning on the day of the recharacterization transfer.

1) Example: Doreen converts a Roth IRA in April 2011, when her traditional IRA balance is $150,000. Unfortunately, by July 2010 her Roth IRA account is worth only $90,000. In a recharacterization, Doreen converts back to a traditional IRA at that time to avoid paying income tax on the $150,000 amount. If this were 1999, Doreen could reconvert back into a Roth IRA anytime during the year. However, since it involves a year after 1999, she must wait until January 1, 2012 to reconvert.

h. Distributions from contributions are treated as made first from regular contributions and then from conversions.

i. A taxpayer's conversion of an amount from a traditional IRA from which he or she was receiving a series of substantially equal periodic payments under Sec. 72(t)(2)(A)(iv) is not treated as a modification of that series under Sec. 72(t)(4) and thus will not trigger recapture of the Sec. 72(t) tax on previous distributions from the traditional IRA as long as the series of substantially equal periodic payments is continued under the Roth IRA (or if Sec. 72(t)(4) would otherwise not apply). Distributions that are part of a series of substantially equal periodic payments are subject to income acceleration to the extent allocable to a 1998 conversion contribution with respect to which the 4-year spread applies, but the additional 10% penalty tax under Sec. 72(t) will not apply, even if the distributions are not qualified distributions (as long as they are part of a series of substantially equal periodic payments).

j. Special Conversion Rules Beginning in 2010

1) The $100,000 adjusted gross income ceiling for converting a traditional individual retirement account (IRA) to a Roth IRA is eliminated for tax years after 2009.

2) The conversion is treated as a taxable distribution, but is not subject to the 10% early withdrawal penalty.

3) Taxpayers who convert in 2010 can elect to recognize the conversion income in 2010 or average it over the next two years.

10. Beginning in 2008, individuals will be able to roll over amounts from company plans to Roth IRAs if they have adjusted gross income of $100,000 or less. [Notice 2008-30]

a. These rollovers are taxable.

b. No 20% withholding is required.

c. Plans need not certify that the worker's AGI is $100,000 or less.

d. Plans must allow these rollovers for payout made after 2007.

11. New IRS rules allow amounts up to the total of your after-tax contributions of a 401(k) to be converted to a Roth IRA without paying tax. [Notice 2008-30] This is much more liberal than converting an IRA to a Roth.

a. The same rule applies to 403(b)s and 457 plans.

12. Granting Waivers of IRA 60-Day Rollover Period

    a. The IRS can waive the 60-day requirement on rolling over an IRA distribution if failure to waive would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the taxpayer.

        1) When evaluating requests for waiver, the IRS looks to all relevant facts and circumstances. These include:

            a) Errors by financial institutions;

            b) Inability to complete rollover;

                (1) Inability to complete a rollover may result from death, disability, hospitalization, incarceration, postal service error, and other events.

            c) Use of the distribution; and

            d) Passage of time since distribution.

    b. Taxpayer A requested the bank to transfer funds from a brokerage account to a personal checking account. The bank disbursed the amount from an IRA. The IRS waived the 60-day requirement because it was caused by a bank error. [Ltr. Rul. 200401020]

    c. Taxpayer B sought to switch her IRA to a bank with a better interest rate. She received a check from the old bank for the full amount of her IRA and took it to the new bank to open the new IRA. Contrary to the taxpayer's instructions, the new bank opened a nonretirement certificate of deposit. The IRS determined that failure to roll over the IRA within the 60-day period was beyond the taxpayer's reasonable control and waived the 60-day requirement. [Ltr. Rul. 200401023]

    d. Taxpayer C, who had a history of alcohol abuse and mental illness, made an IRA withdrawal. The taxpayer intended to redeposit the entire amount into an IRA within 60 days. Shortly thereafter he was involuntarily admitted to a clinic for alcohol and suicidal tendencies. The IRS determined that the taxpayer's severe mental disability and hospitalization were circumstances beyond the taxpayer's control that prevented re-depositing the amount into the IRA within 60 days after receiving the distribution. [Ltr. Rul. 200401024]

        1) If a guardian is appointed and knows of the error, the guardian must take action immediately to request IRS approval. The taxpayer's incapacity no longer becomes an excuse.

    e. Taxpayer D, diagnosed with Alzheimer's disease, made a series of withdrawals from his IRA. The taxpayer's daughter opposed the withdrawals and requested a medical evaluation of her father's mental condition. The 60-day period expired before the funds could be redeposited. The IRS determined that the withdrawals were beyond the taxpayer's reasonable control due to Alzheimer's disease and waived the 60-day rollover requirement. [Ltr. Rul. 200401025]

f. The taxpayer withdrew funds from his IRA to cover repair costs after his home suffered major damage in a tropical storm. The insurance company was not timely with the taxpayer's reimbursement. The taxpayer deposited 40% of the IRS distribution eight months after withdrawal. The IRS waived the 60-day rule with respect to 100% of the amount withdrawn. The IRS gave the taxpayer another 60 days from the letter ruling to contribute the outstanding 60% to the IRA. [Ltr. Rul. 200422053]

g. The taxpayer took money out of an IRA and put it in a money market account with the same institution, intending to roll over the amount to a brokerage IRA. The taxpayer missed the 60-day rollover window because the taxpayer's daughter fell into depression for which she received psychiatric treatment. The taxpayer's son also received treatment. The IRS waived the 60-day rollover rule. The money was not used for personal expenses. [Ltr. Rul. 200422054]

h. The taxpayer withdrew money from an IRA to stop foreclosure on his home. After using the IRA funds to pay the mortgage, he applied for a loan at numerous mortgage companies but was turned down. His mother took out a loan on her home and the taxpayer deposited the proceeds back into the IRA 102 days later. The IRS denied his request for a waiver. [Ltr. Rul. 200422057]

i. Worried about losses in the stock market, the taxpayer transferred distributions from several IRAs to two non-IRAs. The taxpayer only decided to roll over the distributions when he learned of the negative tax consequences. Waiver of the 60-day period was not justified. [Ltr. Rul. 200422058]

j. A recently widowed spouse was granted a reprieve from the 60-day rollover requirement for IRA distributions after the IRS determined that she was in mourning, she also had to take charge of her husband's estate and decide how to handle the IRA. [Ltr. Rul. 200415012]

k. The IRS refused to waive the 60-day limit when a person who lost his job took funds from his IRA to pay his bills and returned them late. "In effect you have engaged in...a short-term interest-free loan [that is] not consistent with the intent of Congress." [Ltr. Rul. 200417033]

l. To receive a waiver of the 60-day rollover period, a taxpayer normally has to request a letter ruling from the IRS. Follow the procedures outlined in Rev. Proc. 2007-4 and pay the applicable user fee of $500 to $3,000 listed in Rev. Proc. 2007-8.

m. Despite evidence of a genuine mutual mistake, the Eighth Circuit ruled that a collateral assignment of retirement annuities was a taxable event. An assignment, pledge, or loan of an annuity is a taxable distribution under Sec. 72(p)(1). The taxpayer's argument that the assignment was void due to a mutual mistake carried no weight. [Armstrong, CA-8, 5-3-04]

13. Late Roth Recharacterizations

a. The IRS has released a set of private letter rulings that will give great comfort to many taxpayers who have converted, or plan to convert, from a traditional individual retirement account to a Roth IRA. If a taxpayer discovers--after the deadline for a Roth "recharacterization" has passed--that an "innocent" mistake that disqualifies the conversion has been made, he or she may be able to put the account assets back into a traditional IRA without penalty--provided the IRS grants permission. [Ltr. Ruls. 200116053, 200116057, 200116058]

The IRS offers Reg. 301.9100-2 and 3, which allows the IRS to grant relief for missing a variety to statutory and regulatory deadlines, including the deadline for Roth IRA recharacterization. Under these rules, relief can be granted if the taxpayer "acted in good faith" and the interest of the government would not be prejudiced. Acting in good faith is assumed (1) if a request for relief is filed before the failure to make a timely election is discovered by the IRS; (2) if the taxpayer failed to make the election because of intervening events beyond his or her control; (3) if, after exercising reasonable diligence, the taxpayer was unaware of the necessity for the election; (4) the taxpayer relied on written advise from the IRS; or (5) the taxpayer relied on the advice of a qualified tax professional.

In the first case, the taxpayer thought that her extension to file Form 1040 was good until October 15 instead of August 15. In September, she learned that she had missed the filing extension deadline and also had sale-of-residence income that counted toward the $100,000 adjusted gross income ceiling.

In the second case, the taxpayer found that his adjusted gross income for the year would exceed the $100,000 limit and instructed his bank to reconvert the account from a Roth back to a traditional IRA. Unfortunately, his bank used the wrong account reference number and did not recharacterize the IRA until after the deadline.

In the third case, the taxpayer was simply unaware of the $100,000 limit and the deadline for reconverting. The taxpayer realized his mistake after the deadline but before the IRS discovered the failure to recharacterize on its own.

For all three taxpayers, the IRS granted relief to file a late recharacterization. It did so because:

1) Each taxpayer was either ignorant of the rules for qualifying for a Roth conversion, or reasonably assumed that a responsible financial institution or professional had properly recharacterized the conversion on time.

2) Upon realizing the error, each taxpayer took immediate steps to remedy the situations and asked the IRS for relief.

3) The tax year of the improper conversion in all three cases was not a "closed" tax year.

4) An IRA owner who was older than 70 ½ converted the balance to a Roth. The adjusted gross income on his 1040 was under $100,000. Unfortunately, his preparer forgot to list some of the filer's income. The added income would have made the taxpayer ineligible to convert the IRA in the first place. Two years later , he asked the IRS to let him retroactively unconvert the Roth to an IRA and delay the minimum payouts he would have been forced to take. The conversion can be undone without penalty. [Ltr. Rul. 200213030]

b. An individual who converted a traditional IRA to a Roth IRA in 1999 did not realize until 2002 that he had been above the income limit for doing so legally. Permission was granted to reconvert -- but because the individual had been over 70 ½ at which time annual distributions from an IRA are required, the reestablished traditional IRA must pay out "make up" minimum required distributions for the fie years from 1999 to 2003. These must be paid out by the end of 2004. [Ltr. Rul. 200352020]

c. In 1999, an individual converted a regular IRA to a Roth IRA, paid the tax due, and file his return on time. Later, he learned he was ineligible to make the Roth conversion because his corrected income for 1999 exceeded $100,000. The IRS ruled he get until 30 days after the ruling to reverse the conversion. [Ltr. Rul. 20412001]

14. Distributions from Roth IRAs are only required upon death.

D. Roth 401(k) Plans

1. After 2005, firms can amend their 401(k) plans to add a special Roth IRA account that can be funded by payroll deduction. The IRS will require that the nondeductible Roth contributions be segregated from deductible 401(k) payins and accounted for separately.

2. The Roth 401(k) contribution cap will be higher than for a regular Roth. The standard 401(k) limits apply, a $17,500 maximum for 2012, plus an additional $5,500 for anyone 50 or older.

   a. Any Roth 401(k) contributions will count toward the regular 401(k) limit.

3. There is no income limits on contributions to Roth 401(k)s, unlike the $173,000 income limit on regular Roths.

4. Employer matches of employee Roth 401(k) contributions are not tax favored. The matches go into a regular 401(k) and are taxed as income when paid out.

5. The Roth 401(k) accounts are subject to the minimum payout rules after the taxpayer reaches age 70 ½.

   a. It appears that the minimum payout rule could be circumvented by rolling the balance to the Roth 401(k) over to a Roth IRA, but the IRS has not yet ruled on this.

6. New IRS regulations say that if a Roth 401(k) contribution for a year is taken out within five years, a portion of the distribution is allocated to earnings and is taxable.

   a. However, if the funds are rolled into a Roth IRA, there is no automatic allocation of earnings.

   b. No tax is due on a payout as long as it does not exceed the total of Roth 401(k) contributions.

7. Roth Rollovers

   a. The five-year period for a Roth 401(k) and a Roth IRA must be determined independently. The period that the rolled-over funds were in the Roth 401(k) account does not count towards the five taxable year period for determining qualified distributions from the Roth IRA. However, if a taxpayer had established a Roth IRA in a prior year, the five-year period for determining qualified distributions from a Roth IRA begin with the earlier period.

8. Roth 401(k) sample plan amendment language has been released by the IRS. [Notice 2006-44]

    a. Individual plan sponsors and sponsors of pre-approved plans may adopt or use the sample plan amendment in drafting their individualized plan amendments.

    b. The deadline for complying with the requirement to timely adopt a discretionary amendment remains set at the end of the plan year in which the amendment is effective.

E. Retirement and Benefit Plans

1. The 2001 Tax Act increased the dollar limits on defined contributions plans; elective deferrals, including Sec. 401(k) plan deferrals; compensation that may be taken into account under a plan; and Sec. 457 plan deferrals after 2001.

    a. Defined contribution plans limits are increased to $50,000 (2012). [IR-2011-103]

        1) This amount is indexed for inflation in $1,000 increments.

    b. The dollar limit on annual elective deferrals under Sec. 401(k) plans, Sec. 403(b) annuities, and Sec. 408(k) salary reduction SEPs to $11,000 in 2002 with $1,000 annual increments until the limits reach $15,000 in 2006.

        1) The $15,000 is indexed for inflation in $500 increments after 2006.

        2)

For tax years beginning	Applicable dollar amount
2002	$11,000
2003	12,000
2004	13,000
2005	14,000
2006	15,000
2007	15,500
2008	15,500
2009	16,500
2010	16,500
2011	16,500
2012	17,000

    c. The maximum annual elective deferrals that may be made to a SIMPLE plan was increased to $10,000 in 2005. The dollar limit is indexed in $500 increments after 2005 and is $11,500 for 2012.

    d. The dollar limit on deferrals under a Sec. 457 plan is increased to conform to the elective deferral limitation.

        1) For the three years prior to retirement, the limit in those years is now computed based on twice the otherwise applicable dollar limit.

    e. The compensation limit that may be taken into account is $250,000 (2012)

        1) In applying the employer deduction rules
        2) For nondiscrimination testing purposes for Sec. 408(l) salary reduction SEPs
        3) For nondiscrimination testing purposes for Sec. 501(c)(9) voluntary employee benefit associations and Sec. 501(c)(17)(A) supplemental unemployment compensation benefit trusts

2. Benefits Limits Under Qualified Plans

   a. The annual benefit limit under a defined benefit plan is $200,000 for 2012. The amount is indexed for inflation in multiples of $5,000.

   b. The dollar limit is reduced if benefits begin before age 62 (instead of the social security retirement age as under prior law) and increased for benefits beginning after age 65.

   c. The compensation limit that may be taken into account in determining benefits under qualified plans in increased to $250,000 (2012).

3. Catch-Up Contributions

   a. For individuals who are at least 50 before the end of the plan year, the current dollar limits on elective deferrals are increased.

      1) For plans other than SIMPLE Plans under Sec. 401(k)(11) or Sec. 408(p) -- the applicable dollar amount is $1,000 for 2002; $2,000 for 2003; $3,000 for 2004; $4,000 for 2005; $5,000 for 2006, 2008, and 2008; and $5,500 for 2009-2012.

      2) For Sec. 401(k)(11) and Sec. 408(p) -- the applicable dollar amount is $500 for 2002, $1,000 for 2003, $1,500 for 2004, $2,000 for 2005, and $2,500 after 2005.

   b. Catch-up contributions are not subject to any other contribution limits and are not taken into account in applying other contribution limits to other contributions or benefits under a plan.

   c. An employer is permitted to make matching contributions with respect to catch-up contributions. Any such matching contributions are subject to the normal applicable rules.

4. Increases in Defined Contribution Plan Limit

   a. The percentage of compensation is raised from 25% to 100%.

   b. Sec. 403(b) plans and simplified employee pension plans are to be treated as defined contribution plans, and any contributions made by the employer are to be treated as employer contributions to a defined contribution plan.

   c. The 33 1/3% of the participant's includible compensation limit for Sec. 457 plans is raised to 100% of the participant's includible compensation.

5. Faster Vesting of Employer Matching Contributions

   a. The minimum vesting schedules of a participant's nonforfeitable right in the employer's matching contributions has been shortened.

      1) The cliff vesting schedule is reduced from 5 years to 3 years

      2) The gradual vesting schedule is reduced from 3-to-7 to 2-to-6

   b. This provision is effective only for employer matching contributions of defined contribution plans. For all other retirement plans the 5- and 7-year vesting schedules remain in effect.

6. Employer's Deduction Limits Increased

   a. The limit on deductible contribution plans is increased from 15% to 25% of compensation.

   b. The increased 25% contribution limit also applies to employer contributions to a simplified employee pension plan.

7. Sample Plan Amendments -- Notice 2001-57, CB 2001-38 IRB 279

8. Credit for Plan Start-Up Costs of Small Employers (Sec. 45E)

   a. Small employers with no more than 100 employees will receive a tax credit for some of the costs of establishing new retirement plans, effective for costs paid or incurred in tax years beginning after 2001.

   b. The credit equals 50% of the start-up costs incurred to create or maintain a new employee retirement plan.

   c. The credit is limited to $500 in any tax year and it may be claimed for qualified costs incurred in each of the three years beginning with the tax year in which the plan becomes effective.

   d. The plan must cover at least one employee who is not a highly compensated employee.

   e. Qualified costs are reduced by the amount of the credit.

   f. The credit is part of the general business credit and no portion of the credit may be carried back to a tax year beginning before January 1, 2002.

   g. At the employer's election, the credit may be claimed in the year immediately preceding the first year in which the new plan is effective.

9. Credit for Elective Deferrals and IRA Contributions (Sec. 25B)

   a. To encourage low- and middle-income taxpayers to establish or maintain private savings accounts to ensure adequate savings for retirement a temporary nonrefundable credit for contributions or deferral to retirement savings plans has been established.

   b. The amount of the credit for a tax year will be equal to the applicable percentage times the amount of qualified retirement savings contributions (not to exceed $2,000) made by an eligible individual in the tax year to certain specified retirement plans.

   c.

Applicable %	Joint Return		Head of Household		All Other Cases	
	Over	Not Over	Over	Not Over	Over	Not Over
50	$ 0	$34,500	$ 0	$25,875	$ 0	$17,125
20	34,500	36,000	25,875	28,125	17,125	18,750
10	37,500	57,500	28,125	43,125	18,750	28,750
0	57,500	--	43,125	--	28,750	--

d. Qualified Retirement Savings Contributions

1) Qualified retirement contributions under Sec. 219(e) (relating to retirement savings);

2) Elective deferral defined under Sec. 402(g)(3) (relating to deferrals of certain specified employer contributions);

3) Elective deferrals of compensation of eligible Sec. 457(b) state and local government and tax-exempt organization deferred compensation arrangements; and

4) Voluntary employee contributions to any qualified retirement plan defined at Sec. 4974© (relating to excise tax on certain accumulations in qualified retirement plans).

e. An individual making a contribution to a qualified retirement savings plan must be at least 18 as of the close of the tax year, must not be claimed as a dependent on someone else's tax return, and must not be a full-time student.

$16,500		$17,930		$38,000	Married Couple
- 5,700	Standard Deduction	- 1,430	IRA Deduction	- 5,000	IRA Deduction
- 3,650	Personal Exemption	$16,500		$33,000	
$ 7,150	Taxable Income	- 5,700		-11,400	
$ 715	Tax	- 3,650		- 7,300	
.		$ 7,150		$14,300	
$ 1,430	Into a Roth	$ 715	Tax	$ 1,430	Tax
x 50%					
$ 715	Credit	$1,430	Into a Deductible	$5,000	Into a Deductible
.		x 50%		x 50%	
.		$ 715	Credit	$2,500	Credit --
.					
	Limited to $1,430				

10. For purposes of determining additional contribution requirements, the interest rate range used in calculating a plan's current liability is increased.

11. Contribution deduction limits applicable to employers that maintain a combination of plans do not apply when only elective contributions are contributed to the employer's defined benefit plan.

12. Distributions from after-tax contributions may be directly rolled over to a qualified defined contribution plan that will separately account for the taxable and nontaxable portions of the distribution, and to traditional IRAs.

13. The percentage of compensation used to determine allowable contributions to simplified employees pensions (SEPs) is increased to conform with the deduction limits.

F. Cash Balance Conversion Regulations

1. The Seventh Circuit reversed a federal district court decision and concluded that it was not improper to convert a defined benefit pension plan to a cash balance plan. [Cooper v. IBM Pension Plan, CA-7, 8-7-06]

    a. Example. An employee who leaves the employer at age 50 after 20 years of service would receive a larger benefit than an employee who left at age 65 after 20 years of service, because the younger employee would be entitled to 15 additional years of interest credit.

    b. The court observed that the crediting of interest to an account in a defined contribution plan did not give rise to discrimination and that the same analysis should apply to a defined benefit plan such as a cash balance plan.

2. The IRS has ruled that firms switching to cash balance plans do not violate pension rules. [Rev. Rul. 2008-7] Employers converting their old-style pension plans to cash balance plans can allow employees to choose whether to be covered by the benefit formula of the new plan or the old plan.

G. Archer Medical Savings Accounts

1. A restricted number of participants will be able to take advantage of a new type of savings vehicle called a Medical Savings Account (MSA) for tax years beginning after 1996. The index numbers for 2012 are

    a. Individual minimum deductible coverage is $2,100 and maximum is $3,150; maximum out-of-pocket limitation is $4,200.

    b. Family minimum deductible coverage is $4,200 and maximum is $6,300; maximum out-of-pocket limitation is $7,650.

2. Within limits, contributions to an MSA will be deductible if made by an eligible individual and excludable from income if made by an employer on behalf of an eligible individual.

    a. 65% of deductible for individual coverage.

    b. 75% of deductible for family coverage.

3. Distributions from an MSA that are not used for payment of medical expenses are includible in income and subject to an additional 15% tax unless made after the participant reaches age 65, dies, or becomes disabled.

4. Generally, an eligible individual is a self-employed person or an employee who is covered by a high-deductible plan sponsored by a small employer and by no other health plan.

    a. A small employer is one who employs, on average, 50 or fewer workers.

5. Treatment upon death of the account holder

   a. If the decedent's spouse is the designated beneficiary of the account, the account becomes the spouse's MSA.

   b. If another beneficiary (including a spouse that is not the designated beneficiary) acquires the interest, that person generally must include in gross income the fair market value of the assets in the account.

   c. If the decedent's estate acquires the interest, the fair market value of the assets in the account is included on the final income tax return of the decedent.

   d. Funds from an Archer MSA can be used to pay for long-term-care coverage. Distributions from the MSA for this purpose are tax free.

H. Retirement Plan Distributions

1. Simplified method must be used for employee annuities with starting date after 11/19/96. Section 72(d) requires the use of the simplified method of recovering the investment in the contract for most annuity distributions from qualified plans under §401(a), employee annuities under §403(a), and §403(b) annuity contracts.

   a. A special rule requires a single sum that is received in connection with the commencement of annuity payments to be treated as if received before the annuity starting date.

   b. To find monthly excludable amount divide total investment in the contract as of the annuity starting date by the number of anticipated payments based on the table below:

Age on starting date	Number of payments
Not more than 55	360
More than 55 but not more than 60	310
More than 60 but not more than 65	260
More than 65 but not more than 70	210
More than 70	160

2. Effective for annuities starting after 1997, a new table may be used for basis recovery where the benefits are based on the life of more than one annuitant.

   a. To find monthly excludable amount divide total investment in the contract as of the annuity starting date by the number of anticipated payments based on the table below:

Combined Age on starting date	Number of payments
Not more than 110	410
More than 110 but not more than 120	360
More than 120 but not more than 130	310
More than 130 but not more than 140	260
More than 140	210

   b. Notice 98-2, IRB 1998-2, 22 explains the simplified method to be used in figuring tax on annuity payable over more than one life.

I. Distribution Developments

1. The Tax Court found that payments the taxpayer made to his ex-wife from funds he withdrew from his IRAs to satisfy the terms of their divorce judgment were taxable income. The taxpayer was also liable for the 10% premature distribution penalty on the funds under IRC §72(t). The taxpayer was required to pay his ex-wife $29,000 "as a further division of the marital property." The taxpayer attempted to satisfy the judgment by directing the bank holding his IRAs to transfer $29,000 directly to his ex-wife's IRA in another bank. The taxpayer's ex-wife refused the transfer of funds because she believed that the transfer did not constitute the cash payment the taxpayer was ordered to pay and that the funds would be taxable to her when she withdrew them from her IRA. The taxpayer ultimately requested a check from the IRAs, which he then in turn paid, by check to his ex-spouse. He then failed to report the distribution he received from his IRAs on his tax return. He claimed that the payment came under a qualified domestic relations order (QDRO). However, he received the distributions directly from his IRAs. [*Czepiel,* TC Memo 1999-289]

2. A withdrawal of $480,000 from a Keogh used to buy stock cannot then be rolled over tax free to an IRA. Using cash to buy stock and then making a rollover to an IRA is not a rollover of the cash distribution from the Keogh. [*Lemishow*, 110 TC 110 (1998)]

3. IRA owner under age 59½ who forfeits his account because of currency crimes is not subject to the 10% early distribution penalty because the distribution is involuntary. However, he is subject to regular income tax on the distribution of the funds to the government. It is not double jeopardy because paying tax is not a punishment. [*Francisco A. Murillo*, TC Memo 1998-13]

4. A taxpayer owed back taxes, but had only enough assets to pay half of the outstanding balance. Although the taxpayer was vested in his employer's pension plan, he decided against using his pension to pay the taxes he owned. He told the IRS he intended to wait until reaching normal retirement age before using the benefits. The IRS collection agent working on the case felt the taxpayer was being uncooperative and asked if the IRS could elect early retirement "on behalf of' the taxpayer. In a legal memorandum, and IRS senior technical reviewer concluded the service could levy and collect taxes on retirement benefits when a taxpayer is eligible for early retirement. According to the reviewer, the IRS can make such an election for the taxpayer even though the retirement would result in a substantially reduced benefit. [ILM 199936041]

5. Pursuant to a draft divorce settlement agreement, the taxpayer had a check issued to him for his full IRA account balance of $68,000, which he endorsed to his wife. The endorsement of the check was not a transfer of the taxpayer's interest in the IRA because his interest in the IRA was extinguished as of the time he withdrew the funds. The husband had to pay income tax on the entire withdrawal, plus a 10% penalty for early withdrawal. [*Jones*, TC Memo 2000-219]

    a. IRS publications describe two commonly used methods of transferring an interest in an IRA that qualify for the exception:

        1) Change the name on the IRA to that of the nonparticipant spouse or

        2) Direct the trustee of the IRA to transfer the IRA assets to the trustee of an IRA owned by the nonparticipant spouse.

6. A person died and left as his IRA beneficiary a trust benefitting his three children and his grandchildren by a fourth deceased child. He died after reaching the date at which required minimum distributions must begin. The beneficiaries of the trust have different investment objectives and want to divide the IRA into four separate IRAs. They will continue to take distributions from all four IRAs using the oldest child's life expectancy. The IRS ruled that the division of the IRA into four will be permitted and have no adverse tax consequences. [Ltr. Rul. 200008044]

    a. The same result was allowed in Ltr. Rul. 200028041.

7. You can take funds out of an IRA before age 59½ without penalty through annuity payments of a size calculated to last over your life expectancy. The payments must last until you reach 59½ and at least five years. If you violate the payment schedule, the 10% early withdrawal penalty will apply not just to any improper withdrawal but to all amounts received through the annuity. After an individual started to take early payments, his IRA earned big investment gains. So he asked if he could increase his annuity by an inflation adjustment. The IRS ruled that any change will result in the penalty. [Ltr. Rul. 199945050]

8. An individual was in the course of taking early distributions when he divorced and one-third of his IRA was transferred in a property settlement to his wife. The IRS ruled that the transfer of IRA funds to his former wife justified a corresponding reduction of the size of his periodic withdrawals by one-third, without the imposition of any penalty. [Ltr. Rul. 200050046]

9. A disabled individual began taking distributions from his IRA before age 59½ without penalty by doing so in substantially equal annual payments. The IRS ruled that the individual can change the schedule of distributions because the Tax Code specifically allows modifications due to a disability. If the individual qualifies as disabled, no penalty will apply. [Ltr. Rul. 200126037]

J. Retirement Plan Distributions

1. Sec. 72(t)(1) imposes a 10% additional income tax (penalty) on early withdrawals from certain retirement plans and IRAs. Early withdrawals are those made before the plan participant or IRA owner attains age 59½. Section 72(t)(2)(A)(iv) provides an exception for early withdrawals that are part of a series of substantially equal periodic payments. Three methods are provided for calculating periodic payments that comply with the "substantially equal" requirements:
    a. Fixed amortization method,
    b. Annuitization method, and
    c. Required minimum distribution method.

    Using methods a and b to calculate the substantially equal periodic payment results in a payment that is fixed for the entire payout period based on the value of the account when payments commenced. Using method c to calculate the payments results in a payment that is recalculated annually based on the adjusted value of the account in subsequent years and on an adjusted life expectancy figure.

2. If any modification is made in the periodic payments before the later of five years or age 59½ the 10% penalty will apply to all previous distributions, plus interest for the deferral period. Rev. Rul 2002-62 allows two exceptions to the penalty rules: [Rev. Rul. 2002-62, 2002-42 IRB 710]

   a. If an individual's assets in an individual account plan or an IRA are exhausted, the individual will not be subject to the 10% penalty as a result of not receiving substantially equal periodic payments and the resulting cessation of payments will not be treated as a modification of the series of payments.

   b. An individual who begins distributions in a year using either the fixed amortization method or the fixed annuitization method may in any subsequent year switch to the required minimum distributions method to determine the payment for the year of the switch and all subsequent years and the change in method will not be treated as a modification subject to the 10% penalty. Once a change is made, the required minimum distribution method must be followed in all subsequent years.

3. The Tax Court says that an unpaid loan is treated as income at the end of the calendar quarter after the quarter when a payment was missed. [White, TC Summ. Op. 2005-62]

   a. Unless an exception applies, a 10% penalty must be paid if the employee is under age 59 ½.

K. Bankruptcy Creditors

1. The Supreme Court says IRAs are like 401(k)s, Keoghs, and pensions, all of which are exempted from bankruptcy creditors. [*Rousey v. Jacoway*, S.Ct., No. 03-1407]

2. The new federal bankruptcy law changes the equation significantly. It provides a $1 million exemption for regular and Roth IRAs.

3. All funds rolled over into an IRA from an employer's retirement plan are protected.

   a. Place any rollover from an employer plan in a segregated "conduit IRA" to identify the source of the funds.

4. The new bankruptcy law became effective on Oct. 17, 2005.

L. Hardship Withdrawals Under 401(k) Plans

1. Final regulations issued at the end of 2004 expanded the list of hardship situations. They had already included such events as buying a home and paying for medical expenses. Paying for funeral expenses and home repairs have been added.

   a. Plan rules determine the requirements for hardship withdrawals.

M. Appreciated Employer Stock and 401(k)s

1. Taxpayers can have the retirement plan distribute appreciated employer stock. The taxpayer pays tax only on the cost to the company when it contributed to the plan. The amount taxed becomes the basis of the stock. Any appreciation over basis is long-term capital gain and will be taxed when the stock is sold. [Notice 98-24] It if stock is held more than one year any further gain will be long-term capital gain.

2. To qualify for the tax break, the taxpayer must take a lump-sum distribution of the entire retirement account within a single tax year.

   a. The shares must be held in a taxable investment account.

   b. Other parts of the distribution can be rolled into an IRA.

3. A taxpayer made a mistake in filling out the paperwork for the withdrawal and the distribution was not completed within the same calendar year. The IRS denied the tax break. [Ltr. Rul. 200434002]

4. A taxpayer took proceeds from his properly completed lump-sum distribution and rolled them over to an IRA. Following the mistaken advice of his financial adviser, he included the distributed stock shares in the rollover. The IRS stated that the requirements can not be waived. [Ltr. Rul. 200442032]

   a. Any distributions will be taxed at ordinary income rates.

N. Withdrawal of Pre-1987 Employee Contributions

1. The IRS says that withdrawals of pre-1987 employee contributions are tax free. This relief applies only to a state pension plan that, before May 6, 1986, allowed employees to withdraw after-tax contributions in a lump sum. [Ltr. Rul. 200450053]

2. Distributions that include employee contributions made after 1986 are taxed under the normal payout rules and are only partially tax free.

O. SIMPLE Contributions

1. Contributions to a SIMPLE are due within 30 days after year end, the Tax Court says. [Runyan, TC Summ. Op. 2006-58]

   a. That is far shorter than the 3 ½ months allowed after year end to make a regular IRA contribution.

P. Plan Loan Offset Eligible for Rollover

1. Taxpayer obtained a loan from his retirement plan to use as a down payment on his first home during the term of his employment. The taxpayer subsequently terminated his employment and received a letter from the plan administrator stating that the balance of his loan was going into default and the balance would be a taxable event. The taxpayer opened an IRA and deposited two checks. One check was from the taxpayer's employer representing the balance in his 401(k) and the other was a personal check from the taxpayer representing the outstanding loan amount. The IRS determined that the taxpayer could rollover the payment made to offset the loan amount into an IRA and the amount could be excluded from the taxpayer's gross income. [Ltr. Rul. 200617037]

   a. The holding could enable the taxpayer to effectively pull out some of the 401(k) plan balance that has been locked into specified investment options and "rollover' the amount into a more self-directed IRA.

Q. Requests for waivers of the 60-day rollover period will now cost from $500 to $3,000, depending on the amount of the rollover. [Rev. Proc. 2006-8]

1. $3,000 for a rollover of $100,000 or more.

2. $1,500 for a rollover of $50,000 or more but less than $100,000.

3. $500 for smaller rollovers.

4. It was $95 under Rev. Proc. 2005-8.

R. Rollover of Deceased Spouse IRA

1. Taxpayer rolled a $1,010,988 distribution from her deceased husband's IRA account into her separate IRA upon her husband's death. Four years later, she received a $977,888 distribution from her IRA. She was under age 59 ½ at the time of the distribution. She claimed that the distribution was an amount received from her deceased husband's IRA and therefore exempt from the 10% additional tax on early distributions. The Tax Court held that the taxpayer received an early distribution and was subject to the 10% tax. The amount received from her deceased husband's IRA lost its character as a distribution made to a beneficiary upon a decedent's death once the wife transferred the funds to her separately owned IRA. [Gee, 127 TC No. 1]

S. Approved Custodians or Trustees [Ann. 2007-47]

1. Among the requirements for qualification of certain tax-preferred savings, custodial, and trust accounts as tax-exempt is that the trustee or custodian of such accounts must be a bank, insurance company, or an approved nonbank trustee or custodian. If an entity that is not a bank, insurance company, or approved nonbank handles such accounts, the amounts in the account will be includible in gross income.

2. The accounts covered by this requirement include Archer medical savings accounts (MSAs), health savings accounts (HSAs), custodial accounts of retirement plans qualified under sec. 401, custodial accounts for RIC stock under Sec. 403(b)(7), traditional individual retirement accounts (IRA), or Roth IRAs, Sec, 456(b) deferred compensation plans, and Coverdell education savings accounts (ESAs).

3. An entity that is not a bank, insurance company, or approved non-bank custodian or trustee must receive approval from the IRS before it may serve as a nonbank custodian or trustee. Such nonbank custodians or trustees must submit an application to the IRS indicating that the requirement of Reg. 1.408-2(e)(2) through Reg. 1.408-2(e)(7) will be met. If the application is approved, a written notice of approval will be issued to the applicant.

T. Retirement Plan Developments

1. Nonspouse Rollovers [Notice 2007-7]

a. If a participant in a retirement plan dies leaving accrued benefits under the plan to a nonspousal designated beneficiary, that designated beneficiary may be able to roll over the inherited funds into an IRA set up specifically to receive those funds. However, the rollover must be accomplished by a direct trustee-to-trustee transfer and the retirement plan must provide for this type of rollover. The distribution must otherwise be eligible for a rollover, meaning that required minimum distributions cannot be rolled over.

b. If a participant dies before his or her "required beginning date, the RMD for purposes of determining the amount eligible for rollover are calculated under either the 5-year rule or the life-expectancy rule.

c. If, under the plan, the 5-year rule applies for determining RMDs, then a nonspouse designated beneficiary may treat the plan as using the life expectancy rule, as long as the rollover into the IRA is made before the end of the year following the year of the participant's death.

1) If the beneficiary waits until the year following death, a RMD is required in that second year using the life expectancy rule.

d. A plan may, but is not required to, offer a direct rollover of a distribution to a nonspouse designated beneficiary.

2. Rolling Over IRA Settlement Payment

a. A settlement payment that restores IRA losses can be rolled over, the IRS rules privately. The payment is directly related to the IRA. [Ltr. Rul. 200705031]

b. A late rollover was also permitted. The IRA owner did not roll the payment into her IRA within 60 days because she was told by the payer that the payment was taxable. She even received a 1099 for it. The IRS decided that is would be inequitable to enforce the 60-day deadline.

3. Investment in Family Business

   a. The Department of Labor has ruled that the taxpayer's investment of IRA funds in a family member's company would have to be treated as a prohibited transaction. An individual with a self-directed IRA would invest account funds in a business owned by his daughter and son-in-law. In the department's view, the investment would be "a sweetheart deal" and therefore violate the prohibited transaction rules. [DOL Ltr. 2006-09A]

      1) The IRA owner cannot end up holding 50% or more of the underlying company either directly or indirectly. Here, due to the attribution rules, the IRA surpassed this threshold.

4. Early IRA Distribution Penalty

   a. The Tax Court ruled that the 10% penalty of early distributions is not reduced by qualified higher educational expenses paid in a year different from the year in which the early distributions were made. [Duronio, TC Memo 2007-90]

   b. In December 2001, the taxpayer made approximately a $20,000 tuition payment to the university for her son. In the fall of 2002, the taxpayer's son obtained a student loan in the amount of approximately $20,000. In the same year, the taxpayer received a $20,000 early IRA distribution. Neither the taxpayer nor her son made any repayments on the student loan. Additionally, the taxpayer did not pay any other educational expenses on her son's behalf during 2002.

5. Trustee-to-Trustee IRA Rollover After Periodic Distributions Began

   a. The taxpayer, who was not 59 ½ years of age, received annual distributions from an IRA maintained by a particular company, which were calculated using the fixed annuity method described in Notice 89025. Later, the taxpayer used a trustee-to-trustee transfer to move balances in the original IRA into a different IRA with a different company. The taxpayer did not receive any distributions from the new IRA. The IRS held that the transfer of funds between the two IRAs was a modification to the series of substantially equal payments the taxpayer was receiving from his original IRA. Thus, the taxpayer was subject to the 10% additional income tax under Sec. 72(t). [Ltr. Rul. 200720023]

6. Retirement Plan Payments for Accident and Health Insurance Premiums

   a. Newly proposed regs clarify that a payment from a qualified retirement plan for an accident or health insurance premium generally is a distribution under Sec. 402(a). The distribution would be taxable under Sec. 72 in the tax year in which the premium is paid. [NPRM REG-148393-06].

   b. The Pension Protection Act of 2006 allows for a tax-free distribution from a pension plan of up to $3,000 per year to pay premiums on health insurance or long-term care for retired public safety officers.

7. Rollover of IRA Funds for Failed First-Home Purchase

   a. Taxpayers have 120 days to roll the money back to an IRA without tax or penalty. [Ltr. Rul. 200729038]

8. Divorce-Related Transfer

   a. A divorce-related transfer will not trigger the 10% penalty. [Ltr. Rul. 200717026] Normally, distributions before 59 ½ incur the penalty unless an IRA owner takes substantially equal annual payouts over a period of least five years. A divorce decree gave half an IRA to an ex-spouse after the IRA owner had started taking such a series of payments. Although the transfer lowered payout amounts, the IRS says no penalty is owed.

9. Financial Need Transfer

   a. A payout due to a change in financial circumstances is subject to the 10% penalty. [Ltr. Rul. 200717032] If a taxpayer chooses to alter a series of pre-59 ½ equal payments because of financial needs, all prior withdrawals will be subject to the penalty.

10. Taxpayers who failed to take a required minimum payout had to pay the 50% penalty up front, even if they had reasonable cause. The IRS has revised Form 5329 to allow filers to seek a waiver and attach an explanation. The penalty is due only if relief is denied.

11. Lifetime distributions not started promptly can be made up later on to avoid triggering the five-year distribution rule. [Ltr. Rul. 200811028] A 30-year old woman who had inherited two IRAs from her deceased father planned to take distributions over her life expectancy but failed to begin them by the end of the year following death. To correct this mistake, the woman made up the missed distributions and paid a 50% penalty. The IRS allowed her to avoid having to distribute the entire amounts within five years.

12. Defaulted Loans

   a. The Tax Court determined that income is reported and the penalty is applied when the period for curing the default lapses. [Leon, TC Summ. Op. 2008-86]

      1) This is usually 90 days after the payment was missed.

13. Early Payout Hardship Exemption

   a. The Tax Court ruled that most hardship withdrawals are not exempt from the 10% penalty on pre-59 ½ payouts. An army wife used funds from her account to pay unreimbursed moving costs for her family when her spouse was transferred to a base in another state. While the Court was sympathetic to her plight, the law does not provide a waiver for hardship. [Carder, TC Summ. Op. 2008-82]

Chapter 9 - Adjustments to Income

A. Health Savings Accounts (HSAs)

1. Created by the Medicare Prescription Drug, Improvement and Modernization Act of 2003, passed in December 2003. [P.L. 108-173]

2. Provides tax benefits for individuals with high-deductible health plans (HDHP).

   a. A high-deductible health plan is one in which the deductible for individuals is $1,200 or $2,400 for a family. The annual out-of-pocket, including deductibles and co-pays, cannot exceed $6,050 for self-only coverage and $12,100 for family coverage (for 2012).

      1) An HDHP may impose a reasonable lifetime limit on benefits provided under the plan. In such cases, amounts paid by the covered individual above the lifetime limit will not be treated as out-of-pocket expenses in determining the annual out-of-pocket maximum. [Notice 2004-50, Q-14]

      2) Amounts paid by covered individuals in excess of usual, customary, and reasonable (UCR) amounts that are not paid by an HDHP are not included in determining maximum out-of-pocket expenses. [Notice 2004-50, Q-16]

      3) Amounts incurred for noncovered benefits are not counted toward the deductible or the out-of-pocket limit.

      4) Under a new safe harbor, high-deductible health plan can provide preventive care benefits without a deductible, or with a deductible below the minimum annual deductible. [Rev. Proc. 2004-20]

      5) There is no requirement that the individual have earned income. [Notice 2004-2, Q-12]

   b. Starting in 2008, for purposes of computing the annual HSA contribution, a taxpayer who is an eligible individual during the last month of a tax year is "deemed eligible" during every month of that year. [Notice 2008-52] Taxpayers must remain eligible through the end of the following year. Otherwise, a portion of the contribution will be recaptured and taxed as income, plus the IRS will impose a 10% penalty. [Notice 2008-52]

   c. Taxpayers enrolled in Medicare cannot contribute to an HSA.

   d. Eligible individuals cannot be covered by a health plan that is not a high deductible health plan. [Sec. 223(c)(1)(A)(ii)(I)]

      1) An individual does not fail to be eligible for an HSA merely because, in addition to and HDHP, the individual has coverage whether provided through insurance or otherwise, for accidents, disability, dental care, vision care, or long-term care. [Notice 2004-2, Q-6]

      2) An eligible individual may be covered "for any benefit provided by permitted insurance." Permitted insurance includes insurance for a specified disease or illness. Therefore, an eligible individual may be covered by an HDHP and also by permitted insurance for one or more specific diseases, such as cancer, diabetes, asthma, or congestive heart failure, as long as the principal health coverage is provided by the HDHP. [Notice 2004-50, Q-7]

e. If an employer offers an employee a choice between a low-deductible health plan and a HDHP, and the employee selects coverage only under the HDHP, the employee is an eligible individual. [Notice 2004-50, Q-1]

3. Contributions to an HSA are tax deductible for eligible individuals, regardless of who makes the contribution or whether the individual itemizes deductions. Employers may also contribute to HSAs under stand-alone plans or as part of a cafeteria plan. In either case, the contributions are excluded from the employee's gross income and are not subject to FICA, FUTA, or the Railroad Retirement Tax Act.

   a. In 2011, the maximum annual contribution limit for an account owner with a single coverage is $3,050. The annual contribution limit for an account owner with family coverage is $6,150.

      1) Family HDHP coverage is a health plan covering one eligible individual and at least one other individual (whether or not the other individual is an eligible individual). [Notice 2004-50, Q-12]

   b. Contribution deduction limited to lesser of the deductible or the HSA maximum.

      1) Example: Family plans with $4,500 deductible. Contribution limited to $4,500 -- lesser of $4,500 or $6,150 HSA maximum.

   c. For those 55 and older, the contribution limit is raised by $500 in 2004 and will increase $100 annually thereafter to $1,000 in 2009.

   d. Contributions for the year may be made up April 15 of the following year.

   e. Each spouse who is an eligible individual must open a separate HSA. [Notice 2004-50, Q-63]

      1) Spouses can divide the annual HSA contribution in any way they want, including allocating nothing to one spouse. [Notice 2004-50, Q-32]

   f. The deduction is an adjustment to gross income and is reportable on the self-employed individual's Form 1040 as an adjustment to gross income. It is not a deduction attributable to the self-employed individual's trade or business so it is not taken as a deduction on Schedule C, Form 1040, nor is it taken into account in determining net earnings from self-employment on Schedule SE, Form 1040. [Notice 2004-50, Q-84]

4. The HSA account is tax-exempt. Earnings and growth on amounts held in the HSA grow tax-free. Money not spent in one year can roll over to the next year.

5. Distributions made exclusively for the purpose of paying qualified medical expenses are excluded from gross income, including expenses paid where the individual ceases to be qualified to make contributions.

   a. Payments made that are not qualified are included in gross income and are subject to a 10% penalty excise tax. Distributions made as a result of death, disability, or upon reaching age 65 are not subject to the penalty.

6. There is no substantiation requirement. Neither an employer-sponsor nor an HSA trustee need to take steps to verify that the expense is qualified.

   a. The individual must keep records demonstrating that the expense is qualified.

7. Form 5305-C, Health Savings Custodial Account, and Form 5305-B Health Savings Trust Account, have been released.

   a. The forms state that the account owner, not the custodian or trustee, is responsible for making sure his or her HSA complies with the Sec. 223 rules for establishing and maintaining an HSA. For example, the account owner must declare that he or she is:

      1) Covered by a high deductible health plan and no other non qualified plan (with exceptions);

      2) Not entitled to Medicare benefits;

      3) Not eligible to be claimed as someone else's dependent; and

      4) Responsible for determining whether contributions to the HSA have exceeded the maximum annual contribution limit.

         a) If contributions to the HSA exceed the maximum annual contribution limit, the account owner must notify the custodian and request withdrawal of the excess contribution and any income attributable to the excess contribution.

   b. The HSA owner is responsible for substantiating that an HSA distribution is for qualified medical expenses.

      1) The individual must maintain sufficient records to show that distributions were tax-free.

      2) The model forms specifically state that the custodian or trustee is not required to determine if the disbursements are for qualified medical expenses.

   c. The model forms are not mandatory. Trustees and custodians can use all or part of the model language. Specific instructions may be added to the model document

      1) Additional provisions may include, for example, definitions, restrictions on rollover contributions, investment powers, prohibited transactions, and custodial fees, among other items.

   d. An HSA is established once the form is executed by both the account owner and the custodian. The form can be completed at any time during the tax year.

8. Prescription Drug Plan

    a. If an individual is covered by both a high deductible health plan that does not cover prescription drugs and by a separate prescription drug plan (or rider) that provides benefits before the minimum annual deductible to the high deductible plan has been satisfied, that individual is not eligible and may not make contributions to an HSA. [Rev. Rul. 2004-38]

9. The IRS provides transitional relief for individuals in states where high deductible health plans are not available because state laws require health plans to provide certain benefits without regard to a deductible or below the minimum annual deduction. [Notice 2004-43]

    a. An HDHP will be treated as qualifying under Sec. 223(c)(2) when the sole reason the plan is not qualified is due to state-mandated benefits.

    b. The transition relief covers months before January 1, 2006.

10. If a married individual has family coverage, then both spouses will be treated as having family coverage. However, if both spouses have family coverage under separate plans, both spouses are treated as being covered under the plan with the lowest deductible. The contribution limit is the lowest deductible amount, divided between the spouses equally, unless they agree otherwise. If the married spouses have self-only coverage, then the contribution limits are determined by reference to their respective plan deductibles.

11. Individuals may rollover contributions from Archer Medical Savings Accounts (MSAs) or other HSAs into an HSA. Such rollovers need not be in the form of cash, as is required of all other contributions and are not subject to the annual contribution limits.

    a. Rollovers from IRAs, Health Reimbursement Arrangements (HRAs), and Flexible Spending Accounts (FSAs) are not permitted.

    b. An account beneficiary may make only one rollover contribution to an HSA during a one-year period. Any amount paid or distributed from an HSA to an account beneficiary must be paid over to an HSA within 60 days after the date of receipt of the payment or distribution.

        1) The rules limiting the number of rollover contributions to one a year do not apply to trustee-to-trustee transfers. There is no limit on the number of trustee-to-trustee transfers allowed during a year.

12. Portability -- The HSA stays with the individual if the individual changes employer or leaves the workforce.

13. Discount cards that entitle holders to obtain discounts for health care services or products at managed care market rates will not disqualify an individual if the individual is required to pay the costs of the health care until the deductible is satisfied. [Notice 2004-50, Q-9]

14. Health insurance premiums are not qualified medical expenses except for:

    a. Qualified long-term care insurance,

    b. COBRA health care continuation coverage, and

    c. Health care coverage while receiving unemployment compensation.

    d. Medigap policies are not qualified medical expenses.

15. Contribution Amounts

    a. Contributions to Archer MSAs reduce the annual contribution limit for HSAs. [Sec. 223(B)(4)(A)]

    b. Contributions, including catch-up contributions, cannot be made once the individual is eligible and enrolled for Medicare. [Notice 2004-50, Q2]

        1) An individual eligible for Medicare, but not enrolled in Medicare, may make the additional catch-up contributions. [Notice 2004-50, Q-3]

    c. An eligible individual who is an employee may establish an HSA with or without his employer's involvement.

16. Permissible Investments

    a. HSA funds may be invested in investments approved for IRAs. HSAs may not invest in life insurance contracts, or in collectibles. HSAs may invest in certain types of bullion or coins. The HSA trust or custodial agreement may restrict investments to certain types of permissible investments. [Notice 2004-50, Q-65]

17. Account beneficiaries may not enter into "prohibited transactions" under rules similar to Sec. 408(e)(2) and (4). [Notice 2004-50, Q-66]

18. Death of Account Holder

    a. Upon death, any balance remaining in the decedent's health account is includible in his or her gross estate.

    b. Upon death, any balance remaining in the account beneficiary's HSA becomes the property of the individual named in the HSA instrument as the beneficiary of the account.

    c. Surviving Spouse Beneficiary

        1) The account becomes the HSA of the surviving spouse.

        2) The amount is eligible for the estate marital deduction.

        3) It is not included in the spouse's gross income.

        4) Can be used to pay qualified medical expenses of the decedent.

d. Other Named Beneficiary

1) The beneficiary includes the fair market value of the account in gross income.

2) The includible amount is reduced by any decedent qualified medical expenses paid within one year after death.

3) The income in respect of a decedent is eligible for the Federal estate tax deduction.

e. No Named Beneficiary

1) The fair market value is included in the decedent's gross income in the year of death.

2) This rule applies even if the surviving spouse is the sole beneficiary of the decedent's estate.

19. A self-insured medical reimbursement plan sponsored by an employer qualifies as an HSA.

20. Trust management should generally be held by an insurance company or bank.

21. Flexible Spending Accounts (FSAs)

a. An HSA cannot cover the same medical expenses as a flexible spending account.

b. An HSA could replace a company's FSA.

c. An individual who participated in the health FSA for the immediately preceding plan year and who is covered by the grace period, is ineligible to contribute to an HSA until the first month following the end of the grace period.

1) Example. The health FSA grace period ends March 15, 2009. An individual who did not elect coverage by a general health FSA for 2009 is HSA eligible on April 1, 2007.

d. The federal government recently amended its plan to provide for limited expense health care FSAs (LEX HCFSA) to federal employees enrolled in HDHPs with HSAs. By establishing a LEX HCFSA, federal employees can save money on taxes by using FSA dollars for dental and vision care while preserving their HSA funds for other purposes, including simply saving those funds for the future.

