

# 2008 Regional Forums - Individual Developments

## New Laws

### **Mortgage Forgiveness Debt Relief Act of 2007 includes wide range of tax changes**

New law. The Mortgage Relief Act, effective for indebtedness discharged on or after Jan. 1, 2007 and before Jan. 1, 2010, generally allows taxpayers to exclude up to \$2 million of mortgage debt forgiveness on their principal residence. Specifically, the Mortgage Relief Act provides that gross income doesn't include any discharge of qualified principal residence indebtedness. (Code Sec. 108(a)(1)(E), as amended by Act § 2(a)) Qualified principal residence indebtedness is acquisition indebtedness under Code Sec. 163(h)(3)(B) with respect to the taxpayer's principal residence, but with a \$2 million limit (\$1 million for married individuals filing separately). (Code Sec. 108(h)(2), as amended by Act § 2(b)) "Principal residence" has the same meaning as under the homesale exclusion rules of Code Sec. 121. (Code Sec. 108(h)(5)) Acquisition indebtedness of a principal residence is indebtedness incurred in the acquisition, construction, or substantial improvement of an individual's principal residence that is secured by the residence. It includes refinancing of debt to the extent the amount of the refinancing doesn't exceed the amount of the refinanced indebtedness. (Joint Committee on Taxation JCX-86-07)

The basis of the taxpayer's principal residence is reduced by the excluded amount, but not below zero. (Code Sec. 108(h)(1))

RIA observation: The mortgage forgiveness exclusion only applies with respect to a taxpayer's principal residence. Thus, while interest for a taxpayer's vacation home may be deductible, debt forgiven with respect to a taxpayer's vacation home isn't excludible.

#### Extension of Treatment of Mortgage Insurance Premiums as Interest

New law. The Mortgage Relief Act extends the rules treating qualified mortgage insurance premiums as deductible qualified residence interest for three years. Thus, they apply if the amounts: (1) are paid or accrued before Jan. 1, 2011; (2) aren't properly allocable to any period after Dec. 31, 2010; and (3) are paid or accrued with respect to a mortgage insurance contract issued after Dec. 31, 2006. (Code Sec. 163(h)(3)(E)(iv), as amended by Act § 3)

#### New Exclusion for Volunteer Firefighters and Emergency Medical Responders

New law. The Mortgage Relief Act provides, effective for tax years beginning after Dec. 31, 2007 and before Jan. 1, 2011, an exclusion from gross income to members of qualified volunteer emergency response organizations for:

- (1) any qualified State or local tax benefit; and
- (2) any qualified payment. (Code Sec. 139B(a), as added by Act § 5(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 performed by individuals as members of a qualified volunteer emergency response organization. (Code Sec. 139B(c)(1)) The amount of State or local taxes taken into account by a taxpayer in determining his deduction for taxes under Code Sec. 164 is reduced by the amount of any qualified State or local tax benefit. (Code Sec. 139B(b)(1))

A qualified payment is a payment (whether reimbursement or otherwise) provided by a State or political subdivision on account of the performance of services as a member of a qualified volunteer emergency response

organization. The amount of these payments is limited to \$30 multiplied by the number of months during the year that the taxpayer performs such services. (Code Sec. 139B(c)(2)) Expenses paid or incurred by the taxpayer in connection with the performance of services are taken into account for a charitable contribution deduction by him only to the extent they exceed the amount of excluded qualified payments. (Code Sec. 139B(b)(2))

#### Homesale Exclusion Liberalized for Surviving Spouse

New law. The Mortgage Relief Act, effective for sales and exchanges after Dec. 31, 2007, allows surviving single spouses to qualify for the up-to-\$500,000 exclusion if the sale occurs not later than 2 years after their spouse's death and the requirements for the \$500,000 exclusion under Code Sec. 121(b)(2)(A) were met immediately before the spouse's death. (Code Sec. 121(b)(4), as amended by Act § 7(a))

#### Limitation on Disclosure of Taxpayer Returns to Partners, S Shareholders, and Beneficiaries of Trusts and Estates

New law. Effective on the enactment date, in the case of an inspection or disclosure under Code Sec. 6103(e) relating to the return of a partnership, S corporation, trust, or an estate, the information inspected or disclosed is not to include any supporting schedule, attachment, or list that includes the taxpayer identity information of a person other than the entity making the return or the person conducting the inspection or to whom the disclosure is made. (Code Sec. 6103(e)(10), as amended by Act § 8(c))

#### Revenue Raising Provisions

To offset the cost of the new tax breaks, the Mortgage Relief Act includes the following revenue raisers:

... Extension of the period for calculating the monthly failure-to-file-penalty for partnership returns from 5 to 12 months and an increase in the per-partner penalty amount from \$50 to \$85 per partner, effective for returns required to be filed after the enactment date. (Code Sec. 6698(a) and Code Sec. 6698(b), as amended by Act § 8(a) and (b))

... Imposition of a monthly penalty for any failure to timely file an S corporation return or any failure to provide the information required to be shown on such a return, effective for returns required to be filed after the enactment date. The penalty, assessed against the S corporation, is \$85 times the number of shareholders in the S corporation during any part of the tax year for which the return was required, for each month (or a fraction of a month) during which the failure continues, up to a maximum of 12 months. (Code Sec. 6699, as added by Act § 9)

### **Technical Corrections Act of 2007 includes many substantive changes**

#### AMT Refundable Credit Amount Liberalized

New law. Under the TCA, the AMT refundable credit amount for a year beginning before 2013 (before any reduction by reason of adjusted gross income) is an amount (not in excess of the long-term unused MTC for that year) equal to the greater of:

- (1) \$5,000;
- (2) 20% of the long-term unused minimum tax credit; or
- (3) the AMT refundable credit amount (if any) for the prior tax year—the preceding year's credit amount—before any reduction by reason of adjusted gross income. (Code Sec. 53(e)(2)(A) as amended by TCA § 2(a))

## Revised Tax Computation When Foreign Earned Income Exclusion is Utilized

New law. For tax years beginning after 2006, the TCA amends the regular tax computation and the AMT computation when an individual taxpayer excludes amounts under the foreign earned income or foreign housing cost exclusion.