22. Employer contributions to an HSA do not create an "ERISA-covered" plan, so long as the employer involvement with the HSA is limited. ERISA "coverage" is avoided, regardless of whether the employee's high deductible health plan is sponsored by an employer or obtained as individual coverage, so long as establishing the HSA is completely voluntary on the part of the employee. [DOL Field Assistance Bulletin 2004-1]

    a. To avoid implicating ERISA, employers contributing to HSAs must not:

        1) Limit the ability of eligible individuals to move their funds to another HSA;

        2) Impose conditions on how HSA funds can be used (beyond those permitted under the Code);

        3) Make or influence the investment decisions with respect to funds contributed to an HSA;

        4) Receive any payment or compensation in connection with an HSA.

    b. HSAs are personal health care savings vehicles, not "group health insurance." In the group health insurance context, the employer determines the type of benefits provided, set conditions for receiving benefits, and prescribes how the claims will be decided. In the context of HSAs, the employer may do little more than contribute funds to an account controlled solely by the employee.

23. HSAs are not subject to COBRA continuation coverage. [Notice 2004-2, Q-35]

24. Health Savings Account Deductions

    a. The IRS has held that one spouse's qualification to use an HSA is not dependent on the other spouse's qualification, even though the couple may file joint returns. [Rev. Rul. 2005-25]

        1) Eligibility is contingent on the taxpayer not being covered by his or her spouse's policy.

        2) The amount the taxpayer can contribute depends on whether the qualifying coverage is only for the taxpayer or if it is family coverage.

    b. S Corporation Contributions to 2% Shareholders

        1) Contributions by an S corporation to an HSA of a 2% shareholder-employee in consideration for services rendered are deductible by the S corporation and are includible in the 2% shareholder-employee's gross income. If the requirements for the exclusion under Sec. 3121(a)(2)(B) are satisfied, the S corporations' contributions are not wages subject to FICA tax.

c. Partnership Contributions for Partner

1) Contributions by a partnership to a bona fide partner's HSA are not contributions by an employer to the HSA of an employee.

a) Contributions that are treated as distributions to the partner are not deductible by the partnership and do not affect the distributive share of partnership income and deductions. The contributions are reported as distributions of money on Schedule K-1.

b) Contributions for services rendered to the partnership that are treated as guaranteed payments are deductible by the partnership and are includible in the partner's gross income and are included in the partner's net earnings from self-employment.

25. HSA and HRA and FSA Interaction

a. To promote HSAs, the IRS interpreted Flexible Spending Arrangements (FSAs) and Health Reimbursement Arrangements (HRAs) narrowly in favor of individual taxpayers. [Rev. Rul. 2004-45] Health FSAs and HRAs are generally not considered high deductible health plans. Therefore, individuals covered by FSAs and HRAs are ineligible to contribute to HSAs. However, an individual will continue to be an "eligible individual" for HSA contribution purposes if the individual is covered by a FSA or HRA that contains certain restrictions:

1) Limited-purpose health FSA or HRA -- These FSAs or HRAs would pay or reimburse benefits only for permitted coverage (not insurance or long-term care services) or permitted insurance (such as a fixed, daily amount for hospitalization). Benefits are available regardless of whether the HDHP deductible has been satisfied.

2) Suspended HRA -- If an individual elects to forgo payment or reimbursement of medical expenses for a particular coverage period (other than preventive care, permitted insurance, and permitted coverage), he or she is eligible for HSA contributions for that period.

3) Post-deductible health FSA or HRA -- An individual covered by a health FSA or HRA that does not pay or reimburse any medical expense incurred before the minimum annual deductible is eligible to make contributions to an HSA.

4) Retirement HRA -- An individual can make HSA contributions before retirement if his or her HRA only pays or reimburses medical expenses after retirement.

26. Reporting Contributions to HSAs [IRS Ann. 2004-2]

a. A new Code [Employer's contributions to an employee's Health Savings Account (HSA)] has been added to the 2004 instructions for Forms W-2 and W-3 for use in box 12 of Form W-2.

b. It will be used to identify the amount of an employer's contribution to an employee's HSA.

27. The IRS released detailed Q&A guidance addressing HSA issues. [Notice 2008-59]

    a. Access to on-site medical clinics does not bar employees from having HSAs. Receipt of free or low-cost services at a clinic in the workplace is permitted, including immunizations, physicals, nonprescription pain relievers, and treatment for on-the-job injuries. Comprehensive health care is not allowed.

    b. Debit cards used to disburse health savings account funds need not be restricted to pay only health care expenses. Employers have the option of restricting the cards, but are not required to do so. For cards that are restricted, employers must notify workers that they are permitted to access their accounts through other means such as online transfers, ATM withdrawals, writing a check, etc.

    c. An employer who erroneously makes contributions exceeding the statutory maximum or to the account of an individual who was never an eligible individual may generally correct the errors and recoup the amounts by requesting the applicable financial institution to return the excess amounts. Amounts not returned by the end of the tax year are included in the employee's gross income and wages.

    d. An employer cannot recoup amounts contributed to the HSA of an employee who ceases to be an eligible individual when the amounts are contributed after the individual has become ineligible.

B. Contingent Attorney's Fees

1. The 2004 Jobs Act created an above-the-line deduction for attorneys' fees and costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination, certain claims against the Federal Government, or a private cause of action under the Medicare Secondary Payer statute.

    a. The amount that may be deducted may not exceed the amount includible in the taxpayer's gross income for the taxable year on account of a judgment or settlement resulting from such claim.

    b. The law applies to fees and costs paid after October 22, 2004, with respect to any judgment or settle occurring after such date.

    c. The law does not cover legal fees for libel and defamation, contract violations, investment losses, false-imprisonment, and damages for emotional distress.

C. Alimony

1. To qualify as alimony the following requirements must be met:
    a. Payments must be in cash
    b. The payments must not be designated as other than alimony
    c. Spouses cannot be members of the same household
    d. No liability to continue payments after death of transferee spouse
    e. Payments are not treated as child support--child support if amount reduced by event relating to child
    f. Payor obligated to make annual payments of at least three years if any payment is over $15,000

2. Developments

a. In a case where alimony is tax free to a foreign recipient under the terms of a tax treaty with the foreigner's country, the IRS held that the alimony was nevertheless deductible by the US payer. [IRS Legal Memorandum 200251004]

b. The husband claimed an alimony deduction for life insurance premiums he paid on a policy benefitting his former wife. She did not report this as taxable alimony on her return. The IRS took an inconsistent position on challenging both taxpayers, arguing that the husband was not entitled to a deduction and that the wife was taxable on the husband's insurance payments. The Tax Court held that the IRS's whipsaw position was substantially justified in order to protect the government's revenues. [Marten, TC Memo 2000-186]

c. For a stream of payments to be deductible as alimony, the payor-spouse must have no liability--either direct or implicit--to continue payments after the death of the payee-spouse. Some states automatically terminate payments upon the payee's death. Under Georgia law, an obligation to pay lump-sum alimony in installments does not terminate upon the payee's death. Thus, the lump-sum award of alimony, payable in installments, did not qualify as alimony. [*Preston*, TC Memo 1999-49]

d. As part of an alimony agreement, a husband was obligated to pay the joint tax liability on joint income earned while they were still married. The wife was obligated to reimburse him for her share of the tax based on her net income for the year. He paid the full amount of federal and state income tax and deducted as alimony his payment to his ex-wife's share of the tax. The Tax Court disallowed the deduction on the grounds that the payment would not have terminated at her death. [*Cologne*, TC Memo 1999-102, CCH Dec. 53,315(M)]

e. The Tax Court in Smith disallowed an alimony deduction for $25,000 to his wife in reimbursement of her lawyer's fee. The Tax Court that the payment did not qualify as alimony because payment would not be extinguished by the death of his wife. [*Smith III*, TC Memo 1998-166]

f. A divorce court issued a provisional order that required the taxpayer's spouse to make maintenance payments, pay life insurance premiums, and reimburse the taxpayer for educational expenses. The order did not indicate how the payments should be treated for tax purposes or whether the payments would terminate at the taxpayer's death. If an obligation to make payments survives the death of the payee spouse under either the terms of the divorce decree or state law, the payments are not considered alimony. Because the provisional order failed to address termination of payments in the event of the taxpayer's death, the court had to refer to state law. In an Indiana divorce proceeding any cause of action terminates with the death of either spouse, as does a provisional order issued in such a proceeding. The payments were considered alimony. [*Mark K. Heckaman*, TCM 2000-85]

g. Indirect payments--for the benefit of the spouse--can qualify as alimony. The Tax Court allowed deductions for indirect alimony in the form of mortgage payments, homeowner's insurance premiums, and other third-party payments made on a former spouse's behalf. The court determined that state divorce law would have discharged the husband's obligation to pay the wife's portion of the first mortgage and other joint obligations. For that reason, he was entitled to an alimony deduction for those expenditures. The attorney's fees were not deductible because state law would have required him to pay that debt even if his wife had passed away during their divorce proceedings. [*Alan Robert Zinsmeister*, TC Memo 2000-364]

h. The Tax Court said that the husband's company payment of cash alimony and the purchase of a new car every year were alimony since they were required by the terms of a divorce decree. The wife's argument that the purchase of the car was an "implicit property settlement" was rejected. There cannot be an implicit property settlement--it must be spelled out. [*A.M. Medlin*, TC Memo 1998-378]

i. Alimony garnished from a husband's wages and paid to the wife's attorney at the end of the year is taxable to her in that year even though she did not receive the payment from the attorney until the following year. Under the doctrine of constructive receipt, receipt of funds by an agent is treated as receipt by the principal. [*Burkes*, TC Memo 1998-61]

j. Garnished wages used to pay alimony constitute a valid payment and thus are deductible as alimony. [*Chambers*, TC Memo 2000-218]

k. Sec. 71 treats a payment as nonalimony if the governing divorce or separation instrument designates the payment as such. Under a property settlement agreement, the taxpayer agreed to pay his ex-wife over $5 million. In addition, he agreed to pay her $20,000 per month during each of the years in issue. The agreement stated that these monthly payments were a division of marital assets and not for spousal support. The Tax Court denied an alimony deduction to the ex-husband. The agreement contained a clear, explicit and express direction that the $20,000 monthly payments were not to be includible in the ex-wife's income. [*Goldman Est*, 112 TC 317 (1999)]

l. Generally, no gain or loss is recognized on a transfer of property between spouses incident to a divorce. Transfers of property to a third party on behalf of a former spouse qualify for nonrecognition treatment in only limited circumstances. Temporary regs under Sec. 1041 allow transfers to a third party on behalf of a former spouse to qualify for nonrecognition in three situations: (1) The transfer to the third party is required by a divorce or separation agreement; (2) The transfer to the third party is pursuant to the written request of the former spouse; or (3) The transferor receives from the former spouse a written consent or ratification of the transfer to the third party. In these situations, the transfer of property is treated as if it were made directly to the non-transferring former spouse, followed by the immediate transfer of the property to the third party.

m. In *Craven v US*, the divorce decree incorporated a settlement agreement requiring the Craven's closely-held corporation to redeem the wife's stock, due in ten to twenty years from the date of the agreement. The husband guaranteed the corporation's payments to the wife for the stock. The district court held that the redemption was entitled to nonrecognition treatment under Sec. 1041. However, the ex-wife was liable for tax on the imputed interest. [*Linda Karen Browlow Craven v US*, 2000-2 USTC ¶50,541, CA-11]

n. Another case dealt with one spouse disposing of property to a third party to satisfy payment requirements of a divorce decree. The taxpayer asserted that the transaction should not be treated as a direct sale from her to the third-party buyer, but rather as a constructive transfer first to her former spouse and then a direct sale by him to the third party. He would then be liable for any tax arising from the sale. The Ninth Circuit in *Ingham* held that a forced sale of property to satisfy an obligation is not the same as transferring title to a specific third party pursuant to directions. [*Ingham v US*, 99-1 USTC ¶50,249, CA-9]

o. Two taxpayers married in 1972. In 1994, the husband filed for divorce and the couple signed a temporary agreement under IRC Section 71(b)(1)(A), which provided that the husband would pay the wife $2,000 a month in alimony but both parties would continue to reside in the home. The husband continued to live in the home for a year and a half, but after several unsuccessful attempts at reconciliation he moved out. The husband deducted the monthly payments as alimony on his return. The IRS denied the deduction because the husband had continued to live with his wife. The court sided with the taxpayer and held that the "residing apart" requirements of Section 71(b)(1)© apply only when the taxpayers are legally separated under a court-ordered divorce or separation decree. [*Behnam*, TC Memo 2000-165]

p. Before the end of the six-month waiting period required by the divorce decree in his first marriage, a man married for the second time. Ten years later he sued to have the marriage annulled on the grounds that it was illegal. He agreed to pay his second wife $4,000 a month for seven years, and a state court approved it in granting the annulment. The IRS did not allow an alimony deduction because there had never been a legal marriage. The Tax Court ruled that the alimony was deductible because the state's law treats divorce and annulment actions under the same rules. [*Fred J. Pettid*, TC Memo 1999-126]

q. Transfers of property to a former spouse result in no gain or loss recognition if the transfer is incident to a divorce--neither the transferor nor the transferee recognizes any income as a result of the transfer, and the transferee takes the transferor's basis in the property. A transfer is incident to a divorce if it is within one year of the divorce or is "related to the cessation of the marriage." The taxpayer and his wife divorced in 1988. In 1989, as part of a property settlement, the taxpayer transferred to his former wife a promissory note for $1.5 million. After he defaulted on the note, a state court entered judgment for his wife. In 1992, pursuant to a settlement agreement relating to the judgment, the taxpayer transferred property to his former wife in exchange for the promissory note. The Code does not define "related to the cessation of the marriage," but temp regs provided a safe harbor for certain transactions occurring within six years of the divorce. The Tax Court concluded that the 1992 agreement was to be considered incident to the divorce decree, and therefore the transfer of the land was related to the end of the marriage. [*Young*, 113 TC 11 (1999)]

r. An employee was eligible to receive his pension benefits but continued working. He got divorced and was ordered to pay his ex-wife her one-half community property share of the pension he could have taken on the date they divorced. He used a portion of his wages to pay the amount. The Tax Court ruled that such a payment is deductible alimony and his ex-wife is taxed on the amount received. [Dunkin, 124 TC No. 10]

s. IRS released sample language for QDROs. (Notice 97-11, IRB 1997-2, 49]

t. Nonqualified Deferred Compensation and Stock Options Transferred in Divorce

    1) The IRS has decided that nonrecognition treatment at the time of transfer will prevail. [Rev. Rul. 2002-22, 2002-19 IRB 849]

        a) The transfer of nonstatutory stock options and nonqualified deferred compensation is a tax-free division of marital property under Code Sec. 1041;

        b) The assignment of income doctrine does not apply to these transfers; and

c) The receiving spouse must include the appropriate amount in income under Code Sec. 83(a) both when the nonqualified stock options are exercised and when distributions are received from the deferred compensation plan.

2) The IRS will apply its holding retroactively except for agreements before November 9, 2002, that require that the transferor must report gross income attributable to the transferred interest, or it can be established to the satisfaction of the IRS that the transferor has reported the gross income for federal income tax purposes.

3) The IRS made it clear that the ruling is not intended to cover:

a) Transfers of property between spouses other than in connection with divorce,

b) Transfers to the extent they are unvested at the time of transfer or to the extent that the transferor's rights to such income are subject to substantial contingencies at the time of the transfer, or

c) Transfers of property incident to divorce that are governed by a specific provision of the Code or regulations (for example, Secs. 402, 408, 484, 424, or 453B).

4) Notice 2002-31, 2002-19 IRB 908, sets forth a proposed revenue ruling explaining how FICA, FUTA, and withholding apply to a transfer of interests in nonstatutory stock options and nonqualified deferred compensation.

a) The transfers do not result in a payment of wages for FICA and FUTA purposes.

b) The nonstatutory stock options are subject to FICA and FUTA taxes at the time of exercise by the nonemployee spouse to the same extent as if the options had been retained by the employee spouse.

c) The nonqualified deferred compensation remains subject to FICA and FUTA taxes to the same extent as if the rights to the compensation had been retained by the employee spouse.

d) To the extend FICA and FUTA taxation apply, the wages are the wages of the employee spouse.

e) The income recognized by the nonemployee spouse on either the nonqualified stock option or from the nonqualified deferred compensation is subject to withholding and the nonemployee spouse is entitled to the credit allowable for the income tax withheld at the source on these wages.

f) The social security wages, Medicare wages, social security taxes withheld, and Medicare tax withheld are reportable on a Form W-2 of the employee spouse. However, no amount is includible in Box 1 and Box 2 of the employee's Form W-2 with respect to these payments. The income is reportable in Box 3 as other income on a Form 1099-MISC for the nonemployee spouse. Income tax withholding is included in Box 4, Federal income tax withheld.

u. Assigning a third party's debt is not a payment of alimony, the Tax Court said. To satisfy an obligation of alimony to his ex-wife, the taxpayer transferred the right to receive future payments on a debt that their son owned him. Only the payment of cash or a cash equivalent such as a check or money order payable on demand qualifies as alimony. [Lofstrom, 125 TC No. 13]

   1) The contract for deed required a $1,408.34 payment on executive, $4,200 or more annually at a rate of $350 monthly, and interest at a rate of 7.5% per year. The debt instrument did not qualify as a cash payment and was not deductible as alimony.

v. An alimony payment made before the due date for the first payment in the decree does not qualify for a deduction. To be deductible, the obligation to pay must be imposed by the decree. Any payments made after that date are deductible alimony, even if paid ahead of schedule. [Ray, TC Summ. Op. 2006-110]

w. While married husband built a home secured by first and second mortgages signed by both spouses. After a divorce the husband retained the residence. The husband was required to pay the first and second mortgages on the home which were described in the decree as being sums that were "in the nature of support" to his ex-wife. The avowed purchase of the paragraph in the divorce decree was "to protect the ex-wife from sole personal liability in the event that her ex-husband filed for bankruptcy and the holder of the mortgages sought recourse against her." After declaring bankruptcy he decided to claim an alimony deduction equal to the mortgage payments made on his behalf by the bankruptcy estate. The Tax Court ruled that the payments were more in the nature of a property settlement than anything else. The payments did not confer any direct economic benefit on her because under the divorce decree she was no longer an owner or occupant of the residence. [Picou, TC Summ. Op. 2006-82]

x. A policeman who was eligible to take his pension but kept on working. He got divorced and the court made him pay his ex her share of the pension he could have received on the date they divorced. He was required to make the payments until he retired, even if he died in the interim. The payment is not deductible alimony because the requirement to pay does not end with the recipient's death. [Dunkin, CA-9, Aug. 31, 2007]

y. Simply calling a payment alimony does not make it deductible if other conditions are not met. It must be clear the payments end when the recipient dies. [Ltr. Rul. 200720007] This requirement can be met by a statement in the divorce court's order or, if the decree is silent on this subject, by operating of state law.

   1) The divorce decree ordered the ex-spouse to pay contractual alimony in monthly payments until a total amount had been paid in full. The decree did not provide any provision allowing for the termination of the payments upon the death of the payee spouse.

z. Although a couple's divorce decree did not require payments of alimony, it stipulated that if any was paid, the recipient was taxed. Because alimony was contemplated under the divorce court's order, that is enough to allow the deduction. [Webb, TC Summ. Op. 2007-91]

aa. The Tax Court held that a former spouse can deduct as alimony that portion of his military retirement payments that he paid to his former spouse under a divorce decree based on her right to a 25% share as set forth under the uniformed Service Former Souses' Protection Act. The fact that the divorce decree used property-settlement type language in called for those payments in lieu of her interest in his retirement plan did not change the nature of the payments as alimony. [Proctor, 129 TC No. 12]

bb. An individual was not entitled to an alimony deduction for payments made to his ex-wife before the entry of an order providing for alimony because the payments "were not made pursuant to a written separation agreement." [Katchmeric, TC Summ. Op. 2007-213]

cc. Payments a taxpayer made to his estranged wife under an oral agreement are not deductible as alimony because they were not required by a written divorce or separation instrument. [Emmel, TC Sum Op 2007-205] A divorce or separation agreement must be made in writing.

dd. School Educator Deduction

3. Primary and secondary school educators may claim an above-the-line deduction up to $250 annually in unreimbursed expenses paid or incurred for books and supplies used in the classroom. Available through 2009.

   a. Books, supplies, computer equipment (including related software and services) and other equipment, and supplementary materials used in the classroom.

   b. Books or equipment kept at the teacher's home for his or her own use are ineligible.

   c. Payment of a class field trip will not qualify for the above-the-line deduction.

4. An eligible educator is an individual who, for at least 900 hours during a school year, is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aid.

   a. The school year means September through June.

   b. Teachers who taught summer school may not be able to count those hours.

5. The term school is defined as one that provided elementary or secondary education, as determined under state law.

6. Qualified expenses do not include expenses for home schooling or for nonathletic supplies for courses in health or physical education.

7. Where both spouses are eligible educators and file jointly, the maximum deduction is $500. [Instructions to Form 1040]

8. Homeschooling does not qualify for the $250 teacher's tax deduction. The classroom supply deduction is only for schoolteachers, aides, counselors, and principals for grades K-12, who work at least 900 hours in a school year. [INFO 2003-0204]

D. Interest on Tax Deficiency Related to Business Income

1. The Code provision disallows deductions for all personal interest, unless it is paid or accrued on indebtedness "properly allocable" to a trade or business other than performing services as an employee. The temporary regulations [Reg. §1.163-9T(b)(2)(i)(A)] provide that interest on income tax deficiencies is personal interest and is not attributable to the taxpayer's conduct of a trade or business, regardless of the source of the income.

2. In 1996, a sharply divided Tax Court held that the applicable reg provision conflicts with the underlying Code provision. [*Redlark*, 106 TC 31] However, the Ninth Circuit in April 1998 overturned this controversial decision, concluding that the reg is a reasonable interpretation of a facially ambiguous statute. [*Redlark v Commr*, 141 F3d 936 (CA-9 1998) revg 106 TC 31 (1995)] The Court concluded that the legislative history for the Code provision at issue and the Joint Committee staff's General Explanation of the Tax Reform Act of 1986 are entirely consistent with the IRS's conclusion that personal income tax obligations are always essentially personal in nature.

3. Prior the 9th Circuit decision, the Tax Court allowed a husband and wife [*Kikalos*, TC Memo 1998-92] to deduct $393,000 of interest paid on tax deficiencies resulting from their operation of an unincorporated trade or business. This interest was deductible because it was paid on indebtedness properly allocable to that trade or business. The Kikalos case was recently reversed by 7th Circuit. [*Kikalos v Comm.*, CA-7, 9-8-99]

4. Some lower courts have agreed that the regs are invalid. Several appellate decisions have held that interest relating to a personal Form 1040 is always personal interest even though it arose in connection with business income and expenses. [*Miller*, 95-2 USTC ¶50,484, CA-8; *True*, CA-10, unreported opinion, 8-26-94]

5. In 1999, the Fourth Circuit [*Allen, Sr. v US*, 173 F3d 533, CA-4, 4-20-99] and the Sixth Circuit [*McDonnell v US*, 180 F3d 721, CA-6, 5-27-99] ruled that the tax deficiency interest is not deductible. One of these cases involved over $500,000 in deficiency interest. Expect the debate to continue in other circuits, perhaps with final resolution in the Supreme Court.

6. The Tax Court has ruled that individuals are not allowed to deduct on interest on back taxes, even if the additional taxes are related solely to the taxpayer's business. [*E.A. Robinson*, 119 TC 44 (2002)] Previously, the Court had allowed such deductions but changed its mind after five Appeals Courts ruled to the contrary.

E. Student Loan Interest

1. Final regs clarify that to be deductible under Sec. 221 as a "qualified education loan," the school loan must be incurred solely for higher education expenses, which are paid within a reasonable period of time before or after the indebtedness is incurred. [TD 9125]

   a. Generally, qualified expenses will be treated as paid or incurred within a reasonable period of time if the expenses:

      1) Are paid with loan proceeds that are part of a federal post-secondary education loan program; or

      2) Relate to a particular academic period and the loan proceeds used to pay the expenses are disbursed within 90 days before the start of, and 90 days after the end of, the academic period to which the expenses relate.

2. Capitalized interest is deductible as qualified educational loan interest. Fees, including loan origination fees or late fees are considered interest if they represent a charge for the use or forbearance of money rather than for specific services.

   a. A payment generally first applies to interest that has accrued and remains unpaid as of the date of payment is due and then applies to the outstanding principal.

3. Interest payments made by someone other than the taxpayer/borrower are treated as first paid to the taxpayer, then paid by the taxpayer to the lender. If a third party pays interest on the taxpayer's behalf as a gift, the taxpayer may deduct the interest. If an employer pays interest on behalf of the taxpayer, and the taxpayer includes the payment in income under Sec. 61, the taxpayer can deduct the interest.

F. Loss of Potential Income

1. The owner of a chocolate company could not claim a bad debt deduction for unpaid commissions owed to him by the company under an employment contract. Since the owner, a cash basis taxpayer, had not reported any of these commissions as income, no bad debt deduction was allowed. [*Koenig*, TC Memo 1998-215]

G. Self-Employed Health Insurance

1. The IRS has made its position crystal clear that a self-employed individual cannot deduct health insurance costs from his or her self-employment income reported on Schedule C of Form 1040. [CCA 200623001]

   a. Instead, the insurance costs must be deducted on Form 1040 as an adjustment to the individual's gross income.

      1) Line 29 on the Form 1040.

2. Premiums on policies purchased by sole owners of one-person S corporations are not eligible for the 100% deduction. The above-the-line deduction for medical premiums applies only to policies purchased in the name of the S corporation. [Headliner Volume 163, May 15, 2006]

   a. Some states do not allow corporations to buy a group health plan with only one participant. That state law limitation does not override the requirements that the S corporation must provide fringe benefits to its employees in order to have the 2% shareholder qualify for the Sec. 162(l) benefits.

   b. To avoid this trap, owners can elect to be taxed as a single-member limited liability company.

H. Whistleblower Fees

1. Effective for information provided with regard to tax cheats on or after Dec. 20, 2006, a deduction from gross income is allowed for attorneys' fees and court costs related to whistleblower rewards.

   a. Whistleblower rewards are increased to a maximum of 30% of collected proceeds, interest, penalties, and additional amounts.

   b. A whistleblower can appeal in court if the IRS decides not to issue a reward.

Chapter 10 - Business Deductions

A. Manufacturing Deduction [REG-105847-05]

1. Under Sec. 199(c)(1), qualified production activities income (QPAI) is the excess of domestic production gross receipts (DPGR) over the sum of:

   a. The costs of goods sold allocable to such receipts;

   b. Other deductions, expenses, or losses directly allocable to such receipts; and

   c. A ratable portion of deductions, expenses, and losses not directly allocable to such receipts or another class of income.

2. Creates a deduction equal to a percentage of the lesser of:

   a. Qualified production activity income (QPAI) or

   b. Taxable income.

3. Percentage Deduction for Taxable Years Beginning in:

   a. 2005-2005 -- 3%

   b. 2007-2009 -- 6%

   c. 2010 and after -- 9%

      1) Code Sec. 199 domestic production activities deduction is capped at 6% for oil and gas production.

4. Sec. 199(c)(4)(A) defines DPGR to mean the taxpayer's gross receipts that are derived from:

   a. Any lease, rental, license, sale, exchange, or other disposition of (a) qualifying production property (QPP) that was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part with the United States; (b) any qualified film produced by the taxpayer; or © electricity, natural gas, or potable water (collectively, utilities) produced by the taxpayer in the United States.

   b. Construction performed in the United States; or

   c. Engineering or architectural services performed in the United States for construction projects in the United States.

5. Land clearing, grading, and demolition qualify as construction.

   a. Retroactive to 2005.

6. Sec. 199(c)(4)(B) excepts from DPGR gross receipts of the taxpayer that are derived from:

   a. The sale of food and beverages prepared by the taxpayer at a retail establishment;
   b. The transmission or distribution of electricity, natural gas, or potable water; and
   c. Gross receipts from ticket sales for viewing qualified films.

7. Sec. 199(c)(6) defines QPP to mean:

   a. Tangible personal property;

   b. Any computer software; and

   c. Any property described in Sec. 168(f)(4) (certain sound recordings).

8. Shrink-wrapped software and software purchased through the internet and downloaded onto a computer are manufacturing products. Online computer software in itself is not a product but is instead a service. [Heather Maloy, IRS Associate Chief Counsel]

9. Fees such as cotton or real estate broker's fees are not DPGR. These fees are non-DPGR because they are not derived from any lease, rental, license, sale, exchange, or other disposition of property under Sec. 199(c)(4)(A)(i).

10. Distribution and delivery of QPP are not DPGR because distribution and delivery are properly regarded as services regardless of whether the taxpayer retains the benefits and burden of ownership of the property at the time it is delivered. As a matter of administrative convenience, the taxpayer can treat embedded distribution and delivery services similar to the qualified warranty exception.

11. Services and nonqualifying property are not considered embedded if they are either separately offered or separately bargained for, or a charge for the service or nonqualifying property is separately stated. Separately stated for bargained for amounts will not be respected unless they reflect the fair market value of the service or nonqualifying property.

12. The installation activity will be considered MPGE activity only if the contractor retains the benefits and burdens of ownership with respect to the parts while the parts are being installed. If the benefits and burdens of ownership pass to the customer prior to the installation of the QPP, the taxpayer is performing a service by installing the customer's property. It is appropriate to treat embedded installation similar to an embedded qualified warranty, qualified delivery, and a qualified operating manual.

13. Generally, in the case of short-term transactions in which significant services are provided in connection with the property, the transaction will consist mostly of services.

14. Sec. 199(c)(7) provides that DPGR does not include any gross receipts of the taxpayer derived from property leased, licensed, or rented by the taxpayer for use by any related person.

15. Taxpayers do not construct land and thus any gain attributable to the disposition of land (including zoning, planning, entitlement costs, and other cost capitalized to the land such as the demolition of structures under Sec. 280B) is not eligible the Sec. 199 deduction.

   a. Income from land improvements such adding roads, sidewalks, or utilities will receive the write-off.

16. A taxpayer must determine the portion of its gross receipts that is DPGR and the portion of its gross receipts that is non-DPGR.

17. All of a taxpayer's gross receipts may be treated as DPGR is less than 5% of the taxpayer's total gross receipts are non-DPGR. If the amount of a taxpayer's gross receipts that do not qualify as DPGR equals or exceeds 5% of the taxpayer's total gross receipts, the taxpayer is required to allocate all gross receipts between DPGR and non-DPGR.

18. Gross receipts and costs are taken into account for purposes of computing QPAI in the taxable year they are recognized for Federal income tax purposes under the taxpayer's methods of accounting, even if the related gross receipts or costs, as applicable, are taken into account in different taxable years.

19. Any reasonable method may be used to identity direct materials, direct labor, factory overhead, and general/administrative cost properly allocated to COGS. The method must be consistent with the approach used to determine DPGR. The principles under Secs. 263A and 861 (Income from Sources within the U.S.) should be utilized to determine if the allocation method is reasonable.

    a. If the three-year prior gross receipts average $5 million or less, costs are allocated on the basis of the ratio of DPGR to total GR derived from all sources.

    b. If the three-year prior GR average is $25 million or less, the simplified method may be utilized to allocate all other costs associated with DPGR. Otherwise, the Sec. 861 method must be utilized.

20. Sec. 4.04(11)(a) of Notice 2005-14 defines the term "construction" to mean the construction or erection of real property by a taxpayer that is in a trade or business that is considered construction for purposes of the North American Industry Classification System (NAICS).

    a. In order for a taxpayer to be considered in a construction NAICS code, it must be engaged in a construction trade or business (but not necessarily its primary trade or business) on a regular and ongoing basis.

21. The amount of the deduction allowable to a taxpayer for any taxable year shall not exceed 50% of the W-2 wages of the taxpayer.

    a. There are three methods for computing W-2 wages:

        1) Unmodified Box Method -- W-2 wages are calculated by taking, without modification, the lesser of:

            a) The total entries of Box 1 (Wages, Tips, and Other Compensation) from all Forms W-2 filed with the Social Security Administration (SSA)

            b) The total entries in Box 5 (Medicare Wages and Tips) from all Forms W-2 filed with the SSA.

        2) Modified Box 1 Method -- W-2 wages are calculated by taking the total entries in Box for Forms W-2, subtracting amounts that are not wages for federal income tax withholding purposes and amounts that are merely treated as wages for withholding purposes (e.g., supplemental unemployment compensation benefits and certain forms of sick pay). This amount is then increased by employee salary reduction contributions to 401(k) arrangements and similar plans.

3) Tracking Wages Method -- Wages are calculated by actually tracing total wages subject to federal income tax withholding, subtracting supplemental unemployment compensation benefits, and adding amounts that are reported in Box 12 for Form W-2, Coded D, E, F, G, or S. If a taxpayer acquires a major portion of a separate business or business or unit thereof, the successor employer's portion of qualified W-2 wages are only those that relate to wages earned under their ownership despite the fact that the successor may issue W-2s that include services provided to the predecessor. Taxpayers may only take into account wages paid to common law employees of the taxpayer.

b. Payments to independent contractors and self-employment income, including guaranteed payments made to partners, are not included in determining W-2 wages.

c. In determining W-2 wages, a taxpayer may take into account any wages paid by another entity and reported by the other entity on Forms W-2 with the other entity as the employer lists in Box c of the Forms W-2, provided that the wages were paid to employees of the taxpayer for employment by the taxpayer. [Prop. Reg. 1.199-2(a)(1)]

d. The deduction is capped at 50% of W-2 wages attributable to production activities.

1) Affects tax years beginning after May 17, 2006.

e. For employees leased from a third-party, common law employee definitions will determine who can apply the W-2 wages of the leased employees for Sec. 199. For employees leased through non-corporate related parties, there are issues as to whom may utilize the W-2 wages for Sec. 199.

f. Wage Limitation in Sec. 199

1) Partners and shareholders in S corporations will be allocated their share of the passthrough entity's W-2 wages, but will include in their wage limit only wages paid to determine QPAI.

g. Stricter W-2 Wage Limitation

1) The Treasury has issued temporary and proposed regs to explain how to compute the new, stricter W-2 wage limitation that applies to any Sec. 199 domestic productions activities deduction. [NPRM REG-127819-06]

2) The Tax Increase Prevention and Reconciliation Act limits W-2 wages to 50% of only those W-2 wages (and deferred compensation amounts) that contribute to domestic production activity for which the deduction is taken.

3) The temporary regs ensure that the wage expenses subtracted from domestic production gross receipts (DPGR) are the same amounts that are used to determine the 50% wage limitation.

22. The Sec. 199 deduction can neither create an NOL carryback or carryover nor increase the amount of an NOL carryback or carryover.

23. Sec. 199(d)(1) provides that, in the case of an S corporation, partnership, estate, or trust, or other pass-thru entity, Sec. 199 generally is applied at the shareholder, partner, or similar level, except as otherwise provided in rules applicable to patrons of cooperatives.

    a. DPGR, COGS, W-2 wages, and related expenses must be allocated to each owner.

    b. Sec. 199(d)(1)(B) provides that such person is treated as having been allocated W-2 wages from such entity in an amount equal to the lesser of:

        1) Such person's allocable share of such wages from such entity; or

        2) 2 times 3% of the QPAI of that entity allocated to such person for the taxable year.

24. Sec. 199 does not apply to taxable years of pass-thru entities beginning before January 1, 2005.

25. The computation of a company's Sec. 199 deduction in computing Alternative Minimum Taxable Income (AMTI) is the same as in computing the regular tax, except that, in the case of a corporation, the taxable income limitation is the corporation's AMTI.

26. Pass-Throughs To Compute Domestic Production Activities Deduction

    a. Rev. Proc. 2007-34 now permits eligible pass-through entities to calculate a partner or shareholder's share of qualified production activities income (QPAI) and W-2 wages at the entity level.

        1) It allows a certain class of S corporations and partnerships to instead choose to report out net QPAI so the only two numbers that are being reported out to the partners and shareholders are the net QPAI and W-2 wages.

27. The manufacturing deduction does not reduce taxpayer basis. [Reg. 1.199-5T]

B. Roof Repairs

1. The Tax Court's Small Tax Case Division allowed a deduction for the $8,000 cost of removing and replacing the roof-covering material on the roof of a rental house. There was no replacement of substitution of the roof. The only purpose in having the work done to the roof was to prevent the leakage and keep the rental house in operating condition and not to prolong the life of the property, increase its value or, make it adaptable to another use. [*Nevia Campbell*, TC Summary Opinion 2002-117]

2. The Tax Court had previously come to the same conclusion when it observed that the taxpayer's only purpose was to prevent leakage and keep the leased property in operating condition over its probable useful life and not to prolong the life of the property, increase its value, or make it adaptable to another use. [Oberman Manufacturing Co. 47 TC 471 (1967)]

3. A commercial building's owners spent over $50,000 to fix a leaky roof, including removing all the tar and gravel and some of the plywood base. The roofing project is a deductible repair the Tax Court says. The work was done to return the roof to its previous leak-free condition, not to substantially extend its life. [Northen, TC Summ. Op. 2003-113]

4. The court held that when the purpose for replacing roof shingles on a barn used in dairy operations was to maintain the property and not to improve or prolong the barn's life, the expenditure was currently deductible. [Gerald W. Pontel Family Estate, TC Memo 1981-303]

5. The taxpayer renovated properties in anticipation of selling them, which she did in 1983. The court held that the taxpayer made the expenditures with the intention of selling the properties; thus, they were capital expenditures. [LaPoint, 94 TC 733 (1990)]

6. The court held that expenditures for a new roof and for repairing boilers, made immediately on the purchase of a building were capital items to be added to the cost of the taxpayer's original investment. [Auerbach, 2 BTA 67 (1925)]

7. The taxpayer incurred various plumbing, carpentry, and electrical expenses on a 10-apartment building. The repairs were made to keep the building in a safe condition to comply with the city's building code. The court held that any repairs done to a building for this purpose would be capital expenditures because compliance would materially increase the property's value. [Cerda, DC IL, 4/30/84]

8. Often the Service will argue that the roof is the property and the repair extends the property's useful life. The court held that the taxpayer could claim a deduction for a roof repair expense, because the roof was an integral part of the building, and the repairs did not extent the property's useful life. [Okla. Transportation Co., WD OK, 12/29/66]

9. The court found that the cost of replacing built-up portions of roofs on a shopping center in which the taxpayer had an interest was not currently deductible. The cost was not of a recurrent nature to repair storm damage, but to completely replace certain sections. The replacements carried 10-year warranties, thus prolonging the roof's useful life. The court deemed the actual roof to be the property repaired; the work appreciably extended its life. [Tsakopoulos, TC Memo 2002-8]

10. The taxpayer spent almost $800,000 to remove or encapsulate asbestos in one of its office buildings. The expenditures were made to keep the taxpayer's office building in effective operating condition, rather than put the building into operating condition. The expenditures did not substantially prolong the building's useful life, appreciable increase its value, or adapt it to a new or different use. The Court ruled that expenditures were currently deductible. [Cinergy Corp., U.S. Ct. Cl. 3/10/03]

11. Guideline:

    a. The roof repair must not materially increase the property's life as a whole.

    b. The roof repair cost must be only a fraction of the building's total cost.

    c. The repair must restore the roof to its original working state in the most cost-efficient manner.

    d. The repair must not put the building to a new use.

    e. The repair must not be part of an ongoing building renovation program.

    f. The repair must not be undertaken to sell the building or to comply with city building codes.

C. Energy-Efficient Commercial Buildings Property Deduction

1. Taxpayers may claim a deduction for costs associated with energy-efficient commercial building property place in service during 2006 and 2007. [Sec. 179D]

2. The maximum amount that can be deducted is $1.80 per square foot of the building less the total amount of deduction taken under this provision with respect the building, in any prior years.

3. The basis of the property generating a deduction must be reduced by the amount deducted.

4. Several criteria must be met:

    a. The costs must be associated with depreciable (or amortizable) property that is installed in a domestic building.

    b. The property must be installed as part of:
        1) The interior lighting system,
        2) The heating, cooling, ventilation, and hot water system, or
        3) The building envelope.

    c. The property must be installed pursuant to a plan intended to reduce the total annual energy and power costs of the building by 50% or more in comparison to a reference building that meets the minimum requirement of Standard 90.1-2001.

        1) The plan must be certified by the IRS.

5. The IRS is required to issue regulations that allow a transfer of the deduction for energy-efficient commercial building property with respect to public property. The regulations are to permit an allocation of any deduction associated with energy-efficient property installed in public building to the "person primarily responsible for designing the property."

D. Corporate-Owned Life Insurance (COLI)

1. The taxpayer purchased what is known as "janitors' insurance;" that is, life insurance policies for more than 20,000 of its employees. The taxpayer was the beneficiary on all the policies. To fund the policies, the taxpayer borrowed against the value of the policies from the insurance carrier and the taxpayer deducted interest on the policy loans. The financing arrangement was circular and essentially cashless. The Court ruled that the COLI plan as a whole lacked economic substance. [American Electric Power Co., Inc., 2003-1 USTC ¶50,416, CA-6]

2. In Dow Chemical Co., a district court in Michigan rejected the IRS's claim that COLI plans were elaborate ruses created solely to generate economic losses and tax deductions. [Dow Chemical Co., DC Mich, 3/31/03]

E. IRS Finalizes $10 Million Cash Method Safe Harbor

1. The safe harbor allows qualifying small businesses that would otherwise have to account for inventories under the accrual method to use the cash method for taxable years ending on or after December 31, 2001. [Rev. Proc. 2002-28, 2002-18 IRB 815]

2. The taxpayer's average annual gross receipts must be $10 million or less for the three taxable years ending with each prior taxable year ending on or after December 31, 2000.

   a. A taxpayer that has not been in existence for three prior taxable years figures the average for the years it has been in existence.

3. The cash method may be used by service businesses, custom manufacturers, and any other taxpayer whose principal activity is not specifically ineligible.

4. The cash method is not allowed for retail or wholesale sales, manufacturing (other than eligible custom manufacturers), publishing, sound recording, or mining.

5. Sections 447 and 448 still apply to deny the cash method to certain C corporations, partnerships with C corporation partners, and tax shelters.

6. If a taxpayer treats two activities as separate businesses, each with its own complete set of books, the cash method can be used for an eligible activity even though the other activity is ineligible.

7. Taxpayers must treat "inventoriable items" as non-incidental materials and supplies. As non-incidental materials and supplies, they are not deductible until the year they are provided to customers.

F. Installment Method for Accrual Basis Taxpayers

1. On December 28, 2000, President Clinton signed the Installment Tax Correction Act of 2000 (P.L. 106-573). The law reinstates the use of the installment method of accounting for accrual method taxpayers, including small businesses, retroactively to when it had been prohibited by the Ticket to Work and Work Incentives Improvement Act of 1999.

2. The IRS has issued a Revenue Procedure allowing taxpayers whose average annual gross receipts (averaged over three years) do not exceed $1 million to switch to the cash method of accounting. [Rev. Proc. 2000-22]

   a. Inventories on hand must be accounted for under Reg. 1.162-3 as supplies that are not incidental and

   b. The taxpayer must not regularly use any method other than the cash method to ascertain income as reported to shareholders, partners, or other owners or beneficiaries.

G. Cheating is Deductible

1. A contractor overcharged the U.S. for work on a project. After an investigation, the contractor agreed to make a lump-sum payment to the feds but denied any liability. The portion of the restitution that was intended to make the government whole is a deductible expense. The rest of the payment is a nondeductible penalty. [TAM-171120-03]

H. Costs to Avoid Fines

1. Environmental remediation project costs to avoid a fine or penalty cannot be depreciated. [TAM 200629030]

2. The taxpayer and the EPA came to a project agreement that required the taxpayer to make capital improvements to its facility. The agreement was made after talk of imposing a fine for certain violations had begun.

3. The IRS maintained that if the costs incurred by the taxpayer were related to a fine or penalty, it must be denied under the same public policy underlying Sec. 162(f).

I. Substantial Repairs

1. The Sixth Circuit allows the cost of major engine overhauls as a repair deduction. It affirms a lower court ruling for an air carrier allowing it to deduct the cost of removing the engines on its airplanes, cleaning them and replacing any worn or damaged parts. [FedEx Corporation, CA-6, No. 03-6514]

   a. The rehabilitation program kept the engines in good operating condition and did not materially extend their useful lives or increase their value.

J. Line-of-Credit Fees

1. Fees paid to obtain a line of credit are deductible. A corporation set up a revolving credit line with its lenders, paying a quarterly fee for the right to draw out funds. The charge did not vary based on the amount borrowed. The IRS concluded that distinguishes the payments from nondeductible loan commitment fees. [TAM-131995-93]

K. Home Office Deduction

1. In order for individuals to qualify for the home office deduction the following requirements must be met:

   a. Must meet one of these conditions

      1) Principal place of business;

      2) Meeting patients, clients, or customers in normal course of business;

      3) Separate structure; or

      4) Conduct administrative or management activities of the trade or business

   b. Must be regular and exclusive use of the area, and

   c. Must be for the convenience of employer

2. Exclusive Use Exceptions

   a. The exclusive use requirement does not apply when the home is used for qualified day care of children, handicapped, or the elderly; and to wholesale or retail sellers regularly storing inventory in the home and solely working out of their home.

   b. The exception to the home office deduction limitation also applies to space used to store "product samples." The taxpayer must be in the trade or business of selling products at retail or wholesale, and the home must be the sole fixed location of such trade or business.

3. The 1997 Act expanded the definition of "principal place of business" for purposes of the home office deduction. [Sec. 280A©]

   a. This new definition only applies to tax years beginning after 1998.

   b. A home office qualifies as a taxpayer's principal place of business if:

      1) The office is used by the taxpayer to conduct administrative or management activities of the taxpayer's trade or business, and

      2) There is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities of the trade or business.

   c. This statutory change overturns the Soliman case of the Supreme Court.

4. The fact that a taxpayer also carries out administrative or management activities at sites that are not fixed locations of the business, such as a car or hotel room, will not affect the taxpayer's ability to claim a home office deduction. If a taxpayer conducts some administrative or management activities at a fixed location of the business outside the home, the taxpayer still will be eligible to claim a deduction so long as the administrative or management activities conducted at any fixed location of the business outside the home are not substantial. The taxpayer's eligibility to claim a home office deduction will not be affected by the fact that the taxpayer conducts substantial non-administrative or non-management business activities at a fixed location of the business outside the home. [House Committee Report]

5. This expanded definition of a principal place of business will also enable many taxpayers to deduct the costs of traveling to and from their home to other locations at which they conduct business. [see Rev. Rul. 94-47, 1994-2 CB 18]

    a. The IRS contends that these traveling costs are nondeductible unless the taxpayer qualifies for the home office deduction; the courts have ruled that the home office deduction is not necessary but taxpayers must litigate to obtain the travel deduction.

6. A person who worked at home only seven hours a week and did not have a home office could deduct travel between home and other temporary work sites. The fact that the home was a "regular" place of business was enough to support the deduction, even though it was not a "principal" place of business as it needs to be to deduct a home office. [Charles W. Walker, 101 TC 537 (1993)]

7. To the extent of any depreciation claimed after May 6, 1997, the 25% capital gain rate applies upon the sale or exchange of a residence (limited to the overall gain recognition).

8. To the extent the area of a residence is used for office or business use and that area has not been used for principal residence purposes for 2 years out of the previous 5 years prior to sale, the business use portion of the gain is not eligible for the Sec. 121 exclusion.

    a. This could result in substantial gain recognition if the value of the residence has appreciated substantially since its original acquisition, or if the adjusted basis of the residence is low due to gain deferrals from the former IRC §1034.

    b. Example: Elmer has owned a home for 20 years and has used this property as 10% business use for the entire 20 years. If Elmer sells the residence in 1999 at a gain, it will be treated as a sale of two properties. 90% of the property will qualify as a principal residence, eligible for the gain exclusion. However, 10% of the property is treated as a sale of a Sec. 1231 business asset and is reportable on Form 4797.

9. Developments

    a. Manager/singer of a jazz band was allowed a home office deduction for the work area (office and studio) in her home since she spent about 30 hours each week on her management functions in the home office and only 12 hours each week as a singer with the band. [*Genck,* TC Memo 1998-105]

    b. Reversing the Tax Court, the Ninth Circuit Court of Appeals found that a musician was entitled to a home office deduction for the area of her residence in which she regularly practiced her craft. The taxpayer, a professional musician, performed regularly with two orchestras. She also worked as a contract employee for numerous studios. At home, she practiced in the living room of her one-bedroom apartment. She claimed a home office deduction for her living room. Since the deduction arose in 1993, the Ninth Circuit applied the so-called Soliman test. [*K.V. Popov v Comm.*, 2001-1 USTC ¶50,353, CA-9]

c. The IRS concluded that an owner of an apartment building could depreciate the home office portion of his apartment over 27 ½ years because the property was residential rental property. [CCA 200526002]

1) For depreciation purposes, a property's status as residential rental property is determined based on the use of the building, not the dwelling units. A building is residential rental property if it contains at least one dwelling unit and at least 80% of its gross rental income is from dwelling units. [Sec. 168(e)(2)]

2) Taxpayers can apparently use a 27 1/2-year life even if the home office is used to conduct a business unrelated to the operation of the apartment building.

L. Renting to the Employer

1. Renting a house to your employer is not treated as an ordinary business rental. You may not deduct home operating expenses such as utilities, insurance, and depreciation.

2. The taxpayer, who was a minority shareholder and worked as a manager on the family-incorporated farm, was paid $12,000 in both 1992 and 1993 for allowing the corporation to store crops, farm equipment, and vehicles on the land adjoining his residence. He also allowed occasional use of his home telephone and bathroom facilities by farm workers. The court disallowed his deduction for rental expenses allocated to rental income. He is considered to have rented his "dwelling unit" for the entire year because the rental included property around the house, and the law specifically treats all such "appurtenant" property as part of the dwelling unit. [*L.A. Roy*, TC Memo 1998-25]

M. Health Insurance Deduction for Self-Employed Individuals

1. Health insurance deduction for self-employed individuals increased. [Health Insurance Portability and Accountability Act; Taxpayer Relief Act of 1997; Tax and Trade Relief Extension Act of 1998]

Year	Percent deductible
1997	40%
1998	45%
1999-2001	60%
2002	70%
2003 and thereafter	100%

2. 100% Spouse Health Insurance Deduction

a. In an ISP Coordinated Issue Paper, the IRS concedes that self-employed individuals--whether in partnerships, limited liability companies, S corporations, or sole proprietorships--can hire their spouses as employees and legitimately transform otherwise nondeductible personal expenses into deductible business expenses. The IRS concludes that one spouse can hire the other spouse as an employee, and pay and deduct that employee's medical benefits--including coverage for the employer-spouse and any dependents--as long as the employment arrangement is deemed legitimate. [UIL-162.35-02]

b. The spouse of a more than 2% shareholder of an S corporation cannot be treated as an employee.

3. The Office of Chief Counsel has determined that the sole proprietor of a business may deduct medical insurance costs for the proprietor and his or her spouse and dependents from the earned income of the business when the health insurance policy is purchased in the individual's name and not the name of the trade or business. [CCA 200524001]

   a. If the individual owns two or more businesses, he or she may not aggregate the profits and losses of the businesses for the purpose of maximizing the net income limit for deducting these costs.

   b. The deduction is limited to the earned income from the business for which the plan was established. If a taxpayer participated in more than one health plan, as in the case where the taxpayer had both a medical and dental plan, then the insurance costs could be deducted from the earned income from different businesses.

4. A married couple was entitled to deduct payment for health insurance premiums and medical expenses that were made under an employee benefits program the employer-husband set for his employee-wife. [Frahm, TC Memo 2007-351]

   a. Ralph Frahm owned and operated a Schedule F gain and livestock farm. He paid his wife $3,000 per year for her services, from which he withheld employment taxes. Ralph established a medical reimbursement plan for the benefit of his wife Erika and her family. Erika paid all of the medical expenses, including insurance premiums, out of her personal checking account. Ralph, as Erika's employer, reimbursed Erika for the health insurance premiums and the non-insurance medial expenses that Erika paid during the year. Ralph deducted the employee benefits program expenses on his Schedule F.

N. Firms can accelerate payroll tax deductions on deferred pay, including vacation pay, according to the IRS. It will allow accrual method firms to switch their accounting methods and deduct payroll tax liabilities attributable to deferred pay earned in a year, even though actual payment occurs in the following year. To qualify, the payment must be made no later than 8 ½ months after the end of the year. [Rev. Proc. 2008-25]

O. Farmer Site-Specific Management Expenses

1. Expenses paid or incurred after 2008 by farmers to achieve site-specific management actions under the Endangered Species Act of 1973 are treated as not chargeable to capital account and are deductible under Sec, 175 subject to the 20% of gross farming income limitation. [Sec. 175(c)(1)]

P. Depreciation

1. Economic Stimulus Act of 2008 Increased Sec. 179 Immediate Expensing

   a. The maximum Sec. 179 deduction is increased to $250,000 from $128,000 for tax years beginning in 2008 and 2009.

      1) For a company with a July to June fiscal year, only assets put in use after June 30, 2008, are eligible for the increased expensing ceiling. The previous $128,000 limit applies for 2008 purchases made before July.

   b. The phaseout threshold is increased to $800,000 from $510,000 for 2008 and 2009.

c. Owners of fiscal year pass-through entities may not get the full benefit. In August 2011, an S corporation with a July to June fiscal year puts a $250,000 asset in service. The S corporation claims an expensing deduction for the $250,000 on its 2011 return filed in 2012. However, the shareholders will report the expensing on their 2012 return, when the limit will fall back to $139,000. [Rev. Proc. 2008-54]

2. Economic Stimulus Act of 2008 Revives 50% Bonus Depreciation

a. Three requirements must be met:

1) It must be qualified property.

a) It is eligible Sec. 168 depreciable property with an MACRS recovery period of 20 years or less.

(1) Qualified property does not include any asset subject to the alternative depreciation system (ADS) unless the taxpayer has voluntarily elected to use ADS for the asset.

(2) Both the boot and the adjusted basis of relinquished asset qualify for the 50% bonus depreciation for assets acquired in a like-kind exchange.

b) It is depreciable computer software that is not amortizable over 15 years under Sec. 197.

(1) Software is amortizable under Sec. 197 only when 1) it is acquired as part of an overall business acquisition transaction and 2) it is not readily available for purchase by the general public.

c) It is water utility property as defined in Sec. 168(e)(5).

d) It is 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.

e) The taxpayer is permitted to elect out of using the 50% bonus depreciation rules.

f) The election must be made by "class of property" which refers to the 3, 5, 7, 10, 15, and 20-year recovery period classes.

2) It must be purchased during calendar 2008 or 2009.

3) The original use of the asset generally must begin with the taxpayer during calendar year 2008 or 2009.

a) Generally, the asset must be new.

b) A special exception applies to assets that are sold and leased back.

b. Certain improvements are ineligible for bonus depreciation:

1) Expenditures to enlarge a building;

2) Cost for any elevator or escalator, any structural component benefitting a common area (e.g., restrooms located in the lobby of a floor which had offices leased out to various tenants), and any internal structural framework of a building;

3) Improvements made pursuant to leases between certain related parties.

c. The 50% bonus depreciation rule increases the maximum first-year depreciation deduction for autos and trucks by $8,000.

1) New passenger autos acquired and placed in service in 2012 have a maximum first year depreciation of $11,160. ($8,000 + $3,160).

2) For new light trucks placed in service in 2012, the maximum first-year depreciation is $11,260 ($8,000 + $3,260).

d. The placed in service deadline is extended to December 31, 2012, for certain qualifying property with "longer lives."

1) Qualifying MACRS property with a recovery period of 10 years or longer;
2) Certain transportation property; and
3) Certain aircraft.

e. The 50% bonus depreciation rule applies for both regular tax and AMT purposes.

3. Racehorses

a. All racehorses placed in service after 2008 and before 2014 are assigned a three-year recovery period under MACRS.

b. Under previous law only those racehorses that are more than two years old when placed in service by purchase are in the three-year recovery period. [Sec. 168(e)(3)(A)]

4. Changing the Depreciation Method

a. If in the past years a taxpayer mistakenly claimed less than the permitted amount of depreciation on property used in business, any action taken to correct the mistake is a change in accounting method for which IRS permission is required.

b. The IRS, in Rev. Proc. 96-31, says it will automatically consent to such a change as long as the taxpayer switches to an accounting method that is permissible for the business.

c. An adjustment for previously omitted depreciation may be taken on the tax return for the year of the change.

d. Rev. Proc. 2002-9, 2002-3 IRB 327 provides the procedures by which a taxpayer may obtain automatic consent to change the methods of accounting described in the Appendix of this revenue procedure.

e. The requirement under Reg. 1.446-1(e)(3)(i) to file a Form 3115 within the taxable year is waived for any application for a change in method of accounting filed pursuant to this revenue procedure.

f. A taxpayer changing a method of accounting pursuant to this revenue procedure must complete and file an application in duplicate, using Form 3115.

g. File Form 3115, Application for Change in Accounting Method, by the due date of the tax return, including extensions.

h. The original must be attached to the taxpayer's timely filed (including extensions) original federal income tax return for the year of change, and a copy (with signature) of the application must be filed with the national office no earlier than the first day of the year of change and no later than when the original is filed with the federal income tax return for the year of change. [Rev. Proc. 2002-9 Section 6.02(a)]

i. A user fee is not required for an application filed under this revenue procedure. Except for a receipt given at the courier's desk, the receipt of an application filed under this revenue procedure will not be acknowledged.

j. This change applies to any taxpayer wanting to make a change in method of accounting for depreciation for property that is owned by the taxpayer at the beginning of the year of change. [Appendix Section 2.02(2)(a)]

k. A Rev. Proc. allows taxpayers to change their method of determining depreciation for an asset after its disposition if the taxpayer claims less than the full allowable amount. [Rev. Proc. 2004-11]

   1) Rev. Proc. 90-38 provides that a taxpayer using an erroneous accounting method on two consecutive returns establishes an accounting method. Rev. Proc. 2004-11 waives this two-year rule for depreciable assets.

   2) Example: Walter has placed similar assets in service each year during 2002, 2003, 2004, and 2005. While preparing the 2005 return, it is discovered that all those assets were erroneously depreciated using a seven-year recovery period. The correct recovery period was five years. Walter has established an accounting method for depreciating the assets placed in service in 2002 and 2003. No accounting method for depreciation has been established for the assets placed in service in 2004. Walter can change his accounting method for the assets placed in service in 2002, 2003, and 2004 effective on his 2005 tax return, under the automatic change provisions of Rev. Proc. 2002-9. Alternatively, Walter could follow the automatic change procedure for the assets placed in service in 2002 and 2003, and file an amended return for 2004 to correct the depreciation on assets placed in service that year.

l. Rev. Proc. 2004-11 allows the taxpayer to initiate a change of depreciation method for any tax year open under the statute of limitations.

m. The Sec. 481(a) adjustment period for positive adjustments is four taxable years.

n. A taxpayer may elect to use a one-year adjustment if the entire adjustment is less than $25,000. [Sections 5.04(1) and (3)(a)]

o. 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]

5. Depreciating Exchanged MACRS Property

a. Taxpayers who exchange modified accelerated cost recovery system (MACRS) property on or after January 3, 2000, through either a Section 1031 like-kind exchange or a Section 1033 involuntary conversion, now are required to treat the excess basis of the acquired MACRS property as newly purchased. According to Notice 2000-4, the new asset will now be treated as two separate properties for depreciation purposes. The IRS will permit taxpayer that put property in service before January 3, 2000, that are depreciating the acquired property as new MACRS property to change the depreciation method on the property, provided the property has been treated by the taxpayer as acquired in either a Section 1031 exchange or a Section 1033 conversion and the change is made for the first or second tax year ending after January 3, 2000. Taxpayers that choose to make this change must follow all of the requirements for an automatic change in accounting method. [Notice 2000-4, IRB 2000-3, 313]

b. Proposed, temporary, and final regs have been issued that apply to property acquired in like-kind exchanges or after certain involuntary conversions. [TD 9115]

c. Generally, exchanged basis (basis in the replacement property) is depreciated over the remaining recovery period of the relinquished MACRS property, using the same depreciation method and convention.

1) New Terms of Art

a) Replacement property -- MACRS property that is acquired.

b) Relinquished property -- MACRS property given up.

c) Exchanged basis -- Depreciable basis in the replacement property.

d) Excess basis -- Additional depreciable basis in the replacement property over and above the amount of exchanged basis.

2) This general rule applies if the replacement property has the same or shorter recovery period, or the same or more accelerated depreciation method, than the relinquished property.

3) If the replacement property MACRS property has a longer recovery period, or less-accelerated depreciation method, the replacement property is treated as placed in service when the relinquished property was placed in service.

4) The depreciation treatment used by the previous owners in determining depreciation allowances for the replacement MACRS property is not relevant.

d. Deferred Exchanges

1) If a taxpayer disposes of MACRS property before acquiring replacement property, the temporary regs do not allow the taxpayer to take depreciation on the relinquished MACRS property for the period between disposal and acquisition.

2) If the replacement property is acquired before the MACRS property is disposed of, the regs allow the taxpayer to depreciate the unadjusted depreciable basis of the replacement property until the original MACRS property is relinquished.

e. Automobiles

1) If the replacement vehicle is a passenger automobile subject to Sec. 280F(a) depreciation limits, then the depreciation limitation is based on the date the replacement vehicle is put in service by the acquiring taxpayer. In allocating the depreciation limitation, the depreciation allowance for the exchanged vehicle generally is limited to the amount that would have been allowed under Sec. 280F(a) for the relinquished vehicle if the transaction had not occurred.

f. Additional First-Year Depreciation

1) In general, the exchanged basis (carryover basis) and the excess basis of the replacement property are eligible for the additional first-year depreciation deduction under Secs. 168(k) and 1400L(b).

   a) The bonus depreciation is not available for property purchased and disposed of in the same tax year.

g. Election Out

1) Taxpayers may elect not to apply the temporary regs if the rules are too burdensome or depreciation components are too difficult to track. However, if a taxpayer elects not to apply the regs, the taxpayer must treat the entire basis (both the exchanged and excess basis) of the replacement MACRS property as being placed in service by the acquiring taxpayer at the time of replacement.

2) The election must be made by typing or legibly printing at the top of Form 4562, Depreciation and Amortization, "ELECTION MADE UNDER SECTION 1.168-6T(i)," or in the manner provided for on Form 4562 and its instructions.

3) Example: Exchanged a building held five-years for a radio transmitting tower. General Rule -- Straight-line, 34 years
   Election -- 150%, 15 years

4) The new temporary regulations are unduly complicated when it comes to depreciating passenger automobiles. Elect out to avoid needless complexity. Take $2,960 depreciation.

6. Depreciation Under MACRS When Use Changes

   a. Final regs. explain how to depreciate property under MACRS when a taxpayer's use of the property changes. [TD 9132]

   b. Changes in primary use occur because of the following triggering events:

      1) The property is converted from personal use to business (or investment) use, or vice versa;

      2) A different use requires a different recovery period, depreciation method, or both; or

      3) The property's use "predominantly" outside the U.S. begins or ends.

   c. If the property's use changes during its first year of service, depreciation is based on its primary use for that year.

   d. The change in use is treated as if the change occurred on January 1.

   e. If a change in use results in a shorter recovery period and/or a more accelerated depreciation method, the property's remaining basis at the beginning of the year of change is depreciated using the more accelerated method or the shorter recovery period.

      1) The regs permit the taxpayer to elect to disregard the change in use and continue to compute depreciation in the same manner as before.

      2) Example: Seven-year property with a basis of $100,000 is place in service in 2003. In 2008, when the property's basis is $22,311, the use changes. The new use requires a new recovery period of five years; the depreciation method is unchanged. The remaining basis must be depreciated over five years, through 2008 through 2012. The depreciation deductions for 2008-2012 are $8,924, $5,355, $3,213, $2,410, and $2,409. Alternatively, the taxpayer may disregard the change in use and depreciate the property over the remaining 2.5 years, through 2010. Depreciation, which switched to the straight-line method in 2007, is $8,930 for 2008 and 2009, and $4,460 for 2010.

   f. If the change in use results in a longer recovery period and/or a slower depreciation method, the property's basis at the beginning of the year is depreciated using the longer recovery period or the less accelerated depreciation method, as if the property were originally placed in service with the longer period or slower method.

      1) Example: Property with a basis of $100,000 is placed in service in the U.S. in 2006. The property has a five-year recovery. In 2008, when the property's basis is $48,000, the equipment is moved to use predominantly outside the U.S. The new recovery period is nine years, and straight-line depreciation applies. The remaining recovery period is 7.5 years, the number of years remaining at January 1, 2008, for property placed in service in 2006. Depreciation is $6,398 each year ($3,199 in the final year).

   g. Property converted from personal use to business (or investment) use is considered placed in service on the date of conversion. The property's basis is the lower of its fair market value or adjusted basis on the date of conversion.

h. Property converted from business use to personal use is treated as a disposition on which the normal depreciation conventions are applied. However, no gain, loss, or depreciation recapture is recognized upon conversion. Depreciation recapture must be recognized when the taxpayer ultimately sells the property.

i. Depreciation is subject to all other usual limitations on business depreciation, such as the restrictions on luxury automobiles.

j. The final regs apply to a change in use occurring in a tax year ending on or after June 17, 2004.

   1) For tax years ending prior to June 17, 2004, a taxpayer can use any reasonable Sec. 168 depreciation method that is consistently applied.

   2) Taxpayers are also free to apply the regs to a prior year change in use on a property-by-property basis.

k. If the use changed in a prior year, taxpayers whose depreciation method violates the final rules do not have to apply for a change of accounting method. They can change their depreciation method on an amended return instead of filing Form 3115.

7. Change of Accounting Method Guidance

a. Recently issued comprehensive guidance (temporary and proposed regs) explains when a change in depreciation and amortization will be deemed a change in accounting method. Taxpayers will be able to apply for automatic consent to a change in accounting method after disposition of improperly treated property. [TD 9105]

b. The IRS considers the following to be changes in methods of accounting:

   1) A change in the depreciation method, period of recovery, or convention of a depreciable or amortizable asset;

   2) A change to, or from, a useful life that is specifically assigned by statute or other guidance;

   3) A change in salvage value to zero for a depreciable or amortizable asset for which the salvage value is expressly treated as zero by statute or other guidance;

   4) A change from claiming the 30% additional first-year depreciation deduction to claiming the 50% additional first-year depreciation or vice-versa;

   5) A change in the accounting for depreciable or amortizable assets from single asset accounting or multiple asset accounting or vice-versa; and

   6) A change in treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable or vice-versa.

c. The regs set forth several changes that the IRS will not treat as an accounting method change. These include:

1) A change in computing depreciation allowances in the tax year in which the use of property changes in the hands of the same taxpayer;

2) The making of a late depreciation election or the revocation of a timely valid depreciation election; and

3) Any change in the placed-in-service date of a depreciable or amortizable asset.

d. Taxpayers not taking into account any depreciation allowance, or taking less than full depreciation before they disposed of property, will benefit under the expanded automatic consent rules. They may change accounting methods by generally following the automatic change provisions in Rev. Proc. 2002-9.

8. SUV Deduction

a. The deduction for sport utility vehicles weighing not more than 14,000 pounds is capped at $25,000 (not indexed), effective for property placed in service after Oct. 22, 2004.

b. A sports utility vehicle is any four-wheeled vehicle:

1) Primarily designed or which can be used to carry passengers over public streets, roads, or highways (except any vehicle operated exclusively on a rail or rails);

2) Which is not subject to the Sec. 280F depreciation caps (i.e., the vehicle has a GVWR in excess of 6,000 pounds or is otherwise exempt); and

3) Which has a GVWR of not more than 14,000 pounds.

c. The term sport utility vehicle is defined to exclude any of the following vehicles:

1) A vehicle designed to have a seating capacity of more than 9 persons behind the driver's seat;

2) A vehicle equipped with a cargo area of at least 6 feet in interior length that is an open area and it not readily accessible directly from the passenger compartment;

3) A vehicle equipped with a cargo area of at least 6 feet in interior length that is designed for use as an open area but is enclosed by a cap and is not readily accessible directly from the passenger compartment; or

4) A vehicle with an integral enclosure, fully enclosing the drive compartment and load carrying device, does not have seating rearward of the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

9. 15-Year Gas Station Recovery Period

   a. A retail motor fuels outlet may be depreciated over a 15-year period; otherwise, it must be depreciated over 30 years.

      1) To be considered a retail motor fuels outlet falling with Asset Class 57.1, a facility must meet either the gross-revenue test of the floor-space test.

         a) A 1996 Senate report states that the floor-space is determined by the IRS coordinated issue paper released in 1995.

            (1) A structure is subject to the 15 year depreciation schedule if "50 percent or more of the floor space in the property is devoted to petroleum marketing sales." Counter areas for selling gasoline and auto supplies, adjacent carwash buildings, pump islands and canopies are "devoted to the marketing of petroleum products."

            (2) "Office area, storage, restrooms, food preparation, walk-in-cooler, general areas, and ...seating for customers" are not petroleum marketing areas. Buildings "primarily used to sell convenience items" are not included in Asset Class 57.1.

   b. The Circuit Court compared the services offered by the taxpayer to the services offered by traditional service stations. The court found that the floor space used for an entertainment center, arcade, showers, laundromat, and TV lounge was not found in traditional service stations. As such, the taxpayer failed the test. [Iowa 80 Group, Inc. CA-8, 5-4-05]

10. Depreciating Leasehold Improvements

   a. 15-year recovery period, using straight-line depreciation, for qualified leasehold improvements to nonresidential real property placed in service after Oct. 22, 2004, and before January 1, 2012.

      1) If the lessor made the improvement, subsequent owners generally cannot use the 15-year period to depreciate the improvement.

         a) An exception applies in the case of death and certain transfers of property that qualify for non-recognition treatment.

   b. 15-year recovery period and straight-line depreciation for qualified restaurant property placed in service after Oct. 22, 2004, and before January 1, 2012.

      1) Qualified restaurant property is a building improvement placed in service more than three years after the building is placed in service.

      2) The restaurant must use more than half of the building's square footage.

11. Qualified Retail Improvement Property

    a. 15-year property using half-year straight-line depreciation.

    b. For 2009 only.

    c. Still Sec. 1250 property and does not qualify for Sec. 179 or bonus depreciation.

    d. Requirements:

        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.

    e. Disqualified:

        1) Elevators and escalators.

        2) Internal structural framework of a building.

        3) Structural components that benefit a common area.

        4) Improvements relating to the enlargement of a building.

12. Amortization of Intangibles

    a. A taxpayer is allowed to deduct up to $5,000 of start-up and $5,000 or organizational expenditures in the taxable year in which the trade or business begins.

        1) Each $5,000 amount is reduced, but not below zero, by the amount by which the cumulative cost of start-up or organizational expenditures exceeds $50,000, respectively.

        2) Start-up and organizational expenditures that are not deductible in the year in which the trade or business begins would be amortized over a 15-year period consistent with the amortization period for Sec. 197 intangibles.

        3) The law is effective for start-up and organizational expenditures incurred after Oct. 22, 2004.

13. Start-Up and Organizational Expenses

    a. The IRS issued temporary, final, and proposed regs providing deemed elections to deduct start-up and organizational expenses. [TD 9411; NPRM REG-164965-04]

    b. Allowing a deemed election avoids the necessity of taxpayers having to formally file a separate election on Form 4562, Depreciation and Amortization.

    c. The temporary regs apply to expenses paid or incurred after September 8, 2008. Taxpayers may choose to apply all the regs to expenses paid or incurred after October 22, 2004, provided the statute of limitations has not expired for the particular year.

14. Amended UNICAP and Accrual Method Regs

    a. The amended final regs impact taxpayers seeking to change their accounting methods to conform to the:

        1) Uniform capitalization rules under Sec. 263A; or

        2) Accrual method under Sec. 448.

    b. Regs under Sections 263A and 448 provide rules for certain changes in accounting method, including the number of tax years over which an adjustment required under Sec. 481(a) to make the change is to be taken into account.

        1) Taxpayers may take into account any Sec. 481(a) adjustment over the same number of tax years under the advance consent procedure of Rev. Proc. 97-27 or the automatic consent procedure of Rev. Proc. 2002-9, both of which have been modified by Rev. Proc. 2002-19.

        2) Generally, positive adjustments attributable to changing an accounting method are taken into account over four tax years. Negative adjustments are taken into account in one tax year.

15. Storage Tank Depreciation

    a. The Tax Court has approved use of a five-year MACRS recovery period for oil storage tanks, rather than a 15-year period, ruling that they were not "inherently permanent structures." [PDV America, Inc., TC Memo 2004-188]

        1) The tanks ranged from 22 to 57 feet high, 40 to 170 feet in diameter, and 7,000 to 194,000 barrels in capacity. Some weighed over one million pounds and could last for 60 years. The tanks could be lifted off the ground for repair or to clean the soil underneath if there was a leak.

    b. Under Asset Class 57.0 of Rev. Proc. 87-56, assets used in marketing and distributing petroleum products may be depreciable over five years. Under Class 57.1, depreciable land improvements used in marketing and distributing petroleum products must be depreciated over 15 years.

Q. Section 179

1. An election may be made to expense the cost of tangible personal property in the year the asset is placed in service.

    a. More than 50% of the property's use in the tax year must be for a trade or business.

        1) Residential real estate rentals are not considered to be the "active conduct of a trade or business."

    b. Production of income property is not eligible for Section 179.

    c. Property generally not eligible for Section 179
        1) Property used outside the United States
        2) Property used in connection with furnishing lodging
        3) Property used by tax-exempt organizations
        4) Property used by governments and foreign persons
        5) Air conditioning or heating units

    d. Off-the-shelf computer software to which Code Sec. 167 applies and that is placed in service in tax years beginning after 2002 and before 2009 is now included as qualifying property that may be expensed under Code Sec. 179. Computer software is defined as software that is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified. In addition, computer software does not include any database or similar item unless it is in the public domain and is incidental to the operation of otherwise qualifying computer software.

2. Section 179 Deductible Amount Increases

Year	Amount
1997	$ 18,000
1998	$ 18,500
1999	$ 19,000
2000	$ 20,000
2001	$ 24,000
2003	$100,000
2004	$102,000
2005	$105,000
2006	$108,000
2007	$125,000
2008	$250,000
2009	$250,000
2010	$500,000
2011	$500,000
2012	$139,000

    a. The deductible limit is reduced dollar-for-dollar if more than $560,000 (2012) in tangible personal property is placed in service during the year.

    b. The Section 179 deduction is limited to the taxable income from the taxpayer's active trades or businesses.

        1) Deduction for self-employment tax and NOL carryover are not deducted in determining the taxable income limitation.

    c. The taxable income limit applies both with respect to the entity and to the owners of the entity. [Sec. 179(d)(8)]

d. The expense deduction disallowance due to lack of income may be carried forward indefinitely. Deduction disallowances due to investments in excess of $560,000 (2012) are not carried forward.

3. If a taxpayer's Section 179 property is not used predominately in a trade or business of the taxpayer at any time before the end of the property's recovery period, the taxpayer must recapture in the tax year in which Section 179 property is not used predominately in a trade or business any benefit derived from expensing such property. The benefit derived from expensing under this section over the total amount that would have been allowed for prior years and the tax year of recapture as a deduction under Section 168 (had Section 179 not been elected) for the portion of the cost of the property to which the expensing relates.

a. If business use falls below 50% in a year after an asset is purchased, the excess of the write-offs claimed over straight-line depreciation is required to be added back to income. Too much personal use will partially negate deduction claimed before 2005 for expensing, 30% or 50% bonus depreciation, and accelerated depreciation. [INFO 2004-0193]

1) The recapture period lasts for five years, starting with the year that the vehicle is placed in use.

4. The IRS has issued temporary and proposed regulations on Sec. 179 expensing election for small businesses. [TD 9146]

a. The taxpayer may make or revoke a Sec. 179 election without consent of the IRS on an amended return for which the election applies, filed within the time required by law for filing an amended return for that tax year.

1) The amended return must include the adjustment to taxable income for the Sec. 179 election and any collateral adjustments (for example, the amount of any depreciation also allowed on the Sec. 179 property).

2) The election must specify the Sec. 179 property and the portion of that property's cost to be taken into account.

b. The taxpayer may revoke an entire Sec. 179 election or any part of it (called a "specification") by filing an amended tax return for that tax year (and any affected succeeding tax years). The amended return must include the adjustment to taxable income for the revocation and any collateral adjustments (such as allowable depreciation).

1) Once a revocation is made on the amended return, it is irrevocable. However, an election or revocation is applicable not only on a property-by-property basis, but also with respect to any particular portion of any property.

c. The taxpayer, a self-employed welder, reported losses from his business. On reviewing his business return, the IRS determined that three items deducted as materials and supplies were in fact depreciable capital assets. After reallocating the items, the taxpayer ended up with a $17,500 profit for the year. The items could have been expensed if the taxpayer had made an election with respect to them on his original return. The taxpayer attempted to amend his return to elect Section 179 for the items. Such treatment must be affirmatively elected by a taxpayer, specifying the assets to which the election is to apply and, once elected, it cannot be revoked without permission of the IRS. The Tax Court ruled that the IRS denial of a request for consent to revoke or modify his original election was not an abuse of discretion. The taxpayer's regrettable condition was of his own making. [*Patton*, 116 TC 206 (2001)]

5. To determine any reduction in the dollar limit for costs over $500,000, the partners does not include any of the cost of section 179 property placed in service by the partnership. [Pub. 946, p. 21]

6. To figure the net income (or loss) from a trade or business actively conducted by an S corporation, take into account the items from that trade or business that are passed through to the shareholders and used in determining each shareholder's tax liability. However, do not take into account any credits, tax-exempt income, the section 179 deduction, and deductions for compensation paid to shareholder-employees.

R. Increase and Extension of Bonus Depreciation

1. The new law increases the additional first-year depreciation allowance percentage from 30 percent to 50 percent. To qualify for the higher percentage, the property must be acquired after May 5, 2003, and placed in service before January 1, 2005 (January 1, 2006, for property with a longer production period).

2. The 50-percent rate does not apply if a binding written contract for acquisition of the property was in effect before May 6, 2003. Property of the type that meets the requirements for the 30-percent bonus depreciation deduction will qualify for the 50-percent rate if the preceding acquisition and placed-in-service dates are met.

3. Taxpayers may elect to continue to use the 30-percent rate.

   a. An additional 30% first-year depreciation allowance applies to qualified new property that is depreciated for 20 years or less under MACRS (original use begins with taxpayer).

      1) Must be purchased, contracted for, or produced by the taxpayer after September 10, 2001, and before September 11, 2004.

      2) Placed in service after September 10, 2001, and before 2005.

4. Qualified leasehold improvements and water utility property are eligible for bonus depreciation -- 20-year rule does not apply.

   a. Qualified leasehold improvement property is any improvement to an interior portion of nonresidential real property made under or pursuant to a lease by the lessee, sublessee, or lessor.

   b. The improvement must be placed in service more than three years after the date the building was first placed in service.

   c. Expenditures for (1) the enlargement of a building, (2) any elevator or escalator, (3) any structural component that benefits a common area, or (4) the internal structural framework of a building are not considered qualified leasehold improvement property.

5. The 30% and 50% first-year depreciation is taken after any Section 179 deduction.

   a. Example. Purchase $400,000, 5-year asset

$400,000	$150,000	$250,000
-250,000	- 75,000	75,000
$150,000	$ 75,000	15,000
x 50%	x 20%	$340,000
$ 75,000	$ 15,000	

6. Bonus depreciation must be claimed unless a taxpayer makes an election out.

7. Like-Kind Exchange and Bonus Depreciation

    a. The full basis of acquired property qualifies for the bonus, not just the extra cash paid by the seller.

    b. The additional first year depreciation is computed separately for the remaining carryover basis and the remaining excess basis. [Reg. 1.168-1T(f)(6)(iii)]

    c. File amended returns before Dec. 31, 2003.

8. Additional Capital Expenditures

    a. Additional capital expenditures incurred by a taxpayer to recondition or rebuild property acquired or owned by the taxpayer satisfy the original use requirement.

    b. However, the cost of reconditioned or rebuild property acquired by the taxpayer does not satisfy the original use requirement. [Reg. 1.168(k)-1T(b)(3)(i)]

9. Used Parts

    a. The regulations provide a safe harbor that property containing used parts will not be treated as reconditioned or rebuilt if the cost of the used parts is not more than 20 percent of the total cost of the property. See Rev. Rul. 68-111, 1968-1 CB 29

10. Personal to Business Use and Bonus Depreciation

    a. If a taxpayer buys a new asset after Sept. 10, 2001, and uses it for non-business purposes, a later switch to use in a business qualifies it for the 30% or 50% write-off, depending on the purchase date.

    b. New property acquired for personal use and then subsequently acquired by a different taxpayer for use in a trade or business does not satisfy the original use requirement. [Reg. 1.168(k)-1T(b)(3)(ii)]

11. Same Year Purchase and Sale

    a. No bonus depreciation can be taken on assets bought and sold during the same year.

    b. Regular depreciation is not allowed on a purchase and sale of an asset in the same year. [Reg. 1.168(k)-1T(f)(1)(i)]

12. The dollar limit on write-offs for luxury business cars has been increased for cars acquired after May 5, 2003, and before 2005.

    a. The new limit is an additional amount of $7,650, up from the former $4,660 limit.

13. The IRS has informally indicated to CCH that a single luxury car cap is applied to the total depreciation deduction claimed on the sum of the carryover basis and the basis treated as a new acquired vehicle when a vehicle is traded in.

14. The additional depreciation allowance may be claimed for alternative minimum tax purposes in the year that qualifying property is placed in service.

15. Intangibles amortized over 15 years under Code Sec. 197 do not qualify for the allowance.

    a. In the case of any Section 197 intangible that is a covenant not to compete, in no event will such covenant or other arrangement be treated as disposed (or becoming worthless) before the disposition of the entire interest described in such subsection in connection with which such covenant (or other arrangement) was entered into. [Sec.197(f)(1)(B)]

16. Property which must be depreciated using the MACRS alternative depreciation system (ADS) does not qualify for bonus depreciation.

    a. However, property that a taxpayer elects to depreciate using ADS is not disqualified.

17. Sec. 179 Developments

    a. The "taxable income limitation" under Treasury regulations prevents a partnership or S corporation from allocating its IRC §179 expense deduction for depreciable property to an owner if the entity realized no taxable income. A taxpayer attempted to claim a Section 179 deduction for a partnership which reported a loss, arguing that the ability to aggregate taxable income from different businesses at the Form 1040 level should also allow aggregation of that taxable income with the income or loss of a partnership. The statutory limitation, they alleged, applies only to the taxable income "of the taxpayer." Since the partnership is not a "taxpayer," the taxable income limitation is meaningless, and should be interpreted to mean gross receipts of the business carried on by the partnership. However, the Tax Court upheld the validity of the regulations and disallowed the Section 179 deduction at the partnership level, due to the lack of taxable income. [*Hayden*, 112 TC 115 (1999)]

S. Recapture of Sec. 197 Amortization

1. If multiple Sec. 197 intangibles are sold, or otherwise disposed of, in a single transaction or series of transactions, the seller must calculate recapture as if all the Sec. 197 intangibles were a single asset. Applies after August 8, 2005.

2. Example: Purchase two intangible assets--Asset A for $150 and Asset B for $250.
   Year 6 sell Asset A for $250 and B for $200
   Depreciation taken on A of $50 and $100 on B
   Gain on A of $150 [$250 - ($150 - $50)]
   Gain on B of $-0- [$200 - ($300 - 100)]
   Old rule -- $50 recapture on A only
   New rule -- $150 recapture from total $150 gain

T. Original Tire Capitalization Method

1. Under the original tire capitalization method, a taxpayer:

   a. Must capitalize the cost of the original tires of a qualifying vehicle and depreciate these tires under Sec. 168 by using the same depreciation method, recovery period, and convention applicable to the vehicle on which the tires are first installed;

   b. Must treat the original tires of the qualifying vehicle as being disposed of at the same time the vehicle on which the tires were first installed is disposed of by the taxpayer; and

   c. Must deduct the cost of the replacement tires of the qualifying vehicle as an expense in the taxable year the replacement tires are installed on the vehicle by the taxpayer. [Rev. Proc. 2002-27, 2002-17 IRB 802]

2. Taxpayers can qualify for an automatic change of accounting method under Rev. Proc. 2002-9.

U. Segregation of Building Components

1. In a 1997 opinion, the Tax Court held that structural components of a building which relate to tangible personalty (i.e., specialized wiring for equipment) may be depreciated as short-term tangible property rather than as building improvements. [*Hospital Corporation of America*, 109 TC 21, 7-24-97, nonacq.]

2. The IRS has issued a District Counsel Memorandum, summarizing its reaction to this case. [Ltr. Rul. 199921045, 4-1-99]

   a. This memorandum acknowledges that items which might normally be categorized as structural components of a building, such as wiring, may in fact be properly categorized as tangible personalty based on the ultimate use of the property.

   b. The memorandum cautions IRS examiners to carefully scrutinize the support and data or estimates which comprise the basis for cost segregation studies which might be prepared to justify segregation of tangible personalty costs.

   c. The memorandum further cautions that any change from 1250 property depreciation to 1245 property depreciation constitutes a change in method of accounting, and requires IRS consent.

   d. The memorandum summarizes the factors discussed by the Tax Court in determining whether an item is inherently permanent and thus part of the building, or whether it is tangible personal property, based on issues as whether the property is capable of being moved, whether it is designed or constructed to remain permanently in place, how much damage would be sustained upon its removal, and the manner of affixation of the property.

3. Cost Segregation Audit Techniques

   a. The IRS has issued a 115-page Audit Techniques Guide (ATG) developed to assist examiners in their review of cost segregation studies (Cost Segregation Audit Techniques Guide, dated April 30, 2004).

   b. The guide explains why cost segregation studies are performed, how such studies are prepared, and what to look for when reviewing these studies.

   c. The same audit guides IRS auditors use are available free on the IRS web site for more than 50 different kinds of businesses.
      go to -- www.irs.gov
      click on -- Information For "Businesses"
      click on -- "Audit Techniques Guide for Cost Segregation Studies"

V. Depreciation Developments

1. Taxpayers who exchange modified accelerated cost recovery system (MACRS) property on or after January 3, 2000, through either a Section 1031 like-kind exchange or a Section 1033 involuntary conversion, now are required to treat the excess basis of the acquired MACRS property as newly purchased. According to Notice 2000-4, the new asset will now be treated as two separate properties for depreciation purposes. The IRS will permit taxpayer that put property in service before January 3, 2000, that are depreciating the acquired property as new MACRS property to change the depreciation method on the property, provided the property has been treated by the taxpayer as acquired in either a Section 1031 exchange or a Section 1033 conversion and the change is made for the first or second tax year ending after January 3, 2000. Taxpayers that choose to make this change must follow all of the requirements for an automatic change in accounting method. [Notice 2000-4, IRB 2000-3, 313]

2. A married couple owned a business proprietorship as community property. When the husband died, the wife inherited his interest in the business. The tax code allows the value of "intangible" business assets (such as goodwill) to be deducted over 15 years when they are acquired after August 10, 1993. Under this provision, the wife can deduct over 15 years the 50% of the business' intangibles that she inherited from her husband after the 1993 date. This is so even though she cannot deduct her own 50% interest in the intangibles, because she acquired them before that date. [Ltr. Rul. 199949037]

3. The IRS amended the regulations for Section 197 to provide a ratable 15-year amortization period for goodwill and other intangibles acquired after January 25, 2000. The regulations also state that purchased computer software should be amortized over 15 years if Section 197 applies and over 36 months if the software is not a Section 197 intangible. [TD 8865]

4. Cost of removing old asset that is replaced by a new asset is deductible and need not be capitalized. [Rev. Rul. 2000-7, IRB 200-9, 712] Ruling involved the replacing of telephone poles.

   a. The IRS has indicated that a taxpayer desiring to change its method of accounting to conform with the ruling is allowed to use the automatic change procedures of Rev. Proc. 2002-9.

5. A firm adopted a policy that it would expense equipment, furniture, etc., that cost under $500, even for assets with useful lives exceeding a year. The deductions added up to an average of $400,000 of write-off annually. Low-cost assets must be depreciated, according to the Tax Court, if their useful life exceeds one year. [*Alacare Home Health Svc.,* TC Memo 2001-149] There is an exception if expensed items represent a minute portion of the company's overall operating expenses and net income -- less than 1%.

6. Farming Business Machinery and Equipment

   a. Treated as five-year property.

   b. Original use and placed in service in 2009 only taxpayer in a farming business.

   c. Does not include grain bin, cotton ginning asset, fence, or land improvement.

W. Amortization of Start-Up Expenditures [TD 8797 1999-5 IRB 5]

1. Under Section 195(b), a taxpayer may elect to amortize start-up expenditures. A taxpayer who elects to amortize start-up expenditures must, at the time of the election, select an amortization period of not less than 60 months, beginning with the month in which the active trade or business begins. The election applies to all of the taxpayer's start-up expenditures with respect to the trade or business. The election to amortize start-up expenditures is irrevocable, and the amortization period selected the taxpayer in making the election may not subsequently be changed.

2. The election to amortize start-up expenditures must be made by attaching a statement containing certain information to the taxpayer's return. The statement must be filed no later than the date prescribed by law for filing the return (including any extensions of time) for the tax year in which the active trade or business begins. The statement may be filed with a return for any tax year prior to the year in which the taxpayer's active trade or business begins.

3. The statement must set forth a description of the trade or business to which it relates with sufficient detail so that expenses relating to the trade or business can be identified properly for the tax year in which the statement if filed and for all future tax years to which it relates. The statement must include the number of months (not less than 60) over which the expenditures are to be amortized, and to the extent known at the time the statement is field, a description of each start-up expenditure incurred (whether or not paid) and the month in which the active trade or business began (or was acquired). A revised statement may be filed to include any start-up expenditures not included in the taxpayer's original election statement, but the revised statement may not include any expenditures for which the taxpayer had previously taken a position on a return inconsistent with their treatment as start-up expenditures. This will prevent taxpayers from increasing the amount subject to amortization by expenditures that they have been unsuccessful in maintaining as expansion costs. The revised statement may be filed with a return filed after the return that contained the election.

4. Section 195(c) defines "start-up expenditures," in part, as any amount (A) paid or incurred in connection with investigating the creation or acquisition of an active trade or business, and (B) which, if paid or incurred in connection with the operating of an existing active trade or business would be a deduction for the tax year in which paid or incurred. Thus, in order to qualify as start-up expenditures under §195(c)(1), a taxpayer's "investigatory costs" must satisfy the requirements of both §§195(c)(1)(A) and (B). In addition, the term "start-up expenditures" does not include any amount with respect to which a deduction is allowable under §163(a), 164, or 174.

5. Rev. Rul. 77-254, 1977-2 CB 63 provides that expenses incurred in the course of a general search for, or an investigation of, a business that relates to the decision *whether* to purchase a business and *which* business to purchase are investigatory costs. However, once a taxpayer has focused on the acquisition of a specific business, expenses that are related to an attempt to acquire that business are capital in nature. Thus, the "final decision" is the point at which a taxpayer makes their decision whether to acquire a business, and which business to acquire, rather than the point at which a taxpayer and seller are legally obligated to complete the transaction.

6. The nature of the cost must be analyzed based on all the facts and circumstances of the transaction to determine whether it is an investigatory cost incurred to facilitate the *whether* and *which* decision, or an acquisition cost incurred to facilitate consummation of the acquisition. The label that the parties use to describe the cost and the point in time at which the cost is incurred does not necessarily determine the nature of the cost. [Rev. Rul. 99-23, 1999-20 IRB 3]

7. Eligible costs include expenses incurred for the analysis or survey of potential markets, products, labor supply, transportation facilities, etc. The amortization election for startup expenditures does not apply to amounts paid or incurred as part of the acquisition cost of a trade or business. Also, startup expenditures do not include amounts paid or incurred for the acquisition of property to be held for sale or property which may be depreciated or amortized based on its useful life.

8. Developments

   a. The taxpayer changed its identity, through a merger, from a C corporation to an S corporation. The taxpayer paid an accounting firm $46,300. The court found that professional fees related to a corporate reorganization must be capitalized. [*United Dairy Farmer, Inc. v U.S.*, DC-Ohio, 5-22-2000]

   b. Amortization of Customer Accounts After Acquisition

      1) The Tax Court found that brokerage accounts taken over after an acquisition are properly amortizable. The court rejected the IRS's argument that the accounts could not be valued and had no determinable useful life. [Charles Schwab Corp. and Subsidiaries, 122 TC No. 10]

      2) The taxpayer's evidence showed that the brokerage accounts were a separate and exploitable asset distinct from goodwill.

      3) The court allowed the taxpayer to use its experience with its own accounts to determine the useful life of the acquired accounts. The court refused to use the acquired accounts' historical data as insisted by the IRS.

      4) The court hinted that the facts it relied on in this case may have been unusual, and that it will continue to be an uphill battle for taxpayers to win amortization treatment for customer accounts.

X. Covenant Not to Compete

1. Covenants not to compete are amortizable over 15 years after August 10, 1993.

2. After working together for 13 years, differences of opinion developed between the taxpayer and the principal shareholder of the firm over how the firm should be managed. The taxpayer agreed to make certain payments to the firm in return for which accounting services relating to approximately 180 clients would be turned over to the taxpayer. The taxpayer paid $334,000 for the 180 clients transferred to his new corporation, $10,000 for client files, $63,500 for the right to receive consulting services, and a $190,000 covenant not to compete. The Tax Court ruled that the covenant not to compete reflected economic substance and was a reasonable amount. Therefore it was properly amortizable. Any payment relating to consulting services provided before the division would be treated as a nondeductible startup expense of the taxpayer's new firm. [*Hass & Associates Accounting Corp.*, TC Memo 2000-183]

Y. Computer Software Costs

1. The IRS has released guidelines on the tax treatment of computer software and related costs. Basically, this guidance clarifies for taxpayers just which software-related expenses can be expensed or deducted under Section 174 and which of these expenses must be capitalized. [Rev. Proc. 2000-50]

2. The guidelines apply to all "computer software." This term includes any program or routine that is designed to cause a computer to perform a desired function or set of functions, together with the documentation that is required to describe and maintain that program or routine. It also includes written, magnetic, and other forms and media in which software is contained.

3. Computer software does not include any data or information base described under Reg. 1.197-2(b)(4) unless it is in the public domain and is incidental to a computer program. The procedure does not apply to computer software that is subject to amortization as a Sec. 197 intangible or has been treated as a research and experimentation expenditure.

4. Software developed by the taxpayer

    a. The IRS will not disturb a taxpayer's treatment of costs connected with developing software, either for its own use or for sale or lease to others, where all costs properly attributed to the development of software are either (1) consistency treated as current expenses and deducted in full according to rules like those applicable under Sec. 174 or (2) consistently treated as capital expenditures recoverable by amortizing the amounts over a period of 60 months from the date of completion of development or 36 months (where applicable) from the date the software is placed in service.

5. Acquired Software

    a. The IRS will accept the taxpayer's treatment of costs for acquired software that are:

        1) Aggregated with the cost of hardware if such treatment is consistent and the hardware is capitalized and depreciated, or

        2) Separately stated, if they are consistently treated as capital expenditures for an intangible asset which will be amortized over a period of 36 months from the date the software is placed in service, in accordance with the rules under Sec. 167.

6. Leased or Licensed Software

    a. The IRS will not disturb a deduction allowable under the provisions of Reg. 1.162-11 as a rental. Such an amount will not be currently deductible if it is properly chargeable, without regard to Reg. 1.162-11, to a capital account.

    b. The procedure covers licensed software in addition to leased software.

7. Any change in a taxpayer's treatment of costs of the type described in the Revenue Procedure will be considered a change in accounting methods. A change in useful life under the methods permitted to account for development of software will not be considered a change in accounting methods.

8. Amortization of Song Rights

    a. Permits a taxpayer that puts any musical composition or musical copyright into service to elect to use the five-year amortization period for certain expenses paid or incurred with respect to all musical compositions and musical composition copyright placed in service in that year.

        1) This will allow music publishers to amortize advances they make to song writers over five years.

Z. Basis for Promissory Notes for Cash-Method Taxpayer

1. Taxpayers reporting on the cash method claimed $240,425 worth of improvements made to real property before they were sold. They financed the improvements with promissory notes, rather than cash payments and there were no payments on the notes in the year of sale.

2. The court ruled that the taxpayers were not entitled to increase their basis in the properties by the costs of the physical improvements made to the properties because they financed the improvements with promissory notes, rather than cash. [*Owen v US,* 99-1 USTC ¶50,159, USDC Tenn]

    a. Allowing a cash basis taxpayer to increase his basis where he issues a promissory note for improvements to property would avail the taxpayer of an immediate increase in depreciation deductions and would afford him the opportunity to decrease any potential gain should the property be sold, without having made any cash outlay. To hold otherwise would also remove any distinction between cash and accrual basis taxpayers when dealing with capital expenditures, a result which the Court finds no authority within the Code.

AA. Environmental Clean Up Costs

1. The IRS has issued two new rulings aimed at clarifying the proper treatment of remediation costs when cleaning up hazardous waste generated in manufacturing operations spanning a number of years. The IRS now insists these remediation costs be capitalized and included in inventory costs. It also holds that Sec. 1341 cannot be used to win an immediate deduction based on the costs being attributable to inventory already sold.

    a. To ease the shock of these new rulings, the IRS carved out a transition rule. It allows remediation costs incorrectly taken as immediately deductible, in all tax years ending on or before February 6, 2004, to remain deductible. [Rev. Rul. 2004-17, Rev. Rul. 2004-18]

    b. The taxpayer buried hazardous waste on its land for many years. In response to new hazardous waste disposal laws, the taxpayer has to clean up its property. It claimed that the remediation costs are immediately deductible.

        1) Under Sec. 1341, amounts received in a prior year, and included in income, may be deducted in the year a repayment is required, if, in that prior year, it appeared the taxpayer had an unrestricted right to the amounts (that is, repayment was not anticipated).

        2) The IRS determined that payment of remediation costs many years later, is not a repayment of an amount previously included in gross income.

        3) Environmental remediation costs are inventory costs, and not deductions. Inventory costs are recovered through cost of goods sold when the inventory is sold. Waste removal expenses were indirect costs of production. Under Sec. 263A and its regs, these expenses generally must be capitalized by including the expenses in inventory costs.

2. A company planned to clean up pollution problems on property it owned and sought to deduct the cost. But an IRS agent objected that because the cleanup would be done while building a new facility, none of the cost was deductible. It would instead have to be capitalized into the cost of the facility. The IRS ruled that the company can deduct the cost of cleaning up pollution it caused, since that merely repairs the property to its original state. But it must capitalize the cost of cleaning up pollution committed by the property's prior owners, since that improves the property compared with its condition when it was acquired. [TAM 199952075]

3. The taxpayer spent $260,000 to correct soil damage from underground gasoline tanks at two of its many retail facilities. The contamination had occurred before the corporation purchased the properties. The court found that under IRS administrative practice environmental clean-up costs are deductible when the soil has been contaminated by toxins released from the taxpayer's business operations. Here, the soil had been contaminated before the taxpayer purchased the properties and commenced business. [*United Dairy Farmers, Inc. v U.S.*, DC-Ohio, 5-22-2000; upheld CA-6, 10-2-2001]

4. The taxpayer spent almost $800,000 to remove or encapsulate asbestos in one of its office buildings. The expenditures were made to keep the taxpayer's office building in effective operating condition, rather than put the building into operating condition. The expenditures did not substantially prolong the building's useful life, appreciably increase its value, or adapt it to a new or different use. The Court ruled that the expenditures were currently deductible. [Cinergy Corp., U.S. Ct. Cl., 3/10/03]

5. Added to Inventory

   a. The IRS has clarified and expanded its recent ruling that allows most of a manufacturer's hazardous waste clean-up costs to be added to inventory. [Rev. Rul. 2005-42]

      1) Rev. Rul. 2004-18 determined that remediation costs are more in the nature of repairs than capital improvements. As with other types of deductible business costs, however, once repair costs are deductible under Sec. 162, a taxpayer with inventories must still apply the rules of Sec. 263A to determine if the repair costs must be included in inventory.

   b. The IRS determined that clean-up costs are incurred because of production activities and are allocable to inventory produced by the taxpayer in the year of remediation even if the hazardous materials were produced in prior periods.

      1) The ruling continues to refuse to allow an immediate expense deduction but does allow eventual recovery when inventory is sold, rather than no recovery at all is the expenses were capitalized into land.

   c. The District Court rejected the argument that current costs incurred for cleaning up pollution should be deductible at the applicable corporate tax rate for the years incurred under the claim-of-right doctrine. [Reynolds Metals Co., DC Va. 8-22-05]

      1) The court read Sec. 1341 to require that previously paid income must be restored to another party.

      2) The court held that the clean-up costs were attributable to the enactment of more stringent environmental laws rather than a restoration of gross income paid in prior years.

6. To deduct remediation costs under Sec. 162 as an ordinary and necessary business expense, the Court of Federal Claim held that the taxpayer not only must show that remediation was undertaken to return the property to its pre-contamination condition and done so under a federal or state statutory mandate. The taxpayer also must show that the expenses were not incurred to improve the property's value or change its use. To prove this, the taxpayer also had to show that it was the cause of the contamination. [Kerr-McGee Corp., FedCl, June 29, 2007].

BB. Automobile Expenses

1. The standard mileage rate for business use of a car for 2012 is 55.5 cents per mile. [Rev. IR-2011-116; Notice 2012-1]

   a. The deemed depreciation rate for 2012 is 22 cents per mile.

   b. Standard mileage rate can be used for leased autos (in lieu of deducting lease payments and other expenses).

2. Depreciation Limitation for Luxury Automobiles

   a. Sec. 280F limits annual depreciation if a purchased business auto is treated as a "luxury auto." The deduction limits depend on the year in which the business auto was placed in service, and are periodically adjusted for inflation.

   b. The dollar limits on depreciation of business cars placed in service in 2012 are as follows: [Rev. Proc. 2012-23]

Year	Passenger Autos	Trucks
First year	$3,160	$3,260
Second year	5,100	5,300
Third year	3,050	3,150
Succeeding years	1,875	1,875

   c. If a vehicle is used less than 100% for business, the depreciation limits must be reduced by the personal portion. Thus, for example, if a new vehicle is used 60% for business in 2012, the depreciation limit is $1,896 ($3,160 x 60%).

   d. Vehicles which have a gross vehicle weight rating of more than 6,000 pounds are not considered passenger vehicles, and the depreciation limits do not apply. [IRC §280F(d)(1))]

   e. For an auto whose business use does not exceed 50%, depreciation is limited to the straight-line amount under the Alternative Depreciation System, instead of MACRS. Further, for an auto whose business use declined to 50% or less, recapture of excess depreciation may be required.

3. Final regs were issued exempting "nonpersonal-use" light trucks and vans from the annual luxury vehicle depreciation limitations. [TD 9133]

   a. Qualified nonpersonal use vehicles include trucks and vans that have been specially modified, such as by installation of permanent shelving and painting the vehicle to display advertising or the company's name, so that they are not likely to be used more than a de minimis amount for personal purposes. [Reg. 1.280F-6F(c)(3)(iii)]

   b. The final regs are retroactive to all open years. Taxpayer may file amended returns or treat the change as a change in accounting method.

      1) The proposed rules applied only to property placed in service after July 5, 2003.

CC. The regulations under Sec. 263A specifically require real estate developers to capitalize property taxes "if, at the time the taxes are incurred, it is reasonably likely that the property will be subsequently developed." The uniform capitalization rules generally apply to real and tangible personal property produced by the taxpayer. The Tax Court concluded that the statute requires taxpayers to capitalize indirect costs, such as real estate taxes, that they incur in connection with property they develop even though no development activities had taken place. [*Reichel*, 112 TC 14 (1999)] The taxpayer paid over $72,000 in real estate taxes.

Observation: If real estate is held for investment, rather than development, the real estate taxes are currently deductible as an itemized deduction. However, this deduction is not allowed for AMT purposes and is subject to potential phaseout for high income taxpayers.