Regular tax computation. The TCA amends the regular tax computation to provide that where a taxpayer has excluded amounts and has taxable income for the tax year, the regular tax is equal to the excess (if any) of:

- (1) the regular tax that would be imposed for the tax year if the taxpayer's taxable income were increased by the amount of these exclusions for the tax year; over
- (2) the tax which would be imposed for the tax year if the taxpayer's taxable income were equal to the amount of these exclusions for the tax year. (Code Sec. 911(f)(1)(A), as amended by TCA § 4(c))

### Donee Use of Donated Personal Property Must be Substantially Related to its Purpose or Function to Avoid Problems for Donor

New law. Under the TCA, the written statement satisfies the requirement at (2) above only if, in addition to certifying that its use of the donated property was related to its exempt use or function, the donee organization certifies that its use of the donated property was substantial. (Code Sec. 170(e)(7)(D)(i)(I), as amended by TCA § 3(c))

### Penalty for Substantial and Gross Valuation Misstatements Attributable to Incorrect Appraisals

New law. The TCA provides that the valuation misstatement penalty described above will also apply to any person who prepares an appraisal upon which a Code Sec. 6662(g) substantial estate or gift tax valuation understatement is based. (Code Sec. 6695A(a)(2), as amended by PPA § 3(e))

The TCA also provides that the Code Sec. 6695A penalty for valuation misstatements attributable to incorrect appraisals is subject to a 3-year limitation period. (Code Sec. 6696(d)(1), as amended by PPA § 3(e)(2))

### Retroactive Repeal of Limits on Estate & Gift Tax Charitable Deductions for Series of Fractional Contributions of Tangible Personal Property

New law. Congress realized that the limits imposed by the PPA on the estate and gift tax charitable deductions allowable for “additional contributions” of tangible personal property had unintended consequences (i.e., the valuation whipsaws described above). (Committee Report) Thus, the TCA retroactively repeals these rules. (Code Sec. 2055(g) as amended by TCA § 3(d)(1)), Code Sec. 2522(e)(2) as amended by TCA § (d)(2)(A))

### Revised Rules for Contributions of Appreciated Property by S corporations

New law. The TCA provides that where the above rule applies to limit the decrease in the basis resulting from the charitable contribution, the rule that limits the aggregate amount of losses and deductions that may be taken by the S corporation shareholder to his basis in the S corporation's stock and debt does not apply to the extent of the excess (if any) of:

... the shareholder's pro rata share of the charitable contribution, over

... the shareholder's pro rata share of the adjusted basis of such property. (Code Sec. 1366(d)(4), as amended by PPA § 3(b))

## **How Economic Stimulus Act of 2008 benefits individuals and businesses**

The Stimulus Act also encourages businesses to buy more capital goods and equipment in 2008 by:

... Increasing the \$128,000 expensing limit under Code Sec. 179 to \$250,000 and boosting the overall investment limit from \$510,000 to \$800,000, effective for tax years beginning in 2008.

... Permitting a bonus first-year depreciation deduction of 50% of the adjusted basis of qualified property (most personal property and software) acquired and placed in service after Dec. 31, 2007, and before Jan. 1, 2009. The otherwise applicable “luxury auto” cap on first year depreciation increases by \$8,000 for vehicles that qualify. Bonus depreciation will be allowed for alternative minimum tax (AMT) as well as for regular tax purposes.

## **Stimulus Act jumpstarts the economy with cash rebates**

New law. To stimulate the economy, the Stimulus Act provides for a refundable recovery rebate credit to eligible individuals in 2008. Most will receive a rebate check in 2008 from the U.S. Treasury based on filing status and income on the 2007 return they file in 2008. Some will get a tax credit in 2009 when they file their returns for tax year 2008, and still others (depending largely on income in tax years 2007 and 2008) may receive a combination of a rebate check in 2008 and an income tax credit in 2009. The credit is composed of a basic credit amount and a qualifying child amount. (Code Sec. 6428, as added by Stimulus Act § 101) Any individual, other than a nonresident alien, an estate or trust, or a dependent, that meets the requirements is eligible for the credit. (Code Sec. 6428(e)(3))

Basic credit amount. An eligible individual receives a basic credit for the first tax year beginning in 2008 equal to the greater of:

- (1) his net income tax liability up to a maximum of \$600 (\$1,200 for a joint return); (Code Sec. 6428(a)) or
- (2) \$300 (\$600 for a joint return) if either (a) the taxpayer's “qualifying income” is at least \$3,000; or (b) his net income tax liability is at least \$1 and gross income is greater than the sum of the applicable basic standard deduction amount and one personal exemption (two personal exemptions for a joint return). (Code Sec. 6428(b)(1)(A))

## **Key Tax Changes in the Food, Conservation, and Energy Act of 2008**

The tax changes in the Farm Act consist of specialized tax breaks for the farming industry (along with a crackdown on farm losses), new and modified credits related to the production of certain fuels, extension of GO Zone-style tax breaks to the Kiowa, Kansas, Presidential disaster area, plus a change in large corporate estimated tax payments for the year 2012.

## **Heroes Act carries new tax breaks for military members and their families**

The Heroes Act provides targeted tax relief for members of the military and their families (plus miscellaneous relief measures for volunteer firefighters and liberalized homesale exclusion rules for certain taxpayers), fully offset with tightened expatriation rules, a new rule requiring U.S. companies working under federal government contract to treat certain overseas employees as subject to employment taxes, and a higher failure to file penalty.