DD. Employment Tax Responsibilities for Disregarded Entities

1. Under proposed regulations, a disregarded entity is treated as the employer of any employees working for the disregarded entity. the entity is responsible for: [NPRM REG-113471-05]

    a. Backup withholding;

    b. Filing returns such as Form 941;

    c. Depositing FICA, FUTA, and withholding taxes with the IRS; and

    d. Issuing Form W-2 statements to employees of the disregarded entity.

2. Disregarded entities include:

    a. Qualified Subchapter S subsidiaries (QSub)

    b. One-owner Limited Liability Companies (LLC)

EE. Capitalized Future Benefits

1. The Supreme Court in INDOPCO in 1992 found that a taxpayer's expenditure, which serves to create or enhance a separate and distinct asset, should be capitalized. The court added that it by no means follows, however, that only expenditures that create or enhance separate and distinct assets are to be capitalized.

    a. The IRS has made aggressive use of the decision.

2. Davenport Bank (DBTC) authorized its executive officers to negotiate a merger with Norwest. None of the officers were hired specifically to render services on the transactions; all were hired to conduct the bank's day-to-day banking business. Following the taxpayer's concession that DBTC must capitalize most of the costs related to the friendly acquisition by Norwest, at issue was whether DBTC may deduct the officers' salaries of $150,000 attributable to services performed in the investigatory transaction. The Tax Court held that DBTC may not deduct any of the disputed costs under the INDOPCO ruling because all costs were sufficiently related to an event that produced "a significant long-term benefit." [*Norwest Corp.,* 112 TC 89 (1999)] The Third Circuit concluded that the Tax Court was mistaken in its interpretation of the future benefits analysis. [*PNC Bancorp v Comm.*, CA-3, 5-19-2000]

3. The taxpayer's predecessor acquired a bank. Prior to its acquisition, the bank paid more than $400,000 in fees to its legal counsel, which had advised it on the merits of the transaction and related business. The bank also had paid salaries to nine executives and seventy three officers. The Tax Court, relying on INDOPCO, found that the expenditures had been incurred before and incidentally with the acquisition and, therefore, they were best characterized as capital. The Eighth Circuit held that an expense related to a capital transaction does not necessarily need to be capitalized. The Tax Court had misapplied INDOPCO by requiring capitalization of a taxpayer's expense because they were incidentally connected with a future benefit. [*Wells Fargo & Co. et al v Comm.*, CA-8, 8-29-2000] The court agreed with the IRS that any "investigatory" expenses that come after a taxpayer's final decision to acquire a business, or to be acquired, must be capitalized.

FF. An independent contractor sued a company that broke a contract with him. He won $80,000 in damages and $250,000 in punitive damages, and deducted $140,000 in legal fees as a business expense. The IRS said the punitive damages were not business income but "other income," and that the corresponding legal fees were a personal expense, not a business expense. This sharply reduced the deduction for them due to the deduction floor on miscellaneous expenses and the Alternative Minimum Tax. The Tax Court ruled the contractor's suit arose entirely out of his business, so all his legal costs were a business expense. [*George W. Guill*, 112 TC 325 (1999)]

GG. Repayment of Corporate Distributions by Former S Corp. The shareholders of an S corporation, after its conversion to a C corporation, removed the previously taxed earnings after the post-termination period. In a later year, they were required to repay the amounts, recharacterized by the corporation as nondeductible dividends. They deducted the repayment of the distributions as business expenses. The IRS held that the repayment constituted contribution to capital since there was no business purpose for the requirement to repay. The repayment was not subject to the relief provisions of Sec. 1341 for items previously included in income under the claim of right doctrine. For relief under Sec. 1341 the item must be shown to have been erroneously included in income, that the taxpayer did not have an unrestricted right to such item. [FSA 9999-1999-77]

HH. Membership Fees Fully Includible in the Year Received

1. Annual membership fees paid to a retailer must be included in income in the year of receipt. The fees are not income from services of a type that may be included in income ratably over the membership period. To defer inclusion of membership fees in gross income under Rev. Proc. 71-21, the advance payments must be for services. The IRS concluded that the membership fees at issue are simply payments for the right to enter the taxpayer's premises and gain access to discounted goods and services. [Ltr. Rul. 200005031]

II. Accrual Method and Current Year Deduction for Expensing Benefitting Next Year

1. The Tax Court held that an accrual method corporation was not entitled to deduct that portion of payments made in the current year for licenses and insurance for which the taxpayer derived benefit the following year. The Court flatly rejected the corporation's argument that it should be allowed to deduct these expenses since, by extending less than one year into the following tax year, they did not relate to property having a useful life substantially beyond the tax year. [USFreightways Corp., 113 TC 329 (1999)] The Seventh Circuit reversed the decision. [270 F.3d 1137 (CA-7, 2001] The IRS has announced that they will issue Proposed Regulations allowing accrual basis taxpayers to deduct prepaid expenses when the prepaid period is one year or less.

JJ. Deductibility of Employer-Provided Meals

1. Sec. 119 provides that an employee's gross income does not include the value of any meal furnished to him or her in kind by or on behalf of the employer for the convenience of the employer if the meal is furnished on the employer's business premises. The Regs provide that a meal is furnished for "the convenience of the employer" if it is furnished for a substantial noncompensatory business reason of the employer. [Reg. 1.119-1(a)-(2)]

2. A newly-enacted Section 119(b)(4) provides that all meals furnished on the business premises of an employer to its employees are treated as furnished for the convenience of the employer if the meals are provided to more than 50% of the employees for the convenience of the employer. The meals are then excludable from the employee's income.

   a. The 50% standard replaces the previously existing 90% standard contained in the Section 119 regulations and applied in *Boyd Gaming Corp.*, TC Memo 1997-445.

3. In Announcement 99-77, the Service (1) acquiesces to *Boyd Gaming Corporation v Commr*, CA-9 5-12-99, reversing TC Memo 1997-445, (2) withdraws proposed training materials relating primarily to the application of Section 119 of the IRC to employer-provided meals in the hospitality industry, and (3) terminates the settlement initiative related to this issue. [Announcement 99-77, 1999-32 IRB 243]

   a. In light of the Ninth Circuit's opinion, the Service will not challenge whether meals provided to employees of casino businesses similar to that operated by Boyd Gaming meet the Sec. 119 "convenience of the employer" test where the employer's business policies and practices would otherwise preclude employees from obtaining a proper meal within a reasonable meal period.

   b. The Service will not attempt to substitute its judgment for the business decisions of an employer as to what specific business policies and practices are best suited to addressing the employer's business concerns. Thus, the Service will consider whether the policies decided upon by the employer are reasonably related to the needs of the employer's business and whether these policies are in fact followed in the actual conduct of the business.

KK. Contested Liability Transfers

1. The IRS has released final regs related to transfers of money, stock, or other property to satisfy certain contested liabilities. [TD 9140]

   a. Under Sec. 461(f), a taxpayer can take a deduction for assets transferred to satisfy certain contested liabilities in the year of the transfer if the taxpayer contests the asserted liability, the contest exists after the transfer, and the liability would otherwise be allowed as a deduction in the year of the transfer (or an earlier tax year).

   b. A taxpayer may satisfy an asserted liability by transferring money or other property beyond the taxpayer's control. The taxpayer must relinquish all authority over the assets. The following are not transfers to provide for the satisfaction of an asserted liability.
      1) Purchasing a bond to guarantee payment of the asserted liability;
      2) An entry on the taxpayer's books of account;
      3) A transfer to an account that is within the control of the taxpayer;
      4) A transfer of any indebtedness of the taxpayer or of any promise by the taxpayer to provide services or property in the future; and
      5) A transfer to a person (other than the person asserting liability) of any stock of the taxpayer or of any stock or indebtedness of a person related to the taxpayer.

2. "Economic performance" does not occur when a taxpayer transfers assets to a trust, escrow account, or court to satisfy a contested liability when economic performance is called for.

LL. Day Traders

1. While the IRS has no strict definition of day trading, if you follow the following general guidelines, you should be considered a trader:

   a. Base your buy/sell criteria on short-term swings in the market.

   b. Make substantial, frequent, and regular securities trades, generally daily, to generate what you expect to be your primary income source for meeting your living expenses.

   c. Hold stock generally 30 days or less.

   d. The length of trades and the nature of the trading are generally more determinative of your status than the number of trades.

2. Making the "mark-to-market" election under Section 475 will help you avoid problems long-term investors have, including:

   a. Wash-sale prohibition - Generally prevents investors from deducting a loss when they sell shares of stock and then buy back the same shares within 30 days before or 30 days after the original sale. The mark-to-market election eliminates this prohibition.

   b. Investment interest limitation - Investment interest is deductible only to the extent of investment income. Making the election lets you deduct all your investment interest.

   c. Investment expense limit - These are usually treated as miscellaneous expenses, deductible to the extent they exceed 2% of adjusted gross income. No AGI limit exists if you make the mark-to-market election.

   d. Investment loss limit - Only up to $3,000 of capital losses are allowed to offset ordinary income. Capital losses are fully deductible if you use the election.

3. Before the end of each day, identify any trades you intent to hold as long-term investments.

    a. This insures that those investments will be taxed at favorable long-term capital gains rates--no more than 15%.

    b. Planning--Maintain long-term investments in accounts at a different brokerage house from the one you use for your day trading.

4. Show the gross sales reflected on your brokerage statements on Schedule D, calculating capital gains and losses as usual. If the mark-to-market election applies, each transaction is reported on Form 4797.

5. Expenses of traders always go on Schedule C.

6. While day trading income is reported as trade or business income, the IRS specifically exempts capital gains and losses from being treated as net earnings from self-employment. [Sec. 475(f)(1)(D)]

7. Developments

    a. To be a trader, the trading activity must be substantial, which means "frequent, regular, and continuous enough to constitute a trade or business." Heavy trading volume is one factor that can weigh in the taxpayer's favor, but continuous activity is also important. The Tax Court in Paoli, TC Memo 1991-351, held that trading was substantial where taxpayer had 326 sales transactions, but sales were not regular and continuous.

    b. Frank Chen was employed as a software engineer earning $75,000 when he started playing the market. During the first three months of the year, he made 290 trades -- but after losing more than $80,000, he stopped trading. From April to July, he made only 33 trades, and during the rest of the year, he made none, for a net loss of $84,794. The Tax Court ruled that Chen's brief burst of trading was not enough to make the mark-to-mark election. He was allowed to deduct only $3,000 for the year. [Frank Chen, TC Memo 2004-132]

    c. Mark-to-Market Election

        1) Taxpayers have until April 15 to elect special tax status for the year of use. Form 3115 is used to make the election. Called a section 475(f) election, it allows traders to recognize their gains or losses for tax purposes as if they had sold all their holdings on the last day of the tax year. The election cannot be revoked unless the Revenue Service agrees. [Rev. Proc. 99-17]

        2) Taxpayer reported a Schedule C net profit of $18,520,775 in 1999 and $16,966,055 in 2000 from settling a class action lawsuit. He decided to wind down his law practice and began securities trading on 1/28/00 using margin borrowing. Unfortunately his account was liquidated on 4/14/00 for fail to cover a margin call after a sharp decline in technology stocks. On that date his net trading losses totaled $15,196,152. After his 1999 return preparer failed to make the Section 475(f) mark-to-market election, a law firm filed a late election for him on 7/21/00. In allowing the taxpayer to make the election under Reg. 301.9100-3, the Tax Court notes that the government was not prejudiced because the taxpayer did not trade any securities between 4/17/00 and 7/21/00, so his losses were the same on both dates. [L.S. Vines, 126 TC No. 15]

MM. Business Deduction Developments

1. Estimated Business Expenses

    a. During 1999 and 2000, taxpayer reported her nursing-related business income and expenses on Schedule C. After noting that the taxpayer's testimony was "vague, conclusory, and/or questionable in certain material respects," the Tax Court cited Cohan v. Comm [39 F.2d 540 (CA-2, 1930)] for the proposition that when taxpayers, "establish that they have incurred deductible expenses but are unable to substantiate the exact amounts, we can estimate the deductible amount, but only if the taxpayers present sufficient evidence to establish a rational basis for making the estimate." Fortunately for the taxpayer, The Tax Court found the testimony of an independent contractor who worked in the nursing business during 2000 to be credible, and relied on her testimony to estimate taxpayer's nursing business expenses under the Cohan rule. [Karen Hough, TC Memo 2006-58]

2. Dual-Use Area

    a. Expenses of dual-use areas are not deductible, the Tax Court says to a couple who owned an inn. They used 77% of the inn's square footage for business, 12% for personal use, and 11% for business and personal use, including the lobby, registration area, office, kitchen, and laundry room. Only the portion of the inn used exclusively for business is counted when computing how much depreciation and mortgage interest is deductible. Although the dual-use portion was used most of the time for business, that space can't produce business write-offs. [Anderson, TC Memo 2006-33]

3. In the Business of Gambling

    a. A regular gambler is engaged in a business. He put in 40 hours a week studying race and spent most days at the track. His losing wagers are deducted on Schedule C, instead of as a miscellaneous itemized deduction. Gambling losses can be deducted only to the extent that they offset gambling winnings. [Castagneta, TC Summ. Op. 2006-24]

4. Cost of Removing Mold

    a. The cost of cleaning up mold is a deductible business expense. Most of the drywall, ceilings, doors, sinks, and electrical fixtures were removed during the cleanup of a nursing home after the owner discovered mold. Except for sums reimbursed by insurance, the cost of returning the building to its original shape is deductible. [Ltr. Rul. 200607003]

    b. The taxpayer used the building as a nursing home both before and after the remediation project. The existing floor plan was not altered. The mold problem did not appear until after the taxpayer owned the building. The project did not cause a material appreciation or prolong the life of the building.

    c. Previously the IRS bifurcated asbestos remediation:

        1) Encapsulation costs are immediately deductible.

        2) Removal costs must be capitalized.

    d. Rationale -- Each solves the environmental hazard in the least expensive way possible.

5. Takeover Expenses

   a. Exploratory expenses can be deducted by the takeover targets, the IRS says. This includes all expenses incurred before the decision is made to proceed with the acquisition and a mate is chosen.

   b. However, merger-related expenses after that date must be capitalized and cannot be deducted. Such costs do not qualify for the amortization of start-up expenses. [Ltr. Rul. 200548022]

6. Amortizing Customer List

   a. Amounts paid to acquire customer accounts can be amortized ratably over 15 years. [Ltr. Rul. 200616015]

      1) The taxpayer is also allowed to amortize contingent payments that the contract requires the buyer to make to the seller in future years if the buyer turns a profit on the new customers. Those additional payments made can be amortized over the remainder of the 15-year period.

7. No Deduction for Medical Marijuana Expenses

   a. The Tax Court held that expenses related to providing medical marijuana to seriously ill individuals were incurred in connection with the trafficking of a controlled substance. The charity that provided the medical marijuana could not deduct the expenses. [Californians Helping to Alleviate Medical Problems, 128 TC No. 17 (2007)]

   b. However, the court further held that the taxpayer's provision of marijuana did not prevent the taxpayer from deducting expenses in connection with its caregiving services.

   c. Congress enacted Sec. 280E after the Tax Court allowed a taxpayer to deduct expenses incurred in an illegal drug trade. In Edmondson v. Comm., TC Memo. 1981-623, the court found that the taxpayer was self-employed in a trade or business of selling amphetamines, cocaine, and marijuana and allowed the taxpayer to deduct his business expenses.

Chapter 11 - Travel, Meals, and Entertainment Expenses

A. Reimbursed Expenses

1. Employees may be partially or fully reimbursed for their expenses of (1) traveling away from home overnight on business for their employer or (2) using their own cars in connection with employment-related business.

    a. Reimbursement made under an "accountable plan" are not subject to income or payroll tax withholding and are not entered on an employee's Form W-2.

    b. Reimbursements received that are not under an "accountable plan" must be included in income.

    c. The employer deducts reimbursements made under an "accountable plan" as a business expense, but can deduct only 50% of the cost of meals and entertainment, including the cost of meals consumed while the employee is away from home overnight on business.

2. A payment is treated as made under an accountable plan only if:

    a. It is made for an otherwise deductible business expense,

    b. The employee provides a full accounting of expenses, time, place, amount, business purpose, and receipts where necessary), and

    c. The employee accounts in full for any reimbursement or advance in excess of actual expenses.

3. Both the substantiation of expenses and the return of any excess (unsubstantiated) advances must occur within a reasonable period of time. [Reg. 1.62-2(f)]

    a. The regulations offer two safe harbors for satisfying the reasonable period requirement [Reg. 1.62-2(g)

        1) Fixed Date Safe Harbor. Under this safe harbor, the timeliness requirement is met if the employer's reimbursement plan requires:

            a) An advance to be made no more than 30 days before the employee pays or incurs the expense (against which the advance is made),

            b) An expense to be substantiated within 60 days after it is paid or incurred, and

            c) Excess advances to be substantiated within 120 days after it is paid or incurred.

        2) Periodic Statement Safe Harbor. Under this safe harbor, the timeliness is met if the company no less often than quarterly provides applicable employees with statements of the amount of advances not yet substantiated, and requests than any advance either (1) be substantiated or (b) returned to the company, within 120 days after the statement is issued.

4. Recordkeeping requirements are simplified if a reimbursement or advance for away-from-home travel or business use of an employee's auto does not exceed IRS-approved maximums. Employees are only required to supply the employer with a record of the time, place, and business purpose of expenses (plus mileage traveled, if employees are reimbursed for auto use). Receipts, bills, and a record of actual dollars spent are not required.

   a. Other reimbursed travel expenses such as round-trip air fares must be fully substantiated by the employee in order to be treated as paid under an "accountable plan."

5. A delivery company reimbursed its courier drivers at 40% of the customer charge less the driver's hourly wage rate. The company treated the hourly wages as income subject to payroll taxes, but treated the other portion of the payments, issued by separate checks, as expense reimbursement and lease fees for the lease of the drivers' vehicles. The court ruled that all payments were considered made under a nonaccountable plan and resulted in taxable income to the drivers. The program reimbursed drivers regardless of actual mileage driven or expenses incurred. There was no requirement to return any payments in excess of the IRS standard mileage rate. [*Shotgun Delivery, Inc. v U.S.*, 2000-1 US ¶50,210, DC-ND CA, 1-20-2000]

B. Per diem travel rates

1. The federal government has decided to establish its per diem meals and lodging rates on a fiscal year basis, October 1 through September 30, instead of on a regular calendar year basis.

2. Employers will have a choice of using either the old or the new rates for the last three months of the year. However, they will not be permitted to mix the two during this period.

3. The per diem rates beginning October 2011 are: [Rev. Proc. 2011-47]

   a. Rate for lodging, meals, and incidental expenses incurred in travel to high-cost localities has increased to $242 per day; rate for all other areas within the continental U.S. is $163 per day.

   b. Per diem reimbursement rates for meals and incidental expenses is $65 for high-cost areas and $52 for other CONUS areas. The rate for incidentals is $3 per day.

4. The per diem rates beginning October 2010 are: [Rev. Proc. 2010-39]

   a. Rate for lodging, meals, and incidental expenses incurred in travel to high-cost localities has increased to $233 per day; rate for all other areas within the continental U.S. is $160 per day.

   b. Per diem reimbursement rates for meals and incidental expenses (M&IE) as of October 1, 2010 is $65 for high-cost areas and $52 for other CONUS areas. The rate for incidentals is $3 per day.

5. Per Diem Incidental Expenses

   a. The Tax Court says a sailor who lodging costs and meals were paid by his employer can use the per diems to deduct incidental expenses. [Balla, TC Memo 2008-18] He can deduct $3 per day for incidentals while he was away from home, even without receipts.

6. After 2002, the new definition of incidental expenses does not include expenses for laundry, cleaning and pressing of clothing, lodging taxes, or the cost of telegrams or telephone calls.

7. The M&IE rate must be prorated for partial days of travel away from home.

8. The "high-low" rates may be used only by accountable plans.

9. Developments

   a. A taxpayer's employer provided him with meals and lodging at no charge. However, he was responsible for his own incidental expenses, such as laundry, dry cleaning, and local transportation. He kept no records but took a miscellaneous itemized deduction for the items, using the per diem substantiation method. The IRS argued that the M&IE cannot be used when only incidental (and not meal) expenses are incurred. The Tax Court rejected this argument and said the revenue procedure may apply to three distinct situations: when a traveling employee pays (1) only for meals, (2) for both meals and incidental expenses, and (3) only for incidental expenses. [*Maria L. Johnson*, 115 TC 210 (2000)]

   b. Incidental expenses include fees and tips for services, such as for porters, baggage carriers, bellhops, hotel maids, stewards or stewardesses and others on ships, and hotel servants in foreign countries. The federal regulations specifically exclude laundry, cleaning and pressing of clothing, lodging taxes and telephone calls.

   c. Statistical Sampling

      1) Meal and entertainment (M&E) deduction now can be supported by "statistical sampling." IRS rules permit a sample of expenses to be used to support M&E deductions that are not subject to the 50% limit. [Rev. Proc. 2004-29]

      2) 50% Exceptions

         a) Sec. 274(n)(2)(A) - treated as compensation; reimbursement of performance of service expenses

         b) Sec. 274(n)(2)(B) - de minimis food or beverages

         c) Sec. 274(n)(2)© - ticket package charitable sports

         d) Sec. 274(n)(2)(D) - moving expenses

         e) Sec. 274(n)(2)(E) - crew food and beverages

   d. Self-employed individuals on travel can use the IRS per diems for meals and incidentals without having to track actual expenditures, the Tax Court says. They still must show the time, place, and purpose for the travel in order to use these per diems. Only 50% of the per diem is deductible, the same as business meals, even though a portion of the allowance covers incidental expenses. Self-employed cannot use per diems for lodging expenses. They must substantiate their deductions. [Riley, TC Summ. Op. 2007-26]

   e. Rev. Rul. 2006-56 concluded that an employer's failure to track excess expense allowance and its routine payment of excess allowances that it did not treat as wages showed a pattern of abuse that caused all payments made under the reimbursement arrangement to be taxable and subject to employment taxes.

f. An IRS Small Business/Self-Employed Division memo to field examiners acknowledges that most businesses not currently in compliance regarding the treatment of excess per diem travel payments will need more time to update or secure accounting software enabling them to compute the proper amount of additional wages. The IRS has instructed its agents to enforce the rule that requires recognition all reimbursement as wages, not just the excess amounts, only in clear patterns of abuse. [SESE-04--1106-049]

1) If the employer has a system in place, then the fact that the employer, due to system errors, fails to treat excess payments as taxable will not be considered a sign of abusive behavior. This result is required even if the employer routinely pays excess allowances that it does not treat as wages under that mistake.

10. Commuting-Only Valuation Rule

a. Under the commuting-only valuation rule, the value of a vehicle provided to an employee for commuting use is determined by multiplying each one-way commute by $1.50. To use this rule, the following requirements must be met:

1) The employee must be required for bona fide noncompensatory business reasons to travel between home and work in a company road vehicle that is not otherwise available for personal use;

2) The employer must have a written policy under which it does not allow the employee to in fact use the vehicle for personal purposes other than for commuting or de minimis personal use;

3) The employee must not actually use the vehicle for personal purposes other than commuting and de minimis personal use; and

4) If the vehicle is an automobile (i.e., any four-wheeled vehicle, such as a car, pickup truck, or van), the employee who uses it for commuting is not a "control employee."

b. A control employee for a government employer is either an elected official, or a government employee whose compensation equals or exceeds the compensation paid to a federal government employee holding an Executive Level V position.

1) Effective January 2008, the compensation paid to a federal government employee holding an Executive Level V position is $139,600.

2) An employee is a control employee for non-governmental employer when the compensation exceeds $185,000.

C. Away from Home Expenses

1. The deduction of traveling expenses while away from home applies only if taxpayers are away temporarily. "Home," for tax purposes, means the place of the taxpayer's principal business or employment, not where he or she resides. If employment at a work location is realistically expected to last (and does in fact last) for one year or less, the employment is temporary in the absence of facts and circumstances indicating otherwise. If employment at a work location is realistically expected to last for more than one year or there is no realistic expectation that the employment will last for one year or less, the employment is not temporary, regardless of whether it actually exceeds one year. If employment at a work location initially is realistically expected to last for one year or less, but at some later date the employment is realistically expected to exceed one year, that employment will be treated as temporary (in the absence of facts and circumstances indicting otherwise) until the date that the taxpayer's realistic expectation changes, and will be treated as not temporary after that date. [Rev. Rul. 1999-7, 1999-5 IRB 4]

   a. Formerly the IRS defined a temporary work location as any location at which the taxpayer performs services on an irregular or short-term (i.e., generally a matter of days or weeks) basis.

   b. IRS Pub. 463 Travel, Entertainment, Gift, and Car Expenses (1998, p. 13) affirms that the new definition of "temporary workplace" applies retroactively to all "open years" and that an amended return may be filed for open years affected by the new definition.

2. IRS "Informally" Tackles Limits on Temporary Work Location Travel Expenses

   a. If a taxpayer has one or more regular work locations away from his or her residence, the taxpayer may be reimbursed tax free under an employer's accountable plan for transportation expenses between the residence and a temporary work location in the same trade or business, regardless of the distance. [Rev. Rul. 1999-7]

   b. Sometimes, an employee is instructed to work at a certain client's office for a specified period, then work at another site, and then work again at the client's office for another specified period. The issue is whether the break in service at the particular location is so significant that the employer may treat employment at the location as two separate periods of employment rather than one continuous period of employment. A Chief Counsel Advise says that a break of three weeks or less is not significant and will not "stop the clock" in applying the one-year limitation for assessing when temporary work becomes permanent. On the other hand, it is reasonable to treat a break of at least seven months as significant. The Chief Counsel Advise states that if there is an initial realistic expectation that an employee will perform services at a work location for a period exceeding one year, but for no more than 35 workdays or partial workdays during each of the calendar years within that period, then employment at that location may be treated as temporary. However, if at some point this expectation changes, then the assignment at that location will not be considered temporary for at least the remainder of that calendar year. [CCA 200025052]

   c. If an employee's office at home meets the principal place of business test of Section 280A(c)(1)(A), trips between home and work locations away from the residence are deductible without regard to the temporary nature of the other business. However, if the home is not the principal place of business, he or she may still deduct transportation expenses for travel from home to another location, so long as the other location is temporary. [CCA 200026025]

d. The Tax Court says a sailor who lodging costs and meals were paid by his employer can use the per diems to deduct incidental expenses. [Balla, TC Memo 2008-18] He can deduct $3 per day for incidentals while he was away from home, even without receipts.

D. Business Meals Deduction for Transportation Workers

1. After 1997, the deductible percentage of the cost of meals consumed by employees subject to Department of Transportation hours of service rules will gradually increase over the next 10 years from the currently allowable 50 percent of otherwise deductible meal expenses to 80 percent. For 2006 and 2007, the percent is 75%.

2. An individual is in the transportation industry only if the work involves moving people or goods by airplane, barge, bus, ship, train, or truck, and requires regular travel away from home that usually involves localities with differing federal M&IE rates.

E. Commuting

1. A taxpayer's costs of commuting between the taxpayer's residence and taxpayer's place of business or employment generally are nondeductible personal expenses. However, the costs of going between one business location and another business location are generally deductible. [Rev. Rul. 55-109, 1955-1 CB 261]

2. There are three exceptions under which a taxpayer may deduct expenses of going between a taxpayer's residence and a work location: [Rev. Rul. 99-7, 1999-5 IRB 4]

a. A taxpayer may deduct daily transportation expenses incurred in going between the taxpayer's residence and a temporary work location outside the metropolitan area where the taxpayer lives and normally works [Rev. Rul. 94-47, 1994-2 CB 18];

1) Example: A taxpayer commutes every day for six months from his home to an office away from the metropolitan area where he usually works. He may be entitled to deduct his travel expenses.

b. If a taxpayer has one or more regular work locations away from the taxpayer's residence, the taxpayer may deduct daily transportation expenses incurred in going between the taxpayer's residence and a temporary work location in the same trade or business, regardless of the distance.

c. If a taxpayer's residence is the taxpayer's principal place of business within the meaning of §280A(c)(1)(A), the taxpayer may deduct daily transportation expenses incurred in going between the residence and another work location in the same trade or business, regardless of whether the other work location is regular or temporary and regardless of the distance.

F. Travel, Meals, and Entertainment Developments

1. Taxpayer was denied travel expenses while away from home because he could not establish he had a home. The taxpayer worked on three separate Disney tours, spending a total amount of two months at his parents' home in Boise, Idaho. Although he did not pay his parents any rent, he did maintain strong contracts in Boise: he received mail at his parents' residence; kept his belongings and his dog there; paid Idaho state income tax; and maintained a bank account, Idaho voter registration, and an Idaho driver's license. [*Henderson v Commr*, 98-1 USTC ¶50,375, CA-9, cert. denied]

2. The taxpayer was an over-the-road truck driver. One year, he was on the road 360 days and 345 days during another year. Because of the large number of days he was on the road, the court rules the driver had no principal place of business and basically did not incur substantial living expenses at a permanent residence. So his travel expenses were not deductible. [William J. McNeill, TC Memo, 2003-65]

3. Living costs at a new job site were not deductible even though an employee worked at the new job only eight months and his family did not move with him. The nature of his position at the new job was such that he could have been reasonably expected to move his residence. The taxpayer signed an open-ended employment agreement for an indefinite period of time and thus the workplace was not temporary. [*Sanderson*, TC Memo 1998-358] An accuracy-related penalty was also assessed because the taxpayer's spouse was a certified public accountant and a former IRS revenue agent and her failure to properly interpret the Internal Revenue Code was not reasonable.

4. A self-employed software quality engineer was denied away from home expenses after the initial 365 days when he began working for more than one year for the same employer. [*Johnson*, TC Memo 1999-153, 5-6-99]

5. A consultant who worked from a home office in Chicago took a job that required him to be in California "as needed," averaging 130 days a year. He rented an apartment there and deducted his rent and travel costs as "away from home" business travel. The IRS said California became his tax home when he took an apartment there to perform a job that was not temporary because it lasted five years. The Tax Court: The California job was temporary because it was "on again, off again," even for five years. [*Thomas J. Mitchell*, TC Memo 1999-283]

6. A sole proprietor was not entitled to use the federal per diem rate to substantiate his lodging expenses because they do not apply to self-employed individuals. [*Starr*, TC CCH Dec. 56,064(M)]

7. Corey Wheir was required by his union to take short-term jobs all over the state of Wisconsin. He sometimes stayed at motels and deducted his travel and stays as away-from-home travel costs. The IRS said that since Wheir did not live in a metropolitan area recognized by the Census, the entire state was his metropolitan area. The Tax Court stated that the IRS position contradicted common sense. Since the taxpayer does not live in a recognized, defined metropolitan area, 35 miles from home is a reasonable limit for the metropolitan area rule. All of his traveling expenses were allowed because all of his deductions were for travel more than 35 miles from home. [Corey L. Wheir, TC Summ. Op. 2004-117]

8. Taxpayer incurred reimbursable business expenses, but did not request reimbursement of those expenses from his employer. The Tax Court held that the expenses will not be considered necessary and will not be deductible. [Alex Rhodes, TC Memo 2003-133]

9. Professional who spent 25-27% of his time at his employer's field office could deduct the cost of commuting from home to job sites as a business expense. The sites were "temporary" because he went to each site only once every two years for two to three weeks at a time. He spent most of his time (75%) at these locations, but only a limited amount of time at any one of them. [Ltr. Rul. 9806007]

10. A self-employed acupuncturist was denied a business deduction for frequent business meals with a chiropractor with whom she shared office space. Their business relationship was well established and did not require "social lubrication." Rather, the frequency of their lunches together and the reciprocal nature of their meal arrangement belied the existence of any business purpose for the meals. [*Dugan*, TC Memo 1998-373]

11. The IRS says it will accept copies of electronically transmitted documents as proof of the deductions. [Ltr. Rul. 9805007] The IRS interpreted the documentary evidence rule to not require an "original document," provided the employee also establishes the amount, date, place, and business relationship of the expenditure.

    a. Examples include e-mail or faxes proving the paperless purchase of airline tickets, including the price of the ticket, time of travel, etc.

12. The taxpayer was not allowed to deduct claimed business expenses that he charged with his credit card. He could not provide substantiation other than the credit card statements. The court was unable to determine the personal or business nature of the expenses based solely on the card statements. [*Shea*, 112 TC 183, 4-1-99]

13. Accountable Plan

    a. The Eighth Circuit Court of Appeals has affirmed a Tax Court decision concluding that employer reimbursements of an employee's business expenses were compensation. The employee's records showed that he received excess payments, which he did not return to the employer.

        1) Under Reg. 1.162-2, to qualify as an accountable plan, an employer that reimburses its employees must show:

            a) The reimbursement expenses must be allowable as a deduction and must be paid or incurred in connection with performing services as an employee of the reimbursing employer;

            b) All reimbursed expenses must be individually and adequately accounted for to the reimbursing employer within a reasonable time; and

            c) Any amounts paid to the employee in excess of the actual expenses must be returned to the reimbursing employer within a reasonable time.

        2) The Court rejected the taxpayer's argument that amounts actually substantiated should be treated as payments under an accountable plan, with only the excess being taxable. To treat only the excess as income would eliminate the third prong of the requirements for an accountable plan.

14. Truck Lease

    a. Taxpayer was responsible for all aspects of on-site job management and supervision. The employer did not have a formal written expense reimbursement policy. The employer's verbal reimbursement policy was to pay $25 per day for the use of a personal vehicle while driving on corporate business. For two years the taxpayer filed a Schedule C listing his principal business or profession: "Truck Lease" and reported business income and deducted business expenses resulting in business losses. The Tax Court agreed that the taxpayer's vehicle expenses were unreimbursed employee business expenses that should be deducted on Schedule A, subject to the 2% floor as miscellaneous itemized deductions. The taxpayer was not in the business of leasing. [Alley, TC Summ. Op. 2006-4]

        1) The employer should have included the reimbursements in the taxpayer's W-2 as this is a nonaccountable plan. The reimbursements would be subject to employment taxes.

15. Trips Near Family

    a. The IRS disallowed $2,710 of an attorney's driving deductions for his 70-plus-mile trips to a distant law library to conduct research for clients. It said that several other law libraries were available much closer to his home, but the attorney's family lived near the distant library and he was making the trips to visit them. He answered that the distant library was superior to the nearby ones. The Tax Court allowed the deductions. The attorney documented the trips and fact that he performed work for clients on them, so they had a primary business purpose. Visiting his family on these trips did not make them nondeductible. [Richard Orin Berge, TC Summ. Op. 2006-29]

16. Away From Home

    a. The Tax Court recently held that a demanding 17-hour work day that included a mid-trip four hour snooze was enough to qualify meals and incidentals at the away-form-home location for a deduction. The Tax Court also found that the day was long enough that the standard per diem rate need not be pro-rated. [Bissonnette, 127 TC No. 10 (2006)]

        1) The Court stated: "If the nature of the taxpayer's employment is such that when away from home, during released time, it is reasonable for him or her to need and obtain sleep or rest in order to meet the exigencies of his employment or the business demands of his or her employment, his or her expenditures ... for the purpose of obtaining sleep or rest are deductible traveling expenses."

        2) Ninety minutes of sleep or rest is not enough to qualify expenses. A four-hour nap between work assignments during a six hour layover was sufficient.

    b. The taxpayer worked out of Print's office in Pennausken, New Jersey but lived in Cumberland, Maryland, a 480 mile round trip from Pennausken, because of its proximity to family and friends. In disallowing the taxpayer's travel expense deduction, the Tax Court notes that Pennausken was not a temporary place of business for the taxpayer. Since Pennausken was the taxpayer's home, he was not away from home when he incurred the expenses. [Gregory Robinette, TC Summ. Op. 2006-69]

c. The IRS has announced that it will no longer contest an employer's deduction of the cost of employee lodging that is located in the same town as the employer, provided the lodging is necessary for the employee to take part in a meeting or function of the employer. [Notice 2007-47]

1) The IRS expects to amend its regulations under Sec. 262 to permit the deduction.

2) The new rules will apply under the following conditions:

a) The lodging must be on a temporary basis;

b) The lodging must be necessary for the employee to participate in or be available for a business meeting or function of the employer; and

c) The expenses must be otherwise deductible by the employee, or would be deduction if paid by the employee if paid by the employee under Sec. 162.

3) If the employer pays for the lodging, the cost will be excluded from the employee's income as a working condition fringe under Sec. 132.

4) The IRS will not raise the issue of how to treat local lodging, in any year ending on or before publication of the planned guidance. The IRS will not pursue the issue if it has been raised in an examination, before the Office of Appeals, or in a Tax Court proceeding, in a tax year ending on or before May 23, 2007.

17. Indefinite Assignment Living Expenses Not Deductible

a. Prior to losing his job a taxpayer worked and lived in Austin, Texas. Taxpayer was offered a job in Boulder, Colorado on an "as needed basis." The Colorado assignment started in March 2002 and continued through April 2003. He maintained his apartment in Austin until June 2002. The taxpayer was then hired on an "as needed basis" in Basking Ridge, New Jersey. He lived and worked in New Jersey from April 2003 through July 2005. The Tax Court denied the taxpayer's away from home expenses because each of the assignments was for a period that exceeded one year and neither could be treated as a "temporary assignment" for federal tax purposes. [Cornelius, TC Sum Op 2008-42]

1) The Tax Court agreed that a moving expense deduction might be appropriate.

18. Traveling Electrician Had No Tax Home

a. An electrician was not permitted to deduct his meals and lodging expenses as business expenses incurred while traveling away from home because they related to a period for which he had no tax home. [Walker, TC Sum Op 2008-41]

b. In 2002, taxpayer lived with his brother in Atlanta, Georgia. He married on March 31, 2002, and his wife continued to live with her mother in Florida. The taxpayer spent 216 days in New Jersey during 202, including those days when he was present there either working or looking for work. As of the end of November 2002, he considered that his residence was in Florida.

c. The Tax Court held that the taxpayer was not entitled to deductions for meals and lodging expenses for the period between the date of his wedding and when he move to Florida because he did not have a tax home for that period. Because the meals and lodging expense deductions related to the period between his wedding and moving to Florida, and there was no evidence that he paid or incurred any living expenses in connection with his brother's house or any other "permanent place of residence: while he was working in New Jersey or elsewhere, the court concluded that the taxpayer had no "tax home" during that period.

19. Traveling Expense Gym Fees

a. The reimbursement of gym fees for traveling employees are taxable income and subject to employment taxes. The cost of using a health club while away on business is a personal expense because the facility is not located on the business premises of the employer.

Chapter 12 - Losses

A. Passive Activity Losses

1. The Seven Material Participation Tests Are as Follows:

Current Year Tests

a. Hourly Safe Harbor
b. Primary Participant
c. Maximum Participant
d. Significant Participation Activity Aggregation

Prior Year Tests

e. Historical Participation
f. Personal Service Activity

Statutory Test

g. Facts and Circumstances

2. More than 100 Hour Participation Test

a. The individual participates in the activity for more than 100 hours during the tax year and the individual's participation in the activity is not less than the participation of any other individual, including individuals who are not owners (this test covers activities that do not require more than 500 hours by any one individual to operate).

b. The couple has a special arrangement with the management firm that operated the building in which the condo was located. While the company took care of all of the cleaning of the unit and supplied the front desk staff, the couple made all the arrangements for advertising their place and actually renting it out. They estimate that this work involved about 200 hours each year. The Tax Court accepted their claim that they spent more time on their unit than the management company and therefore met the 100-hour test. [*G. Pohoski*, TC Memo 1998-17]

c. However, in another case the couple used the management company that maintained the building to handle the reservations. A front desk staff, along with housekeeping department, were involved with the rentals as well. The couple did not put in at least 100 hours, and more than any other party involved with the property. [*Barniskis*, TC Memo 1999-258]

3. Self-Rental Rules Upheld

a. The "self-rental rule" of Income Tax Regulations Section 1.469-2(f)(6) was upheld in a U.S. District court case. The "self-rental rule" provides that "an amount of the taxpayer's gross rental activity income for the taxable year from an item of property equal to the net rental activity income for the year from that item of property is treated as "not from a passive activity" if the property is rented for use in a trade or business activity in which the taxpayer materially participates for the taxable year. An attorney was deemed to be materially participating in a property rented to his personal service corporation based upon the "self-rental rule" of the regulations. The court held that the regulation was not arbitrary or capricious nor was it manifestly contrary to the underlying statue. [*Fransen v U.S.*, 98-2 USTC ¶50,776, East Dist. La, 8-26-98]

b. The "self rental rule" was also upheld in a Tax Court case. [*Schwalbach*, 111 TC 215 (9-8-98)] The taxpayer, a dentist, leased real estate to his personal service corporation for use in the corporate dental practice in which the taxpayer materially participated. In his tax return, the taxpayer offset the rental income with unrelated passive losses.

c. Final regulations specifically make the self-rental rule applicable to transactions between closely-held C corporations and their owners. The First Circuit held that the final regulations represent a valid interpretation of the passive loss provisions. The regulations were issued under a specific grant of authority from Congress and as such are entitled to a higher degree of respect. The court found that it must give legislative regulations controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute. [*Sidell v Comm.*, CA-1, 9-22-2000]

4. Developments

a. When a C corporation switches to an S corporation, any carryforwards are suspended until the S corporation switches back to a C corporation. However, the Tenth Circuit recently ruled that a closely-held C corporation that was subject to the passive activity loss rules is allowed to carry the passive loss carryforwards to S status. A suspended passive loss is not a carryforward item. Passive losses have their own accounting rules, and they continue to apply as if the company remained a C corporation. [*St. Charles Investment Co.,* CA-10, 85 AFTR2d ¶2000-5527]

b. The taxpayer, an attorney, was the sole shareholder of two subchapter C corporations. One corporation operated a health club, the other the law firm for which the taxpayer worked. Each corporation rented their respective buildings from the taxpayer. The Tax Court determined that the taxpayer materially participated in the law firm's business and it recharacterized the rental income as active, which foreclosed using any of the otherwise offsetting passive losses. [*T.P. Krukowksi*, 114 TC 336 (2000); affd CA-7 2002-1 USC ¶50,219]

c. A taxpayer owned an S corporation that involved a management fee paid to the taxpayer. The management fee was reported as taxable income but the offsetting expense was trapped under the passive loss rules because it was part of an overall S corporation passive activity loss. The IRS stated that the existing regulations only addressed self-charged interest. The Tax Court determined that the failure of the IRS to address other self-charged items did not prevent the taxpayer from using the pass-through S loss to offset the related nonpassive management income. [*Hillman*, 114 TC 103 (2000)] However, the decision was reversed by the Fourth Circuit. [*D.H. Hillman*, 250 F.2d 228 (CA-4, 2001)]

d. Reliance on promoters' representations and their own knowledge has proven fatal to taxpayers who invested in a tax shelter. The projected tax benefits exceeded the taxpayers' investment of $12,500. On their 1981 return, they claimed an investment credit of $11,542, an energy credit of $10,785, and a loss of $9,995. The court found that the taxpayer brought forth no expert or persuasive testimony to challenge the IRS's valuation of the recycling equipment which was valued at 20 times its fair market value. [*Carroll*, TC Memo 2000-184]

e. The Tenth Circuit has held that reliance on an accountant's advice may excuse the negligence penalty, even though the accountant lacked expertise with respect to the business of the recommended tax shelter. [*Thompson v. US*, CA-10, 8-29-2000]

f. Extraordinary tenant services negate the passive-loss rules. An attorney and her doctor husband operated their respective businesses from the same building. They leased the remaining space to other lawyers, offering them use of a law library, a paralegal, clerical staff, and more. The wife handled all the rental chores, putting in over 500 hours a year. The Tax Court ruled that the rental losses were deductible in full. Because the services provided to tenants go beyond those typically performed by landlords and the wife's material participation, the rental activity is not a passive activity. [Assaf, TC Memo 2005-14]

g. The income from renting realty to a corporation cannot be offset by passive losses even though it comes from real estate activities, an Appeals court decides. The court upheld IRS rules denying passive losses against rental income when a taxpayer works more than 500 hours per year for the business, and more than 50% of the company's stock is held by five or few owners. [Beecher, CA-9, 2007]

1) The identical rule applies to rentals that are made to S corporations.

2) Unlike salary, the rents received are not subject to payroll taxes.

h. Short-Term Rentals

1) The Tax Court says that owners of short-term rentals must materially participate to deduct the losses. [Akers, TC Memo. 2010-85] Short-term rentals are when the average rental lasts no longer than seven days. The $25,000 loss allowance for actively managed rental realty is only available when the average rental period exceeds a week.

B. Real Estate Professionals

1. Taxpayers who qualify as real estate professionals are permitted to avoid the general rule that treats real estate rentals as passive activities. Real estate professionals are permitted to elect to treat all of their interests in rental real estate activities as a single activity, and to then avoid the passive loss restrictions if they materially participate in their aggregate real estate business activities.

2. The Tax Court has ruled that an individual who owned a number of rental properties did not qualify as a real estate professional because of failure to attach a statement to his Form 1040 indicating that he qualified as a real estate professional and was electing aggregation of his real estate activities. [*Kosenen*, TC Memo 2000-107]

3. The Tax Court ruled that an engineer did not qualify as a real estate professional because he did not have a 5% ownership interest in the real estate firm that employed him. [*Pungo*, TC Memo 2000-60]

4. Real estate professionals are exempt form the passive-loss rules if they spend over half their working hours and at least 750 hours per year materially involved in real estate. IRS agents are checking returns of people claiming to be real estate professionals, such as builders, landlords, managers, and brokers. It wants to make sure the time tests are met.

5. The IRS allowed a couple with multiple rental properties to have extra time to elect to treat the properties as a single entity. [Ltr. Rul. 200728016; also see Ltr. Rul. 200816005]

a. Without that election, few filers would be able to meet the time tests individually on each property.

C. Farming Losses

1. For tax years beginning after 2009, the Act limits the farming loss of a taxpayer, other than a C Corporation, for any tax year in which any "applicable subsidies" are received. The losses are limited to the greater of: 1) $300,000 ($150,000 for a married person filing separately), or 2) the taxpayer's total net farm income for the prior five tax years. [Sec. 461(j)]

   a. Any loss disallowed is carried forward to the next tax year and treated as a deduction attributable to farming businesses in that year.

   b. Farming losses arising because of fire, storm, or other casualty, or by reason of disease or drought, are disregarded for purposes of calculating the limitation.

D. Hobby Losses

1. Hobby Loss Fact Sheet

   a. The IRS released a Fact Sheet on hobby losses as part of its public education campaign to encourage compliance and close the tax gap. Fact Sheet 2007-18 highlights the factors traditionally used by the IRS and the courts to distinguish a business with a profit motive from a hobby. The IRS looks at a non-exhaustive list of factors to determine if an activity is engaged in for-profit or is a hobby.

      1) Does the time and effort put into the activity indicate an intention to make a profit?

      2) Does the taxpayer depend on income from the activity?

      3) If there are losses, are they due to circumstances beyond the taxpayer's control of did they occur in the start-up phase of the business?

      4) Has the taxpayer changed methods of operation to improve profitability?

      5) Does the taxpayer or his or her advisors have the knowledge needed to carry on the activity as a successful business?

      6) Has the taxpayer made a profit in similar activities in the past?

      7) Does the activity make a profit in some years?

      8) Can the taxpayer expect to make a profit in the future from the appreciation of assets used in the activity?

   b. The Fact Sheet describes the presumption that an activity is carried on for profit if it makes a profit during at least three of the last five year, including the current year -- at least two of the last seven for activities that consist primarily of breeding, showing, training, or racing horses.

c. If the activity is deemed to be a hobby, deductions are still available but only if the individual itemizes deductions on Schedule A, Form 1040, but not in excess of income that it generates. Deductions are taken in the following order and only to the extent stated in each of the three categories:

1) Category #1: Deductions that a taxpayer may take for personal as well as business activities, such as home mortgage interest and taxes, may be taken in full irrespective of hobby income, but must reduce the amount of hobby income remaining available to offset deductions in Categories #2 or 3;

2) Category #2: Deductions that do not result in an adjustment to basis, such as advertising, insurance premiums and wages, may be taken next, to the extent gross income for the activity is more than the deductions from Category #1;

3) Category #3: Business deductions that reduce the basis of property, such as depreciation and amortization, are taken last, but only to the extent gross income for the activity is more than the deductions taken in Categories #1 and 2.

2. Three recent Tax Court cases bring out the importance of record keeping. Both cases involved Arabian horse breeding. The Tax Court allowed the loss deduction in one case and in the other it did not. One individual convinced the court to allow him loss deductions by presenting evidence that he kept extensive records. He had a long-range plan to develop the business for his retirement years, he consulted experts, and his losses could be attributed to unforeseen circumstances. The second taxpayer lost her claim because she did not keep records, and did not have a business plan. Over a 20-year period of losses, she never attempted to change her method of operations and never consulted experts. The third taxpayer involved in Arabian horse breeding convinced the court to allow them loss deductions by presenting evidence of their business plan to make a profit from breeding activities. [*Morley*, TC Memo 1998-213; *Surridge*, TC Memo 1998-304, *H.J. Davis*, TC Memo 2000-101]

3. The Tax Court ruled that a father who claimed business expense deductions for soapbox racing could not deduct expenses because his son competed at the amateur level. The Second Circuit has vacated the Tax Court's decision on the lack of a profit motive. A profit motive does not necessarily require that the taxpayer expect immediate gain, which would be impossible as long as amateur status is held. The Second Circuit sent the case back to the Tax Court for consideration of all the facts and circumstances, including expertise and changes of future success. But the Court also agreed that the IRS could raise another issue that may make a taxpayer victory less than complete: whether the "preopening expense" doctrine requires the expenses to be capitalized. [*McCarthy v Commr*, CA-2, 98-2 USTC ¶50,577]

4. You can keep the IRS from questioning the profit motive behind a business by filing Form 5213 within three years after starting the business. Filing the form puts the IRS on notice that there are losses for audit purposes. The form keeps the statute of limitations open for the loss years.

E. Vacation Home

1. Considered vacation home if used the greater of:

    a. More than 14 days during year or

    b. 10% of the number of days is it rented out

2. Do report income if rent dwelling used as a residence for less than 15 days during year. Cannot deduct rental expenses.

3. If rent for more than 14 days

    a. Report revenue and

    b. Limited deduction for expenses related to renting

4. Passive Loss Rules and Vacation Homes

    a. Property is trade or business, not rental, if the average rental period is 7 days or less. Trade or business rentals are not eligible for the $25,000 active participation rules of passive activities. Therefore, they must meet the material participation requirements of Section 469 to qualify as an active trade or business rather than a passive activity.

5. Developments

    a. Rental to Relative at Less than FMV.

        1) If a dwelling unit is rented to a member of the taxpayer's family for any part of a day, the unit is deemed to have been used on that day by the taxpayer for personal purposes unless the unit is used as the principal residence of the family member and the rent charged to the family member reflect a fair rental for the unit. The Court found that the property was rented at less than fair market value to the brother and, therefore, the loss was not allowable. A later loss of $73,500 on the sale of the property was also nondeductible. The taxpayer was not engaged in the trade or business of renting property. [*Ronald and Stephanya Barranti*, TC Memo 1998-427]

        2) Taxpayer let his daughter and her family live in a bed-and-breakfast for free for an indefinite time during the year. They claimed a loss for the rental property. Because a fair rent was not charged, the time the relatives spent there is treated as personal-use days for the taxpayer. This triggered the vacation home loss rules. [Lofstrom, 125 TC No. 13]

F. NOL Carryovers

1. The net operating loss of a taxpayer, which is generally the excess of the taxpayer's business deductions over the taxpayer's gross income, may be carried back and applied against taxable income for prior years and then carried forward and applied against taxable income for years after the NOL year; under the 1997 Act, the NOL carryback period is shortened from three years to two years, but the NOL carryforward period is extended from 15 years to 20 years.

2. Special carryback rules relating to (1) real estate investment trusts (REITs) that do not receive carrybacks; (2) specified liability losses that are subject to a 10-year carryback; (3) excess interest losses that do not receive carrybacks; and (4) corporate capital losses are not affected by the changes.

3. The three-year carryback period is retained for the portion of the NOL that relates to casualty and theft losses of individual taxpayers and to NOLs that are attributable to Presidentially declared disaster areas and are incurred by taxpayers engaged in farming or by a small business.

4. The new carryover rules are effective for NOLs for tax years beginning after August 5, 1997; NOLs carried forward from prior tax years are not eligible to use the 20-year carryover period.