Election to Treat Combat Pay as Earned Income for EITC Made Permanent

## Excluded State Payments or Benefits for Volunteer Firefighters and Emergency Medical Responders Aren't Subject to Social Security or Unemployment Tax, or Withholding

Under Code Sec. 139B, as added by the Mortgage Forgiveness Debt Relief Act of 2007, effective for tax years beginning after Dec. 31, 2007 and before Jan. 1, 2011, an exclusion from gross income applies to members of qualified volunteer emergency response organizations for:

- (1) any qualified State or local tax benefit; and
- (2) any qualified payment.

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 performed by individuals as members of a qualified volunteer emergency response organization. The amount of State or local taxes taken into account by a taxpayer in determining his deduction for taxes under Code Sec. 164 is reduced by the amount of any qualified State or local tax benefit.

A qualified payment is a payment (whether through a reimbursement or other means) provided by a State or political subdivision on account of the performance of services as a member of a qualified volunteer emergency response organization. The amount of these payments is limited to \$30 multiplied by the number of months during the year that the taxpayer performs such services. Expenses paid or incurred by the taxpayer in connection with the performance of services are taken into account for a charitable contribution deduction by him only to the extent they exceed the amount of excluded qualified payments.

## Expatriates Recognize Mark-to-Market Gain Upon Expatriation

New law. The Heroes Act adds a new 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 (i.e., covered expatriates) is treated as sold on the day before the expatriation date for its fair market value. (Code Sec. 877A(a)(1), as added by Act § 301(a)) In addition, a transfer tax is imposed on certain transfers to U.S. persons from covered expatriates, or from their estates.

The “mark-to-market” tax is imposed on the net unrealized gain in the property as if the property had been sold for its fair market value on the day before the expatriation or residency termination. Any gain is taken into account at that time without regard to other Code provisions, and any loss generally is taken into account to the extent otherwise provided in the Code, except that the wash sale rules of Code Sec. 1091 don't apply. Net gain on the deemed sale is recognized to the extent it exceeds \$600,000 (as adjusted for inflation for calendar years after 2008). (Code Sec. 877A(a)(2), Code Sec. 877A(a)(3), as added by Act § 301) Subsequent gains or losses that are realized are to be adjusted for the gains and losses taken into account under the deemed sale rules, without regard to the \$600,000 exemption. (Code Sec. 877A(a)(2))

While the mark-to-market tax applies to most types of property interests held by individuals on the date of citizenship relinquishment or residency termination, deferred compensation items, interests in nongrantor trusts, and specified tax deferred accounts are excepted from the tax but are subject to special rules. (Code Sec. 877A(c))

## Election to Defer Tax Upon Expatriation

Effective for expatriations on or after the enactment date, an individual may elect to defer payment of the new mark-to-market tax imposed on the deemed sale of property. Interest is charged for the period the tax is deferred at the rate normally applicable to individual underpayments. The election is irrevocable and is made on a property-by-property basis. Under the election, the deferred tax attributable to a particular property is due when the return is due for the tax year in which the property is disposed (or, if the property is disposed of in a

transaction in which gain is not recognized in whole or in part, at such other time as IRS may prescribe). The deferred tax attributable to a particular property is an amount which bears the same ratio to the total mark-to-market tax as the gain taken into account with respect to such property bears to the total gain taken into account for the mark-to-market tax. The deferral of the mark-to-market tax may not be extended beyond the due date of the return for the tax year which includes the individual's death. (Code Sec. 877A(b)(1), as added by Act § 301, Committee Report)

#### Rules For Expatriates' Deferred Comp, Tax-Deferred Accounts, and Nongrantor Trusts

Treatment of eligible deferred compensation items. For any eligible deferred compensation item, the payor must deduct and withhold a 30% tax from any taxable payment to a covered expatriate. (Code Sec. 877A(d)(1)(A)) This withholding requirement is in lieu of any other withholding requirement. A taxable payment is subject to withholding to the extent it would be included in gross income of the covered expatriate if such person were subject to tax as a citizen or resident of the U.S. A deferred compensation item is taken into account as a payment when such item would be so includible. A deferred compensation item that is subject to the 30% withholding requirement is subject to tax under Code Sec. 871. (Code Sec. 877A(d)(6))

#### Gifts and Bequests From an Expatriate Citizen or Long-term Resident

New law. The Heroes Act provides a special transfer tax on certain “covered gifts or bequests” received by a U.S. citizen or resident. The tax is calculated as the product of (1) the highest marginal rate of tax specified in the table applicable to estate tax (i.e., Code Sec. 2001(c)) or, if greater, the highest marginal rate of tax specified in the table applicable to gift tax (i.e., Code Sec. 2502(a)), both as in effect on the date of receipt of the covered gift or bequest; and (2) the value of the covered gift or bequest. (Code Sec. 2801, as added by Act § 301(b)) The tax applies to covered gifts and bequests received on or after the enactment date from transferors (or from the estates of transferors) whose expatriation date is on or after the enactment date. (Act § 301(g)(2))

The tax is imposed upon the recipient of the covered gift or bequest from a covered expatriate (i.e., a covered expatriate for the mark-to-market deemed sale rules) and is imposed on a calendar-year basis.

#### U.S. Employer Status for Domestically Controlled Foreign Entities Working for U.S. Government

New law. For services performed in calendar months beginning more than 30 days after the enactment date, a foreign person is treated as an American employer with respect to an employee of the foreign person who is performing services in connection with a contract between the U.S. government (or any instrumentality thereof) and any member of any domestically controlled group of entities which includes such foreign person. (Code Sec. 3121(z), as added by Act § 302(a)) Thus, service performed as an employee for such an employer outside of the U.S. by a U.S. citizen or resident in connection with such a contract is treated as employment subject to FICA. (Committee Report)

#### Other Provisions

... For returns the due date for which (including extensions) is after 2008, the minimum penalty for failure to file a tax return within 60 days of the due date increases from the lesser of \$100 or 100% of the amount of tax required to be shown on the return to the lesser of \$225 or 100% of the amount required to be shown on the return. (Code Sec. 6651(a), as amended by Act § 304)

### **New law bars health insurance and employment discrimination based on genetics**

#### **P.L. 110-233**

A new law has been enacted to bar discrimination in health insurance and employment on the basis of an individual's genetic information, beginning in May 2009. It's called the “Genetic Information Antidiscrimination Act of 2008” (GINA).