5. A special five-year NOL carryback period may be elected for farming losses, beginning after December 31, 1997.

G. Bad Debts

1. A married couple advanced $145,000 to the wife's son over several years but never had him sign any acknowledgment of indebtedness to them. They took a bad debt deduction after he declared bankruptcy. The court denied the deduction. Without loan documentation or record of repayments by the son, there was no evidence that a loan ever existed. It appeared that the couple "were generous parents who financially supported their child in time of need." [Warren J. Kidder, 87 AFTR2d ¶2001-588, CA-9]

2. Taxpayer paid on a loan that he had guaranteed for a friend's business. He took a deduction on his tax return as a theft loss claiming that he had been fraudulently induced into guaranteeing the loan. The court ruled the friend only took the third party's money. Never did he take control of the taxpayer's funds directly or gained any kind of encumbrance on/control over the taxpayer's property. His loss, if any, had to be treated as a bad debt subject to the capital loss limitations. [Stolz v. U.S., SD IN, 97 AFTR 2d p2006-387]

3. The U.S. Court of Appeals for the 9th Circuit has affirmed a Tax Court decision holding that a sole-shareholder/employee of a bankrupt corporation was entitled to a business bad debt deduction for advancing money to the corporation in the course of his employment. However, the deduction was a miscellaneous itemized deduction subject to the 2% of AGI floor and not as an adjustment to gross income as the employee had contented. [Graves, 99 AFTR 2d 2007-480 (CA-9, 20070]

H. Casualty Losses

1. Taxpayer owned various assets that were damaged as a result of a casualty. Taxpayer incurred repair costs to rebuild the assets that were nearly destroyed and to repair the assets that were less damaged. The IRS National Office concluded that taxpayer cannot take both a casualty loss deduction under Sec. 165 and a business expense deduction as a result of one casualty. As provided in Rev. Rul. 71-161, if the loss is deductible under Sec. 165, the cost of restoring the property to its pre-casualty condition must be capitalized under Sec. 263, regardless of the method used to determine the amount of the loss deduction. [AM 2006-006]

   a. The IRS has discovered a growing trend in the utilities and telecommunications industry whereby taxpayer are deducting casualty losses under Sec. 165 and then deducting the cost of restoring the damaged property as repaid expenses under Sec. 162.

I. Deduction Under Single Design Business

1. The Tax Court held that the equestrian and design activities of a taxpayer constituted a single activity and were deductible as ordinary and necessary business expenses. [Topping, TC Memo 207-92]

2. According to the court, the taxpayer utilized her reputation as an equestrian competitor to become an interior designer of horse barns; thus, forming an integrated equestrian-based design business.

   a. Reg. 1.183-1(d)(1) provides that multiple undertakings may be treated as one activity if the undertakings are sufficiently interconnected. Sec. 162(a) allows the deduction of all ordinary and necessary expenses paid or incurred during the taxable year in conducting any business.

   b. The Tax Court has found many situations in which a taxpayer's activities could not be aggregated, but the court did not find sufficient similarity with this case. Here, the court found distinguishing that one activity materially, rather than incidentally, benefitted the other activity.

   c. Her equestrian contacts were responsible for more than 90% of her clientele. These contacts depended on the taxpayer's knowledge and expertise of horses in designing their barns and homes. Her business was a success from the beginning and continues to be successful. More specifically, her overall business produced a sizable net profit for all the tax years at issue.

J. Wash Sales

1. A Revenue Ruling provides that if an individual sells stock or securities at a loss and causes his IRA or Roth IRA to purchase substantially identical stock or securities within a specified period, the loss on the sale of the stock or securities is disallowed under Sec. 1091. [Rev. Rul. 2008-5] The ruling also holds that the individual's basis in the IRA or Roth IRA is not increased by virtue of Sec. 1091(d).

Chapter 13 - Itemized Deductions

A. Medical Expenses

1. Expenses for medical care incurred by the taxpayer, spouse, and dependents and paid during the tax year are deductible as an itemized deduction to the extent they are not compensated for by insurance or otherwise and exceed 7.5% of the taxpayer's adjusted gross income. Medical care includes amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body. Medical care includes amounts paid for transportation primarily for and essential to medical care.

    a. Premium payments for health insurance, hospitalization insurance, membership in group health plans or other associations providing cooperative medical service, or for group hospitalization and clinical care are expenses paid for medical care. Premiums for insurance providing reimbursements only for the cost of prescription drugs are medical care expenses. [Rev. Rul. 68-433]

    b. Premium payments for insurance covering disability are not deductible as medical expenses. [Rev. Rul. 55-331; *Kennedy*, TC Memo 1980-310]

    c. Insurance premiums are considered payable for other than medical care, if the insurance contract provides for the waiver of premiums upon the occurrence of an event. [Reg. 1.213-1(e)(4)(i)(a)]

2. Long-term care insurance premiums are treated like other medical insurance. [Health Insurance Portability and Accountability Act]

    a. The premiums are deductible if paid by taxpayer up to dollar limit based on age. [Rev. Proc. 2011-52] The limits for 2012 are:

40 years or less:	$ 350
More than 40, but not more than 50:	$ 660
More than 50, but not more than 60:	$ 1,310
More than 60, but not more than 70:	$ 3,500
More than 70:	$ 4,370

    b. Note: Self-employed individuals can claim 100% of the deduction as an adjustment to gross income.

    c. Form 1099-LTC, Long-Term Care Benefits are Accelerated Death Benefits, used to report benefits paid to individuals under long-term care insurance contracts.

3. The mileage rate for medical expenses for 2012 is $.23 per mile.

4. Imported prescription drugs are not deductible as medical expenses. The importation of medicines from Canada as well as other foreign countries is not permitted under federal law. [INFO 2005-0011]

    a. Pub. 502 (Medical and Dental Expenses) states that you cannot include in medical expenses amounts you import from foreign countries because importing medicines from Canada and other foreign countries is prohibited under federal law. The cost of such drugs cannot be reimbursed by flex plans or health reimbursement arrangements.

5. Tuition

   a. The cost of special education for a dyslexic child can be treated as a deductible medical expense. [Ltr. Rul. 200552003]

      1) The IRS has set up three conditions for deducting special education to overcome a learning disability as a medical expense:

         a) A doctor must diagnose the condition.

         b) The school must have a professional staff competent to design and supervise a program to help a child overcome a learning disability.

         c) Overcoming the learning disability must be the primary motivation for attending the school. Ordinary education must be considered incidental to the treatment provided at the school.

   b. The IRS determined that tuition paid to send a child to a school accepting only students who did not have strong visual/spatial abilities qualified as a medical expense. The special education program at the child's public school was diagnosed as inadequate. While the school emphasized a core curriculum of reading, writing, research, and math; the instruction favored the students' strong auditory processing strengths and was supplemented by emotional regulation and conflict resolution. [Ltr. Rul. 200704001]

6. Medical expenses paid for surrogate mother are not deductible unless the surrogate qualifies as the payer's dependent. Lawyer fees paid to set up the arrangement cannot be deducted. [INFO 2004-0187]

7. Costs to obtain an egg donor are deductible as medical expenses. [INFO 2005-0102] Obtaining an egg or embryo to be inserted into the taxpayer's body is medical care of the taxpayer. Surgical, hospital, laboratory, and transportation expenses paid by or on behalf of a donor or a prospective donor in connection with an egg or embryo transplant operation are deductible medical expenses for the year in which paid. If legal fees are required for a medical procedure, they may be included in medical care expenses.

   a. These costs can be covered by flexible spending plans.

8. A woman was seeking to become pregnant using donated eggs. Her medical insurance does not cover egg donor fees and related agency fees, legal fees, and medical and psychological testing fees. The egg donor fees are related costs and qualify as deductible medical expenses. [Ltr. Rul. 200318017]

9. The IRS determined that cosmetic surgery is a deductible medical expense even though the sole purpose of the surgery would be to improve the taxpayer's appearance. The surgery qualified for the deduction because it treated a deformity caused in correcting a congenital abnormality. [Ltr. Rul. 200344010]

   a. Under Sec. 213(d)(9)(B), cosmetic surgery is not deductible unless it is necessary to ameliorate a deformity arising from, or directly related to a:

      1) Congenital abnormality;
      2) Personal injury from accident or trauma; or
      3) Disfiguring disease.

10. Retirement Community Expenses

    a. The Tax Court has held that taxpayer may use the percentage method to calculate the portion of monthly fees covering medical costs in a retirement community. The court found that 35 years of published guidance supported the taxpayers' claim that the percentage method was acceptable and the actuarial method was not mandatory. The IRS conceded that the actuarial method is so complex that it defied full explanation in oral testimony before the court and on written briefs. [Delbert L. Baker, 122 TC 143 (2004)]

        1) The actuarial method involves longevity, survivorship, and level-of-care assumptions.

        2) The Bakers, because they filed a joint return, were permitted to deduct around 32% of the monthly fees paid over the two years at issue as medical deductions.

        3) The Tax Court denied medical expense deductions for use of the pool, spa, and exercise facility. These amenities were available to all community residents at no extra charge.

    b. Residents of continuing care facilities cannot write-off a portion of their entrance fee as a medical expense. [Finzer, Jr., 2007-2 USTC p50591]

        1) The couple deducted $137,000, or 19% of the fee they paid, based on the facility owner's analysis of the actual operating expenses. They later filed an amended return claiming 41% of the fee after the owner recalculated the medical-related expenses using an actuarial method. The IRS said none of the fee was deductible. The district court found that the residency agreement stated that the entrance fee would not be used to provide medical services. The entrance fee was in this case a loan. The retirement home in practice always returns 90% of the entrance fee to residents.

        2) In Rev. Rul. 75-302, the IRS determined that the portion of a lump-sum lifetime-care fee allocable to the retirement home's obligation to provide medical care was deductible as a medical expense. Rev. Rul. 76-481 also addresses the deductibility of a lump-sum payment made in connection with lifetime-care at a retirement home.

11. A disabled individual could not deduct his commuting costs as a medical expense under Sec. 213, the Tax Court concluded. Because the taxpayer could not see well enough to drive, his wife drove him to and from work every day, a distance of 40 to 45 miles each way. Expenses must be directly or proximately related to treatment of a medical condition, the Tax Court explained. This standard requires that the expenses be primarily for medical care, and cannot be incurred for personal, nonmedical reasons in ordinary circumstances. [Alderman, TC Summary Opinion 2004-74]

12. Home Exercise Equipment [Info. Letter 3003-02002]

    a. Taxpayers may deduct exercise expenses, including the cost of equipment to use in the home, if required to treat an illness (including obesity) diagnosed by a physician.

    b. The taxpayer must establish that the purpose of the expense is to treat a disease rather than to promote general healthy, and that the taxpayer would not have paid the expenses but for this purpose.

13. Breast Reconstruction Surgery

    a. The cost of breast reconstruction surgery is a medical expense in the case of a breast cancer survivor who had a mastectomy.

    b. But getting implants for cosmetic purposes is not a deductible expense.

14. Laser Eye Surgery

    a. Laser eye surgery expenses are medical expenses and can be deducted. [Rev. Rul. 2003-57]

    b. The cost of laser eye surgery is a qualified medical expense. The IRS OKs a company's plan to reimburse employees for a portion of the cost of a radial keratotomy, which corrects nearsightedness. Workers will not be taxed on the money. The same result should apply to LASIK surgery, IRS officials say. That procedure is a medical expense because it is done to improve vision. Costs can be covered by flexible spending accounts. [Ltr. Rul. 200226003]

15. Teeth Whitening

    a. The cost of teeth whitening is not a deductible medical expense. The procedure is done to improve personal appearance, not to treat disease. [Rev. Rul. 2003-57]

16. Prescription Drugs

    a. Amounts paid for drugs or medicines are deductible only if they are available through prescription.

    b. Over-the-counter drugs, even if recommended by a physician in the treatment of an injury, are not deductible because no prescription is required for their use. [Rev. Rul. 2003-58]

17. Medical Equipment

    a. The cost of medical equipment such as amounts paid for crutches, blood sugar kits for diabetics and even bandages are deductible medical expenses. [Rev. Rul. 2003-58]

18. At a doctor's recommendation, a parent traveled to a distant medical conference to obtain information about a disease affecting a dependent child. The IRS has ruled that the registration fee and travel costs were primarily for and essential to medical care, and were allowable deductions. However, costs for meals and lodging were not deductible, because the taxpayer or dependent was not receiving medical care at the location of the conference. [Rev. Rul. 2000-24, 2000-1 CB 963]

19. Changing its policy after 20 years, the IRS has ruled that uncompensated amounts paid by taxpayers for participation in a smoking-cessation program, and for prescribed drugs designed to alleviate nicotine withdrawal, are deductible medical expenses. However, amounts paid for drugs not requiring a prescription, such as nicotine gum and certain nicotine patches, are not deductible medical expenses. [IR-1999-55; Rev. Rul. 99-28, 1999-25 IRB 6]

    a. Only 5% of individual returns are able to claim medical expenses because of the 7.5% limitation and the standard deduction, however these expenses may be covered under tax-free health insurance plans, and their costs may be paid using pre-tax dollars contributed to a health flex account.

20. Folks with light-sensitive eyes can deduct the cost of sunglasses prescribed by a doctor. Even though the glasses are not-prescription, their cost can be a medical expense if a doctor says they are needed outdoors because sunlight is harmful to a patient's eyes.

21. Fertility treatments also are qualified medical expenses. This includes the cost of in-vitro fertilization and vasectomy reversals.

22. Modifying a Vehicle

    a. The cost of modifying a vehicle for a handicapped person qualifies as a medical expense, such as the cost of adding a wheelchair lift.

23. Obesity

    a. Doctor-prescribed treatment for obesity can be a medical expense. This includes the cost of prescription drugs and weight-loss programs ordered by doctors treating obesity as a disease. If a special diet is prescribed, only the excess of the cost of that food over the cost of normal meals can qualify as a deductible medical expense. Costs of general weight-reduction programs are not deductible medical expenses.

    b. Deductible expenses can be covered by flexible spending accounts. [Rev. Rul. 2002-19, 2002-16 IRB 778; IR-2002-40]

    c. Even though weight-loss costs associated with fighting obesity may be prescribed by a physician, they are not automatically deductible. The IRS cautioned that it would look at the totality of the circumstances surrounding the health club membership. Factors that will be taken into consideration include the: [Info 2002-0077]

       Taxpayer's ability to safely fulfill his or her exercise need without having to join a health club;
       Types of activities available at the health club;
       Services included in the membership fee;
       Location of the health club; and
       Alternative health clubs located closer to taxpayer's home.

24. Depreciation is not a medical expense according to the Tax Court. The court disallowed a couple's deduction for depreciating a van used to transport their handicapped son to see his doctors. [*Henderson*, TC Memo 2000-321]

25. One taxpayer was allowed a $775,000 medical expense deduction when she moved into her new house. The $775,000 represented the cost of medical-related home features that did not add to the home's market value. [*Laurence S. Zipkin*, 866 AFTR2s ¶2000-571, DC Minn]

26. A taxpayer, who was a certified public accountant, was denied a medical expense deduction for a special diet related to a digestive tract disease. He failed to establish that his diet was more than a substitute for a normal diet or that it differed from the diet of an ordinarily health-conscious individual. Moreover, he did not substantiate the amount by which his actual food expenditure exceeded the costs of a normal diet. He submitted little evidence of the cost, quantity, or type of food and supplements purchased. [*Massa*, TC Memo 1999-63, 3-4-99]

27. Over-the-Counter Drugs and Flex Plans

    a. The IRS announced that flexible spending plans can reimburse the cost of over-the-counter drugs, including aspirin, antacids, and allergy medications, but not for vitamins.

    b. Employer Plan documents may need to be amended before any payments can be made.

    c. Employees cannot change their deferrals in midyear to use the new rule. [Rev. Rul. 2003-102]

28. The Cohan rule was used to estimate the amount of deductible medical expenses. [*Emerson*, TCM 7-24-2001]

29. Diet Foods

    a. Diet foods or beverages purchased as part of a weight loss program, which substitute for other food that would normally be consumed to satisfy normal nutritional requirements, do not qualify as medical care. The cost of special food is a medical care expenses only if all of the following conditions are met:

        1) The food does not satisfy normal nutritional needs;

        2) The food alleviates or treats an illness; and

        3) A physician has substantiated the need for the food.

    b. Even if these requirements are satisfied, the food is considered a medical care expense only to the extent that it exceeds the cost of a normal diet.

30. Sex-Change Operation

    a. An IRS legal memo concludes that the cost of male-to-female gender assignment surgery (GRS), along with related medications, treatments, and transportation, were not deductible as medical expenses under Sec. 213. After noting that there is no case law, regulation, or ruling addressing the deductions, the IRS stated that: "In light of the Congressional emphasis on denying a deduction for procedures relating to appearance in all but a few circumstances and the controversy surrounding whether GRS is a treatment for an illness or disease, the materials submitted do not support a deduction. Only an unequivocal expression of Congressional intent that expenses of this type qualify under Sec. 213 would justify the allowance of the deduction in this case. [CCA 200603025]

31. Self-Prescribed Diagnostic Tests

    a. Self-prescribed diagnostic tests qualify as deductible medical expenses. [Rev. Rul. 2007-72] The IRS presents three distinct factual situations where the amounts paid by healthy individuals for self-initiated diagnostic and similar procedures qualify as deductible medical expenses.

B. Taxes

1. The following taxes are deductible as itemized deductions [IRC Sec. 164(a)]:

a. State, local, or foreign real property taxes

1) Local, state, and foreign real property taxes are generally deductible only by the person upon whom they are imposed in the year which they were paid or accrued.

a) A tax paid for local benefits such as street, sidewalk, and other like improvement is not deductible if imposed because of and measured by some benefit inuring directly to the property against which the assessment is levied.

b) If real property is sold during the year, the real property tax deduction must be allocated between the buyer and the seller based on the number of days during the year that each party held the property.

b. State or local personal property taxes

1) To be deductible, personal property taxes must be ad valorem, i.e., a tax which is substantially in proportion to the value of the personal property.

c. State, local, or foreign income taxes

d. State Sales Tax Deduction

1) Allows individuals to elect to deduct state sales taxes in lieu of the itemized deduction provided for State and local income taxes.

2) Available for tax years beginning after 2003 and before 2006.

3) Two options available:

a) Accumulating receipts or

b) Using tables to be prepared by the Secretary of the Treasury based on average consumption among many other factors.

(1) The tables are to be based on average consumption by taxpayers on a State-by-State basis taking into account filing status, number of dependents, adjusted gross income, and rates of State and local general sales taxation.

(2) Taxpayers who use the tables created by the IRS may, in addition to the table amounts, deduct eligible general sales taxes paid with respect to the purchase of motor vehicles, boats, aircraft, homes (including mobile and prefabricated homes), and materials to build a home.

(a) Motor vehicle includes an automobile, motorcycle, motor home, recreational vehicle, sport utility vehicle, off-road vehicle, van, or truck (any of which may be either purchased or leased). [Notice 2005-31]

4) If one spouse deducts sales tax, the other spouse must do so as well. [Notice 2005-31]

5) Sales taxes that are imposed at a rate other than the general rate of tax are not deductible. [Sec. 164(b)(5)(D) and (F)]

   a) Sales taxes imposed on food, clothing, medical supplies, or motor vehicles at a rate lower than the general rate of tax may be deducted.

   b) Motor vehicles at a rate in excess of the general sales tax rate may be deducted only at the general sales tax rate.

6) The deduction is not available for the alternative minimum tax.

7) Reg. 1.164-3 was never amended to reflect the Tax Reform Act of 1986 which eliminated the deduction for sales taxes.

8) Sales Tax on Home Building Materials

   a) It does not appear to matter who bears the ultimate economic burden of the tax.

   b) No sales tax deduction appears to be allowed when the taxpayer purchases a new house that the contractor has built, but not expressly for the taxpayer. Even if the contractor were to separately state the sales tax on building materials, the tax would simply comprise an indirect and indistinguishable part of the sales price.

   c) A deduction should be permitted when the individual acts as his or her own contractor, purchasing and paying for the materials. The builder uses the materials in constructing the house, but is otherwise not involved. The home buyer is both the consumer and payer of the tax. Both the IRS and the courts have permitted deductions in this instance.

   d) The contractor is the agent of the taxpayer and as such is under the direction of the taxpayer. The taxpayer is thus liable under state law for tortuous acts of the contractor. The materials are billed directly to the taxpayer. In this situation, the sales tax is treated as being imposed on the taxpayer and a deduction was permitted. [Rev. Rul. 82-173, 1982-2 CB 58; C.J. Graham, TC Memo 1984-529] However, where the taxpayer was not considered to have a principal/agent relationship with the contractor, and where the materials were billed to the contractor rather than the taxpayer. The Tax Court did not permit the deduction. [R. Harvey, TC Memo. 1983-183]

   e) The taxpayer enters into a contract to construct a house. The contractor purchases and pays for the materials and is reimbursed by the taxpayer when the taxpayer pays the contractor for the house. In the invoice submitted to the taxpayer, the contractor may or may not set out the sales tax separately. In this situation, the thrust of court decisions appears to prohibit a deduction. The landmark case is W.F. Armentrout. [43 TC 16 (1964)] The petitioner, Armentrout, entered into a cost-plus contract with a builder to build a house. The agreement provided that the contractor would purchase the materials needed to build the residence, would furnish the labor, and that Armentrout would pay materials and labor cost plus an additional eight percent to cover overhead and profit.

C. Interest Expense

1. Home Mortgage Interest

a. Taxpayers can take a mortgage interest deduction for the interest paid on loans of up to $1 million used to acquire, build, or substantially improve a home, plus subsequent home equity loans totaling up to $100,000 at any one time.

1) Reg. 1.163-10T(o) allows for an election out on a home equity loan and instead traces the interest under Reg. 1.161-8T. This is done by listing the interest on the loan by its appropriate type. There is no need to include a formal election statement in the taxpayer's return. However, the choice to trace interest on home equity loans must be made in the first year that such interest is incurred and must be made for the entire loan.

b. Home buyers can deduct points on a home acquisition loan even if the seller pays the points. The amount of points paid by the seller is subtracted from the buyer's basis in the new home. [Rev. Proc. 94-27]

c. Prepaid interest is deducted ratably over the term of the loan. When the mortgage proceeds are used to purchase a home, an individual may take the points as an itemized deduction in that year, provided specific requirements are met. Points paid to refinance a loan must be amortized over the term of the mortgage. However, in a letter ruling the taxpayers did not have enough deductions to itemize, and thus requested to be able to spread the points out over the life of the loan. The ruling said that Sec. 461(g) permits, but does not require, taxpayers to currently deduct points. Thus, the taxpayers are permitted to take the allocable amount as an itemized deduction in each year they elect to itemize. [Ltr. Rul. 199905033]

1) For the points to be deducted in year paid, the points: (1) must be paid on a mortgage to purchase or improve, and secured by, the taxpayer's principal residence; (2) charging points must be an established business practice in the area; and (3) the points cannot exceed the amount generally charged in the area. [IRC §461(g)(2)]

d. Taxpayers were allowed to deduct currently 1% loan origination point paid on a home loan as interest since it was paid for the use or forbearance of money. The point was a fixed percentage of the amount borrowed. Moreover, the lender used the funds to offset general expenses rather than to perform traditional services on behalf of borrowers. [Undated FSA 1999-9999-85]

2. Premiums for Mortgage Insurance

a. Treated as interest and deductible after 2006 and before 2011.

b. Phased out for incomes exceeding $100,000.

c. Only policies issued after 2006.

d. Must be on acquisition indebtedness.

e. Any premiums extending to periods beyond the end of the year are treated as paid in those periods to which they are allocated.

f. No deduction is allowed for the unamortized balance of premiums that have been capitalized if the mortgage is satisfied before the end of its term.

g. Taxpayers may allocate premiums ratably over 84 months instead of over the term of the loan. [Notice 2008-15]

1) Taxpayers can use the 84-month period, even if they get a Form 1098 from the lender that bases the deduction over the term of the loan.

3. Capitalizing Investment Interest

a. Under Sec. 266 taxpayers can elect to capitalize carrying charges related to real property. The election must be made by the extended due date of the original tax year in the year in which the charges are first incurred.

b. The S corporation incurred investment interest expense on a loan with respect to real property that it separately stated to the shareholder on the shareholder's Form Schedule K-1. The expense was not deductible by the shareholder due to the investment interest expense limitations.

c. In the following year the preparer advised the shareholder that the S corporation should made an election under Sec. 266 and further advised that the S corporation could have made such an election for the prior tax year. The S corporation then requested an extension of time to file the election to capitalize investment interest expense with respect to real property for the earlier year.

d. The IRS ruled that the S corporation "had acted reasonably and in good faith," and that granting an extension would not prejudice the interests of the IRS. It, therefore, granted an extension of 60 days from the date of its letter ruling for the S corporation to file the election to capitalize the investment interest to the real property of the earlier tax year. [Ltr. Rul. 200750010]

4. Developments

a. New temporary and proposed regs address when and how noncorporate taxpayers may make the election to treat what are otherwise qualified dividends as investment income. [TD 9147] The rules for making this election follow the election for qualified net capital gains spelled out in earlier regs. The regs are retroactive to January 1, 2003.

1) Form 4952 Instructions follow the presumption that, unless otherwise specified by the taxpayer, net capital gains are used before qualified dividends. The Instructions state that this treatment will result in the least amount of tax, except in certain foreign tax credit situations.

2) The instructions provided that if a timely return is filed without making the election, the election can be made on an amended return filed within six months of the original due date of the return.

3) Once made, the election is revocable only with the consent of the IRS.

4) The election cannot be made for Sec. 1231 gain that is treated as long-term capital gain or for unrecaptured Sec. 1250 gain to be treated as investment income. [Sec. 163(d)(5)]

b. Income Tax Deficiency Interest Nondeductible

1) The Fifth Circuit has affirmed the validity of Temp. Reg. 1.163-9T(b)(2)(i)(A), which denies a deduction for interest paid by an individual of a deficiency arising from an unincorporated business. [Alfaro, 2003-2 USTC ¶50,714, CA-5]

a) Five other circuits have all decided in favor of the IRS and have denied the deduction -- Fourth, Sixth, Seventh, Eighth, and Ninth).

c. Owning tax exempts can cause tax problems if you take out a loan to buy portfolio investments while you continue to own municipal bonds. Unless you can demonstrate that the tax-exempt bonds cannot be sold easily, the IRS will deny the interest deduction on the margin loan. If the bonds' cost does not exceed 2% of the total cost of your portfolio, the interest deduction on a margin loan is safe, the IRS privately ruled. The exception does not apply if the loan is used to buy exempts.

d. Interest on a loan from the same lender that is used to pay interest on a previous obligation to avoid default is not deductible. The need to avoid default means that the debtor really does not have unrestricted control over the funds. That the proceeds were deposited in the partnership bank account did not amount to control of the funds. [*Davison*, CA-2, 98-1 USTC ¶50,296]

e. The Tax Court allowed a taxpayer to deduct interest incurred incident to a divorce. The taxpayer had agreed to pay his former wife $300,000 down and another $625,000 at 10% per year for 10 years after his wife transferred stock, real estate, and her principal residence to her former husband in accordance with a property settlement agreement. According to the Tax Court, interest on indebtedness incurred incident to a divorce is not required under the Internal Revenue Code section 1041 to be characterized as nondeductible personal interest. [*J.L. Seymour*, 109 TC 279 (1997)]

f. The Tax Court reached the same result in *Armacost*. The husband gave his wife a promissory note to equalize the distribution of their property. The Court held that the note was meant to compensate the wife for the investment property, so interest paid on it helped the husband carry the investment property and was deductible investment interest. [*Ronald R. Armacost*, TC Memo 1998-150]

g. The taxpayer caught a break in a recent Tax Court case. An individual went bankrupt, couldn't make the mortgage payments on his home, and the bank foreclosed. $80,000 of interest that had accumulated on the mortgage was paid off through the foreclosure. The declaration of bankruptcy invoked an automatic stay that kept the bank from foreclosing. The Tax Court held that the bankruptcy court lifted the stay to let the bank proceed. That returned the home to the individual's ownership--so he can deduct the paid-off interest. [*Patrick E. Catalano*, TC Memo 2000-82]

h. Loan Origination Fee

1) A couple refinanced their home mortgage at a lower interest rate. Over the next four years, they used the cash saved from the refinancing to replace their roof, a door, and some of the flooring in the house. The Tax Court said the points are deductible. The refinancing was done to free up the cash to make the improvements, so the normal rule that refinancing points are deducted over the loan term does not apply. [Hurley, TC Summ. Op. 2005-125]

2) A taxpayer refinanced the mortgage on his principal residence, paying a loan origination fee equal to 0.218% of the borrowed amount. The Tax Court ruled that the fee is not treated as interest. The Court found that the fee was paid for services because the taxpayer did not show it was paid for the use of money. [Lange, TC Memo 2005-176]

a) Had the fee qualified as interest the taxpayer it would have been amortized over the life of the loan.

b) If the loan is for the purchase of a principal residence, a loan origination fee is deductible as interest, even when the charge is levied for services.

i. No interest deduction for amounts paid on another's mortgage. [Nair, TC Summ. Op. 2007-116] A son got his first job and moved out of his parent's home, but made some mortgage payments for them. There is no deduction because the son was not liable on the loan.

1) There is a limited exception to the disallowance rule. In 1997, the Tax Court allowed a couple to deduct the interest they paid on a home even though their relatives took out the mortgage because the couple had a bad credit rating the could not qualify for a loan. In that case they actually lived in the house and made all repairs and improvements. In essence, they assumed all the benefits and burdens of ownership.

j. A son took out a mortgage to buy a home for his parents, who had filed for bankruptcy and could not obtain a mortgage themselves. The son held title to the house. The couple made all the mortgage payments, paid all taxes and upkeep and where the house's only occupants. The Tax Court determined that the parents were the home's equitable owners, bearing all benefits and burdens of ownership, and allowed their deduction of the mortgage interest. [Njenge, TC Summ. Op. 2008-24]

k. Investment Interest

1) If the individual's aggregate investment interest expense is greater than the individual's net investment income, the individual must allocate the taxpayer's net investment income to the two categories of investment interest expenses using a reasonable method of allocation. According to the IRS, one reasonable method is the pro-rata method. [Rev. Rul. 2008-38]

2) A taxpayer's distributive share of a partnership's interest expense, allowed under Sec. 163(d)(1), is deductible in arriving at his adjusted gross income (AGI).

3) To the extent that the taxpayer's allowed investment interest deduction is attributable to indebtedness attributable to stocks and bonds held for investment, the deduction is reported as an itemized deduction.

D. Charitable Contributions

1. In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair market value of property contributed to a charitable organization. However, in the case of a charitable contribution of short-term gain, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis in the property.

2. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose.

3. In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property. However, under a special rule, taxpayers are allowed a deduction equal to the fair market value of "qualified appreciated stock" contributed to a private foundation. Qualified appreciated stock is defined as publicly traded stock which is capital gain property. The fair-market-value deduction applies only to the extent that total donations made by the donor to private foundations of stock in a particular corporation did not exceed 10% of the outstanding stock of that corporation. For this purpose, an individual is treated as making all contributions that were made by any member of the individual's family.

4. Payroll Contributions

   a. The IRS has modified the existing regs to cover the new substantiation requirements in the Pension Protection Act. When a contribution is made by a payroll deduction, an acceptable written communication from the charity will be deemed to include a:

      1) Pay stub, Form W-2, or other document furnished by the employer setting forth the amount withheld during a tax year by the employer for the purpose of payment to a charity together with a

      2) Pledge card or other document prepared by the charity showing the name of the charity.

   b. To substantiate a contribution of $250 or more made by payroll deduction, the pledge card or other document prepared by the donee organization also must state that the charity does not provide goods or services in whole or partial consideration for any contributions made through the payroll deduction.

   c. The contribution amount withheld from each payment of wages to a taxpayer is treated as a separate contribution for purposes of applying the $250 threshold.

5. Noncash Donations

   a. For contributions made after June 3, 2004, a charitable donor of property other than cash, inventory, or publicly traded securities, that exceeds $500,000 in value will be required to attach a qualified appraisal to the donor's tax return.

      1) This requirement applies if the donor is an individual, a partnership, or a corporation.

6. Charitable Contribution Provisions

   a. No deduction allowed for any contribution of a cash, check, or other monetary gift unless the donor maintains as a record of such contribution a bank record or written communication from the charity showing, among other things, the amount of the contribution.

   b. Effective for tax years beginning after August 17, 2006.

      1) Self-created records, such as a log book of donations, no longer suffice.

   c. No deduction for donations of clothing and household goods unless they are in "good" condition.

      1) The Treasury is authorized to deny a deduction for any contribution of clothing or household item that has minimal monetary value, such as used socks and used undergarments.

         a) It is expected that the IRS will exercise the authority to disallow a deduction for some items of low value, consistent with the goals of improving tax administration and to ensure that donated clothing and household items are of meaningful use to charitable organizations.

   d. Enhanced deductions for certain conservation easements.

      1) The donor making a conservation contribution will have a contribution base of 50% rather than a base of 20 or 30%.

      2) If the value of the donor's contribution exceeds the 50% contribution base, the excess may be carried forward for 15 years.

      3) The contribution base is 100% if given to contributions of property used in agriculture or livestock production by individual farmers and ranchers.

      4) Contributions generally must be made in after 2005 and before 2010.

   e. Tax-free distributions from an IRA for charitable purposes.

      1) Taxpayers age 70 ½ and older may distribute up to $100,000 in 2006 and again in 2007 from their IRAs tax-free to charitable organizations.

      2) The distribution is not reported as income to the taxpayer.

      3) The distribution does count for purposes of satisfying any required minimum distribution (RMD) amount.

      4) Distributions may be from a traditional or a Roth IRA.

      5) The recipient of the IRA funds must be a qualifying charity: a "50% organization" described in Sec. 170(b)(1)(A).

6) Distributions of nondeductible contributions from a traditional IRA are not included in income and are not eligible for qualified charitable distribution treatment.

   a) A special ordering rule applies to separate taxable from nontaxable IRA distributions for charitable distribution purposes.

      (1) A distribution is treated first as income up to the aggregate amount that would otherwise be includible in gross income if the aggregate balance of all IRAs having the same owners were distributed during the same year.

f. Basis adjustment to stock of S corporations contributing property for tax years after 2005 and before 2012.

1) The amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution equals only the shareholder's pro rata share of the adjusted basis of the contributed property.

g. Easements in Registered Historic Districts

1) A charitable deduction is allowable with respect to buildings but the qualified real property interest that relates to the exterior of the building must preserve the entire exterior of the building, including the space above the building, the sides, the rear, and the front of the building. In addition, such qualified real property interest must provide that no portion of the exterior of the building may be changed in a manner inconsistent with the historical character of such exterior.

2) For any contribution relating to a registered historic district made after August 17, 2006, taxpayers must include with the return for the taxable year of the contribution a qualified appraisal of the qualified real property interest and attach the appraisal with the taxpayer's return, photographs of the entire exterior of the building, and descriptions of all current restrictions on development of the building, including, for example, zoning laws, ordinances, neighborhood association rules, restrictive covenants, and other similar restrictions. Failure to obtain and attach an appraisal or to include the required information results in disallowance of the deduction. In addition, the donor and the donee must enter into a written agreement certifying under penalty of perjury, that the donee is a qualified organization, with a purpose of environmental protection, land conservation, open space preservation, or historic preservation, and that the donee has the resources to manage and enforce the restriction and a commitment to do so.

3) Taxpayers claiming a deduction for a qualified conservation contribution with respect to the exterior of a building located in a registered historic district in excess of $10,000 must pay a $500 fee to the Internal Revenue Service or the deduction is not allowed. Amounts are required to be dedicated to Internal Revenue Service enforcement of qualified conservation.

4) The amount of the conservation contribution deduction is reduced by an amount that bears the same ratio to the fair market value of the contribution as the sum of the rehabilitation credits under Sec. 47 for the preceding five taxable years with respect to a building that is part of the contribution bears to the fair market value of the building on the date of the contribution.

5) If the aggregate amount of credits claimed by taxpayer within such five year period is $100,000, and the fair market value of the building with respect to which the contribution is made is $1,000,000, the taxpayer must reduce the amount of the deduction by 10% ($100,000 / $1,000,000).

h. Charitable Contributions of Taxidermy

1) In general, the amount allowed as a deduction for charitable contributions of taxidermy property that is contributed by the person who prepared, stuffed, or mounted the property (or by any person who paid or incurred the cost of such preparation, stuffing, or mounting) is the lesser of the taxpayer' basis in the property or the fair market value of the property.

2) Taxidermy property is defined as any work of art that is the reproduction or preservation of an animal in whole or in part, is prepared, stuffed, or mounted for purposes of recreating one or more characteristics of such animal, and contains a part of the body of the dead animal.

3) The basis of such property may include only the cost of the preparing, stuffing, or mounting. It is intended that only the direct costs of the preparing, stuffing, or mounting may be included in basis. Indirect costs, not included in the basis, include the costs of transportation relating to any aspect of the taxidermy or the hunting of the animal, and the direct or indirect costs relating to the hunting or killing of an animal (including the cost of equipment and the costs of preparing an animal carcass for taxidermy).

4) Effective for contributions made after July 25, 2006.

i. Recapture of Tax Benefit on Property not Used for an Exempt Use

1) If a donee organization disposes of applicable property within three years of the contribution of the property, the donor is subject to an adjustment of the tax benefit. If the disposition occurs in the tax year of the donor in which the contribution is made, the donor's deduction generally is basis and not fair market value. If the disposition occurs in a subsequent year, the donor must included as ordinary income for its taxable year in which the disposition occurs an amount equal to the excess (if any) of (i) the amount of the deduction previously claimed by the donor as a charitable contribution with respect to such property, over (ii) the donor's basis in such property at the time of the contribution.

2) There is no adjustment of the tax benefit if the donee organization makes a certification to the IRS, by written statement signed under penalties of perjury by an officer of the organization. The statement must either (1) certify that the use of the property by the donee was related to the purpose or function constituting the basis for the donee's exemption, and describe how the property was used and how such use furthered such purpose or function; or (2) state the intended use of the property by the donee at the time of the contribution and certify that such use became impossible or infeasible to implement. The organization must furnish a copy of the certification to the donor (for example, as part of the Form 8282, a copy of which is supplied to the donor).

3) A penalty of $10,000 applies to a person that identifies applicable property as having a use that is related to a purpose or function constituting the basis for the donee's exemption knowing that it is not intended for such a use.

4) The provision is effective for contributions made and returns filed after Sept. 1, 2006, and with respect to the penalty, for identifications made after August 17, 2006.

j. Taxpayer Penalties

1) The new law lowers the thresholds for imposing accuracy related penalties on a taxpayer. A substantial valuation misstatement exists when the claimed value of any property is 150% or more of the amount determined to be the correct value. A gross valuation misstatement occurs when the claimed value of any property is 200% or more of the amount determined to the correct value.

2) The new law tightens the thresholds for imposing accuracy-related penalties with respect to the estate or gift tax. A substantial estate or gift tax valuation misstatement exists when the claimed value of any property is 65% or less of the amount determined to be the correct value. A gross estate or gift tax valuation exists when the claimed value of any property is 40% or less of the amount determined to be the correct value.

3) The reasonable cause exception to the accuracy-related penalty does not apply in the case of gross valuation misstatements.

k. Appraiser Oversight

1) A civil penalty applies to any person who prepares an appraisal that is to be used to support a tax position if such appraisal results in a substantial or gross valuation misstatement. The penalty is equal to the greater of $1,000 or 10% of the understatement of the resulting from a substantial or gross valuation misstatement, up to a maximum of 125% of the gross income derived from the appraisal. The penalty does not apply if the appraiser establishes that it was "more likely than not" that the appraisal was correct.

2) The new law eliminates the requirement that the IRS assess against an appraiser the civil penalty for aiding and abetting the understatement of tax before such appraiser may be subject to disciplinary action. Thus, the IRS is authorized to discipline appraisers after notice and hearing.

7. Vehicle Donations [Notice 2005-44]

a. Effective for contributions made after 2004, a donor of a motor vehicle, the claimed value of which exceeds $500, will be required to substantiate the contribution with a contemporaneous written acknowledgement from the donee.

1) The acknowledgement must contain certain specific information about the vehicle and the donor:

a) Donor's name and TIN

b) Vehicle identification number

c) Date of contribution

2) The taxpayer is required to submit the acknowledgment with the taxpayer's return that includes the deduction.

b. To be considered contemporaneous, the written acknowledgement must be provided to the donor by the donee organization within 30 days of:

1) The contribution of the qualified vehicle, or

2) The date of sale of the qualified vehicle by the donee organization if it sells the vehicle without any significant intervening use or material improvement.

c. The amount of the deduction will depend on how the donee organization uses the vehicle.

1) If the charity sells the vehicle without any using the vehicle in any significant way or improving the vehicle, the amount of the charitable deduction cannot exceed the gross proceeds from the sale.

d. After 2004, the charity is required to pass along to the IRS the information in the written contemporaneous acknowledgment that is required to be given to the donor.

1) Charities must report the donation to the IRS on Form 1098-C. A copy of Form 1098-C will suffice as an acknowledgement to the donor.

e. A qualified vehicle includes any:

1) Motor vehicle that is manufactured primarily for use on public streets, roads, or highways;

2) Boat; or

3) Aircraft.

4) It does not include any inventory property.

f. If the donee organization sells the vehicle without any significant intervention use or material improvement, the acknowledgement must include:

1) A certification that the vehicle was sold in an arm's-length transaction between unrelated parties;

2) The gross proceeds of the sale; and

3) A statement that the deductible amount may not exceed the gross proceeds.

g. If the donee organization retains the qualified vehicle for its usage, the acknowledgement must include:

1) A certification stating the intended use of the vehicle or any material improvement intended for the vehicle, and the intended duration of such use; and

2) A certification that the vehicle will not be transferred in exchange for money, property, or services prior to completion of the intended use or improvement.

h. Significant intervening use, depends on the nature, extent, frequency, and duration of the use. Incidental use does not rise to the level of significant intervening use.

i. A taxpayer's deduction is not limited to gross proceeds if the charity sells the vehicle to a needy individual at a price significantly below FMV or give the vehicle to a needy individual.

1) The sale or gift must be made to help a poor and distressed or underprivileged individual in need of transportation.

2) The charity must actually transfer the vehicle to the needy person to have this rule apply.

j. When the charity has significant intervening use or sells the vehicle to a needy individual, taxpayers may use the price listed in a used vehicle pricing guide for private party sales.

1) The IRS intends to issue regs, effective after June 3, 2005, that will bar taxpayers from using the dealer retail value listed in a used vehicle pricing guide as their vehicle's FMV.

k. A donee organization that knowingly provides a false for fraudulent acknowledgment, or that fails to provide a contemporaneous written acknowledgement containing the required information within the prescribed time frame, will be penalized for each such act or failure. Those penalties are as follows:

1) If the donee organization sells the qualified vehicle with any significant intervening use or material improvement, the penalty is the greater of:

a) The produce of the highest rate of tax specified in Sec. 1 and the sales price stated on the acknowledgement, or

b) The gross proceeds from the sale of the qualified vehicle.

2) With respect to other qualified vehicles, the penalty is the greater of:

a) The product of the highest rate of tax specified in Sec. 1 and the claimed value of the vehicle; or

b) $5,000.

l. Rev. Rul 2002-67 sets forth the requirements of when an authorized agent for a charity may receive and sell donated used cars.

1) A qualified charity enters into a written agreement with a licensed car dealer in a valid agency relationship. The car dealer acting as the charity's authorized agent will administer a fund-raising program for the charity for a fee. The car dealer will (1) solicit donations of used cars; (2) accept, process, and sell the cars; (3) transfer the proceeds of the sales to the charity less the fee; and (4) provide each donor with substantiation of that donor's contribution.

2) The holdings of the IRS include: (1) a donor's transfer of a car to a charity's authorized agent may be treated as a transfer to the charity; (2) the contemporaneous written acknowledgment may be provided to the donor by the charity's authorized agent; and (3) a donor may use an established used car pricing guide to determine the fair market value of a single donated car if the guide lists a sales price for a car that is the same make, model, and year, sold in the same area, and in the same condition, as the donated car. The donor must use some other method that is reasonable under the circumstances to determine the value of the car if the guide does not have a sales price for a car in the same condition as the donated car.

m. Some charities have sold donated vehicles at auction and have secured documentation from the auction that the vehicle will be transferred to a needy individual. If a vehicle is sold at auction, the IRS has ruled that the vehicle is not sold or otherwise transferred to a needy individual. The donor's deduction is limited to the charity's gross proceeds from the sale. [IR-2004-145; IR-2005-149]

8. Intellectual Property Donations

a. If a taxpayer contributes a patent or other intellectual property (other than certain copyrights or inventory) to a charitable organization, the taxpayer's initial charitable deduction is limited to the taxpayer's basis in the contributed property or its fair market value, whichever is less.

b. The intellectual property donor is allowed to take an additional charitable deduction based on a specified percentage of the income the donee receives with respect to the donated property.

1) The additional deduction can be taken either in the contribution year or subsequent tax years.

2) The amount of any additional deduction is calculated on a sliding scale.

c. Under temporary regulations, donees will have to give donors 1099s to report royalties on the property. [TD 9206]

9. Conservation Easements

a. Under Sec. 170(h)(1), a "qualified conservation contribution" is statutorily defined as a charitable donation in which:

1) The property is a "qualified real property interest,"

2) The donee is a "qualified organization," and

3) The contribution is "exclusively for conservation purposes."

b. Sec. 170(f)(3) says that a taxpayer generally may not deduct a charitable donation of property consisting of less than the taxpayer's entire interest in that property.

1) Sec. 170(f)(3)(B)(ii) waives the conservation contributions if the taxpayer's donation was an undivided portion of his or her entire interest.

c. The Tax Court ruled that the donation of easements on two parcels of real property to a conservation group met the "exclusively for conservation" test for a "qualified conservation contribution" despite benefits that also flowed to private interests. [Glass, 124 TC No. 16]

1) The Court will resolve the easement's disputed $340,000 valuation later.

10. Earmarked Contributions

a. Generally, gifts to charitable organizations must not be earmarked for a designated purpose to be tax-deductible. It a contribution is earmarked for a particular individual and the charity has no control over use, the contribution is treated as a gift to the individual and not the charity.

b. When contributions are earmarked, the IRS looks to the charity's control and discretion over use of the funds. If the charity has full control and discretion, the contribution will generally to tax-deductible, despite the contributor's hope that the gift will be used for a designated purpose.

c. A charitable organization's vague indication that it will attempt to honor donors' requests does not relinquish it control over the contributions. [Ltr. Rul. 200530016]

1) The charity merely will attempt to honor the donors' requests; it makes no promise it will. The contributions will be deductible as long as the taxpayer keeps full control and discretion over the funds.

11. Charitable Contribution Developments

a. Continuing its assault on abusive trusts, the IRS issued a double set of final regulations designed to shutdown schemes that manipulate charitable remainder and charitable lead trusts. Trust promoters were using seriously ill individuals as the measuring lives of charitable lead trusts. The new regulations limit the class of individuals who may be used as measuring lives. [TD 8923, TD 8926]

b. A college football booster asked the IRS how much he could deduct for leasing a skybox in a college stadium. The Tax Court says payments made to an "institution of higher education" for the right to obtain seating at sporting events are 80% deductible as charitable gifts. It also bars any business deduction for a skybox rental in an amount that exceeds the value of "nonluxury box seats" times the number of seats in the box. The IRS has ruled that when a payment is deductible as a charitable deduction, the business expense limit does not apply. So college football skyboxes--which rent for up to $80,000 a year--are 80% deductible. [TAM 200004001 issued to Rod L. French, R. L. French Corp. Des Moines, Iowa]

This involved a single owner accrual basis S corporation that authorized the payment in year 1 and made the payment in year two. A special rule provides that if a donor makes a payment for both the right to purchase tickets and for the purchase of the tickets themselves, 80% is considered the donation portion. An individual can only take a charitable deduction in the year paid, while an accrual-basis corporation is allowed the deduction in the year accrued, if certain requirements are met. Since the deduction passes through to the shareholder, the deduction is allowed in year 2.

c. In 1999 Section 170(f)(10) was enacted to deny deductions for charitable split-dollar insurance arrangements. These arrangements involve a donor contributing funds to the charity that the charity uses to purchase life insurance in which the donor's family is the beneficiary. The new section requires the charity to pay an excise tax and report certain information regarding the premium payments.

1) The IRS issued Notice 2000-24 explaining information reporting requirements by charities. A new Form 4720, Return of Certain Excise Tax on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code has been issued.

d. Fair market value deduction for donations of appreciated publicly traded stock to private foundations for gifts has been made permanent. [Tax and Trade Relief Extension Act of 1998]

e. The regulations under Sec. 170 require individuals claiming a charitable deduction to obtain a qualified appraisal for nonpublicly traded stock with a claimed value in excess of $10,000. An owner of Jackson Hewitt Tax Service Inc. could not deduct his donation of closely held stock to charity because he failed to obtain an appraisal. The fact that the fair market value was easily determined because the stock changed hands frequently did not eliminate the need for the appraisal. The court also rejected arguments that the taxpayers should be allowed deductions for each year for the $10,000 minimum at which the appraisal requirements kick in. [*J.T. Hewitt*, 109 TC 258 (1997), CA-4 98-2 USTC ¶50,880]

f. The Second Circuit has ruled that the mark-to-market rules require taxpayers to recognize the long-term capital gain portion of commodities futures contracts at the time the contracts were donated to the charity. Section 1256 contracts, which include regulated futures contracts, are those for which profit or loss generally must be determined annually on a mark-to-market basis. Thus, even if a taxpayer owning such a contract has not disposed of it by the end of his or her tax year, the taxpayer is treated as having sold it at fair market value on the last business day of each tax year. Any capital gains arising under this rule are treated as 60% long-term and 40% short term ("60/40 rule"). This gain or loss must be adjusted for prior years' transfers. The donation of these contracts to charity constituted a "transfer" within the meaning of §1256(c)(1) that required the taxpayers to mark the contracts to market and to recognize as taxable income the long-term capital gain portion of the contracts at the time they made the donation. [*Greene v US*, 84 AFTR 2d 99-5108 CA-2]

g. Accrual-basis corporations are allowed to deduct charitable contributions in the prior year if the board of directors authorizes the contribution and the payment is made within 2½ months from the end of the year. Since an S corporation computes its income in the same manner as an individual and the IRC §170(a)(2) election is not available to individuals, the IRS ruled that the S corporation must report the contribution for the year when it was paid, and the shareholder cannot deduct the contribution in the earlier year. [TAM 199908039]

h. The IRS in a letter ruling would allow a taxpayer a deduction even though there would be an increase in value of his remaining property. The taxpayer proposed to create a conservation easement on 100 acres he leased out to a farmer, while he lived on the other five acres. The easement will increase the value of his five acres. The IRS ruling stated that the taxpayer will be entitled to claim a charitable deduction for the amount by which the easement reduces the market value of the 110 acres, minus any amount by which it increases the value of his home. [Ltr. Rul. 199952037]

i. Receipts of token benefits from a charity do not reduce the deduction as long as the value of the benefits do not exceed 2% of the contribution, or $91, whichever is less, or the contribution was at least $45.50 and the only benefit received was a low-cost article worth not more than $9.10. [Rev. Proc. 2007-66]

j. The charitable contribution mileage rate has been increased from $.12 to $.14 after 1997.

k. Normally, the purchase price of a raffle ticket is considered equal to the value of the chance to win, and no deduction is permitted. [Rev. Rul. 67-246] However, the tickets in the university's sweepstakes program were made available to the public without cost by means of a direct mailing campaign. The letter to prospective participants clarified that no contribution was required to participate in the sweepstakes and that making a contribution did not increase the chance of winning. Because the sweepstakes tickets were distributed free of charge to all participants, any contributions were deductible. [Ltr. Rul. 200012061]

l. Tuition paid to a parochial school is not deductible as a charitable deduction. [*Michael Sklar*, TC Memo 2000-118]

m. A landowner conveyed an open-space easement on a 320 acre parcel of land to a charitable organization. The court applied a methodology of comparing the value of the property before the easement and the value after the easement to determine the easement's fair market value for charitable contribution purposes. However, the deduction was limited to basis because the taxpayer owned the property one week short of the one-year holding period required for capital asset status. [*Strasberg*, TC Memo 2000-94]

n. The IRS has issued a legal memorandum (ILM 200007030) stating that a foster parent cannot "double dip" by claiming a dependency deduction for a child and a charitable deduction for any of the child's support.