## **Housing Assistance Tax Act of 2008 carries a host of tax changes**

### **New Tax Credit for First-Time Homebuyers**

New law. For qualifying home purchases in the U.S. after Apr. 8, 2008 and before July 1, 2009, the Act gives eligible first-time homebuyers a refundable tax credit equal to the lesser of 10% of the purchase price of a principal residence or \$7,500 (\$3,750 for married individuals filing separately). (Code Sec. 36, as amended by Act § 3011)

The credit, which is generally allowed for the tax year in which the principal residence is bought, phases out for individual taxpayers with modified adjusted gross income (MAGI) between \$75,000 and \$95,000 (\$150,000-\$170,000 for joint filers) for the year of purchase.

Regular recapture rule. The credit for new homebuyers is recaptured ratably over fifteen years, with no interest charge, beginning with the second tax year after the tax year in which the home is purchased. For each tax year of the 15-year recapture period, the credit is recaptured as an additional income tax amount equal to 6 2/3% of the amount of the credit. (Code Sec. 36(f)(1), Code Sec. 36(f)(7))

Accelerated recapture rule. If a taxpayer who claims the credit for new homebuyers sells the home (or he or his spouse no longer use it as a principal residence) before complete repayment of the credit, any remaining credit repayment amount is paid with the tax return for the year in which the home is sold (or ceases to be used as the principal residence).

Neither the regular nor the accelerated recapture rules apply to any tax year ending after the taxpayer's death.

In the case of a transfer of the residence to a spouse or to a former spouse incident to divorce, the accelerated recapture rule won't apply to the transfer, but both the regular and accelerated recapture rules will apply to the transferee spouse (and not the transferor spouse) who will be responsible for any future recapture. (Code Sec. 36(f)(4)(C))

Election for 2009 buyers to accelerate credit into 2008. Eligible first-time homebuyers who purchase a principal residence after Dec. 31, 2008, and before July 1, 2009, may elect to treat the purchase as made on Dec. 31, 2008. (Code Sec. 36(g).

### **New Property Tax Deduction for Non-Itemizers**

For tax years beginning in 2008, the Act permits taxpayers who claim the standard deduction instead of itemizing deductions to claim an additional standard deduction for State and local property taxes paid. The deduction can't exceed the lesser of State and local property taxes actually paid or \$500 (\$1,000 for joint return filers). (Code Sec. 63(c)(7), as amended by Act § 3012)

### **Reduced Homesale Exclusion for Nonqualified Use Periods**

New law. For sales and exchanges after Dec. 31, 2008, the homesale exclusion won't apply to the extent gain from the sale or exchange of a principal residence is allocated to periods of nonqualified use. (Code Sec. 121(b)(4), as amended by Act § 3092) Generally, nonqualified use is any period (other than the portion of any period before Jan. 1, 2009) during which the property is not used as the principal residence of the taxpayer or spouse. However, nonqualified use does not include:

... any portion of the Code Sec. 121(a) 5-year period which is after the last date that the property is used as the principal residence of the taxpayer or spouse;

... any period (not to exceed an aggregate period of 10 years) during which the taxpayer or spouse is serving on qualified official extended duty; and

... any other period of temporary absence (not to exceed an aggregate period of 2 years) due to change of employment, health conditions, or other unforeseen circumstances specified by IRS. (Code Sec. 121(b)(4)(C))

The amount of gain allocated to periods of nonqualified use is the amount of gain multiplied by a fraction where the numerator is the aggregate periods of nonqualified use during the period the property was owned by the taxpayer and the denominator of which is the period the taxpayer owned the property. (Code Sec. 121(b)(4)(B), Committee Report)

#### Alternate Procedure Provided for Nonforeign Affidavits Under FIRPTA Rules

New law. For dispositions of USRPIs after July 30, 2008, the Act provides an alternative procedure for furnishing the nonforeign affidavit. Under this procedure, instead of furnishing a nonforeign affidavit to the transferee, a transferor may furnish the affidavit to a “qualified substitute.” The qualified substitute is then required to furnish a statement (the “statement”) to the transferee stating, under penalties of perjury, that the qualified substitute has the affidavit in his possession. (Code Sec. 1445(b)(9)(A), as amended by Act § 3024(a)) A qualified substitute is the person (including any attorney or title company) responsible for closing the transaction (other than the transferor's agent, and the transferee's agent. (Code Sec. 1445(f)(6))

#### Election to Include Reimbursement for Hurricane-related Casualty in Loss Year

New law. The Act allows a taxpayer who claimed a casualty loss to a principal residence (within the meaning of the Code Sec. 121 homesale exclusion rules) from Hurricanes Katrina, Rita, or Wilma, and in a later year receives a grant under Public Laws 109-148, 109-234, or 110-116 as reimbursement of that loss, to elect to file an amended return for the tax year to which the deduction was allowed. On the amended return, the casualty loss deduction must be reduced, but not below zero, by the amount of the reimbursement. The election to file an amended return under the above rule applies for any grant only if any amended income tax returns with respect to that grant are filed by the later of: (1) the due date for filing the tax return for the tax year in which the taxpayer receives the grant, or (2) July 30, 2009 (one year after the July 30, 2008 enactment date). (Act § 3082(a)(2)(B)) No penalty or interest applies if payment is made no later than one year after the filing of the amended return. (Act § 3082(a))

## Updated Regulations

### Three sets of regs modify reportable transaction rules

**T.D. 9350, 07/31/2007; Reg. 1.6011-4, Reg. 20.6011-4, Reg. 25.6011-4, Reg. 31.6011-4, Reg. 53.6011-4, Reg. 54.6011-4, Reg. 56.6011-4; T.D. 9351, 07/31/2007; Reg. 301.6111-3, T.D. 9352, 07/31/2007; Reg. 301.6112-1**

IRS has issued three sets of final regs that amend various reportable transaction rules. Specifically, the regs deal with: (1) disclosure of reportable transactions under Code Sec. 6011; (2) disclosure of reportable transactions by material advisors under Code Sec. 6111; and (3) the obligation of material advisors to prepare and maintain lists for reportable transactions under Code Sec. 6112. All of the final regs are effective on Aug. 3, 2007 but many apply for various earlier periods as set forth in the regs.