A taxpayer can claim a dependency deduction for a foster child who is under age 19 or a student under age 24, provided the normal dependency requirements are met. Reg. 1.170A-(1)(g) permits a charitable deduction for unreimbursed expenditures made while rendering services to a charitable organization. Rev. Rul. 77-280 indicates that a foster parent may claim a charitable deduction for unreimbursed expenses incurred in supporting a foster child.

The memorandum concludes that:

1) A foster parent cannot allocate unreimbursed foster care expenses so as to claim both a dependency deduction and a charitable contribution.

2) A foster parent cannot choose between the two types of deductions. If the taxpayer qualifies for a dependency deduction, that is all that is available. In applying the more-than-one-half-support test, payments from a governmental or tax-exempt agency count as support provided by someone other than the foster parent.

3) In some situations, unreimbursed foster care expenditures do not qualify for a charitable deduction.

o. Cardholder Entitled to Charitable Deduction for Nontaxable Rebates

1) A credit cardholder who participates in an "affinity credit card program," offered by a for-profit organization, may be entitled to a charitable contribution deduction. To qualify for the deduction, the participant must have the opportunity to decide whether rebates on his or her card purchases will be make to charity or received personally. There must be substantiation of the contribution by the donee organization if the contribution is equal to or exceeds $250. [Ltr. Rul. 200228001]

p. Religious School Tuition

1) A couple sent their children to a school offering religious education along with traditional instruction. The school gave the parents a letter estimating that 55% of the tuition payments were for religious education. The Tax Court denied the deduction, stating that the parents received value from the education for their children from the tuition. [Sklar, 125 TC No. 14]

q. An investment banker gave an upscale thrift shop designer shoes and dresses she had worn once or twice. Although she filed Form 8283 with the IRS and listed each item, she assumed the clothes barely depreciated. The Tax Court disagreed and slashed the $49,000 deduction she claimed on the items to $9,000. But it let her off the hook for the 20% penalty for negligent understatements of tax. [Stamoulis, TC Summ. Op. 2007-38]

r. In Pub. 561, Determining the Value of Donated Property, the IRS reminds taxpayers that used clothing and other personal items are "usually worth far less" than the amount a taxpayer paid for them. Moreover, "valuation of items of clothing does not lend itself to fixed formulas or methods." The price that buyers of used items actually in used clothing stores, is an indication of value.

1) Household items include furniture, electronics, appliances, linens, and similar items. Excluded are food, paintings, antiques, other objects of art, jewelry, gems, or collections.

s. Baby-Sitting Fees

1) The IRS says that taxpayers cannot deduct baby-sitting fees while volunteering for charity. The IRS stands by a 1973 revenue ruling in which it said the cost is a personal expense and is not deductible as a charitable contribution. [Rev. Rul. 73-597]

2) The Tax Court in a Small Tax Case Division case in 1978 let a mother claim the deduction. Thus, the IRS lost the only court case on the issue. [TC Summ. Op. 1978-74]

t. Extended the charitable contributions deduction for contributions of food to charitable organizations, as well as computer equipment to qualifying schools through 2009.

u. Taxpayers will be able to deduct the difference between the amount paid for the Critical Habitat license plate and a regular Minnesota license plate as a charitable contribution. [INFO 2008-0004]

1) When a taxpayer, with the intention of making a gift, purchases an item of value from a qualified charity, the excess of the payment over the value received is a charitable contribution.

v. The Tax Court denied a charitable deduction to a couple because they lacked proper written acknowledgments from the church for each gift. [Gomez, TC Summ. Op. 2008-93] The couple wrote 10 checks totaling more than $6,000.

w. The IRS has model forms to use for charitable lead unitrusts, which make periodic payments to charity for a set term, with the amount that is received fluctuating depending on the year-to-year value of the trust's assets. Using the model forms help ensure that IRS rules for creating such trusts are satisfied, which is important in order to ensure that the donor who sets up the trust receives an up-front deduction for the value of payments received by the charity. [Rev. Procs. 2008-45 and 2008-46]

x. The IRS has provided donor-advised funds with a guide sheet spelling out what practices may trip up the fund's application for exemption. The guide sheet asks whether the organization sponsoring the fund review donor recommendations for charitable distributions and retains final say in the fund's investment choices. Organizations are asked whether their funds must make minimum annual payouts of at least 5% of assets. [Donor-Advised Funds Guide Sheet Explanation, 7-31-08]

E. Casualty Losses

1. Any uninsured loss arising from fire, storm, shipwreck, or other casualty is allowable as a deduction in the year in which the loss is sustained.

2. The amount of loss to be taken into account is the lesser of either (1) the amount equal to the fair market value of the property immediately before the casualty reduced by the fair market value of the property immediately after the casualty, or (2) the amount of the adjusted basis of the property.

3. Personal casualty and theft losses are deductible as itemized deductions subject to limitations. Business casualty and theft losses are deductible from gross income.

4. Each personal casualty loss must be reduced by $100. In addition, personal casualty loss deductions are limited to that portion of the net losses in excess of 10% of adjusted gross income.

5. The IRS position is that the loss must be the result of sudden, unexpected, identifiable, and provable events of an unusual nature, such as an accident, mishap or sudden invasion by a hostile agency, the cause of which was unknown, or was an unusual effect of a known cause, which occurred by chance and unexpectedly.

6. Federally Declared Disasters

a. Federally declared disaster is any disaster determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

b. Waives the 10% of adjusted gross income limitation for a net disaster loss.

c. Increases the standard deduction by the "disaster loss deduction."

d. For losses occurring after December 31, 2007, and before January 1, 2012.

7. Increases the $100 per casualty limitation to $500 for taxable years beginning after December 31, 2008, and before January 1, 2010.

8. Special five-year carryback period for net operating losses to the extent of a qualified disaster loss.

    a. For Federally declared disasters occurring after December 31, 2007, and before January 1, 2012.

9. Casualty Loss Developments

    a. The casualty loss deduction is limited to the property's cost even though the loss is really greater (as measured by the cost of repairs to the property). [*Cziraki*, TC Memo 1998-439]

    b. The loss is limited to the smaller of the decline in value or the basis of the asset. However, in a District Court case in Utah, the court stated that the deductible casualty loss is limited only to damage linked to a physical disaster. The taxpayer was allowed only $9,000 of expenditures needed to fix the physical damage to the structure, even though the house had declined in value by $200,000 because the house was now in an avalanche zone, restricting its use during the winter (Lund, 85 AFTR2d 2000).

    c. A theft loss was allowed for payment of stock that was never delivered. The taxpayer purchased $300,000 of stock in a closely held corporation, a 49% interest. The stock was never received. The former sole shareholder that had sold the stock later filed bankruptcy. A claim was filed in bankruptcy, but the taxpayers did not receive any funds. The court held that a theft occurred when funds were solicited from taxpayer, payment was received, but there was a failure to deliver stock. [*Willey*, TC Memo 1998-58]

    d. A Brentwood couple, whose home was near the O.J. Simpson house, filed for a $400,000 casualty loss deduction. They claimed that the double murder and media frenzy surrounding the trial of O.J. Simpson caused permanent buyer resistance in their neighborhood that lowered the value of their home by at least $400,000. A casualty loss requires actual physical damage caused by a fire, storm, or other sudden, unusual event. [*Caan*, DC Calif., 99-1 USTC ¶50,349]

        1) The Tax Court arrived at the same result in *Chamales*, TC Memo 2000-33. The decline in value did not constitute a sudden and unexpected event as required by Sec. 165(c)(3).

    e. The casualty loss deduction allowed with respect to the theft of a sculpture given to the taxpayer by his father, who had inherited it from the taxpayer's grandfather, was limited to its fair market value on the date of the grandfather's death. *[Vitale*, TC, CCH Dec. 53,503(M)]

    f. The IRS issued Notice 99-2, where the Service will abate, for the period of extension, the assessment of interest on federal income tax for taxpayers who are located in a Federally declared disaster area and are granted an extension of time to file federal income tax returns. This was initially a non-Code provision of the Taxpayer Relief Act of 1997. The provision only applied to disasters declared during 1997. The Tax and Trade Relief Extension Act of 1998 added 1998 to the law. Notice 99-2 now covers all tax years beginning after 1997.

g. When a business's property is damaged by a casualty such as a fire or flood, the business can claim a casualty deduction for the decline in the property's value, and a business expense deduction for the cost of restoring the property. IRS counsel advised the IRS agent that the cost of repairing the property could be used as a measure of the casualty loss deduction, and be deducted itself as a business expense. [IRS Legal Memorandum, 11-24-98]

h. A state made grants to home owners who were forced to incur debt to repair hurricane damage. The IRS has ruled that the grants were "general welfare" payments by the state, so they are tax free and not even subject to information reporting. [IRS Technical Assistance 200016019]

    1) Catch: Home owners will have income to the extent that a grant compensates them for any damage they previously deducted as a casualty loss.

i. Wood Rot

    1) The deck on a couple's residence collapsed because the wood had rotted. Their insurer did not pay because the policy did not cover losses from rot. The Tax Court denied their casualty loss deduction because the loss was caused by progressive deterioration. [Francis Leonard, TC Summ. Op. 2005-114]

j. An income tax deduction cannot be taken for a blown-down tree on residential property in most cases. No basis allocation is made to individual trees when a home is purchased. The casualty loss deduction is limited to the decline in value of the home without the tree, not the total cost of replacing it.

k. A couple was not permitted to claim a theft loss deduction for poor workmanship in the construction of their home where they could not demonstrate fraudulent intent on the contractor's part. [Wanchek, TC Memo 2007-366] The evidence did not show that the contractor ever intended to defraud the Wancheks. There were "simply the victims of poor workmanship, which, without more, is not a crime."

    1) Any of the additional monies paid to effectuate repairs (or, as part of the legal process) would only increase the overall basis of the home.

l. The IRS announced that while taxpayers may voluntarily reduce a casualty loss deduction by expected reimbursements to be received after the end of the tax year, the IRS is limited on examination of the loss to the facts and circumstances that have occurred as of the end of the tax year in which the loss is claimed. [CCA 2007-50016]

    1) If the loss was not reduced by the reimbursement, the taxpayer must include it as taxable income in the year received to the extent of any tax benefit originally generated by the deduction.

F. Gambling Losses

1. The IRS has ruled that the receipt of lottery winnings over a period of years qualifies as gambling winnings in each year of receipt. Thus, the taxpayer's gambling losses were deductible to the extent of winnings. [Ltr. Rul. 9808002]

2. In a related item on gambling, the Ninth Circuit stated that a professional gambler was not entitled to deduct business losses in excess of winnings, in spite the fact he had engaged in wagering as a trade or business. [*Kent*, CA-9, 99-2 USTC ¶50,608] The Supreme Court has denied certiorari.

3. An individual whose gambling activities did not constitute a trade or business and who claimed the standard deduction on his tax return was denied an additional deduction for a gambling loss that he sustained during the tax year. [*Torpie, Jr.*, TC, CCH Dec. 53,893(M)]

4. A taxpayer's sweepstakes winnings in a "no purchase necessary" contest were not Sec. 165(d) gains from wagering because the taxpayer did not give consideration to participate in the contest. The IRS ruled that envelopes, stamps, and the taxpayer's time did not equate to consideration. The taxpayer was denied a deduction for wagering losses from other activities. [TAM 200417004]

   a. Under Sec. 165(d), losses from wagering transactions are allowed only to the extent of gains from wagering transactions. To be eligible for offset against wagering losses, wagering gains must occur in the same year as the losses.

   b. For a transaction to be a "wager" three elements must be present: (1) prize, (2) chance, and (3) consideration. The taxpayer's costs of postage, envelopes, and his time were not consideration.

5. Taxpayer may combine his share of the partnership's wagering gains or losses with is personal wagering gains and losses in calculating his deductible wagering losses under Sec. 165(d) of the Code. [Ltr. Rul. 200725036]

6. The Court of Federal Claims recently ruled against taxpayers who claimed theft loss deductions under Sec. 165(e). The court found that the taxpayers' claimed losses, based on the estimate of what they would not recover through litigation, were premature and did not qualify for the deduction. A theft loss deduction could only be allowed upon final resolution of taxpayer's recovery efforts.

   a. The taxpayers were victims of a fraud scheme through which they lost $78 million. They determined that they would recover only $20 million of the total theft loss and filed an amended tax return with a $58 million theft loss deduction. They were still involved in litigation to recover the stolen funds. In fact, they received $20 million in excess of their estimated amount of recovery.

   b. The count found that, although the estimate allowed taxpayers to determine that they had a reasonable prospect for recovering the funds, it did not allow them to ascertain with reasonable certainty that they would only recover $20 million of the theft loss. The taxpayers could only ascertain the total amount of their theft loss with reasonable certainty when the recovery process was finalized.

G. Miscellaneous Itemized Deductions

1. Employee Bad Debts

a. An employee-shareholder was entitled to a bad debt deduction for discharged loans he made to his corporate employer. The employee made the loans to his corporate employer in order to maintain his employment; therefore, they were made in the course of his trade or business of being an employee. However, because an employee may not deduct items connected wit the performance of his services as an employee as an adjustment to income, his dab debt was deductible as a miscellaneous itemized deduction subject to the 2% floor. [Kenneth W. Graves, TC Memo 2004-140]

b. Employee business expenses are deductible as a miscellaneous itemized deduction subject to the 2% limitation. This deduction is added back in computing the AMT.

2. In Rev. Rul. 92-29, the IRS held that the properly allocable portion of tax preparation costs relating to the preparation of Schedules C, E, or F is deductible in computing adjusted gross income. The IRS also held that the same holds true for cost incurred to resolve asserted tax deficiencies against items reported on these schedules.

3. A taxpayer itemized his income tax audit-related trips to include miles for meeting with IRS personnel, trips to the library to research tax information, and trips to copy documents related to the audit. The Tax Court sided with the taxpayer, allowing a deduction for all of his car usage. [Stussy, TC Memo 3003-232]

4. Rural Letter Carriers

a. If the reimbursements a rural letter carrier receives from the U.S. Postal Service fall short of the carrier's actual costs, the costs in excess of reimbursements qualify as a miscellaneous itemized deduction subject to the 2% floor.

1) Effective for taxable years beginning after December 31, 2003.

2) Under prior law (Sec. 162(o)) carriers were not allowed a deduction for the excess expenses.

5. Golf Club Membership

a. A high school golf coach cannot deduct a golf club membership, even though his team was permitted to practice at the club because he was a member. Despite the fact there is a business purpose for the dues, they are not deductible. [Garcia, TC Summ Op 2005-2]

1) Not even a golf pro can deduct club dues.

6. Employee Business Expenses

a. A clergy member was required to allocate his employee business expenses incurred in the exercise of his ministry between exempt and nonexempt income. [Young, TC Summ Op 2005-76]

1) Because 54% of his ministry salary was his parsonage allowance, 54% of his Schedule A deductions were rendered nondeductible because of Sec. 265.

2) The 2% AGI limitation applied to the remaining amount.

7. Developments

   a. The Tax Court allowed a shareholder of two corporations to deduct legal expenses attributable to regaining possession of the corporations after his wife obtained an ex parte order of protection giving her emergency possession of both corporations. The Tax Court observed that the taxpayers' legal expenses are deductible if the origin of the claim arose from their profit seeking activities, rather than the husband's personal activities. In this case, the husband's legal fees were incurred to establish his right to possess or participate in the income from the corporations, and therefore arose from his profit-seeking activities. [*Liberty Vending, Inc.* TC Memo 1998-177]

   b. Legal fees for defending against racketeering charges are deductible even though the underlying activity is illegal since the payment of the fees themselves is not illegal. [*DiFronzo*, TC Memo 1998-41] However, any fines or penalties that may be incurred are not deductible.

   c. Taxpayer was allowed to deduct a portion of legal expenses incurred during a divorce action that were allocable to the issue of entitlement to alimony. The inclusion of taxable alimony on her return and the production of her attorney's billing records established that a portion of her legal fees were attributable to the alimony issue. Her allowable deduction was calculated under the Cohan rule. [*Schafler*, TC Memo 1998-86]

   d. Legal expenses to defend a charge of sexual assault by a chief financial officer were not deductible. Following company policy that encouraged employees to arrange for complimentary hotel rooms for patrons of its resorts who were intoxicated, the taxpayer obtained a room for three women. The purported sexual assault occurred during his second trip to the hotel room, and the second trip had no business purpose. [*Kelley Jr.*, TC Memo 1999-69]

   e. Katia Popov plays violin with the Los Angeles Chamber Orchestra and is required to wear black clothing. She deducted $1,296 for the cost of her playing wardrobe of black skirts, pants, shoes, and sequined blouses. The IRS disallowed the deduction because the clothing was also suitable for every day wear. The Tax Court sided with the IRS except for the cost of sequined blouses and formal dresses. These were not considered adaptable for general and personal wear. [*Popov*, TC Memo 1998-374]

   f. A nurse was allowed to deduct the cost of nurse's uniforms and cleaning. The nurse was not allowed a deduction for shoes that were athletic shoes suitable for wear outside of work. [*Fontanilla*, TC Memo 1999-156]

   g. Work clothes, work shoes, safety glasses, and work-related equipment were deductible by a U.S. Navy engineer. [*Cotton, Jr.*, TCM Dec. 54,100(M) 10-30-2000]

   h. Attorney's fees paid by a real estate operator were itemized deductions, not Schedule C deductions, where the real estate activities did not amount to a business. [*Douglas*, TC Memo 1998-165]

   i. Legal fees relating to the ownership of stock in a family business are not deductible but, instead, are added to the basis of the stock. [*Lange*, TC Memo 1998-161]

j. The Ninth Circuit denied a deduction for college courses in organizational behavior taken by a correctional officer. The taxpayer did not intend to enter the field of organizational behavior or obtain a degree. The court, however, said that the tax treatment of education costs depends on what the taxpayer could do with the education -- not what he intends to do with it. In this case, if the taxpayer completed the entire program, he could qualify for a job as a human resource specialist, which would be a new trade or business. [*H.J. Meeks*, 2000-1 USTC ¶50,264, CA-9]

k. Taxpayers are allowed to take a deduction in connection with determining the extent of tax liability or in contesting a tax liability. The IRS ruled that a deduction is not allowed for the expenses involved in paying that liability. The fee is a nondeductible personal expense as is viewed as a fee in a transaction unrelated to a determination of tax liability. [SCA 200115032]

l. Legal fees incurred in connection with child custody litigation are nondeductible. There was not a profit motive. [*Rupert*, TCM 7-20-2001]

m. When an heir is a spouse and the estate marital deduction results in no estate tax being due, the IRD deduction is still available based on the "hypothetical" taxable estate of the deceased. [Ltr. Rul. 200316008]

n. An employee traveled for business during a time when his firm required prior approval before reimbursing expenses. The worker assumed he would not be reimbursed, so he wrote off the costs. The Tax Court said they cannot be deducted: He never gave the firm a chance to say no. [Contreras, TC Memo 2007-63]

o. U.S. Navy enlisted personnel, as well as naval officers, who are on permanent duty aboard a ship can deduct unreimbursed expenses for travel away from the ship. [CCM 200750017]

   1) A naval vessel in dry dock is not the tax home of its crew for those purposes.

p. The Tax Court held that an unemployed electrical engineer was prohibited from claiming deductions for expenses related to attending a week-long course to improve his day-trading activities. [Jones III, 131 TC No. 3]

   1) The taxpayer admitted that he was not in the trade or business of day trading.

   2) Sec. 247(h)(7) specifically provides that no deduction is allowed under Sec. 212's investment-related expense provisions for expenses allocable to a convention, seminar, or meeting.

Chapter 14 - Tax Credits

A. Child Tax Credit

1. For taxpayers having qualifying dependents under age 17.

    a. Son, daughter, adopted child, grandchild, stepchild, foster child

2. Credit is $1,000 per child for 2012.

3. Credit phases out when modified adjusted gross income exceeds $75,000 for singles ($110,000 on a joint return).

    a. Credit reduced by $50 per $1,000 (or fraction of $1,000) of adjusted gross income in excess of $110,000.

4. At least a portion of the child credit is refundable for all taxpayers with qualifying children, regardless of the amount of the taxpayer's regular tax or alternative minimum tax.

    a. For tax year 2012, the credit is refundable to the extent of 15% of the taxpayer's earned income in excess of $3,000, up to the per child credit amount.

        1) The supplemental child credit has been repealed.

        2) Taxpayers with three or more children may calculate the refundable portion of the credit using the excess of their social security taxes over the earned income credit, instead of the 10% amount, if it results in a greater refundable credit.

    b. The nonrefundable child tax credit must be reduced by the amount of the refundable child tax credit.

    c. Combat pay is included in earned income for purposes of computing the refundable portion of the child tax credit.

B. Earned Income Credit

1. Earned income credit percentages and thresholds for 2012 have been adjusted for inflation. [Rev. Proc. 2011-52]

Number of Children	Amount of Credit	Credit Percentage	Maximum Earnings	Phase Out Percentage	Maximum Income
1	$3,169	34.	$9,320	15.98	$36,920
2	$5,236	40.	$13,090	21.06	$41,952
3 or more	$5,891	45.	$13,090	21.06	$45,060
0	$ 475	7.65	$6,210	7.65	$13,980

2. The phaseout for married couples filing jointly is $5,210 higher

3. In order to reduce the marriage penalty, the beginning and the end of the phaseout range for joint filers has been increased as follows:

    a. By $1,000 for tax years 2002, 2003, and 2004

    b. By $2,000 for tax years 2005, 2006, and 2007

    c. By $3,000 for tax years 2007 and 2008

    d. By $5,000 for tax years after 2008 indexed for inflation

4. Earned income limited to taxable income

    a. The definition of earned income has been revised to exclude all forms of nontaxable employee compensation.

        1) Nontaxable income items formerly qualifying as earned income:
        Salary deferrals such as contributions to a 401(k) or 403(b) plan
        Salary reductions under a cafeteria plan
        Mandatory contributions to a state or local retirement plan
        Military housing and subsistence allowances and nontaxable combat pay
        Meals and lodging provided by the convenience of an employer
        Dependent care and adoption benefits
        Educational assistance benefits

    b. The earned income credit will be calculated based on the individual's adjusted gross income plus net earnings from self-employment.

        1) Parsonage allowance is included in self-employment income.

    c. Relationship test broadened to include descendants of stepchildren

    d. Combat pay is included in earned income for purposes of computing the earned income credit. [Sec. 32(c)(2)(B)]

    e. Qualifying children are now defined as children, stepchildren, siblings, stepsiblings, or descendants of any of these, in addition to eligible foster children.

        a) Prior to the change, the definition of qualifying children did not include descendants of stepchildren

        b) The revised definition of a qualifying child is the uniform definition of a qualifying child recommended by the Joint Committee on Taxation. They recommended that the same definition of qualifying child should be adopted for the dependency exemption, the child credit, the dependent care credit, and head of household filing status.

    f. The one-year residency requirement for eligible foster children has been eliminated.

        1) All qualifying children will be required to live with the taxpayer for more than six months during the year.

g. A new tie-breaking rule will be used to determine which individual may claim a qualifying child if the child is a qualifying child for more than one individual.

1) Instead of allowing the individual with the highest adjusted gross income to claim the child, the parent of the child will be given the first priority in claiming the child.

a) Example: Grandmother has earned income of $35,000. Mother has earned income of $10,000. Mother and child live with grandmother. Grandmother was the qualifying individual for the earned income credit. Her income was too high to qualify for the earned income credit.

2) If neither competitor is the parent of the child, the claim will be awarded to the individual with the highest adjusted gross income.

3) If two individuals claiming the same qualifying child are both the parents of the child, then the parent with whom the child resided the longest during the year will be able to claim the child. If this test results in a tie, then the parent with the highest adjusted gross income will be entitled to claim the child.

h. The earned income credit is not reduced by the amount of the individual's alternative minimum tax liability.

5. The disqualified unearned income threshold for 2012 is $3,200.

a. Disqualified income has been expanded to include an individual's capital gain net income and the excess of aggregate passive income over aggregate passive losses; disqualified income includes interest (taxable and nontaxable), dividends, net rental and royalty income, net capital gain income, and net passive income that are not self-employment income. Nontaxable distributions from pensions, annuities, and individual retirement accounts are added back to AGI. Trustee-to-trustee transfers and rollover distributions are not added back to AGI.

b. In Rev. Rul. 98-56, the IRS announced that investment income should not include long-term capital gains from the sale of business property. This means that taxpayers may be able to file amended returns for previous years if they included a business long-term capital gain in their investment income for earned income credit purposes.

6. The earned income tax credit will be denied to individuals not authorized to be employed in the United States effective for returns after 1996.

7. Individuals who fail to include their taxpayer identification number and, if married, their spouse's TIN on their tax return will be ineligible for the EIC; TIN is defined as a social security number.

a. Omission of a TIN will be treated as a mathematical or clerical error.

b. Failure by an individual claiming the EIC with respect to net earnings from self-employment to pay the proper amount of self-employment tax on such earnings will be treated as a mathematical or clerical error for purposes of the amount of credit allowed.

c. Jurors' fees are neither earned income nor income from self-employment. They cannot be considered "earned income" for purposes of calculating the earned income tax credit. Jurors are neither employees nor engaged in a "trade or business," but rather are exercising a civic duty. [IRS Service Center Advise, SCA 200028035]

8. A taxpayer who fraudulently claims the earned income credit is ineligible to claim the credit for 10 years.

   a. Reckless or intentional disregard of rules or regulations makes an individual ineligible for the earned income credit for two years.

   b. The disallowance sanction is imposed in addition to any other penalties imposed, such as the accuracy-related penalty or the fraud penalty.

   c. A taxpayer who has been denied an earned income credit may not claim the credit in any future tax year unless the taxpayer provided the IRS with evidence of eligibility for the credit.

9. In the paid preparer area, the Treasury has issued temporary and proposed regulations regarding the due diligence penalty. [NPRM REG-120168-97] However, the regulations more or less follow Notice 97-65 issued in late 1997. This penalty is $100 for each failure to comply with due diligence requirements in determining a taxpayer's eligibility for, or the amount of, the earned income credit. To avoid the penalty, the preparer must:

   a. Complete the Eligibility Checklist or record the information necessary to complete the Eligibility Checklist.

   b. Complete the Computation Worksheet or record the information necessary to complete the Computation Worksheet.

   c. Have no knowledge, and have no reason to know, that any information used in determining eligibility for, and amount of, the EIC is incorrect.

   d. Retain for three years the checklist, worksheet, and other records used to determine eligibility for and the amount of the EIC.

10. For tax years beginning after 1998, the proper checklist will be Form 8867.

11. A preparer may avoid the penalty for a particular return or claim for refund if it can be demonstrated to the IRS's satisfaction that, considering all the facts and circumstances, normal office procedures are reasonably designed and routinely followed to ensure compliance with the due diligence requirements, and that the particular failure was isolated and inadvertent. [Reg. 1.6695-2T©]

12. Earned Income Credit Developments

   a. The earned income credit cannot be claimed by a child with a dependent parent. A daughter with $12,000 in income who took care of her permanently and totally disabled mother was not eligible for the earned income credit. The argument was not accepted that the mother qualified as a foster child of the daughter. [IRS Service Center Advice 199992044]

b. The Tax Court issued several unusual related memorandum decisions on the earned income tax credit. The cases involved five prisoners who attempted to claim the EITC on the money they had obtained from "begging." The Florida inmates claimed that money they solicited from family and friends was earned income from begging. In each case, the prisoner's taxable income was insufficient to result in a tax liability. The court found the amounts received by the inmates were gifts and not income. The EITCs were not allowed. Section 32(c)(2)(B)(iv) states that any income earned for services provided by an inmate in a penal institution is not "earned income" for the purpose of the EITC. In its rulings the court addressed the begging issue for all taxpayers--in or out of prison. [*Pradel Lucas*, TC Memo 1999-321, *John Walter Wolf*, 1999-320, *Alfredo Dominequez*, 1999-319, *Floyd Daniel Jr.*, 1999-318, *Miguel A. Bauta*, 1999-317]

c. Although taxpayers claiming the earned income credit are usually required to live with their children more than six months of the year, the Tax Court said the requirement did not apply to a mother who spent seven months in jail. The court decided her incarceration was a temporary absence from the home that qualifies for a waiver under the credit rules. [Rowe, 128 TC No. 3]

C. Dependent Care Credit

1. The IRS has issued final regs for the child and dependent care tax credit. [T.D. 9454]

a. Expenses for a child in kindergarten or a higher grade are primarily for education and not for care and are not employment-related expenses. Additionally, summer school and tutoring programs are not for care. The cost of overnight camp does not qualify.

b. Dependent care expenses for a period in which the taxpayer is absent from work are not employment-related expenses. Under the proposed regs, the cost of care had to be allocated on a daily basis if expenses are paid for a time only part of which the taxpayer is employed. The proposed regs provided an exception to the allocation requirement for a short and temporary absence from work, such as a vacation or hospital stay. The final regs include a safe harbor that treats an absence of no more than two consecutive calendar weeks as a short, temporary absence.

c. Employment taxes are employment-related expenses if such taxes were paid with regard to wages that are employment-related expenses. Also, the additional cost for a caregiver's room and board are employment-related expenses.

1) An increase in utilities such as electric, water, and gas may be employment-related expense

d. The regs clarify that the dollar limit of $6,000 for taxpayers taking into account employment related expenses for more than one qualifying individual may be applied in unequal proportions.

e. A credit may be taken in the tax year in which the services are provided or in the taxable year in which the expenses are paid, whichever is later, regardless of accounting methods.

f. Expenses for pre-school or other pre-kindergarten programs are allowed as employment-related expenses if they otherwise qualify, even though education may be a big part of these programs.

g. Specialty day camps qualify for employment-related expenses. Specialty day camps refer to camps that focus on one activity, like soccer or computer.

1) Overnight camps are still not included, with no pro-ration of expense for day and night supervision.

h. Transportation provided by a dependent care provider may be an employment related expense if all other requirements are met. This includes transportation to a day camp or after-school activity.

1) Transportation costs incurred by a qualified individual in getting from the taxpayer's household to a care provider are not allowed as employment related expenses.

D. Foreign Tax Credit

1. Carryover

a. A 10-year carryover of the foreign tax credit and a one-year carryback period. (Formerly back two years and forward 5 years.)

b. The AMT foreign tax credit is 100% for tax years beginning after December 31, 2004.

2. An individual with $300 or less of creditable foreign taxes is exempt from the foreign tax credit limitation, provided there is no foreign source income other than qualified passive income reported on Form 1099, such as from interest, dividends, or royalties, and the foreign taxes withheld from your income ($600 for joint filers).

a. Applies for tax year after 1997.

b. Elective for each tax year.

3. You do not have to file Form 1116 to take the credit if all five the following apply:

a. All of your gross foreign-source income is from interest and dividends and all of that income and the foreign tax paid on it is reported to you for Form 1099-INT or Form 1099-DIV (or substitute statement).

b. If you have dividend income from shares of stock, you held those shares for at least 16 days.

c. You are not filing Form 4563 or excluding income from sources within Puerto Rico.

d. The total of your foreign taxes is not more than $300 (not more than $600 if married filing jointly).

e. All of your foreign taxes were:

1) Legally owed and not eligible for a refund, and

2) Paid to countries that are recognized by the United States and do not support terrorism.

E. Work Opportunity Credit

1. New work opportunity credit replacing the old targeted jobs credit for those hired from October 1, 1996, through August 31, 2011.

    a. Categories have been modified and the credit percentage has been reduced to 40% of first year wages up to $6,000, or $3,000 for summer youth.

2. Credit was modified for individuals who began work after September 30, 1997.

    a. Credit is 40% of qualified first-year wages for those performing 400 or more hours of service and 25% for those performing at least 120 hours but less than 400 hours of service.

3. The "Welfare-to-Work Credit" became part of the Work Opportunity Credit in 2007.

    a. Credit is 35% of the qualified first-year wages and 50% of qualified second-year wages.

    b. Credit applies only to the first $10,000 of wages in each with respect to any individual.

    c. Employees must qualify as long-term family assistance recipients.

4. Taxpayers are not allowed the targets jobs credit until it has received certification of an employee's status. However, the certification process was slow in many states and, in many others, discontinued after the targeted jobs credit expired in 1994. The IRS in Announcement 2000-58, IR-2000-48, stated its willingness to settle pending targeted job tax credits refund claims for 50% of the credit claimed. Even though the IRS lost on this issued in Perdue Farm, Inc. (DC Md, 6-14-99), they have taken a hard-line position. Employers must show satisfaction of all the targeted jobs tax credit requirements, with the exception of the certification requirement.

F. General Business Credit

1. For tax years beginning after August 5, 1997, the general business credit carryback becomes one year and carryforward becomes 20 years.

G. Adoption Assistance Credit and Exclusion

1. A nonrefundable tax credit is allowed for up to $12,650 (2012) of qualified adoption expenses per child.

    a. Qualified expenses include adoption fees, court costs, attorney fees, and other expenses related to the legal adoption of an eligible child.

    b. Employees are entitled to exclude from income up to $12,650 (2012) of adoption expenses per adopted child where such amounts are paid or incurred by their employers under a qualified adoption assistance program.

2. Credit and exclusion are phased out beginning at modified adjusted gross income levels between $189,710 and $229,710 (2012).

3. Expenses may include the cost of construction, renovations, alterations, or purchases specifically required by the state to meet the needs of the child; the increase in basis of the property that would result from such an expenditure must be reduced by the amount of credit allowed.

4. Expenses incurred in carrying out a surrogate parenting arrangement or in adopting a spouse's child do not qualify for the credit.

5. The credit is taken in the year of adoption and includes expenses incurred in previous years but not expenses incurred prior to 1997.

6. A carryforward period of five years is allowed for any credit disallowed because of limitation based on tax liability.

7. Example. A married couple incurs $14,000 in 2012 in adoption expenses for a child. Their modified adjusted gross income is $214,710. They would be allowed a credit of $4,744 ($12,650 - (($214,710 - $189,710)/$40,000) x $12,650).

8. Child must be under 18 or incapable of self care.

9. A credit is allowed for adoption expenses paid or incurred in an unsuccessful effort to adopt an eligible child who is a citizen or a resident of the United States at the time the adoption commenced. [Notice 97-70, 1997-49 IRB 9]

10. Temporary regulations allow the IRS to assign an ATIN (adoption taxpayer identification number) to a child in the process of being adopted. [T.D. 8739, 11-97]

11. Foreign-Born Children

    a. The IRS has issued guidance creating safe harbors for taxpayers claiming tax credit for expenses directly related to the adoption of a foreign-born child. [Rev. Proc. 2005-31]

    b. The benefits under the procedure apply specifically to foreign-born children who have been granted an "immediate relative" visa, which is a visa given only to foreign-born children to enter the US under an adoption decree or a decree of guardianship.

    c. Qualifying expenses include "reasonable and necessary expenses" of adoption fees, court costs, attorney's fees, traveling expenses including meals and lodging while away from home, and other expenses "directly related to, or for the principal purpose of" legally adopting an eligible child; and expenses that would otherwise qualify relating to "re-adopting" the child in the taxpayer's home state will be treated as "ordinary and necessary" for purposes of the credit.

    d. A foreign-born child who receives an IR2, IR3, or IR4 "simple adoption" visa, the "immediate relative" visas, will be treated as finally adopted for purposes of claiming the Sec. 23 tax credits and Sec. 137 exclusions from income in two ways:

        1) The year that a competent foreign authority, a court or governmental agency, which has authority to render decisions about child welfare enters a decree of adoption will qualify for the year of final adoption; and

        2) The year in which a state enters a decree of "re-adoption" or other order recognizing the adoption decree from the child's foreign home country will suffice as the year of final adoption.

e. The tax rules for a domestic adoption are much more lenient. The credit is available in the year when the costs are paid and can be taken for failed adoptions.

12. The credit and exclusion have been made permanent.

13. The nonrefundable adoption credit offset against the alternative minimum tax has been made permanent.

14. Credit figured on Form 8839.

H. Increased Research Credit

1. The research tax credit is extended to amounts paid in 2008 through 2011.

   a. The simplified credit is increased to 14% and the alternative incremental research credit is repealed.

2. Expansion of Research Credit

   a. A new provision provides that a taxpayer may claim a credit equal to 20% of amounts paid or incurred by the taxpayer during the tax year to an energy research consortium. [Sec. 41(a)(3)]

   b. The Energy Act provides that 100% of the amounts paid or incurred by the taxpayer to an eligible small business, a university, or a Federal laboratory for qualified research which is energy research constitutes contract research expenses.

I. Low-Income Housing Credit

1. Credit is not affected by the receipt of below market loans from FEMA to repair or reconstruct low-income housing units damaged by a natural disaster.

2. Proposed regulations have been issued on the eligibility of a low-income unit within a project when the income of the renter exceeds the 140% of income limitation.

J. New Markets Credit

1. The new markets tax credit is extended through December 31, 2009.

K. FICA Tax Credit for Unreported Tips

1. The tax credit for certain FICA taxes paid by an employer of an employee's tips is available whether or not the employee actually reported the tips. [Small Business Act]

2. The Small Business and Work Opportunity Act of 2007 provides that the amount of the tip credit is based on the amount of tips in excess of those treated as wages of the FLSA as in effect on January 1, 2007. The tip credit is determined based on a minimum wage of $5.15 per hour. Therefore, if the amount of the minimum wage increases, the amount of the FICA tip credit will not be reduced.

   a. Example. Alexi averages $7.00 an hour in tips. This amount is added to her cash wage of $2.13 an hour. That equals $9.13. Employers subtract the old minimum wage of $5.15 an hour. The result is $3.98 ($9.13 - $5.15) which is then multiplied by the employer FICA tax rate of 7.65% and yields a tip tax credit of $0.304 an hour for that employee.

L. Credit for Employer-Provided Child Care Expenses (Sec. 45F)

1. A new credit for child care expenses has been created as an incentive for businesses to provide child care for their employees.

    a. The credit is equal to 25% of the qualified child care expenses plus 10% of the qualified child care resources and referral expenditures.

    b. The total credit claimed for any given year cannot exceed $150,000.

    c. The employer-provided child care credit is made part of, and subject to, the limitation and carryover provisions of the general business credit.

    d. Qualified Child Care Expenses

        1) To acquire, construct, rehabilitate, or expand property which is to be used as a qualified child care facility of the taxpayer,

        2) For the operating costs of a qualified child care facility, including the cost related to the training of employees, scholarship programs, and providing increased compensation for employees with high levels of child care training, or

        3) Under a contract with a qualified child care facility to provide child care services to the taxpayer's employees.

    e. If an employer terminates its interest in providing child care, all or part of the claimed credit must be recaptured as an increase in tax.

        1) The applicable percentage for calculating the increase in tax:

If the recapture event occurs in	The applicable recapture percentage is
Years 1-3	100
Year 4	85
Year 5	70
Year 6	55
Year 7	40
Year 8	25
Year 9 and 10	10
Years 11 and thereafter	0

    2) The basis of the qualified property must be reduced by the credit claimed. The same expenses cannot be claimed for any other deductions or credits.

        a) If a recapture event occurs, the amount of the increase in tax or any adjustments in carrybacks or carryover is added to the taxpayer's basis in the property just prior to the recapture event.

    f. This credit may be claimed for tax years beginning after 2001.

M. Credit for Health Insurance for Displaced Workers

1. Trade Act of 2002

2. Provision allows an expected 100,000 displaced workers advance refundable tax credits worth $4.8 billion over 10 years to purchase health insurance.

3. Workers dislocated from their employment by foreign trade. Individual must be one of the following:

   a. Trade Adjustment Assistance (TAA) recipient,

   b. Alternative TAA recipient, or

   c. Pension Benefit Guaranty Corporation pension recipient.

4. For an eligible worker the tax credit is up to 65% of the premium cost, with no dollar limit. Eligibility for the credit is determined on a monthly basis as of the first day of the month. The credit must be used to continue COBRA coverage, to obtain coverage under a spouse's insurance policy, or to purchase insurance in state-run health-care arrangements, generally administered for state employees.

5. Workers cannot use the funds to purchase individual policies unless they were covered under such a policy during the entire 30-day period ending on the date that they lost their jobs.

N. Disabled Access Credit

1. Sec. 44 allows a credit for expenditures made to comply with the Americans with Disabilities Act (ADA) accessibility rules. To claim the disabled access credit, a taxpayer must be engaged in a trade or business and must be an "eligible small business."

2. An "eligible small business" has either gross receipts that did not exceed $1 million for the preceding tax year or did not employ more than 30 full-time employees during the preceding tax years.

3. Eligible access expenditures are amounts paid or incurred by a small business to comply with the ADA. These expenditures include amounts paid or incurred to:

   a. Remove barriers to physical access or communication;

   b. Furnish qualified interpreters or readers for persons with hearing or visual impairments;

   c. Modify equipment; or

   d. Supply similar materials or services.

4. The credit is 50% of the amount spent on measures to make a business accessible to individuals with disabilities. The credit is for expenditures over $250, but not more than $10,250, in the tax year.

5. Disallowed Expenditures [CCA 200411042]

   a. A business cannot claim the disabled access credit if it is already in compliance with the ADA's accessibility rules.

      1) For example, the costs of upgrading or improving an accessibility aid or service generally are not eligible for the disabled access credit.

      2) Determination of whether a small business is already ADA compliant is based on the particular facts and circumstances of that business.

   b. The disabled access credit cannot be claimed each tax year, for multiple tax years.

      1) For example, the cost of annual subscriptions to services or materials used for accessibility are ineligible for the credit upon the subscription's renewal.

   c. The cost of making a web site more handicapped accessible does not qualify.

6. Developments

   a. An optometrist spent $17,000 on equipment that measures eyesight automatically, allowing him to diagnose disabled persons. He claimed the maximum $5,000 disabled access credit for the equipment. The optometrist used the equipment on all patients. The Tax Court allowed the credit because there is no exclusive-use test for the credit--a wheelchair ramp can be used by anybody. [David B. Hubbard, TC Memo 2003-245]

O. Residential Energy Property Credit

1. A tax credit of up to $500 is available to individuals for nonbusiness energy property, such as residential exterior doors and windows, insulation, heat pumps, furnaces, central air conditioners, and water heaters. [Sec. 25C]

2. The credit applies to qualified energy efficiency improvements and qualified energy property placed in service in 2006 and 2007.

3. The credit is equal to :

   a. The residential energy property expenditures plus

   b. 10% of the cost of qualified energy efficiency improvements installed during the year at the taxpayer's principal residence in the United States.

4. The qualified expenditures must be made to the taxpayer's principal residence located in the United States.

5. The credit is limited to a maximum of $500 for all tax years, subject to the following specific credit amount limits:
   a. $200 for window components;
   b. $50 for an advanced main air circulating fan;
   c. $150 for any qualified natural gas, propane, or oil furnace or hot water boiler; and
   d. $300 for any item of energy-efficient building property.

6. Eligible improvements include:
   a. Insulation materials;
   b. Exterior windows, including skylight;
   c. Exterior door;
   d. Metal roofs with special pigmented coatings;
   e. Electric heat pump water heaters;
   f. Electric and geothermal heat pumps;
   g. Central air conditioners;
   h. Natural gas, propane, or oil water heaters or furnaces;
   i. Hot water boilers; and
   j. Advanced main air circulating fans.

7. CCH notes the following conditions appear to apply:
   a. Skylights and windows installed in a new location, not only replacement skylights and windows.
   b. Set-back thermostats and ceiling fans, although they help reduce energy consumption, are not included in the definition of qualified energy efficiency improvements.
   c. Insulated garage door replacements qualify as exterior doors and, if sufficiently insulated, are a qualified energy efficiency improvement.
   d. Do-it-yourself installations are permitted, but documentation becomes more critical.
   e. The cost of certain maintenance items, such as outdoor caulking and replacement of weather-stripping appear to qualify as a qualified energy efficiency improvement if done according to IECC code and likely to last at least five years.

8. A qualified energy efficiency improvement is defined as an energy efficient building envelope component that meets the criteria set forth in the 2000 International Energy Conservation Code, or a metal roof that meets the Energy Star Program requirements.

9. An expenditure is considered made when the original installation of the equipment is complete. Property that is installed as part of an overall construction project is treated as made when the original use of the constructed or reconstructed structure by the taxpayer begin.

10. The credit is a nonrefundable personal credit.

11. The basis of the home is reduced by the amount of the credit.

P. Credit for Solar and Fuel Cell Equipment Installed on a Personal Residence

1. A tax credit is available to help individual taxpayers pay for residential alternative energy equipment. [Sec. 25D]

2. The credit is 30% of the cost of eligible solar water heaters, solar electricity equipment (photovoltaics), and fuel cell plants.

3. The maximum credit is $2,000 per tax year for each category of solar equipment, and $500 for each half kilowatt of capacity of fuel cell plants installed per tax year.

4. The credit it available for equipment placed in service during 2006 and 2007.

5. The credit is a nonrefundable personal credit.

6. Any unused credit from 2006 can be carried forward to 2007.

7. Credit not allowed on equipment used to heat swimming pools and hot tubs.

Q. Homebuilder's Credit for New Energy-Efficient Homes

1. An eligible contractor may claim a tax credit of $1,000 or $2,000 for a qualified new energy-efficient home that a person acquires from the contractor during 2006 and 2007 for use as a residence during the tax year. [Sec. 45L]

2. An eligible contractor is a person who constructs a new energy-efficient home, or a manufacturer that produces a qualified new energy-efficient manufactured home.

3. $2,000 credit per dwelling where consumption of energy is at least 50% below that of a comparable dwelling unit sold for use as a residence. $1,000 for a manufactured home that meets a 30% energy efficiency standard.

4. The credit is part of the general business credit.

5. The home must be substantially completed after Aug. 8, 2005 and sold after 2005 and before 2008.

6. The certification of a qualified new energy-efficient home must be made in accordance with guidance that will be provided by the Treasury Department after consultation with the Energy Department. The guidance will specify procedures and methods for calculating energy and cost savings. The certification must be in writing and must specify in a readily verifiable fashion the energy-efficient building envelope components and heating or cooling equipment installed in the home and their respective rated energy efficiency performance.

R. Manufacturer's Credit for Energy Efficient Appliances

1. A new credit has been added for the manufacture of energy-efficient appliances, including only dishwashers, clothes washers, and refrigerators.

2. The credit is a part of the general business credit.

3. The credit applies only to 2006 and 2007.

S. Business Solar Investment Tax Credit

1. The business investment credit for solar energy property is increased from 10% to 30%. [Sec. 48(a)(2)(A)]

2. The credit applies to solar energy property, hybrid solar lighting systems, and qualified fuel cell property.

3. The increased credit applies to (1) equipment which uses solar energy to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat, and (2) equipment which uses solar energy to illuminate the inside of a structure using fiber-optic distributed sunlight.

T. Motor Vehicles Credit

1. Introduction

a. A series of new tax credit to encourage the development, manufacture, and use of alternative fuel motor vehicles was added by the Energy Act. [Sec. 30B]

b. Taxpayers with qualified motor vehicles that are used in a trade or business and subject to depreciation will claim the alternative motor vehicle credit as apart of and subject to the rules of the general business credit.

c. Individuals will claim the credit as a personal credit.

d. The basis of any vehicle is reduced by the amount of alternative motor vehicle credit allowed.

e. The IRS is required to issue regulations providing for the recapture of any alternative motor vehicle credit amounts if the qualified vehicle should cease to be eligible property.

f. Requirements common to all the credit components of the alternative motor vehicle credit:

1) The original use of the vehicle must begin with the taxpayer;

2) The vehicle must be acquired for the use or lease of the taxpayer and not for resale; and

3) The vehicle must be made by a manufacturer.

2. A full hybrid vehicle credit is allowed only if the new vehicle is purchased up to the end of the first calendar quarter after the quarter in which the manufacture records its 60,000th sale of the particular hybrid model purchased. After that the following phase schedule reduces to credit to:

a. 50% of for the second and third calendar quarters after the quarter within which the 60,000th vehicle was sold;

b. 25% for the fourth and fifth calendar quarters after the quarter within which the 60,000th vehicle was sold;

c. Zero for six and subsequent quarters. [FS-2006-14]

3. Qualified Fuel Cell Motor Vehicle Credit

a. For passenger automobiles or light trucks, the vehicle must be certified as meeting or exceed the Bin5, Tier II emission standard for that make and model year.

b. The vehicle must be propelled by power derived from one or more cells which convert chemical energy directly into electricity by combining oxygen with hydrogen fuel.

c. The credit amount ranges from $8,000 to $40,000 based on the weight of vehicle.

d. Passenger automobiles and light trucks will be able to increase their credit amount based on the increase in fuel efficiency over the 2002 city fuel economy standards from $1,000 to $4,000.

e. The credit cannot be claimed for any vehicle purchased after 2014.

4. Advanced Lean Burn Technology Motor Vehicle Credit

   a. An eligible vehicle must be a passenger automobile or light truck with an internal combustion engine which:

      1) Is designed to operate primarily using more air than is necessary for complete combustion of the fuel,

      2) Incorporates direct injection, and

      3) Achieves at least 125% of the 2002 model year city fuel economy.

   b. Vehicles from 2004 and later must receive an emission standard certificate.

   c. The credit ranges from $400 to $2,400 based on fuel economy achievements.

   d. The credit may be increased by additional amounts ranging from $250 to $1,000 based on lifetime fuel savings.

   e. The credits are reduced after 60,000 vehicles are sold.

   f. The credits end after 2010.

5. Qualified Hybrid Motor Vehicle Credit

   a. To qualify for the credit, the vehicle must draw propulsion energy from onboard sources of stored energy that are both an internal combustion or heat engine using consumable fuel, and a rechargeable energy storage system.

   b. Passenger automobiles or light trucks must receive a certificate of conformity under the Clean Air Act.

   c. The term qualified hybrid motor vehicle shall not include any vehicle which is not a passenger automobile or light truck and the vehicle has a gross vehicle weight rating of less than 8,500 pounds.

      1) This would exclude buyers of sports utility vehicles from claiming the credit.

   d. The credit ranges from $400 to $2,400 based on fuel economy achieved.

   e. The credit may be increased by a conservation credit of $250 to $1,000 based on lifetime fuel savings.

   f. The credits are reduced after 60,000 vehicles are sold.

   g. The credits end after 2010.

   h. www.hybridcars.com -- source of information about hybrid vehicles and anticipated tax credits.

6. Qualified Alternative Fuel Motor Vehicle Credit

    a. The credit applies to vehicles capable of operating using an alternative fuel.

    b. Alternative fuels are compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, and any liquid at least 85% of the volume of which consists of methanol.

    c. The amount of the credit is equal to the applicable percentage times the incremental cost of the vehicle.

        1) The percentage could be as high as 80%.

        2) The incremental costs are limited based on the weight of the vehicle.

    d. The credit may be claimed in a reduced amount for vehicles that use a mixture of alternative fuel and petroleum-based fuels.

        1) The credit percentage is based on the amount of mixed fuel use.

    e. The credit ends after 2010.

U. Termination of Deduction for Clean-Fuel Vehicles

    a. No deduction is available for qualified clean-fuel vehicles placed in service after December 31, 2005.

V. Certification

1. The manufacturer of a building envelope component can establish that the component is eligible for the 10% qualified energy efficiency improvements credit by providing the consumer with a certification statement that satisfies the IRS guidelines outline in Notice 2006-26. The statement can be included with the product's packaging, or it can be made available in printable form on the manufacturer's website, or it can be furnished in any other manner that permits the consumer to retain the statement for recordkeeping purposes. Consumers are not required to attach these statements to their returns.

2. An exterior window or skylight that bears the Energy Star label and is installed in the appropriate region(s) identified on the label is automatically treated as being eligible for the 10% credit. No manufacturer's certification statement is required for these products.

3. The manufacturer of a qualified residential energy product can establish that the produce is eligible for the 100% credit by providing the consumer with a certification statement that satisfies the IRS guidelines outlined in Notice 2006-26.

4. Notice 2006-26 does not discuss the credit for residential energy efficient property.

W. Alternative Fuel Vehicle Refueling Property Credit

1. The IRS has released interim guidance on the qualified alternative fuel vehicle (QAFV) refueling property credit. [Notice 2007-43]

2. The property to store alternative fuel must be at the point where the fuel is delivered or dispensed into the fuel tank of a vehicle in order to qualify for the credit.