### Final regs on dependent care credit reflect law changes and clarify qualifying expenses

**T.D. 9354, 08/13/2007; Reg. 1.21-1; Reg. 1.21-2; Reg. 1.21-3; Reg. 1.21-4**

IRS has issued final regs on the Code Sec. 21 credit for child and dependent care expenses. They reflect changes made by multiple statutory amendments, going back to the Deficit Reduction Act of '84 and clarify employment-related expenses that qualify for the credit. The final regs are effective Aug. 14, 2007.

**Proposed regs would make patented transactions reportable transactions** Preamble to Prop Reg 09/25/2007; Prop Reg § 1.6011-4, Prop Reg § 301.6111-3

**Proposed regs would toughen return preparation standards to reflect Small Business Act changes** Preamble to Prop Reg 09/24/2007; Prop Reg § 10.34

Under the proposed regs, a practitioner couldn't sign a tax return as a preparer unless the practitioner has a reasonable belief that the tax treatment of each position on the return will more likely than not be sustained on its merits, or there is a reasonable basis for each position and each position is adequately disclosed to IRS. A practitioner couldn't advise a client to take a position on a tax return, or prepare the portion of a tax return on which a position is taken, unless:

- (1) the practitioner has a reasonable belief that the position satisfies the more likely than not standard; or
- (2) the position has a reasonable basis and is adequately disclosed to IRS. (Prop Reg § 10.34(a))

The “more likely than not” standard would be treated as met if the practitioner analyzes the pertinent facts and authorities (carried under the Reg. 1.6662-4(d)(3)(iii) substantial underpayment penalty rules), and based on that analysis reasonably concludes, in good faith, that there is a greater than 50% likelihood that the tax treatment will be upheld if IRS challenges it. (Prop Reg 10.34(e)(1))

The “reasonable basis” standard would be treated as met if it is reasonably based on one or more of the authorities described in Reg. 1.6662-4(d)(3)(iii). Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard would not be satisfied by a return position that is merely arguable or that is merely a colorable claim. The possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled could not be taken into account. (Prop Reg 10.34(e)(2))

**Temp reg describes how and when to elect capital gain treatment for self-created musical works** T.D. 9379, 02/07/2008, Reg. § 1.1221-3T; Preamble to Prop Reg 02/07/2008

**Final regs clarify treatment of loss from abandoned securities** T.D. 9386, 03/11/2008; Reg. 1.165-5

Abandoned securities. The final regs provide that for purposes of applying the Code Sec. 165(g) loss characterization rules, the abandonment of a security establishes its worthlessness to the taxpayer. A loss established by the abandonment of a security that is a capital asset is treated as a loss from the sale or exchange, on the last day of the tax year, of a capital asset, unless the Code Sec. 165(g)(3) exception applies. While a taxpayer doesn't have to relinquish legal title to property in all cases to establish abandonment, the regs require that to abandon a security a taxpayer has to permanently surrender and relinquish all rights in the security and receive no consideration in exchange for the security. (Reg. 1.165-5(i))

Abandoned or cancelled debt instruments. Generally, the treatment of a worthless debt is governed by Code Sec. 166. However, there's an exception to this rule under Code Sec. 166(e) where a debt is evidenced by a security as defined in Code Sec. 165(g)(2)(C). In that case, based on what IRS stated in Preamble to Prop Reg, the tax treatment of the debt securities is governed by the final regs.

**Final regs on dependent child of divorced or separated parents or parents who live apart** T.D. 9408, 07/01/2008; Reg. 1.152-4

Custodial parent. Like the proposed regs, the final regs define the custodial parent as the parent with whom the child resides for the greater number of nights during the calendar year (the counting nights rule). In response to

commentators' concern that this rule doesn't address how the child's residence for a night is determined (e.g., by the child's physical location at a given time such as midnight, or by where the child sleeps) and for which year the night of Dec. 31 to Jan. 1 is counted, the final regs clarify that, for purposes of Code Sec. 152(e), a child resides for a night with a parent if the child sleeps (1) at the parent's residence (whether or not the parent is present); or (2) in the company of the parent when the child does not sleep at a parent's residence (for example, if the parent and child are on vacation). The time that a child goes to sleep is irrelevant. A night that extends over two tax years is allocated to the tax year when the night begins: for example, the night that begins on Dec. 31, 2008, is counted for tax year 2008. (Reg. 1.152-4(d))

To remedy any ambiguity caused by the proposed regs' failure to define custody, the final regs provide that a child is in the custody of one or both parents for more than one-half of the calendar year if one or both parents have the right under state law to physical custody of the child for more than one-half of the calendar year. But, a child isn't in the custody of either parent for purposes of Code Sec. 152(e) when the child reaches the age of majority under state law. (Reg. 1.152-4(c))

**Proposed regs explain strict charitable contribution substantiation & appraisal rules**  
**Preamble to Prop Reg 08/06/2008; Prop Reg § 1.170A-15, Prop Reg § 1.170A-16, Prop Reg § 1.170A-17,**  
**Prop Reg § 1.170A-18**

## **Cases and Rulings**

**DC Circuit reverses itself; holds non-physical personal injury awards are taxable**  
**Murphy v. IRS (CA DC 07/03/07), No. 05-5139, 99 AFTR 2d ¶2007-5019**

The Court of Appeals for the District of Columbia Circuit has reversed its controversial decision that taxing awards for non-physical personal injury unrelated to lost wages or earnings was unconstitutional. Upon rehearing the case, the appellate court has now held that awards for non-physical personal injury unrelated to lost wages or earnings aren't excludable under Code Sec. 104(a)(2), they are included in gross income under Code Sec. 61, and a tax on them is within Congress' powers.

The Supreme Court has declined to review the decision of the U.S. Court of Appeals.

**Ruling untangles tax consequences when corporate events cause vested stock to become nonvested**  
**Rev Rul 2007-49, 2007-31 IRB**

An employee who had been granted stock in exchange for services under Code Sec. 83 may have to accept new restrictions when his employer takes in new investors or merges with or is bought out by another corporation. A new ruling explains the tax consequences of this type of corporate activity on the employee. It uses three examples to explain the tax consequences under Code Sec. 83 when restrictions are imposed on substantially vested stock resulting in the stock becoming substantially nonvested.

**Fifth Circuit affirms: dollar limits apply to AMT capital loss from worthless ISO stock**  
**Merlo, (CA 5 7/17/2007) 100 AFTR 2d ¶2007-5058**

The Court of Appeals for the Fifth Circuit, affirming the Tax Court, has held that, in determining alternative minimum tax (AMT), the loss limitations of Code Sec. 1211 and Code Sec. 1212 apply for purposes of calculating alternative minimum taxable income (AMTI).

**IRAs can buy shares in trusts invested in gold or silver without triggering collectibles tax**  
**PLR 200732026, PLR 200732027**

IRS has privately ruled that the acquisition of shares of a trust invested in gold or silver by either an IRA or an individually-directed account under a qualified retirement plan won't be considered the acquisition of a collectible under Code Sec. 408(m). Thus, the amount invested won't be treated as distributed under Code Sec. 408(m)(1).

**Home must be completely destroyed for Sec. 121 to apply; mandatory teardown qualifies**  
**Chief Counsel Advice 200734021**

In Chief Counsel Advice (CCA), IRS says that a home must be totally destroyed for gain on a deemed sale of the property to be excluded under the Code Sec. 121 homesale exclusion rules. The CCA also concludes that a disaster-damaged home that must be torn down before it can be rebuilt at a cost exceeding its pre-disaster value qualifies as “destroyed.”

**CPA's gambling loss wasn't from trade or business**      **Mohammadpour, TC Summary**  
**Opinion 2007-163**

In a Summary Opinion, the Tax Court has concluded that a taxpayer's gambling activity didn't qualify as a trade or business. As a result, his gambling losses were only deductible as an itemized deduction.

**Disability income was tax-free where owner-shareholder reimbursed company for policy premiums**      **Cotler, TC Memo 2007-283**

The Tax Court has held that an attorney who reimbursed his solely owned law firm for his disability insurance premiums could exclude the policy payments he received after he became disabled. The Court concluded that the attorney, and not his firm, bore the economic burden of paying the premiums and thus the disability payments were excludable under Code Sec. 104(a)(3).

**IRS now agrees: payments under VA work therapy program are excludible from income**  
**AOD 2007-005,10/18/2007**

In an Action on Decision, IRS has acquiesced in a recent Tax Court decision that held that amounts received by a taxpayer in connection with his participation in a work therapy program administered by the U.S. Dept. of Veterans Affairs (VA) weren't includable in his gross income. IRS says that it will no longer litigate whether such payments are tax exempt veterans' benefits.

**Leasing enterprise and business it rented to are single activity for PAL purposes**  
**Candelaria v. U.S., (DC TX 10/05/2007) 100 AFTR 2d 2007-5378**

For a variety of tax and nontax reasons, entrepreneurs beginning a new business often set up a separate entity to buy the required machinery and equipment and lease it to the business. In a case involving such an arrangement, a district court has held that the leasing enterprise and the business enterprise could be combined for passive activity loss (PAL) purposes since the leasing enterprise was “insubstantial” to the business enterprise. As a result, the losses incurred by the leasing enterprise weren't passive.

**Tool reimbursement plan impermissibly recharacterized wages and failed business connection test**      **Chief Counsel Advice 200745018**

In Chief Counsel Advice (CCA), IRS has concluded that a taxpayer's tool reimbursement plan failed the business connection, substantiation, and return of excess payment requirements for an accountable plan and

might have demonstrated a pattern of abuse. Amounts paid under the plan had to be included in the employee-participants' gross income and reported as wages or other compensation on their Forms W-2, and were subject to withholding and payment of employment taxes.

**VA work therapy program's payments are excludable; no information return is required**  
**Rev Rul 2007-69, 2007-49 IRB**

In a Revenue Ruling, IRS has concluded that payments made by the U.S. Dept. of Veterans Affairs (VA) under a compensated work therapy program are exempt from federal income tax as veterans' benefits. Further, these payments aren't required to be reported on an information return.

**Slots player held to be in the business of gambling**                      **Linda M. Myers, TC Summary**  
**Opinion 2007-194**

The Tax Court, in a summary opinion, has held that a woman who ran a trucking business and also devoted significant time and energy to playing slot machines was in the business of gambling. As a result, she could deduct over \$1.4 million in gambling losses above-the-line rather than as an itemized deduction. This prevented her from being liable for an deficiency of over \$5,000.

**Educational consultant was home worker exempt from self-employment tax**                      **LaVerne**  
**VanZant, TC Summary Opinion 2007-195**

The Tax Court, in a summary opinion, has held that an educational consultant who collected data on schools and collated the data at home using a template provided by the firm who engaged her services qualified as a home worker for statutory employee purposes. Thus, she was exempt from self-employment tax.

**Sole proprietor could deduct health insurance premiums covering his employee-wife and himself as her spouse**                      **Frahm, TC Memo 2007-351**

The Tax Court has held that amounts paid by a sole proprietor-farmer under a medical reimbursement plan that covered his spouse, as his employee, and himself, as his employee-spouse's family member, were fully deductible on Schedule F as ordinary and necessary business expenses under Code Sec. 162(a). The Court rejected IRS's contention that expenses for the sole proprietor weren't covered or deductible under the plan and that he only qualified for the deduction (subject to the applicable limits for the years at issue) for self-employed health insurance under Code Sec. 162(l).