3. A fuel is an alternative fuel if at least 85% of its volume consists of one or more of the following: ethanol, natural gas, compressed natural gas, liquefied natural gas, liquefied petroleum gas, or hydrogen; or is a qualifying biodiesel mixture.

4. Dual-use property is refueling property that is used to store and/or dispense bother alternative fuel and conventional fuel. Converted QAFV refueling property is property that is converted from property that is not QAFV property.

5. The credit is generally 30% of the cost of the property placed in service as QAFV refueling property during the tax year.

   a. The credit is limited to $30,000 per property for property subject to depreciation. It is limited to $1,000 per property for other property.

X. Hybrid Motor Vehicle Credit for Heavy-Duty Vehicles

1. Pending issuance of regs on the Sec. 30B new qualified hybrid motor vehicle credit, the IRS recently released interim guidance upon which manufacturers may relay to certify that their heavy-duty vehicles meet the new qualified hybrid motor vehicle credit requirements, and in turn, on which purchasers rely in taking the credit. [Notice 2007-46]

2. Heavy-duty hybrid motor vehicles are hybrid motor vehicles with gross vehicle weight rating of more than 8,500 pounds.

3. To certify to purchasers that a vehicle meets the requirements for the credit, the manufacturer must submit a certification to the IRS that meets certain requirements. After December 31, 2006, this must occur before December 31st of the applicable calendar year. The IRS must also send the manufacturer a letter acknowledging the certification.

4. Purchasers may rely on the manufacturer's certification concerning the vehicle and the amount of the credit that they are allowed to claim. Vehicles must be placed in service after December 1, 2005, and purchased on or before December 31, 2009.

5. Certification by a manufacturer does not equate to an IRS determination that a heavy-duty hybrid vehicle qualifies for the credit or that the amount of the credit is correct. If the vehicle does not qualify or the amount claimed is incorrect, the IRS will withdraw the manufacturer's right to provide certification and the right of future purchasers to rely upon certification.

Y. Energy Deduction for Efficient Commercial Buildings

1. The IRS has issued rules for owners of energy efficient commercial building property to certify that the property satisfies the requirements of Sec. 179D(c)(1) and (d). The IRS also provides a procedure allowing developers of computer software to certify to the Energy Department that the software is acceptable for calculating energy and power consumption for Sec. 179D purposes. [Notice 2006-52]

2. Components Not Eligible for Credit

    a. A component that provides structural support or a finished surface, or a component that has as a principal purpose any function unrelated to the reduction heat loss or gain, is not a component specifically and primarily designed to reduce heat loss or gain of a dwelling. [Notice 2006-53]

Z. Employee Tip Credit

1. The federal minimum wage must be used to calculate the Employee Tip Credit, even if the employer's state minimum wage is higher. The credit is equal to FICA and Medicare taxes paid on tips to servers that exceed the portion of tips treated as part of the minimum wage. Employers that claimed smaller credits using the state minimum wage figures can file amended returns to obtain refunds.

AA. First-Time Homebuyer Credit

1. 2008 Credit

    a. The housing act give first-time homebuyers a temporary refundable tax credit equal to 10% of the purchase price of a home, up to $7,500 ($3,750 for married individuals filing separately).

    b. The credit phases out for taxpayers with adjusted gross income between $75,000 and $95,000 (between $150,000 and $170,000 in the case of a joint return).

    c. The credit is effective for homes purchased on or after April 9, 2008, and before July 1, 2009.

    d. The credit is refundable to the extent it exceeds the buyer's regular tax liability, but it does not offset the AMT.

    e. A first-time homebuyer who purchases a principle residence in 2009 after filing a 2008 return has the option of filing an amended 2008 return to claim the credit.

    f. The first-time homebuyer credit must be repaid in equal installments over 15 years, interest free.

        1) Repayments begin two years after the year in which the residence is purchased.

        2) Example. A married couple purchased their home in June 2009. They file an amended 2008 return to claim the credit. Repayments of the $7,500 credit would begin at $500 per year in 2010 and end in 2024.

g. A person is considered a "first-time homebuyer" if he or she (or spouse) had no ownership interest in a principal residence during the three-year period before the new home is purchased.

1) Purchase occurs when title closes.

2) The property may not be acquired from certain related persons.

3) Renters who also own a vacation home may qualify for the credit since the three-year look back period for owning a home applies only to a principal residence.

h. Two or more unmarried individuals may purchase a residence and qualify for the credit.

1) They must allocate the credit between them and the total amount of the credit cannot exceed $7,500.

i. If a taxpayer sells or no longer uses the home as his or her principal residence before repaying the credit, the unpaid balance becomes due in the year in which the residence is sold or is no longer used as the taxpayer's principal residence.

1) The amount of recaptured credit may not exceed the amount of gain from the sale of the residence to an unrelated party.

2) The credit does not have to be repaid if the taxpayer dies.

3) Special rules exist for an involuntary conversion and for a residence transferred in a divorce.

2. 2009 Credit

a. The credit is extended to apply to homes purchased before December 1, 2009.

b. The maximum amount of the credit is increased to $8,000 ($4,000 for married filing separately).

c. The recapture of the credit is generally waived.

1) The accelerated recapture rules apply if, within 36 months after purchase, the taxpayer disposes of the home, or the taxpayer (and spouse, if married) ceases to use the home as a principal residence.

d. The credit is available even if the purchased residence if financed by the proceeds of a tax-exempt mortgage revenue bond.

e. A principal residence purchased in 2009 qualifies as a credit on the 2008 return and will be subject only to the new recapture rules.

1) The maximum credit is $8,000 for homes purchased in 2009 and taken on the 2008 return. [IR-2009-14]

BB. Differential Wage Credit

1. The Act creates a new tax credit for eligible small business employers that pay differential wages to qualifying employees. The credit is equal to 20% of up to $20,000 of differential pay to each qualifying employee during the tax year, but only for payments after July 30, 2008, and before 2010.

2. A "qualified employee" is one who has been an employee for the 91-day period immediately preceding the period for which any differential wage payment is made. [Sec. 45P]

3. An "eligible small business employer" is one that:

   a. Employed on average less than 50 employees on business days during the tax year; and

   b. Under a written plan, provides eligible differential wage payments to each of its qualified employees.

4. No deduction may be taken for that part of compensation which is equal to the credit and the amount of any other credit otherwise allowable for compensation paid to an employee. [Sec. 45P©]

5. The differential wage payment credit is part of the general business credit and thus is subject to the rules for business credits. [Sec. 38(b)(33)]

6. The credit is not allowable against a taxpayer's alternative minimum tax liability. [Sec. 280C(a)]

CC. Making Work Pay Credit (MWPC)

1. Refundable credit that is applied against the income tax liability.

2. Lower of:

   a. 6.2% of taxpayer's earned income or

   b. $400 ($800 for married couples filing a joint return)

3. Effectively eliminates the 6.2% employee share of Social Security tax on about the first $6,450 of a single-worker's wages.

4. The credit is reduced by the amount of the taxpayer's economic recovery payment or government retiree credit.

5. The amount of the credit is reduced by 2% of the taxpayer's modified adjusted gross income that exceeds $75,000 ($150,000 on a joint return)

   a. Modified adjusted gross income includes excluded foreign income and excluded income from Guam, American Samoa, Northern Mariana islands, and Puerto Rico.

   b. The $400 credit is completely phased out at modified AGI of $95,000 and the $800 credit is completely phased out at $190,000.

6. Earned income includes combat pay.

7. The following individuals are not eligible for the credit.

    a. A nonresident alien,

    b. An individual who can be claimed as another taxpayer's dependent,

    c. An estate or trust, or

    d. A taxpayer who return does not include his or her Social Security number.

8. The credit applies for 2009 and 2010 tax returns.

Chapter 15 - Alternative Minimum Tax

A. The alternative minimum tax is a special form of tax imposed on certain taxpayers in addition to the regular federal income tax. The objective of the tax is to recapture tax reductions resulting from the use of special tax relief or "tax shelter" provisions of the tax law.

B. The tax is imposed on alternative minimum taxable income (AMTI). AMTI is the taxable income of the taxpayer for the year determined with adjustments and increased for tax preferences, then reduced by an exemption amount. AMTI is multiplied by a tax rate of 26 or 28% to determine a tax which is reduced by a foreign tax credit and then by the regular income tax.

C. Computation

1. Alternative Minimum Tax Formula

	Taxable Income
±	Adjustments to Taxable Income
+	Tax Preferences
=	Alternative Minimum Taxable Income (AMTI)
-	Exemption Amount
=	Net Alternative Minimum Taxable Income
x	26/28% Tax Rate
=	Tentative Minimum Tax (TMT)
-	Regular Tax for the Year
=	Alternative Minimum Tax (AMT)

2. Adjustments can either increase or decrease income for minimum tax purposes.

a. Depreciation on assets acquired after 1986 is computed using the 150% declining balance for personal property and a 40-year life for real property.

b. Mining exploration and development costs, circulation expenditures, and research and development expenditures must be amortized over period ranging from 3 to 10 years.

c. Pollution control facilities must be amortized under alternate MACRS.

d. Long-term contracts must be computed under the percentage of completion method.

e. The excess of fair market value of the stock acquired through exercise of the an incentive stock option over the amount paid for the stock, including any amount paid for the ISO used to acquire the stock.

f. Passive losses allowed in taxable income computation must be added back for AMT computation.

g. Net Operating Loss (NOL) is calculated under special rules and cannot offset more than 90% of AMT income (100% after 2004).

h. Gains and losses on sale or exchange of property are calculated using AMT depreciation methods.

i. The personal exemption and certain itemized deductions are added back.

1) Medical expense deduction exceeding 7.5% of AGI but less than 10% AGI

2) State and local taxes

3) Certain interest deductions

a) Excess of housing interest above original cost

b) The definition of a second home is narrower for AMT purposes than for regular tax purposes.

(1) To qualify as a second home for AMT purposes, the second home must be a house, apartment, condominium, or a mobile home that is not used on a transient basis.

(2) The interest on a loan that is secured by a houseboat that the individual treats as a second home must be added back to income for AMT purposes.

4) Miscellaneous itemized deductions

3. Tax preferences are added back

a. Percentage depletion in excess of the adjusted basis of the property.

b. Intangible drilling costs on oil, gas, and geothermal wells in excess of the amount amortizable with respect to these costs, and in excess of 65% of net income from production.

c. Tax-exempt interest on specified private activity bonds.

1) The law excludes tax-exempt interest on certain housing bonds from being a preference item for AMT purposes.

d. Accelerated depreciation on real property placed in service before 1987 in excess of straight-line depreciation over the useful life or recovery period.

e. Effective for dispositions of small business stock on or after May 6, 2003, only 7 percent of the 50-percent exclusion is treated as a tax preference item when computing AMTI. As a result of this change, 3.5 percent (50% × 7%) of the investor's total realized gain from the sale or exchange of small business stock will be used in the computation of AMTI.

4. An exemption amount reduces AMTI. The AMT exemption amount is increased to:

a. $74,450 for joint return filers and surviving spouses for 2011;

b. $48,450 for a single individual who is not a surviving spouse for 2011; and

c. $37,225 for a married taxpayer who files a separate return for 2011.

d. The 2012 amounts have not be set.

e. Phase out of exemption amount

1) Reduce exemption amount by $.25 for every $1 of AMTI that exceeds
$150,000 - Joint Return or Surviving Spouse
$112,500 - Single or Head of Household
$ 75,000 - Married Filing Separately, Estate, Trust

5. AMT Tax Credits

a. The law allows taxpayers to use the Low-Income Housing Tax Credit and the rehabilitation tax credits to offset AMT liability.

6. Refundable AMT Credit

a. Allows taxpayers to take advantage of a refundable minimum tax credit (MTC) with respect to certain MTCs over three years old.

b. The refundable MTC can offset regular and AMT taxes and is refundable to the extent it exceeds the taxpayer's tax liability for the year.

c. It is available for six years from 2007 through 2012 but is subject to phase out for high-income taxpayers.

d. The refundable credit is the greater of:

1) The lesser of $5,000 or the taxpayer's long-term unused minimum tax credit, or

2) 20% of such credit.

e. Long-term unused minimum tax credit for a tax year is the portion of the minimum tax credit attributable to the adjusted net minimum tax for tax years before the third year immediately preceding such tax year.

1) For 2007 tax year, a taxpayer could potentially receive a refund for AMT paid in 2003 or an earlier tax year.

f. The AMT refundable credit amount is phased out at the income levels applicable to the phase out of the personal exemption deduction.

1) AGI is determined without regard to the exclusion of certain foreign-earned income.

D. Alternative Minimum Tax Developments

1. Home Mortgage Refinancing

   a. The IRS has revised its instructions to Form 6251, Alternative Minimum Tax-Individuals, and will allow an AMT deduction for interest paid on mortgages refinanced more than once. "Qualified housing interest" for AMT purposes now includes interest paid on a mortgage that paid off the mortgage loan that had paid off the original mortgage. [Rev. Rul. 2005-11]

   b. Refinanced debt qualifies as acquisition debt, up to the principal amount of the acquisition debt existing immediately before the refinancing.

   c. Interest on amounts above the original loan balance is deductible for AMT purposes only to the extent the proceeds are used for home improvements.

2. Incentive Stock Options

   a. The law will abate AMT liability stemming from the exercise of incentive stock options (ISOs) before 2008, effective for any unpaid tax liability on the law's date of enactment.

   b. The law allows all individuals, including those who paid their ISO AMT liabilities, to accelerate the refund of the minimum tax credit that has not been used. The law also increases the minimum tax credit by 50% of any interest and penalties paid before the date of enactment.

3. Lower-Income Taxpayer Gets Zapped with AMT

   a. The taxpayer's significant itemized deductions resulted in zero tax liability. The taxpayer showed $45,834.16 in adjusted gross income, $54,275.81 in itemized deductions, and $2,800 in personal exemptions on his 2000 tax return, as married filing separately. The taxpayer computed his taxable income, and his tax liability, as zero. The IRS determined a $4,214 deficiency, the entire amount of which was AMT.

   b. The taxpayer contended that the AMT's propose is to prevent higher income taxpayers from escaping all income tax liability by using exclusions, deductions, and credits. The court noted that it was not free to alter the amount of relief or to change the words of the statute. The taxpayer had to look to Congress for AMT relief. [Katz, TC Memo, 2004-97]

4. The number of taxpayers subject to AMT is expected to climb to 16 million by 2005 and to more than 40 million by 2014. Some experts predict that more than one-third of all taxpayers will no longer be under the regular income tax.

   a. Just seven years ago, 600,000 taxpayers were subject to the AMT.

5. According to the Congressional Budget Office, two million returns subject to AMT liability produced $11 billion in revenue. By 2014, revenue could grow to $55 billion. Some experts estimate that repealing the AMT would cost $1 trillion over 10 years.

   a. Congressional Research Service noted that some projections seem to indicate that it could be less costly to repeal the regular income tax rather than repeal the AMT.

6. Individual taxpayers are permanently allowed to use certain nonrefundable credits to offset both the regular tax and AMT tax liabilities:
   a. Adoption Credit (Sec. 23) in years when it is nonrefundable (it is refundable in 2010 and 2011)
   b. Nonrefundable portion of the American Opportunity education credit (Sec. 25A(i))
   c. Retirement Savers Credit (Sec. 25B)
   d. Residential Energy Efficient Property (REEP) Credit (Sec. 25D)
   e. Nonbusiness portions of the two plug-in electric vehicle credits (Secs. 30 and 30D)
   f. Nonbusiness portion of the Alternative Motor Vehicle Credit (Sec. 30B)

7. Certain nonrefundable personal credits can offset the AMT for 2010 and 2011:
   a. Child and Dependent Care Credit (Sec. 21)
   b. Credit for the Elderly and Disabled (Sec. 22)
   c. Credit for Interest on Certain Home Mortgages (Sec. 25)
   d. Lifetime Learning Credits (Sec. 25A)
   e. Credit for energy-saving improvement installed in a US principal residence (25C)
   f. First-Time DC Homebuyer Credit (Sec. 1400C)
   g. Child Tax Credit (Sec. 24)

8. Specified Business Energy Credit Offset to AMT

   a. The alcohol fuels credit (Sec. 40) and the electricity from renewable sources credit (Sec. 45) may be used against both the regular and alternative minimum tax liability.

9. The separate depreciation lives for AMT are repealed, effective for property placed in service after December 31, 1998. A taxpayer may elect to apply the 150% declining balance method for regular tax purposes.

10. It does not matter whether or not the taxpayer is a "high income" taxpayer. If there is an AMT, it must be paid. [*Holly*, TC Memo 1998-55]

11. The AMT, by not considering personal exemptions does not burden the free exercise of religion for a large family. Thus, a claim that the AMT should not apply to a family with 12 exemptions was rejected by the 10th Circuit. The Circuit Court reasoned that if Congress had intended the AMT to apply only to taxpayers whose incomes reached a certain threshold, or only to those with IRC §57 tax preferences, it could have easily drafted the statute to achieve that result. [*D. R. Klaassen*, TC Memo 1998-241, aff'd CA-10 (unpublished opinion), 99-1 USTC, ¶50,418]

12. The Prosmans had about $83,000 of adjusted gross income for 1995. The company included the reimbursement of Mr. Prosman's per diem expenses on his Form W-2. As a result, the Prosmans were required to claim the expenses as miscellaneous itemized deductions subject to the 2% floor. In addition to $28,000 of employee business expenses, the Prosmans deducted more than $8,000 for state and local taxes. The AMT increased the tax liability by about $2,700. The Prosmans argued that the AMT was intended to apply to high-income earners rather than to lower income earners such as themselves. While the Court sympathized with the taxpayers, it held that under the plain meaning of the statute, they were subject to the AMT. [*G. Prosman*, TC Memo 1999-87]

13. The IRS Chief Counsel has concluded that the use of the standard deduction for regular tax purposes precludes the use of itemized deductions for AMT purposes. [SCA Ltr. Rul. 200103073]

14. Miscellaneous itemized deductions for legal expenses related to the award of punitive damages are not deductible in computing AMT. [*Benci-Woodward*, TC Memo 1998-395]

15. AMT Income Not Reduced by Capital Losses in Succeeding Year

    a. An individual was granted stock options by his employer in 1999. The options qualified as incentive stock options. On December 21, 2000, the individual exercised an option to purchase 46,125 shares at $.20 a share. The total exercise price was $9,225. On that date the stock was worth $23.21 a share. The Tax Court concluded that the taxpayer's shares were not subject to a substantial risk of forfeiture and that he had AMTI of $1,066,064, based on the December 21, 2000, value. The stock became worthless in 2001 and the taxpayer had a capital loss of $1,075,289 for AMT.

       The Tax Court concluded that the loss limitation rules of Sec. 1212(a) also apply when computing AMTI. Therefore the taxpayer could not carry back the losses realized in 2001 to offset the individual's AMTI that he realized in 2000. The Tax Court also stated that the capital losses are excluded from the NOL computation. [Merlo, 126 TC No. 10]

    b. In 1998, the taxpayer entered into an ISO agreement with his employer. The agreement permitted him to purchase shares of his employer's common stock at a set price, which he did on March 15, 2000. At that time the shares had a fair market value of $2.1 million. The taxpayer's ISO price was $100,0000. The taxpayer realized no income or loss on the exercise of the ISOs for the purpose of computing his 2000 taxable income. However, he realized $2 million in income for the purposes of computing his 2000 AMTI. The taxpayer sold the shares in 2001 for $250,000. The transaction generated a regular tax capital gain of $150,000 and a $1.9 million AMT capital loss. For 2001, the taxpayer reported $561,000 in taxable income. His regular tax liability was $191,000. He reported his AMTI as negative $1.34 million ($561,000 taxable income minus the $1.9 million adjustment). His 2001 tentative minimum tax and 2001 AMT were both $0. [Ralahnuk, 127 TC No. 9 (2006)]

       The IRS disallowed the $1.9 million adjustment. The $1.9 million is a capital loss and not a net operating loss. It cannot be carried back and is carried forward and limited to $3,000 per year.

16. Forgoing Available Deduction

    a. Taxpayer, who itemized her deductions for the year at issue, argued that she was not liable for the alternative minimum tax (AMT) because she chose not to deduct her state and local income taxes for that year. In rejecting this argument, the Court of Appeals for the Federal Circuit noted that her total tax was solely based on her alternative minimum taxable income, which does not adjust for state and local income taxes. Therefore, the amount she owed due to the AMT did not depend on whether she chose to deduct her state and local income taxes for regular income tax purposes. [Qureshi v. Comm., 98 AFTR 2d 2006-6473 (Fed. Cir.)]

17. Alternative Motor Vehicle Credit

    a. The alternative motor vehicle credit cannot be used to offset the AMT. It cannot be carried forward or back to another tax year.

18. The effective rate on long-term capital gains can be as high as 22% in the AMT exemption phaseout zones. A couple in the phaseout zone paid a flat 15% tax on their gain and got an extra bill from the IRS. The Tax Court upheld the IRS assessment. [Weiss, 129 TC No. 18]

Chapter 16 - Other Taxes, Extensions

A. Self-Employment Tax

1. Wage base for Social Security portion of self-employment tax for 2012 increased to $110,100.

    a. For the Medicare portion of the self-employment tax, there is no wage base so that all self-employment income is subject to the Medicare portion.

2. The Treasury Department issued proposed amendments to the regulations relating to the self-employment tax on January 13, 1997.

    a. The Code provides that a limited partner's self-employment income includes only guaranteed payments for services. The proposed regulations would extend self-employment taxes to other limited partners with personal liabilities for partnership debts or those who participate in the partnership's business.

        1) A major issue is the classification of members in limited liability companies (LLCs) as limited partners or general partners for self-employment tax purposes.

    b. As part of the Taxpayer Relief Act of 1997, Congress placed a moratorium on any temporary or final regulations relating to the definition of a limited partner issued or made effective before July 1, 1998.

    c. A Senate resolution expressed dissatisfaction with the proposed rule, noting that Congress, not the Treasury or the IRS, should determine the law governing self-employment income for limited partners.

3. Sign-On Bonuses and Cancellation Settlements

    a. Reversing decades-old guidance, the IRS issued a new set of rulings that hold sign-on bonuses, early termination settlements, and noncompete amounts paid under an employment contract are considered wages subject to FICA, FUTA, and income tax withholding. [Rev. Rul. 2004-109, Rev. Rul. 2004-110]

    b. The IRS used the new rulings to categorically reject a growing argument among some employees and independent contractors that an employment contract creates property rights, which are a capital asset and, therefore, payments that give rise to capital gain.

    c. Employment is any service that an employee performs for his or her employer. Employment includes establishing, advancing, changing, or canceling the employer-employee relationship.

4. Effective January 1, 2005, employers will not be required to make a deposit of FUTA taxes until the FUTA liability exceeds $500. [TD 9162]

    a. This should eliminate the need for employers with eight or fewer employees to make up to four quarterly FUTA tax deposits.

5. The Tax Court found that payments from an agricultural cooperative are income subject to self-employment tax. [Fultz, TC Memo 2005-45 and 46] They were not investment income.

6. Wages paid to certain workers hired by federal, state, or local governments to respond to an emergency are not subject to social security and Medicare taxes. For this exemption to apply, the employee must be hired to perform services on a temporary basis due to a storm, earthquake, flood, or similar emergency. Once a temporary worker becomes permanent, he or she is subject to the regular rules for social security and Medicare coverage. Long-term or permanent federal, state, or local government employees who perform services in emergency situations, such as municipal firefighters, are not eligible for this exception even if they work extra time because of an emergency. [www.irs.gov/govt/fslg/article/0,,id=149219,00.html]

7. Employment Tax Responsibilities for Disregarded Entities

   a. Under proposed regulations, a disregarded entity is treated as the employer of any employees working for the disregarded entity. The entity is responsible for: [NPRM REG-113471-05]

      1) Backup withholding;

      2) Filing returns such as Form 941;

      3) Depositing FICA, FUTA, and withholding taxes with the IRS; and

      4) Issuing Form W-2 statements to employees of the disregarded entity.

   b. Disregarded entities include:

      1) Qualified Subchapter S subsidiaries (QSub)

      2) One-owner Limited Liability Companies (LLC)

8. Developments

   a. The taxpayer operated a retail store for more than 40 years, and in his spare time created and patented various inventions. On his tax return, he reported royalty income from patents and settlement payments he received from a business that had infringed his patents. The IRS imposed the self-employment tax on his invention-related income. The Tax Court stated that the taxpayer did not design inventions regularly or continuously, but only sporadically. Thus, he was not engaged in the "trade or business" of inventing, and did not owe self-employment tax on his invention-related income. [*Melvin L. Levinson*, TC Memo 1999-212]

   b. An S corporation shareholder who actively participated in the business that was conducted by his three corporations was not entitled to take into account passthrough items in computing his net earnings from self-employment. The taxpayer's active participation in his business did not cause the passthrough items to arise from his conduct of a trade or business. He chose the corporate form and, in doing so, created separate entities for tax purposes. Furthermore, the literal language of Section 1366 provides that S corporation passthrough items are not taken into consideration in determining a shareholder's liability for self-employment tax. [*Ding v US*, 2000-1 USTC ¶50,137 (CA-9, 12-20-99)]

c. The taxpayer, a professional legal corporation, and its sole owner, an attorney, executed a two-year employment contract. The corporation agreed to pay the attorney a base salary of $110,000 per year. The 1993 salary would be paid in December 1993, and the 1994 salary would also be paid in December 1993. The attorney lent the corporation $120,000 on December 31, 1993, to be repaid over 1994 and 1995. The court held that the corporation's scheme lacked economic substance. It noted that federal tax laws assess taxes based on a transaction's true economic purpose. [*Jeffrey B. Fleck, Co LPA* v US, DC-Ohio]

B. Employment Taxes

1. Termination Agreements

a. In general, payments made to an employee by an employer on account of a dismissal that is an involuntary separation are subject to FICA and FUTA taxes, regardless of the whether the employer is legally required to make the payment.

b. Voluntary terminations, however, are subject to employment taxes only if the payments are remuneration for past services. If the payments are "buy-outs" of payments intended to buy an employee out of his or her right to future employment, the payments are not treated as wages but rather are treated as purchases of contract right and are not subject to FICA and FUTA taxes.

c. Even if payments would otherwise be treated as dismissal payments or remuneration for past services, they are not treated as wages if they qualify as supplemental unemployment benefits (SUBs). Under Sec. 3402(o)(2), SUBs must be benefits paid as a result of an involuntary separation from employment.

1) In general, separation payments qualify for SUB treatment if the payments are elected by employees that are in layoff status. Since the employee is already separated from service, he or she is not considered to have voluntarily separated from employment. If, however, the employee is still an active employee, the separation payments do not qualify as SUBs because the decision to terminate employment is considered to be voluntary.

2) The Court of Federal Claims held that separation payments to electing employees under a "forced transfer" program were payments for compensation for services and subject to employment taxes. The forced transfer agreement allowed employees on furlough status to choose to transfer to a different location or to separate from service and receive a separation allowance. The court reasoned that because the employees had the choice to remain with the employer, the ones who chose to separate did so voluntarily, even if it was at the price of disrupting their personal lives by moving to a new area. [CSX Corporation, 2006-2 USTC p50,377]

2. Buyout of Faculty

   a. Over the years, a university sponsored several early-out programs for tenured faculty members and nontenured librarians to cut expenses. To participate, teachers who were tenured had to relinquish those rights.

      1) The early-out payments were not made for services. The professors were paid to forfeit their right to guaranteed employment. So payments made to them escape FICA tax.

      2) However, payroll taxes were due on severance pay for nontenured employees. They did not waive any employment right and could have been fired at will. [Univ. of Pittsburgh v. U.S., D.C. Pa. (2005)]

   b. The Court of Appeals for the Sixth Circuit has held that payments made to public school teachers who relinquished their statutory tenure rights and resigned from their positions were wages taxable under the Federal Insurance Contribution Act. The teachers unsuccessfully argued that the payments were not wages under FICA because they were received in exchange for their rights as tenured employees. [Appoloni, CA-6, June 7, 2006]

      1) The case was consolidation of two Michigan district courts. The Eastern District of Michigan held that the teachers were entitled to a refund of the FICA taxes while the Western District of Michigan denied the refunds.

3. Retired Insurance Agents

   a. Retired insurance agents owe SECA tax on renewal commissions, the Tax Court stated. Although a 1997 law exempted a variety of payments for retired agents from self-employment tax, that relief does not apply to any post-retirement renewal commissions based on policies they sold while working. [Gilbert, TC Summ. Op. 100-176]

4. Notary Public

   a. Income for notary services is exempt from self-employment taxes. For federal tax purposes, the performance of functions of a public office, including work as a notary public, is not a trade or business. [INFO 2006-0022; Reg. 1.1402(c)-2]

      1) Notary income is reported on Schedule C, but Schedule SE need not be filed.

      2) Retirement plan contributions cannot be based on notary income.

5. Back Pay

   a. Back pay generally is treated as wages subject to income tax withholding, FICA, and FUTA in the year paid, rather than in the year(s) in which it should have been paid. [INFO 2006-0023]

6. Ex-Spouse Exercising Options

    a. A taxpayer who received employee stock options as part of a divorce settlement had income when her former spouse exercised the stock options at her direction. The taxpayer was entitled to a credit for the income tax withheld from the stock option proceeds. However, the taxpayer was not entitled to a credit for the FICA taxes withheld from the proceeds. [Ltr. Rul. 2006-46003]

    b. The IRS ruled that the transfer of the options from ex-husband to ex-wife was a nontaxable transfer of property under Sec. 1041. The income from the exercise of the ex-wife's options was taxable to her under Sec. 83, as if she was the employee who was compensated with the options.

    c. In Rev. Rul. 2004-60, the IRS determined that an employee-spouse received FICA wages when the nonemployee spouse exercised stock options. The employee-spouse provided the services and the payments related to the employee's employment. The employer was required to withhold income tax and FICA taxes on the proceeds and both amounts were deducted from the amount paid to the nonemployee spouse.

7. Employment Contract Buy-Outs

    a. The IRS has adopted a new litigation position related to payments to tenured faculty members in exchange for cancellation of employment contracts. For payments made before January 12, 2005, the IRS will not pursue litigation for FICA taxes for taxpayer in the jurisdiction of the Eighth Circuit Court of Appeals. Outside of those parameters; however, it intends to continue to vigorously pursue FICA and FUTA taxes and income tax withholding on such early retirement payments. [AOD 2007-1]

    b. In 2001, the Eighth Circuit held in North Dakota State University v. U.S., 2001-2 USTC 50,485, 255 F3d 599, that a payment made to a tenured faculty member at the university in exchange for that professional's tenure rights was not treated as wages. As such, the payment was not subject to FICA taxes.

    c. The IRS did not agree with the court's decision. In response, the IRS issued a ruling in 2004 (Rev. Rul. 2004-110) holding that amounts paid to employees as consideration for cancellation of an employment contract and relinquishment of contract rights are considered ordinary income and wages subject to FICA, FUTA, and federal income tax withholding. The IRS determined that such payments were still "remuneration for employment," even though they were technically paid for the termination of employment.

8. Sole LLC Owner Liable for Payroll Taxes

    a. The owner of a single-member limited liability company (LLC) who fails to have the LLC treated as a corporation under IRS check-the-box regs may be held personally liable for the LLC's unpaid payroll taxes. [McNamee, CA-2, May 23, 2007]

    b. The court held IRS's collection of the LLC's unpaid payroll taxes from the taxpayer did not violate the limited liability granted by state laws to LLCs. State limited liability laws did not abrogate a LLC owner's federal tax liabilities. While state incorporation laws control aspects of business relations, "they may affect, but do not necessarily control, federal tax provisions," the court said.

9. Disregarded Entity Employment Taxes

   a. Final regs require that a disregarded entity be treated as a separate entity responsible for both employment tax and excise tax liabilities. The new rule applies to disregarded entities such as a qualified subchapter S subsidiary (QSub) and a limited liability company (LLC). [T.D. 9356]

   b. Under Notice 99-6, the owner of a disregarded entity could handle employment taxes under the owner's name and taxpayer identification number. Alternatively, a disregarded entity that was an entity under state law could handle employment taxes under its own name and taxpayer identification number.

      1) Regardless of the method chosen, the entity continues to be treated as a disregarded entity for other Tax Code provisions.

   c. In addition to withholding FICA, FUTA, and income taxes and depositing them timely with the government, the employer must file, under their own name and employer identification number, Form 941, form 940, and Form W-2. Excise taxes must be reported on Forms 720, 730, 2290, and 11-C.

   d. The employment tax provisions will not take effect until January 1, 2009.

      1) Owners that handle employment taxes after April 19, 1999, may continue to be responsible for them prior to January 1, 2009. However, for the period August 15, 2007, to December 31, 2008, owners may switch without the IRS's consent and consider the wages to be paid by the disregarded entity.

      2) The owner remains ultimately liable for employment tax responsibilities prior to January 1, 2009.

   e. The excise tax provisions take effect January 1, 2008. Payments and actions before that date will be treated as made by the owner of the disregarded entity.

10. Embezzlement of Tax Payments

   a. The Third Circuit Court of Appeals affirmed that a business was liable for overdue employment taxes, even though it paid the taxes in full to its payroll firm, which embezzled some of the funds. [Pediatric Affiliates, CA-3, 4-16-07]

      1) The court emphasized that it is well established that a taxpayer's reliance on a third party to fulfill its tax obligations does not release the taxpayer from its obligations to collect and pay employment taxes to the government.

   b. An agent's embezzlement is not an excuse for the failure to pay payroll taxes. The employer remains responsible for the shortfall when the payroll service hired to prepare quarterly employment tax returns and deposit taxes turns out to be crooked. [Pediatric Affiliates, P.A. v. USA, D.C., NJ (2006)]

   c. Appointing a Payroll Agent

      1) Be sure to use the May 2007 version of Form 2678 to receive IRS' acceptance. IRS revamped the form to simplify instructions and make it easier to use. Businesses must also use the 2678 to revoke an agent's exiting authority.

11. Misclassified Workers

    a. Workers treated as contractors who think they are actually employees will report payroll taxes on Form 8919 starting next year. Currently, those workers have no easy way to pay their half of Social Security and Medicare taxes: They must use Form 4137 which for servers to pay payroll taxes on tips.

C. Kiddie Tax

1. For tax years beginning after May 25, 2007, the kiddie tax to applies to children who are under 19 years old or who are full-time students over 18 but under age 24;

2. Applies only to children whose earned income does not exceed one-half of the amount of their support;

3. The child must have at least one living parent at the close of the tax year; and

4. The kiddie tax does not apply to a child who is married and files a joint return.

D. Indoor Tanning Salons

1. A new 10% excise tax applies to tanning services provided after June 30, 2010.

2. The excise tax is imposed on the total amount paid by an individual for indoor tanning service, including any amount paid by insurance. [TD 9486]

3. Full payment is due at the time the provider timely Files Form 720, Quarterly Federal Excise Tax Return.

4. The cost of other goods may be excluded from the excise tax if they are separable, do not exceed the fair market value of such other goods, and are shown in the exact amounts in the records pertaining to the indoor tanning service charge.

5. Certain medical procedures are exempt from the excise tax. These include phototherapy service for the treatment of dermatological conditions, sleep disorders, seasonal affective disorder, or other psychiatric disorders; neonatal jaundice; wound healing; and other qualified procedures.

    a. If performed by a licensed medical professional on the medical professional's premises.

6. No portion of a membership fee is subject to the tax if the facility meets the definition of a qualified physical fitness facility.

    a. In this case, the indoor tanning service is treated as incident to the physical fitness facility's predominant business and no liability for the excise tax attaches.

    b. A tanning salon cannot quality as a QPFF by allowing users access to exercise classes or equipment.

    c. Qualified Physical Fitness Facility -- A facility (i) in which the predominant business or activity is providing facilities, equipment, and services to its members for purposes of exercise and physical fitness, (ii) indoor tanning services is not a substantial part of its business and (iii) it does not offer tanning services to the public for a fee or offer different pricing options to its members based on indoor tanning services.

E. Tax Shelter Audit Technique Guide

1. The IRS has issued two Audit Technique Guides (ATG) for internal use by agency field personnel that are valuable to practitioners representing clients who have invested in tax shelters.

    a. Tax Shelter ATG assists IRS employees in identifying and developing abusive tax shelter issues.

    b. Penalty ATG explains the application of accuracy-related penalties for taxpayers involved in tax shelter transactions.

2. All tax shelters share certain common characteristics:
    a. Lack of meaningful economic risk of loss or potential for gain
    b. Inconsistent financial and accounting treatment
    c. Presence of tax-indifferent parties
    d. Unnecessary steps or novel investments
    e. Promotion or marketing of a produce
    f. Confidentiality surrounding the transaction
    g. High transaction costs associated with a transaction
    h. Risk-reduction arrangements such as contingent or refundable fees

F. Farmers and Fishermen Income Averaging

1. For tax years after 1997, individuals engaged in a farming business may elect to average farm income over three years. Fisherman are eligible after 2003.

2. Gain on sale of property other than land, regularly used by the farmer for a substantial period in farming business is eligible for income averaging.

3. Income averaging does not apply for purposes of alternative minimum tax and self-employment tax. These taxes are figured without the use of income averaging even if it is elected for regular tax purposes.

4. Although final regulations for Farmer Income Averaging have not been issued, Pub. 225 clearly states that negative taxable income may be used for a base year when figuring tax on Schedule J.

5. A farmer and fishermen's alternative minimum tax is computing using the regular tax liability without regard to income averaging for tax years beginning after December 31, 2003.

6. Example: Farmer has $12,000 income tax; $9,000 using income averaging. He has a tentative minimum tax of $13,000, creating an AMT of $1,000 ($13,000 - $12,000). The total tax liability is $10,000 ($9,000 income averaging plus the $1,000 AMT).

G. Interest on Amended Returns

1. If the IRS does not notify a filer of extra tax due within 18 months of filing, interest stops accruing. It resumes 21 days after the taxpayer is billed for additional tax.

2. The IRS says it will apply this rule to amended returns that indicated more tax was due. [Rev. Rul. 2005-4]

    a. The ruling is retroactive to 1998, so the IRS will check its records and send out refunds to taxpayers who paid more interest than required.

H. Accumulated Earnings Tax and Personal Holding Company Tax

1. Under prior law, the accumulated earnings tax was equal to the product of the highest rate of tax applicable to single filers and a corporation's accumulated taxable income. The personal holding company tax was computed by multiplying undistributed personal holding company income by the highest rate of tax on single filers. The new law, however, reduces the tax rate for the accumulated earnings tax and personal holding company tax to 15 percent effective for tax years beginning after December 31, 2002, and beginning before January 1, 2009.

I. Luxury Automobile Tax

1. The excise tax imposed on the sale of automobiles priced above a designated threshold expired at the end of 2002.

J. Limousines and the "Gas Guzzler" Tax

1. The gas guzzler tax's definition of "automobile" no longer includes a limousine, effective October 1, 2005.

K. Nanny Tax

1. If you owe employment taxes on wages for the year, you must pay these taxes during the year through wage withholding or quarterly estimated payments.

   a. Employment taxes generally apply to the wages of household workers who earn more than $1,800 for 2012.

L. Estimated Tax Payments

1. De Minimis Threshold for Estimated Tax

   a. De minimis threshold for estimated taxes after 1997. There is no penalty if the underpayment during the year is $1,000 or less. The figure was $500.

2. Taxpayers with adjusted gross income over $150,000 in 2011 must make estimated tax payments of the lesser of (1) 90% of the 2012 tax or (2) 110% of their 2011 tax in order to avoid an underpayment penalty.

3. The penalty exceptions apply even if a prior year's return is filed late. [Rev. Rul. 2003-23]

4. Designating Tax Deposits

   a. An employer is subject to a penalty if the employer fails to make timely deposits. An underpayment is the excess of the tax required to be deposited over the amount, if any, deposited on or before the prescribed date. The penalty ranges from 2 to 15 percent depending upon the lateness of the deposit.

   b. Rev. Proc. 90-58 provides that deposits for a return period are applied against deposit liabilities in due-date order. Thus, the IRS applies a deposit (or other credit) first to satisfy the oldest past due deposit liability within the same period.

c. RRA 1998 added new IRC §6656(e), effective for federal tax deposits required to be made after January 18, 1999, which permits a taxpayer receiving a penalty notice to designate, during the 90-day period beginning on the date of the period beginning on the date of a penalty notice, the deposit period or periods within the return period to which a deposit to tax shall apply.

d. Under Rev. Proc. 99-10, 1999-2 IRB 11, a taxpayer that receives a penalty notice showing multiple failure-to-deposit penalties for any enumerated tax that is required to be deposited after January 18, 1999, may, within 90 days of the date of the penalty notice, call the toll-free number shown on the penalty notice and designate the deposit period(s), within the return period to which the deposit(s) (or credit(s)) are to be applied. The IRS will adjust the multiple penalties and notify the taxpayer in writing.

1) This will help the taxpayer minimize the failure-to-deposit penalties when the taxpayer missed a deposit early in a return period when subsequent deposits were timely filed.

M. FUTA

1. Beginning in 2004, a de minimis exception to the FUTA deposit rules becomes effective under Prop. Reg. 31.6302(c)-3(a). An employer does not have to deposit FUTA taxes for any quarter if its employment tax liability is less than $2,500 (even if it has an accumulated FUTA tax liability greater than $100).

N. Backup Withholding Rates

1. The backup withholding for dividends and interest, which was 30% in 2002, drops to the fourth lowest individual income tax rate, now 28%

2. The rates on voluntary withholding on Social Security benefits and certain other payments, which were 7%, 10%, 15%, or 27%, at the taxpayer's choice, after 2001, are now 7%, 10%, 15%, or 25%. However, the withholding on unemployment benefits remains at 10%

3. The rate on withholding for gambling winnings, such as lottery tickets, which was 27% in 2002, dropped to the third lowest individual income tax rate of 25% after 2002.

4. Withholding at Highest Rate

a. Individuals receiving supplemental wages (e.g., bonuses or commission) in excess of $1 million for any tax year will be subject to withholding at the highest current income tax rate of 35% rather than the 25% rate.

O. IRS Levy

1. The IRS annually updates Publication 1494, which contains tables to be used in computing the amount of a taxpayer's income that generally will be exempt from levy. [Notice 2004-4]

2. All non-exempt salary, wages, and other income are subject to the IRS's levy. The levy on wages attaches to salary or wages earned but not yet paid at the time the levy is served as well as salary or wages earned and to be paid, or paid as an advance, after the date of levy.

   a. The amount exempt from levy on wages, salary, and other income varies by taxpayer filing status, and the number of exemptions the taxpayer claims.

   b. The exempt amount does not vary based on cost of living in any particular geographic area.

P. Taxpayer Deposits

1. Taxpayers will be allowed to deposit cash with the IRS that can later be used to pay income, estate, gift, generation-skipping transfer, or certain excise taxes. The amount on deposit may be used to pay an underpayment of tax that is subsequently assessed.

2. Except for any underpayment interest that accrues between the due date of the return and the date of the deposit, underpayment interest that accrues between the due date of the return and the date of deposit, underpayment interest would only be charged on the difference between the amount of the deposit and the total underpayment.

3. Taxpayers will be allowed to withdraw any amount of the deposit upon request, assuming it has not already been used to pay tax owed or the IRS determines that the collection of tax would be in jeopardy.

4. Interest is to be paid on withdrawn deposits based on the short-term applicable federal rate.

   a. However, interest would not be payable unless the deposit was attributable to a "disputable tax." A disputable tax is one for which the taxpayer believes that both the taxpayer and the IRS have a reasonable basis for their respective positions as to the treatment of the item. [Rev. Proc. 2005-18]

5. The Fifth Circuit Court of Appeals has upheld a Tax Court decision that a married couple's remittance of $125,000 with an automatic tax extension request was a payment and not a deposit. [Deaton, CA-5 (2/9/06)]

   a. Unlike payments, deposits are not subject to the 3-year look-back period of Sec. 6511.

   b. The IRS has revised Form 4868. Taxpayers are advised that the IRS will treat any remittance sent with Form 4868 as a payment of tax.

Q. Tax Shelters

1. Promoters and Participants

a. Among the tax-shelter changes are new disclosure requirements and a new penalty that applies to any person who fails to include with any tax return, information concerning a "reportable transaction," regardless of whether the transactions results in an understatement of tax.

1) In most cases, the penalty for failure to disclose a reportable transaction is $50,000. If the transaction is a "listed transaction" or substantially similar, the penalty is the greater of $200,000 or 50% of the advisor's fees. If the material advisor intentionally fails to disclose a listed transaction, the penalty is 75% of the advisor's fees.

a) There is no judicial review for advisors.

2) The list of reportable transactions includes:

a) Listed transactions;

b) Confidential transactions;

c) Transactions with contractual protection;

d) Loss transactions; and

e) Transactions with a significant book-tax difference.

(1) Of the five, the largest group is the book-tax difference.

2. Reportable Avoidance Transactions

a. Under new Sec. 6662A, a reportable avoidance transaction (RAT) is any reportable transaction "if a significant purpose of such transaction is the avoidance or evasion of federal income tax."

1) An understatement of tax liability attributable to a RAT is subject to a 20% penalty.

2) If the RAT is undisclosed, the penalty is increased to 30%.

b. The penalty can be avoided by establishing reasonable belief. The taxpayer may not rely on the opinion of a disqualified tax advisor.

1) A disqualified advisor includes a material advisor that participates in the organization, management, promotion, or sale of the transaction.

3. Practitioner Privilege

a. The new law expressly states that the federally authorized tax practitioner privilege does not apply to any written communication between a taxpayer and a federally authorized tax practitioner if the communication is with respect to any tax shelter.

1) Before the 2004 Jobs Act, this rule applied only to communications about corporate tax shelters.

b. Generally, communications between federal authorized tax practitioners and their clients involving tax advice are afforded the same privilege as between attorneys and their clients.

1) A federally authorized tax practitioner includes any non-attorney who is authorized to practice before the IRS, including CPAs and enrolled agents.

4. Uniform Issue List Codes

a. The IRS now assigns Uniform Issue List (UIL) codes to shelter, abusive transaction, and scam cases.

1) UIL codes must be entered for all cases, whether in litigation for not.

2) UIL codes enable Chief Counsel to track work items.

b. The codes are numerical. UIL codes for tax shelters usually begin with the prefix "9300." UIL codes for other abusive transactions relate to relevant sections of the Code.

c. The category "other abusive transactions" in connection with the UIL codes is new. This appears to be a catch-all category of common individual and business tax avoidance schemes. The list includes: abusive trusts, home-based businesses, ADA credit, U.S. possessions residency and coursing IMT4, frivolous filer, corporate sole, offshore credit card project, family limited partnerships, ABAR penalty, consumer credit counseling, donor advised funds, and supporting organizations.

R. Lock-In Letters

1. The IRS issued proposed and temporary regs on April 5, 2005, that changed employer's reporting requirements.

a. The regs eliminate the requirement that employers submit all questionable Forms W-4 to the IRS.

b. If the IRS determines that an employee has inadequate withholding, it will send the employer and the employee a lock-in letter. The lock-in letter will specify the maximum number of withholding allowances permitted for the employee and the new rate for withholding.

1) Employers will receive two copies of the lock-in letter as a backup in case the employee does not receive the lock-in letter.

a) If the employee is still working for the employer, the employer must give the employee copy to the employee within ten days of receiving it.

b) If the employee no longer works for the employer, the employer must notify the IRS.

2) The employer must withhold tax at the new rate specified in the letter, which is not supposed to be any sooner than 45 days after the date on the lock-in letter.

3) The employer may not decrease the rate after the new rate becomes effective.

c. If employers do not withhold in accordance with the lock-in letter, they will be liable for any additional tax owed. Additionally, employers may be liable for a penalty if they do not ensure the lock-in rate is in place by the date specified in the letter.

S. Penalty for Failure to Disclose Interest

1. In an effort to gain greater compliance from taxpayers required to disclose their interests in foreign accounts or trusts, penalties were increased and added (Form 1040, Schedule B, Part III)

   a. A new penalty, of up to $10,000 for non-willful violations of the disclosure rules.

   b. The penalty for willful violations was increased to a maximum of $100,000 or 50% of the amount of the account or transaction.

T. Partial Installment Agreements

1. The IRS is authorized to enter into partial installment agreements.

   a. The IRS would have to review partial installment payment agreements at least every two years.

2. The IRS is allowed to use private debt collection agencies to collect taxes.

   a. If the taxpayer cannot pay in full, the debt collection company can offer the taxpayer an installment to pay over five years.

   b. Otherwise, it must turn the taxpayer's financial information over to the IRS for further action.

U. Return Preparers

1. Return Preparer Standard

   a. The new law retains, the "more likely than not" return preparer standard for tax shelters and Sec. 6662A reportable transactions, but replaces the standard with a "substantial authority" standard for other transactions, retroactive to the effective date of the 2007 Small Business Tax Act.

   b. The law states that, "No penalty shall be imposed under this subsection if it is shown that there is reasonable cause for the understatement and the tax return preparer acted in good faith."

      1) Passage of the provisions equalizes tax return reporting standards for tax preparers.

2. Paper Copies of Clients' Returns

   a. Accountants and other tax professionals do not have to keep paper copies of clients' returns to satisfy their statutory obligation to retain records, the IRS confirmed in final regs. [TD 9119]

      1) The final regs adopt temporary regs issued in April 2003 without change.

   b. The final regs also clarify who must sign as preparer of a return if more than one individual is involved in preparation of the client's return. The individual who has primary responsibility for the overall accuracy of the return must sign as preparer.

3. Preparer Signature Requirements

   a. Return preparers have three new ways to affix their signatures to clients' returns. Preparers may sign original and amended returns, and filing extensions, by rubber stamp, mechanical device, or computer software program. [Notice 2004-54]

      1) Preparers must sign returns after they are completed but before they are presented to taxpayers for their signatures. Otherwise, they risk the imposition of penalties, which can reach as high as $25,000.

      2) The signature must include either a facsimile of their original signature or their printed name. Preparers also must furnish their addresses, employer identification numbers, personal individual identification, and telephone numbers.

      3) The new rules apply to original and amended returns, as well as filing extensions, filed on or after January 1, 2004.

   b. Rubber stamps, mechanical devices, and computer software signatures are not permitted for elections, applications for change in accounting method, powers of attorney, and consent forms. Manual signatures are required for these documents.

   c. Clients must still manually sign original returns, amended returns, and requests for filing extensions. Clients cannot use any of the three new alternative methods of signing.

V. Tax Return Signature Requirement

1. Individual income tax returns must be signed under penalties of perjury by the person required to make the return, unless the return is signed for the taxpayer by a duly authorized agent. Agents may make a signed return with the consent of the District Director of the internal revenue district in which the taxpayer resides or has his principal place of business. Under Reg. 1.6012-1(a)(5), the taxpayer must request this consent in writing and must show good cause why the agent should sign the return. Returns made by agents must be accompanies by a power of attorney.

   a. Not all forms require a power of attorney. For example, the Instructions for Form 2688, Application for Additional Extension of Time to File, state that if there is a good reason why both spouses cannot sign, one can sign this form for the other. These instructions also advise that anyone with a power of attorney can sign, but that a power of attorney is not needed for an attorney, CPA, or enrolled agent to sign for the taxpayer; or, with an attached note of explanation, for a person to sign who is in a close personal or business relationship with the taxpayer who cannot sign because of illness or absence.

2. The IRS received an extended 1990 Form 1040 on October 17, 1991, submitted in the taxpayer's name by his attorney. The return was signed by the attorney. There was no Form 2848, or other power of attorney accompanying the Form 1040, and there was no evidence that the attorney or the taxpayer obtained the consent of the District Director. A week later, the IRS returned the Form 1040 to the attorney and requested that he return the form with a copy of the power of attorney. The attorney did not do so until July 1993. On October 10, 1995, the IRS issued a notice of deficiency for the taxpayer's 1990 tax year. The taxpayer argued that the notice of deficiency was barred by the three year statute of limitations from October 17, 1991. The Tax Court concluded that the execution of the Form 1040 by the attorney in October 1991 did not comply with the Regs, resulting in an invalid return. Accordingly, the notice deficiency was issued within the 3-year period beginning with the July 1993 submission of Form 2848. [*Elliott*, 113 TC 7 (1999)]

W. Electronic Signatures

1. The paper signature jurat was eliminated for electronically filed federal individual income tax returns during the 2001 filing season. This means that taxpayers who file electronically do not have to file a paper copy of Form 8453. Instead, a personal identification number (PIN), together with tax liability, prior year adjusted gross income, and the taxpayer's name and Social Security number will constitute a valid signature.