**Self-prescribed diagnostic tests qualify as deductible medical expenses**                      **Rev Rul 2007-72,**  
**2007-50 IRB 1154**

A new revenue ruling makes it clear, in the context of three distinct factual situations, that amounts paid by healthy individuals for self-initiated diagnostic and similar procedures qualify as deductible medical expenses under Code Sec. 213(a).

**Eased rules for above-the-line health insurance deduction for 2% S shareholders**  
**Notice 2008-1, 2008-2 IRB**

A new notice explains when a 2% shareholder-employee in an S corporation is entitled to the Code Sec. 162(l) above-the-line deduction for health insurance premiums that are paid or reimbursed by the S corporation and included in his gross income.

RIA observation: Without affirmatively saying so, Notice 2008-1 effectively repudiates guidance appearing in an article on IRS's web site last year. That guidance had concluded that an S corporation's

sole shareholder-employee couldn't buy health insurance in his own name and get the above-the-line deduction for the premium expense. As explained below, if certain requirements are met, such a deduction is now possible and may be gained for a prior year by filing an amended return.

### **Loss sale rule applied where individual sold stock at loss and repurchased it in his IRA Rev Rul 2008-5, 2008-3 IRB**

A new 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 (i.e., 30 days before or 30 days after the date of sale), the loss on the sale of the stock or securities is disallowed under Code Sec. 1091. But the ruling also holds that the individual's basis in the IRA or Roth IRA is not increased under Code Sec. 1091(d).

### **AMT calculation must take qualified dividends into account      Tobias Weiss, (2007) 129 TC No. 18**

The Tax Court has held that taxpayers improperly calculated the tax on their qualified dividends because they did not take the dividends into account for purposes of the alternative minimum tax (AMT).

### **New simplified method for allocating prepaid mortgage insurance premiums      Notice 2008-15, 2008-4 IRB**

IRS has issued a Notice explaining how individuals may use a simplified method to allocate prepaid qualified mortgage insurance premiums to determine the amount that may be deducted in 2007. The simplified method allows prepaid premiums to be allocated ratably over 84 months or if shorter, the term of the mortgage. Entities that report the amount actually received from the individual or the amount determined under the simplified allocation method will be treated as having met their information reporting requirements.

### **Insurance agent's termination payments were ordinary income, not capital gain Trantina, (CA 9 1/9/2008) 101 AFTR 2d ¶ 2008-358**

Affirming a district court, the Ninth Circuit has held that a termination payments received by a retiring insurance agent were taxable as ordinary income, not capital gain.

### **Limited personal use won't sour Code Sec. 1031 tax-free exchange of residence Rev Proc 2008-16, 2008-10 IRB**

A new Revenue Procedure concludes that limited personal use won't prevent a dwelling unit from qualifying as property held for trade or business or investment use for purposes of the Code Sec. 1031 tax-free exchange rules.

### **Noncorporate limited partner subject to the investment interest deduction limitation Rev Rul 2008-12, 2008-10 IRB**

A new ruling concludes that where a noncorporate limited partner doesn't materially participate in the partnership's activity, his distributive share of the interest expense on debt allocable to the entity's trade or business of trading securities is investment interest, subject to the Code Sec. 163(d)(1) deduction limitation.

**Limited partner's investment interest from trader partnership deductible above-the-line**  
**Rev Rul 2008-38, 2008-31 IRB; Ann. 2008-65, 2008-31 IRB**

Rev Rul 2008-38 provides that, in the case of an individual, interest paid or accrued on debt allocable to property held for investment described in Code Sec. 163(d)(5)(A)(ii) is (to the extent allowable after the application of the Code Sec. 163(d) limitation) a deduction described in Code Sec. 62(a)(1) and is therefore taken into account in determining the individual's adjusted gross income (AGI). New Ann. 2008-65, 2008-31 IRB, clarifies that the limited partner described in Rev Rul 2008-12 properly includes the allowable amount of his distributive share of the trading partnership's interest expense in computing his ordinary business income or loss on Schedule E of his Form 1040.

**Investors suffered theft loss in connection with company that issued sub-prime loans**  
**Chief Counsel Advice 200811016**

A Chief Counsel Advice (CCA) has concluded that a theft occurred in connection with investors' losses on loans to a company engaged in writing sub-prime loans. However, it determined that whether and when a theft occurred for any particular investor, and what losses resulted from the theft, were questions of fact since the company had been engaged in legitimate business for many years before the theft occurred.

**Tax breaks for qualifying relatives are limited**                      **Internal Legal Memorandum 200812024**

An Internal Legal Memorandum (ILM) explains that various tax breaks are not allowed for qualifying relatives. Specifically, the ILM concludes that, apart from a dependency exemption, a taxpayer's qualifying relative may not qualify him for the earned income credit, head of household filing status, or the child tax credit, but in limited circumstances may qualify the taxpayer for the child and dependent care credit.

**“Makeup” minimum distributions salvage lifetime payouts to nonspouse IRA beneficiary**  
**PLR 200811028**

A private letter ruling allows the nonspouse beneficiary of an IRA to salvage lifetime payouts even though she failed an essential rule requiring distributions to begin by the end of the year following the year of the IRA owner's death. She made up missed annual required minimum distributions (RMDs) and paid a penalty excise tax, but by doing so she avoided a tough 5-year payout rule.

**Forgiven credit card debt triggered taxable income**                      **Payne, TC Memo 2008-66**

A new Tax Court case illustrates how a taxpayer generally has taxable income when a credit card company agrees to accept a reduced payment in settlement of his or her account.

**Noncompete agreement in sale of family business wasn't for sale of goodwill**                      **Muskat v. U.S., (DC NH 4/2/2008) 101 AFTR 2d ¶2008-662**

A district court has held that a taxpayer failed to show that a noncompetition agreement in the sale of his family business was actually intended to purchase his personal goodwill. The court found that the taxpayer's initial treatment of the noncompete agreement payments as ordinary income was correct and rejected his refund claim based on treating it as capital gain.

**Payments made by retailer in connection with sales promotion weren't taxable**  
**PLR 200816027**

IRS has privately ruled that payments made by a retailer in connection with a sales promotion were nontaxable purchase price adjustments and they weren't subject to reporting or withholding.

**Cancellation of law school loan in exchange for public service work wasn't included in income**  
**Rev Rul 2008-34, 2008-28 IRB**

In a revenue ruling, IRS has ruled that the forgiveness of a law student's loan in exchange for the borrower working for a certain period of time in a qualifying law-related public service position wasn't includible in his gross income. The revenue ruling clarified that a law school loan made under a Loan Repayment Assistance Program generally satisfies the requirements of Code Sec. 108(f).

**Loan repayment to shareholder's spouse wasn't constructive distribution**     **Beckley, (2008)**  
**130 TC No. 18**

The Tax Court has ruled that payments made by a corporation to the wife of one of its shareholders represented repayment of money she advanced to a predecessor corporation. Despite the absence of a written loan agreement, the repayment wasn't a constructive distribution to the shareholder.

**Limited partner denied business deduction for management fees of investment partnership owning business partnerships**     **Rev. Rul. 2008-39, 2008-31 IRB 252**

A new ruling concludes that an individual who is a limited partner of an upper-tier partnership (UTP) that holds lower-tier partnerships (LTPs) for the production of income can't deduct as a Code Sec. 162 business expense the management fees paid by the UTP, even if the LTPs are engaged in a trade or business. Instead, the management fees are deductible only as Code Sec. 212 investment expenses. The ruling also concludes that the management fees of the LTPs are taken into account in computing each LTP's taxable income or loss, and the UTP's distributive share of income or loss.

**Writeoff for cost of day-trading course barred by investment seminar deduction disallowance**     **Carl H. Jones, 131 TC No. 3**

The Tax Court has held that a taxpayer who wasn't in the trade or business of day-trading couldn't deduct the cost of attending a day-trading seminar to improve his skills. The seminar costs were subject to the broad investment seminar deduction bar of Code Sec. 274(h)(7).

**Ninth Circuit says valid Sec. 83(b) election causes gain on all ISO stock to be recognized for AMT purposes**     **Kadillak v. Comm., (CA 9 7/29/2008) 102 AFTR 2d ¶2008-5111**

The Ninth Circuit has affirmed the Tax Court holding that a taxpayer's Code Sec. 83(b) election on ISO stock was valid and thus required him to recognize as alternative minimum taxable income (AMTI) the excess of both his vested and nonvested stock's fair market value over its exercise price on the exercise date. The Court also joined with the Fifth Circuit in holding that an individual taxpayer's AMT capital losses are subject to the Code Sec. 172(d) and Code Sec. 1211(b) limits, and therefore aren't allowed as an alternative tax net operating loss (ATNOL) deduction.

## **Court rebuffs IRS and allows policyholder to escape gain on demutualization**

**Eugene A. Fisher et al. v. U.S. (Ct Cl 8/6/2008) 102 AFTR 2d ¶ 2008-5150**

The Court of Federal Claims has applied a variation of the open transaction doctrine with the result that a policyholder had no gain to report when it chose a cash option in connection with a demutualization of an insurance company. Under this option, the shares awarded to the policyholder were immediately sold by the company and the proceeds were then paid to the policyholder in cash. IRS said that the policyholder was taxable on the full amount of the gain without being able to allocate any of his basis in the contract to offset the sales proceeds. The Court allowed the policyholder to use his basis in the contract (which greatly exceeded the amount of the sales proceeds) to fully offset the proceeds and thus to report no gain.

## **Taxpayer taxed on sale of pledged stock using FIFO method**

**Rendall, (CA 10 08/05/2008)**

**102 AFTR 2d ¶ 2008-5146**

The Tenth Circuit, affirming the Tax Court, has held that gain on a sale of stock that was pledged for a loan and sold by the lender in satisfaction of the loan was taxable to the individual who pledged the stock. Furthermore, the Appeals Court agreed with the Tax Court that the basis of the stock that was sold had to be determined using the first-in, first-out (FIFO) method, which produced a much larger gain for the taxpayer (who filed jointly with his spouse), rather than the last-in, last-out (LIFO) method, which would have resulted in a smaller gain.

## **IRS eases tax breaks for children of divorced and separated couples**

**Rev Proc 2008-48,**

**2008-36 IRB**

In a Revenue Procedure, IRS has described the circumstances under which it will treat a child of parents who are divorced, separated, or living apart as the dependent of both parents for purposes of Code Sec. 105(b) (dealing with employer-provided medical expense reimbursements), Code Sec. 132(h)(2)(B) (dealing with excludable fringe benefits), Code Sec. 213(d)(5) (dealing with deductible medical expenses), Code Sec. 220(d)(2) (dealing with Archer Medical Savings Accounts (MSAs)), and Code Sec. 223(d)(2) (dealing with Health Saving Accounts (HSAs)) when the custodial parent has not released the claim to the exemption for the child under Code Sec. 152(e)(2).

## **Frequent but sporadic stock trading & longer holding periods result in investor status**

**Holsinger, TC Memo 2008-191**

A new Tax Court case illustrates how difficult it is for a stock market investor to show that his activities rise to the level of a trade or business. Around 289 trades one year and 372 the next by a taxpayer weren't enough to justify trader treatment because they took place in a limited period of time. Additionally, his holding periods demonstrated that he was an investor and not a trader hoping to make money on short-term market swings. As a result, the taxpayer's losses were capital losses, and his expenses were miscellaneous itemized deductions.