2. Facsimile Signatures

 a. The IRS has expanded the number of employment-related returns that may be filed with the use of facsimile signatures. [Rev. Proc. 2005-39]

  1) A facsimile signature is one made by a rubber-stamp, mechanical device, or computer software program.

 b. Facsimile signature may be used on:

  1) Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return;
  2) Form 941, Employer's Quarterly Return;
  3) Form 943, Employer's Annual Return for Agricultural Employees
  4) Form 945, Annual Return of Withheld Federal Income Tax;
  5) Other Forms 94X;
  6) Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons
  7) Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips;
  8) Form CT-1, Employer's Annual Railroad Retirement Tax Return; or
  9) Any variant of these forms.

 c. The person filing the form must retain for four years from the date that the return is due or the date on which the related to the return is paid (whichever is later) a letter signed by the corporate officer or duly authorized agent that the officer or agent adopts the signature. The officer or agent is personally responsible for ensuring their facsimile signature if affixed to the returns.

  1) The letter must affirm that the signature was used at the direction of the officer or agent, and that it is affirmed under the penalties of perjury.

  2) The letter must identify each return by name and identifying number.

  3) The letter should be retained rather than sent to the IRS unless the IRS specifically requests the letter.

X. Failure to File Return

1. Taxpayers receiving a Notice of Deficiency and filing with the Tax Court have the three-year statute of limitations to receive refunds from overpayments; previous court decisions required the taxpayer to file for a refund within two years of the due date of the return.
2. Final regs treat credit and refund claims made on late returns as timely filed on postmark date. [TD 8932]

    a. The regs expressly provide that claims for credit for refund made on a late-filed original return will be treated as timely filed on the postmark date.

    b. This rule also applies to claims for credits or refunds made on late-filed original income tax returns and other returns.

    c. A late filed return will be treated as filed on the postmark date.

    d. The final regs expressly apply to documents filed electronically. A document filed electronically with an electronic return transmitter is deemed filed on the date of the electronic postmark.

    e. The IRS will give automatic reconsideration to claims filed on an individual income tax return for 1995 or later. Claims filed on other types of original returns will not qualify for automatic reconsideration. Taxpayers seeking reconsideration should note, on the top of the first page of the return, that the request is a "Weishart Claim."

Y. Last-Moment Refunds Allowed

1. IRS policy formerly was to disallow refunds claimed on late tax returns mailed just before the three-year statute of limitations expired -- and delivered after the three-year date. A recent court decision overruled the IRS and held that such refund claims are timely. The IRS accepts this decision. [*Faye Anastasoff*, 2002 USTC ¶50,705 CA-8]

    a. Claims that previously were rejected may now be accepted.

Z. FICA and FUTA

1. Employment Taxes on Qualified Tax Options

    a. There is a specific exclusion from FICA and FUTA wages for remuneration on account of the transfer of stock pursuant to the exercise of an incentive stock option or under an employee stock purchase plan, or any disposition of such stock.

        1) Such remuneration is not taken into account for purposes of determining Social Security benefits.

2. In 1994, and as part of a settlement of a labor dispute between the baseball players' union and the 26 major league baseball teams, the Cleveland Indians Baseball Club paid $610,000 to 8 players for the 1986 season and $1,457,848 to 15 players for the 1987 season. The disputed issue was which tax year those wages were attributable under the FICA and FUTA tax rules. The District Court determined that it was bound by *Bowman v US*, 824 F2d 528. [CA-6, 1987] In *Bowman*, the Sixth Circuit unanimously concluded that a settlement for back wages should be allocated to the period when the regular wages were earned, and not to the periods when the employer finally paid the wages. [*Cleveland Indians Baseball Co. v US*, DC Ohio, 1-25-99]

   In a unanimous decision, the Supreme Court held that back wages are subject to FICA and FUTA taxes by reference to the year the wages are in fact paid, and not when services are rendered. [*US v Cleveland Indians Baseball Co.,* S.Ct. 4-17-2001]

3. Buyouts of tenured faculty are not subject to Social Security tax. To cut costs, a college set up an early-out program for faculty and staff. Tenured faculty had to relinquish their employment rights to be paid off. The payments were not made for services, an Appeals court says. The professors were paid to forfeit their rights to guaranteed employment. This makes the payments to them exempt for FICA tax. [*North Dakota State Univ.,* 2001-2 USTC ¶50,488, CA-8] Payroll taxes are due on severance pay for other school employees. They did not waive any employment rights. They could have been fired at will.

AA. EINs On-Line -- Businesses now can obtain identification numbers (EINs) on-line. To apply, go to www.irs.gov, then click on "Businesses," "Small Bus/Self Employed", and "Employer ID Numbers (EINs)." Firms still have the option of calling 800-829-4933 to request a number.

1. Internet EINs can be easily identified because they start with a unique prefix: 20.
2. Not all businesses can use the online application. Taxpayers with foreign addresses cannot apply for EINs online. The service is generally available to all taxpayers in the continental U.S., Alaska, and Hawaii, except:
   a. LLCs without entity types;
   b. FEMICs;
   c. Federal government/Military;
   d. State and local governments; and
   e. Native American Governments and enterprises.

3. New businesses requesting employer identification numbers will automatically be pre-enrolled in the IRS's Electronic Federal Tax Payment System (EFTPS). When new businesses receive their EINs, they will also receive an EFTPS personal identification number along with instructions on how to activate their pre-enrollment. Taxpayers will call a special toll-free number and enter their banking information. After this information is provided, they will authorize the transfer of funds from their accounts to the Treasury. [IR-2004-10]

   a. Businesses can schedule payments up to 120 days in advance. Individuals have longer; they can schedule payments up to 365 days in advance.

BB. Informant Rewards

1. An informant whose information to the IRS admittedly resulted in the recovery of millions of unpaid taxes of third parties learned that there is no implied contract that obliges the IRS to pay a reward. In affirming the Court of Federal Claims, the Federal Circuit held that the IRS's refusal to make good on an award was not an abuse of discretion. [*Krug v US*, CA-FC, 99-1 USTC ¶50,298, 2-17-99]

   a. Practice Tip - Informants would be well advised to discuss a reward with the IRS before, rather than after divulging information.

CC. Paying by Credit Card

1. Tax year 1998 was the first year taxpayers could pay their federal income taxes with an American Express, MasterCard, or Discover. Visa did not participate.

2. Starting in March 2000, taxpayers were able to use their cards to make quarterly payments.

DD. Tax Preparer Identification Numbers

1. The IRS Restructuring and Reform Act of 1998 authorized the use of alternatives to Social Security Numbers (SSNs) to identify tax return preparers. The change responds to concerns that a preparer's SSN could be used inappropriately by clientele and others having access to a prepared return. Preparers may download Form W-7P, "Application for Preparer Tax Identification Number," at http://ftp.fedworld.gov/pub/irs-pdf/fw7p.pdf or call IRS's toll-free tax forms line -- 1-800-829-3676. To ensure that the person assigned to and identified by a specific Preparer Tax Identification Number (PTIN) is the person applying for it, the application form asks for the preparer's name, home address, date of birth, and SSN.

EE. Statute of Limitations

1. Under Sec. 6501(a), a valid assessment cannot be made more than three years after the later of the date the return is filed or the return's due date.

2. Sec. 6501(e) provides an exception to the general rule. A six-year limitation period applies when a taxpayer omits from gross income an amount that exceeds 25% of the gross income stated in the return.

   a. In the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods or services prior to diminution by the cost of such sales.

   b. The Tax Court has rejected the IRS's argument that a taxpayer's gross income does not include his or her share of a partnership's gross receipts if he or she as a partner did not materially participate in the business that generated the receipts. [*P.M. Hoffman*, 119 TC 140 (2002)]

3. Under Sec. 6501(c)(1), in the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time.

4. An understatement of gain from the sale of an asset on account of an overstated tax basis counts as an omission of income. This is so even though the seller fully reports the gross sales proceeds. This allowed a six-year statute of limitations. [Ltr. Rul. 200537029]

5. Fraud by Preparer

   a. The Tax Court lengthened the limitations period for assessment of a tax debt against at taxpayer, from three years to the unlimited period for fraud, even though the fraud was perpetrated by the return preparer. The court held that it is not excessively demanding for taxpayers to review their returns for erroneous information that is apparent; in fact it is their duty to do so. [Allen, 128 TC No. 4]

   b. The court concluded that the limitations period for assessing a taxpayer's income taxes is enlarged indefinitely if the taxes were inaccurate due to the fraud of the preparer. The court noted that the petitioner was not assessed a fraud penalty.

   c. The decision in this case contradicts the Tax Court's previous reasoning "that fraud by its very nature is a question of a taxpayer's intent." It also contradicts FSA 200104006, which states that although the statute does not explicitly require that the plan to avoid tax be the personal intent of the taxpayer, only the taxpayer's intent was pertinent. The court did not address this inconsistency.

6. Basis Overstatement

   a. The Tax Court found that an overstatement of basis is not an omission of gross income triggering an extended statute of limitations. The Court was persuaded that the extended limitations period under Sec. 6501(e)(1)(A) is limited to situations in which specific receipts or accruals of income are left out of the computation of gross income. [Bakersfield Energy Partners, 229 TC No. 17]

   b. The Tax Court agreed with the partners that Sec. 6501(e) is limited to situations in which specific receipts or accruals of income items are left out of the computation of gross income. The extended limitations period does not apply when an understatement of gross income resulted from an overstatement of basis.

   c. The Federal Court of Claims found that the assertion of deficiencies against taxpayers for their 1999 tax year as a result of overstated basis adjustments was barred by the three-year statute of limitations. [Grapevine Imports, Ltd, Fed.Cl, July 17, 2007]

      1) A timely deficiency in the open 2000 tax year, however, could challenge loss carryforwards from 1999. It is well established that the IRS and the courts may recompute taxable income in a closed year to determine liability in an open year.

FF. Statute of Limitations During Periods of Disability

1. Generally, under IRC Sec. 6511(a), a taxpayer must file a claim for credit or refund of tax within three years after the date of filing a tax return or within two years after the date of payment of the tax, whichever period expires later.

2. Section 6511(h) suspends the statute of limitations period for filing a claim for credit or refund for any period that an individual is unable to manage the taxpayer's financial affairs because of a medically determinable mental or physical impairment.

   a. The mental or physical impairment can be expected to result in death, or has lasted or can be expected to last for a continuous period of not less than one year.

3. An individual is not considered to be financially disabled unless the proper proof is provided to the IRS. The IRS will evaluate whether a medical opinion that a physical or mental impairment exists has been offered by a person qualified to do so with respect to the particular type of impairment.

4. The suspension of the limitation period does not apply for any period during which the taxpayer's spouse or another person is authorized to act on behalf of the individual in financial matters.

5. Rev. Proc. 99-21, 1999-17 IRB 18, requires that the following statements are to be submitted with a claim for credit or refund of tax to claim financial disability:

   a. A written statement by a physician qualified to make a determination, that sets forth:

      1) The name and a description of the taxpayer's physical or mental impairment;

      2) The physician's medical opinion that the physical or mental impairment prevented the taxpayer from managing the taxpayer's financial affairs;

      3) The physician's medical opinion that the physical or mental impairment was or can be expected to result in death, or that it has lasted (or can be expected to last) for a continuous period of not less than 12 months;

      4) To the best of the physician's knowledge, the specific time period during which the taxpayer was prevented by such physical or mental impairment from managing the taxpayer's financial affairs; and

      5) The following certification, signed by the physician:
         I hereby certify that, to the best of my knowledge and belief, the above representations are true, correct, and complete.

   b. A written statement by the person signing the claim for credit or refund that no person, including the taxpayer's spouse, was authorized to act on behalf of the taxpayer in financial matters during the period described in 4) above. Alternatively, if a person was authorized to act on behalf of the taxpayer in financial matters during any part of the period described in 4) above, the beginning and ending dates of the period of time the person was so authorized.

GG. Innocent Spouse Claims

1. For married taxpayers, joint and several liability is the obligation that accompanies the privilege of filing a joint return. Thus, one spouse may be subject to joint liability for the omissions from income or erroneous deductions of the other spouse.

2. The IRS Restructuring and Reform Act of 1998 contained significant provisions designed to protect married taxpayers from the tax misdeeds of their spouses. A new requirement is that a taxpayer must elect innocent spouse relief within two years after tax collection activities are begun.

3. Innocent spouse relief applies to all understatements of tax attributable to erroneous items of the other spouse. It is no longer necessary for an understatement to be "substantial," which eliminates the $500 minimum and the minimums based on the innocent spouse's AGI. In addition, it is no longer necessary for the items of the other spouse to which an understatement is attributable to be "grossly" erroneous.

4. Innocent spouse relief continues to be available only if the spouse invoking such relief establishes that, in signing the return, he or she did not know, and had no reason to know, that there was an understatement of tax.

    a. However, if the spouse establishes that, in signing the return, he or she did not know, and had no reason to know, the extent of the understatement, innocent spouse relief is available on an apportioned basis.

    b. In such a case, the spouse is relieved of liability to the extent it is attributable to the portion of the understatement that the spouse did not know of or have reason to know.

5. Divorced taxpayers and married taxpayers who are legally separated or who have been living apart for at least one year may elect separate tax liability despite having filed a joint return.

6. Taxpayers must elect innocent spouse relief using IRS Form 8857, Request for Innocent Spouse Relief.

7. The Tax Court is given jurisdiction to review denials of innocent spouse relief and separate tax liability elections and restrains IRS collection efforts while a Tax Court procedure is pending.

8. Reversing its traditional rule, the Tax Court has allowed a taxpayer to challenge the IRS's grant of innocent spouse relief to his ex-wife. [*Corson*, 114 TC N. 24 (2000)]

9. Although the husband had access to the correct information, the Tax Court clarified that such a finding does not mean that he actually knew of the omitted income. The husband was entitled to relief under Sec. 6015©, which would limit his liability only to the income allocable to him. [*F.L. Charlton*, 114 TC 333 (2000)]

HH. Disclosure is Considered Adequate [Rev. Proc. 2003-77]

1. Taxpayers must furnish all required information in accordance with the applicable forms and instructions. Money amounts entered on these forms must be verifiable. A number is verifiable if, on audit, the taxpayer can demonstrate the origin of the number and the taxpayer can show good faith in entering that number on the applicable form.

2. Additional disclosure generally is unnecessary for the following items:

    a. Form 1040, Schedule A, Itemized Deductions: Medical and dental expenses; taxes, interest expense; contributions including non-cash contributions; and casualty and theft losses on Form 4684.

    b. Certain trade or business expenses, including the following as they relate to the rental of property: Casualty and theft losses on Form 4684; legal expenses; specific bad debt charge-off; reasonableness of officers' compensation as reported on Form 1120; repair expenses; and taxes, other than foreign taxes.

    c. Form 1120, Schedule M-1, Reconciliation of Income (Loss) per Books with Income per Return, provided the amount of deviation is not the result of a computation that includes the netting of items and the information may be expected to apprise the IRS of the nature of the potential tax controversy.

    d. Other miscellaneous items: Moving expenses; employee business expenses on Forms 2106 or 2106-EZ; fuels credit on Form 4136; and investment credit on Form 3468.

II. IRS Position Not Substantially Justified

1. Taxpayers are allowed to recover the cost of fighting a tax bill from the IRS.

2. To qualify for reimbursement, the taxpayer must be the prevailing party and must show that the IRS's position was "not substantially justified."

3. The Taxpayer Bill of Rights II creates a presumption that the IRS's position is not substantially justified when the IRS:

   a. Did not follow it own published guidance (such as regulations, revenue rulings, and notices, or a private letter ruling and determination letter issued earlier to the taxpayer), or

   b. Previously lost in a federal Court of Appeals on the same issue.

4. In such instances, the burden falls on the IRS to rebut the presumption.

JJ. EFTPS

1. The IRS is offering refunds of past employment tax penalties to businesses that begin using the Electronic Federal Tax Payment System (EFTPS). The IRS is offering to refund one federal tax deposit penalty incurred on a quarterly Form 941 employment tax return during the prior year. [IRS News Release IR 2004-70]

   a. The offer is available to employers that are not required to use EFTPS;

   b. The employer must use EFTPS for one year;

   c. Make all Form 941 payments on time; and

   d. Have previously fully paid the penalty.

KK. Delivering Payee Statements Electronically

1. Final regs allow the voluntary electronic furnishing of statements on Forms W-2, Wage and Tax Statement, and statements on Forms 1098-T, Tuition Statement, and Forms 1098-E, Student Loan Interest Statement. [TD 9114]

   a. Furnishers and recipients must voluntarily participate in the electronic delivery system and must ensure that the system complies with the requirements of the regs.

   b. Furnishers are allowed to treat a request for a paper statement as a withdrawal of consent.

   c. Any electronic communication, to which the recipient consents, including e-mail, is allowed.

   d. High priority need not be assigned to e-mails because some software does not have this capability.

   e. Furnishers may decide whether to store on their web servers all statements or only those statements for which consents are received.

2. The IRS permits electronic delivery of many payee statements relating to educational savings, pensions, IRAs, Archer MSAs, and other accounts. [Notice 2004-10]

3. The following may furnish Form 1099 or Form 5498 payee statements electronically if they satisfy consent, format, posting, and notification requirements:

    a. Sponsors or administrators of retirement plans or qualified tuition programs (529 plans);

    b. Employers sponsoring SEPs; and

    c. Trustees, custodians or issuers of IRAs, Roth IRAs, CESAs, or Archer MSAs.

4. The Job Creation and Worker Assistance Act of 2002 authorized electronic reporting of contributions and distributions of pensions, IRAs, and other accounts.

5. The filing deadline with the IRS is March 31 instead of February 28.

LL. Tipped-Employee Reporting

1. Voluntary participation in the Tip Rate Determination and Education Program has been made permanent by the IRS.

    a. The IRS agrees not to audit the business on tips for participating in the program.

2. Under one option, a business agrees to educate employees about their tip-reporting duty and gives them monthly statements of credit card and other known tips.

3. A business can design details of its own program.

MM. IRS Transcript Delivery System (TDS)

1. Enables practitioners to obtain tax return transcripts and account information of their clients in minutes over a secure line.

2. Only practitioners who have e-filed 100 or more returns can use TDS.

NN. Internal Revenue Service

1. Revoking Sec. 83(b) Election

    a. The IRS has issued guidance on the factors required for revoking a Sec. 83(b) election. The election applies to non-vested stock or other property that an employee receives as compensation. [Rev. Proc. 2006-31]

    b. To revoke a Sec. 83(b) election, the employee must be under a mistake of fact and must apply for revocation within 60 days after the mistake of fact became known.

        1) The IRS will not consent to the revocation if the employee was under a mistake of law.

        2) Failure to understand that property was subject to a substantial risk of forfeiture and failure to understand the tax consequences of the transfer or the election are not mistakes of fact.

c. The IRS will consent to revocation if it is requested within the 30-day dealing for making the election.

   1) Even if there is no mistake of fact.

   2) The application for consent must provide:

   3) A description of the facts and the mistake of fact;

   4) The date of the election;

   5) Copies of relevant documents, including the election; and

   6) The date when the mistake of fact became known.

2. Offers-In-Compromise Disclosure Authorization

   a. Taxpayers involved in the offer-in-compromise (OIC) program can designate a third party to discuss their OIC and related return information with the IRS during the initial stages of processing an offer. [Announcement 2005-6]

      1) The check-the-box designation does not serve as authorization to represent the taxpayer before the IRS or during a Collection Due Process hearing.

3. Mandatory E-Filing [TD 9175]

   a. Corporations and S corporations with assets of $50 million or more must e-file Forms 1120 or 1120S for tax years ending on or after December 31, 2005. Exempt organizations with assets of $100 million or more must e-file Form 990 for tax years ending on or after December 31, 2005.

   b. Corporations and S corporations with assets of $10 million or more must e-file Forms 1120 or 1120S for tax years ending on or after December 31, 2006. Exempt organizations with assets of $10 million or more must e-file Form 990 for tax years ending on or after December 31, 2006.

   c. A taxpayer's assets are determined based on total assets at the end of the tax year as reported on Form 1120, 1120S, or 990.

   d. The mandatory e-filing rules apply only to large businesses, exempt organizations, and private foundations required to file at least 250 returns during the calendar year.

      1) If the taxpayer meets the asset qualifications, but files fewer than 250 returns during the calendar year, it may continue to file paper returns.

   e. Taxpayers in existence for less than one calendar year from the due date of the appropriate form (excluding extensions) are exempt from the e-filing requirements.

4. E-Filers

   a. Tax professionals who e-file five or more accepted individual or business returns in a calendar year may now use three of the IRS's e-Service products previously reserved for those who e-filed 100 or more individual returns: [IR-2005-33]

      1) Disclosure Authorization, which allows powers of attorney and related documents to be filed on-line;

      2) Electronic Account Resolution, to solve client account problems through electronic communication; and

      3) Transcript Delivery System, which delivers tax account records electronically.

5. Where's My Refund

   a. Taxpayers may now start a trace for a lost or missing refund check. [IR-2005-35]

      1) A refund can be traced starting 28 days after the IRS says it has been sent.

         a) To see if anyone else cashed it.

         b) When a refund check has been returned to the IRS by the postal service as undeliverable, the site can be used to change an address in the IRS database.

6. W-4 Submission Rules

   a. Under proposed, temporary, and final regulations, employers will not have to submit copies of Forms W-4 when an employee claims more than 10 withholding exemptions or complete exemption from withholding. Under the new rules, employers will only have to submit withholding certificates if instructed by the IRS. [T.D. 9196, IR-2005-45]

   b. Employers should keep Form W-4 as future guidance or written notice from the IRS may require them to submit the withholding certificates at a later date.

7. Telefile

   a. Due to a decline in taxpayer use and increasing costs, the IRS discontinued Telefile on August 16, 2005. 2.7 million taxpayers used Telefile in 2005.

8. Package X

   a. The IRS will no longer publish Package X, the set of reference copies of income tax forms it mailed out each year to tax professionals. The move saves printing and mailing costs.

9. Estate Tax Liens

   a. An estate's administrator sold three houses to unrelated buyers. The IRS later did an audit of the estate and demanded additional tax, which the estate began to pay in installments. When the estate defaulted, the IRS sent letters to the home buyers threatening to seize their homes and sell them unless they paid the $189,000 in delinquent estate taxes. A District Court said the IRS can go after the buyers for unpaid estate taxes. [First American Title, D.C., Wash]

   b. The IRS tax lien lasts 10 years.

   c. All of the buyers had title insurance.

10. Fast Track Settlements

   a. The fast track settlement program is being made available to small businesses.

   b. The program bypasses normal IRS procedures and used a mediator to expedite voluntary settlement of tax disputes.

   c. Among the large and midsized businesses to which it has been made available so far, it has been successful in resolving cases more than 80% of the time, and in those cases, it reduced resolution time to an average of only 84 days compared with 815 days for cases going the traditional IRS appeals.

11. IRS Interest Charge

   a. The Tax Court ruled that the IRS cannot charge interest for the period that it prevented payment of tax. [David Jackson, TC Summ. Op. 2005-12]

   b. Taxpayer intended to borrow against his house to pay a tax bill -- but the IRS put a lien on it first. The bank would not make the loan until the IRS gave it a letter saving that the lien would be lifted as a result. The IRS did not provide the letter for four months and when it finally did, the bank promptly made the loan. The IRS's delay in providing the letter prevented the payment of the tax bill, so it cannot charge interest for the corresponding period.

12. IRS Whipsaw Position

   a. The Court of Federal Claims ruled that the IRS's decision to adopt a whipsaw position to protect its interests was reasonable. [Walker, FedCl, 4-13-2005]

   b. Courts have consistently taken the position that the IRS has the right to maintain opposite positions in order to "break even" under the tax laws.

   c. Whipsaw positions have been taken in alimony situations, disputes involving goodwill vs. covenant not to compete, allocation of purchase price, sale vs. rental/royalty, and employee vs. independent contract disputes.

13. Form 4868 Remittance

    a. The Fifth Circuit Court of Appeals has decided that a remittance made on a Form 4868 request for an extension was a payment and not a deposit. [Harrigill, CA-5, 5-31-05]

        1) As a result, a refund credit request made five years later, although within three years of the date on which the taxpayer finally got around to filing the return, was too late.

14. European Public Limited Liability Company

    a. The new European Union entity, a public limited liability company will be added to the list of entities treated as corporations under Sec. 7701.

        1) The check-the-box regulations will be amended.

        2) Also referred to as Societas Europaea or SE.

15. The IRS will no longer treat a Form 2848 listing an ineligible representative as tax information authorizations. The IRS will reject the Form 2848 and a submission of Form 8821 - Tax Information Authorization will be required.

16. Garnish Pension Plans

    a. An individual was convicted of a crime and the government garnished his account in a company pension plan. Federal law exempts qualified retirement plans from creditor claims made against plan participants, and prohibits plans from making payments to such creditors. Criminal fines are treated as if they were tax assessments -- and qualified plans are not exempt from claims made by the IRS. [Ltr. Rul. 200342007]

17. The IRS realized it had lost a return, found it, processed it -- and added 11 years interest to the tax bill. The IRS must abate the interest charge because even though the return was underpaid, the error was entirely due to the IRS's error in losing the amended return and not telling him the status of his tax bill even when he had asked. [Nicholas J. Palihnich, TC Memo 2003-297]

18. Notice of Deficiency Refusal

    a. The U.S. Postal Service (USPS) attempted delivery of the Notice of Deficiency twice, but delivery was refused. The court found that taxpayer had actual notice of the proposed tax assessment. He did not contest the deficiency through the proper protest and appeal process. Pollack v. U.S., 94 AFTR 2d 2004 (D.C. W. Tenn)]

    b. In 1996, the IRS had about 26,000 employees working on audits, collections, and investigations. In 2005, the number fell to about 19,000. Of course, the IRS had 20 million fewer returns to deal with in 1996.

19. Estimated Taxes

    a. Penalties for underpaying estimated taxes can be avoided if total estimated payments equal 100% of the tax shown on the prior year's return (110% if income on the prior return exceeded $150,000). But when an individual made estimated payments for a year before filing a return for the prior year, an IRS auditor asked if the penalty exception still applies. The Tax Code does not set any time limit for filing the prior year's return. If the payments for one year actually exceed 100% (or 110%) of the amount owned for the prior year, no penalty applies -- even if the prior year's return is filed late. [Rev. Rul. 2003-23]

20. IRS Scrutinizes Executive Compensation and Benefits of Tax Exempts

    a. Executive pay and perks are under the IRS's microscope as it hunts for abuses by tax-exempt organizations. The agency has announced a major initiative to identify and terminate abuses by nonprofits. Nearly 2,000 charities and foundations will be contacted in the IRS's sweep. [IR-2004-106]

21. Offer in Compromise Scams

    a. False claims about the IRS's offer in compromise program (OIC) are proliferating, the IRS recently warned. Taxpayers are being duped into believing they can settle their liabilities for "pennies on the dollar' through the OIC program. [IR-2004-17]

    b. A tax liability can be compromised only for limited reasons:

        1) Doubt that the accessed tax is correct;

        2) Doubt that the taxpayer can pay the full amount;

        3) Collection would be unfair, inequitable, or create an economic hardship.

    c. Commissioner Mark Everson stated that "We are increasingly concerned about unscrupulous promoters charging excessive fees to taxpayers who have no chance of meeting the OIC program's requirements." He reminded taxpayers that the OIC program serves a select group of taxpayers and participation is at the discretion of the IRS, not the taxpayer.

        1) The IRS reports that OICs resolve less than one percent of all balance due accounts.

    d. Recently, the IRS added a $150 application fee to discourage bogus OICs. A taxpayer may request waiver of the fee if the OIC is submitted because of doubt that the accessed tax is correct or the taxpayer's income is below federal poverty guidelines.

22. Frivolous Arguments Are a Growing Problem

    a. Frivolous arguments are consuming too much of its resources, the IRS recently warned, and it intends to crack down on taxpayers making bogus claims and assertions to avoid taxes. [IR-2004-26, Notice 2004-22, Rev. Ruls. 2004, 27, 29, 30, and 31]

    b. The "top 10" tax avoidance devises and schemes are:
        1) Misuse of trusts;
        2) "Claim of Right";
        3) Phony, one-person religious organizations;
        4) Offshore transactions;
        5) Employment tax evasion;
        6) Return preparer fraud;
        7) Abuse of the Americans with Disabilities Act;
        8) Slavery reparations;
        9) Home-based business; and
        10) EITC abuse

    c. The IRS is on alert for other frivolous arguments, such as claims that:
        1) Domestic income is not taxable;
        2) Individuals are not "citizens" for tax purposes;
        3) Tax returns are voluntary not obligatory;
        4) Payroll taxes are voluntary;
        5) Taxpayers need only pay taxes when they agree with government expenditures;
        6) Taxpayers can avoid taxes by filing returns showing zero income/zero/liability;
        7) Taxpayers need not use official returns;
        8) Taxpayers can "disclaim" their tax liability; and
        9) Social Security taxes are refundable.

    d. Top IRS officials have been stressing that voluntary compliance is at a critical junction. If it is not shored-up soon, the system could be permanently impaired. More taxpayers than ever before are willing to cheat on their taxes or disregard their tax obligation. The growth of avoidance scams and schemes seems to reflect the prevailing attitude.

23. Charitable Deduction Conservation Easements

    a. The IRS recently issued a strong warning to charities and donors that it intends to challenge improper deduction for conservation easement transferred to charity. [IR-2004-86, Notice 2004-41]

        1) A conservation easement must permanently restrict the use of property, to preserve habitat or open space, and must be donated to a charity. The easement must be substantiated by records reflecting the donation's conservation purpose and the fair market value of the underlying property before and after the contribution.

        2) An open space easement must provide a significant public benefit. The IRS will disallow charitable deductions if the donor received greater benefits than the public for providing the easement. Deductions will be disallowed if the easement increases the property's value or does not materially reduce its value.

3) One source of abuse involves property sales by charities to purported donors. A charity purchases property and places a conservation easement on it. The charity then sells the property to a "donor." The donor makes two payments, one payment for the property at a substantially lower price than the charity paid, and a second payment designated as a charitable contribution. The two payments equal the amount paid by the charity. The IRS will treat the total paid by the purchases as the actual price for the property.

24. Guide to Fringe Benefits

a. The IRS has a guide to fringe benefits, a 118-page training manual for agents that has been updated to reflect the IRS's current views.
www.irs.gov/pub/irs-tege/fringe_bnft_flsg.pdf

25. Not an Examination

a. A recent Chief Counsel Advice takes the position that asking taxpayers to answer a voluntary questionnaire and to participate in an informal meeting with the IRS is not an examination for purposes of the second-examination prohibition under Sec. 7605(b). [CCA 200612015]

1) The IRS is sending questionnaires and requests for informal meetings to taxpayers whose returns show a high probability of error.

2) The cover letter attached to the request specifies that the IRS is not conducting an investigation of the taxpayer and that the IRS does not want to examine the taxpayer's books and records. Taxpayers are told that their decision to answer the questionnaire and informally meet with an examiner is strictly voluntary.

26. Medicare Part B Premiums

a. Medicare Part B premiums will increase in 2007 for up to 2 million people. The more income a beneficiary has, the higher the premium due.

b. For Singles

If your 2005 modified AGI is		Your month 2007
More than	But not over	premium will be
$0	$80,000	$93.50
$80,000	$100,000	105.80
$100,00	$150,000	124.40
$150,000	$200,000	142.90
$200,000	-	161.40

c. Modified adjusted gross income is 2005 adjusted gross income plus tax-exempt interest, EE bond interest used for educational expenses, and any excluded foreign earned income.

d. Taxpayers will be able to appeal if income was affected by a "life-changing event." Regulations will be issued that will detail what circumstances apply.

e. The premium increase is owed even if you did not sign up for prescription drug coverage.

f. The add-on percentages for 2008 will be double those of 2007 and be based on 2006 income. In 2009, the percentages will triple.

OO. Circular 230

1. Tax Shelter Opinions

   a. New Circular 230 regs impose strict standards on attorneys, accountants, and other professionals who give tax shelter opinions. [TD 9165]

   b. The Circular 230 standards apply to "covered opinions," this is, written advice (including emails) on a tax issue involving:

      1) Abusive ("listed") tax shelter transactions identified by the IRS;

      2) An entity or arrangement created for the principal purpose of avoiding or evading taxes; or

      3) An entity or arrangement that has a principal purpose of avoiding or evading tax, if the opinion is a reliance, marketed, or confidential opinion, or includes contractual protection.

   c. Practitioners who issue tax shelter opinions must use reasonable efforts to identify all relevant facts, discuss the applicable law, evaluate the significant tax issues, and give an opinion on "significant" tax issues that could jeopardize the transaction's tax benefits. The rules also require the tax supervisors to ensure their firm's compliance with the shelter opinion rules.

   d. The regs require practitioners to inform investors of any referral or compensation arrangement with a transaction's promoter and to disclose that their opinion may not protect the client from penalties.

   e. The rules exclude preliminary advice; opinions of qualified pension plans; or for SEC documents; and opinions indicating that the opinion cannot be used to avoid penalties.

   f. The rules also provide minimum standards for non-tax shelter advice. Practitioners may not rely on unreasonable factual assumptions, representation, statements or findings they knew or should have known were incorrect or incomplete.

   g. After June 20, 2005, practitioners providing advise on tax shelters must say that the promised tax benefits have a better than 50% chance of being upheld. [Circular 230, Sec. 10.35]

2. Covered Opinions

   a. Circular 230 literally requires pages of facts and legal analysis to back every piece of tax advice sent to clients that possibly could be considered a "covered opinion."

   b. Disclaiming language should be provided to clients to avoid imposition of penalties under Circular 230

   c. The language must include an explanation to clients that hey may not use the tax advice as a defense later for avoiding penalties if the advice proves to be faulty.

d. CCH Inc. provides the following letter to be used to inform clients about Circular 230 and the use of a disclaimer in your communications:

Dear Client:

The IRS has issued new rules that will affect how we, tax professionals, communicate with your, our client. The rules, which took effect June 20, apply whenever a practitioner provides written advice, including e-mails, faxes, and letters, on tax issues. While the rules are motivated by the government's well-founded concern with abusive tax shelters, they will apply to advice given on many common and accepted transactions.

The rules grew out of the government's decision to attack the mechanisms used by tax shelter promoters to sell abusive tax shelters. The new rules address the practice of promoters to obtain boiler-plate opinions for tax shelters. Taxpayers engaging in abusive transactions use these types of opinions to escape tax penalties of 20 percent or more, on top of what they owe in taxes, by claiming they "reasonably" and "in good faith" relied on the tax opinion for their belief that the transaction was permissible.

In the new IRS rules, clients cannot rely on a tax opinion for protection from penalties unless the practitioner provides a comprehensive opinion that considers and discusses:

1) All relevant facts and applicable law,
2) The relationship between the facts and the law,
3) A conclusion as to the legal consequences of each tax issue, and
4) The likelihood that the taxpayer will prevail if the IRS challenges the transaction.

The new rules apply to tax advice for transactions that have a "significant purpose" of tax avoidance. This standard is vague and uncertain, in large part because the IRS did not want to create any loopholes. Consequently, the new rules may sweep in many routine, non-abusive transactions. The penalties to practitioners can be severe providing written advice that does not meet these requirements, including disbarment from practice before the IRS.

Because of the new rules, the cost of securing a comprehensive opinion will be higher. An alternative to writing an expensive opinion is to include a disclaimer on written advice furnished to the client. This disclaimer will state that the client cannot rely on the opinion for protection from tax penalties. According, effective June 20, this firm will routinely include the following language in written communications:

"This written advice is not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer."

Even with this legend, there are other penalty defenses to penalties. You will not automatically be penalized if the IRS challengers a transaction.

Please be assured that we will continue to act diligently to meet your needs. The use of this legend does not change the quality of our service and the advice you have come to expect from us. In appropriate cases, after consultation with you, we will provide a comprehensive opinion that meets the new rules.

If you have any questions about this important development, please contact us.

3. Cost Segregation Studies

   a. Any practitioner who markets an asset depreciation study as a tax saver must include a disclaimer that the study's conclusions cannot be relied on to avoid IRS penalties.

   b. The IRS has the power to require penalty disclaimers on asset depreciation studies marketed by engineering firms, which are not covered now by IRS disciplinary rules.

PP. Penalties

1. Failure to File Penalty

   a. The failure to file can result in a penalty of 5% for each month that there is a failure to file any return, up to a maximum of 25%. The penalty is computed on the net amount due, after withholding, estimated tax payments, and other credits on the return.

      1) If failure to file and failure to pay penalties both apply, the failure to file penalty may reduced by the failure to pay penalty. However, if a late filed return understates the tax due, the failure to pay penalty cannot offset the failure to pay penalty.

2. Failure to File Criminal Penalties

   a. The IRS reports that its policy is not to recommend criminal prosecution of individuals who fail to file their tax returns, provided the individual voluntarily files, or makes arrangements to file, before he or she is notified that the IRS has begun a criminal investigation.

      1) However, if the taxpayer's actions are particularly egregious, the IRS may seek to impose criminal penalties as well as civil penalties.

3. Penalties to Appraisers

   a. Recent advice from the IRS's Office of Chief Counsel reviews the applications of penalties under Sec. 6701 to appraisers who know that their statements will lead to understatements of tax liabilities. [CCA 200512016]

   b. The Chief Counsel identified three elements to the misconduct punishable under Sec. 6701:

      1) The individual must have assisted in the preparation of a return, affidavit, claim, or other document;

      2) The appraiser must know, or have reason to believe, that the document will be used in any material matter; and

      3) The appraiser must have actual knowledge that the use of the document will result in the understatement of tax liability.

   c. The penalty assessed is $1,000 for each individual return affected by any misstatement and $10,000 for each corporate return. The IRS may seek injunctions against appraisers to prevent the recurrence of misconduct, and individuals may be subject to disqualification under Circular 230 from presenting evidence before Treasury or the IRS in any administrative proceedings.

QQ. Protective Claims

1. A protective refund claim is a claim filed to protect the taxpayer's right to a potential refund based on a contingent event for a taxable period for which the period of limitations is about to expire.

2. A protective claim generally must follow certain guidelines:

    a. The claim must be filed with the service center in which the tax was paid;

    b. It must set forth in detail upon which a credit or refund is claimed and facts sufficient to apprise the IRS of the exact basis for the claim;

    c. It must be verified in writing under penalty of perjury;

    d. It must be filed in the proper form; and

    e. It must be timely filed.

3. Informal Refund Claims

    a. Taxpayers frequently assert that an informal written communication such as a letter constitutes an informal refund claim. Some taxpayers have prevailed in their argument.

4. An employer's timely filed protective claim for refund of FICA tax will also protect its employees' individual claim filed after the period of limitations has expired. [Rev. Rul. 83-79; Rev. Proc. 81-69]

5. Apprising the IRS

    a. A notation on the back of a check that the tax is being paid under protest and pending final decision of an issue that the taxpayer is litigating with the IRS was held to be a valid and timely claim for refund. [Nit Hawk Leasing Co. v US, 37-1 USTC p9211, CtCls]

6. Form 1040-X

    a. Write "Protective Claim" at the top of the form.

    b. In part 2 of the form, "Explanation of Changes" note that this is a "protective claim -- do not process"

7. An initial protective claim generally is perfected by filing a subsequent claim for refund upon the occurrence of the contingency.

Chapter 17 - Family Limited Partnerships

A. Family limited partnerships have been marketed by estate planners as vehicles to substantially reduce estate and gift taxes.

1. While it is possible to achieve favorable results due to valuation discounts, it is important to note that the IRS will look closely at these arrangements.

2. Where the partners themselves do not respect the arrangement, the IRS may disregard the arrangement entirely.

3. Where the arrangement is a sham, the IRS may invoke special valuation rules to thwart the attempted benefits from the family limited partnership.

B. How the family limited partnership operates

1. In the usual situation, a parent sets up a limited partnership funded with his or her assets.

2. The parent retains a small general partnership interest and makes gifts of limited partnership interests to children and grandchildren.

   a. The gifts are designated to fall within the annual $13,000 gift tax exclusion ($26,000 if a spouse consents to gift-splitting).

3. Since the parent is the general partner, management and control of the assets are retained.

   a. The parent can decide when and the extent that any distributions should be made.

4. The partnership stays in existence until the parent (or surviving spouse if he or she is also a partner) dies.

5. Then the partnership is dissolved and assets distributed to partners according to their ownership interests.

C. For gift and estate tax valuation purposes, the interests of the limited partners are eligible for sizable discounts due to lack of marketability and for minority interests.

1. Lack of marketability--sales of interests in the family partnership generally are restricted.

2. Minority interests--limited partners cannot participate in management, compel distributions, nor liquidation.

3. Discounts can range from 30% to 60%, depending on the restrictions and other aspects of a particular partnership.

4. The availability of such large discounts means that greater amounts can be transferred under the shield of the annual gift tax exclusion.

   a. Partnership interests worth $18,500 without any discount can be valued within the $13,000 annual exclusion with just a 30% discount.

D. Recent Developments in Family Limited Partnerships

1. The Seventh Circuit affirmed the Tax Court's ruling that gifts of shares in a family limited liability company did not confer immediate economic benefit. The transferred shares amounted to future interests and were ineligible for the annual exclusion. The company's restrictions on the transferability of the shares meant that the shares were essentially without immediate value to the members. [*Hackel v. Comm.*, 335 F.3d 664 (CA-7, 7-11-03)]

   a. Under the operating agreement, the husband/taxpayer was manager-for-life.

   b. During his tenure, the company operated at a loss and did not make any distributions.

   c. The shareholders needed the manager's approval to withdraw from the company or sell shares. If a member transferred his or her shares without consent, the transferee would receive the shares' economic value but not any membership or voting rights.

2. Mary Lou Edelstein, the IRS National Coordinator for Family Limited Partnership Appeals, emphasized that the IRS has coordinated all family limited partnership discount cases at the Office of Appeals level and will actively seek to determine whether a FLP's underlying assets are includible in a transferor's estate under Sec. 2036(a), without a discount.

   a. Some red flags:

      1) Whether the parties respected the technical formalities of a FLP in its creation and operation;

      2) Whether the transferor used personal assets to fund the FLP; and

      3) Whether the transferor retained sufficient assets to maintain a reasonable standard of living, without having to rely on the FLP's assets.

3. Estate of Strangi, TCM 2003-145 (Strangi II) is the first Tax Court case in which the IRS has successfully used Section 2036(a)(2) to include assets transferred to a FLP in the transferor's estate.

   a. The assets contributed by Strangi to SFLP constituted approximately 98% of his wealth and included his personal residence.

   b. Distributions from SFLP after its formation, although pro rata, were all occasioned by either Strangi's personal needs or the needs of his estate.

   c. The Tax Court was upheld by the Fifth Circuit. Based on the facts, the Fifth Circuit found that the estate's latest appeal failed on two counts: [Strangi, CA-5, 2005-2 USTC p60,506]

      1) The taxpayer had retained "possession or enjoyment" of the assets transferred, as the periodic payments made to him, and the payment of his expenses, met the "substantial" and "present" requirements of Sec. 2036(a)(1), resulting in his enjoyment of the assets; and
      2) The sale was not in good faith, as it had no other objective purposes than to lower tax liability.

4. The Tax Court has ruled that asset transfers to five family limited partnerships by a deceased husband and wife were not included in their estates because the transfers were bona fide sales for adequate and full consideration under Sec. 2036(a). [E. Stone III Estate, TC Memo 2003-309]

   a. The decedents received pro rata partnership interests in return for the contributions made to the FLPs.

   b. The decedents decided which assets to transfer. They did not accept their children's recommendations without considering the issues.

   c. The taxpayers did not transfer everything to the FLPs, but retained sufficient assets to sustain their accustomed standard of living.

   d. The court found that the five FLPs had economic substance as joint enterprises for profit. They were not merely "circuitous recycling of value," but were motivated by substantial business purposes regarding asset management.

5. The Fifth Circuit held that an intra-family transaction was a bona fide sale even though the decedent's trust contributed assets on both sides of the deal. The transaction method met both of the Sec. 2036 exceptions, thus escaping inclusion in the gross estate. [D. Kimbell, Sr., 2004-1 USTC ¶60,486, CA-5]

6. Before his death, decedent transferred $2.8 million in securities and other assets to two family limited partnerships, taking a 40% discount. The court ruled that the taxpayer retained lifetime control and enjoyment of the assets, and the transfer of the assets was not a bona fide sale for adequate and full consideration. "Other than favorable estate tax treatment resulting from the change in form, it is difficult to see what benefit could be derived from holding an untraded portfolio of securities in this [FLP] with no ongoing business operations." [Estate of Theodore R. Thompson v. Comm., 49 AFTR 2d 2004 (CA-3)]

7. A parent tried to use a limited partnership for estate planning by setting up a family limited partnership and transferred her assets to the trusts. However, she deposited income from the partnership assets in her personal checking account. She did not keep separate records for the partnership's funds. The Tax Court concluded that there was an implied agreement between the partners and the decedent that she would retain the full beneficial enjoyment from the assets. As such, the value of the assets held by three family limited partnerships was includible in her gross estate.

8. The IRS declared family limited partnerships and family limited liability companies should be disregarded where the transfer occurred shortly before death. [TAM 9719006 - 2 days before death; TAM 9735003 - shortly before death; TAM 9725002 - 2 months before death; TAM 9730004 - 2 months before death; see also TAM 9723009 and TAM 9736004]

9. The IRS has disallowed the annual gift tax exclusion in TAM 9751003. Even if the transaction is valid, no present income interest passes if the general partner/manager has complete discretion to retain funds in the entity. If there are substantial restrictions on the transfer of an interest, no present interest is created.

   a. Tax Planning - (1) Provide the ability to retain funds for operating needs, reserves for capital, etc. for the purposes set forth in the agreement, (2) Provide a right of first refusal instead of a blanket limitation on transfers.

10. The Tax Court found that a family limited partnership funded with personal use property did not have to meet the economic substance test. The taxpayers formed a limited partnership under state law. They contributed the two homes in which their children resided, a ranch, cash, and Treasury notes, shares in municipal bond funds, and insurance policies--approximately $10 million in assets. The taxpayers also created a management trust to serve as the general partner of the family limited partnership, with one of the taxpayers serving as trustee. The taxpayers also established a trust for each of their two children. The taxpayer each contributed 22.3% partnership interest to each of their children's trust. The court held that the taxpayers had established a valid trust under state law and that they had legitimately transferred a partnership interest to each of the children's trusts. The court rejected an aggregate 44% discount in favor of a 15% discount for a minority interest and lack of marketability. [*I.F. Knight*, 115 TC 506 (2000)]

11. The Ninth Circuit Court of Appeals held that the full value of property transferred from a trust to a Family Limited Partnership was includible in her gross estate under Sec. 2036(a). The Court denied a 37% discount that had been applied in the estate return for lack of control and marketability. The Ninth Circuit agreed with the Tax Court that an implied agreement existed among the parties that the decedent would retain the right to use income from the property and the benefit of using the property to secure her debt. The court found it significant that the decedent transferred her primary income-generating asset to the FLP, which left her without sufficient asset to meet her financial needs. Moreover, the partnership made the monthly loan payments despite no legal obligation to do so. [Bigelow, CA-9, 9/14/07]

Chapter 18 - Other Useful Tidbits

A. Check 21

1. Check Clearing for the 21st Century Act

2. Became effective Oct 28, 2004.

3. Allows bank to truncate each of your checks and create a new electronic negotiable instrument called a substitute check.

4. The IRS reports it will accept bank statements that contain images of canceled checks and/or substitute checks.

5. To be used as proof, an account statement must show the check number, amount, payee's name, and the date the check was posted.

B. If you have a refund coming, it is forfeited if the return is filed more than three years after it was due (including extensions).

1. Loophole - If you have made a "deposit" of money (as opposed to a "payment") with the IRS and advised the IRS of such deposit pursuant to the provisions of Rev. Proc. 84-58, there is no time limit to claim your money back.

C. To request a replacement refund check, file IRS Form 3911, Taxpayer Statement Regarding Refund. It will probably take 10 to 12 weeks to receive the replacement check.

D. The same audit guides IRS auditors use are available free on the IRS web site for more than 50 different kinds of businesses.
Go to www.irs.gov
click on "Businesses"
click on "Market Segment Specialization Program"

E. The IRS announced an updated list of private delivery services designated to serve as substitutes for the US Mail with respect to the timely-mailed, timely-filed/paying rules under IRC §7502. The list deletes Airborne Express, which was acquired by DHL Worldwide Express, and includes: [Notice 2004-83]

DHL Express (DHL Same Day Service, DHL Next Day 10:30 am, DHL Next Day 12:00 pm, DHL Next Day 3:00 pm, and DHL 2nd Day Service);

Federal Express (FedEx Priority Overnight, Fed Ex Standard Overnight, FedEx 2Day, FedEx International Priority, and FedEx International First); and

United Parcel Service (UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, UPS 2nd Day Air A.M., UPS Worldwide Express Plus, and UPS Worldwide Express).

The IRS will not routinely publish an annual list, but will only publish if a designated private carrier is being added to, or removed from, the current list. [Notice 99-41, 1999-35 IRB 325]

F. The IRS will apply the same timely mailing as timely filing rule of Sec. 7502 for US mailed documents to documents that bear foreign postmarks and those mailed using an international delivery service. [Rev. Rul. 2002-23] The new ruling addressed only paper delivery of documents. Legal holiday does not include foreign countries' legal holidays, unless the holiday is also a legal holiday in Washington, DC or the applicable state. Timely filing treatment is inapplicable to foreign postmarked documents filed with the Tax Court unless given to a designated international delivery service.

G. Check on Your Federal Tax Refund

1. Go to the IRS' Web site at www.irs.gov and click on "Where's My Refund?" or call the IRS's Automated Tax Refund Service at 800-829-4477.

2. You will need your Social Security number, filing status, and refund amount.

3. Automated refund information is generally available four to five weeks after filing.

H. The TaxLinks Web site (www.taxlinks.com) has a searchable archive of all Revenue Rulings back to 1954, plus a well-organized directory of links to key areas within the IRS Web site.

I. False Slavery Reparations Claims

1. A new IRS policy effective April 15, 2002, will give taxpayers one opportunity to withdraw a reparations claim before a $500 penalty for frivolous returns is imposed.

2. According to the IRS, a claim generally takes the form of a tax credit of between $40,000 and $80,000 for "reparations for African-Americans," "black inheritance tax refund," "racial discrimination," or "black investment taxes." Credits purport to be for tax paid on undistributed gains from a mutual fund or real estate investment trust. Some claims are for thousands of dollars of nonexistent tax withholdings.

J. Companies typically pay workers their regular wages when they service on a jury. The jury duty pay is turned over to the employer. The company paid employment taxes on the full amount of wages it pays. Planning -- let the employees keep the jury duty pay and reduce their wage payment by that amount. The company saves on employment taxes.

K. Code Sections 901(j) and 952(a)(5) deny the foreign tax credit and impose other tax restrictions for income earned in a listed country.

1. The restrictions on the foreign tax credit applies to five countries: Cuba, Iran, North Korea, the Sudan, and Syria. The restrictions on the foreign earned income exclusion apply solely to Cuba.

L. Form 8888

1. Starting in 2007, taxpayer will be able to divide their refunds into as many as three accounts, including checking, savings, and retirement savings.

   a. The IRS is expanding the direct deposit program to encourage savings.

2. Taxpayers who want to split their refunds will have to file new Form 8888.

   a. Taxpayers who do not want to split their refunds will continue to use the appropriate line on Form 1040.

b. An account can be a: [IR-2006-134]

1) Checking,

2) Savings,

3) IRA,

4) Health Savings Account (HSA),

5) Archer Medical Savings Account (MSA), or

6) Coverdell Education Savings Account.

c. The split refund option will be available to taxpayers who file their returns electronically or who file paper returns.

d. Taxpayers who designate that their IRA deposit is for the previous year must verify that the deposit was actually made to the account by the due date of the return (without extensions).

3. You cannot request a deposit of your refund to an account that is not in your name (such as your tax preparer's own account.

4. Change in Refund Amount

a. If refund is decreased -- The decrease will be taken from the last listed account).

b. If refund is increased -- The increase will be added to the last listed account.